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TABLE OF CONTENTS

EDITORIAL

The 2023 issue of the *Journal of Australian Taxation* is contained in Volume 25(1) and a special edition focusing on New Zealand in Volume 25(2). The editors are very grateful for the hard work and dedicated effort of the guest editor of the special edition, Associate Professor Jonathan Barrett in attracting the excellent papers for the second volume in 2023. The editors recommend that readers take particular note of the introduction to the special edition written by Jonathan. He makes a very apt statement as to the role of tax academics in the following comment:

> In short, as tax researchers, we can and should be taking our research to the public to promote general debate about taxation, and tax justice in particular. If we fail to stake a claim in that space, others may take it.

The first volume, 25(1) consists of four articles covering a wide range of taxation topics. The Editors are grateful for the contribution made by the authors in this edition of the journal, especially Professor Brett Freudenberg for his ongoing support of this journal.

The first article by Melissa Belle Isle, Brett Freudenberg and Tapan Sarker explores whether the internal resource of understanding business tax, financial statements and/or computer accounting software (CAS) by small business owners is related to their business success in the service sector. The results demonstrate that small businesses with a higher understanding of business tax and CAS achieve a higher value of gross annual revenue, as well as net annual income. These results are important in demonstrating the need for small business owners to improve their understanding of business tax and CAS can aid the overall success of their business. The authors examined the outcome of the data collected from 116 small business owners to understand in more depth what aids or hinders an increase in small business owners (SBO) literacy. The article provides a broad summary of the importance of the three literacies for small businesses, namely the importance of cash flow management concerning the SBO's literacy of financial statements, computer accounting software (CAS), and business tax. The authors clearly demonstrate through their research that these literacies are important in the management of the cash flow of the business. The surveys explored what may aid or hinder the development of these literacies for SBOs through the interview of small business experts. From these interviews a number of key inhibitors were identified including time, lack of business acumen, low training, cost, and the focus on producing business records for tax compliance rather than management practices. From these findings, the authors were able to provide recommendations that could assist SBOs to improve their understanding of these three important areas.

The second article is written by James McMillan and examines the links between Indonesia's tax collection performance and the design and operation of its tax compliance system through a study of the tax audit practices and procedures of Indonesia's tax authority, the Directorate General of Taxation. The article considers the distortionary effect of some features of Indonesia's tax compliance approach under which audits tend to be focused largely on taxpayers who are already compliant and the fact that audit activities are narrowly focused and not risk based. The article also considers ways in which the Indonesian tax authorities could expand tax audit coverage and modify audit procedures and thereby increase the

effectiveness of their compliance activities in the future leading to improved revenue collection outcomes.

The third article is written by Dominic Breznik and an earlier version of this article was awarded the 2023 Forsyth Pose Scholarship by the Law Council of Australia. The article critically examines the legislation which applies Australia's capital gains tax regime to partnership assets and contends that the design is peculiar. Dominic contends that it diverges from the general law by treating partners as holding fractional interests in partnership assets while relying on the same general law to quantify these interests. The article argues that the design of the CGT regime was influenced by an assumption that the general law recognises partners as holding direct interests in partnership assets. Dominic demonstrates that inconsistent elements in the regime's design have produced confusion concerning the meaning and application of its provisions. Finally, he proposes reforms to the legislation which governs the regime and the primary Australian Taxation Office ruling that is relevant to these issues.

The fourth and final article in this volume is written Lisa Marriott and Max Rashbrooke and examines the different approaches to tax concessions for political donations in Australia and Aotearoa New Zealand (NZ). In Australia, a tax deduction may be claimed for a moderate donation to a political party. Conversely, in NZ no tax concessions are available for donations to political parties. The study concludes that while there are several benefits of using the tax system to facilitate political donations, the two different policies align with the two countries general approaches to using the tax system to influence behaviour. An analysis of tax expenditures is used to support this argument.

John McLaren and John Minas

Editors 2023

DOES TAX LITERACY MATTER? THE RELATIONSHIP BETWEEN SMALL BUSINESS LITERACY AND BUSINESS PERFORMANCE AND CASH FLOW

MELISSA BELLE ISLE*, BRETT FREUDENBERG≠ AND TAPAN SARKER#

Abstract

Resource Based Theory would suggest that owners or managers who efficiently and effectively make use of internal resources and implement strategies in their businesses have a greater chance of realising a competitive advantage over others in the same industry. This research explores whether the internal resource of understanding business tax, financial statements and/or computer accounting software (CAS) by small business owners is related to their business success in the service sector. The results demonstrate that small businesses with a higher understanding of business tax and CAS achieve a higher value of gross annual revenue, as well as net annual income. These results are important in demonstrating the need for small business owners to improve their understanding of business tax and CAS can aid the overall success of their business.

Keywords: Small business, tax literacy, business performance, Resource Based Theory.

I INTRODUCTION

This article explores whether having a better business tax knowledge amongst other things helps small businesses achieve greater profitability. There can be a number of characteristics that contribute to the effective running of a business. Resource Based Theory (RBT) suggests that these characteristics can include internal resources. Internal resources in one business are likely to be different from those evident in other businesses due to varying levels of skill, and capital investments. This diversity can be advantageous when the ability of the business owner and manager allows them to exploit the internal business resources to a greater extent than others in the same industry.[1] RBT indicates that owners or managers who efficiently and

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[1] Jay Barney, 'Firm Resources and Sustained Competitive Advantage' (1991) 17(1) *Journal of Management* 99.

effectively make use of internal resources and implement strategies that promote those internal resources in their business, have a greater chance of realising a competitive advantage over others in the same industry.[2] Firm resources are one of the three identified components of RBT, with the others being a competitive advantage and sustained competitive advantage.[3] Such firm resources have three components, being: physical capital, organisational capital, and human capital.[4] Physical capital includes geographical location, plant, equipment, and access to raw materials. Organisational capital encompasses the formal and informal processes and practices implemented within the business. Whereas human capital relates to the training, experience, intelligence, and relationships that exist within the workforce of a business. It can also include the ability of owners and managers to have insight and to make judgements that have a positive impact on the success of the business.[5]

Human capital is critical when considering small businesses, as small business success may be influenced by the managerial capabilities of small business owners ('SBOs'). The skill strengths of SBOs at the commencement of their business can revolve around the technical skills that the owner possesses.[6] Research has suggested that a major cause of small business failure can be explained by inadequate SBO management skills.[7] Financial management skills can be lacking for SBOs at the start of their business (except for those operating in finance or accounting).[8] It is argued the skills and strengths of the SBOs is of critical importance as there can be financial constraints that can inhibit the use of external advisors.[9] Even when external advice is sought out, it can centre on compliance rather than management advice.[10] This is important to keep in mind as failure rates in new businesses are particularly high in comparison to established firms, with many businesses in the early stages ceasing to exist past five years.[11] Viability can be influenced by internal and external barriers in the business environment, including the individual structure and characteristics of the small business; as well as the requirement to comply with the policy, legislation, and regulations.[12]

A related issue is cash flow management, which has been identified as one of the most important problems for businesses.[13] Effective cash flow management is important to

[2] Ibid.
[3] Ibid.
[4] Robert S. Nason, and Johan Wiklund, 'An Assessment of Resource-Based Theorizing on Firm Growth and Suggestions for the Future' 44(1) (2018) *Journal of Management* 32.
[5] Gerald F. Davis and Theodore DeWitt, 'Organization Theory and the Resource-Based View of the Firm: The Great Divide' (2018) 47(7) *Journal of management* 1684.
[6] Arthur R DeThomas and William B Fredenberger, 'Accounting Needs of Very Small Business' (1985) 55(10) *The CPA Journal* 14.
[7] Pearl Dahmen and Eileen Rodríguez, 'Financial Literacy and the Success of Small Businesses: An Observation from a Small Business Development Centre' (2014) 7(1) *Numeracy* 1.
[8] Michael Peel, Nicholas Wilson and Carole Howorth, 'Late Payment and Credit Management in the Small Firm Sector: Some Empirical Evidence' (2000) 18(2) *International Small Business Journal* 17.
[9] OECD, *Taxation of SMEs in OECD and G20 Countries* (Paris: OECD Publishing, 2015).
[10] Sue Yong and Brett Freudenberg, 'Perceptions of Tax Compliance by SMEs and Tax Practitioners in New Zealand: A Divergent View?' (2020) 26(1) *New Zealand Journal of Taxation Law and Policy* 57.
[11] OECD (n 9).
[12] OECD, *Financing SMEs and Entrepreneurs: An OECD Scoreboard – Australia* (Paris, OECD Publishing, 2018).
[13] Peel, Wilson and Howorth (n 8).

business survival irrespective of the size of the business.[14] For cash flow management, SBOs with advanced human capital resources supporting their ability to collect, analyse and use accounting information, have a greater likelihood of improving and enhancing business processes and strategies.[15] Assessment of small business liquidity suggests that small businesses are less liquid and exhibit more volatility with cash flow and profit than their larger competitors.[16] Research has proposed that liquidity management should be regarded as important at the start and throughout the growth of the business.[17] Cash flow management may change overtime because of external events or due to requests from stakeholders who inadvertently force SBOs to learn new procedures and routines.[18] For example, a bank may require financial statements when an SBO applies for a business loan. In contrast, for those who have never prepared a cash budget or business plan for an external party, they may be unaware of the importance of these skills for implementing effective and efficient cash flow management practices.[19] Recent research by the Australian Taxation Office (ATO) has highlighted that advisors (more specifically tax agents) believe that, with the exception of tax-related advice, small businesses need more assistance with cash flow than with any other area of non-tax-related advice.[20] Other areas where experts perceived that SBOs needed guidance included financial management, record keeping, business planning, and staff-related advice.[21] While external advice could be sought, given financial constraints the use of external advisors could be limited, meaning that the skills and strengths of the SBOs is of critical importance.[22] Research demonstrates that even when external advice is sought out, which can be prompted by tax, it appears that the advice is largely about compliance matters rather than managerial insights about the business performance.[23]

This research focuses on small businesses, particularly those in the service sector, due to their importance the economy. Small businesses account for 98% of all Australian private sector businesses,[24] and play a critical role in business-to-business transactions, providing goods and services to almost two-thirds of all Australian businesses.[25] Their contribution to national income is 34.7% of total gross value added ('GVA') and they employ 4.8 million people, representing 45.7% of all Australian private sector employees.[26] Furthermore, the magnitude of the service sector to the Australian economy, measured in GVA, is 77.25% or $2,910.2

[14] DeThomas and Fredenberger (n 6).
[15] Norhasni Haron, Sofri Yahya and Md Harashid Haron. 'Cash Flow Information and Small Enterprises' Performance' (2014) 7 *International Journal of Organizational Innovation* 7.
[16] Peel, Wilson and Howorth (n 8).
[17] Ibid.
[18] David Deakins, Alana Morrison and Laura Galloway, 'Evolution, Financial Management and Learning in the Small Firm' (2002) 9(1) *Journal of Small Business and Enterprise Development* 7.
[19] Ibid.
[20] Australian Taxation Office, 'Small Business Engagement 2017' (5 April 2018).
[21] Ibid.
[22] Dedy Suahputra Sijabat and Taufik Fathurohman, 'The Relationship of MSME Owners Financial Literacy Score and MSME's Performance: Case Study of MSME's in School of Business and Management Bandung Institute of Technology' (2017) 2(1) *Journal of Innovation, Business and Entrepreneurship* 23.
[23] Yong and Freudenberg (n 10).
[24] Australian Bureau of Statistics, '*Counts of Australian Businesses including Entries and Exits (Jun 2017 to Jun 2021).*' (Catalogue No 8165.0, 24 August 2021) (Canberra, ABS, 2021).
[25] Department of Industry, Innovation, Science, Research and Tertiary Education, *Australian Small Business Key Statistics and Analysis* (Canberra: Department of Industry, Innovation, Science, Research and Tertiary Education, 2012).
[26] Australian Bureau of Statistics (n 24); Australian Bureau of Statistics, '*Australian Industry 2019-20.*' (Catalogue No 8155.0, 28 May 2021). (Canberra, ABS, 2021).

billion.[27] The service sector employs 87% of all Australian private sector employees and is responsible for 89% of all business registrations.[28] Within the service sector, small businesses have a large presence.[29] Service sector small businesses employ approximately 41% or 4,053,000 of all service sector employees and contribute $1,088 Billion to the GVA of Australia.[30] Consequently, focusing on small businesses in the service sector makes sense. For this research project, the term 'small business' incorporates those businesses identified by their quantitative measures by the ATO and Australian Bureau of Statistics ('ABS') as being 'micro' and 'small'.[31] Broadly, small businesses will be those with an annual turnover of $10 million or less and a full-time workforce of 20 or fewer employees.

Also, given that small business ongoing success has been associated with the implementation of effective cash flow management systems, it is important to examine whether the personal levels of literacy of SBOs could have some impact on the cash flow management systems that are employed in the business. Research has investigated the financial literacy and taxation literacy of individuals and found that, broadly, SBOs have a higher level of taxation and financial literacy than individuals who are not involved in operating a business.[32] However, from a taxation perspective, literacy was measured using tax systems relevant to complying as an individual taxpayer, not as a small business taxpayer.[33] In research that focused on five business taxes applying to SBOs in Australia, it was found that those younger businesses, with simple structures such as a sole trader with lower employee numbers are likely to have a lower business tax literacy.[34] However, is increased business tax literacy associated with improved business performance? This research seeks to consider whether effective cash flow management for SBOs in the service sector could be influenced by their level of understanding of business tax, financial statements and computer accounting software ('CAS').

Section Two of this article will provide a broad summary of literacy in terms of business tax, professional financial and CAS. The third section will then provide the research method undertaken, followed by the demographics of the participants in section four. The results are presented in Section Five, with Section Six containing recommendations. Limitations and future research are outlined in the seventh section of the article before concluding.

