eJournal of Tax Research

Volume 22, Number 2 September 2024
(Special Edition: Tribute to the late Professor John Taylor)

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ISSN 1448-2398

eJournal of Tax Research

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The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation.

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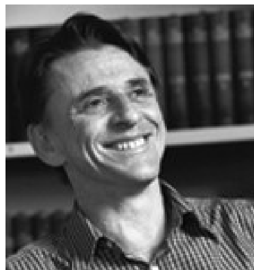
Guest editorial



Christopher John Taylor (24/12/1952 – 29/1/2023)

Emeritus Professor Christopher John Taylor was an outstanding tax scholar, mentor and person. He was also a former editor of this journal. His untimely passing has been an immense loss to the tax discipline, his friends and colleagues, and it has left an irreplaceable gap in the hearts of his family. It is our privilege, upon the invitation of the two co-editors of the *eJTR*, to edit this special issue in honour of the life and achievements of John Taylor (as he was known).

John was truly a Sydneysider, born and raised in the Drummoyne area. He enrolled at the University of Sydney where he earned all of his academic qualifications from the (then) Faculty of Law. In particular, he completed his doctoral degree much later in life, after having already established himself as an academic and professor at UNSW Sydney, while also serving as Head of School at that institution. This accomplishment highlights John's passion for research and his relentless thirst for knowledge.

Prior to his academic career, John spent seven years in private legal practice. His association with UNSW began in 1985, when he joined as a tutor in the Department of Legal Studies and Taxation (later renamed the School of Business Law and Taxation or BLAT). After a brief spell at the University of New England in Armidale, he returned to UNSW in 1989 as a lecturer. He steadily rose through the ranks, becoming a professor in 2010. He also served as Head of BLAT from 2009 to 2011, and was the inaugural Head of the School of Taxation and Business Law (TaBL) at UNSW from 2011 to 2016.

John's international recognition as a scholar was reflected in his role as a visiting scholar at prestigious institutions, including Harvard University, the University of Cambridge, the International Bureau of Fiscal Documentation (IBFD), the University of British Columbia, the University of Western Ontario and Leiden University. He also delivered lectures and seminars in the Harvard International Tax Program, the LLM Program in International Taxation at Leiden University, and at the IBFD in Amsterdam.

John made significant contributions to three key areas of taxation: capital gains tax (CGT), international taxation (including double tax treaties) and the taxation of business entities, combining all three with his deep interest in the history of taxation. As a tax

scholar, he possessed several important qualities. First, he obviously had a deep love for academic life and was passionate about his research. Secondly, he was an avid reader who meticulously studied archival data, giving him an exceptional breadth of knowledge in his areas of interest. Thirdly, he embraced a multidisciplinary approach, incorporating political, economic, and social history from Australia and other relevant countries into his analyses of international tax issues.

It is no surprise that the quality of John's research was widely recognised. His book on CGT, for example, was cited and quoted with approval by the High Court of Australia in *FCT v Murry*. He received several prestigious awards, including the Best Senior Paper Prize at the Australasian Tax Teachers Association (ATTA) Conference in 2006 and the Best Theme Paper Prize at ATTA 2009. In 2005, he was appointed the inaugural Honorary Research Fellow of the Taxation Institute of Australia. Additionally, in 2006 and 2007, he served as a consultant to the Department of the Treasury of the Commonwealth of Australia.

John was a committed and innovative teacher. Despite being a traditional lawyer, he was forward-thinking in the digitalisation of tax education. One example of this was his development of one of the first tax textbooks with an electronic user interface for students. Another was his collaboration with colleagues to adapt an interactive online game for teaching international tax planning. As a PhD supervisor, he was generous with his time, dedicated to helping students grasp the intricacies of tax law.

John epitomised the relaxed, modest and unassuming nature often associated with Australians. He was also warm, friendly, hospitable and embraced a multicultural outlook. His wisdom, insights, quirky humour and expansive knowledge will be sadly missed!

The remainder of this special issue presents a curated selection of papers that are intended to honour and celebrate John's remarkable contributions to taxation. These tributes focus on John's primary areas of research. The contributors include his PhD supervisor, colleagues, mentees and co-authors, all of whom have been inspired by his ideas and approach to tax research. The first paper offers personal insights into John as a PhD candidate and later as a research collaborator. The second paper explores custom houses in colonial Australia, reflecting John's passion for tax history. The following three papers focus on John's deep interest in international tax treaties: the 1947 NZ–UK tax treaty, the influence of domestic tax reviews on Australia's network of international tax treaties, and the history of New Zealand's Double Tax Agreements. The sixth paper examines tax history and philanthropy while the next paper delves into CGT and the main residence exemption. The final two papers touch on John's interest in the taxation of business entities, specifically inhibitors to business structuring for Australian SMEs, and the application of business taxation to socially oriented cooperative entities in Australia.

It is truly difficult to capture the full scope of John's contributions to taxation in a single issue. Nonetheless, we have done our best and hope you find these tribute papers both insightful and enjoyable.

Binh Tran-Nam and Chris Evans (with input from Michael Walpole)

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Remembering John Taylor

John Taylor did his undergraduate Arts and Laws degrees, coursework Master of Laws and Doctor of Philosophy all at the (then) Faculty of Law, University of Sydney over 45 years from the early 1970s to 2016. I first recall meeting him in 1986 when he was undertaking his last coursework year-long subject in his Master's being Income Tax Law I taught by Professor Ross Parsons. 1986 was a momentous year in tax in Australia as it saw the enactment of most of the Hawke-Keating 1985 tax reform measures, including the fringe benefits tax (FBT), capital gains tax (CGT) and foreign tax credit and was the last year of teaching of Ross Parsons, who was the main founder of tax law as an academic discipline in Australia. Ross had published his monumental treatise on income tax in 1985 and along with the rest of us in the room in 1986 was then grappling with the CGT – I was attending because I was due to teach the subject in 1987. This was the only tax subject taken by John in the Master's, and he was perhaps prompted to take it by his appointment to UNSW around this time and being asked to teach tax. He completed his Master's degree with an honours dissertation in the tax field in the following year on CGT and business entities and assets which subsequently became a book.

John and I were in touch thereafter mainly because we shared interests in taxation of legal entities and international taxation and found ourselves writing in similar areas and attending annual Congresses of the International Fiscal Association in locations around the world. We also had another shared academic interest which had largely been dormant since undergraduate days – in history. International tax history started to attract tax academics more widely after 2000 and John and I found our academic interests aligning even more closely.

Then out of the blue John said he would like to do a PhD at Sydney on an archival history of Australia's tax treaties and asked whether I would supervise to which I quickly agreed knowing that it would be more a journey together rather than the usual supervisor-research student relationship. By this time John was in his mid-50s and a professor, and for much of the nine-year journey of his part-time PhD John was head of business law and tax in the Business School at UNSW. He wanted to do the PhD for fun, the love of history and perhaps some escape from the ever-growing university bureaucracies.

His approach was very novel internationally at that time as most historical interest, including my own, related to the international organisations that had played a part in developing the current international tax system rather than international tax history from a country perspective. Needless to say he was the ideal PhD student, self-starting,

industrious and creative and we had a great time together during this period. He unearthed a huge amount of archival material, so much so that it was necessary to limit his thesis to treaties signed up to the early 1970s. His thesis was also novel among international tax history written by lawyers at that time in two other ways: by incorporating the Australian political, economic and social history of the period he was covering to give a much broader view of the technical detail he was unearthing, as well as by researching to the extent possible, the national archives of the other countries which were parties to the Australian treaties he covered.

I really enjoyed working with John so we did some smaller joint projects together after he finished his thesis. We were planning to do some bigger projects on tax treaty history but first COVID got in the way and then came his untimely death in early 2023. John also continued using the archival material he could not use in his thesis for time and space limitations for journal and book chapter publications such as the history of arguably Australia's most important treaty still, the 1982 treaty with the US.

It would be a great pity if the electronic historical archive John built up was to be lost. He and I had talked about mounting the material on a public website somewhat similar to the archival international tax material of international organisations found at taxtreatieshistory.org so that scholars (and others) can have access to the archival history of Australia's tax treaties. Since his death and with the cooperation of John's wife, Janine Wood, and another former international tax history research student, Nikki Teo, we have been slowly working to make this a reality. I hope that this will prove to be a fitting and internationally noticed memorial to John and his work.

Most of the contributors to and readers of this issue of the journal in honour of John, like me, largely knew him as a tax academic. Those of us who were able to attend his memorial service found out there were many other major interests and achievements in John's life such as being a pastor and Head of the Community of Christ Church in Australia.

Richard Vann, Professor Emeritus, University of Sydney

eJournal of Tax Research (2024) vol. 22, no. 2, pp. 203-221

Symbols of fractured nationalism: custom houses in colonial Australia

Jonathan Barrett*

Abstract

Customs duties were the first sustainable source of revenue for New South Wales, the colonies that hived off from it, and the other colonial settlements in Australia. From Sydney's original three-roomed customs house, with its wooden walls and bark roof, to the magnificent neo-renaissance palazzo of Melbourne, the neoclassical splendour of the Brisbane Customs House, to a Queen Anne confection in Albany, custom houses became symbols of the Australian colonies' growing economic power. Yet, unlike Anglophone Canada and New Zealand, which also engaged in practices of marginalising First Nations peoples and asserting exclusionary Britannic identities, the Australian colonies were parochial. They competed with one another for revenue and protected their own infant industries. Tariffs played an important role in establishing and maintaining this fractured nationalism; they were also instrumental in healing it. Federation was only made possible by the horse-trading over customs duties that is enshrined in the Australian Constitution.

Professor John Taylor's tax history practice included extracting uniquely Australian stories from the grand narrative of international taxation. This article seeks to pay tribute to that approach and investigates custom houses at the time of fractured nationalism as a story which, on the one hand is part of the greater British-heritage narrative of indirect taxation and related architecture, but, on the other hand, is specifically Australian.

Keywords: customs duties, custom houses, tax competition, architecture, Federation

* Associate Professor in Taxation, School of Accounting and Commercial Law, Victoria University of Wellington Te Herenga Waka. Email: jonathan.barrett@vuw.ac.nz.

1. INTRODUCTION

Customs duties are levies 'imposed by law on imported or, less commonly, exported goods'.[1] They are typically listed in a tariff.[2] According to Adam Smith, 'The duties of customs are much more ancient than excise.[3] They seem to have been called customs, as denoting customary payments which had been in use since time immemorial'.[4] In the Anglophone world, customs duties can be traced to the Roman introduction of 'a portorium or transit tax into ancient Britain, where it developed into a system of customary dues'.[5] English kings enjoyed an absolute prerogative to raise customs duties,[6] which were first levied on leather and wool – both imports and exports, the latter to compensate the king for any duty lost through reduced imports. Later, wine became assessable by the ton (tun) – hence 'tonnage' and all other goods by the pound – hence 'poundage'.[7] According to Gautham Rao, 'In the "fiscal-military states" of early modern Europe, sovereigns used customs duties to secure credit, service debt, finance governance, and bankroll military expeditions'.[8] By the time Smith wrote *The Wealth*

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[1] See *The Macquarie Dictionary* (online at 2 September 2024) 'customs duty' (def 1).

[2] The word 'tariff' appears to be derived from the Arabic word for knowledge. See Walter W Skeat, *An Etymological Dictionary of the English Language* (Clarendon Press, 2nd ed, 1893) 625. The otherwise reliable David Day asserts that '[t]he term originated from the ransoms demanded by the pirates of Tariffa'. See David Day, *Smugglers and Sailors: The Customs History of Australia 1788-1901* (Australian Government Publishing Service Press, 1992) xxxiv. This seemingly baseless claim has traction in Australia. See, eg, Museums Victoria, 'Customs House', *Immigration Museum* (Web Page) <https://museumsvictoria.com.au/immigrationmuseum/resources/customs-house/>. Perhaps the name of the island of Tarifa has the same root as knowledge.

[3] *Macquarie Dictionary*, above n 1, defines 'excise' as a 'tax or duty on certain commodities, as spirits, tobacco, etc, levied on their manufacture, sale, or consumption within a country'; 'a tax levied for a licence to carry on certain types of employment, pursue certain sports, etc'. Excise duties compensate the state for reduced customs revenue caused by local production of imported goods.

[4] See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Strahan, 1776) Bk V, Ch II, 493. Under the common law, 'time immemorial' identifies a legal norm that existed before 1189. See Jonathan Law (ed), *A Dictionary of Law* (Oxford University Press, 9th ed online, 2018). It is unclear whether Smith intended such precision.

[5] See David McGill, *The Guardians at the Gate: The History of the New Zealand Customs Department* (Silver Owl Press, 1991) 7. On the Roman *portoria*, see Sven Günther, 'Taxation in the Greco-Roman World: The Roman Principate' in *Oxford Handbook Topics in Classical Studies* (Oxford University Press, 2014) <https://doi.org/10.1093/oxfordhb/9780199935390.013.38>.

[6] Although Parliament ostensibly usurped this prerogative from Edward III in 1372, in *Bate's Case* (1606) 2 St Tr col 371, which was decided at the time of assertion of Stuart absolutism, it was held that the suspension of the king's prerogative only applied to Edward III himself. See John Snape, 'The "Sinews of the State": Historical Justifications for Taxes and Tax Law' in Monica Bhandari (ed), *Philosophical Foundations of Tax Law* (Oxford University Press, 2017) 9, 16. It is not obvious why an absolute kingly privilege could be removed from a particular monarch and that monarch only.

[7] See Smith, above n 4, 494. 'Ton' refers to a large barrel, not a unit of mass. 'Tonnage' may, therefore, also be referred to as 'tunnage'. See 'Custom House Quay and the Old Custom House' in GH Gater and Walter H Godfrey (eds), *Survey of London: Volume 15, All Hallows, Barking-By-The-Tower, Pt II* (London, 1934) 31, available at: Institute of Historical Research and University of London, *British History Online* (Web Page) <http://www.british-history.ac.uk/survey-london/vol15/pt2/pp31-43>. For a detailed account of early English customs administration, see Michael J Braddick, *The Nerves of State: Taxation and the Financing of the English State, 1558-1714* (Manchester University Press, 1996) 56-59.

[8] See Gautham Rao, *National Duties: Custom Houses and the Making of the American State* (University of Chicago Press, 2016) 4 (footnote omitted). A fiscal-military state is able to raise sufficient taxes to engage in prolonged warfare. See John Brewer, *The Sinews of Power: War, Money and the English State, 1688-1783* (Knopf, 1989) xvii.

of Nations in 1776, the focus of customs duties overwhelmingly lay with taxing manufactured or processed imports.[9]

In its precarious early years, New South Wales, the original UK settlement in Australia, had no plausible fiscal alternative other than to raise customs duties.[10] 'The Customs Service was the only revenue collector in an outpost of Empire struggling for economic survival.'[11] Discussing the similar reliance on the tariff of the fledgling United States, Rao observes: 'Just as *oikos* – ancient Greek for "house" – was the root of the concept of the economy, so the custom house was a pillar of political economy, the early modern science devoted to increasing government wealth and power'.[12]

Originally, New South Wales alone constituted colonial Australia but, through a process of scissiparity, became just one colony of a (non)federation. (Western Australia was settled separately.) The colonies, which would become the constituent states of the Commonwealth, employed customs duties to compete with one another both for revenue and to protect their own infant industries.[13] Indeed, on the Murray River, '[t]he ingredients existed for a fratricidal struggle between the colonies',[14] with the constabularies of New South Wales and Victoria coming close to open conflict over highly contested rights to levy duties on goods transported along the inland waterway.[15]

Within a federal state it seems prudent to prohibit internal customs duties, as the United States *Constitution* does,[16] but pre-federation – and, of course, federation may not eventuate[17] – contiguous colonies or states needed to decide whether to cooperate or compete over tariffs. The *Constitutional Act of 1791*, for example, created a customs union between Upper Canada and Lower Canada, although revenue sharing proved problematic.[18] The *Zollverein* (customs union) formed in 1834 between German principalities not only demonstrated the possibility of a free trade area between affiliated territories, it is also generally thought to have constituted a major step towards unification.[19] Such an arrangement among the Australian colonies might have brought Federation, which finally took place in 1901, forward by decades. As Davina Jackson

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[9] See Smith, above n 4, 495-496.

[10] On the political background to the first New South Wales customs duties, see Stephen Mills, *Taxation in Australia* (Macmillan, 1925) 23-25.

[11] See Orwell and Peter Phillips Architects, *Conservation Management Plan: Sydney Customs House, Circular Quay* (2003) 16 <http://heritagensw.intersearch.com.au/heritagenswjspui/handle/1/10112>.

[12] See Rao, above n 8, 4.

[13] See generally Peter Lloyd, 'The First 100 Years of Tariffs in Australia: The Colonies' (2017) 57(3) *Australian Economic History Review* 316 ('The First 100 Years of Tariffs').

[14] See Day, above n 2, 426.

[15] See ibid. See also GD Patterson, 'The Murray River Border Customs Dispute, 1853-1880' (1962) 2(2) *Business Archives and History* 122.

[16] See *United States Constitution*, Article I, Section 10, Clause 2. Cf the Indian octroi which operated at a city level and was only abolished in 2010 with the introduction of goods and services tax. See Anita Rath, 'Octroi – A Tax in a Time Warp: What Does Its Removal Imply for Greater Mumbai?' (2009) 44(25) *Economic and Political Weekly* 86.

[17] See, eg, the stalled federal project in the European Union.

[18] See Gordon Blake, 'The Customs Administration in Canadian Historical Development' (1956) 22(4) *Canadian Journal of Economics and Political Science* 497, 503-504.

[19] See, eg, WO Henderson, 'The Zollverein' (1934) 19(73) *History* 1. The abolition of internal tolls and customs duties in the Helvetic Republic also contributed to the eventual unification of Switzerland. See Benedict Anderson, *Imagined Communities: Reflections on the Origins and Spread of Nationalism* (Verso, rev ed, 2006) 136. Cf the difficulties faced in uniting Italy. See for example, Mark Dincecco, Giovanni Federico and Andrea Vindigni, 'Warfare, Taxation, and Political Change: Evidence from the Italian Risorgimento' (2011) 71(4) *Journal of Economic History* 887.

notes, the idea of Federation emerged with the formation of the Australian League in 1850,[20] but customs duties stood in the way of its realisation for half a century.

Customs duties, as a source of revenue for the modern state, have diminished considerably. In the first fiscal year of Federation, the tariff contributed 86.2 per cent of tax revenue,[21] whereas, in 2020, 'customs and other import duties' raised just 4.4 per cent of Australian government tax revenue.[22] Nevertheless, numerous custom houses still stand. These buildings did not simply act as colonial counting houses, they were also locations of control over immigration, hygiene, and morality. Today, they constitute some of the country's most distinguished heritage buildings. Many have been repurposed as cultural centres. Despite this redemptive reuse, for tax and other scholars it is instructive to consider the symbolism of these buildings in their particular contexts.

In the centuries before World War I (1914-18) and its aftermath, when customs duties were by far the most important source of government revenue, custom houses were the principal edificial symbols of tax administration. Sir Christopher Wren's neoclassical design for London's Custom House (1671) was seminal.[23] The architecture of colonial-era customs houses in Australia, as well as perpetuating the tropes of neoclassical architecture,[24] is distinctly symbolic. The ideas these buildings conveyed include Crown assertion of authority over territories previously occupied and tended by First Nations, and aspirations for the formation of new Britannic group identities in the South.

Professor John Taylor's tax history practice included extracting uniquely Australian stories from the grand narrative of international taxation.[25] This article seeks to pay tribute to that approach and investigates the symbolism of custom houses at the time of fractured nationalism as a story which, on the one hand, is part of the greater British-

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[20] Davina Jackson, *Australian Architecture: A History* (Allen and Unwin, 2022) 151.

[21] See Australian Bureau of Statistics, 'Taxation During the First 100 Years of Federation' (Web Page) <https://www.abs.gov.au/ausstats/abs@.nsf/Previousproducts/1301.0Feature%20Article472001>.

[22] See World Bank, 'Customs and Other Import Duties (% of Tax Revenue) – Australia' <https://data.worldbank.org/indicator/GC.TAX.IMPT.ZS?locations=AU> (accessed 31 August 2024).

[23] In London, Churchman's Custom House (started in 1382) was designed for officials of the Great Custom on Wool and Woolfells – hence the use of the singular. Even when officials of the Petty Customs were accommodated in the building, the singular was retained. 'From that day all buildings have been known as Custom House, despite housing Customs officers': see Graham Smith, *Something to Declare: 1000 Years of Customs and Excise* (Harrap, 1980) 6. While the term 'customs house' has invariably been used in Australia, following the older tradition, this article uses the phrase 'custom house' unless the formal name of a building is 'Customs House'.

[24] 'Neoclassical architecture is characterized by grandeur of scale, simplicity of geometric forms, Greek – especially Doric … – or Roman detail, dramatic use of columns, and a preference for blank walls': see Encyclopedia Britannica, 'Neoclassical Architecture' (online, last updated 8 August 2024) <https://www.britannica.com/art/Neoclassical-architecture>.

[25] See, eg, C John Taylor, 'The Negotiation and Drafting of the UK Australia Double Taxation Treaty of 1946' [2009] (2) *British Tax Review* 201; C John Taylor, '"I Suppose I Must Have More Discussion on This Dreary Subject": The Negotiation and Drafting of the UK–Australia Double Taxation Treaty of 1946' in John Tiley (ed), *Studies in the History of Tax Law, Vol 4* (Hart Publishing, 2010) 213; C John Taylor, 'The Negotiation and Drafting of the 1967 United Kingdom–Australia Taxation Treaty' in John Tiley (ed), *Studies in the History of Tax Law, Vol 5* (Hart Publishing, 2012) 427; C John Taylor, '"Send a Strong Man to England – Capacity to Put Up a Fight More Important Than Intimate Knowledge of Income Tax Acts and Practice": Australia and the Development of the Dominion Income Tax Relief System of 1920' (2014) 12(1) *eJournal of Tax Research* 32; C John Taylor, 'The History of Australia's Double Tax Conventions' in Michael Lang and Ekkehart Reimer, *The History of Double Taxation Conventions in the Pre-BEPS Era* (IBFD Publications, 2020) 623.

heritage narrative of indirect taxation and related architecture, but, on the other hand, is specifically Australian.

This article first provides a brief survey of the architecture of Australian custom houses.

Second, the general symbolism of buildings and tax administration infrastructure is discussed.

Third, custom houses as symbols of Crown authority are considered. Two aspects of the assertion of sovereignty over Australia are principally relevant – the assumption of control over First Nations' land, and control of immigration and goods entering the territory.

Fourth, the role of customs duties in ensuring fractured nationalism is outlined. If the separate customs systems operated by the colonies were a significant contributor to inter-colony rivalry, then the states' capital city custom houses, in particular, symbolised that antagonism.

Conclusions are then drawn.

2. A SURVEY OF AUSTRALIAN CUSTOM HOUSES

The first custom house in New South Wales 'was a three-room, bark roofed wooden hut with a brick chimney'.[26] Similarly, early customs infrastructure in Victoria typically consisted of no more than a basic gauging shed, boat shed and a bond store as part of its premises.[27] Yet, by 1855, the Victorian government started construction of the Melbourne Customs House as a magnificent palazzo.[28] To indicate how the custom houses developed from absolute basics to some of the most remarkable public buildings in the colonies, this section of the article briefly surveys custom houses built between the time of first European settlement of Australia and the start of World War I (1788-1914).

Richard Apperly and co-authors divide the selected time range into different periods, during which particular architectural styles were prominent.[29] Not all the styles Apperly et al identify are manifest in Australian custom houses. As Jackson notes, the most popular Victorian architectural styles were 'neo-classical, neo-Gothic, Filigree, Queen Anne and Romanesque'.[30] Some styles were specific to churches and houses; others were too fanciful to convey the message of reliability and respectability expected of a

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[26] See Jackson, above n 20, 30.

[27] See John M Petersen, 'Customs Houses and Officers in 19th Century Victoria' (1992) *Australian Customs History Journal* 11, 12.

[28] For an image of the building, which is now the Immigration Museum, see Heritage Council of Victoria, 'Former Customs House', *Victorian Heritage Database* (Web Page) <https://vhd.heritagecouncil.vic.gov.au/places/4689>.

[29] See Richard Apperly, Robert Irving and Peter Reynolds, *A Pictorial Guide to Identifying Australian Architecture: Styles and Terms from 1788 to the Present* (Angus and Robertson, 1989) 21. These periods and styles are: the Old Colonial Period, 1788-1840 (Georgian, Regency, Grecian and Gothick Picturesque); the Victorian Period, 1840-1890 (Georgian, Regency, Egyptian, Academic Classical, Free Classical, Filigree, Mannerist, Second Empire, Italianate, Romanesque, Academic Gothic, Free Gothic, Tudor, Rustic Gothic and Carpenter Gothic); and the Federation Period, 1890-1915 (Academic Classical, Free Classical, Filigree, Anglo-Dutch, Romanesque, Gothic, Carpenter Gothic, Warehouse, Queen Anne, Free Style, Arts and Crafts, and Bungalow).

[30] See Jackson, above n 20, 155-156.

customs service. For example, whereas the Federation Academic Classical style communicates a 'conservative expression of community aggrandisement' and whose '[l]argeness of scale [is] befitting [for] public buildings',[31] Federation Filigree became the preserve of pubs and hotels,[32] and Gothic was most commonly applied to grand churches and university buildings.[33] Nevertheless, Apperly and co-authors' taxonomy is useful in tracing developments in colonial and national growth.

Projecting state and mercantile power, customs buildings were principally the counting houses of colonial governments,[34] and represented 'civilising' aspirations expressed in their typical neoclassical design. Within the colonies, port settlements competed with each other to host custom houses by lobbying government. 'Customs houses were not only considered to be a reflection of the status and importance of a port's condition, but as catalysts for future growth and prosperity through trade.'[35] Australia's need for customs infrastructure was compounded by the absence of an inter-colonial free trade zone.[36]

Melbourne's custom house was built in two phases (1855 and 1876). 'The architecture was based on an Italian Renaissance palace. In the Palazzo style, the ground floor is a storage area, and the main activity occurs on the piano nobile (noble level) on the first floor.'[37] The 'Customs House is an outstanding example of a mid-Victorian colonial public building, the northern façade and Long Room being of particular distinction. The building was a symbol of the successful transition from a lawless colony to a respectable mature society'.[38]

Brian de Garis reports: 'In the centenary year of 1888 Australia enthusiastically celebrated its first hundred years of European settlement; colonial leaders vied with each other in a scramble for superlatives to express their past achievements and unbounded confidence in the future'.[39] Many impressive customs buildings were built around the time of the centenary and Federation. The Customs House Brisbane, for example, was designed by Charles H McLay, in the Victorian Free Classical style, and built between 1886 and 1889. The building, which is an architectural gem that links the Brisbane River (Meannjin) to the city, is distinguished by its copper dome, pillars, and extant long

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[31] See Apperly et al, above n 29, 103.
[32] See ibid 108-111.
[33] See Celeste van Gent, 'Edmund Blacket, Medievalism and the Gothic in the Colony' (BA (Hons) Thesis, University of Sydney, 2020).
[34] The customs service had multiple functions, not the least of which was countering smuggling. But this article is most interested in what occurred in the custom house. The primary activity was collecting duty from goods importers.
[35] See Petersen, above n 27, 13.
[36] See Sam Reinhardt and Lee Steel, 'A Brief History of Australia's Tax System' (2006, Winter) *Economic Roundup* 1. Cf New Zealand, which, as a unitary state, with few navigable rivers only needed custom houses at maritime ports.
[37] See Museums Victoria, 'Customs House', *Immigration Museum* (Web Page), above n 2, <https://museumsvictoria.com.au/immigrationmuseum/resources/customs-house>. Geelong also hosts an impressive three-storey Georgian custom house, built 1855-56. See Heritage Council of Victoria, 'Geelong Customs House', *Victorian Heritage Database* (Web Page) <https://vhd.heritagecouncil.vic.gov.au/places/18398>.
[38] See Petersen, above n 27, 14.
[39] See BK de Garis, '1890-1900' in FK Crowley (ed), *A New History of Australia* (William Heinemann, 1974) 216, 216.

room.[40] It is an extravagant classical statement, reminiscent in certain regards of a US state capitol.

On the central Queensland coast, Maryborough (1899),[41] Rockhampton (1901),[42] and Bundaberg (1903)[43] each hosted handsome custom houses, with Rockhampton's building being a particularly ostentatious example of the Federation Academic Classical style. Maryborough's custom house (and grand accommodation for the chief customs collector) is distinctive. Unlike other Australian custom houses, which tended to be built in some or other version of neoclassicism, its design followed the Arts and Crafts style, which referenced Medievalism, and was fashionable at the time but generally reserved for schools and private residencies.[44] Elsewhere in Queensland, heritage-quality customs houses were also built in 1902 in Mackay and Townsville.[45]

In Tasmania, Launceston's 1885 custom house, which is extravagant and classical in style,[46] replaced the 1838 customs house, whose neoclassicism had been expressed in a more modest fashion.[47] Hobart's 1903 customs house[48] possesses '[a] forceful, richly modelled classical façade in sandstone'.[49]

In New South Wales, the Wollongong custom house (used 1885-1904), which was originally a courthouse, is a modest building but is nevertheless in a conspicuous

[40] A 'long room' is '[t]he public room, often of grand design, in which merchants or their agents passed entries for imported goods and in which the other public business of the department was conducted. The original long room was in the London Custom House, built by Christopher Wren in 1671': see Day, above n 2, xxxiv. Stebbings omits discussion of Long Rooms which, after Sir Christopher Wren's design, were the principal feature of major custom houses in the UK: see Chantal Stebbings, 'The Architecture of Tax Administration: Function or Form?' in Peter Harris and Dominic De Cogan (eds), *Studies in the History of Tax Law, Vol 8* (Hart Publishing, 2017) 85. Long Rooms were also the central feature of custom houses in the capital cities of Australia.

[41] For an image, see Queensland Government, 'Customs House and Residence (Former)', *Queensland Heritage Register* (Web Page) <https://apps.des.qld.gov.au/heritage-register/detail/?id=600709>.

[42] For an image, see Queensland Government, 'Customs House' (Web Page) <https://www.queensland.com/us/en/things-to-do/attractions/p-5ad58c36c69bc77c4e363f53-customs-house>.

[43] For an image, see Michael Gorey, 'Bundaberg Customs House Symbolises Early Prosperity', *Bundaberg Now* (28 September 2019) <https://www.bundabergnow.com/2019/09/28/bundaberg-customs-house/>.

[44] See, eg, Harriet Edquist, *Pioneers of Modernism: The Arts and Crafts Movement in Australia* (Miegunyah Press, 2008); Kristyna Olsen Mizelle and Jim Kane, 'Evolution of a Movement: The Arts and Crafts in Australia' (2001) 14(4) *Style 1900* 40.

[45] See Queensland Government, 'Mackay Customs House', *Queensland Heritage Register* (Web Page) <https://apps.des.qld.gov.au/heritage-register/detail/?id=600669>; Queensland Government, 'Townsville Customs House', *Queensland Heritage Register* (Web Page) <https://apps.des.qld.gov.au/heritage-register/detail/?id=600937>. Custom houses were built in 1938 at Cairns and Thursday Island, as public works projects.

[46] For an image, see 'A Sense of Place: Launceston Heritage Walk', *Our Tasmania* (Web Page) <http://www.ourtasmania.com.au/launceston/launceston-heritage-walk.html>.

[47] For an image, see PocketSights LLC, 'Old Custom House Launceston Architecture A' (Web Page) <https://pocketsights.com/tours/place/Old-Custom-House-37991:4457>.

[48] 'Custom House was built between 1899 and 1903 and was occupied by the Customs Department and several other Federal Government departments during much of the twentieth century. The Australian Customs Service moved to new premises in 1990, and Custom House became part of the Tasmanian Museum and Art Gallery (TMAG)': see Callum J Jones, 'Tas That Was – Custom House', *Tasmanian Times.com* (27 October 2021) <https://tasmaniantimes.com/2021/10/tas-that-was-custom-house/>.

[49] See Apperly et al, above n 29, 100.

position above the port and neoclassical in design. The Newcastle (New South Wales) customs house (1889) was built in the Victorian Renaissance Revival style.[50]

In Fremantle (Western Australia), the 1908 customs house follows Federation Free Style.[51] Being built in the eclectic Queen Anne style, Albany's is, perhaps, the most idiosyncratic Australian customs building.[52]

What do these heritage buildings symbolise? The following sections of the article discuss two main themes – Crown authority, and fractured nationalism – but custom houses also symbolised other concepts and practices. The 'sin' tax aspect of customs duties on 'stimulants' (alcohol, but not necessarily beer) and 'narcotics' (tobacco and, later, opium) is a perennial symbol of disapproval, if not social control. The 'high and often prohibitive' duties levied on opium, first in Victoria and later in New South Wales, were undisguised attempts at social control; their purpose lay in discouraging Chinese miners from travelling to the Victorian gold fields.[53] Generally, the customs service was and continues to be engaged in public health matters,[54] and 'became … a watchdog over goods, people and ideas coming into the country'.[55]

3. CUSTOM HOUSES AS SYMBOLS

Rudolf Arnheim observes: 'Buildings are visible to the human eye. This would not necessarily have to mean that their appearance is purposively shaped and colored to convey a visual message. … Man, however, rarely makes an implement with total disregard for the image it presents to the eyes'.[56] Seeing comes before language.[57] In addition to performing certain functions, buildings also act as signs: for example, the decoration of buildings can send important messages.[58] Semiotics, as the study of signs, may be applied to buildings. According to Geoffrey Broadbent, in the theory of Ferdinand de Saussure (1857-1913), the *signifier* is the 'building forms by which the sign itself is made physically manifest', and the *signified* is 'the concepts, ideas or other thoughts which the signifier actually "stands for"'.[59] Charles Jencks observes that

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[50] For an image, see University of Newcastle, 'Customs House, Newcastle, NSW, [1930s]', *Living Histories* (Web Page) <https://livinghistories.newcastle.edu.au/nodes/view/76499>.

[51] For an image, see Garry Gillard, 'Customs Houses', *Freotopia* (Web Page, 28 August 2015) <https://freotopia.org/buildings/customshouse.html>.

[52] For an image, see Heritage Council, Government of Western Australia, 'Image Details – South Elevation (Rear of Building)' (Web Page) <https://inherit.dplh.wa.gov.au/Public/inventory/Image/01790c70-370a-478f-8e42-900c491456b8>.

[53] See Peter Lloyd, 'The First 100 Years of Tariffs', above n 13, 323. Australia prohibited opium as an import in 1906.

[54] See Maria Mamma and Demetrios A Spandidos, 'Customs Officers in Relation to Viral Infections, Tuberculosis, Psittacosis and Environmental Health Risk' (2019) 17(2) *Experimental and Theoretical Medicine* 1149.

[55] See Orwell and Peter Phillips Architects, above n 11, 75. The authors note (at 121): 'Customs was also responsible for moral purity and administered Acts prohibiting the importation of books and later films which might contain material perceived by Customs Officers and later by the Censorship Board as seditious, inflammatory, or pornographic'.

[56] See Rudolf Arnheim, 'Symbols in Architecture' (1977) 36 *Salmagundi* 69, 69.

[57] See John Berger, *Ways of Seeing* (British Broadcasting Corporation and Penguin Books, 1972) 7.

[58] See Stebbings, above n 40, 99.

[59] See Geoffrey Broadbent, 'General Introduction' in Geoffrey Broadbent, Richard Bunt and Charles Jencks (eds), *Signs, Symbols, and Architecture* (John Wiley and Sons, 1980) 1, 2.

'*signifieds* of architecture can be just about any idea or set of ideas' but argues they must not be 'too long or complex' if they are to effectively convey messages.[60]

In his disquisition on the language of classical architecture, John Summerson observes:

> Words, expressions, grammatical constructions have all at some time had to be invented to meet particular needs of communication. Those immediate needs are long since forgotten, but the words and their patterns will form the language we use for a thousand purposes …[61]

Summerson, therefore, alerts us to shifting meaning. The classical architecture of ancient Greece and Rome,[62] particularly as reborn as neoclassicism in Europe and the US from the 17th century, is a durable architectural symbol but its signifieds are not constant. As Broadbent observes, 'Greece was seen as the "cradle" of liberty, of democracy, of philosophy, of mathematics, of sculpture, of everything that was good in civilization, including architecture itself'.[63] But he further notes that the dictatorships of the 1930s used 'Greek orders to express not freedom and democracy, but power – the naked power, that is, of the totalitarian state'.[64]

Chantal Stebbings emphasises 'a physical expression of democratic values' manifest in neoclassical architecture,[65] yet neoclassicism emerged first in France at a time of absolute monarchy.[66] A more stable meaning arises from the 'careful proportions, aesthetic principles, symmetry, balance, and attention to scale' which 'evoked perceptions of order, control and power'.[67]

While it is plausible that the architecture of the administrative buildings for general taxes in 19th century UK 'demonstrated an appreciation of the inevitable tensions surrounding the visual communication to the taxpaying public of the sovereign power of the state to tax and reconciling it with the principle of consent',[68] it is submitted that, in colonial Australia, the messages of order, control, power and, later, state wealth were most important. Stebbings adduces four reasons for architectural restraint in UK tax administration, including concerns for significant buildings becoming the focus of civil unrest.[69] This consideration does not appear to have influenced the designers of custom houses in Australia.[70] The closest Australia has come to a tax revolt was the Eureka

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[60] See Charles Jencks, 'The Architectural Sign' in Geoffrey Broadbent, Richard Bunt and Charles Jencks (eds), *Signs, Symbols, and Architecture* (John Wiley and Sons, 1980) 71, 74.
[61] See John Summerson, *The Classical Language of Architecture* (Thames and Hudson, 1980) 14.
[62] For an argument that the principal influence on American neoclassicism in government buildings was Rome, rather than Athens, see Christopher Saint-Carter, 'The Politics and Piety of Neoclassical Architecture: How Early American Elites Practiced an Old Religion to Subvert the New One' (2023) 11(1) *Themis*.
[63] See Geoffrey Broadbent, 'Architects and their Symbols' (1978) 6(1) *Built Environment* 10, 23.
[64] Ibid. For a discussion of the relationship between power and violence, see, eg, Torsten Menge, 'Violence and the Materiality of Power' (2022) 25(6) *Critical Review of International Social and Political Philosophy* 761.
[65] See Stebbings, above n 40, 96 discussing the mid-Victorian era.
[66] See generally Wend von Kalnein, *Architecture in France in the Eighteenth Century*, tr David Britt (Yale University Press, 1995); Max Beloff, *The Age of Absolutism, 1660-1815* (Hutchinson's University Library, 1954).
[67] See Stebbings, above n 40, 96.
[68] See ibid 107.
[69] See ibid 104-106.
[70] Stebbings notes that, with the magnificent exception of Somerset House, many tax administration buildings in the UK, including regional custom houses, were unexceptional private residences rented from

Stockade which took place in Ballarat in 1854. A principal cause of the uprising by independent miners was the exorbitant fee charged for a mining licence. When the dust had settled, the licence fee was replaced by a gold export duty.[71]

Caution should, therefore, be exercised when considering the transplantation of UK taxes to its colonies. While excise duty in the UK was an important tax that applied to a wide range of goods, the first excise in Australia was practically restricted to locally distilled liquor.[72] New South Wales, which then included the areas of Queensland and Victoria (Port Phillip), introduced an excise tax on locally produced spirits in 1819.[73] Victoria (1851) and Queensland (1859) as independent colonies continued the excise. South Australia followed New South Wales in 1842 but, indicating the relative lack of importance of excise relative to customs duties, Tasmania did not introduce an excise duty until 1880 and Western Australia only in 1898.[74] In accordance with the Commonwealth Constitution, the *Excise Act 1901* (Cth) introduced a federal excise duty to replace the colonial excises.[75]

According to Sam Reinhardt and Lee Steel, 'excise duties provided much less revenue than customs duties, partly because of the limited amount of manufactured goods produced in the colonies'.[76] In contrast, excise duties historically contributed proportionately far more to UK tax revenue – as much as 50 per cent at the turn of the 18th century – than they did to Australian colonies' revenues.[77] Consequently, excise duties and excise buildings do not appear to have attracted the degree of resentment in Australia that they may have attracted elsewhere.[78]

According to Stebbings, 'certain architectural forms were understood to have meaning, and, for example, domes, towers, columns and colonnades were accepted symbols of power'.[79] Furthermore, the materials used, and decoration were expected to convey 'a message of wealth, power, majesty, authority and control'.[80] Certainly, the choice of building materials between, say, marble or brick in themselves can communicate messages about the ability to amass and spend wealth, whether for a temple, treasury,

their owners. See ibid 90. These offices could have been expected to have blended in with surrounding dwellings (although the private dwelling customs occupied in Berwick-on-Tweed is a Grade I listed building). While not all custom houses in Australia were originally built for that purpose – the Wollongong custom house, eg, was built as a courthouse – the impressive capital city custom houses were purpose built.

[71] See generally Richard Butler, *Eureka Stockade* (Angus and Robertson, 1983) and specifically *An Act for Granting Duties of Customs upon Gold Exported from Victoria 1855* (Vic) (Assent 20 April 1855).

[72] In 1851, eg, in New South Wales customs duties raised £201,501, whereas excise raised £7,210. See Mills, above n 10, 34.

[73] For a discussion of excise development in Australia, see Caroline Dick, 'Taxation in Australia Up Until 1914: The Warp and Weft of Protectionism' (2014) 12(1) *eJournal of Tax Research* 104.

[74] See Lloyd, 'The First 100 Years of Tariffs', above n 13, 49. The Tasmanian and Western Australian excise only applied to beer.

[75] For a discussion of the 1901 Act and its context, see Max Spry, 'What Is an Excise Duty? *Ha and Hammond v NSW*' (Department of the Parliamentary Library Research Note No 1, August 1997).

[76] See Reinhardt and Steel, above n 36.

[77] See Philip Brien and Matthew Keep, 'The Public Finances: A Historical Overview' (House of Commons Library Briefing Paper No 8265, 22 March 2018).

[78] On the sanguineous whiskey rebellion of 1784, see, eg, Kevin T Barksdale, 'Our Rebellious Neighbors: Virginia's Border Counties during Pennsylvania's Whiskey Rebellion' (2003) 111(1) *Virginia Magazine of History and Biography* 5.

[79] See Stebbings, above n 40, 96.

[80] See ibid 104.

business or private residence.[81] But individual features, such as a cupola, do not in themselves communicate power. For example, ornate music halls, as they flourished in the 19th century, may have incorporated turrets and cupolas in ironic imitation of the edifices of power.[82] What really matters is the overall impression a building gives to the observer in a particular context. A spic and span wooden structure in an elevated position with a flagpole flying the Union Jack, as early Australian custom houses often presented, could project an image of authority to boats approaching a settlement of people mostly living under canvass, as much as later grand neoclassical buildings would send messages of authority in rapidly developing cities. Indeed, whereas as Stebbings argues, in the UK, 'even custom houses … were characterised by a degree of architectural restraint',[83] in Australia custom houses tended to reflect the meteoric economic growth of the capital cities.[84]

Stebbings observes that the royal coat of arms, prominent on all UK custom houses, 'signified the authority and position of the monarch … It was an image legible to foreign traders unambiguously asserting the taxing authority of the Crown, and, thereby, the right of the customs' officers to record goods entering or leaving the port and to collect the customs duties'.[85] Before Federation, Australian custom houses invariably incorporated that coat of arms in a prominent position, thereby conveying a similar message about the power of the Crown in its colonies.

In Sydney, the coat of arms was carved from sandstone; in Melbourne, the emblem is polychromatic; and, in provincial Maryborough, it was moulded in concrete. The Maryborough example is significant because the custom house was built in 1899. Queen Victoria conferred the colony of Queensland its own coat of arms in 1893 – the first British colony to be granted such as an honour since Jamaica in 1661. It might reasonably be expected that the Queensland emblem, no doubt a source of pride for that colony, would have been used for the custom house but loyalty to the mother country appears to have prevailed.

The 1889 Brisbane Customs House is an exception with regards to coats of arms. Rather than the royal coat of arms, the façade incorporates a *sui generis* emblem that anticipates and yet is significantly different from the eventual Commonwealth coat of arms. Incorporating the motto 'Advance Australia', it hints at Patrick Dodds' 1878 patriotic song, *Advance Australia Fair*, which ultimately became Australia's national anthem.[86] The Brisbane emblem, therefore, points beyond fracture towards Federation.

4. CROWN AUTHORITY

Even the earliest, crudely constructed customs houses tended to be built in elevated places. John Petersen explains that 'for reasons of prominence as well as permanence,

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[81] For an argument that architecture is generally determined by the energy available, eg, to bake bricks, see Barnabas Calder, *Architecture: From Prehistory to Climate Emergency* (Pelican, 2021).
[82] Irony in architecture is today most commonly associated with postmodernism but, it is submitted that theatres and vaudeville music halls much earlier may have subverted the traditional symbol of formal power. See, eg, Robert Kronenburg, *This Must Be The Place: An Architectural History of Popular Music Performance Venues* (Bloomsbury Publishing, 2019).
[83] See Stebbings, above n 40, 104.
[84] The growth of Melbourne and its custom house, eg, surged during Victorian gold rushes two decades apart.
[85] See Stebbings, above n 40, 103.
[86] See Australian Government, *Australian Symbols* (2022) 11.

representing Customs as a department controlled by the Crown, rather than an insubstantial colonial government. Potential offenders would be impressed by the importance of Customs and respectability of the officials inside the building'.[87] Elevation not only gave visual prominence and security from flood, it also allowed officials to observe and monitor dock activity.[88] In lawless places, some custom houses were fort-like constructions. The last surviving example of this type of building was built in 1849 and is located at Portland (Victoria).[89]

The proliferation of customs houses symbolised the spread of Crown authority across the continent,[90] but arguably, the extant Sydney Customs House (construction started 1844), the site of the first assertion of customs-levying power is the most symbol-laden customs building. It is an imposing edifice off Circular Quay, allegedly built on the spot where the Union flag was raised by the First Fleet in 1788. Orwell and Peter Phillips Architects report:

> This was an historical event which bears the same significance to the history of Australia as, for instance, does the site of the Mayflower landing to American history and that of the Roman invasion to Britain's history. … The building's location is a physical reminder of the importance of Circular Quay as the original maritime and civic centre for the colony.[91]

4.1 First Nations

Without treaties with the numerous First Nations,[92] but with the espousal of the pernicious doctrine of *terra nullius*,[93] indigenous people were marginalised, often through acts of great violence throughout the Australian colonies.[94]

The infrastructure of large-scale import and export – ports, customs houses and bonded warehouses – would have obliterated and, thereby, denied the history of traditional indigenous places and patterns of food gathering and any trade activity. The creation of the harbour at Circular Quay was not done for taxing purposes, but, as Sydney's port infrastructure developed, the colony would need revenue. 'Gadi', the indigenous name for the area, was erased, and traditional gathering of cockles and oysters by the Gadigal

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[87] See Petersen, above n 27, 13.
[88] See ibid. Cf Jeremy Bentham's Panopticon. See generally, Janet Semple, *Bentham's Prison: A Study of the Panopticon Penitentiary* (Oxford University Press, 1993).
[89] For an image, see Heritage Council of Victoria, 'Victorian Heritage Database Report: Customs House' (17 May 2005) <https://vhd.heritagecouncil.vic.gov.au/places/64348/download-report>.
[90] On the role of coats of arms symbolising Crown power in the colonies, see nn 59 and 60. It is not suggested that custom houses were the only buildings that symbolised Crown authority. Courts, eg, were also important signs. Later State Parliaments and Treasuries became critical symbols.
[91] See Orwell and Peter Phillips Architects, above n 11, 74-75.
[92] See generally George Williams and Harry Hobbs, *Treaty* (2nd ed, Federation Press, 2020).
[93] For a general discussion of the doctrine of *terra nullius*, see Colin Samson, 'The Rule of *Terra Nullius* and the Impotence of International Human Rights for Indigenous Peoples' (2008) 5(1) *Essex Human Rights Review* 1. For a review of the doctrine in Australia, see eg Stuart Banner, 'Why *Terra Nullius?* Anthropology and Property Law in Early Australia' (2005) 23(1) *Law and History Review* 95.
[94] See, eg, Asafa Jalata, 'The Impacts of English Colonial Terrorism and Genocide on Indigenous/Black Australians' (2013) 3(3) *Sage Open*.

people was prevented by the building of the dock.[95] The custom house became a prominent and symbolic presence on the quay.

Tariffs and the customs service intervened in the centuries-old trading relationships between the Macassars of modern-day Indonesia and First Nations on the northern coast,[96] who controlled Macassar sailors' entry onto their territory to harvest sea cucumbers (*bêche de mer* or *phylum Echinodermata*). David Day argues that, by exercising such control over ingress and takings, First Nations people operated a customs system, if not a customs service.[97]

4.2 Exclusion

Imagining and creating a national community are necessarily exercises in both inclusion and exclusion.[98] Custom houses embodied, on the one hand, dispossession of indigenous peoples and, on the other hand, control of immigration. As noted, First Nations trade and tax-like traditions were extinguished. In the second regard, the so-called poll taxes,[99] which penalised Chinese efforts to settle or to sojourn,[100] were administered by customs officers based in some of the grandest public buildings in the colonies. The Department of Trade and Customs administered the *Quarantine Act 1908* (Cth) until responsibility was transferred to the Commonwealth Department of Health in 1921. Along with its enforcement of the *Immigration Restriction Act 1901* (Cth), its initial involvement with the *Quarantine Act* deeply implicated the customs service and its officers in the implementation of the nascent 'White Australia' policy (1901-1958).

5. Fractured Nationalism

From a Eurocentric perspective, custom houses were perhaps most potent in their symbolising the inchoate nationhood of settler Australia. According to Ron Palenski, New Zealand had forged a national identity by 1890, just 50 years after signing the Treaty of Waitangi Te Tiriti O Waitangi.[101] In contrast, a distinct Australian national identity probably only cohered during World War I. This section of the article considers

[95] See, eg, Sue Jackson, Libby Porter and Louise C Johnson, *Planning in Indigenous Australia: From Imperial Foundations to Postcolonial Futures* (Routledge, 2018) 93.
[96] See Day, above n 2, 1. See also Kellie Clayton, 'An Historical Reassessment of the Maritime Southeast Asian Forest and Marine Commodities Trade and Its Implications for Archaeological Investigations of Asian Contact in Northern Australia' (2023) 89(2) *Australian Archaeology* 115.
[97] See Day, above n 2, 1.
[98] For a discussion of inclusion of political community members and exclusion of strangers, see Michael Walzer, *Spheres of Justice: A Defence of Pluralism and Equality* (Basic Books, 1983) 31-35.
[99] The first anti-Chinese immigration legislation was introduced in Victoria in 1855. An entry charge of £10 was payable by the master of any ship for a Chinese immigrant arriving at a Victorian port. Furthermore, only one immigrant was permitted per 10 tons of tonnage. See *An Act to Make Provision for Certain Immigrants 1855* (Vic) (Assent 12 June 1855). The legislation does not include the words 'poll' or 'tax'.
[100] For a general discussion of Chinese 'poll taxes', see Sue Yong and Rob Vosslamber, 'Race and Tax Policy: The Case of the Chinese Poll Tax' (2018) 20(1) *Journal of Australian Taxation* 147.
[101] See Ron Palenski, *The Making of New Zealanders* (Auckland University Press, 2012) 18. Despite the Treaty, it is not suggested that 19th century New Zealand nationalism was bicultural in nature. As in Australia, indigenous people were marginalised, and non-European settlers excluded in order to forge a Britannic group identity.

how custom houses symbolised Australia's fractured nationalism before World War I,[102] and how customs duties were also a key enabler of Federation.[103]

5.1 Different colonial loyalties

Donald Horne observed in 1964:

> Many people still living were born into an Australia where there were customs posts on the State borders and which, according to its official texts, did not achieve full status as a nation until 25 April 1915, when the Australian soldiers assisted in the Gallipoli landing by storming Anzac Cove. It was as if the whole process of achieving nationhood was so easy that it wasn't until men died … that Australians felt they had earned their way into the world.[104]

The absence of a unified nationalism before Gallipoli arose from governmental structures and a failure of the collective imagination. From a constitutional perspective, the British monarch 'was Australia's head of state and … State governors and the Governor-General were British. As a self-governing colony in the British Empire, Australia had no national army or navy, and its foreign policy was determined by Britain'.[105]

People failed to imagine themselves as members of an Australian nation.[106] They 'would refer to themselves as Australians in relation to Britain (for example, as Anglo-Australian or as Scottish-Australian and Britain was often referred to as "home")'.[107] This is perhaps understandable since 'British history was taught in schools. Professional standards in education, engineering, medicine and law were determined according to British standards'.[108]

In the 1870s, separate colonial flags were adopted – essentially the British Blue ensign with the addition of each colony's badge. These flags would have been raised over prominent colonial government buildings, including custom houses. Flags are remarkably potent symbols of nationhood but, before 1901, there was no Australian national flag.[109] Robert Schatz and Howard Lavine observe:

> Many … accounts … suggest that individuals' ties to national symbols often supersede their ties to the group that the symbols represent. The crux of these assertions is that expressions of national sentiment are directed toward national

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[102] Responses to the Covid pandemic, notably the closing down of most travel between states, indicated contemporary fractures in the national imaginary.
[103] See generally C Forster, 'Federation and the Tariff' (1977) 17(2) *Australian Economic History Review* 95.
[104] Donald Horne, *The Lucky Country* (Penguin Books, 6th ed, 2008 [1964]) 159.
[105] See Rob Lundie and Joy McCann, 'Commonwealth Parliament from 1901 to World War I' (Parliamentary Library Research Paper, 4 May 2015) 4 <https://parlinfo.aph.gov.au/parlInfo/download/library/prspub/3810416/upload_binary/3810416.pdf;fileType=application/pdf>.
[106] In Benedict Anderson's thesis, nations are essentially imagined by their members. See generally, Anderson, above n 19.
[107] See Lundie and McCann, above n 105, 4.
[108] See ibid (footnote omitted).
[109] In the 1850s, the Australian League astutely promoted symbols of nationalism, notably a national flag – 'five silver stars, in the form of a cross, on a blue background, with the Union Jack in the top left-hand corner'. See TH Irving, '1850-70' in FK Crowley (ed), *A New History of Australia* (William Heinemann, 1974) 124, 135.

> symbols rather than to the nation itself and that such symbolism is infused with unique psychological meaning and political import.[110]

Other absent national symbols included a coat of arms, an anthem or particular Australian honours or medals.[111] In the terminology of Eric Hobsbawm and Terence Ranger, at the time of Federation, Australian national traditions had not yet been invented. Hobsbawm explains:

> 'Invented tradition' is taken to mean a set of practices, normally governed by overtly or tacitly accepted rules and of a ritual or symbolic nature, which seek to inculcate certain values and norms of behaviour by repetition, which automatically implies continuity with the past.[112]

Even after Federation, according to Rob Lundie and Joy McCann:

> The state governments still controlled much of what affected their everyday lives (for example, land, roads, railways and education). Loyalty was to their state, not federal, government. Parochialism predominated, aided by the concentration of the population in New South Wales (NSW) and Victoria and in the cities.[113]

Furthermore, despite the establishment of the High Court of Australia as the Federal Supreme Court,[114] appeals to the Queen in Council continued, if with limitations.[115]

The settler people of the colonies, of course, shared similarities, notably their typical Anglo-Celtic heritage and the commonality of the English language.[116] And so, from the early days, the colonists were seen as constituting new Britannic groups in an empty land. While Western Australia was unusual in accommodating immigrants of colour, notably Malay pearl divers, that appearance of enlightenment was attributable to chronic labour shortages. 'This changed during the 1890s when gold discoveries led to a surge of white immigration from other colonies and the movement towards Federation of all colonies put pressure on Western Australia to join in a restrictive immigration policy.'[117] Preceding Federation, from 1880, the Australian Native Association promoted through its magazine *The Bulletin* a vision of Australian nationalism that was 'a racist, sexist and republican style of jingoism'.[118] That vision faced the reality of customs rivalry.

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[110] Robert T Schatz and Howard Lavine, 'Waving the Flag: National Symbolism, Social Identity, and Political Engagement' (2007) 28(3) *Political Psychology* 329, 330.
[111] See Lundie and McCann, above n 105.
[112] See Eric Hobsbawm, 'Introduction: Inventing Traditions' in Eric Hobsbawm and Terence Ranger (eds), *The Invention of Tradition* (Cambridge University Press, 1983) 1, 1.
[113] See Lundie and Joy McCann, above n 105, 4.
[114] See *Constitution* s 71.
[115] See ibid s 74. For a discussion on the limitations on appeals, see A F Mason, 'The Limitation of Appeals to the Privy Council from the High Court of Australia, from Federal Courts Other Than the High Court, from the Supreme Courts of the Territories and from Courts Exercising Federal Jurisdiction' (1968) 3(1) *Federal Law Review* 1. On terminating appeals to the Judicial Committee of the Privy Council, see *Australia Act 1986* (Cth) s 11.
[116] Cf the difficulties of forging a national identity among, say, the multilingual Swiss. See Anderson, above n 19, 136.
[117] See Day, above n 2, 359.
[118] See Jackson, above n 20, 151.

No doubt class differences existed between, say, transportees and voluntary immigrants. Indeed, David Cannadine refers to the 'stratification and Gothicization of the dominions',[119] by which he means, in the major colonies of the British Empire, the class system and architecture of Britain were replicated.[120] Nevertheless, an uneasy unity manifested against 'the Other'[121] – First Nations people, on the one hand, and potential non-British immigrants, on the other hand. The customs services, from their fine customs houses, played an essential role in this exclusionary process.

5.2 Protectionism

Smith commended the free flow of goods within the United Kingdom, and proposed an extension of uniform British taxation and free movement of goods to Ireland and 'the plantations' – in effect, an imperial customs union.[122] In Smith's view, Britain's standardised customs system, and freedom of movement of goods within the country was 'perhaps one of the principal causes of the prosperity of Great Britain, every great country being necessarily the best and most extensive market for the greater part of the productions of its own industry'.[123] This was not the model adopted in the Australian colonies before Federation.

John Stuart Mill, who otherwise promoted free trade, made an exception for infant industries in new countries which could be protected for a limited period of time to enable them to attain a competitive status.[124] From the time of foundation, Victoria adopted this exception enthusiastically. At the beginning of the 1860s, Victoria had half as many factory workers as New South Wales, and so was dependent on imports. There were constant shortages of goods, unemployment, and a lack of investment opportunities. Clearly this was fertile ground for protectionist policies. The 1865 tariff reduced duties on tea, sugar and that other staple, opium, and imposed an ad valorem import duty on other imports.[125] The tariff on imports was further increased in 1867. By 1871, the number of factory workers in Victoria had increased by about 300 per cent, whereas the number of New South Wales factory workers had increased by about 10 per cent.[126] Whether or not these differences are attributable to Victoria's protectionist tariff, some causative relationship seems plausible. This outcome runs counter to the presumptions of the *laissez faire* orthodoxy that prevailed in the British Empire from the mid-1840s until World War I, when Britain reverted to mercantalist protectionism.[127]

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[119] See David Cannadine, *Ornamentalism: How the British Saw Their Empire* (Oxford University Press, 2001) 34.

[120] Nicolas Pugin, who designed London's Palace of Westminster (1801), 'sought to revive not merely Gothic architecture but a whole imaginary civilisation behind it'. See Hugh Trevor-Roper, 'The Invention of Tradition: The Highland Tradition of Scotland' in Eric Hobsbawm and Terence Ranger (eds), *The Invention of Tradition* (Cambridge University Press, 1983) 15, 37.

[121] See for example, Peter Benson, 'The Concept of the Other from Kant to Lacan', *Philosophy Now* (2018) <https://philosophynow.org/issues/127/The_Concept_of_the_Other_from_Kant_to_Lacan>.

[122] See Smith, above n 4, 523.

[123] See ibid.

[124] See JS Mill, *Principles of Political Economy*, ed WJ Ashley (Longmans, 1909) 923 cited and discussed by Douglas A Irwin, *Against the Tide: An Intellectual History of Free Trade* (Princeton University Press, 1996) ch 8.

[125] See Irving, above n 109, 160-161.

[126] See ibid 161.

[127] See William D Grampp, 'The Third Century of Mercantilism' (1944) 10(4) *Southern Economic Journal* 292, 302.

Despite Victoria's characterisation as highly protectionist, this position is relative to New South Wales.[128] In 1898, customs revenue per capita was £1 4s 1d for New South Wales, and £1 18s 0d for Victoria.[129] The other colonies, however, had higher per capita duties, and New Zealand's corresponding rate was £2 15s 2d.[130] Nevertheless, the Melbourne's custom house had great political significance as it was the 'functional and geographic focal point of Victoria's early protectionist policies which, at the time they were introduced in the 1860s and 1870s, gained for the colony an international reputation as economic heretic and potential destroyer of the British Empire'.[131]

5.3 Federation and customs compromise

De Garis observes that 'whereas the problem of reconciling different tariff policies had once seemed an immovable barrier to federation, some colonists now saw the need for this as an irresistible reason for federation'.[132] Smith would no doubt have demonstrated the absurdity of nascent, contiguous colonies on a British-claimed island continent competing with each other through protectionist tariffs. But, in the absence of a unitary or federal state, competition may have seemed inevitable.[133] Day observes:[134]

> The wealth of the gold rushes underwrote colonial separatism, causing the mid-century talk of federation, or even an independent Australian republic, to slip from the political agenda as the colonies vied for their economic supremacy. Border Customs and differential tariffs were the weapons in this self-defeating war that only concluded under the combined pressure of colonial manufacturers seeking a national market and of fears that imperial competition in the Pacific and the rise of Asian empires might rob Australians of their emerging nation.

In accordance with the so-called 'Braddon Blot',[135] unification was dependent on the new federal government returning 75 per cent of customs revenue to the constituent states for the first 10 years after Federation.[136] Western Australia could only be persuaded to join the Federation by a promise of full reimbursement of customs duties for five years.[137] Dianne Heriot explains that three main causes underpinned Western

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[128] See, eg, A Mahinda Siriwardana, 'The Impact of Tariff Protection in the Colony of Victoria in the Late Nineteenth Century: A General Equilibrium Analysis' (1991) 31(2) *Australian Economic History Review* 45. Unlike Victoria, 'New South Wales … relied heavily on revenue from land sales and rent, which in 1875 contributed half of the Colony's revenue, and about twice that from all sources of taxation'. See Reinhardt and Steel, above n 36, 5.

[129] See TA Coghlan, *A Statistical Account of the Seven Colonies of Australasia, 1899-1900* (Gullick, Government Printer, 1900).

[130] See ibid.

[131] See National Trust, 'Former Customs House', *Victorian Heritage Database* <http://vhd.heritage.vic.gov.au/search/nattrust_result_detail/64956>. For practical explanations of protectionism, see generally Lloyd, 'The First 100 Years of Tariffs', above n 13, 316; Kym Anderson, 'Trade Protectionism in Australia: Its Growth and Dismantling' (Working Papers in Trade and Development 2020/10, Australian National University, 2020).

[132] See De Garis, above n 39, 249.

[133] Various attempts were made by New South Wales, South Australia, and Victoria to cooperate over traffic passing along the Murray River, but tensions remained. See, eg, Adam Webster, 'A Colonial History of the Murray River Dispute' (2017) 38(1) *Adelaide Law Review* 13, 16, n 10.

[134] See Day, above n 2, 441.

[135] See Hon Sir E Braddon (Premier of Tasmania), 'The Case for the "Braddon Clause" in the Federal Bill' (1898) *Review of Reviews* 329, available at: <https://nzetc.victoria.ac.nz/tm/scholarly/tei-Stout75-t28-body-d2.html>.

[136] See *Constitution* s 93.

[137] See ibid s 95.

Australian reluctance to join the Federation: first, 'the colony had only been granted responsible government in 1890'; second, 'it was geographically remote from the eastern colonies with which its early settlers felt little affinity'; and, third, 'almost half of Western Australia's revenue derived from inter-colonial customs duties which would be abolished under the new Australian Constitution'.[138]

Horse-trading over customs duties therefore played a major role in healing Australia's fractured nationalism and continued after Federation. The *Customs Tariff Act 1902* (Cth) was inevitably a compromise, given the protectionist and free trade factions in the new federal Parliament.

After Federation, inland customs posts were no longer necessary, but regional ports typically sought to retain their custom houses and attendant bonded warehouses, as they were thought to facilitate efficient import and export. But the removal of the colonial era trade barriers made centralisation and cost-cutting attractive to the federal government, and, despite local opposition, many regional customs posts were decommissioned in the first decades of the 20th century. The ascendant role of income tax is also important here. In 1901-02, customs duties accounted for 86.2 per cent and excise 13.8 per cent of Commonwealth tax revenue. After the introduction of a federal income tax,[139] government tax revenue in 1918-19 for customs duties and income tax were roughly on par (35.3 per cent and 35.2 per cent respectively).[140] The neo-mercantilist postwar era saw a resurgence in customs revenue, as the world reverted to protectionism, which reached its peak in the 1928-29 tax year when revenue from customs duties contributed 52.4 per cent of government revenue, and income tax, just 17.4 per cent.[141] Since then, the percentage of revenue from customs has steadily declined,[142] as has the need for symbolic customs houses.

6. CONCLUSION

The central focus of this article lies with the symbolism of the architecture of pre-1914 Australian custom houses. Principally the Crown's counting houses in its expansion of empire, these buildings, perhaps more than any others, symbolised the formation and development of Australia from a single, fiscally precarious settlement to a cluster of thriving and competitive colonies, to a federal dominion asserting its position of prominence in British empire.[143]

The experiences of the Australian colonies, including customs duties, are shared and similar but also different. An overarching grand narrative is, nevertheless, the creation of Britannic offshoots in the colonies that would become the States and Territories of a unified dominion. These sub-nations needed funding, principally, from customs duties,

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[138] See Dianne Heriot, 'Western Australia: A State of Secession?' *FlagPost* (Blog, 1 September 2017) <https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/FlagPost/2017/September/WA_state_of_secession> (accessed 1 December 2023) (emphasis added). According to Day, above n 2, 362, 'The new Commonwealth of colonies was left with the formidable task of integrating a poorly trained and badly housed colonial department into a nationwide department of Trade and Customs'.
[139] See *Income Tax Assessment Act 1915* (Cth).
[140] See Australian Bureau of Statistics, above n 21.
[141] See ibid.
[142] See ibid.
[143] Summerson, above n 61, 43 observes: 'when you are in the Strand, just look across from there to the shop filled arches and arrogantly bedizened Doric column of Australia House', built at the peak of Britannic imperialism (1911-18).

and the maintenance of Britishness required exclusion of indigenous people and non-Britannic immigrants.

In massive tracts of land that lacked the signs and protocols of nationalism, custom houses symbolised parochial colonial government.

Magnificent customs buildings no longer announce the colonies' and, later, the Commonwealth's unique power to control and tax entrance of people and things into Australia. The symbolic buildings identified in this article have been converted for other uses – mostly cultural centres, but also hospitality venues. In their typical neoclassical style, references were made to both an ancient authority to tax and military force. Customs buildings were, therefore, designed to symbolise the fiscal and military control of the colonies. It is unlikely that any contemporary government would celebrate its power to levy customs duties through the construction of splendid portside edifices. However, the change of the name of the Customs *Service* to the Australian Border *Force* draws aside an ostensible veil of service to reveal the potential for violence that informs the Crown's assertion of the power to levy customs duties, and to enforce who and what enters the country's borders.

eJournal of Tax Research (2024) vol. 22, no. 2, pp. 222-256

New Zealand's first double tax agreement: the United Kingdom–New Zealand treaty of 1947

Ella Griffiths*

Abstract

The 1947 United Kingdom–New Zealand double taxation agreement was New Zealand's first comprehensive double tax treaty and one of the United Kingdom's earliest tax treaties. Initiated by the United Kingdom only two years after the landmark negotiation of the 1945 United States–United Kingdom treaty, the agreement largely reflected its contemporary tax policy toward its Dominions. It was concluded before the OECD produced the first version of its influential model treaty in 1963, and its drafting was influenced by other United Kingdom treaties. Although rudimentary compared to modern tax treaties, the agreement contained most of the provisions found in standard double tax agreements, albeit in an embryonic form. This article examines the provisions of the 1947 treaty and compares them to the articles of the OECD Model Convention, the basis for almost all modern double tax treaties. The 1947 treaty was a significant moment in the development of New Zealand's network of double tax treaties and is also a reminder of New Zealand's close ties to the United Kingdom at the time.

Keywords: double tax agreement, double taxation, OECD Model Convention, New Zealand, United Kingdom, tax treaty, DTA, tax history

* Senior Policy Advisor, Office of the Privacy Commissioner, New Zealand. Email: ellavaleriegriff@gmail.com. I am indebted to Professor C John Taylor who kindly sent me archival material on the 1966 treaty negotiations from London, making the topic of historic tax treaties come alive. To Professor Michael Littlewood of the University of Auckland, my wholehearted thanks for your support and persistence. I am very grateful to my family and friends for all their love, tolerance and referencing skills.

1. INTRODUCTION

There are more than 3,000 double tax agreements (DTAs) in operation today, providing relief from double taxation to the residents of the contracting states. New Zealand is party to 40 DTAs in this extensive network.[1] By removing the impediment of double taxation, DTAs foster cross-border trade and investment, and facilitate the movement of people and capital between countries.

The Model Convention on Income and Capital developed by the Organisation for Economic Co-operation and Development (OECD) has been enormously influential in the development of tax treaties; almost all modern DTAs are closely based on it. The OECD first published a draft model to aid harmonisation of tax treaties in 1963 (the OECD Draft Convention)[2] and later released the first version of the OECD Model Tax Convention on Income and on Capital (the OECD Model) in 1977, which has since been revised regularly.[3]

New Zealand's foray into the domain of international tax agreements began in 1947 with the conclusion of the agreement with the United Kingdom (UK) (the 1947 treaty).[4] This is not surprising considering the dominant role the United Kingdom played in New Zealand's economy and the global economy for most of the 20th century. Although some limited forms of unilateral relief had been implemented by each country before 1947, it was New Zealand's first comprehensive DTA, dealing with most major classes of income and requiring full tax credits for tax paid in the other country.

The 1947 treaty is notable also in that it is to date the only DTA that has been unilaterally terminated by New Zealand (in 1964).[5] The parties negotiated and entered into subsequent DTAs, in 1966 (the 1966 treaty)[6] and in 1984 (the 1984 treaty).[7] That third treaty remains in force and largely follows the prevailing OECD Model.

This article examines the 1947 treaty and places it within the international context of double tax treaties. As well as being New Zealand's first DTA, it was also one of the United Kingdom's earliest DTAs and formed part of that country's rapidly expanding treaty network after the negotiation of the landmark United States–United Kingdom

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[1] Inland Revenue Department, New Zealand, 'Tax Treaties', *Tax Policy* (Web Page, 27 November 2023) <www.taxpolicy.ird.govt.nz/tax-treaties>.

[2] OECD, *Draft Double Taxation Convention on Income and Capital* (OECD Publishing, 1963) ('OECD Draft Convention').

[3] OECD, *Model Tax Convention on Income and on Capital 2017* (OECD Publishing, 2019) ('OECD Model Tax Convention'). The original version was published in 1977, which was then updated in 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010, 2014 and most recently 2017.

[4] *Agreement Between the Government of the United Kingdom and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 27 May 1947, 17 UNTS 211 (entered into force 8 August 1947) ('1947 UK–New Zealand treaty').

[5] Terminated by notification of 1 July 1964, effective 1 July 1965.

[6] *Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 13 June 1966, 598 UNTS 121 (entered into force 11 August 1966) ('1966 UK–New Zealand treaty').

[7] *Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains*, signed 4 August 1983, 1416 UNTS 129 (entered into force 16 March 1984) ('1984 UK–New Zealand treaty').

treaty of 1945 (1945 US–UK treaty).[8] Concluded before the OECD produced their influential Model, the 1947 treaty was heavily shaped by contemporary British policy on tax treaties, as well as the recently concluded agreement with the United States. Although rudimentary compared to modern DTAs, many of the provisions of the 1947 treaty would be recognisable to those familiar with the current OECD Model.

First, it may be helpful to explain how DTAs operate and describe the relevant features of the two countries' tax systems at the time the 1947 treaty was negotiated. Then, in section 2, the study outlines the historical context leading up to the conclusion of the 1947 treaty, and in particular, the impact of the 1945 US–UK treaty. Section 3 considers the treaty itself and the terms of its 19 articles. The 19 articles fall broadly into the following categories: (1) scope provisions; (2) definitions; (3) provisions dealing with particular types of income; (4) provisions for the elimination of double tax; (5) anti-avoidance provisions, and (6) miscellaneous provisions. The study examines the terms of each article and compares them to the formulae used in the current version of the OECD Model and to contemporary tax treaties of the time. The development of the provisions in the two subsequent DTAs between New Zealand and the UK, the 1966 treaty and the current 1984 treaty, is also useful for understanding the articles of the first treaty. In section 4, the study sets out some conclusions.

1.1 The operation and impacts of double tax agreements

DTAs are concerned with juridical double tax; where two countries impose taxes on the same taxpayer in respect of the same income. The taxpayer's income is subject to tax in the country where it was sourced (the source country) and in the state where the taxpayer is resident (the residence state). A DTA allocates the taxing rights of the two participating governments by imposing obligations on each to restrict their taxing rights under domestic law in certain circumstances.

The 1947 treaty relieved the burden of double taxation by two methods, both reflected in the present OECD Model. First, the exclusive right to tax some classes of income was conferred upon the state of residence. Double taxation was eliminated because the *source country* agreed to exempt this income from tax. Second, where other classes of income were still subject to double tax because both states had the right to tax, the state of residence was obliged to relieve double taxation, by giving credit for tax paid in the other state.

Tax treaties are reciprocal; therefore, between countries with equal income flows, any contraction of revenue suffered by a country in its 'source' capacity would be balanced by its ability to tax residents on income sourced in the other country.[9] However, income flows are rarely equal between countries, especially when one is developed and the other is less developed. For a capital-exporting country, outward investment exceeds inward investment; therefore, it will be protective of its right to tax on a residence basis because its residents will be deriving income in other countries. In contrast, capital-importing

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[8] *Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains*, signed 16 April 1945, 6 UNTS 189 (entered into force 25 July 1946) ('1945 US–UK treaty').

[9] Oladiwura Ayeyemi Eyitayo-Oyesode, 'Source-Based Taxing Rights from the OECD to the UN Model Conventions: Unavailing Efforts and an Argument for Reform' (2020) 13(1) *Law and Development Review* 193.

countries are generally concerned with protecting their right to tax on the basis of source to preserve their right to tax income derived by non-residents, such as business profits and investment income (dividends, interest and royalties).

