Journal of Australian Taxation

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EDITORIAL

There are two issues of the Journal of Australian Taxation for 2020. Volume 1 is the standard edition for each calendar year and Volume 2 is a special edition featuring the National Tax Clinic program sponsored by the Australian Government. The year 2020 will be remembered for the Coronavirus pandemic and its impact on the population of the world. It is heartening to see that tax academics, tax students and tax practitioners were able to find the inspiration to write about taxation issues during this period.

The Editor is grateful for the contribution made by Celeste Black, Harry Waddell and Zaif Fazal to this edition of the journal. This issue comprises the three articles written by the authors on three very different topics.

Celeste Black has provided a very insightful paper on the dilemma facing the Australian government with funding for roads, and the collection of fuel taxes in a future with electric motor vehicles and more fuel-efficient cars. The paper explores the complex tax issues surrounding the fuel credit system, the collection of excise and the future of road user charges to protect the environment.

The second paper by Harry Waddell presents the research he conducted through interviews of accounting practitioners in New Zealand on the Look Through Company ('LTC') regime. In particular, he found that while the intention of LTC's was to provide limited liability, the compliance costs were still an important issue for business owners contemplating using the structure.

The third paper is written by Zaif Fazal on tax competition and small countries. He adopted Public Choice theory and Game theory to assess the benefits of tax competition for those countries that are small and lack natural resources. He found that tax competition was beneficial for these small countries.

For many years, the Joint Editor of this journal was John Passant. Unfortunately, John Passant passed away earlier this year and he is deeply missed for his energy and enthusiasm in producing the journal. He was a most generous and fair-minded person who was an admired member of the tax community in Australia. This edition of the Journal of Australian Taxation is dedicated to his memory.

The Editor is very grateful for the editorial assistance provided by Stephanie Bruce from Curtin University and her group of volunteer student editors at Curtin University:

- *Courtney Banks* – Bachelor of Commerce (Business Law and Marketing)
- *Keane Bourke* – Bachelor of Laws, Bachelor of Arts (Journalism)
- *Emma Harvey* – Bachelor of Commerce (Human Resource Management and Business Law)

JOHN MCLAREN
Editor

TAXING ENERGY OR A ROAD USER CHARGE? AUSTRALIA'S FUEL TAX SYSTEM AT THE CROSSROADS

CELESTE M BLACK*

ABSTRACT

The Organisation for Economic Co-operation and Development's report, Taxing Energy Use 2019, reveals patterns in the taxation of energy and concludes that the use of energy taxes as a climate policy instrument continues to fall short of its potential across the globe. The position in Australia is noteworthy given that most energy use is not taxed; the major exception being transport fuels. This article examines Australia's transport fuel excise and credit system, and shows that the historical basis for the system weighs heavily on its structure and operation. This stems from the fact that one of the early objectives of taxing transport fuels, by way of customs duties and excise, was to fund the construction and maintenance of public roads. Even though formal hypothecation ceased in the late 1950s, fuel taxes are still seen as a crude road user charge. This drives complexity in the structure of the fuel tax regime, which includes significant effective exemptions for non-transport and non-public road uses of fuel by commercial operators and reduced net fuel tax rates for heavy vehicles using public roads. A variety of factors are putting net fuel excise revenues under pressure and the mechanism that sets the current heavy vehicle user charge has also been the subject of criticism. This article contributes to the current debate regarding the future of road funding by examining another ground for reform: the complexity of the current fuel tax system. The development of alternative road user charge systems could provide the opportunity to fundamentally reform the fuel excise as an environmental tax so as to align the price signal with the environmental costs of using transport fuels across all sectors.

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I INTRODUCTION

In the report *Taxing Energy Use 2019: Using Taxes for Climate Action*, the Organisation for Economic Co-operation and Development ('OECD') recognised that energy taxes have the potential to contribute to reaching governments' environmental policy goals whilst simultaneously improving the performance of the fiscal system.[1] Energy taxes can be a source of revenue to fund government services whilst simultaneously internalising the climate cost of emissions from energy use, sending a price signal to reduce consumption and support the switch to cleaner energy sources. However, the OECD report evidences that 'governments are not deploying energy and carbon taxes to their full potential.'[2] The one exception is the case of road transport fuels: the OECD found that all jurisdictions covered by the report had in place fuel excise taxes in relation to the road sector and only three countries of the 44 countries covered by report apply a tax rate below the 'low-end' benchmark of EUR30 per tonne of CO_2.[3] However, the OECD also observed that, contrary to what environmental policy would dictate, only three countries tax diesel at a higher rate than petrol and two countries tax them at the same rate (per litre).[4] As a result, from the perspective of the cost to the environment, in most countries diesel is effectively discounted.

The energy tax profile for Australia in the *Taxing Energy Use* report details Australia's energy tax mix and reveals that, aside from taxing natural gas and liquefied petroleum gas ('LPG') used in the residential sector for heating and a low level of tax on certain aviation fuels, the only significant tax on energy use is the tax on gasoline, diesel and other fuels used in road transport.[5] Like the other countries included in the OECD report, Australia taxes transport fuels by way of excise. As calculated by the OECD, based on the excise rates and exchange rates at the time of the report, the effective fuel tax rates in Australia were approximately EUR115 and EUR80 per tonne of CO_2 for gasoline and diesel, respectively,[6] well above the OECD's low-

[1] OECD, *Taxing Energy Use 2019: Using Taxes for Climate Action* (Report, 2019) 3 ('*Taxing Energy Use*').

[2] Ibid.

[3] Ibid 11, 14. Those countries are Brazil, Indonesia and Russia.

[4] Ibid 37-8. The evidence suggests that diesel should be taxed at rates at least as high as those of gasoline.

[5] Ibid 41, Annex Figure 2.A.2. See also OECD, *Taxing Energy Use 2019: Country Note – Australia* (Report, 2019) (supplement to *Taxing Energy Use*) for a more detailed breakdown of the calculation of the effective energy tax rates.

[6] *Taxing Energy Use* (n 1) 81, Annex Figure 3.A.2.

end environmental tax benchmark of EUR30.[7] Although the fuel excise rates per litre of both gasoline and diesel are high, what these headline rates do not reveal is that many uses of transport fuels do not bear the full burden of the tax as a result of the fuel tax credit system: the credit operates to refund in full the excise paid on transport fuels used in relation to transportation on private roads as well as the use of those fuels for purposes other than travelling on roads, such as to power auxiliary machinery, and to refund in-part the excise paid on fuel used in heavy vehicles on public roads.[8]

This article's examination of the fuel tax system in Australia reveals that the operation of the system is heavily influenced by its original design as a road funding mechanism based on a user-pays model, with fuel use serving as a proxy for road use. Although formal hypothecation to road funding ceased in the late 1950s, the fuel excise still functions as a quasi road user charge and this has led to significant complexity in the operation of the fuel tax credit element, which seeks to refund the excise in relation to fuel consumption not related to the use of public roads. This contrasts with what the modern lens of climate policy, as applied to evaluate energy taxes by the OECD, would dictate, given that transport fuel consumption has the same environmental impact whether or not associated with public road usage.

Improving fuel efficiency in vehicles and a growing shift to electric cars are putting increasing pressure on net fuel tax receipts. Many governments are setting targets for electric vehicles[9] and a recent report predicts that, even without government intervention in the market, 22% of new passenger vehicle sales will be electric by 2030.[10] Road tolls and vehicle telemetry

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7 The Report notes that this low-end carbon benchmark is unlikely to represent the environmental damage caused by emissions and is also unlikely to be sufficient to meet the requirements of the Paris Agreement. *Taxing Energy Use* (n 1) 14.

8 Although the OECD Report states that the tax rates are adjusted to take into account refunds available to certain users and sectors, the details of the calculations are not available. *Taxing Energy Use* (n 1) 15; *Taxing Energy Use 2019: Country Note – Australia* (n 5) 3.

9 The Australian Government released a short document entitled 'A national strategy for electric vehicles' in early 2019 but no details regarding a strategy have yet been released. In contrast, the NSW Government has committed to 10% of new passenger cars being electric or hybrid by 2020/21 and the Queensland Government has created an 'electric super highway' of charging stations up its east coast. See NSW Government, *NSW Electric and Hybrid Vehicle Plan* (2019); Queensland Government, *The Future is Electric: Queensland's Electric Vehicle Strategy* (2017). The Government of South Australia has also started work on developing a strategy: Government of South Australia, 'Targeted Industry Consultation Discussion Paper & Survey: To support the development of an electric vehicle strategy for South Australia' (2019).

10 Energeia, *Australian Electric Vehicle Market Study* (Report, May 2018) 70. Energeia prepared this report for the Australian Renewable Energy Agency and the Clean Energy Finance Corporation. Under the report's preferred moderate intervention scenario, electric car sales would be 49% of all sales by 2030.

systems, such as being trialled in relation to heavy vehicles, can serve as a direct user-pay system and could also incorporate congestion charging. These developments offer an opportunity for a broad rethink of the fuel tax system. If an effective and more direct user-pays system can be implemented (which could potentially be earmarked as funding to support road infrastructure), the fuel excise system could be reformed to instead be driven by environmental policy goals. These suggestions are not novel,[11] but the analysis provided in this article contributes to and further supports the case for reform by highlighting the legal and administrative complexity of the fuel tax, drawing together data on the operation of the current fuel tax credit system and an analysis of the legal framework.

The structure of this article is as follows. Part 2 places the fuel tax in context of the broader tax system in Australia, provides a brief summary of the history of the fuel tax system, and outlines the current structure of the excise system. Part 3 provides an overview of the fuel tax credit system and provides some statistics on the scale and distribution of fuel tax credits. Part 4 examines the legal framework that provides fuel tax credits and highlights some of the features of the system that leads to its complexity. Part 5 provides a brief overview of various calls for reform to date and suggests an approach that supports the development of direct user-pay systems for both heavy and light vehicles, to replace the reliance on fuel tax as a proxy for road use. A detailed analysis of these proposals is outside the scope of this article but reform of the fuel tax system seems inevitable. Part 6 concludes. Consideration of other tax instruments applicable to petroleum production or products aside from fuel tax, such as the Petroleum Rent Resource Tax, is also beyond the scope of this article.[12] For current purposes, the term ‘transport fuels’ will be used to refer, collectively, to liquid petroleum products (petrol/gasoline and diesel), LPG, compressed natural gas (‘CNG’), ethanol and other biofuels. All monetary values are in Australian dollars unless otherwise stated.

[11] The most recent contribution to this reform discussion, released in July 2020, is NSW Government, *NSW Review of Federal Financial Relations: Supporting the Road to Recovery* (Draft Report, July 2020) (‘*NSW Review of Federal Financial Relations*’). Chapter 8 focuses on road funding and fuel taxes and makes reference to a number of the recent reports and reviews. See footnote 86 and references therein.

[12] Diane Kraal has recently published analysis of the 2017 review of this tax. See Diane Kraal, ‘Petroleum Resource Rent Tax Review 2017: Split priorities found in public submissions’ (2018) 33(2) *Australian Tax Forum* 343; Diane Kraal, ‘Review of Australia’s Petroleum Resource Rent Tax: Implications from a case study of the Gorgon Gas Project’ (2017) 45(2) *Federal Law Review* 315.

II AUSTRALIA'S CURRENT FUEL TAX SYSTEM

Australia's current federal tax mix relies heavily on income taxes and to a lesser extent on indirect taxes. The most recent breakdown provided by the Australian Government Budget Papers shows that, for the 2018-19 financial year, 74% of taxation receipts came from income taxes (which includes corporate tax), whilst the balance came from indirect taxes.[13] The main sources of indirect taxes are the Goods and Services Tax ('GST') (57% of indirect taxes), excise and customs duty[14] on fuel products (largely petrol and diesel excise) (17% of indirect taxes and 4.4% of total tax revenues with a value of $19,770m), and excise on tobacco (11% of indirect taxes).[15] Petrol and diesel are effectively taxed twice, being first subject to excise or customs duty on a volumetric basis and then 10% GST on an ad valorem, excise-inclusive basis. Based on a pump price of $1.50 per litre for unleaded petrol, approximately 37% of that price represents taxes.[16]

A *A Brief History of the Fuel Tax System*

In order to appreciate the current structure of the fuel tax system, it is instructive to consider its history. This history reveals a persisting tension in road funding that stems from the Federal Government having access to a greater variety of revenue raising mechanisms whilst the Australian States and Territories have the responsibility to provide and maintain road

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13 Australian Government, *Budget 2019-20, Budget Paper No 1*, Statement 4: Revenue, Table 7. Income tax receipts of $332,970m (individuals and companies combined) out of a total taxation receipts of $448,821m for the 2018-19 financial year.

14 Excise applies to fuels produced or manufactured in Australia whilst customs duty applied to excise equivalent goods ('EEGs'). As transport fuels are subject to excise, imported fuels are EEGs. The physical control of fuels subject to customs duty is managed by the Department of Home Affairs but since 2010 the administration of the duty has been under the auspices of the ATO, though the payment is still made to the Department. See Department of Home Affairs, 'Administration of excise equivalent goods from 1 July 2010' (Web Page) <https://www.homeaffairs.gov.au/Importingandbuyinggoodsfromoverseas/Documents/eeg_reference_guide.pdf>.

15 Australian Government, *Budget 2019-20, Budget Paper No 1*, Statement 4: Revenue, Table 7. Indirect tax receipts totalled $115,851m for the 2018-19 year, GST receipts of $65,783m, excise and customs duty on transport fuels $19,770m, and tobacco excise $12,850m.

16 As prices are required to be advertised as a GST-inclusive amount, $0.136 would be GST plus the current excise rate of $0.423 per litre.

infrastructure. Relevantly, the *Australian Constitution* grants to the Federal Government the exclusive power to impose duties of custom and excise.[17]

As one of the early pieces of legislation enacted by the newly constituted Commonwealth of Australia, the *Customs Duty Act 1901* (Cth) imposed duty on, amongst other products, imports of gasoline and other oils used for heating, lighting and as industrial solvents.[18] With the introduction and growing take up of automobiles in the 1920s, the duty effectively became largely a tax on transport fuels.[19] The 1920s also saw the establishment of domestic refineries and therefore local fuel products, so from 1929, excise was applied to domestic petroleum products and, importantly, fuel excise revenue was from that time hypothecated to road funding.[20] The fuel tax system was extended to diesel in 1957, along with an exemption certificate system for off-road use.[21] This reinforced the link to road funding given that the excise thereby effectively only applied to on-road use.[22] In 1959, formal hypothecation ended and grants to the states to fund road infrastructure under the *Commonwealth Aid Roads Act 1959* (Cth) were sourced from consolidated revenue.[23] Several other legislative efforts saw some excise revenue earmarked to road projects[24] but since the early 1990s, road funding has been part of the general federal government budget process. Even though hypothecation was abandoned, analyses of the fuel excise system and government provision of roads almost invariably continue to compare fuel excise and other identified sources of 'road-related revenue' (such as vehicle registration and stamp duty) to levels of funding for road infrastructure.[25]

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[17] *Commonwealth of Australia Constitution Act 1900* (Imp) 63 & 64 Vict, c 12, s 90.

[18] Government of Australia, Treasury, *History of Fuel Taxation in Australia* (Report, 2001) 1-2, n 4 ('*History of Fuel Taxation*').

[19] Ibid.

[20] Ibid 2.

[21] Ibid 6.

[22] For a detailed history of Commonwealth road funding legislation up to the mid-1970s see RH Burke, Bureau of Transport Economics, *Occasional Paper No 8: History of Commonwealth Government Legislation relating to Roads and Road Transport 1900-1972* (Occasional Paper, 1977) available at: <https://www.bitre.gov.au/sites/default/files/op_008.pdf>.

[23] Ibid 7.

[24] See, eg, *Australian Bicentennial Road Development Trust Fund Act 1982* (Cth); *Australian Land Transport Development Act 1988* (Cth).

[25] See, eg, Commonwealth of Australia, *Australia's Future Tax System* (Final Report, 2010), Pt 2, 375-6 ('*Henry Review*'); Australian Government, Department of Infrastructure, Transport, Cities and Regional

The States and Territories have also had a role in the taxation of fuels. Although they do not have the power to impose excise, the States began to impose 'business franchise taxes' in the form of licence fees to sell certain products, where the fee was an ad valorem component based on sales.[26] Early petrol franchise fees in the mid-1970s were short-lived but, after protests over road maintenance charges led to their repeal, fuel franchise schemes were re-introduced across most states in the early 1980s.[27] By 1995-6, petroleum business franchise fees were raising $1,531m across the States.[28] This all came to an abrupt end when, in 1997, the High Court of Australia handed down a decision invalidating the tobacco business franchise fee of NSW as unconstitutional.[29] Given that the fuel and other franchise fees were based on the same legislative model, the effect of the decision was to disallow all of these fees. In response, the Commonwealth instituted a 'stop gap' measure whereby it increased its taxes on the affected products, including transport fuels, and provided this revenue to the states.[30] This temporary arrangement was unwound with the introduction of the GST in 2000.[31] An important feature of the GST system is that the GST revenue is collected by the Australian Taxation Office ('ATO'), under federal legislation, but this revenue is wholly distributed to the States.[32]

As indicated above, the view of fuel taxes as a source of funding for roads was the basis for the introduction of the exemption certificate system for off-road use of diesel in 1957. This was replaced with a rebate scheme in 1982 for certain sectors of the economy (mainly mining and

Development, Bureau of Infrastructure, Transport and Regional Economics (BITRE), *Australian Infrastructure Statistics Yearbook 2019* (2019) Pt T (Transport) ('*BITRE Statistics Yearbook 2019*'); Infrastructure Partnerships Australia, *Road Pricing and Transport Infrastructure Funding: Reform Pathways for Australia, Discussion Paper* (2013) ch 2.

26 Australian Parliament, 'Federalism up in Smoke? The High Court Decision on State Tobacco Tax' Current Issues Brief No 1 1997-98 (1999) 6.

27 Ibid.

28 Ibid 7.

29 *Ha and Anor v State of NSW; Walter Hammond & Assoc v State of NSW* (1997) 189 CLR 465.

30 *History of Fuel Taxation* (n 18) 9.

31 Australian Parliament, Parliamentary Library, 'Petrol and Diesel Excises' Research Paper No 6 2000-01 (2000) 12. Excise rates were reduced by around 6.7 cents with the introduction of the GST but excise rates have since increased due to the six-monthly indexation mechanism. *History of Fuel Taxation* (n 18) 9.

32 Council of Australian Governments, *Intergovernmental Agreement on Federal Financial Relations* (2008) available at: <http://www.federalfinancialrelations.gov.au/content/intergovernmental_agreements/IGA_federal_financial_relations_aug11.pdf>.

agriculture).[33] Because the diesel fuel rebate rate was not linked to the excise rate, a gap developed after 1983 so that a full rebate was effectively no longer available, and some off-road activities were not eligible for the rebate at all. The reforms accompanying the introduction of the GST returned the system to a full rebate basis and extended eligibility to certain other off-road sectors, such as rail transport and marine use.[34] The transition to the current fuel tax credit system under the *Fuel Tax Act 2006* (which, contrary to its name, is actually the legislation providing the fuel tax credits) was phased in over the period of 2006 to 2012 and through these measures, relief from fuel tax was expanded to industrial uses broadly.[35] The current credit system is described below.

The other area of development has been the treatment of alternative fuels. In 1979, excise was eliminated for LPG and CNG, and ethanol became duty free in 1980 and, from 1994, excise free when blended with petrol.[36] The contractually-based federal government Ethanol Production Grants Programme reduced effective excise on domestically produced fuel ethanol to nil – this program ceased on 30 June 2015 after a government report concluded that it had little merit (the estimated cost of emissions reduction from a switch to E10 petrol mix was $274 per tonne of CO_2 and the program only benefitted three producers).[37] Similarly, the *Energy Grants (Cleaner Fuels) Scheme Act 2004*, which effectively reduced the excise on biodiesel to nil, was also repealed as at 30 June 2015. From that date forward, these alternative fuels have been subject to excise but initially at a nil rate, with a long phase-in time to, ultimately, reach only a fraction of the full excise rate (the rate on fuel ethanol rose to 32.77% of the petrol rate on 1 July 2020[38] and the rate on biodiesel is due to rise to 50% of the diesel rate (which is the same rate as petrol) by 1 July 2030).[39]

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[33] *History of Fuel Taxation* (n 18) 10.

[34] Ibid 15.

[35] *Fuel Tax (Consequential and Transitional Provisions) Act 2006* (Cth).

[36] *History of Fuel Taxation* (n 18) 16.

[37] Australian Government, Bureau of Resource and Energy Economics, *An assessment of key costs and benefits associated with the Ethanol Production Grants program, A report for the Department of Industry* (Report, 2014) 18.

[38] *Excise Tariff Act 1921* (Cth) s 6H.

[39] See Richard Webb, 'Taxation treatment of ethanol and biodiesel' (Australian Parliament, Parliamentary Papers, Budget Review 2014-15). These measures were enacted through *Excise Tariff Amendment (Ethanol and Biodiesel) Act 2015* (Cth).

B *The Current Fuel Excise Regime*

The rates and system for the collection of excise are found in the *Excise Tariff Act 1921* (Cth) whilst customs duty operates under the *Customs Tariff Act 1995* (Cth) and is designed to match the excise rates.[40] Excise rates are currently indexed bi-annually in line with the consumer price index and the current rates (from 3 February 2020) are: gasoline and diesel $0.423 per litre; LPG $0.138 per litre; CNG $0.290 per kg; denatured ethanol for use in internal combustion engine $0.111; and biodiesel[41] $0.056. The most recent figures available for the collection of excise and customs duty on fuel products are as follows.

TABLE 1 – CASH RECEIPTS FOR EXCISE AND CUSTOMS DUTY[42]

PRODUCT	**2018-19 ACTUAL ($M)**	**2019-20 ESTIMATE ($M)**
Petrol	6,000	6,350
Diesel	11,550	12,300
Other fuel products	2,220	2,280
Total	**19,770**	**20,930**

The tax gap on fuel excise has been measured by the ATO as quite low, only 1.3% for the 2017-18 year[43] (compared to, for example, the small business income tax gap of 12.5%).[44]

What these figures alone do not reveal is the *net* effect of excise and customs once the fuel tax credit scheme is taken into account. Although the receipts from customs and excise flow into consolidated revenue and are no longer earmarked for road funding, the continued link to roads is revealed through the operation of the fuel tax credit ('FTC') system. The impact of the fuel excise is in effect limited to public road use and is reversed in relation to private road and non-road use of transport fuels. Through this mechanism, the fuel excise serves as a rough proxy

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40 See Australia, Department of Home Affairs, Notice No 2018/03, Table 1 Excise Equivalent Goods.

41 The meaning of 'biodiesel' is given at s 3 of the *Excise Tariff Act 1921* (Cth) to mean 'mono-alkyl esters of fatty acids of a kind used as a fuel, derived from animal or vegetable fats or oils whether or not used'.

42 Australia, *Budget 2019-20, Budget Paper No 1: Budget Strategy and Outlook 2019-20*, Statement 4: Revenue, Table 7: Australian Government general government (cash) receipts.

43 For the ATO's research on the tax gap see ATO, 'Fuel Excise Tax Gap' (Web Page) <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Fuel-excise-tax-gap/>.

44 ATO estimate for the 2015-16 year, see ATO, 'Tax Gap Program Summary Findings' (Web Page) <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-gap/Australian-tax-gaps-overview/?page=5#Income_based_taxes_summary>.

for a user charge, however the amount payable is based on the quantity of fuel used rather than actual use of public roads.