II LITERACY

[27] Australian Trade Commission, 'Why Australia: Benchmark Report 2019' (8 April 2019).
[28] Ibid.
[29] Department of Industry, Innovation, Science, Research and Tertiary Education, (n 25).
[30] Australian Bureau of Statistics (n 26).
[31] Australian Bureau of Statistics (n 24); Australian Taxation Office (n 20).
[32] Toni Chardon, Brett Freudenberg and Mark Brimble, 'Tax Literacy in Australia: Not Knowing Your Deduction from Your Offset' (2016) 31(2) *Australian Tax Forum* 321; Brett Freudenberg, Toni Chardon, Mark Brimble and Melissa Belle Isle, 'Tax Literacy of Australian Small Businesses' (2017) 18(2) *Journal of Australian Taxation* 21.
[33] Chardon, Freudenberg and Brimble (n 32).
[34] Melissa Belle Isle, Brett Freudenberg and Tapan Sarker 'The Business Tax Literacy of Australian Small Businesses' (2022) 37(1) *Australian Tax Forum* 65.

A *Owner Literacy*

Small business failure has been affiliated with several barriers including financial constraints, market imperfections, resource restrictions, inadequate technical expertise, and limited managerial skills.[35] The inability of the SBO to recognise the influence of these barriers on their business can be detrimental, particularly given the central role they can play in their business operations. Some of these barriers are outside of the control of the SBO. For example, in Australia, small business financial constraints were evident during the global financial crises.[36] However, many internal barriers could potentially be overcome by an increased level of SBO literacy.[37] In recent times the notion of 'capability' (compared to literacy) has arisen, as capability covers not only a person's understanding something but also the confidence and capability to actually use that knowledge. The notion of literacy is not static and it can develop over time,[38] and refers broadly to a person's knowledge and ability to use that information.[39] Of course what literacies required by a person can depend upon their activities. When faced with managing a business it has been suggested that SBOs require a broad range of knowledge.[40] In terms of cash flow for a small business this could include concepts related to business tax, finance and CAS, as well as accounting.

The ability to maintain consistent cash flow levels is important for cash flow management. Ekanem argued that SBOs should attempt to avoid extended cash shortages, as supply constraints affect the ongoing operations of the business.[41] For example, creditors may stop supplying goods to the small business, which means the small business cannot trade and generate income. In order to reduce cash constraints and to achieve better control of cash flow, it has been suggested that SBOs need to implement effective cash flow management practices.[42]

Effective cash flow management practices consist of keeping financial accounts; maintaining a business plan and a cash budget; keeping records of revenue, expenses, creditor and debtor invoicing; and maintaining an inventory schedule.[43] Previous research in Australia and the United Kingdom (UK) has suggested that SBOs are not actively involved in systematic cash

[35] Suahputra Sijabat and Fathurohman (n 22).
[36] Melissa Belle Isle, Brett Freudenberg and Richard Copp, 'Cash Flow Benefit from GST: Is it Realised by Small Businesses in Australia?' (2014) 29(3) *Australian Tax Forum* 417.
[37] Sandra J. Huston, 'Measuring financial literacy' (2010) 44(2) *Journal of Consumer Affairs* 296.
[38] Ibid.
[39] Reva Berman Brown, Mark N.K. Saunders and Richard Beresford, 'You owe it to Yourself: The Financially Literate Manager' (2006) 30(2) *Accounting Forum* 171.
[40] Ibid.
[41] Ignatius Ekanem, 'Liquidity Management in Small Firms: A Learning Perspective' (2010) 17(1) *Journal of Small Business and Enterprise Development* 123.
[42] Peel, Wilson and Howorth (n 8).
[43] Alejandro Drexler, Greg Fischer and Antoinette Schoar, 'Keeping it simple: Financial literacy and rules of thumb' (2014) 6(2) *American Economic Journal: Applied Economics* 1.

flow management practices.[44] While day-to-day recording of activities involving cash inflow and outflow may be undertaken, the process involved in receiving and making payment for those activities, or in managing cash once received, may not be actively conducted.[45]

Defining the exact literary requirements of SBOs to effectively manage cash flow could be a challenging exercise due to the heterogeneity of the small business sector. The level of literacy held by SBOs could be wide ranging because of education, experience and social backgrounds. For migrant SBOs, their level of literacy could be further restrained by the challenges from having English as a second language.[46] For the management of cash flow, this research focuses on the literacy of SBOs in terms of business tax, professional financial literacy and CAS literacy. The importance of literacy in these areas is examined further exploring existing literature and highlighting areas of research that require further investigation.

B *Business Tax Literacy*

Business tax literacy concerns the tax knowledge that is essential to a taxpayer's situation within the region or country in which that taxpayer resides.[47] To obtain tax knowledge this can occur as a taxpayer is exposed to and has experience with the tax system; but also, they could undertake courses or training, or obtain advice and assistance.[48]

An area that could benefit from improved tax literacy is potentially tax compliance, as those taxpayers with lower tax literacy could be engaging in unintentional non-compliance behaviour due to inadvertent mistakes.[49] Such mistakes could result in tax debts leading due to cash shortfalls, [50] as well as the further financial burden of penalties and interest. [51] Additionally, improved tax literacy could influence taxpayer behaviour through better trust and understanding of the tax system.[52] Of course, even though higher tax literacy taxpayers might engage in intentional non-compliance behaviour.

[44] Melissa Belle Isle and Brett Freudenberg, 'Calm Waters: GST and Cash Flow Stability for Small Businesses in Australia' (2015) 13(2) *eJournal of Tax Research* 492.
[45] Peel, Wilson and Howorth (n 8).
[46] L Chen, E Sinnewe and Michael Kortt, *Evidence of Migrant Business Ownership and Entrepreneurship in Regions* (Regional Australia Institute, 2018).
[47] Newman Wadesango, N Mwandambira, Charity Mhaka and Ongayi Wadesango, 'Literature Review on the Impact of Tax Knowledge on Tax Compliance among Small Medium Enterprises in a Developing Country' (2018) 22(4) *International Journal of Entrepreneurship* 1.
[48] Ibid; Belle Isle, Freudenberg and Sarker (n 34).
[49] Ibid; Natrah Saad, 'Tax Knowledge, Tax Complexity and Tax Compliance: Taxpayers' View' (2014) 109 *Procedia - Social and Behavioral Sciences* 1069.
[50] Elisabeth Poppelwell, Gail Kelly and Xin Wang, 'Intervening to Reduce Risk: Identifying Sanction Thresholds Among SME Tax Debtors' (2012) 10(2) *eJournal of Tax Research* 403.
[51] Ibid.
[52] Rosalita Rachma Agusti and Aulia Fuad Rahman, 'Determinants of tax attitude in small and medium enterprises: Evidence from Indonesia' (2023) 10(1) *Cogent Business & Management* DOI: 10.1080/23311975.2022.2160585.

In relation to business operations, a way that lower business tax literacy could adversely impact is that cash flow forecasting may fail to take into account the correct tax liabilities (including the quantum as well as the timing for payment). This could mean small businesses might have a cash short fall and be unable to pay their tax debt to the tax authority.[53] This appears to be a common problem in Australia, as over two-thirds of unpaid tax debt outstanding to the ATO relates to small businesses.[54]

For this research five Federal taxes are considered, being income tax, pay as you go (PAYG) withholding and PAYG instalment, goods and services tax (GST), fringe benefits tax (FBT), and superannuation guarantee (SG), each of which is briefly discussed below.

Generally, income tax will be payable on the income generated by the business, with the tax rates varying according to the business structure utilised. A PAYG instalment is a payment made in advance to reduce the tax payable on expected annual taxable income. PAYG withholding tax is a liability that relates to payments an entity makes to employees and businesses that have not provided an Australian Business Number (ABN) when entering a trade arrangement with that particular entity.

The GST is a multi-staged broad-based consumption tax, with tax collected at more than one stage of the production and distribution chain.[55] Generally, in Australia, each stage of the supply of goods and services has GST liability imposed if recorded as a Taxable Supply or Taxable Importation. FBT is an employer obligation where tax is calculated on taxable benefits the employer provides to employees. The Australian Government implemented a compulsory Superannuation Guarantee Levy in 1992, which requires employers to make regular SG payments on behalf of most of their employees.

Recently the business tax literacy of Australian SBOs in the service sector was reported.[56] This study considers five major Federal taxes that apply to Australian businesses[57] and demonstrated for service SBOs their overall business tax literacy was below average at approximately 42%.[58] That is, SBOs are incorrect in their business tax knowledge over half the time. When considering each of the Federal taxes individually, GST had the greatest understanding by SBOs followed by Income Tax, FBT, SG, and then PAYG Withholding. In terms of demographics, it was found that greater business tax literacy is likely to be held by service SBOs who have operated for more than 10 years, employ staff, are set-up in a company or trust/company structure and have prior business experience.[59] However, it is not clear whether such increased business tax literacy is related to improved business performance, or ability to manage cash flow.

[53] Guilia Mascagni and Fabrizio Santoro, 'What is the Role of Taxpayer Education in Africa?' (International Centre for Tax and Development, 2018).
[54] Commissioner of Taxation, Annual Report 2021-22, Appendix 6.0.
[55] Cedric Sandford, Michael Godwin, Peter Hardwick and Ian Butterworth, *Costs and Benefits of VAT* (London: Heinemann Educational Books, 1981).
[56] Belle Isle, Freudenberg and Sarker (n 34).
[57] Income Tax, Goods and Services Tax, Fringe Benefits Tax, Pay-As-You-Go Withholding and Superannuation Guarantee. Note it is acknowledged that technically Superannuation Guarantee is not a business tax.
[58] Belle Isle, Freudenberg and Sarker (n 34), 88.
[59] Belle Isle, Freudenberg and Sarker (n 34).

C *Professional Financial Literacy*

The notion of professional financial literacy relates to the type of financial literacy that an SBO may need to hold to run their business. Overall, the notion of 'financial literacy' is the degree to which an individual understands key financial concepts and possesses the ability and confidence to manage their personal finances through the appropriate short-term decision making and sound long-range financial planning.[60] While there is research about individual's level of financial literacy,[61] the focus here is for those conducing a small business as they need greater financial awareness.[62] Previous research has raised concerns about SBOs having inadequate financial literacy to make important financial decisions for their business.[63] The consequences of such defines in professional financial literacy is that SBOs do not have the knowledge or confidence to implement adequate financial management systems in their business and make appropriate decisions.[64] The concepts that could be encapsulated by 'professional financial literacy' include understanding financial statements, the ability to implement and sustain effective cash flow management processes, implementation of internal control mechanisms and corporate governance.[65] The solvency of the business could hinge on the SBO having sufficient professional financial literacy.[66] Such knowledge allows the SBO to comprehend the financial position of the business, as well as to allow them to plan for their cash flow.[67] As part of this knowledge about and understanding the important financial statements could include reading and understanding Balance Sheets, Income Statements, Cash Flow Statements and preparation of a Cash Budget.[68] Professional financial literacy of SBOs can impact firm growth and productivity: those with higher levels of financial literacy have been known to be more effective when using financial products and are more engaged in using and offering trade credit.[69]

The professional financial literacy of SBOs is important for small businesses when competing in the marketplace. Their larger competitors are more likely to employ experts in the fields of accounting or finance to propose financial decisions and implement effective cash flow management practices.[70] In contrast, the small business may rely on the knowledge and abilities of the SBO, or of an external advisor who is afforded a snap-shot view of the individual business situation.[71] Therefore, in order to remain solvent in the market, SBOs need adequate financial foundations that allow them to make smart financial decisions. They

[60] David L. Redmund, 'Financial Literacy Explicated: The Case for a Clearer Definition in an Increasingly Complex Economy' (2010) 44(2) *Journal of Consumer Affairs* 276.
[61] The Social Research Centre, 'ANZ Survey of Adult Financial Literacy in Australia' (May 2015).
[62] Berman Brown, Saunders and Beresford (n 39).
[63] Drexler, Fischer and Schoar (n 43).
[64] Suahputra Sijabat and Fathurohman (n 22).
[65] Andrew Worthington, The distribution of financial literacy in Australia (No. 185) (School of Economics and Finance, Queensland University of Technology, 2004).
[66] Berman Brown, Saunders and Beresford (n 39).
[67] DeThomas and Fredenberger (n 6).
[68] Berman Brown, Saunders and Beresford (n 39).
[69] Miriam Bruhn and Bilal Zia, 'Stimulating Managerial Capital in Emerging Markets: The Impact of Business Training for Young Entrepreneurs' (2013) 5(2) *Journal of Development Effectiveness* 232.
[70] Jack Foley, 'We Really Need to Talk About Owner-Managers and Financial Awareness!' (2018) 25(1) *Small Enterprise Research* 90.
[71] Ibid.

also need to implement strategic business plans that allow them to recognise risk, maintain cash flow and utilise assets to ensure maximum profit generation.[72] This can be difficult, as SBOs are multitasking in their business and carrying out a multitude of roles from the primary generator of income, such as human resource manager and administration assistant to the financial controller. As such it is thought that an SBO would need some professional financial literacy to assist with managing their business cash flow.

D *Computer Accounting Software (CAS) Literacy*

With improvements with technology, the affordability and useability of CAS has improved over the last decades.[73] If small businesses use and understand such CAS, they may have enhanced profitability.[74] CAS may be able to produce reports that provide insights into the financial health of the business, as well as provide for automated warnings and/or reminders, such as overdue accounts.

In the context of a small business, it may be the SBO that has to be the one to understand and use the CAS. This is because small businesses may not have the financial resources to employ others or pay external advisors to use the CAS;[75] or even when they do have employees, these employees may lack the expertise required.[76]

CAS has been advocated as being of great importance to small business success. This can be explained partly due to the digital management support of the CAS system and the fact that it allows the SBO to measure performance with up-to-the-minute data.[77] Recent Australian research has indicated that the CAS is not being used effectively to assist with the management of cash flow, as there was a low engagement in the use of the CAS reporting options.[78] It is argued that this may be a result of limited knowledge about the use and benefits that a CAS system can create for small businesses, which can be compounded by the lack of SBO confidence or by their anxiety about their ability to operate the CAS efficiently.

Considering that small businesses might be non-employing or have a small number of employees, it is fair to suggest that the SBO could be tasked with understanding all necessary requirements for cash flow management. This includes compliance with tax systems relevant to their business, the use and understanding of financial statements and CAS. This could mean that cash flow management could be influenced by SBO literacy in these areas and as a consequence, the overall performance of the business could be impacted by their literacy.

