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Explaining the U.S. Income Tax Compliance Continuum

Brian Erard* and Chih-Chin Ho†

Abstract

Within an economy, tax compliance behavior falls along a continuum. At one extreme are households who fully report and pay their tax obligations despite any opportunities or incentives to cheat. At the other extreme are households who undertake considerable efforts to conceal their income and repudiate their tax responsibilities. Using a micro-simulation database, we undertake a preliminary statistical analysis of why 34 distinct occupational groups in the U.S. differ in their location along the compliance continuum. We find that compliance across occupations has a strong positive association with the share of income subject to third party information reporting and a strong negative association with the burden of preparing and filing a return.

I. INTRODUCTION

Although there is by now a vast empirical literature on individual income tax compliance, most of this literature addresses only underreporting by filers of tax returns, ignoring the millions of nonfilers who fail to pay their income tax obligations each year.1 In this paper, we address this gap, providing an analysis that accounts for underpayment of taxes through both nonfiling and underreporting. Our analysis relies on a proprietary micro-simulation data base that we have developed using audit information from two special U.S. Internal Revenue Service (IRS) Taxpayer Compliance Measurement Program (TCMP) studies conducted for tax year 1988—one for filers and the other for nonfilers.2 Although this data base would benefit from further refinement, particularly with respect to the imputation and allocation of certain forms of income, it provides detailed information on noncompliance, both by individuals who file returns but understate their taxes and individuals who neither file a return nor pay all of the taxes that they owe. We use our data base to map where members of 34 distinct occupational groups in the U.S. fall along a continuum ranging from fully compliant to fully noncompliant. Then, using a regression model, we examine the degree to which various factors can explain the observed variation in compliance among the different groups.

The remainder of our paper is organized as follows. Section 2 summarizes the key data elements underlying our micro-simulation data base. Section 3 provides a brief description of our methodology for imputing certain forms of income to individual filers and nonfilers to account for income that has gone undetected during examination. Section 4 presents the results of our statistical analysis of the variation in compliance by occupation, and Section 5 provides a brief conclusion.

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* Any opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Internal Revenue Service

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II. DATA SOURCES

The core elements of our micro-simulation data base are derived from two separate TCMP studies that were conducted for tax year 1988, one for filers and another for nonfilers. Although these data are now some 15 years old, they have the advantage of providing detailed compliance information about both filers and nonfilers for a common tax year. We recognize that the magnitude and composition of tax noncompliance are likely to have changed since these data were collected. Notwithstanding, we believe that the data remain informative about the fundamental nature of the compliance decision and the broad underlying factors associated with noncompliance.

TCMP Filer Data
The data for filers of 1988 federal income tax returns are taken from the IRS TCMP Phase III Survey. This survey contains the results of intensive line-by-line audits of a stratified random sample of approximately 54,000 individual income tax returns for tax year 1988. For most line items both the amount that was reported by the filer and the amount that the examiner determined should have been reported are available. For income items, changes assessed by the examiner to the amount originally reported by the taxpayer are broken down according to whether the change was based on a review of third party information return documents or if it was based on other information. As discussed below in section 3, this distinction is useful for purposes of imputing additional non-detected income to taxpayer returns. A code is also available for the primary filer’s occupational category based on the IRS examiner’s assessment of the filer’s main line of work. A set of sample weights is included to make the data representative of the national return population.3

TCMP Nonfiler Data
Our data on nonfilers comes from the examination-based segment of the IRS TCMP Phase IX Nonfiler Survey. The special TCMP study began with a stratified random sample of 23,283 potential nonfilers from a population of 83 million individuals for whom there was no record of a 1988 individual income tax return being filed.4 Revenue officers set out to locate each of the individuals in this sample to determine whether they should have filed an individual income tax return for tax year 1988.5 A total of 18,689 of the 23,283 potential nonfilers were successfully located through the search process. The revenue officers had access to information documents and past filing records. Using these records along with the information they collected during an interview or field visit with the individual, the officers made a determination whether the individual was required to file a return; i.e., whether the potential nonfiler was a “true nonfiler”. Tax returns were secured from 3,546 individuals who were deemed to have been in violation of their tax filing requirements, and a random sample of 2,195 of these returns were subjected to intensive line-by-line audits, comparable to the audits performed for the TCMP Phase III study of individual return filers. It is the details from these 2,195 examined returns that we include in our micro-simulation data base. As with the filer data, the nonfiler records include the occupation of household head as well as detailed line item information about the sources and levels of household income, deductions, credits, and expenses.

Since not all potential nonfilers in the original sample of 23,283 were located, it is highly likely that a number of true nonfilers went unidentified.6 We have therefore modified the sample weights for our sample of 2,195 located true nonfilers to make
these individuals broadly representative of all true nonfilers using an econometric approach that accounts for the likelihood that a household could be located on the basis of the information (prior tax returns, third-party information slips, etc.) that was available to the revenue officer at the time he began searching for the household. This approach, which we previously employed in developing the official IRS estimate of the nonfiling tax gap, is described in Internal Revenue Service (1996).7

**Combined Sample**
To develop our core data base, we merged together the detailed information (both per return and per exam) from the TCMP filer and nonfiler data files. When weighted, our combined sample of approximately 56,000 households represents an estimated population of 112.3 million, including 104.3 million filers and 9 million nonfilers. For each household, the data base allows us to identify the occupation of the primary taxpayer and assess the sources and magnitudes of noncompliance. It also includes an imputed variable meant to approximate the burden associated preparing and filing a tax return for each of the households in our sample. This variable was defined using an IRS formula for the average time burden, in hours, for an individual whose return contains a particular set of forms and schedules.8

### III. IMPUTATION OF UNDETECTED NONCOMPLIANCE

Even intensive examinations such as those conducted under the TCMP cannot fully uncover all noncompliance that is present. Unless undetected noncompliance is accounted for, TCMP results can provide a misleading account of the degree to which different households and occupational groups comply with their tax obligations. Below, we briefly summarize the methodology we employ to impute undetected noncompliance to returns in our micro-simulation data base. Further details are provided in Erard and Ho (2003).

TCMP examinations are generally believed to be very effective in identifying improper reports of deductions, credits, and expenses. As well, examiners have relatively little difficulty uncovering noncompliance on key income items (such as wages and interest) that are reported by third parties. For all such items, we assume that any noncompliance is fully uncovered during the examination. Our imputation of undetected noncompliance is therefore restricted to the subset of income items that not subject to information reporting. To account for undetected noncompliance, we follow a procedure similar to that employed by the IRS to generate its official estimates of the individual income tax gap—the difference between the amount of income that households owe and the amount they voluntarily pay in a timely manner.

**General Imputation Approach**
In most cases, we follow the IRS in assuming that for every dollar of undeclared income detected without the aid of third-party information returns, there is another $2.28 that has gone undetected by the examiner. This assumption is based on a special TCMP study conducted for tax year 1979, from which the IRS determined that examiners, on average, were able to identify only a little less than one third of undeclared income amounts when they did not have access to information returns.

**Imputation of Tip Income**
One major exception to this general approach for imputing undetected noncompliance is our treatment of undeclared tip income. Rather than expanding the undeclared tip income that the TCMP examiner uncovered to account for non-detection, we have
replaced the TCMP examiner figure with an independent estimate of tip underreporting by the Bureau of Economic Analysis (BEA). For tax year 1988, the BEA estimated that filers reported only $5.9 billion in tips on their returns, understating their true tip income by $11.6 billion. In the absence of specific information on who understated this income, we identified some 4.4 million filers in our database that were likely to receive tip income on the basis of their occupation codes (waiters, barbers, hairdressers, bellhops, etc.), and we assigned each an equal share of the $11.6 billion (approximately $2,650 each). We employed a comparable approach to allocate $532 million in tip income to nonfilers based on the BEA estimate for nonfilers.9

**Imputation of Informal Supplier Income**

A second major exception to our general imputation approach is our treatment of “informal suppliers.” The IRS defines “informal suppliers” as:

> individuals who provide products or services through informal arrangements which frequently involve cash-related transactions or ‘off the books’ accounting practice.

(Internal Revenue Service, 1996, p. 43)

Examples include self-employed domestic workers, street-side vendors, and moonlighting tradesmen. Conceptually, the informal economy includes all types of market economic activity that are potentially under-measured in the National Accounts owing to the vendors’ informal business style (sales in cash, lack of adequate records of sales and purchases, etc.) Since the detection of noncompliance among such individuals is likely to be especially difficult, the IRS commissioned the Survey Research Center of University of Michigan to conduct some special studies during the 1980s to derive estimates the gross sales revenue earned by informal suppliers. Rather than attempt to interview the *suppliers* of goods and services in the informal economy (who might not be forthcoming about their activities), the University of Michigan researchers elected to interview the *purchasers*. Specifically, they relied on telephone surveys of nationally representative samples of households in 1981, 1985, and 1986 on their purchases of informally supplied goods and services. The results of these surveys were used to develop an estimate of the gross revenue of informal suppliers in tax year 1988. Estimated expenses were then accounted for, resulting in an aggregate net income figure of $62.2 billion.

Some informal suppliers do report at least a portion of their net income from sales on their tax returns. To assess the amount that was reported, the IRS developed criteria for identifying likely informal suppliers based on their tax return information. Specifically, a taxpayer was designated as an informal supplier if (s)he: (1) filed a Schedule C return (report of self-employment income); (2) reported a principal industrial activity (PIA) that was closely aligned with one of 14 categories of informally supplied goods and services; and (3) made no claim for certain types of business expenses (taxes, rent, insurance, etc.) that informal suppliers are not believed to typically incur.

Following this approach, we designated a subsample of households in our database representing approximately 2.7 million filers and 712,000 nonfilers as informal suppliers. We divided the estimated $62.2 billion in true net informal supplier income among filers and nonfilers according to their shares in the overall informal supplier
population. We assumed that all of the Schedule C (self-employment) net income reported by these households ($9.5 billion by filers and $9.7 billion by nonfilers) on their tax returns was attributable to informal activities. The aggregate difference between our measures of true and reported informal supplier income for each group represented our estimate of total undeclared income. In the absence of specific information about the relative levels of underreporting by different informal suppliers, we imputed an equal share of the estimated total level of undeclared informal supplier income to each member of the group.

**Computation of Additional Tax Liability**

The above imputations resulted in the assignment of additional net taxable income for many households beyond that detected during the examination. We applied a simplified tax calculator to translate this additional income into additional tax liability. A more elaborate algorithm was required to estimate the additional self-employment tax associated with our imputations of additional self-employment income to returns.

**IV. AGGREGATION OF RESULTS BY OCCUPATION**

For each filer in our data base, we have computed our overall measure of tax noncompliance as the difference between our expanded measure of total tax after credits (inclusive of the Earned Income Tax Credit) and the amount originally reported on the return. This measure of noncompliance can be positive, zero, or negative depending on whether the filer has understated, correctly stated, or overstated his tax liability on the return. Often overstatements of tax liability are the result of unintentional errors, as are some understatements. We do not attempt to distinguish between intentional or unintentional errors in our analysis.

In the case of nonfilers, our measure is the difference between our expanded measure of total tax after credits (again, inclusive of the Earned Income Tax Credit) and the total amount of tax that was prepaid (for instance, through withholding and estimated tax payments). As with our filer measure, this noncompliance measure can be positive, zero, or negative depending on whether the nonfiler has made tax prepayments that fall short of, just meet, or exceed his full tax liability.

While our data base therefore contains a measure of tax noncompliance at the household level, we do not perform our analysis at this level, because we feel that our above methodology for imputing undetected income to individual households is not sufficiently refined. In particular, the procedure is likely to understate the amount of unreported income that has gone undetected for some households, while overstating the amount for others. To address this problem, we have aggregated results into 34 distinct occupational groups, thereby canceling out many of the errors made in imputing undetected income at the household level. Below we present the results of our analysis of compliance by occupation.

**V. RESULTS**

Using our micro-simulation data base, we have developed a preliminary map of where members of 34 distinct occupational groups in the U.S. fall along a continuum ranging from fully compliant to fully noncompliant. With the aid of this map, we have conducted a regression analysis to explore the factors responsible for the variation in compliance among the different occupational groups.
Overall Noncompliance by Occupation

Table 1 presents our estimates of overall noncompliance by occupational category, which accounts for both nonfiling and misreporting. On net, underpayments of tax liability more than offset overpayments within each category, so that the average level of noncompliance is positive in all cases. The occupations in the table are ranked in order of the average dollar level of noncompliance. By this measure, the 5 least compliant occupations are: (1) vehicle sales; (2) investors; (3) informal suppliers; (4) lawyers and judges; and (5) doctors and dentists.

At the other end of the continuum, the 5 most compliant occupations are: (1) the “other” occupation category, which includes homemakers; (2) military; (3) administrative support; (4) retired or disabled; and (5) production/manufacturing.

As stressed in Erard and Ho (2003), however, the compliance rankings differ when noncompliance is measured in terms of the aggregate percentage of taxes unpaid rather than the average level of noncompliance. For instance, as noted above, lawyers and judges rank fourth highest in terms of the average level of noncompliance, underpaying taxes by an estimated average of $2,273 per return. However, this represents only about 8.9 percent of their estimated overall tax liability, compared to an estimated 14.9 percent underpayment for all occupations as a whole. Similarly, doctors and dentists rank high in terms of the average estimated dollar level of noncompliance ($2,181), but low in terms of the estimated share of their overall liability that goes unpaid (7 percent).

Conversely, certain occupational groups rank relatively low in terms of average dollars of noncompliance, but quite high in terms of the aggregate share of tax liability that goes unpaid. For instance, individuals employed in service occupations other than those associated with tip earners, informal suppliers, or protective services (“other services”) understate their taxes by an estimated $371 – well below the mean of $655 for the population as a whole. However, this represents some 33.1 percent of their estimated overall tax liability, which is very large relative to the average underpayment rate of 14.9 percent. Similarly, helpers and handlers (who do routine work under close supervision, such as assisting skilled workers in the construction trades, stocking grocery shelves, or packing or moving freight, cargo, or materials) are estimated to understate taxes by the relatively low amount of $409 on average, but this represents 23.8 percent of their estimated overall tax liability.

Although the relative compliance rankings for the above occupational groups depend critically on whether noncompliance is measured in absolute or percentage terms, many groups rank consistently high or low under both types of measure. For instance, the vehicle sales group ranks highest both in terms of estimated average level of noncompliance ($6,406) and estimated share of overall taxes not paid (51.1 percent). Other occupational groups that rank consistently high in terms of noncompliance are: informal suppliers; farm and agriculture-related workers; tip earners; real estate, financial, and insurance; construction and extraction; and forestry, logging, fishing, hunting, and trapping.

At the other extreme, occupational groups that rank consistently high in terms of compliance include: military; administrative support; retired or disabled; production and manufacturing; protective services; technologists and technicians; accountants, auditors, and tax preparers; postsecondary teachers; other teachers, counselors, and
Compliance by Filing Status
Table 2 breaks down compliance by occupation and filing status. Nonfiling appears to be heavily concentrated within certain occupational groups. Specifically, although individuals employed in the informal suppliers, helpers and handlers, and other service categories account for only an estimated 11 percent of the filer population, we estimate that they account for over 60 percent of the nonfiler population. Together, these three occupational groups account for over one quarter of the overall estimated tax gap (for filers and nonfilers combined). Particularly among these occupational groups, it is important to account for the behavior of nonfilers when drawing inferences about compliance.

Across all occupations, the average estimated level of noncompliance is over twice as large for nonfilers as it is for filers ($1,215 compared to $607). This is consistent with Erard and Ho (2001), who found that the aggregate share of noncompliance attributable to nonfilers was large in relation to their representation in the population.

Table 2 illustrates that compliance is sometimes relatively high among those members of an occupational group who file returns, but relatively low among those members who elect not to file. For instance, mechanics and repairers who file tax returns underreport their taxes by an average of $486, compared to $607 for all filers combined. However, among those mechanics and repairers who do not file returns, noncompliance tends to be much larger than for other nonfilers ($5,373, on average, compared to $1,215 for all nonfilers combined). A similar pattern is observed for the transportation and material moving category.

Regression Analysis
To investigate the reasons underlying the variation in compliance by occupation, we undertook a grouped data regression analysis. In particular, we regressed the average dollar level of noncompliance for each occupational group against the following regressors:

- **IRP Income Share**: the group mean of the ratio of income subject to third party information reporting to total income, multiplied by 100;
- **Audit Rate**: the average group audit rate, computed by assigning the relevant IRS district level audit rate for the prior tax year (multiplied by 100) to each household in a given occupational group and computing the mean of these rates;
- **AGI**: the group mean adjusted gross income divided by $100,000;
- **Marginal Tax Rate**: the group mean marginal tax rate, multiplied by 100;
- **Time Burden**: the group mean time burden (in hours) associated with preparing and filing a return;
- **Percentage Elderly**: the group percentage of taxpayers of age 65 or older, multiplied by 100; and
- **Percentage Married**: the group percentage of taxpayers with a married joint filing status, multiplied by 100.

The first two regressors in our specification relate to the opportunity of successful noncompliance. All else equal, the larger the share of total income that is subject to third party information reporting, the lower the opportunity for evading taxes by not
declaring income. Similarly, a household from an IRS district with a relatively high audit rate may perceive relatively less opportunity for noncompliance.

Assuming decreasing absolute risk aversion, the standard expected utility theory of tax compliance predicts that compliance will tend to be decreasing in income, but increasing in the marginal tax rate. However, the latter prediction remains controversial.

The time burden may impact a household’s willingness to file a return and report what is owed. This variable may also serve as a proxy for legal ambiguity, which can also impact on the compliance decision.

Finally, our specification includes demographic variables to investigate the impact of age and marital status on compliance.

The dependent variable and each of the regressors contain one observation for each of the 34 occupational groups. We employ a weighted regression analysis to control for the heteroskedasticity associated with specifying our model in terms of group means.16 All regressors are defined using the values of the relevant variables as determined by examiner and amended through imputation rather than the amounts originally reported by the households. We believe that the former are likely to provide a more accurate representation of actual household characteristics than the latter.

**Results for Combined Sample of Filers and Nonfilers**

The results of our regression analysis of the variation in compliance by occupation for our combined sample of filers and nonfilers are presented in Table 3. As expected, noncompliance tends to be greater in occupations with a lower share of income subject to third party information reporting. More specifically, a one percentage point reduction in this share, all else equal, is associated with a $34 increase (or a 5 percent rise, on average) in noncompliance. The estimated coefficient for the audit rate is also negative, indicating a deterrent role for audits. However, the latter estimated relationship is not statistically significant. Similarly, the signs of the estimated coefficients of adjusted gross income and the marginal tax rate are consistent with the standard expected utility theory of tax compliance, but neither estimate is statistically significant.