III THE OPERATION OF THE FUEL TAX CREDIT SYSTEM

A *Overview of the System*

Under the *Fuel Tax Act 2006* (Cth) ('FTA'), certain taxpayers who have acquired and consumed fuel subject to fuel excise or customs duty can apply to the ATO for a credit (refund) of that tax. Under Division 41 of the FTA, fuel tax credits are made broadly available to business taxpayers and some non-profit bodies (where the fuel is used in a vehicle providing emergency services). Eligibility of 'business taxpayers' requires that the taxpayer is registered for GST and the fuel is used in carrying on the enterprise.[45] Credits are also available for fuel supplied for domestic heating, packaged for supply (limited types) and LPG supplied to tanks (small, residential use, not to supply motor vehicles).[46] An important limitation is that no credit is available for fuel used in light vehicles travelling on public roads, even if this travel is connected with a business enterprise.[47] Non-business taxpayers are only entitled to credits for fuel used to generate electricity for domestic use.[48]

The amount of credit available to business taxpayers is partial (rather than full) if the fuel is used in heavy vehicles (with a gross vehicle mass of more than 4.5 tonnes) travelling on public roads for business purposes. The amount of the credit is limited to the 'road user charge' ('RUC') on the basis that operators of heavy vehicles on public roads pay a lower (net) fuel excise but also pay high heavy vehicle registration charges collected at the State level – these two components are seen together as forming the user charge system for heavy vehicles. The RUC is determined by legislative instrument and corresponds to an amount agreed upon by Commonwealth and State governments through the Transport and Infrastructure Council. The

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[45] *Fuel Tax Act 2006* (Cth) s 41-5 ('*Fuel Tax Act*'). For an analysis of some of the issues that arise from the requirement that the taxpayer acquire and use the fuel see ATO, Fuel Tax Ruling FTR 2009/1: 'Fuel tax: entitlement to a fuel tax credit under section 41-5 of the *Fuel Tax Act 2006* in a vehicle or equipment hire arrangement' (2009).

[46] *Fuel Tax Act* (n 47) s 41-10.

[47] Ibid s 41-20.

[48] See ATO, PCG 2016/3: 'Fuel tax credits – fuel tax credit rate for non business claimants' (2016), which sets out a simplified basis for determine fuel tax credit entitlements for non business taxpayers in relation to the generation of electricity and the use of fuel by non-profits bodies in emergency vehicles.

current rate of $0.258 (set in 2017 and frozen through 2020-21) means that heavy vehicles are subject to a (net) fuel excise rate of $0.165 per litre.[49] The States and Territories work together to coordinate heavy vehicle registration charges, which they collect directly. The charge consists of a road component and a regulatory component and varies depending on the type and size of vehicle and trailers.[50] The combined effective of the fuel excise and FTC system is as follows.

TABLE 2 – EFFECTIVE FUEL TAX RATES BY TAXPAYER TYPE AND USE OF FUEL

TAXPAYER TYPE	USE OF FUEL	LEVEL OF FUEL TAX CREDIT	EFFECTIVE FUEL EXCISE RATE
Business taxpayers	Off road – any vehicle or any other use	Full	Nil
	Public road – light vehicle	None	Full rate = $0.423
	Public road – heavy vehicle	Reduced by user charge	$0.423 – $0.258 = $0.165
Non-business taxpayers	Electricity generation	Full	Nil
	All other uses	None	Full rate = $0.423

The amount of excise refunded by way of the FTC system is quite substantial, amounting to roughly 35% of receipts. The Australian Government has made forward estimates of the gross cash receipts and estimated credits to be provided, which produces the net figures as provided at Table 3 below.

TABLE 3 – NET FUEL EXCISE (FUTURE ESTIMATES) [51]

YEAR	CALCULATION BASIS	FUEL EXCISE AND CUSTOMS DUTY ($M)	FUEL TAX CREDIT SCHEME ($M)	NET FUEL EXCISE ($M)
2018-19	Estimate	19,770	7,168	12,602
2019-20	Estimate	20,930	7,504	13,426

49 Fuel Tax (RUC) Determination 2017 (F2017L00532).

50 The registration charges are laid out in the Heavy Vehicle Charges Model Law based on recommendations of the National Transport Commission to the Transport and Infrastructure Council.

51 The total fuel excise and customs duty figures were calculated from the data provided in *Budget 2019-20, Budget Paper No 1: Budget Strategy and Outlook 2018-19*, Statement 4: Revenue, Table 7: Australian Government general government (cash) receipts. The figures for fuel tax credits are sourced from Statement 5: Expenses and Net Capital Investment, Table 12.1: Trends in the major components of fuel and energy sub-function expenses.

2020-21	Estimate	21,540	7,937	13,603
2021-22	Projection	22,510	8,424	14,086
2022-23	Projection	23,760	8,966	14,794

The increase in real terms of fuel tax credits (calculated by Treasury as 2.6% from 2018-19 to 2019-20 and 11.4% from 2019-20 to 2022-23) is projected to be due to increased use of fuels eligible for the scheme.[52]

B *Quantum and Distribution of Credits*

The sectors benefitting from the fuel tax credit system can be identified by examining the *Taxation Statistics* report released by the ATO annually.[53] The detailed tables supporting the *Taxation Statistics 2017-18* (the most recent available) report the value of the fuel tax credits processed by the ATO up to the 2018-19 year and these have been aggregated by the author by broad industry group to produce the figures in Table 4 below.

TABLE 4 – VALUE OF FUEL TAX CREDITS (2018-19)[54]

BROAD INDUSTRY GROUPING	**VALUE OF CREDITS ($M)**
Agriculture, Forestry and Fishing	839.5
Mining	3,184.1
Manufacturing	274.3
Electricity, Gas, Water and Waste Services	167.1
Construction	469.9
Wholesale Trade	114.0
Retail Trade	62.9
Accommodation and Food Services	11.8
Transport, Postal and Warehousing	1,385.6
Information Media and Telecommunications	1.7
Financial and Insurance Services	89.9

52 Australia, Treasury, *Budget 2019-20, Budget Paper No 1: Budget Strategy and Outlook 2018-19,* Statement 5: Expenses and Net Capital Investment, 5-31.

53 ATO, *Taxation Statistics 2017-18* (Web Page, 2020) <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2017-18/>.

54 Ibid Excise - Table 4.

Rental, Hiring and Real Estate Services	52.9
Professional, Scientific and Technical Services	224.2
Administrative and Support Services	61.0
Public Administration and Safety	89.6
Education and Training	4.6
Health Care and Social Assistance	2.1
Arts and Recreation Services	4.7
Other Services	43.4
Other	53.9
Total	**7,137.2**

In some of these sectors, taxpayers would benefit from a full credit for the excise due to use of fuel in relation to off-road transport whilst in others the credit will only be net of the RUC. The two largest sectors (by value of credit claims paid) would likely represent each of these situations. The mining sector receives approximately 44.6% of the credits by value, likely due to their use of fuel in relation to equipment and off-road transportation (including on private mining roads). The second largest sector (by value of claims paid) is transport at approximately 19.4% of claims paid, where this is likely to represent credits for on-road use reduced by the RUC.

IV COMPLEXITY IN THE DESIGN OF THE FTC SYSTEM

As mentioned in the history snapshot above, initially non-road use of fuels was excluded from fuel excise through an exemption system but, to improve administration, this was changed to the credit system that now operates. However, the operation of the current system has its own administrative challenges. The resulting FTC system is one where administrative and compliance costs are incurred to collect and then refund back approximately one-third of fuel tax receipts. By the ATO's estimates, the complexity of the system has resulted in under-claiming of credits (so overpayment of tax) to produce a small negative fuel tax credit gap of -0.1% (that is, under-claimed credits exceeded over-claimed credits).[55] This section explores some of the more significant sources of complexity.

[55] Fuel tax credits gap, estimate for 2017-18 year at -0.1% or -$5.7m. Source: ATO (n 43).

A *Changing Excise Rates and the Mechanics of Claiming the Credit*

The FTC is claimed as part of the business activity statement ('BAS') lodgement cycle, a system that provides for periodic reporting and netting off payments due to the ATO (such as pay-as-you-go income tax instalments and GST liabilities) and refunds payable by the ATO (for example, FTC and GST refunds). The amount of FTC that can be claimed depends upon the type of fuel, when the taxpayer acquired the fuel, and its use. Although the fuel user does not pay the fuel tax directly (as this is paid by the importer or manufacturer), the user effectively bears the burden of the tax as it is incorporated into the price. Recognising the complexity, the ATO has developed a number of online tools and smartphone applications to assist taxpayers in working out their eligibility and claimable amount.

A government decision to halt the indexation of fuel excise in 2001 contributed significantly to what was estimated in 2014 to be a 30% fall in real terms of net fuel tax revenue.[56] Indexation resumed on 1 August 2014 on a bi-annual basis and, as the fuel excise rate changes, so too does the FTC entitlement. Unfortunately, the timing of indexation does not align with BAS lodgement, so that BAS periods must often be split to reflect the two rates applicable within a period. By way of an administrative concession, the ATO allows a simplified system to be used where less than $10,000 in FTC is claimed, such that taxpayers can use the rate at the end of the period rather than the two rates.[57] An ATO online calculator assists in calculating FTC by providing the relevant rate once the purchase period is identified and simplified rules are also available for working out the cost of fuel purchased and in relation to record keeping requirements.[58]

B *Apportionment Between Public and Private Roads*

The FTC otherwise available under the FTA for fuel used in carrying on an enterprise is eliminated for fuel used in a light vehicle travelling on a public road[59] and reduced by the RUC in relation to heavy vehicles to the extent that the taxpayer acquires 'taxable fuel to use, in a

56 Productivity Commission, *Public Infrastructure Inquiry Report* (Report, 2014) 154.

57 ATO, Practical Compliance Guideline PCG 2016/2: 'Fuel tax credits – practical compliance methods for small claimants' (2016).

58 Ibid. For record keeping requirements more generally see ATO, Fuel Tax Determination FTD 2006/2: 'Fuel tax: What records are required to be kept by taxpayers to substantiate a claim for a fuel tax credit?' (2006).

59 *Fuel Tax Act* (n 47) s 41-20.

vehicle, for travelling on a public road',[60] but this reduction does not apply 'if the [heavy] vehicle's travel on a public road is incidental to the vehicle's main use'.[61] One issue that arises is whether a road is a public road.

1 *Is the Road a Public Road?*

The term 'public road' is not defined in the FTA and therefore takes its ordinary meaning. The Explanatory Memorandum that accompanied the introduction of the Fuel Tax Bill provided a list of examples where a road is a public road[62] and these have been included in the ATO's public advice on the matter.[63] A public road includes a road opened, declared or dedicated as a public road under a statute, a road under government authority to control and maintain as a public road, and a road dedicated as a public road at common law.[64] Examples of roads that are not public roads are forestry roads, private access roads for mining, and roads over private land that have not been dedicated as public roads.[65] Further consideration by the ATO effectively excludes travel on a public road if that road is under construction, repair or maintenance and the vehicle is moving on that road as part of the undertaking of that work.[66]

The meaning of 'public road' was recently considered by the Full Federal Court in *Linfox Australia Pty Ltd v Commissioner of Taxation* in the context of addressing whether toll roads that are operated and maintained by private operators are public roads.[67] The taxpayer, Linfox, had sought to draw the link between the funding of roads and the taxing of transport fuels as a basis for arguing that fuel used in relation to travelling on a toll road should not be taxable as the government is not responsible for toll road maintenance. The Court responded in this way:

> While the reference to a heavy vehicle shows that it is likely there will be some relationship between the rate of the road user charge, as determined, and the need for maintenance of roads

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[60] Ibid s 43-10(3).

[61] Ibid s 43-10(4).

[62] Explanatory Memorandum, Fuel Tax Bill 2006, para 2.50.

[63] ATO, Fuel Tax Ruling FTR 2008/1: 'Fuel tax: Vehicle's travel on a public road that is incidental to the vehicle's main use and the RUC' (2008 and most recently amended 2017) ('FTR 2008/1').

[64] Ibid paras 43D-46 and 121-129C.

[65] Explanatory Memorandum, Fuel Tax Bill 2006, paras 2.51-2.53.

[66] FTR 2008/1 (n 64) para 22.

[67] *Linfox Australia Pty Ltd v Commissioner of Taxation* [2019] FCAFC 131 (21 August 2019) ('*Linfox*').

> surfaces, that relationship is insufficient to persuade us of the conclusion for which the applicant [Linfox] contends, which is that acquiring taxable fuel to use in a vehicle for travelling on a public road excludes acquiring fuel for use for travelling on these toll roads.[68]

Instead, the Court concluded that the notion of 'public road' was 'more closely aligned' with an entitlement or right of access of the public to use the road, which would include toll roads.[69]

2 *Incidental Travel*

A second issue is whether the travel of a heavy vehicle on a public road is 'merely incidental' so that it will not trigger the RUC reduction of the FTC. The Explanatory Memorandum to the Fuel Tax Bill provided that '[i]ncidental use of fuel may occur when a vehicle that is used almost exclusively off a public road, is moved a short distance from one off-road location to another via a public road or is operating incidentally on a public road.'[70] So, for example, the ATO considers that the travel of a harvester from one part of a farm a limited distance on a public road to another part of the farm will be incidental,[71] such that no apportionment of fuel use to travel on public roads is required. On the other hand, in the ATO's view, the travel of a special purpose vehicle (such as a mobile crane) from the place it is garaged to and from the work site will be integral to its use rather than incidental,[72] so apportionment would be necessary.

C *Apportioning the Use of Fuel Across Different Vehicle Elements and Usages*

Another aspect of the complexity that is inherent in the current FTC system stems from the need to determine the specific use of the fuel. If the fuel is for use 'in a [light] vehicle … travelling on a public road' there is no credit available[73] but if it is used in a heavy vehicle and if it is 'fuel to use, in a vehicle, for travelling on a public road', the credit is available but reduced by the RUC.[74] As a corollary, fuel used in a heavy vehicle but not for travelling on a

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[68] Ibid [111].

[69] Ibid [113], [118].

[70] Explanatory Memorandum, Fuel Tax Bill 2006, para 2.80.

[71] FTR 2008/1 (n 64) paras 67-68. See also ATO, PCG 2016/4: 'Fuel tax credits – incidental travel on public roads by certain vehicles' (2016).

[72] FTR 2008/1 (n 64) para 63.

[73] *Fuel Tax Act* (n 47) s 41-20.

[74] Ibid s 43-10.

public road is fully creditable. The interpretation of these phrases has caused some difficulty. The term 'vehicle' is not defined in the legislation but the ATO has provided its interpretation in a fuel tax ruling: a vehicle includes any vehicle, plant, machinery or other equipment that is capable of locomotion (and need not be self-propelled) and which may be authorised to travel on a public road by the relevant road traffic authority.[75] This is a broader concept than 'motor vehicle' and would include, for example, a forklift, street sweeper or garbage truck.[76]

In a 2012 decision, the Administrative Appeals Tribunal ('AAT') considered whether the RUC reduction to the credit applied to take into account the use of fuel in powering air conditioning units in refrigerated transport trailers used to transport perishable goods.[77] The equipment used by the taxpayer, again Linfox, was such that the fuel supply to the refrigeration unit was separate to the fuel supply for the prime mover. The taxpayer accepted that the trailers were vehicles so the focus on the AAT decision was on whether the fuel designated for the air conditioning units was for use 'for travelling'.[78] The rule applicable to light vehicles does not contain the same 'for' travelling requirement and instead denies the credit for 'all on-road applications of taxable fuel in the vehicle.'[79] The AAT considered that the use of the preposition 'for' preceding 'travelling' was critical and limited the road use charge to fuel used to propel the vehicle.[80] As a result, the full FTC was available for the fuel used in the refrigeration units.

However, a more recent decision of the AAT in 2019 (also stemming from an application by Linfox as taxpayer) disagreed.[81] Justice Jagot, sitting as Deputy President of the AAT, did not accept that 'for travelling' was limited to 'mere propulsion'[82] and concluded that fuel used in air conditioning the driver's cabin in relation to the journey of a heavy vehicle on a public road

[75] FTR 2008/1 (n 64) paras 11-13.

[76] Ibid para 100.

[77] *Linfox Australia Pty Limited v Commissioner of Taxation* [2012] AATA 517, (2012) 89 ATR 931 ('*Linfox 2012*').

[78] Ibid [32].

[79] Ibid [43].

[80] Ibid. See also ATO, Fuel Tax Determination FTD 2016/1: 'Fuel tax: fuel tax credits – fuel used for idling and cabin air-conditioning of a vehicle on a public road' (2016).

[81] *Linfox Australia Pty Limited v Commissioner of Taxation* [2019] AATA 222. This issue was not contested as part of the appeal to the Full Federal Court, see (n 68).

[82] Ibid [37].

was 'for travelling' and therefore the FTC was reduced by the RUC.[83] The rules of precedent do not operate with respect to decisions of the AAT but the ATO's decision impact statement in relation to the 2019 Linfox litigation states that it intends to apply the 2019 AAT decision (which has the effect of reducing the availability of the FTC) on this point.[84] The ATO has further stated the view that, in light of this decision, FTCs for fuel used to power passenger air conditioning units (such as in commercial buses and coaches) whilst travelling on public roads should also be reduced by the RUC.[85]

More generally, the ATO has produced published advice in the form of a tax ruling that addresses the need to distinguish what portion of the fuel used in a heavy vehicle is for travelling (only partly creditable) and what portion is for other purposes (fully creditable). The meaning given to 'travel' by the ATO is to go from one place to another and includes the ordinary incidents of a journey.[86] Fuel used 'for travelling' includes not only fuel from propulsion but also fuel used for the other functions that relate to travelling, including fuel used for idling, lights, brakes, power steering and windscreen wipers.[87] The enquiry therefore turns to whether a particular function of the vehicle is connected with travelling or some other purpose. The ATO provides a number of examples to illustrate this, such as the example of the garbage truck:

> The fuel used for the vehicle to travel along the public road is subject to the RUC [so only partly creditable]. The fuel used to operate the bin lift and the compacting mechanism is unrelated to the vehicle's movement along the public road. Hence the fuel used to operate the bin lift and the compacting mechanism is not subject to the RUC [and is fully creditable].[88]

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[83] Ibid [38].

[84] ATO, Decision impact statement: *Linfox Australia Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia*, issued 24 Sep 2019.

[85] This view is currently expressed only as online web guidance, with effect from 1 November 2019, see ATO, 'Fuel Tax Credits for Passenger Air Conditioning' (Web Page, 4 November 2019) <https://www.ato.gov.au/Tax-professionals/Newsroom/Activity-statements/Fuel-tax-credits-for-passenger-air-conditioning/>.

[86] FTR 2008/1 (n 64) paras 14-15.

[87] Ibid para 23B.

[88] Ibid para 31.

In light of the 2019 Linfox litigation, this ruling is currently the subject of review but in relation to this issue, the AAT's 2019 decision is generally consistent.

Taxpayers must apportion fuel consumed across these various uses and the Commissioner's view is that taxpayers may choose a basis that is fair and reasonable when determining their entitlements to fuel tax credits.[89] To assist taxpayers, the ATO has issued two PCGs that provide examples of acceptable bases for such apportionment, in more general cases[90] and in relation to heavy vehicles with auxiliary equipment (this guideline provides safe harbour percentages for fuel used to run auxiliary equipment but is also the subject of review following the 2019 Linfox decision).[91]

V CRITICISMS OF THE FUEL TAX SYSTEM AND THE OPPORTUNITY OF REFORM

There have been repeated and growing calls over the last fifteen years for reform of Australia's road funding system. Australia's Productivity Commission undertook a major review of infrastructure funding in 2014[92] and its concerns and recommendations regarding road funding were reiterated in 2017.[93] Funding pressures are usually identified by way of comparisons of road-related government revenue and road-related government expenditure. In the 2017 report, the Productivity Commission concluded that funding levels were broadly equivalent to expenditure but that revenues were projected to continue to fall in real terms relative to demand and the major weakness was to be found in fuel tax receipts.[94] The Productivity Commission stated that 'fuel tax receipts have declined and are projected to continue to fall in real terms due to improved fuel efficiency of cars, charges in travel preferences of commuters, the emergence of e-commerce, and the anticipated shift toward electric vehicles, which all reduce

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[89] ATO, FTD 2010/1: 'Fuel tax: apportionment may apply when determining total fuel tax credits in calculating the net fuel amount under section 60-5 of the *Fuel Tax Act 2006*' (2010).

[90] ATO, PCG 2016/8: 'Fuel tax credits – apportioning fuel for fuel tax credits' (2016).

[91] ATO, PCG 2016/11: 'Fuel tax credits – apportioning taxable fuel used in a heavy vehicle with auxiliary equipment' (2016).

[92] Productivity Commission, *Public Infrastructure Inquiry Report* (Report, 2014) ('*Public Infrastructure Inquiry Report*').

[93] Productivity Commission, *Shifting the Dial: 5 year productivity review* (Report, 2017), ch 4.

[94] Ibid 136.

average fuel consumption.'[95] Other reports continue to focus on fuel excise as the major source of road funding and its primary risk.[96]

A *Traditional Road Funding Sources*

The work of the Productivity Commission in comparing road funding and expenditure builds on annual data reported by the Australian Bureau of Infrastructure, Transport and Regional Economics ('BITRE'). BITRE identifies and then collates road-related expenditure and revenue at the various levels of government. The most recent figures available (for the 2017-18 year) show public sector expenditure on roads at all levels of government totalled $30,249.4m.[97] Selected road-related taxes and charges (excluding those items that raise relatively low levels of revenue) were as shown in Table 5 for the same year.

TABLE 5 – SOURCES OF ROAD-RELATED REVENUE, BY GOVERNMENT SECTOR AND TYPE[98]

GOVERNMENT LEVEL	**TAX/CHARGE DESCRIPTION**	**AMOUNT FOR 2017-18 ($M)**
Commonwealth	Net road-related petroleum products excise (net fuel excise)	11,810.2
	Road-related GST	3,973.0
	Road-related Fringe Benefits Tax	984.0
	Federal Interstate Registration Scheme	68.6
	Luxury car tax	705.0
	Passenger motor vehicle customs duty	490.0
State/Territory	Vehicle registration fees	7,645.7
	Driver licence fees	585.0
	Stamp duty	2,917.5
	Tolls	2,418.4
Total		**31,597.4**

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[95] Productivity Commission, *Shifting the Dial: Supporting Paper No 9* (2017) 4.

[96] See, eg, Infrastructure Partnerships Australia, *Road Pricing and Transport Infrastructure Funding: Reform Pathways for Australia, Discussion Paper* (2013). Although only a small part of the report, the Harper Competition Policy Review also recommended the reform of road pricing. Australia, *Competition Policy Review* (Final Report, 2015) Rec 3, 38.

[97] *BITRE Statistics Yearbook 2019* (n 27) Table T.1.2d.

[98] BITRE, *Infrastructure Statistics Yearbook 2019*, Table T.1.4a. (Total calculated by author).

The data compiled by the BITRE in the *Statistic Yearbook* shows a general decline in real terms in net petrol excise throughout the period from 1997 until 2017 but a slight increase in the most recent 2017-18 year.[99] This is in contrast to an overall increase over time in State and Territory government vehicle registration fees, driver's licence fees and stamp duty.[100] There is also strong growth in tolls.[101] BITRE statistics also show a trend of increasing passenger kilometres travelled, broadly doubling since 1979-80,[102] whilst the fuel excise revenues have declined in real terms.

The comparison of fuel taxes and other 'road related revenue' to road expenditure could lead to the misapprehension that fuel taxes are actually directed to fund roads. The reality is that all government revenues, with the exception of the Federal Interstate Registration Scheme for heavy vehicles (which ceased to operate on 30 June 2019),[103] at both Commonwealth and State/Territory levels, flow into consolidated revenue and are not hypothecated. The Commonwealth independently determines grants to the States and Territories, which in turn make decisions regarding the spending of those funds on road or other projects and on further grants to local governments.

B *The Development of Alternative User Charge Systems for Roads*

To the extent that roads are generally seen as a public infrastructure, road not unlike other services where access generally can at least theoretically be controlled (electricity, water, telecommunications etc), there is a strong case for a user charging system.[104] The Productivity Commission recommends that (direct) user charges should replace, where possible, other road funding mechanisms and should flow into special purpose Road Funds, thereby achieving earmarking.[105] Infrastructure Australia has joined the call for a user charge system for road use and advocates that it replace fuel tax and vehicle registration charges.[106] There has already been

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99 Ibid 49, Table T.1.4a.

100 Ibid.

101 Ibid. Toll revenues have increased, in real terms, from $231.2m in 1997-98 to $2418.4m in 2017-18.

102 Ibid Figure T 3.

103 *Interstate Road Transport Legislation (Repeal) Act 2018* (Cth).

104 *Public Infrastructure Inquiry Report* (n 93) 142.