Early DTAs tended to allocate taxing rights in favour of the *residence* country and restrict the *source* country's rights to tax. This allocation thereby benefited *capital-exporting* countries seeking to retain taxing rights over their residents who had derived income in overseas jurisdictions.

New Zealand, in relation to the United Kingdom, is a net capital importer and has been since 1840. United Kingdom investment into New Zealand generally exceeds investment flowing the other way and was even more one-sided in 1947 than it is now. Therefore, New Zealand expected to give up more revenue under the 1947 treaty than it gained, due to the priority given to residence taxation. However, revenue is not the only consideration for a country concluding a treaty. DTAs encourage inward investment and trade by reducing or eliminating double taxation and although New Zealand may concede tax revenue, it might gain from the increased foreign investment and trade.

1.2 Relevant features of the countries' tax systems

1.2.1 United Kingdom's tax system

At the time of treaty negotiations, the financially sapped United Kingdom levied substantial rates of income tax and additional wartime taxes. A company was taxed on its total profits at the standard rate (50 per cent in 1945).[10] Distributed profits (dividends) were assumed to have already been subject to income tax, and a further surtax liability arose only for natural-person shareholders in higher income brackets than the standard rate. There was no withholding tax for dividends paid to non-residents and it was difficult to collect this surtax from them.[11]

A national defence contribution, introduced to finance the United Kingdom's involvement in World War II, was imposed upon company profits. Post-war, the national defence contribution was renamed profits tax, a tax covered by the 1947 treaty.

1.2.2 New Zealand's tax system

In the 1940s, New Zealand had a steep progressive income tax system driven by New Zealand's costly involvement in World War II and the Labour Party's welfare state agenda.[12] A progressive tax regime operates when higher tax rates are imposed on the taxpayer as their taxable income increases. On top of income tax, an additional 5 per cent social security charge was levied, funding a superannuation scheme.

[10] C John Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946' [2009] (2) *British Tax Review* 201, 204 ('The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946').
[11] Ibid.
[12] Paul Goldsmith, *We Won, You Lost, Eat That! A Political History of Tax in New Zealand Since 1840* (David Ling Publishing, 2008).

The company tax rate was also high and progressive, with the top bracket rate at 43.75 per cent in 1940.[13] At this time, the company tax regime was structured in a slightly unusual way. Companies were taxed on their profits, but dividends were exempt in the hands of shareholders, the rationale being that the income had already been taxed in the hands of the company.[14] However, exempting dividends from tax resulted in revenue loss as shareholders' income rates were higher than company tax rates.[15] The 'average-rate' system was used to mitigate this; income from dividends were included in the shareholder's assessable income to determine the shareholder's rate of tax to apply to their income, excluding the dividends which remained untaxed.[16] The average-rate system is reflected in several provisions in the 1947 treaty; specifically the dividends article, the credit provision and the article handling assessable income for New Zealand tax-setting purposes.[17]

2. BACKGROUND TO THE 1947 UK–NEW ZEALAND TREATY

2.1 The problem of double tax

Double tax became a problem from 1916 when New Zealand, mirroring the United Kingdom, moved to a worldwide model of taxation.[18] Income tax had previously been imposed exclusively on a *source* basis; tax was imposed on income derived in New Zealand (regardless of whether the taxpayer was a resident). From 1916 onwards, however, income tax was also levied on the worldwide income of persons and companies resident in New Zealand, on the basis of *residence*.[19] The United Kingdom had been taxing on a residence and source basis since 1803.[20] With both countries operating a worldwide taxation model, the issue of double taxation arose. Where a taxpayer engaged in cross-border income earning activities, they would generally be liable for tax on the same income in their country of residence *and* the country the income was sourced.

Such double taxation was a serious problem. In a 1916 issue, *The Economist* said:[21]

> The real difficulty is to answer the following question – 'which government, Downing Street or the Dominion, shall sacrifice its claim to the tax income sent from the colonies to England?'

In a 1918 issue, a letter to the editor discussed a hypothetical example of a company that traded in New Zealand and had it head office located in London to demonstrate the injustice of double taxation.[22] This theoretical company had profits of £15,000 to be

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[13] Annie Cho, 'The Five Phases of Company Taxation in New Zealand: 1840–2008' (2008) 14(1) *Auckland University Law Review* 150, 163.
[14] Ibid 150, 155.
[15] Ibid 151.
[16] Ibid.
[17] 1947 UK–New Zealand treaty, above n 4, Arts VI, XIII and XIV.
[18] *Land and Income Tax Act 1916* (NZ).
[19] Craig Elliffe, *International and Cross-Border Taxation in New Zealand* (Thomson Reuters, 2nd ed, 2018) 7.
[20] C John Taylor, '"Send a Strong Man to England – Capacity to Put Up a Fight More Important Than Intimate Knowledge of Income Tax Acts and Practice": Australia and the Development of the Dominion Income Tax Relief System of 1920' (2014) 12(1) *eJournal of Tax Research* 32, 34 ('"Send a Strong Man to England"').
[21] 'Double Income-Tax' (1916) 082 *The Economist* 451, 451.
[22] Merchant, 'Double Income Tax' (1918) 087 *The Economist* at 398, 398.

distributed among United Kingdom shareholders. The imposition of both New Zealand and United Kingdom taxes on the profits, the writer explained, resulted in a total tax of at least 50 per cent and 'so penalised the men whose energies are devoted to the development of internal trade of the British Empire'.[23]

Some international firms sought to mitigate their tax burden by restructuring, changing domicile or incorporating subsidies in overseas territories.[24] For instance, the United Kingdom firm Joseph Nathan and Co incorporated separate companies in Australia and New Zealand to avoid double taxation of their 'Glaxo' milk powder factories operating there.[25]

2.2 Early forms of double tax relief

2.2.1 Domestic relief for tax within the British Dominion

In 1916, when New Zealand started taxing residents on their offshore income, it also provided for the unilateral relief from tax of income which had been derived from and had borne tax in, other jurisdictions in the British Empire, including the United Kingdom.[26] Relief was provided by simply exempting the income from New Zealand tax. However, the exemption was not absolute and British-sourced income was subject to social security taxes.[27] This unilateral domestic relief continued to operate until 1962 when foreign tax credits were finally introduced.[28]

2.2.2 Orders in Council

Reflecting its status as a capital-importing country, New Zealand sought to protect and even extend source taxing rights, evident in two provisions dating back to the 1920s.[29] One provision deemed the profits of non-resident traders operating through independent agents in New Zealand as New Zealand-sourced income, ensuring the same tax treatment as non-resident traders operating through a branch. Another provision deemed any income derived by non-resident shipping countries from the carriage of goods from New Zealand as New Zealand-sourced. The established approach promoted by the League of Nations to tax shipping enterprises based on residence (where their 'real centre of management is situated') disadvantaged New Zealand which was dependent on foreign shipping companies for trade and it was felt that these companies should have to pay some New Zealand tax on profits derived from business there.[30]

New Zealand's protection over source taxing rights led to a clash with Belgium which was not happy with New Zealand taxing Belgian exporters on orders obtained in New Zealand through local agents.[31] As a result, in 1935, Parliament amended the *Land and Income Tax Act 1923* to give the Governor-General the power by Order in Council to

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[23] Ibid.
[24] Simon Mollan and Kevin D Tennent, 'International Taxation and Corporate Strategy: Evidence from British Overseas Business, Circa 1900–1965' (2015) 57(7) *Business History* 1054, 1062.
[25] Ibid.
[26] *Land and Income Tax Act 1916* (NZ) s 92.
[27] Andrew MC Smith, 'A History of New Zealand's Double Tax Agreements' (2010) 16 *New Zealand Journal of Taxation Law and Policy* 105, 106.
[28] *Land and Income Tax Amendment Act (No 2) 1962* (NZ) s 14.
[29] Smith, above n 27, 106.
[30] Ibid.
[31] Ibid 107.

exempt profits of non-resident traders from New Zealand tax if satisfied that the foreign country provided reciprocal relief.[32] In the period 1936-1946, seven such Orders in Council were made, one covering the United Kingdom (in 1942).[33] These Orders were limited compared to modern DTAs and generally only exempted the profits of the non-resident traders from New Zealand tax.[34]

The Order in Council relating to the United Kingdom was broader in scope than the others, likely as it was made pursuant to a treaty, and had retrospective effect (dated back five years to 1937).[35] As well as exempting profits of non-resident traders, it also exempted income derived from orders obtained by New Zealand agents of non-resident traders, including where the order was filled from a warehouse in the country as long as the warehouse was for delivery, not display, purposes.

2.2.3 *Dominion tax relief*

From the late 1880s, other British Dominions,[36] including Australia, South Africa and Canada also introduced income taxes and they exerted a growing pressure on the United Kingdom to provide relief from double taxation.[37] Various commercial societies such as the London Chamber of Commerce rallied to protest against double tax.[38] The United Kingdom responded with the introduction of the Dominion Relief system in 1920.[39]

Dominion Relief was a limited unilateral concession implemented by the United Kingdom, applying where income tax had been paid in the Dominion.[40] The United Kingdom gave credit for the lesser of the amount of tax paid in the Dominion or one-half of the amount payable in the United Kingdom. The aim of this mechanism was that the total tax paid should not exceed the greater of the tax calculated at the United Kingdom rate or the relevant Dominion rate. Where the Dominion tax rate was more than half the United Kingdom rate this was not the result because the credit given by the United Kingdom (of up to only one-half the amount payable in the United Kingdom) would not account for the full amount of tax paid in the Dominion. The final tax burden would be the United Kingdom tax plus the amount of Dominion tax not covered by the credit.

The expectation was that the Dominion would provide any relief required in excess of half the United Kingdom tax rate, but this was not expressly required under the Dominion system. However, while a list of reciprocating countries in 1925 showed that many Dominions did so, New Zealand was not among them.[41] A 1945 *Economist* article noted that this system did not require an undertaking by the Dominions to give mutual

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[32] *Land and Income Tax Amendment Act 1935* (NZ) s 11.
[33] These included Belgium (1936), Switzerland (1936), the Netherlands East Indies (1938), Japan (1938), Czechoslovakia (1938), the United Kingdom (1942) and Canada (1946): Smith, above n 27, 107.
[34] Smith, above n 27, 108.
[35] Ibid.
[36] The term 'Dominion' was used in the period 1907 to 1948 to refer to the self-governing countries within the British Empire, namely, Canada, Australia, New Zealand, Newfoundland, South Africa and the Irish Free State.
[37] Peter Harris, 'An Historic View of the Principle and Options for Double Tax Relief' [1999] (6) *British Tax Review* 469, 473.
[38] Ibid.
[39] *Finance Act 1916* (UK) s 43; *Finance Act 1920* (UK) s 27; Harris, above n 37.
[40] Harris, above n 37, 476; See generally Taylor, '"Send a Strong Man to England"', above n 20.
[41] HE Seed and AW Rawlinson, *Double Income Tax Relief: The Law and Practice Regarding the Relief from Double Taxation* (Pitman & Sons, 1925) 116.

relief and consequently 'very high' rates of tax were being paid by United Kingdom investors and businesses within the Empire, especially on profits derived from New Zealand and Australia.[42] Nevertheless, Dominion tax relief remained essentially unchanged as the double tax relief mechanism used throughout the British Empire for the next 25 years.[43]

2.3 The international context

High taxation levels in industrial countries led some countries to initiate a coordinated response to double taxation in the 1920s.[44] In 1920, the Brussels International Financial Conference asked the League of Nations to investigate the problem of double taxation.[45] The resulting report formed the basis for draft tax agreements authored by the League of Nation's Fiscal Committee in 1928; the inception of the modern DTA.[46] A handful of European countries and the United States started concluding DTAs based on these drafts which the Fiscal Committee continued to revise through the 1930s and 1940s. Britain, however, lagged behind and apart from a treaty with Ireland in 1926, did not conclude any comprehensive DTAs until the end of World War II.[47] The allocation rules adopted by the League's Fiscal Committee into their draft treaties divided taxing rights to classes of income between source and residence countries.[48] By contrast, the United Kingdom advocated for taxation on the basis of residence which benefited its position as a capital exporter and refused to enter into any DTAs due to its strong objection to source country taxation.[49] Moreover, the United Kingdom was reluctant to enter DTAs which gave other countries more favourable arrangements than within the British Empire under Dominion Relief.[50] Eventually, financially sapped by the War and heavily indebted to the United States, the United Kingdom agreed to a treaty in 1945. The 1945 US–UK treaty was a significant landmark in the history of DTAs, both as the United Kingdom's first comprehensive DTA and due to its enduring influence on treaty development.[51]

The 1945 US–UK treaty marked the start of a rapidly proliferating United Kingdom treaty network and was a key development leading to its agreement with New Zealand. Even before negotiations with the United States, the United Kingdom realised they would need to reform the existing Dominion Relief.[52] Under the 1945 US–UK treaty with the United States, the United Kingdom had agreed to allow a foreign tax credit for United States tax paid up to the *full* amount of United Kingdom tax the taxpayer was

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[42] 'Double Taxation' (1945) 148 *The Economist* 601.
[43] Harris, above n 37, 477.
[44] Mollan and Tennent, above n 24, 1059.
[45] Kevin Holmes, *International Tax Policy and Double Tax Treaties: An Introduction to Principles and Application* (IBFD Publications, 2nd ed, 2014) [3.4.1].
[46] Ibid.
[47] Mollan and Tennent, above n 24, 1059.
[48] Harris, above n 37, 477.
[49] Ibid.
[50] Ibid.
[51] John F Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement' [2007] (3) *British Tax Review* 211, 254 ('The History of the United Kingdom's First Comprehensive Double Taxation Agreement').
[52] Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946', above n 10, 207.

liable for and therefore was more generous than Dominion Relief (where credit was given only up to *half* the United Kingdom tax).

Not wishing to treat the United States more favourably than its Dominions, the United Kingdom initiated negotiations and concluded agreements with Canada (1946), Australia (1947), South Africa (1947) and New Zealand (1947).[53] The implementation of the United States treaty also opened the United Kingdom to DTAs with non-Empire countries, including France (1947), Sweden (1949), and Israel (1950). By 1951, Britain had concluded 50 DTAs, a large proportion of these with countries within the British Commonwealth.[54]

In 1947, New Zealand's economic ties to the United Kingdom were extensive. The United Kingdom was New Zealand's principal market for trade and it was a major source of capital; the relationship 'resembled that of a colony rather than independent dominion'.[55] In addition, the policies adopted by the United Kingdom were highly influential, and in light of this, it is not surprising that New Zealand accepted the offer to negotiate a DTA.

The draft treaty that the United Kingdom sent to New Zealand was very likely the same draft sent to initiate negotiations with other British Dominions, including Canada and Australia.[56] This 'colonial model' developed by the United Kingdom generally provided for taxation of dividends on a residence basis and had distinctive structural features. Australia and New Zealand negotiated their treaty with the United Kingdom at the same time and the final DTAs of each country were quite similar.

3. THE 1947 UK–NEW ZEALAND TREATY

The UK–New Zealand treaty was signed on 27 May 1947 by the countries' respective finance ministers, Walter Nash for New Zealand and Hugh Dalton for the United Kingdom.

With only 19 articles, the treaty is short compared with modern DTAs which typically have around 30 articles. This section covers each article organised into the following categories: scope provisions, definitions, substantive provisions, double tax relief, anti-avoidance and miscellaneous.[57]

3.1 Scope provisions

Setting the parameters for the treaty's operation, the scope provisions included the title and preamble, Article I (taxes covered), Article XVII (entry into force), Article XVIII (succession of previous agreement) and Article XIX (termination).

[53] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 236.

[54] Harris, above n 37, 477.

[55] David Hall, *Emerging from an Entrenched Colonial Economy: New Zealand Primary Production, Britain and the EEC, 1945–1975* (Palgrave Macmillan, 2017) 23-24.

[56] Ibid 277; Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946', above n 10, 238.

[57] Philip Baker, *Double Taxation Conventions: A Manual on the OECD Model Tax Convention on Income and on Capital* (Sweet & Maxwell, 3rd ed, 2001) [D.01] ('*Double Taxation Conventions*').

3.1.1 *Title and preamble*

The title and preamble outlined the twin purposes of the DTA which were 'the avoidance of double taxation' and 'the prevention of fiscal evasion'. The principal focus of early DTAs was the problem of double tax, although the inclusion of articles on 'associated enterprises' and 'exchange of information' demonstrates that tax avoidance and evasion were also issues of interest at this time.

Today, the prevention of fiscal evasion is a significant motivation for entering tax treaties. Globalisation trends over the last few decades combined with the complexity of international tax rules have created opportunities for the tax planning industry to exploit and have led to the proliferation of avoidance and evasion.[58] Provisions in tax treaties like the exchange of information mechanism in tax treaties empower governments to fight avoidance and evasion activities by circumventing strict confidentiality laws which would otherwise protect tax administration information. Amendments made to the current UK–New Zealand treaty in the last two decades were primarily to counter tax avoidance and evasion.[59]

3.1.2 *Entry into force*

As with modern DTAs, the entry into force provision stipulated the agreement would come into force after each country had completed its domestic ratification process, usually signalled by the exchange of diplomatic notes.[60] In 1946, at the time of the negotiations, New Zealand law did not contain any provision enabling the government to enter bilateral tax treaties. The *Land and Income Tax Act 1923* was accordingly amended to give the government authority to negotiate an agreement with the United Kingdom.[61] The 1947 agreement was ratified by the *Double Taxation Relief (United Kingdom) Order 1947* which enabled it to override domestic law to, in some circumstances, waive tax that would otherwise have been payable, which is in fact an integral function of DTAs. Article XVII (entry into force) also lists the date of *effect* for each tax covered by the DTA to mark the tax period from which the agreement will have practical impact on tax liabilities.

To avoid conflicts and inconsistencies and ensure legal clarity, Article XVIII of the 1947 treaty deemed the previous 1942 Order in Council made by New Zealand with respect to the United Kingdom to be superseded. In modern tax treaties, any previous agreements are terminated under the 'entry into force' article.[62]

3.1.3 *Termination*

The termination article provided that either country could give notice to terminate the treaty just one year after it had come into force.[63] This is a notably short time period. By contrast, the concurrent 1946 UK–Australian agreement was not able to be terminated

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[58] Graham Hunt, 'New Zealand's Evolving Approach to Tax Treaties' (2008) 14 *New Zealand Journal of Taxation Law and Policy* 131, 137.
[59] The 1984 UK–New Zealand treaty, above n 7, was amended by protocols to the agreement in 2003 and 2007 to reflect updates to the OECD Model and by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in 2017.
[60] 1947 UK–New Zealand treaty, above n 4, Art XVII.
[61] *Land and Income Tax Amendment Act 1946* (NZ) s 5, amending *Land and Income Tax Act 1923* (NZ).
[62] OECD Model Tax Convention, above n 3, Art 31.
[63] 1947 UK–New Zealand treaty, above n 4, Art XIX.

before March 1954, ensuring its application for at least eight years. This difference perhaps indicates a level of uncertainty the New Zealand government may have felt about the agreement. Eventually, after 17 years of operation, New Zealand gave notice to terminate in 1964,[64] the only time New Zealand has one-sidedly ended a tax treaty.[65]

Changes to the New Zealand tax system, namely the introduction of non-resident withholding tax (NRWT), were a major impetus for the termination. The government was also paying closer attention to the increase of foreign investment in New Zealand over the previous two decades and was concerned that the treaty was costing New Zealand considerable revenue.[66]

It is usual to negotiate a successor treaty before ending one; however, no treaty had been negotiated when New Zealand terminated the 1947 treaty. Two years after the notice of termination, a second treaty was signed in 1966 following negotiations conducted in Wellington (1966 UK–New Zealand treaty) and had retrospective effect to ensure continuity between the two treaties.[67]

The 1966 UK–New Zealand treaty was developed after the OECD published its Draft Convention in 1963 providing a standard template for countries concluding DTAs. The 1966 treaty is an amalgamation of the previous treaty and the OECD Draft Convention; it largely followed the wording used in the Draft Convention but had the same structure as the 1947 treaty. It had several substantial differences in taxing rights, for instance allowing dividends and royalties to be taxed based on source. A third treaty with the United Kingdom was concluded in 1984 to succeed the second one.[68] This treaty remains in force currently and closely follows the provisions in the influential OECD Model which had been released by a few years prior, in 1977. The 1984 treaty has been amended several times. Protocols in 2003 and 2007 made changes to reflect updates to the OECD Model and to deal with schemes designed to avoid the UK capital gains tax. Both the United Kingdom and New Zealand signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) in 2017 and so the current treaty is accordingly modified by the MLI.

3.1.4 Taxes covered

The first article of the 1947 treaty listed the taxes the treaty was to apply to.[69] For New Zealand these were the income tax and the social security charge and for the United Kingdom, the income tax, including the surtax, and the profits tax.[70] As outlined above, the surtax was a further tax on dividends paid to natural-person shareholders. Neither New Zealand nor the United Kingdom taxed capital gains at this time; in 1965 the United Kingdom introduced a capital gains tax which is subject to the current treaty.[71]

Any future modification to either country's tax system was captured by providing that the treaty also applied to any taxes of a 'substantially similar character' imposed by

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[64] Notified 1 July 1964, termination effective 1 April 1965.
[65] Smith, above n 27, 113.
[66] Ibid.
[67] Signed 13 June 1966.
[68] 1966 UK–New Zealand treaty, above n 6.
[69] 1947 UK–New Zealand treaty, above n 4, Art I.
[70] Ibid Art I(1).
[71] 1984 UK–New Zealand treaty, above n 7, Art 2(1)(a)(iii).

either country after the date of signature.[72] Under the OECD Model, each state is required to notify the other if it makes significant changes to its taxation laws.[73]

3.2 Definitions

Most of the significant terms used in the treaty were defined in Article II. Several terms still used in the OECD Model are relatively unchanged and uncontroversial, including 'person' and 'company'.[74] In contrast, the definitions for 'resident' and 'permanent establishment' have been considerably developed since 1947 and are the subject of their own articles in the OECD Model, reflecting the importance of these concepts.[75]

Terms not defined were captured by the definitional rule, which instructed that undefined terms were to be given meaning by reference to the domestic law of the state applying the provision, and where possible the domestic tax law, which was to take precedence over a definition proposed by other law.[76] The modern counterpart is similar.[77]

3.2.1 Country definitions

The definitions of 'United Kingdom' and 'New Zealand' designated the territorial application of the treaty.[78] 'New Zealand' included 'all islands and territories' within its limits and specifically included the Cook Islands. The other territories within New Zealand limits at this time were Niue, Samoa and Tokelau.[79] New Zealand's current treaty practice is to specifically exclude the now self-governing territories of Samoa, Niue and the Cook Islands as well as the dependent territory of Tokelau.[80]

The subsequent 1966 UK–New Zealand treaty included the continental shelf in the definitions of each country, reflecting developments in international law which established the right of coastal states to the large area of shallow seafloor off their shoreline.[81] Including the continental shelf in the country definitions allowed income from oil drilling and other activities to come within the application of the treaty and was especially included in the 1966 agreement because offshore exploration for oil had begun.[82]

3.2.2 Taxation authorities

The term 'taxation authorities' referred to New Zealand and the United Kingdom's respective Commissioner of Taxes and Commissioners of Inland Revenue, their

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[72] 1947 UK–New Zealand treaty, above n 4, Art I(2).
[73] OECD Model Tax Convention, above n 3, Art 2(4).
[74] 1947 UK–New Zealand treaty, above n 4, Arts II(1)(e) and (f); OECD Model Tax Convention, above n 3, Arts 3(1)(a) and (b).
[75] OECD Model Tax Convention, above n 3, Arts 5 and 7.
[76] 1947 UK–New Zealand treaty, above n 4, Art II(3).
[77] OECD Model Tax Convention, above n 3, Art 3(2).
[78] 1947 UK–New Zealand treaty, above n 4, Art II(1)(a) and (b).
[79] Jon Fraenkel, 'Pacific Islands and New Zealand', *Te Ara – The Encyclopedia of New Zealand* (Web Page) <https://teara.govt.nz/mi/pacific-islands-and-new-zealand/print> (accessed 23 December 2023).
[80] Hunt, above n 58, 154.
[81] Ibid 155.
[82] Ibid; unknown author, 'Notes of Meeting in Wellington February 1966', The National Archives (UK), IR40/17246 (Inland Revenue) ('1966 Meeting Notes').

authorised representatives, and the competent authority of any territory to which the agreement was extended.[83]

3.2.3 Residence

The concept of residence is central to the operation of DTAs. Only taxpayers who are residents of the two contracting countries obtain the benefits of the agreement. Further, residence is one of the factors used to allocate taxing rights (the other factor being the source of the income); for certain types of income only the taxpayer's country of residence is permitted to tax that income. DTAs typically do not dictate rules for determining who is a tax resident, but instead defer to the domestic law of each contracting country.[84] This holds in the 1947 treaty where a 'New Zealand resident' was 'any person who was resident in New Zealand for the purposes of New Zealand tax and not resident of the United Kingdom' for its tax purposes, and the same applied for 'United Kingdom resident'.[85]

However, the residence provision in the 1947 treaty was notable because it did not include a mechanism to determine the treaty residence of dual-resident taxpayers, that is, natural person taxpayers who are considered a resident of both contracting countries under the respective domestic laws. In fact, the definition of residence was structured to exclude taxpayers who were dual residents and hence excluded these taxpayers from treaty benefits.

Resolution of dual residence was not covered in the United Kingdom's tax treaties until after it had been dealt with in a 1958 report by the Organisation for European Economic Co-operation (the predecessor organisation to the OECD).[86] The residence clause in the successive 1966 UK–New Zealand treaty included a dual resident 'tie-breaker' test that was almost identical to the one in the current OECD Model.

Today, the 'tie-breaker' test set out in Article 4 of the OECD Model is one of the most invoked provisions in modern DTAs. Globalisation has facilitated the mobility of people across borders and it is not uncommon for individuals to find themselves considered resident for tax purposes in more than one country. The tie-breaker test deems a dual resident taxpayer the resident of one of the contracting countries by applying several criteria to determine the taxpayer's connection to that country, such as where the taxpayer has their permanent home.[87]

For companies, the residence rule in the 1947 treaty had an additional limb: 'a company shall be regarded as resident in the United Kingdom and not resident in New Zealand if its business is managed and controlled in the United Kingdom' and vice versa. The effect of this limb was that in the case of dual residency, primacy was to be given to management and control. Under New Zealand domestic law at the time, the test of company residence was incorporation or centre of administrative management in New Zealand; under United Kingdom law, the test was management and control in the United

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[83] 1947 UK–New Zealand treaty, above n 4, Art XV(2).
[84] OECD, Model Tax Convention, above n 3, Commentary on Article 4, paras 4-7.
[85] 1947 UK–New Zealand treaty, above n 4, Art II(1)(g).
[86] John F Avery Jones, 'The Definition of Company Residence in Early UK Tax Treaties' [2008] (5) *British Tax Review* 556, 556, n 1 ('The Definition of Company Residence').
[87] OECD Model Tax Convention, above n 3, Art 4(2).

Kingdom.[88] Dual residence could arise when a company was incorporated in New Zealand but managed and controlled in the United Kingdom. In these cases, with priority given to management and control, the company would be regarded as a United Kingdom resident for the purposes of the treaty.[89]

Many of the United Kingdom's early tax treaties had a similar formulation where the other contracting country had an incorporation residence test.[90] These countries, including New Zealand, were willing to give up incorporation as the basis for corporate residence, presumably acknowledging that the United Kingdom had the better right to tax on a factual rather than legal test, as jurisdiction of incorporation is easy to manipulate.[91] In contrast, the United States was not willing to give up the incorporation test, leaving a company incorporated in the United States but controlled and managed in the United Kingdom as a dual resident and outside the ambit of the treaty benefits.[92]

Instead of 'management and control', the OECD has preferred the phrase 'place of effective management' as the tie-breaker test for dual resident companies and has used this test in its model tax conventions since the 1963 Draft Convention.[93] In 2017 however, the OECD Model was revised, and the test was replaced with an alternative formula where contracting countries must resolve a dual residency of a company by mutual agreement on a case-by-case basis.[94] The OECD considered that although dual-resident companies are relatively rare, cases involving dual-resident companies often involve tax avoidance arrangements, and are best solved on an individual approach.[95]

3.2.4 Enterprise, and industrial or commercial profits

The definitions of 'enterprise' and 'industrial or commercial profits' were important for the operation of Article III which allocates the right to tax the industrial or commercial profits of an enterprise to the resident country, unless the enterprise is operating through a fixed place of business (a permanent establishment).[96] Under the slightly convoluted definition in the 1947 treaty, 'enterprise' was defined to mean an 'industrial or commercial enterprise or undertaking' carried on by a resident of one of the countries[97] and 'industrial or commercial enterprise or undertaking' was further defined to expressly include activities in mining, agriculture and pastoral farming, and the business of banking, insurance, life insurance and dealing in investments.[98] These areas likely formed the bulk of the economic activity between the two countries and the two governments presumably wanted to ensure application of the relevant article to them.

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[88] *Land and Income Tax Act 1923* (NZ) s 86; Avery Jones, 'The Definition of Company Residence', above n 86, 573.
[89] John F Avery Jones, 'Corporate Residence in Common Law: The Origins and Current Issues' in Guglielmo Maisto (ed), *Residence of Companies Under Tax Treaties and EC Law* (IBFD Publications, 2009) 121, 165 and 169.
[90] Ibid 168.
[91] Ibid 167.
[92] Ibid 166.
[93] Avery Jones, 'The Definition of Company Residence', above n 86, 576.
[94] Ibid.
[95] OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2015) 72.
[96] The modern equivalent is Article 7 of the OECD Model Tax Convention which deals with business profits.
[97] 1947 UK–New Zealand treaty, above n 4, Art II(1)(i).
[98] Ibid Art II(1)(j).

The archaic term 'industrial or commercial profits' immediately betrays the age of the agreement. Unsurprisingly, industrial or commercial profits were the profits derived from the activities of industrial or commercial enterprises or undertakings. However, several types of income were expressly excluded from the definition: dividends, interest, rents, royalties, management charges or remuneration for personal services.[99] Some of these types of income were dealt with elsewhere in the treaty under specific provisions (dividends, royalties) and excluding them from the definition of industrial and commercial profits was intended to ensure that Article III did not apply to them. Where a form of income was not addressed elsewhere in the treaty (interest, rents and management charges), the intention was that the taxation of that income would be subject to the domestic laws of each respective country.[100] Where double taxation arose from domestic taxation, Article XIV of the 1947 treaty would direct the residence state to give relief in the form of a credit, thereby ensuring that the *source* country retained full taxation rights to interest, rents and management charges.

By contrast, the OECD Model defines 'enterprise' simply and broadly as 'the carrying on of any business' and omits a definition of the term 'business profits'.[101]

Defining industrial or commercial profits in a way that excluded some types of income was a distinctive structural feature of the United Kingdom's treaties with other Dominions, such as the 1946 UK–Australia agreement. This structure has been described as the 'colonial model' as it appears to have been present in the United Kingdom draft agreement sent to all British Dominions to initiate negotiations but was not a feature in other treaties such as the 1945 US–UK treaty.[102] This arrangement appears unnecessarily complicated compared to the more straightforward way enterprises and business profits are dealt with in modern treaties. It was evidently influential, and features in New Zealand's subsequent treaties with the United States (1948), Canada (1948) and Australia (1960). It also remained in New Zealand's 1966 treaty with the United Kingdom, despite the British doubting whether a definition of industrial or commercial profits was 'really necessary'.[103]

3.2.5 Permanent establishment

The right of a contracting country to tax the industrial or commercial profits of an enterprise of the other contracting country was decided by reference to the permanent establishment (PE) concept.[104] The PE concept was likely already the international norm by the time of negotiating the 1947 treaty through the work of the League of Nations.[105] The concept reflects a basic principle developed in this work; taxation on the basis of economic allegiance. Under this principle, the source country should be able to tax a foreign enterprise with a real and substantial economic nexus with the country where

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[99] Ibid.
[100] Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946', above n 10, 238.
[101] OECD Model Tax Convention, above n 3, Art 3(1)(c).
[102] C John Taylor, 'Some Distinctive Features of Australian Treaty Practice: An Examination of Their Origins and Interpretation' (2011) 9(3) *eJournal of Tax Research* 294, 294 n 1.
[103] 1966 Meeting Notes, above n 82.
[104] 1947 UK–New Zealand treaty, above n 4, Art III.
[105] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 240.

the profits are sourced. Whether a foreign company has such a connection to the source country is established through the concept of PE.

The definition of PE in the 1947 treaty was rudimentary by modern standards, although all of its elements are still found in some form in the OECD Model definition.[106] The essential test of a PE was the physical 'situs' test: an enterprise had a PE in the other contracting country if it had a 'branch, management, factory, mine, farm, or other fixed place of business' there.[107] There were several exceptions to this rule, for purchase of goods, business dealings and subsidiaries. Under these exceptions, simply having a fixed place of business to purchase goods, doing business through a legitimate broker or general commission agent, or having a subsidiary in the other contracting country would not of itself mean that the enterprise was deemed to have a PE in a contracting state. On the other hand, an enterprise would be deemed to have a PE where it used an agent in the other contracting country who 'has, and habitually exercises, a general authority to negotiate and conclude contracts' in the other country, or who 'regularly fills orders' on behalf of the enterprise from stock in that other country. This latter provision was a fairly basic precursor of the now elaborate dependent agent test set out in Article 5(5) of the OECD Model.

With the proliferation of companies operating internationally, the PE concept is one of the most important provisions in all DTAs based on the OECD Model. The definition of PE is an attempt to divide the taxing rights of business profits of a company where it operates across borders. Naturally, where the line should be drawn is contentious and the PE definition has evolved significantly since early DTAs where the focus was on a bricks-and-mortar nexus.[108] The definition has also undergone significant further revisions to deal with issues raised by its practical application and the artificial avoidance of PE status by multinational enterprises. Most recently, the 2017 MLI amended Article 5(5) to capture schemes where a dependent agent in one contracting country habitually negotiates contracts for its non-resident parents but leaves the formalities of offer and acceptance to the parent enterprise to avoid tax in that country.[109]

Now the extensive definition of PE is outlined in a standalone article in the OECD Model and includes a list of passive and preparatory activities that will not constitute a PE. By contrast, the definition was not regarded as a particularly important concept by the United Kingdom in their 1945 negotiations with the United States and, in 1965, the Deputy Chairman of the United Kingdom Inland Revenue wrote that those negotiating the treaty 'might be surprised to see the highly sophisticated definition which now appears in the model convention of the OECD'.[110]

3.3 Substantive articles

The substantive articles in a DTA allocate the right to tax particular categories of income to either the country where the income is derived (the source country) or the country

[106] 1947 UK–New Zealand treaty, above n 4, Art II(1)(k); OECD Model Tax Convention, above n 3, Art 5; C John Taylor, 'Twilight of the Neanderthals, or Are Bilateral Double Taxation Treaty Networks Sustainable?' (2010) 34(1) *Melbourne University Law Review* 268, 272 ('Twilight of the Neanderthals').
[107] 1947 UK–New Zealand treaty, above n 4, Art II(1)(k); OECD Model Tax Convention, above n 3, Art 5.
[108] Julia Bellemare, 'Evolution of the Permanent Establishment Concept' (2017) 65(3) *Canadian Tax Journal* 725, 728.
[109] Ibid 740.
[110] Robert Willis, 'Great Britain's Part in the Development of Double Taxation Relief' [1965] (4) *British Tax Review* 270, 278.

where the person or company receiving the income is resident (the resident country). Substantive articles usually allocate taxing rights in one of three ways, namely: (1) the source country may tax without limit; (2) the source country may tax up to a maximum, or (3) the source country may not tax the income at all, the residence country has the exclusive right to tax.[111]

In the 1947 treaty, all apart from one of the substantive articles were in the third form, where the jurisdiction to tax the income was allocated exclusively to the residence state. Otherwise, these articles (concerning income from shipping, dividends, royalties, government remuneration, employment income, pensions and annuities, and income of visiting professors and teachers, and students and apprentices)[112] stipulated that the income 'shall be *exempt from*' tax in the other territory, ie, the source country, whereas equivalent provisions in the OECD Model read 'shall be *taxable only* that other State [the residence country]'.[113]

The substantive provision that took a different form was the article dealing with industrial or commercial profits which permitted exclusive *source* taxation of profits derived from a PE in the source country.[114] The equivalent article in the OECD Model that deals with business profits also confers exclusive taxing rights on the source country.[115]

None of the substantive articles in the 1947 agreement assigned taxing rights according to the second method, where the source country is given taxing rights up to a maximum. In modern DTAs, as reflected in the OECD Model, income arising in the form of dividends and interest is generally taxed in this way.[116] For instance, in the current UK–New Zealand treaty the source country has the right to tax dividends up to a maximum rate of 15 per cent.[117]

An analysis of the substantive articles in the 1947 treaty reveals a tendency to prioritize the taxing rights of the residence country over the country where the income originated. As discussed earlier, in cases where capital flows are balanced between the two contracting countries, this approach results in a fair division of taxable revenue. However, when capital flows are unequal, the capital-exporting country (in this case, the United Kingdom, both in 1947 and presently) stands to benefit. This is because its residents are likely to generate more income from investments in the capital-importing country that is party to the treaty (New Zealand in this case) than residents of the capital-importing country would in the reverse scenario.

3.3.1 Industrial or commercial profits

Article III governed the right of a country to tax the profits of a foreign enterprise and was the precursor of the business profits article in the OECD Model.[118]

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[111] Baker, *Double Taxation Conventions*, above n 57, [D.06].
[112] 1947 UK–New Zealand treaty, above n 4, Arts V, VI(1), VII(1), VIII(1), IX, X(1), XI(1) and XII(1).
[113] Ibid (emphasis added).
[114] Ibid Art III.
[115] OECD Model Tax Convention, above n 3, Art 7.
[116] Ibid Arts 10 and 11.
[117] 1984 UK–New Zealand treaty, above n 7, Art 11.
[118] OECD Model Tax Convention, above n 3, Art 7.

The PE concept was fundamental to the operation of Article III. The profits of a United Kingdom or New Zealand enterprise operating in the other country were *only* taxable in that country if the enterprise operated its business there through a PE. If the business of the enterprise did not constitute a PE, the source country could not tax the profits of the foreign enterprise; taxing rights were conferred exclusively on the residence state.

The profits that were permitted to be taxed by the source country were those profits that could be *attributed* to the PE of the foreign enterprise. To determine 'attributable' profits, the PE was to be treated as a separate entity and the profits that attached to the PE were the profits it would expect to derive in the source country if it were an independent enterprise engaged in the same activities, holding arm's length contracts with the main enterprise or an independent enterprise.[119]

This attribution method in the 1947 treaty can be contrasted with the 'force of attraction' method adopted in the contemporaneous 1945 US–UK treaty, originating from a domestic United States policy.[120] Under the 'force of attraction' method, the source country had the right to tax all of the foreign enterprise's profits derived there, even those unrelated to the activity of the PE. This rule considerably expanded the rights of a source country to tax the profits of a non-resident enterprise. Nevertheless, it was the attribution method that became standard in modern DTAs.[121]

The attribution method provision in the 1947 treaty contained an unusual clause for a United Kingdom DTA at the time; a savings clause that permitted the domestic tax authority to exercise discretion in determining the income attributable to the permanent establishment where there was insufficient information to apply the arm's length principle.[122] This clause originates from the United Kingdom's DTA with Australia concluded in 1946.[123] Australia pushed for the inclusion of a savings clause to ensure the treaty did not affect a provision in domestic law that empowered the taxation authority to determine the taxable income of a business but did not require the assessment to be in accordance with arm's length principles.[124] Evidently, New Zealand also wanted to include the clause in its treaty with the United Kingdom which, at the very least, provided some leeway in the application of the arm's length principle in some cases. It remained in the 1966 treaty but is not found in the current UK–New Zealand treaty or the OECD Model.

Consistent with New Zealand's longstanding policy of protecting its right to tax non-resident insurers, any business of insurance carried on in New Zealand by a United Kingdom resident was excluded from Article III thus allowing New Zealand to tax these insurers in the absence of a PE, based its domestic rules.[125] Almost all of New Zealand's current DTAs provide a similar carve-out for income from insurance from the equivalent business profits article, for example, Article 8(6) of New Zealand's present

[119] 1947 UK–New Zealand treaty, above n 4, Art III(3).
[120] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 242 n 198.
[121] OECD Model Tax Convention, above n 3, Art 7(2).
[122] 1947 UK–New Zealand treaty, above n 4, Art III(3).
[123] See Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946', above n 10, 201 for a discussion of the negotiation leading to the inclusion of this savings clause.
[124] Ibid 226-227.
[125] Smith, above n 27, 109 and 1947 UK–New Zealand treaty, above n 4, Art III(1).

treaty with the United Kingdom.[126] This is likely to arise from a concern about tax avoidance as deductions for offshore insurance premiums can be manipulated to artificially lower business profits thereby avoiding New Zealand's jurisdiction to tax such income.[127]

Article III(4) provided that profits arising from the sale of goods were excluded from being attributed to a PE if the goods were stocked in a warehouse in the PE country 'for convenience of delivery'. An equivalent provision does not exist in the OECD Model business profits article, possibly because it is partially redundant in light of Article 5(4)(a) which provides that the use of facilities in the other country solely for the delivery of goods will not trigger the threshold for a PE.

The last provision in Article III stated no profits shall be attributed to a PE solely due to its purchase of goods for the enterprise.[128] An equivalent provision was removed from the OECD Model in 2010. The reason for removing the provision was that it would be inconsistent and administratively difficult to exempt profits from purchasing activities when profits from the PE's other activities are attributable to the PE under the arm's length principle.[129]

The equivalent OECD Model Article 7 dealing with business profits contains the same general rule as the industrial or commercial profits article in the 1947 treaty; the portion of a non-resident enterprise's profits attributable to a PE are taxable in the country where the PE is located. One provision not found in the 1947 treaty is the priority rule in Article 7(4) of the OECD Model, stipulating that articles addressing specific types of income take precedence over Article 7.[130] Business profits could include several different types of income and it could be unclear which article was to apply; the priority rule thereby removes any uncertainty.[131] An equivalent priority rule was not needed in the 1947 treaty because the definition of profits expressly excluded types of income covered by separate articles in the treaty (a feature of the so-called 'colonial model') so there was no doubt as to whether Article III would apply.

3.3.2 Shipping and aircraft profits

The shortest article in the 1947 treaty provided that profits from operating ships and aircraft were to be taxed by the taxpayer's country of residence.[132] Resident taxation would apply even if the shipping operator had a PE in the other country. For example, a United Kingdom company operating a shipping company between the United Kingdom and New Zealand with a branch office in New Zealand was exempt from tax there despite having a PE in New Zealand.

The present rule on shipping and aircraft income in the OECD Model also provides for taxation on a residence basis, which has been the case since the League of Nations' early

[126] Hunt, above n 58, 161.
[127] Ibid.
[128] 1947 UK–New Zealand treaty, above n 4, Art III(5).
[129] OECD Model Tax Convention, above n 3, Commentary on Article 7, para 43.
[130] John F Avery Jones, 'Understanding the OECD Model Tax Convention: The Lesson of History' (2009) 10(1) *Florida Tax Review* 1, 27.
[131] Peter Hongler, *International Law of Taxation* (Oxford University Press, 2021) [2.3.5.3](c).
[132] 1947 UK–New Zealand treaty, above n 4, Art V.

drafts.[133] It was hotly contested at the time; however, the League of Nations experts drafting the 1928 model tax treaties eventually agreed that income from shipping should be taxable only in the country where the 'real centre of management' was situated.[134] This policy suited the interests of the United Kingdom which was the undisputed world maritime power at the beginning of the 20th century, owning 45 per cent of the international fleet, and still had the third largest flagged fleet in 1967.[135] Without exception, the United Kingdom's early double tax agreements provided that profits derived by United Kingdom residents from the international operation of ships would be exempt from tax in the other country.[136]

Nevertheless, the right to tax shipping profits was also a sensitive issue for New Zealand, a remote island country dependent on international shipping for freight and passenger transport. New Zealand had previously enacted legislation deeming income derived by non-resident shipping companies from the carriage of goods from New Zealand as New Zealand-sourced income and thus subject to tax.[137] However, the United Kingdom's position on shipping was unyielding. It refused to enter DTAs without a provision to exempt shipping income in the source country, this being the reason why the United Kingdom did not have an agreement with India, and evidently New Zealand conceded to the exemption.[138] When the recently signed treaty was discussed in the New Zealand Parliament in 1947, the shipping article was noted in particular.[139] Mr Bowden MP observed that the New Zealand Shipping Company, registered in the United Kingdom, which had been previously taxed on its income derived in New Zealand by New Zealand, would now only be levied tax in the United Kingdom. The Union Steam Shipping Company, on the other hand, if trading between the two countries and earning income from freight in the United Kingdom, would only be subject to income tax in New Zealand. As the example demonstrates, the source taxation exemption was reciprocal; however, the shipping provision was likely in the United Kingdom's favour because of its dominance in the industry. To illustrate, 'across the ditch', Australia was reluctant to agree to residence taxation of shipping because it would effectively mean it surrendered the whole of its revenue received from United Kingdom–Australia shipping and transport.[140]

3.3.3 Dividends

Under the 1947 treaty, the source country gave up the right to tax income from dividends; dividend payments were taxable only by the residence country.[141] In the first half of the 20th century, New Zealand was heavily reliant on United Kingdom

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[133] OECD Model Tax Convention, above n 3, Art 8; see generally Sunita Jogarajan, *Double Taxation and the League of Nations* (Cambridge University Press, 2018) ch 7.
[134] Jogarajan, above n 133, 216-218.
[135] SG Sturmey, *British Shipping and World Competition* (Oxford University Press, 2017 [1962]) 1; Sarah Palmer, 'Government and the British Shipping Industry in the Later Twentieth Century' in Gelina Harlaftis, Stig Tenold and Jesús M Valdaliso (eds), *The World's Key Industry: History and Economics of International Shipping* (Palgrave Macmillan, 2012) 124, 124.
[136] Inland Revenue (UK), 'Letter to Chancellor of the Exchequer on Double Taxation Negotiations, 13 November 1964', The National Archives (UK) TNA IR 40/15565, 4.
[137] Smith, above n 27, 106.
[138] Ibid 116.
[139] New Zealand, *Parliamentary Debates*, 19 August 1947, vol 277, 423 (Mr Bowden MP).
[140] Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946', above n 10, 211.
[141] 1947 UK–New Zealand treaty, above n 4, Art VI.

investment and it was likely that more dividend payments were flowing to the United Kingdom than the other way.[142] Therefore, on first examination, giving up taxing rights to dividends would appear to be a large concession of source taxation on New Zealand's part. However, due to New Zealand's prevailing system of company-shareholder taxation, it was not really a concession, as all dividends were exempt from income tax under the average-rate system.[143]

In line with the average-rate system, the 1947 dividends article provided that the income from the dividend could be taken into account for rate-setting purposes in New Zealand. The dividend itself would not be taxed, but the dividend amount received by a United Kingdom shareholder from a New Zealand company was considered part of the United Kingdom resident's total assessable income.[144] This was to determine the rate of New Zealand tax to apply to the resident's income if the United Kingdom resident had other taxable income in New Zealand (excluding dividends).[145]

In respect of dividends paid by a United Kingdom company, the United Kingdom gave up the right to levy its surtax on the payment received by a New Zealand shareholder. This did not amount to a great concession either; as the surtax was not a withholding tax, there were considerable difficulties associated with collecting it from non-residents anyway.[146]

As a rule, the United Kingdom was firmly against source taxation of dividends and other investment income, as expounded by Sir Percy Thompson in the discussions on the League of Nations drafts.[147] As a large exporter of capital, the United Kingdom stood to lose more revenue by giving relief for foreign taxes than it would gain by taxing income derived from the United Kingdom.[148] In the tax treaties with its Dominions, the United Kingdom negotiated for residence taxation of dividends, and largely achieved either a nil rate of withholding tax or full exemption by the source country (as in the 1947 UK–New Zealand treaty).[149] In the subsequent 1966 treaty with New Zealand, the United Kingdom conceded to source taxation of dividends up to a maximum rate of 15 per cent, but only because New Zealand agreed to continue to exempt income from international shipping.[150]

Taxation of dividends exclusively in the country of the taxpayer's residence would be uncommon in modern DTAs today; as the OECD Commentary states, 'it would be unrealistic to suppose that there is any prospect of it being agreed that all taxation of dividends at the source should be relinquished'.[151]

The 1947 dividends article contained a PE proviso; the dividend exemption did not apply if the recipient was 'engaged in trade or business' through a PE in the source

[142] New Zealand Treasury, *International Investment for Growth* (New Zealand Government, 2015) 8.
[143] Cho, above n 13, 151.
[144] Ibid 159.
[145] 1947 UK–New Zealand treaty, above n 4, Art VI(1).
[146] Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946', above n 10, 204.
[147] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 226.
[148] Ibid 213.
[149] Ibid 227.
[150] 1966 Meeting Notes, above n 82.
[151] OECD Model Tax Convention, above n 3, Commentary on Article 10, para 6.

country.[152] The PE proviso is also part of the dividend article in the OECD Model and stipulates that the exemption does not apply if the shareholding is 'effectively connected' to the PE. Instead, Article 7 shall apply with the dividend forming part of the business profits attributable to the PE. The idea behind the PE proviso is that the source country 'should not be obliged to refrain from exercising its taxing rights in the case of a domestic investment by a local PE'.[153] The dividend article in the 1947 treaty and DTAs today are concerned with true cross-border situations and not where a dividend is paid to a PE in the same country as the payer.[154]

The second paragraph of the dividends article in the 1947 treaty was concerned with the extraterritorial taxation of dividends. It prohibited each country from taxing dividends paid by a non-resident company merely because the underlying profits arose in the first state. Neither New Zealand nor the United Kingdom had such a tax.[155] However, the United States imposed such 'secondary withholding taxes' and an equivalent provision was in the 1945 US–UK treaty, which likely explains its inclusion in the 1947 UK–New Zealand agreement.[156] Article VI(2) also prevented special taxes being imposed on the undistributed profits of non-resident companies, such as a branch profits tax. Both provisions are in the OECD Model.[157]

In 1958, New Zealand moved to a classical system of company taxation and for the first time, dividends were taxable in the hands of shareholders under domestic law.[158] Later, in 1964, New Zealand introduced a non-resident withholding tax (NRWT) at a flat rate of 15 per cent on dividends, interest and royalties.[159] This change in tax policy was one reason for the need to renegotiate the treaty with the United Kingdom. In the next treaty, New Zealand negotiated for source taxation of dividends (and royalties) up to a maximum rate of 15 per cent. This was advantageous for a capital-importing country which had a large proportion of inward direct foreign investment. Source taxation up to a maximum of 15 per cent is also the current position for dividend taxation in the present UK–New Zealand treaty.[160]

Due to differences in the systems of company-shareholder taxation between countries, the dividends article often varies across treaties. For instance, the major divergence between the 1947 UK–New Zealand treaty and the 1946 UK–Australia treaty was the dividends article, due to Australia having a classical system of company taxation at the time (as well as negotiating for some source taxation of dividends).[161]

[152] 1947 UK–New Zealand treaty, above n 4, Art VI(1).
[153] Hongler, above n 131, [2.3.5.7](c).
[154] Baker, *Double Taxation Conventions*, above n 57, [10B.24].
[155] John Prebble, 'The General Principles, Effects and Structure of Tax Treaties' (1992) 10 *Asian Pacific Tax and Research Centre Bulletin* 555, 570.
[156] Mitchell B Carroll, 'Evolution of US Treaties to Avoid Double Taxation of Income Part II' (1968) 3(1) *International Lawyer* 129, 134.
[157] OECD Model Tax Convention, above n 3, Art 10(4).
[158] Cho, above n 13, 164.
[159] *Land and Income Amendment Act 1964* (NZ) s 17.
[160] 1984 UK–New Zealand treaty, above n 7, Art 11(1).
[161] Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946', above n 10, 202 and 222.

3.3.4 Royalties

As in the dividends article, the article dealing with income from royalties conferred jurisdiction to tax royalty payments to the country of the recipient's residence, subject to the PE proviso.[162] To counter tax avoidance, a safeguard clause was added to deal with excessive royalty payments. No exemption was allowed for the amount of a royalty payment exceeding 'fair and reasonable consideration'.[163] This anti-avoidance measure appears in modern DTAs and protects a country's taxation revenue from being undermined by artificially inflated royalty payments.[164]

Full source country taxing rights were retained in respect of some types of royalty payments by carving them out from the definition of royalty. 'Royalty' included payments for the use of any 'copyright, patent, design, secret process or formula, trade-mark, or other like property' but did not include 'royalties paid in respect of the operation of mines or quarries, or of the extraction or removal of timber or other natural resources or rents or royalties in respect of motion picture films'.[165] Royalties or other amounts paid for natural resource extraction and films were outside the source tax exemption, the source country was permitted to tax them, and the country of the resident would be obliged to relieve double tax under the credit provision. Australia had achieved this position in their DTA, and it would have been difficult for the United Kingdom to refuse New Zealand source taxing rights having given them to Australia.[166]

Article 12 of the OECD Model provides for residence taxation of royalties, but this position is modified in many treaties. For instance, the current UK–New Zealand treaty allows the source country to tax royalties at a concessional rate of 10 per cent.[167] Echoing the split in the 1947 definition of royalty, income from the working of 'mineral deposits, sources and other natural resources' is now dealt with in the article on immovable property in the OECD treaty.[168] The immovable property article provides for source taxation in light of the close economic connection between the source of the income and the source country.

Both the articles on dividends and royalties in the 1947 treaty contain a 'subject to tax' test; that is, the exemption in the source country was conditional on the income being subject to tax in the other country to prevent abuse of treaty benefits.[169] In the 1960s, the United Kingdom began to replace the subject to tax test with the 'beneficial owner' concept in its DTAs, now part of the OECD Model articles on dividends and royalties.[170] The beneficial owner concept ensures that the recipient of treaty benefits is genuinely

[162] 1947 UK–New Zealand treaty, above n 4, Art VII.
[163] Ibid Art VII(1).
[164] OECD Model Tax Convention, above n 3, Art 12(4).
[165] 1947 UK–New Zealand treaty, above n 4, Art VII(2).
[166] Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946', above n 10, 222.
[167] 1984 UK–New Zealand treaty, above n 7, Art 13(2).
[168] OECD Model Tax Convention, above n 3, Art 6.
[169] 1947 UK–New Zealand treaty, above n 4, Arts VI(1) and VII(1).
[170] Philip Baker, 'The Meaning of "Beneficial Ownership" as Applied to Dividends under the OECD Model Tax Convention' in Guglielmo Maisto (ed), *Taxation of Intercompany Dividends under Tax Treaties and EU Law* (IBFD Publications, 2012) 87, 88.

the ultimate owner of the income, rather than a conduit or nominee attempting to exploit favourable tax treaty provisions.[171]

3.3.5 Government remuneration

The paying government had the sole right to tax the remuneration of government employees performing services in the other country.[172] However, the exemption did not apply if the government employee was ordinarily a resident of the country where they were resident and had not become a resident only for the purpose of government employment, for example, local staff of a high commission.[173] Nor would the exemption apply if the individual's services were in connection with trade or business for profit undertaken by either the New Zealand or British government, such as state-owned companies, ie, employees of a state-owned company.[174]

Similar government remuneration rules are found in the OECD Model.[175] An additional article in the Model preserves the fiscal privileges of diplomats and consular officials to which they are entitled under international law.[176]

3.3.6 Pensions and annuities

Double taxation of pensions arises when a pensioner relocates and both the country from which the pension is paid and the pensioner's new country of residence subject the pension to tax. Under the 1947 treaty, pensions and annuities were taxed on a residence basis; that is, a pensioner who relocated would only be subject to tax on their pension in their new country of residence.[177]

In the negotiations for the subsequent 1966 treaty, the British noted that New Zealand attached 'considerable importance' to residence taxation of pensions insofar as the outcome would affect New Zealand's attitude as to whether a new agreement 'was worthwhile having at all'.[178] The pension provision was also specially mentioned by Mr MacDermot, the UK's Financial Secretary to the Treasury, when the 1966 treaty was tabled in the House of Commons: 'As under the former Agreement, pensioners who are residents of New Zealand are exempted from United Kingdom tax on their pensions'.[179] One can infer that there was likely a number of pensioners from the United Kingdom now living in New Zealand, causing this provision to be of significance to both countries. Nevertheless, the substance of Article X of the 1947 treaty was not changed by the 1966 treaty.

The equivalent OECD Model article also provides for taxation of pensions on a residence basis, the rationale being that the residence country is better placed to assess

[171] Louisa Boyd, 'Double Taxation Agreements: New Zealand's Approach to Treaty Shopping' (2007) 13 *Auckland University Law Review* 63, 76.
[172] 1947 UK–New Zealand treaty, above n 4, Art VIII.
[173] Ibid.
[174] Ibid Art VIII(2); Holmes, above n 45, [17.6].
[175] OECD Model Tax Convention, above n 3, Art 19.
[176] Ibid Art 28; Baker, *Double Taxation Conventions*, above n 57, [28B.01].
[177] 1947 UK–New Zealand treaty, above n 4, Art X(1).
[178] 1966 Meeting Notes, above n 83.
[179] United Kingdom, *Parliamentary Debates*, House of Commons, 21 July 1966, vol 732, col 144W.

the recipients' overall ability to pay tax and the residence basis is simpler from an administrative perspective.[180]

International taxation of pension payments has become more contentious since the increased mobility of individuals from the 1980s gave rise to increasing numbers of people working and retiring in different countries.[181] Many tax treaties distinguish between pensions from state social security schemes, pensions from government employment, and pensions from non-government employment, allowing the source country to tax the former two and the residence state to tax the latter.[182] As a popular retirement destination, residence taxation of pensions suits New Zealand.[183] Rather than exclude some pensions from residence taxation, New Zealand often seeks to extend residence taxation rights by including all pensions, including government service pensions and pensions paid under social security legislation, in its pension provision.[184]

3.3.7 Personal and professional remuneration of individuals

Article IX governed income from employment. The jurisdiction to tax employment income, including payment for professional services, was given to the country where the work was performed (the source country) unless the taxpayer was only working there for a short time (the 183-day exception). Under the 183-day exception in the treaty, employment income was exempt in the source country if the taxpayer was there for less than 183 days (about six months), the services were performed for or on behalf of an employer residing in the other country, and the income was subject to tax in the other country.

The provisions on employment taxation are similar in the OECD Model, albeit more nuanced.[185] The 183-day exception is standard but includes a third condition, which is different to the one in the 1947 treaty. The third condition required to meet the 183-day exception is that the remuneration is not 'borne by' a PE in the country where the work was performed.[186] The objective is to avoid exempting employment income from source taxation where the income has given rise to a deduction by the PE (thereby reducing the amount of the PE's taxable income that can be taxed by the source country).[187] This condition was not part of the 183-day exception test in the 1947 treaty. The OECD Model also contains two additional articles to govern remuneration for personal services: an article covering directors' fees and an article on the income of entertainers and sportspersons.[188]

Under the 1947 treaty, the income of public entertainers ('such as stage, motion picture or radio artists, musicians and athletes') was dealt with by excluding it from the rules on employment income; the general rule providing for source taxation along with the 183-day exception.[189] The intention was that the country where the entertainers performed – the source country – should tax their income, regardless of the time spent

[180] OECD Model Tax Convention, above n 3, Commentary on Article 18, para 1.
[181] Holmes, above n 45, [18.2].
[182] Ibid; OECD Model Tax Convention, above n 3, Art 19(2).
[183] Hunt, above n 58, 164.
[184] Ibid.
[185] OECD Model Tax Convention, above n 3, Art 15.
[186] Ibid Art 15(2)(c).
[187] Ibid Commentary on Article 15, para 7.
[188] Ibid Arts 16 and 17.
[189] 1947 UK–New Zealand treaty, above n 4, Art IX(3).

in the country. A source taxation rule reflected the fact that artists and athletes often receive considerable compensation for brief visits to the country of performance.[190]

However, entertainers are often self-employed or 'loaned-out' under personal service corporations and income ascribed to such a corporation would therefore fall under Article III as profits arising from a commercial enterprise.[191] To recall the operation of this article, non-resident enterprises were exempt from source country taxation on their industrial or commercial profits unless they operated business through a PE. Due to the itinerant nature of the entertainment business, it is unlikely the activities of a self-employed entertainer or personal service corporation would constitute a PE and therefore income received from performances or games would be taxed only in the country of residence of the performer or the enterprise (ie, the corporation) which employs them.

New Zealand was concerned about the revenue cost in respect of non-resident entertainers, and it was a factor in the eventual termination of the treaty in 1964.[192] Notably, the Beatles toured New Zealand in June 1964; and two days after they left the country, New Zealand gave notice to terminate the 1947 agreement.[193]

The subsequent 1966 treaty with the United Kingdom included a separate article on the taxation of public entertainers.[194] It provided that, notwithstanding other provisions on personal and professional remuneration, the country of performance could tax the income earned by public entertainers. Further, to capture the income of the entertainer furnished through a personal service corporation, the definition of PE in the 1966 treaty provided that an enterprise was deemed to have a PE if it 'carries on the activity of providing the services … of public entertainers or athletes' in the other country.[195] This ensured the profits of a personal service corporation attributable to the PE were taxed under Article III (industrial or commercial profits).

Today, Article 17(2) of the OECD Model addresses this issue. It permits source taxation of an entertainer's income where it accrues to another person (such as a personal service corporation) and overrides the articles pertaining to business profits, employment and independent services.

3.3.8 *Visiting professors and teachers*

A special provision was included in the 1947 treaty for visiting professors or teachers.[196] It stipulated that income earned by professors or teachers teaching in one country was exempt from tax in that source country, provided they only resided there for two years or less. The exemption was not contingent on a subject to tax test; it applied even where the academic's income was not taxed in the other country, if for example, they had not

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[190] Stephanie C Evans, 'United States Taxation of International Athletes: A Reexamination of the Artiste and Athlete Article in Tax Treaties' (1995) 29(1) *George Washington Journal of International Law and Economics* 297, 311.
[191] Dick Molenaar, 'New Options to Restrict Article 17 for Artistes and Sportsmen' (2016) 44(12) *Intertax* 972.
[192] Smith, above n 27, 113.
[193] Manatū Taonga – Ministry for Culture and Heritage, New Zealand, 'The Beatles in New Zealand', *New Zealand History* (Web Page, updated 28 April 2023) <https://nzhistory.govt.nz/culture/beatles>.
[194] 1947 UK–New Zealand treaty, above n 4, Art XIV.
[195] 1966 UK–New Zealand treaty, above n 6, Art II(1)(p)(iv)(bb).
[196] 1947 UK–New Zealand treaty, above n 4, Art XI.

maintained residence status in the country of usual residence. Its purpose was less to allocate tax jurisdiction and more to foster cross-border research and teaching and attract the services of foreign educators.[197] An exemption for visiting professors first appeared in the 1945 US–UK treaty, and subsequently was included in many early tax treaties.[198]

This provision is not found in the current OECD Model. Remuneration received by visiting educators may now be covered by the employment provisions if the educator is employed by the host university or other relevant educational institution, or the business profits article if the educator is self-employed.

3.3.9 Students and apprentices

Payments made to students or apprentices visiting one country for full-time education or training were exempt from tax on the payments in that host state made for the purpose of the student's maintenance, education or training.[199] The OECD Model provides the same without the stipulation that the student or apprentice be full-time.[200]

3.4 Elimination of double tax

The OECD Model gives a choice of two methods for the elimination of juridical double tax, the exemption method and the credit method.[201] Each contracting country is free to choose between the two methods. The provisions are not highly prescriptive, and the details are left for the contracting countries to work out in accordance with their domestic laws and policies.[202] In the 1947 treaty, provision of credit was the method used to relieve double tax.[203]

3.4.1 Provision of credit

Mr Bowden MP rightly called the credit article 'the dominant article' when the agreement was explained to the New Zealand Parliament in 1947.[204] The object of the credit article was to eliminate double taxation where this had not been achieved under the other articles in the treaty.

Operation of the credit article

As has been shown in this study, most of the substantive provisions in the 1947 treaty eliminated double tax by requiring the source country to exempt a particular class of income from tax and therefore conferring on the residence state the exclusive right to tax that income. However, where the source country retained the right to tax a class of income, or where the income fell outside the provisions of the treaty, double taxation was not eliminated because both states had the right to tax. For instance, the source country retained to the right to tax the profits of a foreign enterprise attributable to a PE and employment income not falling within the 183-day exception. The treaty was silent

[197] Baker, *Double Taxation Conventions*, above n 57, [20B.07].
[198] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 253.
[199] 1947 UK–New Zealand treaty, above n 4, Art XII.
[200] OECD Model Tax Convention, above n 3, Art 20.
[201] Ibid Arts 23A and 23B.
[202] Ibid Commentary on Article 23, para 32.
[203] 1947 UK–New Zealand treaty, above n 4, Art XIV.
[204] New Zealand, *Parliamentary Debates*, 19 August 1947, vol 277, 423.

on the tax treatment of interest and payments for natural resource exploitation or film royalties were outside the scope of the royalty article. In these cases, the credit provision operated to eliminate double tax.

The credit provision obliged the residence country to give relief from double taxation in the form of a credit. The United Kingdom would allow a credit against United Kingdom tax liability for New Zealand tax paid on income sourced in New Zealand.[205] The converse also applied; where United Kingdom tax had been imposed upon income that had its source in the United Kingdom, New Zealand was required to give a credit for the tax paid to offset New Zealand tax liable on that income.[206]

Compared to Dominion Relief, the credit provision was a great improvement toward relieving the burden of double tax. The United Kingdom gave full credit for taxes paid in New Zealand, instead of the half-credit given under the previous system.[207]

Domestic laws providing for foreign tax credits

The provision of credit was subject to each country's domestic laws regarding the allowance of foreign tax credits, which generally related to the timing and amount of credit granted.[208]

The granting of United Kingdom credits was subject to the rules contained in the *Finance (No 2) Act 1945*. The *Finance (No 2) Act* was enacted as a direct result of the 1945 US–UK treaty. Prior to this treaty, the United Kingdom did not have a foreign tax credit regime, only providing a deduction for United States tax and limited credit for Dominion tax.[209] By contrast, the United States had provided foreign tax credits since 1919.[210] Providing foreign tax credits conflicted with the United Kingdom's ardent stance against tax at source and was only reluctantly accepted as a practical solution during the negotiation of the US treaty.[211]

New Zealand did not provide for foreign tax credits in its domestic law at the time of negotiations. Therefore, the provision of New Zealand credits was 'subject to such provisions … as may be enacted in New Zealand' in anticipation of New Zealand providing for foreign tax credits in its domestic law.[212]

Strangely, however, New Zealand did not enact the legislation envisaged until 1962.[213] Instead, New Zealand continued to exempt the income under its domestic law provisions which provided income derived in the Dominions and subject to tax there was exempt in New Zealand.[214] Therefore, the domestic Dominion tax exemption which had

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[205] 1947 UK–New Zealand treaty, above n 4, Art XIV(1).
[206] Ibid Art XIV(2).
[207] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 236; Harris, above n 37, 477.
[208] Elliffe, above n 19, 176-177.
[209] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 233.
[210] Ibid 232.
[211] Ibid 233.
[212] 1947 UK–New Zealand treaty, above n 4, Art XIV(2).
[213] Section 14 of the *Land and Income Tax Amendment Act (No 2) 1962* (NZ) repealed and amended section 170 of the *Land and Income Tax Act 1954* (NZ), the then provision providing for the exemption of income subject to tax in the Commonwealth.
[214] Smith, above n 27, 110 and 113.

operated since 1916 continued to operate, so that no obligation to grant foreign tax credits would arise. From the United Kingdom's perspective, it would have made little difference for New Zealand to use the Dominion exemption method to eliminate double tax (unless the New Zealand tax rate was higher than the United Kingdom rate).

Source rules

The credit article in the 1947 treaty contained several source rules deeming income to be 'sourced' in one country or the other. Source rules were necessary to deal with potential conflict between domestic law credit provisions and the treaty provisions.[215] Generally, domestic law credit provisions require income to have a source in the other state as a condition for granting relief (such as granting credit). In the absence of a treaty definition of source, the residence state may use its domestic definition of source which may not align with the treaty provisions. In addition, at this time countries had less sophisticated source rules and therefore the source of some types of income was doubtful.

Countries address this in their tax treaties by specifying the source of various types of income to avoid conflicts.[216] In the 1947 credit provision, income from personal and professional services (employment) was deemed to be sourced where the services were performed. Income from employment onboard ships and aircraft was deemed sourced where the operator was resident. Income from insurance taxable under New Zealand law was deemed to be sourced in New Zealand. The provisions of the 1947 treaty preserved New Zealand's right to tax insurance premiums and this source rule ensured the United Kingdom would grant credits for any double tax that arose. There were two other source rules in other articles in the 1947 treaty; business profits attributed to a PE were deemed sourced in the country where the PE was situated, and adjusted profits under the associated enterprises article were deemed sourced in the relevant state post-adjustment.[217]

From about 1967, the United Kingdom inserted a general source rule in their DTAs.[218] It appears in the credit provision of the current UK–New Zealand treaty and deems all income which may be taxed in the other country in accordance with the treaty to have a source there for the purpose of giving relief under the treaty.[219]

Under the OECD Model, the credit provision is drafted to eliminate any consideration of source.[220] However, it may be necessary to refer to source in the relief article if the treaty gives relief following domestic law relief provisions.[221]

Underlying tax credits

The credit article provided for 'underlying tax' credits. When a taxpayer received a dividend payment, underlying tax credits took into account the tax paid by the company

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[215] John F Avery Jones, 'Tax Treaty Problems Relating to Source' [1998] (3) *British Tax Review* 222, 240 ('Tax Treaty Problems Relating to Source').
[216] Ibid 239.
[217] See section 3.5.2 below.
[218] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 235.
[219] 1984 UK–New Zealand treaty, above n 4, Art 22(3).
[220] Avery Jones, 'Tax Treaty Problems Relating to Source', above n 215, 250.
[221] Ibid 239.

on its profits, from which the dividend was distributed. Underlying tax credits were important to United Kingdom-resident shareholders of New Zealand companies for granting credit for New Zealand tax paid on the profits out of which dividends were paid.[222] Under its system of company taxation at the time, New Zealand did not impose tax on dividends therefore there was no direct tax for the United Kingdom credit to compute, only the underlying corporate tax.

3.5 Anti-avoidance

Two articles in the 1947 treaty, exchange of information and associated enterprises, were related to the second purpose of the agreement – the prevention of fiscal evasion.[223]

3.5.1 Exchange of information

The exchange of information provision remains one of the most powerful anti-avoidance and anti-evasion mechanisms in double tax treaties.[224] As the international tax community has increasingly focused its attention on widespread avoidance and evasion, the article has been similarly enhanced and is comprehensive compared to the limited formula in the 1947 treaty. Broadly, the exchange of information article requires the two countries to exchange information about respective residents and their taxable activities.

The 1947 article was almost identical to the provision in the 1945 US–UK treaty and was likely drawn from it. It permitted the taxation authority of each country to exchange information necessary for carrying out the agreement, for prevention of fraud and 'for the administration of statutory provisions against legal avoidance' in relation to the taxes covered by the treaty. The unusual wording 'statutory provisions against legal avoidance' refers to domestic tax avoidance provisions.