The results indicate that the time burden associated with filing and preparing a return is positively related to noncompliance. All else equal, a one hour increase in the time burden is associated with an additional $119 (an 18 percent increase, on average) of noncompliance. As a direct factor, a large burden may discourage some households from filing a return and induce others to cheat in attempt to recoup their costs associated with preparing and filing their return. Perhaps more importantly, burden is likely to be positively correlated with legal ambiguity. Ambiguity regarding the proper treatment of a tax issue can give savvy taxpayers (and their preparers) a basis for taking an aggressive interpretation of the law. Such a basis can make it less likely that a penalty would be imposed if the taxpayer’s position were ultimately rejected during an audit or appeal. Furthermore, for less savvy taxpayers, ambiguity may promote a higher incidence of unintentional errors, stemming from confusion over how certain sources of income, deductions, or expenses should be treated.

Finally, the results indicate that elderly individuals and married couples tend to be somewhat more compliant than young and single individuals.
Results for Filer Sample
Most econometric studies of tax compliance have relied solely on data for filers of tax
returns. To investigate whether the exclusion of nonfilers from the sample leads to
biased inferences, we have repeated our analysis of the variation in compliance by
occupation using only the data from our filer sample. As summarized in Table 4, the
filer sample results are qualitatively very similar to the full sample results in Table 3,
although the regressor for the percentage of married taxpayers loses its statistical
significance in the restricted sample. Thus, restricting attention to filers does not seem
to impart much bias on inferences concerning the determinants of noncompliance.

VI. CONCLUSION
In this paper, we have performed a preliminary analysis of noncompliance by
occupation using a micro-simulation base that contains information on both filers and
nonfilers of U.S. federal individual income tax returns. We began by deriving a map
of where 34 distinct occupational groups fall along the compliance continuum. The
results show that, for many occupational groups, the relative ranking depends on
whether compliance is defined in absolute terms or as a share of taxes owed.

Using a grouped data regression analysis, we have explored what factors are
responsible for the variation in compliance along the continuum. The results indicate
that opportunity plays a key role in determining which occupations are relatively
compliant and which are relatively noncompliant. More specifically, compliance
tends to be substantially lower among those occupations with relatively little income
subject to third party information reporting. Further, noncompliance tends to increase
with the time burden associated with preparing and filing a return. This may be an
indication that a large burden discourages some households from filing and drives
others to report dishonestly. The time burden regressor also serves as a proxy for legal
ambiguity. Therefore, the result may also be an indication that ambiguity provides
savvy taxpayers and tax practitioners with an improved opportunity for
noncompliance, while increasing the likelihood that less able taxpayers will make
unintentional errors.

Although opportunity and burden were found to play the greatest roles in explaining
the variation in compliance by occupation, the percentages of elderly individuals and
married couples were also significant explanatory variables. In particular, occupations
with larger shares of such individuals, other factors equal, tend to be relatively more
compliant.

A comparison of the grouped data regression results based on the full sample of filers
and nonfilers with those based on filers alone indicates that the exclusion of nonfilers
in past empirical studies may not have imparted much bias on qualitative inferences
about the determinants of noncompliance. However, it is clear from the breakdown of
compliance by occupation in Table 2 that one cannot fully understand compliance
among such occupational groups as informal suppliers, helpers and handlers, and other
services without examining both filing and nonfiling behavior.
### APPENDIX - TABLES

**TABLE 1: DISTRIBUTION OF NONCOMPLIANCE BY OCCUPATION, RANKED BY ESTIMATED AVERAGE LEVEL OF NONCOMPLIANCE**

<table>
<thead>
<tr>
<th>Occupation</th>
<th>Avg. level of noncompliance</th>
<th>% of total taxes not paid</th>
<th>Group’s share of population</th>
<th>Group’s share of total tax gap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vehicle sales</td>
<td>$6,406</td>
<td>51.1%</td>
<td>0.1%</td>
<td>0.49%</td>
</tr>
<tr>
<td>Investors</td>
<td>$4,398</td>
<td>15.0%</td>
<td>0.2%</td>
<td>1.38%</td>
</tr>
<tr>
<td>Informal suppliers</td>
<td>$4,011</td>
<td>44.1%</td>
<td>3.0%</td>
<td>18.66%</td>
</tr>
<tr>
<td>Lawyers and judges</td>
<td>$2,273</td>
<td>8.9%</td>
<td>0.5%</td>
<td>1.73%</td>
</tr>
<tr>
<td>Doctors and dentists</td>
<td>$2,181</td>
<td>7.0%</td>
<td>0.5%</td>
<td>1.78%</td>
</tr>
<tr>
<td>Real estate, financial, insurance</td>
<td>$2,165</td>
<td>20.9%</td>
<td>1.4%</td>
<td>4.63%</td>
</tr>
<tr>
<td>Farm and agriculture related</td>
<td>$1,465</td>
<td>33.0%</td>
<td>2.0%</td>
<td>4.49%</td>
</tr>
<tr>
<td>Non-govt. officials &amp; administrators</td>
<td>$1,132</td>
<td>6.0%</td>
<td>3.4%</td>
<td>5.94%</td>
</tr>
<tr>
<td>Construction &amp; extraction</td>
<td>$1,039</td>
<td>22.3%</td>
<td>4.5%</td>
<td>7.11%</td>
</tr>
<tr>
<td>Tip earners</td>
<td>$1,010</td>
<td>49.8%</td>
<td>4.0%</td>
<td>6.15%</td>
</tr>
<tr>
<td>Other sales occupations</td>
<td>$964</td>
<td>18.9%</td>
<td>6.7%</td>
<td>9.86%</td>
</tr>
<tr>
<td>Forestry, logging, fishing, hunting, trapping</td>
<td>$948</td>
<td>23.1%</td>
<td>0.3%</td>
<td>0.47%</td>
</tr>
<tr>
<td>Writers, performing artists, editors, announcers</td>
<td>$823</td>
<td>13.7%</td>
<td>1.0%</td>
<td>1.27%</td>
</tr>
<tr>
<td>Social and religious workers</td>
<td>$813</td>
<td>23.4%</td>
<td>0.7%</td>
<td>0.83%</td>
</tr>
<tr>
<td>Athletes and related workers</td>
<td>$762</td>
<td>10.3%</td>
<td>0.1%</td>
<td>0.13%</td>
</tr>
<tr>
<td>Social scientists</td>
<td>$731</td>
<td>7.0%</td>
<td>0.1%</td>
<td>0.08%</td>
</tr>
<tr>
<td>Managers, consultants, public relations</td>
<td>$666</td>
<td>9.6%</td>
<td>2.2%</td>
<td>2.22%</td>
</tr>
<tr>
<td>Mechanics &amp; repairers</td>
<td>$600</td>
<td>16.0%</td>
<td>3.5%</td>
<td>3.25%</td>
</tr>
<tr>
<td>Transportation &amp; material Moving</td>
<td>$577</td>
<td>14.8%</td>
<td>2.8%</td>
<td>2.50%</td>
</tr>
<tr>
<td>Mathematicians, engineers, computer &amp; natural scientists, architects</td>
<td>$571</td>
<td>6.6%</td>
<td>2.6%</td>
<td>2.26%</td>
</tr>
<tr>
<td>Govt. officials &amp; administrators</td>
<td>$450</td>
<td>7.8%</td>
<td>0.7%</td>
<td>0.51%</td>
</tr>
<tr>
<td>Occupation</td>
<td>Avg. level of noncompliance</td>
<td>% of total taxes not paid</td>
<td>Group’s share of population</td>
<td>Group’s share of total tax gap</td>
</tr>
<tr>
<td>------------------------------------------------</td>
<td>-----------------------------</td>
<td>---------------------------</td>
<td>-----------------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>Post-secondary teachers</td>
<td>$433</td>
<td>6.3%</td>
<td>0.3%</td>
<td>0.19%</td>
</tr>
<tr>
<td>Other teachers, counselors, librarians</td>
<td>$416</td>
<td>10.1%</td>
<td>2.1%</td>
<td>1.31%</td>
</tr>
<tr>
<td>Helpers and handlers</td>
<td>$409</td>
<td>23.8%</td>
<td>7.1%</td>
<td>4.42%</td>
</tr>
<tr>
<td>Accountants, auditors, tax preparers</td>
<td>$386</td>
<td>5.4%</td>
<td>1.1%</td>
<td>0.65%</td>
</tr>
<tr>
<td>Other health workers</td>
<td>$372</td>
<td>10.2%</td>
<td>3.1%</td>
<td>1.74%</td>
</tr>
<tr>
<td>Other services</td>
<td>$371</td>
<td>33.1%</td>
<td>4.8%</td>
<td>2.72%</td>
</tr>
<tr>
<td>Technologists &amp; technicians (other than health)</td>
<td>$344</td>
<td>6.7%</td>
<td>2.1%</td>
<td>1.10%</td>
</tr>
<tr>
<td>Protective services</td>
<td>$300</td>
<td>7.7%</td>
<td>1.6%</td>
<td>0.73%</td>
</tr>
<tr>
<td>Production/manufacturing</td>
<td>$296</td>
<td>9.8%</td>
<td>11.8%</td>
<td>5.34%</td>
</tr>
<tr>
<td>Retired or disabled</td>
<td>$281</td>
<td>8.8%</td>
<td>7.0%</td>
<td>3.00%</td>
</tr>
<tr>
<td>Administrative support</td>
<td>$176</td>
<td>8.0%</td>
<td>7.8%</td>
<td>2.11%</td>
</tr>
<tr>
<td>Military</td>
<td>$131</td>
<td>7.4%</td>
<td>1.4%</td>
<td>0.27%</td>
</tr>
<tr>
<td>Other</td>
<td>$47</td>
<td>8.2%</td>
<td>9.4%</td>
<td>0.67%</td>
</tr>
<tr>
<td>All occupations combined</td>
<td>$655</td>
<td>14.9%</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>
TABLE 2: DISTRIBUTION OF NONCOMPLIANCE BY OCCUPATION AND WHETHER A RETURN WAS FILED

<table>
<thead>
<tr>
<th>Occupation</th>
<th>Filers</th>
<th>Nonfilers</th>
<th>Filers &amp; nonfilers combined</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Avg. level of non-compliance</td>
<td>% of filer popn.</td>
<td>Avg. level of non-compliance</td>
</tr>
<tr>
<td>Vehicle sales</td>
<td>$6,643</td>
<td>0.1%</td>
<td>*</td>
</tr>
<tr>
<td>Investors</td>
<td>$4,228</td>
<td>0.2%</td>
<td>*</td>
</tr>
<tr>
<td>Informal suppliers</td>
<td>$3,540</td>
<td>2.6%</td>
<td>$5,826</td>
</tr>
<tr>
<td>Lawyers and judges</td>
<td>$1,994</td>
<td>0.5%</td>
<td>$5,434</td>
</tr>
<tr>
<td>Doctors and dentists</td>
<td>$2,154</td>
<td>0.6%</td>
<td>*</td>
</tr>
<tr>
<td>Real estate, financial, insurance</td>
<td>$1,861</td>
<td>1.4%</td>
<td>$5,046</td>
</tr>
<tr>
<td>Farm and agriculture related</td>
<td>$1,386</td>
<td>2.1%</td>
<td>$4,449</td>
</tr>
<tr>
<td>Non-govt. officials &amp; administrators</td>
<td>$1,105</td>
<td>3.6%</td>
<td>$1,986</td>
</tr>
<tr>
<td>Construction &amp; extraction</td>
<td>$995</td>
<td>4.7%</td>
<td>$2,022</td>
</tr>
<tr>
<td>Tip earners</td>
<td>$982</td>
<td>4.2%</td>
<td>$1,728</td>
</tr>
<tr>
<td>Other sales occupations</td>
<td>$876</td>
<td>6.8%</td>
<td>$2,246</td>
</tr>
<tr>
<td>Forestry, logging, fishing, hunting, trapping</td>
<td>$890</td>
<td>0.3%</td>
<td>*</td>
</tr>
<tr>
<td>Writers, performing artists, editors, announcers</td>
<td>$742</td>
<td>1.0%</td>
<td>$2,177</td>
</tr>
<tr>
<td>Social and religious workers</td>
<td>$840</td>
<td>0.7%</td>
<td>$147</td>
</tr>
<tr>
<td>Social scientists</td>
<td>$731</td>
<td>0.1%</td>
<td>*</td>
</tr>
<tr>
<td>Athletes and related workers</td>
<td>$755</td>
<td>0.1%</td>
<td>*</td>
</tr>
<tr>
<td>Occupation</td>
<td>Filers</td>
<td>Nonfilers</td>
<td>Filers &amp; nonfilers combined</td>
</tr>
<tr>
<td>----------------------------------------------------</td>
<td>--------</td>
<td>-----------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td></td>
<td>Avg. level of non-compliance</td>
<td>% of filer popn.</td>
<td>Avg. level of non-compliance</td>
</tr>
<tr>
<td>Managers, consultants, public relations</td>
<td>$645</td>
<td>2.3%</td>
<td>$1,051</td>
</tr>
<tr>
<td>Transportation &amp; material moving</td>
<td>$538</td>
<td>3.0%</td>
<td>$2,752</td>
</tr>
<tr>
<td>Mathematicians, engineers, computer &amp; natural scientists, architects</td>
<td>$554</td>
<td>2.8%</td>
<td>$1,593</td>
</tr>
<tr>
<td>Govt. officials &amp; administrators</td>
<td>$439</td>
<td>0.8%</td>
<td>$718</td>
</tr>
<tr>
<td>Post-secondary teachers</td>
<td>$449</td>
<td>0.3%</td>
<td>*</td>
</tr>
<tr>
<td>Other teachers, counselors, librarians</td>
<td>$420</td>
<td>2.2%</td>
<td>$101</td>
</tr>
<tr>
<td>Helpers and handlers</td>
<td>$305</td>
<td>5.6%</td>
<td>$679</td>
</tr>
<tr>
<td>Accountants, auditors, tax preparers</td>
<td>$368</td>
<td>1.2%</td>
<td>$1,047</td>
</tr>
<tr>
<td>Other health workers</td>
<td>$379</td>
<td>3.3%</td>
<td>$0</td>
</tr>
<tr>
<td>Other services</td>
<td>$566</td>
<td>2.8%</td>
<td>$148</td>
</tr>
<tr>
<td>Technologists &amp; technicians (other than health)</td>
<td>$321</td>
<td>2.2%</td>
<td>$893</td>
</tr>
<tr>
<td>Protective services</td>
<td>$294</td>
<td>1.7%</td>
<td>$723</td>
</tr>
<tr>
<td>Retired or disabled</td>
<td>$293</td>
<td>12.4%</td>
<td>$392</td>
</tr>
<tr>
<td>Production/manufacturing</td>
<td>$282</td>
<td>7.6%</td>
<td>$67</td>
</tr>
<tr>
<td>Administrative support</td>
<td>$176</td>
<td>8.3%</td>
<td>$172</td>
</tr>
<tr>
<td>Military</td>
<td>$143</td>
<td>1.4%</td>
<td>*</td>
</tr>
<tr>
<td>Other</td>
<td>$43</td>
<td>9.5%</td>
<td>$87</td>
</tr>
<tr>
<td>All occupations combined</td>
<td>$607</td>
<td>100.0%</td>
<td>$1,215</td>
</tr>
</tbody>
</table>

*Insufficient observations for estimation
TABLE 3: RESULTS OF GROUPED DATA REGRESSION TO EXPLAIN VARIATION IN TOTAL NONCOMPLIANCE BY OCCUPATION; COMBINED FILER AND NONFILER SAMPLE

<table>
<thead>
<tr>
<th>Regressor</th>
<th>Weighted Mean Value</th>
<th>Coefficient</th>
<th>t-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant Term*</td>
<td>1.000</td>
<td>5640.3</td>
<td>2.40</td>
</tr>
<tr>
<td>IRP Income Share*</td>
<td>81.725</td>
<td>-33.81</td>
<td>-5.80</td>
</tr>
<tr>
<td>Audit Rate</td>
<td>0.823</td>
<td>-3536.0</td>
<td>-1.31</td>
</tr>
<tr>
<td>AGI</td>
<td>0.290</td>
<td>439.1</td>
<td>0.72</td>
</tr>
<tr>
<td>Marginal Tax Rate</td>
<td>18.505</td>
<td>-20.39</td>
<td>-0.36</td>
</tr>
<tr>
<td>Time Burden*</td>
<td>13.111</td>
<td>119.0</td>
<td>4.09</td>
</tr>
<tr>
<td>Percentage Elderly*</td>
<td>11.139</td>
<td>-22.56</td>
<td>-6.66</td>
</tr>
<tr>
<td>Percentage Married*</td>
<td>42.838</td>
<td>-8.68</td>
<td>-2.12</td>
</tr>
</tbody>
</table>

*Significant at .05 level

TABLE 4: RESULTS OF GROUPED DATA REGRESSION TO EXPLAIN VARIATION IN TOTAL NONCOMPLIANCE BY OCCUPATION; FILER SAMPLE

<table>
<thead>
<tr>
<th>Regressor</th>
<th>Weighted Mean Value</th>
<th>Coefficient</th>
<th>t-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant Term*</td>
<td>1.000</td>
<td>4362.2</td>
<td>2.07</td>
</tr>
<tr>
<td>IRP Income Share*</td>
<td>83.10</td>
<td>-31.12</td>
<td>-5.48</td>
</tr>
<tr>
<td>Audit Rate</td>
<td>0.822</td>
<td>-1673.5</td>
<td>-0.70</td>
</tr>
<tr>
<td>AGI</td>
<td>0.305</td>
<td>497.5</td>
<td>0.95</td>
</tr>
<tr>
<td>Marginal Tax Rate</td>
<td>18.675</td>
<td>-38.73</td>
<td>-0.79</td>
</tr>
<tr>
<td>Time Burden*</td>
<td>13.112</td>
<td>90.49</td>
<td>3.30</td>
</tr>
<tr>
<td>Percentage Elderly*</td>
<td>11.771</td>
<td>-21.68</td>
<td>-6.55</td>
</tr>
<tr>
<td>Percentage Married</td>
<td>44.303</td>
<td>-3.45</td>
<td>-0.90</td>
</tr>
</tbody>
</table>

*Significant at .05 level
REFERENCES


ENDNOTES

1 Refer to Andreoni, Erard, and Feinstein (1998) and Slemrod and Yitzhaki (2002) for reviews of this literature. Erard and Ho (2001) provide one of the only empirical analyses of nonfilers.

2 Unfortunately, this data base is not in the public domain, because it contains sensitive individual taxpayer information that cannot be publicly disclosed.

3 The TCMP filer population excludes returns that were filed late as well as returns filed by non-resident taxpayers.

4 Non-residents and individuals without valid social security numbers were excluded from the analysis.

5 In the U.S., households with income below a specified filing threshold that varies according to age, marital, and dependency status are not required to file a federal income tax return.

6 Unlocated individuals in the sample tended to have much larger sample weights as a consequence of the way the sample was stratified. The sample weights for the 4,594 individuals in the sample aggregate to approximately 43 percent of the potential nonfiler population.