105 Ibid 309-10.

106 Infrastructure Australia *Making Reform Happen: Using incentives to drive a new era of infrastructure reform* (Report, 2018) 18.

recognition that the current heavy vehicle charge system, which is seen as a rough estimate user charge, is not equitable across vehicle operators and a small scale national pilot study to replace it with a system based on vehicle telematics began in July 2019.[107] A larger scale trial that will also include other methods of data collection is due to follow in 2020.[108]

A 2019 report by industry think-tank Infrastructure Partnerships Australia calls for state governments to institute road use charge systems for electric passenger cars, noting a 'terminal' decline in fuel excise revenue and suggesting a simple distance-based charge as a starting point.[109] Media announcing this report also suggest that Victoria and NSW are currently examining this option.[110] As identified by the Productivity Commission, user charge pilots undertaken by other jurisdictions, like the program based on vehicle telemetry data run by the state of Oregon in the United States, can provide very valuable experience for a light vehicle system.[111]

Another concern that has been repeatedly raised is the cost of road congestion.[112] It is now also accepted that a reconsideration of road pricing should include an analysis of congestion pricing, perhaps built into the user charge system depending on its technical capabilities.[113] But it is acknowledged that a transition to these measures will take time to develop and implement and there will still likely be a gap between what the Road Funds can support and governments' needs for the construction and maintenance of roads.

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107 Department of Infrastructure, Transport, Cities and Regional Development, 'National Heavy Vehicle Charging Pilot' (Web Page) <https://www.infrastructure.gov.au/roads/heavy/charging-trials/index.aspx>.

108 Ibid.

109 Infrastructure Partnerships Australia, *Road User Charging for Electric Vehicles* (2019).

110 See, eg, Eryk Bagshaw, 'Road user charges for electric vehicles "on the radar" as fuel excise revenue falls' *The Sydney Morning Herald* (online, 20 November 2019) <https://www.smh.com.au/politics/federal/road-user-charges-for-electric-vehicles-on-the-radar-as-fuel-excise-revenue-falls-20191120-p53cdj.html>.

111 Information on Oregon's road usage charge system, 'OReGO', is available here: <https://www.myorego.org/>. See also Oregon Department of Transportation, *Oregon's Road Usage charge: OReGO Program, Final Report* (2017).

112 See KPMG, *Unblocking traffic congestion: A map to Australian road pricing schemes* (Report, 2016).

113 See Grattan Institute, *Stuck in traffic? Road congestion in Sydney and Melbourne* (Report, 2017); *NSW Review of Federal Financial Relations* (n 13) 89-92.

C *An Environmental Tax Policy*

In light of the issues raised in relation to fuel excise, the question for fuel tax could be reframed: given that consolidated revenue will continue to be the source of at least some road funding into the future, could a reformed fuel tax provide a fairer and more efficient mechanism to raise revenue? Given that fuel is already subject to the GST, the policy rationale supporting the additional taxation of this product should be reconsidered, especially given the concern that consumption taxes in general and fuel taxes in particular may be regressive.[114] As governments rely more on broad-based income and consumption taxes to fund expenditure, excise is now rarely used and is largely seen as a 'sin tax' applying to alcohol and tobacco products for the dual policy objectives of raising revenue whilst pursuing public health outcomes.[115] An obvious economic argument for targeting transport fuels is due to the environmental costs associated with their use, this being the traditional economic basis for environmental taxation in the tradition of Pigou and Coase.[116] Recognition of this justification for specially taxing transport fuels has received some support in Australia. In the report of the Future Tax System Review (the 'Henry Review'), the following was recommended:

> The only additional taxes to those on the four broad bases described earlier [personal income, business income, rents on natural resources and rents, and private consumption] would be specific taxes imposed for one of three purposes: to improve market or social outcomes by addressing spillover costs and benefits; to help counteract self-control problems (in the special case of tobacco); and to improve market efficiency through appropriate price signals.[117]

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[114] Sterner finds some evidence of regressivity in a study of 7 European countries but concludes that the evidence is very weak. Thomas Sterner, 'Distributional effects of taxing transport fuel' (2012) 41 *Energy Policy* 75. See also Katri Kosonen, 'Regressivity of environmental taxation: myth or reality' in Janet E Milne and Mikael S Andersen (eds), *Handbook of Research on Environmental Taxation* (Edward Elgar, 2014). The NSW sees evidence that the fuel excise is regressive on the basis that persons on lower incomes tend to have older, less fuel-efficient cars and often have longer commutes. *NSW Review of Federal Fiscal Relations* (n 13) 83.

[115] For a discussion of these issues see, eg, Richard Bird, 'Tobacco and Alcohol Excise Taxes for Improving Public Health and Revenue Outcomes: Marrying Sin and Virtue?' World Bank Group, Policy Research Working Paper 7500 (2015).

[116] A C Pigou, *The Economics of Welfare* (Macmillan, 1920) and R H Coase, 'The Problem of Social Cost', (1960) 3 *Journal of Law and Economics* 1. The literature building on this work in the field of environmental taxation is too numerous to site but for an excellent collection of writings related to this topic see Janet E Milne and Mikael S Andersen (eds), *Handbook of Research on Environmental Taxation* (Edward Elgar, 2014).

[117] Australia, *Australia's Future Tax System* (Final Report, 2010) Part I at 53.

The Henry Review took the view that revenue from fuel taxes should be replaced over time with revenue from more efficient broad-based taxes[118] but if fuel taxes were retained they 'should not exceed the levels justified by broadly defined social costs of use (whether of roads or environmental costs)'.[119] The crudeness of fuel tax as a user charge is obvious once it is recognised that electric vehicles get a 'free ride',[120] so the remaining justification of environmental cost should dictate the reform agenda.

Consistent with these recommendations, the policy justification for a fuel tax should be to reflect the climate externality associated with fuel use. Viewed from this perspective, the fuel tax could be reformed to remove much of its current complexity, resulting in significant savings in administration and compliance costs. The fuel excise could continue to apply to all road transport fuels but the rate of tax would be based on the estimated cost of the externality, so that diesel would be taxed at a higher rate to petrol, which could be revisited on a regular basis. Based on the OECD's work on energy taxes, this would likely lead to a reduction in the rate. By severing the (imagined) link to funding public roads, there would no longer be a need for the FTC system — the differentiation of fuel usage between travel and other purposes would no longer be necessary. This would have the effect of broadening the base of the tax to all users of transport fuels. It should also be possible to model the fuel tax in a way that recognises its potentially regressive impact and seeks to minimise it.

VI CONCLUSION

The history of fuel excise and the hypothecation of this revenue to road funding until the late 1950s explain the design of the excise and credit system as an indirect road user charge system. In addition to the obvious crudeness of equating fuel use to road use, many reviews and reports have highlighted the weakness of transport fuels as a tax base, given the increasing fuel efficiency of vehicles and the predicted significant growth in electric vehicles. This article provides another basis for criticism of the current system — the significant complexity in determining the availability of the fuel tax credit. The system is so complex that the ATO estimates that taxpayers under-claim credits otherwise available, a negative tax gap.

[118] Ibid Recommendation 65.

[119] Ibid 53.

[120] *NSW Review of Federal Fiscal Relations* (n 13) 83.

The development of direct user charging for roads would allow the Australian Government to reformulate the fuel tax system to disconnect it from road use so that instead it can operate as an environmentally motivated mechanism and continuing to target transport fuels for this additional tax could be justified economically. Ultimately, both goals of generating government revenue and protecting the environment could be better served.

NEW ZEALAND'S LOOK-THROUGH COMPANY REGIME AND COMPLIANCE COSTS: THROUGH THE EYES OF THE PRACTITIONER

HARRY WADDELL*

ABSTRACT

New Zealand's tax regime is distinct in offering a specific entity targeted towards closely held companies, the look-through company ('LTC'). One of the stated policy intents of the LTC regime is reducing compliance costs. This research sought the views of tax practitioners as to uses for the LTC regime, advantages of the LTC regime, disadvantages of the LTC regime and the complexity of the LTC regime. Notably, practitioners viewed the LTC regime as being complex and giving rise to increased compliance costs for those that use the regime. Part of this complexity arose from the now repealed loss/deduction limitation rule, however, other drivers of complexity still exist. To this end, further overhauls are recommended.

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I INTRODUCTION

One of the earliest authors to associate a cost with tax compliance was Adam Smith, who propounded four canons of taxation: equity, certainty, convenience and economy.[1] Amongst these four canons, certainty and convenience of payment are wholly concerned with tax compliance costs, whilst economy in collection is concerned with both the collection and efficiency costs of tax.[2] Compliance costs are different to administrative costs, and are incurred by taxpayers in efforts to comply with tax legislation.[3] Conversely, administrative costs are those incurred by revenue authorities in collecting tax.[4]

Compliance costs arise for a number of different reasons.[5] Perhaps the most important cause of tax compliance costs is the complexity of legislation.[6] Other drivers of tax compliance costs include the administration of the revenue authority itself, tax accounting rules and regulations, and international tax issues.[7] Additional drivers of tax compliance costs include the nature of the taxes themselves, the cost of learning about new taxes or changes, and the processes and procedures of remitting the tax.[8] Further, it is widely acknowledged that smaller businesses have a greater burden of tax compliance costs. This is due to the regressive nature of

1 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Dent, 1910).

2 Binh Tran-Nam, 'Measuring Tax Complexity Costs' in Chris Evans, Rick Krever and Peter Mellor (eds), *Tax Simplification* (Kluwer Law, 2015).

3 Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (Victoria University Press, 1992).

4 Cedric Sandford, Michael Godwin and Peter Hardwick, *Administrative and Compliance Costs of Taxation* (Fiscal Publications, 1989).

5 Betty Jackson and Valerie Milliron, 'Tax Compliance Research: Findings, Problems, and Prospects' (1986) 5(1) *Journal of Accounting Literature* 125; Maryann Richardson and Adrian Sawyer, 'A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects' (2001) 16(2) *Australian Tax Forum* 137; Lin Mei Tan and Adrian Sawyer, 'A Synopsis of Taxpayer Compliance Studies: Overseas Vis-a-Vis New Zealand' (2003) 9(4) *New Zealand Journal of Taxation Law and Policy* 431.

6 Ranjana Gupta, 'Simplify Tax Maze to Grow Small Business: New Zealand Study' (2011) 26(2) *Australian Tax Forum* 173.

7 Sebastian Eichfelder and Francois Vaillancourt, 'Tax compliance costs: A Review of Cost Burdens and Cost Structures' (2014) 210(3) *Review of Public Economics* 111.

8 Philip Lignier, Chris Evans and Binh Tran-Nam, 'Tangled Up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector' (2014) 29(2) *Australian Tax Forum* 217.

compliance costs, that is, smaller businesses experience a larger cost burden in comparison to larger businesses.[9] In fact, large businesses often benefit from complying with tax legislation.[10]

Globally, efforts have been made to reduce compliance costs for smaller businesses. In New Zealand, a specific regime targeted towards closely held companies has been adopted as one method to achieve this goal, with the loss-attributing qualifying company ('LAQC') regime being introduced in 1992. New Zealand's closely held company regimes have proved to be popular, with there being an estimated 130,000 active LAQCs when the regime was repealed.[11] However, despite the regime having widespread use, the repeal of the regime was subject to limited public scrutiny and consultation.[12] In fact, the repeal of the LAQC regime was announced during the National Government's budget of 2010. Shortly after, the look-through company ('LTC') regime was implemented in a Supplementary Order Paper during the third reading of a remedial tax bill.[13] Traditionally, changes to tax legislation go through a process known as the Generic Tax Policy Process ('GTPP'), which necessitates public scrutiny and consultation via submissions and the Select Committee process.[14]

This hurried implementation of the LTC regime is understood to be the main cause of the numerous tweaks and amendments made since its enactment. These have ranged from being remedial in nature, to major changes such as the removal of the owner's basis and the loss/deduction limitation rule, which will be discussed further on. These major changes were enacted in 2017, and unlike the original regime, were subject to the GTPP. The use of the GTPP

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9 See, eg, Sandford and Hasseldine (n 4); Colmar Brunton, *Measuring the Tax Compliance Costs of Small and Medium-Sized Businesses - A Benchmark Survey* (Final Report, 2005).

10 Binh Tran-Nam et al, 'Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia' (2000) 53(2) *National Tax Journal* 229. See, eg, Philip Lignier, 'A Silver Lining in the Tax Compliance Cost Cloud? A Study of the Managerial Benefits of Tax Compliance in Small Business' in Margaret McKerchar and Michael Walpole (eds), *Further Global Challenges in Tax Administration* (Fiscal Publications, 2006).

11 New Zealand, *Parliamentary Debates*, House of Representatives, 9 December 2010, 16085.

12 Peter Vial, 'The Generic Tax Policy Process: A "Jewel in Our Policy Formation Crown"?' (2012) 25(2) *New Zealand Universities Law Review* 318.

13 See New Zealand Parliament, 'How a Bill Becomes Law', *How Parliament Works* (Web Page, 12 January 2016) <www.parliament.nz/en/visit-and-learn/how-parliament-works/how-laws-are-made/how-a-bill-becomes-law/>.

14 Adrian Sawyer, 'Broadening the Scope of Consultation and Strategic Focus in Tax Policy Formulation: Some Recent Developments' (1996) 2(1) *New Zealand Journal of Taxation Law and Policy* 17.

resulted in many submissions from tax practitioners and other impacted parties many of whom were not consulted in the first instance.

Whilst one of the original aims of the LAQC regime was to reduce compliance costs, two empirical studies have found that the opposite was true.[15] That is, the use of the LAQC regime resulted in higher compliance costs compared to the other business structures such as ordinary companies, trusts, sole traders and partnerships. Non-empirical studies have also pointed to increased compliance costs for those using the LAQC regime. This is due to more complex and onerous legislative requirements[16] and the tax flow-through treatment offered by the structure.[17] In addition to compliance costs, literature also suggests that the LAQC regime undermined tax neutrality due to the use of LAQCs in tax avoidance arrangements,[18] and because of various inconsistencies in the taxation of LAQCs compared to other tax structures.[19]

In regard to the LTC regime, one study has concluded that the LTC regime and its associated legislation is complex and obtuse.[20] Specifically, the only way that the New Zealand Institute of Chartered Accountants ('NZICA')[21] were able to gain confidence in the original legislation was through policy discussions with officials, which is contradictory to New Zealand's self-assessment system. The LTC regime has also been reviewed from the perspective of various stakeholders, with the authors concluding that the LTC regime has been successful in

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15 Katherine Ritchie, *New Zealand Small Business Tax Compliance Costs - Some Empirical Evidence* (Inland Revenue, 2002); Gupta (n 6).

16 Kevin Holmes, 'The Taxation of Closely-Held Companies: Concepts, Legislation and Problems in New Zealand' (1992) 9(3) *Australian Tax Forum* 323.

17 Brett Freudenberg, 'Is the New Zealand Qualifying Company Regime Achieving its Original Objectives?' (2005) 11(2) *New Zealand Journal of Taxation Law and Policy* 185; Brett Freudenberg, 'The Troubled Teen Years: Is the Repeal of New Zealand's LAQC Regime Required?' (2008) 14(1) *New Zealand Journal of Taxation Law and Policy* 67; Brett Freudenberg, Fact or Fiction? A Sustainable Tax Transparent Form for Closely Held Businesses in Australia (2009) 24(3) *Australian Tax Forum* 375; Brett Freudenberg, *Tax Flow-through Companies* (CCH, 2011).

18 Brett Freudenberg, 'Are Qualifying Companies Quality? The Lessons to be Learnt from New Zealand's Hybrid Entities for Australia' (Conference Paper, Australasian Tax Teachers' Association Conference, 2004); Justice Susan Glazebrook, 'Statutory Interpretation, Tax Avoidance and the Supreme Court: Reconciling the Specific and the General' (2014) 20(1) *New Zealand Journal of Taxation Law and Policy* 9.

19 Freudenberg, 'Is the New Zealand Qualifying Company Regime Achieving its Original Objectives?' (n 18).

20 Aylton Jamieson, 'Loss Limitation Rules - The Sow's Ear' (2011) 90(8) *Chartered Accountants Journal* 46.

21 The New Zealand Institute of Chartered Accountants ('NZICA') merged with the Institute of Chartered Accountants Australia ('ICAA') in 2013 to become Chartered Accountants Australia New Zealand (CAANZ).

eliminating the neutrality concerns associated with the LAQC regime.[22] Furthermore, it has been found that in general, tax flow-through entities, such as the LTC regime, lead to a greater compliance burden for small businesses.[23] Thus, simplification of rules will still lead to a greater overall compliance burden in comparison with other business structures, such as traditional companies.[24]

Despite major changes to the LTC regime in 2017, there are still doubts as to whether the LTC regime is meeting a key objective of closely held company regimes. That is, the reduction of compliance costs for those that utilise the structure. This is especially relevant given the recent review of the Government Tax Working Group, whose scope extended to encompass closely held company taxation. Accordingly, this paper seeks to evaluate the LTC regime through interviews with tax practitioners, with a particular emphasis on compliance costs. Documentary analysis is also used to ascertain Parliament's purpose in enacting the LTC regime, and this is compared with responses from tax practitioners.

Section 2 of this paper briefly outlines the background to New Zealand's LTC regime. For the purposes of this paper tax practitioners are referred to as 'Tax Practitioner 1' through to 'Tax Practitioner 12'. Details of the research method are outlined in section 3. The research results are outlined in section 4. Discussion and analysis are contained in section 5, followed by concluding observations and limitations in section 6.

II BACKGROUND

A *Loss Attributing Qualifying Companies*

The origins of the LTC regime can be traced back to its predecessor, the LAQC regime, which itself is a subset of the qualifying company ('QC') regime. The QC regime was introduced at the recommendation of The Consultative Committee on the Reform of the Taxation of Income from Capital,[25] who were tasked with reviewing New Zealand's income tax system in the 1980s

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[22] Divya Sharma et al, 'Look-Through Companies: Stakeholder Perspectives' (2019) 25(4) *New Zealand Journal of Taxation Law and Policy* 365.

[23] Brett Freudenberg et al, 'Comparative Analysis of Tax Advisers' Perception of Small Business Tax Law Complexity: United States, Australia and New Zealand' (2012) 27(4) *Australian Tax Forum* 677.

[24] Office of Tax Simplification, *Lookthrough Taxation* (2016).

[25] Consultative Committee on the Reform of the Taxation of Income from Capital, *The Taxation of Distributions from Companies* (Government Printer, 1990) ('*Valabh Committee*').

and 1990s. One specific aim of the review was to simplify taxation for closely held companies. The QC regime was chosen over other models for the taxation of dividends (a dividend exemption system and a full integration system), as it was concluded that this regime reduced the role taxation played in the choice of business entity, achieved greater integration between company and individual taxation, whilst also minimising complexity,

The New Zealand Income Tax Amendment Act (No.2) 1992, brought this legislation into force. This new regime was open to companies with five or fewer shareholders, with shareholders being related by blood or marriage counting as one shareholder.[26] QCs were taxed on all dividends they received. Conversely, shareholders received either fully imputed dividends or exempt dividends. This means that when the company paid no tax on a profit (e.g. capital profits), those profits flowed through to the shareholder tax-free. Non-cash dividends were exempt.[27] Companies electing to become a QC were subject to qualifying company election tax ('QCET') on entry, which was a final tax on that part of the company's shareholder's funds that were not 'sheltered' by imputation credits. This was changed in 2007 so that payments were credited to the imputation credit account, effectively changing QCET into a withholding tax.[28]

A subset of the QC regime, the LAQC regime, was initially rejected by the Valabh Committee due to fears that different classes of shares would make attributions complicated and impractical.[29] However, a raft of submissions from interest groups forced policymakers to reconsider, and the LAQC regime was permitted provided that there was only one class of shares available.[30] This new structure meant shareholders could elect to access the company's losses if the class of shares requirement was met, and if losses were distributed in proportion to shareholding. The Consultative Committee on the Reform of the Taxation of Income from Capital stated that this change was because the pass through of losses would help achieve one of its objectives: closer integration between taxation of the company and its shareholders.[31]

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[26] Inland Revenue Department, *Tax Information Bulletin Vol 3, No 2* (1991).

[27] *Income Tax Amendment Act (No 2) 1992* (NZ).

[28] Inland Revenue Department, *Remedial amendments: Qualifying Company Election Tax* (2008).

[29] Valabh Committee (n 25).

[30] Bill Hale and Darren Johnson, 'Look-Through Companies: A Diamond in the Rough' (Conference Paper, NZICA Tax Conference, 2011).

[31] Valabh Committee (n 25).

Whilst there was a provision in the legislation aimed at limiting the amount of tax losses shareholders could access, this was largely considered ineffective.[32]

Both the QC and LAQC regimes were subject to few legislative amendments during their existence;[33] however, the LAQC regime was a common component in many tax avoidance arrangements.[34] Examples include *Case Z20*,[35] where the Taxation Review Authority ('TRA') ruled that a taxpayer who bought a home in a LAQC and claimed normal renting expenses, thus resulting in a personal tax loss, was a tax avoidance arrangement.[36] A further example can be found in *Ben Nevis Forestry Ventures Limited and Ors v the Commissioner of Inland Revenue*,[37] where taxpayers utilised the LAQC regime to invest in a forestry scheme. This forestry scheme was deemed by the Supreme Court to be a tax avoidance arrangement, in part due to the excessive losses deducted by shareholders.

These excessive tax deductions resulting from an ineffective loss limitation rule, as well as the differences in tax rates leading to arbitrage opportunities, was the main rationale cited for the repeal of the QC and LAQC regimes.[38] Remission income inconsistency, such as when taxpayers could be allocated losses but not income, was also cited as further rationale. The final rationale cited for the repeal of these regimes was the interaction with the limited partnership ('LP') regime. It has been contended that LAQC regime could have been used to structure around loss limitation rules in the LP regime, as LAQCs could be general partners in a LP.[39] An interesting point is that while the Victoria University of Wellington Tax Working Group identified issues with rental property taxation, the repeal of the LAQC regime was not considered as an option for fixing these issues. Instead, the TWG recommended a risk-free return method ('RFRM') of taxing rental property, which was not adopted by the

32 Casey Plunket and Nick Wells, *Limited partnerships* (2008).

33 Hale and Johnson (n 30).

34 Inland Revenue Department, *Revenue Alert RA 07/01* (2008).

35 *Case Z20* [2009] 24 NZTC 14,271.

36 Aaron Quintal and Kirsty MacLaren 'LAQC Structure Ruled Tax Avoidance' (2010) 89(1) *Chartered Accountants Journal* 39.

37 *Ben Nevis Forestry Ventures Limited and Ors v the Commissioner of Inland Revenue* [2008] 24 NZTC 23,188.

38 Inland Revenue Department, *Qualifying Companies: Implementation of Flow-Through Tax Treatment* (2010).

39 Inland Revenue Department, *General and Limited Partnerships – Proposed Tax Changes* (2006).

Government.[40] The most recent Government Tax Working Group will be discussed further in section 5.

B *The Look-Through Company Regime*

1 *Introduction*

The LTC regime, contained in subpart HB of the Income Tax Act 2007, was introduced into Parliament via Supplementary Order Paper 187. It was subsequently enacted on 20 December 2010, as part of the Taxation (GST and Remedial Matters) Act 2010. Submissions from interest groups were not requested, due to the regime being controversially introduced by a Supplementary Order Paper.[41] This meant that key tax policy processes (such as the Generic Tax Policy Process which necessitates public scrutiny) were omitted.[42] However, submissions from interest groups were requested for the later amendments, and the majority of submissions pointed to both the truncated policy development process and legislative complexity of the regime.[43] Table 1 outlines a timeline of the LAQC/QC tax reform process.

TABLE 1 – TIMELINE OF LAQC/QC REFORMS

DATE	**REFORM**
January 2010	TWG Report highlights issue with negative fiscal return from property sector.
7 April 2010	Regulatory Impact Statement on policy options for a tax reform package prepared by Treasury and Inland Revenue.
12 April 2010	Cabinet agrees to replace QC / LAQC rules with flow-through treatment.
20 May 2010	Budget 2010: proposed changes (all QCs to become flow-through vehicles) announced; Budget Regulatory Impact Statement ('RIS') makes scant reference to proposals; brief fact sheet on LAQC / QC changes released.

[40] Victoria University of Wellington, Tax Working Group, *A Tax System for New Zealand's Future* (Final Report, 2010).