At the time, the United Kingdom did not have a general anti-avoidance rule (GAAR), only some targeted anti-avoidance provisions that had been introduced primarily in the late 1930s.[225] By contrast, New Zealand did have a GAAR dating to 1878 (possibly the oldest in the world) but it was rarely invoked until the 1960s.[226] The widely drafted provision is likely due the importance that the United States attached to the equivalent article in the 1945 US–UK treaty.[227] The United Kingdom readily agreed to a provision requiring sharing of information for fraud and avoidance purposes, having themselves encountered issues with avoidance through formation of foreign companies.[228]

The initial exchange of information article in the 1984 treaty was quite similar to the 1947 version. However, it has been updated twice in the last 20 years under the 2003 and 2008 protocols to align with changes in the OECD Model which reflect the

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[222] 1947 UK–New Zealand treaty, above n 4, Arts XIV(1) and (2).
[223] Ibid Arts XV and IV.
[224] Xavier Oberson, *International Exchange of Information in Tax Matters: Towards Global Transparency* (Edward Elgar, 2nd ed, 2018) ch 3.
[225] Peter Scott, 'A Fiscal Constitutional Crisis: Tax Avoidance and Evasion in Inter-War Britain' (2022) 137(584) *The English Historical Review* 170.
[226] Craig Elliffe, 'New Zealand's General Anti-Avoidance Rule – A Triumph of Flexibility over Certainty' (2014) 62(1) *Canadian Tax Journal* 147, 148.
[227] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 237-239.
[228] Ibid.

movement of strengthening anti-avoidance provisions. The current version is highly permissive, it provides that the competent authorities shall exchange information 'as is foreseeably relevant' and the provision is not restricted by the scope articles outlining residence and taxes covered. As a result, the exchange of information is not strictly limited to that necessary for the implementation of the agreement, the residents of the two countries or the taxes covered by the agreement.[229] Further, each country cannot deny information solely because it has no domestic interest in it and domestic rules such as bank secrecy must not prevent information exchange.[230]

Amendments to the information exchange provision have been driven by the goal of facilitating the exchange of tax information between jurisdictions to the widest extent to counter avoidance and evasion. The developments are connected to several global initiatives and events, including the Global Forum on Transparency and Exchange of Information created in 2000, the OECD model tax information exchange agreements and the 2008 global financial crisis.[231]

3.5.2 Associated enterprises

An associated enterprises article was an expected feature of bilateral tax treaties by 1947. The rules had been part of UK tax policy since 1915 and equivalent provisions were included in the 1935 League of Nations Draft Model Tax Treaty and the 1945 US–UK treaty.[232] Australia was reprimanded by the United Kingdom for attempting to reject it in its DTA as they regarded it as 'fundamental to any double taxation agreement dealing with trading profits'.[233]

The associated enterprise article was concerned with the allocation of business profits arising from transactions between related enterprises in different countries.[234] It worked in a similar way to the industrial or commercial profits article, but allocated profits between two associated enterprises instead of two divisions of one enterprise, to calculate tax liabilities.[235] If profits made by one enterprise from transactions with an associated enterprise in the other country were not at the level which might be expected if the enterprises were separate and independent, the accounts could be re-written as if they were dealing at arm's length, to calculate the tax liability of the first enterprise. The adjusted profits were included in the enterprise's income, deemed to be sourced in the country where the enterprise was situated and taxed accordingly. Enterprises were associated if one enterprise participated in the management, control or capital of the other enterprise.[236]

Adjusting profits between associated enterprises can give rise to economic double taxation where the same profits are taxed twice in the hands of each enterprise.[237] If one country makes a profit adjustment and increases the taxable income of an enterprise, the

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[229] Baker, *Double Taxation Conventions*, above n 57, [26B.01].
[230] 1984 UK–New Zealand treaty, above n 7, Arts 25(4) and (5).
[231] Baker, *Double Taxation Conventions*, above n 57, [26B.08].
[232] Veronika Solilová and Marlies Steindl, 'OECD/Austria/Czech Republic – Tax Treaty Policy on Article 9 of the OECD Model Scrutinized' (2013) 67(3) *Bulletin for International Taxation* 128, 128.
[233] Taylor, 'Twilight of the Neanderthals', above n 106, 286 n 97, citing R Willis, then Secretary of the United Kingdom Board of Inland Revenue.
[234] 1947 UK–New Zealand treaty, above n 4, Art IV.
[235] Baker, *Double Taxation Conventions*, above n 57, [A7B.13].
[236] 1947 UK–New Zealand treaty, above n 4, Art IV(1).
[237] OECD Model Tax Convention, above n 3, Commentary on Article 9, para 5.

profits will be taxed twice if the other country does not make a corresponding adjustment. For this reason, the OECD Model includes a provision requiring a corresponding adjustment by the other country where there has been a re-writing of an enterprise's accounts in accordance with the article.[238] The 1947 article did not contain an equivalent provision. Nor has it been incorporated as part of the current UK–New Zealand treaty, but this is not uncommon, as there tends to be much disagreement over initial profit adjustments.[239]

As well as helping to achieve an appropriate allocation of taxable income in the two states, the associated enterprises article also has an anti-avoidance function to counteract the use of artificial prices between the members of multinational groups to manipulate levels of profits of its enterprises in high-tax jurisdictions. This function has become increasingly important with the steady rise of multinational enterprises in the world but is impaired by issues in the application of the arm's length principle.[240]

3.6 Miscellaneous provisions

3.6.1 Assessable income for rate-setting purposes

To recall, under New Zealand's average-rate system, dividends were exempt from tax in the hands of shareholders but counted as part of their total income to calculate their tax rate. Reflecting this system, Article XIII permitted New Zealand to use dividends paid to United Kingdom residents, exempt from source taxation under the dividends article, to make tax rate-scale adjustments to determine the amount of New Zealand tax payable on other assessable income. This article was unique to the 1947 treaty; New Zealand moved to a classical company taxation system in 1958 so the subsequent treaty did not need an equivalent provision.[241]

3.6.2 Territorial extension

The territorial extension article permitted either the contracting country to extend the application of the treaty to its colonies or other territories which imposed substantially similar taxes to that covered by the treaty.[242] The extension would become effective 60 days after notification unless the other government refused to accept the extension. Although the extension could be exercised by either country, the article could in fact only pertain to the United Kingdom as the agreement already applied to 'all islands and territories' within New Zealand's territorial limits.[243]

The extension provision was invoked by the United Kingdom in 1951, five years after the treaty was entered into.[244] The reason for this is unclear and it seems peculiar because the territories the United Kingdom requested come within the treaty framework were 18 small United Kingdom colonies, mostly in Africa and the Caribbean with little connection to New Zealand: Aden Colony, Antigua, Cyprus, Falkland Islands, Gambia, Gold Coast, Grenada, Jamaica, Mauritius, Montserrat, Nigeria, Nyasaland, St

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[238] Ibid Art 9(2).
[239] Ramon SJ Dwarkasing, 'The Concept of Associated Enterprises' (2013) 41(8/9) *Intertax* 412.
[240] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Publishing, 2022) 13.
[241] Cho, above n 13, 151.
[242] 1947 UK–New Zealand treaty, above n 4, Art XVI.
[243] Ibid Art II(1)(b).
[244] By notification on 12 June 1951, accepted by New Zealand 27 June 1951.

Christopher and Nevis, St Vincent, Seychelles, Sierra Leone, Trinidad and the Virgin Islands. However, it seems New Zealand was not perturbed by the extension as the request was accepted just two weeks after notification. The United Kingdom also exercised the extension in respect of its treaties with Canada, Sweden, Norway and Denmark to broadly the same territories in the early 1950s.[245]

The territorial extension provision was novel to the United Kingdom's first DTA, the US–UK 1945 treaty. The United States was initially suspicious of this provision, concerned that it would be used to extend the treaty to low-tax territories for tax avoidance purposes.[246] These concerns were countered by the idea that any extension would increase United States trade with such territories. In 1959, the United Kingdom did extend the US–UK treaty to 20 colonies, also mostly in Africa and the Caribbean.[247]

The expansion of the tax haven market between 1945 and 1970 might shed some light on this curious development.[248] Very high rates of income and corporate taxes in Europe, to finance post-war debt and the welfare state, drove demand for tax havens, particularly by returnees from Britain's 'dissolving empire' who were used to favourable tax arrangements in the colonies and dependent territories.[249] In fact, there was a view amongst some British officials that tax havens provided a way for the developing world to become self-sustaining and decrease their reliance on foreign aid.[250] The United Kingdom was at the centre of these emerging tax havens, most of which were dependent territories in the Caribbean and within the 'Sterling Area' (countries that pegged their currency to the pound).[251]

One can only speculate on the United Kingdom's intention for bringing these emerging tax havens within the framework of its tax treaties. It seems that this policy may have been driven by the Colonial Office, rather than for reasons of tax, to encourage trade between these countries and the treaty partner.[252] This would have made some sense for the Caribbean Islands and the United States, but much less sense in treaties with European countries and New Zealand.

3.7 Absent articles

Several provisions were notable by their absence from the 1947 treaty. For instance, not all major classes of income were covered. There was no provision allocating taxing rights to interest nor income from immovable property, standard provisions in the OECD Model and covered by most modern DTAs today. Leaving out some classes of income was a distinctive feature of the United Kingdom's early DTAs with its Dominions, as discussed previously. Double taxation was still avoided as the treaty's

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[245] Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement', above n 51, 248 n 244.
[246] Ibid 249.
[247] Ibid 248.
[248] Vanessa Ogle, 'Archipelago Capitalism: Tax Havens, Offshore Money, and the State, 1950s–1970s' (2017) 122(5) *The American Historical Review* 1431, 1437.
[249] Ibid 1438.
[250] Ibid.
[251] Ibid 1441-1442.
[252] John F Avery Jones, 'The UK's Early Tax Treaties with European Countries' in Peter Harris and Dominic de Cogan (eds), *Studies in the History of Tax Law, Vol 8* (Hart Publishing, 2017) 295, 328-333.

credit provision would direct the taxpayer's country of residence to relieve any double tax that resulted from both countries taxing these classes of income.

There was no provision for a mutual agreement procedure nor a residence tie-breaker where individual taxpayers were considered residents by both countries, today considered essential elements of a DTA.[253] Both provisions were included in the subsequent 1966 treaty.

Lastly, the 1947 treaty did not contain a non-discrimination article. Notes from the negotiations for the 1966 treaty (which also omitted a discrimination article) indicate that this was due to the belief of United Kingdom officials that discrimination between members of the Commonwealth was so unlikely that it need not be expressly guarded against.[254]

4. CONCLUSION

Tax treaties have evolved significantly since their fumbling beginnings in the first half of the 20th century. The 1947 UK–New Zealand treaty was rudimentary by modern standards and contained some unusual features distinctive to the United Kingdom's early tax treaties. The definition of PE was brief and crude compared to the sophisticated version found in modern DTAs and not all types of income were covered by the treaty.

However, the majority of the provisions in the agreement can still be found in the present OECD Model. Notably, the rules for taxing business profits still apply, reflecting the principle of economic allegiance which also governed the allocation of income in the 1947 treaty. An emerging New Zealand position on tax treaties is also apparent in this early treaty, for instance, with New Zealand protecting its right to tax income from the business of insurance and ensuring pensions were taxed on a residence basis.

In the 1966 negotiations for the subsequent treaty, the British asked why New Zealand had put in a reservation to an article dealing with 'other income'. The New Zealanders admitted they had not come across this kind of article before and did not know 'what they would be letting themselves in for if they accepted it'.[255] Nevertheless, on the advice of the British, the provision was included. This interaction is revealing of the reliance New Zealand had on the United Kingdom in the formation of its early tax treaties.

The 1947 treaty was largely directed by the United Kingdom's prevailing policy on tax treaties. Many provisions were drawn from its treaty with the United States in 1945 and modified by the United Kingdom's desire for taxation on a residence basis. The 1947 treaty likely cost New Zealand a considerable amount of tax revenue. However, it did obtain more generous double tax relief than under Dominion Relief; the United Kingdom gave full credits for taxes paid in New Zealand.

The New Zealand Prime Minister, Michael Joseph Savage, summed up the prevailing attitude of New Zealand toward the United Kingdom, in his 1939 speech:

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[253] OECD Model Tax Convention, above n 3, Arts 4 and 25.
[254] 1966 Meeting Notes, above n 82.
[255] Ibid.

> Both with gratitude for the past and confidence in the future, we range ourselves without fear beside Britain. Where she goes, we go. Where she stands, we stand. We are only a small and young nation, but we are one and all a band of brothers and we march forward with union of hearts and wills to a common destiny.[256]

While these words were uttered in the context of New Zealand entering World War II, their sentiment captured New Zealand's complete loyalty and trust toward Britain at the time. If the British thought it was a good idea to conclude a tax treaty, then so did New Zealand. Today, the OECD directs the content and structure of New Zealand's tax treaties. In 1947, it was the United Kingdom that initiated and shaped New Zealand's first comprehensive double tax treaty.

[256] Manatū Taonga — Ministry for Culture and Heritage, New Zealand, 'Prime Minister Declares New Zealand's Support for Britain, 5 September 1939', *New Zealand History* (Web Page, updated 24 July 2024) <https://nzhistory.govt.nz/pm-declares-new-zealands-support-for-britain-in-famous-radio-broadcast>.

eJournal of Tax Research (2024) vol. 22, no. 2, pp. 257-279

The influence of domestic tax reviews on Australia's network of international tax treaties

Kerrie Sadiq[*] and Na Li[**]

Abstract

The academic writing of Professor John Taylor on double tax treaties, particularly his meticulous documenting of the history of Australia's tax treaty network, is well known to international tax scholars. In honour of his contribution to this field of literature, we humbly attempt to contribute to the historical analysis of Australia's tax treaty network by testing and documenting the influence of domestic tax reviews conducted since 1999 on tax treaties negotiated or renegotiated in Australia over the same period. In the last 25 years, three significant reviews have extended recommendations beyond domestic tax reform to propose policy changes to the international tax treaty network. The Review of Business Taxation in 1999, the Board of Taxation's Review of International Taxation Arrangements in 2002-2003, and the Australia's Future Tax System review in 2010 made recommendations specifically relating to the tax treaty network. Between 1999 and 2023, the 25-year period of this study, Australia signed 33 tax treaties and protocols, thereby providing an ideal setting for examining the influence of tax reviews on tax treaty policy. This article examines the recommendations from the three reviews and considers their influence on Australia's tax treaty network. It notes the exemplary work of John Taylor in the analysis of the history of Australia's tax treaty policy and practices and provides a recommended approach to a future review of Australia's tax treaty network, concluding that a comprehensive review is not only warranted but long overdue.

Keywords: international taxation, double tax treaties, review of taxation, tax treaty policy

[*] Professor, School of Accountancy, QUT Business School. Email: kerrie.sadiq@qut.edu.au.
[**] School of Accountancy, QUT Business School. Email: n41.li@qut.edu.au.

1. INTRODUCTION

Professor John Taylor's academic writing on double tax treaties, particularly his meticulous documenting of the history of Australia's tax treaty network, is well known to international tax scholars.[1] In honour of his contribution to this field of literature, we humbly attempt to contribute to the historical analysis of Australia's tax treaty network by testing and documenting the influence of domestic tax reviews conducted since 1999 on tax treaties negotiated or renegotiated in Australia over the same period.

Australia has a long history with double tax treaties and is currently a party to 47 agreements,[2] each of which is considered an important part of Australia's international tax regime. The first treaty, entered into with the United Kingdom in 1946,[3] was the genesis of Australian tax treaty policy. It was negotiated at a time when Australia was a dominion of the British Commonwealth and a net importer of capital from the United Kingdom. At that time, the primary purpose of the United Kingdom–Australia double tax agreement (titled the *Agreement Between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*) was to remove the possibility of double taxation on United Kingdom investment in Australia. Attempts to relieve double taxation through the domestic United Kingdom Dominion Income Tax Relief regime were inadequate and failed to alleviate economic double taxation on dividend income derived from Australia.[4] Hence, as part of the treaty negotiations, Australia agreed to limit the source state's taxing rights in exchange for a foreign tax credit that could replace the Dominion Income Tax Relief system for United Kingdom residents.[5]

Throughout the 1950s to the 1970s, Australia's tax treaty network slowly expanded, with a second treaty entered into with the United States in 1953,[6] followed by Canada in 1957, New Zealand in 1960, and Japan and Singapore in 1969.[7] In 1971, Australia

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[1] See, for example, C John Taylor, 'The Negotiation and Drafting of the UK–Australia Double Taxation Treaty of 1946' [2009] (2) *British Tax Review* 201 ('The Negotiation and Drafting of the UK–Australia Double Taxation Treaty'); C John Taylor, '"I Suppose I Must Have More Discussion on This Dreary Subject": The Negotiation and Drafting of the UK–Australia Double Taxation Treaty of 1946' in John Tiley (ed), *Studies in the History of Tax Law, Vol 4* (Hart Publishing, 2010) 213; C John Taylor, 'Twilight of the Neanderthals, or Are Bilateral Double Taxation Treaty Networks Sustainable?' (2010) 34(1) *Melbourne University Law Review* 268; C John Taylor, 'Some Distinctive Features of Australian Tax Treaty Practice: An Examination of Their Origins and Interpretation' (2011) 9(3) *eJournal of Tax Research* 294 ('Some Distinctive Features of Australian Tax Treaty Practice').

[2] As at February 2024, the treaty with Iceland has not yet been incorporated into Australian law, a step necessary for its operation, and the treaty with Portugal has been signed on 30 November 2023 but has not come into force.

[3] *Agreement Between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 29 October 1946, 17 UNTS 181 (entered into force 3 June 1947 and terminated 8 May 1968) ('Australia–UK Double Tax Agreement (1946)').

[4] See C John Taylor, 'The History of Australia's Double Tax Conventions', in Michael Lang and Ekkehart Reimer (eds), *The History of Double Taxation Conventions in the Pre-BEPS Era* (IBFD Publications, 2021) 623 ('The History of Australia's Double Tax Conventions'). In this chapter, Taylor described the details of Australia negotiating and signing tax treaties from 1946 to 1960, which were valuable historical archival documents for studying and researching Australian tax policy.

[5] Taylor, 'The Negotiation and Drafting of the UK–Australia Double Taxation Treaty', above n 1.

[6] Taylor, 'The History of Australia's Double Tax Conventions', above n 4.

[7] See Australian Treasury, 'Income Tax Treaties' (Web Page) <https://treasury.gov.au/tax-treaties/income-tax-treaties>.

joined the Organisation for Economic Co-operation and Development (OECD), with the treaty network subsequently extending to member countries, especially those in Europe. Amongst a total of seven tax treaties signed in the 1970s, five were with OECD members, namely Germany, New Zealand, France, Netherlands, and Belgium.[8] All, bar New Zealand, were European countries and those with which Australia was likely to strengthen economic connections. While Australia's treaty network has continued to expand with OECD member countries, the 1980s also saw a shift in focus to Asian countries. This shift in focus was driven by a change in economic policy to a more open economy and a dramatic tariff reduction, the removal of capital controls, and the floating of the currency. During this period, Australia signed tax treaties with Asian countries such as China, the Republic of Korea, Malaysia, Sri Lanka and Thailand, as well as continuing to expand the network by adding more European countries such as Austria, Denmark, Finland, Ireland, Italy, Malta, Norway, Sweden, and Switzerland. Following the 1980s, the number of new treaties declined but treaties continued to be negotiated when new trading partners emerged in Asia, such as India, Indonesia and Vietnam, and in Europe with the dismantling of the Iron Curtain and the expansion of the European Union.

Throughout the same period, starting in 1950 with the Spooner Committee,[9] Australia has had a history of tax reviews.[10] This long history of tax reviews has, however, resulted in little in the way of genuine and successful reform,[11] and, until 1999, there was also little in the way of suggested reform to Australia's network of double tax treaties. Consequently, a reconciliation of Australia's tax treaty network and tax reviews was simply not possible. However, this recently changed, and in the last 25 years, there have been three significant reviews that extended recommendations beyond domestic tax reform to propose policy changes to the international tax treaty network.

The first review to specifically deal with Australia's tax treaty network was the 1999 Review of Business Taxation,[12] known as the Ralph Review, which provided four recommendations that directly addressed Australia's tax treaty network with a policy objective of finding a balance between residence and source taxing rights. The second review took place in 2002 when the Board of Taxation was tasked to examine high-level aspects of the double tax agreement policy and processes.[13] Its report, as a response to

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[8] Australia signed an air profit agreement, rather than a double tax agreement, with Italy in 1972 and with Greece in 1977, so these two agreements are not counted here although Greece joined the OECD in 1961 and Italy joined in 1962. The Australia–New Zealand tax treaty signed in 1972 is also counted into the six treaties signed with the OECD members, although New Zealand joined the OECD in 1973.

[9] Commonwealth Committee on Taxation (ES Spooner, chair). Evans and Krever note that the Committee became a standing committee to which the Treasurer referred particular matters (there were over 50 such referrals) on income tax over the period 1950 to 1954: Chris Evans and Richard Krever, 'Tax Reviews in Australia: A Short Primer' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, 2009) 3, 3, n 2. There had also been the two Royal Commissions on Taxation in 1921-23 and 1934.

[10] Evans and Krever, above n 9.

[11] Ibid 4-11; Michael Dirkis, 'Tax Change or Tax Reform: Business Tax Reform Evaluated' in Geoffrey Lehmann (ed), *Business Tax Reform: Meet the Critics* (Australian Tax Research Foundation, 2007) 17, 47.

[12] See Review of Business Taxation (John Ralph, chair), *A Tax System Redesigned: More Certain, Equitable and Durable* (1999) <https://treasury.gov.au/review/review-of-business-taxation> ('Review of Business Taxation').

[13] See Board of Taxation, *International Taxation Arrangements: A Report to the Treasurer* (2003) <https://taxboard.gov.au/consultation/international-taxation-arrangements> ('Review of International Taxation Arrangements').

the Review of International Taxation Arrangements, contained four separate recommendations relating to Australia's tax treaty network and focused on a move towards a more residence-based treaty policy along with a more up-to-date process for treaty negotiations. The third review to consider tax treaties was the Australia's Future Tax System review, known as the Henry Review, with its report released in 2010.[14] The Henry Review made two recommendations relating to the treaty network, both specifically dealing with interest withholding tax.

This article examines the recommendations coming out of these three reviews and considers their influence on Australia's tax treaty network over the last 25 years. It does so as, unlike previous reviews, the three domestic reviews during this period, the Review of Business Taxation in 1999, the Board of Taxation Review into International Taxation Arrangements in 2002-2003, and Australia's Future Tax System review in 2010, made recommendations specifically relating to the tax treaty network. Further, between 1999 and 2023, the 25-year period of this study, Australia signed 33 tax treaties and protocols, thereby providing an ideal setting for an examination of the influence of tax reviews on treaty policy.[15]

Following this introduction, section 2 of this article analyses the 1999 Review of Business Taxation, while section 3 considers the 2002-2003 Board of Taxation Review of International Tax Arrangements. Section 4 examines the Australia's Future Tax System review. Section 5 notes John Taylor's exemplary work in analysing the history of Australia's tax treaty policy and practices. Further, it provides a recommended approach to a future review of Australia's tax treaty network, concluding that a comprehensive review is not only warranted but long overdue.

2. THE REVIEW OF BUSINESS TAXATION

The first review to specifically deal with Australia's tax treaty network was the 1998-1999 Review of Business Taxation, known as the Ralph Review. The Review Committee, consisting of three Australian businessmen, John Ralph (Chairman), Rick Allert, and Bob Joss, was established in 1998 to conduct a review into the reform of the Australian tax system. In 1999, the Ralph Committee submitted its report containing eight parts and 280 recommendations. Of those 280 recommendations, four specifically dealt with Australia's tax treaty network,[16] with a stated policy objective of finding a balance between source- and residence-based taxing rights.[17] The four recommendations, numbered 22.21 to 22.24, were set out in the section headed 'Improving Australia's Double Taxation Agreements'.[18] Specifically, these four recommendations dealt with dividend withholding taxes, non-discrimination articles, prioritising renegotiated treaties with trading partners, and a review of the treaty policy

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[14] See Australia's Future Tax System Review Panel (Dr Ken Henry, chair), *Australia's Future Tax System: Report to the Treasurer* (2009) <https://treasury.gov.au/review/the-australias-future-tax-system-review/final-report> ('Henry Review').

[15] Note that this involves 27 countries as three protocols were signed by Malaysia, and tax treaties and protocols were signed with New Zealand, Finland, Norway, and France respectively.

[16] Review of Business Taxation, above n 12. Some recommendations in the report were indirectly relevant to the Australian tax treaties, for example, Recommendation 20.1 for applying an imputation credit for foreign dividend withholding taxes up to a 15 per cent tax rate, which is relevant to the application of the Article on the method to relieve double taxation when Australia is in the position of the residence state. This study considers those recommended measures directly addressing tax treaty issues.

[17] Ibid Recommendation 22.24 (Review of DTA Policy').

[18] Ibid 677-680 ('Improving Australia's Double Taxation Agreements').

to ensure it reflected a balanced taxation of international investment and changed investment patterns.

On 11 November 1999, the then Treasurer, The Honourable Peter Costello MP, announced The New Tax System: Stage 2 Response,[19] supporting the four recommendations relating to Australia's tax treaty network. In doing so, it was stated that the double tax agreement policy had, to date, reflected that Australia had traditionally been a capital-importing country but that the increasing amount of Australian investment abroad required a greater focus in double tax agreements on the taxation of foreign source income.[20] The implementation of this policy and the adoption of each of the recommendations is reflected in a change in treaty position as discussed below.

2.1 Reduction in dividend withholding taxes (DWT)

The first recommendation, contained in Recommendation 22.21, provided that in negotiating double tax agreements, Australia should endeavour to reduce dividend withholding tax rates on non-portfolio investment. This measure aimed to complement the recommended imputation credit for foreign dividend withholding taxes up to 15 per cent, with the motivation for reducing the rates of withholding taxes being to facilitate cross-border direct investment by lowering the tax cost of repatriation of profits (dividends) at the border. The Review noted that Australia had traditionally sought a rate of 15 per cent in its treaties reflecting its position as a net capital importer, with dividend withholding tax unilaterally reduced to zero on franked dividends after the introduction of the imputation system in 1987. However, this left Australian investors offshore receiving no complementary benefits when investing overseas in treaty partner countries. A rate of 5 per cent, as the international standard, was recommended in most cases as it retained some source country taxation of the profits in the hands of the shareholders.[21]

Prior to the Review of Business Taxation, six of Australia's tax treaties had provisions that reduced withholding tax on non-portfolio dividends below 15 per cent.[22] This is in stark contrast to the treaties signed after the Review, suggesting that the recommendation was adopted. Of the 33 treaties and protocols signed by Australia since the Review, 22 have contained articles that lower the dividend withholding tax rates on non-portfolio dividends. Of the 22 treaties and protocols entered into, 10 were treaties signed with new treaty partners, eight were new tax treaties signed with existing treaty partners, thereby replacing existing treaties, and four were protocols signed with the treaty partners to amend existing double tax agreements. While 15 per cent was the default rate prior to the Review, post-Review, the negotiated dividend withholding tax rate on non-portfolio dividends ranged from 10 per cent down to zero, with 5 per cent, the international standard recommended by the Review, being the most frequently

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[19] See Hon Peter Costello (Treasurer), 'The New Business Tax System: Stage 2 Response' (Media Release, 11 November 1999) <https://ministers.treasury.gov.au/ministers/peter-costello-1996/media-releases/new-business-tax-system-stage-2-response>.

[20] Ibid Attachment G ('Allocating Income Between Countries').

[21] Review of Business Taxation, above n 12, Recommendation 22.21 ('Lower Rates of DWT on Non-Portfolio Investment').

[22] Czech Republic (1995), France (1989), Philippines (1979), Taiwan (1996), Thailand (1989) and Vietnam (1992).

negotiated position.[23] Of note is the 1982 United States–Australia tax treaty, specifically mentioned in the Review, which had a rate of 15 per cent, being re-negotiated in the 2001 US Protocol, to a rate of 5 per cent or zero where the shares owned represent 80 per cent or more of the voting power of the company paying the dividends (subject to treaty shopping protections). Many subsequent treaties have introduced a similar provision. Further treaties and the relevant rates are noted in Table 1.

Table 1: DWT Rates for Non-Portfolio Dividends in Australian Tax Treaties/Protocols Concluded Since 1999

Treaty Partner States	DWT for portfolio dividends	DWT for non-portfolio dividends*
Double Tax Agreements signed with new treaty partners		
Argentina	15%	10%
Chile	15%	5%
Iceland	15%	0% or 5%
Israel	15%	5%
Mexico	15%	0%
Romania	15%	5%
Russia	15%	5%
Turkey	15%	5%
Portugal	10%	5%
Double Tax Agreements signed with existing treaty partners to replace a previous treaty		
Finland	15%	0% or 5%
France	15%	0% or 5%
Germany	15%	0% or 5%
Japan	10%	0% or 5%
New Zealand	15%	0% or 5%
Norway	15%	0% or 5%
Switzerland	15%	0% or 5%
The U.K.	15%	0% or 5%
Protocols signed with existing treaty partners to amend the existing Tax Treaties		
Canada	15%	5%
Malaysia	15%	0%
South Africa	15%	5%
The U.S.	15%	0% or 5%

*A rate of zero per cent will apply on intercorporate non-portfolio dividends where the recipient holds directly at least 80 per cent of the voting power of the company paying the dividend, subject to certain conditions.

[23] The Review noted that there were cases of zero, for example, in the case of countries in the European Union.

2.2 Non-discrimination articles

The second recommendation of the Review of Business Taxation, contained in Recommendation 22.22,[24] stated that in accordance with international norms, Australia should agree to a non-discrimination article in future double tax agreements. By including a non-discrimination article, Australia ensures that a non-resident is treated no less favourably than a comparable resident. The Review Committee noted that, at the time, Australia was the only OECD country that did not include a non-discrimination article in its treaties as this position was regarded as originally necessary to protect Australia's source country taxing rights and narrow base prior to the introduction of capital gains tax in 1985. The Review Committee believed that such an article was necessary to ensure Australia's good record in the area, to protect Australian enterprises expanding overseas, and so as to not hinder future negotiations. In this regard, it was suggested that renegotiating treaties had been difficult because of a lack of a non-discrimination clause and that a change in policy would greatly assist the process.

Prior to the Review of Business Taxation, the only Australian tax treaty with a non-discrimination article was the Australia–United States treaty signed in 1982 (and entering into force in 1983). At that time, the United States negotiators were adamant that a non-discrimination article be included in the treaty and Australian negotiators agreed but reached an arrangement that the article would not be given force of law in Australia and would not create private law rights of appeal.[25] It provided, however, for consultation between the two governments and expressed the best intentions of the parties to achieve the stated aims.[26] In the legislation bringing the treaty into Australian law, however, the non-discrimination article in the Australia–United States treaty (1982) was not included and consequently has never been given the force of domestic law in Australia.[27]

Subsequent to the Review of Business Taxation, 14 more treaties were entered into containing non-discrimination articles. Five of these 14 treaties were with new treaty partners,[28] and seven were new treaties signed with the existing treaty partners to replace prior treaties,[29] with the remaining two being protocols to amend the existing double tax agreements between Australia and the treaty partners.[30] The language in all 14 articles is similar, generally stating that 'Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to

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[24] Review of Business Taxation, above n 12, Recommendation 22.22 ('Inclusion of a Non-Discrimination Article').

[25] For a comprehensive discussion of the negotiations and the resulting agreement, see C John Taylor, 'Much Ado about Non-discrimination in Negotiating and Drafting of the 1982 Australia–US Taxation Treaty' in Peter Harris and Dominic de Cogan (eds), *Studies in the History of Tax Law, Vol 10* (Hart Publishing, 2021) 253.

[26] Explanatory Memorandum to the Income Tax (International Agreements) Amendment Bill 1983.

[27] Li Na, Kerrie Sadiq and Richard Krever 'Can Australia's Double Tax Treaties Invalidate State Real Estate Taxes?' (2024) 113(1) *Tax Notes International* 47, 48.

[28] Chile (2010), Israel (2019), Turkey (2010), Iceland (2022) and Portugal (2023). As noted at n 2 above, the treaty with Iceland has not yet been incorporated into Australian law, a step necessary for its operation, and the treaty with Portugal has been signed but has not come into force.

[29] United Kingdom (2003), Norway (2006), Finland (2006), Japan (2008), New Zealand (2009), Switzerland (2013) and Germany (2015).

[30] South Africa (2008) and India (2011).

which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected'.[31]

The format of these 14 non-discrimination articles also tends to follow the format of Article 24 of the *OECD Model Tax Convention on Income and on Capital* (OECD Model Tax Convention). However, perhaps surprisingly, the taxes covered by these treaties vary somewhat. As a result, the extent of protection offered by the non-discrimination clauses in these 14 jurisdictions is different. The relevant articles can be divided into four categories. The most restrictive versions of the non-discrimination article, found in five treaties,[32] limit its application to taxes explicitly covered by the treaty, normally the income tax and sometimes the fringe benefits tax and petroleum resource rent tax. In one case, that of Chile, the taxes covered are extended to include, for non-discrimination purposes, Australia's federal indirect tax, the goods and services tax. In only five cases[33] are Australia's DTAs consistent with the OECD Model Tax Convention, where the scope of the non-discrimination article is extended to cover any taxation or taxes of every kind and description, with this construction, on its face, including subnational state taxes. However, there may be some doubt about this interpretation given the explicit addition in three treaties, Finland, Japan, and New Zealand, extending the scope of the non-discrimination article to taxes of every kind and description imposed by a contracting state or a political subdivision.[34] More recently, the reach of non-discrimination articles to state taxes has arisen due to higher state sales taxes being imposed on foreign investors. Legislation has now been passed to include in the *International Tax Agreements Act 1953* a provision that ensures the non-discrimination clause in treaties only extends to income and associated fringe benefits, not state taxes.[35]

2.3 Priority to trading partners

The third recommendation, contained in Recommendation 22.23,[36] provided that priority should be given to renegotiating ageing double tax agreements with major trading partners to make them consistent with Australia's current treaty policy and with decisions concerning tax reform. The Review Committee noted that, at that time, treaties with the United Kingdom and Japan dated to 1967 and 1969, respectively. Further, although the current United States Convention dated from 1983, essentially it reflected a bargain struck in the early 1970s, and none of these treaties properly reflected modern tax treaty policy or took into account emerging tax treaty issues such as arbitration, assistance in recovery, data protection, and offshore activities.

The tax treaties and protocols that Australia has concluded since 1999 consist of the following three categories; new tax treaties, existing tax treaties that were renegotiated, and protocols signed to amend existing tax treaties. Since 1999, there have been 11 new

[31] See, for example, the Australia–Chile tax treaty signed in 2010: *Convention Between Australia and the Republic of Chile for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion*, signed 10 March 2010, [2013] ATS 7 (entered into force 8 February 2013) art 24 ('Australia–Chile Double Tax Agreement').
[32] The United Kingdom, Turkey, Israel, Iceland, and Portugal.
[33] Norway, South Africa, India, Switzerland, and Germany.
[34] Li et al, above n 27, 48.
[35] *Treasury Laws Amendment (Foreign Investment) Act 2024*.
[36] Review of Business Taxation, above n 12, Recommendation 22.23 ('Priority for DTAs with Major Trading Partners').

treaty partners with no discernible geographical pattern. These treaties range from Argentina (1999), Slovakia (1999), South Africa (1999), Romania (2000), Russia (2000), Mexico (2002), Chile (2010), and Turkey (2010), to the more recent treaties with Israel (2019), Iceland (2022), and Portugal (2023). On the other hand, renegotiated treaties with existing partners reflect a more traditional approach, with those countries being the United Kingdom (2003), Finland (2006), France (2006), Norway (2006), Japan (2008), New Zealand (2009), Switzerland (2013) and Germany (2015). Further, protocols signed are also consistent with the targeted countries for renegotiation as they include the United States of America (2001), Canada (2002), Malaysia (1999, 2002 and 2010), Vietnam (2002), New Zealand (2005), South Africa (2008), Belgium (2009), Finland (2009), Singapore (2009), India (2011), Norway (2011), and France (2018).

Consistent with the recommendations of the Review of Business Taxation, Australia focused on updating its existing network to reflect modern tax treaty policy. Australia indeed made efforts to renegotiate the ageing tax treaties with its trading partners, especially those particularly listed by the Review, namely the United States, the United Kingdom, and Japan, through concluding new double tax agreements to replace the prior ones or signing protocols to amend their existing double tax agreements. However, it should be noted that some ageing tax treaties with contracting states in Asia and Europe have still not been renegotiated despite many of these jurisdictions being major trading partners where Australian residents have investments or have been carrying out cross-border transactions. For example, the Philippines (1979), Ireland (1983), China (1988), and Thailand (1989), all fall within this category.

2.4 A review of treaty policy

The fourth recommendation, contained in Recommendation 22.24,[37] provided that to assist Australia's competitiveness, its overall treaty policy should be reviewed in order to ensure that it reflected a balanced taxation of international investment and changed investment patterns. This broad recommendation, perhaps the most significant of the four, acknowledged the changing landscape in the Australian economy, particularly from one of traditionally being a net capital importer to an increasingly large amount of capital exports. Statistics provided in the Report suggested that in the first half of the 1980s, Australian investment abroad was only 10 to 20 per cent of the volume of foreign investment in Australia, but by the late 1990s, Australian investment abroad was approximately 60 per cent of the level of foreign investment in Australia.[38] The aim of reviewing treaty policy was to ensure an appropriate balance of source- and residence-based taxing rights to encourage both inbound and outbound investment.

As John Taylor noted, it is extremely rare for government material on Australian tax treaty policy and practice to be made public.[39] An exception occurred in 2008[40] when

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[37] Ibid Recommendation 22.24, above n 17.

[38] Ibid; Review of Business Taxation (John Ralph, chair), *A Strong Foundation: Discussion Paper, Establishing Objectives, Principles and Processes* (1998) 24, Fig 2.3.

[39] See Christopher John Taylor, 'A Critical Assessment of the Origins and Continued Validity of Variations in Australian Tax Treaties from the OECD Model' (PhD Thesis, University of Sydney, 2016) 21 <https://ses.library.usyd.edu.au/bitstream/handle/2123/15785/?sequence=2> ('A Critical Assessment').

[40] Hon Chris Bowen (Assistant Treasurer and Minister for Competition Policy and Consumer Affairs), 'Australia's Tax Treaty Negotiation Policy' (Media Release, 25 January 2008) <https://ministers.treasury.gov.au/ministers/chris-bowen-2007/media-releases/australias-tax-treaty-negotiation-policy#attach>.

the government at the time commissioned a review of Australia's tax treaty policy and provided feedback on submissions received.[41] A formal report was not published. However, a media release indicated that '[s]ubmissions presented a range of suggestions to improve Australia's treaty policy and provided recommendations for the treaty program. Submissions called on the Government to prioritise negotiating tax treaties with emerging economies in our region and countries with which Australia has most favoured nation (MFN) obligations'.[42]

Seven key themes were identified from the consultation process and made public.[43] The first was the need to prioritise the emerging economies of China and India as well as other countries in the region, such as Singapore, Hong Kong, Indonesia, the Philippines, Malaysia, Thailand, and countries that would position Australia as a regional headquarters for United States, United Kingdom, and European multinational companies.[44] The remaining themes included a more residence-based approach, lower dividend and royalty withholding tax rates, provisions to deal with real estate investment trusts, treatment of capital gains, transfer pricing audits, and arbitration clauses. Of note is that many of these themes are consistent with the Board of Taxation Review in 2002 rather than the Review of Business Taxation that preceded it, perhaps due to its intervening effect and its more comprehensive consideration of Australia's treaty network.

Subsequent to the 2008 Review and feedback provided by the government, two consultation processes have been conducted into the expansion of Australia's tax treaty network. In September 2021, the Treasury sought submissions from stakeholders on the key outcomes Australia should seek in negotiating these tax treaties and other issues related to Australia's treaty network.[45] Forty-one submissions were received, with 35 of those publicly available. However, the federal government did not provide a response to those submissions or address key themes. On 13 March 2024, another consultation was announced with the Australian government seeking stakeholder views on key outcomes it should seek in entering into tax treaty negotiations with Brazil, New Zealand, the Republic of Korea, Sweden, and Ukraine as part of its expansion of Australia's tax treaty network.[46] At the time of writing, submissions have not been made public and the federal government has not provided feedback.

3. The Board of Taxation's Review of International Taxation Arrangements

The Board of Taxation, a non-statutory advisory body charged with contributing a business and broader community perspective to improving the design of taxation laws and their operation, was charged in 2002 with reviewing Australia's international

[41] Hon Chris Bowen (Assistant Treasurer and Minister for Competition Policy and Consumer Affairs), 'Australia's Tax Treaties – Industry's Message to Government' (Media Release, 26 June 2008) <https://ministers.treasury.gov.au/ministers/chris-bowen-2007/media-releases/australias-tax-treaties-industrys-message-government> ('Australia's Tax Treaties – Industry's Message to Government').
[42] Ibid.
[43] Ibid.
[44] Ibid.
[45] Australian Treasury, 'Expanding Australia's Tax Treaty Network' (Consultation, 16 September 2021) <https://treasury.gov.au/consultation/c2021-208427>.
[46] Australian Treasury, 'Expanding Australia's Tax Treaty Network' (Consultation, 13 March 2024) <https://treasury.gov.au/consultation/c2024-506070>.

taxation arrangements from four principal areas. These areas consisted of the dividend imputation system's treatment of foreign source income, the foreign source income rules, the overall treatment of conduit income, and the high-level aspects of the double tax agreement policy and processes. In February 2003, the Board of Taxation delivered its Report to the Treasurer, which was subsequently made public on 13 May 2003 as Volume 1 and Volume 2 of the Board's Report.[47]

From a broad policy perspective, the Board endorsed the direction of the government at the time in moving to a more residence-based approach in its tax treaties.[48] It noted that the existing treaties tended to emphasise source through their wide definition of permanent establishment and relatively high withholding tax ceiling on dividends, interest, and royalties. The Board expressed the view that it believed 'the source-based [double tax agreement] policy has detrimental impacts on Australian firms investing offshore because it exposes them to high taxes in tax treaty partner countries.'[49] and suggested Australia's tax treaty policy should move towards a more residence-based treaty policy in substitution for the treaty model based on the source taxation of income'.[50] The consequence of this overarching view was that the Board's recommendations were generally broader and more aggressive than the earlier Review of Business Taxation.

The broad recommendations were made in an attempt to update Australia's tax treaty negotiation policy to reflect a change from being a significant capital importer to having a more equal inflow and outflow of investments. The Board expressed the view that '[t]he distorting effects of source-based taxes may mean that resulting economic efficiency gains for both inbound and outbound investment will exceed revenue foregone by moving to a residence-based policy for [double tax agreements]'.[51] The Board also commented on the 2001 Amending Protocol with the United States (2001 US Protocol), citing it as an example of a move towards residence-based taxing rights but one that still has greater source-taxing emphasis than the OECD Model Tax Convention.[52]

While numerous recommendations dealt peripherally with treaty issues,[53] and other recommendations supported the views expressed in the Review of Business Taxation,[54] four substantive recommendations that had the potential to lead to changes in Australia's tax treaty network can be identified. The Board suggested these four recommendations as potential solutions to what it saw as the overarching challenges to

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[47] Board of Taxation, Review of International Taxation Arrangements, above n 13. Volume 3 of the Report involving confidential submissions was not released by the Treasurer.
[48] Ibid vol 1, 11.
[49] Ibid para 3.55.
[50] Ibid 94; there is some incidental discussion of tax treaties elsewhere in the report, eg, at 105-106.
[51] Ibid 93; there is some incidental discussion of tax treaties elsewhere in the report, eg, at 105-106.
[52] *Protocol Amending the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 6 August 1982 ([1983] ATS 16),* signed 27 September 2001, 2260 UNTS 117 (entered into force 12 May 2003) ('2001 US Protocol'). See <https://www.austlii.edu.au/au/other/dfat/treaties/2003/14.html>.
[53] For example, Recommendation 3.13 provided that a non-resident for treaty purposes should be treated as a non-resident for all purposes of income tax law, as an alternative to the current dual resident company provisions. See Board of Taxation, Review of International Taxation Arrangements, above n 13, vol 1, 10.
[54] For example, lowering the dividend withholding tax on non-portfolio dividends, priority in renegotiating tax treaties with major trading partners.

Australia's tax treaty network. Numbered 3.5 to 3.8, the four recommendations were found in the section discussing '[promotion of] Australia as a location for internationally-focused companies'.[55] Specifically, these four recommendations dealt with a move towards a more residence-based treaty policy, rejecting the application of capital gains tax to the sale by non-residents of non-resident interposed entities with underlying Australian assets (apart from land, discussed below), prioritising treaty negotiations with investment partners, and improvements around the processes on negotiating tax treaties.

3.1 A more residence-based treaty policy

In line with the Board's overarching comments, Recommendation 3.5 of the Report suggested a move towards a more residence-based treaty policy in substitution for the treaty model based on the source taxation of income.[56] The emphasis within this recommendation was placed on withholding taxes based on the argument that higher levels of withholding tax may disadvantage Australian companies operating offshore against local competitors and against competitors resident in countries that negotiate lower withholding tax rates.[57] This recommendation was consistent with Australia increasingly becoming a capital-exporting nation. It was suggested that future treaties should be negotiated or renegotiated in line with the 2001 US Protocol and that treaties should eliminate the dividend withholding tax for most franked and unfranked non-portfolio dividends, reduce the royalty withholding tax rate, and reduce the interest withholding tax rate to zero for financial institutions.[58] These changes would have the resulting effect of reducing both tax paid by non-residents on Australian sourced income and reducing the cost to Australian businesses investing in treaty partner countries.

A review of Australia's negotiated or renegotiated treaties since 2002 indicates that dividend withholding tax rates have been reduced and are listed in Table 1 above. There has also been a change in policy in relation to interest withholding taxes for financial institutions and a reduction in the rate of royalty withholding taxes. Treaties negotiated since 2002 have generally adopted a zero per cent rate for interest withholding taxes for financial institutions. This includes the treaties with the UK, France, Norway, Finland, Japan, New Zealand, Switzerland, Germany, Iceland, and South Africa. The treaties with Chile and Portugal provide for a reduced rate of 5 per cent on interest paid by financial institutions. Royalty withholding tax in treaties negotiated since 2002 are generally at the rate of 5 per cent (UK, France, Norway, Finland, Japan, New Zealand, Chile, Switzerland, Germany, Israel, South Africa), with the more recent treaties of Iceland and Portugal increasing the rate to 10 per cent.

Three treaties negotiated in or post-2002 contain a zero per cent dividend withholding tax rate – the treaty signed with Mexico in 2002, the protocol signed with Malaysia in the same year, and the treaty signed with France in 2006. Each, however, adopts a different approach. The treaty entered into with Mexico in 2002[59] provides a reciprocal

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[55] Board of Taxation, Review of International Taxation Arrangements, above n 13, vol 1, 89-97.
[56] Ibid vol 1, 3.
[57] Ibid vol 1, 93.
[58] Ibid.
[59] *Agreement Between the Government of Australia and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 9 September 2002, 2453 UNTS 3 (entered into force 31 December 2003).

approach of eliminating dividend withholding tax on franked non-portfolio dividends.[60] In contrast, the treaty with France in 2006 provided a unilateral approach where France and Australia, in the position of the source state, committed to imposing a zero per cent dividend withholding tax rate on dividends paid out of profits that have borne the normal rate of company tax and those dividends are paid to a company which, in the case of Australia, holds directly at least 10 per cent of the voting power of the company paying the dividends, or in the case of France, holds directly at least 10 per cent of the capital of the company paying the dividends.[61]

The 2002 protocol with Malaysia adopted a different approach to the Mexico and France treaties. Specifically, the protocol provided that when Australia is the source country, no tax shall be charged on dividends to the extent to which those dividends have been '"franked" in accordance with Australia's law relating to tax, if the person beneficially entitled to those dividends is a company (other than a partnership) which holds directly at least 10 per cent of the voting power in the company paying the dividends'.[62] When Malaysia is the source country, 'no tax shall be charged on dividends paid by a company which is resident in Malaysia for the purposes of Malaysian tax being dividends to which a resident of Australia is beneficially entitled, in addition to the tax chargeable in respect of the income or profits of the company paying the dividends'.[63] Consequently, Malaysia committed to exempting the dividend withholding tax on dividends, regardless of whether the dividends were franked or unfranked and whether they were portfolio or non-portfolio in nature.

By far the most significant development during this period was the introduction of a zero rate of dividend withholding tax on inter-corporate dividends where the beneficial owner of the dividends is a company that owns directly shares representing at least 80 per cent of the voting power of the company paying the dividends for the 12-month period ending on the date on which entitlement to the dividends is determined. The policy rationale for this reduction is to remove distortions in the raising of capital for direct investment that results from the more favourable terms that applied in many of the earlier treaties.

3.2 Not extending capital gains tax to sale of shares in non-resident companies

The Review of Business Taxation had, in 1999, proposed that capital gains tax should apply to the sale by non-residents of non-resident interposed entities with underlying Australian assets.[64] The Board of Taxation, in Recommendation 3.6, disagreed with

[60] Ibid Art 10.2.
[61] *Convention Between the Government of Australia and the Government of the French Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion*, signed 20 June 2006, 2614 UNTS 63 (entered into force 1 June 2009) Art 10.2(a).
[62] *Agreement Between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 20 August 1980, 1334 UNTS 237 (entered into force 26 June 1981) Art 10.2(a)(ii) (as amended by the *Second Protocol Amending the Agreement Between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income as Amended by the First Protocol of 2 August 1999*, signed 28 July 2002, 2651 UNTS 105 (entered into force 23 July 2003) Art 2 ('Second Protocol to the Australia–Malaysia Double Tax Agreement')).
[63] Ibid Art 10.2(b) as amended by the Second Protocol to the Australia–Malaysia Double Tax Agreement, above n 62, Art 2.
[64] Review of Business Taxation, above n 12, Recommendation 21.7 ('Avoidance of Tax on Capital Gains by Non-Residents').

such a proposal on the basis that it would be difficult to comply with and hard to enforce.[65] Further, such an extension of Australia's capital gains tax regime would cause inadvertent breaches for overseas investors with a relatively small revenue gain in terms of Australian taxes collected.[66]

When Australia introduced a capital gains tax in 1985, two important issues arose in relation to double tax agreements. The first was how existing treaties applied in relation to capital gains tax, and the second was how future double tax agreements would deal with it. Consistent with Australia's broad-source taxing policy, the Australian Taxation Office (ATO) had taken the position that pre-capital gains tax treaties do not limit taxing rights.[67] Australia also preserved domestic law source taxing rights over capital gains in treaties negotiated after the introduction of the capital gains tax up to 2003. The provisions operated to ensure the capital gains tax is paid on gains by non-residents on shares in resident private companies and non-portfolio interests in public companies. However, capital gains tax did not extend to the sale of shares by non-residents in non-resident companies that hold Australian assets.

The application of the capital gains tax provisions to non-resident shareholders who hold shares in non-resident companies with underlying Australian assets had previously been decided by the court in *Lamesa Holdings*.[68] In that case, it was held that non-residents were not liable for capital gains tax when selling interests of interposed entities whose underlying value is principally derived from Australian real property.[69] In that case, a Dutch company – Lamesa Holdings – sold an interest held in Australian real property via three interposed companies. The shares disposed of by Lamesa Holdings were held in a first-tier Australian company. The Federal Court supported the arguments of Lamesa Holdings, finding that Australia could not tax the gains because the alienation of property article (Article 13) of the Australia–Netherlands income tax treaty (1976)[70] only dealt with gains from the disposal of shares in companies with direct ownership of land and related interests.

Subsequent to *Lamesa Holdings*, the Australian government amended the *International Tax Agreements Act 1953* by inserting section 3A to clarify the meaning of terms used in the alienation of property article in Australia's tax treaties.[71] The Australian government intended to use this new section 3A to override all treaties with limited wording by stipulating that they were to be read as if they applied to profits on the sale of companies with both direct and indirect, through other entities, interests in real property or related interests.[72] While the treaty override was technically legal under Australian law as opposed to international law, as tax treaties only have full application

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[65] Ibid vol 1, 94.
[66] Ibid 93.
[67] ATO, 'Income Tax and Capital Gains Tax: Capital Gains in Pre-CGT Tax Treaties', Taxation Ruling TR 2001/12, now withdrawn.
[68] *Federal Commissioner of Taxation v Lamesa Holdings BV* (1997) 77 FCR 597.
[69] See Robert Deutsch and Nolan Sharkey, 'Australia's Capital Gains Tax and Double Taxation Agreements' (2002) 56(6) *Bulletin for International Taxation* 228; Nikki Teo, 'Australia' in Guglielmo Maisto (ed), *Taxation of Companies on Capital Gains on Shares under Domestic Law, EU Law and Tax Treaties* (IBFD Publications, 2013).
[70] *Agreement Between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed on 17 March 1976, 1029 UNTS 135 (entered into force 27 September 1976).
[71] See the Taxation Laws Amendment Bill (No 11) 1999.
[72] Ibid.

when incorporated into domestic law, the move did not enhance Australia's reputation as a reliable treaty partner.[73] Secondly, Australia concluded eight treaties,[74] in the form of new tax treaties or protocols to amend the prior treaties, with a provision ensuring Australia taxes the transfer of interest directly or indirectly derived principally from the Australian real property.

Domestic law was also amended in 2006 with the *Income Tax Assessment Act 1997* now providing that non-resident shareholders are subject to Australia's capital gains tax rules on the disposal of interests in an entity that holds taxable Australian real property if the entity's underlying value is principally derived from real property located in Australia. As such, from a domestic law perspective, non-residents are taxed on capital gains in respect of certain capital gains tax events happening to Australian property by broadly limiting these assets to real property situated in Australia.[75] Where, however, a non-resident disposes of an indirect interest in Australian real property through one or more interposed entities, the Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No 4) Bill indicates that the amending provision has the effect that the legislation is consistent with Australian and OECD Model Tax Convention practice by applying the capital gain taxes on disposal of interposed resident or non-resident entities by non-residents where more than 50 per cent of the value of the interposed entity is derived from Australian real property.[76] Further, the Explanatory Memorandum notes that Australia has a double tax agreement source country taxing right in respect of capital gains/losses from interests in entities whose assets consist principally of Australian real property, even where held indirectly through a chain of entities.

The Board of Taxation rejected any proposal that the capital gains tax should be extended to shares in non-resident companies as proposed by the Review of Business Taxation. It noted that while the issue has been well understood internationally for many years, very few countries have sought to extend their capital gains tax to shares in foreign companies. The Board's recommendation was to align Australian treaty provisions with the international norm. That is, apart from land-rich companies, capital gains tax should not be levied on non-residents when they dispose of shares in domestic companies, whether portfolio or non-portfolio interests.[77] This approach is consistent with both Australian treaty policy and domestic policy, as outlined above.[78]

Currently, 20[79] of the 47 Australian tax treaties contain a provision in Article 13 allocating the taxing rights to Australia over non-residents' alienation of interests

[73] Richard Krever, 'Tax Treaties and the Taxation of Non-Residents' Capital Gains' in Arthur J Cockfield (ed), *Globalization and Its Tax Discontents: Tax Policy and International Investments, Essays in Honour of Alex Easson* (University of Toronto Press, 2010) 212.
[74] Argentina (1999), Canada (protocol 2002), Malaysia (protocol 1999), Mexico (2002), Romania (2000), Russia (2000), Slovakia (1999), South Africa (1999, and protocol 2008).
[75] Philip Bender, 'Double Tax Treaties and the New Regime for Capital Gains Taxation of Non-Residents' (2007) 36(1) *Australian Tax Review* 49.
[76] Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No 4) Bill 2006.
[77] Board of Taxation, Review of International Taxation Arrangements, above n 13, vol 1, para 3.57.
[78] See Hon Peter Costello (Treasurer), 'International Tax Reforms' (Media Release, 10 May 2005) attachment B <https://ministers.treasury.gov.au/ministers/peter-costello-1996/media-releases/international-tax-reforms>.
[79] Argentina (1999), Canada (protocol 2002), Chile (2010), Finland (2006), France (2006), Germany (2015), Israel (2019), Japan (2008), Malaysia (protocol 1999), Mexico (2002), New Zealand (2009), Norway (2006), Romania (2000), Russia (2000), Slovakia (1999), South Africa (1999, and protocol 2008), Switzerland (2013), Turkey (2010), UK (2003), Iceland (2022), Portugal (2023).

directly or indirectly held in immovable (real) property-rich companies located in Australia. Fifteen of these treaties were signed or amended by relevant protocols since 2002. The typical text of such a specific provision with a principal test of either 'more than 50 per cent of the value' or 'principally attributable' is as follows:

> Income, profits or gains derived by a resident of a Contracting State from the alienation of any shares, comparable interests or other rights deriving more than 50 per cent of their value directly or indirectly from immovable (real) property situated in the other Contracting State may be taxed in that other State.[80]

or

> Income, profits or gains derived by a resident of a Contracting State from the alienation of any shares or other interests in a company, or of an interest of any kind in a partnership or trust or other entity, where the value of the assets of that company, partnership, trust, or other entity, whether they are held directly or indirectly (including through one or more interposed entities, such as, for example, through a chain of companies), is principally attributable to real property situated in the other Contracting State, may be taxed in that other State.[81]

The description of the 'real property' in these tax treaties varies from both the OECD Model Tax Convention and the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN Model Tax Convention), which use the civil law term 'immovable property'. In contrast, Australia prefers to use the common law term 'real property'. The assumption underlying this rule is that gains from the sale of real property are unambiguously connected with the source jurisdiction and that jurisdiction merits first access to taxing rights from the gains.[82] At the same time, the treaties recognise other gains may be directly related to real property or derive from it such as mineral exploration rights and mining rights. Australian treaties commonly extend the application of the article to these ancillary property rights or include them in the definition of real property covered by Article 6 of the treaty, which often includes both the interest in or over land and natural resources, given that Australia is a resource-rich country.

3.3 Priorities in negotiation

The Board commented that in recent times, priority had been given to relatively minor investment partners in extending the network.[83] In addition to keeping key treaties up to date with Recommendation 3.5, in Recommendation 3.7, the Board affirmed the Review of Business Taxation's suggestion to renegotiate tax treaties with existing major trading partners rather than extend the tax treaty network to countries with which Australia has little trade or investment. However, it was recognised that political and economic events could also affect negotiation priorities at particular times.[84] The Board stressed the need

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[80] Australia–Chile Double Tax Agreement, above n 31, Art 13(4).

[81] *Agreement Between the Government of Australia and the Government of the Argentine Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 27 August 1999, 2117 UNTS 3 (entered into force 31 December 1999) Art 13(2).

[82] Richard Krever and Kerrie Sadiq, 'Non-Residents and Capital Gains Tax in Australia' (2019) 67(1) *Canadian Tax Journal* 1.

[83] Board of Taxation, Review of International Taxation Arrangements, above n 13, vol 1, 91.

[84] Ibid.

to take into account the fact that negotiations were underway at the time with the United Kingdom and Germany, the need to update pre-capital gains tax treaties, and the countries Australia may be obliged to approach because of the most favoured nations clauses in existing treaties.[85]

The eight countries listed as being priority countries were the Netherlands, France, Switzerland, Italy, Norway, Finland, Austria, and the Republic of Korea on the basis that the United States treaty had been renegotiated and the most favoured nations clause on rates of withholding tax would apply. To date, Australia has renegotiated four, either through new treaties or updating protocols – Finland in 2006, Norway in 2006, France in 2006, and Switzerland in 2013. The earlier treaties with The Netherlands (1976), Italy (1982), the Republic of Korea (1982), and Austria (1986) are yet to be renegotiated.

Similarly, the Board suggested that if the new treaties with the United Kingdom or Germany contained non-discrimination clauses, Australia would be obliged to enter into an equivalent clause with France, Finland, the Republic of Korea, Spain, and South Africa. To date, of these listed countries, the non-discrimination articles have only been added to treaties with Finland (2006) and South Africa (2008).

3.4 Improving consultation arrangements

An overarching concern of the Board was that double tax agreements were negotiated largely in secret.[86] It noted that while the process had become more open to consultation with the Australian Taxation Office Tax Treaties Advisory Panel and direct dealings with specific taxpayers, the balance remained on the side of secrecy.[87] Further, it was noted that stakeholders were invited to comment only after the negotiation process was almost complete and that any subsequent discussion focused on technical wording rather than matters of policy.[88]

The Board recommended that Australia follow best practice on consultation in relation to double tax treaties in the same way as other countries do for treaties. The overarching conclusion in Recommendation 3.8 was that 'the consultation processes on negotiating tax treaties be improved by adopting processes similar to those of the Board's consultation report as adopted by the Government for domestic tax legislation'.[89] To achieve such an objective, the Board suggested that the Tax Treaties Advisory Panel should be maintained with an improved approach by having more frequent meetings, input into the formation of basic policy as well as technical details, flexible membership to allow affected taxpayers to be consulted on relevant treaties, and the publishing of an Australian model tax treaty.[90]

The Treasurer at the time responded that 'consultation processes similar to domestic tax legislation will be adopted wherever possible, including direct consultation with key industry stakeholders and seeking submissions from the public on forthcoming negotiations. However, these processes will be adapted to reflect the fact that treaties represent a negotiated outcome between two governments and must work within the

[85] Ibid vol 1, 94.
[86] Ibid 90.
[87] Ibid.
[88] Ibid, vol 1, 96.
[89] Ibid 97.
[90] Ibid 96.

broad framework of established treaty practice'.[91] However, publishing an Australian model tax treaty was expressly rejected, with the Treasurer stating that '(it) is not proposed to publish an Australian model tax treaty. Such models can rapidly become out of date, and publication also reduces flexibility'.[92]

4. AUSTRALIA'S FUTURE TAX SYSTEM REVIEW

The Australian government, in its 2008-09 Federal Budget, announced a comprehensive 'root and branch' review of Australia's tax system, aimed at positioning Australia to deal with its 'social, economic and environmental challenges and enhance economic, social and environmental wellbeing'.[93] The Review, known colloquially as the Henry Review, after its Chair, Dr Ken Henry AC, had its findings made public on 2 May 2010. The recommendations, 138 in total, were designed to meet the challenges that Australia would face over a 40-year period, thereby adopting a medium- to long-term view of Australia's tax and transfer system. Of the 138 recommendations, two specifically related to Australia's tax treaty network, with both addressing withholding tax rates and aimed at reducing distortions in how foreign debt is accessed. The two recommendations are complementary, with Recommendation 33 providing that financial institutions operating in Australia should generally not be subject to interest withholding tax on interest paid to non-residents and Recommendation 34 suggesting that '[c]onsideration should be given to negotiating, in future tax treaties, or amendments to treaties, a reduction in interest withholding tax to zero so long as there are appropriate safeguards to limit tax avoidance'.

The two recommendations were a response to industry concerns[94] as it was considered that Australian businesses were discouraged from borrowing money from the international capital market due to higher interest rates, a result of withholding tax rates being built into the cost of debt. The Australia's Future Tax System Review Panel agreed and found that interest withholding tax on foreign capital invested in Australia in the form of debt, while subject to low tax rates, negatively affected the financial sector by distorting the way foreign debt is accessed.[95] The targeted recommendation aimed to cover authorised deposit-taking institutions such as banks, building societies, and credit unions, as well as other financial institutions, to enable greater debt borrowing. To facilitate a zero rate of withholding tax, the Review Panel suggested that the interest withholding tax could be removed through the use of tax treaties, with the example given of the United States–Canada double tax agreement.[96]

This recommendation has been adopted in subsequent treaties, as discussed above in section 3.1.

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[91] Hon Peter Costello (Treasurer), 'Review of International Tax Arrangements' (Media Release, 13 May 2003) <https://ministers.treasury.gov.au/ministers/peter-costello-1996/media-releases/review-international-taxation-arrangements-0>.
[92] Ibid attachment E.
[93] Henry Review, above n 14.
[94] Bowen, 'Australia's Tax Treaties – Industry's Message to Government', above n 41; Richard J Vann, 'Australia's Future Tax Treaty Policy' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson Reuters, 2009) 401.
[95] Henry Review, above n 14, vol 1, 181.
[96] Ibid 182.

5. A RECOMMENDED APPROACH TO REVIEWING AUSTRALIA'S TAX TREATY POLICY

The broad observations of the Board of Taxation's Review of International Taxation Arrangements in 2002-03 are perhaps more telling than any of the specific recommendations coming out of the three reviews examined. Reviews are generally designed to take stock of the current flaws in a system, make recommendations to address challenges, and future-proof the regulatory regime. The Board of Taxation's observations are feasibly the most telling in terms of Australia's tax treaty policy and the approaches to negotiations. Not only did it note the fact that double tax agreements are negotiated largely in secret,[97] but also that the treaty negotiation agenda was largely due to earlier inactivity and the practice of giving priority to extending the network to relatively minor investment partners.[98] It also noted that political events may affect negotiation priorities at particular times.[99]

Consistent with prior studies that have undertaken an historical analysis of tax reform as a result of tax reviews,[100] this study finds that recommendations over the last 25 years that specifically relate to Australia's tax treaty network have had limited response from the government in terms of formalising Australia's tax treaty policy. This is not to say that recommendations coming out of the reviews are inconsistent with developments. The most significant reforms relate to the withholding taxes and changes to the capital gains tax provisions as well as the non-discrimination articles as discussed above. Recommendations, being at the government's discretion, have been selectively implemented, with little consideration of administrative recommendations such as priorities in negotiation and improving consultation arrangements. Within the context of tax treaties, this is perhaps in part because the reviews were conducted in a piecemeal way without a comprehensive review of Australian tax treaty policy.

This article proposes a comprehensive review of Australia's tax treaty policy. To do so, an investigation into the current policy, as well as what the policy should look like moving into the future, is required. We suggest that this raises two broad issues. First, Australia's position on what it will negotiate within treaties needs to be determined. Second, Australia's process of treaty negotiation should be established and transparent.

As to the first, the broad question of what Australia's position is on whether it should adopt a source-based or a residence-based treaty policy, needs to be established. To date, a consensus has not been reached as reflected in current treaties, although traditionally, there has been a bias towards source taxation. This is reflected in a number of features in current treaties, such as a wide definition of permanent establishment, which increases Australia's taxing rights over non-residents' business operations in Australia, and relatively high withholding tax rate ceilings for dividends, interest and royalties derived by non-residents from Australia, although this is of little significance in the current treaty network.[101]

In line with a decision as to whether Australia's approach is one of source-based treaty policy or residence-based treaty policy, there needs to be clear guidelines as to what taxing rights Australia is not prepared to give up and what taxing rights it is prepared to

[97] Board of Taxation, Review of International Taxation Arrangements, above n 13, vol 1, 90.
[98] Ibid 91.
[99] Ibid.
[100] Evans and Krever, above n 9.
[101] Board of Taxation, Review of International Taxation Arrangements, above n 13, vol 1, para 3.50.

negotiate. As a resource-rich country, Australia needs to take into account the competing imperatives of ensuring tax policy facilitates foreign investment while ensuring taxing rights and revenue are not forgone. A move towards a residence-based approach requires economic interests such as natural resources to be taken into account to ensure tax from the exploitation of its natural resources is collected. Currently, this is captured by ensuring taxing rights on income from or relevant to natural resources in articles dealing with permanent establishments and articles dealing with income from immovable property and alienation of property in its tax treaties. To date, Australia has made a reservation to Article 5, paragraph 1 of the OECD Model Tax Convention, reserving the right to treat an enterprise as having a permanent establishment in a state if it carries on activities relating to natural resources or operates substantial equipment in that state with a certain degree of continuity, or a person – acting in that state on behalf of the enterprise – manufactures or processes in that state goods or merchandise belonging to the enterprise.

Australia has also made a reservation to Article 6 of the OECD Model Tax Convention, reserving the right to include rights relating to all natural resources under the article. In Australian treaty practice, the use of agricultural, pastoral, or forestry property in the list of examples of a permanent establishment has existed since Australia signed its first tax treaty with the United Kingdom in 1946.[102] Currently, in all treaties except the 2010 Turkish treaty,[103] Australia's 47 tax treaties, in addition to the core elements of the definition in both the UN and OECD Model Tax Conventions, specifically include in the permanent establishment article agricultural, pastoral, or forestry property as one of the fixed places provided as examples of a permanent establishment, regardless of whether the partner states are developed countries or developing countries.

In contrast to these reservations, there are certain taxing rights that Australia seems to be prepared to give up during negotiations or after a treaty has been introduced into Australian law. As such, we suggest that both the giving up of taxing rights and the method by which taxing rights and obligations under treaties need to be reviewed.

The most recent example of treaty override is Australia's negotiation with India and its desire to conclude the *Australia–India Economic Cooperation and Trade Agreement* (AI-ECTA) in 2022 to achieve its free trade objectives. In this case, it agreed with India to stop taxing certain Indian offshore technical services. In *Tech Mahindra Ltd v Federal Commissioner of Taxation*[104] in 2016, and *Satyam Computer Services Limited*

[102] Article II, para (1)(j) of the Australia–UK Double Tax Agreement (1946), above n 3, defined the term 'permanent establishment' as 'a branch or other fixed place of business and includes a management, factory, mine, or agricultural or pastoral property, but does not include an agency in the other territory unless the agent has, and habitually exercises, authority to conclude contracts on behalf of such enterprise otherwise than at prices fixed by the enterprise or regularly fills orders on its behalf from a stock of goods or merchandise in that other territory'. It did not include 'forestry' property.

[103] Note, in Article 5(1) of the Australia–Finland tax treaty (2006), the term 'permanent establishment' is specifically defined as 'an agricultural, pastoral or forestry property situated in Australia': *Agreement Between the Government of Australia and the Government of Finland for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion*, signed 20 November 2006, 2512 UNTS 3 (entered into force 10 November 2007) Art 5(1).

[104] *Tech Mahindra Limited v Federal Commissioner of Taxation* (2016) 250 FCR 287. See further Richard Krever and Jonathan Teoh, 'The *Tech Mahindra* Case – Royalties Derived Through a PE' (2016) 84(1) *Tax Notes International* 33; Anton Joseph, 'Double Tax Agreements – More Sword than Shield' (2019) 26(2) *International Transfer Pricing Journal* 122.

v Federal Commissioner of Taxation[105] in 2018, the courts determined that by virtue of the deemed source rule in Article 23 of the India–Australia tax treaty, payments to Indian residents were deemed to have an Australian source and, therefore, should be assessable under Australian domestic law.[106] The Indian government, in response and as part of the negotiations process of the AI-ECTA in 2021 and 2022, requested that the Australian government remove these tax barriers.

According to government reports, through exchanging side letters on the signature day of the AI-ECTA, Australia agreed to amend 'domestic taxation law to stop the taxation of offshore income of Indian firms providing technical services to Australia' in a similar timeframe as the AI-CETA.[107] To fulfil its commitment, the Australian Treasury, on 28 September 2022, submitted a Bill to the Parliament, namely the Treasury Laws Amendment (Australia-India Economic Cooperation and Trade Agreement Implementation) Bill 2022, with the intention of amending the *International Tax Agreements Act 1953.*[108] The Bill proposed to introduce section 11J into the *International Tax Agreements Act 1953*, which states that certain payments are not royalties for the purposes of the India–Australia treaty.[109] Consequently, section 11J ensures Australia is prevented from taxing the payments and credits made to Indian residents by Australian customers for technical services provided remotely and covered by Article 12(3)(g) of the India–Australia tax treaty.[110]

The second broad issue that needs to be addressed in a comprehensive review of Australia's tax treaty network is the process and transparency of Australia's treaty policy and negotiation practices. This is a key step in providing greater transparency and certainty for all stakeholders, especially cross-border businesses. This would be in stark contrast to the current approach of successive governments dealing tangentially with treaty issues or because of court cases and behind closed doors.[111] The current Australian policy is to not publish a model convention. If this policy is to remain, a comprehensive treaty policy review could be used as guidance. At this time, it is unclear whether Australia follows the OECD Model Tax Convention or the UN Model Tax Convention, as neither has been strictly followed.

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[105] *Satyam Computer Services Limited v Federal Commissioner of Taxation* (2018) 266 FCR 502.

[106] See C John Taylor and Richard J Vann, 'Source Rules in Tax Treaties and Domestic Law: Satyam Case' in Michael Lang, Alexander Rust, Jeffrey Owens, Pasquale Pistone, Josef Schuch, Claus Staringer, Alfred Storck, Peter Essers, Eric CCM Kemmeren, Cihat Öner and Daniël S Smit (eds), *Tax Treaty Case Law around the Globe 2019* (Linde Verlag and IBFD Publications, 2020) 187. See further Celeste M Black, 'Digitalisation and Broadcasting: Evaluating the Application of Royalty Withholding Tax to Digitalised Business Models' (2019) 48(4) *Australian Tax Review* 264.

[107] The side letters exchanged between Australia (Hon Dan Tehan, Minister for Trade, Tourism and Investment) and India (Hon Piyush Goyal, Minister of Commerce and Industry, Consumer Affairs, Food and Public Distribution and Textiles) on 2 April 2022. See Department of Foreign Affairs and Trade, 'Australia–India ECTA Official Text' <https://www.dfat.gov.au/trade/agreements/in-force/australia-india-ecta/australia-india-ecta-official-text> (accessed 8 November 2023).

[108] See Treasury Laws Amendment (Australia-India Economic Cooperation and Trade Agreement Implementation) Bill 2022, sch 1, cl 3.

[109] *Treasury Laws Amendment (Australia-India Economic Cooperation and Trade Agreement Implementation) Act 2022* (Cth) Sch 1, which commenced on the day that the Economic Cooperation and Trade Agreement entered into force (29 December 2022).

[110] The *Income Tax (International Agreements) Amendment Act (No 2) 1991* (Cth) amended domestic legislation to give force to the India–Australia tax treaty (1991).

[111] Vann, above n 94.

Currently, there is a bias towards the OECD Model Tax Convention. However, this has not been explicitly stated. When Australia signed its first treaty with the United Kingdom in 1946, the OECD Model Tax Convention had not been published. Australia became a member of the OECD in 1971, which means it should '(w)hen concluding new bilateral conventions or revising existing bilateral conventions, conform to the Model Tax Convention, as interpreted by the Commentaries thereon'.[112] Hence, Australia, logically, should follow the OECD Model Tax Convention when concluding tax treaties with partner states, particularly with more advanced economies that are also fellow members of the OECD. However, the OECD Model Tax Convention works on the assumption that in terms of economic relations of any one country with the entire group of OECD countries overall, outbound and inward investment flows and initiation of cross-border business transactions would roughly equate with one another, so the bias in favour of residence countries would yield about the same tax revenue as a system biased towards source country taxation of cross-border income.[113]

Australia's willingness to adopt different stances in negotiations with OECD and non-OECD members, often yielding taxing rights to developing and transitional countries, is documented in the literature.[114] Most of Australia's tax treaties are however with OECD members. Of the current 47 Australian tax treaties, 29 were signed with the OECD member states, which represents 62 per cent of the current treaty partners of Australia. Seven of the total of eight countries, that have not signed tax treaties with Australia so far, that are on Australia's planned treaty negotiations agenda are OECD countries.[115]

The question of which Model Convention to follow is perhaps the most vexing for Australia. In terms of its relationship with large OECD member states, Australia is generally a net capital importer, leaving it in a similar position to less developed countries with large OECD treaty partners. In this respect, it would be to Australia's advantage to use the UN Model Tax Convention as a model when negotiating treaties with most other OECD members. At the same time, Australia is a capital exporter with many poorer regional neighbours, and it would be to Australia's benefit if tax treaties with these jurisdictions followed the OECD Model Tax Convention. On the other hand, it would be expected by fellow OECD members that Australia would follow the OECD Model Tax Convention in treaties with other OECD members, and poorer regional treaty partners would hope Australia would recognise their need for a greater share of taxing rights over the income generated in their territories and rely more on the UN Model Tax Convention when negotiating treaties with these jurisdictions.

Scholars such as John Taylor have noted this distinctive feature of Australia's treaty network and tested the Australian treaty provisions in the context of determining

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[112] According to OECD Council, *Recommendation of the Council Concerning the Model Tax Convention on Income and on Capital*, adopted by the Council on 23 October 1997, C(97)195/FINAL, para I(2).

[113] OECD, *Draft Double Taxation Convention on Income and Capital* (OECD Publishing, 1963).

[114] Kathrin Bain, Richard Krever and Anthony van der Westhuysen, 'The Influence of Alternative Model Tax Treaties on Australian Treaties' (2011) 26(1) *Australian Tax Forum* 31.