7 Our approach includes an enhancement to the original IRS approach in that we adjust the weights separately by sampling stratum to make the 2,195 returns broadly representative of all nonfilers who were located during the search process. For the 1996 tax gap report, the IRS adjusted the sample weights for all 2,195 returns by the same factor.

8 We employ the IRS measure of filing burden originally developed by Arthur D. Little, Inc., which is computed by aggregating the estimated average completion times associated with each form and schedule used by the taxpayer. Thus, in essence, the measure reflects a weighted number of forms and schedules, where the weights are the estimated completion times.

9 This estimate represents “true nonfilers”; individuals with no legal filing requirement were separately estimated to have received $93 million in tips.

10 Our calculator ignores issues such as the Alternative Minimum Tax, but does take into account the phase-out of personal exemptions that applies to taxpayers with high levels of income.

11 The principal difficulty was computing the additional self-employment tax for married joint filers. For such households, it was not possible using our data to determine what shares of additional self-employment and wage and salary income were attributable to each spouse. Nor was it possible to determine which households were entitled to use the optional method for computing self-employment taxes.
Details on the algorithm used to compute the change in self-employment tax are available from the authors.

12 This measure includes not only income taxes, but also the items classified as “additional taxes” (taxes on distributions from trusts) and “other taxes” (self-employment tax, alternative minimum tax, recapture tax, social security tax on tip income not reported to employer, etc.).

13 Not all overstatements of tax liability are accidental. In some cases, taxpayers deliberately accelerate the reporting of certain sources of income or postpone claiming expenses or deductions in an improper attempt to reduce their tax liability in another year. This can result in the discovery by an examiner of an overstatement of tax liability in the current year, but a more than offsetting understatement of liability in another tax year.

14 An econometric approach to distinguish between intentional and unintentional tax reporting errors is developed in Erard (1997).

15 In an earlier regression, we also included the group average number of dependent children as a regressor, but we removed this variable after it was found to be uncorrelated with noncompliance. All group averages were computed as the weighted arithmetic mean.

16 Heteroskedasticity arises in our specification, because (weighted) number of households being averaged in each of the occupational groups is different. The reader is referred to Kmenta (1986, pp. 366-373) for a discussion of this issue and the appropriate procedure to correct for heteroskedasticity.
The Interrelation of Scheme and Purpose Under Part IVA

Maurice J Cashmere *

Abstract
The way in which a scheme is defined under Part IVA is emerging as the principal factor which circumscribes the purpose of the scheme. Context is critical to this inquiry. If the identified tax benefit is not referenced to its practical context, then the inquiry regarding whether obtaining the tax benefit is the dominant purpose is largely a forgone conclusion. This essay examines the principles which have been established to date and argues for the need to determine dominate purpose by reference to the practical context of the transaction, in order to ensure that the general anti-avoidance measure does not annihilate all tax benefits.

INTRODUCTION
Part IVA Income Tax Assessment Act 1936 ("ITAA") contains the statutory test which applies in Australia for determining what transactions are arrangements for the avoidance of tax. To do this, it establishes a purposive test. The statutory framework provides that where there is a scheme from which a taxpayer has obtained a tax benefit, the Federal Commissioner of Taxation ("Commissioner") may cancel the tax benefit obtained and issue an amended tax assessment where, having regard to eight listed criteria, it would be concluded that the taxpayer entered into, or carried out the scheme, for the dominant purpose of obtaining the tax benefit.1

Before the Commissioner may make such a determination, three elements must be established. There must be:-

a) a tax benefit;
b) which arises out of a scheme; and
c) the existence of a dominant purpose on the part of the taxpayer, or one of those involved with the scheme, to obtain the tax benefit.

While each of these elements is a separate part of the statutory test, each is interrelated.

A tax benefit arises where either:-

• an amount was not included in the taxpayer's assessable income when it would, or might reasonably otherwise have been expected to be included; or

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* Solicitor, Senior Lecturer, ATAX Program, Faculty of Law, University of New South Wales
1 S177D
• an amount was deducted from the taxpayer's assessable income where it would not, or might reasonably have been expected not to be deducted otherwise.²

There is no qualification on the word "amount," so it is not limited to tax advantages which are contrived or artificial, or have been created by self-cancelling paper transactions. A tax benefit is any tax advantage.

The tax benefit must, however, arise out of a scheme to which ITAA applies. A scheme is:-

• any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable by legal proceedings; and
• including any unilateral scheme, plan, proposal, action, course of action or conduct.³

This definition is wide. In fact, it is so wide, that it can relate to any course of action, or any single act, including a unilateral act. So broad is the definition of the concept of a scheme, that a tax benefit could arise out of any course of action so long as a purpose, which is a dominant purpose, to obtain the tax benefit, can be ascertained.

What has become apparent from the cases which have come before the courts to date is that the definition of the scheme is critical to the finding relating to the purpose of the taxpayer in entering into the scheme. The more narrowly the scheme can be defined just by reference to the facts which generate the tax benefit, the easier it will be for a dominant purpose of obtaining that tax benefit to be established. In fact, it is this issue which is at the heart of the current tussle between the Commissioner and the courts, as manifest in the appeal in Hart v FCT⁴ at present before the High Court.

If the Commissioner is able to convince the High Court that schemes can be identified just by reference to the tax benefit – ignoring the context in which the tax benefit was obtained – then the Commissioner will have achieved the power to annihilate any commercial or family transaction where a tax advantage is found, which is something which no general anti-avoidance measure has succeeded in doing to date. So far, the courts have held the line by ensuring that:

• the purpose test is assessed in relation to the factual context in which the taxpayer operated; and that
• the scheme whose purpose is relevant is not so narrowly defined that it ignores the factual basis of the transaction which the taxpayer entered into or carried out.

As a consequence, the identification of the scheme has become critical to the finding which the Court can make about purpose. This paper seeks to examine the manner in which the courts have narrowed the breadth of Part IVA by insisting upon the concepts of both “scheme” and “purpose” being identified by reference to the practical reality of the circumstances out of which the tax benefit emerged.

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² S177C
³ S177A(1) and (2)
⁴ 2002 ATC 4608
THE SCHEME

Scheme Identification
Part IVA is not concerned with any old scheme. It is concerned only with those schemes which produce a tax benefit, where the requisite purpose has been established. This is underscored by observations made by Hill J. in *Hart v FCT*.

The definition of the scheme is very important. Any tax benefit which is identified must have a relationship to the defined scheme and not some other scheme. The conclusion of dominant purpose must be made by reference to the defined scheme, not some other scheme. Any determination made by the Commissioner must, likewise, be made by reference to the defined scheme and not some other scheme.5

As the purposive test has been developed, it has become apparent that the concept of a tax benefit and the test of purpose depend very much on the way in which the scheme is identified.

The importance of identifying the scheme properly was emphasised by the High Court in *FCT v Peabody* 6 - the first Part IVA case to reach the High Court.

Under S177F(1), the Commissioner's discretion to cancel a tax benefit extends only to a tax benefit obtained in connection with a scheme to which Part IVA applies. The existence of the discretion is not made to depend upon the Commissioner's opinion or satisfaction that there is a tax benefit, or that, if there is a tax benefit, it was obtained in connection with a Part IVA scheme. Those are positioned as objective facts. The erroneous identification by the Commissioner of a scheme as being one to which Part IVA applies or a misconception on his part as to the connection of a tax benefit with such a scheme will result in the wrongful exercise of the discretion conferred by S177F(1).7

The point here is that the discretion vested in the Commissioner can only be exercised where it has been established, as a matter of objective fact, that a tax benefit exists and that it arises out of a scheme to which Part IVA applies.

So far, there appears to have been little difficulty in establishing what the tax benefit is. The difficulty has been in identifying the Part IVA scheme.

In identifying the scheme certain elements must be established. The critical elements are:-

- the parties to the scheme, in so far as they are known;8
- the terms or content of any agreement, arrangement, understanding, promise or undertaking;9 and
- the steps or stages of any course of action or proposal in so far as they are relevant.10

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5 Ibid 4618-4619
6 [1994-95] 181 CLR 359
7 Ibid 382
8 Ibid 382, FCT v Spotless Ltd 95 ATC 4775, 4805
9 FCT v Spotless Services Ltd 95 ATC 4775, 4805
It is critical that the parties to the scheme are identified - particularly the taxpayer who has had a tax benefit cancelled. If the taxpayer is not correctly identified, this will result in the revised assessment being set aside. Further, the terms of the scheme need to be identified with some degree of particularity. It is not sufficient for the whole of the facts to be relied upon. The Commissioner must establish which facts constitute the scheme. If facts less than the whole of the circumstances constitute the scheme, they must be particularised.

The difficulties of identification are illustrated by the lengthy consideration given to this issue by the Full Federal Court in *FCT v Spotless Services Ltd*.11 (There was no consideration given to this issue by the High Court in this case as by the time the matter reached the High Court, the parties had decided on the identification of the scheme). There, a resident Australian company had invested Australian-based funds in Australian dollars on short-term deposit with a financial institution in the tax haven of the Cook Islands. Because of perceived credit risk on the part of the financial institution, the deposit was supported by credit enhancement documentation. This deposit was made offshore to obtain a better after-tax return than would have been possible by leaving the funds invested in Australia. The advantage lay in the fact that interest on foreign funds was subject to a low withholding tax in the Cook Islands, and at the time the ITAA exempted from tax, any income which had been taxed offshore in a country with which Australia had no double tax treaty. Australia had no double tax treaty with the Cook Islands.

On these facts, the Commissioner identified two schemes. The more broadly drawn scheme was identified as the calculated steps taken to source income overseas in order to attract a tax benefit where, but for the scheme, the funds would have been invested in Australia. The alternative scheme was identified as the loan which, ostensibly would have been entered into on commercial terms in Australia, was made offshore on unusual commercial terms to attract a special tax concession.

In neither of these formulations was there any mention of a taxpayer. That was held to be a fatal flaw. Likewise, in neither formulation had the steps of the relevant course of action been identified accurately. For instance, the Commissioner had maintained that the taxpayer had a choice about where the deposit was made and that it could have been made in Australia. That was held to be incorrect, since the deposit actually made could only have been made in the Cook Islands. That inaccuracy failed to satisfy the basic requirements of identification.

In addition, the Court criticised the attempt to portray the scheme as a deliberate device to render income immune from tax by siting the transaction offshore, when it would ordinarily have been expected to be sited in Australia. This was regarded as hypothesis, rather than fact or reality. Furthermore, the Commissioner cannot allege, as he did here, that the scheme is a sham if it is not.

**IDENTIFICATION PRINCIPLES**

**The First Identification Principle**

While the formal identification of the scheme has presented difficulties, the real battleground is over whether the scheme can be so narrowly drawn that it encapsulates

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10 Peabody 181 CLR at 382, Spotless 95 ATC at 4805
11 95 ATC 4775
just the identified tax benefit, or whether it must take into account the substance of the transaction which the taxpayer entered into. It is axiomatic that the more narrowly the scheme is identified as the facts whereby the tax benefit was obtained, the more likely it is that the necessary dominant purpose of obtaining the tax benefit will be found.12 This was apparent from the very first case to go to the High Court, FCT v Peabody.

Peabody's case involved inter-related corporate transactions, being the acquisition of shares with borrowed funds and a corporate reduction in capital which provided the funds whereby the loan could be repaid. The narrowly drawn scheme, which the Commissioner relied upon, was the reduction in capital, because that was the part of the overall transaction which produced the tax benefit. However, at the first instance hearing, the Commissioner had particularised the steps of the scheme more broadly. The High Court concluded that the Commissioner could not single out the reduction of capital as the relevant transaction, divorced from the share acquisition part of the corporate restructuring. The High Court took the view that the narrow scheme relied on by the Commissioner was not a scheme for the purpose of Part IVA because:-

... Part IVA does not provide that a scheme includes part of a scheme and it is possible, despite the very wide definition of a scheme, to conceive of a set of circumstances which constitutes only part of a scheme and not a scheme in itself. That will occur where the circumstances are incapable of standing on their own without being 'robbed of all practical meaning'.13

This was the approach taken subsequently by the majority of the Full Federal Court in FCT v Spotless Services Limited. There, the majority emphasised that it was necessary to ensure that, where part of an overall set of facts is identified as a scheme for the purposes of Part IVA, it must be capable of standing on its own and having practical effect severed from its antecedent or subsequent conduct.14 What this establishes is that the identification of the scheme is not an abstract exercise to be carried out in a vacuum, divorced from the practical reality of the factual situation.

This analysis was borne out by observations made by the Full Federal Court in FCT v Consolidated Press Holdings Ltd.15

In particularising his case in appeal proceedings the Commissioner may identify one scheme and alternatively rely upon another which is a subset of the first ... (a) scheme identified as such may ... be a scheme for the purposes of Part IVA even if it can also be regarded as part of a larger scheme. The first resort in determining whether what the Commissioner ... identified as a 'scheme' properly answered that description must be the words of the description S177A. The caveat in Peabody sets a broadly stated outer limit upon those words. It is evaluative in character. Whether circumstances 'standing on their own' are 'robbed of all practical 'meaning' is a matter of judgment rather than logical analysis.16

On appeal in the High Court these observations were not criticised.

12 Hely J. Hart v FCT 2002 ATC at 4626
13 181 CLR at 383-384
14 95 ATC at 4805
15 1999 ATC 4945
16 Ibid 4967
This is the very issue which is central to *Hart v FCT*, which is currently before the High Court on appeal. This case involved an attack by the Commissioner on a home loan product which has been marketed in Australia by financial institutions with great success. The product - in this instance known as a wealth optimiser loan - provided for a loan in two facilities. One facility related to the loan in respect of the taxpayer's residence; the other related to the loan for an investment property. The special feature of this product was that all the payments of interest and principal were directed to the facility relating to the owner-occupied residence until it was completely repaid. Meantime, interest on the investment property facility accrued at compound rates, which increased the principal amount and consequently the interest payable. Once the loan in respect of the owner-occupied residence facility was repaid, the loan payments were directed towards the investment facility; the deductions for interest on the investment facility were consequently higher than they would otherwise have been.

The Commissioner identified the scheme as the provision in the loan for the division into two facilities, whereby the borrower could direct that loan payments be applied towards repaying the home loan facility prior to the investment facility.

In identifying the scheme so narrowly, the Commissioner equated the scheme just with the loan structure which enabled the tax benefit to be obtained. But the scheme so identified took no account of the fact that there was a taxpayer involved, who had refinanced his house in order to acquire another residence in which to live and to enable him to retain his existing house as an investment. So, the narrow scheme ignored the making of the loan and the incurring of interest payments under it, and the context in which the loan was made.

That approach did not find favour with the Court. The Court took the view that a definition which did not include the raising of the loan by the taxpayer to finance and refinance the two properties on the terms of the wealth optimiser loan and the incurring of interest payments under it, could not stand on its own two feet having any practical contextual meaning. What the Commissioner had done was to identify part of a series of steps as a scheme, whereas the scheme should have been defined as a series of steps which encapsulated the essence of the transaction which the taxpayer had entered into.

One of the grounds upon which special leave to appeal to the High Court was granted, was that the Full Federal Court had erred in declining to accept that the Commissioner could rely on the narrowly defined scheme. It was argued that the narrow scheme could stand by itself without being robbed of all practical meaning. Objection was also taken to the fact that the scheme must take the factual context into account.

This is a direct attack on the *Peabody* principle of identification which has been adopted consistently ever since. It is clear from *Peabody* that the High Court was referring to the need for a scheme to reflect a transaction which made practical sense by itself. Indeed, it made reference to the shape of transactions being influenced by revenue considerations. If the Commissioner were able to identify the scheme just as the situation which gave rise to the tax benefit, this would escalate the situation which gave rise to the tax benefit into the transaction itself, and the shape of the transaction would be irrelevant.

Hart’s case is on appeal to the High Court. If the High Court were not to uphold the Full Federal Court’s decision-based as it is on the principles established by the High
Court itself in *Peabody* – then Part IVA will be capable of annihilating any transaction, something which no general anti-avoidance provision to date has ever achieved before.

The reason why the identification of the scheme by reference to the substance of the transaction is so important, is that the way the scheme is identified affects the inquiry that needs to be made later regarding the purpose of the scheme. If the Commissioner were able to identify just the part of the facts whereby the taxpayer obtained the tax benefit as the scheme, then few, if any, transactions would survive annihilation. The purpose would be clear even without the need to consider the eight specific factors necessary to establish the dominant purpose of the scheme. The *Peabody* approach is clearly an attempt to limit a very broadly drawn anti-avoidance measure.

**The Second Identification Principle**

*Peabody*’s case established another principle which is that the Commissioner may rely on alternative schemes and is not necessarily bound by the original identification of the scheme. But how far the Commissioner may go in redefining the scheme, or in relying on a newly identified scheme, is a matter of some uncertainty. The view expressed by the High Court in *Peabody* was that the Commissioner was entitled to redefine the scheme even as late as the initial hearing, if it were originally defined too widely. Specifically, the High Court said:-

> If, within a wider scheme which has been identified, the Commissioner seeks also to rely upon a narrower scheme as meeting the requirements of Part IVA, then in our view there is no reason why the Commissioner should not be permitted to do so provided it causes no undue embarrassment or surprise to the other side. If it does, the situation may be cured by amendment, provided the interests of justice allow such a course.\(^{17}\)

The High Court in *Peabody* did not go further than that. In the context of the facts in that case it said:-

> In this case (the first instance judge) took the view that the Commissioner had particularised the scheme too widely and that it should be confined…. He was not bound to accept the wider scheme advanced by the Commissioner before him and there was no unfairness to the taxpayer in his reaching the conclusion which he did, notwithstanding the apparent failure of the Commissioner to advance alternative schemes.\(^{18}\)

It is clear here that there was no unfairness since the determination had been made in relation to the narrow scheme which had originally been identified.

What this observation shows is that the High Court was acknowledging that the Commissioner could redefine a scheme, if he wished to identify a narrower scheme, within a more widely defined scheme. The High Court also appears to have accepted that the Commissioner’s wider formulation in terms of the particularised steps could be regarded as the scheme, notwithstanding the lateness of the formulation. However, all of this took place before or at the initial hearing. There is no support here for the view that the Commissioner can re-identify a scheme at any time subsequent to the initial hearing.

\(^{17}\) 181 CLR at 382-383

\(^{18}\) 181 CLR at 383
There are observations to be found which tend to suggest otherwise. In 1999 the Full Federal Court in *FCT v Consolidated Press Holdings Ltd* said that the exercise of the Commissioner’s discretion does not depend on the correct identification of a scheme by the Commissioner. The Commissioner’s discretion is enlivened so long as there is a Part IVA scheme.\(^{19}\) The basis of this view must be that the identification of the scheme is posited as one of objective fact and therefore it would follow that so long as a scheme can be identified as a matter of objective fact, Part IVA applies.