[41] For more information on the legislative process in New Zealand: see, Vial (n 12); Adrian Sawyer, 'Reviewing Tax Policy Development in New Zealand: Lessons from a Delicate Balancing of "Law and Politics"' (2013) 28(2) *Australian Tax Forum* 401.

[42] Vial (n 12); Sawyer (n 41).

[43] See, eg, KPMG, Submission to the Finance and Expenditure Committee, *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill 2012* (NZ) (24 February 2012); New Zealand Law Society, Submission to the Finance and Expenditure Committee, *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill 2012* (NZ) (8 February 2012).

24 May 2010	Release of Officials' Issues Paper "Qualifying companies: implementation of flow-through tax treatment".
5 August 2010	Taxation (GST and Remedial Matters Bill) introduced.
19 August 2010	First reading of Bill.
11 October 2010	Minister announces reform and confirms draft legislation to be released later that week and that Government will review dividend rules.
12 October 2010	Minister releases QC reforms Q and A.
15 October 2010	Draft legislation with new approach (the LTC; repeal of loss attribution for LAQCs and QCs grandfathered) circulated to narrow group but not to public.
29 October 2010	Revised tax policy work programme released, including for the first time, reference to reforms of the QC rules.
15 November 2010	Finance & Expenditure Committee reports back on Taxation (GST and Remedial Matters) Bill.
24 November 2010	Second reading of Bill.
November 2010	Circulation of revised draft of legislation for QCs transitioning to NZICA and parties who had commented on transitional issues.
7 December 2010	70-page Supplementary Order Paper released (and introduced 9 December 2010) between second and third readings of Taxation (GST and Remedial Matters) Bill.
9-10 December 2010	Parliamentary debate: Committee of the Whole House / Third reading of the Bill stage.
20 December 2010	Bill receives the Royal assent.
23 December 2010	Policy Advice Division of Inland Revenue ('PAD') issues special reports on LTC rules and QC changes.
1 April 2011	New LTC regime and amended QC rules commence.
14 September 2011	Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill introduced, which contains amendments to LTC rules.
27 September 2011	First reading of Bill.
6 June 2012	FEC reports back on Taxation (Remedial Matters) Bill.
2 August 2012	Second reading of Bill.
16 October 2012	Parliamentary debate: Committee of the Whole House
25 October 2012	Third reading of Bill.
2 November 2012	Bill receives the Royal assent.
8 September 2015	Release of Officials' Issues Paper "Closely held company taxation issues".
2 December 2015	Release of Regulatory Impact Statement "Review of closely held company taxation".

3 May 2016	Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill introduced.
15 June 2016	First reading of Bill.
24 November 2016	FEC reports back on Taxation (Closely Held Companies) Bill.
9 March 2017	Second reading of Bill.
14 March 2017	Parliamentary debate: Committee of the Whole House.
23 March 2017	Third reading of Bill.
30 March 2017	Bill receives the Royal assent.
1 April 2017	Amended LTC regime commences.

2 *The Resulting Regime*

The LTC regime applies for income years commencing on or after 1 April 2011.[44] A LTC is transparent for tax purposes, with income, expenses, gains, losses, tax credits and rebates passing through to the shareholders and being taxed at the shareholders' marginal tax rates.[45] Some tax matters are dealt with at the company level such as GST, PAYE and other withholding taxes and matters related to the amalgamated companies regime.[46] As income tax is not payable at the company level, imputation accounts are not required to be kept.[47]

A LTC must have only one class of shares. While the LTC must be a resident in New Zealand for tax purposes, there is no requirement that the shareholders be New Zealand tax residents. Notably, a LTC can only have five or fewer ‘look-through counted owners’, with relatives being counted as one owner. Look-through counted owners can only be natural persons, trustees or another LTC. A company that is not a LTC is not able to be a shareholder in a LTC.[48]

Further, in order for a company to meet the definition of ‘look-through company’, it must have no more than $10,000 of foreign-sourced income. This restriction applies only if more than 50 percent of the LTC’s ownership interests are held by foreign LTC holders.[49]

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[44] *Income Tax Act 2007* (NZ) sub-pt HB.

[45] Ibid s HB 1.

[46] Ibid.

[47] Ibid s OB 1.

[48] Ibid s YA 1.

[49] Ibid.

3 *Subsequent Changes and Amendments*

Considering the lack of public consultation and scrutiny, it is hardly surprising that there have been many legislative changes to the LTC regime since its inception. For example, the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill in 2011, introduced a raft of amendments, covering things such as QC amalgamations, tax elections, valuation and timing methods and the look-through counted owner test.[50] Major overhauls to the LTC regime were enacted with the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act. The main changes were the removal (in most instances) of the loss/deduction limitation rule (on the basis it gives rise to undesired complexity) and changes to entry criteria.[51] As well as these, there were a range of measures aimed at decreasing compliance costs for taxpayers that use LTCs. Most of these changes took effect from 1 April 2017.

III METHODOLOGY

This research utilises interviews with tax practitioners in conjunction with documentary analysis.[52] Tax practitioners have been used as a sample due the important role they play within the tax system. That is, tax practitioners provide a link between taxpayers and the revenue authority.[53] Because of this, the services provided by tax practitioners have a substantial impact on taxpayer's voluntary compliance. Additionally, tax practitioners have an impact on the minimisation of both compliance and administrative costs for taxpayers.[54] This is due to tax practitioners having a greater knowledge of tax laws and procedures than that of the average taxpayer.[55] Accordingly, tax practitioners are often regarded as "gatekeepers" to the tax system

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[50] The look-through counted owner test was narrowed in order to prevent trusts from being used to bypass the shareholding restrictions. Specifically, distributions of beneficiary income now need to be traced for the purposes of establishing the number of 'look-through counted owners'.

[51] *Income Tax Act 2007* (NZ) s HB 11. Previously, the loss limitation rule required each shareholder in the LTC to calculate their 'owner's basis'. Broadly, this reflects the economic contribution to the LTC by that respective shareholder. If the losses attributed to a shareholder exceeded their owner's basis, then a deduction was disallowed. From 1 April 2017, this rule only applies to LTCs in partnerships or joint ventures.

[52] See also John Scott, *A Matter of Record: Documentary Sources in Social Research* (Polity Press, 1990).

[53] Ranjana Gupta, 'Relational Impact of Tax Practitioners' Behavioural Interaction and Service Satisfaction: Evidence from New Zealand' (2015) 13(1) *eJournal of Tax Research* 76.

[54] Brian Erard, 'Taxation with Representation: An Analysis of The Role of Tax Practitioners in Tax Compliance' (1993) 52(2) *Journal of Public Economics* 162.

[55] Steven Kaplan et al, 'An Examination of Tax Reporting Recommendations of Professional Tax Preparers' (1988) 9(4) *Journal of Economic Psychology* 427.

for taxpayers.[56] To this end, the views of tax practitioners are invaluable in evaluating the LTC regime, especially from a compliance cost perspective.

A *Semi-Structured Interviews*

The primary research method utilised was semi-structured interviews, which were undertaken during 2017. This was considered to be the most appropriate method, as the research was concerned with practitioner's perspectives on the LTC regime. That is, interviews allow rich data to be gathered from people in various roles and situations.[57] Other methods of data gathering, such as questionnaires, would likely mean that rich data would not be gleaned from participants. An additional advantage of interviews is that follow-up questions could be asked, resulting in further insights being revealed to the researcher.

B *Interview Guide Development*

An interview guide was also used to ensure any topics or areas were not overlooked. The interview guide was flexible, and whilst there were set sections, the order of questions was fluid. This paper draws on four sections from the interview guide: 'Use of the LTC regime', 'Advantages of the LTC regime', 'Disadvantages of the LTC regime' and 'Complexity of the LTC regime'. As well as this, the interview guide evolved as interviews occurred. That is, it was tweaked and updated as interviews progressed. Additionally, the interview guide was piloted with the author's previous employer who is a tax practitioner, with the pilot responses providing further avenues for exploration and consideration.

C *Sample Selection*

This research utilised a broad definition of tax practitioners, where tax practitioners were deemed to be tax preparers, tax accountants, tax lawyers and tax agents, provided that they held membership of a professional body (such as Certified Practicing Accountants ('CPA'),

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[56] Peggy Hite and Gary McGill, 'An Examination of Taxpayer Preference for Aggressive Tax Advice' (1992) 45(4) *National Tax Journal* 389; Kaye Newberry, Philip Reckers and Robert Wyndelts, 'An Examination of Tax Practitioner Decisions: The Role of Preparer Sanctions and Framing Effects Associated with Client Condition' (1993) 14(2) *Journal of Economic Psychology* 439; Lin Mei Tan, 'Taxpayers' Preference for Type of Advice from Tax Practitioner: A Preliminary Examination' (1999) 20(4) *Journal of Economic Psychology* 431.

[57] Michael Myers, *Qualitative Research in Business & Management* (Sage, 2009).

Chartered Accountants Australia and New Zealand ('CAANZ'), and the New Zealand Law Society).

Tax practitioners were recruited with the assistance of Peter Vial, who was, at the time, the New Zealand Tax Leader of CAANZ. Peter Vial identified a number of potential interviewees and an individual email was sent to each with information on the research and a consent form. Human Ethics approval was gained from the University of Canterbury.[58] Responses were received from 4 practitioners, whom all agreed to participate in the research. Accordingly, the researcher sought to identify and recruit further participants. This was done predominately through a search on Google using key words to identify tax practitioners that had relevant experience. This resulted in nine more tax practitioners agreeing to participate in the research, with each of these participants receiving the same email as the other 4 practitioners.

Accordingly, the sample of tax practitioners was composed of 4 practitioners recruited through 'snowball' sampling. That is, participants were recruited using one contact.[59] Snowball sampling is advantageous in that it is a low-cost solution allowing participants to be found easily and quickly, especially from a specific population.[60] However, snowball sampling can lead to various types of sampling bias and can make generalisation difficult.[61] These limitations were overcome by the use of purposive sampling to recruit the other 9 participants.

A total of 12 tax practitioners were interviewed in their professional capacity. Three practitioners were located in Wellington, two were located in each of Auckland, Christchurch and Dunedin, and one was located each in Tauranga, Napier and Blenheim. Of these practitioners, nine were partners/directors and one was a tax manager. Two interviewees were members of the independent bar.[62] Additionally, one tax practitioner provided email responses to the interview guide, providing a total of 13 usable responses. The firms employing these

[58] The author wishes to note that data was collected as part of a Master of Commerce thesis that explored look-through companies from a tax practitioner's perspective.

[59] Alistair Geddes, Charlie Parker and Sam Scott, 'When the Snowball Fails to Roll and the Use of 'Horizontal' Networking in Qualitative Social Research' (2018) 21(3) *International Journal of Social Research Methodology* 347.

[60] Ibid.

[61] Ibid.

[62] This bar comprises lawyers who practise as 'barristers sole'. Barristers sole are not permitted to practise in partnerships, but may employ other barristers. Applicants must have had at least three years' legal experience in New Zealand during the preceding five years before applying for the independent bar.

practitioners were a mix of Big 4 firms, mid-tier firms, specialist tax consultancy practices, tax barristers and small accounting firms. This provided a number of different perspectives. After thirteen responses, saturation of information occurred; no new information or themes were observed from the final interviews.

D *Data Collection Procedures*

As stated above, a consent form was issued to all participants and returned prior to each interview commencing. Interviewees were given a chance to ask any questions prior to the interview. Additionally, interviewees were free to withdraw from the research at any time. Prior to the interviews, interviewees were asked if they consented to being recorded with an audio-recording device. Each of the interviews was transcribed by the author within approximately a week of completing that particular interview. Alongside audio recordings, brief notes were taken by the author during the interviews.

The majority of the semi-structured interviews were conducted over the phone. One interview was conducted face-to-face at the practitioner's office. Interviews were conducted with 12 tax practitioners, with each being 30 to 90 minutes in length. One email response was received, resulting in 13 usable responses. Whilst phone interviews have disadvantages (for example, the researcher cannot gauge body language), this was the most practical method given that the interviewees were located in various parts of New Zealand.

E *Data Analysis*

Once the interviews were transcribed, the author analysed them with a view to identifying trends and themes. Specifically, thematic analysis was undertaken with the assistance of NVivo, a qualitative data analysis software package. NVivo allows the researcher to highlight common themes and trends in interview responses. Conflicting viewpoints were also noted.

F *Documentary Analysis*

This research also utilised documentary analysis to establish the rationale behind legislative changes and the implementation of the LTC regime. Accordingly, the vast majority of documents analysed were public documents such as Acts of Parliament and officials' reports. Documents were assessed using the four criteria suggested by Scott:[63] authenticity, credibility,

[63] Scott (n 52).

representativeness and meaning. Whilst public documents are authentic and have meaning (they are clear and comprehensible to the researcher), the other two criteria may require greater thought.[64] In regard to representativeness, this is not as important in qualitative research as no case can be representative in a statistical sense.[65] In terms of credibility, public documents have the potential to be biased, as they are prepared by institutions for specific purposes. This bias can reveal interesting insights, but the researcher must also be cautious as these documents may not be true depictions of reality. By combining documentary analysis with interviews, triangulation helped the researcher gain greater insights.

IV RESEARCH FINDINGS

This chapter introduces the findings from the interviews with tax practitioners. The findings will be compared amongst interviewees, with a view to revealing common themes and views. This will provide a basis for Chapter 5, which will set out the discussion and analysis of the findings outlined in this chapter.

A *Use of LTCs*

1 *Typical Uses*

As a starting point, the researcher sought to determine typical scenarios where the LTC regime might be utilised. Answers varied between tax practitioners; there did not appear to be a consensus on what a typical use might be. An example that highlighted this was using LTCs as a holding vehicle for rental property. Some practitioners felt that the LTC regime was useful in this context:[66]

> The classic use is to hold rental properties, particularly residential rental properties, and many people transitioned into that regime from the old LAQC. (Practitioner J)

> And probably residential rental type properties. Obviously for residential rental properties they often run at a tax loss, that means that the losses are attributed up to the individuals and they get to offset it against their salary and get a bit of a tax break there. (Practitioner A)

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64 Alan Bryman and Emma Bell, *Business Research Methods* (University Press, 2015).

65 Ibid.

66 Rental property losses are now ring-fenced. That is, they generally cannot be offset against income from other sources.

However, a number of practitioners were of the view that LTCs were not ideal as a vehicle for holding rental property. The reason for this was that other structures were often easier or provided more tax advantages:

> We did have rental properties [that we] started putting them into LTC's but because of some of the problems of the LTCs we've actually backed away and just find now if you've really got rentals it's just as easy to leave it in your own name or as a partnership. We're backing those out. (Practitioner I)

> I really do question – people will go off and buy rental properties, do they have to be in an LTC? Well, no. There's different ways you can structure your rental property investments. Not using look-through companies. You don't need a look-through company for rental properties. You can get the same [treatment] if you have it in your own name, and then don't have the complexity with a company. (Practitioner D)

Practitioner A noted that rental properties often did not make losses since the removal of depreciation on buildings in 2010,[67] and as such, did not have a need for such a structure:

> And the only thing tax change, in recent times that has impacted on the residential rental property…was removing depreciation on buildings. (Practitioner A)

Some practitioners were of the view that the LTC regime was best used for businesses anticipating losses (other than companies with rental properties), such as those in the start-up phase or vineyards:

> So it's really rental properties or companies with an expectation of loss certainly in the early three or four years, or first three or four years that we see. The LTC structures that we know it's driven by loss. And, you know, it's an interesting discussion that isn't it? Because outside the rental properties there's not very many businesses you expect to run at a loss, but sometimes it's that thing or that initial period of "we're going to run at a loss." (Practitioner K)

> Up here in Marlborough it's mostly vineyards. They're perfectly suited for that, where you're going to have losses for properties five to seven years minimum while you're setting the thing

[67] As part of the New Zealand Government's COVID-19 relief measures, depreciation has now been reintroduced for commercial buildings.

up and then down the track hopefully you'll make some money. For us it's mostly vineyards. (Practitioner I)

In addition to companies anticipating losses, practitioners perceived the typical use of the LTC regime to be for small and/or family-owned businesses:

> Obviously with the limitation on number of shareholdings, it is usually smaller, family-owned, well not necessarily family-owned but can be family-owned, or businesses that are one to two or three non-associated individual partners. (Practitioner B)

> From a design perspective, it was originally aimed at small businesses, so your electricians, your plumbers, your builders, and that sort of thing. (Practitioner A)

Another notable use of the LTC regime is for international tax planning and structuring.[68] Practitioner L outlined a specific situation where LTCs were useful in an international context:

> I've got one LTC where the guy does contracting work in Ireland. We're using an LTC just because of the limited liability it gives us. We're looking at individual ownership, which eliminates double taxation versus a corporate, which would impose double taxation, so certainly the LTC sits nicely in the middle and gives us the best of both worlds depending on how it's looked at in a foreign jurisdiction. (Practitioner L)

Other practitioners, including Practitioner F and Practitioner G, also shared the view that the LTC regime was useful in an international context:

> We've seen a few foreign things in the context with foreign trusts as well. Where they're operating using New Zealand as a tax haven for foreign investments effectively. Sometimes a look-through company could've been used in that context. (Practitioner F)

> And then on the other extreme, I have clients who have businesses in foreign jurisdictions and they have used look-through companies for that. (Practitioner G)

1 *Reasons for Use*

Because various practitioners viewed the LTC regime as being used for different purposes and situations, the reasons for use also vary. However, the most common reason for using the LTC

[68] At the time of these interviews, there was no cap on the foreign sourced income a LTC could receive.

regime was stated by practitioners to be the fiscal transparency that the structure provides. That is, the requirement that losses and profits flow through to the shareholders of LTCs:

> There are a few reasons. The first, the most obvious one, is if they want to hold an investment or a business in a company structure, but they're anticipating losses in a reasonably regular fashion, just from the nature of it, or tax losses at least, not necessarily economic losses, but tax losses being the benefit is that the losses flow through to the shareholders. (Practitioner B)

Of note is that some practitioners viewed the fiscal transparency of LTCs as being a disadvantage, which is discussed further on. Alongside fiscal transparency, some practitioners viewed limited liability as being important. Practitioners I and M were of this view:

> If you're running a vineyard there are risks involved. So they want limited liability but obviously if you're looking at generally seven years of losses in the vineyards before you start making any money. You want to be able to, well you have to access that loss usually to fund the thing. That's the biggest reason for using an LTC. (Practitioner I)

> But at the same time, clearly if you can get access to losses that's an efficient way of using a corporate structure but still getting the tax effect of a partnership, or even sometimes I guess the advantages are that you still get your look-through treatment so it is still actually treating you as a partnership from a tax perspective but a corporate from a commercial perspective. (Practitioner M)

Practitioner D provided a different view, as they considered limited liability to often be the sole reason for the use of the LTC regime:

> So, I have seen an orthopaedic surgeon with a look-through company because that means that they're just effectively doing what they do as if they were self-employed but with limited liability. And there are no tax savings in that; it is absolutely a commercial claim. (Practitioner D)

Conversely, some practitioners did not view limited liability as being important in deciding whether to use the LTC regime:

> The biggest liability for a property owner is the bank or the liability of the bank that's personal anyway through the personal guarantees that they give to the bank. So asset protection in my view, I don't think people would see an LTC as offering any major asset protection. (Practitioner C)

> The point I was making about limited liability is that when it comes to a small business, very often suppliers, and particularly banks, want personal guarantees from shareholders. Limited liability is a little bit more of a perceived notion than a real opportunity if you like. (Practitioner H)

Practitioners indicated that in an international context, the LTCs regime is used to help minimise double taxation. This is mainly due to the attributes of fiscal transparency and limited liability mentioned previously:

> If they're operating in foreign jurisdiction they're able to eliminate double taxation if they use a vehicle like an LTC, which benefits because in the overseas jurisdiction the LTC is simply seen as a corporate, so tax liabilities, generally speaking, are taxed at a fixed rate, at a corporate rate in that jurisdiction and then, when it comes to New Zealand, they get their share of income and expenses plus their share of the foreign tax credit, which is beneficial. (Practitioner G)

> If I'm a New Zealand resident individual and I'm investing in Australia, for example, and there's no corporate formed there yet, then having an LTC could make quite a lot of sense. If you had a company there, you'd pay tax on income in Australia. If you had a company there, you would lose the tax credit when it came through and you were distributing out to the shareholder, whereas if you've got an LTC, that doesn't happen. (Practitioner F)

Practitioners also mentioned that one of the reasons that the LTC regime was used was because the rules surrounding the regime allowed tax-free distributions to shareholders[69] and the ability to minimise tax on historic retained earnings:[70]

> The other possibility, the other one that we've used it a bit more for is as a means of ensuring that distributions are tax-free, without having to go through liquidation. If I had a farm and I sold a block, for example, then in order to get that money out, and it was a capital gain, in order to get that money out tax-free I'd have to liquidate the company. (Practitioner F)

> Yeah, so if I had a company and I've had several circumstances, one in particular where they had, believe it or not, 30 million dollars-worth of retained earnings. So roughly 45 million dollars-worth of profit built up over time, with 15 million dollars-worth of imputation credits. So, if they paid a dividend out of that company, they would have had gross income, gross dividends of 45 million and 5% withholding tax on that, so about 2.2 million of withholding

[69] This arises as shareholders are treated as holding the LTC's property in proportion to their effective look-through interests.

[70] *Income Tax Act 2007* (NZ) s CB32C.

> tax. Under the LTC rules, if you enter the LTC regime and you've got fully imputed retained earnings there was no cost to enter. You were able to escape 5% withholding tax. (Practitioner A)

One final reason for their use mentioned by practitioners was that many taxpayers viewed the LTC regime as a default replacement for the LAQC/QC regime, and as such, chose to transition into the regime:

> Look with the smaller clients because, generally speaking, most of them were within the qualifying company regime and, when the LTC came through it just seemed sensible for them to roll over. For those sort of clients, I think little thought was put into whether they should or not. (Practitioner G)

> I think a lot became LTC's by default and as in, people transferred from what was the LAQC regime to LTC's so I think there were a lot of LTC's who perhaps ought not to have been. (Practitioner M)

2 *Recommendation of Use and Taxpayer Knowledge*

Tax practitioners stated that in almost all circumstances, it was they who recommended clients use the LTC regime. Practitioner J provided an example of this view:

> Mostly we're the ones who are driving it in terms of a choice of structures. If somebody is setting up an entity in the first instance, alternatively, and we've got a few of these on the books at the moment, where people are looking to restructure their businesses to be able to get assets out or to try and get gains out and so forth. It often turns out that the best answer in terms of the viable options is to convert an ordinary company into an LTC effective from the beginning of the next tax year, and do these things at the least possible tax cost. That is often us who is driving it. (Practitioner J)

It was only in a small portion of instances clients requested to utilise a LTC, or showed interest in forming one:

> You know, they've been talking to people at the pub who say they've got a rental property and a look-through company, why haven't you? But there tends to be a relatively uninformed view, so it would tend to be our recommendation or our advice, which either puts them in or doesn't put them in. (Practitioner L)

> I have had a client who comes in and says, "I would like to explore an LTC." So, they've got the idea from somewhere and they just want to make sure that it works. That's another way that they might raise it. (Practitioner F)

However, practitioners were of the view that clients generally had very low levels of knowledge on LTCs, regardless of whether clients utilised them or not. Practitioner H responded with this when asked if clients had good levels of knowledge on the LTC regime:

> No. Not at all. If you happen to operate via an LTC you need an accountant. And you probably need a tax accountant. (Practitioner H)

In fact, practitioners stated that many clients know more about the LAQC/QC regime than the LTC regime, even though the LAQC/QC regime has been repealed for over five years at the time of research:

> I've been in so many meetings where I have mentioned an LTC, blank look, I can then refer to an LAQC, which has been gone for what, five or six years, and people still know it. (Practitioner K)

> A lot of people are still getting their heads round LAQCs, but things have moved on from that five years ago, six years ago. (Practitioner C)

3 *Popularity*

Practitioners also held mixed views on the popularity of the LTC regime. Practitioner D stated that LTCs were not popular in their practice:

> Now you can probably count on one hand the number of LTC clients we've had in our office. If I said we had 600 corporate clients, less than one percent of them are in the LTC rules. (Practitioner D)

Practitioner L and M shared this view:

> We tend to use them in limited circumstances. So, we've got 1000 tax returns, and best guess, we do 33 LTC returns. (Practitioner L)

> I don't know that the LTC regime was popularly used by our firm at all. So, I don't know if its necessarily now considered to be the most popular of structures, its used, [but] there's better options I guess (Practitioner M)

Conversely, some practitioners believed that the LTC regime was popular. Practitioner A was of the view that most LAQCs chose to transition to into the LTC regime:

> So, most taxpayers, I would hazard a guess, 95% of LAQCs would've transitioned to look-through companies. (Practitioner A)

However, practitioners were generally of the view that the LTC regime was not as popular as the LAQC regime:

> I don't think they're as popular, certainly not in my understanding popular as maybe LAQCs were. (Practitioner C)

> They're not as popular as the LAQC regime. We've got just over 100 LTCs but still got 250 QCs left. We would have had about 500 LAQCs in the hey-day. Some exited when they changed the rules. Some went the QC, some went the LTC. (Practitioner I)

B *Advantages of LTCs*

1 *Overview of Advantages*

The advantages of the LTC regime overlap with the reasons that practitioners use the structure. These were discussed in the previous section, and included fiscal transparency, limited liability, minimising double taxation in an international context, distributing tax-free capital gains and minimising tax on historic retained earnings. Alongside these advantages, practitioners also indicated other advantages of the LTC regime, such as simplicity and the ability to use a LTC to maximise interest deductibility.