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[72] Ibid.
[73] Timothy L. Pett and James A. Wolff, 'SME Identity and Homogeneity – Are There Meaningful Differences between Micro, Small, and Medium-Sized Enterprises?' (2012) 6(2) *Journal of Marketing Development and Competitiveness* 48.
[74] Paul Matthews, 'ICT Assimilation and SME Expansion' (2007) 19(6) *Journal of International Development* 817; Morikawa, 2004; Mike Rich, 'IT-Savvy Businesses are more Profitable' (2012) 25(11) *NZ Business* 26.
[75] Ibid; Kossaï and Piget, 2014; Kossaï and Piget, 2014.
[76] Matthews (n 74); Pett and Wolff (n 73).
[77] Rich (n 74).
[78] Belle Isle, Freudenberg and Copp (n 36).

This research seeks to investigate the relationship between cash flow management, SBO literacy, and business performance.

III RESEARCH METHOD

In terms of cash flow management and RBT, a positive significant influence on performance has been associated with the extent of the cash flow information used in the preparation of cash budgets and cash flow statements.[79] Strategies implemented to effectively manage cash flow have been advocated as providing a competitive advantage when compared to others in the same industry who do not create well developed strategies.[80] Cash flow information is ranked higher for business performance than other sources of information used for decision making. Further studies suggest that there is a significant positive relationship between improved performance and the use of accounting information in formal and informal planning.[81]

To ascertain any possible relationship between literacy and cash flow management a survey was designed to measure the various areas of literacy, as well as the performance of the small business. The survey was informed by prior interviews with SBOs and advisors.[82] This was also combined with the prior literature, particularly that relevant to tax knowledge of small businesses.[83] Creating the current instrument by combining past survey questions with contemporary responses obtained, was thought to improve the strength of the survey's content validity.

The survey was circulated in the form of self-administered questionnaires, where the method of participation was in electronic form. Previous research suggests that administering electronic surveys as opposed to mail surveys offers the advantage of a reduction in time from sending and receiving traditional mail.[84] This also allows for quicker and more accurate generation of data files, as the possibility of transcribing errors is eliminated at the data capture stage.[85]

The survey was constructed using a web-link to the survey created in the Survey Monkey online survey platform. This web-link was used on multiple platforms to engage with SBOs

[79] Haron, Yahya and Harashid Haron (n 15).
[80] Ibid.
[81] Ibid.
[82] Melissa Belle Isle, Brett Freudenberg and Tapan Sarker, 'Is the literacy of small business owners important for cash flow management?: The experts' perspective' (2018) 13(1) *Journal of Australasian Tax Teachers Association* 31.
[83] Margaret McKerchar, 'Understanding Small Business Taxpayers: Their Sources of Information and Level of Knowledge of Taxation' (1995) 12 *Australian Tax Forum* 25.
[84] Edith de Leeuw, 'To Mix or Not to Mix Data Collection Modes in Surveys' (2005) 21(2) *Journal of Official Statistics*, 233.
[85] Chris Evans, Binh Tran-Nam and Brian Andrew, 'Towards Systematic Reform of the Australian Personal Income Tax: Developing Sustainable Model for the Future' (2007) 22(2) *Australian Tax Forum* 15.

in the service industry (service SBOs), as it was cost effective and provided the ability to have greater geographic reach.[86]

The sample of service SBOs in Australia was achieved through three different sampling techniques, being convenience, snowballing, and stratified sampling.[87] Convenience sampling was used to contact both professional and personal contacts of the research team using email, Facebook, and LinkedIn. This also resulted in snowball sampling techniques, as possible participants were encouraged to share the survey with their own networks. Additionally, industry associations and representatives of professional bodies were contacted to share the survey web-link with their network. These bodies included Business South Australia, The Tax Institute, and the Australian Institute of Credit Management.

The ABN register was used to do a stratified sample of businesses, with businesses categorised by their geographical location. A conscious decision was made to exclude Queensland from just the stratified sample method, which was because the research team resided in Queensland, and that small business participants drawn from the convenience and snowball sampling were more likely to be Queensland based.

A specific response rate is not possible due to the variety of sampling techniques, although it is possible calculate the completion rate. A total of 259 started the survey and a total of 116 completed it, giving a completion rate of 45%. While 116 is slightly disappointing, engaging small businesses in research has been previously identified as problematic.[88] Nevertheless, the results are still useful to demonstrate insights into the literacy of service SBOs and how literacy influences business performance.[89]

The survey was designed to collect demographic information relating to the service SBO, the sources of advice and the tax systems relevant to the research. The survey questions also sought to measure service SBO literacy related to business tax literacy, understanding financial statements, and CAS systems. A literacy score was determined based on the number of correct answers to the literacy questions for each participant which is similar to other tax literacy research in Australia.[90] The literacy score when established, was used for comparative analysis with net income and gross annual revenue as well as with the adoption of cash flow activities in the business.

An overview of each of the 43 questions and its classification within the three areas explored in the research project can be found in Appendix A. There were twenty-six business tax literacy questions, seven financial statements, and ten CAS questions. Of the twenty-six business tax literacy questions, eleven were relevant to income tax, there were four questions for GST, SG and FBT and there were three questions for PAYG withholding. Literacy scores

[86] de Leeuw (n 84).
[87] John W Creswell and Vicki L Plano Clark, *Designing and Conducting Mixed Methods Research* (Sage Publications, 1st Ed, 2007), 123; 'Stratified Random Sampling' Lærd Dissertation (2018) Dissertation.laerd.com (Web Page) <http://dissertation.laerd.com/stratified-random-sampling.php>.
[88] Ian Wallschutzky and Brian Gibson, 'Small Business Cost of Tax Compliance' (1993) 10(4) Australian Tax Forum 511; Belle Isle, Freudenberg and Copp (n 36).
[89] The survey was concluded in June 2019 and therefore the data was collected prior to the economic effect of the COVID-19 pandemic.
[90] Chardon, Freudenberg and Brimble (n 32).

were used to create a mean score which was applied in discussions related to the service SBOs of those businesses. The literacy business tax literacy scores (with detailed discussion about demographic variations) have been reported elsewhere,[91] as have the potential relationship between business tax literacy and professional and CAS literacy.[92] What this article uniquely considers is the possible relationship of these literacy scores with business performance, as well as cash flow management activities. It is suggested that this is critical to consider, as it could give weight as to whether such literacies are important for SBOs or not.

A *Participants*

Table 1 details the descriptive characteristics of the survey participants. The sample, which demonstrates that almost two-thirds of participants have an Australian domicile by birth, with the remaining one-third arriving in Australia as migrants, is similar to the pattern of the percentage of ownership of Australian small businesses.[93]

[91] Belle Isle, Freudenberg and Sarker (n 34).
[92] Melissa Belle Isle and Brett Freudenberg, 'A comprehensive analysis of the business literacies of Australian small businesses' (2021) 23(1) *Journal of Australian Taxation* 67.
[93] CGU Insurance, *Migrant Small Business Report*' (Australia, CGU Insurance, 2018) available at https://apo.org.au/node/128756. Accessed on Feb. 21 2020.

Table 1: Summary of service SBO participants

Demographic	Categories	N = 116	Percentage
Residency	Less than 5 years	1	0.9%
	More than 5 years but less than 10 years	7	6.0%
	More than 10 years but less than 15 years	8	6.9%
	More than 15 years but less than 20 years	8	6.9%
	More than 20 years	17	14.7%
	I was born in Australia	75	64.7%
Education	Left school before completion of year 10	1	0.9%
	Year 10	1	0.9%
	Year 12	8	6.9%
	TAFE qualification	23	19.8%
	University undergraduate degree	36	31.0%
	University post graduate degree	47	40.5%
Business Age	Less than 2 years	22	19.0%
	More than 2 years but less than 5 years	19	16.4%
	More than 5 years but less than 10 years	28	24.1%
	More than 10 years	47	40.5%
Number of Employees (excluding the owner)	Zero	46	39.7%
	1 to 5	51	44.0%
	6 to 10	9	7.8%
	11 to 20	10	8.6%
Past Business Experience	Yes	62	53.4%
	No	54	46.6%
Annual Turnover	Under $50000	30	25.9%
	$50001-$200000	36	31.0%
	$200001-$2000000	44	37.9%
	$2000001-$5000000	4	3.4%
	$5000001-$10000000	2	1.7%

* Percentages may be affected by rounding

The responses suggest that just over 40% of participants had a postgraduate qualification and slightly fewer than one-third had an undergraduate qualification. A TAFE qualification was the highest level of education completed by 23 respondents (20%), with the remaining respondents having their highest level of education at a secondary school. These proportions of service SBO education levels in the sample differ from those previously reported for all business owner/managers in Australia.[94] The results reported in the Census suggest that post graduate study among Australian business owner/managers is as low as 7%, whereas those who have their highest level of education at a secondary school is 31%.[95] Therefore, the participants involved in this research appear to have higher levels of education than the levels of the general population of small businesses owner/managers in Australia. This could mean that the education of participants could be higher than the normal population, so this needs to be considered when determining the results.

Participants were asked to indicate the age of their businesses as it was thought this might be important when discussing service SBO literacy and business survival. Businesses trading for less than 5 years made up 35% of all participants, 16% had been in operation for 2 to 5 years and 19% have been active for less than 2 years. The remaining 63% of businesses were represented by those trading for 5 to 10 years (24% or 28 businesses) and those trading for more than 10 years (41%).

Almost half (44%) of the participants employed between 1 and 5 employees and 40% were non-employing entities. The employment brackets of 6 to 10 and 11 to 19 employees were each represented by 7.8% and 8.6% of participants, respectively. The survey data indicates an under-representation of non-employing businesses compared to the Australian population.[96] In Australia, 64% of all businesses employing between 0 to 20 employees are non-employing businesses.[97] In contrast, the employment brackets of 1 to 5 and 6 to 20 are over-represented in the survey when compared to the Australian small business population of businesses employing 0 to 20 employees. According to ABS data, in 2019 Australian businesses employing 1 to 5 employees are represented by 28% of the businesses, compared to 44% in the survey, and 9% of the businesses employing 6 to 20 employees whereas 16% of survey participants employed between 6 and 20 employees.[98]

The annual turnover of each respondent was categorised according to the ABS catalogue no. 8165-0.[99] For businesses earning ranges of $0-$50,000, $2,000,001-$5,000,000 and $5,000,001-$10,000,000, the survey representation is comparable to the population for the same income groups when calculated as a percentage of total businesses earning up to $10 million.[100] The survey responses differ only marginally by one percentage point in all three turnover groups, compared to the population. Compared to the population for the annual turnover category of $50,001-$200,000, the survey responses under-represent the Australian

[94] Australian Bureau of Statistics, '*Census of Population and Housing: Reflecting Australia - Stories from the Census 2016.*' (Catalogue No 2071.0, 11 July 2018) (Canberra, ABS, 2018).
[95] Ibid.
[96] Australian Bureau of Statistics (n 24).
[97] Ibid.
[98] Ibid.
[99] Ibid.
[100] Ibid, Table 17.

population by 3% and the income group of $200,001-$2,000,000 is over-represented in the survey by 4%.[101]

B *Results*

The results are now discussed in terms of the potential relationship between SBO literacy and business performance.

I *Service SBO literacy and Resource-Based Theory*

The foundations for RBT suggest that businesses with a higher level of internal resources should achieve a higher level of performance. A superior level of internal resources should allow businesses to procure and maintain a competitive advantage in the marketplace in which they reside. To measure the performance of the participants, two values were chosen for statistical analysis. The values recorded for gross annual revenue and net income (calculated by subtracting participant responses to gross annual revenue and gross annual expenses) [102] were compared to the three literacy scores to determine if the internal resource 'literacy' of service SBOs has a relationship with business performance. Table 2 displays the results of the linear regression tests conducted for gross annual revenue and suggests that business tax literacy score and CAS literacy score yielded significant results when compared to gross annual revenue. This suggests that those service SBOs with higher levels of literacy for business tax and CAS achieve a higher value of gross annual revenue for their businesses. In contrast, the results for financial statement literacy score, when compared to gross annual revenue, does not produce a significant relationship. This suggests that business performance in terms of gross annual revenue does not appear to be a significant relationship to the level of financial statement literacy held by service SBOs.

Table 2: The relationship between literacy score (IV) and Gross Annual Revenue (DV)

Literacy scores (IV)	**Sum of Squares**	**df**	**Mean Square**	**F**	**Sig*.**
Business tax literacy score[#]	6.795E+12	1	6.795E+12	5.453	.011[b]
Financial statement literacy score [#]	2.168E+12	1	2.168E+12	1.685	.099[b]
CAS literacy score [#]	1.028E+13	1	1.028E+13	7.695	.004[b]

***** a one-tail test was undertaken to ascertain if income increases when literacy increases.

DV = Dependent Variable, [#]IV = Independent Variable.

Business performance in terms of RBT was also examined using net income and the internal resource of literacy, using the service SBO literacy scores. Linear regression was conducted

[101] Ibid.

[102] Net income has been an accepted measure of performance for RBT in previous studies: Christopher D. Ittner and David F. Larcker, 'Total Quality Management and the Choice of Information and Reward Systems' (1995) 33 *Journal of Accounting Research* 1; Sally K. Widener, 'Associations Between Strategic Resource Importance and Performance Measure Use: The Impact on Firm Performance' (2006) 17(4) *Management Accounting Research* 433.

with net income as the dependent variable and each of the literacy scores as the independent variable. The results displayed in Table 3 demonstrate that the ability to achieve a higher

level of net income for the business has a significant relationship with business tax literacy score and CAS literacy score. Similar to the results for gross annual revenue, it was found that financial statement literacy score was not significantly related to business performance when measured in accordance with net income. This suggests that an improvement in the value of net income when considering RBT is unlikely to be explained by the financial statement literacy of service SBOs.

Table 3: The relationship between literacy score (IV) and Net Income (DV)

Literacy scores (IV)	Sum of Squares	df	Mean Square	F	Sig*.
Business tax literacy score[#]	4.397E+11	1	4.397E+11	4.528	.018[b]
Financial statement literacy score [#]	2.053E+11	1	2.053E+11	2.070	.077[b]
CAS literacy score [#]	5.586E+11	1	5.586E+11	5.493	.011[b]

* a one-tail test was undertaken to ascertain if income increases when literacy increases.