But this view is not borne out by what has been said in more recent cases. Nor would it appear to be sustained by the provisions of Part IVA\(^{20}\) or fundamental principles of due process.

In 2002 in *Hart v FCT* Hill J. said that if the Commissioner can re-identify schemes it is only initially and only between narrowly and widely defined schemes. The Commissioner may change his mind, but only subject to considerations of fairness.\(^{21}\) This appears to be directed to his ability to choose between the narrowly and widely defined schemes which he has identified. His Honour’s observation simply confirms the narrow way in which the High Court in Peabody expressed itself.

Nor does the High Court decision in Peabody support the proposition that the Court can itself identify a scheme as the Full Federal Court did in Spotless. If the Court were to formulate its own scheme at the hearing or on appeal, then the discretion vested in the Commissioner would not have been exercised.

As Hill J. observed in delivering the unanimous judgment of the Court when *Peabody v FCT* was before the Full Federal Court, the determination which the Commissioner makes must be made in relation to the scheme he identifies. The scheme which then has to be considered by the Court is the scheme in respect of which the Commissioner made his determination. As His Honour said:-

\[\begin{align*}
\text{…this Court cannot stand in the shoes of the Commissioner and exercise} \\
\text{discretions which the legislature has committed to the Commissioner. This} \\
\text{Court is confined to deciding whether the Commissioner’s decision has been} \\
\text{affected by some error of law, whether the Commissioner has addressed} \\
\text{himself to the right issue or whether he has taken some extraneous factor} \\
\text{into consideration or failed to take into account some relevant factor.}\ \end{align*}\]

Hill J. then went on to address the possibility that the Commissioner could formulate a new scheme, but came to the conclusion that in this situation the Commissioner would have to make a fresh determination and make an amended assessment. Those observations were not commented on or criticised in the High Court.

This approach also appears to be supported by the way in which the Full Federal Court last year in *FCT v Mochkin*\(^{23}\) handled an attempt by the Commissioner to reformulate the scheme. The Commissioner attempted, before the Full Federal Court, to advance a wider scheme which had not been put to the first instance judge. The Full Federal Court took the view that the Commissioner could not rely on this wider scheme, as the

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\(^{19}\) 1999 ATC at 4967  
\(^{20}\) *FCT v Peabody* [1993-94] 181 CLR 359,382  
\(^{21}\) 2002 ATC at 4619  
\(^{22}\) 93 ATC 4101, 4116  
\(^{23}\) 2002 ATC 4465
taxpayer would have been prejudiced by not being able to call additional evidence relating to this scheme.

That approach accords with the principle established by Peabody and is consistent with the thrust of the principles formulated in the Full Federal Court subsequently.

**The Third Identification Principle**

The third principle is that in identifying schemes, the Commissioner must ensure that they exist in fact and reality, and are not simply figments of the Commissioner's imagination. This was referred to by the Full Federal Court in Spotless in the following way:--

> It is not sufficient to identify a scheme by reference to a hoped for fiscal outcome [Part IVA] requires that a scheme has an existence in fact and reality and is not something based on the Commissioner's view of the facts or their legal effect.  

This was illustrated in Spotless. When the case was before the Full Federal Court, the fact that the scheme, which the Commissioner had identified, was said to be a scheme to capture a tax benefit in the form of a special exemption from tax was criticised as being a reflection of the Commissioner's perception of the arrangement.

**The Fourth Identification Principle**

There is another issue regarding identification and that is whether a scheme can be identified only by what was in fact done, as distinct from what might otherwise have been done.

The issue was raised in Mochkin. In Mochkin, the taxpayer, who was a stockbroker, had been sued by a firm of stockbrokers for defaults made by clients he had introduced. Subsequently, in order to protect himself from such liability, the taxpayer arranged for his family trust to carry out stockbroking services for stockbroking firms. During most of this time the service trust had the benefit of services from various people to carry on the business. Some work also appears to have been done by the taxpayer. From these circumstances, the Commissioner alleged that the taxpayer had entered into a Part IVA scheme by using the trust to receive commissions which the taxpayer would otherwise have received for personal services. It was alleged that this was a diversion of personal service income, which enabled a tax benefit to be obtained in the form of the distribution of the commission income to members of the taxpayer’s family, instead of to the taxpayer himself.

The Commissioner appears to have contemplated alleging that there was a narrow Part IVA scheme that consisted of the taxpayer not receiving a salary for services performed. In the event, this submission was not pursued. If the Commissioner had pursued this approach, he would have been defining a scheme largely by reference to hypothesis i.e. that the taxpayer would have received the commission income if the trust had not been formed and that the trust should have paid the taxpayer a salary, presumably commensurate with the commissions received.

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24 95 ATC at 4805
However, unlike the definition of a tax benefit, the definition of a scheme does not encompass some hypothesis. The definition is posited as being of objective fact based in reality, not on the fiscal outcome sought by the Commissioner.

Furthermore, the definition of a scheme, in both limbs, uses words which denote positive action. The fact that commissions were not received by the stockbroker, or that no income by way of salary was paid, does not necessarily denote positive action. It denotes passive acquiescence. That appears to be the situation in Mochkin as there did not appear to be any evidence of any arrangement or unilateral decision whereby the taxpayer forewent commission or salary.

**The Fifth Identification Principle**

The issue of whether commerciality is relevant to the identification of a scheme was considered by the Full Federal Court in *Spotless*. As indicated earlier, the Commissioner, in his first formulation, had identified the scheme as a plan which would otherwise have been entered into on normal commercial terms was not.

Notwithstanding the attempts made by the Commissioner to portray the essence of the scheme as artificial and contrived and therefore lacking in commerciality, the Full Federal Court held that the commerciality (or otherwise) of a scheme was not relevant to the issue of identification. Questions of what are, or are not normal commercial practice, are only relevant to the issue of determining the purpose of the scheme. Nor is the purpose of the scheme relevant to the issue of identification. The identification is concerned simply with identified facts.  

**Summary**

Part IVA cannot apply to all transactions where a tax benefit is obtained. If it did then all deductions for tax purposes would be at risk and income which had not reached the likely recipient identified by the Commissioner would be reallocated at will. This is the result which would arise from an identification of the scheme which is equated just with the perceived tax benefit. That cannot have been the intention of Parliament. A consideration of the Federal Treasurer's second reading speech, when Part IVA was before Parliament, bears this out. The Treasurer said that the new measures sought to "give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions..." The *Peabody* principles in relation to the identification of the scheme, assist in achieving this objective.

**PURPOSE**

**The Relevance of Purpose**

The central issue which arises under Part IVA is whether the identified scheme contravenes the anti-avoidance provision. The only schemes which contravene Part IVA are those which were entered into for the dominant purpose of enabling the taxpayer to obtain a tax benefit in connection with that scheme. This issue is determined in relation to the identified scheme by considering eight listed factors. It

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25 Ibid
has now been established that by dominant purpose is meant that purpose which is "the ruling, prevailing or most influential purpose." 26

The legislation refers to the conclusion about purpose being the purpose of the person, or one of the persons, who entered into or carried out the scheme – not the purpose of the scheme. 27

In so far as the meaning of “entered into or carried out the scheme” is concerned, Hill J. in Peabody’s case, when it was before the Full Federal Court, equated the expression with the word “participate”. His Honour also emphasised that the relevant purpose is that of enabling the taxpayer to obtain the necessary tax benefit. In this context His Honour said that the expression “enabling” carried its ordinary meaning of “make able” or “make possible” and probably also meant “assist in making able or possible” or “contribute to making able or possible”. 28

The legislation refers to the conclusion about purpose being the purpose of the person, or one of the persons, who entered into or carried out the scheme. Therefore, the relevant purpose may be contributed by someone who is not the taxpayer. That does not mean that the purpose of the taxpayer is irrelevant, since the taxpayer may be a person who entered into or carried out the scheme. But, it does mean that anyone connected with the scheme can taint it, even if the taxpayer’s purpose is totally untainted, which was the position in Vincent v FCT. 29

It is also apparent that the requisite purpose may be contributed by someone who is not a party to the scheme. This is borne out by the Peabody case itself. There, the person whose purpose was relevant was Mr Peabody, yet he was not a party, in any legal sense, to any of the transactions. He was, however, a participant, in the sense of being the controlling mind behind the scheme.

The legislation highlights another problem. The purpose which is relevant is the purpose of the person, or one of the persons, who entered into or carried out, the scheme. As a scheme for Part IVA purposes can only be a stand-alone scheme, this raises the question of whether the inquiry must relate to the purpose of a person concerned with the stand-alone scheme, or whether the purpose of someone connected with part of a stand-alone scheme will suffice.

The High Court in Peabody’s case held that if a person participates in only part of a stand-alone scheme, the purpose of that person can be taken into account, but that purpose must be ascertained in relation to the whole of the stand-alone scheme, not just that part of it with which the person was associated. 30 Therefore, it would follow that while a person may participate in only part of a scheme (which will be sufficient to provide the physical nexus) the purpose must relate to the whole scheme. The purpose which is relevant to this inquiry, however, is the dominant purpose.

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26 FCT v Spotless Services Ltd [1996] 186 CLR 404 at 416
27 S177D; Hill J. Peabody v FCT 93 ATC 4104 at 4113
28 Hill J. Peabody 93 ATC at 4113
29 2002 ATC 4490
30 181 CLR at 424
Ascertaining Purpose

If it is the dominant purpose which is relevant, the question is then, how the dominant purpose is to be ascertained. The legislation refers to the conclusion about purpose being drawn from the purpose of the person, or one of the persons who entered into or carried out the scheme. This tends to suggest that the conclusion about purpose can be ascertained from the subjective intention of the taxpayer, or anyone else who was connected with the scheme. However, the High Court has clarified that the relevant purpose is an objective purpose ascertained by having regard to objective facts. Thus, in the main judgment, in the High Court in Spotless, is to be found the following passage, regarding the requirement for an objective test:

Section 177D presents the question whether, having regard to the eight categories of matter identified in part (b), posited as objective facts … a reasonable person would conclude that the taxpayers entered into the scheme for the dominant purpose of enabling each to obtain a ‘tax benefit’ in the necessary sense.31

The Court also emphasised that the focus is not on the actual purpose of the taxpayer (or anyone associated with the scheme), but on the purpose objectively assessed.

The eight categories set out in para (b) of S177D as matters to which regard is to be had ‘are posited as objective facts’. That construction is supported by the employment in S177D of the phrase ‘It would be concluded that …’. This phrase also indicates that the conclusion reached, having regard to the matters in para (b), as to the dominant purpose of a person or one of the persons who entered into or carried out the scheme or any part thereof, is the conclusion of a reasonable person. In the present case, the question is whether, having regard, as objective facts, to the matters answering the description in para (b), a reasonable person would conclude that the taxpayers entered into or carried out the scheme for the dominant purpose of enabling the taxpayers to obtain a tax benefit in connection with the scheme.32

This passage underscores that in considering the question of purpose, the conclusion regarding the objective purpose is not made by attributing a purpose to the taxpayer, or any person connected with the scheme, or by drawing a conclusion about the actual purpose of the taxpayer. It is drawn from making a decision about what a reasonable person would conclude was the purpose of some person connected with the scheme. It follows that it is unnecessary to ascertain the actual purpose of those connected with the scheme, including the taxpayer. Evidence of the subjective purpose of such persons has been held to be irrelevant.

... while the conclusion required to be drawn is one that requires consideration of the purpose or dominant purpose of a person, including the taxpayer, that conclusion cannot take into account evidence of the actual purpose of a taxpayer or other person, save and except so far as that could be forensically relevant to any one of the matters specifically referred to in S177(b), for example, the manner in which the scheme was entered into.33

Impact of Statutory Criteria

31 Ibid CLR at 424
32 Ibid at 421
33 Hill J. FCT v Zoffianes Pty Ltd 2003 ATC 4942, 4954
It is inherent in what the High Court in *Spotless* said, that a conclusion about what the purpose is, must be determined by having regard to the eight factors set out in S177D. It was highlighted in the Full Federal Court decision in *Peabody*, in a passage from the main judgment delivered by Hill J. (that was not questioned by the High Court on appeal), that regard must be had only to these enumerated factors and no others. Regard must also be had to each of the factors:

In arriving at his conclusion, the Commissioner must have regard to each and every one of the matters referred to in S177(b). This does not mean that each of those matters must point to the necessary purpose referred to in S177D. Some of the matters may point in one direction and others may point in another direction. It is the evaluation of these matters, alone or in combination, some for, some against, that S177D requires in order to reach the conclusion to which S177D refers.34

While it appears from the Full Federal Court decision in *Consolidated Press Holdings Ltd* that a global assessment of purpose is sufficient,35 post *Peabody*'s case, the courts hearing anti-avoidance cases have generally taken the approach of considering each of the listed factors in turn.

Even a brief perusal of the eight factors indicates that not all of them are equally important, which might lead to speculation that some are more important than others. From a perusal of the list of factors, it would appear that the more important which are to be considered, are at the top of the list. These include:

- the manner in which the scheme was entered into or carried out;
- the form and substance of the scheme;
- the time at which the scheme was entered into and the length of the period during which the scheme was carried out; and to a lesser degree
- any change in the financial position of any one connected with the scheme.

It would appear from the High Court’s decision in *Spotless*, that the evidence which impacted on the first three criteria (manner, form and substance and timing) was critical to the conclusion which the Court drew in relation to the purpose of the taxpayer, since no other criteria were referred to.

From this it might be concluded that it is possible to give more weight to those criteria, than criteria further down the list. But the Full Federal Court has not necessarily followed this approach. The approach consistently stated by Hill J., most recently in *Hart*, is to the effect that while manner, form and substance and timing are more significant issues, no factor should be weighted more than any other. This approach is, however, qualified by the need to have regard to the circumstances of each case.36

There is some difficulty in what Hill J. says in this regard. If some factors are more significant, then it would be reasonable to expect that in the evaluation process that must be carried out, these factors would carry more weight. Evaluation involves a

34 Peabody v FCT 93 ATC 4104, 4113-4114
35 99 ATC at 4971
36 Hill J. Hart v FCT 2002 ATC at 4623
balancing exercise. All of the factors may not be relevant. The evidence relevant to each factor may not be equally important. But, the more significant factors and the evidence which supports them could be expected to carry more weight in the balancing process. However, what may be underpinning the observations which Hill J. has consistently made is a desire to ensure that a dominant purpose is not determined primarily by reference to the first few criteria. Some flexibility may be a useful tool in such determinations, particularly since the principles for determining dominant purpose are still evolving.

But, even if manner, form and substance and timing are more significant, this still leaves open the question of how an evaluation is to be made once a tax benefit has been identified as arising from the scheme. Tax benefits do not arise in a vacuum. They arise in a commercial or family context. So it is important to determine how a dominant tax purpose is to be determined in a commercial or family context.

The Importance of Context

This is the dilemma which has consistently dogged discussion on tax avoidance. In the past this dilemma was solved by having regard to the predication test laid down by Lord Denning in *Newton v FCT*. The test was formulated as follows:-

In order to bring the arrangement within the section (the predecessor of Part IVA) you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way so as to avoid tax. If you cannot so predicate, but have to acknowledge that the transactions are capable of explanation by reference to ordinary business or family dealing without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section.

It followed that if there was a commercial or family reason for obtaining the tax advantage, then it could not be said that the transaction had been implemented to avoid tax. Tax avoidance used to be determined on the basis of whether there was a rational commercial or family reason to explain what had been done, or whether what had been done could only be explained on the grounds of avoiding tax. It was only if there was no valid commercial reason to explain the transaction, that the predominant tax avoidance purpose could be established.

However, this approach was rejected by the High Court in *Spotless* as being a fallacy or false dichotomy. The rejection of the fallacy was expressed in the following way:-

...references ...on the one hand to a ‘rational commercial decision’ and on the other to the obtaining of a tax benefit as the dominant purpose of the taxpayer in making the investment suggest the acceptance of a false dichotomy. ... A person may enter into or carry out a scheme within the meaning of Part IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business.

“A particular course of action may be, to use a phrase found in the Full Court judgment both ‘tax driven’ and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person

37 [1958] 98 CLR1
38 Ibid 8
entered into or carried out a scheme for the dominant purpose of enabling the taxpayer to obtain a tax benefit. Much turns upon the identification among various purposes of that which is dominant.\textsuperscript{39}

The key to this new formulation of principle appears to lie in the words “dominant purpose” since the High Court underscored this by saying that “much turns upon the identification, among various purposes, of that which is ‘dominant’”. As indicated above the High Court has interpreted the word “dominant” as indicating “that purpose which was the ruling, prevailing or most influential purpose” and made it clear that the conclusion to be reached “is the conclusion of a reasonable person”.\textsuperscript{40} As a result the real inquiry under Part IVA is to see whether getting a tax benefit is the dominant purpose of the taxpayer, not whether it can be explained away by reference to ordinary commercial or family dealings.

And, that purpose has to be tested at the time the scheme was entered into and by reference to the facts and law in existence at that time.

The inquiry is made more complex because, immediately after stating that a dominant tax purpose can be found in an ordinary commercial transaction, the High Court went on to explain that tax considerations may be taken into account in implementing a commercial transaction, without Part IVA coming down on the taxpayer’s head like a ton of bricks. This appears clearly from the High Court’s approval of the dictum of Harlan J. in the United States Supreme Court decision in \textit{Commr of IR v Brown}.

[The] tax laws exist as an economic reality in the businessman’s world much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source.\textsuperscript{41}

Later, the United States Supreme Court stated that it could not “ignore the reality that the tax laws affect the shape of nearly every business transaction”. This statement was again approved in \textit{Spotless} by the High Court, which went on to say:-

A taxpayer within the meaning of the Act may have a particular objective or requirement which is to be met or pursued by what, in general terms, would be called a transaction. The ‘shape’ of that transaction need not necessarily take only one form. The adoption of one particular form over another may be influenced by revenue considerations and this, as the Supreme Court of the United States pointed out, is only to be expected. A particular course of action may be, to use a phrase found in the Full Court judgments, both ‘tax-driven’ and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person entered into or carried out a ‘scheme’ for the ‘dominant purpose’ of enabling the taxpayer to obtain a tax benefit'.\textsuperscript{42}

In \textit{Spotless}, McHugh J. in a separate judgment, noted that the rejection of the dichotomy between seeking a higher after-tax profit and the pursuit of a legitimate

\textsuperscript{39} Spotless186 CLR 415-416
\textsuperscript{40} Hill J. Hart 2002 ATC 4621; Attorney-General’s Department v Cockcroft (1986) 10 FCR 180,190
\textsuperscript{41} 186 CLR 416
\textsuperscript{42} Ibid 416
commercial purpose could cause a problem in future cases. His Honour’s comments to this effect (they were not endorsed by the majority in that case, but nor were they rejected) were as follows:-

… However, Pt IVA does not authorise the Commissioner to make a determination …merely because a taxpayer has arranged its business or investments in a way that derives a tax benefit. More is required before the Commissioner of Taxation can lawfully make a determination under that paragraph. First, the scheme must be examined in the light of the eight matters set out in para (b) S177D. Second, that examination must give rise to the objective conclusion that the taxpayer or some other person entered into or carried out the scheme or a part of the scheme for the sole or dominant purpose of enabling the taxpayer or the taxpayer and some other person to obtain a tax benefit in connection with the scheme. That conclusion will seldom, if ever, be drawn if no more appears than that a change of business or investment has produced a tax benefit for the taxpayers.