[115] The OECD countries on the Australian agenda for negotiating tax treaties are Colombia, Estonia, Latvia, Lithuania, Slovenia, Greece, and Luxembourg. See Hon Andrew Leigh (Assistant Minister for Competition, Charities and Treasury and Assistant Minister for Employment), 'Tax Treaty Network Expansion' (Media Release, 16 November 2022) <https://ministers.treasury.gov.au/ministers/andrew-leigh-2022/media-releases/tax-treaty-network-expansion>. It means that amongst the 37 OECD member states, only Costa Rica is not yet on Australia's treaty negotiation plan.

whether they follow the OECD Model Tax Convention or the UN Model Tax Convention.[116] Taylor examined the definition of a permanent establishment, the savings clause in non-arm's length provisions, treaty articles giving income an Australian source that it would not have under domestic law, the 'other income' article, the experience of not agreeing to and then modifying the non-discrimination article, the capital gains articles and rates of withholding taxes on investment income in the Australian tax treaties from 1946 to 2011. He argued that although Australian tax treaty policy and practice since 2001 has moved closer to the OECD norms, they still have many distinctive features as a product of Australia's emphasis on source-based taxation as well as responding to Australian domestic law concerns.[117]

Further, Taylor, in 2012, examined the factors that influenced Australian taxation treaty practice in the period from 1946 to 1976, including the economic factors, cultural and political considerations, domestic law considerations, model treaties of the partner states, treaty practice of third countries, model conventions developed by the League of Nations, the OECD and UN, and the development of an Australian model treaty. He argued that:

> For most of the period, Australian entry into taxation treaties was linked to an expectation of encouraging greater foreign investment in Australia while maintaining a relatively high level of source country taxing rights and obtaining bi-lateral measures of use in combating international tax avoidance. For most of the period, Australian domestic law considerations and prior Australian treaty practice were major factors affecting the technical content of Australian treaties. While gradually moving closer to the OECD model, Australian treaties in this period differ from the model in their structural and certain technical features. Towards the end of the period the relatively insignificant revenue impact of new treaties and Australia's membership of the OECD influence Australia in entering into new treaties as a normal link between civilised and friendly countries.[118]

In 2016, Taylor submitted his PhD thesis to the University of Sydney with the title 'A Critical Assessment of the Origins and Continued Validity of Variations in Australian Tax Treaties from the OECD Model' where he reviewed the development of Australia's tax treaty policy and practice since 1946, listed the variations of the Australian tax treaties from the OECD Model Tax Convention and explained the original rationale of this variation based on the relevant archival documents.[119]

The work of John Taylor in the analysis of the history of Australia's tax treaty policy and practices is exemplary. Much of his research demonstrates the disparity in approaches. Consequently, a comprehensive review of the tax treaty network in Australia is not only warranted but long overdue.

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[116] Taylor, 'Some Distinctive Features of Australian Tax Treaty Practice', above n 1.
[117] Ibid.
[118] C John Taylor, 'Factors Influencing Australian Taxation Treaty Practice 1946-1976' (2012) 27(3) *Australian Tax Forum* 571.
[119] Taylor, 'A Critical Assessment', above n 39.

A thematic history of New Zealand's double taxation agreements

Andrew MC Smith[*] and Jonathan Barrett[**]

Abstract

This article seeks to pay tribute to John Taylor's scholarship in the field of the history of Australian double taxation agreements (DTAs). Referencing Taylor's formidable body of research, the article adopts a thematic approach to outline the history of New Zealand's DTAs, including tax treaties with Australia.

Keywords: double taxation agreements, history, Australia, New Zealand, passive income

[*] Associate Professor in Taxation, School of Accounting and Commercial Law, Victoria University of Wellington Te Herenga Waka. Email: andrew.smith@vuw.ac.nz.
[**] Associate Professor in Taxation, School of Accounting and Commercial Law, Victoria University of Wellington Te Herenga Waka.

1. INTRODUCTION

From the Dominion-era and beyond, histories of Australia and New Zealand have been parallel, connected and occasionally entwined, as exemplified by the role of the ANZAC bloodshed in building imageries of nationhood.[1] Indeed, how many states have, as Australia has done, invited another country to join it and maintained that possibility in its *Constitution* for more than a century?[2] New Zealand has often looked across the Tasman for inspiration for its legislation, including tax statutes: for example the *Land and Income Assessment Act 1891* (NZ) closely followed South Australia's *Taxation Act 1884* (SA),[3] Australia's first general income tax legislation.[4] Nevertheless, despite obvious similarities and commonalities of history, in the field of taxation, small but arguably significant differences distinguish the two countries. Specifically, in the development of double taxation agreements (DTAs) before the countries joined the Organisation of Economic Co-operation and Development (OECD),[5] they manifested particularist approaches to engaging with international juridical double taxation. Professor Taylor has extensively investigated the Australian approach; more modestly, here we attempt to sketch the New Zealand means of engagement with that issue, while referencing his work.

Sigmund Freud coined the phrase 'the narcissism of small differences' (*der Narzissmus der kleinen Differenzen*) to explain why the more a relationship shares commonalities, the more likely the partners to that relationship are to engage in interpersonal feuds and mutual ridicule because of hypersensitivity to minor differences perceived in each other.[6] We are, then, conscious of the implications of the 'small differences' between Australian and New Zealand approaches to international juridical taxation but, in general, do not intend a Freudian meaning. Postcolonial Australia and New Zealand are cognate and cooperative countries but nevertheless are rivalrous in certain regards, including trade and the assertion of taxing rights. Those small differences, manifest for example in the ways the countries have differently taxed companies and their distributions, have played an important role in both establishing and overcoming barriers to double taxation.

As an effective historian, in his studies, Taylor identifies historical currents but also teases out particularities from grand narratives. The French historian Emmanuel Le Roy Ladurie has been described as having distinguished members of his profession between 'parachutists', who look at the general contours of a subject from a high-altitude perspective and 'truffle hunters', 'who look for events and vignettes that speak to bigger truths about a time in history [and who] he said, keep "their noses buried in the

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[1] See, eg, Marilyn Lake, 'Beyond ANZAC: What Really Shaped Our Nation?' *Pursuit* (Blog Post, 23 April 2018) <https://pursuit.unimelb.edu.au/articles/beyond-anzac-what-really-shaped-our-nation>.

[2] See *Australian Constitution*, s 6, definition of 'States'.

[3] See John Prebble, '100 Years of Income Tax' (1993) 47(2) *Bulletin for International Taxation* 59, 60.

[4] See Peter Mellor, 'Origins of the Judicial Concept of Income in Australia' (2010) 25(3) *Australian Tax Forum* 339.

[5] Australia ratified the Convention on the Organisation for Economic Co-operation and Development (1960) on 7 June 1971, and New Zealand ratified on 29 May 1973. See OECD, 'List of OECD Member Countries – Ratification of the Convention on the OECD' (Web Page) <https://search.oecd.org/about/document/ratification-oecd-convention.htm>.

[6] See Sigmund Freud, *Civilization, Society and Religion: Group Psychology, Civilization and Its Discontents and Other Works, Volume 12,* tr James Strachey (Penguin Books, 1991) 131.

details"'.[7] In the field of DTAs, Taylor was both a parachutist and truffle hunter. And so, while it is important to understand, say, the broad development of DTAs – the Dominion Income Tax Relief (DITR) scheme granted within the British Empire,[8] the early work of the League of Nations in formulating international tax norms,[9] the OECD model tax conventions,[10] and, today, anti-BEPS initiatives[11] – it is nevertheless illuminating to uncover how these broad developments were received and given effect in specific jurisdictions. Taylor's meticulous investigation of Australian DTAs is a paragon of such research,[12] and, while this article cannot do justice to his oeuvre, by referencing his work, it seeks to pay tribute to his scholarship.

The article adopts a thematic, rather than a strictly chronological, approach and is structured as follows. Section 2 analyses the development of New Zealand's DTAs.[13] This history is distinguished by a Canute-like resistance to following international tax norms to retain taxing rights over New Zealand-sourced income but ultimate concession, albeit subject to some victories for recalcitrance. The focus lies with taxation of passive income, in particular dividends. Non-discrimination is an adjunct consideration. Australia's broader political approach to DTAs, which Taylor excavates, is compared with New Zealand's somewhat rudimentary cost benefit analyses. Section 3 then outlines the development of the DTAs negotiated between Australia and New Zealand.

Generally, the article highlights New Zealand's historical approach to relieving double taxation, which may be distinguished from the Australian approach that Taylor identifies.

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[7] Brian Murphy, 'Emmanuel Le Roy Ladurie, Historian of the Downtrodden, Dies at 94' *The Washington Post* (25 November 2023) <https://www.washingtonpost.com/obituaries/2023/11/25/roy-ladurie-historian-french-dies> (accessed 8 August 2024).

[8] DITR was introduced by the *Finance Act 1920* (UK) s 27. For a discussion of DITR, see C John Taylor, '"Send a Strong Man to England – Capacity to Put Up a Fight More Important Than Intimate Knowledge of Income Tax Acts and Practice": Australia and the Development of the Dominion Income Tax Relief System of 1920' (2014) 12(1) *eJournal of Tax Research* 32.

[9] See, generally, Sunita Jogarajan, *Double Taxation and the League of Nations* (Cambridge University Press, 2018).

[10] See, eg, Donald R Whittaker, 'An Examination of the OECD and UN Model Tax Treaties: History, Provisions and Application to US Foreign Policy' (1982) 8(1) *North Carolina Journal of International Law* 39.

[11] See, eg, Alison Lobb and Lisa Shipley, 'OECD Inclusive Framework Publishes Outcome Statement on Pillar One and Pillar Two' *Tax Journal* (Blog Post, 21 July 2023) <https://www.taxjournal.com/articles/oecd-inclusive-framework-publishes-outcome-statement-on-pillar-one-pillar-two> (accessed 8 August 2024).

[12] For an item that captures the essence of Taylor's oeuvre, see C John Taylor, 'The History of Australia's Double Tax Conventions' in Michael Lang and Ekkehart Reimer (eds), *The History of Double Taxation Conventions in the Pre-BEPS Era* (IBFD Publications, 2020) 623 ('The History of Australia's Double Tax Conventions').

[13] For a comprehensive chronological history of New Zealand's DTAs, see Andrew MC Smith, 'A History of New Zealand's Double Tax Agreements' (2010) 16 *New Zealand Journal of Taxation Law and Policy* 105; Andrew MC Smith, 'The History of New Zealand's Double Tax Conventions' in Michael Lang and Ekkehart Reimer (eds), *The History of Double Taxation Conventions in the Pre-BEPS Era* (IBFD Publications, 2020) 693.

2. NEW ZEALAND'S DTAS

From the earliest colonial period, New Zealand tended to follow British law and policy,[14] including in the field of taxation.[15] And so, when the UK moved to full worldwide taxation of its residents' incomes in 1914,[16] New Zealand followed this precedent.[17] Despite mimicking the policies of the mother country, significant differences distinguished the economies of New Zealand and the UK. First, New Zealand was a capital importer or 'debtor country',[18] with much of its external investment derived from the UK.[19] Second, New Zealand was primarily an exporter of primary products but lacked a merchant fleet to transport its goods beyond the near Pacific region.[20] These characteristics led the country to seek to claim taxing rights over income of any New Zealand origin. This practice became increasingly incompatible with residence-oriented international tax norms as they developed in the 20th century.[21] Consequently, New Zealand's experience of negotiation of DTAs can be reductively characterised as pursuit of increasingly abnormal claims based on source, and, despite some small victories for recalcitrance, ultimate concession in the face of more powerful negotiating counterparties.

2.1 Early DTAs and issues

The 1924 Royal Commission Report recommended that:

> the question of double taxation be further considered, and arrangements made that will result in British capital invested in New Zealand being placed in a position at least as favourable as in Australia, provided such an arrangement does not put British investors in New Zealand on a better footing than New Zealand investors.[22]

In the arguments presented to the Royal Commission by Dalgety,[23] a British commodities trader, the firm claimed it would be better off investing in Australia (if tax were the only investment consideration).[24] And here is the dilemma New Zealand

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[14] See, eg, *English Laws Act 1858* (NZ).
[15] See Paul Goldsmith, *We Won, You Lost, Eat That! A Political History of Tax in New Zealand Since 1840* (David Ling Publishing, 2008) 104-160. Cf Prebble, above n 3, 60 on another legislative tendency which is to borrow from Australian tax law.
[16] See *Finance Act 1914* (UK) s 5. For a discussion, see MJ Daunton, 'How To Pay For The War: State, Society and Taxation in Britain, 1917-24' (1996) 111(443) *English Historical Review* 882.
[17] See *Land and Income Tax Act 1916* (NZ) s 88(1).
[18] For a discussion of the debtor nations' preference for source-based taxation, see generally Ke Chin Wang, 'International Double Taxation of Income: Relief Through International Agreement 1921-1945' (1945) 59(1) *Harvard Law Review* 73.
[19] See C John McDermott and Rishab Sethi, 'Balance of Payments' *Te Ara – the Encyclopedia of New Zealand* (Web Page, 11 March 2010) <http://www.TeAra.govt.nz/en/balance-of-payments/print> (accessed 8 August 2024).
[20] See Neill Atkinson, 'Seafarers' *Te Ara – the Encyclopedia of New Zealand* (Web Page, 12 June 2006) <http://www.TeAra.govt.nz/en/seafarers/print> (accessed 8 August 2024).
[21] For a discussion of the development of international tax norms, see Marilyne Sadowsky, 'The History of International Tax Law' in Florian Haase and Georg Kofler (eds), *The Oxford Handbook of International Tax Law* (Oxford University Press, 2023) 3.
[22] Royal Commission to Inquire Into and Report Upon Land and Income Taxation (William Alexander Sim, chair), *Land and Income Taxation (Report of the Royal Commission Appointed to Inquire into the Subject of) in New Zealand* (1924) ('Royal Commission') 6.
[23] Ibid 204-205.
[24] Ibid.

policy-makers faced: the country needed to ensure it remained competitive with its much larger neighbour, when both sought UK capital, but it should not disadvantage local investors, who themselves might be tempted to shift capital to Australia. New Zealand's response was to rely on the DITR.

By the mid-1930s, New Zealand treating all commission agents as effective permanent establishments (PEs) was incompatible with international tax norms.[25] In 1935, Belgium, a significant trading partner at that time,[26] threatened to tax New Zealand wool exporters doing business in Belgium in retaliation for New Zealand taxing Belgian exporters on orders obtained in New Zealand through local agents. In response, Parliament passed the *Land and Income Tax Amendment Act 1935* (NZ). This Act, in section 11, amended the *Land and Income Tax Act 1923* (NZ) to provide for a power for the Governor-General power by Order in Council to exempt profits of non-resident traders from New Zealand tax if he was satisfied that New Zealand residents were similarly exempt in the other country.

From 1936 to 1946, in addition to Belgium (1936),[27] Orders in Council were issued in relation Switzerland (1936),[28] Netherlands East Indies (1938) but not the Netherlands itself,[29] Japan (1938),[30] Czechoslovakia (1938),[31] the UK (1942),[32] and Canada (1946).[33]

These exemption orders were rudimentary mechanisms in comparison to modern DTAs that for the most part, simply exempted non-resident traders from New Zealand tax. They also set a precedent of conceding to the more powerful negotiating party. The UK and Canadian Orders were, however, broader in scope. They also exempted income arising from orders obtained by New Zealand agents of non-resident traders, even if they were filled from a warehouse in New Zealand, provided the warehouse was for 'the

[25] The *Land and Income Tax Act 1923* (NZ) s 104 did not distinguish between dependent and independent commission agents, whereas the League of Nations Model Convention, Art 5 did not consider 'a *bona fide* agent of independent status' to be a PE: League of Nations, 'Draft of a Bilateral Convention for the Prevention of Double Taxation' in League of Nations, *Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, Document C.216.M.85.1927.II (April 1927) ('League of Nations Draft Model Convention').

[26] Belgium was also an important trading partner for Australia during the 1930s. See Boris Schedvin, *Emissaries of Trade: A History of the Australian Trade Commissioner Service* (Austrade, 2008) 60.

[27] See 'Reciprocal Application of Income-tax Exemption to Non-resident Traders Resident in or Nationals of Belgium', Order in Council, 18 February 1936 in New Zealand, *Government Gazette*, No 16, 27 February 1936, 340. 'The principal provisions of this agreement were: (a) Each country granted most-favoured-nation treatment to the other; (b) New Zealand reduced the duty on certain Belgian goods, chiefly matches (by abolition of surtax), carpets, glassware, sensitized surfaces, and firearms; and (c) Belgium reduced the duty on New Zealand cheddar cheese and fresh apples, and provided for the free admission into Belgium of New Zealand tallow, hides, skins, greasy wool, and phormium fibre': New Zealand, *The New Zealand Official Year-Book, 1936* (1935), reproduced at: *Statistics New Zealand* <https://www3.stats.govt.nz/New_Zealand_Official_Yearbooks/1936/NZOYB_1936.html>.

[28] See *Income-Tax: Exemption of Traders Resident in or Nationals of Switzerland*, Order in Council, 12 August 1936, 4/1936.

[29] See *Income-Tax: Exemption of Traders Resident in or Nationals of Netherlands East Indies*, Order in Council, 23 February 1938, 1938/35.

[30] See *Income-Tax: Exemption of Traders Resident in or Nationals of Japan*, Order in Council, 12 April 1938, 1938/50. This order was suspended when New Zealand declared war with Japan in 1941 and was not resumed when a peace treaty was signed with Japan in 1951.

[31] See *Income-Tax: Exemption of Traders Resident in or Nationals of Czechoslovakia*, Order in Council, 13 July 1938, 1938/85.

[32] See *Income-Tax (United Kingdom Traders) Exemption Order 1942*, Order in Council, 1 July 1942, 1942/199.

[33] See *Income-Tax (Canadian Traders) Exemption Order 1946*, Order in Council, 15 May 1946, 1946/71.

convenience of delivery' and not for the 'purposes of display'. This broader scope is probably attributable to the UK and Canadian Orders being treaty-based.[34]

After concluding a comprehensive DTA with the US in 1945,[35] the UK pressured its Dominions to negotiate DTAs to replace the DITR system. In 1947, New Zealand's first comprehensive DTA was therefore concluded with the UK and was based on a template provided by the senior partner.[36] At the time of negotiation, New Zealand's economic ties to the UK were extensive – the UK was both New Zealand's dominant export market and principal source of capital.[37] New Zealand had the opportunity to monitor and observe negotiations between the UK and Australia to gauge concessions being made and sticking points. It seems that New Zealand concluded its UK DTA more easily than Australia, an experience that was perhaps attributable to its smaller economy and coming later to the negotiating table.

New Zealand concluded a tax treaty with Canada in 1948,[38] using the UK–Canada DTA as a template. Negotiations for a treaty with the US were completed in the same year, although the DTA did not come into effect until late 1951.[39] This early flurry of tax treaty-making ended with a DTA negotiated with Sweden in 1956.[40] Negotiations stalled due to New Zealand's efforts to protect its source-dependent tax base. By adhering to its conception of national interest (retaining taxing rights over source

[34] See Land and Income Tax Department *Agreement Dated 10th Day of March 1942, Between His Majesty's Government in the United Kingdom and His Majesty's Government in New Zealand for the Reciprocal Exemption from Income-Tax on Certain Profits or Gains Arising Through an Agency,* Appendix to the Journals of the House of Representatives (AJHR), 1942 Session I, A-02, (SR) 1942 No 1179 and Land and Income Tax Department, *Agreement Dated 3rd November, 1945, Between His Majesty's Government in Canada and His Majesty's Government in New Zealand for the Reciprocal Exemption from Income-Tax on Certain Profits or Gains Arising Through an Agency*, AJHR, 1946 Session I, A-06.

[35] See Peter Harris, 'An Historic View of the Principle and Options for Double Tax Relief' [1999] (6) *British Tax Review* 469, 477. Harris notes that, despite the growth of DTAs elsewhere to relieve international double taxation, the UK and its Dominions maintained DITR for 25 years: ibid 476-477. See also John F Avery Jones, 'The History of the United Kingdom's First Comprehensive Double Taxation Agreement' [2007] (3) *British Tax Review* 211.

[36] See *Agreement Between the Government of the United Kingdom and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 27 May 1947, 17 UNTS 211 (entered into force 8 August 1947) ('New Zealand–UK DTA'). See also *Double Taxation Relief (United Kingdom) Order 1947*, Order in Council, 24 June 1947, 1947/96.

[37] In the period 1947-49, exports to the UK were worth £107,912,430 (£40,491,147 trade surplus), whereas those to Australia, the next highest destination were worth £3,955,960 (£10,745,875 trade deficit). See New Zealand, *The New Zealand Official Year-Book, 1947-49* (1950), reproduced at: *Statistics New Zealand* <https://www3.stats.govt.nz/New_Zealand_Official_Yearbooks/1947-49/NZOYB_1947-49.html#idsect1_1_5340>.

[38] *Agreement Between the Government of New Zealand and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 12 March 1948, 231 UNTS 219 (entered into force 30 June 1948) ('New Zealand–Canada DTA').

[39] *Convention Between the Government of New Zealand and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 16 March 1948, 127 UNTS 133 (entered into force 18 December 1951) ('New Zealand–USA DTA').

[40] *Convention Between the Government of New Zealand and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 16 April 1956, 274 UNTS 259 (entered into force 22 November 1956) ('New Zealand–Sweden DTA').

income) New Zealand was unable to finalise negotiations with Austria, Denmark, the Federal German Republic, France, Greece, Italy, the Netherlands, and Norway.[41]

In these early tax treaties, omissions, lacunae, and vagaries generally favoured New Zealand's assertion of taxing rights on a source basis. Since royalties were tax exempt in the source state under the New Zealand–Canada and New Zealand–UK DTAs, the definition of 'royalty' was important for New Zealand in terms of retention of taxing rights. The royalty article in the Canadian DTA applied to copyright royalties only,[42] while the UK DTA contained a more expansive definition which also included industrial royalties, except those relating to mining and natural resource exploitation.[43]

Since dividends were not contemplated in the Canadian treaty, New Zealand-sourced distributions could be taxed in New Zealand. Likewise, neither the New Zealand–Canada nor New Zealand–UK DTA considered interest or included a residence tiebreaker clause which again favoured the source country. These early victories in maintaining New Zealand's source-based taxing rights became, however, increasingly abnormal.

2.2 Abnormal tax claims

Before it joined the OECD in 1973 and became obliged to follow the template of the Organisation's model tax conventions,[44] New Zealand's taxing claims consistently ran counter to international tax norms as they developed in the 20th century. Four instances demonstrate this theme – the treatment of shipping, agents, insurance, and, most significantly for the purposes of this article, passive income, in particular dividends.

2.2.1 Shipping

Income derived by a non-resident shipper from the carriage of goods from New Zealand was deemed to have a New Zealand source.[45] This policy was justified on the grounds that New Zealand was dependent on foreign shipping companies for its international trade and these companies could be expected to pay some local tax on the profits they derived from this business. In contrast, under the League of Nations Model Tax Convention,[46] shipping enterprises were taxable only in the place where their 'real centre of management is situated' (ie, on a residence basis).[47]

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[41] See Letter from the Commissioner of Inland Revenue to the Secretary of the Treasury on 'Double Tax Agreements: Review of Policy', dated 20 August 1975, sighted by author's search of Archives New Zealand.
[42] New Zealand–Canada DTA, above n 38, Art VI.
[43] New Zealand–UK DTA, above n 36, Art VII.
[44] The Convention on the Organisation for Economic Co-operation and Development (1960) does not specifically mention DTAs but Article 3 provides: 'With a view to achieving the aims set out in Article 1 and to fulfilling the undertakings contained in Article 2, the Members agree that they will:
(a) keep each other informed and furnish the Organisation with the information necessary for the accomplishment of its tasks;
(b) consult together on a continuing basis, carry out studies and participate in agreed projects; and
(c) co-operate closely and where appropriate take co-ordinated action'.
[45] See *Land and Income Tax Act 1923* (NZ) s 87; *Land and Income Tax Act 1954* (NZ) s 167(m).
[46] See League of Nations Draft Model Convention, above n 25. For a discussion on the informing recommendations, see WH Coates, 'League of Nations Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman, and Sir Josiah Stamp' (1924) 87(1) *Journal of the Royal Statistical Society* 99.
[47] See League of Nations Draft Model Convention, above n 25, Art 5.

During the 1950s, New Zealand suspended taxation of non-resident shippers on the commencement of DTA negotiations on an administrative basis (ie, not authorised by law) as a goodwill gesture but did not resume taxing shippers if the negotiations failed.[48]

2.2.2 *Agents*

Since New Zealand was primarily an exporter of primary products,[49] overseas businesses could engage in trade with New Zealand by using local agents without the need for establishing a branch or subsidiary. The policy response was to deem a New Zealand source to income derived by a non-resident trader from business obtained on their behalf by a commission agent resident in New Zealand.[50] This policy put foreign principals on a similar footing to overseas companies with branch operations but was inconsistent with the increasingly normalised concept of a taxable PE.[51]

As more DTAs were negotiated, resident trader exemptions New Zealand had granted tended to be removed. Nevertheless, new non-resident trader exemptions were extended to several European countries and Japan. Both unilateral concessions undermined New Zealand's position in DTA negotiations.[52]

2.2.3 *Insurance*

Being reliant on overseas insurers, New Zealand generally sought to keep foreign insurance operations outside the scope of the business profits article. For example, in the New Zealand–Canada and New Zealand–UK DTAs, the business profits article did not cover the business of insurance carried on in New Zealand by a resident of the other contracting state.[53] The effect of this provision allowed New Zealand to tax non-resident insurers in the absence of a PE. Without such an exclusion for insurance from the business profits article, New Zealand could only tax foreign insurers if they operated a PE there.

Only the DTA with Switzerland does not contain the exclusion for insurance from the business profits article.[54] A protocol of 2001 to the New Zealand–Netherlands DTA 1980 excludes only general insurance from the scope of the business profits article. It limits the amount to be taxed at 10 per cent of gross premiums with the result that Dutch life insurers can only be taxed in New Zealand if they have a PE there.[55] In particular,

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[48] See Commissioner of Inland Revenue and The Treasury, 'Note to Minister of Finance on Double Taxation' (Report, 1962) 6-7, sighted by author's search of Archives New Zealand.
[49] See 'Trade, External – Historical Evolution and Trade Patterns' in AH McLintock (ed), *An Encyclopedia of New Zealand* (1966), available at *Te Ara – the Encyclopedia of New Zealand* <http://www.TeAra.govt.nz/en/1966/trade-external>.
[50] See *Land and Income Tax Act 1923* s 168 carried over to *Income Tax Act 2007* (NZ) ss HD 26 and 29.
[51] See, generally, Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge University Press, 2011).
[52] See 'Note to Minister of Finance on Double Taxation from the Commissioner of Inland Revenue and The Treasury' (Report, 1955), sighted by author's search of Archives New Zealand.
[53] See New Zealand–Canada DTA, above n 38, art IV; New Zealand–UK DTA, above n 36, art III.
[54] See *Convention Between New Zealand and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income*, signed 6 June 1980, 1324 UNTS 173 (entered into force 21 November 1981); *Double Taxation Relief (Switzerland) Order 1981*, Order in Council, 15 October 1981, SR 1981/285.
[55] See *Convention Between the Government of New Zealand and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 15 October 1980, 1315 UNTS 115 (entered into force 18 March 1981) Art 4 as amended by the *Second Protocol Amending the Convention Between the Government of the Kingdom of*

this concession concerning insurance made in negotiations for the Swiss DTA has made it difficult for New Zealand to protect its right to tax non-resident insurers in the absence of a PE.

2.2.4 *Passive income*

Not only was New Zealand an importer of capital, it was also an importer of intellectual property and know-how, and therefore sought to maintain taxing rights over various forms of passive income with a New Zealand source. Again, this brought its policies into conflict with the expectations of potential DTA partners.

A compromise concerning the taxation of passive income was reached with Sweden in 1956 through a DTA provision for interest and royalties to be taxed on a split basis 60 per cent/40 per cent in favour of the source state.[56] Until the 2000s, New Zealand was able to prevail in its DTA negotiations and retain taxation of royalties at source (at rates of 10 per cent to 15 per cent) and not agree to a lower rate of withholding tax for parent-subsidiary dividends.

The 2008 protocol to the 1982 New Zealand–US DTA and the 2009 New Zealand–Australia and New Zealand–Singapore DTAs include significant reductions in non-resident withholding tax (NRWT) rates for interest, dividends and royalties.[57] These reductions for withholdings on interest and dividends largely reflect reductions that were unilaterally enacted under the foreign investor tax credit (FITC) and approved issuer levy (AIL) regimes and represent a significant concession.[58]

2.3 Non-discrimination

New Zealand is tied under several most favoured nation (MFN) clauses to extend reductions in NRWT rates to other treaty partners. Amending legislation enacted in 2009 effectively passed on the reductions in NRWT on dividends where a non-resident's voting interest in a New Zealand company is 10 per cent or greater.

New Zealand DTAs negotiated since 1995 have been based on the OECD Model. Reservations about including non-discrimination articles appear otiose since seven of the 11 most recent DTAs include such an article, and another (with Taiwan) included

the Netherlands and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Signed at the Hague on 15 October 1980, signed 20 December 2001 (entered into force 22 August 2004) Art 4.

[56] See New Zealand–Sweden DTA, above n 40, Arts 7 and 8; *Double Taxation Relief (Sweden) Order 1956*, Order in Council, 21 November 1956, 1956/191.

[57] *Protocol Amending the Convention Between New Zealand and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 1 December 2008, 2728 UNTS 167 (entered into force 12 November 2010) Arts 6-8; *Convention between New Zealand and Australia for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion*, signed 26 June 2009, 2723 UNTS 3 (entered into force 19 March 2010) Arts 10-12 ('New Zealand–Australia DTA 2009'); *Agreement Between the Government of New Zealand and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 21 August 2009, 2722 UNTS 319 (entered into force 12 August 2010) Arts 10-12. NRWT was introduced into the *Land and Income Tax Act 1954* as s 203S by *Land and Income Tax Amendment Act 1964* (NZ) s 17.

[58] For a discussion of the FITC and AIL regimes, see Inland Revenue Department, 'Taxation of Inbound Investment' (Tax Policy Report, 3 May 2002).

an MFN clause providing for subsequent inclusion of one.[59] A plausible explanation of New Zealand's seeking to maintain this position is it wished to tax branches of non-resident companies at a higher rate to compensate for the inability to levy NRWT on branch profits attributed to their head office, akin to how a local subsidiary pays dividends to its foreign parent company.[60] With the introduction of the FITC rules in 1993 and their extension in 1995 to direct shareholdings, this uplift for non-resident companies has been eliminated and thereby removes one of the reasons for omitting non-discrimination articles. A secondary concern was whether non-discrimination articles would stand in the way of domestic transfer pricing and thin capitalisation rules.[61] Where New Zealand has agreed to a non-discrimination article there is usually specific clarification that the non-discrimination article does not apply to its domestic transfer pricing and thin capitalisation rules.[62]

2.4 Concessions

Some double taxation issues could be settled through domestic measures, but it was inevitable that New Zealand, as a minor player in the world economy, would need to make compromises to negotiate DTAs with economically more powerful states. At the time of accession to the OECD, the Organisation was in the process of revising the 1963 Draft Model Convention.[63] Officials thought New Zealand would have needed to lodge numerous reservations and observations to that model which they deemed would be unacceptable to other OECD members, especially as New Zealand was a new member.[64] Therefore, New Zealand policy-makers decided, first, to re-examine parts of the country's international tax policy and, secondly, to have its reservations and observations entered in respect of the new 1977 Model Convention,[65] rather the 1963 draft. In the event, the number of reservations and observations New Zealand asserted was similar to those entered into by other OECD members.[66]

New Zealand's principal reservations were capping withholding tax on interest and royalties (10 per cent) and dividends (15 per cent), with no reduced rate for parent/subsidiary dividends; protecting source taxing rights for natural resource exploration and exploitation, such as mining, fishing, and petroleum; and maintaining

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[59] For a discussion on MFN clauses in DTAs, see Ines Hofbauer, 'Most-Favoured-Nation Clauses in Double Taxation Conventions – A Worldwide Overview' (2005) 33(10) *Intertax* 445.

[60] See Graham Hunt, 'New Zealand's Evolving Approach to Tax Treaties' (2008) 14(2) *New Zealand Journal of Taxation Law and Policy* 131, 166. Hunt notes that, given New Zealand's objection to non-discrimination articles, '[o]ne might therefore expect to find that New Zealand does have discriminatory tax laws that it wishes to protect, but that does not seem to be the case'.

[61] Ibid.

[62] See *Agreement Between the Government of New Zealand and the Government of the People's Republic of China for the Elimination of Double Taxation with Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance*, signed 1 April 2019, 3374 UNTS (entered into force 27 December 2019) Art 24 as amended by Protocol to the Agreement, Art 7(a) ('New Zealand–China DTA').

[63] See OECD Fiscal Committee, *Draft Double Taxation Convention on Income and Capital* (OECD Publications, 1963).

[64] See RP Kellaway, Chief Deputy Commissioner of Inland Revenue, 'Memorandum of Official Attending Meeting on Double Taxation Policy' (4 February 1976).

[65] See OECD, *Model Double Taxation Convention on Income and Capital* (OECD Publishing, 19 October 1977).

[66] See Officials Economic Committee, Memorandum to Cabinet Economic Committee, *International Agreements for the Avoidance of Double Taxation: OECD Draft Model Double Taxation Convention* (16 September 1976) para 3.

the right to tax leasing of industrial, commercial, or scientific equipment at source (usually within the scope of the royalty article).[67]

After accession, New Zealand's DTAs largely followed the 1977 Model Convention. Points of disagreement in negotiations typically arose from New Zealand's insistence on retaining source country taxing rights for interest and royalties and a 15 per cent rate for all dividends. The insistence that a non-discrimination article be omitted was also contentious. In most cases, the disagreements were resolved through the inclusion of protocols containing MFN clauses for taxes on interest, dividends and royalties which would apply if New Zealand agreed in subsequent treaties to lower withholding tax rates.

2.5 Victories

In the first New Zealand–US DTA, a special provision was made for the New Zealand film hire tax imposed on non-resident film renters.[68] Given the importance of US-produced films in the cinema industry of the time, this was a significant concession by the US, although it may be attributable to the relatively small New Zealand market.

New Zealand was receptive to a Japanese approach to negotiating a DTA in the late 1950s. Although trade with Japan was limited at the time, the 'Japanese Economic Miracle' was gathering pace.[69] In 1959, Sumitomo, a major Japanese corporation, and Commonwealth Aluminium Company, an Australian company, formed a joint venture for a New Zealand aluminium smelter powered by hydroelectricity generated in the South Island. The smelter, which opened in 1969, represented a major investment that would lead to significant future exports to Japan, and boosted Japan's interest in negotiating a DTA with New Zealand. This was concluded in 1963.[70] New Zealand was able to negotiate exclusion of articles covering interest and royalties from the Japanese DTA thereby maintaining its existing source taxing rights.

In the mid-1960s New Zealand gave notice to the UK to terminate its 1947 DTA. This is the only time New Zealand has given such notice unilaterally. Motivation to terminate lay with the perception that the DTA was costing New Zealand considerable revenue in respect of royalties, payments to non-resident entertainers, and the impact of the territorial extension article. Another factor lay with significant changes in the underlying domestic law of the two countries since the DTA was concluded. The newly introduced NRWT, for example, could not be imposed on royalties and dividends paid to UK residents due to provisions in the 1947 DTA that required exemptions in the source country. The UK had also changed the basis of taxing companies there with the passing of the *Finance Act 1965* (UK).[71]

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[67] Ibid.
[68] See New Zealand–USA DTA, above n 39, Art 8.
[69] See, eg, Hannah Shiohara, 'The Japanese Economic Miracle' *Berkeley Economic Review* (26 January 2023) <https://econreview.berkeley.edu/the-japanese-economic-miracle>.
[70] See *Convention Between New Zealand and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 30 January 1963, 517 UNTS 183 (entered into force 19 April 1963); *Double Taxation Relief (Japan) Order 1963*, Order in Council, 8 April 1963, SR 1963/49.
[71] For a discussion of the Act, see Leonard Lazar, 'Finance Act 1965: The Corporation Tax' (1966) 29(1) *Modern Law Review* 50.

Generally, at the margins, New Zealand has been able to preserve some of its source taxing rights on construction projects, natural resource exploration and exploitation, with oil exploration being the most important.[72] The definition of 'New Zealand' for the purposes of DTAs tends to include the country's extensive continental shelf, which is increasingly important in the context of oil exploration.[73] However, not all treaty partners have been willing to recognise New Zealand's position and it is understood an objection to recognising New Zealand's territorial claims to the Ross Dependency at Antarctica stood in the way in renegotiating a new Japanese DTA until recently.[74]

2.6 Concluding comments

The theme of concession has been a major focus of this section. A plausible narrative may be constructed that tells how a small country, which is remote from the major economies and has demonstrated a penchant for autarky but has a practical need for imported capital and technology, and overseas shipping and insurance services, gradually surrendered taxing rights to comply with the international taxation norms that suited more powerful creditor nations. Yet a counter-narrative may be presented in which presumptions about maximising taxing rights over New Zealand sourced income may have been ill-founded, and the concessions led to gains outside the immediate ambit of the source-residence tax yield calculus.

The analyses undertaken in preparation for the negotiation of the early DTAs apparently omitted consideration of exchange controls or import restrictions which had a considerable influence on trade and investment to and from New Zealand. From the 1930s until the mid-1980s New Zealand had a highly controlled economy with tight exchange controls (making the remittance of capital out of New Zealand by residents very difficult) and import controls limiting or preventing importation of a wide range of products that could otherwise be made locally.[75] In addition, imports often faced high tariffs which were heavily skewed in favour of products from the UK (and, to a lesser extent, those from Australia and British Commonwealth countries) at the expense of goods from other countries.[76]

Little economic analysis appears to have been undertaken in preparation for the negotiations for New Zealand's first three DTAs. Similarly, negotiations during the 1950s and 1960s typically involved a simple assessment of the trade between the other contracting state and the potential for increased trade in addition to other payments and receipts (interest, dividends, pensions, migrant transfers) between New Zealand and the

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[72] Of New Zealand's current 40 DTAs, 20 specify a period of 12 months for construction projects to constitute a PE, another 19 specify six months (New Zealand's preferred position) and one provides for only 90 days.

[73] For example, the New Zealand–Australia DTA 2009, above n 57, Art 3(1)(b) and the New Zealand–China DTA, above n 62, Art 3(1)(b) provide the definition that New Zealand for the purposes of each treaty 'means the territory of New Zealand but does not include Tokelau; it also includes any area beyond the territorial sea designated under New Zealand legislation and in accordance with international law as an area in which New Zealand may exercise sovereign rights with respect to natural resources'.

[74] Personal communication from an Inland Revenue Department official to Andrew MC Smith in the mid-1990s.

[75] See, generally, GR Hawke, *The Making of New Zealand: An Economic History* (Cambridge University Press, 1985).

[76] See, eg, Chris Nixon and John Yeabsley, 'Overseas Trade Policy – Early Trade – 1840s to 1920s' *Te Ara - the Encyclopedia of New Zealand* (Web Page, 11 March 2010) <http://www.TeAra.govt.nz/en/overseas-trade-policy/page-1>.

other state. Only from the late 1950s was the possibility of increased foreign investment into New Zealand with associated technology considered.[77]

Officials argued that New Zealand should emphasise domestic laws in relieving double taxation, with DTAs playing a secondary role.[78] They also argued that the country should review its existing DTAs to assess whether they promoted economic growth. It was thought that DTAs 'that have fallen out of line with current policy' should be renegotiated.[79] These arguments appear to reflect a view of some officials that earlier DTAs had been negotiated carelessly and did not serve New Zealand's interests. No public indication was given on how New Zealand's DTAs were out of line with current policy. The report also proposed that '[t]he same criteria that are used to assess proposed changes to domestic tax laws will be used to assess proposed DTAs. Within these constraints, New Zealand will continue to use DTAs where they can provide a positive effect on investment and trade'.[80]

DTA negotiations have always involved several departments. Foreign affairs officials would have been very wary of any radical moves by New Zealand which could give rise to foreign retaliation, especially given New Zealand's heavy dependence and vulnerable position on foreign trade and capital. Given their different roles and functions, Inland Revenue Department (IRD) officials would have been more attuned to the advantages and necessity of DTAs with major trading partners than Treasury officials, who were more likely to view the issues in more in conceptual terms. IRD officials were also in the position of having more regular contact with their counterparts in DTA countries and the day-to-day issues arising under the existing DTAs. Furthermore, New Zealand had probably gained from the reciprocal granting of foreign tax credits under DTAs given it was a capital-importing country and nothing would be gained from trying to move to a deduction regime for foreign taxes.

Analyses generally predicted a net revenue cost to New Zealand through concessions on source taxing rights with little obvious gain in return.[81] However little consideration was given to the possibility of dynamic benefits arising from double taxation relief in the longer term. For example, did taxes on non-resident shippers lead to higher freight rates being charged to New Zealand importers and exporters?

Since 2000, New Zealand negotiators appear to have recognised that, while New Zealand is a net capital importer, in the absence of exchange controls, it is also a capital exporter. This realisation is evidenced in a controlled foreign company (CFC) discussion document in which it was suggested that New Zealand's stringent CFC rules have indirectly contributed to New Zealand's poor export performance and have also encouraged corporate/capital migration.[82] In the same document lower limits for NRWT were identified as potentially reducing barriers to offshore investment to assist with the

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[77] See Commissioner of Inland Revenue and The Treasury, above n 48, 4.
[78] See Inland Revenue Department, *Taxing Income Across International Borders: A Policy Framework* (July 1991) 33.
[79] Ibid 35.
[80] Ibid 36.
[81] See 'Memorandum to Minister of Finance on Double Taxation, from the Commissioner of Taxes and the Secretary to the Treasury' (19 June 1962).
[82] See Inland Revenue Department, *New Zealand's International Tax Review: A Direction for Change, A Government Discussion Document* (2006) 1 and 3 ('*New Zealand's International Tax Review: A Direction for Change*').

internationalisation of New Zealand businesses.[83] It appears that policy-makers have recognised that reductions in NRWT rates are not necessarily against its interests when this is done reciprocally under a DTA. This direction is also consistent with the earlier observation of officials that the FITC regime was problematic because it was a unilateral reduction in tax on New Zealand dividends derived by non-residents which did not result in New Zealand investors receiving reciprocal tax reductions in the other direction. Strangely, this point seems to have been forgotten or abandoned a year later with the passing of the *Taxation (Consequential Rate Alignment and Remedial Matters) Act 2009* (NZ) which introduced a zero rate of NRWT for fully imputed dividends paid to non-resident shareholders with voting interests of 10 per cent or more.[84]

In common with New Zealand, Australia faced the problems of a debtor country seeking to negotiate DTAs with creditor countries. Taylor's observation on the difficult negotiations prefatory to the conclusion of the 1947 DTA between Australia and the UK has common relevance:

> The treaty negotiations are a microcosm of the tensions that can exist where the countries involved have fundamental differences on the jurisdictional foundations for international taxation. No country in the world at the time could have been more committed to residence-based taxation that the United Kingdom. At the same time, the Australian federal income tax system had, since its inception, been fundamentally sourced-based.[85]

Taylor identifies eight factors which influenced Australian DTA negotiation practice between 1946 and 1976. These were:

> (a) economic considerations relating to the current and expected trade and investment flows between Australia and the treaty partner; (b) cultural and political considerations; (c) Australian domestic law considerations (including tax avoidance considerations); (d) Australian revenue considerations and jurisdictional claims; (e) the treaty practice and domestic law considerations of and model treaties developed by the other party in the treaty negotiations; (f) the treaty practice of third countries in their prior treaties into the prospective Australian treaty partner; (g) model treaties developed by international organisations such as the League of Nations, the OECD, and the United Nations; and (h) the development of an Australian model treaty reflecting prior Australian treaty practice.[86]

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[83] Ibid 2.
[84] See *Income Tax Act 2007* (NZ) s RF 11B.
[85] See Taylor, 'The History of Australia's Double Tax Conventions', above n 12, 629. For a full analysis of the negotiations leading to the Australia–UK DTA, see C John Taylor, '"I Suppose I Must Have More Discussion on This Dreary Subject": The Negotiation and Drafting of the UK–Australia Double Taxation Treaty of 1946' in John Tiley (ed), *Studies in the History of Tax Law, Vol 4* (Hart Publishing, 2010) 213; C John Taylor, 'The Negotiation and Drafting of the UK–Australia Double Taxation Treaty of 1946' [2009] (2) *British Tax Review* 201. On negotiations for the 1967 DTA, see C John Taylor, 'The Negotiation and Drafting of the 1967 United Kingdom–Australia Taxation Treaty' in John Tiley (ed), *Studies in the History of Tax Law, Vol 5* (Hart Publishing, 2012) 427.
[86] See C John Taylor, 'Factors Influencing Australian Taxation Treaty Practice 1946–1976' (2012) 27(3) *Australian Tax Forum* 571, 571 ('Factors Influencing Australian Taxation Treaty Practice').

The willingness of the Australian government to use DTAs as a political tool or, at least, to understand them in political context, rather than conceiving them as purely technical tax arrangements distinguishes its approach from that of New Zealand.

While the 1946 Australia–UK DTA reflects the long-term connections between Australia and the mother country, the 1953 Australia–US DTA represents the post-World War II presumption, particularly on the part of the second Menzies government (1949-66), that Australia's security was dependent on an alliance with the US,[87] *primus inter pares* of the country's 'Great and Powerful Friends'.[88] And so, while tax officials calculated that no fiscal benefit would arise from a US DTA, broader government strategists saw a tax treaty as a means of 'maintaining good relations' with the US and increasing the possibility of inter-government loans.[89] Despite the arguments of the Treasurer that a DTA would be inconsistent with tax principles, 'it was necessary to consider political considerations arising out of the relationships between the two countries in the then current circumstances'.[90] It is notable that no obvious evidence exists to indicate that such considerations played a role in New Zealand's negotiations with the US, although such considerations may have been present if not documented.

Political considerations also motivated Australia to respond positively to an approach from Canada to negotiate a DTA.[91] Again, no tax benefits would obviously be gained from a treaty but the Australian government 'regarded it as difficult and perhaps embarrassing to deny a DTC to Canada once the DTC with the United States was concluded'.[92] Without discounting the technical negotiations that contributed to the final treaty text, it seems that the treaty was informed by a perception of the politically right thing to do.

One might have presumed that politics would have similarly led to an early DTA with New Zealand, particularly after the conclusion of the 1944 'Canberra Pact'.[93] Nevertheless, New Zealand's request to start negotiations in 1947 gained no traction with Australia until it changed its system of corporate taxation in 1958 to be compatible with Australia's classical method.[94] Even with this barrier removed, another hurdle lay with Australia being a capital exporter to New Zealand. (Negotiations for Australia's treaties with the UK and the US came from the position of a capital importer.[95]) Ultimately, concerns for further capital exportation to New Zealand, which might eventuate from a DTA, were outweighed by expectations of greater trade gains.[96]

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[87] See, eg, Frank Bongiorno, 'The Price of Nostalgia: Menzies, the "Liberal" Tradition and Australian Foreign Policy' (2005) 51(3) *Australian Journal of Politics and History* 400.
[88] See Taylor, 'Factors Influencing Australian Taxation Treaty Practice', above n 86, 583.
[89] See Taylor, 'The History of Australia's Double Tax Conventions', above n 12, 636.
[90] Ibid 637 (footnote omitted).
[91] For a full analysis of the negotiation of the Australia–Canada DTA, see C John Taylor, 'The Negotiation and Drafting of the First Australia–Canada Taxation Treaty (1957)' (2013) 61(4) *Canadian Tax Journal* 915.
[92] See Taylor 'The History of Australia's Double Tax Conventions', above n 12, 640 (footnote omitted).
[93] *Australian-New Zealand Agreement 1944*, signed 21 January 1944, 18 UNTS 357 (entered into force 21 June 1944). See, eg, EA Olssen, 'The Australia – New Zealand Agreement' (1944) 16(3) *Australian Quarterly* 10.
[94] See Taylor, 'The History of Australia's Double Tax Conventions', above n 12, 642.
[95] Ibid 644.
[96] Ibid.

Taylor's analysis of the negotiations for an Australian DTA with Japan provides the most illuminating example of Australia pursuing broader national interests over a simple tax calculus. In short, the DTA negotiations were used as a tool to prise open Japan to Australian investment. 'The incident shows the importance of the mining and agricultural industries to Australia at the time and shows that Australia was prepared to use DTC negotiations to advance trade policy objectives.'[97] The example also tacitly acknowledges the coincidence of government and industries' interests in DTA negotiations.

After joining the OECD in 1971, Australia affirmed its allegiance to the West. Before the disintegration of the Soviet Bloc, Australia received overtures from some Comintern countries to negotiate DTAs, but these were not taken further.[98] It would have been unthinkable for the US' staunchest regional ally to be seen to be acting amicably with Communist countries.[99]

In New Zealand, formal National Interest Analyses (NIAs) only became mandatory in 2002, with the first exercise covering DTAs with South Africa, the United Arab Emirates, Chile, UK, the Philippines and the Netherlands.[100] Even then, NIAs tend to be cursory, boilerplate analyses that focus on possible trade gains, much like the ad hoc officials' analyses that preceded them.

3. DEVELOPMENT OF AUSTRALIA–NEW ZEALAND DTAS

From a contemporary perspective, it seems remarkable that Australia and New Zealand did not conclude a DTA until 1960. Trade between the countries was second only in importance to that with the UK. Australian banks and insurers were major investors in New Zealand, and the free movement of labour between the two countries under the Trans-Tasman Travel Arrangement of 1973 and preceding arrangements had been in place since the 1920s.[101]

In 1951, the New Zealand Government convened the Gibbs Committee to review all aspects of New Zealand's tax system.[102] The Committee noted that international double taxation was a considerable problem, especially with Australia, and 'strongly recommended' early negotiation of a DTA.[103]

New Zealand's system of company-shareholder taxation presented a hurdle to conclusion of a treaty. Australia employed the classical approach to company-shareholder taxation with a much lower company tax rate (35 per cent) than New Zealand. New Zealand exempted dividends from tax until 1958 but had a much higher

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[97] Ibid 679.
[98] Taylor, 'Factors Influencing Australian Taxation Treaty Practice', above n 86, 586.
[99] Cf New Zealand's importation of Czech automotive technology to produce the notorious Trekka. See Eric Pawson, 'Cars and the Motor Industry – Sources of Cars' *Te Ara – the Encyclopedia of New Zealand* (11 March 2010) <http://www.TeAra.govt.nz/en/photograph/22838/trekka>.
[100] See New Zealand Parliament, Finance and Expenditure Committee, *International Treaty Examination of Taxation Agreements with the Republic of South Africa, the United Arab Emirates, the Republic of Chile, the United Kingdom of Great Britain and Northern Ireland, the Republic of the Philippines, and the Kingdom of the Netherlands: Report of the Finance and Expenditure Committee* (2003).
[101] See Susan Love and Michael Klapdor, 'New Zealanders in Australia: A Quick Guide' (Parliamentary Library Research Series 2019-20, 13 February 2020).
[102] See Taxation Committee (Theodore Gibbs, chair), *Report of the Taxation Committee* (1951) (Gibbs Report).
[103] Ibid 100.

company tax rate set at 57.5 per cent. Australian policy-makers believed that, if a DTA were negotiated with New Zealand, they would face pressure to limit source tax on dividends paid to New Zealand residents.[104] A similar limitation on New Zealand, however, would involve no concessions on its part because dividends were already exempt in New Zealand and had effectively been taxed at the corporate level in New Zealand given the high rate of company tax imposed there. This impasse was overcome when New Zealand adopted the classical approach to company/shareholder taxation in 1958.[105] (A comprehensive dividend imputation regime, which included an unanticipated but exploitable inter-company dividend exemption, was introduced in 1988 to replace the classical system.[106])

Another point of contention lay with taxing the salaries of businesspersons when on short trips to the other country.[107] Although New Zealand had adopted a unilateral exemption for such visitors in the late 1950s, this was an area that both countries recognised needed addressing.

The first tax treaty between the two countries when finally concluded omitted an interest article, or a residence tiebreaker. This omission was significant, given the liberal trans-Tasman travel arrangements. The treaty otherwise followed a similar pattern to those New Zealand had negotiated with Canada and the UK in the 1940s.

Juridical taxation assumed greater importance due to increasing trade and investment between the two countries under the 1965 New Zealand–Australia Free Trade Agreement.[108] Consequently, a revised tax treaty was concluded in 1972. This was New Zealand's second DTA to include an interest article, although the limitations on the source taxation of interest did not apply to interest paid between associated persons. This reservation reflected New Zealand concerns that business profits could be stripped out of the New Zealand tax net by inter-company loans between associated companies. The treaty also included a tiebreaker clause for residency, an issue of increasing importance given the significant trans-Tasman migration from the mid-1960s.[109]

Australia's economic importance to New Zealand increased even further after the conclusion of the Closer Economic Relations agreement in 1983, and a new DTA was signed in 1995.[110] While negotiations for the revised DTA indicated a new approach to

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[104] Ibid 98.
[105] See New Zealand Parliamentary Debates, vol 316 (26 June 1958) 286.
[106] See *Income Tax Act 2007* (NZ) ss OB 1 to OB 70.
[107] See *Federal Commissioner of Taxation v French* (1957) 98 CLR 398, illustrating the complications that could arise from such taxation.
[108] See *New Zealand–Australia Free Trade Agreement Act 1965* (NZ). This was New Zealand's first free trade agreement and was replaced with the broader 1983 Closer Economic Relations (CER) agreement. See Ministry of Foreign Affairs and Trade, 'Australia-New Zealand Closer Economic Agreement' (Report, 2005).
[109] See Carl Walrond, 'Kiwis Overseas – Migration to Australia' *Te Ara – the Encyclopedia of New Zealand* (Web Page, 8 February 2005) <http://www.TeAra.govt.nz/mi/kiwis-overseas/page-4>.
[110] *Agreement Between the Government of Australia and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, signed 27 January 1995, 1938 UNTS 207 (entered into force 29 March 1995).

international taxation,[111] changes were, in practice, minimal.[112] Besides, as members of the OECD, both countries were expected to follow the OECD Model Convention.[113]

New Zealand politicians have tended to avoid direct involvement with DTA negotiations, leaving these to public officials. However, in the 1990s there was some political involvement with trans-Tasman double taxation issues arising out of each country's adoption of domestic dividend imputation regimes. These undermined foreign tax credits when foreign-sourced income was distributed. Pressures from the corporate sector for the benefit of these imputation regimes to be extended to shareholders in the other country were dismissed by politicians from both countries on arguably spurious grounds.[114] Some agreement was reached on addressing double tax issues arising from 'triangular' trans-Tasman taxation, but these have limited practical effects.[115]

Once negotiations began in 2008 for a revised DTA, in a novel initiative, the IRD sought public submissions. Extensive economic ties had developed between the two countries and many taxpayers could be expected to hold views on the negotiations, based on their trans-Tasman business, work or investment experiences. Whether public input influenced final outcomes is, however, a matter of speculation.

In mid-2008 negotiations with Australia began and led to a new DTA being concluded in 2009.[116] New Zealand agreed to substantial reductions in NRWT on interest, dividends, and royalties after resisting for nearly 60 years in its DTA negotiations. Certain cross-border payments of interest became exempt from NRWT. Royalties

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[111] See David White, 'New Zealand Double Tax Treaty Policy and Practice, 1987-2004: A Preliminary Assessment' in Rodney Fisher and Michael Walpole (eds), *Global Challenges in Tax Administration* (Fiscal Publications, 2005) 45.

[112] White concludes that the 1995 DTA is an improvement over the 1972 agreement in respect of several matters identified by him: see ibid 55.

[113] For an analysis of how Australia has gradually adopted the provisions of the OECD Model Convention, see C John Taylor, 'Some Distinctive Features of Australian Tax Treaty Practice: An Examination of Their Origins and Interpretation' (2011) 9(3) *eJournal of Tax Research* 294.

[114] The basic issues standing in the way of mutual recognition of each other's imputation (franking) credits were potential revenue cost (especially in the short term) and likely flow-on effects if third countries demanded similar treatment. See David Barber 'We Must Share Blame for Huge Tasman Tax Losses' *National Business Review* (28 May 1993) 8. In addition, politicians sought to argue that progress could only be made on the issue if the other country made significant changes to its domestic tax rules, knowing that such changes were unlikely or politically unpalatable. For example, Prime Minister Paul Keating argued that New Zealand needed to introduce a comprehensive capital gains tax before Australia could consider recognition of New Zealand imputation credits. See Hon Paul Keating (Prime Minister), Transcript of Press Conference, Wellington (21 May 1993) <https://pmtranscripts.pmc.gov.au/release/transcript-8869> and Peter Lloyd, 'The Future of Trans-Tasman Closer Economic Relations' (1995) 2(3) *Agenda* 267, 273. In addition, New Zealand's CFC and FIF rules enacted from the 1992 Budget would have been at variance with Australia's equivalent rules. See Income Tax Act 1994 (NZ) Subpart CG.

[115] See *Income Tax Act 2007* (NZ) subpt OB. Companies facing a triangular tax problem can elect to pay dividends with both Australian and New Zealand imputation credits attached. Shareholders may only use the credits of their country of residence. No streaming of one country's credits is permitted only to shareholders resident in the same country. See David G Dunbar, 'Trans-Tasman Taxation Reform: Will It Be Third Time Lucky or Will History Repeat Itself? – Part One' (2002) 8(1) *New Zealand Journal of Taxation Law and Policy* 93 and David G Dunbar, 'A Critical Evaluation of the New Zealand and Australian Governments' Solution to Triangular Taxation Relief: Part Two' (2003) 9(2) *New Zealand Journal of Taxation Law and Policy* 183.

[116] New Zealand–Australia DTA 2009, above n 57. See also a contemporaneous protocol signed on 1 December 2008 to the 1983 New Zealand–US DTA. For an analysis, see Andrew MC Smith, 'New Protocol to the 1982 New Zealand-United States Treaty' (2009) 63(7) *Bulletin for International Taxation* 289, 291-293.

became liable to NRWT at a maximum of 5 per cent (the previous rates were 10 per cent to 15 per cent) and dividends paid to corporate shareholders with interests of 10 per cent or more became liable to 5 per cent NRWT.[117] Furthermore, when a corporate shareholding interest was 80 per cent or more, dividends were exempted from NRWT, subject to a limitation of benefit provision.[118]

It is not obvious why New Zealand agreed to lower NRWT rates on passive income. Perhaps, in pursuit of competitiveness, the country sought to obtain the same reductions in NRWT in its US DTA as Australia had obtained when it renegotiated its US DTA in 2002. This concern was expressed in an IRD discussion document: 'It is important that New Zealand's tax system is not out of line with systems in comparable jurisdictions, particularly Australia'.[119] Once these reductions in NRWT had been agreed with the US in 2008, New Zealand became practically obliged to negotiate similar changes with other DTA partners, most obviously Australia.

4. Conclusion

John Taylor accessed, collated, and analysed a remarkable trove of primary resources to bring an especial richness to his research into the history of Australia's DTAs. His revelation that Australia, rather than relying on technical expertise, sent 'a strong man' to negotiate the DITR, and titling an article 'I suppose I must have more discussion on this dreary subject' are instances of welcome relief from the dryness of much of the research in this field. Despite an archetypal Antipodean piercing of pomposity, his research was always meticulous. He set a 'Jolene' standard,[120] which, in this article, we do not pretend to match.

In this article, we have focused on themes that have characterised New Zealand's engagement with international juridical taxation, which, at least before joining the OECD, were distinguished by recalcitrance in the face of developing cross-border tax norms, but ultimate concession, albeit with some small victories.

As Dominions of the British Empire, Australia and New Zealand – distant territories of the Angloworld[121] – shared much in common, including complex relationships with the motherland, but this commonality not only generated comity, it also led to competition in trade, investment, and taxing rights. In some ways, Australia faced similar problems to New Zealand but on a greater scale. If, for example, the UK granted concessions to New Zealand, extending the same indulgence to Australia would be far more economically significant. But overall, when the historical approaches of Australia and New Zealand are compared, we conclude that a significant distinction lay with Australia taking broad political considerations to the DTA negotiating table, whereas New Zealand for many decades focused on a relatively unsophisticated tax-trade calculus. An important lesson we can learn from Taylor's research is that DTAs are as political

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[117] New Zealand–Australia DTA 2009, above n 57, Art 10(2).
[118] Ibid Art 10(3).
[119] See Inland Revenue Department, *New Zealand's International Tax Review: A Direction for Change*, above n 82, [1.3].
[120] See Dolly Parton, *Jolene* (1973).
[121] See generally James Belich, *Replenishing the Earth: The Settler Revolution and the Rise of the Anglo-World, 1783-1939* (Oxford University Press, 2009).

as the development of domestic tax laws – we are well advised to consider their broadest context, without losing sight of the particular.

eJournal of Tax Research (2024) vol. 22, no. 2, pp. 300-323

Tax history and philanthropy: a tribute to John Taylor

Ian Murray,* Tony Ciro,** Alistair Haskett*** and Michael Walpole****

Abstract

The Productivity Commission's philanthropy inquiry highlights that Australia's current tax regime for philanthropic tax concessions is sorely lacking guiding principles. This is an area that calls out for tax history analysis, in the vein of John Taylor, to properly lay bare the social context of philanthropic tax concessions. Building on the Productivity Commission's approach and previous work by Fiona Martin, this article investigates the history of donation concessions for appreciated property and of donation integrity measures as applied to refundable imputation credits.

Keywords: tax history, philanthropy, charity, appreciated property, refundable franking credits, integrity measures

* Professor, University of Western Australia Law School. Email: ian.murray@uwa.edu.au.
** Professor of Law, Thomas More Law School, Faculty of Law and Business, Australian Catholic University; Barrister-at-Law; CPA Australia.
*** Barrister, Victorian Bar.
**** Professor, UNSW Business School.

1. INTRODUCTION

When the federal Labor government came to power in 2022, one of the election commitments it had made was to 'double philanthropic giving by 2030'.[1] The Productivity Commission (Commission) was subsequently tasked with undertaking the heavy lifting to determine how philanthropy might be incentivised.[2] The Commission was asked to gain an understanding of the underlying drivers and trends into philanthropic giving in Australia.[3] The terms of reference for the inquiry included making recommendations to government to 'address barriers to giving and harness opportunities to grow it further'.[4] Included within the terms of reference, the inquiry was also to examine the tax expenditure framework and in particular, 'assess the effectiveness and fairness of the deductible gift recipient framework'.[5] Importantly, the Commission was to further investigate how the deductible gift framework aligns with the public policy objectives and priorities of the broader community.[6]

The Commission has delivered a report calling for major reform of the deductible gift recipient system and corresponding adjustments to integrity measures.[7] The breadth of the terms of reference and the high aspirations of the inquiry mean that many major reforms are being proposed and considered. An understanding of the history of philanthropic tax measures is of major significance to this process in order to help identify potential costs and benefits from changes. Such an approach is very much in keeping with the emphasis placed by John Taylor on the role of tax history in informing a proper interpretation of tax law. In this tribute to John, it is also fitting that we build on the work of one of John's colleagues, Fiona Martin, who has explored the broader history of the deductible gift recipient system, demonstrating the ad hoc way in which the system developed.[8]

In this article, we focus on the interaction between the deductible gift recipient system and capital gains tax (CGT), as well as on deductible gift recipient integrity measures – in the context of refundable franking credits. Both the areas of capital gains taxation and taxation of business enterprises (especially franking credits) were subjects dear to John and neither the issue of appreciated property, nor the refundable franking credit integrity measures have received a tax history analysis. Both are relevant to the reforms proposed by the Productivity Commission.

The article is structured as follows. Section 2 provides context, both in relation to John Taylor's work and in relation to the deductible gift recipient system and integrity measures and CGT. Section 3 analyses the history of the tax treatment of gifts of appreciated property. Section 4 examines the tax history of integrity measures for refundable franking credits for charities. Section 5 concludes.

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[1] Andrew Leigh MP, 'Labor to Double Philanthropic Giving by 2030' (Media Release, 7 April 2022).
[2] Productivity Commission, *Future Foundations for Giving: Inquiry Report* (May 2024) iv-v ('Final Report').
[3] Ibid (setting out the terms of reference).
[4] Ibid.
[5] Ibid.
[6] Ibid.
[7] Ibid.
[8] Fiona Martin, 'The Socio-Political and Legal History of the Tax Deduction for Donations to Charities in Australia and How the "Public Benevolent Institution" Developed' (2017) 38(1) *Adelaide Law Review* 195.

2. CONTEXT

We chart out below John Taylor's interest in tax history research and the importance of such an approach to properly understanding the meaning of tax law. This is followed by an outline of the interaction between gift deductibility and the CGT regime and its treatment by the Commission, along with a sketch of the role of integrity measures, including in relation to the imputation system.

2.1 Tax history research and John Taylor

Christopher John Taylor was an accomplished tax scholar, despite his early request of his superior, when starting at University of New South Wales, that he not be required to teach the subject. He acknowledged later that by ignoring this request his head of department had done him a wonderful favour.

In his long and illustrious career, John was always prepared to engage in detailed examination of provisions of the tax law and to analyse them deeply. But another great passion of his as an academic was an understanding of history, and happily he was able to marry the two areas of interest. On many occasions, he did so with thoroughness, enthusiasm, and insight. Indeed, John's University of Sydney doctoral thesis (awarded 2016) was entitled 'A Critical Assessment of the Origins and Continued Validity of Variations in Australian Tax Treaties from the OECD Model'. Much of the work undertaken in writing it involved archival (literally) research, poring over the diaries, memoranda and correspondence of officials (such as Prime Minister Sir Robert Menzies) to reach an understanding of the terms included in the Australia–United Kingdom Double Tax Agreement and the reasons for their inclusion. John even gave presentations to colleagues, sharing the practical insights he had accumulated about the various archives he had worked in and about how those archives functioned.[9]

John's love of the history of taxation was plain enough. His curriculum vitae at the time of his retirement at the end of 2020 revealed that he had (aside from his other technical writings) at least 14 publications of chapters, articles and papers on tax history – many of them focused on tax treaty negotiations[10] – such as those affecting the Double Tax

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[9] C John Taylor, 'Archival Research as an Aid to the Interpretation of Tax Legislation' (Conference Paper, Tax Research Network Conference, University of Roehampton, 5-7 September 2012) ('Archival Research').

[10] C John Taylor, 'The Negotiation and Drafting of the First Australia–United States Double Taxation Treaty of 1953' in Peter Harris and Dominic De Cogan (eds), *Studies in the History of Tax Law, Vol 7* (Hart Publishing, 2015) 213; C John Taylor, 'The Negotiation and Drafting of the 1967 United Kingdom–Australia Double Taxation Treaty' in John Tiley (ed), *Studies in the History of Tax Law, Vol 5* (Hart Publishing, 2012) 427; C John Taylor, '"I Suppose I Must Have More Discussion on This Dreary Subject": The Negotiation and Drafting of the UK–Australia Double Taxation Treaty of 1946' in John Tiley (ed), *Studies in the History of Tax Law, Vol 4* (Hart Publishing, 2010) 213 ('"I Suppose I Must Have More Discussion on This Dreary Subject"'); C John Taylor, 'The History of Australia's Double Tax Conventions' in Michael Lang and Ekkehart Reimer (eds), *The History of Double Taxation Conventions in the Pre-BEPS Era* (IBFD Publications, 2020) 623; C John Taylor, '"Send a Strong Man to England – Capacity to Put Up a Fight More Important Than Intimate Knowledge of Income Tax Acts and Practice": Australia and the Development of the Dominion Income Tax Relief System of 1920' (2014) 12(1) *eJournal of Tax Research* 32 ('"Send a Strong Man to England"'); C John Taylor, 'The Negotiation and Drafting of the First Australia–Canada Taxation Treaty (1957)' (2013) 61(4) *Canadian Tax Journal* 915; C John Taylor, 'Factors Influencing Australian Taxation Treaty Practice 1946–1976' (2012) 27(3) *Australian Tax Forum* 571; C John Taylor, 'Some Distinctive Features of Australian Tax Treaty Practice: An Examination of Their Origins and Interpretation' (2011) 9(3) *eJournal of Tax Research* 294 ('Some Distinctive Features'); C John Taylor, 'Twilight of the Neanderthals, or Are Bilateral Double Taxation Treaty Networks

Treaties Australia has with the United Kingdom, the United States of America and Canada.

It was not only individual treaties that intrigued John but, of course, themes could be identified and thus learnings derived from the mass of the literature John had read.[11]

Sometimes the words of the historical figures involved were quoted to give extra life and allure to John's topic. Take for example titles such as:

> '"I Suppose I Must Have More Discussion on This Dreary Subject": The Negotiation and Drafting of the UK–Australia Double Taxation Treaty of 1946';[12] and
>
> '"Send a Strong Man to England – Capacity to Put Up a Fight More Important Than Intimate Knowledge of Income Tax Acts and Practice": Australia and the Development of the Dominion Income Tax Relief System of 1920'.[13]

Such titles would have been a delight to John's wry sense of humour and a drawcard for his readers and conference audiences.

The result of John's work was a rounded, human, appreciation of the relevant tax law and the explanation for its form – in a manner that the written word of the law cannot yield. Thus, John became the expert on such things, and he was generous in sharing his knowledge of the subject matter but also of the techniques he had learned.

It therefore seems highly appropriate to approach the topic of this article from an historical perspective as we do here and John, as a capital gains tax and business entities expert[14] as well as a tax historian, would have approved of the idea of a review of the history of the tax treatment of appreciated property in Australia and of refundable franking credits.

2.2 Deductible gift recipient system and capital gains tax

The current tax-deductible gift system provides incentives for both individuals and corporations to make donations and receive a tax deduction in return. For individuals who derive taxable income and who give more than AUD 2 to a charity or other entity that has deductible gift recipient (DGR) status, the individual can claim a 100 per cent tax deduction. The Commission found that a tax deduction is likely to provide an 'effective mechanism for encouraging donations of money and does not need to substantively change'.[15] Despite the obvious benefit provided by the deductible gift system, the Commission was of the view that further reform was warranted to the DGR framework. This was especially the case with the entities that are designated as DGRs.

Sustainable?' (2010) 34(1) *Melbourne University Law Review* 268 ('Twilight of the Neanderthals'); C John Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946' [2009] (2) *British Tax Review* 201; C John Taylor and Andrew MC Smith, 'Trans-Tasman Taxation of Companies and Their Shareholders 1945–2005' (Conference Paper, 4th International Accounting History Conference, Braga, Portugal, 8-9 September 2005); Taylor, 'Archival Research', above n 9.

[11] Taylor, 'Some Distinctive Features', above n 10; Taylor, 'Twilight of the Neanderthals', above n 10.

[12] Taylor, '"I Suppose I Must Have More Discussion on This Dreary Subject"', above n 10.

[13] Taylor, '"Send a Strong Man to England"', above n 10.

[14] CJ Taylor, *Capital Gains Tax: Business Assets and Entities* (Law Book Company, 1994).

[15] Productivity Commission, *Future Foundations for Giving: Draft Report* (November 2023), 11 ('Draft Report'). See also Productivity Commission, 'Final Report', above n 2, 6.

The Commission was of the view that the definition and access status of entities and charities that have been designated as DGRs has been 'poorly designed' and become 'overly complex' with 'little or no coherent policy rationale'.[16]

The Commission also engaged in preliminary econometric modelling to identify any changes in behaviour by individual taxpayers in response to tax incentives. The Commission provided an estimate of the *price elasticity of giving*.[17] The price elasticity was modelled on a person's individual marginal tax rate. The Commission also looked at the *income elasticity of giving* as a measure for philanthropy by the individual taxpayer.[18] The preliminary estimates by the Commission regarding the elasticity of giving and income elasticity associated with philanthropy were, for a taxpayer giving AUD 100 and with disposable income of AUD 50,000[19] that:

- 'a 1% decrease in the price of giving increases giving between 48 cents and $1.67';[20]
- 'a 1% increase in disposable income increases giving between 86 cents and $1.17'.[21]

The Commission found that the above price elasticities for both giving and disposable income along with the relationship of philanthropy were consistent with findings from overseas jurisdictions, including the United States,[22] Canada[23] and the UK.[24]

In terms of philanthropy, the Commission considered the CGT implications of donating CGT assets to a charity. Where assets or property that are subject to CGT are donated, the donor would ordinarily bear the CGT liability upon disposal. This liability would be offset by the donor claiming the market value of the gifted property against assessable income and thus realise a tax deduction in the same way as a monetary donation.[25] The Commission considered whether further incentives should be provided to incentivise the donation of capital in the form of assets and property to encourage further philanthropy. One suggestion was to provide a CGT exemption for donated property, at the same time as allowing a deduction for the market value of the donated property. This would apply not only where the donated asset was not used to claim a tax deduction

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[16] Productivity Commission, 'Final Report', above n 2, 6.
[17] Ibid 128-136, 422-439. The Commission estimated on the basis that if an individual marginal tax rate were to decrease by 1 per cent, would they give less because they would receive a lower tax deduction for each dollar of donation.
[18] Ibid. The Commission modelled income elasticity of 'giving' by estimating how individuals change their behaviour in response to changes in the individual's income.
[19] Other factors that may be relevant include the taxpayer's demographics, such as age and gender, the charitable cause and the design of the tax incentive: Productivity Commission, 'Final Report', above n 2, 129.
[20] Ibid 7.
[21] Ibid.
[22] John Peloza and Piers Steel, 'The Price Elasticities of Charitable Contributions: A Meta-Analysis' (2005) 24(2) *Journal of Public Policy and Marketing* 260.
[23] Ross Hickey, Brad Minaker, A Abigail Payne, Joanne Roberts and Justin Smith, 'The Effect of Tax Price on Donations: Evidence from Canada' (Melbourne Institute of Applied Economic and Social Research Working Paper No 02/23, January 2023).
[24] Miguel Almunia, Irem Guceri, Ben Lockwood and Kimberley Scharf, 'More Giving or More Givers? The Effects of Tax Incentives on Charitable Donations in the UK' (2020) 183 *Journal of Public Economics* 104114.
[25] Productivity Commission, 'Final Report', above n 2, 149.

against assessable income, but more broadly. This would effectively allow a donor of a CGT asset to not incur a tax liability upon disposal, yet still receive a full deduction. The Commission was not persuaded to recommend such a change based on a very brief analysis of the policy implications.[26]

2.3 Integrity measures

The Commission's report highlights the need for any changes to tax concessions such as the DGR system to be made in such a way that they 'maintain integrity and direct government subsidised donations toward entities that provide the greatest community-wide benefits'.[27] The report recommends strengthening some DGR integrity measures and removing others, due to their disincentivising effect.[28] In this article we examine the history of integrity measures that apply to franked dividends received by charities, that were modelled on DGR system integrity rules. That history highlights the legislative decision to design integrity measures for the imputation system using concepts emerging from judicial analysis of the nature of a 'gift'. The common law indicia of a 'gift' will often be instructive in a law design project concerning charities. However, as always, care must be taken when constructing targeted integrity measures lest they impede the core purpose of a legislative regime – eg, a regime intended to support and promote the charity sector. Integrity rules relying on the indicia of a 'gift' have the capacity to cover a broad spectrum of potential activity and, accordingly, ought to be designed with appropriate consultation and careful thought about necessary carve-outs.