DV = Dependent Variable, #IV = Independent Variable.

Overall, the results from measuring the net income and gross annual revenue to the literacy of service SBOs suggest that small businesses with a greater level of internal human capital (that is SBO literacy) achieve higher performance. Participants with higher business tax literacy and CAS literacy appear to realise a greater amount of income and revenue when compared to those with lower levels of literacy. Financial statement literacy does not seem to relate to the improvement of financial performance, which is unusual, considering that the determination of business performance could relate to the ability of SBOs to understand financial statements. This could suggest that a basic understanding of financial statements is all that is required for business performance or that SBOs rely on the information of expenses and income readily available in CAS as an alternative to having a thorough knowledge of financial statements. From the results for RBT, when literacy is the measure of internal human capital, those with higher business tax literacy and CAS literacy have a competitive advantage over those in the same market who have lower literacy in these two areas.

II *Service SBO literacy and cash flow management*

To understand how SBO literacy could be related to cash flow management a variety of data was collected in the survey relevant to cash flow. Initially, literacy scores were used to determine whether literacy of service SBOs influences their ability to implement cash *inflow* and cash *outflow* activities for cash flow management.

III *The SBO literacy and cash flow activities*

The ability of SBOs to maintain cash flow is vitally important for their success. Cash flow stability can be achieved by enacting effective cash flow management strategies. Some strategies have been proposed as essential for ensuring that cash is incoming in a short period and that cash outflow is extended to the maximum allowable time.[103] To assist cash *inflow*, practices can include invoicing quickly, requesting part payment before commencement of work, providing easy payment options and payment incentives, enquiring about outstanding payments and resolving any payment disputes in a timely manner.[104] Prior research suggests that SBOs spend insufficient time and place low importance on these activities.[105] Table 4 illustrates various activities that can be implemented to improve the collection time of revenue, along with the responses of the participants as to whether these practices are used in their business. It is possible that participants that selected 'not applicable' may trade on cash and not credit basis, hence these activities may not need to be followed.

Table 4: Cash flow activities of participants

My business makes use of these cash flow activities …	**Not Applicable**	**Strongly Disagree**	**Disagree**	**Neutral**	**Agree**	**Strongly Agree**
Raise Progress invoices	43	1 (1.4%)	9 (12.3%)	5 (6.8%)	34 (46.6%)	24 (32.9%)
Invoice in Advance	23	3 (3.2%)	24 (25.8%)	15 (16.1%)	27 (29.9%)	24 (25.8%)
Provide Direct Debit options	33	10 (12.0%)	17 (20.5%)	6 (7.2%)	26 (31.3%)	24 (28.9%)
Chase outstanding accounts	20	4 (4.2%)	7 (7.3%)	5 (5.2%)	50 (52.1%)	30 (31.3%)
Negotiate shorter trading terms	41	2 (2.7%)	13 (17.3%)	10 (13.3%)	33 (44.0%)	17 (22.7%)
Have stock on hand for orders	60	1 (1.8%)	6 (10.7%)	12 (21.4%)	19 (33.9%)	18 (32.1%)

[103] Australian Small Business and Family Enterprise Ombudsman 'Payment Times and Practices Inquiry – Final Report (April 2017).' (Canberra, Australian Small Business and Family Enterprise Ombudsman, 2017); Australian Taxation Office (n 20).
[104] Ibid; Australian Taxation Office (n 20).
[105] Belle Isle and Freudenberg (n 44).

* Note: 'not applicable' is not included in the percentage calculations due to the other responses being part of a Likert scale (which is then used for statistical analysis).

For those businesses offering services that allow them to issue invoices during the time when a contract is being provided, it appears that almost 80% of participants raise invoices during the process of the work being completed. Just over half of the participants who could implement issuing invoices in advance suggested that they are engaging in this activity. Those disagreeing or strongly disagreeing represented close to one-third of participants. Being unable to issue in advance could suggest that this practice is not common for the service industry, or it could be that the service SBOs did not feel they could request money in advance from their trading partners for work yet to be completed.

In terms of improving payment times from debtors, participants were asked to advise whether they provide direct payment methods to their customers. Direct payment methods can include setting up an authority that allows a supplier to debit a customer's account and to withdraw the relevant funds that are outstanding when it is due for payment. It also includes the ability for the customer to pay outstanding amounts directly to the supplier using a transfer from their bank account to the supplier account or making use of debit, credit, or bank cards to pay directly to the suppliers' account. In terms of the participant responses, it can be seen, that slightly less than two-thirds of the participants suggested that direct payment methods are used to assist with cash management. However, almost one-third of participants suggest they do not make use of direct payments. This could imply that almost one-third of the service SBOs are not making use of effective payment options to improve the inflow of cash on a timely basis. This could be due to lack of knowledge in how to implement direct debit payment options.

In terms of cash flow activities questions related to contacting customers to request payment for outstanding invoices and to negotiating shorter trading terms with customers. Both questions relate to the provision of credit to customers, allowing the customer to receive goods or services and pay sometime in the future. Common credit terms in Australia include payment in 7 days, 14 days, 28 days or 30 days from the end of the month. Contacting customers about outstanding invoices achieved a very high response, compared to the other cash inflow activity questions with almost 85% confirming that they are contacting customers about outstanding accounts. In contrast, negotiation of shorter trading terms with customers was confirmed by only two-thirds of those participants. This could be due to service SBOs feeling that they lack power in their customer trading relationship or believing that negotiation of trading terms could have negative consequences for ongoing trade.[106]

The final question related to whether participants held stock to satisfy customer orders. It was expected that there would be a high number of 'not applicable' responses due to the research being centred around participants who are offering services in contrast to selling goods. The question was posed nonetheless, as some businesses may sell a portion of goods to supplement the services they offer. The results suggest that two-thirds of participants who carry goods will keep stock to satisfy future customer orders. Cash restrictions have been linked to the accumulation of trading stock in anticipation of future orders.[107]

[106] Ibid.
[107] Belle Isle, Freudenberg and Copp (n 36).

Therefore,service SBOs responding with affirmative answers may be restricting their cash inflow by holding goods for longer periods than necessary to satisfy customer orders in the future.

The survey also explored the trading relationship that participants have with their suppliers. Prior research indicates that the effective use of trade credit facilities can be an alternative source of finance when more formal options are not available.[108] Other activities promoted as being useful in improving cash flow for small business includes replacing the old stock with fast moving stock and only ordering stock when necessary.[109] Three questions were posed to determine whether service SBOs are optimising the time delay between the purchase and the payment date of supplies: Table 5.

Table 5: Cash *outflow* activities of participants

My business makes use of these cash flow activities …	**Not Applicable**	**Strongly Disagree**	**Disagree**	**Neutral**	**Agree**	**Strongly Agree**
Negotiate extended trading terms	50	4 (6.1%)	15 (22.7%)	11 (16.7%)	25 (37.9%)	11 (16.7%)
Make use of early settlement discounts	32	2 (2.4%)	3 (3.6%)	9 (10.7%)	43 (51.2%)	27 (32.1%)
Always have the cash to pay suppliers	1	3 (2.9%)	3 (2.9%)	16 (15.2%)	55 (52.4%)	28 (26.7%)

* Note: 'not applicable' is not included in the percentage calculations due to the other responses being part of a Likert scale (which are then used for statistical analysis).

More than half of the participants who trade on credit with suppliers suggest that they have arranged extended trading terms with suppliers in contrast to one-quarter confirming they have not engaged in negotiations (see Table 5). This suggests that at least half of participants are attempting to hold onto cash for longer periods of time. For those not negotiating this could be due to service SBOs feeling that the supplier was non-approachable about changing trading terms. Alternatively, it could be that service SBOs are reluctant to place strain on the relationship they have with those providing important resources for their business.[110]

The results also demonstrate that a large proportion of participants take advantage where possible of early settlement discounts. This type of discount is becoming increasingly popular

[108] Mervi Niskanen and Jyrki Niskanen, 'Small Business Borrowing and the Owner-Manager Agency Costs: Evidence on Finnish Data' (2010) 48(1) *Journal of Small Business Management* 16.
[109] Belle Isle, Freudenberg and Copp (n 36).
[110] Ibid.

in the energy, telecommunication and government service industries, among others. More than 80% of businesses agreed or strongly agreed that they make use of early settlement

discounts. This is likely to improve cash flow, as it allows the monetary value of the discount percentage to be kept as business income. This strategy also removes the requirement for service SBOs to request changes to trade with their suppliers, relieving the possibility of placing strain on the business relationship. The participants were also questioned about whether they keep enough cash on hand to settle their supplier accounts. Slightly more than three-quarters confirmed that they pay their suppliers within trading terms. This could suggest that three-quarters of service SBOs appear able to manage their cash flow to pay suppliers on time. Alternatively, it could suggest that service SBOs place more importance on maintaining a favourable trading relationship with their suppliers, and as such pay their supplier invoices before other debts. Literature suggests that SBOs are apprehensive about jeopardising the rapport they have with suppliers, being concerned that goods and services will be restricted for non-payment.[111]

These cash flow activities enacted by the participants were compared to the service SBO literacy scores to explore whether literacy influences the implementation of cash flow management systems and procedures. Simple linear regression tests at the .05 level of significance were conducted where the literacy score was the independent variable, and the cash activity was the dependent variable: Table 6.

When regression tests were carried out between literacy and the cash *inflow* activity of 'contacting customers regarding outstanding accounts', all literacy scores were found to be linearly related. This suggests that service SBOs with a high level of literacy in business tax, financial statements and CAS engage in the activity of enquiring about outstanding accounts, with the relationship strongest with business tax literacy (.003), followed by CAS literacy (.005) and then financial statement literacy (.019).

[111] Australian Small Business and Family Enterprise Ombudsman (n 103); Belle Isle, Freudenberg and Copp (n 36).

Table 6: Service SBO literacy (IV) and cash *inflow* activities (DV)

Literacy score and cash *inflow* activities	**Sum of Squares**	**df**	**Mean Square**	**F**	**Sig*.**
Raising progress invoices (DV)*					
Business tax literacy score#	.013	1	.013	.012	.911[b]
Financial statement literacy score#	.380	1	.380	.367	.546[b]
CAS literacy score#	4.129	1	4.129	4.138	.046[b]
Invoicing in Advance (DV) *					
Business tax literacy score#	.144	1	.144	.096	.758[b]
Financial statement literacy score#	.506	1	.506	.336	.563[b]
CAS literacy score#	.592	1	.592	.394	.532[b]
Providing direct debit payment options (DV) *					
Business tax literacy score#	1.151	1	1.151	.578	.449[b]
Financial statement literacy score#	4.273	1	4.273	2.188	.143[b]
CAS literacy score#	1.315	1	1.315	.671	.416[b]
Contacting customers regarding outstanding invoices (DV) *					
Business tax literacy score#	7.905	1	7.905	8.158	.005[b]
Financial statement literacy score#	5.269	1	5.269	5.688	.019[b]
CAS literacy score#	7.873	1	7.873	9.332	.003[b]
Negotiating shorter trading terms with customers (DV) *					
Business tax literacy score#	1.272	1	1.272	1.063	.306[b]
Financial statement literacy score#	7.725	1	7.725	6.967	.010[b]
CAS LS#	1.514	1	1.514	1.394	.242[b]
Always having enough stock on hand to satisfy customer orders (DV) *					
Business tax literacy score#	.346	1	.346	.305	.583[b]
Financial statement literacy score#	0.46	1	.046	.040	.842[b]
CAS literacy score#	.989	1	.989	.901	.347[b]

*DV = dependent variable, #IV = independent variable

When testing was carried out for ‘raising progress invoices’ and ‘negotiating shorter trading terms with customers’, a linear relationship was found to exist between the CAS literacy score (.046) and the financial statement literacy score (.010). Business tax literacy scores when compared to these two variables, were not found to be significantly related.

For cash inflow activities of 'invoicing in advance', 'providing direct debit payment options' and 'having enough stock on hand to satisfy customer orders', the test outcomes imply that service SBO literacy has no relationship with carrying out these activities: Table 6.

These test outcomes suggest that other than 'contacting customers regarding outstanding invoices', the implementation of cash *inflow* activities in business is predominantly not influenced by the literacy of service SBOs. This could demonstrate that service SBOs implement cash inflow activities due to other business factors.

The relationship between the implementation of cash *outflow* activities and service SBO literacy was also examined: Table 7. Simple linear regression was tested at a level of .05 significance between the literacy scores and each of the cash outflow activities. The cash *outflow* activity with the largest number of significant results was to 'always have enough cash to pay suppliers'. From the test outcomes, it can be inferred that a significant relationship exists with all literacy scores (apart from financial statement literacy score), as a result of $p < .05$ was achieved. The test outcome for business tax literacy score was the strongest at .019 and then CAS literacy score at .020. This could suggest that the decisions to pay suppliers on time are not related on financial statement literacy.

Table 7: Service SBO literacy (IV) and cash outflow activities (DV) implemented by the business.

Literacy score and cash flow outflow activities	Sum of Squares	df	Mean Square	F	Sig*.
Negotiate extended trading terms with suppliers (DV)*					
Business tax literacy score[#]	.067	1	.067	.040	.842[b]
Financial statement literacy score[#]	6.393	1	6.393	4.009	.049[b]
CAS literacy score[#]	.285	1	.285	.208	.650[b]
Make use of early settlement discounts (DV)*					
Business tax literacy score[#]	.986	1	.986	1.252	.266[b]
Financial statement literacy score[#]	.382	1	.382	.481	.490[b]
CAS literacy score[#]	.244	1	.244	.341	.561[b]
Always have enough cash to pay suppliers (DV)*					
Business tax literacy score[#]	4.325	1	4.325	5.668	.019[b]
Financial statement literacy score[#]	.876	1	.876	1.100	.297[b]
CAS literacy score[#]	4.689	1	4.689	5.593	.020[b]

*DV = dependent variable, [#]IV = independent variable

Table 7 demonstrates that none of the literacy scores are significantly related to 'making use of early settlement discounts'. Only one significant relationship regarding 'negotiating

extended trading terms with suppliers' was found for the financial statement literacy score (.049).