The facts of the present case show much more than a switch of investments resulting in a tax benefit. The elaborate nature of the scheme and its attendant circumstances lead inevitably to the conclusion that the scheme was not merely tax driven but that its dominant purpose was to enable the taxpayer to obtain a tax benefit by participating in the scheme.43

The Spotless principles unsettled the established perception of the operation of Part IVA, because it was obvious that even if a transaction were an ordinary commercial transaction, this would no longer save it from being annihilated by Part IVA. Yet, it was difficult to see how the High Court’s adoption of the view that a tax dollar saved was as good as any other sat comfortably with the decision on the facts.

The Spotless case arose out of a commercial transaction where a decision had been made to adopt a particular investment strategy to take advantage of a tax concession specifically granted by the ITAA. The taxpayer had a substantial sum of money available for short-term investment and deposited the money with a financial institution in the tax haven of the Cook Islands. The interest paid by the Cook Islands institution was less than the interest available in Australia, but because that interest was exempt from tax in Australia, the after-tax amount received was higher than it would have been had the funds been invested in Australia and subject to tax in Australia.

There was no doubt that this was a commercial transaction and that net after-tax returns are important to business. The effect of the High Court’s enunciation of principle is that a taxpayer is entitled to take tax considerations into account when considering and implementing a business transaction.

If that is so, it should have followed that the taxpayer in Spotless was entitled to have regard to the provisions of ITAA which provided an exemption from Australian tax for all income on which tax had been paid overseas. The fact that the money was taken off deposit in Australia and placed on deposit overseas should not have been relevant, since a change of investment should seldom, if ever, lead to a conclusion that the change has been accomplished to obtain a tax benefit. The fact that the deposit of

43 Ibid 425
the funds in the Cook Islands was accompanied by additional security documents, designed to eliminate the perceived credit risk with the Cook Islands financial institution, should not have been a material factor, since the High Court accepted that the shape of a transaction can take more than one form and the form adopted was explicable on ordinary commercial considerations. Nor should it have mattered that the arrangement produced a better after-tax result, since the High Court approved the approach that a tax dollar saved was as good as any other. Furthermore, the tax dollar which could be saved was provided pursuant to a provision of the ITAA that specifically provided a special tax concession to Australian residents who derived taxed income from overseas.

An assessment of the facts against the criteria adopted by the High Court should have led to a conclusion that the deposit transaction was not one to which Part IVA applied. This was the conclusion of the Full Federal Court in this case. The core of that decision can be seen in the following passage taken from the judgment of Cooper J., who delivered the majority judgment.

Where all other things are equal the investment offering the highest rate of interest will be chosen. Where taxation rates on particular investments are different, the incidence of tax as a cost becomes one of the important matters for consideration in coming to an investment decision. For example, the treatment of income from gold mining operations as exempt … may be a factor which influences an investment in a gold mine returning income at a lower rate as a percentage of capital invested than an investment of the funds on deposit at a higher gross rate of return but subject to the payment of full income tax. Therefore, when investing outside Australia, the incidence of tax and the operation of any relevant double taxation treaties between Australia and the countries in which investment is being considered will be relevant to a decision to invest overseas or not. Whereby the operation of the foreign taxation laws and the existing Australian taxation laws the net return after the payment of all applicable tax and other costs of the investment is higher investing offshore than within Australia, it cannot be said that, objectively, the dominant purpose of the investor investing offshore is to get a tax benefit; the purpose is to obtain the maximum return on the money invested after the payment of all applicable costs, including tax.44

However, on the contrary, the High Court took the view that the dominant purpose of the taxpayer in carrying out the transaction was to obtain a tax benefit. The Federal Court has subsequently accepted the decision as being correct. The basis for this support appears to lie in the fact that the only explanation for taking the money off deposit in Australia and lodging it in a complicated way overseas at a lower rate of interest, was to obtain a tax benefit. However, this still does not explain why the tax advantage which was obtained as a result was the dominant purpose of the transaction. It is equally possible to say, as Cooper J. said in the Full Federal Court, that the dominant purpose was to obtain a better return on the money invested with the shape of the transaction being dictated by legitimate commercial considerations. The principle that a tax dollar saved is just as good as any other, which was supported by

44 Spotless 95 ATC at 4811
the High Court, is equally able, if not better able, to support the Full Federal Court decision.

**The Commercial Context**
The decision in *Spotless* has raised two difficulties:

1. How can a commercial transaction, in which a tax benefit has been identified, survive on the basis that obtaining the tax benefit was not the dominant purpose?
2. How can any transaction, where it has been structured to obtain a tax benefit, specifically provided by ITAA, survive on the basis that obtaining the tax benefit was not the dominant purpose?

Some assistance regarding the interpretative approach which should be taken by the courts in addressing these two issues, is afforded by the Treasurer’s statement in the second reading speech at the time the Bill for introducing Part IVA into ITAA was before Parliament, where the Treasurer said:-

The proposed provisions – embodied in a new Part IVA of the Income Tax Assessment Act – seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements, but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs … Some writers on the subject suggest that tax avoidance involves conduct entered into for the sole or dominant purpose of obtaining a particular tax advantage.

That description could be expected to cover the types of tax avoidance that, again using the language of social or political debate, are blatant, artificial or contrived, and which are indeed intended to be covered by this Bill.

But it is also apt to describe other arrangements, including some family arrangements, which are beyond the appropriate scope of general anti-avoidance measures and ought, if need be, to be dealt with by specific measures.

In order to confine the scope of the proposed provisions to schemes of the ‘blatant’ or ‘paper’ variety, the measures in this Bill are expressed so as to render ineffective a scheme whereby a tax benefit is obtained and an objective examination, having regard to the scheme itself and to its surrounding circumstances and practicable results, leads to the conclusion that the scheme was entered into for the sole or dominant purpose of obtaining a tax benefit.

The emphasis made by the Treasurer here is to the effect that Part IVA is concerned with controlling ‘blatant, artificial or contrived’ types of tax avoidance, not normal commercial transactions. While the High Court in *Spotless* has established that Part IVA applies to real commercial transactions, it may be that the Court’s approach is directed to sorting out blatant and artificial cases from normal commercial cases through the mechanism of determining whether, without the taxation benefit the particular form, shape or structure makes no sense. Reasonable men and women are bound to differ on where the line should be drawn on this issue. The recent decision of the Full Federal Court in *Eastern Nitrogen Ltd v FCT*\(^45\) throws considerable light on the way in which the Court is interpreting the purposive test in relation to tax-driven

\(^{45}\) 2001 ATC 4164
transactions which would not have been entered into, but for the tax benefit, in a manner consistent with the Spotless principles, yet maintaining consistency with the approach outlined in the Treasurer’s second reading speech.

In Eastern Nitrogen the taxpayer had sold plant affixed to the taxpayer’s premises to a financier and then leased the plant back at a commercial rental. This has been a familiar method of financing in Australia for decades. The transaction took the form of a lease. The rental payments under the lease gave a higher tax deduction than interest would have done. That was the identified tax benefit. This arrangement was held, by a unanimous decision, not to be a scheme to which Part IVA applied, notwithstanding that the transaction would not have been structured as a lease, but for the tax advantage.

The tax question confronting the Court was clear - whether the financing transaction, which provided a better after-tax return, could be said to have been entered into for the dominant purpose of obtaining the tax advantage.

The judgments in this case clearly show that the inquiry was directed, at least initially, to a consideration of the manner, form and substance of the transaction. In other words, the approach adopted in Spotless was followed. The approach to be adopted was outlined by Lee J. in the following statement:–

For S177D to apply and a determination made under S177F that Part IVA applies it must be shown that the ‘maximised … after-tax return’ has been obtained in a manner that speaks of the presence of a purpose above all others to obtain a tax benefit. (FCT v Spotless Services Ltd.46

The manner in which the transaction was entered into showed that there had been an exhaustive examination over a lengthy period time about the terms of the deal consistent with the size of the transaction, but the basic transaction was simple and straightforward, and there was nothing unusual, uncommercial or unexpected about the way in which it had been concluded or carried out.

The form of the transaction was constituted by a lease of equipment which had provided the taxpayer with deductions for the full amount of the rentals that were larger than the deductions for interest, under the pre-existing loan arrangements. The deduction was a tax benefit and it was an important element in the taxpayer’s decision to enter into and carry out the transaction. The substance of the transaction was the same.

His Honour then went on to state, in relation to form, that where a transaction is documented and the document creates legally enforceable rights and obligations, an objective assessment of the purpose of the transaction must take into account the rights and obligations undertaken.47

And, when considering form and substance the statutory provision does not limit the consideration which needs to be made regarding this factor, simply to a comparison

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46 Ibid 4166
47 Ibid 4167
between the form and substance of the scheme. Both elements have to be considered separately and together.48

It was emphasised though that although the rights, obligations and duties arising under an agreement may disclose elements of artificiality, whether in the documents or content, they do not determine purpose in favour of the Commissioner under the Spotless principle. Nor do elements of commerciality determine the issue in favour of the taxpayer. They are simply matters to be considered.

The other factors were also considered, but the only one of note was the change in the financial position of the taxpayer. This was significant. The scheme resulted in the taxpayer receiving a large up-front cash payment for its business. Then, instead of being reliant on short-term financing, the taxpayer had a long-term financial facility available which reduced its exposure to interest rate fluctuations. The off-balance sheet nature of the lease financing also had the benefit of enhancing the taxpayer’s credit rating, thereby reducing its cost of credit. While none of these considerations was taken to point to a purpose of obtaining a tax benefit, the fact that the taxpayer was able to deduct the whole of the rent payments – which were higher than its previous deductions for interest – pointed towards obtaining a tax benefit, because it resulted in a higher after-tax profit.

The Commissioner attempted to persuade the Court that there were elements of artificiality both in the documentation and the context of the matter, which indicated a dominant tax-driven purpose which tipped the scales in his favour.

First, it was alleged that artificiality was present because there was no connection between the price at which the equipment was sold to the financier and its market value. The Court considered that this did not indicate artificiality. The purchase price was a matter for the financier to be satisfied about. Even if it had been artificial, the presence of artificial elements does not determine the question of purpose. The rights and obligations of the parties still had to be considered.

Second, it was alleged that while the transaction may have been commercial, it was, in substance, a hire purchase agreement, whereby the rental payments were, at least in part, capital payments in reduction of the purchase price of the equipment. This argument required a conclusion that there was an arrangement or understanding arising from the rights and obligations of the parties pursuant to which the taxpayer had a right to acquire the equipment at the end of the lease. As there was no arrangement or understanding of this nature, this argument failed. The substance of the transaction was that the parties had entered into an equipment lease.

Notwithstanding that the transaction would not have been entered into apart from the tax deduction which was available, the Court decided that this transaction was explicable by reference to a commercial rationale. Tax, although a significant element, was not its dominant purpose.

**Achieving better after-tax returns**

The pursuit of a better after-tax return was at the heart of *Spotless*, and it caused the taxpayer to come to grief.

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48 Ibid Carr J. at 4180
In *Eastern Nitrogen*, it was also at the heart of the matter and the Court specifically addressed the *Spotless* principles in relation to tax-driven transactions. Lee J., with whom Sundberg J. concurred, maintained that proper business management requires the net cost of financing to be taken into account. Furthermore, where a business relies on borrowings to provide circulating capital, the net cost of that finance, after taking into account any deductions that are available under ITAA, is a relevant consideration, and to adopt one form of financing over the other on such a basis, does not, by itself, lead to a conclusion that a dominant purpose to obtain that tax advantage exists.

To show that a business which depends upon financiers to provide the recirculating capital needed for the operation of the business, has obtained that finance at a net cost, after taking into account provisions of the [ITAA], that is less than the net cost of obtaining finance by another method, will not, in itself, show that the dominant, ruling or supervening purpose of the operator of the business is to obtain the tax benefit constituted by the extent to which deductible outgoings incurred in respect of that borrowing will be greater than the deductible outgoings that would have been incurred under another method of obtaining finance. That is to say, something more must be shown than that the business has obtained finance at best available net cost after-tax before it can be said that a tax benefit has arisen to which S177C(1)(b) applies.49

This is a significant step forward on the position that existed after the High Court’s decision in *Spotless*, because it acknowledges that the pursuit of better after-tax returns is a legitimate commercial objective which will not, of itself, lead to a conclusion that the pursuit of such returns is tax driven. Obviously, in this case there was nothing more which was apparent to lead to a conclusion that a tax benefit had arisen. The conclusion which had been reached, that the transaction was simple and straightforward and there was nothing unusual, uncommercial or unexpected about the way in which it had been concluded or carried out, supported this result. It would seem to follow that if the transaction is a normal commercial transaction carried out in the usual way, this will not invoke Part IVA even if obtaining a tax advantage in the form of deductions is a significant aspect of the matter. Something more is required - something which is significantly unusual, uncommercial or unexpected, particularly about the manner in which the transaction was entered into or carried out. In other words, what is needed is significant blatancy, artificiality or contrivance.

*Eastern Nitrogen* is also important because it establishes that the dominant purpose is not established by asking whether the taxpayer would have entered into the transaction 'but for' the tax benefit. The taxpayer may not have entered into the transaction but for the tax benefit, but that does not establish that the tax advantage was the dominant purpose. The dominant purpose test requires a higher level of attainment.

Then there is *Hart’s* case which held a tax-driven loan transaction did not contravene Part IVA.

While the facts in this case were identified as constituting a tax-driven transaction, the critical importance of *Hart’s* case lies in the way in which this conclusion was reached. Critical to the decision was not the form of the loan providing two facilities

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49 Ibid Lee J. at 4168
which enabled the tax advantage to be available, nor that the substance of the
transaction was a single advance; nor the fact that the scheme brought about the
obtaining of a greater amount of interest than would otherwise have been available, or
the manner in which the transaction was entered into or carried out.

No, the importance of Hart's case lies in the fact that it has reconfirmed the necessity
to identify the scheme by reference to the commercial reality of what the parties did
and then to test dominant purpose against that. Hill J. said:-

It is obvious enough, however, that so long as the scheme is found to include
the making of the loan or loans, that one of the objectives of the scheme and
indeed an important objective of it, was the financing of the acquisition of
the (new house) and the refinancing of the (existing house).50

In other words, unless the scheme is identified by reference to what the taxpayer
actually did, it is robbed of all practical meaning and cannot be considered to be a Part
IVA scheme. Having identified the scheme in this way it is necessary, in order to
ascertain the dominant purpose of the scheme by taking into account the eight S177D
factors, to weigh the commercial side of the transaction against the income tax
advantage arising out of the transaction. Having put the two sides of the transaction
on the scales, His Honour said:-

On any view of the matter, the dominant purpose of the scheme which
included the borrowing by the (taxpayer) of funds used to finance and
refinance the two properties, was the obtaining of funds to permit (him) to do
so. … The scheme was directed to a commercial end, the borrowing of
money for use in financing and refinancing the two properties. That is what
a reasonable person would conclude was the ruling, prevailing or most
influential purpose of the (taxpayer) into or carrying out the scheme.51

The issue then becomes one of ensuring that evidence relating to the commercial side
of the transaction is before the Court. There is nothing in Part IVA itself which
indicates that the commerciality of a transaction is relevant. This was a difficulty
which obviously troubled Hill J. and he addressed it in the following way:-

[The High Court in Spotless] certainly did not say that it would be an error to
take into account the commercial outcome of a transaction, at least where
that commercial outcome has nothing to do with tax, or that shape, form or
structure of a scheme was even the most significant matter to consider under
Part IVA. Clearly all relevant circumstances must be considered.52

The statement that "all relevant circumstances must be considered" appears to
encompass the view that relevant circumstances include the commercial objectives of
the parties. If this is so then it needs to be determined how commerciality is to be
taken into account.

The courts have already ruled out the possibility that evidence relating to what the
parties were trying to achieve is relevant. The subjective purpose of anyone connected
with the scheme is irrelevant – at least in so far as establishing that the dominant
purpose was to obtain a tax benefit is concerned. However, Hill J. in Zoffanies does

50 Hart v FCT 2002 ATC at 4623
51 Ibid at 4624
52 Ibid at 4622
accept that subjective intention may be relevant to one of the eight factors prescribed by S177D, e.g. the manner in which the scheme was carried out. The observation was not developed.\textsuperscript{53} But, if subjective intention might be relevant to some of the S177D factors, it might equally be a relevant circumstance concerning the identification of the scheme itself.

The issue on appeal in \textit{Zoffanies} was whether the Tribunal had applied the correct test, not the broader issue of what evidence may be admissible to support various S177D factors, or the aspect of commerciality. The ground on which the appeal ultimately succeeded was that the Tribunal had applied the wrong test. The Tribunal was found to have substituted the taxpayer's subjective motive or purpose for the objective test required by Part IVA, using subjective evidence of the taxpayer to do so.

The courts have also indicated that commerciality is not relevant to the identification of a scheme. This emanates from the decision of the Full Federal Court in \textit{Spotless}.\textsuperscript{54}

However, what the Full Federal Court said in \textit{Spotless} on this issue needs to be examined. The observations of the majority were directed to criticism that the scheme identified by the Commissioner stated certain terms of the scheme were not normal commercial terms.\textsuperscript{55} The majority judgment does not state that the ambit of what the parties were entering into or carrying out was irrelevant, or that it was irrelevant whether it was of a commercial nature. The Court only said that whether the terms were commercial was a matter to be considered in determining the purpose of the scheme. It said nothing about the commerciality of what the parties did, which is necessarily of critical importance to the identification of the scheme.

The importance of \textit{Hart's} case is that it establishes that there are two tests to be applied in relation to ascertaining whether obtaining the tax benefit is the dominant purpose. First, the eight factors need to be considered with an assessment being made about the impact of tax in relation to each. Then the commercial side of the transaction needs to be weighed against the assessment made under S177D in order to establish whether there was a legitimate commercial objective, which is the overriding purpose of the transaction or, whether within the context of that commercial objective, tax considerations are all encompassing. At present, it appears that the commerciality of what the parties did is to be ascertained from the identification of the scheme and evidence relevant to that issue. If that is the correct reading of the effect of \textit{Hart's} case, then the evaluation required under Part IVA is only two degrees of separation removed from the old Newton predication test.

\textbf{CONCLUSION}

What has emerged is that the way in which the scheme is identified in large measure determines the finding of purpose.