2 *Simplicity*

Another advantage posited by some practitioners was simplicity of administration. Practitioner J and K were of the opinion that a LTC is simpler than a traditional company in some aspects:

> There's probably a bit of an ease of administration that you don't have to muck around with imputation credits and RWT when making distributions. (Practitioner J)

> It does simplify some of those things otherwise you see around FBT or overdrawn current accounts. (Practitioner K)

3 *Separation and Interest Deductibility*

Practitioners were of the view that an advantage of the LTC regime was the ability to use them to restructure affairs. A LTC can allow separation between taxpayers private and business matters, and can thus maximise interest deductibility.

> But I suppose the other major advantage is that we have a lot of clients when they want to restructure their affairs, let's say they have a rental property in their personal name that is not very highly geared, and they want to buy a new family home, and it's going to involve more borrowing, so what we typically do, and you're probably aware of this, is you might establish a look-through company, transfer the rental property to the LTC, and make that 100% geared and then use the equity that you have in the rental property to put into your private residence. And say you're essentially making some of that debt, which would have otherwise been private non-deductible; you're turning it into tax-deductible debt. (Practitioner A)

> For example, in terms of our deductibility of interest where people restructure their private home and their rental property maximises interest deductions into an LTC structure and whether that works. (Practitioner J)

C *Disadvantages of LTCs*

1 *Overview of Disadvantages*

As well as advantages of the LTC regime, practitioners were also of the view that there were a number of disadvantages of the LTC regime. These included the loss/deduction limitation rule, the requirements regarding who can be owners, the inability to quarantine profits or losses in the company, shareholder changes, transparency of LTCs and poorly/ambiguously drafted legislation. Each will be discussed in more detail below.

2 *Loss/Deduction Limitation Rule*

The most common disadvantage mentioned by practitioners was the loss/deduction limitation rule, and the associated owners' basis test. Almost all the practitioners had a negative view of the rule:

> The drawback of the regime, if you're speaking about today, loss limitation rule or deduction limitation rule would be the most significant drawback and the biggest impediment to entry into the regime. (Practitioner L)

> The loss limitation rule. Which is essentially, you're only supposed to get losses to the extent of your equity in the investment. Your owners' basis. And that's been a complete balls up from day one. (Practitioner A)

However, Practitioner B did not view the loss/deduction limitation rule as being a disadvantage of the regime:

> A lot of people tried to predict that there would be a lot of disaster and a lot of doom and gloom with that loss limitation rule in practice, but I never saw that. I never envisioned it would actually be a big problem from that. I never saw it in practice. (Practitioner B)

3 *LTC Eligibility Requirements*

Practitioners also mentioned the LTC eligibility requirements as a disadvantage of the structure. Practitioner D thought that the restriction on five-counted owners was a disadvantage:

> Effectively, because there was Mum, Dad, and the family trust and the other Mum, the other Dad, the other family trust, or whatever and something was going on with the particular fact pattern. They couldn't bring in a new shareholder because they're going to lose their look-through company status. (Practitioner D)

Practitioner I was also of this view:

> Yeah, which is not ideal and really what is the point having five because you can structure around it. But you're just incurring more accounting and legal costs. They'd be the only real bug-bear I'd see left there actually to be honest. (Practitioner I)

Practitioner M also thought this was a disadvantage, along with the requirement that LTC owners are New Zealand tax residents:

> Because of course there's a limitation on the number of people that limits the kind of industry and those businesses that can use the regime in any event. Because of the New Zealand registered requirements, or the New Zealand tax resident requirement, that also limits the scope of it. (Practitioner M)

4 *Unable to Quarantine Profits or Losses*

Due to LTCs being fiscally transparent, profits and losses cannot be quarantined in the company. Instead, they must flow out to shareholders in proportion to their owners' basis.

Some practitioners viewed this as a disadvantage of the LTC regime. Practitioner H thought this was a disadvantage as shareholders were potentially subject to a tax liability:

> Oh absolutely. I mean because they're taxed as partnerships, you've then got personal tax liabilities in the shareholder name. For example, if it was an ordinary garden variety company that had a tax liability and it couldn't pay that tax, then in most circumstances, Inland Revenue couldn't seek redress from the shareholder. Whereas with an LTC, the liability for tax rests with the shareholder individually. (Practitioner H)

Other practitioners viewed the inability to quarantine profits and losses as a disadvantage because of the differences in the top marginal tax rate (33%) and the company tax rate (28%):

> Well, it's not possible to accumulate income at the corporate tax rate, flow-through aspects of it, so if the shareholders are fairly well heeled, then they're essentially paying tax at their top marginal tax rate rather than be able to accumulate income at a lower tax rate. That's often perceived to be the main disadvantage. (Practitioner J)

> Now that'll be 33% to individuals and trusts or you can accumulate your retained earnings within the company and you'll pay taxes at 28% corporate rate if it's not a look-through company and that 5% can get reinvested in the business. (Practitioner D)

5 *Shareholder Changes*

Some practitioners also mentioned shareholder changes as being a disadvantage of the LTC regime. Shareholder changes can trigger a deemed sale and repurchase of the LTC's assets at market value, which often has negative tax implications:

> There's also the issue with when the shareholder exits, as you'll know you've got a deemed sale of underlying assets. Generally, the $50,000 exemption, and the $200,000 dollar fixed assets threshold gets most people out but not all. So that can be a problem. (Practitioner I)

> Of course, with an LTC you've got the deemed sale of all the underlying assets and you've got these issues around dividends that are paid out of retained earnings earned while the company is an LTC but distributed after it ceases to be an LTC, they can still be exempt, you know. (Practitioner A)

Practitioner D was of the view that shareholder changes required LTCs to keep multiple sets of accounts, to reflect that each shareholder has a different cost basis. This resulted in increased complexity:

> And if you do have a deemed disposal, you know if you're outside of that, eight thousand de minimis, you end up in a situation where ... you effectively keep two sets of books? You know the company's accounts because the Companies Act says it has to, and then you'll have Shareholder A, who was an original one at the time that it went in. So, Shareholder A could piggyback off the company accounts. But if you came into the office today and bought out Shareholder B and you'd get all the plant based on today's market value et cetera. And the IRD forms don't even lend themselves to that because the IR7s think, "Oh you're 50/50 shareholders in the LTC that means you get half." No, because the cost of my half might be different than the cost of Shareholder A's half. (Practitioner D)

6 *Transparency*

Some practitioners were of the view that the transparency of the LTC regime itself was a disadvantage. This transparency often created confusion, as practitioners were unsure how far this transparency extended. Practitioner D used an example of working owners to highlight this view:

> Now there's some funny stuff goes on and they've got some particular provision in the rule that gives a deduction for payments to working owners. The IRD was saying that four shareholders, four cars, you just claim private business use on each vehicle cause that's transparent. It's as if you're self-employed now. And that's a fallacy. You are not self-employed. You're not self-employed. You are deemed to do the things that a look-through company does in the proportions of your own share. (Practitioner D)

Practitioner J referred to 'one-way' transparency, where the tax treatment differed and was not consistent across different circumstances:

> Yeah, well just how that works in terms of the IRD's almost invented this notion that, "Yeah. Okay. You're deemed to hold these assets in your name but we're going to treat that as being held in a different capacity, as if you're the shareholder of the LTC as opposed to your personal capacity," which almost seems like dancing on the head of a pin. I can understand why they have to do that, otherwise there'll be some funny tax results going around, but that lacks a little bit of clarity there, particularly when you're trying to explain that to people. (Practitioner J)

7 *Poorly Drafted and Ambiguous Legislation*

A final disadvantage raised by practitioners was the belief that legislation associated with the LTC regime is poorly drafted and ambiguous. Practitioner F was of the view that the legislation created uncertainty:

> Yeah, so I think that's the main drawback of it. There's quite a bit of uncertainty. It goes to things, for example, about contributing property into the LTC. What is the consequence of that? If I have two people who have put property into an LTC or into a partnership, are they deemed to have realised 100% or 50%, 50/50% partners. And then what's the depreciation base? These are pretty elementary, really elementary questions for which there should be absolute certainty, but there is not. (Practitioner F)

Practitioners D and G shared this view:

> Now, part of the reason for that is that the rules are so badly, and I say that with capital letters, badly written and so there are some parts of the rules that you just roll your eyes and think that's stupid. (Practitioner D)

> Yes, I would. Maybe 'poor' is the wrong word, but unnecessarily complex is probably appropriate because things like working out owner's bases, I think if you talked to anyone, any practitioner who's actually invested the time in doing it, I mean it's, you'd think it was rocket science you know. (Practitioner G)

D *Complexity of LTCs*

When practitioners were asked if the LTC regime was complex, the majority of practitioners were of the view that they were:

> That I think is a drawback in the sense in that the fundamentals of the regime are not easy. (Practitioner F)

> They are probably more complex than any other structure. Certainly of other company QCs, partnerships, I'd rank the LTCs the most complicated. (Practitioner I)

> And I guess the other part of the LTC regime is it's complex to apply. I don't use them at all because I think they're too bloody complicated. (Practitioner H)

However, Practitioner B did not believe the LTC regime was normally complex:

> Not really in most cases. If you're trying to ... if you're on the, I wouldn't say the edge, but if you're in an area that it isn't necessarily done all the time in terms of look-through counted owners or a partnership of LTCs than it can be somewhat complex, but most of the time it's not particularly complex.

Practitioners who thought the LTC regime was complex gave differing reasons in support of their view. The most common reasons given were the loss/deduction limitation rule and the quality of the legislation. For example, Practitioner F was of the view that ambiguous and poor legislation resulted in the regime being complex:

> Essentially because they've been lazy in the craftsmanship of the legislation, and haven't provided for the results, but have tried to do it by way of a set of general principles but without great clarity around how each of them interact and which ones prevail when. (Practitioner F)

Conversely, Practitioner A was of the view that complexity resulted from the loss/deduction limitation rule and the need to calculate owners' basis:

> A lot of accountants are now steering away from LTCs because the compliance, particularly the owners' basis crap is too onerous and costs the taxpayer too much. (Practitioner A)

V ANALYSIS AND RECOMMENDATIONS

A *General Analysis*

1 *Use of LTCs*

The intended target market of the LTC regime is small family businesses. Whilst some practitioners indicated that small family businesses used the LTC regime, there were also a number of uses stated by practitioners that did not seem to be contemplated by Parliament and Inland Revenue. These other uses included rental properties, companies anticipating losses and international tax structuring and planning. As mentioned above, another reason mentioned by the Valabh Committee in recommending the QC/LAQC regime was to reduce taxation's role in the choice of which business entity to use.[71] However, uses such as rental properties, companies anticipating losses, and international tax structuring and planning, utilise the LTC regime solely for its taxation characteristics.

[71] Valabh Committee (n 25).

Practitioners also indicated that it was they who recommended clients use the LTC regime, and that clients had very low levels of understanding surrounding the LTCs regime. Due to its target market of small family businesses, it would be reasonable to expect that these clients would have some sort of knowledge of a regime specifically targeted towards them. Practitioners indicated that clients instead had higher knowledge levels in regard to the LAQC regime, even though this had been repealed for over six years at the time of the research. This is likely to be due to the level of media coverage surrounding the use of the LAQCs up until their eventual repeal.

Whilst Parliament and Inland Revenue have provided a specific structure for this target market, they have not promoted and educated this target market. In hindsight, this may have resulted in a higher uptake of the LTC regime.[72]

Practitioners also provided various reasons for why the LTC regime is used. The most common reason given for using the structure was the fiscal transparency that the structure provides. There was no consensus from practitioners on whether limited liability was important in deciding whether to use or recommend the LTC regime. Notably, only limited partnerships offer limited liability and tax flow-through treatment, alongside the LTC regime.[73] Practitioners gave other reasons for using the LTC regime, but these were not consistent across the majority of practitioners. These included minimising double taxation, tax-free distributions to shareholders, and minimising tax on historic retained earnings.

2 *Advantages of LTCs*

In addition to the advantages discussed above, practitioners also stated that the LTC regime had other benefits. These included simplicity, separation and interest deductibility. The perceived advantage of simplicity aligns with the policy rationale for the LTC regime. Because the LTC regime is aimed at small family businesses by nature, it should be simple and easy to apply. This is because small family businesses are resource constrained, especially when compared to large businesses. However, very few practitioners were of the view that the LTC

[72] At the time when the LAQC regime was repealed, there were over 130,000 LAQCs in existence. In comparison, the Government Tax Working Group stated that there were approximately 48,000 LTCs in existence at the time of their review. See, eg, Tax Working Group, *Background Paper for Sessions 6 and 7* (March 2018) <https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-appendix-1--types-of-business-entities-in-new-zealand-and-how-they-are-taxed.pdf>.

regime is simple, mainly due to the loss/deduction limitation rule and the associated owners' basis test. In regard to separation and interest deductibility, these do not appear to have been contemplated by Parliament. However, it is important to note that these benefits can be achieved using other structures.

3 *Disadvantages of LTCs*

Practitioners were of the view that there were a number of disadvantages of the LTC regime. The most commonly mentioned disadvantage was the loss/deduction limitation rule and the (now repealed) associated owners' basis test. This resulted in unnecessary complexity, and thus compliance costs. The next most common disadvantage mentioned by practitioners was the LTC eligibility requirements. To ensure that closely held companies are used by their intended audiences, there is a limit on the number and the types of shareholders. Whilst this was perceived to be a disadvantage by many practitioners, this is arguably a prerequisite for a closely held company regime. Further advantages include the complexities associated with shareholder changes, as well as issues surrounding transparency; it is unclear as to exactly how transparent LTCs are and in what circumstances they are or not to be 'looked-through'.

4 *Complexity of LTCs*

When the QC/LAQC regime was implemented, one of the stated intentions was to simplify taxation for small, closely held companies by treating them the same, regardless of their legal structure.[74] Ultimately, this would result in lower compliance costs. Due to LTC regime being the successor to the QC/LAQC regime that simplification of taxation is also a policy intention for the LTC regime.[75] However, the majority of practitioners were of the view that the LTC regime is complex, especially when compared to structures such as sole traders, partnerships and traditional companies. Practitioners believed that LTCs were complex for two main reasons, one being the loss/deduction limitation rule. This has now been repealed for all LTCs except for those in partnership or joint venture.

The other reason practitioners believe the LTC regime is complex is due to poor quality legislative drafting. This has also been recognised by Inland Revenue, who drafted the

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[74] Valabh Committee (n 25); Inland Revenue Department (n 26).

[75] Inland Revenue Department, *Regulatory Impact Statement - Review of Closely Held Company Taxation* (2015).

legislation, and there have been a multitude of amendments to the legislation associated with the LTC regime since enactment. However, many of these amendments have been practitioner instigated through submissions and consultation with Inland Revenue. Notably, some practitioners were of the view that this low quality legislation was a direct result of Parliament implementing the LTC regime through Supplementary Order Paper 187. This occurred at the third reading of the Bill, and as such only very limited consultation was sought from practitioners. If the LTC regime had instead gone through the GTPP, then it is highly likely that better legislation would have resulted.[76]

Previous literature has indicated that flow-through entities such as the LAQC regime and the LTC regime result in unavoidable complexity (and thus compliance costs), especially when compared to traditional structures.[77] This sentiment appeared to be shared by the practitioners interviewed.

B *Adam Smith's Canons of Taxation*

In the context of compliance costs, the most relevant of Adam Smith's canons of taxation are certainty, convenience and economy.[78] Certainty is the idea that the taxpayers should be able to ascertain the amount of tax that is required to be paid and when. Additionally, taxes should not be arbitrary in nature.[79] Convenience is the concept that taxes should be readily and easily assessed, collected, and administered, which ensures compliance.[80] Finally, economy concerns collecting tax with the lowest amount of cost.[81]

The findings above indicate that the LTC regime is problematic in respect to each of these canons. That is, the LTC regime gives rise to uncertainty through vague and ambiguous legislation. Whilst the changes in 2017 have gone some way to resolving these issues, there are still concerns surrounding the transparency of the LTC regime and the subsequent tax outcomes that may result. Accordingly, taxpayers that use the LTC regime may have difficulty in

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[76] Vial (n 12).

[77] Freudenberg et al (n 23).

[78] Smith (n 1).

[79] Ibid.

[80] Andrew Maples and Stewart Karlinsky, 'The United States Capital Gains Tax Regime and the Proposed New Zealand CGT: Through Adam Smith's Lens' (2014) 16(2) *Journal of Australian Taxation* 156.

[81] Smith (n 1).

ascertaining their tax liability. For the same reason, the LTC regime is also problematic in respect to convenience; taxes are not easily assessed, and unpredictable tax outcomes may result in the associated tax impost arising at an inconvenient time for the taxpayer. Finally, given the complexity associated with the LTC regime, there also concerns around economy. Taxpayers that utilise the LTC regime will normally require assistance from a tax practitioner, leading to increased compliance costs. This is especially pertinent given that the target audience of the LTC regime is closely held companies, which are generally small, family businesses.

C *Government Tax Working Group*

The Government Tax Working Group also considered the taxation of closely held companies.[82] Whilst it was concluded that progressive taxation would be desirable, this was thought as being already possible through the LTC regime. Further, it was thought that the introduction of progressive taxation for closely held companies would result in higher compliance costs.[83] Overall, it is unclear whether the Government Tax Working Group viewed the LTC regime as being successful or not. However, given that one of the main recommendations was the implementation of a capital gains tax, it may have been that their focus was elsewhere.

Considering the findings above, and especially due to the compliance costs imposed by the LTC regime, an alternative basis of taxation may better deliver the objective of reducing compliance costs. In this regard, the Government Tax Working Group may have missed an opportunity. An example of an alternative basis of taxation is a full integration approach, which avoids the complexity associated with hybrid entities. On the other hand, a cash basis or concessionary accounting method may also result in reduced compliance costs for closely held companies.

VI CONCLUSIONS, LIMITATIONS AND FUTURE RESEARCH

Practitioners indicated that whilst small family businesses used the LTC regime, there were also other uses such as rental properties, companies anticipating losses and international tax structuring and planning. Practitioners indicated that it was they who recommended clients use the LTC regime, and that clients had very low levels of understanding surrounding the LTC

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[82] See, eg, Tax Working Group, *Future of Tax: Interim Report* (Report, 20 September 2018).

[83] Tax Working Group, *Future of Tax: Final Report Volume I: Recommendations* (Final Report, 21 February 2019).

regime. Regarding advantages, these were perceived to include fiscal transparency, limited liability, minimising double taxation in an international context, distributing tax-free capital gains and minimising tax on historic retained earnings. Disadvantages were considered to include the loss/deduction limitation rule, eligibility criteria, transparency issues, inability to quarantine profits or losses and ambiguous legislation. Notably, practitioners viewed the LTC regime as being complex and giving rise to increased compliance costs for those that use them. Part of this complexity arose from the now repealed loss/deduction limitation rule, however, other drivers of complexity still exist.

Whilst previous research has concluded that the LTC regime has been a success in respect to mitigating neutrality concerns,[84] this does not hold true from a compliance cost perspective. Accordingly, the LTC regime did not, and is still not, meeting one of its key objectives. That is, to minimise compliance costs for those that use them. This is contrary to Adam Smith's canons of certainty, convenience and economy. To this end, further overhauls are recommended. For example, further work could be done establish exactly how transparent LTCs are (or should be). As noted above, there is inherent complexity (and compliance costs) associated with hybrid entities. Thus, an alternative basis of taxation for closely held companies may better the objective of reducing compliance costs. International comparisons may provide useful insights and suggestions for this alternative basis of taxation.

Accordingly, the contributions of this research are two-fold. Firstly, this research provides an evaluation of the LTC regime from the perspective of tax practitioners. Secondly, this research concludes as to whether the LTC regime is meeting its objectives in respect of compliance costs, and how this might be improved upon.

This research is subject to several limitations. The first limitation is the lack of input from other stakeholders. Interviews with Inland Revenue or other parties involved in the policymaking process would provide useful insights into the LTC regime and better assist in evaluating its success. A second limitation of this research is its scope. Interviews were conducted in the course of fulfilling a Master of Commerce degree. As a consequence of this, there was a limited timeframe that the research was able to be completed within. In addition, there was a limit on the length of the research. This may mean that information has been missed, or not considered at all. Triangulation has been used to minimise this limitation, that is, documentary evidence

[84] Sharma et al (n 22).

has been considered alongside interviews. Follow-up interviews with tax practitioners may have provided further insights into the complexity costs after the most recent round of amendments to the LTC regime, such as the removal of the loss/deduction limitation rule.

TAX COMPETITION: A BLESSING IN DISGUISE FOR SMALL COUNTRIES

ZAIF HASSAN FAZAL[*]

ABSTRACT

Criticism is often levelled against countries that engage in tax competition by claiming it is a means for the wealthy to dodge financial obligations. However, this reputation overshadows the vital benefits it has for small countries. The aim of this paper is to demonstrate that tax competition is a valuable tool for small and developing countries. Before exploring this, tax competition and other key concepts will be defined. Then, the relationship between tax competition and the government will be analysed. Public choice theory will be used to show that governments often function as self-serving monopolies, and so competitive policies improve their efficiency. Next, game theory will be used to show that small countries are the winners of tax competition. However, this paper narrows this typology down further to small, developing countries with a lack of resources. Due to their lack of size, resources and infrastructure, these countries have little choice but to rely on tax competition for capital injection necessary for their development. This capital injection comes in the form of Foreign Direct Investment, which creates several positive spill-over effects within the economy and leads to sustainable and long-term growth. Unfortunately, due to the movement against tax competition, several governments have banded together to try to limit it. Some potential pathways for reform and the impacts that they might have on small countries will be considered. This paper concludes with a suggestion for a final proposal that is most practically feasible.

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I INTRODUCTION

The terms 'tax haven' and 'tax competition' are often associated with some form of scandal involving a renowned multinational company, prominent businesspeople or wealthy politicians, and the offshore accounts they use for tax avoidance. This image has led the public to view tax competition as a universally harmful phenomenon that should be eliminated. However, it is important to remember that this is but one side of the story. This paper attempts to shed light on the other side of tax competition, including the benefits it has to offer small developing countries with low natural resources ('SDCs') and why their use of competitive tax regimes is justified.

Lacking existing infrastructure, a large population, or any natural resources that can be used to foster economic growth, SDCs are often left with few development opportunities. In many cases though, tax competition proves to be their saviour, as it presents a change they can easily adopt to increase Foreign Direct Investment ('FDI'), which can ultimately lead to sustainable long-term development. FDI simply refers to cross-border investments from one country into another.[1] Thus, tax competition is a way for SDCs to adapt to their situation and level the global economic playing field.

This paper proceeds in five parts. Part 1 offers definitions for tax competition, tax avoidance and tax havens. As tax competition is a complex phenomenon, it has been difficult for academics to define. This part submits that this lack of an agreed definition leads many developed countries to use their own, biased, definition which characterises tax competition as harmful. Instead of adopting this problematic view, this paper uses a more universal definition of tax competition. The difference between tax competition and tax avoidance will also be explained. Importantly, this paper only justifies the use of tax competition by SDCs with low natural resources who use it to attract FDI.