Overall, the results indicate that service SBO literacy has little effect on whether service SBOs implement cash flow activities. For cash *inflow* activities, those that appear to have a relationship with service SBO literacy include 'contacting customers regarding outstanding accounts' (relevant to all scores), 'raising progress invoices' (related to CAS literacy score) and 'negotiating shorter trading terms with customers' (related to financial statement literacy score). Similar results were found when investigating cash *outflow* activities: only two statements across all literacy areas were found to be significantly related to service SBO literacy. 'Having enough cash to pay suppliers' was linearly related to the business tax literacy score and CAS literacy score, whereas 'negotiating extended trading terms with suppliers' was significantly related to the financial statement literacy score. The findings suggest that, when service SBOs decide to implement cash *inflow* and *outflow* activities to effectively manage cash flow, their decision does not appear to be heavily reliant on the level of literacy that they have obtained in understanding business tax, financial statements or using CAS. Therefore, it could be suggested that enacting cash inflow and outflow activities could be influenced by other factors in the business environment such as industry norms, or reliance on others, including both internal and external stakeholders, to decide what activities will be used.

Overall, to measure if SBO literacy has an impact on the financial performance of businesses, the research incorporated RBT, which suggests that business with superior internal resources, when compared to their competitors, will achieve a higher level of financial performance. In terms of RBT, SBO literacy was considered as an internal resource. In order to measure the relationship between internal resources and financial performance, the literacy scores were compared to net income and annual revenue. The findings suggest that SBOs with higher business tax and CAS literacy score will realise a level of financial performance superior to that of their competitors, indicating that SBO levels of literacy can have an impact on cash flow stability. This would tend to suggest that efforts to improve business tax literacy could overall increase the performance of the business for service SBOs.

The implementation of cash flow activities was then compared to the literacy scores of the service SBOs to determine whether employing these activities is motivated by service SBO literacy. The outcome of testing principally suggests that employing cash flow activities cannot be predicted by service SBO literacy. For cash inflow activities, the strongest relationship existed for contacting customers regarding outstanding invoices, which was linearly related to all literacy scores. This could highlight that SBOs know the importance of not just billing but making sure that clients do pay. With respect to cash outflow activities, business tax literacy score and CAS literacy score were found to have a linear relationship to 'always having enough cash to pay suppliers'. It appears that literacy does relate to having surplus/excess cash (liquidity) to pay suppliers. This liquidity factor is extremely important for SBOs generally.

IV RECOMMENDATIONS

The findings of the research have emphasised that improving internal resources (particularly SBO literacy) could result in improved business performance and assist SBOs to manage their cash flow. Given that there appears to be a positive relationship between the literacy of SBOs, in terms of business tax and CAS, and the performance of their business (as measured by gross annual revenue and net income) this would add support to initiatives to try to enhance the literacy of SBOs. This evidence adds more weight to recommendations to improve business tax literacy for SBOs. These initiatives could include a requirement could be made for new SBOs to undertake a series of education modules prior to business registration for an ABN or within the first 12 to 18 months of operation;[112] to provide a tax rebate for $1,000 to $5,000 when the business lodges its first tax return if it has completed relevant education modules,[113] as well as subsidised education when businesses start to engage employees.[114]

Even in terms of prompting the importance of improved literacy in these areas, the results of this study about the link to improved business performance could be used as an endorsement as to why SBOs should try to increase their literacy. The findings of this study could be used by small business advisors and government agencies to promote the importance of their learning activities. This is important as the motivation of the SBO could be a key factor as to whether they will seek to improve their knowledge or not.

To encourage SBOs to improve their CAS literacy, the Australian Government should provide an incentive related to CAS knowledge acquisition. This could be in the form of a grant where the government matches a dollar-for-dollar funding amount up to $1,500. It would be advantageous for this training to be carried out over a period of time, as increases in knowledge have been associated with ongoing exposure to the CAS system.[115] Increased CAS literacy could help SBOs evaluate their cash flow position and business performance using up-to-the-minute data available in the business CAS.

V LIMITATIONS AND FUTURE RESEARCH

A limitation of this study was that it only relied on the human capital (SBO literacy) component of RBT to determine whether businesses recognise a competitive advantage over their competitors despite the study including some components of organisational capital (the process and practices implemented for cash flow management). The reason for not evaluating organisational capital was due to the extensive variety of cash flow management activities that could be used in such a diverse group of small businesses. To do so effectively, it was

[112] Belle Isle, Freudenberg and Sarker (n 34), 97.
[113] Belle Isle, Freudenberg and Sarker (n 34), 97.
[114] Belle Isle, Freudenberg and Sarker (n 34), 101.
[115] Masayuki Morikawa, 'Information Technology and the Performance of Japanese SMEs' (2004) 23(3) *Small Business Economics* 171; Julien Pollack and Daniel Adler, 'Skills that improve profitability: the relationship between Project Management, IT Skills, and Small to Medium Enterprise Profitability' (2016) 34(5) *International Journal of Project Management* 831.

thought that all businesses involved in the study would need to be competing in the same market.

A further limitation was that the literacy scores for CAS were calculated based on feedback from service SBOs about whether they created reports and carried out cash flow activities in their CAS. Ideally, a more relevant approach to testing literacy would have been witnessing service SBOs carrying out these tasks or asking the participant to confirm the necessary steps required to successfully complete such a task. However, these alternatives were not possible using the survey method and were also restricted due to the variety of different CAS platforms that could be used by the participants.

The participants completing the survey had on average higher educational levels than the general public, which could mean that the literacy results are higher or not representative of the general SBOs, so this needs to be considered when determining the results. Additionally, the survey data indicate an under-representation of non-employing businesses compared to the Australian population.[116] Again, this could mean that the resulting literacy scores are higher than normal as higher literacy scores have been associated with employing more staff.[117]

Future research could focus on non-service sector small businesses to see whether their literacy has a similar relationship to performance and cash flow management. Also, research could consider how best to improve the literacy of SBOs, as well as their cash flow management practices.

VI CONCLUSION

This article explores whether the literacy of SBOs is related to financial performance and cash flow activities of a business. This is important for small businesses and their operations, as having the ability (or literacy) to recognise when a business is experiencing cash flow constraints could allow the SBO to instigate actions to overcome cash constraints. When literacy as compared to net income and annual revenue, the findings suggest that those SBOs with higher business tax and CAS literacy will realise higher net income and annual revenue than their competitors and in turn have a competitive advantage over their competitors.

The findings also indicate that SBO literacy has minimal (if any) effect on determining which cash flow activities are implemented by service SBOs. However, the important activities of ‘contacting clients for outstanding invoices’ and ‘having enough cash on hand to pay suppliers’ had some relationships to the literacies studies. This could suggest that the reason that cash flow activities are implemented could be influenced by other factors in the business environment like industry norms and/or they could be set by internal or external business stakeholders.

Small businesses are seen as a vital part of the Australian economy, given that it appears that literacy in terms of business tax and CAS can be linked with higher net income and annual

[116] Australian Bureau of Statistics (n 24).
[117] Freudenberg, Chardon, Brimble and Belle Isle (n 32).

revenue, it is important to consider how these literacies can be enhanced. The findings may help promote the importance for small businesses to improve their literacy in these areas, as it can have a positive effect on business operations and make them more competitive in the marketplace.

Appendix A

Overview of Survey questions and their relevance to literacy

Question overview **Questions related to the financial year ending 30 June 2018**	**Research area explored**
Superannuation Guarantee	Literacy – taxation
The rate of Superannuation Guarantee for 2017 is 9.25%	
For employees over the age of 18, Superannuation Guarantee only has to be paid for employees whose income per calendar month is $450 or more.	
Payment of Superannuation Guarantee is not tax deductible for the employer	
The amount of superannuation contributions to be paid is based on ordinary time earnings and does not include overtime.	
GST	Literacy – taxation
I must hold a tax invoice for all goods or services that I claim GST input tax credits for if they are over the value of $50 + GST	
Businesses (excluding non-for-profit organisations) should register for GST once their annual turnover is reaches $100,000.	
Prices for the sale of goods or services to a consumer in Australia should be displayed or quoted as GST exclusive.	
If your receipt for purchasing fuel at a petrol station is $80, the GST portion of that purchase is $8.	
FBT	Literacy – taxation
A benefit provided to an employee's spouse will not be subject to Fringe Benefits Tax (FBT).	
Generally, travel to and from work in an employer's vehicle is not considered as "private use" by the employee.	
The cost of providing staff with a light lunch whilst at work is exempt from FBT.	
The FBT reporting year runs from 1st July to 30th June	
Income Tax	Literacy – taxation
Individuals can claim a 25% discount on capital gains for assets held > 12 months.	
An immediate deduction can be claimed for the purchase of work equipment for $30,000 when it is used in the business over a number of years.	
Generally, a deduction for mortgage interest can be claimed by a business operating from a home in accordance to the percentage area of the home that is used for business purposes.	

If your business is GST registered then the business' assessable income for income tax will be excluding GST.	
Income Tax	Literacy – taxation
You can claim an immediate deduction for work clothing that you purchase from a supplier provided that it is made from durable material.	
For a person on a 30% tax rate the 'after tax cost' of a fully deductible work related item of $1,000 will be $700.	
For a person on a 30% tax rate who is entitled to a $1,000 tax offset will save $700 in tax.	
Income Tax	Literacy – taxation
Paying a PAYG Instalment offsets the final amount of income tax that the business has to pay at the end of the financial year.	
If you are required to pay a PAYG Instalment, you cannot vary the amount raised by the ATO from the assessment of your previous income.	
The company income tax rate of 27.5% is available only for businesses with an aggregated turnover of $2 million dollars or less in the 2017-2018 year.	
Records should be kept for tax purposes for a minimum of 7 years.	
PAYG Withholding	Literacy – taxation
PAYG Withholding and Payroll Tax are the same tax system.	
If the business employs staff or plans to employ staff it needs to register for PAYG withholding within the first month of paying that employee.	
Employers will never have to collect PAYG Withholding when the engage a contractor.	
CAS reporting I create the following in the business computer accounting software:	Literacy – CAS
A Balance Sheet at least every 3 months.	
A Profit and Loss Statement at least every 3 months.	
A Statement of Cash Flows at least every 3 months.	
A Cash Budget at least once a year.	
Reports for taxation at least every 3 months.	
Reports for employee obligations eg. Superannuation and PAYG Withholding.	
CAS activities: Which of the following activities do you regularly carry out in your business computer accounting software?	Literacy – CAS
Automated invoicing .	
Automated invoice reminders.	

Processing invoices on a weekly basis.	
Reconcile transactions monthly	
Financial Statements	Literacy – financial statements
If you wanted to determine the liquidity (or solvency) of your business you would need to use information contained in both the Profit and Loss statement and the Balance Sheet.	
Working capital is calculated by dividing Current Assets by Current Liabilities.	
If you receive full payment for work completed you have made a profit on that job.	
Gross Profit is a better indicator of how your business is performing than Net Profit	
Financial Statements	Literacy – financial statements
Examples of 'Current Assets' include: Cash at Bank, Trade Debtors, Short-term investments, Petty Cash and Stock.	
The Cash Flow Statement can be separated into three areas of cash flow from operations, financing and investment.	
A Cash Flow Forecast or Budget helps businesses to predict cash surpluses or shortages.	

TAX AUDIT EFFECTIVENESS AND REVENUE COLLECTION OUTCOMES IN INDONESIA

JAMES MCMILLAN*

Abstract

This article considers links between Indonesia's tax collection performance and the design and operation of its tax compliance system through a study of the tax audit practices and procedures of Indonesia's tax authority, the Directorate General of Taxation. The article considers the distortionary effect of some features of Indonesia's tax compliance approach under which audits tend to be focused largely on taxpayers who are already compliant and audit activities are narrowly focused and not risk based. The article also considers ways in which Indonesian tax authorities could expand tax audit coverage and modify audit procedures and thereby increase the effectiveness of their compliance activities in the future leading to improved revenue collection outcomes.

Key Words: Indonesia, Tax Compliance, Tax Audits, Tax to GDP ratio

I INTRODUCTION

The article considers the relationship between Indonesia's generally poor revenue collection outcomes and the effectiveness of its tax compliance approach, by an examination of the way in which Indonesia's main tax authority, the Directorate General of Taxation (DGT), carries out tax audits and other tax compliance activity. The potential importance of further reform to the DGT's tax compliance practices is highlighted by Indonesia's consistently low tax to GDP ratio, which was in the 8% to 10% range over the 5-year period from 2017 to 2021.[1] This is well short of the Indonesian Ministry of Finance's "Tax Policy Objective" to achieve a tax to GDP ratio of 16%.[2] Recent World Bank data indicates that Indonesia's tax to GDP ratio remained 9.1% in the 2021 year, and that Indonesia's declining tax to GDP ratio reflects

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[1] Directorate General of Taxation, *DGT Annual Report 2021: Collaborative Effort for National Economic Recovery* ('DGT Annual Report, 2021') 192; accessible at Laporan Tahunan DJP 2021 - English.pdf (pajak.go.id)

[2] Directorate General of Taxation, *DGT Annual Report 2019: Continuous Development of Organizational Capacity through Strengthening the Governance of Taxation Data and Information Technology,* 60.

a long-term trend.[3] The Indonesian Government has recently introduced various legislative and regulatory measures to increase tax collections, including an increase in the top marginal tax rate for individuals from 30% to 35%, an increase in the Value Added Tax (VAT) rate to 11% (with a further increase to 12% in 2025), the adoption of broad based anti-avoidance rules, improved DGT access to taxpayers' financial data, and a new "Electronic Transactions Tax" applying to foreign e-commerce business.[4] In this context, the focus of this article is on identifying potential inefficiencies in the design and delivery of the tax audit program which might contribute to the DGT's difficulties in achieving higher levels of taxpayer compliance.