If the scheme is identified as those facts by which the tax benefit was obtained, then the purpose of such a narrowly defined scheme is a foregone conclusion and the inquiry required by S177D to establish the dominant purpose is irrelevant. It is only if

\textsuperscript{53} 2003 ATC at 4954
\textsuperscript{54} \textit{Spotless} 95 ATC 4805
\textsuperscript{55} Ibid at 4805
the scheme is identified by reference to the practical reality of what the taxpayer did, that the S177D considerations have a role to play and it becomes possible to make a determination about whether tax is the dominant purpose of the taxpayer’s actions.
The Influence of Education on Tax Avoidance and Tax Evasion

Jeyapalan Kasipillai*, Norhani Aripin† and Noor Afza Amran‡

Abstract
This study evaluates the influence of education on tax compliance among undergraduate students in Malaysia. The survey considers existing literature in the field of education and ascertains whether education can influence the respondents’ compliance behaviour. The statistical findings confirm the prevalence of a relationship between education and tax compliance. This relationship is generally consistent, particularly so to the questions relating to general avoidance and personal avoidance. There is an improvement in personal tax compliance among students especially among females after one semester of pursuing a preliminary taxation course. It is suggested that universities providing courses in social science as well as business, management and accounting studies should offer the preliminary taxation course as a core subject to all their students.

I. INTRODUCTION

Past research has indicated that tax evasion, especially in small amounts, is not viewed as being morally wrong or considered as a serious crime (Song and Yarbrough, 1978; Westat, 1980; Yankelovich, Skelly and White, 1984). Several research findings have reported a positive relationship between taxpayers’ view of tax evasion as wrong and tax compliance behaviour (Scott and Grasmick, 1981; Thurman, John and Riggs, 1984; Kaplan, Reckers and Roark, 1988; Klepper and Nagin, 1989; Grasmik and Bursik, 1990). Basic principles of taxation include low compliance costs; certainty in tax law and minimal interference with economic incentives to work, save and invest.

According to Andreoni, Erard and Feinstein (1998), there is a need for more empirical and institutional research on compliance behaviour within jurisdictions outside the United States (US). As for Malaysia, there has been little research dealing with taxpayer attitudes on tax compliance and the possible influence of education on those attitudes. This research contributes, albeit in a small manner, to a better understanding of Malaysian taxpayers’ attitude towards tax compliance. In the United States (US), Hite (1995) observed that the level of education was not linked to evasion or avoidance. In a research carried out in the US and Hong Kong, Chan, Troutman and O’Bryan (2000) found that US respondents’ decisions to comply with their tax laws were mainly driven by their age and education. Meanwhile, Hong Kong respondents have a lower level of moral development, a less favourable attitude towards the tax system, and consequently a lower level of tax compliance.

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In New Zealand, Lin and Carrol (2000) examined the linkages between an increase in tax knowledge on perceptions of fairness and tax compliance attitudes by using students enrolled in an introductory taxation course in a tertiary institution. Their results indicated that an increase in tax knowledge did not have a significant impact on perceptions of fairness and tax compliance attitudes. This result is inconsistent with the findings of other researchers (see Crane and Nourzad, 1990) who found a positive linkage.

II. LITERATURE REVIEW

The literature section deliberates on the definition of tax avoidance and tax evasion followed by a review of the theoretical framework surrounding tax compliance.

**Tax avoidance and tax evasion**

Tax resistance takes two basic forms: evasion and avoidance. Evasion of tax is immoral as it is illegal (Brown, 1983). Tax evasion is meant to be deliberate acts of non-compliance resulting in payment of lower taxes than are actually owed. Therefore, not paying ‘ones’ lawful share of tax is evasion of income. On the other hand, tax avoidance, which denotes the taxpayers’ ingenuity to arrange his affairs in a proper manner so as to reduce the incidence of tax, is legal. As long as the provisions of the law are not violated and transactions *bona fide*, any attempt to minimize tax is acceptable.

The term non-compliance encompasses both intentional evasion and unintentional non-compliance which is likely due to calculation errors and inadequate understanding of tax laws. A particular taxpayer may intentionally evade some of his or her obligations while intentionally being non-compliant in other aspects. Intentional non-compliance to reduce or eliminate the amount of tax payable requires some measure of understanding of the tax system. While there may not be a one to one correlation, it may be reasonable to assume that the greater the understanding of the tax system, the greater is one’s ability to ‘hookwink’ the system. If so, there is a direct relationship between understanding the tax system and the probable propensity to evade the full payment of tax.

Evasion can take place in a number of ways. Individuals may choose to underreport their true income. They may also overstate adjustments in moving from Total Income to Adjusted Gross Income (AGI), or claim excessive deductions from AGI when computing taxable income. Kolm (1973) stated that some degree of tax evasion was expected and tolerated. The author (Kolm) estimated that one-third of the French income tax base fails to be reported to the revenue authorities.

Taxation is a social phenomenon that comprises of political, social and legal aspects and can be influenced by attitudes. Thus, in order to change taxpayer behaviour, it requires great care and effort (Van Hoorn, 1978). Crane and Nourzad (1990) found that individuals with higher levels of income tend to evade more. Citizens with greater tax education may be aware of non-compliance opportunities such as tax loopholes and hence there is a reduced likelihood of deliberate non-compliance (tax evasion). The findings of a study by Peacock and Shaw (1982) revealed that an increase in tax evasion will result in an expansion of domestic income and a contraction in the Government’s tax revenue if the marginal propensity to spend out of tax evaded is less than unity. Clotfelter (1983) evidenced that successful tax evasion
has serious consequences to Governments as it not only cause losses in current revenues but it fosters a threat to voluntary compliance.

**Theoretical framework on tax compliance**
Achieving tax compliance is costly for both tax authorities and taxpayers. Tax audit and investigation is obviously costly to tax authorities (Allingham and Sandmo, 1972). Compliance is also costly to taxpayers, who must keep records as well as consult tax professionals and this is particularly true under a self-assessment system. Malaysia introduced a self-assessment tax system in stages commencing with companies from year of assessment 2001. In 2004, it would apply to all categories of taxpayers, including individuals. Slemrod and Sorum (1984) suggested that the compliance cost of managing individual income taxes in developed countries is between five and seven percent of revenue raised. According to Henry (1983), perfect compliance to tax law is not a rational objective for public policy.

Most taxation systems in the world reveal that taxation authorities employ a mixture of enforcement activities and penalties in order to enforce tax compliance. Research in the US (Schwartz and Orleans, 1967) and in Sweden (Vogel, 1974) found that taxpayer norms are important in analysing individual behaviour towards tax obligations. Spicer and Lundstedt (1976) found that the internalised norms and role expectations in each taxpayer are the major role elements in taxpayer choice between tax compliance and tax evasion.

Taxpayers are less compliant when they perceive the tax system to be unfair (Spicer and Becker, 1980 and Mustafa, 1997). Jackson and Milliron (1986) listed out variables that relates to compliance such as tax evasion behaviour, gender, occupation and risk attitude. In their study, they found that attitudes are more important than opportunities in determining taxpayer behaviour. Older taxpayers are found to be less willing to take risks and are more sensitive to sanctions. Meanwhile, females tend to be more conforming, conservative and bound by moral restraints. Single taxpayers are less compliant apparently because they are less risk averse (Tittle, 1980).

In the US, available statistics suggest that there was an increase in the level of tolerance for tax evasion from 35 percent in 1966 to 44 percent in 1979. Silver (1995) carried out a survey on university students and he found that 56 percent of the students disagreed that most people are honest in paying their taxes.

**Relationship between tax compliance and education**
Roth, Scholz and Witten (1989) identified two primary factors that have a significant effect on taxpayer compliance: financial self-interest and moral commitment. Financial self-interest assumes that individuals maximize their expected utility by reporting on income that balances the benefits of successful evasion against the consequences of detection. Thus, the importance of detection and sanctions are the primary means to increase compliance.

Chan, Troutman and O’Bryan (2000) carried out a survey to compare compliance behaviour between Hong Kong and US taxpayers. They found that the US respondents’ decisions to comply with tax laws were primarily driven by their age and education, which in turn positively influenced moral development and attitude. In contrast, Hong Kong respondents have shown a negative link between education, moral development, attitude and compliance. Although Hong Kong subjects felt the tax system was generally fair, lower levels of education and moral development
This research examined several norms of accounting students at University Utara Malaysia (UUM) to determine what impact these norms may have on the participants’ responses to several tax question scenarios such as honesty and sense of moral duty towards the taxation system.

III. OBJECTIVE OF THE STUDY

The objective of this study is to evaluate the influence of education on tax compliance among undergraduate students at UUM. This study considers existing literature in the field of education and ascertains whether education can influence the respondents’ compliance behaviour. Consequently, the study explores whether education has an effect on accounting undergraduates’ attitude towards tax evasion and tax avoidance. This study extends prior compliance research by finding support for a link between individuals’ education and compliance intentions. The findings of the study would be useful to create awareness of voluntary tax compliance through education under the self-assessment system.

IV. METHODOLOGY

A questionnaire was administered on UUM accounting students to determine whether education influences respondents’ tax avoidance and tax evasion behaviour.

Survey Procedure
The questionnaires were distributed to University Utara Malaysia accounting students who had yet to commence their taxation course. The study therefore, would exclude students who had taken the taxation paper at the diploma level.

Pilot Study
Initially, the questionnaire was pre-tested by enrolling lecturers attached to the School of Accountancy, UUM as respondents. The criticisms of the five commentators on this study were helpful in preparing the final questionnaire. The findings of the pilot study were not reported as it was merely meant to improve the structure of the questionnaire. After improving the survey instrument so as to eliminate ambiguous questions, the questionnaire was distributed to the respondents.

Data Collection Method
The instrument used for this quasi-experimental research was a survey questionnaire. The tax-case based scenario questionnaires were sent to a total of 560 students who commenced their preliminary taxation paper for the May 2001/2002 semester. The tax-case scenario questions relied on respondent’s basic knowledge of the Income Tax Act (ITA) to determine the outcome of the survey findings. From the total of the questionnaires that was distributed, 553 were completed, providing a response rate of 98.75% for the beginning of the semester. Seven of the questionnaires were rejected due to insufficient data. At the end of the semester, the same set of questionnaires, with one additional question was distributed to the set of sample. The additional question posed the following scenario to the respondents:

“My study of tax this semester has influenced my attitude to my own income tax affairs in the following manner”
Out of 560 questionnaires that were distributed at the end of the semester, 551 were returned by the respondents providing a response rate of 98.39%. Five of the questionnaires were rejected due to insufficient data, leaving a total of 546 usable responses.

**The Questionnaire**

The questionnaire was divided into two parts: Part A and Part B. Part A consisted of four tax case scenarios to measure the behavioural dimension of respondents to tax compliance. After reading each scenario, the respondents were asked to evaluate (on a seven-point “Likert” scale) whether he or she would report their earned income if faced with an identical situation. Part A of the questionnaire comprised of four questions. The first question is structured to gain response to a general public evasion (GE) issue. The second question seeks response to a general public avoidance (GA) issue. The third question relates to a personal evasion (PE) matter and the last question deals with personal avoidance (PA). As mentioned earlier, at the end of the semester, one additional question was added to the same set of questionnaire. The additional question sought from respondents whether their attitude on tax affairs had changed after studying the taxation subject for one semester.

Part B (“demographic information”) solicits respondents’ background information such as gender, age, ethnic group and work background of parents.

**Data Analysis**

In Part A, a Likert scale was used for most of the questionnaires and the respondents had to tick the appropriate column. In Part B, the questionnaires required a tick for the correct answer. The responses derived from the questionnaires were coded, entered and analysed by using the SPSS statistical package.

**V. FINDINGS**

This section reports on the respondent’s characteristics, and results of hypotheses introduced for this study.

**Respondent’s Characteristics**

A summary of the characteristics of respondents is reported in Table 1. For both sets of questionnaire, the percentages of sample characteristics are broadly the same. The sample characteristics suggest that about 26% of the respondents were males and 74% were females. Seventy-one percent of the respondents were Malays, 23% were Chinese, four percent were Indians and two percent were others.

Most of the respondents (84%) are between 20 and 30 years of age. This is because the respondents are undergraduate students pursuing a degree program at University Utara Malaysia (UUM). About one-quarter of the student’s parents (24%) are
employed with the Government but most of them (48%) are employed with the private sector.

**Hypotheses Testing**

The research hypotheses were structured to seek answers to the issues raised in the introduction section, that is, the association, if any, between (i) extent of tax compliance and (ii) level of education. As mentioned earlier, the respondents completed the questionnaires at the commencement as well as at the end of the semester. The survey questionnaires for each of groups were coded in relation to the respondent’s background data and the mean scores for each survey question were then determined.

**Table 1 Summary of Sample Characteristics**

<table>
<thead>
<tr>
<th></th>
<th>Percent</th>
</tr>
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<tbody>
<tr>
<td><strong>Gender</strong></td>
<td></td>
</tr>
<tr>
<td>Male</td>
<td>25.7</td>
</tr>
<tr>
<td>Female</td>
<td>74.3</td>
</tr>
<tr>
<td><strong>Ethnic Group</strong></td>
<td></td>
</tr>
<tr>
<td>Malay</td>
<td>70.7</td>
</tr>
<tr>
<td>Chinese</td>
<td>23.5</td>
</tr>
<tr>
<td>Indian</td>
<td>4.0</td>
</tr>
<tr>
<td>Others</td>
<td>1.9</td>
</tr>
<tr>
<td><strong>Age</strong></td>
<td></td>
</tr>
<tr>
<td>Below 20 years</td>
<td>15.4</td>
</tr>
<tr>
<td>20 to 30 years</td>
<td>84.4</td>
</tr>
<tr>
<td>Over 30 years</td>
<td>0.2</td>
</tr>
<tr>
<td><strong>Parent’s work background</strong></td>
<td></td>
</tr>
<tr>
<td>Sole proprietor/partnership</td>
<td>15.6</td>
</tr>
<tr>
<td>Government servant</td>
<td>23.7</td>
</tr>
<tr>
<td>Employed in private sector</td>
<td>47.7</td>
</tr>
<tr>
<td>Others</td>
<td>13.0</td>
</tr>
<tr>
<td><strong>Parent’s approximate annual income (Year: 2000)</strong></td>
<td></td>
</tr>
<tr>
<td>Below RM18,000</td>
<td>87.4</td>
</tr>
<tr>
<td>RM18,001 to RM36,000</td>
<td>9.9</td>
</tr>
<tr>
<td>Above RM36,001</td>
<td>2.7</td>
</tr>
<tr>
<td></td>
<td>100.0</td>
</tr>
</tbody>
</table>

* Number of respondents: 546

The first hypothesis was posited in relation to respondents’ scores over time (period of tax education).

H-1: There is no difference in the mean scores of students at the commencement of the semester and at the end of the semester.
Data to test hypothesis, H-1, was gathered from students who completed the Taxation 1 program in May 2001. The student’s responses to four taxation scenarios were obtained at the commencement of the semester, and student responses to the same questions were gathered at the end of the semester. No student was identified in relation to his or her response in order to make it confidential and to encourage truthful responses. As such, individual responses could not be compared. Only total responses were analysed. Table 2 summarizes the student mean scores to each of the questions on both occasions.

### Table 2 Comparison of Mean Scores of Tax Questions Before and After Tax Education

<table>
<thead>
<tr>
<th></th>
<th>Commencement of the semester</th>
<th>End of the semester</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>n = 553</td>
<td>n = 551</td>
</tr>
<tr>
<td></td>
<td>Means</td>
<td>Standard Deviation</td>
</tr>
<tr>
<td>Q1 GE</td>
<td>4.02</td>
<td>1.45</td>
</tr>
<tr>
<td>Q2 GA*</td>
<td>4.78</td>
<td>1.34</td>
</tr>
<tr>
<td>Q3 PE*</td>
<td>4.22</td>
<td>1.31</td>
</tr>
<tr>
<td>Q4 PA</td>
<td>3.39</td>
<td>1.34</td>
</tr>
</tbody>
</table>

* Significant at 5% level
Note: GE: General Evasion, GA: General Avoidance, PE: Personal Evasion, PA: Personal Avoidance

Hypothesis H-1 was partially accepted because the t-test revealed that there was significant difference at five percent level for GA (t=6.51, df=1102, p<0.05) and PE (t=2.41, df=1102, p<0.05). The students seem to be neutral as to whether it is acceptable under the Income Tax Act (ITA) to under-report the income if faced with special circumstances such as unfair tax laws or economic hardship, at the beginning of the semester. After undergoing the tax course, the results showed that student attitudes to the given tax scenarios had changed over time. These findings suggest that students may have become more compliant on tax avoidance and evasion through participation in tax education.

In order to understand whether education can influence students’ tax compliance attitude, further tests were carried out in terms of gender and ethnic background. The following hypothesis was formulated, that is:

H-2: There is no difference between the mean scores of males and females in relation to attitude change after one semester of tax education.

Although hypothesis H-1 indirectly tested the influence of one semester of Taxation 1 education on tax compliance attitude of students, hypothesis H-2, was posited as a direct test of students’ own view on a possible change in attitude. At the end of the semester (November 2001), the students were asked an additional question which reads as follows:

“My study of tax this semester has influenced my attitude to my own income tax affairs in the following manner.”
Student responses were then expressed on a seven point Likert scale with a score of 1 showing a negative change in attitude and a score of 7 displaying a positive change in attitude to the requirements of Income Tax Act (hereafter referred to as the Act) 1967. Table 3 displays the mean responses to this new question posed at the end of the semester.

**TABLE 3: MEAN SCORES OF MALES AND FEMALES TO A CHANGE IN ATTITUDE IN MEETING THE REQUIREMENTS OF THE INCOME TAX ACT**

<table>
<thead>
<tr>
<th>Question Number</th>
<th>Males n = 130</th>
<th>Females n = 421</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q5 (Personal Perception)</td>
<td>Mean Response Score</td>
<td>5.07</td>
</tr>
</tbody>
</table>

Hypothesis H-2 was accepted as the mean scores of males and females were 5.07 and 5.35 respectively in relation to question 5 (Personal Perception). T-test statistics revealed that the difference was significant at 5% level (t=2.40, df=549, p<0.05). Our study revealed that both male and female mean scores fell in the upper half of the Likert scale, suggesting that in the minds of the students, there was some degree of improvement in tax compliance, highly likely due to tax education. This finding substantiates earlier survey reports carried out in the US and Hong Kong [Hite (1995) and Chan, Troutman and O’Bryan (2000) which showed similar results.