Part 2 then examines the relationship between the government and tax competition. This is crucial because tax is generally a government's main income source. It is also argued that many governments oppose tax competition because it undermines their autonomy and decreases their revenue through capital flight. These corrosive impacts are often far more significant in developing countries. However, these claims all rely on the assumption that the government is

[1] Department for International Trade, *Estimating the Economic Impact of FDI to Support the Department for International Trade's Promotion Strategy* (Analytical Report, 1 August 2018) 13.

perfectly benevolent. Public choice theory is used to show that this is not the case, and that often they behave similar to a monopoly. It will be shown that tax competition offers a restraint on the rampant power of the government and ultimately increases their efficiency.

Part 3 then uses game theory to demonstrate how tax competition affects countries of different sizes. It shows that in tax competition, the winners are the small countries. The rationale for narrowing the focus of this paper to SDCs will also be explained. Samuelson's theory of public goods is then used to highlight the drawbacks of tax competition, and particularly the threat of a 'race to the bottom'. However, flaws in the theory are then identified which show it is more useful in hypothetical scenarios, than in the real world. Samuelson's theory is then reiterated to provide further proof that small countries benefit the most from tax competition.

Part 4 identifies the specific benefits that SDCs receive, predominantly due to FDI and its spill-over effects. This increase in investment will directly lead to increased economic growth. Indirectly, it will lead to knowledge, technology, and new ideas being imported into the economy, all of which play a role in increasing the efficiency of the country. This also leads to a decrease in unemployment and an increase in average wages. Conclusively, these benefits will lead to sustainable economic growth in the long run.

Finally, Part 5 returns to the notorious reputation of tax competition and the attempts of many large developed countries to limit it through institutional reform. The potential pathways to reform, including the outcomes for SDCs, will be analysed to understand what each pathway has to offer for each type of country. By understanding what both sides seek, an alternative proposal for reform where neither party suffers significant loss will be suggested. Although it is not a perfect proposal, it is submitted that it is the most pragmatic solution to a complex problem.

II DEFINING TAX COMPETITION

Prior to discussing tax competition, it is important to first define it. Despite the ongoing debate around tax competition, academics have found it difficult to properly define and determine what, if anything, makes it harmful. Nevertheless, this chapter will determine a definition for the purposes of this paper by considering different views on tax competition. First, it will identify the difference between tax competition and tax avoidance. Second, Faulhaber's

method for defining the term will be examined.[2] Faulhaber uses anti-tax-competition policies implemented by countries within organisations such as the European Union ('EU') and the Organization for Economic Co-operation and Development ('OECD') to reverse-engineer what policymakers believe constitutes harmful tax competition.[3] It will then show that these defensive measures have been enacted for the benefit of these large developed countries because they are the ones who stand to lose the most. It will be shown that their approach is biased, and that less developed countries will bear the consequences of these countries adopting a view that tax competition is harmful. The section will then give a conclusive definition by considering Wilson and Wildasin's more universally applicable view on tax competition.[4] Finally, the term 'tax haven', and the types of tax competition these countries engage in, is defined for the purpose of this paper.

A *The Emergence of Tax Competition*

Tax competition was not a concern for most developed countries until the mid-to-late 20th century when a dramatic rise in FDI and portfolio investment allowed countries at all stages of development to use it as a tool to attract investment.[5] At this stage, due to increased capital flight from the developed world to small tax havens, large countries began to view tax competition as a threat. By the late 20th century, countries of all sizes had lowered their statutory corporate tax rates.[6] Unless stated otherwise, taxes will refer to corporate taxes from hereon.

B *Profiling Tax Avoidance and Tax Competition*

At the outset, it is vital to look at the relationship between tax competition and tax avoidance. Although tax competition and tax avoidance are different, they are interdependent. Tax

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2 Lilian V Faulhaber, 'The Trouble with Tax Competition: From Practice to Theory' (2018) 71 *Tax Law Review* 311.

3 Ibid.

4 John Douglas Wilson and David Wildasin, 'Capital Tax Competition: Bane or Boon' (2004) 88 *Journal of Public Economics* 1065, 1066.

5 Jeffrey Owens, 'The David H. Tillinghast Lecture Tax Competition: To Welcome or Not' (2012) 65 Tax Law Review 173, 180.

6 Faulhaber (n 2) 42.

competition certainly helps avoiders, and so, the fight against tax avoidance and tax competition is undeniably linked.

Most anti-tax-avoidance policies prevent taxpayers from taking advantage of discrepancies between domestic tax systems.[7] The OECD's Base Erosion and Profit Shifting Project helps demonstrate this. It includes rules which prohibit taxpayers from shifting income outside a jurisdiction by establishing a wholly owned foreign subsidiary, as well as Interest Limitation rules which stop taxpayers from taking excess interest deductions.[8] Since several tax avoidance schemes, including the Double Dutch Irish Sandwich used by Google, rely on these methods, the OECD's plan would prevent many companies from avoiding tax.[9] Consequently, the countries these wholly owned subsidiaries exist in will suffer, as the companies will have less incentive to shift their income overseas. As a result, these countries will then have less motivation to engage in tax competition, and so, these policies can be viewed as measures against both tax avoidance and tax competition.

It is important to note that despite the links between tax avoidance and tax competition, they remain fundamentally different and cannot be reduced down to the same concept. Tax competition is centred around *countries* competing against each other through their tax policies, while tax avoidance focus on actions taken by *taxpayers* to reduce the amount they pay in tax. Tax avoidance is not a direct consequence of tax competition, even though it may, at times, help avoidance.

1 *Faulhaber's Definition of Tax Competition*

Faulhaber argues that many policies implemented by the OECD and the EU are informed by what these organisations perceive as harmful tax competition – that is, any form of tax competition where they are more likely to lose.[10] These policies shift the playing field and stifle the ability of other countries to compete, to help ensure large developed countries do not lose out.

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[7] Ibid 34.

[8] OECD, *Action Plan on Base Erosion and Profit Shifting* (Report, 2013).

[9] Edward D Kleinbard, 'Through a Latte, Darkly: Starbuck's Stateless Income Planning' (2013) *Tax Notes* 1515, 1518.

[10] Faulhaber (n 2) 60.

For example, the EU and the OECD recently proposed a policy under which the amount of intellectual property income countries may tax is proportionate to the amount of research and development undertaken in that jurisdiction.[11] This shifts the competitive advantage away from those with preferential tax rates and towards those with the infrastructure and education necessary for research and development.[12] Therefore, this policy benefits developed countries with existing investment in these areas. On the other hand, developing countries who lack the requisite infrastructure will suffer the most.

One of the reasons why governments may consider tax competition harmful is because there is no agreed definition of what tax competition is. Hence, 'without a neutral definition, tax competition is in the eye of the beholder', ultimately leading to a partisan view which benefits the developed countries.[13]

2 *Wilson and Wildasin's View*

Wilson and Wildasin propose both a broad and narrow definition for tax competition. The broad definition encompasses any form of non-cooperative tax setting by different governments.[14] They argue that this definition is too wide because it could include competition between different countries, as well as competition between different levels of government in one country. Therefore, Wilson and Wildasin propose another narrower definition: the non-cooperative tax setting by different countries to influence the allocation of mobile tax bases.[15] The mobile tax bases include workers, firms, capital, entrepreneurship and consumers. This narrow definition does not concern 'vertical tax competition' where different levels of governments impose different taxes on the same base, contrary to the broad definition.[16] Instead, it refers to 'horizontal tax competition' where governments at the same level are competing for mobile factors.[17] In other words, it is a competition between different countries

[11] Ibid 27.

[12] Ibid 43.

[13] Ibid 52.

[14] Wilson and Wildasin (n 4) 1066.

[15] Ibid 1067.

[16] Ibid.

[17] Ibid.

to attract mobile tax bases. This is the definition of tax competition which will be used in this paper.

C *The Types of Tax Competition*

Among the factors of production, capital is the one countries most aim to attract. The type of capital countries aim to attract using tax competition can be used to distinguish the three types of tax competition.

The first type is portfolio capital, which consists of multiple assets such as stocks, equity and cash.[18] Investors are incentivised to transfer portfolio capital to a location with the lowest tax rate to retain maximum wealth. Paper-profits are the second type, which involves Multi-National Corporations ('MNCs') shifting their profits from high to low tax jurisdictions.[19] The third type is real investment from MNCs in the form of FDI.[20] This is the type of capital SDCs are trying to attract.

Empirical studies show that reducing taxes increases the inflow of FDI.[21] Because this will be achieved by using fiscal policy to greatly lower tax, these countries are often described as 'tax havens'. Among these countries that reduce taxes to attract FDI, this paper favours only those that have a population below 1.5 million people,[22] lack natural resources and are less economically developed. A developing country is considered here to be any country that has a Human Development Index ('HDI') lower than 0.7. Although the most appropriate measure of development is greatly contested, HDI is preferred here because it considers a wider set of factors, including. life expectancy, knowledge and living standards.[23]

One of the key differences between the first two types of tax competition and the third is that in the former, the corporation or owner of capital does not physically relocate to the low tax

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[18] Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* (Oxford University Press, 1st ed, 2015) 36.

[19] Ibid 40.

[20] Ibid 43.

[21] Ibid 44.

[22] João Antonio Brito, 'Defining Country Size: A Descriptive Analysis of Small and Large States' (2015) *Munich Personal RePEc Archive* 5.

[23] United Nations Development Programme, 'Human Development Reports' (Web Page) <http://hdr.undp.org/>.

jurisdiction.[24] These types of tax competition are therefore described as 'poaching' by the OECD.[25] However, the third type involves the owner of the capital migrating and setting up operations in the low tax jurisdiction. Therefore, instead of 'poaching' the tax base, it 'lures' it.[26] This paper seeks to defend only this type of tax competition.

III THE ROLE OF GOVERNMENTS

Tax is considered one of the most powerful fiscal tools a government has at their disposal. It is because tax competition diminishes the value of this tool that so many countries are determined to eradicate it. The government uses taxes to gain revenue to use for their expenditure to promote the welfare of the public. As such, some level of autonomy is necessary to carry this out. The first section of this section shows that tax competition subverts this autonomy, leading to adverse effects like greater inequality of wealth and a decreased provision of public and merit goods. It also shows that these effects are usually felt most by developing countries.

The next section of the chapter argues that this line of thinking is dependent on the assumption that the government is perfectly benevolent and will always promote the welfare of the public. Public choice theory is used to show that this assumption is wrong as governments are actually self-serving. They function as a monopoly and may excessively tax their constituents, then inefficiently spend this revenue in order to gain self-serving benefits. This leads us to view tax competition in a new light, not as a problem faced by the government, but rather a means to restrain government.

A *Tax Competition Hinders the Role of Governments*

There are three broad reasons why governments impose taxes: to raise revenue to spend on public and merit goods;[27] to redistribute income and wealth,[28] which helps reduce the gap between rich and poor in a society; and to influence or stabilise the business cycle.[29] A

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[24] Ibid.

[25] Organisation for Economic Co-operation and Development, *Harmful Tax Competition – An Emerging Global Issue* (OECD Publications, 1998).

[26] Dietsch (n 18) 44.

[27] Ibid 12.

[28] Ibid 13.

[29] Ibid.

government requires fiscal autonomy to decide their public budget[30] but, it is argued, tax competition undermines this autonomy.

Firstly, tax competition results in mobile capital relocating to low tax jurisdictions – a phenomenon called capital flight. A government is supposed to have the autonomy to decide what and who to tax, and at what rate.[31] However, when a country's tax base reduces, their choices become limited. As a result, they often resort to more regressive tax regimes to raise the required amount of revenue. For instance, a government may tax labour and consumption more to offset the reduction of capital. Additionally, tax competition incentivises the rich to engage in capital relocation to benefit from it. This pushes the government to shift the tax burden onto the poor to compensate. Due to this, the gap between the rich and the poor is widened further, hindering vertical equity.

Brazil is one country which illustrates the detrimental effects that tax competition can have on government autonomy. In Brazil, during 1985 and 1997, the highest personal income tax rate fell from 60% to 25%, while the lowest rate increased from 0 to 15%.[32] As a result of significant capital flight,[33] 70% of Brazil's tax revenue ended up being raised from indirect taxes, which are regressive in nature[34] and will only make the situation worse.[35] This shows that tax competition undermines a government's autonomy by leaving them in a situation where they are unable to raise the requisite amount of revenue without taxing regressively.

A decrease in the public budget puts pressure on government expenditure as well.[36] A smaller budget could be reflected in the form of poor healthcare development or perhaps lower quality education. The poor, who now have lower purchasing power due to the regressive taxes, are the ones who will lose out further because the rich do not need government provided healthcare or education. The reduction in subsidised healthcare may make treatment unaffordable to the

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30 Ibid 35.

31 Ivan O Ozai, 'Tax Competition and the Ethics of Burden Sharing' (2018) 42(1) *Fordham International Law Journal* 61, 70.

32 Parthasarathi Shome, 'Taxation in Latin America: Structural Trends and Impacts of Administration' (IMF Working Paper 99/19, 1999) 5.

33 Dietsch (n 18) 50.

34 Ibid 50.

35 United Nations Development Programme, '*Human Development Report 2006: Beyond Scarcity-Poverty and the Global Water Crisis'* (Palgrave Macmillan, 2006) 292, 336.

36 Dietsch (n 18) 52.

poor. They may also face a lack of opportunity in the work environment if they do not have access to proper education, leaving them with low skill jobs which pays less. This creates a spiral of negative effects that leave the poor in a continuous struggle.

Another consequence of tax competition is the risk of a race to the bottom.[37] Because of globalization, capital is more mobile than ever before, which makes it easier to always transfer capital to the jurisdiction which yields the lowest tax. To attract this capital, governments continue to undercut one another. The concern is that this may lead to governments reducing taxes to the point where tax rates are extremely low, or even zero, with clear negative consequences. This idea will be discussed further in the next section.

Although the consequences of tax competition explored above are inimical, there is no doubt that developing countries face additional, more severe implications. These countries will often have weaker administrative capacity and experience difficulty collecting tax revenue from their existing tax base,[38] in part, because they may struggle to keep up with technological changes and lack a highly productive workforce. They therefore face a high cost in the collection of tax revenue. People in these countries also often face difficulty understanding the tax system, leading to compliance costs[39] that may be four to five times higher than in developed countries.[40] Tax competition only aggravates these effects further as the decrease in tax revenue combined with higher costs lead to a lower public budget.

Additionally, developing countries may be home to significant black markets. Various traders that exist in these markets will not report any of their accounts and instead trade undercover. Compliance efforts will often be near impossible and expensive.[41] Furthermore, the elasticity of tax on income for such traders is also high.[42] This means if the government tried to increase taxes to boost revenue, the taxable income reported will decrease more than proportionately, thus increasing the size of the informal market.

[37] Ozai (n 31) 70.

[38] Ibid 71.

[39] Ibid 71.

[40] Roy Bahl and Richard Bird, 'Tax Policy in Developing Countries: Looking Back and Forward' (2008) 61 *National Tax Journal* 279, 291.

[41] Ozai (n 31) 72.

[42] Ibid.

B *Government as a Leviathan*

The section above considers a government that is utterly democratic, acting to further the view of the majority. However, this is can be far from reality as governments often act on the philosophy of their respective party, which may not always align with the interests of the majority. This section uses public choice theory to show that the government is not perfectly benevolent and that self-interest may result in it acting like a monopoly – a modern-day Leviathan,[43] charging people excessively high taxes to provide services that may not be necessary or in their best interests. This section then argues that tax competition may be a solution to this problem because it acts as a restraint on the government by decreasing its price-making power and increasing the efficiency of government spending.

1 *Public Choice Theory*

The study of human behaviour by economists makes it clear that people's primary motivator is almost always self-interest. Buchanan and Tullock suggest that this view not only applies to the individuals, but also the government.[44] Going a step further, they concluded that rather than governments acting in line with the 'public interest', they were liable to inefficiency and manipulation. Public choice theory states that governments usually consist of individuals who have an interest in government power and activity,[45] and therefore have an interest in increasing government revenue.

Using this theory as a lens to analyse tax competition makes it clear that increasing taxes does not always mean increased spending on public welfare. Instead, governments and politicians may have a vested interest in raising revenue for their own welfare.[46] Therefore, in the absence of tax competition, government expenditure may be higher than the socially optimum point.[47] Accordingly, although the previous section stated that the decrease in government expenditure due to tax competition leads to the under-provision of public and merit goods, it could

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[43] Thomas Hobbes, *Leviathan,* ed Richard Tuck (Cambridge University Press, 1996) [1].

[44] James M Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (University of Michigan Press, 1965) 281.

[45] Richard Teather, *The Benefits of Tax Competition* (The Institute of Economic Affairs, 2005) 53.

[46] Eamonn Butler, *Public Choice – A Primer* (The Institute of Economic Affairs, 2012) 34.

[47] Teather (n 45) 53.

alternatively be argued that this decrease prevents the government from spending on what is excessive and unnecessary.

(a) *Government Failure*

Market failure occurs when resources are not allocated efficiently by the market. One of the main reasons for market failure is the undersupply of public goods, which have the characteristics of both non-rivalry and non-excludability. Non-rivalry means that the consumption by one person does not reduce the availability of consumption for another. Non-excludability means that once a good is paid for and provided for one person, the consumption by another cannot be excluded. This is what leads to the 'free rider' problem: when a good is provided to one person, everyone makes use of it. As a result, the private sector is not incentivised to provide public goods because they cannot profit by doing so. An example of this is sanitation infrastructure. Once the government has paid for the construction of a sanitary system, every citizen benefits. Just because one person uses it does not mean that others cannot. And, because the private sector has difficulty charging for these types of goods, under-provision leads to market failure.

To prevent this, the government has to intervene by providing public goods up to the socially optimum point. However, the government can only budget for such public goods within the funding available. For this purpose, the government collects taxes.

In the provision of public goods, it is acknowledged that the government often has an advantage over private firms because they are able to pool larger sums of capital and invest into larger-scale production, leading to lower average costs. This then enables them to provide the same good at a lower cost because of the benefits of economies of scale.

The inefficiencies that can be observed in many economies today would not exist if this was the end of the story. In reality, public choice economists remind us that just because the government steps in to remedy the wrongs of the market, it does not mean they will be successful.[48] When a government attempts, but fails, to fix market failure, it is referred to as government failure. Sometimes government actions can create more damage than it initially intended to rectify.[49] For instance, the substitution effect is observed when a government

[48] Butler (n 46) 44.

[49] Ibid.

increases income tax to raise their revenue because people may be discouraged from working and rather substitute their time with leisure. This, therefore, reduces the active labour force in the economy.

Government failure occurs largely due to information asymmetry, large-scale mismanagement and the lack of efficiency incentives for the public sector. This also indicates that the government may not be able to provide public and merit goods successfully even in the absence of tax competition. Hence, it is unjust to consider the under-provision of such goods to be caused solely due to tax competition, as it may be the inefficiencies of the government itself that lead to the failure.

Finally, governments may be described as leviathan because they are often largely bureaucratic and oligarchic in nature with the power accrued to a few at the top.[50] While some argue that a democratically elected government will act in the interests of the people because electors have the ability to check the actions of the government at elections,[51] these are infrequent and voter turnout is often very low, unless voting is compulsory.[52] Therefore, despite a democracy working in theory, it is rarely the case in practice.[53]

2 *Tax Competition as a Means to Discipline the Government*

In free markets, competition roots out efficient suppliers and the invisible hand acts as a tool that balances the price at the equilibrium where demand meets supply.[54] Problems arise when monopolies exist in the market and individual participants act as price makers instead of takers. The government, as shown in the previous section, exists as a monopoly.[55] They could force people, their consumers, to pay any price they desire as tax, to provide services that individuals do not even need or want. If the government is a monopoly then, it would be expected to be inefficient, leading to higher costs and ultimately higher taxes.[56] Tax competition acts as a restraint on such governments to be the price maker because it means other supplier-

[50] Ibid.

[51] Ibid.

[52] Ibid 83.

[53] Ibid.

[54] Adam Smith, *The Wealth of Nations*, ed John B Wright (Harriman House, 2007) Book II Ch II [106].

[55] Butler (n 46) 83.

[56] Ibid.

governments are providing similar services for a lower price elsewhere. This allows investors, workers, and companies to move to a low tax jurisdiction rather than remaining unproductive by reducing labour and investment.[57]

On the other hand, the restraint on the government's ability to raise higher revenue is also likely to encourage efficient spending.[58] If the government sees the public as a bottomless bucket, of which funds can be squeezed out, the value they place in the money raised will decrease. Tax competition which leads to a lower public budget can therefore be argued to encourage governments to do proper due diligence on projects and only focus on those with lucrative prospects.

C *Section III Conclusion*

This chapter considered the role of governments and how tax competition influences their performance. It showed that competitive tax policies lead to lower tax revenue, underfunding of general welfare projects and increased inequality. These corrosive impacts fuel the governmental movement against it. However, it was also shown that these claims are based on the assumption that the government always operates according to the interests of the public. Public choice theory shows that this assumption is often wrong, and several of these claims were critically analysed in this light. Finally, tax competition was viewed as a tool that checks and balances the government's actions by encouraging efficiency and the exercise of caution in their spending. Although many justifications for tax competition were considered, it is important to note that in most cases, especially in the case of large developing countries, the drawbacks of tax competition outweigh these arguments.

IV USING GAME THEORY TO ANALYSE WHO WINS AND WHY

This chapter intends to prove how and why small countries are the clear winners of tax competition. To analyse the effects of changing tax rates by different countries, economists often use game theory. Although this exercise over-simplifies the complexities of tax competition, it remains a useful analytical tool. It will help identify the effects of tax competition and explain why small countries benefit most from capital relocation as a result of their size. Capital relocation will be considered in greater depth by using Samuelson's theory

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[57] Ibid.

[58] Teather (n 45) 35.

of efficient public goods. The theory claims that tax competition and capital flight are harmful because they lead to a race to the bottom.[59] The section afterwards provides counterarguments for this theory and submits that it is not realistic when applied practically.

A *Game Theory Analysis*

TABLE 1 – PAYOFFS UNDER SYMMETRIC TAX COMPETITION[60]

COUNTRY A \ **COUNTRY B**	**TAX**	**UNDER TAX**
TAX	0; 0	-10; 5
UNDER TAX	5; -10	-4; -4 (Nash eq.)

In a symmetric situation, both countries will collectively benefit if they cooperate in setting the same level of tax rate (at the payoff 0;0). This is the Pareto optimal outcome – the point at which it is impossible to make one party better off without making the other worse. However, individual countries have an incentive to reduce tax in order to steal the tax base from another country.[61] When one country (A) reduces tax and if the other country (B) refrains from doing so, the payoff benefits the country that reduces tax (payoff 5;-10). Here, while country A benefits, country B loses more than proportionately. As this situation is analogous to a prisoner's dilemma, it eventually leads to country B also reducing tax. Country B does this to be less worse off. The final result is therefore suboptimal at the Nash equilibrium (-4; -4).[62] This is the point the countries arrive at when they both choose to reduce taxes and means no party can gain by a change of strategy as long as all other parties remain unchanged. Therefore, based on this model, it would be better off for both countries collectively, if they cooperate instead of undercutting one another.

59 Ibid 38.

60 Dietsch (n 18) 55.

61 Ibid.

62 Eckhard Janeba and Wolfgang Peters, 'Tax Evasion, Tax Competition and Gains from Non-discrimination: The Case of Interest Taxation in Europe' (1999) 109(452) *Economic Journal* 93, 97.

TABLE 2 – PAYOFFS UNDER ASYMMETRIC TAX COMPETITION[63]

SMALL COUNTRY / **BIG COUNTRY**	**TAX**	**UNDER TAX**
TAX	0; 0	-10; 5
UNDER TAX	3; -8	-5;3 (Nash eq.)