3. Gifts of appreciated property

As noted above, the Commission's philanthropy inquiry has involved consideration of whether to increase the tax concessions available to donors of appreciated property, that is, gifts of property where the donor has a small cost base compared with the current market value of the property, for instance, shares in a company founded by the donor or real estate purchased long ago.[29] Australia is far less generous than jurisdictions such as the United States, Canada and the United Kingdom in its treatment of gifts of appreciated property. Increasing the level of generosity might result in greater levels of donation, thus helping toward the goal of doubling philanthropy by 2030. However, as noted by the Productivity Commission, the potential application of the CGT discount (50 per cent for individuals) for property acquired at least 12 months before the donation already results in a concession and there is the risk of unintended consequences such as the difficulties of liquidating property – especially unlisted shares – and the introduction of greater inequity from favouring donations of capital assets over salary income.[30] It is

[26] Ibid 149-150. See also Productivity Commission, 'Draft Report', above n 15, 154-155.
[27] Productivity Commission, 'Final Report', above n 2, 211.
[28] Ibid 211-214.
[29] The practice is common in the United States with prominent examples including Malcolm and Emily Fairbairn's donation of Energous shares (they were early investors rather than founders) to Fidelity Charitable, *Fairbairn v Fidelity Investments Charitable Gift Fund*, 2018 WL 6199684 (ND Cal 2018) ('*Fairbairn*'), and Charles Johnson's donation of his own mansion at a very high market valuation: Jeff Ernsthausen, 'How the Ultrawealthy Use Private Foundations to Bank Millions in Tax Deductions While Giving the Public Little in Return' *ProPublica* (26 July 2023) <https://www.propublica.org/article/how-private-nonprofits-ultrawealthy-tax-deductions-museums-foundation-art>.
[30] Productivity Commission, 'Final Report', above n 2, 149-150.

therefore useful to look at the context and history of the less generous Australian treatment.

3.1 Deduction and market value CGT exemption

A recent OECD report on taxation and philanthropy indicates that most countries provide donation concessions for gifts to philanthropic organisations (such as charities) of cash and property.[31] Some countries provide donation concessions only for monetary gifts, not property.[32] Others impose numerous restrictions on the type or value of property that can be donated.[33] Historically, Australia was quite restrictive about gifts of property. Prior to 1 January 1978, a deduction was available only for property acquired within 12 months of making a gift, but from 1 January 1978, cultural property was added.[34] Some further additions were made over the intervening years, but it was not until 1 July 1999 that Australia permitted deductions for most items of property that had been purchased 12 months or more before the donation.[35] However, disposing of property by way of gift to a deductible gift recipient is a CGT Event and so raises the risk that CGT – based on market value at the time of the gift[36] – might apply to eliminate or reduce the benefit of the deduction.[37] Other than cultural property donated under the Cultural Gifts Program[38] and main residence gifts,[39] no other property types are granted both an exemption from CGT on disposal and a deduction.[40]

The United States broadly excludes charity-donated property from CGT (provided in the US that it has been held for at least one year), as well as permitting a market value deduction.[41] The United Kingdom provides both an income or corporation tax deduction and a capital gains tax exemption for gifts of listed shares or securities, shares or securities dealt with on the AIM (Alternative Investment Market) or PLUS–Quoted Market, units in authorised unit trusts, certain other shares, and land and buildings.[42] In

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[31] OECD, *Taxation and Philanthropy*, OECD Tax Policy Studies No 27 (OECD Publishing, 2020) [4.2].
[32] Ibid, listing New Zealand as an example.
[33] Ibid.
[34] Hon John Howard (Treasurer), 'Taxation Incentives for the Arts Scheme' (Press Release, 14 October 1981); Peter Clayton, 'The Taxation Incentives for the Arts Scheme' (1988) 37(1) *Australian Library Journal* 5, 6.
[35] *Taxation Laws Amendment Act (No 2) 2000* (Cth) Sch 6. For a discussion, see Myles McGregor-Lowndes, 'The Australian Charitable Contribution Deduction' (Paper presented at the National Centre on Philanthropy and the Law, Reforming the Charitable Contribution Deduction 13th Annual Conference, New York, 2001) 14 <https://ncpl.law.nyu.edu/wp-content/uploads/pdfs/2001/Conf2001_McGregor-Lowndes_Final.pdf>.
[36] *Income Tax Assessment Act 1997* (Cth) s 116(1) or s 116(2) (ITAA 1997) would typically deem the market value of the gifted property to be capital proceeds received by the donor.
[37] A gift of property that is deductible would be expected to result in a change in beneficial ownership and so result in CGT Event A1 under ITAA 1997, above n 36, s 104-10.
[38] ITAA 1997, above n 36, ss 30-15(2) (table items 4 and 5) and 118-60(2).
[39] The CGT main residence exemption can potentially apply to gifts of a main residence: ITAA 1997, above n 36, sub-div 118-B. This could potentially include heritage gifts of a main residence to which ITAA 1997 s 30-15(2) (table item 6) applies.
[40] Albeit that other CGT concessions may apply if, for instance, the gifted property was a war medal or a collectable such as jewellery or artwork acquired for AUD 500 or less: ITAA 1997, above n 36, ss 118-5(b), 118-10. For discussion of potential CGT concessions, see Ann O'Connell, *Taxation of Charities and Not-for-Profits* (LexisNexis, 2021) 405-408.
[41] OECD, above n 31, [4.2.7].
[42] HM Revenue and Customs, 'Detailed Guidance Notes on How the Tax System Operates for Charities' (updated 27 March 2024) Ch 5 <https://www.gov.uk/government/publications/charities-detailed-guidance-notes/chapter-5-giving-land-buildings-shares-and-securities-to-charity>.

Canada, from very shortly after the introduction of capital gains taxation in 1972, charitable gifts of property generally gave rise to an income tax concession.[43] While the Canadian Parliament was not persuaded by attempts from the inception of the capital gains tax to exempt all forms of property donations from CGT,[44] Canada exempts a range of property donations (eg, public company listed shares, cultural property and ecologically sensitive land) from capital gains tax.[45] Interestingly, the Canadian classes of exempt property only included cultural property (the exemption was introduced in 1977) on the basis that Canadian museums and other cultural institutions were otherwise competing on an uneven playing field with US institutions, given that US donors could claim a market value deduction and ignore any realised capital gain.[46] Canada subsequently expanded the CGT exemption to publicly traded securities (providing a 50 per cent exemption in 1997) and ecologically sensitive land (providing a 50 per cent exemption in 2001).[47] Then, in 2006, Canada provided full exemption for both publicly traded securities and ecologically sensitive land, with the US approach of full disregard of CGT being provided as a rationale for achieving greater support for capital transfers to Canadian charities.[48]

Further (setting aside listed public company shares worth AUD 5,000 or less, property purchased within 12 months of a deduction and cultural, heritage or environmental property), in Australia, the amount that can be deducted is based on a valuation carried out by the Commissioner of Taxation.[49] In contrast, in jurisdictions such as Canada and the United States, the market value that can be deducted is generally determined by the philanthropic recipient or donor (often with a requirement that they obtain an appraisal), not the revenue authority.[50] Special rules apply to cultural and heritage or environmental property in each jurisdiction.[51]

3.2 Historical explanation for the limited availability of a deduction and exemption in Australia

Martin's analysis of the historical development of income tax deductions in Australia explains that they were fashioned from concessions for charities in income and land tax legislation of the Australian colonies, based on earlier English practice.[52] This occurred without any 'real discussion of the policy behind' the earlier concessions.[53] While theoretical explanations for charity deductions now abound,[54] in earlier times, deduction

[43] First a deduction and then a credit: David G Duff, 'The Tax Treatment of Charitable Contributions in a Personal Income Tax: Lessons from Theory and the Canadian Experience' in Matthew Harding, Ann O'Connell and Miranda Stewart (eds), *Not-for-Profit Law: Theoretical and Comparative Perspectives* (Cambridge University Press, 2014) 199, 224.
[44] As to suggestions of a broad exemption from commencement of the CGT, see ibid.
[45] OECD, above n 31, [4.2.7].
[46] Duff, above n 43, 224-225.
[47] Ibid 225.
[48] Ibid.
[49] O'Connell, above n 40, 387-389, 402-403. A deduction can also be claimed for donations of trading stock, but a disposal of trading stock outside the ordinary course of business generates a corresponding amount of assessable income: at 388-392.
[50] OECD, above n 31, [4.2.7].
[51] Ibid.
[52] Martin, above n 8.
[53] Ibid 220.
[54] See, eg, OECD, above n 31; Duff, above n 43; Roger Colinvaux, 'Ways the Charitable Deduction Has Shaped the US Charitable Sector' in Matthew Harding (ed), *Research Handbook on Not-For-Profit Law* (Edward Elgar, 2018) 444.

concessions seem to have been largely justified based on the desirability of incentivising more donations so as to enable charities to achieve more public benefit, albeit that this needed to be balanced against the revenue forgone by government.[55]

In this context, it is perhaps unsurprising that the Asprey Review, which discussed the introduction of an Australian CGT and devoted an entire chapter to charities, did not discuss the issue of whether charitable gifts of property should be made exempt from CGT, as well as deductible.[56] Indeed, in 1975 when the Asprey Review was handed down, the only property for which an income tax deduction could be claimed was property acquired within 12 months of making a gift, for which one might expect the price paid to roughly equal the market value such that capital appreciation was not a major issue. Instead, the Asprey Review recommended that gifts (including non-charitable gifts) should result in a deemed disposal of the gifted property at market value.[57] This was despite the Asprey Review noting the existence of a general view that gifts to charities and other public bodies ought to be encouraged so as to help subsidise the welfare services provided by those bodies and that might otherwise have to be provided by government.[58]

When the Taxation Incentives for the Arts scheme was introduced in 1978, lifetime gifts of cultural property accepted by public galleries, museums and the like institutions were made deductible.[59] There was some recognition that this might encourage gifts of appreciated property, with the government's stated rationale being that '[i]n liberalising the gift deduction provisions in this way, the Government's intention was to encourage the donation for public display of significant works of art, and other cultural property, that had been inherited or that had been held for an extended period of time over which its value had considerably appreciated'.[60] However, there does not appear to be discussion of the potential CGT consequences, likely because Australia had not yet introduced a comprehensive CGT.

In June 1985, the government released a Draft White Paper on taxation reform containing detailed proposals for an Australian CGT.[61] The Draft White Paper contained no discussion about charitable donation concessions in its discussion of CGT, instead adopting a general position similar to that outlined in the Asprey Review. That is, a gift (or bequest upon death) should act as a realisation point for recognising any capital gains, in order to avoid excessive deferral of the realisation time.[62] The resulting CGT provisions that were introduced by the *Income Tax Assessment Amendment (Capital Gains) Act 1986* (Cth) are consistent with this sentiment, applying the provisions to disposals of assets and deeming bequests to tax-exempt persons to result in a disposal.[63] A CGT exemption was included for medals awarded for valour or brave conduct,[64] but

[55] Martin, above n 8, 221. The revenue saved could presumably have been used directly by government to achieve public benefit.
[56] Taxation Review Committee (Justice Kenneth Asprey, chair), *Full Report* (31 January 1975) chs 23 (capital gains tax) and 25 (charities) (Asprey Review).
[57] Ibid [23.51].
[58] Ibid [25.3]-[25.6], [25.20]-[25.21].
[59] Howard, above n 34.
[60] Ibid.
[61] Australian Treasury, *Reform of the Australian Tax System: Draft White Paper* (June 1985).
[62] Ibid [7.11].
[63] Then ss 160L and 160Y of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936).
[64] Then s 160L(6) of the ITAA 1936, above n 63.

the Explanatory Memorandum and the Second Reading Speech to the Bill for this Act do not explain why this exemption was included, or why no exemption was included for gifts to charities.

It was not until 1994 that a CGT exemption was provided for charitable gifts. That exemption was in the form of the Cultural Bequests Program. The Program was conceived as an addition to the Taxation Incentives for the Arts scheme.[65] The Budget announcement recognises the issue of capital appreciation and identifies achievement of 'cultural significance to the nation' as the rationale for providing a concession:

> [T]ax concessions will be made available for bequests of selected major items of cultural significance to the nation. The tax concessions will be available after the donor's death, to be offset against income in the donor's final tax return and income of the donor's estate, and will consist of a tax deduction equal to the value of the testamentary gift at the time the donor agreed to make the gift, and a capital gains tax exemption. The capital gains tax exemption will relate to the unrealised capital gain at the time a donor agreed to make the bequest, and the subsequent capital gain prior to the donor's death. The program will operate as a supplement to the existing Taxation Incentives for the Arts Scheme. A selection process will assess proposed bequests on the basis of historical and cultural significance, with approvals each year capped at a notional revenue cost of $2m per year.[66]

In line with the Budget announcement, *Taxation Laws Amendment Act (No 3) 1994* (Cth) introduced both a deduction (because bequests were testamentary gifts, for which deductions were not generally available) and a CGT exemption.[67] The Program was devised to focus on a particular type of property – items of material cultural significance – and to minimise the risk of lost revenue. That was achieved by requiring that proposed bequests not only be accepted by the relevant recipient public institution, but also approved in advance by the Minister for the Arts, with the value of the deduction also approved by the Minister.[68] Further, the Minister was required to determine an annual cap on deductions under the scheme before the start of each year, such that no deduction could be claimed once cultural bequests had already been approved up to the cap. The Cultural Bequests Program CGT exemption was rewritten into section 118-60 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) as part of the Tax Law Improvement Project.[69] The Cultural Bequests Program provisions were removed by the *Tax Laws Amendment (2011 Measures No 9) Act 2012* (Cth) on the basis that the program had by then become inoperative.[70]

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[65] Explanatory Memorandum to the Taxation Laws Amendment Bill (No 3) 1994, [8.5].

[66] Australian Treasury, *Budget Statements 1993-94: Budget Paper No 1* (1993). The Explanatory Memorandum to the Taxation Laws Amendment Bill (No 3) 1994, above n 65, [8.3]-[8.4] is consistent with this.

[67] Division 9 of the Act introduced amendments to section 78 of the ITAA 1936, above n 63, (the deduction provision) and introduced section 160L(9) to exempt from CGT disposals of assets under the cultural bequests program.

[68] *Taxation Laws Amendment Act (No 3) 1994* (Cth) s 81. See also McGregor-Lowndes, above n 35, 20.

[69] *Tax Law Improvement Act (No 1) 1998* (Cth). The deduction for cultural bequest program gifts under section 78 of the ITAA 1936, above n 63, had already been rewritten into Sub-div 30-D of the ITAA 1997, above n 36, by the *Tax Law Improvement Act 1997* (Cth).

[70] Explanatory Memorandum to the Tax Laws Amendment (2011 Measures No 9) Bill 2011, [8.7].

Effective from 1999, the CGT exemption for Cultural Bequests Program bequests was extended to cultural gifts under the Cultural Gifts Program, being the new name for the Taxation Incentives for the Arts scheme.[71] The *Taxation Laws Amendment Act (No 2) 2000* (Cth) added the CGT exemption, at the same time as broadening the CGT exemption for bequests to all testamentary gifts that would be deductible but for being testamentary bequests.[72] The only rationale provided in the explanatory materials was that this would 'encourage greater corporate and personal philanthropy in Australia'.[73] A press release by the Prime Minister, Treasurer and Minister for Family and Community Services indicated that the CGT changes were intended to 'boost' donations and 'cut through the red tape that has discouraged many businesses, individuals and families who want to give more to their communities'.[74] At the same time, the deduction for property was broadened to cover most items of property, though no corresponding CGT exemption was included and no additional explanation provided in the explanatory materials as to why a different approach was taken to general property versus cultural property.

In its report the Productivity Commission draws on Martin's research and refers to the lack of a clear policy basis for the development of donation concessions:

> Since a tax deduction for donations was introduced in 1915, the scope of activities eligible for deductible donations has evolved in an ad hoc way. This means that the DGR system does not have a clear overarching policy rationale that explains why certain types of charitable activity receive DGR status and other charitable activities do not. Charities that undertake similar activities and/or have similar purposes can be treated differently, creating anomalous outcomes. This can create uncertainty for charities about their eligibility for DGR status, and complexity in obtaining it … The system also lacks clarity for donors (who claim the tax deduction) because of the anomalous treatment of similar charities.[75]

However, the Productivity Commission does not draw further on the history outlined above, other than an implicit reference to the 'cultural significance' of cultural property as justifying the current CGT exemption for cultural gifts.[76]

3.3 What can we learn?

What can we draw from this review of the history of the tax treatment of appreciated property in Australia? It is clear that, as Martin found for donation concessions generally, there has historically been no sustained policy consideration of the issue. At

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[71] The initiatives were the result of a philanthropy report produced in 1999 by the Prime Minister's Community and Business Working Group chaired by David Gonski. The report does not appear to have been released publicly. As to discussion of business/corporate philanthropy more broadly, see, eg, Tony Ciro and Bulend Terzioglu, 'Corporate Philanthropy in Australia: Evidence from Australia's Top 100 Listed Firms' (2017) 32(1) *Australian Journal of Corporate Law* 27.

[72] *Taxation Laws Amendment Act (No 2) 2000* (Cth) ss 26, 28.

[73] Explanatory Memorandum to the Taxation Laws Amendment Bill (No 8) 1999, [5.4] (this Bill became the *Taxation Laws Amendment Act (No 2) 2000*).

[74] Hon John Howard (Prime Minister), Hon Peter Costello (Treasurer) and Hon Jocelyn Newman (Minister for Family and Community Services), 'Joint Press Release' (1 July 1999) <https://pmtranscripts.pmc.gov.au/release/transcript-11225>.

[75] Productivity Commission, 'Final Report', above n 2, 162-163.

[76] Ibid 149-150.

best, what we can glean is that decisions have been made at various times over the last 40 years to not provide a general CGT exemption in respect of all appreciated property for which a charitable deduction can be claimed. For instance, there have been occasions, such as in 2000, when major changes have been made to the breadth of property for which a deduction can be claimed and yet the CGT exemption has been doled out sparingly to particular types of property. It is clear that the special nature of cultural property – its socio-cultural significance to the nation – is part of the rationale for limiting additional concessions to such property and this is consistent with the Productivity Commission's conclusions in its report.[77] Additionally, the inclusion of restrictive mechanisms as to acceptance and approval for the limited instances of CGT exemption for cultural property suggest a desire to strongly protect the revenue.

The several paragraphs added by the Productivity Commission in its philanthropy inquiry draft and final reports are a major advance on the existing situation and represent an opportunity to reconsider the issue. First, the Productivity Commission refers to the potential preference of donors to leave the management and potential liquidation of donated property to the charity recipient (which can bring difficulties), as opposed to gifts of money. This can be linked to the tax history theme of the use of restrictive acceptance and approval mechanisms, largely due to floodgates and valuation concerns. It is potentially very difficult to value and to sell property such as unlisted shares. This would likely materially increase the transaction costs of giving (and potentially disincentivise giving of illiquid property), which the Productivity Commission found were relatively low under the current regulatory settings.[78]

In the United States, the ability to donate illiquid property and claim a (top of the range) deduction without the donor having to worry about the actual sale of the property is one reason for the spectacular rise of a particular type of philanthropic intermediary/structured giving vehicle: donor advised funds.[79] Donor advised funds are essentially management accounts within a public charity that permit advisory privileges to donors, such that donors obtain extensive concessions for their donations, but in practice retain decision-making privileges about the charity recipients to whom the donated property is ultimately distributed. There are concerns that such philanthropic intermediaries have an in-built tendency to prioritise donor interests so as to ensure further donations, without adequately considering the pursuit of their own charitable purposes, since many are essentially flow-through vehicles with donors determining the charitable recipients.[80] Many professional donor advised fund sponsor organisations also market their supposedly superior ability to deal with illiquid assets and reduce transaction costs.[81] However, practice has sometimes materially diverged from the rhetoric, with *Fairbairn v Fidelity Investments Charitable Gift Fund*[82] being a well-known US example whereby donors sued their donor advised fund sponsor organisation

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[77] See n 76, above, and accompanying text.
[78] Productivity Commission, 'Final Report', above n 2, 387.
[79] Roger Colinvaux, 'Donor Advised Funds: Charitable Spending Vehicles for 21st Century Philanthropy' (2017) 92(1) *Washington Law Review* 39, 71-81 ('Donor Advised Funds'); Mary C Hester, 'Donor-Advised Funds: When Are They the Best Choice for Charitably Minded Clients?' (2008) 108(6) *Journal of Taxation* 330, 333.
[80] See, eg, Colinvaux, 'Donor Advised Funds', above n 79, 73-74.
[81] Ibid 76-81; Hester, above n 79, 330, 333.
[82] *Fairbairn*, above n 29.

for alleged negligence in relation to selling *listed* shares in a large block and thereby significantly depressing the amount realised for the charitable giving account.

The US experience suggests that philanthropic intermediaries similar to donor advised funds might disproportionately attract illiquid property donations (because ordinary gift recipients find liquidation too difficult) potentially reducing the transaction costs of realising illiquid property. However, philanthropic intermediaries like donor advised funds might combine this with a tendency to prioritise donor interests so leading to maximal asset valuations at the point of donation and posing a real risk that the ultimate benefit to the community from gifts of appreciated property is less than the tax forgone.[83] This is a separate issue to the question of delay in the distribution of funds held in structured giving vehicles, a matter considered by the Productivity Commission in its report and in relation to which Australia has an advantage over the US in that one of the main forms of structured giving vehicles used to provide sub-funds or donor advised funds, the Public Ancillary Fund, is already subject to an annual minimum distribution rate of 4 per cent (and with the Productivity Commission recommending a slight increase).[84]

Second, the Productivity Commission refers to potential inequity between taxpayers if gifts of capital assets are further privileged.[85] The Productivity Commission apparently refers to horizontal equity concerns by contrasting capital gain income with salary income. This is undoubtedly correct. However, as noted elsewhere by the Productivity Commission, Australian giving trends already suggest that higher income and wealthier taxpayers are increasingly giving a greater proportion of donations.[86] That is why the Productivity Commission's finding 3.1 is that 'Rising income and wealth are the major reasons behind rising tax-deductible donations'[87] and why the Productivity Commission's finding 4.1 includes the statement that 'those on a higher income [are] more likely to give'.[88] It is these very same Australians who are likely to hold a disproportionate share of capital assets and so gain greater benefit from additional concessions for gifts of capital assets. Accordingly, there is the potential to also materially detract from vertical equity.

The historical context suggests that a cautious and limited approach to concessions for gifts of appreciated property is justified to protect the revenue, and also that a special reason, such as protecting the nation's cultural heritage, is likely to be required to warrant inequitable treatment of gifts from capital receipts and revenue (salary) receipts. A rejection of calls for a broad-based appreciated property CGT exemption which draws on the historical context as well as a more expansive understanding of the Productivity Commission reasons relating to liquidity and inequity could help politicians and others when responding to the inevitable attempts by interest groups to call for Australia to adopt the more generous treatment granted by jurisdictions such as the US, Canada and the UK.

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[83] For a useful analysis of the extent of the transaction costs and valuation difficulties, resulting in revenue leakage, see, eg, Roger Colinvaux. 'Charitable Contributions of Property: A Broken System Reimagined' (2013) 50(2) *Harvard Journal on Legislation* 263.
[84] See, eg, Productivity Commission, 'Final Report', above n 2, 271-272, 275-289.
[85] See n 30, above and accompanying text.
[86] Productivity Commission, 'Final Report', above n 2, 86-89.
[87] Ibid 93.
[88] Ibid 136.

4. INTEGRITY MEASURES: DEDUCTIBLE GIFTS AND REFUNDABLE FRANKING CREDITS

4.1 Overview

The history of deductible gifts also traces into a more modern element of Australian taxation law – namely, Subdivision 207-E of the ITAA 1997, which includes integrity rules concerning the refundability of franking credits received by tax-exempt entities. The language used for the integrity rules in Subdivision 207-E derives from section 78A of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). Section 78A was introduced as part of anti-avoidance legislation that was designed, in part, to put an end to 'gift schemes' that were commonplace through the 1970s.[89] Subdivision 207-E[90] is a rewrite of former Division 7 of Pt IIIAA of the ITAA 1936,[91] which was introduced as part of large-scale tax reforms responsive to recommendations in the Review of Business Taxation chaired by John Ralph in Australia.[92] Among those recommendations was a proposal to allow for refunds of excess imputation credits to taxpayers whose income was taxed at a rate below the company tax rate.

To the knowledge of the authors, neither former Division 7 of Pt IIIAA of the ITAA 1936 nor Subdivision 207-E received significant attention in the years after they were enacted. More recently, Subdivision 207-E has been brought into frame following the publication by the Australian Taxation Office on 8 December 2023 of Taxpayer Alert TA 2023/3, 'Franking credit refunds – income tax exempt entities receiving franked distributions in the form of property other than money', which concerns distributions of property other than money to tax-exempt entities and, in particular, the application of section 207-122(b)(i) of the ITAA 1997.

4.2 Allowing a refund of franking credits to charities – some observations

While the focus of the Productivity Commission's report is philanthropic giving, one of its underlying themes is the way Australian governments support charities. The primary forms of Australian government support are the allowance of income tax deductions for donations and direct funding by way of grants and contracts.[93] Charities also receive government support through various federal, State, Territory and local government tax concessions.[94]

Refundability of franking credits received by charities is regarded as a form of tax concession.[95] Charities might receive franking credits because of direct investment, for example by holding shares in an Australian company, or by means of gift, for example where a private trust estate that holds shares in an Australian company distributes

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[89] Section 78A of the ITAA 1936, above n 63, was enacted by the *Income Tax Assessment Amendment Act 1978* (Cth).

[90] Subdivision 207-E of the ITAA 1997, above n 36, was enacted by the *Tax Laws Amendment (2004 Measures No 6) Act 2005* (Cth).

[91] Former Division 7 of Part IIIAA of the ITAA 1936, above n 36, was enacted by the *New Business Tax System (Miscellaneous) Act (No 1) 2000* (Cth).

[92] Review of Business Taxation (John Ralph, chair), *A Tax System Redesigned: More Certain, Equitable and Durable* (1999) (Ralph Review).

[93] Productivity Commission, 'Final Report', above n 2, 4-5; Productivity Commission, 'Draft Report', above n 15, 9.

[94] Productivity Commission, 'Draft Report', above n 15, 176.

[95] Productivity Commission, *Contribution of the Not-for-Profit Sector* (Research Report, 2010) 163, E.2 and E.8; Ann O'Connell, 'Stretching the Concept of Charity in the Tax Context: Membership-Based Entities as Charities' (2021) 50(2) *Australian Tax Review* 121, 122.

franked dividends to a charity. The extent of support afforded by the refundability of franking credits is substantial, but appears to be in decline, with the latest figures recording refunds to tax-exempt philanthropic entities of AUD 2,095 million in 2019-20, AUD 1,040 million in 2020-21 and AUD 900 million in 2021-22.[96]

The Productivity Commission report does not directly interrogate the role refunds of franking credits can play with respect to philanthropic giving. Refunds of franking credits are mentioned as potentially increasing income for ancillary funds and dividend imputation is mentioned in the context of assessing the cost of giving for an Australian resident shareholder in an Australian company,[97] but otherwise franking credits do not feature.

In our view, the refundability of franking credits received by charities is a topic that warrants consideration in an analysis of philanthropic giving. The absence of consideration by the Productivity Commission may be explained by its characterisation of tax concessions for charities as a means of indirectly reducing 'their operating costs'.[98] In view of the history discussed in section 4.4, that characterisation with respect to the refundability of franking credits might be qualified in at least two respects. First, the refundability of franking credits does not reduce a cost that would otherwise be incurred by a charity; rather, a refund of franking credits is accretive to charities; refunds reverse the payment of tax on corporate income, such tax being an operating cost of the underlying taxable entity that has generated franking credits from (presumably) non-charitable activities. In that sense, the policy of refunding franking credits to charities constitutes a direct contribution by the Australian government (potentially through the actions of an intermediary, such as a private trust), because a refund of franking credits increases a charity's cash flow; it does not avoid a reduction in cash flow that would otherwise arise by the imposition of tax.

Second, one might compare the refundability of franking credits with the income tax deduction for gifts, the latter of which involves the government 'effectively subsidising the gift *by a donor*'.[99] A gift deduction incentivises the donor directly.[100] By contrast, the incentive effect of franking credit refundability operates differently. As noted in section 4.4, the legislative decision to allow a refund of franking credits to charities was explained as removing a potential 'tax-driven distortion' that disincentivised tax-exempt entities from investing in Australian companies,[101] arguably indicating a policy of encouraging charities to partially self-support their activities through investment. However, that policy can also be viewed through the lens of philanthropic giving: allowing a refund of franking credits to charities would, in theory, encourage giving through intermediary trust estates from which charitable objects may receive franked distributions because the cash benefit of a franked distribution for a charity is increased by the government's 'co-contribution', being a refund of tax paid at the company level.

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[96] Australian Treasury, *Tax Expenditures and Insights Statement* (January 2024) 108.
[97] Productivity Commission, 'Final Report', above n 2, 124-125, 282-283.
[98] Ibid 174.
[99] Ann O'Connell, 'The Tax Position of Charities in Australia – Why Does It Have To Be So Complicated?' (2008) 37(1) *Australian Tax Review* 17, 27 (emphasis added).
[100] See Productivity Commission, 'Final Report', above n 2, 120-127.
[101] Supplementary Explanatory Memorandum to the New Business Tax System (Miscellaneous) Bill 1999, [1.2].

The Productivity Commission touches on the topic of tax credits in the context of considering the effectiveness of the personal income tax deduction, finding that:[102]

1. 'The current design of the personal income tax deduction is likely to be the most cost-effective way for the Australian Government to encourage giving';
2. 'A flat tax credit would likely incentivise more people to give, but the total amount given overall would likely fall if people who have a high income faced a higher price of giving than they currently do';
3. 'Adjustments to a tax credit to account for the likely fall in overall giving, including a hybrid approach – a tax deduction for some income cohorts and a tax credit for others – would add complexity and the effect on total donations would be uncertain'; and
4. The use of tax credits 'would likely increase tax integrity risks and compliance costs given volunteer work and expenses are often undocumented or informal'.

Those conclusions might be contrasted with the nuances discussed above regarding the tax concession afforded to charities in the form of a refund of franking credits:

1. A personal deduction or tax credit predominantly incentivises supply-side (donor) behaviour. By contrast, imputation credits can target specific behaviours on the supply side and demand side, namely by: (a) encouraging charities to self-support their activities through investment in Australian companies, and (b) potentially, encouraging philanthropists to direct franked distributions to charities.

2. Unlike the flat tax credit (which may reduce overall giving because high-income donors would face a higher price of giving), the refundable franking credit does not differentiate based on a donor's tax rate; instead, it provides a flat credit rate (the corporate tax rate) regardless of donors' personal circumstances.

3. The refunding of franking credits might be characterised as akin to a 'co-contribution' model, whereby the Australian government contributes directly in an accretive way to the cash flow of charities (otherwise than through grants and contracts) by refunding corporate taxes. Participation in the 'co-contribution' program is at the election of charities (by investing in Australian companies) or philanthropists (by directing franked distributions to charities), without substantial and complex regulation.

4. Finally, as explored below, integrity risks associated with the refunding of franking credits are a matter of concern and require careful management. However, those risks are of a different nature to those identified by the Productivity Commission (regarding undocumented

[102] Productivity Commission, 'Final Report', above n 2, 25.

and informal volunteer work and expenses), because the imputation system already operates through a rigorous legislative regime, including with respect to credits and debits to a company's franking account.[103]

In sections 4.3 and 4.4, we consider this topic further through a historical lens, specifically by looking at connections between, first, integrity measures in section 78A of the ITAA 1936, which were designed to counter 'gift schemes' and, second, similar measures incorporated in former Division 7 of Pt IIIAA of the ITAA 1936 and Subdivision 207-E of the ITAA 1997.

4.3 Section 78A

The schemes at which section 78A was directed occurred in an environment in which tax avoidance activities ran rife throughout Australia.[104] Those activities, which included the well-known '*Curran* scheme',[105] were the subject of various anti-avoidance measures enacted in the *Income Tax Assessment Amendment Act 1978* (Cth).[106]

Then Treasurer John Howard's[107] second reading speech for the Income Tax Assessment Amendment Bill 1978 (1978 Bill) was emphatic as to the focus of the new legislation. Mr Howard spoke of the government's 'program to strike down tax avoidance arrangements' perpetuated by a 'flourishing tax avoidance industry in all corners of the world'.[108] The government accepted the reasonableness of tax minimisation, but drew a line in the case of 'some techniques of tax avoidance [that] are so blatant, contrived and artificial as to go beyond the bounds of reasonableness'.[109] Later, in 1981, Mr Howard used the same expression when describing the 'blatant, artificial and contrived schemes' to which the proposed Part IVA of the ITAA 1936 (which contains Australia's general anti-avoidance rule) would apply.[110]

Section 78A revolved around a 'common feature' of gift schemes of the time: 'the donor seeking a deduction for a gift … does not, when the reality of the situation is laid bare, really make a gift of anything like the amount or value for which a deduction is claimed'.[111] This feature permeates the four paragraphs of section 78A(2), being the

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[103] See, for example, Div 205 of the ITAA 1997, above n 36.

[104] A history of the tax avoidance activities throughout the relevant period can be found in Trevor Boucher, *Blatant, Artificial and Contrived: Tax Schemes of the 70s and 80s* (Australian Taxation Office, 2010).

[105] *Curran v Federal Commissioner of Taxation* (1974) 131 CLR 409, overruled in *John v Federal Commissioner of Taxation* (1989) 166 CLR 417.

[106] The Act created rules targeted at 'the creation of tax losses through the issue and subsequent sale of bonus shares, abuse of the gift provisions, creation of artificial share trading losses, dividend stripping, artificial acquisition of "primary producer" status for averaging purposes and steps to avoid tax on undistributed income and tax on dividends': Commonwealth, *Parliamentary Debates*, House of Representatives, 7 April 1978, 1245 (John Howard, Treasurer).

[107] The wider context of the 1978 Bill includes the fact that Mr Howard took the role of Treasurer following the forced resignation on 19 November 1977 of Phillip Lynch, who had fallen into the spotlight following revelations that he had been using family trust arrangements for tax minimisation purposes.

[108] Commonwealth, *Parliamentary Debates*, House of Representatives, 7 April 1978, 1244 (John Howard, Treasurer).

[109] Ibid.

[110] Commonwealth, *Parliamentary Debates*, House of Representatives, 27 May 1981, 2685, 2687 (John Howard, Treasurer); Income Tax Laws Amendment Bill (No 2) 1981 (Cth). See also Explanatory Memorandum to the Income Tax Laws Amendment Bill (No 2) 1981, 2.

[111] Commonwealth, *Parliamentary Debates*, House of Representatives, 7 April 1978, 1245 (John Howard, Treasurer).

operative provision. In summary, section 78A(2) denies a gift deduction where a relevant arrangement connected to the gift results in:

1. the value of the gifted property being less than its value at the time it was gifted: section 78A(2)(a);

2. the donee being liable to transfer property, or incurring some other detriment, disadvantage, liability or obligation: section 78A(2)(b);

3. the donor (or an associate) obtaining some benefit, advantage, right or privilege (other than the tax deduction): section 78A(2)(c); or

4. the donee (or another entity) acquiring some property from the donor (or an associate): section 78A(2)(d).

Section 78A(3) added that, without limitation, section 78A(2)(c) would be deemed to apply where:

> the terms and conditions on which a gift of property other than money is made are such that the fund, authority or institution to which the gift is made does not receive immediate custody and control of the property, does not have the unconditional right to retain custody and control of the property in perpetuity to the exclusion of the donor or an associate of the donor or does not obtain an immediate, indefeasible and unencumbered legal and equitable title to the property…

It may be observed that the circumstances contemplated by section 78A(2) appear to have been identified with reference to the common law indicia of a 'gift'.[112]

The necessity of section 78A has been questioned in light of the decision of the Full Federal Court in *Leary v Commissioner of Taxation*,[113] which was handed down just two years after the 1978 Bill was enacted. The scheme in *Leary* was described in Mr Howard's second reading speech and the Supplementary Explanatory Memorandum to the 1978 Bill. The scheme involved the Order of St John receiving $120 from a purported donation of $10,000, the latter amount being the deduction claimed by Mr Leary:

> Under one gift scheme the donor seeks a deduction for a $10,000 gift that is made to an institution, $1,500 of the amount coming out of his or her own funds and the balance of $8,500 being lent by the promoters of the scheme. The institution, pursuant to an overall arrangement, pays the promoters a procuration fee of 98.8 per cent of the gift, leaving it with $120 out of the $10,000. The procuration fee puts the promoters in funds not only for their $8,500 loan to the donor but provides them with a substantial fee. In practical terms, the donor does not have to repay the $8,500 loan.[114]

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[112] See, eg, Australian Taxation Office, 'Income Tax: Tax Deductible Gifts – What Is a Gift', Taxation Ruling TR 2005/13 (20 July 2005) [13].
[113] *Leary v Federal Commissioner of Taxation* (1980) 11 ATR 145 ('*Leary*').
[114] Commonwealth, *Parliamentary Debates*, House of Representatives, 7 April 1978, 1245-1246 (John Howard, Treasurer).

The Court denied Mr Leary's deduction, primarily because of an absence of benefaction.[115] That conclusion may have applied to many schemes of the time, causing one commentator to note that:

> [i]n the light of the courts' approach in *Leary*'s case, the amendment may not have been necessary, but who was to know at the time?[116]

Evidently the government was not content to rely on the judiciary alone to end the gift schemes, and perhaps with good reason. In *Commissioner of Taxation v Clendon Investments Pty Ltd*,[117] the Supreme Court of Victoria held that a company was entitled to deduct the value of an artwork gifted to the National Gallery of Victoria despite the terms of the gift providing that the managing director of the company was entitled to retain control of the artwork during his lifetime. Later, in *Commissioner of Taxation v Coppleson*,[118] the Full Federal Court distinguished *Leary*, observing that:

> [t]he fact that the donor in circumstances such as these is, to some extent, motivated by a desire to achieve a tax deduction under s 78(1)(a), cannot itself disentitle him to that deduction.[119]

4.4 Refunding franking credits received by tax-exempt entities

The integrity model developed and enacted under section 78A provided a framework for a later integrity regime designed to protect against potential abuse of rules allowing for refundability of franking credits received by tax-exempt entities.

In August 1998, the government (then led by Prime Minister John Howard) released a White Paper which, among many things, proposed to reform Australia's imputation system by providing for full refundability of excess franking credits. Central to that proposal was a policy of ensuring that 'overall tax paid on profit distributed by a company or trust to low income resident individuals would reflect their marginal tax rates'.[120] The Paper contemplated that '[s]pecial arrangements would apply to *registered charitable organisations*',[121] namely that '[r]egistered organisations would … be allowed to claim refunds of excess imputation credits for tax paid at the trust level on donations to them by way of trust distributions'.[122] In the Ralph Review's final response to the government's White Paper, and following an extensive consultation process, the Review recommended the government's proposal.[123]

Curiously, when the New Business Tax System (Miscellaneous) Bill 1999 (Cth) (1999 Bill) was first introduced, nothing was included to provide for the refund of franking credits to tax-exempt entities. The 1999 Bill clearly included provision 'to enable taxpayers whose tax rates are below the company tax rate … to receive a refund of

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[115] *Leary*, above n 113, 155 (Bowen CJ), 161 (Brennan J), 166 (Deane J).
[116] Boucher, above n 104, 74.
[117] (1977) 7 ATR 493.
[118] (1981) 12 ATR 358.
[119] Ibid 360.
[120] Australian Treasury, *Tax Reform: Not a New Tax, a New Tax System* (August 1998) 115.
[121] Ibid 113.
[122] Ibid 114 to 115. The reference to 'trust distributions' arose because the extracted comments were made in the context of a proposal that trusts would be taxed like companies.
[123] Ralph Review, above n 92, 423-424.

excess imputation credits',[124] but omitted to extend the rules to the tax-exempt community. Subsequently, on 14 April 2000, then Treasurer Peter Costello announced that the government had 'decided that it will legislate to refund excess imputation credits to registered charitable and gift deductible organisations', touting the proposal as a means to 'provide a significant financial boost (around $50 million annually) to charities' who would 'therefore be in a position to provide more services and assistance to their beneficiaries'.[125]

Following Mr Costello's announcement, the 1999 Bill was amended while it remained before the Senate. The Supplementary Explanatory Memorandum explained the proposed amendments by reference to a potential 'tax-driven distortion' under the existing law, being that investments in companies were unattractive to tax-exempt entities because franking credits were non-refundable.[126] Alongside the refundable imputation credits, the Bill introduced 'anti-avoidance rules' (despite, perhaps, the expression 'integrity rules' being more apt) tied to the 'object of the amendments' of 'ensur[ing] that ordinary investment income received by an eligible institution is not subject to underlying taxation simply because it is received through a company as a franked dividend'.[127]

Notably, the new 'anti-avoidance rules' bore close resemblance to section 78A(2), denying the refundability of franking credits where:

1. a 'related transaction'[128] results in:

   (a) the value of the distribution being less than its value at the time it was paid: section 160ARDAC(2), ITAA 1936;

   (b) the tax-exempt entity being liable to make a payment or transfer property, or incurring some other detriment, disadvantage, liability or obligation: section 160ARDAC(4), ITAA 1936; or

   (c) the distributing entity (or an associate) obtaining some benefit, advantage, right or privilege: section 160ARDAC(5), ITAA 1936;

2. for a distribution that to any extent takes the form of property other than money – the terms and conditions on which the dividend is paid are such that the tax-exempt entity does not receive immediate custody and control of the property, does not have the unconditional right to retain custody and control of the property in perpetuity to the exclusion of the distributing entity (or an associate), or does not obtain an immediate indefeasible and unencumbered legal and equitable title to the property: sections 160ARDAC(6) and (9), ITAA 1936;

[124] Explanatory Memorandum to the New Business Tax System (Miscellaneous) Bill 1999 (Cth), 3.
[125] Hon Peter Costello (Treasurer), 'Refunding Excess Imputation Credits to Charities' (Press Release No 24, 14 April 2000).
[126] Supplementary Explanatory Memorandum to the New Business Tax System (Miscellaneous) Bill 1999, above n 101, [1.2].
[127] Ibid [1.23].
[128] 'Related transaction' was defined very broadly in former s 160ARDAA(1) of the ITAA 1936, above n 63.

3. in the case of trust distributions only – the total value of transfers of money and property from the relevant trust to the tax-exempt entity in a year is less than the amount of 'notional trust amounts'[129] for the year: section 160ARDAC(7), ITAA 1936; or

4. an arrangement is entered into in relation to a distribution and, because of the arrangement, the tax-exempt entity (or another entity) acquires property other than the property comprising the distribution: section 160ARDAC(10), ITAA 1936.

Subdivision 207-E was introduced to replace former Division 7 of Pt IIIAA of the ITAA 1936 in connection with the enactment of the simplified imputation system.[130] In relation to the 'anti-avoidance rules', the Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No 6) Bill 2004 simply stated that '[t]hese anti-avoidance rules, included in new Subdivision 207-E, will replicate the outcomes provided for under the former rules'.[131]

Having regard to the unique and multifaceted role that the imputation system can play in its interaction with charities (discussed in section 4.2), it might be queried whether the concepts in section 78A(2), which (as already noted) appear to derive from the common law indicia of a 'gift', were suitably adapted for application to franked distributions paid by an investee to an investor. The practicality of repurposing the drafting in section 78A to the refundable franking credit rules is self-evident. But the distinction between, first, the making of a 'gift' (which includes matters such as voluntariness and benefaction) and second, the payment of a distribution on invested capital is not insignificant. At a minimum, it would be expected that the complexities of commerce and business would more likely accompany franked distributions, rather than gifts, thereby adding a layer that may not have been in the minds of the drafters of section 78A.

That distinction has been accommodated in some respects. For example, but for section 207-128(1) of the ITAA 1997, section 207-120(2)(a)(i) would deny a tax-exempt entity from obtaining a refund of franking credits where the entity has elected into a dividend reinvestment plan (DRP) and the franking credits attach to a dividend to which the DRP applies. In particular, section 207-120(2)(a)(i) applies where, because of a 'distribution event',[132] a tax-exempt entity (or another entity) 'makes, becomes liable to make, or may reasonably be expected to make or to become liable to make, a payment to any entity'. If the conditions of section 207-128(1) are satisfied, it will provide a 'carve-out' from section 207-120(2)(a) to ensure that a refund of franking credits is not denied in the case of genuine participation in a DRP.

It might be assumed that the absence of a more extensive set of 'carve-outs' indicates the distinction between gifts and distributions has been sufficiently accommodated in Subdivision 207-E's integrity rules. However, the scope of the concepts derived from

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[129] 'Notional trust amount' was defined in former s 160ARDAA(1) of the ITAA 1936, above n 63, and, broadly, refers to an amount that would be included in the taxable income of an exempt entity if the entity was not exempt from income tax.
[130] See *New Business Tax System (Imputation) Act 2002* (Cth) and *Tax Laws Amendment (2004 Measures No 6) Act 2005*, above n 90.
[131] Explanatory Memorandum to the Tax Laws Amendment (2004 Measures No 6) Bill 2004, [3.24].
[132] 'Distribution event' is defined very broadly in s 207-120(5) of the ITAA 1997, above n 36.

section 78A and adopted in Subdivision 207-E must create some risk of circumstances arising where a tax-exempt entity might be denied a refund of franking credits notwithstanding an absence of the kind of mischief at which the integrity rules are directed. To the extent those circumstances arise in practice, consideration of further carve-outs might be appropriate.

The history discussed above invites a question as to whether the integrity model adopted in Subdivision 207-E reflects a carefully tailored legislative regime or an expedient solution designed without consideration of the unique role that franking credit refunds play as a means of supporting charities. That is not to say that the integrity rules in Subdivision 207-E lack a 'coherent policy rationale' (being the conclusion reached by the Productivity Commission regarding the DGR system).[133] However, it might be regarded as evidencing another patchwork element of the legislative scheme surrounding philanthropic giving. The Productivity Commission recommended strengthening some DGR integrity measures and removing others, due to their disincentivising effect.[134] The history outlined above suggests that a similar reconsideration of the integrity rules in Subdivision 207-E may also be a worthy exercise.

4.5 Concluding observations regarding franking credit refunds

The observations in section 4.2 highlight unique qualities of the tax concession comprising the policy to refund franking credits to charities. It appears that, at the introduction of that policy, those qualities were not front of mind, such that the relevant legislative amendments were expected to be of 'limited cost to the revenue'.[135] In circumstances where the government has committed to doubling philanthropic giving by 2030, it may be time to consider further the role that franking credit refunds can play to support charities.

As indicated in section 4.4, one potential avenue of enquiry might be a re-examination of the appropriateness of applying concepts designed to counter 'gift schemes' to refunds of imputation benefits. Another might be to contrast the potential role of tax credits offered to donors (which the Productivity Commission regards as less preferable than the personal income tax deduction) with the role that franking credits play as a means of: (a) government support, and (b) potential incentive for specific behaviour for both charities and philanthropists. With respect to the latter, in a context where 'Australia is on the cusp of a significant intergenerational transfer of wealth',[136] it might be expected that policy settings that potentially encourage philanthropists to direct franked distributions to charities (such as the implicit government 'co-contribution' program discussed in section 4.2) have the capacity to play a significant role in supporting charities over the coming decades.

5. CONCLUSION

In keeping with John Taylor's passion for tax history research as a means of exposing the broader and more social context in which tax law is developed, this article has shed

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[133] Productivity Commission, 'Final Report', above n 2, 25.
[134] Ibid 211-214.
[135] Supplementary Explanatory Memorandum to the New Business Tax System (Miscellaneous) Bill 1999, above n 102, [1.3].
[136] Productivity Commission, 'Final Report', above n 2, 300.

light on the history of two aspects of philanthropic tax concessions, with the aim of enhancing the debate now the Productivity Commission's final report of its review of philanthropy has been released.

Doubling philanthropic giving by 2030 is a very ambitious target, for which it might be tempting to import quick fixes from other jurisdictions, such as providing a CGT exemption and market value deduction for donations of a range of appreciated property. However, a tax history analysis supports the Productivity Commission's cautious approach to this issue. There is a real risk to the revenue due to the difficulties of valuing some appreciated property, as well as the linked issue of potentially greater reliance on philanthropic intermediaries to deal with property that is difficult to value or liquidate, but in a context where those intermediaries prioritise donor interests, rather than having a strong independent mission. As noted by the Productivity Commission, philanthropic intermediaries, or structured giving vehicles, have many potential benefits, including the potential for enhancing social capital,[137] yet they also pose risks. In particular, the Productivity Commission noted the risk of delayed distribution and the desirability of further investigation into the risks of trustee companies as professional managers of structured giving vehicles, including behavioural impacts of the ways that management and investment services might be remunerated and provided by affiliated entities.[138] The concerns underlying the discussion of these risks mirror concerns in the US context about donor advised fund sponsors being motivated by fee income and therefore aligning with donors' interests rather than focusing on community benefit.[139] A clear justification would also be needed to warrant inequitable treatment of gifts from capital receipts and revenue receipts and for the harm that would likely be done to vertical equity from advantaging donations of capital assets. Historically, a justification for these detriments and risks has been found primarily in respect of appreciated cultural property that is of unique national cultural significance. If the classes of appreciated property for which a CGT exemption is provided are broadened, significant attention will need to be given to the treatment of structured giving vehicles to maintain tax system integrity, with that broader issue being a matter that the Productivity Commission has grappled with to an extent in Chapter 8 of the report.

The history of the gift deduction integrity measures introduced in section 78A of the ITAA 1936 is also relevant to the Commission's task of reforming DGR integrity measures in line with its proposed broad reforms to the DGR system and its larger task of removing barriers to philanthropy. Three key points can be made. First, clear statutory measures provide greater robustness rather than seeking to rely too heavily on the courts to appropriately apply flexible tests such as whether a donation qualifies as a 'gift'. Second, the history of refundable franking credits for tax-exempt entities demonstrates the danger of seeking to lift integrity tests from one context and automatically apply them to another. Not only does this call for greater consideration of carve-outs for Subdivision 207-E, but more broadly in terms of changed context, the Commission's approach of excluding classes of activities (from being funded by deductible donations) for organisations categorised by reference to purposes will require close attention to the slippery divide between activities and purposes. Third, further consideration is warranted of the differences between the role of tax credits offered to donors and the role that franking credits play as a means of both government support

[137] Ibid 270-271.
[138] Ibid 271-272, 295-300.
[139] See n 83, above.

and potential incentives for specific behaviour on the part of charities and philanthropists.

eJournal of Tax Research (2024) vol. 22, no. 2, pp. 324-346

The Australian capital gains tax main residence exemption: firm foundations or flaky footings?

Glenn Davies* and Chris Evans**

Abstract

Professor John Taylor noted that much of the complexity in the Australian regime for the taxation of capital gains derived from the design of the main residence exemption. Building on this work, this article explores both the policy underlying this most generous concession and the legislative provisions introduced to give effect to that policy. It argues that the underlying policy has failed to provide an appropriate set of foundations for such a major concession, owing more to political pragmatism than to any notions of equity, efficiency or simplicity. These poor foundations have, in turn, meant that the legislative provisions suffer from uncertainty and ambivalence and often do not operate in an effective fashion or as intended. The article considers both policy issues and technical improvements which may lead to improved outcomes in the interpretation and operation of the exemption from capital gains arising on the disposal of the family home.

Keywords: capital gains tax; main residence exemption; family home; complexity

* Sessional Lecturer, School of Accounting, Auditing and Taxation, UNSW Sydney, Australia. Email: glenn.davies@unsw.edu.au. The authors wish to thank two anonymous reviewers for their helpful comments on this article.
** Emeritus Professor, School of Accounting, Auditing and Taxation, UNSW Sydney, Australia and Extraordinary Professor, Department of Taxation, Faculty of Economic and Management Sciences, University of Pretoria, South Africa.

1. INTRODUCTION

Professor John Taylor researched and published extensively on Australian capital gains tax (CGT) issues.[1] His work in the area embraced both the policy and the technical aspects of CGT. Of particular concern was his perception that the Australian CGT regime was 'one of the more complex elements in a very complex tax system'.[2] Much of that complexity, in Taylor's view, was explicable by certain design features in the Australian CGT regime, and the main residence exemption (MRE) was cited by him as one such feature.[3] If complexity is measured by reference to the length of legislative provisions, the MRE must rank highly. More pages of the *Income Tax Assessment Act 1997* (ITAA 1997) are contained in Subdivision 118-B (the subdivision devoted to this exemption) than to any other subdivision of Part 3-1 of the ITAA 1997, where the core provisions of the CGT regime are contained.[4]

This article seeks to build on John Taylor's work by undertaking an exploration of the MRE. It does so by considering both the policy rationale and the legislative provisions of the exemption, using a comparative international lens where appropriate. A key motivation is to affirm his concerns that the underlying policy is unclear and uncertain, that the existing provisions relating to this exemption are more complex than they need to be, and that the lack of solid foundations causes problems in the interpretation and operation of the exemption in all but the simplest of cases.

An exemption for the home is highly significant for the operation of the CGT regime, and directly impacts a considerable number of individual taxpayers and tax revenue. Treasury estimates in January 2024 indicate that the revenue forgone in 2023-24 from the existence of the MRE is a total of AUD 47.5 billion, comprising AUD 22.5 billion for the exemption itself and a further AUD 25 billion accounted for by the discount component (the 50 per cent exemption available for certain capital gains) on the main residence exemption.[5] These are significant sums that separately rank only behind the concessional taxation of employer superannuation contributions (revenue forgone of AUD 28.55 billion) and rental deductions (revenue forgone of AUD 27.1 billion) in order of magnitude of tax concessions.

The high cost of the concession in Australia is mirrored in other countries with a similar exemption. The concession in the United Kingdom (UK) – Private Residence Relief (PRR) – is estimated to have cost the UK Exchequer GBP 31.5 billion in the tax year 2023-24.[6] In Canada the tax shelter for the Principal Residence Exemption (PRE) is

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[1] See, for example, C John Taylor, *Capital Gains Tax: Business Assets and Entities* (Law Book Company, 1994); C John Taylor, 'CGT Reform and the Reduction of Tax Law Complexity' (2008) 23(4) *Australian Tax Forum* 427 ('CGT Reform'); Ann Kayis-Kumar and C John Taylor, 'The Application of Capital Gains Tax to Trusts: Conceptual, Technical and Practical Issues, and a Proposal for Reform' (Conference Paper, Australasian Tax Teachers Association Conference, 17 January 2019).

[2] Taylor, 'CGT Reform', above n 1, 427.

[3] Ibid 428. The other features he cited were the exemption for gains from the disposal of pre-CGT assets and the discounts applicable to capital gains accruing to certain taxpayers.

[4] Neil Brydges and Edward Hennebry, 'The CGT Main Residence Exemption: Tips and Traps' (2023) 58(5) *Taxation in Australia* 254.

[5] Australian Treasury, *Tax Expenditures and Insights Statement* (January 2024) 5, Table 1.1, 'Large Tax Expenditures and Deductions by Revenue Forgone 2023-24'.

[6] HM Revenue and Customs, *Non-Structural Tax Relief Statistics (December 2023)* (Updated 17 January 2024) <https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs/non-structural-tax-relief-statistics-december-2023> (accessed 12 February 2024).

estimated to cost roughly CAD 10 billion at the Federal level in 2022, and a further amount up to that same amount at the provincial level.[7]

Although currently lower than at any time since the Australian Bureau of Statistics started the data series in 1994, home ownership in Australia remains at relatively high levels. As shown in Table 1, roughly two thirds (66.3 per cent) of Australian households owned their own home in 2019-20 (the latest year for which comparable figures are available), compared to nearly 71 per cent in 1999-2000. Over that period of time, again evident in Table 1, there has been a sizable shift from ownership without a mortgage to ownership with a mortgage.

Table 1: Australian Housing Tenure 1999-2000 to 2019-20

Year	Owner without a mortgage (%)	Owner with a mortgage (%)	Total home ownership (%)
1999-2000	38.6	32.1	70.7
2005-2006	35.3	35.0	70.3
2011-2012	30.9	36.6	67.5
2015-2016	30.4	37.1	67.5
2019-2020	29.5	36.8	66.3

Source: Australian Bureau of Statistics *Survey of Income and Housing* for relevant year, accessed at abs.gov.au, 12 February 2024.

By way of international comparison, the latest available estimate for home ownership in the UK is 63 per cent,[8] while in Canada it is 66.5 per cent,[9] in New Zealand it is 64.5 per cent[10] and the United States (US) it is 65.7 per cent.[11] Home ownership in Australia is thus at very similar levels to home ownership in other comparable countries. And all of these comparable countries – like Australia and others – are also experiencing, over recent decades, similarly problematic and potentially harmful outcomes related to home

[7] Department of Finance Canada, *Report on Federal Tax Expenditures: Concepts, Estimates and Evaluations* (2022) 36.

[8] Ministry of Housing, Communities and Local Government (UK), 'Home Ownership' (February 2020; Last Updated 8 August 2023) <https://www.ethnicity-facts-figures.service.gov.uk/housing/owning-and-renting/home-ownership/latest/> (accessed 12 February 2024).

[9] Statistics Canada, 'To Buy or to Rent: The Housing Market Continues to be Reshaped by Several Factors as Canadians Search for an Affordable Place to Call Home', *The Daily* (21 September 2022) <https://www150.statcan.gc.ca/n1/daily-quotidien/220921/dq220921b-eng.htm> (accessed 12 February 2024).

[10] Statistics NZ, *Housing in Aotearoa: 2020* (8 December 2020, Updated 2021) 10 <https://www.stats.govt.nz/reports/housing-in-aotearoa-2020> (accessed 12 February 2024).

[11] US Census Bureau, *Quarterly Residential Vacancies and Homeownership, Fourth Quarter 2023* (Release CB24-10, 30 January 2024) <https://www.census.gov/housing/hvs/files/currenthvspress.pdf> (accessed 12 February 2024).

ownership, including rising housing unaffordability and housing wealth inequality,[12] as well as intergenerational inequity.

The fundamental policy underlying the CGT MRE is straightforward. Subdivision 118-B of the ITAA 1997 sets out the rules for the exemption of the whole or part of the capital gain (or capital loss) that otherwise would have been made by an individual taxpayer where a CGT event happens to their ownership interest in the dwelling that has been the taxpayer's main residence. For persons who dispose of a dwelling they did not acquire as a surviving joint tenant or as a legal personal representative (LPR), or beneficiary of a deceased estate, the disregard of capital gains and capital losses under the MRE depends mainly on the extent to which the dwelling was a person's main residence during their period of ownership. In some cases, the disregard is only partial (usually referred to as a partial MRE). The policy implications of the MRE are explored in section 2 below.

The 'foundations' of the MRE may be 'solid' for the most basic of all cases as envisaged in 1985 – a person buys an established home (not land to build); owns (on a family basis) no other houses they have lived or do live in; does not derive any income from the home; and over the period of ownership, does not go and live somewhere else. Even that was probably not typical in 1985; today, it certainly is not with many more cases of multiple dwelling ownership, relocating for work reasons, more home-based work (affected by the Covid pandemic), and financial pressures encouraging Airbnb or similar arrangements. A common modern scenario is some distance from the basic case.

The exemption is subject to the satisfaction of a range of complex conditions. In addition to the rules that apply in the simple 'vanilla' or basic case situation, there are various rules which may limit the exemption and a further array of rules which may extend it. Sometimes these rules interact, and the interaction is unclear. These rules increase the complexity of the law whilst at the same time seeking to protect revenue and increase flexibility and fairness (equity) for taxpayers.

Ironically, many of the limitations designed to restrict the exemption while taxpayers are alive (such as part occupancy, and income producing use at some stage during ownership) drop away on death (with a market value acquisition cost for the LPR or beneficiary) provided the dwelling was the deceased's main residence and was not being used to produce income *just before* that time. This concession, done for compliance cost reasons, can result in undue tax savings contrary to the overall policy of the MRE.[13]

A number of technical issues derive from the applicable conditions of the basic case and the limitations and extensions that may be available, and these are considered in some detail in section 3.

The overwhelming conclusion of the analysis in sections 2 and 3 is that the underlying policy rationale and the legislative provisions enacted to give effect to that policy are not entirely 'fit for purpose', and that the edifice of the MRE may be less stable than should be the case. There are several reasons for this unsatisfactory situation:

[12] Paul Kershaw, 'Policy Forum: Revisiting the Principal Residence Exemption and Public Support for Reducing the Home Ownership Tax Shelter' (2022) 70(4) *Canadian Tax Journal* 827, 841.

[13] This article does not consider further, except occasionally in passing, the operation of the MRE so far as dwellings acquired from deceased estates are concerned. This may be the subject of a future article.

- confused or uncertain policy parameters and choices leading to the adoption of an inappropriate overall complex policy framework to underpin the legislative provisions of the exemption;
- an overemphasis on 'black-letter' and prescriptive drafting, and the desire for revenue protection, dating from the time of the introduction of the CGT provisions in 1986 (with effect from 20 September 1985) in the *Income Tax Assessment Act 1936* (ITAA 1936) and not relieved significantly in the ITAA 1997 provisions;
- the lack of a full appreciation of the relevant exemption scenarios that needed to be covered, and how they should be covered, when CGT was first introduced; and the subsequent 'tacking on' of amendments to existing provisions without consideration of any need to reshape or consolidate the whole; and
- the impact of compliance cost savings measures made to the regime in 1996-97 may not have been fully thought through and interactions with other provisions not made clear. This includes the use of 'precipice' tests (eg, looking at circumstances just before a CGT event) which may not interact well with other provisions and are capable of manipulation.

Because the MRE legislation can 'cope' with simple cases, but not much more, the law leads to high compliance costs for practitioners,[14] with certainty in relation to primary tax only obtainable through private rulings. There is a sparsity of binding Australian Taxation Office (ATO) views, though some matters are dealt with in guides providing at least protection from penalties and interest. In respect of individual private rulings, edited versions from the ATO pitched at a high level of abstraction suggest that it too may be experiencing difficulties arriving at sensible outcomes through a strict application of the provisions themselves.

In some cases there may be opportunities to consider the Commissioner's remedial power, and/or minor technical amendments, to address these issues at some time in the future.

This article focuses on identifying and managing some of the complexity, uncertainty, quirks and flaws in the CGT MRE, and where feasible makes suggestions about how some of the deficiencies might be addressed. It does not seek to deal with all aspects of the exemption. For example, it does not deal with the provisions (and parts of provisions) that now largely deny the main residence exemption for non-residents (excluded non-residents). These are well considered in the literature elsewhere.[15]

2. POLICY CONSIDERATIONS

The tax systems in almost all developed, and most developing, countries include CGT regimes. In 2017, 171 out of 220 countries had a broad, comprehensive CGT regime

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[14] Chris Evans, 'The Operating Costs of Taxing Capital Gains: A Conspectus' (2000) 54(7) *Bulletin for International Taxation* 357.

[15] Brydges and Hennebry, above n 4.

applying to individuals and businesses, while a further 16 countries had a CGT regime that applied only to businesses.[16]

Most, though not all, also provide some form of concessional treatment for the family home, although not necessarily in a uniform or consistent manner. A 2017 analysis of eight countries evidenced the range of approaches to the treatment of the family home used by different CGT regimes.[17] Two of the countries (Australia and the UK) completely exempted gains made on the disposal of the family home. In South Africa, the gain was also exempt, but capped at a maximum gain of (roughly) USD 220,000 (following a similar capped approach in the US). In Turkey, by way of contrast, unlimited gains made on the disposal of the family home were exempt, but only if the family home had been held for at least five years prior to disposal. Yet another approach was taken in India, partially modelled on the Scandinavian approach to the CGT treatment of the family home: a rollover (deferral) was available where any capital gain (not just one derived from the disposal of the family home) was reinvested in the family home. Another variation occurred in Indonesia where a potential exemption could apply where the transferor of the property was on a low annual income (roughly USD 3,000) and the value of the property transferred was less than (roughly) USD 5,000. The final two countries (Bangladesh and Pakistan) of the eight that were studied did not have an overt exemption for disposals of the family home, although in Pakistan a zero rate was applied if the property has been held for more than two years, making it conceptually similar to the treatment in Turkey, albeit with different methods and time periods involved.[18]

Notwithstanding the differences in approach, the reasons for providing concessional treatment on the disposal of the family home are relatively clear, and can be summed up in the following quote from the UK's then Financial Secretary to the Treasury Niall MacDermot when CGT was introduced in that jurisdiction in 1965:

> The reasons for our exemption are to encourage home ownership, to avoid any feeling of resentment there might be – and I think that it would be widespread if this was subject to tax – and, also, from a social point of view, to assist greater mobility, which is an important matter from a labour point of view. The effect of it, as I say, is to make home ownership very attractive from the investment point of view.[19]

Despite this clear political statement in support of the exemption for capital gains on the disposal of the family home, there is considerable debate about whether it is appropriate on economic or tax policy grounds to provide such a generous concession.[20] While the

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[16] Chris Evans, John Hasseldine, Andy Lymer, Robert Ricketts and Cedric Sandford, *Comparative Taxation: Why Tax Systems Differ* (Fiscal Publications, 2017) 121.

[17] Chris Evans and Richard Krever, 'Taxing Capital Gains: A Comparative Analysis and Lessons for New Zealand' (2017) 23(4) *New Zealand Journal of Taxation Law and Policy* 486, 498.

[18] Ibid 498. An historical curiosity is that in former section 26AAA of the *Income Tax Assessment Act 1936* (Cth) ('ITAA 1936'), which taxed gains on property sold within 12 months of purchase, main residence gains were exempted only in circumstances of change of place of business or employment. Section 26AAA preceded CGT and operated alongside it until 1988.

[19] United Kingdom, *Parliamentary Debates*, House of Commons, 27 May 1965, vol 713, col 997.

[20] See, for example, Natalie Lee, 'Capital Gains Tax Principal Private Residence Relief Reform: An Alternative to the "Mansion Tax"?' [2015] (1) *British Tax Review* 130; Matt Grudnoff, *CGT Main Residence Exemption: Why Removing the Tax Concession for Homes Over $2 million Is Good for the*

exemption for capital gains realised on the disposal of a main residence may be appreciated by existing homeowners, who otherwise would be subject to CGT, the concession is predicated on uncertain, even shaky, foundations so far as both equity and efficiency considerations are concerned.[21] It is also the case that there is no clear policy rationale to be found in the third of the major criteria deemed critical in tax policy analysis – the concept of simplicity. Each of these three criteria – equity, efficiency and simplicity – and their relationship with the exemption, is now considered in more detail.

Removing the charge to CGT arising on the disposal of the family home runs counter to the equity principle on several levels. It very obviously offends the principle of horizontal equity – the notion that individuals with similar income and assets should pay the same amount in taxes. Homeowners obtain an advantage that is not available to those in rented accommodation. Critics also point out that the exemption is of far more value to high income taxpayers than to lower income taxpayers, thus offending the principle of vertical equity. Modelling commissioned by the Australia Institute shows that low-income households (those in the bottom 30 per cent) obtain almost no benefit from this tax break, and that almost 90 per cent of the benefit goes to the top half of income earners, with 55 per cent of the benefit going to the highest income households (those in the top 20 per cent).[22] The greatest benefit afforded by the exemption of gains on the family home is enjoyed by the most wealthy, who typically make the largest gains.[23]

The MRE (and its overseas equivalents) also fall short in relation to notions of intergenerational equity. The rapid growth in house prices in Australia and around the world in the last few decades, attributable, to some extent at least, to the existence of the very generous tax shelter treatment afforded to the family home, not only makes it increasingly difficult for low-income households to gain a step on the housing ladder, it also disproportionately disadvantages younger generations *vis-à-vis* their older peers. Research shows that housing wealth inequality is higher than income inequality and that it tends to grow across generations and over time.[24] For example, evidence from British birth cohorts' data supplemented by the Wealth and Assets Survey in the UK show that home ownership rates have fallen rapidly over time, most markedly amongst younger people in more recent birth cohorts.[25] Perhaps most critically in the Australian context, the growth of house prices well beyond the rate of household income growth is fuelling intergenerational inequality and destroying social mobility.[26]

Solid policy foundations for the exemption of the family home from the charge to CGT cannot therefore be found in arguments about equity. Nor can they be found in

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Budget, the Economy and Fairness (The Australia Institute Policy Brief, January 2016); Kershaw, above n 12.

[21] Chris Evans and Tim Russell, *Australian CGT Handbook 2023-24* (Thomson Reuters, 2023) 269-270.

[22] Grudnoff, above n 20, 5. The modelling was commissioned by the Australia Institute from the National Centre for Social and Economic Modelling (NATSEM) at the University of Canberra.

[23] David Collison, 'Reflections on Capital Gains Tax and Some Comments on the Office of Tax Simplification Capital Gains Tax – Second Report' [2021] (3) *British Tax Review* 253.

[24] Martin Lux and Petr Sunega, 'Housing Wealth Inequality, Intergenerational Transfers and Young Households in the Super-Homeownership System', *International Journal of Housing Policy* (advance online, 15 November 2023).

[25] Jo Blanden, Andrew Eyles and Stephen Machin, 'Intergenerational Home Ownership' (2023) 21(2) *The Journal of Economic Inequality* 251.

[26] Per Capita, *Housing Affordability in Australia: Tackling a Wicked Problem* (Report by Per Capita for V&F Housing Enterprise Foundation, May 2022).

efficiency arguments. It is argued that it has biased investment away from productive commercial and industrial activities and into owner-occupied housing, leading in many cases to over-investment in houses relative to the occupants' real needs.[27] The exemption encourages over-capitalisation in main residences since any increase in their value is tax free.[28] As a result, commercial enterprises have had less investment capital available to them[29] and have had to rely on more expensive debt financing and overseas financing, which has greatly exacerbated foreign debt problems. Moreover, over-investment in housing, with consequent increases in house prices, has meant that homes have become unaffordable for all but the very wealthy or very fortunate younger members of society.

As has already been noted, the MRE also adds significantly to the complexity of the Australian CGT regime, a feature which is also common to those other jurisdictions that exempt the family home. This was a fundamental point made by Taylor who considered, in the context of the Australian CGT, that the removal of this exemption, along with the removal of the 50 per cent CGT discount and the exemption for assets acquired before the introduction of CGT in 1985, would go a long way to reducing the inherent complexity of the regime.[30] Collison reinforces the point when he notes that 'every relief granted in taxation is an abandonment of the taxing principle. True simplification would follow the taxation of all capital gains equally. Every relief has a border and every border creates problems, as well as interesting work for the tax practitioner'.[31]

However, notwithstanding these equity, efficiency and simplicity arguments against the family home exemption, it is highly unlikely that any mainstream politician or political party would suggest that the exemption should be removed, whether in Australia or any other country with the exemption. The dream of owner-occupied housing represents a national aspiration in Australia, as elsewhere, and support for owner-occupied housing holds a high priority for leaders of all political parties. Therefore, it is unlikely to be removed. As noted by Lee in the UK context, 'the total abolition of principal residence relief would be … unacceptable to the public'.[32] And the point is well made by Kershaw that fixing the problem many years after such an exemption has been introduced and operating by eliminating the exemption is fraught with challenges, not the least of which would be the need to act retroactively in order to obviate the horizontal inequities that would ensue if the removal of the concession were to take place only on a prospective basis.[33]

There may, however, be stronger arguments in favour of adapting or curtailing the concession. This could be done in any one of a number of ways. One possibility lies in 'capping' the amount of the gain that is exempt (as in the US and South African provisions). The difficulty with this suggestion is that there are very significant differences in the value of homes in a country such as Australia, where Sydney and

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[27] Evans and Russell, above n 21, 269-270.
[28] Grudnoff, above n 20, iii.
[29] Kershaw, above n 12, 830.
[30] Taylor, 'CGT Reform', above n 1, 451.
[31] Collison, above n 23, 268.
[32] Lee, above n 20, 140. Note, however, that Kershaw argues that, in Canada at least, there is more public support for the removal or reduction of the home ownership shelter than is usually implied in Canadian political discourse: Kershaw, above n 12, 827.
[33] Kershaw, above n 12, 831-832.

Melbourne significantly outstrip other parts of the country in terms of house prices.[34] To counter these massive variations, it might well be necessary to introduce different caps for different parts of the country, which would potentially add yet more complexity to an already complex set of provisions.[35] Grudnoff, in contrast, has suggested a single cap of AUD 2 million across Australia, claiming that this would both be less politically contentious and have the advantage of raising revenue only from those who can most afford it while maintaining the exemption for the vast majority of householders.[36]

An alternative to 'capping' is to introduce a form of rollover relief (as in some of the Scandinavian and other countries such as India) where the exemption applies only if capital proceeds from the sale of the family home are used to purchase a new family home.[37] Such a policy is advocated by Lee for the UK, who suggests that rollover relief should be available in the same circumstances that currently allow for full exemption for the PPR.[38] One difficulty with such a proposal is that this policy adaptation may well be unfair on older taxpayers deciding to downsize but perhaps 'locked in' to their existing home by the potential tax charge that would arise. But this difficulty can, of course, be avoided by permitting downsizing retirees (those above a certain age) to extract a certain amount of equity from the family home on disposal without generating a chargeable capital gain (as is the case in Sweden).

A further alternative may be to provide an exemption only in certain circumstances, such as relocating for employment or business or selling and relocating because of ill-health. The difficulty with this would be determining a fair list of acceptable reasons and discouraging the sorts of contrivances that so often accompany the creation of artificial borders or boundaries alluded to above.

What is clear from this analysis of the policy foundations for the exemption of the family home is that – once such an exemption is entrenched in the tax system – it becomes very hard to seek to remove it. In such circumstances, and despite its inequity, inefficiency and complexity, it may prove most sensible to accept that the main residence exemption cannot easily be removed and that the optimal course of action may be to accept its continuation, perhaps along with other measures to counteract its worst implications. For example, Kershaw, in Canada, considers that leaving the PRE in place but adding a progressive annual surtax to existing annual property taxation (domestic rates in the case of Australia) would help to raise revenue as well as reduce inequity, improve efficiency and enhance the simplicity of the tax system.[39] And – if the continuation of the exemption is accepted – it is also critical to ensure that the rationale for its continuation is clearly enunciated, which in turn can help to ensure its technical

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[34] The same is, of course, true of countries such as the UK, where house prices in London and the South-East are vastly different to the prices encountered elsewhere in the UK; and of Canada, with significant regional and provincial variations.

[35] Differential capping may also raise Commonwealth constitutional issues as taxes should not discriminate between States or parts of States. Section 51(ii) of the *Commonwealth of Australia Constitution Act* gives Parliament the right to make laws relating to, inter alia, taxation but 'so as not to discriminate between States or parts of States'. In addition, Section 99 of the *Constitution* also provides that the Commonwealth may not 'by any law or regulation of trade, commerce, or revenue (including a taxation law) give preference to one State or any part thereof over another State or any part thereof'.

[36] Grudnoff, above n 20, 7.

[37] Evans and Russell, above n 21, 269-270.

[38] Lee, above n 20, 140-141.