Table 4 focuses on the mean scores of females on the four taxation scenarios at the beginning and at the end of the semester. The results revealed that there is significant difference among female attitudes in respect of general avoidance (GA) tax issues at the commencement and at the end of the semester (t =5.94, df =830, p<0.05) and PE (t =2.44, df =830, p<0.05). The results suggest that education can remarkably influence the attitude of female students. Consequently, the results indicate that female students are more aware about the legal implications of tax evasion and tax avoidance, compared to male counterparts, after having completed one semester of tax education.
TABLE 4: STATISTICALLY DIFFERENT MEAN SCORES AND STANDARD DEVIATION FOR FEMALES ON TAX QUESTIONS

<table>
<thead>
<tr>
<th>Question Number</th>
<th>Commencement of Semester</th>
<th>End of Semester</th>
<th>Commencement of Semester</th>
<th>End of Semester</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 GE</td>
<td>4.02</td>
<td>3.99</td>
<td>1.42</td>
<td>1.40</td>
</tr>
<tr>
<td>Q2 GA*</td>
<td>4.72</td>
<td>5.25</td>
<td>1.28</td>
<td>1.30</td>
</tr>
<tr>
<td>Q3 PE*</td>
<td>4.22</td>
<td>4.44</td>
<td>1.25</td>
<td>1.38</td>
</tr>
<tr>
<td>Q4 PA</td>
<td>3.36</td>
<td>3.37</td>
<td>1.25</td>
<td>1.37</td>
</tr>
</tbody>
</table>

* Significant at 5% level

Note: GE: General Evasion GA: General Avoidance PE: Personal Evasion PA: Personal Avoidance

Similar analysis were also undertaken on male attitudes as shown in Table 5. The t-test results revealed that there is a significant difference among male attitudes between the commencement and the end of the semester for only GA (t=2.91, df=270, p<0.05). The findings suggest that male students have shown an improvement in the understanding of the legal provisions pertaining to general tax avoidance under the Act. Indirectly, it has proved that male students’ attitudes in respect of general tax avoidance under the Act have changed after undergoing the tax course for one semester.

TABLE 5: MEAN SCORES AND STANDARD DEVIATION FOR MALES ON TAX QUESTIONS

<table>
<thead>
<tr>
<th>Question Number</th>
<th>Commencement of Semester</th>
<th>End of Semester</th>
<th>Commencement of Semester</th>
<th>End of Semester</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 GE</td>
<td>4.01</td>
<td>3.97</td>
<td>1.53</td>
<td>1.55</td>
</tr>
<tr>
<td>Q2 GA*</td>
<td>4.94</td>
<td>5.45</td>
<td>1.49</td>
<td>1.39</td>
</tr>
<tr>
<td>Q3 PE</td>
<td>4.21</td>
<td>4.32</td>
<td>1.46</td>
<td>1.52</td>
</tr>
<tr>
<td>Q4 PA</td>
<td>3.48</td>
<td>3.55</td>
<td>1.57</td>
<td>1.48</td>
</tr>
</tbody>
</table>

* Significant at 5% level

Note: GE: General Evasion GA: General Avoidance PE: Personal Evasion PA: Personal Avoidance

The third hypothesis on participant’s gender was proposed as follows:

H-3: There is no difference in the mean scores of attitudes between males and females on each survey.

TABLE 6: MEAN SCORES FOR MALES AND FEMALES ON BOTH SURVEYS

<table>
<thead>
<tr>
<th>Question Number</th>
<th>Commencement of Semester</th>
<th>End of Semester</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 GE</td>
<td>4.01 Male 4.02 Females</td>
<td>-0.04 t test</td>
</tr>
<tr>
<td>Q2 GA</td>
<td>4.94 Male 4.72 Females</td>
<td>1.70 t test</td>
</tr>
<tr>
<td>Q3 PE</td>
<td>4.21 Male 4.22 Females</td>
<td>-0.04 t test</td>
</tr>
<tr>
<td>Q4 PA</td>
<td>3.48 Male 3.36 Females</td>
<td>0.89 t test</td>
</tr>
</tbody>
</table>

Note: GE: General Evasion GA: General Avoidance PE: Personal Evasion PA: Personal Avoidance
Hypothesis H-3 was accepted. It was observed that in both surveys carried out at the commencement and end of the semester, there was no significant difference in attitudes between male and female groups. The fourth hypothesis on participant’s ethnic group was proposed as follows:

H-4: There is no difference in the mean scores of attitudes among ethnic groups at the commencement of the semester and at the end of the semester.

Table 7 shows the mean scores for ethnic groups over time (tax education). Results of ANOVA revealed that there are significant differences among ethnic group attitudes for tax education in (General Evasion) GE ($F_{7,1096} = 4.68, p<0.05$) (General Avoidance) GA ($F_{7,1096} = 7.83, p<0.05$) and (Personal Evasion) PE ($F_{7,1096} = 3.78, p<0.05$).

**TABLE 7: MEAN SCORES FOR ETHNIC GROUP OVER TIME**

<table>
<thead>
<tr>
<th>Question Number</th>
<th>Commencement of Semester</th>
<th>End of Semester</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Malay</td>
<td>Chinese</td>
</tr>
<tr>
<td>Q1 GE</td>
<td>4.10</td>
<td>3.78</td>
</tr>
<tr>
<td>Q2 GA</td>
<td>4.81</td>
<td>4.58</td>
</tr>
<tr>
<td>Q3 PE</td>
<td>4.33</td>
<td>3.92</td>
</tr>
<tr>
<td>Q4 PA</td>
<td>3.41</td>
<td>3.38</td>
</tr>
</tbody>
</table>

The Least Square Distance (LSD) tests indicated that differences existed at the 5% significance level as follows:

**Q1GE (General Evasion)**
In this category, the change in attitude among the ethnic groups was examined. The mean scores of compliance (GE) attitude of Indian students have changed over time from 3.68 to 2.83 suggesting that tax education had the greatest impact on this ethnic group for GE compared to Malays and Chinese students.

**Q2GA (General Avoidance)**
The mean scores of attitudes (GA) for Malay and Chinese groups have changed from 4.81 to 5.26 and 4.58 to 3.35 respectively. Malay students have positively reacted to tax education for GA but the reverse is true for Chinese students.

**Q3PE (Personal Evasion)**
The mean scores of attitudes (PE) of Chinese and Indian groups have changed from 3.92 to 4.29 and 3.64 to 5.04 respectively. Again, tax education had the greatest impact on Indian students on PE compared to Chinese and Malay students.

**VI. CONCLUSION**
The results of the study are generally consistent with the hypotheses posited in the paper. It is found that there is a relationship between education and tax compliance which is partially consistent with hypothesis 1, particularly so to questions relating to ‘general avoidance’ and ‘personal evasion’. With higher level of education, both male and female respondents changed their attitude in meeting the requirements of the Malaysian tax law. This finding is supported by hypothesis 2.
Furthermore, the findings indicate there is no difference in attitudes between male and females and this is in line with hypothesis 3. The statistical findings of this study confirm the existence of a relationship between education and tax compliance. Therefore, it is suggested that universities offering social science courses as well as business and management studies should offer the preliminary taxation course as a core subject to all their students. Currently, the taxation course is offered as a compulsory subject to all accounting-based undergraduates. It will be useful if the taxation paper is also offered to other students pursuing non-accounting courses. This is because when undergraduate students are subsequently employed and earn taxable income, they will more likely to be compliant with tax laws. If the employees had adequate tax knowledge, then there would be minimal unintentional non-compliance. When there is tax evasion among those who have adequate tax knowledge, then, it is as a result of deliberate non-compliance that would then attract higher tax penalties. Indirectly, this study does make a contribution towards a better understanding of internalised norms of Malaysian taxpayers.

The principal limitation to this study is due to the small sample size covering UUM accounting students. Consequently, it is not appropriate to make a generalization on the change in attitude among Malaysian taxpayers resulting from tax education, although there are indications to suggest that this view is likely to be true. Furthermore, it can be argued that the responses in this study may not accurately reflect the tax-paying public as a whole. The findings of this study show that education may significantly influence the tax compliance behaviour of students. More studies need to be carried out among accounting students from other public and private universities so that the results can be realistically compared to gather more accurate responses. A comparison could also be made among undergraduates from different countries to investigate how the results would differ.
REFERENCES


Scheme New Zealand or An Example of The Operation of Div 165*

Justice Graham Hill*

Abstract
There is no decided case in Australia yet regarding the application of general anti-avoidance rules to a transaction with respect to GST. However, this has been considered to some extent in a recent case in New Zealand, TRA No 001/02 v Commissioner of Inland Revenue. This paper considers the decision made by the New Zealand Taxation Review Authority on that case as a vehicle for speculating on the outcome under the general anti-avoidance rules contained in the Australian GST Act, had a scheme equivalent to the New Zealand scheme been implemented in Australia.

INTRODUCTION

It took 13 years from the introduction of Part IVA into the Income Tax Assessment Act 1936 until it first engaged the attention of the High Court in Commissioner of Taxation v Peabody^1. It may well take around that time for Division 165 of the A New Tax System (Goods & Services Tax) Act 1999 (“the GST Act”) to receive detailed consideration in the High Court. Perhaps that is to be unduly pessimistic given recent murmurings in the newspapers suggesting the possible application of Division 165 to “joint venture” schemes.

Because there are, as yet, no cases in Australia which have considered Division 165 it is useful to consider the facts of a recent New Zealand case TRA No 001/02 v Commissioner of Inland Revenue (“the deferred payment scheme”) decided by the New Zealand Taxation Review Authority. This, then, provides a vehicle for speculating on the outcome under Division 165, had the scheme been implemented in Australia (and worked). It also enables us to assess the difficulties (if any) which the transplantation of Part IVA into the GST Act (albeit with some modifications) may have brought with it.

It should, at the outset, be noted that the provisions of the GST Act relating to contracts to acquire property differ from those in New Zealand with the consequence that the scheme could not, at least without modification, work here. As will later be seen the normal provisions in a contract that the deposit would be held by a stakeholder had been deleted. That was a necessary element of the scheme and would ensure that Division 99 of the GST Act would have no application should the scheme be tried in Australia. Section 9-15(3) of the GST Act would create difficulty for the scheme in Australia. However, for the purposes of the paper I propose to assume that the Australian legislation does produce the same attribution mismatch on the same facts. Otherwise there is nothing to talk about.

The paper will not set out the legislative scheme of Division 165. That will be assumed. There will, however, be a need to set out some of the provisions of s 76 of the *Goods & Services Tax Act 1985* (“the NZ Act”).

**THE FACTS**

The basic outline of the facts of the deferred payment scheme is quite simple. The taxpayer T contracted to purchase some 114 sections of land in a subdivision from a similar number of companies (“the A group of companies”) by separate agreements. The agreements were conditional upon each of the A group of companies completing a purchase agreement it had entered into with W Developments Limited the owner of the land.

The total consideration payable under the contracts exceeded $80 million (NZ). Each had a deferred settlement date ranging from 10 to 12 years. Each provided for payment of $10 on signing, as part payment of an agreed deposit of $30,000. Each provided that the vendor would build a house on the land agreed to be sold. The consideration in each contract reflected the expected market value of the land on completion after a house had been built upon it.

A typical example of a contract is given at par [13] of the Tribunal’s reasons. The purchase price was $810,000 (NZ). Settlement was to take place on 26 August 2016. Settlement contemplated a second mortgage being granted back from the vendor in the sum of $240,000 (NZ) with a term of 3 years from settlement with the balance of $520,000 being payable in cash on completion. There is a mathematical problem with the figures in the judgment. With a purchase price of $810,000 and after allowing the deposit of $30,000 and the mortgage back of $520,000 there is an amount of $20,000 not accounted for. However nothing turns on this.

The secret of the scheme for GST purposes lay with the mismatch in GST attribution that was brought about because the taxpayer was registered to pay GST on an invoice (ie non cash basis), whereas each relevant vendor was registered to pay GST on a cash basis. On these facts (but for simplicity sake I have assumed the Australian GST rate of 10%) the taxpayer under the NZ Act would be entitled to an input tax credit of $73,636 at the time the contract was entered into. (The New Zealand figure was approximately $NZ 90,000). The vendor, on the other hand would only be liable to pay an output tax of $2,727 at the time the $30,000 deposit was paid with the balance payable on completion in 2016. Commercially the promoter of the scheme was the real winner. A had contracted to purchase the property the subject of the example for $70,000. The deposit of $30,000 (after GST) paid by T allowed A to pay a fair percentage of the purchase price to W Developments and T had some $NZ 60,000 left over which would assist in financing the balance.

In respect of 104 of the properties sold, an input tax credit of nearly (NZ) $9,000,000 was claimed.

As is often the case with income tax schemes, and one might assume GST schemes will be the same, things went wrong for the promoters of the scheme. The Commissioner was not inclined to grant the refund sought. That refund was intended, among other things, to fund the actual cash deposit. Since the deposit was not paid (which would also have funded the purchase of the properties by the A Group of...
Companies), W Developments Ltd rescinded those contacts and then commenced to sell off the land which the taxpayer had contracted to buy from the various companies in the A Group of companies. Other relevant facts will be mentioned in the course of the analysis of the potential application of Division 165. Indeed, the Tribunal took over 130 paragraphs (or 29 A4 pages) to recite the facts it found.

THE CONCLUSION IN NEW ZEALAND

It was held that the general anti-avoidance provision (s 76) in the NZ Act applied to negate the input tax credit claimed.

Section 76 of the NZ Act at the relevant time (it was subsequently amended) had two main ingredients. The first was that there be “an arrangement” defined in s 76 as meaning:

…any contract agreement, plan or understanding (whether enforceable or unenforceable) including all steps and transactions by which it is carried into effect.

The second was that the arrangements identified be:

entered into between persons to defeat the intent and application of this Act, or of any provision of this Act.

If these two elements were, to the Commission’s satisfaction, “found to exist, the Commissioner was entitled to treat the arrangement as void for the purposes of this Act, or of any provisions of this Act”, and to adjust the tax payable or the refund required to be made, as the case may be, so as to “counteract any tax advantage obtained…from or under that arrangement.”

The expression “tax advantage” was defined to include:

a) Any reduction in the liability of any registered person to pay tax:

b) Any increase in the entitlement of any registered person to a refund of tax:

b) Any reduction in the total consideration payable by any person in respect of any supply of goods and services.

Not surprisingly the Tribunal found there to be an arrangement in the defined sense. It consisted of the contracts for the sale of land, an understanding how those contracts would fit into a master plan for the purchase of vacant sections by the A Group, the sale to the disputant and resale to the A Group. Central to the plan was, the Tribunal said, the availability of the GST input refunds.

There was a debate in the Tribunal that nothing had been entered into “between persons”. The arrangement had to be consensual. But it was said it was only the taxpayer who had sought to defeat the intent and application of the Act. The debate, resolved in favour of the revenue, has no resonance in the Australian context and can be put to one side.

The difficult question in the NZ Act was the need to find “intent to defeat the intent and application of the Act”, a concept somewhat difficult to understand in a case such as the present. This was not a case like the income tax cases where the taxpayer was seeking to argue that the transaction did not attract tax and the revenue to argue that it
did. Here the taxpayer wished to argue that the Act did operate to bring about a taxable supply. More importantly, the taxpayer wished to argue that the transaction attracted GST consequences which the Act specifically intended, those consequences depending upon which method of GST accounting was applied. What really caused the problem was the long period of time which was to elapse between the allowing of the input tax credit on the one hand and payment of the output tax on the other.

The taxpayer’s argument was quite obvious. The parties “constructed” their transaction specifically to meet the requirements of the legislation and not to defeat either the intent or the application of the Act or any provisions of it. Indeed, it was predicated upon the provisions of the Act applying. The problem was merely that many years would elapse before the payment of output tax crystallised. That, however, was a function of the commercial arrangement between the parties.

Under the NZ Act the question of purpose was, so the Tribunal said, subjective and not, as in Division 165, a conclusion as to the purpose of some person where that conclusion was to be ascertained from objective facts. (Of course Division 165 permits effect to be considered as well as purpose). Relevant, so the Tribunal said, to a finding of the subjective purpose of a relevant person were 5 circumstances which may be thought to be reminiscent of the 12 factors in the GST Act. These were:

a) The relationship of the parties. Are they strictly at arms length, or is there a premeditated collusion in the design of the arrangement?

b) The significance to the transaction of the GST consequences under consideration.

c) Whether the arrangement is explicable in ordinary commercial terms if the contested GST component is abstracted.

d) In what way the arrangement defeats the particular intent and application of the GST Act which is relevant to the facts.

e) The identity, relevant experience and financial probity of the parties as that touches on their ability to perform their side of the bargain without the benefit of the contested GST component.”

The transaction failed, so the Tribunal said, on every count. The Tribunal’s analysis was as follows:

a) The relationships between Mr A and the original proprietor of the disputant company were more social than commercial. The company which she formed was to be no more than a conduit for obtaining the GST input refunds.

b) The arrangement was entirely dependent on obtaining the GST inputs. The disputant had no ability to pay for any of the land purchased from its own resources. Similarly with the input refunds the A Group of companies had no ability to finance the purchase of the sections which they onsold to the disputant.

c) If one removes the input refund from the equation the arrangements are wholly inexplicable in commercial terms. They could not and did not come to fruition.

d) This arrangement defeats the intention of the Act to tax transactions at the time they entered into by exploiting the mismatches which the Courts have found to exist between payment based and invoice based
taxpayers. That served to prevent the application of the Act by denying on the one hand the Crown the revenue which the Act was designed to exact, and on the other, requiring the crown to disgorge public monies for private use.

Perhaps the most difficult of these conclusions is paragraph (d) with the premise implied in that paragraph that the exploitation of the attribution mismatch defeated the intention of the NZ Act or a provision of it. Certainly it is a consequence of the two methods of accounting that a mismatch could arise. Nothing in the transaction was intended to deny the Crown revenue as such. The purpose was to ensure that there would be a time delay in payment brought about by the combination of the mismatch and the period of time which would elapse between contract and completion. Clearly the transaction was designed to ensure an immediate credit and if that meant “disgorging public monies”, so be it. The purpose which a taxpayer has for the use of any refund hardly appears relevant to the question posed by s 76.

Anyway, the outcome seems an appropriate one. It can hardly be doubted that what was before the Tribunal should qualify as tax avoidance, even if the language of s 76 may be thought to present some difficulty. I turn now to consider the application of Div 165 to the scheme.

THE SCHEME

Division 165, as has become clear from the cases decided under Part IVA, requires some care in identifying the relevant scheme. Given that both an “action” as well as a course of conduct may constitute a scheme, as well as a “plan” or even a “proposal”, there will never be any doubt that there will be a scheme, although there may be some difficulty in deciding how narrowly the scheme might be defined. Certainly, there is no requirement in Australia that there be a meeting of minds such as may be implicit in s 76 of the NZ Act. The only limitation in Division 165 is that the scheme be one from which the taxpayer got the tax benefit. Incidentally, the Part IVA test that the tax benefit be in “connexion” with the scheme may be wider from the point of view of the revenue than a test of whether the taxpayer “got” a GST benefit “from” the scheme in the context of GST. It is at least a different test.