However, the symmetrical model is hypothetical and fails to provide a real-world representation.[64] In reality, small countries have a higher advantage from tax competition and this can be observed in Table 2 above.[65] The Nash equilibrium is still suboptimal collectively.[66] However, under this model, there is no longer an incentive for both countries to try to cooperate.[67] This is because of both the tax rate effect – that, ceteris paribus, a state will receive less revenue when it reduces its tax rate[68] – and the tax base effect – that when a country reduces its tax rate, the increase in capital inflows will add to its tax base and so its revenue will increase.[69] The size of the country determines which effect dominates. For large countries, the tax rate effect dominates and when tax rates are reduced, they lose substantial revenues while attracting small capital inflows.[70] For small countries, the tax base effect is more dominant and they gain from substantial capital inflows when they decrease their tax rate which more than compensates for the lower rate.[71] Therefore, in a real-world situation, small countries benefit more from tax competition in any situation, despite what strategy the other country follows. So, they will always be incentivised to reduce tax in order to attract capital.[72]

63 Dietsch (n 18) 56.

64 Ibid 55.

65 Sam Bucovetsky, 'Asymetric Tax Competition' (1991) 30(2) *Journal of Urban Economics* 167, 178.

66 Dietsch (n 18) 56.

67 Ibid.

68 Ibid.

69 Ibid.

70 Ibid.

71 Ibid.

72 Vivek H Dehejia and Philipp Grenschel, 'Tax Competition in the European Union'(1999) 27 *Politics & Society* 403, 411.

1 *Narrowing Down to Small Developing Countries with Low Natural Resources*

Small countries, whether high or low income, are winners of tax competition as shown in Table 2. However, it is not argued here that the small, high income countries should keep on benefitting from tax competition at the expense of other countries. There is no ethical reason to further economic inequality. A developed country can use its existing infrastructure to sustain its economy. In stark contrast, small, low-income countries are in need of capital inflow for them to be able to compete on a level playing field in the long run. Once a country has capitalized on tax competition to propel its economy into high development, it is argued they should stop that practice.

It is acknowledged that there is discrimination here between large and small developing countries by favouring the latter. However, new research suggests that in the very long-run, size can be a great advantage to an economy.[73] This is because people can be described as direct raw material for economic growth. So, larger countries have the option of utilizing their population size to increase real output. The research suggests that, in particular, this growth is achieved by technological improvements, and that larger populations make larger investments in technology worthwhile.[74] This is simply because there is a larger consumer base to make purchases.[75] Therefore, for larger developing countries, it is suggested that they capitalize on their population size instead of participating in tax competition for economic growth. Smaller countries do not have this option and usually have the most trouble stimulating their economy. Moreover, as explained above, the benefits of capital inflow for large countries are less significant. Therefore, there is less reason for them to partake in tax competition.

Small developing countries with high natural resources are encouraged to capitalize on their natural resources for growth. For instance, countries like Qatar developed exponentially by profiting from their gas reserves. Being the largest exporter of liquefied natural gas, they do not need to engage in tax competition.[76] They have and continue to grow steadily depending

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[73] Klaus Desmet, David Krisztian Nagy and Esteban Rossi-Hansberg, ‘The Geography of Development’ (2018) 126 (3) *Journal of Political Economy*.

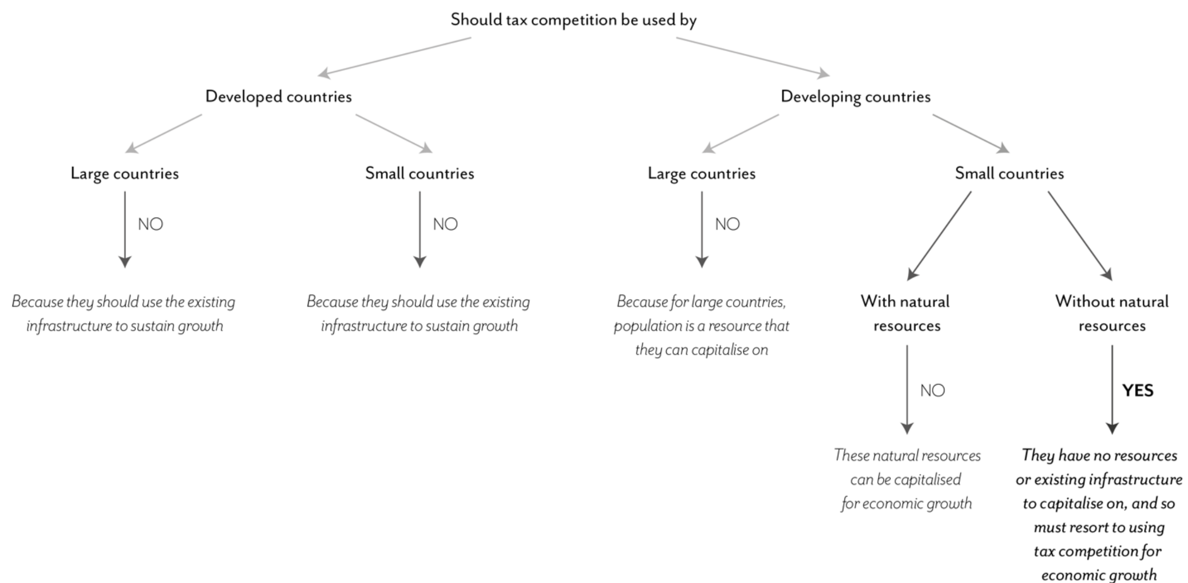
[74] Ibid.

[75] Ibid.

[76] Matt Smith, ‘How is Qatar coping with its economic embargo’, *BBC News* (Online, 10 January 2019) <https://www.bbc.co.uk/news/business-46795696>.

on their natural resource despite several external challenges.[77] This is not an option for those without natural resources.

FIGURE 1 – WHEN TAX COMPETITION SHOULD BE USED



B *Samuelson's Theory of Public Goods.*

Samuelson's theory of public goods implies that tax competition is harmful because it will cause a 'race to the bottom' due to capital flight, leading to an inefficient allocation of resources.[78] However, in this section, it will be shown that his view on capital flight ignores the benefits it carries for smaller countries.

According to Samuelson's rule, in the absence of tax competition, governments will raise taxes only until the benefits that flow from public spending are equal to the cost.[79] The formula for this is Marginal Cost ('MC') = Marginal Benefit ('MB'). This is the point where the advantages of the next dollar of government expenditure is equal to its marginal cost. If spending is below this, there is an under-provision of public goods leading to a loss of welfare. At this point, the

[77] Ibid.

[78] Paul A Samuelson, 'The Pure Theory of Public Expenditure' (1954) 36(4) *The Review of Economics and Statistics* 387, 387-8.

[79] Ibid 388.

government will only carry out profitable public spending. This is the economically efficient equilibrium that exists in the absence of tax competition.

When tax competition exists, the indirect effect of capital flight has to be factored in. The model of simply comparing the benefits with the direct costs of the project are no longer enough, as the flow of capital due to tax competition is now also a factor. [80] So, for a government project to be feasible, it must satisfy the test of MB = MC + X. This means the benefits must not only cover the direct cost, but also the cost of exports. The problem of this new test is that the threshold is too high to satisfy. With the assumption that global capital is constant, when observing globally, even if a project satisfied MB=MC, nationally a project might be rejected as MB<MC+X. This leads to underspending on public goods globally. To avoid this, countries should opt for international tax harmonisation, which would mean there would be significantly less capital flight, thus reducing the value of X.

Another problem arises when many countries engage in tax competition to benefit from this flight of capital. If taxes are reduced over several rounds, countries may finally end up with significantly low rates approaching zero.[81] Moreover, the country that reduces tax, and so too public spending, is doing so at the expense of another country's capital. Vanuatu in the 1990s is a good example that depicts this. The net effect on the global economy then is a loss, as the gain to the country that reduces taxes is less than the loss to the other country.[82]

1 *Flaws of Samuelson's Theory*

This section aims to show that Samuelson's theory is grounded on unrealistic and hypothetical assumptions. It is submitted that it is an inadequate representation of what occurs in reality and ignores the benefits that tax competition may bring to small countries.

First, the race to the bottom argument is not practical.[83] There is no empirical evidence of countries reducing tax rates to compete with each other to the point where it has reached zero.[84] Additionally, the algebraic formula fails to work in practice because it is oversimplified and

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[80] Teather (n 45) 41.

[81] Ibid.

[82] Ibid.

[83] Ibid 44.

[84] Ibid.

based on hypothetical scenarios.[85] It fails to consider the benefits of tax competition from the view of the countries, particularly SDCs, who are the recipients of the capital inflow. When such an important variable is neglected from the formula, it is obvious that unrealistic results will follow.

Second, Samuelson's theory assumes that global capital is fixed and that the only effect tax has is on its location.[86] However, a major effect of tax reduction is the increase of investment. When the post-tax return is higher, people will be more willing to invest because profitability will be higher. Moreover, when taxes are reduced, peoples' ability to save increases, which is likely to be converted into investment as well. Therefore, it cannot be ignored that in addition to its effects on location, taxes have a significant impact on the growth of capital.

Thirdly, it assumes that all government spending is efficient.[87] The theory purports that a fixed marginal benefit can be obtained at a fixed marginal cost.[88] In the real world, all costs are not fixed and, as explained above, since governments act like a large monopoly, they have little incentive to be efficient. This in itself will lead to higher marginal costs, contrary to Samuelson's hypothesis. So even in the absence of tax competition, a government is unlikely to be able to obtain the preferred equilibrium of MB=MC. Oppositely, tax competition encourages a government to operate more efficiently, as outlined above. As opposed to Samuelson's assumption, tax competition could actually help governments operate closer to the economically efficient equilibrium.

2 *Where Does the Flight of Capital Land? A Race to Provide the Best Runway*

As shown in IV(A), the SDC will always reduce taxes to attract capital. Therefore, they are the most likely recipient of any leaked capital and will have to consider whether there is a net benefit. A net benefit would mean that the reduction of tax rates which will be reflected by lower public spending is compensated by the capital coming from other high tax jurisdictions.[89] So, the economically efficient point for any project will be reached sooner for them due to the

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[85] Ibid.

[86] Ibid 46.

[87] Ibid 48.

[88] Ibid.

[89] Ibid 42.

inflow of the X factor. By providing the most attractive runway, the SDC will position itself to be the location where the flight of capital lands.

Furthermore, it must be understood that the effects of changes in tax rates are not the same for all countries. The game theory analysis mentioned above helps us to understand that X is a more significant factor for smaller countries – it is where X will make its biggest impact.[90] This is simply because even a small injection of capital has a bigger, more evident impact on a comparatively smaller economy.

For instance, imagine there are two rocks which are similar. One is dropped into a small pond and the other into the ocean. The impact the rock makes on the pond will be more vivid and evident, whereas the ocean would have swallowed the rock as if nothing has changed. Therefore, even though the taxes raised by these small countries are reduced, leading to lower public expenditure, the impact of the inflow of capital is much greater and so the net benefit to these countries is much higher. For larger countries, the potential benefit of the capital inflow will not outweigh the loss in raised tax revenue due to reduced tax rates. When observed closely it could be considered that this is the invisible hand at play at a global level and doing its job to bring the global economy to an equilibrium. The result of this is that SDCs benefit from the opportunity to develop exponentially which enables them to catch up with the rest of the developed world. Until then, the use of tax competition by SDCs, it is argued, is justified.

C *Section IV Conclusion*

This section has shown that small countries are the winners of tax competition. Samuelson considered this displacement of capital to be an adverse effect of tax competition. However, it has been shown that this argument is flawed for several reasons. Most importantly, his negative view of capital flight ignores how it is an asset for SDCs. For these reasons, this paper supports the use of tax competition by SDCs. These countries will not only benefit the most due to tax competition, but they are also the ones who crucially need the ensuing capital inflow.

V BENEFITS OF TAX COMPETITION

Now that the justification for SDCs using tax competition has been explained, it is useful to consider the benefits it has to offer. This section discusses these, focusing mainly on FDI

[90] John Douglas Wilson 'Tax Competition With Interregional Differences in Factor Endowments' (1991) 21(3) *Regional Science and Urban Economics* 423, 425.

because it has one of the most significant effects on tax competition with both long and short-term influences. FDI occurs when MNCs invest in an economy with the intent of operating in it, rather than simply opening a shell company in a low-tax jurisdiction. This is one of the reasons why the effects of FDI spills over to different sectors and leads to more sustainable growth. By analysing these benefits, this section aims to show that one should tolerate tax competition practices if it is exercised by SDCs to pull themselves out of poverty, especially by those that lack natural resources.[91] This paper chooses to focus on SDCs because their lack of capital and natural resources leaves them with few fiscal options at their disposal to foster growth.

A *Increased Investment and its Effect on GDP*

The direct effect of tax competition is increased investment, as lower taxes act as a signal for local and foreign suppliers to invest in an economy. Reducing tax is a fiscal policy tool used by governments to stimulate their economy to encourage local investment and FDI. However, it is not without its drawbacks. Whenever a tax incentive is offered, it opens the doors to tax avoidance and evasion.[92] Therefore, a country must consider whether the benefits of increased investment and its effect on GDP outweighs this problem. In order to reach a potential answer to this conundrum, the benefits of investment and the problems in offering tax incentives will be considered individually in this section.

In economics the law of supply provides that suppliers are more willing to sell at higher prices.[93] This is because, in a free market, the main motive of a firm is profit. Tax incentives enable firms to take home a higher profit. Tax incentives, therefore, enable countries to attract capital from abroad in the form of FDI, as well as encourage investment within the economy. On the other hand, if the profits are taxed heavily through corporate tax, investors are likely to invest elsewhere. Moreover, if taxes are too high, economic participants are also more likely to direct greater resources to tax avoidance, as Starbucks famously did in the UK.[94]

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[91] Dietsch (n 18) 60.

[92] Kim Brooks, 'Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice' (2009) 34 *Queen's Law Journal* 505, 542.

[93] Joseph E Stiglitz and John Driffill, *Economics* (W.W Norton & Company, 2000) 71.

[94] Kleinbard (n 9) 1516.

Ceteris paribus investment leads to an increase in capital assets. This causes three economic effects. In the short-run, the aggregate demand ('AD') increases, the aggregate supply ('AS') increases, and in the long-term, the long run aggregate supply ('LRAS') increases. Any increase in AD, AS or LRAS will cause it to shift to the right, showing growth.

Aggregate demand is an economic measurement showing the sum of all final goods and services produced in an economy at any given price level in a given period.[95] This is equal to the gross domestic product ('GDP') as it shares the same equation. A shift in AD to the right shows economic growth in the short-term, and so an increase in GDP. Because investment is a factor that makes up the equation of AD, such an increase can be directly driven by increased investment.

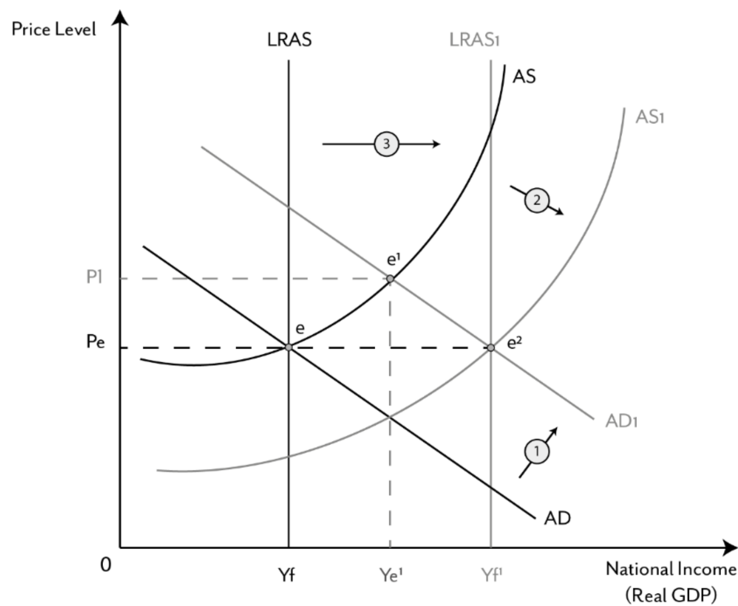
Aggregate supply increases and shifts to the right when investment in technology increases and average cost fall.[96] In the long-run, investment results in the productive capacity of the economy increasing, which in turn causes the LRAS to shift to the right.[97] The final result is actual (short-run) and potential (long-run) economic growth without inflationary pressure. These are the direct benefits that occur within the economy and are reflected by the increase in real GDP. Figure 2 below, shows these effects.

95 Stiglitz and Driffill (n 93) 71.

96 Howard R Vane and John L Thompson, *An Introduction to Macroeconomic Policy* (Harvester Wheatsheaf, 4th Edition, 1993) 283.

97 Ibid.

FIGURE 2 – THE EFFECTS OF CAPITAL INVESTMENT



The AD, AS, and LRAS have all shifted to the right to reflect an increase in each. The new points are AD1, AS1, and LRAS1 at the new equilibrium point e^2. This is the assumed final effect of an increase in investment in an economy. Consequently, the GDP of the economy increases despite the price level of the economy remaining the same.

On the other hand, Brookes states that every type of tax incentive provides clear opportunities for tax avoidance.[98] Therefore, it can be argued that these SDCs may increase avoidance and evasion by acting as tax havens. For instance, for a number of years Starbucks operated in the UK without paying almost any income tax, despite receipts amounting to billions of pounds.[99] This was possible only because it could divert its income outside the UK to a low tax jurisdiction. However, this argument is generally restricted to countries that serve as tax havens by allowing companies to open subsidiaries as shell companies to make paper profits. The countries that this paper considers are those that open their economies as hosts for companies to invest for economic operations. Therefore, her argument is not entirely applicable to SDCs.

B *Positive Externalities*

An increased level of FDI causes external benefits that spill over into the economy more generally, in addition to the effects of the capital injection mentioned above. These externalities

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98 Brooks (n 92) 542.

99 Vanessa Barford and Gerry Holt, 'Google, Amazon, Starbucks: The Rise of "Tax Shaming"' *BBC News* (Online, 21 May 2013) <www.bbc.co.uk/news/magazine-20560359>.

include the spill-over of knowledge, technology and ideas, as well as a decrease in unemployment and an increase in the average wage.[100] Each of these will be considered in detail below.

SDCs with a lack of indigenous natural resources generally face the difficulty of having unskilled human capital, lacking modern technology and experiencing a high level of unemployment. Therefore, a justification can be made in the classic Pigouvian tradition for using tax incentives as a policy instrument especially, for these countries.

FIGURE 3 – ECONOMIC EFFECTS OF SPILL-OVERS

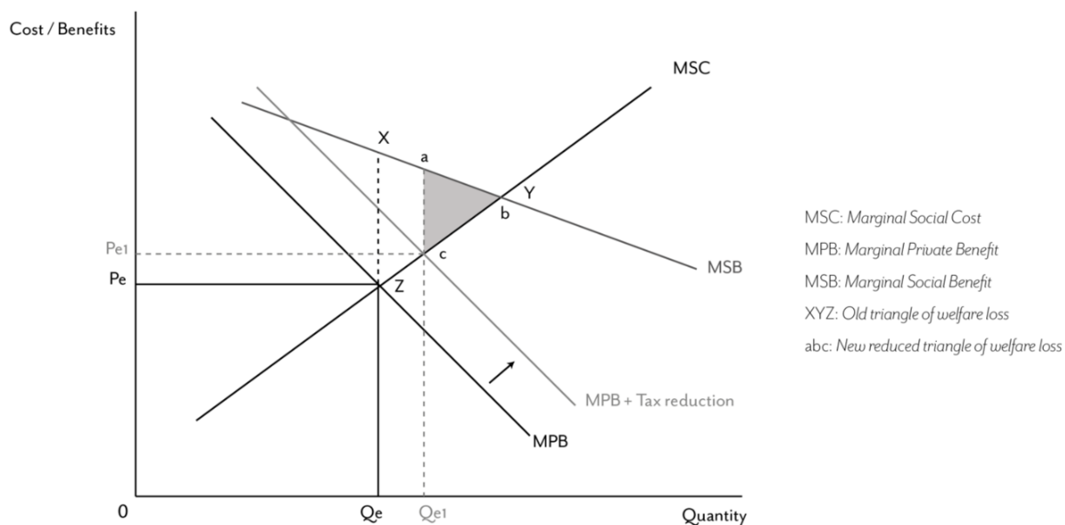

Figure 3 shows the economic effect of positive spill-overs caused due to tax competition. At the starting point, the equilibrium is at Z where the price is at P_e and quantity traded at Q_e. Private sector firms are motivated by profit and so when a government reduces taxes, it increases their ability to make higher profits. It then acts as a signal to invest in that economy and produce more. As production increases, quantity traded increases from Q_e to Q_{e1} and price elevates to P_{e1}, forming the new equilibrium at c. The desired equilibrium of production for the government is at b but, that is not reached. However, c is closer to the socially optimum point at b, than the previous position at Z. At the previous equilibrium Z, there was a deadweight loss to the society equal to the area XYZ, but with a reduction in tax the deadweight loss reduces to the area of abc. Despite not being at the socially optimum point, it improves the

[100] Brooks (n 92) 533.

situation. To put it simply, a smaller triangle of welfare loss means that welfare in society has improved due to this policy.

1 *Knowledge Spill-Over and the Effect of FDI on Incumbent Firms.*

One positive externality of FDI is the spill-over of knowledge. With the migration of MNCs into an economy, they indirectly transfer knowledge to incumbent firms and the labour force. Girma states that these competitive foreign entities have two distinct influences on the incumbent firms: competitive pressure and demonstrative effect.[101]

Firstly, when an FDI enters a market, the incumbent firms in the host country either cope with the competitive pressure by increasing their efficiency or they are driven out of the market. This depends on the 'absorption capacity' of the country.[102] If there is sufficient capacity, the host country will increase output to respond to the FDI increase. However, it is more likely that an SDC will not have sufficient absorption capacity with their level of resources and the market may contract instead. Moreover, SDCs are considered to be less competitive environments and therefore will benefit less from FDI spill-over.[103] Therefore prima facie, it seems as if FDI may cause either the market of SDCs to contract, or not have as much of an effect as developed competitive markets.

However, the second influence of this spill-over, the demonstrative effect, may in some cases be enough to positively counter the competitive pressure. The demonstrative effect occurs when local firms pick up on the productive techniques imported by foreign firms coming in. The demonstrative effect causes two types of spill-overs: horizontal spill-over, and vertical spill-over.[104]

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[101] Sourafel Girma, David Greenaway and Katharine Wakelin, 'Who Benefits From Foreign Direct Investment in the UK?' (2001) 60(5) *Scottish Journal of Political Economy* 560, 566.

[102] Marta Bengoa and Blanca Sanchez-Robles, 'Foreign Direct Investment, Economic Freedom and Growth: New Evidence From Latin America' (2003) 19(3) *European Journal of Political Economy* 529, 532.

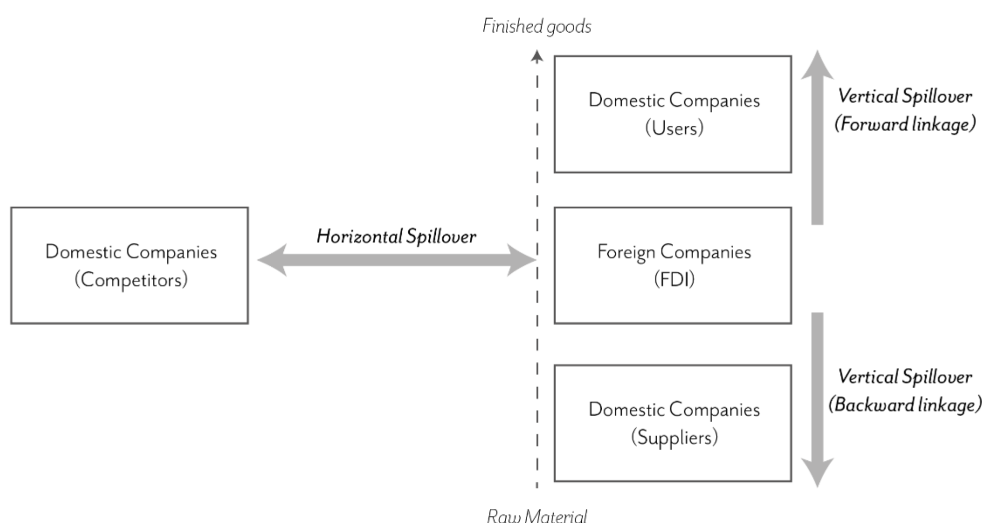
[103] Sourafl Girma and Katharine Wakelin, 'Are There Regional Spillovers From FDI in the UK?' in David Greenaway, Richard Upward and Katharine Wakelin (eds), *Trade, Investment, Migration and Labour Market Adjustment* (*Palgrave Macmillan*, 2002) 172, 178.