[39] Kershaw, above n 12, 832.

legislative provisions – to which the analysis now turns – can operate in as efficient and effective a fashion as is possible or practicable.

3. TECHNICAL ISSUES

3.1 Observations relating to the 'basic case'

As will be shown, the MRE provisions are among the most difficult and complicated of all the CGT provisions to navigate unless a practical scenario under consideration 'fits neatly'. This is often not the case. Unfortunately, even though it is usually quite clear what the answer 'should be' in such cases, it may not easily be obtained from a reading of the law. The inappropriateness of this is clearly evident as the provisions are directed mainly at ordinary individuals in relation to the family home.

The 'basic case' for disregarding (in full or in part) a capital gain or capital loss arises where a CGT event happens in relation to a CGT asset that is a dwelling or an ownership interest in it.[40] 'It' refers presumably to the CGT asset that is a dwelling. The dwelling needs to have been the individual's main residence throughout the period of ownership.

Although nothing practically turns on this, the change in terminology from 'sole or principal residence' in the ITAA 1936 to 'main residence' in the ITAA 1997 is arguably inexact – if a person owns only one dwelling, how can it be a 'main' residence?

There are a number of further issues that arise from the basic case terminology set out in section 118-110.

3.1.1 CGT asset and dwelling may not be the same

The legislation assumes that the dwelling will be a CGT asset. But it often happens that the CGT event happens in relation to a CGT asset that is not the same as the dwelling. For example, if a property comprising four hectares of post-CGT acquired land and a house is sold, the CGT asset is most likely to comprise the entire land parcel with the improvement, whereas the 'dwelling' is statutorily limited to the building and up to two only hectares of land (including the land beneath the building).[41]

There are no provisions that address this issue, and the ATO does not appear to have publicly ruled or advised on it. While a CGT asset includes part of an asset (if a CGT event happens to only part), the dwelling is not sold 'as part of' the land.[42] Further, the capital proceeds apportionment rule in section 116-40 of the ITAA 1997 does not work either because all the proceeds relate to the CGT event; it is just that not all relate to the 'dwelling'. And how is the cost base of the 'dwelling' to be determined? Neither section 112-25 of the ITAA 1997 dealing with split, changed or merged assets, nor section 112-30 of the same Act has any application.

Obviously, some sort of reasonable apportionment of capital proceeds and cost base is necessary. The fix would be to treat a 'dwelling' as a 'separate CGT asset' just for the exemption calculations. The current 'gap' in the law is not a major issue, certainly, but it is not a good start.

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[40] *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') s 118-110.
[41] See ibid ss 118-115 and 118-120.
[42] Ibid s 108-5(2)(a).

3.1.2 What is a taxpayer's CGT asset – the physical dwelling or the ownership interest?

The basic case applies to a CGT event that happens in relation to a CGT asset that is a dwelling or a person's ownership interest in it. Although the definition of 'dwelling' in section 118-115 of the ITAA 1997 is inclusive, it is defined very much in 'physical' or tangible terms. However, ownership interest in section 118-130 is, as might be expected, defined in terms of a person's intangible legal or equitable interests (or a right to occupy). Hence, while in common parlance a person sells 'the dwelling', they actually sell their ownership interest in it.

Thus, it is the dwelling (the physical element) in relation to which 'main residence' is tested, whereas it seems the CGT event would ordinarily happen in relation to an individual's ownership interest, for example, when an individual sells their freehold title to property.

If that is correct, the question arises as to why it is necessary to refer at all to a CGT event that happens 'in relation to a CGT asset that is a dwelling'. This is not clear, but a possible explanation may lie in the specific exemption for a forfeited deposit amount in section 118-110(2)(b) of the ITAA 1997 where it is part of an uninterrupted sequence of events leading to a CGT event referred to in section 118-110(2)(a). At the time the deposit is forfeited, CGT event H1 happens 'in relation to … a dwelling' but the ownership interest is not (at that point) sold.

3.1.3 Dwelling includes the land underneath it, but no other land (unless the adjacent land provision in section 118-120, discussed below, applies)

When the CGT provisions were rewritten in 1998, it was decided to clarify the law to provide expressly that the land beneath the dwelling was part of the dwelling as defined, without needing to have regard to the adjacent land rule in section 118-120 (although it takes account of the land under the dwelling in the two-hectare maximum). No explanation was provided in explanatory materials for the change.[43] One effect of it, perhaps, is to make it more difficult to assert that 'curtilage' is automatically part of a dwelling. Interestingly, land above the dwelling (eg, in the case of underground accommodation) is not covered, and falls to be considered only under section 118-120. (One might say that such land could more readily be used by the taxpayer differently from land under the dwelling which probably cannot be 'actively' used at all, except in the case of 'Queenslanders' (houses on stumps).)

With one exception, discussed below, including land under the dwelling in its defined meaning merely raises the theoretical possibility that if land under the dwelling exceeded two hectares, it may qualify for exemption whereas it would not under the previous law. This is of course an extremely unlikely scenario.

Mostly the change has no practical effect at all (as that land will generally be much less than two hectares integral to the dwelling and its use), but a potential problem arises if the dwelling is removed and the land under the building is sold. Is the sale of the land (now vacant) that was under the building the sale of a dwelling? The ATO considers not,[44] with a finessed argument that the land is covered only while the building or other

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[43] Senate Explanatory Memorandum to the Tax Law Improvement Bill (No 1) 1998, 90.

[44] ATO, 'Income Tax: Capital Gains: Is Land Under a Unit of Accommodation Subject to the Main Residence Exemption Under Subdivision 118-B in Part 3-1 of the Income Tax Assessment Act 1997 if the

'dwelling' remains present. In other words, the land is treated if sold in the same way that the sale of adjacent land is treated (generally no exemption, subject to some narrow exceptions for involuntary destruction or acquisition). The ATO interpretation may be correct, but the outcome is certainly unclear, and the clarification to the law has probably raised more issues than it has solved.

3.1.4 'Main residence' not defined

Whether something is someone's main residence has for years been a question of fact. The ATO has published some guidance,[45] but the legislation could usefully include some (non-exhaustive) factors that would usually be relevant.

There are some curiosities in this area. The ATO would almost certainly insist on the need for (at least some initial) physical occupation of the dwelling, but the legislation does not actually specify this. If a house is set up to be a person's main residence and it is available to be occupied as such by the person (whether they live there or not), can it not be the person's main residence? For example, assume the person keep many of their belongings there, but is otherwise itinerant.

The use of 'main' is also interesting. Some people are able to 'duplicate' lifestyles in different countries such that it may be very difficult to determine (or for the taxpayer with the onus to prove) which of the dwellings is their 'main' residence. In such a case, it would seem that no exemption may exist at all. A fairer result in such a case would be to allow the taxpayer to nominate one dwelling, as is the case where spouses, or dependent children, have more than one dwelling.

This is in fact the position in the UK's PRR where a taxpayer with more than one house may nominate which house is to receive the relief. If they fail to do so, a similar factual enquiry as must occur in Australia is needed, but at least the taxpayer has the choice to nominate. While some concerns have been expressed about the nomination approach, such as the fact that less well-advised taxpayers may not be aware of it, and in some cases the nomination might be 'flipped' by taxpayers as circumstances change,[46] this does not go to the fundamental merits of the idea in the first place.

3.1.5 Ownership period defined by reference to 'legal ownership'[47]

In order to obtain a full exemption, the dwelling must have been a person's main residence for their full ownership period. (A partial exemption may be available in other cases under section 118-185.) What some say is a 'quirk' of the exemption is that the 'ownership period' (for which period a dwelling can be – or be taken to be – a taxpayer's main residence) is defined in terms of the period of 'legal' ownership of the dwelling (or of the land on which it sits).

Taxpayer Sells the Unit of Accommodation Separately from the Land?', Taxation Determination TD 1999/73.

[45] See, for example, the list of factors in former Taxation Determination TD 51, 'Capital Gains: What Factors Are Taken into Account in Determining Whether or Not a Dwelling Is a Taxpayer's Sole or Principal Residence?' (26 March 1992), now withdrawn but cited with approval in AAT *Case 8769* (1993) 26 ATR 1051.

[46] Office of Tax Simplification (UK), *Capital Gains Tax – Second Report: Simplifying Practical, Technical and Administrative Issues* (May 2021) 41-44 ('*Capital Gains Tax – Second Report*').

[47] ITAA 1997, above n 40, ss 118-125 and 118-130.

The rationale for this was that although CGT usually works on the basis of contract dates for the timing of disposal and acquisition, that would not usually be the period where a person was actually able to occupy a dwelling. Rather, a person would usually be able to occupy only from settlement on purchase through to settlement on sale. However, the contract rules require first an ordinary disposal (or change in ownership as per CGT event A1), and so 'ownership' (its ordinary meaning) rather than 'legal ownership' would seem to have been a better term.

Arguably, however, in relation to land, 'legal ownership' is not obtained, at least under the Torrens land title system, until registration of title.[48] This is not settlement, but sometime later. It is a system of title by registration not registration of title. This is an example of a mismatch between the law and practice: the ATO treats contract completion (or 'settlement') as the time legal ownership is acquired or disposed of, but the law arguably provides differently.

3.1.6 Can a person obtain an exemption for more than one dwelling (more than one unit of accommodation) on a single parcel of land?

If, notwithstanding the inclusive-only definition, 'dwelling' is technically limited to a single unit of self-contained accommodation, there would be a problem if, for example, a family resided in two adjoining self-contained flats, or in two houses on a parcel of land. A full exemption would require the identification of one dwelling that was the 'main' residence (if it was possible to so describe one), but no exemption would be available for the other. However, an exemption might arguably be available for the other building as part of adjacent land even if it were a complete separate accommodation unit, although this is not clear. There would appear to be no difficulty for a building not fully contained, for example a rumpus room used by children with a toilet and sleeping area.

It is not desirable that the legislation fails to make clear whether an exemption can apply to more than one fully self-contained accommodation unit.

Fortunately, the ATO does not in practice take a narrow view of 'dwelling' and will allow an exemption for multiple units of self-contained accommodation where they are used together (as a matter of fact) as the taxpayer's main residence.[49] Hence, an exemption would be available in the case where adjoining units were used by a family, whether or not there was a common door. Provided, that is, one could say that both units comprised the main residence. It is less clear what happens if the units are physically separate but in the same apartment block, or if they are in different blocks. The greater the physical separation the more difficult it may be to argue that they constitute one main residence.

The UK provisions and case law are more easily and flexibly applied in this regard. It is clear in the UK that a main residence can be more than one building.[50] The UK has the concept of 'curtilage' which identifies the dwelling-house that attracts the relief. (This is different from the additional permitted area in the UK (like 'adjacent land' in

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[48] The alternative view is that entitlement to be registered is enough.

[49] ATO, 'Income Tax: Capital Gains: Can the Term "Dwelling" as Defined in Section 118-115 of the Income Tax Assessment Act 1997 Include More Than One Unit of Accommodation?', Taxation Determination TD 1999/69.

[50] *Batey v Wakefield* [1981] STC 521.

Australia as discussed below) of garden and grounds, which is usually one-half a hectare (about an acre), but can be increased if the area required 'for reasonable enjoyment of the dwelling house' is larger.) In Australia, the dwelling by definition includes only land beneath it, whereas the UK curtilage concept can extend further, though not too far.[51] It can, for example, embrace different buildings that comprise an integral whole. So, buildings around a courtyard will generally be considered part of the one dwelling-house, but not perhaps a cottage 175 metres from the main house,[52] although it may still fall within the 'permitted area'. In this sense, the curtilage of an estate must be distinguished from curtilage of the dwelling-house.

It is clear that in the UK case law has gone a long way to clarify some of the issues that remain uncertain in Australia.

It can be said, however, that Australia provides greater certainty by placing a fixed two-hectare limit on the adjacent land, whereas in the UK the area required for 'reasonable enjoyment' depends on the facts – there is no fixed limit – and this is apparently a frequent source of disputes with HM Revenue and Customs.[53]

In summary, it can be seen that technical difficulties and anomalies can arise even in dealing with relatively straightforward scenarios, and these peculiarities are even more evident when considering both limitations to the basic case and extensions of the exemption, which are now briefly discussed.

3.2 Limitations to the exemption

The main aims of the limitations are to limit the exemption to one post-CGT property per family unit, and the special rules regarding land (including the two-hectare maximum) reflect the fact that 'extra' (often potentially subdivisible) land can fairly easily be acquired in Australia. Specifically, rules that can limit the exemption include denying the exemption to land sold separately from the dwelling (except in certain cases, such as involuntary sales including resumptions), limiting spouses (and minor dependants) essentially to one MRE, and reducing the exemption where the dwelling is concurrently used to produce assessable income (eg, a business run from home).

It may legitimately be queried as to the extent to which taxpayers actually take these limitations on the exemption into account when filing their tax returns.

3.2.1 Adjacent land

The 'adjacent land' provisions are sometimes referred to as extending the exemption that can apply to a dwelling (eg, the accommodation unit with land beneath). While that is often true, there is 'devil in the detail'.

There are two aspects of section 118-120 that deserve comment here.

First, it would appear that a dwelling only includes adjacent land if a CGT event happens to the owner of the interest in the dwelling. At other times, 'dwelling' seems *prima facie* limited to the unit of accommodation and underlying land. This causes problematic interactions with provisions like section 118-192 which treat a 'dwelling' as acquired at

[51] *Methuen-Campbell v Walters* (1978) 1 QB 525.
[52] *Lewis v Rook* [1992] STC 171, per Balcombe LJ.
[53] Office of Tax Simplification, *Capital Gains Tax – Second Report*, above n 46, 40.

market value at the time of its first income-producing use. There is no CGT event happening at that time in this case. (Even if that technicality is overlooked, it is evident that it may not be knowable until a CGT event whether adjacent land is included in the dwelling at all, and whether the section 118-192 market value could apply to the adjacent land. It may have been used to produce income at some point, but overall may have been used mainly for private purposes in association with the dwelling.) Clearly, the adjacent land is meant to be included in the section 118-192 market value in at least some cases, and taxpayers would usually be very keen to obtain a market value uplift, but the law itself is unclear.

Secondly, the extension for adjacent land is expressed to be for the purposes of Subdivision 118-B, which raises the question whether it applies for other parts of the CGT provisions not in Subdivision 118-B, such as the market value cost base rules for a dwelling that is inherited in Division 128.

At a less intricate level, it is commonly (and incorrectly) thought that the main residence exemption applies automatically to up to two hectares of adjacent land (including land under the dwelling) without appreciating that any 'extra' land (over and above what sits beneath the physical structure) must satisfy some very specific requirements set out in section 118-120 of the ITAA 1997.

First, it must be 'adjacent' to the dwelling, where 'adjacent' is not defined. Arguably, it need not be contiguous, and does not have to be on the same title.[54] It could possibly extend to a nearby field, or some land across the road from a dwelling. But it probably would not extend to vacant land some distance from the dwelling itself (eg, the other side of town) even if used for private family purposes.

Secondly, the land must have been 'used primarily for private or domestic purposes in association with the dwelling'.[55] 'Use' arguably does not require 'active use'. The land can provide amenity or give ambience to the dwelling, by distancing the home from neighbours or by facilitating good 'views'. But 'extra' land purchased with an eye to capital growth or later subdivisional potential which has no reasonable connection at all with residential use would not qualify. Note that the test of use is throughout the period of ownership, and not simply at the time the dwelling is sold. Thus, 'use' has both an area and a time dimension, and, especially where there is income producing use or other 'non-private' use, details of what parts of the land are involved and for what periods need to be retained. It should also be observed that even where land satisfies the 'primary use' test and is included in the dwelling, income-producing use may still lead to a partial loss of exemption.[56]

Thirdly, difficulties arise when there is more than two hectares of adjacent land and all is used integrally with the dwelling. Obviously, a reasonable apportionment is acquired, but identifying what two hectares to include can be problematic. The taxpayer may wish to identify the more valuable land, the ATO the less valuable.

Finally, the question arises whether some dwellings may not qualify for adjacent land at all. For example, if a houseboat is moored up against vacant land owned by the

[54] The Privy Council held in *Mayor of Wellington v Mayor of Lower Hutt* [1904] AC 773, 775 that the word adjacent 'is not confined to places adjoining, and it includes places close to or near'.
[55] ITAA 1997, above n 40, s 118-120(1).
[56] Ibid s 118-190.

taxpayer, can that land be adjacent land? If the land is used with the boat as part of the residence, one might ask why not, but then would the boatowner have to sell the boat with the land at the one time (and perhaps to the one buyer who may not want the boat)? A similar issue arises with mobile homes like caravans that are not fixed to any land. There is no apparent requirement in the law that the dwelling must be 'part' of (an improvement fixed to) the land in a real property law sense.

It has on some occasions been questioned whether a main residence exemption can be obtained for vacant land that has been owned for less than four years by erecting a tent on it (concreting in the tent posts if required) and living in the tent as a main residence for three months and making a 'construction period' choice under section 118-150. (It is of course a definite challenge to establish that the tent was, on all the facts, a person's 'main residence' but if that is established, the question about the degree of integration with the land required and the taxpayer's 'use' will be relevant. The law does not, however, help to make this clear.) The MRE policy is not to provide an exemption for vacant land where there is a very tenuous, and perhaps, contrived connection with a dwelling.

It is arguable, too, that the law now more clearly accommodates a less than permanent and substantial structure[57] such as a tent as a 'dwelling' because of the now separate test of a 'unit of accommodation' comprising a caravan, houseboat, or other mobile home.[58]

3.2.2 *Use of a dwelling for producing assessable income*[59]

Much has been written about the potential reduction in exemption that can apply if a dwelling being a main residence of a relevant person is used to produce assessable income.[60] This, ordinarily, means actual concurrent use as a residence and partly to produce assessable income.

Essentially, concurrent income producing use will occur if a person lets part of the property at commercial rates, or runs a 'business' from part of it, in circumstances where a tax deduction for interest expense would be available (whether or not any interest has actually been incurred). In other words, use of the home as a study where there is no separate place of business would not result in a loss of main residence exemption.

Calculating the loss of exemption from income-producing use can raise some particular challenges, notably where there are joint owners of a property, or where the joint owners have different ownership and usage profiles. There is tension, for example, where a proportion of a physical dwelling is used for income production, and a person's ownership interest in the dwelling may differ from that. For example, if a dwelling is used overall 60 per cent for the production of income (based on the notional interest deductibility test), but a taxpayer has only a 50 per cent ownership interest, arguably the withdrawal of exemption for that taxpayer would be better determined on the basis of 60 per cent of the 50 per cent interest rather than on 60 per cent of the overall dwelling.

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[57] See ATO, 'Income Tax: Capital Gains: Can the Following Comprise a 'dwelling' and Therefore Be Eligible for Exemption as a Main Residence (i) a Structure Built Underground? (ii) a Yacht? (iii) a Tent?', Taxation Determination TD 92/158.
[58] Evans and Russell, above n 21, 272-275.
[59] ITAA 1997, above n 40, s 118-190.
[60] See, for example, Kathrin Bain and Dale Boccabella, 'The Age of the Home Worker – Part 2: Calculation of Home Occupancy Expense Deductions, Deduction Apportionment and Partial Loss of CGT Main Residence Exemption' (2019) 34(1) *Australian Tax Forum* 65, 83ff.

These issues are dealt with comprehensively by Bain and Boccabella and so are not considered further here.[61]

It is important to note that where an absence choice is made (see below), it does not cover income-producing use that existed just before the absence. For example, if a doctor leased out her house which include a surgery for six years, and she made an absence choice, it would not apply to the part that was the surgery. But the rest of the income-producing use would be ignored.

3.2.3 *First income-producing use rule*[62]

This provision has an interesting history and its application, from 20 August 1996, is not widely understood. Its effect is to substitute market value at the time of first income-producing use for the dwelling's actual cost base. Before the equivalent of this provision was inserted into the ITAA 1936, a person's loss of exemption was based on the capital gain or capital loss that arose over the entire period of ownership.

The problem was that if a taxpayer started out on the assumption that the property would never be used to produce assessable income and any capital gain or capital loss would always be exempt, records may not have been kept of relevant costs, such as those of capital improvements, or non-deductible holding costs such as interest and rates. A person who did not keep those records was therefore likely to have been disadvantaged.

For example, if a person bought a house for $100,000, lived in it for two years, then rented it out for three years after which time it was sold, under the previous rule (assuming no absence choice was made) the non-exempt capital gain or capital loss would be 3/5 (60 per cent) of the amount calculated normally. Assume, for example, that there was a sale price of $600,000 and a capital gain of $500,000. $300,000 of this would not be disregarded. But the person may have had no records for any costs, which might for example have been $200,000, incurred during the first two years of ownership.

The law was therefore changed to provide a substituted market value acquisition cost at the time of first income-producing use. In the case above, if that was, say, $400,000 after the end of the first two years, the non-disregarded capital gain would be calculated as $200,000. In other words, the taxpayer would only be taxed on the capital gain that arose during the actual period they were not using the house as a main residence.

When the change was made there was no option to continue calculating the non-disregarded capital gain or capital loss on the previous basis, even where the person had kept records of expenditure during the period of actual residence. For example, if the person had records of the $200,000 costs, the non-disregarded gain would have been only 3/5 x $300,000 = $180,000. The change in the law was therefore to an extent 'retrospective' in its operation. The argument for not allowing a choice is that the law change was meant to be compliance-cost saving, and that if the choice were present, costs would be incurred to determine which outcome was better. But fairness would suggest that if a taxpayer has records that enable them to calculate an exemption more accurately and precisely and pay less tax, that taxpayer should not be denied the opportunity.

[61] Ibid.
[62] ITAA 1997, above n 40, s 118-192.

The wording of one of the preconditions for the operation of current section 118-192 is also highly nuanced and not well understood. Paragraph (a) says:

> you would get only a partial exemption under this Subdivision [ie, Subdivision 118-B] for a *CGT event happening in relation to a *dwelling or your *ownership interest in it *because* [emphasis added] the dwelling was used for the *purpose of producing assessable income during your *ownership period.

This is clearly meant to apply both to a case where there is concurrent income producing use of the dwelling (eg, a home office) as well as where the dwelling is rented out in its entirety. 'Because', however, suggests 'cause and effect'. Where the property is fully rented out the partial exemption results not because the dwelling is income producing[63] but because (without an absence choice) the dwelling is not a person's main residence for part of the ownership period.[64]

3.3 Extensions to the exemption

The rules that may extend the exemption include relief from having to occupy a dwelling immediately as a main residence when it is not practicable so to do (eg, if a person has been hospitalised, or the dwelling has been flooded), allowing two dwellings to qualify for up to six months when a person is changing main residence, allowing absences (including where the dwelling is rented out), and various rules relating to building and construction of a dwelling on land. Although the extending rules can be stated relatively simply, once again they mask a measure of complexity that causes practical difficulties in the operation of the exemption. Some of these shortcomings are now explored.

3.3.1 Moving in as soon as reasonably practicable

Section 118-135 which allows a dwelling a person owns to be treated as their main residence before they move in was introduced in the rewritten CGT provisions. Prior to this, it was most likely the subject of an administrative concession on a case-by-case basis by the ATO. Unfortunately, the scope of the relief remains uncertain, and it does not involve a loss (or denial) of exemption on another property during the period concerned. The scope is uncertain because it is not time restricted and takes (at least some) personal circumstances into account. It is not clear whether the reason for not moving in has to be something involuntary that has happened to either the dwelling or the taxpayer. This would cover, for example, a collapsed roof on the day of settlement that prevented occupancy, or the taxpayer recovering in hospital. It is not clear whether voluntary actions (such as accepting a job for two years in another part of the world) count, or leaving a tenant *in situ* for the balance of the lease term, count. The AAT in several cases[65] has indicated that the test is 'practicable' not 'convenient' and so having to shift from another part of the world, or quit a job and take up a new one, are more likely to be issues of convenience rather than practicability. This may mean that in terms of personal circumstances, only things that go to actual capacity or ability to occupy (eg, illness or injury) as opposed to personal preference may be relevant. Being incarcerated may be another example!

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[63] Ibid s 118-190.
[64] Ibid s 118-185.
[65] AAT Case [2009] AATA 890 (*Caller v Federal Commissioner of Taxation*) and AAT Case [2009] AATA 41 (*Couch v Federal Commissioner of Taxation*).

This concept of 'moving in' also reinforces the long-held contention that physical occupancy of a dwelling (living there) is necessary for establishing a main residence. It is noteworthy that the legislation overall is strict on when a dwelling becomes, or is, actually a main residence, but is rather generous once established for it to continue to be treated as one (eg, via the absence choice).

Interestingly, the UK law allows taxpayers to nominate a dwelling-house as a main residence before moving in for up to two years from the commencement of ownership of a property which is not occupied by them or someone else, either where a taxpayer sells another home in that period, or is building/getting the property ready for occupancy. This is more generous generally than the Australian rules, although they allow up to four years for construction, renovation etc. The UK also 'backends' their exemption to allow non-occupancy for the last nine months of ownership (which may extend to 36 months for people with disabilities). The generosity of the UK provisions may, in part, be accounted for by the fact that land transactions in the UK can often take much longer to finalise than in Australia.

3.3.2 The absence choice[66]

A person can choose to treat a dwelling they are absent from as their main residence indefinitely if the property is not used to produce assessable income, or for up to six years where it is. Multiple six-year periods are possible as well, but the dwelling must 'again become and cease to be' the person's main residence. Whether this has occurred is a question of fact, which is of the same type as whether the dwelling has become a person's main residence in the first place. Suffice it to say that whilst it might be thought that a short period (eg, one month or even one week) of occupying the property between tenants would suffice, occupying does not necessarily mean the dwelling has become a person's 'main residence' again.

The six-year period and the possibility of 'restarts' after resuming actual residence, is very generous. Admittedly, if the absence choice is made, normally no other main residence exemption for the same period can be claimed, but even so with a little tax planning an almost indefinite exemption for what is fundamentally a rental property with negligible total actual main residence use can be obtained.

It is interesting to note that, in the UK, the time periods are not so generous, and are to some degree based on the reason for the absence, with a maximum of three years where there is no specified reason.[67] The longer permitted period of absence in Australia may be accounted for, in part, by the fact that in the 1980s and before that time many Australian public servants were often required, under the terms and conditions of their employment, to serve in remote or rural communities, necessitating a move away from 'home'. It is also not clear that an absence choice can be made after a person has died. Literally, there is no provision which says that a person's LPR or surviving joint tenant or a beneficiary of their estate can make a choice to cover a period where the deceased was absent. This is in contrast, for example, to specific provisions such as section 118-155 that refer to a choice being made by a legal personal representative or surviving joint tenant.

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[66] ITAA 1997, above n 40, s 118-145.

[67] See HM Revenue and Customs, 'HS283 Private Residence Relief' (Guidance, 2023).

It is far from clear on the words of the ITAA 1997 that such a choice is available under section 118-145, though it was clear in the ITAA 1936 that it was.[68] Section 118-145 refers to 'you' choosing to treat a dwelling that was 'your' main residence as if that continued. There is no reference to someone else doing it on the person's behalf if the person dies. The ATO does, however, seem to allow absence choices to be made by persons after a death has happened, at least the LPR.[69] There remains a question whether a beneficiary who inherits the property can make a choice on behalf of the deceased.

3.3.3 *Where a dwelling is built on land, the ownership period for a dwelling constructed on post-CGT land starts when ownership of the land was acquired*[70]

It is frequently misunderstood that the MRE requirements start 'ticking' once post-CGT land is acquired on which a dwelling is later constructed. Obviously, a person cannot reside on vacant land, so it cannot actually be someone's main residence at that time, but section 118-150 enables a person to make a choice to treat the dwelling (retrospectively – at a point in time when it was not actually there) as their main residence for the period from the time of land acquisition through to their moving into the constructed dwelling ('construction period'). This choice comes at a cost, however; because if the choice is made, it will prohibit the person from treating another post-CGT dwelling as a main residence for the same period to which the choice relates, except for the six-month overlap period where a person is allowed to have two dwellings treated as their main residence.[71]

The rationale for this complex rule is that it prevents someone 'speculating' to make a profit on land through the main residence exemption. For example, a person buys two blocks of land in Adelaide. She builds a home on one, and after one year it is ready, so she moves in. She lives there for a year then sells. She then builds on the other block and does the same thing. If she makes the 'construction period' choice for the first home, that will not be a period for exemption purposes on the second home. In effect, she is prevented from obtaining a full exemption from gains on 'two' blocks of land.

While the intention of the rule is clear, it is debatable whether the complexity it produces is justified. It seems very unlikely that taxpayers who do not receive professional advice would even think that a full exemption was not available on both properties.

The approach also produces a strange anomaly in the following circumstances. A taxpayer lives in a dwelling which includes land on a separate title (bought at the same time as the dwelling) that would qualify as adjacent land if sold with the dwelling. The taxpayer chooses to build a new home on the adjacent land, move into it as a new residence, and sell the original dwelling. If the taxpayer does not make a section 118-150 choice for the new build, only a partial CGT exemption will be available because the clock starts ticking on that from the time the land was acquired and not when the dwelling was built. If the section 118-150 choice is made, a full exemption may be obtained on the new build but there will be a loss of exemption on the initial dwelling that is sold. This makes no policy sense when the new build is on land that was bought at the same time as the original dwelling and would qualify as adjacent land for the initial residence had it been sold with that dwelling. There is a need for the law to reset

[68] ITAA 1936, above n 18, s 160ZZQ(11A).
[69] See, for example, ATO, 'Deceased Estate', edited private ruling 1051979216697 (5 May 2022).
[70] ITAA 1997, above n 40, s 118-125(b).
[71] Ibid s 118-140.

the clock for the adjoining block of land in that instance, reflecting its history in use with the previous dwelling. This anomaly can discourage the division of land, and the building of new dwellings, in times of housing shortages, urban infill, and in the provision of new accommodation for relatives (such as certain 'granny flat' arrangements where a fee simple interest is desired).

If the taxpayer had sold the first dwelling and all the land to a developer, and then bought the adjoining block back at some point, then (subject to the general anti-avoidance provisions in Part IVA of the ITAA 1936), a full exemption would ultimately be obtainable on both properties because the land on which the new dwelling was built has a 'freshened up' acquisition date.

The UK tax authorities have also struggled with the anomalous tax outcomes that can arise if a taxpayer sells part of the dwelling's garden to a developer, as opposed to building a new home on the garden, moving in, and selling the original residence. Unlike the Australian position, where a person generally cannot sell adjacent land separately from the dwelling and obtain an exemption (there is an exception for accidental destruction of the dwelling or involuntary sales), a person can do so in the UK although HMRC may seek to argue that if the person sells it (except for reasons of financial necessity and other involuntary circumstances) it was never part of the permitted area to start with.[72]

The UK grappled for some time with the issue of when 'ownership' of a residence commences when it is built on land – is it when the land was acquired or when the dwelling was built? The UK does not have the express rule existing in Australia that the clock starts ticking when the land is acquired. The question is just when ownership of a dwelling-house commences when it is constructed on land the taxpayer owns. There have been a number of cases which have considered the point.[73] On appeal, the Upper Tribunal in *HMRC v Lee*[74] have confirmed that the period of ownership commences when the construction of a dwelling-house is completed, not when the land was acquired. This gives the opposite result to that in Australia.

Again, this is a situation where UK case law has been able to provide a practical and sensible outcome despite the conceptual purity of the alternative view, although it remains to be seen whether the UK government will change the law.

The technical analysis set out in this section above has demonstrated that the lengthy black-letter style drafting of the MRE has nevertheless left many key concepts undefined (with policy unclear). The exemption is meant to apply to an individual's major asset, but the various interacting provisions, including all the conditions and restrictions, are unlikely to be comprehended or properly managed by the average person without obtaining tax advice. That is an unsatisfactory situation. The provisions are meant to offer relief from tax, but they make the quantum of that relief very difficult to ascertain because the provisions are actually drafted not with the flavour of providing relief, but with the flavour more characteristic of anti-avoidance provisions.

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[72] See HM Revenue and Customs, 'Private Residence Relief: Permitted Area: More Than One Disposal' (Internal Manual, Capital Gains Manual CG64829, 12 March 2016; Updated 28 February 2024).
[73] See *Henke v HMRC* (2006) SpC 550 and *Lee v HMRC* [2022] UKFTT 175.
[74] *HMRC v Lee* [2023] UKUT 00242 (TCC).

4. CONCLUSIONS

John Taylor has correctly identified that the Australian MRE is one of the key drivers of complexity – however measured – in the Australian tax system. Nearly 20 years ago it was noted that many of the difficulties encountered in the CGT regime 'lie in inappropriate policy selection, poor or incomplete legislative drafting, poor implementation and administration of the provisions and "legislative layering" – whereby new policy and legislation is superimposed upon an existing framework that is insufficiently robust or compatible'.[75] That position has not changed in the intervening years, and the MRE is a clear example of these forces at work.

This article has shown that much of the complexity and confusion in the MRE derives from a lack of clarity about what the exemption is supposed to do, itself a product of the somewhat equivocal policy decisions relating to how and why capital gains are taxed – or not taxed – in the Australian tax system. Poor policy begets poor legislation, and the consequences are now all too evident. It may now be time for a reconsideration of the policy rationale that underpins the existence of the MRE. As it currently exists it is neither simple, nor equitable, nor efficient.

Australia, like many other countries, is plagued by rising housing unaffordability and significant intergenerational wealth inequality, and the tax shelter provided by the MRE not only does nothing to alleviate these problems, it exacerbates them considerably. It may not prove politically acceptable to remove the MRE, and indeed its elimination might well produce its own horizontal inequities and would certainly prove complicated and potentially add further complexity to the CGT regime whether applied retrospectively or prospectively.[76] But it may, nonetheless, be possible to mitigate some of the more egregious aspects of the policy shortcomings by imposing a monetary cap on the extent of the concession, or by imposing a deferrable progressive annual surtax on the value of all property, including family homes.

This article has also explored some of the complexity, uncertainty, quirks and flaws in the technical legislative provisions that comprise the CGT main residence exemption, and suggested ways that these can be managed. There is scope for legislative amendments to clarify a number of areas, or at least to identify and provide binding ATO positions so that taxpayers can achieve a greater level of certainty.

In a legislative sense, it should be possible to:

(a) rationalise, and correct errors in, such concepts as 'dwelling', 'adjacent land' and 'ownership period'; and

(b) provide more legislative guidance (by way of relevant, but non-exhaustive factors) that may be relevant to determine whether a dwelling is a person's main residence.

In a broader sense, there is a question whether the complexity of the MRE is justified given the amount of revenue likely to be collected (for example, as a result of ATO audit activity) as a result of technical non-compliance by taxpayers. In other words, if

[75] Chris Evans, 'CGT – Mature Adult or Unruly Adolescent?' (2005) 20(2) *Australian Tax Forum* 291, 291.

[76] Kershaw, above n 12, 841.

the exemption does not have or need an audit focus, it is likely that the revenue potentially available from the current legislation is not being collected, and as long as big loopholes do not result from a simplification, the revenue effect is likely to be minimal, but the reduction in compliance and administration costs significant.

On that basis, and assuming the existing generosity of the current MRE might be tempered by the imposition of either a cap on the extent of the shelter or by the levying of a progressive annual surtax to existing domestic property taxes, it may be possible to reformulate the current MRE provisions in such a manner as to provide firmer foundations through greater certainty in their operation and interpretation. Revisiting the technical provisions of the exemption with less focus on the prevention of abuse and more attention to the intention of the provisions to provide a sensible measure of relief in an equitable, efficient and less complex manner might indeed give credence to the apparent Confucian quote that ‘the strength of a nation derives from the strength of the home’.

eJournal of Tax Research (2024) vol. 22, no. 2, pp. 347-384

Inhibitors for business structuring for Australian small and medium enterprises

Barbara Trad,[*] John Minas,[**] Brett Freudenberg[***] and Craig Cameron[****]

Abstract

The interaction of the tax system with business entities was an area of academic research for Professor C John Taylor, especially the tax treatment of companies and trusts, and the influence of the tax impost on these. This article reports a study of 48 advisors in the small and medium enterprise (SME) sector and explores the factors that may inhibit SMEs from structuring, as well as the techniques used to reduce these inhibitors. The results demonstrate that advisors perceive transfer costs of capital gains tax and stamp duty as major inhibitors, but they are able to use mechanisms to reduce them.

Keywords: business structures, small and medium enterprises (SMEs), restructuring, small business restructure roll-over, choice, barriers, inhibitor

[*] Griffith University. Email: barbara.trad@alumni.griffithuni.edu.au.
[**] Associate Professor, Monash Business School, Monash University. Email: john.minas@monash.edu.
[***] Professor, Griffith University. Email: b.freudenberg@griffith.edu.au.
[****] Senior Lecturer, University of the Sunshine Coast. Email: ccameron1@usc.edu.au.

1. INTRODUCTION

Professor C John Taylor was passionate about history and the lessons learnt from the past. This included his extensive work on treaty negotiations,[1] as well as how governments have struggled to appropriately tax different business entities[2] and/or their members.[3] This consideration of the taxation of business entities is critical, as the utilisation of business entities can be an important way to facilitate economic activity.[4] Over the decades, governments have tried to facilitate commerce through regulating business entities to provide a consistency of legal frameworks,[5] including how they are taxed. In Australia there is a lack of tax neutrality, as a dividend imputation system applies for corporations, partial tax flow-through for trusts, and full tax flow-through for general partnerships and sole traders. A business may also need to change its business structure for tax and other reasons during its life cycle. Factors which inhibit a business from changing business structure may undermine economic activity.

Taylor analysed the interaction of foreign source income rules and Australia's company imputation system.[6] Through this research he considered how the lack of tax neutrality would increase the cost of capital for a resident shareholder when the dividend income was derived by a foreign subsidiary. Taylor noted how the 'current policy of national neutrality at the underlying resident shareholder level would be inhibiting the international expansion of Australian companies'.[7] With Kayis-Kumar, Taylor examined the use of trusts in the Australian economy, including tracing some of the history of taxing trusts.[8] They argued for trustees to be taxed on accumulated trust income, and for any distributions to beneficiaries to be deductible to the trust, with such distributions assessable to the beneficiary; but with a credit for any tax paid by the trustee on accumulated income.[9] In another article, Taylor considered franking credits

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[1] For example, C John Taylor, 'The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946' [2009] (2) *British Tax Review* 201.
[2] For this article the following terms are used: (a) 'Entity': describes the legal entity recognised at law, such as a company; note that sometimes the tax law will recognise something as a taxpayer entity (such as a partnership or trust), even though technically it may not be a separate legal entity; (b) 'Business': describes in a broad sense the economic activity of the business being conducted; there may be a number of entities used in a single business; and (c) 'Business Structure': describes the entities used in conducting a business; it may consist of just one entity (such as a sole trader or a company), or a combination of entities (such as a trustee of a trust holding the shares in a trading company).
[3] For example, C John Taylor, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia' (2003) 57 (8) *Bulletin for International Taxation* 346.
[4] Brett Freudenberg, 'Lifting the Veil on Foreign Tax Flow-Through Companies: Could Australian Closely Held Business Benefit from Their Governance Regimes?' (2013) 28(3) *Australian Journal of Corporate Law* 201.
[5] This can be known as networking benefits. See ibid 214: 'This refers to the idea that enacting laws to govern business forms can reduce transaction costs. That is, as case law considering the standard set of rules develops, there is understanding and improved certainty about how the provisions will be applied in the future. These networking benefits extend to third parties, such as trade creditors, dealing with the business form as they have improved understanding about the governance of the business form'.
[6] C John Taylor, 'Alternative Treatments for Foreign Source Income in Australia's Dividend Imputation System' (2005) 20(2) *Australian Tax Forum* 189.
[7] Ibid 263.
[8] Ann Kayis-Kumar and C John Taylor, 'The Application of Capital Gains Tax to Trusts: Conceptual, Technical and Practical Issues, and a Proposal for Reform' (Paper presented at the 31st Australasian Tax Teachers' Association Conference, Perth, 16-18 January 2019).
[9] Ibid.

flowing through partnerships and trusts; and the problems that could arise with this.[10] To try to improve this, one of his arguments was for a proportionate approach.[11] Taylor also analysed Australia's imputation system and evaluated proposals for foreign source income in terms of international tax policy criteria.[12] Taylor observed that 'corporate-shareholder taxation … is more complex than it needs to be for those Australian companies which do not have nonresident shareholders'.[13] In that article Taylor considered how the international tax environment has led to the complexity of the domestic tax system, which in part can be due to a legacy of the choices made in the development of Australia's dividend imputation system.[14] Taylor observed that the resulting complex tax system 'arguably distorts … constructive business activity'.[15] Research has demonstrated that Taylor's concern about the tax system potentially influencing business structure choice is well founded.[16]

From an advisor perspective, an important task is the selection of a business structure that can assist clients with a small and medium enterprise (SME)[17] to realise the commercial potential of their business. This business structure choice can have significant implications in terms of debt and equity finance, legal obligations, asset protection, and taxation. In Australia the popular business entities are companies and trusts (especially discretionary trusts).[18] Taylor's research delved deeply into how these two structures and/or their members are taxed.[19]

If one considers the business life cycle[20] from inception to survival, growth, expansion, and maturity, the business's needs and attributes are likely to alter. This can mean the choice of business structure may arise more than once in the business' life cycle, and it may be reassessed by advisors and their clients at various stages. However, any change in business structure might be difficult. This article reports, from the advisors' perspective, the inhibitors for SMEs to change business structures. This is an important consideration, as it is of concern that SMEs could be trapped in a business structure that

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[10] C John Taylor, 'Problems with Franking Credits Flowing Through Partnerships and Trusts: The 2004 Amendments and a Simpler Alternative' (2005) 34(3) *Australian Tax Review* 154 ('Problems with Franking Credits').
[11] Ibid 179.
[12] C John Taylor, 'Dividend Imputation and Distributions of Non Portfolio Foreign Source Income: An Evaluation of Some Alternative Approaches' (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 192.
[13] C John Taylor, 'An Old Tax is a Simple Tax: A Back to the Future Suggestion for the Simplification of Australian Corporate-Shareholder Taxation' (2006) 2(1) *Journal of the Australasian Tax Teachers Association* 30, 32.
[14] Ibid 45.
[15] Ibid 56.
[16] Barbara Trad and Brett Freudenberg, 'All Things Being Equal: Small Business Structure Choice' (2017) 12(1) *Journal of the Australasian Tax Teachers Association* 136; Brett Freudenberg, 'Tax on My Mind: Advisors' Recommendations for Choice of Business Form' (2013) 42(1) *Australian Tax Review* 33.
[17] This research uses a definition that is based on a combination of the Australian Taxation Office and Australian Bureau of Statistics characteristics. Specifically, an SME business is defined as a business with an annual turnover of less than AUD 100 million, and less than 200 equivalent full-time employees. See Australian Taxation Office, *Taxation Statistics 2018-19* (2021) Table 1 and Australian Bureau of Statistics, *Counts of Australian Businesses, Including Entries and Exits, July 2017 to June 2021* (Cat No 8165.0, 2021) Table 10.
[18] Australian Taxation Office, above n 17.
[19] See, for example, Taylor, 'Problems with Franking Credits', above n 10.
[20] Mel Scott and Richard Bruce, 'Five Stages of Growth in Small Business' (1987) 20(3) *Long Range Planning* 45.

is no longer considered appropriate for their business, thereby not having the opportunity to realise their full economic potential.

The study reported in this article is focused on SMEs because they are important to the economy and the social fabric of society. In member countries of the Organisation for Economic Co-operation and Development (OECD), SMEs are the major form of entrepreneurship: on average they account for approximately 99 per cent of all businesses and 70 per cent of employment.[21] SMEs contribute to value creation, generating more than 50 per cent of value added to the economy.[22] In Australia, SMEs represent over 99 per cent of all businesses and they significantly contribute to the Australian economy in terms of employment (67 per cent) and Gross Domestic Product (GDP) (57 per cent).[23] Furthermore, SMEs play an important part in the fabric of commerce and society, as they can contribute to larger businesses by being customers or suppliers.[24] Additionally, SMEs may create employment opportunities across geographic areas and sectors,[25] and provide opportunities for skill development for low-skilled workers.[26]

Recent research has revealed advisors' perceptions that most SMEs had not adopted an appropriate business structure due to an absence of advice at the inception stage of the business.[27] Even if an appropriate structure had been initially adopted, given a change in the business's circumstances, such as growth, it may be desirable to alter the business structure. Australian policy-makers have recognised this and have introduced a number of concessions to facilitate restructuring, such as the *Small Business Restructure Roll-Over* (SBRR) tax relief.[28] However, concerns have been raised about whether the SBRR provides adequate restructure relief,[29] especially as it appears not to apply when an established business, a sole trader, wants to transfer to a trading company with shares held by a discretionary trust. Research has provided empirical evidence that such a structure can be the most recommended structure for SMEs.[30] It is important to appreciate what factors may be inhibiting the adoption of advisors' preferred business structures for SMEs, and it is this question which motivates the research reported in this article.

The research reported in this article is a study of 48 advisors who were provided with one of 12 business scenarios to recommend a business structure for either an established or new business. After recommending their business structure(s), advisors were then questioned about the inhibitors to the adoption of their recommended structure. The

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[21] OECD, *Entrepreneurship at a Glance 2017* (OECD Publishing, 2017).
[22] Ibid.
[23] Australian Small Business and Family Enterprise Ombudsman (ASBFEO), *Affordable Capital for SME Growth* (2018).
[24] Greg Tanzer, 'What Is ASIC Doing to Help Small Business?' (Speech to the Council of Small Business Australia (COSBOA) Conference, Sydney, 2015).
[25] OECD, 'Enhancing the Contributions of SMEs in a Global and Digitalised Economy', C/MIN2017(8) (29 May 2017).
[26] Ibid.
[27] Barbara Trad, Brett Freudenberg and John Minas, 'Small Business Restructure Roll-Over: In Need of Its Own Restructure?' (2022) 37(1) *Australian Tax Forum* 105 ('Small Business Restructure Roll-Over').
[28] Ibid. *Income Tax Assessment Act 1997* (Cth) Sub-div 328-G (ITAA 1997).
[29] Trad et al, 'Small Business Restructure Roll-Over', above n 27.
[30] Barbara Trad, John Minas, Brett Freudenberg and Craig Cameron, 'Choice of Australian Business Structures in the SME Sector: What Do Advisors Recommend?' (2023) 52(3) *Australian Tax Review* 177 ('Choice of Australian Business Structures').

results demonstrate a difference between the factors that impact an established business compared to a new business. For established businesses, transfer costs (such as capital gains tax (CGT) and stamp duty) are more frequently mentioned by advisors as inhibitors, whereas for new businesses, the more frequently mentioned inhibitors are establishment costs and client understanding. The second part of the results then analyses the techniques used by advisors to reduce these inhibitors. This further analysis demonstrates that advisors are using an array of different tax concessions to reduce the tax impost (sometimes with concessions not technically for restructuring) or alternatively the restructuring may be only partially implemented resulting in legacy issues. Through these results, policy recommendations are formulated to better facilitate structuring by SMEs.

Section 2 provides an outline of the business structures and the restructuring relief available for SMEs in Australia. Section 3 sets out the research methodology undertaken and the demographics of the advisors participating in this study, followed by the results in section 4. Through the analysis of the results, recommendations are proposed, and areas of possible future research are considered in section 5, before the conclusion in section 6.

2. STRUCTURING ISSUES

To gain a deeper understanding of what is known about business structure choice for Australian SMEs, the following section outlines the current understanding about businesses altering their structure.

2.1 Business structure choice

In Australia, SMEs may operate as sole traders, partnerships, trusts,[31] companies, or a combination of structures.[32] Until recently the understanding about what the considerations are when choosing a business structure in Australia was limited. The possible considerations that may influence the choice of business structure include tax,[33]

[31] Note that, unlike other jurisdictions, Australian businesses can utilise the trust for trading activities: Brett Freudenberg and Dale Boccabella, ‘Changing Use of Business Structures: Have University Business Law Teachers Failed to Reflect this in Their Teaching?’ (2014) 9(1) *Journal of the Australasian Tax Teachers Association* 180. Note also that, legally, the trust is not a separate legal entity.

[32] Brett Freudenberg, ‘Fact or Fiction? A Sustainable Tax Transparent Form for Closely Held Businesses in Australia’ (2009) 24(3) *Australian Tax Forum* 373.

[33] Trad and Freudenberg, above n 16, 142, have noted that ‘[n]umerous studies have demonstrated that there is a potential influence by tax arbitrages for taxpayers when considering the choice of a business structure. In the US, research by Scholes and Wolfson, and by Gordon and MacKie-Mason, has considered the effect on business structure choice due to the 1986 tax reforms’, citing Myron Scholes and Mark Wolfson, ‘Issues in the Theory of Optimal Capital Structure’ in Sudipto Bhattacharya and George M Constantinides (eds), *Theory of Valuation: Frontiers of Modern Financial Theory, Vol 1* (Rowman and Littlefield, 1989) 49; Roger H Gordon and Jeffrey MacKie-Mason, ‘Effects of the Tax Reform Act of 1986 on Corporate Financial Policy and Organizational Form’ (National Bureau of Economic Research Working Paper No 3222, 1990).

liability protection,[34] asset protection,[35] ability to facilitate finance, such as equity,[36] and compliance costs.[37] Other factors could encompass franchisor and supplier requirements. The prominence of these factors appears to vary, as factors mentioned at a 'high frequency' by advisors can include tax minimisation/tax rate, complexity and compliance costs, asset protection, separation of assets from business risk, income splitting/flexibility in distribution, the requirement for working capital/ability to retain profits, and small business concessions.[38] Less frequently mentioned factors can include succession planning/exiting the business, limited liability, and industry. The factors least mentioned were trends in structure over time and superannuation.[39] Consequently, advisors may consider that some of these factors are more important than others.

Nevertheless, business structure choice can be a difficult decision, even with the support of advisors. In part, this relates to the realisation that there may be no 'perfect' structure, as any decision requires the assessment of different advantages and disadvantages across business structures, and how business structure choice can impact on current and future circumstances. A recent study found that in all but one of the recommendations, a combination of business structures for the one business operation was proposed by advisors.[40] Nearly two-thirds of SME advisors recommended a trading company with shares held by a discretionary trust (referred to as a '*trading company with holding trust*').[41] Approximately one-fifth of advisors recommended a trading discretionary trust with a corporate trustee, whereby the discretionary trust operates the business (referred to as a '*trading trust*').[42] A tax consolidated group with the shares held by a discretionary trust was the third most recommended structure by just over one-tenth of advisors and

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[34] Trad and Freudenberg, above n 16, have noted that, in a survey of small businesses, it appeared that asset protection and limited liability are the driving motivations for the choice of business structures, as their aggregated weighted score was 61. However, tax does appear to be a strong consideration. This is because tax characteristics were six of the top 10 factors (3rd, 4th, 6th, 7th, 8th and 9th), and when these weighted averages are aggregated, they amount to 100, exceeding the aggregated average of asset protection and limited liability. In particular, access to the small business concessions was seen as very important (3rd), as well as retaining income at low tax rates (4th).

[35] Freudenberg, above n 16, explored the important considerations regarding the formation of businesses in a survey of 81 advisors. His study found that on average the most important factor was asset protection (8.26 on a 10-point scale), which was seen to be more important than tax benefits/savings (6.84), which ranked 2nd. This could indicate that, while tax is important, it is not the dominant reason for choosing a business structure. Other important factors related to liability exposure: level of risk (4th: 5.96) and limited liability (5th: 5.95).

[36] Ayers et al found that non-tax factors such as the size and the age of the business, the ownership structure and the business risk are all important considerations in choosing the business structure: Benjamin C Ayers, Bryan C Cloyd and John R Robinson, 'Organizational Form and Taxes: An Empirical Analysis of Small Businesses' (1996) 18(2) *Journal of the American Taxation Association* 49.

[37] Brett Freudenberg, 'Advisors' Understanding of Tax Compliance for Choice of Business Form' (2013) 4(1) *Global Review of Accounting and Finance* 1. This study demonstrated that many advisors were not aware of empirical studies demonstrating the difference in compliance cost and the different types of business structures.

[38] Barbara Trad, Brett Freudenberg, John Minas and Craig Cameron, 'Reasons behind SME Advisor Business Structure Recommendations' (2024) 39(1) *Australian Tax Forum* 93 ('Reasons behind SME Advisor Business Structure Recommendations'). High frequency is defined as advisor responses in the range of 75 per cent to 100 per cent.

[39] Ibid.

[40] Trad et al, 'Choice of Australian Business Structures', above n 30.

[41] Ibid.

[42] Ibid. It is suggested the use of a company as a corporate trustee for a trust is a combination of business structures, as by using a corporate trustee several advantages are potentially realised compared to just an individual acting as a trustee. These additional advantages are derived from the attributes of a company. See Trad et al, 'Reasons behind SME Advisor Business Structure Recommendations', above n 38.

is referred to as a '*tax consolidated group*'.[43] Only one advisor recommended a single entity structure, being a trading company with shares held by an individual (referred to as a '*trading company*'). In any event, it can be the case that circumstances change, which can mean the initial business structure is no longer adequate to meet the commercial needs of the business.[44]

Advisors have reported that many SMEs at the inception stage do not choose the most appropriate business structure(s) for their business.[45] This is, in part, due to a lack of adequate engagement with advisors at inception, which may result in unnecessarily complex structures which can, in turn, result in increased compliance costs.[46]

2.2 Factors influencing restructure choice

There are many reasons why a restructure may be considered necessary by advisors and operators of SMEs. These can include facilitating new investors, allowing access to generous tax concessions only available to certain business structures, and to address legacy issues (such as a complicated structure having developed over time due to the purchase of businesses and/or the sale of different business segments).[47] A restructure may also be considered necessary to facilitate a business succession plan, whether by sale to a third party or by passing the business to the next generation.[48]

2.3 Restructuring relief

A deterrent to restructuring is the complexity and the costs that can be involved. The complexity can be due to determining the legal ownership of various assets (and any security creditors might hold over them) and operational licences.[49] Another potential deterrent is the tax impost at the State and federal level when business assets are transferred from the original business structure to the new one.[50] Collectively, such costs have been referred to as 'transaction costs',[51] which if the restructure occurs may adversely impact the business's cashflow and the available working capital.[52] Overall, these transaction costs may be seen as too prohibitive for, or otherwise detract from, the benefits of restructuring a business.[53]

In recognition of how tax may inhibit business restructuring from occurring, the government has implemented tax roll-over reliefs, especially in relation to CGT, such

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[43] Trad et al, 'Choice of Australian Business Structures', above n 30.
[44] Ibid.
[45] Trad et al, 'Small Business Restructure Roll-Over', above n 27.
[46] Ibid.
[47] Mark Giancaspro, Sylvia Villios and Chris Graves, *The Use of Family Trusts in Small Business and Family Enterprise, ASBFEO Final Report* (University of Adelaide, 2019) 63.
[48] Ibid.
[49] Mark Edmonds and Craig Duncan, 'Transaction Costs' (Tax Institute New South Wales Division presentation, 4 September 2013).
[50] This is because technically there can be a transfer of assets from one legal entity to another one, even if the effective economic ownership remains the same.
[51] Transfer costs such as tax liability can be seen as a subset of transaction costs. Transaction costs is an overarching term used to describe the costs involved in changing a business structure, which can include professional fees, government changes, administrative practices, and then tax transfer costs, such as the income tax liability and stamp duty.
[52] Edmonds and Duncan, above n 49.
[53] Giancaspro et al, above n 47, 64.

as those in Subdivisions 122-A, 122-B, and 328-G of the *Income Tax Assessment Act 1997* (ITAA 1997). Each of these provisions is briefly discussed below.

2.3.1 Subdivisions 122-A and 122-B

Formal restructure roll-over relief for income tax purposes is available in limited circumstances, namely when the business restructure involves the transfer of a business's assets from a sole trader,[54] a trustee, or partners in a partnership to a wholly-owned company.[55] These two regimes are more focused on allowing for no tax impost when there is no change in the economic ownership and that the contemplation of a business being rolled-over (restructured) is just one aspect of these two roll-overs.

However, these two roll-overs do not apply to a restructure in the opposite order, such as a business from a company to a sole trader, partnership, or a trust. Additionally, these provisions relate to the relief from CGT, but not to other tax consequences such as the disposal of revenue assets.[56] This can be described as the transfer of a 'business', which practically involves the transfer of multiple assets (capital and revenue assets; tangible and non-tangible) involving different legal and business considerations, as well as various tax consequences.

2.3.2 Subdivision 328-G

From 1 July 2016, the SBRR was introduced to address in part some of the restrictions of the prior provisions.[57] When the SBRR applies to a restructure of the ownership of the business assets, the relief removes possible CGT liability, as well as the tax consequences for the transfer of trading stock, revenue assets, and depreciating assets.[58]

The SBRR aims to allow small businesses to transfer active assets from one entity to another entity without incurring an income tax liability.[59] Active assets include CGT assets, trading stock, revenue assets and depreciating assets[60] and these must be assets used in the course of carrying on a business, and generally not be generating passive income.[61] The SBRR is available to a small business with an annual aggregated turnover of less than AUD 10 million, known as a small business entity (SBE).[62] As a consequence, the SBRR may not be available to larger SMEs (beyond micro and small).[63]

Entities are eligible if, in the income year in which the transfer occurs, each party to the transfer is either an SBE, an entity that has an affiliate that is an SBE, an entity that is

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[54] ITAA 1997, above n 28, Sub-div 122-A.
[55] Ibid Sub-div 122-B.
[56] Revenue assets could include trading stock and depreciable assets. Note that technically depreciable assets are not revenue assets, but the balancing adjustment calculation on their disposal brings them outside the CGT provisions, and either includes an amount as assessable income or an immediate tax deduction, which is a similar outcome to a revenue asset: ibid s 40-285.
[57] Ibid Sub-div 328-G.
[58] Ibid s 328-420.
[59] Ibid s 328-430(1).
[60] Ibid s 328-430(1)(d).
[61] Ibid s 152-40.
[62] Ibid s 328-110.
[63] Note that sometimes an SME might be considered 'medium' size due to employee numbers, when its turnover is more modest.

connected with an SBE, or a partner in a partnership that is an SBE.[64] When the SBRR applies, in general, no income tax liability arises for either party. For assets transferred under the roll-over, the transferor is treated as having received an amount that is equal to the cost of the transferred assets,[65] and the transferee is treated as having acquired the assets for an amount that is equal to the cost of the transferor just before transfer.[66] There are two additional conditions, first, that there is no material change to the 'ultimate economic ownership' of the assets[67] and, second, that the transfers are part of a 'genuine restructure of an ongoing business'.[68]

Industry has acknowledged that the SBRR can be useful for some clients wanting to benefit from a change in business structure.[69] However, the SBRR has been criticised in relation to its limited application; for instance, the SBRR does not apply to restructures to facilitate succession planning and does not permit a sole trader to restructure to a trading company with a holding discretionary trust.[70]

This article provides new insights to the understanding of these issues by analysing the factors which may inhibit SMEs from adopting the business structure recommended by advisors. This is important, as while advisors may have a preferred business structure for their SME client, there may be inhibitors to the advisor's recommendations being realised.

3. RESEARCH METHODOLOGY

The scope of this research is limited to SME advisors' perceptions and not the perceptions of SME operators. The advisors were selected based on their engagement and knowledge in relation to the Australian SME sector. However, the validity of this research is based on the knowledge of the advisors. Thus, the aim is to deliver an accurate representation of the advisor perceptions, by exploring the factors that may inhibit SMEs from implementing the business structures recommended.

3.1 Case study design

An experimental case study design was utilised to answer the following research question:

> 'Are there any inhibitors for the adoption of the recommended structure?'

Case study was selected as the most appropriate design for this research. Case studies are the most common method in social science studies,[71] and they can offer a rich explanation of circumstances.[72] It was considered that an experimental case study would provide more accurate insights into what advisors may consider inhibitors when

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[64] ITAA 1997, above n 28, s 328-430(1)(b). This means that an entity holding assets for an SBE may be eligible for this roll-over, even though that entity is not carrying on a business.
[65] Ibid s 328-450.
[66] Ibid s 328-455.
[67] Ibid s 328-430(1)(c).
[68] Ibid s 328-430(1)(a).
[69] Crowe Horwath, Submission to the Board of Taxation Review of Small Business Tax Concessions (20 July 2018) 3 <https://taxboard.gov.au/consultation/small-business-tax-concessions#submissions>.
[70] Trad et al, 'Small Business Restructure Roll-Over', above n 27.
[71] Robert K Yin, *Case Study Research: Design and Methods* (Sage Publications, 2nd ed, 1989) 5.
[72] Robert S Kaplan, 'The Role for Empirical Research in Management Accounting' (1986) 11(4-5) *Accounting, Organizations and Society* 429.

recommending business structures. Essentially, these case studies were real-life examples of scenarios where advisors were asked to provide their recommendations as to the ideal business structure. The advisors were then asked whether they perceive any inhibitors for their client in adopting the recommended structure. The scenarios were developed by the researchers based on the results obtained from the literature.[73]

There were six sets of business scenarios developed (refer to a short summary in Table 1). These six scenarios were effectively doubled to 12, as each of the six business scenarios was either a new or established business. The first set of six scenarios was to ascertain what an advisor would recommend if approached by a new SME client considering setting up a business structure, and why (the ‘new SME’). The second set of six scenarios was about an established SME business, and asked the advisor, in retrospect, whether they would have recommended a different business structure, and why (the ‘established SME’).

Each scenario was considered by four advisors. For example, with Scenario One (an orthodontic business), four advisors considered the ‘new’ business, and four advisors considered the ‘established’ business. With these four repetitions of each case study, 48 SME advisors were required. Overall, multiple cases were generated to examine, compare, and gain a deeper understanding of SME advisors’ perceptions.

3.2 Advisor selection

This research involved 48 advisors (accountants or lawyers) who advise and engage with SMEs. Before contacting advisors, university ethics clearance for the research was obtained, and included such caveats as anonymity and the ability of advisors to withdraw at any time.[74]

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[73] Barbara Trad, Brett Freudenberg, Craig Cameron and John Minas, ‘Not in Isolation: The Rationale for a Combination of Business Structures in Australia’ (2023) 51(3) *Australian Business Law Review* 162.
[74] Full Research Ethics Clearance: GU Ref No: 2020/555.

Table 1: SME Scenario Overview

SME Scenario	Short overview of business	Established business structure
One	Involved an orthodontic and a dental business that has been operating as one business since 2000, with an annual turnover of $1.97 million, and 10 employees. Business Assets: Building $1.9 million; plant and equipment $1.7 million. Personal Assets: House and land owned jointly by Peter and Debbie $2.5 million; cars $125,000. Business creditors: Bank loan on building $920,000. Personal creditors: Bank loan on house $615,000; cars: $62,000. The business is owned by a couple (an orthodontist: Peter and a dentist: Debbie) who have two adult children. The children are not in receipt of any income. The couple are contemplating selling the business in 10 years' time prior to their retirement. There is no need for new equity and the business can grow using profit with no need for unrelated investors.	Family discretionary trust with a company trustee
Two	Involved a web design business with an annual turnover of nearly $1 million, with no employees. Business Assets: Plant and equipment $35,000. Personal Assets: Charlie: car $45,000; Jane: house $850,000, car $40,000. Business creditors: Landlords $2,000 monthly lease (12-month lease). Personal creditors: Car and home loan of $590,000. The owner is a 53-year-old man (Charlie) who is married to a stay-at-home mother (Jane). They have three children over the age of 18. Their children are university students who are not in receipt of any income. There is no need for new equity nor finance, with no need for unrelated investors.	Partnership
Three	Involved an electrical service business, with a turnover of $500,000 and two employees. Business Assets: Plant and equipment $45,000. Personal Assets: Paul: car and boat $85,000; Lynette house & car $660,000. Business creditors: Business loan $25,000. Personal creditors: Paul personal loan $35,000; Lynette home loan $420,000. The owner (Paul) is 35 years of age, and his wife (Lynette) is a stay-at-home mother. They have two children under the age of 18. There is no need for new equity and the business can grow using profit with no need for new investors. There is a preference not to have unrelated investors.	Sole proprietorship
Four	Involved a medium-size business manufacturing human heart valves. Its turnover is $20 million, it has 80 employees. Business Assets: Intangible asset - patent $10,000,000; plant and equipment $6,000,000. Personal Assets: House: $950,000 (as joint tenants); car: $95,000. Business creditors: Bank loan: $6,000,000. Personal creditors: Bank loan: house: $205,000 and car: $40,000.	Trading company owned by asset-holding company (known as Happy Heart Pty Ltd), which is then owned by a family discretionary trust

	The owner is 45 years old, a heart surgeon, who lives with his partner, and has no children. There is the need for new equity and the need for public investors in the future.	(known as Cardio Family Discretionary Trust)
Five	Involved a small business with an annual turnover of $2.6 million, with 12 employees. The business involves importing and selling furniture. Business Assets: Warehouse $1.3m; plant and equipment: $70,000; inventory: $650,000. Personal Assets: Boat $60,000. House owned by wife worth $850,000. Business creditors: Bank $750,000; suppliers $900,000. Personal creditors: Bank loan: $43,000. The owner is 60 years old, married, with two adult children. There is potential for a divorce in the future. In the future his son Matthew will have equity in the business, but there is no need for unrelated investors.	Family discretionary trust (individual as trustee)
Six	Involved a small bridal gown business, with an annual turnover of $6.1 million, and 25 employees. Business Assets: Goods $900,000; machinery $400,000. Personal Assets: Building $1.5m; house and car $750,000. Business creditors: Bank loan $950,000; Suppliers $250,000. Personal creditors: Bank loan: $400,000. The owner is 55 years old, female, and single. There is a likely need for new equity including from unrelated investors in the future. The business profits are likely to be reinvested in the business.	Company

*Values are stated in current market value. The full scenarios are detailed in: Barbara Trad, Brett Freudenberg, John Minas and Craig Cameron, 'Reasons behind SME Advisor Business Structure Recommendations' (2024) 39(1) *Australian Tax Forum* 93.

To recruit advisors, convenience sampling and snowball sampling were used. Convenience sampling was used to contact both professional and personal contacts of the research team using email and LinkedIn. Snowball sampling techniques were applied to those contacts, as potential advisors were encouraged to share the invitation to participate in the research with their own networks. Advisors were also recruited by contacting representatives of professional bodies. In addition, there was a mass email distribution seeking potential advisors sent to various accounting and law firms using their website contacts. Criteria for selecting the advisors included that they must be engaged/knowledgeable with the SME sector, have at least five years' experience, and be aware of the issues that challenge SME businesses.

An overview of each advisor's current profession, number of years in their profession, state of residency, current position, clients' business size, frequency of advice per year, and area of practice is presented in Table 2 (Appendix). The advisors included 29 accountants, 15 lawyers, two tax advisors and two business consultants. Thirty-three of the 48 advisors had over 15 years' experience in their profession, nine advisors had 10 to 15 years of experience, and six advisors had five to 10 years of experience.

There were 31 advisors (65 per cent) who lived in Queensland, and five advisors from each of Victoria, New South Wales and Western Australia. Of the remaining advisors, one was from Tasmania and one from South Australia.

Advisors indicated that they engage with a range of business sizes. Four advisors indicated that their clients include micro-to-medium size businesses (AUD 500,000–<100 million), nine advisors indicated that their clients include micro-businesses (AUD 500,000–<2 million), one advisor serviced micro to small businesses (AUD 500,000–<5 million), 17 advisors serviced small businesses (AUD 2 million–<5 million), two advisors serviced small to medium businesses (AUD 2 million–<100 million), and 15 advisors indicated that they provide services to medium businesses (AUD 10 million–<100 million). When the advisors were asked how regularly they provide business structure advice per year, the majority (27 advisors) commented that they provide advice more than 20 times per year, four advisors give advice 11 to 20 times, six advisors give advice six to 10 times, six advisors advise two to five times, and five advisors give advice once per year. Over three-quarters of those advisors (78 per cent) who reported giving advice more than 20 times per year serviced small and medium firms.

Given the advisors' years of experience and the frequency of their advice to SMEs, this provides a substantial level of assurance as to the expertise of the advisors, and their ability to provide considered insight about this subject.

3.3 Interview design

The qualitative data collected and analysed in this study was via in-depth interviews, which consisted of structured, semi-structured and open-ended questions and were conducted by the researchers. Interviews of 45 minutes to 55 minutes in duration were conducted online, via Zoom or Teams, approximately one week after the scenarios were emailed to advisors.

After ascertaining the advisors' recommended structure, advisors were asked whether there were any inhibitor(s) for the adoption of their recommended structure. The key questions for the purpose of the research reported in this article are:

- *Do you think there could be any inhibitors for the adoption of your recommended structure? If so, what are they?*
- *Is there anything to reduce these inhibitors?*

Data analysis occurred after all interviews were conducted and transcribed. The qualitative data were analysed in three stages: initial reflexivity,[75] pattern coding,[76] and data representation.[77] The inhibitors for adopting the recommended structure are presented in the following section.

[75] Initial reflexivity involved reflecting on the interview itself and on the notes taken during the interviews.
[76] Jaber F Gubrium et al (eds), *The Sage Handbook of Interview Research: The Complexity of the Craft* (Sage Publications, 2nd ed, 2012). Pattern coding was used to develop categories and sub-categories relevant to the research question. To code the data, content analysis techniques were employed, in which similar content was identified from the transcribed interview scripts.
[77] Svend Brinkmann, *Qualitative Interviewing: Understanding Qualitative Research* (Oxford University Press, 2013).

4. RESULTS

4.1 Inhibitors

Table 3 (Appendix) provides an overview of a frequency analysis of the inhibitors identified by advisors for the adoption of their recommended business structure. The data are categorised according to 'new' and 'established' businesses, and for each advisor the relevant scenario, recommended structure and inhibitors are identified.

4.1.1 Overall observations

CGT and stamp duty were identified most often as an inhibitor (35 per cent of advisors), followed by establishment costs (27 per cent), client understanding (23 per cent) and complexity and compliance cost (17 per cent). Other inhibitors mentioned less frequently related to land tax (4 per cent), leases (4 per cent), bank accounts (4 per cent), and employees (4 per cent). However, nearly one-fifth (19 per cent) of advisors thought there would be no inhibitors for their recommended structure being adopted, although most advisors in this category advised on the 'new' business scenarios (discussed below).

Some of the advisors who recommended a combination of business structures for the one business referred to the complexity of implementing multiple structures for one business. This included client understanding of the multiple structures for the one business operation, when compared to one structure (such as A25, Scenario One, Est.). Advisor A48 noted that a tax consolidated group with shares held by a discretionary trust may be complex for a non-businessperson to understand. For example, there are restrictions under the *Corporations Act 2001* (Cth) as to when owners can take money out of the company, namely by means of dividends or by entering into a loan agreement (A48, Scenario Six, New).

Given the significant transfer costs such as CGT, stamp duty and administrative costs that may inhibit changing a structure, many advisors stressed the importance of setting up the structure correctly from the beginning:

> The best advice I've ever heard, it's a constant, is set it up right because if they try and change it later, it's going to be more costly (A44, Scenario Five, New).

Advisor A31 commented about their own business structure. With hindsight, they would have implemented a company structure instead of a unit trust; however, there would be a significant cost involved in changing his business structure now:

> The challenge that we've got, we can spend a lot of money in terms of structuring, so we can get the Rolls Royce structure, but I don't know his limitation. [the cost] is an inhibitor because dealing with the Tax Practitioner Board, if I have my time again and I didn't have a business partner, I wouldn't set up with a unit trust, I would have gone with a company structure, but with the cost in trying to change my structure now, changing the bank account, look at the capital gains tax, change the registration with the CPA [Certified Practising Accountant], with the cost involved in changing down the track, it is too much, I would've been better off getting it right in the first instance (A31, Scenario Two, New).

The results are now analysed according to established and new businesses scenarios, as there appear to be distinct trends.

4.1.2 Established businesses

Over two-thirds of advisors in the established business scenarios considered that CGT (67 per cent) was an inhibitor, followed closely by stamp duty (62.5 p cent).[78]

However, the stamp duty cost depends on the State in which the business is located. While some States in Australia, such as Queensland, levy stamp duty on transfer of assets, other States, such as Victoria and New South Wales, do not apply stamp duty on the transfer of business assets:

> Queensland still levies duty on business assets, so, there is a stamp duty issue. I think Queensland has recently put in some exemption for moving a business into a company, but I'm not sure if it covers trusts because I'm practising in New South Wales. So, in New South Wales, we wouldn't have that issue because we don't levy duty on business assets (A29, Scenario Two, Est.).

For those businesses operating across multiple States, stamp duty can be a real problem, as such cost could inhibit SME owners from restructuring. For instance, a study in South Australia identified that business owners may not restructure if it involves a tax cost.[79] Business operators need to be aware of the stamp duty and land tax[80] liabilities that may arise when restructuring:

> So, as any change of structure, if it involves property, you should always be careful about changing structures with clients. So, the client should be aware of implications of stamp duty and/or tax, and as well as, if you hold a property in the trust in New South Wales in particular, they pay higher land tax. So, I make sure we tell our clients the implications of those costs. Asset protection is on one side, but these costs are hidden costs which people don't realise at the beginning. So, we are very transparent about those issues (A41, Scenario Five, Est.).

Advisor A42 (Scenario Five, Est.) noted that, in addition to CGT and stamp duty costs, there are administrative costs such as change of ownership, setting up new bank accounts, as well as updating business agreements including employment contracts and leases. It is these additional administrative inhibitors that can also make a restructure problematic, even though they were identified less frequently in responses (4-8 per cent of advisors with established business scenarios).

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[78] The term 'stamp duty' is used given its historical prominence, even though modern reference is 'duties'.
[79] Giancaspro et al, above n 47, 63.
[80] Australian Taxation Office, 'Getting Started as a Not-for-Profit – State and Territory Taxes and Duties' (last updated 12 November 2018) <https://www.ato.gov.au/non-profit/getting-started/in-detail/induction-package/induction-package-for-not-for-profit-administrators/?page=8>. Land tax is an annual tax levied by State or Territory governments, except in the Northern Territory, on property that is above the land tax threshold. Restructuring may cause an entity to go over the relevant threshold and then be liable for land tax.

4.1.3 New businesses

The two most frequently mentioned inhibitors for the new business structure being adopted related to establishment costs (29 per cent) and client understanding (29 per cent). A similar percentage of advisors (29 per cent) thought there would be no inhibitors for their recommended business structure being adopted.

Some advisors considered that the costs of setting up a combination of business entities may deter clients from proceeding with the advisor's recommendation. This is understandable given that, when starting a business, finances may be limited and various costs are involved, including advice and registration. Advisor A20 acknowledged client reluctance with adopting a recommended business structure due to costs:

> My ideal structure for trading is a company but my ideal structure for asset protection is trust. So, I don't often win, I've got to be objective there and I always have considerable costs for some clients, some clients don't want to spend $5,000 at the beginning to set up (A20, Scenario Five, New).