The problem of the identification of the scheme is a difficult one because the same facts can give rise to a wider or a narrower scheme. This is the problem that the High Court must face up to in Commissioner of Taxation v Hart, an appeal which has been argued and judgment reserved. In dicta in Federal Commission of Taxation v Peabody the High Court said that the Commissioner could, subject to questions of fairness, choose between a narrow or broad definition of the scheme. This though was subject to the qualification that the Commissioner could not take a set of circumstances which constituted only part of a broader scheme and test that to see if the required conclusion would be reached in a case where then the circumstances were “incapable of standing on their own without being robbed of all practical meaning.”

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2 (2002) 121 FCR 206 (FCFCA)
3 (1993-94) 181 CLR 389; ATC 4663
It is far from clear what that qualification means despite an elliptical reference to *Inland Revenue Commissioners v Brebner*\(^4\) in Peabody which presumably was intended to elucidate it. And, as Hely J pointed out in *Hart*,\(^5\)

> The more the scheme can be confined to the essential elements by which the tax benefit is obtained, the more likely it will be that the conclusion will be drawn that the dominant purpose for a person entering into a scheme so defined was to obtain the tax benefit.

Whatever the outcome in *Hart* it will ordinarily not matter whether a wider or narrower definition of the scheme is adopted as the objective facts required to be taken into account in deciding whether the relevant conclusion should be drawn will include all the relevant surrounding circumstances. Naturally these include those elements of the plan or proposal that might be eliminated from the wider scheme in formulating a narrower scheme.

In the present circumstances it is easier to regard the scheme as being the whole of the course of conduct which was set out earlier in this paper under the heading “The Facts”. There is no need to narrow the scheme to some narrower scheme.

**THE GST BENEFIT**

As already noted the relevant scheme must be one from which the “avoider” got a GST benefit. The relevant paragraphs of the definition applicable to the taxpayer will be either s 165–10(1)(b) [namely that there is an amount payable to the entity (the taxpayer) under the GST Act which is or could reasonably be expected to be larger than it would be apart from the scheme] or s 165-10(1)(d) [namely that all of an amount that is payable to the entity (the taxpayer) is or could reasonably be expected to be payable earlier than it would have been apart from the scheme or a part of the scheme.]

The first of these alternatives is relevantly concerned with a scheme which maximises input tax credits. The latter is relevantly concerned with the timing of the payment of the input tax credits, that is to say advancing the time when refunds are payable. Either could be applicable here.

There is another GST benefit as well here, in that the scheme defers the time at which the vendor companies (the A Group of companies) were required to account for output tax. That other tax benefit would involve a different set of taxpayers. What is perhaps unusual with the deferred payment scheme is that it depended upon both the taxpayer being entitled immediately to the input tax credit and the vendor to the taxpayer not being required to pay GST until a later time. It is not unusual in the income tax context for the Commissioner to issue alternative assessments against different taxpayers.

**GST BENEFITS TO BE IGNORED IF ATTRIBUTABLE TO AN ELECTION**

There is a statutory exclusion from the definition of GST benefit to be found in s 165-5(1)(b) of the GST Act. So, a relevant GST benefit is not to be taken into account if

\(^4\) [1967] 2 AC 18 at 27
\(^5\) (2002) ATC 4608 at 4628; (2002) 121 FCR 206
the benefit “got” from the scheme is one “attributable to the making, by any entity, of a choice or election” expressly provided for by the GST law.

Section 29-40 of the GST Act permits a taxpayer to “choose to account on a cash basis” so long as certain tenets are observed, for example, the annual turnover does not exceed the cash accounting turnover threshold in s 29 – 40 (3) of $1(AUS) million. That, of course, is why it would be essential in Australia (it was also essential in New Zealand) for each contract to be a single venture of one parcel of land with a consideration under the threshold. Otherwise accounting on a cash basis would invoke the exercise of discretion by the Commissioner. It could not be expected that that discretion would be favourably exercised.

Clearly there is a choice under s 29-40(1) of the GST Act. That choice on one view of the matter, ensures that there is a deferral of output tax by the vendor to the taxpayer. It does not in any way accelerate the obtaining of an input tax credit by the taxpayer.

Accepting for the moment that the relevant GST benefit is the deferral of the output tax by each company in the A Group of companies, such that each such company become the relevant taxpayer, the next question would be whether that benefit, is one that is “attributable” to a choice and thus excluded from the definition of GST benefit.

The word “attributable” is not defined in the legislation. The relevant dictionary (not the “Dictionary” in Div 195-1) meaning of “attributable” as a verb, is, according to the Macquarie Dictionary (3rd ed) “to consider as belonging; regard as owing, as an effect to a cause”.

Mr Pagone QC in an article “The Divine Comedy: Consolidations and Part IVA of the Income Tax Assessment Act 1936 (Cth) suggests that attributable:


calls for “some sufficient relationship to exist between the tax benefit and the choice. The degree of sufficiency may still be an area for debate and exploration but it is unlikely that the requirement that the tax benefit be attributable to the choice will be satisfied merely by satisfying the “but for” test.

With respect, I agree.

The provision of s 177C(2) of the Income Tax Assessment Act 1936 was obviously designed to aid in resolving the problem which all general anti-avoidance provisions pose of reconciling it with the more specific provisions of the taxing statue designed to confer concessions or advantages upon taxpayers. The ordinary rule would be that specific provisions prevail over general provisions. That is the true rationale of the income tax cases decided under s 260 of the Income Tax Assessment Act 1936, the predecessor to Part IVA, for example, the cases which developed the so-called “choice doctrine” such as W P Keighery Pty Ltd v Federal Commissioner of Taxation or Slutzkin v Federal Commissioner of Taxation. It must, however, in this context be noted that in the last of the High Court s 260 cases, Federal Commissioner of Taxation

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7 (1957) 100 CLR 66
8 (1977) 140 CLR 314
Dawson J suggested that reconciliation between s 260 and the rest of the Act required a qualification to the choice principle namely,
that s 260 does not deny a taxpayer a choice which is offered by the Act unless there is something other than the making of such a choice to indicate that a contract, agreement or arrangement has the purpose or effect of avoiding tax in a way which is prohibited by the section.

(emphasis added)

His Honour continued by suggesting that there was a distinction between a mere choice on the one hand and the case where the taxpayer sought to avail himself of the choices offered by the Act by means of a contrived scheme which could only be explained upon the basis of tax avoidance.

It might be thought that specific provisions like s 165-5(1)(b) remove the general “choice” doctrine and replace it with a statutory doctrine. That is true. But s 177C(2) in the income tax context goes further than Division 165 does in the GST context, by providing as a qualification to the choice exclusion that it would not operate where the relevant scheme was entered into or carried out “for the purpose of creating any circumstances or state of affairs the existence of which is necessary to enable the choice to be made.”

If there were in the GST Act a comparable qualification such as is to be found in s 177C(2) then the present case would clearly come within it and permit a wider or even narrower definition of scheme to be one from which the taxpayer (that is to say here each company in the A Group of Companies “got” the tax benefit. Presumably the omission of these words was deliberate although it is not clear to me why. The omission provides a respectable argument for the companies in the A group of companies in a case such as the present.

Perhaps it was thought by the drafter that the omitted words added nothing. My own tentative view is that paragraph (b) will not be read widely or certainly not so widely that a scheme such as the deferred payment scheme here under discussion escapes Div 165 on that basis.

In the present case while it is the exercise of the choice to account on a cash basis which produces a GST benefit to the companies which are members of the A Group of companies, the scheme as a whole is more than that. The real benefit of the scheme is not just the deferral of output tax, it is in great part the mismatch between that and the obligation of the taxpayer which is not entitled to account on a cash basis but required to account on an invoice basis. This obligation carries with it the entitlement of the taxpayer to an input tax credit immediately on invoicing. The other matter which adds to this benefit is the long delayed settlement which means that output tax is deferred for up to 15 years. And in any event the contracts between the taxpayer and each of the companies in the A group of companies has been inserted into what is otherwise an ordinary commercial transaction, that is, the contracts to purchase the lots from W Investments Ltd.

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9 (1985) 160 CLR 55 at 122-3
Further, it is an essential element of the scheme that the input tax credit to which the taxpayer is otherwise entitled funds the deposit which the taxpayer is obliged to pay and thus the amount which the various companies in the A group of companies are required to pay to W Investments Ltd. To achieve this it is necessary that the A group companies are so structured that each can chose to account on a cash basis and also that the contracts are so structured that settlement is long delayed thereby maximising the amount of the initial input tax credit and delaying payment of the output tax.

In summary, it may be that a taxpayer who sets up a scheme to avail himself or herself of the making of a choice expressly legislated for does not have a relevant tax benefit if that is all that the scheme involves. For then the tax benefit is attributable solely to the election or choice. However, here the tax benefit obtained, whether by the taxpayer or the companies in the A group of companies, is attributable to other factors such as the structuring of the transaction to avail the taxpayer of the mismatch in manner and time of payment of output tax and receipt of the input tax credits. However it can not be said that the question is free from doubt.

Since, however, it is the taxpayer who is to be denied the input tax credit here, the relevant tax benefit has to be the acceleration of the input tax credit or the obtaining of an input tax credit at all by the taxpayer. No election, choice, application or agreement is exercisable by the taxpayer so as to exclude there being a tax benefit. Obtaining a credit arises from the act itself. Accounting on an invoice basis is an obligation the act itself imposes absent the making of a successful election.

It will be recalled that the relevant definition of GST benefit reads:

all or part of an amount that is payable to the entity under this Act apart from this Division is, or could reasonably be expected to be, payable earlier than it would have been apart from the scheme or a part of the scheme.

There is no doubt that “reasonable expectation” involves more than a possibility. Rather, as the High Court said in Peabody10 reasonable expectation involves:

Prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out, and the prediction must be sufficiently reliable for it to be regarded as reasonable.

Where the GST benefit involves the payment of output tax it may sometimes be possible for a taxpayer to argue that it is just plain unreasonable to suggest that if the scheme had not been entered into GST would be payable if only because apart from the scheme the taxpayer would do nothing at all and thus have no GST to pay. In the resolution of such an argument the provisions of s 165-10(3) may have some application.

The same argument can not be made where the relevant benefit is the obtaining of an input tax credit. If the taxpayer did not enter into the scheme and did nothing at all no GST credit would be payable to him or her. So the whole of the input tax credit will be the GST benefit “got” by the taxpayer from the scheme.

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10 at 385
THE REASONABLE CONCLUSION – PURPOSE OR EFFECT?

Division 165 requires the drawing of a conclusion. That conclusion may be either a conclusion about purpose or a conclusion about effect. Whichever alternative is to be adopted the conclusion must be one that it is reasonable to draw. That presumably means no more than that the conclusion has to be one based upon reason. Some of the cases under Part IVA have spoken of the conclusion being such that a reasonable man (or woman) would draw it. Perhaps nothing turns upon these two different formulations. In the discussion which follows I use the expression “tax avoidance purpose” to mean the sole or dominant purpose of an entity getting a GST benefit from the scheme in accordance with s 165-5(1)(c)(i) of the GST Act and “tax avoidance conclusion” to meant the conclusion required to be drawn as to the tax avoidance purpose or effect as the case may be. Likewise references to “tax avoidance effect” are to be read as references to the principal effect of the scheme being that the taxpayer or some other entity gets the GST benefit from the scheme directly or indirectly.

Both purpose and effect have to be answered taking account of the matters set out in s 165-15. As long as all of the matters are considered the conclusion can be global: Federal Commissioner of Taxation v Consolidated Press Holdings Ltd11. Generally Judges seem to look at these matters separately in the Part IVA context. As I pointed out in Peabody12 some matters may point to the conclusion in favour of the Commissioner, other matters may point against the tax avoidance conclusion and some may be neutral. It is the evaluation of these matters, alone or in combination, some for, some against, that s 177D requires in order to reach the conclusion which the section requires. These comments would be as relevant to the principal effect conclusion as they are to the purpose conclusion.

I still doubt that there will be much difference whether the purpose test is adopted or whether the effects test is adopted because every man or woman is to be presumed to have intended the natural and probable consequences of his or her acts. Hence the most obvious way a conclusion as to the purpose of a relevant person will be arrived at when only objective factors may be taken into account will be to have regard to the effects which the scheme has. I propose to consider “purpose” first. However, before doing so I would set out some principles that have been now established in the Part IVA context which would seem to be equally applicable to Division 165.

First, the reference to “dominant purpose” is a reference, in a case where there is more than one purpose present, to the “ruling, prevailing or most influential purpose”13.

Secondly the conclusion as to dominant purpose is one that may be reached not only with respect to the taxpayer but also with respect to some other person so long as the other person entered into or carried out the scheme.14 So, for example, the purpose of a promoter may be considered. However, the promoter may be quite indifferent to the

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12 (1993) 93 ATC 4104 at 4113-4
14 Spotless at 418.
tax purpose but motivated by profit to himself or herself. The purpose of an adviser may be attributed to the taxpayer in an appropriate case.\textsuperscript{15}

Thirdly, there is no necessary dichotomy between the pursuit of commercial gain in the course of carrying on a business and a finding that the dominant purpose was to obtain a tax benefit.\textsuperscript{16}

Fourthly, at least in the operation of Part IVA it is clear that evidence of the actual purpose of a person will be irrelevant to the conclusion. None of the eight matters listed in s 177D(b) include the state of mind of any person. That is less clearly the case in Division 165 where regard is directed to be had to “any other relevant circumstances”. A state of mind may, perhaps, be a circumstance, although I doubt that this is the way paragraph (l) of s 165-15(1) will be construed.

\textbf{CONCLUSION AS TO DOMINANT PURPOSE}

Rather than go through each of the 12 matters I propose here to confine myself to those which are of the greatest significance, being the manner in which the scheme is entered into or carried out, its form and substance and the advantages to others connected with the taxpayer. These are, after all, almost always the most significant factors in determining whether tax avoidance is present. Naturally in the present case both timing and the period over which the scheme is entered into and carried out will point to the tax avoidance purpose.

There are a number of facts which appear in the evidence before the Tribunal which point towards the tax avoidance purpose.

One important matter is that the insertion of the contracts between the taxpayer and the A group of companies was not really relevant to the commercial deal which the A group of companies had with the W Investments Ltd. The insertion was solely to obtain the mismatch advantage which included the immediate input tax credit.

The mind behind the scheme was the proprietor of the A Group of Companies, a property developer, advised by a tax specialist from a large firm of solicitors and (for those involved with sales tax in the 1980’s, shades of the black box schemes) a former senior officer of the Revenue. The sole proprietor of the taxpayer was a person with no business experience or interest much in the scheme and with little or no knowledge of GST. She was a friend of Mr A and her only experience of land development was work with a property publication. Since the purchase price payable by the taxpayer was the expected market value in at least 10 years time, there was no real profit to be had by the taxpayer.

The deposits payable were to come from the input tax refund. The taxpayer had, otherwise, no assets. Mr A, in turn, needed the money from the deposits to help him pay W Developments. Presumably the taxpayer could finance the amount payable on completion from the proceeds of sale of the lots together with houses erected on them to third parties.

\textsuperscript{15} Consolidated Press at 264.
\textsuperscript{16} Consolidated Press at 95.
The normal provision in the contract that the deposit was to be held as stakeholder was crossed out. This may have been thought necessary to ensure the time of supply was immediately upon the contract being entered into.

The need for 114 separate companies to make the purchases from W Developments Ltd had, despite protestations that the separate companies limited the commercial risks involved, no commercial basis. The separate companies could only be explained by the need for ensuring that each company kept below the threshold so as to permit it to account on a cash basis as a matter of right.

The land agent, although according to the contractual arrangements entitled to commission from W Developments Ltd immediately the contract was entered into with the A group companies, as a result of an understanding entered into informally, not to receive his commission until the GST refund was received. In fact he never received any.

Before the 114 contracts were entered into favourable rulings had been obtained from the Revenue in respect of three unrelated property transactions having a similar mismatch.

No doubt in favour of the taxpayer it would be argued that the taxpayer stood to make a profit from the arrangement. This is somewhat like the argument that, in the income tax context, was made in Spotless. There the taxpayer’s after tax return was substantial and much better than the after tax return that would have been obtained had the taxpayer left the funds invested at interest with an Australian bank and thus suffered Australia tax upon it. However, the higher after tax return was only achieved because the effect of the then s 23(q) of the Income Tax Assessment Act 1936 was that the ex Australian sourced interest was not liable to tax in Australia. Before tax the interest derived off shore was substantially less than the interest that would have been derived in Australia. The High Court found Part IVA applied. Hence the tax avoidance purpose must predominate where the commercial profit could only arise as a result of the tax benefit.

Perhaps it might be more difficult to draw the necessary tax avoidance conclusion in a deferred payment scheme if the taxpayer could have funded the purchase without the GST refund. For then it could more strongly be argued that the dominant purpose overall was to make the commercial profit and the GST benefit was not a predominant factor in entering into the contracts which gave rise to the input tax credit. It would then depend upon weighing up the quantum of profit from the land transaction which was not to be derived for many years into the future and the advantage of the accelerated use of the input tax credit which was immediate and continued for twenty years until the taxpayer finally completed the contract. However, as earlier noted, the agreement between the taxpayer and the A group of companies was really interposed into the commercial deal and in circumstances where the taxpayer was really just helping out the controller of the A group of companies.

**CONCLUSION AS TO EFFECT**

The GST effect of the scheme is obvious enough. There is an immediate right in the taxpayer to receive the input tax credit brought about by the fact that the taxpayer accounted for GST on an invoice basis and a payment of the output tax by the A group of companies was deferred because the vendor accounted on a cash basis. In the result
the taxpayer would, in the event the scheme was successful, have, as a result of the input tax credit, a large fund from which to pay the deposits on the contract with the A group of Companies which in turn would be used by them to fund the deposit obligations to W Developments Ltd. No amounts would be needed to pay GST to the Revenue until the contracts were completed when the A Group of Companies would become liable to pay output tax on the 114 contracts.

There will be the same commercial advantage as discussed above in the context of purpose – an advantage that would exist only so long as the GST advantage was available. Not surprisingly in the New Zealand case, everything collapsed when the revenue refused to pay to the taxpayer the input tax credit.

The conclusion as to principal effect would, thus, be the same as the conclusion as to dominant purpose.

WHAT CONCLUSION SHOULD BE DRAWN ABOUT DIVISION 165

Part IVA has been interpreted, generally, quite favourably to the Commissioner in Australia and it may be expected that Division 165 will likewise be interpreted favourably to him.

The above analysis makes it clear that the only possible difficulty for Division 165 overcoming the Deferred Payment Scheme could lie in the definition of GST benefit having regard to the fact that the scheme depended, albeit only in part, upon the express provisions of the Act and particularly the ability of an entity to adopt a cash basis method of accounting for GST if below the threshold. But, I suspect, that the Courts would have little difficulty in upholding the Commissioner and in thus denying the taxpayer the credit.