"Tax compliance" generally refers to compliance with a range of tax obligations imposed under a tax system, which extends to taxpayer registration, lodgement of tax returns, and payment of tax liabilities. In an Indonesian tax context, the term "compliance" is sometimes taken to have a narrower meaning and may refer only to the extent to which registered taxpayers have complied with their obligations to lodge tax returns. In this article, "compliance" refers to fulfillment of all tax obligations in the broader sense, rather than the narrower sense sometimes used in Indonesia. Taxpayers who are registered and participants in the system but delinquent in some respects (for example, who may not have disclosed all income in tax returns, or made other errors) could be considered to be "semi-compliant" or "broadly compliant", whereas those individuals and entities which should be registered as taxpayers but have not done so could be regarded as "non-compliant" (in the sense that they do not comply with any of their tax compliance obligations).

The article deals mainly with the DGT's compliance enforcement activities with respect to Income Tax and VAT, and associated withholding taxes, and it examines in detail the DGT's practices when conducting tax audit activity. Any inefficiency in conducting the audit process could reduce the capacity of the DGT to extend tax audit activity to other non-compliant taxpayers. As an OECD working paper has observed: "Tax audits constitute an integral part of any tax system based on self-assessment. Given that the tax administration has limited resources to conduct tax audits, these should be allocated in a way to maximise expected revenue collection".[5]

By its examination of the tax compliance approach adopted in Indonesia, the article considers whether, through a combination of the human resource constraints within the DGT, the nature of the tax audit methodology that is generally applied in the conduct of tax audits, the legal requirement that all tax refund cases must be audited, and the workload on audit teams resulting from that legal requirement, the practical effect is that only already-compliant taxpayers are likely to be subject to tax audit.[6] Consequently, there is a very low audit probability for Indonesian entities that should be paying tax but elect to be non-compliant or partially compliant and this, in turn, has a direct and adverse impact on revenue collection outcomes (when measured by the tax to GDP ratio achieved by Indonesia). The magnitude of the tax gap reflected in Indonesia's low tax to GDP ratio is an indicator that non-compliance

[3] Data about Indonesia's historical tax to GDP ratio outcome, with the most recent data being for the year ended 31 December 2021, can be accessed here: Tax revenue (% of GDP) - Indonesia | Data (worldbank.org) (accessed 3 June 2023). Tax to GDP ratio calculations by different economic agencies can vary; here, World Bank data is used to enable a "like for like" comparison.

[4] See generally: PwC, *Indonesian Pocket Tax Book, 2023*

[5] J Arnold, 'Improving the Tax System in Indonesia' (2012), *OECD Economics Department Working Papers,* No. 998, 28

[6] There is a specific requirement under Indonesian law that an audit must be conducted in all cases where a taxpayer seeks a tax refund: refer to Article 17B(1) of the *General Provisions and Tax Procedures Law*. Arnold (supra, 29) has suggested this requirement should be abolished.

in the sense considered in this article (i.e., disengagement with tax registration and compliance requirements) is a major contributor to the revenue collection challenges Indonesia experiences, and that greater focus on enforcing compliance by the non-compliant should therefore be a greater priority for the DGT.[7]

II RESEARCH METHOD

The research employs a mix of methods, including analysis of primary legal sources (e.g., English-language versions of Indonesian tax legislation and regulations), other official data sources such as the comprehensive annual report published by the DGT (in English), as well as legal textbooks, academic literature, journal articles, newspaper reports, and other publications such as those produced by professional tax consulting firms based in Indonesia. The core research about tax audit practices and procedures is based on face-to-face interviews with active participants in the Indonesian tax audit process, comprising past and present DGT audit officers and professional tax advisors, and with tax academics based at Indonesian tertiary institutions. The research employs a qualitative approach, within an interpretivist research framework, using qualitative research methods, comprising semi-structured interviews in combination with other non-doctrinal legal research methods such as textual analysis.[8]

A *Interview design and approach*

A total of 24 semi-structured interviews were conducted, which allows the research to be informed by a range of views expressed by participants in the Indonesian tax system. The interview data has been anonymized, necessitating a sufficiently large sample of interview subjects to ensure that anonymity is maintained. Interviews were conducted with the following people: 9 experienced tax practitioners (senior partners from 3 of the "Big 4" international accounting firms, 2 partners in a leading local tax consulting firm, and 3 senior staff from smaller local firms); 11 past and present DGT audit officers; and 4 Indonesian tax academics (drawn from 3 different Indonesian tertiary education institutions). Interviews were conducted face-to-face at various locations in Indonesia between September 2019 and February 2020. All interviews were conducted in English, with contemporaneous notes of discussions being taken by the researcher and provided to interviewees for review and correction or clarification (if required) prior to finalisation. The interviews with DGT officials and tax practitioners (20 in total) were structured around 6 main themes, designed to explore how tax audit activity in Indonesia is conducted by the DGT, to help gain an understanding of the DGT's audit objectives and the effectiveness of tax audit activity. The interviews with tax academics were focused more on understanding the process in Indonesia for developing tax policy and implementing change (these issues were also canvassed to some extent in the interviews with tax practitioners and DGT officials). The use of the interview methodology allowed information to be compiled by drawing on the direct experience and

[7] A 2013 study by the IMF suggests that Indonesia's tax system has a theoretical capacity to generate revenue of around 28% of GDP, which by comparison with the actual achievement of a 9.1% tax to GDP ratio in 2021 indicates the extent of the "tax gap". See: R Fenochietto and C Pessino, '*Understanding Countries' Tax Effort',* International Monetary Fund, working paper: WP/13/244, 2013, 13. Note that whilst some changes to the Indonesian tax system have been made since 2013, broadly, these further measures have been designed to increase revenue rather than to erode the tax base.

[8] M McKerchar, M 2010, *Design and Conduct of research in Tax, Law and Accounting,* (Lawbook Co, 2010) 118; T Hutchinson, *Researching and Writing in Law,* (3rd edn, Law Book Co, 2010) 113

knowledge of the interview participants, and the data gained from the interviews with the 24 individuals referred to above is sufficient in the context of this research (consistent with the literature about interview-based research of this nature).[9] Further, the possibility of conducting further interviews after February 2020 was prevented by travel restrictions introduced by both the Australian and Indonesian governments in response to the COVID-19 pandemic.

Written consent was obtained from all interview subjects, and ethics approval for the research was obtained from both the University of South Australia (where the researcher was based when the interviews took place) and from the Indonesian Ministry of Research, Technology and Higher Education (usually referred to as "RISTEK"), the Indonesian Government agency which (at the time the research was conducted) had regulatory oversight of foreigners conducting research in Indonesia. The interview-based research approach employed is consistent with the approach taken by other tax compliance researchers, notably Braithwaite, but also by numerous other researchers who have used an interview-based approach in studies about Indonesian taxation.[10]

B *Tax Compliance Theory*

Although the present research is about the practical operation of the Indonesian tax compliance system, and the identification of potential inefficiencies in the way in which it operates in practice, it is informed by general scholarly theories of tax compliance. Principles for designing taxation systems can be traced to Adam Smith's *Wealth of Nations.*[11] In a more modern context (comprising a wholesale policy-based review of Australia's tax and transfer system on behalf of the Australian Government), Henry articulated five key design principles that underpin an effective tax system under the headings of equity, efficiency, simplicity, sustainability and policy consistency.[12] Henry noted that "legal and administrative institutions and frameworks should also be robust to maintain the effectiveness of the system and underpin the legitimacy of the system", in which it is implicit that a "robust" and "effective" tax compliance system is a necessary and important element of tax system design.

Much of the early research on tax compliance focused on economic deterrence and was influenced by the analysis of illegal behaviour using an "economic framework" undertaken by Becker, which sought to "demonstrate that optimal policies to combat illegal behaviour are part of an optimal allocation of resources. Since economics has been developed to handle resource allocation, an 'economic' framework becomes applicable to, and helps enrich, the

[9] As few as 12 interviews may suffice where "the aim is to understand common perceptions and experiences among a group of relatively homogenous individuals": G Guest, A Bunce, and L Johnson, , 'How Many Interviews are Enough? An Experiment With Data Saturation and Variability', (*Field Methods*, Vol. 18 No.1, February 2006) 59-82

[10] J Braithwaite, *Markets in Vice, Markets in Virtue,* (Oxford University Press, 2005) 16. See also: J Braithwaite and P Drahos *Global Business Regulation,* (Cambridge University Press, 2005) 12; P Grabosky, P and J Braithwaite, *Of Manners Gentle* (Oxford University Press, 1986); N Korte, N 2013, 'The Political Economy of Public Administration Reforms in Southeast Asia: A Comparative Analysis of the Tax Administration in Indonesia and the Philippines', (PhD Thesis, University of Hamburg, 2013); A Rosid, C Evans, and B Tran-Nam, 'Perceptions of Corruption and Tax Non-compliance Behaviour: Policy Implications for Developing Countries', Bulletin of Indonesian Economic Studies, Vol. 54, No. 1, 2018, 25–60; K Prasetyo, 'The Role of Effective Tax Administration in Encouraging Greater Compliance with Taxation Laws in Indonesia' (PhD Thesis, Curtin University, 2018); MH Pratomo, 'Investigating Tax Compliance Risks of Large Businesses in Indonesia', (PhD Thesis, RMIT Graduate School of Business and Law, 2018)

[11] Adam Smith, *Wealth of Nations* (1776), Chapter V, Book II

[12] K Henry, *Australia's Future Tax System,* (The Treasury, Canberra, 2009) 17

analysis of illegal behaviour".[13] Allingham and Sandmo's early study on tax evasion employed this economic approach in considering the impact of deterrent factors such as the probability of detection and penalties.[14] Subsequently, a view emerged that a broad range of factors affect levels of tax compliance, highlighting the need for an integrated approach to be taken in efforts to improve levels of tax compliance, with McKerchar observing that "it may be more fruitful (and economical) to abandon the search for the all-encompassing single model of taxpayer compliance and consider the use of different models to explain different types of compliance behaviour".[15]

Within that broader theoretical context, the Indonesian study considered in this article highlights an issue (the effectiveness of tax compliance activity) that is directly relevant to any consideration of whether Indonesia's current tax administration approaches meets the requirements articulated by Henry. If tax compliance activities are inefficient, poorly targeted, or ineffectual, not only are deterrence objectives compromised through the reduction of an individual taxpayer's risk of detection of non-compliance, but Indonesian tax morale (the motivation to pay tax) may also be compromised, if taxpayers form a general perception that their peers are unlikely to meet tax compliance obligations.

III LITERATURE ON INDONESIAN TAX AUDIT PRACTICES

Although there is a growing body of literature about Indonesian taxation generally, with numerous journal articles published by both Indonesian-based and foreign researchers in recent years, the literature on Indonesian tax administration and tax compliance approaches is more limited, and many studies approach tax compliance issues mainly from the taxpayer's perspective, without considering in detail the possible impact of the DGT's own compliance actions. Whereas some articles refer to Indonesia's tax compliance challenges and examine a range of factors that potentially affect compliance levels, there appears to be no previous comprehensive analysis about the way in which Indonesian tax audits are conducted (in a practical sense) by the DGT. Nevertheless, over the past decade, there have been some significant studies concerning Indonesia's general approach to tax administration matters, reflecting the upsurge in academic interest in understanding and addressing Indonesia's poor tax revenue mobilisation performance. From the literature, various features of Indonesia's approach to tax administration and tax compliance can be identified, which are relevant to the issues explored in this article, although the research relating to the way in which the DGT conducts tax audit activity is limited.

Several previous studies have considered aspects of deliberate non-compliance in Indonesia. In Widihartanto's study about Indonesia's failed efforts to implement a High Wealth Individuals compliance program like that successfully adopted in Australia, various inter-connected themes were noted, such as Indonesia's low levels of tax compliance (reflected in its low tax to GDP ratio), and the twin problems of substantial informality in the Indonesian

[13] G. Becker (1968), 'Crime and punishment: an econometric approach', *Journal of Political Economy*, Vol. 76 No. 1, 169-217, at p.209

[14] M. Allingham and A. Sandmo (1972), 'Income Tax Evasion: A Theoretical Analysis', *Journal of Public Economics 1*, 323-338

[15] M. McKerchar (2001) 'Why Do Taxpayers Comply – Past Lessons and Future Directions in Developing a Model of Compliance Behaviour', 16 *Australian Tax Forum* 99, at p.127

economy (i.e., the cash economy) as well as outright tax evasion. [16] The extent of deliberate non-compliance in an Indonesian context was also considered in a major study by Rosid et al, who used a mixed methodology of face-to-face interviews and self-completed surveys to gauge the attitudes of a broad-based sample of personal income taxpayers in Indonesia to tax compliance, with an emphasis on perceptions of corruption and the impact of corruption on tax compliance attitudes. [17] Their study also noted issues such as the limited enforcement resources available to the DGT, and the low risk of being subject to audit faced by Indonesian personal income taxpayers, which are relevant to the issues examined in this article. [18] However, it should be noted that this study focused on attitudes of individuals who had already registered as taxpayers and were already "within" the formal taxpaying system, and therefore who could be regarded as being at least semi-compliant.

Insights into the source of Indonesia's tax compliance problems were provided by Hamilton-Hart and Schulze who noted that whilst the Indonesian tax system is "well-designed in principle", its problems "lie in tax policy and in tax administration" and they concluded by stating: "[t]here are too few taxpayers, compliance levels are much too low, and auditing is not risk-based".[19]

Another study which considered the extent of non-compliance amongst a segment of Indonesian taxpayers was that undertaken by Mukhlis looking at levels of tax compliance in the SME business sector in East Java. [20] This study was based on a survey of 283 individuals engaged in small business activity. Although mainly focussed on compliance cost issues, another study by Susila examined the attitudes of large corporate taxpayers to the DGT's audit processes and, amongst other things, the study found that large corporate taxpayers have a relatively low (less than 50%) level of satisfaction with the DGT's tax audit processes, compared with the generally more favourable impressions of other interactions with the DGT.[21] The study also included some relevant background analysis of the structure and operations of the DGT, including its approach to conducting tax audits.