This finding is consistent with previous research, which found that business structure advice may not be sought prior to commencing the business due to financial restrictions and/or attitudes.[81] The advisors' concerns in this study are also supported by Australian research that found nearly 30 per cent of people setting up a business in Australia sought no advice or information.[82]

The third most identified inhibitor for new businesses related to complexity and compliance costs (17 per cent). Transfer costs was not frequently identified by advisors for the new businesses (CGT: 4 per cent, stamp duty: 8 per cent). No advisors discussed the following factors as potential inhibitors for new businesses adopting their recommended structure: land tax, leases, and/or employees.

4.1.4 Comparing established and new businesses

The results demonstrate that new and established businesses have different inhibitors for adopting business structures. For example, the transfer cost of CGT is more frequently mentioned as an inhibitor for established businesses compared to new businesses (67 per cent vs 4 per cent), along with stamp duty (62.5 per cent vs 8 per cent). The difference may be explained by the fact that an established business may own valuable assets, and changing a business structure would likely involve the legal transfer of these assets, with associated transfer costs.[83] This is supported by the finding that 29 per cent of advisors for new businesses considered that there were no inhibitors for the business structure recommended by them. Unlike established businesses, new

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[81] OECD, *Taxation of SMEs in OECD and G20 Countries*, OECD Tax Policy Studies No 23 (OECD Publishing, 2015); Mark Pizzacalla, 'Developing a Better Regime for the Preferential Taxation of Small Business' (PhD thesis, Monash University, 2014) 42; Margaret McKerchar, 'Understanding Small Business Taxpayers: Their Sources of Information and Level of Knowledge of Taxation' (1995) 12(1) *Australian Tax Forum* 25; Ian G Wallschutzky and Brian Gibson, 'Small Business Cost of Tax Compliance' (1993) 10(4) *Australian Tax Forum* 511.

[82] Robyn Rutley, Sophia Elliott and Rachelle Tatarynowicz, 'Small Business Engagement Research', *Australian Taxation Office* (TNS Social Research Consultants, 2016).

[83] A taxpayer is generally only liable for CGT on the realisation of the gain, generally the transfer of assets, if CGT Event A1 has occurred; the availability of a roll-over may allow the taxpayer to defer the realisation of a capital gain.

businesses will not generally have significant assets and represent a 'blank slate' for the advisor to recommend an appropriate structure, without the inhibitor of transaction costs. Overall, the results suggest that transfer costs such as CGT and stamp duty are an inhibitor for established SMEs from restructuring.

For new businesses the most frequently cited inhibitor was client understanding which was higher than established businesses (29 per cent vs 17 per cent). This suggests that with new businesses it is essential to ensure that the client understands what the business structure entails. It may also suggest that with established businesses the advisor may consider their clients have a greater understanding about business structures. This observation is supported by business tax literacy research which demonstrates higher business tax literacy for those businesses who have been operating longer.[84] Two other inhibitors identified in the research are similar for both new and established businesses: the initial establishment costs of setting up a business (29 per cent vs 25 per cent) and the complexity in adopting multiple structures (17 per cent vs 17 per cent).

Overall, advisors perceived that there are inhibitors from enabling SMEs to alter their business structure to the recommended structure – which in most circumstances in this study was a trading company with holding trust.[85] These transaction costs are concerning, as they mean SMEs may be using less than ideal business structures for their needs. This demonstrates the importance of setting up the structure correctly at the inception stage, otherwise the costs may not justify the benefits of the restructure and/or the SME client may not have the financial capacity to incur the costs. In addition to transfer costs such as CGT and stamp duty, advisors identified other administrative costs such as change of ownership, setting up new bank accounts, and updating business agreements including employment contracts and leases.

The following section is an analysis of the potential techniques, as reported by SME advisors, to reduce these inhibitors to restructuring.

4.2 Reducing inhibitors

During the interview advisors were asked '*Is there anything to reduce these inhibitors?*'. The results are discussed below in terms of overall observations, followed by an analysis of the established businesses and then the new businesses.

4.2.1 Overall observations

Reducing inhibitors for business restructures are techniques which advisors perceived as beneficial in assisting their clients to implement what they considered an appropriate business structure. For those advisors who perceived that there were inhibitors that may prevent SMEs from restructuring, they were asked whether there was anything to reduce these inhibitors. A variety of perspectives were expressed by advisors, and their frequency is presented in Table 4 (Appendix).

Overall, for all advisors that reported inhibitors (both established and new scenarios) the three most frequently mentioned techniques used to reduce inhibitors were client education (30 per cent), explaining the benefit of advice (30 per cent) and Division 152

[84] Melissa Belle Isle, Brett Freudenberg and Tapan Sarker, 'The Business Tax Literacy of Australian Small Businesses' (2022) 37(1) *Australian Tax Forum* 65.
[85] Trad et al, 'Choice of Australian Business Structures', above n 30.

CGT concessions (30 per cent). The less frequently mentioned techniques were: Subdivision 328-G SBRR (14 per cent), Subdivision 122-A (11 per cent), no change in property ownership (8 per cent), fewer entities (6 per cent), Division 115 CGT 50 per cent discount (3 per cent) and Subdivision 122-B (3 per cent). A strategy that appeared to be consistent between established and new scenarios was explaining the benefits of advice to the client (29 per cent vs 36 per cent). Otherwise, the trends are quite distinct between established and new scenarios. For example, client education was only mentioned by 14 per cent of advisors in established scenarios compared with 57 per cent in new scenarios. Given the differences between new and established scenarios, they are discussed separately below.

4.2.2 Established businesses

The strategies recommended by advisors to reduce or defer the inhibitors for established business scenarios (in descending order) were: Division 152 CGT concessions (43 per cent); explaining the benefits of advice (29 per cent); Subdivision 328-G SBRR (24 per cent); client education (14 per cent); no change in property ownership (14 per cent); Division 115 (5 per cent); Subdivision 122-A (5 per cent), and Subdivision 122-B (5 per cent). No advisors mentioned fewer entities (0 per cent).

Previously it was identified that CGT and stamp duty costs could inhibit SMEs from restructuring. However, a common view amongst advisors (mainly in the established businesses) was that, while there are some tax concessions which may apply to remove the CGT, there would generally be no relief from stamp duty when restructuring. These concessions pertaining to reducing the burden of CGT costs are discussed below.

Accessing small business CGT concessions (Division 152 and/or Division 115)

To lessen the burden of the transfer costs of restructuring, advisors (eg, A2, Scenario One, Est.; A6, Scenario Two, Est.; A21, Scenario Six, Est.) identified and described potential CGT roll-over or small business CGT concessions.[86] For example, A22 suggested using Division 152 for restructuring:

> As an established business is an active asset, shares are active assets, and the building is an active asset, I'm assuming that she runs the business more than 15 years, stamp duty will be my only issue, because the CGT small business roll-over relief doesn't work for stamp duty unfortunately, that gives you income tax relief … you'll get that GST free when you transfer the business assets. So, there will be stamp duty on the shares when you'll transfer that from her to a discretionary trust, that will be the big one (A22, Scenario Six, Est.).

Interestingly, Division 152 was mentioned more frequently than the formal restructure relief provisions, such as Subdivision 328-G (24 per cent), Subdivision 122-B (5 per cent) and Subdivision 122-A (5 per cent). The use of Division 152 of the ITAA 1997 as a pseudo roll-over relief for business restructures has been observed in previous research,[87] even though this use may not be entirely consistent with the legislative intention for its enactment, which focused more on the sale of a business rather than its

[86] ITAA 1997, above n 28, Div 152.

[87] Giancaspro et al, above n 47, 64; Trad et al, 'Small Business Restructure Roll-Over', above n 27.

restructure.[88] However, it should be acknowledged that one of the reasons for a restructure could be to better facilitate a future sale or succession planning of the business.[89] This use of Division 152 as a pseudo roll-over relief from restructure transfer costs may account for its high tax expenditure cost.[90] While advisors might find this as an effective way of mitigating the potential transaction costs for a restructure, it has been observed that this practice may create uncertainty, and the potential application of Pt IVA of the *Income Tax Assessment Act 1936* (the general anti-avoidance provision).[91]

It appears that there is uncertainty when using formal restructure roll-over relief, such as the SBRR. While some advisors considered that there could be formal restructure roll-over relief, or some small business exemptions for restructuring the business, others argued that the application of such restructuring roll-over relief is uncertain and that any restructure involving property could potentially have significant costs in stamp duty (depending on the State legislation) and CGT, and such costs could be a major impediment for clients to restructure:

> If we were to change the structure, it may incur CGT depending upon whether there was any roll-over available, so, there may be a roll-over available here, but it's a little bit difficult to know whether the (subdivision) 328-G roll-over would apply (A6, Scenario Two, Est.).
>
> There are small business exemptions on restructuring the business, but you will have to make sure they apply, and that you are fine with those because if they don't apply, potentially you are going to be up for a potential CGT implication. So, if you don't plan it properly, you could get transfer duty, CGT and both of those can be significant (A42, Scenario Five, Est.).

Many advisors observed that multiple CGT concessions could be used in conjunction with each other to reduce, if not, eliminate the tax burden. For example, the owner may be entitled to a 50 per cent CGT discount under Division 115, and then another 50 per cent reduction using Division 152 (known as the active asset reduction), with the remaining 25 per cent of the capital gain being subject to tax.[92] Provided there are available funds, this remaining 25 per cent could then be potentially rolled into superannuation using the small business CGT retirement concession (A9, Scenario Three, Est.).[93]

While most of the advisors who commented about transfer costs stated that there could be some relief from CGT when restructuring, all agreed that there could be stamp duty consequences for restructuring an established business. For instance, A2 argued that the future tax savings need to outweigh the transfer costs:

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[88] Board of Taxation, *Review of Small Business Tax Concessions: A Report to the Treasurer* (March 2019) ('*Review of Small Business Tax Concessions*').
[89] Trad et al, 'Small Business Restructure Roll-Over', above n 27.
[90] Board of Taxation, *Review of Small Business Tax Concessions*, above n 88.
[91] Board of Taxation, *Review of CGT Roll-Overs: Consultation Paper* (December 2020) 49.
[92] ITAA 1997, above n 28, Div 115.
[93] The retirement concession allows for a lifetime limit of AUD 500,000 to be contributed to superannuation: ibid Div 152. However, such a contribution could be problematic, as with a restructure there is generally no external money coming in, so funds to make the superannuation contribution would need to be found elsewhere.

> The two biggest inhibitors: one would be the capital gains tax to transfer that from the current structure to the new one, there would be CGT which will be potentially solved through small business CGT concessions, but then stamp duty would be your big issue. So, the cost to transfer would be quite significant and there has to be some sense of real tax benefit over the next few years to justify that (A2, Scenario One, Est.).

The tax costs associated with a restructure can be minimised for small business entities through the CGT roll-over relief provisions, as demonstrated by A22 in Scenario Six (Est.) with respect to the transfer of the shares of the business and the building from the owner to a discretionary trust. However, not all clients in the scenarios could access the concessions, because the business did not meet the requirements of a 'small' business.[94]

Accessing small business restructure roll-over relief (Subdivision 328-G)

Advisors discussed the SBRR as a mechanism to relieve SME clients from the CGT consequences of restructuring. For example, one advisor referred to the application of such roll-over relief to transfer the business property to a new trust because the business's annual turnover was less than AUD 10 million (A25, Scenario One, Est.). However, accessing the SBRR relief can come with uncertainty for advisors. The concern is that if a business intends to restructure assuming it can satisfy the conditions for roll-over relief, and the Commissioner of Taxation objects to such restructure, there might be significant CGT costs incurred:

> The problem is, if they say no, and you want to object, what are you objecting to? You know there's no law there, there's the Commissioner, and it sort of happened in South Australia, there's some case law where that's gone south in the courts, just said there's nothing there to object to, it's completely discretionary (A17, Scenario Five, Est.).

This highlights the ambiguity about the application of the SBRR and how its limited application may mean that established businesses either do not restructure or try to utilise other concessions.[95]

Benefit of advice and client education

Some advisors noted how it was important for them to explain the benefit of the restructure advice to the client (29 per cent), which relates to client education (14 per cent). Advisor A14 observed that:

> Explaining the benefit and the risk that is mitigated will make it worth it, because with a company with this value and this level of turnover, you would want the structure to be set up right and you probably talk [the client] through it, explaining the benefits and the cost savings in other areas to try to overcome those inhibitors (A14, Scenario Four, Est.).

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[94] The size of the businesses in the scenarios ranged from micro, small to medium businesses. This means for the scenarios that involved 'medium' sized businesses, access to 'small' business concessions could be problematic. However, this would depend upon how 'small' is measured for the relevant concession. See Appendix.

[95] For a more detailed exploration of the SBRR, see Trad et al, 'Small Business Restructure Roll-Over', above n 27.

To overcome the inhibitors, advisors may explain to the clients that the benefit of adopting a correct structure outweighs the initial costs of setting up a business structure. Such discussions may ensure that the client implements the most appropriate business structure from the start. Conducting a cost-benefit analysis is a technique to overcome these inhibitors because there is a cost to later restructure, as well as ongoing compliance costs – and the advisor needs to justify to the client that the benefits outweigh these costs (A5, Scenario Two, Est.). This is consistent with the Scholes and Wolfson's theory of balancing tax and non-tax costs in the selection of a business structure.[96] Advisors need to ensure that their clients have an adequate understanding of business structuring so that they can evaluate this trade-off. Advisor A30 stated that seeking professional advice is valuable, although the initial costs could be a burden, but 'that [it] will pay for itself down the track' (A30, Scenario Two, Est.). However, a fear about costs may mean that a client is reluctant to approach an advisor.

No change in property ownership

Another method to reduce transfer costs identified by advisors was undertaking a partial restructure without changing the ownership of valuable assets that would otherwise trigger CGT and/or stamp duty (14 per cent):

> Just don't change the property holdings, leave it as is, because even if you change it to a corporate trustee, it'll still cost you stamp duty unless there are some provisions in a particular State. Each State has its own standard exemption rules, I'm not sure about certain States, they allow certain standard exemptions if it's only change of structure. But in New South Wales, definitely, it would cost this client a lot in stamp duty (A41, Scenario Five, Est.).

This non-transfer of assets might then be combined with a tax consolidation strategy:

> He has got some [intellectual property] assets, so having the patent being so valuable, given that the patent is a CGT asset; from the perspective of having CGT discount, it may be worthwhile having that held by a separate discretionary trust. But if we are talking about restructuring this current business, I would leave it there, it's probably not worth crystallising a capital gain to transfer it. ... I would form a tax consolidated group, with the holding company there. … If you talk about shifting the patent out, tax is going to be your biggest issue, and potentially stamp duty (A38, Scenario Four, Est.).

To alleviate the possible transfer cost, another advisor dealt with this in Scenario Five (a trading family discretionary trust owning the building, the owner is the trustee) by transferring all the business assets into a company and by leaving the significant asset, the warehouse, in the established structure:

> Now what you might end up doing is transfer all of those assets of the business into a company, and then potentially leave the warehouse where it is, and that becomes the discretionary trust that owns the warehouse, and you don't have to deal with the transfer issue, you still have the warehouse in the discretionary

[96] Myron S Scholes and Mark A Wolfson, *Taxes and Business Strategy: A Planning Approach* (Prentice Hall, 1992).

> trust, but the rest of the business is in a separate structure (A42, Scenario Five, Est.).

While this may minimise the transaction costs, it is questionable whether the desired asset protection will be fully achieved.[97]

Using Subdivision 122-A

Subdivision 122-A of the ITAA 1997 provides CGT roll-over relief for a sole trader or a trustee on the disposal of business assets to a company, in which the business owner then owns all the shares in the company.[98] This provision was referred to by A38 (with respect to Scenario Four, refer Table 1).[99] Advisor A38 suggested incorporating a holding company by using the Subdivision 122-A roll-over (between Happy Heart and the Cardio Family Discretionary Trust) to then form a tax consolidated group (with Cardiac Biological Valve, Happy Heart and Hold Co). This was followed by the transfer of the shares in Cardiac Biological Valve from Happy Heart to Hold Co, therefore eliminating tax liability on the whole restructure. This demonstrates how Division 122 can be applied to reduce some of the transfer costs to enable a restructure to occur, although its availability depends upon the factual circumstances.[100]

Using Subdivision 122-B

Subdivision 122-B is a roll-over provision which allows a partnership to dispose of assets by a partner to a wholly owned company.[101] Advisor A29 suggested (Scenario Two, Est.) that there is a choice of using small business CGT concessions or using Subdivision 122-B to move from a partnership to a company, and this depends on the client's needs. They further commented that the advisor assesses all the potential approaches to minimise the transfer costs. Using roll-overs may offer the business owner a cost base transfer, or alternatively if the small business CGT concessions are utilised they may get a step-up in cost base. This demonstrates how advisors can be proactive in determining whether a concession is available or not, including some that are not technically for restructuring but are used as a pseudo restructure relief to reduce the overall tax burden.[102] Additionally, the consideration is not just the immediate possible tax impost but also other tax advantages, such as an increased cost base, or a lower possible future tax cost. Additionally, Subdivisions 122-A and 122-B have limited application given they only apply to certain business structures.

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[97] The reason that the asset might be at risk could be because it is held by the same entity conducting the business, and thereby business creditors could sue. Also, if the asset is held by an individual then that individual might be exposed to business risk and be sued, or the asset might become part of a property settlement in the advent of a divorce. For a discussion about asset protection, see Trad et al, 'Reasons behind SME Advisor Business Structure Recommendations', above n 38.

[98] ITAA 1997, above n 28, Sub-div 122-A.

[99] Note advisor A40 in respect of the new scenario four also mentioned Subdivision 122-A.

[100] However, a transaction cost that may be incurred is the advisor's fees in providing advice on the application of Subdivision 122-A.

[101] ITAA 1997, above n 28, Sub-div 122-B.

[102] For a more detailed explanation of this phenomenon, see Trad et al, 'Small Business Restructure Roll-Over', above n 27.

4.2.3 New businesses

Client education and benefit of advice

For clients with new businesses, advisors were of the strong opinion that to mitigate the inhibitors encountered by SMEs in implementing an ideal business structure, important strategies were client education (57 per cent) and for advisors to explain the benefits of the advice (36 per cent). The advisors' focus on education and the need for advice is consistent with arguments that the Australian tax system is too complicated for SMEs to navigate, and this may lead to high compliance costs for this sector.[103] Complexity and compliance costs have been identified as a significant factor influencing advisors' recommended business structure for SME clients.[104] The findings may raise concerns as to the extent to which business owners are equipped to face challenges with business structuring, and whether they are competent in comprehending the different types of business structures and/or in meeting their legal and tax obligations. This lack of 'business structure literacy' may mean SMEs are not proactive in seeking advice to alter structures. Research has demonstrated that small business owners who have more sophisticated business structures of trusts and/or companies may have higher small business tax literacy.[105]

Advisors expressed that client education is paramount in overcoming some of the complexity associated with business structures, especially at the inception stage of the business. The importance of implementing a correct structure at the commencement of a business and the benefit of receiving professional education was highlighted by A31 (Scenario Two, New):

> I think having the conversation of what I've just said and explaining it to them. Try to simplify it to them, those are the boxes, and if we do this right in the first instance that would actually save money down the track. You want to get it right, there is nothing worse than getting the structure incorrect in the beginning and then trying to fix it.

Client education was a consistent theme during interviews, particularly with the new scenarios. For example, A3 (Scenario One, New) stressed the importance of educating the client by clearly explaining the structure through a diagram and ensuring that the clients understand the structure. This view was echoed by A44 (Scenario Five, New) who argued that by educating the client and explaining the benefit of protecting the assets against the claim of suppliers and creditors, as well as the flexibility of income distribution, the benefits of a trading company with holding trust may outweigh the cost of implementing the structure. Advisor A20 (Scenario Five, New) stressed the importance of educating clients to overcome some of the complexity associated with the structure, and to convince business owners that paying an accountant will be a worthwhile investment over time through reduced tax and other benefits. Advisor A48 (Scenario Six, New) employed the approach of explaining to the clients the advantages and disadvantages of the business structure, and of providing the clients with

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[103] Review of Business Taxation (John Ralph, chair), *A Tax System Redesigned: More Certain, Equitable and Durable* (1999) Overview, 105 (Review of Business Taxation); Board of Taxation, *Review of Tax Impediments Facing Small Business: A Report to the Government* (2014) 68.
[104] Trad et al, 'Reasons behind SME Advisor Business Structure Recommendations', above n 38.
[105] Belle Isle et al, above n 84.

professional advice so that the clients can focus on the business activities. A similar approach was expressed in the prior discussion by A14 (Scenario Four, Est.).

Client education was viewed by advisors as minimising the risk of SME clients making mistakes in relation to the business structure. Business operators needed to be competent in understanding and dealing with business structures ('business structure literacy'), especially trusts, to overcome some of the inhibitors to restructuring the business:

> If they manage it properly, even if they say they have no real understanding, they need to have a real understanding of how this works, it's their structure, it's their income. So, they need to educate themselves enough to understand what's happening, because if there's an audit and they get asked direct questions, they need to be able to say they understand it, and they can make decisions as to how they want to distribute from the trust or what they want to do, but that's what they have to do to overcome the risks (A36, Scenario Three, New).

In particular, education may minimise the risk of errors by SME operators in relation to tax and asset protection.

A key finding from this research is that cost may prevent a new SME from seeking advice about an appropriate business structure (29 per cent of advisors with a new business scenario). It has been identified that cost can be a major factor that inhibits seeking advice at the inception stage of a business.[106] The importance of having an advisor who understands business structures, and who may assist the business owner to navigate the complexity of the structure, was highlighted by A16 (Scenario Four, New). Another relevant point was raised by A19 (Scenario Five, New) that business structure advice requires a comprehensive approach involving an accountant, lawyer and business manager who keeps timely records and promptly attends to advice. For example, if the company is at risk of insolvency, contacting an insolvency practitioner early on or receiving legal advice is crucial.

According to A7 (Scenario Two, New), seeking advice regularly, ensuring the client's understanding of the structure, and complying with administrative and legal requirements should be used with any business structure:

> I think he said he's going to speak to his advisor once a month, so that's probably a good thing. So, the client understanding, and making sure the administrative and legal formality are complied with from time to time, that's probably the case with any structure.

The advisors' responses reveal the need for ongoing advice from various advisors. However, SMEs may be reluctant to meet with advisors, and when SME clients do meet with advisors it may be more about tax compliance work (such as completion of tax returns), rather than management and/or broader business advice.[107] The research findings demonstrate that SME clients may not be using the ideal business structure at

[106] Trad et al, 'Small Business Restructure Roll-Over', above n 27.

[107] Sue Yong and Brett Freudenberg, 'Perceptions of Tax Compliance by SMEs and Tax Practitioners in New Zealand: A Divergent View?' (2020) 26(1) *New Zealand Journal of Taxation Law and Policy* 57.

the inception stage, or they do not apply the business structure to maximise the benefits, because they fail to obtain comprehensive advice.

Fewer entities

Complexity and compliance costs are two significant challenges for SMEs, and implementing a combination of structures for one business may lead to increased complexity and compliance costs.[108] To reduce the complexity and to mitigate the compliance costs associated with multiple entities, some advisers suggested having fewer entities (14 per cent):

> Well, you could have only one business trust instead of two, and you could have the building owned by the same business trust. You can have the building owned by the corporate entity; you can have that in the trust that runs the corporate beneficiary. You could also have the same one owning the building. That way you can reduce the number of trusts you've got. So, obviously doing all these, has a stamp duty cost … and so that might be cost prohibitive. So other than that, you can put it all in one entity to reduce the costs, the compliance cost, and the cost of maintenance (A27, Scenario One, New).

The trade-off between fewer entities and asset protection was echoed by A44 (Scenario Five, New) who said that some individuals may choose an individual trustee rather than a corporate trustee as an approach to mitigate the cost of registering and maintaining an additional entity. Although appointing an individual trustee may reduce costs, this should be balanced against any risks related to asset protection. Despite the complexity and compliance costs, most advisors appear to recommend multiple entities for the one business.[109]

4.3 Discussion

The inhibitors perceived by advisors for SMEs to restructure their business include transfer costs (CGT and stamp duty), establishment costs, client understanding, and complexity and compliance costs. Due to inadequate advice at inception, some SMEs may not have implemented the most appropriate business structure.

Significant transfer and administrative costs reported by advisors provide an explanation for the factors that may inhibit SMEs from restructuring. Research reveals that advisors perceived that most SMEs had not implemented appropriate business structures when commencing their business.[110] This may indicate the need for some of those SMEs, during their business lifecycle, to restructure their business to fully realise commercial benefits. Further, advisors indicated that transfer costs associated with restructuring an established business can be a major inhibitor to restructuring. It is these costs that may adversely impact the working capital of the business and cause business owners to feel 'trapped' with inappropriate structures.

A broad theme which emerged from the analysis is that CGT and stamp duty costs, being transfer costs, are major inhibitors to restructuring an established business. While some advisors perceived there could be some restructure roll-over relief available that

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[108] Trad et al, 'Reasons behind SME Advisor Business Structure Recommendations', above n 38.
[109] Trad et al, 'Choice of Australian Business Structures', above n 30.
[110] Trad et al, 'Small Business Restructure Roll-Over', above n 27.

may reduce or eliminate CGT cost, all agreed that there would be stamp duty cost if there are no relief concessions, which varies across States. However, some concessions are limited to small business entities and therefore not available to those medium businesses. Nevertheless, two divergent and often conflicting views emerged from the interviews – while some advisors indicated that there could be some concessions to relieve the CGT cost, others argued that the application of such concessions are uncertain and limited to small businesses, and that restructuring an established business involving valuable assets could have significant costs in CGT and stamp duty. These contentions are supported by observations of the Board of Taxation which stated that many practitioners identified that the SBRR is unlikely to apply to a restructure involving a combination of business structures – particularly a trading company with holding trust – which advisors consider the most advantageous business structure from both a tax and commercial perspective.[111] It appears that many SME advisors can recommend such a business structure.[112] As currently drafted, the SBRR does not apply to a sole trader converting to this combination of business structures,[113] nor does it apply to inserting a discretionary trust between a shareholder and a wholly-owned company,[114] because there are special rules about continuity of economic ownership for non-fixed trusts.[115] Consistent with the Board of Taxation's observations, concerns were expressed by advisors over unintentional structural issues in terms of applying the SBRR to the business most frequently recommended by advisors – a trading company with holding trust.[116] Furthermore, the inability of applying the SBRR to enable this restructure may inhibit business growth, which is contrary to one of the government's stated objectives for the SBRR.[117] Serious consideration about reforming the SBRR needs to be undertaken.[118]

From an SME advisor perspective, there were various techniques they used to reduce these inhibitors. This included the use of the existing concessions that could mitigate the CGT consequences of restructuring, such as the Division 115 CGT discount, Division 152, and the SBRR. These concessions are a key mechanism to reduce transfer costs as the restructure is not likely to occur otherwise.[119] The advisor discussion also supports the need for certainty on the application of the SSRR relief and its scope. Advisors also advocated for client education and seeking advice at the inception stage to reduce the complexity and the compliance costs associated with adopting a combination of structures, or by simply reducing the number of entities for one business to reduce complexity and compliance cost.

Overall, the analysis reported in this study illuminates factors perceived by advisors as inhibiting SMEs from restructuring and offers a rich description of the techniques which

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[111] Board of Taxation, *Review of Small Business Tax Concessions*, above n 88.
[112] Trad et al, 'Choice of Australian Business Structures', above n 30.
[113] Board of Taxation, *Review of Small Business Tax Concessions*, above n 88, Example 1, para 7.53. The SBRR does not apply to small business owners restructuring their business from a sole trader to an operating company owned by a discretionary trust.
[114] Ibid, Example 2, para 7.53.
[115] Trad et al, 'Small Business Restructure Roll-Over', above n 27.
[116] Ibid.
[117] Ibid.
[118] However, there can be contention as to whether the SBRR should be expanded beyond the 'continuity of economic ownership', as such economic ownership is used as an integrity measure for a number of tax provisions dealing with business structures, such as for the 'continuity of ownership' test for the carry forward rules for company losses: ITAA 1997, above n 28, s 165-150.
[119] Giancaspro et al, above n 47, 63.

advisors can use in reducing such inhibitors. The results demonstrate that for established businesses restructuring can be costly and time intensive, requiring the services of an advisor to recommend an ideal structure. The factors that could inhibit an ideal structure from being implemented, for the established SMEs, are the transfer costs mainly related to CGT and stamp duty, whereas for the new SMEs, the inhibitors are the advice and establishment costs. This can mean SME owners may adopt an inappropriate business structure, and then later encounter the same issues experienced by an 'established' business trying to restructure, with the potential of prohibitive transaction costs as described above.

The findings from this study are used to inform and formulate two recommendations set out in the next section.

5. RECOMMENDATIONS AND FUTURE RESEARCH

5.1 Recommendations

There are two recommendations formulated, focusing on advice and the restructuring provisions.

5.1.1 Incentivise advice

Previously, it has been argued that there is a need for incentives to encourage SMEs to seek advice at the inception stage of their business, which could be in the form of a tax rebate.[120] The findings from this research provide further evidence of why this initial advice about business structures is important.

Understanding the different types of business structures can be difficult and complex for a person wanting to start a business. This may raise concerns as to the extent to which business owners are equipped to face such challenges, and whether they can fully comprehend the different types of business structures, and/or meet their obligations in respect of the structures. The business structure affects the tax impost on the businesses' income and deductions, as well as the legal obligation to stakeholders including creditors, clients, employees, and government agencies such as the Australian Taxation Office (ATO) and the Australian Securities and Investments Commission (ASIC).

The legal complexity and consequences of business structures requires advice and education, especially at the inception stage of the business. Advisors in the study noted that the lack of extensive advice at the inception of a business was due to the initial cost of advice. In starting a business, funds can be limited, cash flow is critical and business owners may not be able to meet many of the unbudgeted costs that can impact cash flow and increase risk of business failure. Simply put, paying for a structure set-up and advice may be too onerous for the new SME business operator.

A unique finding, and a clear theme which emerged from analysing the interview data from the case study, was the importance of setting up the structure correctly at the inception stage of the business to avoid the cost and the complexity of changing the structure in the future, or the detrimental consequences of continuing to operate with an inappropriate structure. This would support the importance of advice as a preventative measure at the inception of the SME to minimise these risks. For this reason, and to

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[120] Trad et al, 'Small Business Restructure Roll-Over', above n 27, 143.

address the initial cost of advice, the Australian government could consider incentives to encourage SMEs at the inception stage to seek advice. For example, a tax offset (or inflated tax deduction)[121] to lower the cost of advice could be implemented. This could be aimed particularly at small businesses, as it is these businesses that could grow into medium (and large) businesses. In fact, a tax offset was one of the recommendations put forward by the Small Business Association of Australia, targeted at supporting and growing the capacity of Australian small businesses.[122]

Furthermore, a similar advice tax offset has been previously mooted for small business operators.[123] Seeking advice at the inception stage, and education about the implemented business structures and their obligations, are most likely to result in beneficial outcomes to business owners, the tax system, and to society overall. While there are currently some free services in place offered by government agencies (including the ATO) and business organisations to assist business owners to develop their skills,[124] the introduction of a tax offset may complement and encourage the use of these programs, as well as being a strong 'signal' to business owners of adopting good business habits.

A tax offset could be framed to assist SMEs in the crucial first three years of business operation. This three-year period could equip business owners with critical information and education concerning the implemented business structure and their obligations. For instance, in the first year of setting up a business, a tax offset could be offered, capped at AUD 5,000, for advice. The rebate for the first year could also include education concerning the implemented business structure and the obligations in terms of the structure. In the second year, a tax offset, capped at AUD 3,000, could be considered for further consultations concerning the appropriateness of the implemented business structure, and the business owner's competence in relation to understanding the structure and their obligations. A rebate of AUD 2,000 for the third year would be beneficial for further consultations and education related to the business structure if these were needed. In addition to business structure advice, business owners may seek advice in relation to business administration, managing cash flow, regulatory compliance, and tax compliance (including income tax, goods and services tax (GST), and superannuation). It is hoped that a period of three years of education and advice would be a good start to equip business owners towards achieving long-term commercial goals.

Eligibility for the rebate could cover advice from members of registered professional bodies and may require business owners to undertake a series of specific modules of study. These modules could be offered by professional bodies and provide education in accordance with each year that the offset is claimed. Furthermore, the Institute of

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[121] An inflated tax deduction could be set at 150 per cent or 200 per cent. This would mean that if a business spent $1,000 on eligible professional advice, the tax deduction (depending upon the inflation percentage) would be inflated to either $1,500 or $2,000.

[122] Small Business Association of Australia, *Capacity Building: Tax Reforms to Assist Australian Small Businesses* (Small Business Association of Australia, 2019).

[123] Brett Freudenberg, Binh Tran-Nam, Stewart Karlinsky and Ranjana Gupta, 'A Comparative Analysis of Tax Advisers' Perception of Small Business Tax Law Complexity: United States, Australia and New Zealand' (2012) 27(4) *Australian Tax Forum* 677; Yong and Freudenberg, above n 107.

[124] One such approach could be the National Tax Clinic Program which sees universities providing free services to the community (including small and micro businesses) through student tax clinics. See Brett Freudenberg, Colin Perryman, Kristin Thomas and Melissa Belle Isle, 'The Griffith Tax Clinic' (2020) 22(2) *Journal of Australian Taxation* 64.

Certified Bookkeepers, in its submission to the Board of Taxation, recommended that the eligibility for such tax offset could involve having an agent sign off on a Business Induction Program.[125] This type of tax expenditure early in the inception stage of a business might be better targeted than having tax concessions that apply later in the business cycle, which generally is how the small business tax concessions are currently drafted.[126] It is argued that by this stage, these concessions might be retrofitting, or fixing a problem that could have been prevented earlier.[127] To reduce tax expenditure costs for the government, existing small business concessions may be reduced or removed, as recommended by the Board of Taxation.[128]

5.1.2 Enhance restructuring provisions

The ability for established businesses to restructure needs to be considered. No structure is perfect, and circumstances can change. To facilitate the restructuring of an established business, certainty about the application of the concessions is essential. Otherwise, SMEs will continue operating with inappropriate structures, or potentially incur significant transfer costs which may jeopardise their working capital. The trade-off between the benefits of restructuring and the significance of transfer costs may remain a difficult decision for SME operators and advisors.

It appears that the factor of 'life cycle' of the business can influence the business structure.[129] For instance, it is common, when commencing a business, to start as a sole proprietor or as a partnership because owners may perceive less risk given that they are conducting most of the work and will be more assured of the work being done. However, when the business grows and needs to engage other workers, limited liability can then become a concern. For this reason, business owners may restructure to a trading company with holding trust (a common combination of structures), as a company structure may provide the owners with limited liability. Restructuring may not pose an issue if there are no valuable assets held in the business structure, but restructuring an established business involving valuable assets can be an issue because of the transfer costs (CGT and transfer stamp duty). At present, the SBRR does not apply to such a restructure to a trading company with holding trust.[130] This may result in SME operators adopting a less than ideal business structure, whereby the business and assets are exposed to financial risks, or alternatively the SME employs a partial restructure with valuable assets left in the original structure or large transaction costs are imposed even though the economic ownership is similar.

Furthermore, it is a concern that the SBRR does not apply to a sole trader restructuring to a trading company with holding trust, which can be the preferred business structure

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[125] Institute of Certified Bookkeepers, Submission to the Board of Taxation Review of Small Business Tax Concessions (17 July 2018) 4 <https://taxboard.gov.au/consultation/small-business-tax-concessions#submissions>.

[126] For example, Division 152 really only applies for a mature business, especially when a sale of the business is occurring.

[127] For example, using Division 152 as a pseudo restructure roll-over relief to reduce the transaction costs to restructure to a more appropriate business structure.

[128] Board of Taxation, *Review of Small Business Tax Concessions*, above n 88.

[129] Trad et al, 'Small Business Restructure Roll-Over', above n 27.

[130] There is also Subdivision 122-A which provides access to the CGT roll-over relief by a sole trader or a trustee on the disposal of business assets to a company, in which the business owner then owns all the shares in the company. This requires the shares to be owned by the business owner not by a trust.

recommended by SME advisors.[131] It is important for the SBRR relief to allow for this restructure, particularly if advisors consider that such a combination is the most ideal business structure for SMEs. This structure could offer limited liability and access to the lower company tax rate, with the discretionary trust as a shareholder offering an extra layer of asset protection, as well as some flexibility with income splitting among beneficiaries. Therefore, to promote and assist small businesses to adopt a preferred structure, it is recommended that the scope of such roll-over provision be extended to restructuring that involves trading companies owned by discretionary trusts. Concerns about revenue leakage and integrity could be addressed by limiting the availability of relief to discretionary trusts that have made family trust elections. It is acknowledged that 'medium' SMEs would not be able to access the SBRR, and for this reason future research and deliberation about extending the SBRR to all SME operators is worthy of consideration.

5.2 Limitations of research and future research

The study reported in this article is subject to several limitations. The interview sample was skewed towards SME advisors based in Queensland compared to other States – 31 out of 48 advisors (65 per cent) lived in Queensland. Although there may be some jurisdictional differences such as stamp duty, the SME environment (and its associated issues) is relatively consistent across States. For example, business structure and tax regulation are similar or the same in each State. However, it needs to be acknowledged that there may be some regional trends, with some firms recommending certain structures, or having alternative positions on the interpretation of the tax law. While this might be the case, the advisors in this study did come from a broad range of firms. While there was a selective distribution of the scenarios to the advisors amongst accountants and lawyers, and according to regions, several lawyers had indicated a willingness to participate in the study, but after a scenario was allocated to them, they no longer wanted to participate. As a consequence there were more accountants than lawyers, and Scenario Four (new) was only considered by Queensland advisors.

While there was a variety of case studies, including different industries, there were only six scenarios used. It could be that alternative client scenarios may generate other factors.[132] A limitation of the hypothetical business scenarios is that advisors are likely to require extra information about the clients when seeking to restructure their business – more than the one page of information provided in the scenarios. For instance, some advisors required more background documentation, asset registers, general ledgers, profit and loss statements and balance sheets, signed financial statements, income tax returns, all leases and licences of any properties owned by the trustee, Business Activity Statements (BAS), Running Balance Account (GST, PAYG and income tax) and any recent market appraisals of the property by a registered valuer. To address this limitation, the interviewer clarified any issues raised during the interviews. If advisors asked for more information or clarification, the lead researcher (the interviewer) ensured that these were consistent between interviews.

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[131] Trad et al, 'Choice of Australian Business Structures', above n 30.

[132] Another limitation was that due to COVID-19 restrictions, all the interviews were conducted online, instead of in person. It is considered that this has not posed any significant impact for the interviews or for data collection. In fact, the online interviews aided the conduct of the research in that it reduced costs and enabled the collection of data from a richer sample of advisors.

Stamp duty was identified as a particular transaction cost that could be problematic to mitigate and which might stop assets from being transferred as part of a restructure. Stamp duty on business transfers was supposed to be removed after five years from the introduction of the GST,[133] but due to fiscal constraints the political motivation for this reform appeared to stall. However, the Queensland government introduced an exemption for small business restructures, which is available for small business owners who restructure their business on or after 7 September 2020 by transferring assets from a sole trader, partnership or discretionary trust structure to a company structure.[134] Under this exemption business owners may be eligible for either a full or partial duty exemption on the transfer, but this is limited to entities with less than AUD 5 million turnover.[135] However, it is not clear to what extent this would apply to a discretionary trust holding shares in a trading company. Future research could focus on how stamp duty is an inhibitor of business growth, and potentially consider its removal or replacement.

Research could also be conducted on the application of the SBRR relief, as advisors can be reluctant to use it.[136] The research could test to what extent advisors are aware of this provision, as well as an analysis of the cases where the application of SBRR was sought. This relief is important as it could aid the ability for SMEs to restructure. Future research could also survey SME owners, as the unit of study, about their considerations relating to their initial adoption of business structures and what their considerations are about restructuring. This could include the extent SME owners understand their business structure in terms of both regulatory and tax implications, referred to as business structure literacy. Additionally, research could consider if there are differences, between the different sizes of micro, small and medium businesses, in terms of the inhibitors for business structuring. Future research could also test the inherent conflict for advisors who recommend complex business structures that could result in greater initial fees and ongoing annual fees for advisors, and whether the advantages for clients outweigh these additional costs.

Research could also consider some themes that were not mentioned frequently to prompt advisors as to their relevance or not. This might explore such issues as the personal services income provisions, non-commercial losses, payroll tax and franchisor requirements.

6. CONCLUSION

Selecting an appropriate business structure is a complex task, with a range of possibilities. Once chosen, this will have varying implications for a business and the way it operates, including legal obligations and how tax is imposed. John Taylor’s research revealed different tax outcomes and uncertainty, particularly for companies and trusts. For SMEs at inception, they may not adopt the most ideal business structure, or due to changing circumstances their structure may no longer be suitable. This can mean that at some point during the business life cycle there could be a need for the SME to restructure.

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[133] Australian Treasury, *Tax Reform: Not a New Tax, a New Tax System* (1998).

[134] Queensland Revenue Office, ‘Exemption for Small Business Restructures’ (last updated 31 July 2024) <https://qro.qld.gov.au/duties/investors/business/restructure/>.

[135] Ibid.

[136] Trad et al, ‘Small Business Restructure Roll-Over’, above n 27.

This article reported on a case study that sought to provide insights into the factors that may inhibit SMEs from implementing the ideal business structure recommended by advisors. The results indicate that advisors considered transfer costs (CGT and stamp duty) as a frequently mentioned inhibitor to restructuring an established business; other factors were administrative costs and complexity of adopting multiple entities for the one business. In addition, advisors offered techniques aimed at reducing such inhibitors and assisting SMEs in restructuring their current business, or in implementing a new structure at the inception stage. The advisors suggested that some of the existing concessions could assist in alleviating the burden of transfer costs, such as the SBRR, but there were some criticisms about the uncertainty of its application. Stamp duty may be another significant transfer cost in the absence of concession, which is dependent on the State the business operates in. Client education, seeking advice, and reducing the number of entities adopted by a single business were some of the techniques used by advisors to lessen the burden of complexity and compliance costs. These results highlight the importance of setting up the business structure correctly from the inception stage to avoid the complexity and costs of later restructuring.

It is hoped that these findings assist SMEs to appreciate the benefits of obtaining advice in terms of implementing a business structure at the inception stage, that may prevent the need to restructure. The findings could also assist the government in implementing policy changes to the taxation of business structures, which could assist the SME sector to realise the benefit of adopting an ideal business structure, a structure that maximises business opportunities and minimises the risks for SMEs.

7. APPENDIX

Table 2: Demographics of SME Advisors

Code	Scenario considered	Type of advisor	Advisor Years	State	Current position	Clients' business size ($)	Frequency of advice /year	Area of practice
A1	One est.	Accountant	>15	Victoria	Partner/Principal	10m–<100m	>20	Specialist tax consultant
A2	One est.	Accountant	>15	Queensland	Partner	500,000–<2m	2–5	Taxation and business advisory services
A3	One new	Accountant	10–15	Queensland	Director	500,000–<2m	>20	Tax advice
A4	One new	Lawyer	>15	Victoria	Partner/Principal	10m–<100m	6–10	Private taxation and succession
A5	Two est.	Lawyer	>15	Queensland	Principal	2m–<5m	1	Tax advice/tax disputes
A6	Two est.	Accountant	>15	Queensland	Partner	10m–<100m	>20	Income tax, FBT and superannuation
A7	Two new	Lawyer	>15	Queensland	Partner	10m– <100m	>20	Tax restructuring
A8	Two new	Lawyer	>15	Queensland	Partner	5m–<10m	11–20	Commercial transaction
A9	Three est.	Accountant	>15	Queensland	Partner	10m– <100m	>20	Corporate tax
A10	Three est.	Lawyer	10–15	Queensland	Partner	500,000–<2m	>20	Commercial litigation and insolvency
A11	Three new	Accountant	>15	Queensland	Principal	500,000–<2m	>20	Specialist tax advisor
A12	Three new	Accountant	>15	Queensland	Partner	2m–<5m	>20	Business and taxation advisor
A13	Four est.	Accountant	10–15	Queensland	Partner	10m–<100m	6–10	Tax advisor
A14	Four est.	Accountant	5–10	Queensland	Senior	500,000–<2m	2–5	Accounting for small businesses
A15	Four new	Accountant	>15	Queensland	Principal	10m–<100m	>20	SME structuring
A16	Four new	Accountant	>15	Queensland	Partner	10m–<100m	>20	Corporate and international tax
A17	Five est.	Lawyer	>15	Queensland	Partner	10m–<100m	>20	Taxation and restructuring of SMEs
A18	Five est.	Accountant	>15	Queensland	Partner	500,000–<100m	>20	SME tax advisor
A19	Five new	Accountant	>15	Queensland	Partner	10m–<100m	6–10	Business advice tax strategy
A20	Five new	Accountant	>15	Queensland	Partner	2m–<5m	2–5	Tax advisor
A21	Six est.	Lawyer	10–15	Western Aust.	Partner	5m–<10m	>20	Tax lawyer
A22	Six est.	Accountant	5–10	Queensland	Senior	5m–<10m	1	Tax and business advisory
A23	Six new	Lawyer	>15	Queensland	Partner	5m–<10m	>20	Tax advisory, structuring, commercial
A24	Six new	Accountant	10–15	Western Aust	Principal	500,000–<5m	2–5	Tax and business advisor
A25	One est.	Lawyer	>15	Qld (all states)	Sole Practitioner	2m–<5m	>20	Family/SME business structuring
A26	One est.	Tax advisor	5–10	Western Aust.	Manager	5m–<10m	11–20	Tax consulting on transactions
A27	One new	Accountant	>15	Victoria	Partner	500 k to <100m	1	Accounting and taxation
A28	One new	Accountant	>15	Victoria	Partner	10m–<100m	>20	Tax technical area
A29	Two est.	Lawyer	>15	NSW	Special Counsel	10m–<100m	>20	Taxation and Superannuation

A30	Two est.	Lawyer	>15	NSW	Partner	10m–<100m	6–10	Corporate taxation (inc disputes)
A31	Two new	Accountant	>15	Queensland	Director	500,000–<2m	>20	Taxation and financial statements
A32	Two new	Accountant	>15	Queensland	Partner	500,000–<2m	>20	Taxation and small business advisory
A33	Three est.	Accountant	5–10	Queensland	Manager	500,000–<100m	2–5	Business service and tax
A34	Three est.	Accountant	>15	Tasmania	Sole Practitioner	500,000–<2m	2–5	Small business tax
A35	Three new	Lawyer	>15	Western Aust.	Principal	2m–<5m	6–10	Succession planning
A36	Three new	Lawyer	>15	Queensland	Principal Director	5m–<100m	>20	Tax specialist
A37	Four est.	Advisor	10–15	South	Sub-contractor	2m–<5m	1	Business effectiveness and marketing
A38	Four est.	Accountant	10–15	Victoria	Manager	2m–<5m	>20	Tax advice
A39	Four new	Lawyer	>15	Queensland	Partner	5m–<10m	>20	Estate and succession planning
A40	Four new	Lawyer	>15	Queensland	Partner	10m–<100m	11–20	Legal structuring, tax, asset protection
A41	Five est.	Accountant	>15	NSW	Partner	2m–<100m	6–10	Business structures and cost cutting
A42	Five est.	Accountant	10–15	Queensland	Partner	500,000–<2m	>20	SME strategy, risk and governance
A43	Five new	Accountant	>15	Western Aust	Partner	5m–<10m	>20	Tax and accounting consultant
A44	Five new	Accountant	5–10	NSW	Manager	500,000–<100m	11–20	Income tax for private clients
A45	Six est.	Consultant	5–10	Queensland	Self-employed	2m–<5m	1	Domestic and international tax
A46	Six est.	Accountant	>15	Queensland	Manager	2m–<5m	>20	Tax and business advisory
A47	Six new	Consultant	>15	Queensland	Consultant	5m–<10m	>20	Consulting services to CFOs
A48	Six new	Accountant	10–15	NSW	Manager	10m–<100m	>20	Income tax specialist

Table 3: Inhibitors to Adopting Recommended Business Structure

Status of business	Advisors	Scenario	Recommended Structure			Inhibitors to adopting									
			Trading Co + disc trust	Trading Disc trust + corp. trustee	Consolidated Group held by Disc. trust	None	Est. Cost	Transfer Costs		Land tax	Lease	Bank account	Employees	Client understandin g	Complexity & compliance costs
								CGT	Stamp Duty						
Established scenarios	A1	Scenario One	✓					✓	✓						
	A2	Scenario One	✓					✓	✓						
	A25	Scenario One	✓					✓	✓					✓	
	A26	Scenario One	✓					✓	✓						
	A5	Scenario Two	✓				✓								✓
	A6	Scenario Two	✓					✓	✓						
	A29	Scenario Two		✓				✓	✓		✓	✓	✓		✓
	A30	Scenario Two	✓				✓							✓	✓
	A9	Scenario Three	✓					✓	✓						
	A10	Scenario Three	✓											✓	
	A33	Scenario Three	✓	✓			✓								
	A34	Scenario Three	✓			✓									
	A13	Scenario Four		✓		✓									
	A14	Scenario Four			✓		✓								✓
	A37	Scenario Four	✓					✓							
	A38	Scenario Four			✓			✓	✓						
	A17	Scenario Five	✓					✓	✓						
	A18	Scenario Five	✓				✓							✓	
	A41	Scenario Five	✓					✓	✓	✓					
	A42	Scenario Five	✓				✓	✓	✓		✓	✓	✓		
	A21	Scenario Six	✓					✓	✓						
	A22	Scenario Six	✓					✓	✓						
	A45	Scenario Six		✓				✓	✓						
	A46	Scenario Six	✓					✓	✓						
	Total Est		19	4	2	2	6	16	15	1	2	2	2	4	4
	Est. %		79%	17%	8%	8%	25%	67%	62.5%	4%	8%	8%	8%	17%	17%

Status of business	**Advisors**	**Scenario**	**Recommended Structure**			**Inhibitors to adopting**									
			Trading Co + disc trust	**Trading Disc trust + corp. trustee**	**Consolidated Group held by Disc. trust**	**None**	**Establishment Cost**	**Transfer Costs**		**Land tax**	**Lease**	**Bank account**	**Employees**	**Client understanding**	**Complexity & compliance costs**
								CGT	**Stamp Duty**						
New scenarios	A3	Scenario One		✓			✓								
	A4	Scenario One		✓		✓									
	A27	Scenario One		✓					✓						✓
	A28	Scenario One	✓			✓									
	A7	Scenario Two	✓	✓										✓	
	A8	Scenario Two		✓										✓	
	A31	Scenario Two		✓			✓								✓
	A32	Scenario Two		✓										✓	
	A11	Scenario Three	✓				✓								
	A12	Scenario Three	✓			✓									
	A35	Scenario Three	✓				✓								
	A36	Scenario Three	✓											✓	
	A15	Scenario Four			✓	✓									
	A16	Scenario Four			✓	✓									
	A39	Scenario Four			✓		✓								
	A40	Scenario Four			✓			✓	✓						
	A19	Scenario Five	✓			✓									
	A20	Scenario Five	✓				✓							✓	
	A43	Scenario Five	✓			✓									
	A44	Scenario Five	✓				✓								✓
	A23	Scenario Six	✓												
	A24	Scenario Six	✓												
	A47	Scenario Six	Co.*											✓	
	A48	Scenario Six			✓									✓	✓
	Total New		12	7	5	7	7	1	2	0	0	0	0	7	4
	New %		50%	30%	21%	29%	29%	4%	8%	0%	0%	0%	0%	29%	17%
Overall total (new and established)			30	10	7	9	13	17	17	1	2	2	2	11	8
Overall % (new and established)			62.5%	21%	14.5%	19%	27%	35%	35%	4%	4%	4%	4%	23%	17%

Table 4: Reducing Inhibitors for Business Restructure

Advisors	Client education	Benefit of advice	Div 152 CGT Conc	Subdivision 328-G SBRR	No change to property ownership	Fewer entities	Subdivision 122-A	Div 115 50% discount	Subdivision 122-B
A1 (Scenario One: Est.)			✓	✓					
A2 (Scenario One: Est.)			✓						
A25(Scenario One: Est.)				✓					
A26(Scenario One: Est.)			✓						
A5 (Scenario Two: Est.)		✓							
A6 (Scenario Two: Est.)			✓	✓					
A29 (Scenario Two: Est.)			✓	✓					✓
A30 (Scenario Two: Est.)		✓							
A9 (Scenario Three: Est.)			✓					✓	
A10 (Scenario Three: Est.)		✓							
A33 (Scenario Three: Est.)		✓							
A34 (Scenario Three: Est.)	None reported								
A13 (Scenario Four: Est.)	None reported								
A14 (Scenario Four: Est.)	✓	✓							
A37 (Scenario Four: Est.)	✓								
A38 (Scenario Four: Est.)					✓		✓		
A17 (Scenario Five: Est.)			✓						
A18 (Scenario Five: Est.)	✓								
A41 (Scenario Five: Est.)					✓				
A42 (Scenario Five: Est.)					✓				
A21 (Scenario Six: Est.)			✓						
A22 (Scenario Six: Est.)			✓						
A45 (Scenario Six: Est.)				✓					
A46 (Scenario Six: Est.)		✓							
Total Est	3	6	9	5	3	0	1	1	1
Total Est. % (reporting inhibitors)	14%	29%	43%	24%	14%	0%	5%	5%	5%

A3 (Scenario One: New)			✓						
A4 (Scenario One: New)	None reported								
A27 (Scenario One: New)						✓	✓		
A28 (Scenario One: New)	None reported								
A7 (Scenario Two: New)		✓							
A8 (Scenario Two: New)		✓							
A31 (Scenario Two: New)	✓		✓						
A32(Scenario Two: New)	✓								
A11 (Scenario Three: New)	None reported								
A12 (Scenario Three: New)	None reported								
A35 (Scenario Three: New)	✓								
A36 (Scenario Three: New)	✓								
A15 (Scenario Four: New)	None reported								
A16 (Scenario Four: New)		✓							
A39 (Scenario Four: New)	✓	✓							
A40 (Scenario Four: New)							✓		
A19 (Scenario Five: New)	None reported								
A20 (Scenario Five: New)	✓								
A43 (Scenario Five: New)	None reported								
A44 (Scenario Five: New)	✓					✓	✓		
A23 (Scenario Six: New)	None reported								
A24 (Scenario Six: New)	None reported								
A47 (Scenario Six: New)		✓							
A48 (Scenario Six: New)	✓								
Total New	8	5	2	0	0	2	3	0	0
Total New % (reporting inhibitors)	57%	36%	14%	0%	0%	14%	20%	0%	0%
Overall Total	**11**	**11**	**11**	**5**	**3**	**2**	**4**	**1**	**1**
Overall Percentage (for those reporting inhibitors)	**30%**	**30%**	**30%**	**14%**	**8%**	**6%**	**11%**	**3%**	**3%**
% excludes those advisors who did not report any reducing inhibitors: 2 for Established & 9 for New									

eJournal of Tax Research (2024) vol. 22, no. 2, pp. 385-416

A co-operative approach to taxation: the application of business taxation to socially oriented co-operative entities in Australia

Sally-Ann Joseph[*]

Abstract

Co-operatives are business entities owned by their members and governed democratically with a view to providing benefits for their members and communities. Not driven by the need to maximise short-term profitability, they tend to have a long-term view of business, serving both economic and social needs. With a legal regime that differs from that of commercial, capital-based companies and a philosophy and purpose that are socially focused and community based, the question arises: how are co-operatives taxed in Australia? This article exposes a regime that is fragmented, ambiguous, inconsistent and complex in its application. Tax policy will become increasingly important as co-operatives, as a business model, increase.

This article was inspired by Emeritus Professor John Taylor's contribution to the literature on the taxation of business entities, including his work related to this topic.

Keywords: co-operative; mutuality; mutual income; non-profit company; not-for-profit; patronage rebates; social economy

[*] Adjunct Associate Professor, School of Accounting, Auditing and Taxation, UNSW Sydney. Email: sally-ann.joseph@unsw.edu.au.

1. INTRODUCTION

On 14 March 1761, in Fenwick, East Ayrshire, Scotland, a group of local weavers dismayed at the downturn in weaving and wanting to help their neighbours by providing access to cheap food, dragged a sack of oatmeal into the front room of a barely furnished cottage and began selling the contents at a discount. The Fenwick Weavers' Society is considered to be the earliest known co-operative in the world for which full records exist.[1]

What began as sharing equipment such as looms and raw materials within the weaving industry progressed to buying food in bulk to be sold to members and non-members at a good price, including on credit to members.[2] This concept of credit developed into lending small amounts of money to the families of its members making it the first recorded credit union or community-based bank. In 1808 funds were used to buy books and a library for the local community was founded. It also saw an 'emigration society' established to help members relocate abroad to take advantage of opportunities elsewhere. A victim of its own success, the Fenwick Weavers' Society collapsed in 1873 when the population of Fenwick dropped from 2,000 to 500 people, partly due to the society's emigration support program.[3] Today, the co-operative movement has hundreds of millions of members worldwide.

A co-operative is an incorporated entity designed to serve the interests of its members.[4] As a people-centred enterprise, it is 'owned, controlled and run by and for their members to realise their common economic, social, and cultural needs and aspirations'.[5] The Co-operatives National Law of the Australian States and Territories mirrors many of the key provisions of the *Corporations Act 2001* (Cth) and directly applies other provisions. Both laws share a number of characteristics including separate legal personality, limited liability and the right to raise capital from the public in some circumstances. However, there are also differences such as, in a co-operative, a share represents membership not equity and a co-operative exists to promote member value not capital growth.[6] Further, a co-operative is an 'excluded matter' for the purposes of the *Corporations Act 2001* (Cth)[7] meaning that the Act does not apply other than in limited circumstances[8] or where the State or Territory legislation includes a declaratory provision for the inclusion of a specific provision.

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[1] National Library of Scotland, 'Fenwick Weavers' Society Foundation Charter, 1761' (Web Page) <https://www.nls.uk/learning-zone/politics-and-society/labour-history/fenwick-weavers/>.

[2] Johan Crawford, 'The Community Library in Scottish History' (2002) 28(5-6) *IFLA Journal* 245; John McFadzean, *The Co-operators – A History of the Fenwick Weavers* (East Ayrshire North Communities Federation Ltd, 2008).

[3] The Fenwick Weavers' Society was reconvened in March 2008.

[4] Australian Government, 'Co-operative', *Business.gov.au* (Web Page) <https://business.gov.au/planning/business-structures-and-types/business-structures/co-operative>. This website is described as 'a whole-of-government website for the Australian business community'. Co-operatives may also be unincorporated.

[5] International Cooperative Alliance, 'What Is a Cooperative?' (Web Page) <https://ica.coop/en/cooperatives/what-is-a-cooperative>.

[6] For a discussion on the differences between a co-operative and a company, see Ann Apps, 'Legislating for Co-operative Identity: The New Co-operatives National Law in Australia' (2016) 34(1) *Company and Securities Law Journal* 6 ('Legislating for Co-operative Identity').

[7] See for example s 12(1) of the Appendix to the *Co-operatives (Adoption of National Law) Act 2012* (NSW) being the Co-operatives National Law (CNL) template.

[8] *Corporations Act 2001* (Cth) s 5F(2).

Although co-operatives can do what other business entities do, they differ in structure, philosophy and purpose. These significant differences pose particular challenges, including in their taxation where some co-operatives are income tax exempt while others are not.

This article is structured as follows. Section 2 considers the prevalence of co-operatives, both domestically and internationally. A basic understanding of co-operatives is provided in section 3 where co-operatives are considered in terms of business structure, as a business entity and their regulation. This provides context for the discussion and analysis that follow. Section 4 considers the taxation of co-operatives. The section commences with a discussion of the approaches to the taxation of co-operatives and the preferential treatment they may be afforded, followed by an analysis of the taxation of co-operatives in Australia and international comparisons. Section 5 concludes.

2. THE THIRD SECTOR AND CO-OPERATIVES

Business enterprises are usually classified according to two discrete criteria: ownership (public or private) and objectives or purposes (for-profit or not-for-profit). The environment in which these enterprises operate can be separated into three sectors. The first sector consists of the public sector comprising central and local governments and their agencies while the private (or non-government), for-profit sector makes up the second sector. Here, 'for-profit' refers to a profit motive being the predominant objective. The third sector is an area that lies between the private business sector and government, between the market and the state.[9] It comprises various organisations such as charities, associations, clubs, societies, unions, foundations, mutuals and not-for-profit co-operatives.[10] It is a sector that is referred to as not-for-profit (or non-profit), the social economy or even civil society. While their objective may be to provide goods or services which may produce profits, this is achieved through collective action for a predominantly non-profit motive. That is, the difference between the second and third sectors is not so much in the type of activity, but rather in its purpose and in the way it is carried out.[11]

This is not to say that third sector organisations do not engage in trade. Many not-for-profit co-operatives and mutuals do. While co-operatives are a type of mutual entity, the major difference between co-operatives and other types of mutual entities is that co-operatives subscribe to the seven principles of the International Co-operative Alliance.[12] However, data on these two entity forms are usually amassed making analysis of co-operatives, as a distinct business entity type, difficult. Mutual entities are found predominantly in the financial sector and include banks, mutual investment funds,

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[9] Paul Krugman, 'Cooperating for a Better Future' (2023) 107 *CIRIEC-España, Revista de Economía Pública, Social y Cooperativa* 5; Annette Zimmer and Benedikt Pahl, 'Barriers to Third Sector Development' in Bernard Enjolras et al, *The Third Sector as a Renewable Resource for Europe: Concepts, Impacts, Challenges and Opportunities* (Palgrave Macmillan, 2018) 125.

[10] Mark Lyons and Andrew Passey, 'Need Public Policy Ignore the Third Sector? Government Policy in Australia and the United Kingdom' (2006) 65(3) *Australian Journal of Public Administration* 90.

[11] Juan José Hinojosa Torralvo, 'European Taxation of Cooperatives: An Examination of the Possibilities Offered by the New Concept of Limited Profitability' (2022) 4 *International Journal of Cooperative Law* 64, 74.

[12] Australian Parliament, Senate Economics References Committee, *Cooperative, Mutual and Member-Owned Firms* (Report, March 2016) [2.6]; UK Parliament, House of Commons, Communities and Local Government Committee, *Mutual and Co-operative Approaches to Delivering Local Services* (Fifth Report of Session 2012–13, HC 112, 21 November 2012) [2.10].

superannuation funds, credit unions and insurance companies. They also dominate health insurers (eg, HCF, Australian Unity) and motoring organisations (eg, RACV, NRMA). They also tend to dominate the data and statistics.[13]

2.1 Co-operatives in Australia

In Australia, co-operatives operate in a diverse range of sectors including agriculture, arts, child care, communications, community services, education, energy, finance, hardware, health care, housing, radio broadcasting, fishing, manufacturing, retail, superannuation funds, transport and wine sales.[14] It has been claimed that eight in every 10 Australians are members of a co-operative or mutually owned enterprise.[15] This survey, conducted by the Australia Institute, included automobile clubs that are often, but not always, co-operatives or mutuals.

The largest co-operatives by gross annual turnover are in the wholesale and retail trade industries, predominantly in agribusiness. For example, Co-operative Bulk Handling Ltd (CBH Group), a grain growers' co-operative that handles, markets and processes grain from the wheatbelt of Western Australia and includes the operation of four port terminals, had revenue of AUD 6.22 billion in the 2021-22 financial year.[16] Figure 1 depicts the top 20 Australian co-operatives in terms of gross annual turnover for the 2021-22 year. The majority (11) are in the wholesale industry, followed by retail (5), manufacturing (3) and childcare (1). That only 14 co-operatives had gross annual turnover exceeding AUD 100 million indicates that co-operatives may be a preferred structure for smaller entities.

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[13] See generally Business Council of Co-operatives and Mutuals, *2023 National Mutual Economy Report, Incorporating the Top 100 Co-operatives and Mutuals* (2023) ('*2023 National Mutual Economy Report*'); Co-operative Development Services Ltd, 'Top 20 Australian Co-operatives', *Australian Co-operative Links* (Web Page, September 2023) <https://www.coopdevelopment.org.au/topcoopsau.html>.

[14] For a history of co-operatives in Australia see Nikola Balnave and Greg Patmore, 'The History of Co-operatives in Australia' in Australian Bureau of Statistics (ABS), *Year Book Australia, 2012* (Catalogue No 1301.0, 24 May 2012).

[15] Richard Denniss and David Baker, *Who Knew Australians Were So Co-operative? The Size and Scope of Mutually Owned Co-ops in Australia* (The Australia Institute, October 2012) <https://australiainstitute.org.au/report/who-knew-australians-were-so-co-operative-the-size-and-scope-of-mutually-owned-co-ops-in-australia/>.

[16] Business Council of Co-operatives and Mutuals, *2023 National Mutual Economy Report*, above n 13, 23. CBH Ltd was retrospectively endorsed as a charitable institution with effect from 1 July 2000: CBH Group, *90 Harvests Strong: Annual Report 2023*, Notes to the consolidated financial statements, 88. Australian Charities and Not-for-profits Commission (ACNC), 'Co-operative Bulk Handling Limited' (Charity Register) <https://www.acnc.gov.au/charity/charities/b9ef6be7-39af-e811-a95e-000d3ad24c60/profile>.

Fig. 1: Top 20 Australian Co-operatives by Gross Annual Turnover (2021-22)

$1billion+	$1bn - $500m	$500m - $100m	$100m - $50m	$50m - $30m

	Name of Co-operative	Industry	State
1	Co-operative Bulk Handling Ltd	Wholesale	WA
2	Norco Co-operative Ltd	Manufacturing	NSW
3	Western Australian Meat Marketing Co-operative Ltd	Wholesale	WA
4	Independent Liquor Group Distribution Co-operative Ltd	Wholesale	NSW
5	Independent Liquor Group (Suppliers) Co-operative Ltd	Wholesale	NSW
6	Geraldton Fishermen's Co-operative Ltd	Wholesale	WA
7	Oz Group Co-op Ltd	Wholesale	NSW
8	Northern Co-operative Meat Company Ltd	Manufacturing	NSW
9	Yenda Producers Co-operative Society Ltd	Retail	NSW
10	Plumbers Supplies Co-operative Ltd	Wholesale	NSW
11	New South Wales Sugar Milling Co-operative Ltd	Manufacturing	NSW
12	Hastings Co-operative Ltd	Retail	NSW
13	Victorian Aboriginal Child Care Agency Co-operative Ltd	Child Care	Vic
14	CCW Co-operative Ltd	Wholesale	SA
15	Tasmanian Independent Retailers Co-operative Society Ltd	Wholesale	Tas
16	Dairy Farmers Milk Co-operative Ltd	Wholesale	NSW
17	Master Butchers Co-operative Ltd	Wholesale	SA
18	The Community Co-operative Store (Nuriootpa) Ltd	Retail	SA
19	N.Q. Co-op Ltd	Retail	Qld
20	Mount Barker Co-operative Ltd	Retail	WA

Source: Co-operative Development Services Ltd (2023), 'Top 20 Australian Co-operatives', *Australian Co-operative Links* (Web Page, September 2023) <https://www.coopdevelopment.org.au/topcoopsau.html>.

Statistics on co-operatives in Australia are lacking. A feature article on co-operatives in the Australian economy and society was included in the Australian Bureau of Statistics (ABS) 2012 *Year Book*, with 2012 being the United Nations International Year of Co-operatives[17] but there has not been much research or discussion since then. There has, until very recently when the Commonwealth government added co-operatives to the types of business structures on the business.gov.au website, been a lack of recognition of 'co-operatives' as a type of entity, for example, by the ABS. Co-operatives were classified as other types of entities, including 'Australian public company', 'Other

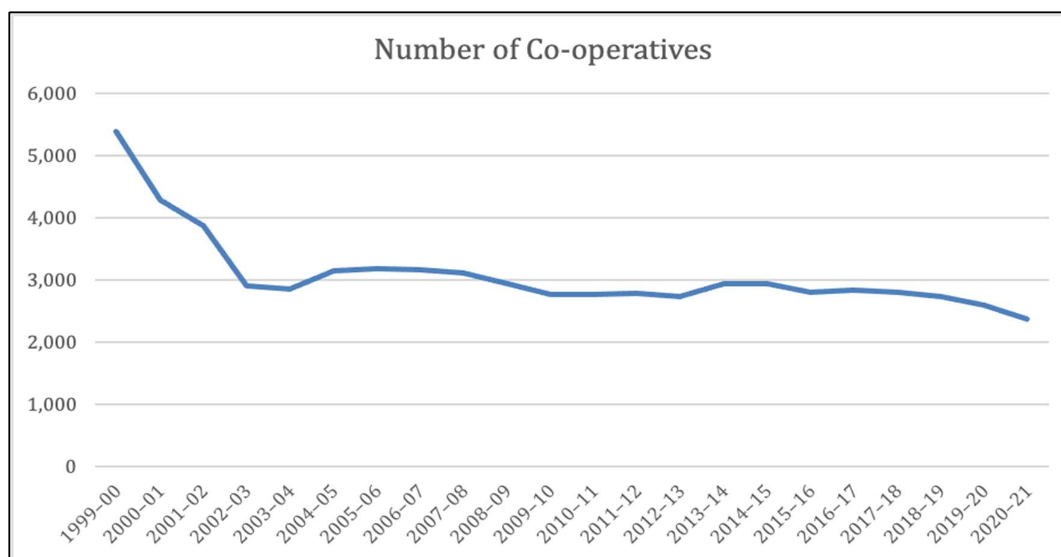
[17] ABS, *Year Book Australia, 2012*, above n 14. Note this was the last year the ABS produced Year Books.

incorporated entity' and 'Other unincorporated entity' on the Australian Business Register.[18] The ABS Business Register is based on these entity types with the consequence that co-operatives cannot be reliably captured in ABS business surveys.

Tax data on co-operatives is also lacking. Since the 2012-13 income year, co-operatives have been relegated to the 'other' category in the tax statistics, along with non-profit, strata title and similar entities. But, as 'co-operative' is a recognised business form on the company tax return, the Australian Taxation Office's (ATO) statistics do capture the number of co-operatives on an annual basis. In addition, there are discrepancies between the ATO's statistics and the (few) statistics provided by the ABS. The ABS reports 2,350 registered co-operatives in 2000 and 1,700 in 2012.[19] The ATO reported 5,380 in 1999-2000 and 2,775 in 2011-12.[20]

Nevertheless, from the data available, it would appear that the number of co-operatives in Australia has been declining. Figure 2 shows the number of entitles that have classified themselves as 'co-operative' in their income tax returns.[21]

Fig. 2: Number of Co-operatives in Australia (Income Tax Returns 1999-2000 to 2020-21)



Source: Adapted from ATO, *Taxation Statistics 2020-21* (2023) Companies: Selected Items, for income years 1980-81 to 2020-21, Table 1A.

[18] Ibid. See also Business Council of Co-operatives and Mutuals, BCCM Federal Budget Submission 2019/20 (February 2019). Each co-operative has to update their ABN in order to change the entity status on the register.
[19] ABS, above n 14.
[20] Australian Taxation Office (ATO), *Taxation Statistics 2020-21* (2023) Company Detailed Tables, Table 1 <https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/taxation-statistics/taxation-statistics-previous-editions/taxation-statistics-2020-21/statistics/company-statistics?anchor=Companies#ato-Companydetailedtables>.
[21] Ibid.

This decrease in numbers could be due to restrictions and additional compliance costs in the regulatory environment (discussed in section 3.3) and/or a lack of understanding, training and support for the sector.[22] Alternatively, or in addition, increased demutualisation may be a contributing factor. This could result from members cashing in on strong balance sheet growth or a change in business structure, or be the result of an ageing and diminishing membership.[23] Yet equally it is open for member-owned organisations that embrace co-operative principles to opt to register under the *Corporations Act* 2001 (Cth) instead of the relevant State or Territory co-operative laws. While State and Territory co-operative laws are now 'uniform', the lack of national legislation may be a contributing factor to the decline in numbers.

The Business Council of Co-operatives and Mutuals reports that, during the 2019-20 financial year, Australia's co-operatives and other mutuals (excluding superannuation funds) had a combined turnover of more than AUD 35.3 billion with an active membership exceeding 31.1 million, increasing to AUD 40.4 billion and 33.3 million respectively in 2021-22.[24] These numbers are not insignificant.

2.2 Co-operatives internationally

Due to the lack of cohesive reporting, international statistics should be considered as suggestive only. Nevertheless, they are indicative of a substantial form of business enterprise.

There are estimated to be 3 million co-operatives and other mutuals globally, with a membership exceeding 1 billion,[25] or 'more than 12% of humanity'.[26] In New Zealand, Canada and France, around 40 per cent of their population are members of a co-operative with Finland and Singapore even higher.[27] Co-operatives therefore contribute significantly to national economies, through economic activity and employment. The global spread of numbers of co-operatives and members as at 2018 is depicted in Figure 3.

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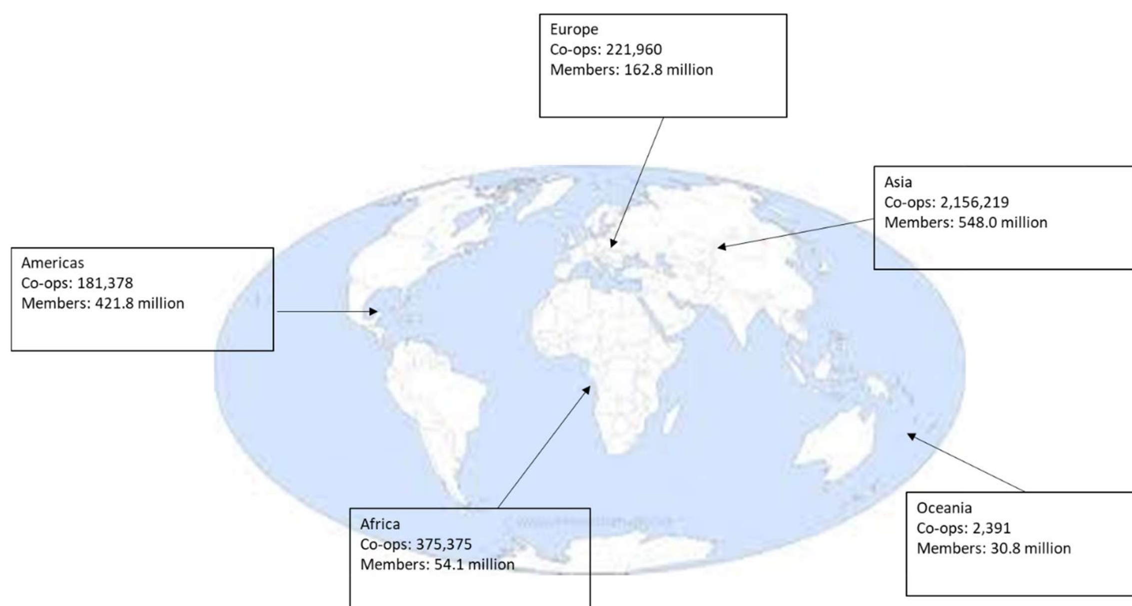
[22] Richard O'Leary and Sam Byrne, *Co-operatives in Australia: A Manual* (Co-operative Federation of NSW, 2nd ed, 2017).
[23] ABS, above n 14.
[24] Business Council of Co-operatives and Mutuals, *2023 National Mutual Economy Report*, above n 13, 14-16.
[25] Ibid 19.
[26] International Cooperative Alliance, 'Facts and Figures' (Web Page) <https://www.ica.coop/en/cooperatives/facts-and-figures>.
[27] ABS, above n 14.