[104] Horas Djulius, 'Foreign Direct Investment and Technology Transfer: Knowledge Spillover in the Manufacturing Sector in Indonesia' (2017) 18(1) *Global Business Review* 57, 59.

Horizontal spill-over is the process by which businesses in the same industry and production sector share knowledge with one another.[105] In practice, these firms will be competitors and therefore it is unlikely that trade secrets will be shared explicitly, so it is unlikely to be spread in a short span of time. However, with time, the practice of one firm tends to spread across the industry. The amount of horizontal spill-over also depends on the technological capacity available to incumbent firms. In the short-run, firms in SDCs may initially lack the equipment necessary to utilise the knowledge gained through FDI. Therefore, the results may not be apparent at the outset. However, despite a time-lag, in the long-run, the information and techniques imported will bleed into the local firms.

The demonstrative effect may also occur as a result of a partnership being formed between FDI investors and domestic firms. This relationship is called vertical linkage and causes a vertical spill-over effect in the same industry but between different production sectors. Domestic firms may supply finished or semi-finished products. To cater to the FDI's demand, domestic workers will be expected to meet a certain level of specialization in terms of technical expertise. To help with this, the FDI is likely to offer technical assistance followed by a set of standard operating procedures to follow, in order to meet their requirement. This could either be forward, where the domestic firm supplies to a foreign firm, or backward if it is vice versa. In most developing countries forward vertical linkage is common.

FIGURE 4 – VERTICAL AND HORIZONTAL SPILL-OVER[106]



105 Ibid.

106 Ibid.

Conclusively, despite the competitive pressure that the SDC will face at the start of FDI, the demonstrative effect is likely to combat and overtake that pressure in the long-run. The supply of new knowledge through FDI will allow local firms to rise to the level where they will be able to endure and possibly even thrive in the competitive environment caused by the entry of MNCs. This will lead to an increase in the country's productive capacity in the long-run. The economic result would be the LRAS shifting to the right (shown in figure 2 effect no.3), which will yield many benefits such as an increase in the absorption capacity which will allow even more firms to come in. The economy will also experience a lower rate of inflation. Conclusively, FDI provides the solution through these demonstrative effects to the dilemma of competitive pressure caused by itself.

2 *Technology Spill-Over*

Technological spill-over is another positive externality that results from FDI.[107] When an MNC invests into an economy, they often invest heavily into non-current assets such as factories and equipment to set up a foothold. In this process, a significant amount of state-of-the-art technology is imported into the economy and labour is trained on how to use it. This is called technology transfer and is the direct effect of the importation of new technology.

However, this section focuses on the unintended and indirect effects of technology on domestic firms. Empirical evidence suggests that significant cross-industry technology spill-over among large and small firms exists and occurs in two steps.[108] First, high-level technology is transferred from the MNC's parent company to its subsidiary in the host country.[109] Second, this technology slowly spreads into domestic firms in the host country.[110] The foreign companies are not compensated by domestic firms directly in order to benefit from this externality, rather, it is the by-product of FDI investment into the economy. This results in higher efficiency of domestic firms and an increase in their innovative capacity.

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[107] Stephen D Cohen, *Multinational Corporations and Foreign Direct Investment: Avoiding Simplicity, Embracing Complexity* (Oxford University Press, 2007) 186.

[108] Elhanan Helpman, 'R&D and Productivity: The International Connection' (Working Paper No 6101, National Bureau of Economic Research, 1997) 4.

[109] Smruti Rajan Behera, Pami Dua and Bishwanath Goldar, 'Foreign Direct Investment and Technology Spillover: Evidence Across Indian Manufacturing Industries' (2012) 57(2) *The Singapore Economic Review* 1, 2.

[110] Ibid.

India helps demonstrate the many economic effects of technological spill-overs.[111] In order to attract FDI, India lowered their tax rates.[112] A study conducted from 1990 to 2007 analysed 2148 domestic firms and 231 foreign firms across 16 different Indian manufacturing industries.[113] It concluded that foreign presence played a significant role in improving the level of technology of domestic firms through technological spill-overs and that these spill-overs were only possible because the MNCs invested in the economy for the long-run, rather than having short-run operations which exploit the economy before moving on to the next best host.

Although using a large developing country such as India to show these effects is a deviation from the primary focus of this paper, it is understood that these effects would be similar for SDCs as well. In fact, if anything, they would feel a greater positive impact due to technological spill-overs as the effects of capital inflow are generally greater in small countries as explained in IV(A).

3 *Idea Spill-Overs Leading to Structural Retransformation*

Countries in slumps are often left with few options to break free of the mould that is withholding them. Romer argues that FDI can play a key role in helping such countries to structurally transform.[114] FDI can bring in new 'ideas' into an economy which can instigate economic growth endogenously.[115] Developing countries, therefore, need not come up with their original ideas in order to apply it, the importation of new ideas via multinational investors may be enough to cause economic growth.

Romer uses Mauritius as an example to illustrate the potential idea spill-overs have to change an economy.[116] When Mauritius gained independence in the 1960s, it was one of the poorest countries in the world.[117]

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[111] Ibid 2.

[112] Ibid.

[113] Ibid 16.

[114] Paul M Romer, 'Two Strategies for Economic Development: Using Ideas and Producing Ideas' (1992) 6(63) *World Bank Economic Review* 76.

[115] Ibid.

[116] Ibid.

[117] Ibid.

Much of this was turned around in the years following 1971 as they began to encourage investment from MNCs.[118] They offered tariff-free imports of machinery and materials, no restrictions on ownership or repatriation of profits and a ten-year income tax holiday for foreign investors, all to attract FDI.[119] As a result, there was a sharp increase in foreign and domestic investment. Most of this investment was in garment production. At first glance, it may seem that foreign investors 'flocked to the island bearing sewing machines'.[120] However, in reality, capital alone could not have accounted for the subsequent success of Mauritius as they had always had the means of purchasing the necessary equipment and fostering trade relationships.[121] In fact, domestic savings were invested heavily into these operations following the arrival of the FDI. This shows that rather than the investment itself, the new ideas brought in by the foreign entrepreneurs had a much bigger impact on the island. They imported original ideas about running a garment enterprise such as the best equipment to use, how to manage a small factory and managing relations with foreign importers.[122]

Romer concluded that as a result of this influx of ideas and the ensuing development, Mauritius experienced a period of high economic growth. GDP per capita grew by 9 percent a year[123] and employment grew by 17,000 within seven years – a very significant amount for an island nation with a population of around one million people.[124]

Finally, in 1988, the economy had essentially reached full employment.[125] The importation of new ideas from developed countries enabled Mauritius to grow exponentially and world's seventh biggest exporter of manufactured products between 1970 to 1996.[126] This initiation of

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118 Ibid.

119 Ibid 77.

120 Ibid 78.

121 Ibid.

122 Ibid.

123 Ibid 77.

124 Ibid.

125 Ibid.

126 Steven Radelet, 'Manufactured Exports, Export Platforms, and Economic Growth' (CAER II Discussion Paper, Harvard Institute for International Development, 1999) 43, 46.

new practices brought in through FDI not only increased efficiency but set the economy on a new growth trajectory. [127]

4 *Unemployment and the Average Wage*

Decreasing the level of unemployment is one of the macro-economic objectives of any economy. When FDI is brought in, the government will often require them to offer a set number of jobs to local employees, boosting the nation's employment rate. Additionally, many local companies often form part of the supply-chain of these foreign firms, which in turn will employ more people. Therefore, FDI creates a positive multiplier effect in the economy, which creates a compound effect that benefits several parties. In the UK alone, for example, FDI created around 75,000 new jobs in 2017/18.[128] The report by the UK Department for International Trade and Investment ('DIT') showed a net creation of approximately 1.3 jobs for every £1 million of FDI in Britain.[129] This benefit will be further appreciated by SDCs as they usually have higher levels of unemployment than developed countries.

In addition to decreasing unemployment directly, employees hired by MNCs will be given training, which often involves exposure to more productive techniques which leads to a higher marginal product and higher wages.[130] The local firms may therefore be forced to increase wages to attract high-level employees to remain competitive. However, Girma argues that this is not the most significant reason for which wages increase. Instead, he states that any positive effect that takes place is due to local firms training their employees in order to match the increased level of productivity and avoid being driven out of the market. It is acknowledged that some firms may be driven out of the market due to competitive pressure. Nevertheless, the benefits of the training provided to human capital by both MNCs and local firms cannot be ignored. The level of skill in the labour force increasing is vital for any economy for the long term because it provides a myriad of benefits. High skilled labour is more likely to be employed and paid more as they are more productive. The big picture is an increased level of national output per fiscal year.

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[127] Theodore H Moran, *Foreign Direct Investment and Development* (Peterson Institution for International Economics, 2010) 87.

[128] Department for International Trade (n 5) 22.

[129] Ibid.

[130] Girma, Greenaway, and Wakelin (n 101) 561.

On the other hand, the extent to which local employees are employed will depend on the production methods employed by the MNCs. Having better access to technology, they are more likely to automate basic tasks if most of the investment is in the primary and secondary sectors. A significant benefit will only be felt if MNCs are investing in the tertiary sector. However, because SDCs lack natural resources, investment by FDI into the primary and secondary sector is less likely. Moreover, studies show that SDCs usually have a larger service sector.[131]

The lack of natural resources by these countries can be mitigated by the development of highly skilled labour in the service sector. Therefore, encouraging investment into the tertiary sector is a worthwhile policy effort for SDCs to consider. Singapore is an example that operates in this model. Initially, they were a small country without natural resources. However, they have grown using their tertiary sector and are now one of the strongest economies with a highly skilled workforce.

C *The Big Picture*

When one considers all of the benefits discussed above, it may seem as though FDIs offer a 'free lunch' to any host country. However, this is not the case as MNCs' due diligence prior to investing is comprehensive, and their potential tax liability is just one out of many factors that will be considered. What is paramount to them is earning the highest risk-adjusted return,[132] which requires considers about infrastructure, workforce skills, access to raw materials and markets.[133] Although SDCs with low tax rates may seem like a lucrative investment location, drawbacks such as high levels of corruption, difficult governments, and a lack of infrastructure may be reasons why MNCs may choose not to invest in these countries. Therefore, the ease of doing business may be low. Kim Brooks posits that these factors outweigh any benefit that can be received by a low tax.[134]

Nevertheless, the weighing of these drawbacks against the benefits of low tax will depend on how sensitive FDI is to changes in the tax rates. In other words, it depends on the elasticity of demand for investment, to the change in tax. James Hines concluded that FDI is sensitive to

[131] Brito (n 22) 14.

[132] Brooks (n 92) 537.

[133] Ibid.

[134] Ibid.

tax policies.[135] Thus, it is likely the low tax's benefit could actually outweigh some of the other factors, therefore making investment lucrative. The workforce is likely to develop as explained above however, the governments of the SDCs will have to actively improve the infrastructure if they would prefer the MNCs to remain in the country and attract more FDI.

The short-term benefits received from tax incentives are temporary. However, fundamental reforms in developing core government functions are vital for long term sustainability. A significant influx of FDI which pulls out shortly can leave an economy in a depression. Therefore, a low tax can be used as bait, but it will then have to be supplemented with long-run-oriented development.

D *Section V Conclusion*

In summary, tax incentives offered by SDCs with low natural resources attract FDI. FDI brings external benefits to the SDC but its significance depends on the absorption capacity. However, it is argued that despite the absorption capacity being low in the short-run, it can be increased in the long-run. This will lead to several other positive spill-over effects such as idea, knowledge and technology spill-overs. Unemployment is likely to reduce and the average wage is likely to increase. For this result to be sustained, the government will need to focus on developing the infrastructure for a higher productive capacity for the long run. For SDCs, building a long runway to capture capital flight is the long runway.

VI INSTITUTIONAL REFORM: LEARNING TO COMPROMISE.

Now that the justification for SDCs to continue to engage in tax competition and the resulting benefits have been analysed, the elephant in the room needs to be addressed: what to do about the push from large companies for institutional reform to eradicate tax competition.

This section evaluates the merits of potential proposals for reform and considers what the most optimal solution might look like. Firstly, it considers the worst-case scenario for SDCs – complete tax harmonisation without any compensation. Next, it considers the best-case scenario for SDCs – continuation of their tax practices until they reach sufficient development. Finally, it is important to consider the most pragmatic solution. A solution that provides benefits to all parties involved while minimizing everyone's losses. Although this solution is

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[135] James R Hines Jr, 'Lessons from Behavioral Responses to International Taxation' (1999) 52(2) *National Tax Journal* 305, 309.

not the best-case scenario for those against or for tax competition, it is the most politically viable solution.

A *Complete Eradication of Tax Competition with No Compensation*

The most popular proposal will be for all countries to cooperate in setting taxes in order to be globally optimal. For developed countries, this would be their ideal solution. Tax competition is a disease that persists even if one country were to operate as a tax haven.[136] This is because a significant amount of mobile capital will still have the opportunity to escape as long as one tax haven remains. Tax harmonisation must be unanimous for countries to be able to fully escape the parasitic effects of tax competition, however, the results of such reform will be detrimental.

Additionally, some developed countries may argue that compensation should not be offered to the countries who will now be unable to rely on tax competition. This is because not engaging in tax competition is the normative baseline. Hence, they should not be offered anything in return for giving it up. For instance, if a drug dealer was caught and forced to stop his illicit business, it would be ridiculous for him to demand money in compensation for the loss of the source of his income. Similarly, although tax competition is not illegal, it is using an unacceptable method for their individual gain. Hence, countries need not be paid for ending such activities.

Moreover, they should not be compensated as they have continually been implementing policies that could be considered 'beggar thy neighbour'.[137] These are policies which improve the economic situation of one country while worsening others'.[138] In this way, the capital that these countries have received through tax competition will all have been at the expense of other nations.

Nevertheless, this reform would significantly worsen the SDCs economic condition. Remaining competitive is the only option they have available to stimulate their market and continue growth while fending off poverty. If they are forced to raise taxes, their once lucrative runway will no longer be pursued by incoming capital flight. Furthermore, while small

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[136] Dehejia and Grenschel (n 72) 419.

[137] Smith (n 54) Book IV Ch III [9].

[138] Ibid.

developed countries might be able to pay compensation fees, SDCs will only sink further in debt if they were to pay.

However, it may not come to this. SDCs can remain stubborn if left with no choice without changing their policies because even if one country were to remain as a tax haven, the proposal would fail. Although the countries pushing for reform are far more powerful, the SDCs could play this card in order to ensure that they are given a fair proposal. This is the main reason why large countries have been unable to use their geopolitical strength to bully small countries to harmonise.[139]

B *The Toleration of Tax Competition by SDCs Only*

In the absence of tax competition, there would be less distortion in the market and the distribution of resources amongst countries would be arguably be more fair. However, it is important to consider that all countries are not at an equal standing internationally to begin with and eliminating tax competition could increase this inequality. Without low taxes, natural resources, or a large market, SDCs will have little to attract foreign investors. Hence, the best outcome for them would be to continue their tax practices as is.

In order to avoid widening the global inequality gap further, it is proposed that the use of tax competition by countries such as SDCs should be tolerated until they reach an HDI of 0.7. Once these SDCs grow enough to have the necessary infrastructure in place to support sustainable long-term growth, they could be weaned off tax competition. This way, tax competition will eventually be abolished, but only after the global market has shifted to a fairer position and most countries are on a more level playing field.

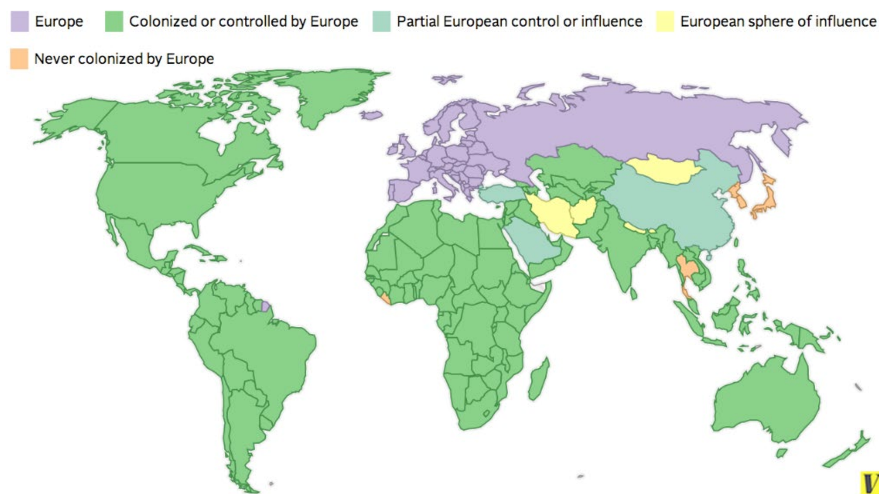
Additionally, if one were to look at common factors amongst developing countries, one that would stand out is the fact that almost all of them are former colonies of Western Europe. Whilst currently SDCs reap the rewards of tax competition, the history of how developed countries benefited at the expense of developing countries ought not to be ignored.

During colonial times, their limited resources were looted. When these countries finally experienced independence, they had to start from scratch with the minimal resources they had left. By the end of the imperial era, colonisation had left the colonisers significantly developed

[139] Dehejia and Grenschel (n 72) 420.

at the expense of the colonised. The map below shows the magnitude of colonisation. With the exception of Thailand, all countries which are considered to be 'third world' had been forcibly colonised or fallen under the sphere of influence of colonial power at one point or another.[140] Now, many of these SDCs are forced to lure resources over their borders to at least try and catch up with the rest of the world. They strive against instability and low fiscal autonomy and should not be punished for using legal and competitive policies to pull themselves out of a situation they may not have been in had it not been for colonisation.

FIGURE 5 – COUNTRIES THAT HAVE BEEN UNDER EUROPEAN CONTROL[141]



Mauritius is a great example of a former colony's struggle to reach stability after gaining independence.[142] As highlighted in IV, tax competition played a huge role in allowing the nation to reach this stability and they now score a 0.8 on the HDI.[143] Admittedly, this means that they should now stop engaging in tax competition under the criterion of this paper. Nevertheless, other low-scoring countries should be allowed to continue the practice until they reach a minimal level of development.

Additionally, SDCs only rely on the benefits of tax competition for their basic survival. The situation of small *developed* countries could be compared to that of Eve in the Garden of Eden; motivated by greed and wanting more, she took a bite of the forbidden fruit. Similarly,

140 Cohen (n 107) 181.

141 Max Fisher, 'Map: European colonialism conquered every country in the world but these five' *VOX* (Online, 24 February 2015) <www.vox.com/2014/6/24/5835320/map-in-the-whole-world-only-these-five-countries-escaped-european>.

142 Romer (n 114) 76.

143 United Nations Development Programme (n 23).

countries such as Singapore with an HDI score above 0.9 continue to engage in tax competition while enjoying some of the highest living standards in the world.[144] For SDCs, taking a bite from the forbidden fruit of tax competition is solely due to need. They do not use this policy to earn more, but to earn enough.

C *The Abolition of Tax Competition with Compensation to the SDCs*

After considering two sides of the coin, one must consider what the optimal solution is. The eradication of tax competition without any reparations will be far too damaging to SDCs. On the other hand, if the practice were allowed to continue, there is no doubt that the corrosive impacts of tax competition will continue to be felt worldwide. Therefore, a solution that provides a middle ground should be considered. This is proposed to be abolishing tax competition globally, while offering compensation for SDCs who rely on it for their growth. This remuneration will only be given until these countries reach a level that is sufficient enough for them to independently sustain growth. As mentioned before, this will be considered to be any level equal to or above 0.7 in the HDI. The compensation will be paid for by countries that are developed and have actively pushed for reform.

The problem with tax competition is that the end does not justify the means. What this solution offers is another means by which SDCs could reach that end. As SDCs only use this policy because they have few options to help them grow, if they were to gain the benefits offered from tax competition through another path, there should be little reason to object.

Furthermore, FDIs that have already set-up operations in the SDC are unlikely to take flight immediately just because taxes are levelled. This is because they have sunk costs in the host country and there is less incentive to relocate if other jurisdictions also have the same tax rate. Therefore, under this proposal, although the high influx of FDI is reduced, they will not lose most of the investment they had secured.

Nevertheless, one may still question why countries that did not engage in tax competition will be required to pay compensation to the small nations engaging in the very behaviour they targeted to stop. The main reason would be because they have much more to gain through the

[144] Ibid.

eradication of tax competition than to lose from the compensation they will have to pay. Thus, giving them a net benefit.

First, it is argued that compensation should only be given to countries that are considered to be SDCs. The exact amount that other nations would likely have to pay as compensation will be much less than what they were previously losing to tax competition. This is because they would have lost money to developed countries with low taxes as well previously, but will now only have to compensate SDCs.

Second, money that was flowing out of the country due to avoidance and evasion will decrease greatly. As explained in I, tax competition helps tax avoidance, so by eliminating one problem, a government can successfully reduce the other.

Finally, due to the high purchasing power within populations of developed countries, there will be higher demand for products. Without tax competition, MNCs will be more likely to invest in these countries rather than SDCs. Therefore, these developed countries will be able to gain increased FDI as well.

For the reasons highlighted above, it could be argued that there are no clear losers in this solution. The developed countries successfully eliminate tax competition globally and the SDCs can continue to develop without suffering. Therefore, this proposal could be considered to be impartial with sufficient political acceptability for it to be a hypothetically feasible solution to the problem of tax competition and SDCs. However, solving such a complicated problem such as tax competition is not as simple as this in reality. What remains crucial is that no matter what policies are implemented, the burden that reform places on SDCs is addressed fairly and equitably.

VII CONCLUSION

The continuous plea of this paper is not to promote tax competition globally, nor is it to encourage its practice by every country. As shown through game theory, for most countries, tax competition remains to be harmful, and if adopted worldwide, could be detrimental to the global economy. This paper argues that SDCs should use tax competition to their benefit as a narrow exception to the rule.

The literature on tax competition has shown a steady tide against it, labelling it as harmful. In this process, attempts to fully define it have been washed away. While the literature has primarily focused on the loss to developed countries, this paper addressed how SDCs with low natural resources can benefit from lower tax rates. These are primarily benefits arising by FDI inflow. Discussing all the benefits arising from an FDI in a host economy is beyond the scope of this paper but the primary benefits have been explained.

Moreover, it was also shown how tax competition could act as a shackle to restrain governments from being able to exercise unlimited autonomy. While a government's role could arguably be hindered by tax competition, public choice theory was used to show how it could instead be used to discipline the government when they are not perfectly benevolent.

Resources are limited globally and tax competition distorts them from being distributed equally. However, in reality, all things are not equal. Different countries have naturally been blessed or cursed with different level of resources. To make things worse, events like colonisation have caused an unnecessary handicap to some countries. Economic development is far from being equal globally. Tax harmonisation is one solution and has the capability to reduce resources flying from one economy to another. However, rather than creating an equal environment, it widens the inequality between the developed and developing by giving more to the wealthy. Instead of adopting a view that tax competition is harmful just because those that are developed prefer to say so, SDCs should be given the opportunity to be competitive in order to catch up and achieve true equality. In reality, they would be better off without the reforms altogether, but it is understood that this may not be a realistic long-term option. Therefore, the next best option for them is to negotiate and accept a middle ground that will still enable them to grow.

In addition to being a matter of equality, this paper sought to justify tax competition on the basis of equity. The daily challenges faced by people in developing countries can hardly be imagined by those in developed nations. State aid is often provided to show international harmony, but what is the value of such aid if developing countries are prevented from exercising competitive fiscal policies for their own long-term development? Is the rest of the world only allowed to catch up on the terms of rich countries?

Tax competition empowers otherwise helpless countries to start benefiting from economic activity. While the developed world is years ahead, with large countries having mass

consumption and a large labour force, and some countries being blessed with vast amounts of natural resources, SDCs do not have many options to choose from to stimulate their economy. In this current climate, for them, it is like lighting a fire with a matchstick in the rain. However, tax competition and the consequent benefits of external capital injection have the most positive and powerful impacts on SDCs due to their small size. For SDCs, tax competition is truly a blessing in disguise.