The tax compliance literature in Indonesia generally does not consider the specific details of how tax audit activity is undertaken by the DGT. Whilst there is some focus in Korte's research on the DGT's administrative practices, including compliance activities, her principal focus was on the circumstances in which Indonesia implemented its tax reform program in the period up to 2008. Nevertheless, Korte noted various potentially significant matters affecting the effectiveness of the DGT's compliance activities, such as misalignment of audit resources, whilst also noting the lack of focus on risk-based auditing, and the low risk of audit faced by most Indonesian taxpayers.[22] In this respect, Korte's study was consistent with the later study of Rosid et al.[23] Sari examined the impact on levels of tax compliance from the adoption of risk management strategies by the DGT, particularly the adoption of the

[16] S. Widihartanto, 'Regulating Indonesia's High Wealth Individual Taxpayers: Ideas for Policy Transfer' (PhD thesis, Australian National University, 2014)
[17] Rosid et al (n 11)
[18] Rosid et al (n 11) 46
[19]N Hamilton-Hart and G Schulze, 'Taxing Times in Indonesia: The Challenge of Restoring Competitiveness and the Search for Fiscal Space' (2017) 52.3 *Bulletin of Indonesian Economic Studies* 265, 291.
[20] I Mukhlis, 'Tax Compliance for Businessmen of Micro, Small and Medium Enterprises Sector in the Regional Economy' (*International Journal of Economics*, *Commerce and Management*, IV, Issue 9, 2016)
[21] B Susila, 'The Compliance Costs of Large Corporate Taxpayers in Indonesia' (PhD Thesis, Curtin University, 2014) 198
[22] Korte (n 11) 69
[23] Rosid et al (n 11)

"Account Representative" strategy, whereby DGT officers are allocated to monitor compliance with tax obligations of taxpayers, using risk management strategies, to ensure higher overall levels of compliance.[24]

Pratomo also examined the DGT's compliance approach and identified shortcomings in the way tax audit activities are conducted, suggesting that there should be greater risk-based focus in assessing compliance risks presented by large corporate taxpayers, with a particular focus on "undisclosed high-risk transactions or arrangements or abnormally low tax payments in a specific situation".[25] Pratomo also identified the importance of the DGT adopting a flexible approach in encouraging greater levels of voluntary compliance. The focus of Pratomo's study was on factors which might affect the way in which large corporate taxpayers approach their tax compliance obligations, which may have either a positive or negative effect on overall tax compliance levels but did not examine the DGT's own compliance approach. Pratomo noted that the probability of detection and penalties are factors which may motivate large business taxpayers to be more compliant.

As with Pratomo's research, Prasteyo also considered some aspects of the DGT's compliance approach, and his research was based on capturing the views of interview participants on how best to improve the DGT's internal management to improve overall taxpayer compliance levels.[26] Most of the factors described by Prasetyo relate to the DGT's internal working environment, including relationships between staff and supervisors and creating more "positivity" within that environment. Given that the focus of this research was on the need for behavioural changes within the DGT that can assist in implementing tax administration reform measures, it did not examine how tax compliance activities are conducted in practice.

The examination of the DGT's approach to tax audit activities described in this article therefore builds on the existing literature, particularly with its focus on the issue identified by Hamilton-Hart and Schulze, that Indonesia's revenue collection problems are not so much because of the design of the tax system, but rather through problems in tax policy and administration. However, unlike other studies, its focus is on the way that audit activities are undertaken by the DGT.

IV LAWS AND REGULATIONS RELATING TO TAX AUDITS IN INDONESIA

Consistent with the civil law tradition that applies in Indonesia, Butt and Lindsey observed that "most Indonesian statutes aim to provide a general legal framework for their subject matter, leaving the regulatory detail to lower-level laws, such as government regulations (*peraturan pemerintah*), presidential regulations (*peraturan presiden*), and ministerial regulations (*peraturan menteri*)" and they comment that statutes might be regarded as a "statement of national intention", with implementation depending on the promulgation of separate implementation rules,[27] In the field of Indonesian tax law, this approach is reflected

[24] D Sari, 'Risk Management and Taxpayer Compliance', (*Proceedings of the International Conference on Education For Economics, Business, and Finance*, Universitas Negeri Malang, 2016)
[25] Pratomo (n 11) 210
[26] Prasetyo (n 11) 228
[27] S Butt and T Lindsey *Indonesian Law*, (Oxford University Press, 2018) 49.

in the *Law on Income Tax* which comprises fewer than 30 pages, with detailed rules dealing with implementation and application of the law to be found in other regulations.[28]

The DGT is generally authorised to perform tax audits by Article 29 of the *General Provisions and Tax Procedures Law*. The two main purposes of tax audits are stated as being to test taxpayer compliance and "other purposes in the context of implementing the provisions of taxation legislation" (Article 29.1). Tax audits must be performed within 5 years after the end of a tax period (Article 13). However, in the case of a tax over-payment where a taxpayer requests a refund as permitted by Article 11, Article 17B(1) of the *General Provisions and Tax Procedures Law* requires that the DGT complete its tax audit and issue any tax assessment letter within 12 months of the tax refund request being made. A significant proportion of tax audits are the result of tax refund requests and the time pressures imposed by the 12-month deadline for completing the audit have a significant bearing on the way in which tax audit activities are conducted in practice. Also, given that this requirement is set by legislation enacted by the Indonesian Parliament, which is the highest level of law within the Indonesian hierarchy of laws under the Constitution, it is a requirement which must be strictly adhered to and cannot be modified by Regulations.[29] However, it should be noted that in some circumstances a taxpayer with a good tax record (known as a "golden taxpayer") may seek an early tax refund without an audit being conducted, although in such cases the DGT is still entitled to conduct a tax audit later.[30] This potentially reduces the DGT's burden to conduct tax audits in all tax refund cases.

Article 31 of the *General Provisions and Tax Procedures Law* allows tax audit procedures to be determined by Regulations made by the Minister of Finance and under this specific authority the Ministerial Regulation governing the conduct of tax audits (PMK-17) was made.[31] This Regulation states that tax audits "must be carried out" where taxpayers seek refunds (Article 4(1)) and "can be carried out" in a number of other circumstances, including where tax overpayments are made (but a refund is not sought), a tax loss is reported, asset revaluations take place, taxpayers have failed to lodge a tax return (or lodged late), and other cases where taxpayers "have been selected for a tax audit based on a risk analysis" (Article 4(2)). The regulation also sets out various procedural obligations relating to the conduct of tax audits e.g., the need for periodic meetings with taxpayers, and the time frames for completing audit activity (4 to 6 months for examination, and a further 2 months for discussion). Note that the DGT has also issued a separate regulation outlining procedures for conducting a group tax audit "of two or more taxpayers within a business group".[32] The need for extensive regulations governing tax audit procedures appears to be a product of the strict timelines set by law for completing audit activities (in particular, the 12-month time limit in tax refund cases) balanced against the need to provide procedural fairness to taxpayers.

PMK-17 does not specify in detail the audit procedures that must be followed by an audit team in its analysis of whether a taxpayer has complied properly with its tax obligations. Rather, the focus of PMK-17 is on various other formalities that must be complied with by the DGT in conducting a tax audit e.g., formal notification of the audit to the taxpayer, then

[28] Law Number 7 of 1983, last amended by Law Number 36 of 2008
[29] Butt and Lindsey (n 28) 37
[30] PwC Indonesia (2023), *Indonesian Pocket Tax Book – 2023*, 99
[31] Regulation of the Minister of Finance of the Republic of Indonesia Number 17/PMK 03/ 2013 Concerning Procedures for Examination – generally referred to as "PMK-17".
[32] PwC Indonesia , 'Tax Flash No. 12 – Group tax audit procedure' (2013) 2; DGT Circular Letter No. SE-26/PJ/2013, dated 30 May 2013

issue of audit findings letters, and setting meeting schedules and timetables for the audit activity to take place. These formal matters are dealt with in exhaustive detail by PMK-17.

Consistent with Article 29 of the *General Provisions and Tax Procedures Law,* PMK-17 confers a broad power on the DGT "to carry out an Audit with the purpose of testing compliance with taxation obligations and/or for other purposes in implementing the provisions of taxation laws and regulations" (Article 2). For these purposes, "compliance" is not defined and "taxation obligations" presumably extends beyond the mere lodgement of a tax return. In PMK-17, "verification" is defined as the fulfillment of obligations to calculate and pay tax, based on data and information obtained or held by the DGT.[33]

From this analysis of the *General Provisions and Taxation Procedure Law* and the terms of Regulation PMK-17, various observations about the regulatory framework governing tax audits can be made. First, it is clearly a legal requirement under the *General Provisions and Taxation Procedure Law* that tax audits must be conducted by the DGT in tax refund cases. Also, it is evident that DGT officers are subject to strict timelines within which audit activities must be completed. It is notable that PMK-17 contemplates that group audits can be undertaken. It is also relevant that the regulations provide the DGT with broad powers to request information and documents and impose corresponding obligations on taxpayers to comply with such requests. Perhaps surprisingly, PMK-17 does not impose any requirements relating to the actual verification and checking procedures that must be undertaken during an audit, notwithstanding that it spells out in considerable detail requirements around timelines and formalities associated with communications to taxpayers. Rather, it appears that the way audit activities are conducted is determined by the DGT itself, based on past practice and experience, rather than being governed by the regulation. PMK-17 can be changed by an amending regulation, although (as noted) the mandatory requirement to conduct tax audits in refund cases is set by law and therefore can only be changed by a legislative amendment. Also, there is scope for changes to be made to internal DGT procedures, to permit different approaches to the conduct of tax audit activity.

V HOW TAX AUDITS ARE CONDUCTED IN INDONESIA

This analysis is based on 20 interviews conducted with tax consultants and DGT auditors and is built around 6 main themes covered in the interviews, as follows:

1. DGT's objectives in undertaking audit activities.
2. Common triggers for a tax audit.
3. DGT's tax audit practices and procedures.
4. Type of adjustments generally made during a tax audit.
5. Reasons for the DGT's low success rate in Tax Court appeals.
6. DGT's efforts to target intentional non-compliance.

As described earlier, detailed contemporaneous records of the interviews were compiled by the author. In preparing the analysis below, the author carefully reviewed the interview data to identify common themes which form the basis for the author's conclusions.

[33] PMK-17 - Article 1.5

A *Interview Approach*

Tax auditors and tax consultants were asked questions that were broadly similar but given the nature of the different roles that each group of interview subjects play in the Indonesian tax system there were some differences between the questions put to each group. Although standard questions were pre-prepared, not all interview subjects expressed views in respect of all the questions, either because an individual interview subject was unable or unwilling to express a view on a particular matter or insufficient time was available to canvass all issues fully. Therefore, in respect of some of the topics considered here, the analysis may reflect comments from some, but not all, of the interview subjects.

Generally speaking, the level of experience with tax audit work (in terms of the actual number of audit cases worked on) of the tax consultants who were interviewed was less than that of the DGT auditors who were interviewed, although a significant proportion of the professional services provided by tax consultants involves assisting clients during a tax audit, including managing information requests and discussions with tax auditors and associated appeals to the Tax Court against audit based assessments. Foreign tax consultants (who typically work for "Big 4" accounting firms) do not generally have direct contact with DGT audit teams, and when their clients are subject to audit, other Indonesian-qualified tax consultants working for their firm will manage the direct dealings with the DGT auditors. The range of direct tax audit experience amongst the tax consultants interviewed therefore varied widely, from working on as few as 100 or so audits to upwards of 300 audits, over the course of their careers. It should be noted that many tax consultants also work on non-audit related tax matters, especially Mergers and Acquisitions transactions (including tax due diligence checks for potential undisclosed tax liabilities of target companies in an acquisition) as well as tax compliance services (preparation and checking of income tax returns) and general tax consulting and inbound investment advice work.

The DGT audit staff who were interviewed generally have worked on many more audits than the tax consultants who were interviewed. Head Office auditors, and those working in the Large and Specialist tax offices, are usually engaged on fewer audits than those working in a local tax office. Most auditors who were interviewed reported working on 20 to 25 audits a year, but the range varied from 10 to 15 per annum in a large tax office, to as many as 40 to 50 per annum in a local tax office. Accordingly, at any given time, most auditors work concurrently on numerous audits, and it became evident through the interviews that DGT auditors generally have a heavy case load. This high workload highlights the importance of efficient allocation of audit resources and of itself is therefore relevant in assessing whether the DGT's audit activities are inefficient or poorly focussed.

B *Key Interview Findings*

The first of the interview themes concerns the differing perceptions of auditors and tax consultants about the DGT's objectives in undertaking audit activities. Tax consultants generally expressed a view that audits were undertaken by the DGT for the direct purpose of extracting more tax from the taxpayer under audit. However, tax auditors were inclined to a view that the DGT's objectives when conducting audit are broader, and that whilst revenue collection is important, audits also play a significant role in promoting "better compliance" by taxpayers, so that audits also perform an educative function. By educating taxpayers about

their compliance obligations, one auditor explained that this helps ensure that taxpayers "will not make the same mistakes in future".

In respect of the second theme, the interviews confirmed that the mandatory requirement for a tax audit in tax refund cases remains the most common reason why the DGT will conduct an audit of a taxpayer, with the tax consultants generally have a much stronger perception that this is the case compared to the view of the DGT auditors. Although the interviews with DGT officers revealed that some audits are initiated for other reasons, the interviews also revealed that there is no significant focus on conducting audits of non-compliant taxpayers and that (in effect) there is no real risk that an individual or entity that has not registered as a taxpayer (and therefore chooses to be non-compliant) will be subject to an audit, which is also consistent with the views of tax consultants. As an example of a non-refund case audit, one auditor discussed the case of a company which gets audited every year, because of its past track record, as a result of which the auditors came to the belief that it had a "high potential" to pay extra tax, meaning that it had demonstrated a willingness in the past to pay extra tax and therefore would do so again in other years. This indicated that the DGT does not use "proper criteria" to select audit targets because auditors have a preference to conduct repeat audits of companies they have audited before. The auditor also mentioned that this practice is referred to by DGT auditors as "hunting in the zoo", meaning that auditors prefer auditing companies that have proved their "potential to pay".

A key exception to the general proposition that most tax audits are refund related has emerged more recently and relates to transfer pricing compliance. Most of the tax consultants who were interviewed mentioned that transfer pricing audits are sometimes conducted even where taxpayers do not seek a tax refund. This reflects the DGT's commitment to tackling perceived tax avoidance by multi-national company groups carrying on business in Indonesia. Nevertheless, the interview findings support a conclusion that there is a heavy focus of tax audit activity on tax refund cases rather than on risk-based auditing, and this bias could compromise the effectiveness of Indonesia's tax compliance program.