Fig. 3: Number of Co-operatives and Membership Globally (2018)



Source: Adapted from Cooperative Business New Zealand, *The New Zealand Co-operative Economy* (2021).

Globally, in 2022, the largest 300 co-operatives and mutuals collectively reported total turnover of USD 2,170.99 billion.[28] Even a decade ago, agribusiness featured prominently with Canadian maple sugar co-operatives producing 35 per cent of the world's production, French co-operatives producing 40 per cent of food and agricultural production and 91 per cent of all Japanese farmers being co-operative members.[29] In New Zealand, 3 per cent of gross domestic product was generated by co-operatives which held 95 per cent of the dairy market, 70 per cent of the meat market, 60 per cent of the farm supply market and 80 per cent of the fertiliser market.[30]

3. CO-OPERATIVES

3.1 Co-operatives as a business structure

A co-operative is an entity designed to serve the interests of its members. These interests may be economic, social or cultural. It is a structure that encourages member contribution and shared responsibility. With people (ie, members) at the centre of the organisation, any trade for surplus is designed to further or fulfil their purpose rather than being focused on maximising a financial return on investment.

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[28] International Cooperative Alliance and Euricse, *World Cooperative Monitor: Exploring the Cooperative Economy* (December 2022) 13, 20.
[29] ABS, above n 14.
[30] Ibid.

There are two types of co-operatives: distributing and non-distributing.[31] A distributing co-operative has shares and can distribute any surplus funds to members. This can be done by way of the issue of a dividend or of bonus shares, or by way of a rebate. While any distribution may be based on each member's shareholding, profits can be distributed to members based on their level of use of the co-operative's services. A non-distributing co-operative cannot, by definition, distribute surplus funds to members and therefore does not require share capital. It is not, however, prohibited from issuing shares, the consequence of which is that a regular subscription fee is then not required.[32] Any profits are reinvested back into the co-operative such as into improved products and services. A non-distributing co-operative is likely to meet the definition of being 'not-for-profit' for tax purposes, although being not-for-profit does not necessarily mean the entity is exempt from tax.

Previously, distributing and non-distributing co-operatives were known as trading and non-trading co-operatives, respectively. But this does not prevent a non-distributing co-operative from engaging in trading activities. It does mean that any surplus (profit) is to be used to further the entity's purpose.

Co-operatives are democratic organisations that focus on concepts of self-help, equality and responsibility. Their values are ensconced in what is referred to as the 'Rochdale Principles'.[33] Co-operatives around the world generally operate according to these same seven core principles adopted by the International Co-operative Alliance in 1995 and now incorporated into Australian law.[34] In summary these are:

1. Voluntary and open membership – ie, non-discriminatory.
2. Democratic member control – ie, active participation by members.
3. Member economic participation – ie, equitable contributions with membership benefits.
4. Autonomy and independence – ie, self-help on terms that ensure democratic control.
5. Education, training and information – ie, ensure effective contributions and public awareness.
6. Co-operation among co-operatives – ie, strength through local, national and international structures.
7. Concern for community – ie, sustainable development of communities.

[31] See, for example, *Co-operatives (Adoption of National Law) Act 2012* (NSW), above n 7, s 17.
[32] Australian Government, above n 4.
[33] The Rochdale Equitable Pioneers Society, formed in 1844, is credited with laying the foundation of the modern co-operative model. International Cooperative Alliance, 'The Rochdale Pioneers' (Web Page) <https://ica.coop/en/rochdale-pioneers>.
[34] National Cooperative Business Association CLUSA International, 'Our Cooperative Identity' (Web Page) <https://ncbaclusa.coop/resources/7-cooperative-principles/>; International Co-operative Alliance, *Guidance Notes to the Co-operative Principles* (2015). See, for example, *Co-operatives (Adoption of National Law) Act 2012* (NSW), above n 7, s 10; *Co-operatives National Law Application Act 2013* (Vic) s 10.

Being a distinct legal entity as a consequence of being registered as a co-operative, members of both distributing and non-distributing co-operatives have equal voting rights[35] and liability is limited.[36] A key element of membership is that all members, of which there must be a minimum of five, must maintain an active relationship with their co-operative.[37] This is usually achieved by using or contributing to its main activities which could be being a customer of, a supplier to, or a worker in, a co-operative. In turn, a worker could be an employee paid to perform a particular role, a contractor paid to provide a particular service or a volunteer who may be 'paid' in the form of discounts, credits or vouchers.

3.2 Co-operatives as a business entity

It has been argued that many Australians 'have lost confidence in the ability of profit maximising firms to make decisions in society's interests',[38] as well as their failure to make decisions that meet community expectations.[39] Indeed, the majority of Australians believe that corporate Australia is too focused on profit and not concerned enough with their customers.[40] Recent scandals such as Westpac's money laundering, Rio Tinto's destruction of sacred sites in Juukan Gorge, Qantas not honouring flight credits and the Optus outage has arguably fuelled the growing tide of resentment.[41]

As required by the co-operative principles, co-operatives are more likely to put people ahead of profits, for example by being concerned about community. As values- and principles-based enterprises, they are more likely to exist for the greater good of the many and not for the financial gain of a few. Not driven by the need to maximise short-term profitability, they tend to have a long-term view of business, serving both economic and social needs. They may also operate in remote and rural areas that are typically unattractive investments for for-profit enterprises. In addition, the 'one member one vote' principle contrasts with many listed companies where the power and/or influence is vested in a few shareholders.

Co-operatives play a significant role in employment creation, although many are reliant on volunteers.[42] They provide a means of transitioning from the informal economy to

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[35] *Co-operatives (Adoption of National Law) Act 2012* (NSW), above n 7, Annexure, Part 1.3; *Co-operatives National Law Application Act 2013* (Vic), above n 34, Annexure, Part 1.3.

[36] *Co-operatives (Adoption of National Law) Act 2012* (NSW), above n 7, s 121; *Co-operatives National Law Application Act 2013* (Vic), above n 34, s 121.

[37] *Co-operatives (Adoption of National Law) Act 2012* (NSW), above n 7, s 119.

[38] Denniss and Baker, above n 15, 4; Tim Mazzarol, 'Co-operatives and Social Enterprise: Are They a Replacement for Mainstream Capitalism?', *The Conversation* (4 November 2012).

[39] Louise Davidson, 'ACSA Statement on Westpac CEO and Board Changes' (Media Release, 26 November 2019).

[40] Denniss and Baker, above n 15. See also International Labour Office, 'Rediscovering Cooperatives: Young People Finding Work the Cooperative Way' (Cooperatives and the World of Work No 4, 2015).

[41] Ian Verrender, 'Alan Joyce and Kelly Bayer Rosmarin Have Joined a Long Line of CEOs Who Failed to Win the Blame Game', *ABC News* (28 November 2023).

[42] Eum Hyung-sik, *Cooperatives and Employment: Second Global Report, Contribution of Cooperatives to Decent Work in the Changing World of Work* (CICOPA, 2017); Bruno Roelants, Eum Hyungsik and Elisa Terrasi, *Cooperatives and Employment: A Global Report* (CICOPA, 2014); OECD, *Platform Cooperatives and Employment: An Alternative for Platform Work* (OECD Local Economic and Employment Development Papers 2023/16, 2023). For reliance on volunteers see Lyons and Passey, above n 10, 90 where, referring to third sector organisations in Australia, they state 'there are several hundred thousand that are entirely reliant on volunteers'.

the formal economy. Often this is through skill development. It has been suggested that placing people at the centre of development is more likely to ensure equality.[43]

Environmental sustainability is a particular strength of co-operatives. The co-operative movement is very much engaged in the *2030 Agenda for Sustainable Development* with its 17 Sustainable Development Goals.[44] Many co-operatives, especially those operating in the development space, are committed to using natural resources in a sustainable way, and promoting sustainable practices to the community. They are also 'early adopters of sustainability reporting, with many co-operatives tracking and making available data on their environmental impacts'.[45] In July 2023, CBH Group became the first grain marketer in Australia to achieve carbon neutral certification for a product.[46]

Increasingly recognised as enterprises that promote sustainable development across the three dimensions of social development, economic development and environmental protection,[47] co-operatives are being seen as a more attractive business model than traditional enterprises. Food co-operatives, for example, now constitute a vital part of the alternative food movement along with farmers markets.[48] Food co-operatives generally have stringent standards about what they will or will not sell, favouring local and organic products. Ethical consumption is becoming more accepted as mainstream,[49] denoted by terms such as 'green', 'fair trade', 'responsibly sourced' and 'eco-consumerism'.

Co-operatives may play an important role in sustaining a strong, tolerant and cohesive society.[50] With their core principles and community focus, co-operatives are sources of social capital that can foster a sense of community, empowerment and inclusion. In relation to the third sector generally, it has been said that it is the capacity for self-organisation, that is, the readiness of people 'voluntarily to work together without direction from government and without the lure of profit or the necessity of earning a wage … [that] is sometimes referred to as social capital'.[51] Not only is this at the heart of a sustainable society but it is a necessary underpinning for the effective operation of a market economy.[52]

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[43] International Cooperative Alliance, *Co-ops for 2030: A Movement Achieving Sustainable Development for All, Annual Report Vol 1* (2017) ('*Co-ops for 2030*').

[44] International Cooperative Alliance, 'Cooperatives: Key Partners in Realizing the Agenda 2030 for Sustainable Development' (Position Paper, 2023).

[45] International Cooperative Alliance, *Co-ops for 2030*, above n 43, 24.

[46] CBH Group, 'CBH Achieves Climate Active Carbon Neutral Certification' (Media Release, 21 July 2023).

[47] United Nations, General Assembly, *Cooperatives in Social Development: Report of the Secretary-General*, A/78/187, report pursuant to General Assembly resolution 76/135, 17 July 2023.

[48] Andrew Zitcer, 'Food Co-ops and the Paradox of Exclusivity' (2015) 47(3) *Antipode* 812.

[49] Rebecca Walker Recsek and Julie R Irwin, 'Ethical Consumption' in Michael I Norton, Derek D Rucker and Cait Lamberton (eds), *The Cambridge Handbook of Consumer Psychology* (Cambridge University Press, 2015) 507; Colin Foad, Geoff Haddock and Gregory Maio, 'Hypocrisy in Ethical Consumption' (2022) 13 *Frontiers in Psychology* 880009; Alex Hiller and Helen Goworek, *Ethical Consumption: A Research Overview* (Routledge, 2023).

[50] Lyons and Passey, above n 10, 90.

[51] Mark Lyons, 'The Legal and Regulatory Environment of the Third Sector' (2003) 25(1) *Asian Journal of Public Administration* 87, 88.

[52] Robert D Putnam, *Bowling Alone: The Collapse and Revival of American Community* (Simon and Schuster, 2000).

Since the 2008 Global Financial Crisis and perhaps fuelled by corporate excesses, the concept of the co-operative as a business entity has been gaining traction.[53] In 2021 the Commonwealth government added co-operatives to the types of business structures on the business.gov.au website.[54] However, as a consequence of their differences in terms of structure, philosophy and purpose, co-operatives are not considered the same as other business entities. And they are not necessarily substitutes for, or alternatives to, mainstream for-profit companies. Indeed, many could be considered too socially oriented to be 'for-profit' enterprises. However, there clearly is a place for co-operatives as a type of business entity.

3.3 The regulation of co-operatives

From a regulatory perspective, Australian co-operatives, as a business model, have a short history.[55]

The Australian *Constitution* expressly sets out the federal government's specific law-making powers.[56] Excluded from this, and therefore remaining with the States, is the power to make laws with respect to the formation of corporations (including co-operatives) and the power to regulate financial mutuals, as opposed to banks. It is only through the referral of powers from the States that a national scheme in relation to corporations can exist.[57] This transpired with the *Corporations Act 2001* (Cth) which, nevertheless, contemplates the possibility that a State or Territory may declare a particular matter to be an 'excluded matter' in relation to the whole or some specified portion of the Act.[58]

While the corporations model prospered in the federal jurisdiction, the legislation and regulations pertaining to co-operatives has remained State- and Territory-based. Co-operatives that chose to register as companies,[59] or are financial co-operatives[60] and are required to register as companies, are governed and regulated as corporations notwithstanding that they are distinguished from other corporations by their commitment to co-operative principles.[61] Non-distributing co-operatives that are not registered as companies and non-financial co-operatives remained under State or Territory jurisdiction.

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[53] Claudia Sanchez Bajo and Bruno Roelants, 'Mainstreaming Co-operatives After the Global Financial Crisis' in Anthony Webster, Linda Shaw and Rachael Vorberg-Rugh (eds), *Mainstreaming Co-operation: An Alternative for the Twenty-First Century?* (Manchester University Press, 2016) 14; Sonja Novkovic, 'Cooperative Identity as a Yardstick for Transformative Change' (2022) 93(2) *Annals of Public and Cooperative Economics* 313.

[54] Luke Michael, 'Co-ops and Mutuals Move into the Mainstream', *Pro Bono Australia* (1 June 2021) <https://probonoaustralia.com.au/news/2021/06/co-ops-and-mutuals-move-into-the-mainstream/> (accessed 21 August 2024).

[55] In New South Wales, for example, the *Co-operatives Act 1992* (NSW) shifted the focus of co-operatives from a development tool to a 'corporate business model': Ann Apps, 'A Brief History of Co-operative Law in NSW – Acknowledging the Contribution of Dr Gary Lewis' (presentation, 2019) <https://business.sydney.edu.au/data/assets/pdf_file/0007/440098/History-of-Co-op-Law_Ann-Apps.pdf>.

[56] *Commonwealth of Australia Constitution Act 1900* s 51.

[57] Kenneth Wiltshire, 'Australian Federalism: The Business Perspective' (2008) 31(2) *University of New South Wales Law Journal* 583.

[58] *Corporations Act 2001* (Cth) s 5F.

[59] Includes distributing co-operatives that have a share capital.

[60] Includes co-operatives that are mutual banks, building societies and credit unions.

[61] Apps, 'Legislating for Co-operative Identity', above n 6.

Nevertheless, shortly after referring its power with respect to corporations, New South Wales commissioned a review of the *Co-operation Act 1923* (NSW), an aspect of which was the potential harmonisation of co-operative law with the law applicable to corporations generally.[62] John Taylor noted that the report 'raises fundamental issues relevant to all co-operatives which conduct business in increasingly deregulated market economies', concluding that 'legal, financial and general commercial developments have meant that traditional co-operative structures have to an extent been found wanting'.[63]

The first attempt to harmonise co-operative legislation between the States and Territories was made in the mid-1990s through an intergovernmental agreement, the Co-operatives Law Agreement.[64] Uniform legislation that would be consistent across all jurisdictions was to be based on core consistent provisions. However, the agreement was not signed by Western Australia and some States sought to retain certain provisions not agreeable to the other jurisdictions.[65] By 2007 it was recognised that this regulatory regime imposed restrictions and compliance costs on co-operatives and placed them at a competitive disadvantage when compared to other entities.[66]

In 2011, the States and Territories entered into the Australian Uniform Co-operatives Laws Agreement to implement a scheme to promote uniform or consistent legislation and systems of administration for co-operatives.[67] The national framework included a model template, the Co-operatives National Law (CNL). This process began in 2012 with New South Wales and Queensland was the last to adopt the law in 2020.[68] This governance structure is what differentiates co-operatives from other member-based entities. Co-operatives are required to register under the CNL while clubs and societies may be unincorporated or incorporated associations, the latter falling under each State or Territory's associations incorporation legislation.[69]

The CNL enables co-operatives to operate on a national level whilst reducing red tape and the cost of compliance between jurisdictions, with simplified financial reporting for

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[62] Blake Dawson Waldron and Dominguez Barry Samuel Montagu Ltd, 'Interim Report to the Minister for Business and Consumer Affairs on Review of the Co-operation Act 1923' (Sydney, 1990).

[63] C John Taylor, 'Reform of Co-operative Legislation in New South Wales, Australia' (1991) *Yearbook of Co-operative Enterprise* 107, 118 ('Reform of Co-operative Legislation').

[64] Apps, 'Legislating for Co-operative Identity', above n 6; Co-operative Development Services Ltd, 'Australian National Co-operatives', *Australian Co-operative Links* (Web Page, March 2021) <https://www.coopdevelopment.org.au/natlinks.html>.

[65] Co-operative Development Services Ltd, above n 64.

[66] Ministerial Council for Consumer Affairs, 'Co-operatives: A National Approach' (Co-operatives National Law, Decision Making Regulatory Impact Statement, 2012)

[67] The Australian Uniform Co-operatives Laws Agreement (AUCLA) was an agreement between the Ministers responsible for consumer protection and co-operatives in each State and Territory and commenced in February 2012.

[68] *Co-operatives National Law Act 2020* (Qld); *Co-operatives National Law (ACT) Act 2017* (ACT); *Co-operatives Act 2009* (WA) amended by the *Co-operatives Amendment Act 2016* (WA); *Co-operatives National Law (Tasmania) Act 2015* (Tas); *Co-operatives (National Uniform Legislation) Act 2015* (NT); *Co-operatives National Law Application Act 2013* (Vic), above n 34; *Co-operatives National Law (South Australia) Act 2013* (SA); *Co-operatives (Adoption of National Law) Act 2012* (NSW), above n 7.

[69] Other differences include membership (co-operatives usually restricted to those who contribute or use the services while clubs and societies are open to various groups), decision-making (co-operatives have a democratic decision-making process involving all members while decisions in clubs and societies are made by a few individuals) and ownership of property (co-operatives are collective while clubs and societies can be individual as well as collective). See for example *Associations Incorporation Act 2009* (NSW); *Associations Incorporation Reform Act 2012* (Vic).

co-operatives categorised as 'small'. While there are also differences between co-operatives in terms of type of trade (such as agriculture, childcare and arts and crafts) and types of members (such as consumer, producer and worker), the CNL only differentiates between 'distributing' and 'non-distributing' (previously trading and non-trading) co-operatives.[70] The CNL is accompanied by national regulations and local regulations. The national regulations are consistent across all States and Territories and supplement the CNL. The local regulations, on the other hand, address matters specific to that State or Territory, such as fees and penalties which means there could be differences between the various jurisdictions.

In March 2016 the Senate Economics References Committee delivered a report on the role, importance and overall performance of co-operative, mutual and member-owned entities.[71] As the then CEO of the Business Council of Co-operatives and Mutuals noted: 'It is an important first step in recognising how co-operative and mutual enterprises … increase competition and diversity in markets and contribute to a stable and resilient economy'.[72]

In 2017 the Parliamentary Friends of Co-ops and Mutuals Group was formed in Federal Parliament. Also in 2017 the ASX Governance Principles were adapted to apply to co-operatives and mutuals.[73] In 2019 legal changes were made to the *Corporations Act* to recognise Mutual Companies and Mutual Capital Instruments.[74] However, it was not until 2021 that the business.gov.au website was updated to include co-operatives as a business model.

In regulation too, co-operatives are very different to all other forms of business entities. Co-operatives have a legal regime that differs from that of commercial, capital-based companies. The identity of co-operatives is intrinsically intertwined with the co-operative principles. These differences pose particular challenges, not least with regard to taxation, and the question arises: should co-operatives be taxed differently?

4. THE TAXATION OF CO-OPERATIVES

4.1 Approaches to the taxation of co-operatives

There are two approaches to the taxation of co-operatives: entity taxation and flow-through taxation. In addition, preferential treatment may be afforded through the principle of mutuality and tax incentives. Few countries have developed a specific and consistent taxation framework for taxing co-operatives. Some provide specific provisions, some reduced tax rates, but not necessarily consistently across all co-operatives. Different criteria apply, according to the policy priorities of the legislator at any given time.

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[70] See for example ss 17-19 of the Appendix to the *Co-operatives (Adoption of National Law) Act 2012* (NSW), above n 7, being the CNL template.
[71] Australian Parliament, Senate Economics References Committee, above n 12.
[72] Melina Morrison, quoted in Business Council of Co-operatives and Mutuals, 'Senate Recommends Level Playing Field for Co-ops and Mutuals' (16 March 2016) <https://bccm.coop/deadline-for-submissions-to-senate-inquiry-set-for-1-july/>.
[73] Business Council of Co-operatives and Mutuals, *2023 National Mutual Economy Report*, above n 13, 8.
[74] These related to Recommendations 4 and 17 of the Senate report: Australian Government, *Australian Government Response to the Senate Economics References Committee Report: Cooperative, Mutual and Member-Owned Firms* (November 2017).

4.1.1 *Entity taxation*

Under entity taxation, the vehicle (for example, a co-operative) is treated as an entity and tax is applied at the entity level based on the entity's attributes, but tax is also applied at the owner level (in the case of a co-operative, this is the member level). This double taxation is mitigated through the imputation system whereby the extent to which the entity has paid tax on its income is taken into account in calculating the tax that is payable at the member or shareholder level.[75]

With respect to trading with members, the tax legislation provides the co-operative with a deduction for amounts distributed to members while taxing undistributed income that has been derived from trading.[76]

4.1.2 *Flow-through taxation*

With flow-through taxation, any income is passed straight through to the owners or investors, be they members or shareholders, with the consequence that these individuals, and not the entity itself, are taxed on profits. This type of taxation applies to partnerships and trusts.

Members either invest capital or subscribe on an annual basis to co-operatives thereby providing co-operatives with capital to perform their functions. Yet members are also receivers of goods or services, for example as purchasers. The 'dividend' (or benefit) they receive is not paid on the capital but rather on the purchases or other contribution made.

The return of the surplus is sometimes referred to as patronage rebates, refunds, discounts or net margins. The distribution of benefits is in proportion to individual dealings rather than in proportion to capital investment. To illustrate: if a co-operative has a surplus of $5,000 for the year and Member Jane accounted for 5 per cent of the business conducted, then Member Jane receives a refund or patronage rebate of $250, being 5 per cent of the $5,000.

In Australia, there is an underlying policy against flow-through taxation when the business form, for example a corporation, reduces members' risk via liability protection.[77] Thus, flow-through taxation does not apply to co-operatives. In the United States, the general principle of co-operative income tax is that the co-operative is a flow-through entity, providing single-level tax treatment.[78] Any surplus flows through the co-operative to its patrons where it is ultimately taxed. This only applies to co-operative income sourced from members (that is, mutual receipts) that are distributed to members.[79]

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[75] Under Australian income tax law this follows from *Income Tax Assessment Act 1997* (Cth) s 4-1 (ITAA 1997), ie, the entity as well as the individual are taxpayers.
[76] Under Australian income tax law this follows from *Income Tax Assessment Act 1936* (Cth) s 120 (ITAA 1936).
[77] Brett Freudenberg, 'Australia's Struggle With Tax Transparent Companies' (2007) 48(1) *Tax Notes International* 83.
[78] Unless the co-operative adopts the form of a C corporation then the co-operative itself is the taxpayer.
[79] Donald A Frederick, *Income Tax Treatment of Cooperatives: Background* (United States Department of Agriculture Cooperative Information Report 44-1, 2013) 26.

4.1.3 Mutuality principle

Some entities in Australia obtain the benefit of the principle of mutuality in relation to dealings with members. The effect is that mutual receipts are not taxable income. In *Royal Automobile Club of Victoria v Federal Commissioner of Taxation*[80] (*RACV*), Anderson J stated:

> It has been long established and many times reaffirmed that in the field of income tax the principle of mutuality may relieve wholly or in part certain associations from liability to tax.[81]

In *Social Credit, Savings and Loans Society Ltd v Commissioner of Taxation*, Gibbs J succinctly described the principle as:

> [W]here a number of people, associated together for a common purpose, have contributed to a common fund in which all the contributors are interested, the surplus of their contributions remaining after the fund has been applied to the common purpose 'is in essence a return of their own moneys which they have overpaid and is not a profit'.[82]

The mutuality principle is dependent upon the existence of an 'identity' between contributors to the entity and those who are entitled to participate in it. The identity required is not an identity between individuals, but an identity between classes, and all that is required is a reasonable relationship between what a member contributes, and the member's expected participation.[83] To the extent that the entity deals with or extends its facilities to non-members, then to that extent the element of mutuality is missing.[84]

The concept of mutuality is that the contributing members must be entitled to the recoupment or refund of any surplus with the result that the entity does not make a profit from them.[85] But it applies equally to contributions made. For example, annual subscriptions have been held to be, in substance, advances of capital for a common purpose and so not 'income' of the entity.[86] Any excess of income over costs is usually termed a surplus, rather than a profit.

The principle of mutuality, determined by case law,[87] recognises that 'any surplus arising from contributions to a common fund created and controlled by people for a

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[80] *Royal Automobile Club of Victoria v Federal Commissioner of Taxation* (1974) 4 ATR 567 ('*RACV*').
[81] Ibid 569, referring to *Social Credit, Savings and Loans Society Ltd v Federal Commissioner of Taxation (Com.)* (1971) 125 CLR 560 ('*Social Credit, Savings and Loans Society*'); *Colonial Mutual Life Assurance Society Ltd v Federal Commissioner of Taxation* (1946) 73 CLR 604 ('*Colonial Mutual Life Assurance Society*'); *Sydney Water Board Employees' Credit Union Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 446 ('*Sydney Water Board*').
[82] *Social Credit, Savings and Loans Society*, above n 81, 570-571, citing *Colonial Mutual Life Assurance Society*, above n 81, 618-619.
[83] *Sydney Water Board*, above n 81, 457; *Social Credit, Savings and Loans Society*, above n 81, 571-572.
[84] *RACV*, above n 80.
[85] *Jones v South-West Lancashire Coal Owners Association Ltd* [1927] AC 827, 832; *Coleambally Irrigation Mutual Co-operative Ltd v Federal Commissioner of Taxation* (2004) 139 FCR 115 ('*Coleambally Irrigation*').
[86] *The Bohemians Club v Acting Federal Commissioner of Taxation* (1918) 24 CLR 334, 337 per Griffith CJ ('*Bohemians Club*'); *Coleambally Irrigation*, above n 85.
[87] See, for example, *Bohemians Club*, above n 86; *Sydney Water Board*, above n 81; (1968) 18 TBRD *Case T55*. See also RD Giles, 'Mutuality in Income Tax Law: British Broadcasting Corporation v Johns' (1966) 5(2) *Sydney Law Review* 278.

common purpose is not income'.[88] Thus the characteristics of organisations that can access mutuality typically include that the organisation is carried on for the benefit of members collectively, not individually; that the members share a common purpose in which all participate, or are entitled to; and that the members have ownership and control of the common fund.[89] The ATO accepts that the business of an organisation to which the principle of mutuality applies can either be for a taxable purpose and therefore producing assessable income or for a non-taxable purpose, producing mutual receipts.[90]

The ATO refers to receipts derived by the entity from dealings with members as 'mutual receipts'.[91] As mutual receipts do not give rise to taxable income, any expenses incurred in deriving them are not deductible. In addition, where other expenses are incurred when dealing with members, these costs also cannot be claimed as deductions due to the mutuality principle.[92] Where goods or services are provided to both members and non-members, revenue may have to be apportioned between that which is assessable and that which is not assessable.[93] Similarly with any expenses. The principle does not extend to include income that is derived from sources outside the members collectively. Examples are bank interest and leasing of facilities to a single member for their exclusive use.[94]

As the concept of mutuality was developed by the courts, common law countries are more likely to invoke the principle. Through much of the 20th century, the United Kingdom governments have grappled with the dichotomous controversy with arguments that co-operative dealings were indistinguishable from ordinary business dealings, countered with arguments that it was unfair to extend an income tax to tax what was not, at common law, income.[95]

Australia has been far more accepting of the principle.[96] The Review of Business Taxation recommended '[t]hat the current common law exclusion from the calculation of taxable income of "mutual gains" – being gains by certain mutual entities and organisations from some dealings with their members – be given explicit effect in the tax law', rather than being left to the common law.[97] Following the Full Federal Court's

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[88] ATO, 'Income Tax: How Should a Licensed Club Apportion Expenses When Calculating Its Taxable Income?', Taxation Determination TD 93/194 (7 October 1993) [1] ('TD 93/194').
[89] ATO, 'Mutuality and Taxable Income for Not-for-Profits' (NAT 73436, 4 December 2018) ('Mutuality and Taxable Income for Not-for-Profits').
[90] Ibid.
[91] Ibid.
[92] Ibid.
[93] *RACV*, above n 80.
[94] ATO, 'Mutuality and Taxable Income for Not-for-Profits', above n 90.
[95] Report of the Royal Commission on the Income Tax [1920] (UK) as set out in AM Carr-Saunders, PS Florence and R Peers, *Consumers' Co-operation in Great Britain* (1938) quoted in Edward James Stewart Chambers, 'Should the Earnings of Co-operative Associations Be Made Subject to the Federal Income Tax?' (MA Thesis, University of British Columbia, 1947) 88; Committee on the Present Position of Co-operative Societies in Relation to Income Tax (WN Raeburn, chair) (1933); United Kingdom, *Parliamentary Debates*, House of Commons, 12 May 1932, vol 265, cols 2072–73 (Neville Chamberlain, Chancellor of the Exchequer); United Kingdom, *Parliamentary Debates*, House of Commons, 22 May 1933, vol 278, cols 770–71 (Neville Chamberlain, Chancellor of the Exchequer), cols 781–83 and 1222–43 (Sir Stafford Cripps).
[96] Lyons and Passey, above n 10.
[97] Recommendation 5.6 of the Review of Business Taxation (John Ralph, chair), *A Tax System Redesigned: More Certain, Equitable and Durable* (July 1999), reported in Australian Competition and Consumer

decision in *Coleambally Irrigation Mutual Co-operative Ltd v Commissioner of Taxation*,[98] which held that an entity that could not distribute surplus was not a mutual entity, the *Income Tax Assessment Act 1997* (ITAA 1997) was amended to ensure that the mutuality principle, 'a long established principle in tax law', was retained.[99]

In the past, attempts by the Commissioner to dispel the mutuality principle have failed. Submissions that (1) there is no place for the mutuality principle in the Income Tax Assessment Act and (2) that the mutuality principle is confined solely to the field of insurance[100] were summarily dismissed by the High Court in *Sydney Water Board Employees' Credit Union Ltd v Federal Commissioner of Taxation* (*Sydney Water Board*) as being 'inconsistent with expressions of that principle', that 'where it has not been excluded by statutory provision, it still applies' and that the notion of being confined to insurance 'is opposed to authority and must be rejected'.[101]

4.1.4 Tax incentives

Tax incentives may take the form of tax exemptions, tax deductions, tax rebates, reduced tax rates or deferred tax liability. There are many reasons why, as a matter of policy, co-operatives enjoy various tax incentives. These include being a catalyst to economic growth,[102] such as through employment,[103] agricultural development,[104] or in support of general welfare.[105] Co-operatives are also seen as a means of promoting food security[106] and assisting in alleviating poverty.[107]

Tax incentives for co-operatives are not uniformly provided across all countries and, for those countries that do provide tax incentives, they are not necessarily consistently applied across all co-operatives. The use of tax incentives to 'acknowledge the importance of cooperatives to the economy' was the subject of a study in the Philippines

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Commission, *Report to the Treasurer on the Relative Financial and Corporate Differences Between Friendly Society Dispensaries and Pharmacist-Owned Pharmacies* (October 2002) 33–34.

[98] *Coleambally Irrigation*, above n 85.

[99] Explanatory Memorandum to the Tax Laws Amendment (2005 Measures No 6) Bill 2005, [2.2].

[100] *Sydney Water Board*, above n 81, discussed at 455 per Mason J.

[101] Ibid 457 per Mason J.

[102] E Kireyeva, 'Tax Regulation in Agriculture: Current Trends, Selection of a State Support Forms' (2016) 2(3) *Journal of Tax Reform* 179.

[103] Francisco Sancho, Luis Rivera and Julio Rosales, 'Housing Finance in Central America: What Is Holding It Back?' (Inter-American Development Bank Working Paper No IDB-TN-285, January 2012); Gökçen Özdemir, 'Good Governance in Sustainable Human Development: A Subnational Case in Turkey' (PhD Thesis, Middle East Technical University, 2013).

[104] Devendra Gauchan and Shreemat Shrestha, 'Agricultural and Rural Mechanisation in Nepal: Status, Issues and Options for Future' in MA Sattar Mandal, Stephen D Biggs and Scott E Justice (eds), *Rural Mechanisation: A Driver in Agricultural Change and Rural Development* (Institute for Inclusive Finance and Development, 2017); Poonam Gupta, 'Generating Larger Tax Revenue in South Asia' (MPRA Paper 61443, January 2015).

[105] Leopoldo Blugerman, Adrián Darmohraj and Mariana Lomé, 'Social Enterprises in Argentina' (Country Report, Social Enterprises on the Move, 2017).

[106] Shaikh Tanveer Hossain, 'Impacts of COVID-19 on the Agri-Food Sector: Food Security Policies of Asian Productivity Organization Members' (2020) 15(2) *Journal of Agricultural Sciences – Sri Lanka* 116; Vishwas Satgar, 'Challenging the Globalized Agro-Food Complex: Farming Cooperatives and the Emerging Solidarity Economy Alternative in South Africa' (2011) 14(2) *WorkingUSA* 177.

[107] Master Mushonga, Thankom G Arun and Nyankomo W Marwa, 'Drivers, Inhibitors and the Future of Co-operative Financial Institutions: A Delphi Study on South African Perspective' (2018) 133 *Technological Forecasting and Social Change* 254; Manuel Larrabure, Marcelo Vieta and Daniel Schugurensky, 'The "New Cooperativism" in Latin America: Worker-Recuperated Enterprises and Socialist Production Units' (2011) 43(2) *Studies in the Education of Adults* 181.

covering 56 countries.[108] In Europe, North America and Oceania – overwhelmingly developed countries – only France provides a full exemption. Canada, Germany and Ukraine have no exemptions. For those with selective and/or partial exemptions, policies generally target issues such as increasing financing flexibility[109] or climate change initiatives[110] although agribusiness does feature.[111] Of the 24 Asian countries considered, six granted full exemptions[112] and another 14 provided exemptions either according to specific co-operative types or at reduced rates. The sector most favoured for tax incentives was the agricultural sector with a focus on strengthening food security and nutrition.[113] In Africa, only Egyptian and Nigerian co-operatives, other than financial co-operatives, have full income tax exempt status.[114] To that end it has been noted that '[t]he taxation of cooperatives appears to be a topic that is neglected in policies'.[115] Only four South American countries were considered. Of these, two were exempt from profit tax in full while the other two enjoy conditional exemptions. Their reasons vary: for Venezuela, the policy objective for full exemption was said to be poverty reduction,[116] in Argentina the full exemptions were based on the provision for general welfare by co-operatives,[117] while redistribution of wealth was the focus in Brazil.[118] On the other hand, in Mexico the intention of tax exemptions was said to be to increase the profit margins of co-operatives.[119]

Therefore, where co-operatives enjoy some form of tax incentive, there is generally a clear public policy rationale for them, for example encouraging food production. However, policies can change over time and what was considered good policy in the past may no longer be desirable. Further, the types of tax incentives vary between different types of co-operatives, and they also may only apply to certain or selective types of co-operatives.

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[108] Ma Belinda S Mandigma and Blesilda P Badoc-Gonzales, 'Tax Exemptions of Cooperatives in the Philippines and in Other Countries: A Comparative Study' (2022) 11(2) *Review of Integrative Business and Economic Research* 144, 144.

[109] Jarka Chloupková, 'European Cooperative Movement – Background and Common Denominators' (Royal Veterinary and Agricultural University Unit of Economics Working Paper 2002/4, 2002).

[110] Thomas Bauwens, Boris Gotchev and Lars Holstenkamp, 'What Drives the Development of Community Energy in Europe? The Case of Wind Power Cooperatives' (2016) 13 *Energy Research and Social Science* 136.

[111] Chloupková, above n 109; Jan Brusselaers, Krijn Poppe and Tomas Garcia Azcarate, 'Do Policy Measures Impact the Position and Performance of Farmers' Cooperatives in the EU?' (2014) 85(4) *Annals of Public and Cooperative Economics* 531.

[112] These are India, Mongolia, Philippines, South Korea, Thailand, Tajikistan.

[113] Hossain, above n 106; Maria Cristina F Melo, 'Organic Rice Production and Consumption to Sustain Food Security in Oriental Mindoro, Philippines' (2021) 10(S3) *Review of Integrative Business and Economics Research* 338.

[114] Mandigma and Badoc-Gonzales, above n 108.

[115] Jan Theron, 'Cooperative Policy and Law in East and Southern Africa: A Review' (Coop Africa Working Paper No 18, International Labour Organization, 2010) 18.

[116] Larrabure, Vieta and Schugurensky, above n 107.

[117] Blugerman, Darmohraj and Lomé, above n 105.

[118] Tarcisio Pedro Da Silva, Mauricio Leite, Jaqueline Carla Guse and Vanderlei Gollo, 'Financial and Economic Performance of Major Brazilian Credit Cooperatives' (2017) 62(5) *Contaduría y Administración* 1442.

[119] Mauricio Ramírez-Rodríguez and Luis César Almendárez-Hernández, 'Subsidies in the Jumbo Squid Fishery in the Gulf of California, Mexico' (2013) 40 *Marine Policy* 117.

4.2 Taxation of co-operatives in Australia

Income tax is payable by companies,[120] which include corporate or unincorporated bodies.[121] In the absence of a special regime, co-operatives would be taxed as companies.

A specific taxing regime is provided for co-operatives that meet certain criteria. If the requirements cannot be met, it is necessary to consider whether or not the general tax provisions for companies apply. If the general provisions apply it will also be necessary to consider the provisions dealing with not-for-profit organisations and to consider the principle of mutuality.

4.2.1 Co-operative provisions

Specific provisions regarding the taxation of co-operatives are contained in Division 9 of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936). The consequence of the specific provision is that the principle of mutuality has been displaced.[122]

A co-operative is defined very differently for tax purposes than for legal (regulatory) purposes. For tax purposes, a 'co-operative company' is defined to mean a company (defined as a body corporate or any other unincorporated association of body of persons[123] but explicitly excluding a friendly society dispensary and a credit union) that may or may not have share capital and is established specifically to carry on a business (the business requirement) with the object of:

(a) the acquisition of commodities or animals for disposal or distribution among its shareholders;

(b) the acquisition of commodities or animals from its shareholders for disposal or distribution;

(c) the storage, marketing, packing or processing of commodities of its shareholders;

(d) the rendering of services to its shareholders;

(e) the obtaining of funds from its shareholders for the purpose of making loans to its shareholders to enable them to acquire land or buildings to be used for the purpose of residence or of residence and business.[124]

If the co-operative has share capital, there are further requirements in that the number of shares per shareholder is limited (the ownership requirement) and the listing of securities on the stock exchange is prohibited.[125] These requirements regarding the

[120] ITAA 1997, above n 75, s 4-1.
[121] Ibid s 9-1 item 2, s 995-1(1) 'company'.
[122] *Sydney Water Board*, above n 81, 457 per Mason J.
[123] ITAA 1936, above n 76, s 6 read with ITAA 1997, above n 75, s 995-1 (definition of 'company').
[124] ITAA 1936, above n 76, s 117(1).
[125] Ibid.

entity's business and primary objects are to be considered 'at the time when the question whether or not it is to be treated as a co-operative company has to be determined'.[126]

Notwithstanding that a co-operative may meet all these requirements, it will nevertheless fail to be a co-operative, for tax purposes, if its dealings with members is less than 90 per cent of its total dealings.[127] In other words, where non-members account for more than 10 per cent of the goods or services provided, the entity will not be a co-operative for tax purposes. Where two or more of the objects or purposes are being carried on, the amount attributed to each object must be considered individually to determine whether the 90 per cent threshold has been exceeded.[128] This business test is an integrity measure, guaranteeing that, while trading with non-members does occur, this is more the exception than the rule thus ensuring that the essence of a co-operative is not compromised.

A co-operative's assessable income includes all income received, whether from members or non-members and whether on account of the co-operative or on account of its members.[129] However, any assessable income that is distributed to members either by way of rebates or bonuses according to their involvement in the co-operative or that is distributed to members in accordance with their shares, is deductible.[130] This ensures effectively flow-through taxation.[131] Taylor expressed the tax provisions, aimed at distributions by co-operatives to members, as being, 'in effect, a statutory substitute for the mutuality principle'.[132]

Co-operative companies whose primary object is the acquisition of commodities or animals from their members for disposal or distribution can also claim a deduction for repayments of certain government and non-government loans.[133] These are loans for the purchase of assets to carry on the business of the co-operative. The deduction is allowed only if 90 per cent or more of the value of the co-operative is held by members who supply the co-operative with the commodities or animals.[134] As noted by Taylor, '[i]n the past this provision has assisted these co-operatives in retaining profits equal to the loan repayments as the deductibility of the loan repayments offset the tax payable on the retained profits'.[135] Because the repayment of the principal on a loan is generally not deductible, this constitutes a tax concession only available to co-operatives. However, no estimate of the cost of this concession (tax benchmark variation) pertaining to repaying these loans is available.[136]

A further concession for co-operatives that meet the requirements of this Division is that any distributions made within three months of the end of the year of income can be

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[126] *Renmark Fruitgrowers Co-operated Ltd v Federal Commissioner of Taxation* (1969) 121 CLR 501, 506 per Menzies J (*Renmark*). See also *Brookton Co-operative Society Limited v Federal Commissioner of Taxation* (1981) 147 CLR 441, 445 per Gibbs CJ, 461 per Aickin J.
[127] ITAA 1936, above n 76, s 118.
[128] *Renmark*, above n 126, 507 per Menzies J.
[129] ITAA 1936, above n 76, s 119.
[130] Ibid s 120(1)(a)-(b). See also *Ardmona Fruit Products Co-operative Co Ltd v Federal Commissioner of Taxation* (1952) 86 CLR 530, 534.
[131] Thank you to the anonymous referee for this insight.
[132] Taylor, 'Reform of Co-operative Legislation', above n 63, 111.
[133] ITAA 1936, above 76, ss 120(1)(c), 120(3).
[134] Ibid s 120(1).
[135] Taylor, 'Reform of Co-operative Legislation', above n 63, 112.
[136] Australian Treasury, *Tax Expenditures and Insights Statement* (January 2024) 103.

attributed to the preceding income year.[137] Thus, if eligible under Division 9, the co-operative is entitled to a tax deduction for patronage rebates, bonuses or dividends on shares paid to members based on business transacted with members. Some agricultural producer co-operatives may also be entitled to deductions for capital repayments on certain loans.

While these provisions may appear straightforward, their application is complex. This is because they apply only to some types of co-operatives and only in certain circumstances. In addition, they will only apply in a financial year where the 'business' and 'ownership' requirements are met.

4.2.2 Company tax provisions

The general provisions of the ITAA 1997 are relevant to co-operative companies in a number of ways. For example, the rules relating to imputation may apply. This means that instead of claiming the distributions to members as deductions, the entity may pass on franking credit for tax paid by the entity. However, the imputation system only applies to co-operatives with a share capital. That is, to distributing co-operatives and those non-distributing co-operatives who have elected to have share capital. Thus, co-operatives that are registered as companies in Australia will be taxed as companies. This includes all financial co-operatives.[138]

If Division 9 of the ITAA 1936 does not apply, and the co-operative does not have a share capital, the co-operative is prima facie taxed as a company, ie, entity taxation applies. It is also necessary to consider whether the entity may be a not-for-profit company.

4.2.3 Not-for-profit company

If an entity is not-for-profit this may impact its liability to tax. The tax law does not define the term 'not-for-profit'. The ATO describes a not-for-profit organisation as 'a company that is not carried on for the purposes of profit or gain to its individual members [and] its constituent documents must prohibit it from making any distribution'.[139] That is, any profit made goes back into the operation of the organisation to carry out its purposes.

There are three types of not-for-profits: charities, other exempt and taxable. In the tax law, certain entities are exempt from income tax irrespective of the type of income they receive.[140] These include registered charities,[141] and entities that are exempt (ie, eight groups of entities that require an organisation to self-assess whether entitled to exemption).[142]

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[137] ITAA 1936, above n 76, s 120(6).
[138] Apps, 'Legislating for Co-operative Identity', above n 6.
[139] ATO, 'Mutuality and Taxable Income for Not-for-Profits', above n 89; see also ATO, 'Definitions' (Web Page, 30 May 2023) <https://www.ato.gov.au/using-our-website/definitions#N>.
[140] ITAA 1997, above n 75, s 11-5.
[141] Registered with the Australian Charities and Not-for-profits Commission and endorsed by the ATO as income tax exempt. *Australian Charities and Not-for-profits Commission Act 2012* (Cth) s 30-20 and ITAA 1997, above n 75, s 50-5.
[142] These are community service organisations, cultural organisations, educational organisations, employment organisations, health organisations, resource development organisations, scientific organisations and sporting organisations: ITAA 1997, above n 75, Div 50, ss 50-5 to 50-40.

In *Commissioner of Taxation v Co-operative Bulk Handling Limited*,[143] the majority in the Full Federal Court held that the test for exemption is what the entity does and why it does it.[144] If the 'what' refers to an activity for the sole or dominant purpose of one of the exempt categories and the 'why' refers to not being for the profit or gain of its individual members, then that is sufficient to qualify for an exemption from tax. Specifically,

> The focus must be upon the periodic or recurrent purposes of the body in the year of income. The formal objects or purposes for which the body was incorporated may also be considered but taken alone will not be determinative.[145]

In that case, the Full Federal Court accepted that CBH was exempt under section 50-40 of the ITAA 1997 (ie, established for the purpose of promoting the development of agriculture resources) and was not carried on for the profit of individual members, despite the entity making significant distributions to members.[146] Despite this, within a few years CBH was granted charitable entity status and is now registered as such with the Australian Charities and Not-for-profits Commission.[147]

If the co-operative is not a registered charity and does not come within one of the eight exempt groups, then it is considered to be taxable. For income tax purposes, an entity could be either a 'non-profit company' or 'other taxable company'.[148] 'Other taxable companies' are taxed on every dollar of taxable income whereas 'non-profit companies' have a tax-free threshold (AUD 416), are subject to special rates of tax and have special arrangements for lodging tax returns.[149]

A 'non-profit company' is defined to mean a company that is not carried on for the purposes of profit or gain to its individual members and is, by the terms of the company's constituent document, prohibited from making any distribution, whether in money, property or otherwise, to its members.[150] However, the 1936 income tax legislation makes no reference to non-profit companies while the references in the 1997 income tax legislation have very specific application such as the 2019 flood recovery grants,[151] in relation to marriage education,[152] and special rules dealing with ownership of companies.[153]

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[143] *Federal Commissioner of Taxation v Co-operative Bulk Handling Limited* (2010) 189 FCR 322, per Mansfield and McKerracher JJ (Siopis J dissenting) ('*Co-operative Bulk Handling*').
[144] Ibid [114] per Mansfield and McKerracher JJ.
[145] Ibid [15] per Mansfield and McKerracher JJ.
[146] *Co-operative Bulk Handling*, above n 143.
[147] ACNC, above n 16. Thank you to the anonymous referee for this insight.
[148] ATO, 'Not-for-Profit Organisations' (QC 33560, 7 April 2017).
[149] ATO, 'Lodgement Rules and Tax Rates' (QC 23099, 4 December 2018) <https://www.ato.gov.au/businesses-and-organisations/not-for-profit-organisations/your-organisation/in-detail/income-tax/mutuality-and-taxable-income-for-not-for-profits/lodgment-rules-and-tax-rates>.
[150] *Income Tax Rates Act 1986* (Cth) s 3.
[151] ITAA 1997, above n 75, s 59-85
[152] Ibid s 30-70
[153] Ibid ss 165-12, 165-37, 165-115C, 165-115L, 165-123.

4.2.4 Mutuality

An entity such as a co-operative may be able to apply the principle of mutuality in calculating their tax liability. Here the issue is not the classification of the entity but rather the characterisation of the entity's receipts.

Mutuality is concerned with a mutual arrangement or relationship. For a co-operative, this relationship is with members. Dealings with non-members can never be considered a mutual arrangement or relationship. However, where dealings go beyond a mutual arrangement and are in the nature of trade, then the fact that the co-operative is dealing with a member is irrelevant – the mutuality principle does not apply.[154]

The definition of 'business' includes carrying on a trade.[155] To assist businesses in determining whether a business or trade is being carried on, the ATO has issued a public ruling that comprises a set of indicators as developed by the courts.[156] The ATO accepts that 'the capacity to earn and distribute profits need not be present before an activity of a [not-for-profit] entity has the form of a business'.[157] Thus, if a business or trade is being carried on, the co-operative may have a taxable purpose that produces assessable income, a non-taxable purpose that produces mutual receipts or a combination of both.

In *Fletcher v Income Tax Commissioner*,[158] Lord Wilberforce explained:

> In other cases, there may be in some sense a trading activity, but the objective, or the outcome, is not profits, it is merely to cover expenditure and to return any surplus, directly or indirectly, sooner or later, to the members of the group. These two criteria often, perhaps generally, overlap; since one of the criteria of a trade is the intention to make profits, and a surplus comes to be called a profit if it derives from a trade. So the issue is better framed as one question, rather than two: is the activity, on the one hand, a trade, or an adventure in the nature of trade, producing a profit, or is it, on the other, a mutual arrangement which, at most, gives rise to a surplus?[159]

Although aspects of a co-operative's activities may generate mutual receipts, that does not mean that all its receipts, even those from members, are covered by the principle of mutuality.[160] For example, in the *Sydney Water Board* case it was held that the interest paid by individual members on borrowings from their credit union were not contributions by those members to a common fund but simply the cost of obtaining their individual loans.[161] Similarly, fees paid by the organisers of a trade fair to an association were held not to be fees payable by the members of the association into a common fund as the purpose of the fair was to facilitate trading for profit by individual traders.[162] But determining whether a trade or a mutual arrangement is occurring is not necessarily

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[154] ATO, 'Mutuality and Taxable Income for Not-for-Profits', above n 89.
[155] ITAA 1997, above n 75, s 995-1.
[156] ATO, 'Income Tax: Am I Carrying On a Business of Primary Production?', Taxation Ruling TR 97/11 (16 November 2011).
[157] ATO, 'Mutuality and Taxable Income for Not-for-Profits', above n 89.
[158] *Fletcher v Income Tax Commissioner* [1972] AC 414.
[159] Ibid 421. See also *Municipal Mutual Insurance Ltd v Hills* (1930) 16 TC 430, 441 per Viscount Dunedin and *Federal Commissioner of Taxation v Australian Music Traders Association* [1990] FCA 192 [4].
[160] *Sydney Water Board*, above n 81; *RACV*, above n 80.
[161] *Sydney Water Board*, above n 81.
[162] *Commissioner of Taxation v Australian Music Traders Association* [1990] FCA 192.

straightforward. The ATO provides an example of each. Sales to members from a bar, provided for the benefit of all members, is a mutual arrangement; 'leasing a club facility to a member for their individual benefit … is in the nature of a trade'.[163] But what of a food co-operative that sells fresh and preserved groceries and other household products? Are the sales to members a mutual arrangement or in the nature of a trade? There is no requirement that, to be a mutual receipt, sales must be at cost as the ATO acknowledges that even if sold at a profit, 'the revenue would also be classified as mutual receipts'.[164]

Where a co-operative engages in trade with both members and non-members, and where expenses are incurred, it will be necessary to apportion receipts and expenses.

4.2.5 Apportionment

Differentiating between types of revenue adds significant compliance costs. Apportioning between income that is assessable and that which is not requires reliable systems, processes, procedures and policies, and the clear definition on whether the target entity is dealing with a member or non-member. There are a number of methods available and the method, or methods, chosen must reasonably and accurately reflect the co-operative's revenue and expenses. Where revenue but not expenses can be readily identifiable as coming from members or non-members, the simple method is appropriate.[165] Typically this is recorded by members signing in any guests or the entity recording when a non-member uses the facilities. Here the ratio of members to non-members income is applied to revenue as a single percentage to determine the quantum of member and non-member revenue.

The application, however, is not always as simple. *Royal Automobile Club of Victoria v Federal Commissioner of Taxation*[166] concerned a number of activities. Anderson J was of the opinion that, notwithstanding the complexity or diversity of activities, the principle remained, concluding that '[j]ust as some of the activities of the one organization may be mutual and some not, so also some dealings in relation to an activity may be mutual and some not'.[167] While the revenue attributable to each of the activities was readily ascertainable, the costs were not due to the 'cross services', requiring 'an examination of each head of cost and appropriate allocation', leading to the conclusion that 'while there may be room for differences of opinion as to particular items of cost, what is involved are principles of accountancy rather than principles of law'.[168]

An apportionment methodology accepted as a reasonable basis, particularly for registered and licensed clubs, is referred to by the ATO as 'the Waratahs formula'.[169] It

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[163] ATO, 'Mutuality and Taxable Income for Not-for-Profits', above n 89.
[164] Ibid.
[165] Ibid.
[166] *RACV*, above n 80.
[167] Ibid 572, referring also to *Carlisle and Silloth Golf Club v Smith* [1913] 3 KB 75.
[168] *RACV*, above n 80, 579.
[169] The reference to the formula suggests it is derived from the case of *"The Waratahs" Rugby Union Football Club Ltd v Federal Commissioner of Taxation* (1979) 10 ATR 33. See ATO, 'Mutuality and Taxable Income for Not-for-Profits', above n 89; ATO, 'Waratahs Formula' (Web Page, last updated 4 December 2018) <https://www.ato.gov.au/businesses-and-organisations/not-for-profit-organisations/your-organisation/in-detail/income-tax/mutuality-and-taxable-income-for-not-for-profits/separating-apportionable-items/waratahs-formula>. See also ATO, TD 93/194, above n 88, re apportionment of expenses.

applies where the separation of apportionable revenue and expenses is more involved, and simplifies the process for separating expenses that cannot be easily identified as either member or non-member. This method calculates the 'non-member percentage', which is then applied to the entity's revenue and expenses to arrive at the assessable and deductible components.[170] However, the formula requires a differentiation to be made between members, on the one hand, and members' guests and other visitors (non-members) on the other hand. While clubs and some associations maintain daily registers, co-operatives generally do not. Much depends on the degree of sophistication of the systems, such as point-of-sale, used by each co-operative. As an alternative, the ATO recommends 'a minimum of two one-week surveys be done each year',[171] further increasing complexity, ambiguity and hence compliance costs. Further, because of the variability in the components of the Waratahs formula, this apportionment method will have to be calculated each financial year.

A third apportionment method is available but requires the co-operative to negotiate a percentage with the ATO.[172] This is the fixed percentage method and will only apply so long as there are no material changes in circumstances. What is considered a 'material change' is not stated in the ATO's guide.

4.2.6 Tax rate

If taxable income exceeds AUD 416 in any financial year, a co-operative is required to lodge a company tax return for that year. This threshold is considered very low, not having been changed for several decades.[173] While a recommendation was made to raise this to AUD 10,000, this has not, to date, eventuated.[174]

The tax rate to apply depends on whether the co-operative is a 'base rate entity' (25 per cent rate) or not (30 per cent rate). This requires assessment of aggregate turnover to a turnover threshold and ratio of active (trading) to passive (interest, dividends, rent) assessable income.[175] If the requirements of being a base rate entity are met, the lower tax rate applies (currently 25 per cent). Base rate entity passive income only includes assessable income that is legislatively specified.[176] Therefore mutual receipts being non-assessable, non-exempt income are excluded. But mutual receipts are not excluded from turnover calculations.[177]

4.3 International comparisons

The taxation of co-operatives internationally is varied. The issue of mutual receipts is similar, yet the perspectives taken are different.

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[170] ATO, 'Mutuality and Taxable Income for Not-for-Profits', above n 89.
[171] Ibid.
[172] Ibid.
[173] See, for example, Community Sector Banking, Submission to NFP Tax Concessions Discussion Paper (The Treasury); Moore Stephens, Submission to the Discussion Paper: Not-For-Profit Sector Tax Concessions Working Group (The Treasury) (14 December 2012).
[174] Not-for-Profit Sector Tax Concession Working Group (Linda Lavarch, chair), *Fairer, Simpler and More Effective Tax Concessions for the Not-for-Profit Sector: Final Report* (May 2013); Danielle Kutchel, 'Exclusive: '"Unfinished Business" for Not for Profit Tax System', *Pro Bono Australia* (17 August 2022).
[175] *Income Tax Rates Act 1986* (Cth), above n 150, s 23AA.
[176] Ibid s 23AB.
[177] ATO, 'Mutuality and Taxable Income for Not-for-Profits', above n 89, above n 89.

4.3.1 United Kingdom

In the United Kingdom the principle of mutuality has been at the core of the development of the taxation of co-operatives. However, this has been progressively eroded to the point now where co-operatives are considered companies for tax purposes, liable to corporation tax computed in accordance with the rules pertaining to companies. Mutuality is still recognised but in specified circumstances.[178] Provided the calculation of certain sums that constitute the profit meet certain criteria[179] and the co-operative only has a relationship with members, those sums are excluded from the calculation of profits.[180] In addition, if a distribution is made to members, whether that distribution comes from the surplus of trading with members or with non-members must be established as distributions out of a mutual surplus give rise to taxable receipts whereas distributions out of taxable income give rise to non-taxable receipts.[181]

The basis of the taxation treatment of mutual trading is *Ayrshire Employers Mutual Insurance Association Ltd v Commissioners of Inland Revenue*.[182] The decision shows that it is not the fact of membership or non-membership that determines exemption from or liability to tax. It is the nature of the transactions themselves which is the case in Australia. If the transactions are in the nature of mutual trading the resulting surplus is not taxable. But the transactions can only amount to mutual trading if the contributors are members who are entitled to a return of their share of the surplus contributions.

4.3.2 United States

The position in the United States is very different. While most provisions in the *Internal Revenue Code* apply to co-operatives on the basis that they conduct business, Subchapter T[183] specifically relates to co-operatives. It applies to 'any corporation operating on a cooperative basis', without defining 'cooperative' or 'operating on a cooperative basis'. It has been held to include non-farming businesses such as co-op grocery stores,[184] hardware stores,[185] and service providers.[186] The benefit of qualifying as a co-operative is access to single tax treatment (flow-through taxation) where the patron or member, rather than the co-operative, pays the tax.[187] Earnings from sources

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[178] For example, there is specific statutory confirmation of the non-application of the mutuality principle to property income: *Corporation Tax Act 2009* (UK) s 260 for corporation tax and *Income (Trading and Other Income) Act 2005* (UK) s 321 for income tax.
[179] These are: (1) that contributors to and participants in a surplus must be identical; (2) that the surplus must go back to contributors; (3) that surplus contributions must be returned, and (4) that members control the co-operative.
[180] *Corporation Tax Act 2009* (UK), above n 178, s 132.
[181] *Corporations Tax Act 2010* (UK) s 1070.
[182] *Ayrshire Employers Mutual Insurance Association Ltd v Commissioners of Inland Revenue* [1946] 27 TC 331.
[183] Internal Revenue Code ss 1381-1388 covering determining qualifying co-operatives, definitions of key co-operative tax terms, how taxable income is calculated and also addresses patron taxation. In addition, s 521 provides an exemption of farmers' co-operatives from tax.
[184] *Certified Grocers of California, Ltd v Commissioner*, 88 TC 238 (1987); *Twin County Grocers, Inc v United States*, 2 Cl Ct 657 (1983); and *United Grocers, Ltd v United States*, 308 F.2d 634 (9th Cir 1962), aff'g, 186 F. Supp 724.
[185] *Cotter and Co v United States*, 765 F.2d 1102 (Fed Cir 1985), rev'g, 6 Ct Cl 219 (1984).
[186] *Washington-Oregon Shippers Cooperative, Inc v Commissioner*, 52 TCM (CCH) 1406 (1987).
[187] *Puget Sound Plywood, Inc v Commissioner* (44 TC 305, 307-308 [1965], acq 1966-1 CB 3); Frederick, above n 79, 8; Sofia Arana-Landin, 'US Worker Cooperatives: A Dire Need for a Profound Revision of Their Tax Regulation at a Federal Level' (2022) 4 *International Journal of Cooperative Law* 131, 150.

other than members are taxed in the co-operative. Surpluses not distributed are treated as if they had been distributed and re-invested. As a consequence, undistributed surpluses are taxed in the hands of the co-operative and later the patrons (members) when distributed.[188]

Following a number of disputes over the meaning of 'operating on a cooperative basis', a revenue ruling was issued in 1972 effectively stating that, to qualify, the co-operative must do more than 50 per cent of its business with members.[189] This ruling was subsequently invalidated by the courts.[190] The revenue ruling was modified so that whether a corporation is operating on a cooperative basis 'will be determined from all the facts and circumstances and the cooperative principles enunciated in *Puget Sound Plywood*'.[191] The Court in *Puget Sound Plywood v Commissioner*[192] listed 'three guiding principles … as the core of cooperative economic theory', being: (1) limiting the financial return of capital; (2) democratic control by the members, and (3) allocation of margins (or surplus) on the basis of patronage.[193]

It is important to note that incorporation as a co-operative under a state or federal law does not necessarily qualify that entity to apply Subchapter T of the *Internal Revenue Code*.[194] When considering if an entity is a co-operative, it is not the fact that it has been constituted or registered as such, but rather how it operates – that the entity acts on a cooperative basis.[195] The legal forms a co-operative can take are: corporations, limited liability companies, section 501(c) co-operatives, and exempt or section 521 entities and partnerships.[196] Thus, in the US, there are different choices of taxation depending on the legal form the entity, acting on a cooperative basis, takes. Consequently, there is no single special regime for all co-operatives but several, as different tax provisions may apply depending on the legal form chosen and how it operates.

4.3.3 European Union

In the European Union the focus has been on the balancing of Member State tax sovereignty with State Aid, ie, tax competition. As the basic law on the European Cooperative Society expressly excludes taxation,[197] this has allowed individual Member States to create specific tax regimes for their own co-operatives.[198] A constraining factor is the prohibition of State Aid.[199] The Court of Justice of the European Union has determined that tax exemptions, granted to co-operative societies, would only constitute

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[188] Arana-Landin, above n 187, 150.
[189] United States Internal Revenue Service, Revenue Ruling, Rev Rul 93-21; 1993-1 CB 188; United States Internal Revenue Service, Revenue Ruling, Rev Rul 72-602, 1972-2 CB 511
[190] On the grounds that it added a quantitative requirement not intended by Congress. See, for example, *Conway County Farmers Association v United States*, 588 F.2d 595 (8th Cir 1978), rev'g 1978-1 USTC (CCH) and 9334 (ED Ark 1978); *Columbus Fruit and Vegetable Cooperative Association, Inc v United States*, 7 Cl Ct 561 (1985); *Geauga Landmark, Inc v United States*, No 81- 942 (ND Ohio 1985).
[191] United States Internal Revenue Service, Revenue Ruling 93-21, IRB 1993-1 CB 188, modifying Revenue Ruling 72-602, 1972-2 CB 510.
[192] *Puget Sound Plywood, Inc v Commissioner*, 44 TC 305, 308 (1965), acq 1966-2 CB 6.
[193] Ibid 308 per Pierce J.
[194] Frederick, above n 79.
[195] Arana-Landin, above n 187.
[196] Ibid 131.
[197] European Council, Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society, [2003] OJ L 207/1 (as amended).
[198] Torralvo, above n 11.
[199] *Treaty on the Functioning of the European Union*, Art 107(1).

State Aid if they were selective and not justified by the nature or economy of the tax system.[200] Consequently, in 2016, the European Commission drew up a Commission Notice on State Aid and Article 107.[201] Importantly, it was confirmed that economic activity, not legal status, defines undertakings as entities, meaning that '[t]he classification of a particular entity as an undertaking thus depends entirely on the nature of its activities'.[202] The Notice also specifically addressed co-operative societies. It held that, in light of their particular features (such as specific membership requirements, activities conducted for the mutual benefit of members, reserves and assets being non-distributable), co-operatives 'can be regarded as not being in a comparable factual and legal situation to that of commercial companies'.[203]

For co-operatives specifically, any exemption or special treatment requires 'an analysis of whether the tax regime in question is justified by the logic of the tax system',[204] that is, its nature or general scheme.[205] A tax exemption or reduced tax rate granted to a co-operative can, for example, be justified by the fact that all profit or surplus is distributed and subsequently taxed in the hands of the receiving members. Alternatively, as in Spain, Portugal and Italy, where it is seen as desirable to retain a percentage of the net revenue, tax provisions are used to achieve this by making a percentage of net revenue deductible.[206] The justification is qualified in that 'the reduced taxation must be proportionate[207] and not go beyond what is necessary' and appropriate controls are implemented.[208]

4.3.4 Concluding comments

Australia and the United Kingdom distinguish mutual activities from non-mutual trading activities, giving rise to the need for apportionment, and both tax the entity. The United States, on the other hand employs flow-through taxation. It also takes the view that the entity is taxed as a corporation in the first instance unless it can establish itself as a co-operative whereas Australia's view is that, provided it does not have a share capital, being taxed as a corporation is more of a last resort.

The legal form is of no consequence in both the United Kingdom and United States. In the former all co-operatives are considered companies for tax purposes while in the latter the legal form is not a consideration at all. The European Union, on the other hand, adopts an either/or approach. In Australia co-operatives registered as companies and co-

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[200] *Paint Graphos and others* (Joined Cases C-78/08 to C-80/0) ECLI:EU:C:2011:550 (8 September 2011) [82].

[201] European Commission, *Commission Notice on the Notion of State Aid as Referred to in Article 107(1) of the Treaty on the Functioning of the European Union* [2016] OJ C 262/1 ('*Commission Notice on the Notion of State Aid*').

[202] Ibid [2.1]. See also *Pavlov and Others* (Joined Cases C-180/98 to C-184/98) ECLI:EU:C:2000:428 (12 September 2000) para 74; *Cassa di Risparmio di Firenze SpA and Others* (C-222/04) ECLI:EU:C:2006:8 (10 January 2006) para 107.

[203] European Commission, *Commission Notice on the Notion of State Aid*, above n 201, [157] and [158].

[204] Ibid [159].

[205] Richard Lyal, 'Transfer Pricing Rules and State Aid' (2015) 38(4) *Fordham International Law Journal* 1017, 1032.

[206] Arana-Landin, above n 187.

[207] The principle of proportionality is laid down in Article 5(4) of the *Treaty on European Union* and seeks to set actions taken by European Union institutions within specified bounds which includes that the measure must be both suitable and necessary to achieve the desired end and must not impose a burden on the individual that is excessive in relation to the objective sought.

[208] European Commission, *Commission Notice on the Notion of State Aid*, above n 201, [160].

operatives with a share capital are taxed as companies thereby differentiating non-distributing co-operatives without a share capital

The manner in which co-operatives are taxed in Australia, the United Kingdom and United States has in each case developed on an ad hoc basis, driven largely by developments in the principle of mutuality at common law. The consequence is that they all generally agree that proceeds from mutual trade distributed to members are not taxed and proceeds from trade with non-members are taxed. In the United States, this can give rise to double taxation when distributed while in Australia and the United Kingdom such amounts are excluded from the calculation of profit and hence the calculation of assessable income.

The European Union has taken a purposive approach, based on clear policy objectives. Here the courts consider the justification for any special treatment in accordance with the principle of proportionality laid down in the *Treaty on European Union*.[209] However, this can result in piecemeal concessions that are not uniformly applied.

When it comes to the taxation of co-operatives, best practice is still illusive.

5. CONCLUSIONS

The 2012 International Year of Co-operatives, initiated by the United Nations, raised awareness of the important role of co-operatives in promoting sustainable development and contributing to economic development more generally. This contributed to also raising awareness of co-operatives as a viable business model that advances both social and economic development. The year 2025 has been proclaimed by the UN as the next International Year of Co-operatives.[210] The 2023 resolution also sought to draw governments' attention to the recommendations made in the UN Secretary-General's report, *Cooperatives in Social Development*, so as to support and strengthen co-operatives as successful business enterprises.[211] One recommendation relates to improving laws and regulations with respect to, inter alia, taxation. The report particularly noted that co-operatives 'continue to play a relatively small part in overall economic and social policies and practice, compared with their huge potential contribution'.[212]

If co-operatives are to be afforded differential tax treatment, this must be justifiable to avoid accusations of, or even suspicions of, favouring a position of unfair competition against companies operating in the 'open' market. It could be argued that the attributes of a co-operative – in particular the focus on social objectives – provide this justification.[213] A further recommendation suggested by John Taylor was to collect into

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[209] Article 5(4). See n 207 above.
[210] United Nations, General Assembly, *Resolution on Cooperatives in Social Development*, GA Res A/RES/76/135, UN Doc A/C.3/78/L.11 (10 October 2023, adopted 3 November 2023).
[211] United Nations, *Cooperatives in Social Development: Report of the Secretary-General*, above n 47.
[212] Ibid 13.
[213] See, for example, European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Building an Economy That Works for People: An Action Plan for the Social Economy*, COM/2021/778 final, 9 December 2021 ('*An Action Plan for the Social Economy*').

one Division of the income tax Act the 'various provisions which govern the distribution of surpluses to members'.[214]

Co-operatives are different from all other forms of business organisations. They have been termed the 'enfants terribles' of economics[215] as they are arguably too socially or community-oriented for mainstream business but too business-oriented for the not-for-profit sector. Perhaps they are better termed 'social economy organisations'. The characteristics of co-operatives can assist in fostering more sustainable business models. Their participatory and democratic structures, collective decision-making, frequently multi-objective and multi-stakeholder nature, and their focus on social aspects are foundational characteristics that could prove to be fundamental for a paradigm shift in the prevailing operating models.[216]

Recently, there has been a flurry of activity promoting the social economy/social enterprise model, with prominence given to co-operatives. For example, in 2023, the OECD released two policy guides[217] and nine thematic papers. This followed a 2022 manual and a number of policy briefs and in-depth country reviews on social entrepreneurship.[218] The European Commission provided an action plan for the social economy to the European Parliament, Council and other committees in 2021.[219] The International Labour Organization's Recommendation 193 on the Promotion of Cooperatives, adopted in 2002 and updated in 2014, provides an internationally agreed template for national policy[220] and the social and solidarity economy was a key feature of its 2022 conference.[221]

On 19 June 2023 the UK government announced a review of the *Co-operative and Community Benefit Societies Act 2014*.[222] Apart from legislative changes, which entailed more of a consolidation of legislation rather than material changes to the law

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[214] Taylor, 'Reform of Co-operative Legislation', above n 63, 112.
[215] Yair Levi and Peter Davis, 'Cooperatives as the "Enfants Terribles" of Economics: Some Implications for the Social Economy' (2008) 37(6) *The Journal of Socio-Economics* 2178.
[216] International Cooperative Alliance and Euricse, *World Cooperative Monitor: Exploring the Cooperative Community* (December 2021) 30; Marek Hudon and Benjamin Huybrechts, 'From Distant Neighbours to Bedmates: Exploring the Synergies Between the Social Economy and Sustainable Development' (2017) 88(2) *Annals of Public and Cooperative Economics* 141.
[217] OECD, *Policy Guide on Legal Frameworks for the Social and Solidarity Economy* (Local Economic and Employment Development Series, 20 March 2023); OECD, *Policy Guide on Social Impact Measurement for the Social and Solidarity Economy* (Local Economic and Employment Development Series, 20 March 2023).
[218] See OECD, 'Social Entrepreneurship and Social Enterprises' (Web Page, 2023) <https://www.oecd.org/cfe/leed/social-economy/social-entrepreneurship.htm>.
[219] European Commission, *An Action Plan for the Social Economy*, above n 213.
[220] International Labour Organization, *Promoting Cooperatives: An Information Guide to ILO Recommendation No 193* (2014).
[221] International Labour Organization, '110th Session of the International Labour Conference' (Web Page, 2022) <https://www.ilo.org/ilc/ILCSessions/110/lang--en/index.htm>.
[222] Andrew Griffith (Economic Secretary to the Treasury), 'Law Commission Reviews of the Co-operative and Community Benefit Societies Act 2014 and Friendly Societies Act 1992' (Treasury Ministerial Statement, 19 June 2023). At the time of writing, the Terms of Reference have not been released.

and which resulted in the 2014 Act,[223] the last general review and reform of the law pertaining to co-operatives in the UK was reportedly undertaken in 1893.[224]

In 2016 an Australian Senate inquiry provided its report into co-operative, mutual and member-owned firms.[225] Here the recommendations related to compiling statistical data to better understand the sector, developing support programs to encourage growth in the sector and ensuring co-operatives are better represented in government policy. While taxation was sporadically referred to, no express recommendations were made. Taxation is also not mentioned in the Australian Business Council of Co-operatives and Mutuals discussion paper, issued in August 2023, on the regulation of co-operatives,[226] where the focus is on the Co-operatives National Law as a legislative framework, and uniformity in administration.

Historically, the debate about co-operatives has always been ideological more than technical. However, with an increased focus on sustainable development and the social economy, the co-operative business model provides a viable innovative and democratic alternative. Tax policy will become increasingly important as the use of co-operatives, as a business model, increases.

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[223] Mike Aiken et al, 'Social Enterprise in the UK: Models and Trajectories' in Jacques Defourny and Marthe Nyssens (eds), *Social Enterprise in Western Europe: Theory, Models and Practice* (Routledge, 2021) 253. See also Law Commission (UK), *Annual Report 2013-14* (Law Com No 352, 2014).

[224] Co-operatives UK, 'Andrew Griffith MP Announces Government Review of Co-operative and Community Benefit Societies Act 2014 at Congress' (Web Page, last updated 19 June 2023) <https://www.uk.coop/news/andrew-griffith-mp-announces-government-review-co-operative-and-community-benefit-societies>.

[225] Australian Parliament, Senate Economics References Committee, above n 12.

[226] Business Council of Co-operatives and Mutuals, *Modernising Australian Co-operatives Regulation: Discussion Paper* (August 2023).