In respect of the third theme, the interviews with both tax consultants and tax auditors revealed that the DGT's audit approach is heavily reliant on a reconciliation methodology (known as "tax equalisation") which involves a comparison between the tax return information disclosed by the taxpayer and other data provided by the taxpayer, such as its audited financial accounts. Consistently, auditors referred to the reconciliation approach as the "standard" approach, with audit adjustments being made based on items that did not properly reconcile. Tax auditors also expressed frustration about the difficulties they experience in gaining access to data held by third parties about taxpayers. Tax consultants generally viewed the DGT's audit approaches as simplistic and unsophisticated, with one foreign tax consultant describing the DGT's audit conduct as "robotic" and another describing audits as "paper warfare".

Both interview groups indicated they understood there were deficiencies in the DGT's audit methodologies, and that there is little real focus on employing risk-based audit techniques. Audits tend to follow a "one size fits all" approach. It also became apparent that there is little tax audit focus on detecting non-compliance by entities that should be registered to pay tax but have failed to do so, and even registered taxpayers can avoid audit scrutiny by the simple device of managing their affairs in a way that avoids seeking a refund of tax overpayments. The interviews also revealed that there is no real focus on conducting audits on a company group basis, notwithstanding that (as previously noted) there is specific regulatory guidance

about the conduct of group audits. Rather, the audit focus is generally confined to the individual taxpayer that made the tax refund request, even where the taxpayer is part of a wider company group or is a member of a group of inter-connected family businesses. As a result, these findings support a view that the scope and extent of audit activities conducted by the DGT is limited and provide support for a view that audit activities are poorly focused.

The fourth interview theme relates to the type of adjustments which are generally made during a tax audit in Indonesia, and the information captured through the interviews revealed that the completion of audits is often rushed, with adjustments being made by audit teams based mainly on the data reconciliation process (tax equalisation) described above. Other key findings from the interviews are that audit teams often experienced difficulties in obtaining data and that few adjustments are based on differences of opinion with taxpayers about the technical application of the law.

The fifth theme covered in the interviews relates to an issue identified in the OECD's 2012 report concerning the high proportion of tax appeal cases in which taxpayers successfully challenge DGT assessments before the Indonesian Tax Court. [34] The DGT itself has reported that in 2019, its success rate in tax appeal cases was only 40.54%.[35] The OECD report attributed this outcome to the availability of better legal resources to taxpayers, and the DGT's own lack of resources, resulting in an uneven playing field. However, based on the interviews, a lack of DGT resources for conducting appeals work does not seem to be the real cause of the DGT's poor record in winning Tax Court appeals. Rather, it was generally acknowledged by both groups of interviewees (i.e., tax consultants and DGT auditors) that the completion of audits is often rushed due to time pressures, with the result that assessments are made without a proper basis, and that taxpayers must rely on appeals to the Tax Court to have a proper consideration of their evidence and explanations. In many cases, this leads to a favourable outcome for the taxpayers. Interviews with the tax consultants revealed a perception that the tax objection process does not involve an independent evaluation of the DGT's assessments and that a taxpayer's objection is rarely upheld. In combination, it is these factors which seem to be the main reason for the high rate of successful appeals to the Tax Court by taxpayers. In turn this is a further indication of inefficiency in the DGT's tax audit process and resource allocation.

The sixth theme covered by the interviews concerns the extent of the DGT's efforts to focus on intentional non-compliance by individuals and businesses which should be registered to pay tax but have not done so. This issue lies at the core of the hypothesis that the DGT's audit activity is excessively focused on compliant taxpayers rather than those who are non-compliant. Based on the interviews with tax auditors and tax consultants, it appears the DGT conducts little compliance activity focused on identifying and conducting audits in cases of intentional non-compliance by individuals and businesses that should have registered to pay tax but have failed to do so. There appears to be limited co-ordination between audit teams and other sections of the DGT that are responsible for "tax extensification" measures (i.e., new taxpayer registrations) and even where unregistered taxpayers are identified, there appears to be no focus on conducting audits in respect of the years prior to the taxpayer's registration. There are some indications that this lack of focus is for procedural reasons, with auditors only being responsible for the audit tasks that are allocated to them and that someone who has not registered to pay tax is therefore very unlikely to be selected for an audit.

[34] Arnold (n 6) 28
[35] DGT 2019 (n 3) 63

C *Attitudes to changing the DGT's tax compliance approach.*

The interviews with all three groups of interview subjects also canvassed a broad range of other issues, about the way in which the DGT sets audit targets and monitors the effectiveness of its audit program, the extent to which the DGT may be open to changing its current tax compliance approach, and the processes by which tax policy can be developed and implemented in Indonesia. Discussions with tax academics also included a consideration of the extent of academic research about taxation in Indonesia and opportunities for public discussion and consultation about taxation policy.

With respect to the DGT's audit objectives, it emerged from the interviews that tax auditors are more likely to see the DGT's audit focus as being to ensure taxpayer compliance, whereas tax consultants believe the DGT is very focused on achieving revenue targets. Amongst the tax auditors who were interviewed, perhaps surprisingly, revenue targets do not seem to have a major influence on their approach to audit work. It should be noted that the auditors who were interviewed were all engaged directly in conducting audits as audit team members and none held a senior management position with the DGT. Therefore, it is possible that for more senior DGT staff, a failure to meet revenue targets may carry sanctions. Nevertheless, it also emerged that the DGT appears to have little interest in improving its audit coverage or effectiveness, and the measures it uses to monitor audit effectiveness are built around maintaining the *status quo*, with a primary focus on audit completion rates and the rate of objections against audit-based assessments. This tends to reinforce a key proposition of this article, which is that the DGT's audit approach is poorly focused.

There was a broad consensus between all interviewee groups that there is some willingness to change within the DGT, and that change has been successfully implemented in the past. However, it also appeared that there is little current appetite within the DGT for changing the way in which audit activity is carried out. In considering whether audit effectiveness can be improved through change, some views were expressed by the DGT interviewees which indicate that such change would be possible if the right impetus can be generated, especially if a proposed change is backed with support "from the top" (meaning from the DGT senior leadership team and the Ministry of Finance).

Also, from the interviews with tax academics, it emerged that there has been a relatively limited focus on academic tax research in Indonesia in the past, but that this has grown significantly in recent years, and the DGT plays an active role in setting the tax academic research agenda, including sponsorship of tax academic research conferences. On the other hand, apart from the DGT sponsored conferences, there are few forums available for public debate and for discussion of tax policy and tax reform in Indonesia, and whilst the Ministry of Finance does seek input to policy development from tax academics and business and professional bodies from time to time, it does so selectively and on an *ad hoc* basis. Based on previous experience, it is also apparent that external agencies (including the major international economic agencies such as the OECD, IMF and World Bank) can influence the tax policy making and reform processes.

VI PRIORITY ISSUES

A key priority for Indonesian tax policy makers should be to analyse who currently pays tax in Indonesia and who does not, which would assist the DGT in better understanding where future compliance activity should be directed. There needs to be a robust policy discussion about the design of the current tax compliance system and to identify ways in which its effectiveness can be improved. These efforts would be enhanced if there is a better understanding of where current tax compliance levels are lowest, and by extension how future tax compliance effort could be more efficiently focused to maximise revenue collection.

The DGT should move away from its current data reconciliation focus and instead adopt more effective data matching methods using third party data, and by using other information available from public sources. Avenues for obtaining data relating to the financial and business affairs of taxpayers under audit, as well as methodologies for identifying risk, and the audit practices and procedures successfully employed elsewhere, all need to be examined. Other key priorities for change should include increased focus on group audit activity and better co-ordination of compliance activities by different DGT offices. It would be more efficient if all companies sharing a significant percentage of common ownership could be consolidated under the responsibility of a single tax office, with a greater focus on group-wide audit activity rather than audits of individual entities (as is the case at present). There should also be greater effort in identifying high-risk businesses, including those which have not registered to pay tax.

Part of a comprehensive review of DGT audit practices should be to examine how other countries conduct tax audits, especially in the field of cross-border transactions, to assist the DGT in identifying the type of information it needs and the methodologies it can use to identify secret asset holdings and income sources outside Indonesia, especially with high wealth individuals (this might have a similar focus to the ATO's Project Wickenby, which commenced in 2006, and targeted tax avoidance practices of the wealthy in Australia). This would require a comprehensive examination of how the wealthy in Indonesia manage their tax affairs and extend to considering the extent to which wealth is held overseas, and it would also require a focus on the tax practices of inter-connected family companies and associated individuals.

VII CONCLUSION

This research has confirmed that the DGT's major tax compliance focus is on audits in tax refund cases and that there is little focus on enforcing compliance by individuals and entities which have not registered as taxpayers. It follows that the DGT's audit activities are almost entirely focused on registered taxpayers who are already compliant or broadly compliant rather than non-compliant entities (i.e., which should be registered as taxpayers but have not done so). The absence of any real risk of detection or adverse consequences for the non-compliant needs to be addressed if greater levels of voluntary compliance are to be achieved.

Other factors that compromise the effectiveness of the DGT's compliance approach and thereby contribute to Indonesia's poor revenue outcomes, principally relate to the narrow scope of audit activities, a lack of focus on auditing groups of related companies, and the heavy reliance on a "data reconciliation" methodology as a basis for identifying audit adjustments. Other significant issues relate to the difficulties DGT auditors experienced in

accessing third party data and the very tight deadlines for audit completion set under the tax audit regulations, which means that the completion of many audits is rushed.

Although the Indonesian Ministry of Finance has set an ambitious long-term review target (a tax to GDP ratio of 16%), it remains well short of meeting this target. This failure should be the catalyst for a comprehensive review of the effectiveness of Indonesia's current tax collection strategies. Efforts to generate more tax by increasing tax rates, and introducing new taxes, do not address the much broader problem of non-compliance, whilst increasing the tax burden on those taxpayers who are compliant. It should be obvious that greater effort by Indonesian tax policy makers and administrators in tackling the core challenges of extensive non-compliance will lead to better overall revenue collection outcomes and achieve progress in meeting the 16% Tax to GDP ratio target.

THE APPLICATION OF CAPITAL GAINS TAX TO PARTNERSHIP ASSETS: CHALLENGES AND REFORM

DOMINIK BREZNIK*

Abstract

The legislation which applies Australia's capital gains tax regime to partnership assets is peculiarly designed. It diverges from the general law by treating partners as holding fractional interests in partnership assets while relying on the same general law to quantify these interests. This article argues that the design of the CGT regime was influenced by an assumption that the general law recognises partners as holding direct interests in partnership assets. It is then demonstrated that inconsistent elements in the regime's design have produced confusion concerning the meaning and application of its provisions. Finally, proposed reforms to the legislation which governs the regime and the primary Australian Taxation Office ruling relevant to these issues are suggested.

I INTRODUCTION

The interaction between Australia's capital gains tax ('CGT') regime and partnership law is neither clear nor conceptually consistent. On the one hand, the CGT regime disregards the general law of partnership by treating partners as holding fractional interests in partnership assets. On the other, it purports to rely upon partnership law to quantify interests that it proposes to tax. This article will argue three propositions. First, that the design of the CGT regime was influenced by a reading of the seminal High Court of Australia decision *The Commissioner of Taxation v Everett* ('*Everett*')[1] as establishing that partners hold a proprietary interest in individual assets. Second, that in recent years various courts have clarified that partners hold no such interest. Third, that the assumption partners hold proprietary interests in individual partnership assets has created imprecision and inconsistency in the CGT regime. Proposed reforms to the CGT regime will then be examined. In particular, the practice of His Majesty's Revenue and Customs ('HMRC') in the United Kingdom will be considered, and suggestions for aspects of this practice to be adopted and modified for the Australian regime put forward.

* Associate, Federal Court of Australia. The author thanks Professor Richard Vann for his helpful advice and suggestions in the preparation of this article. An earlier version of this article was awarded the 2023 Forsyth Pose Scholarship by the Law Council of Australia.

[1] (1980) 143 CLR 440 ('*Everett*').

II THE STATUTORY REGIME

The law of partnership began as a derivative of contract,[2] almost entirely defined by the general law until the late 1890s.[3] Various 'Partnership Acts' have since been passed by each Australian State and Territory,[4] which govern the operation of partnerships at a high level. These Acts provide a framework within which a detailed body of general law largely defines the operation of partnerships.

At general law, partnerships have no separate legal personality from the partners who comprise them.[5] In contrast to the general law position that a partnership is not an entity separate from its partners, s 960-100(1)(d) of the *Income Tax Assessment Act 1997* (Cth) ('*ITAA 1997*') deems a partnership to be an entity for taxation purposes. However, partnerships are not *tax paying* entities separate from the partners that comprise them. Rather, partnerships are required to lodge an income tax return, while responsibility to pay tax on each partner's share of the partnership's net income 'flows through' the deemed entity to the individual partners themselves. The term 'partnership' is defined in s 995-1 of the *ITAA 1997* as follows:

> 'Partnership' means:
>
> (a) an association of persons (other than a company or a *limited partnership) carrying on business as partners or in receipt of *ordinary income or *statutory income jointly; or
>
> (b) a limited partnership.
>
> Note 1: Division 830 treats foreign hybrid companies as partnerships.
>
> Note 2: A reference to a partnership does not include a reference to a corporate limited partnership: see section 94K of the *Income Tax Assessment Act 1936*.

Section 91 of the *Income Tax Assessment Act 1936* (Cth) ('*ITAA 1936*') provides: 'A partnership shall furnish a return of the income of the partnership, but shall not be liable to pay tax thereon.' Pursuant to s 92(1) of the *ITAA 1936*, this income or loss is included in the assessable income of each partner, in proportion to that partner's entitlement to the net income of the partnership:

> Section 92 Income and deductions of partner
>
> (1) The assessable income of a partner in a partnership shall include:

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[2] Roderick I'Anson Banks, *Lindley & Banks on Partnership* (Sweet & Maxwell, 21st ed, 2022) 3 [1-03].
[3] Ibid.
[4] *Partnership Act 1963* (ACT); *Partnership Act 1958* (Vic); *Partnership Act 1892* (NSW); *Partnership Act 1997* (NT); *Partnership Act 1891* (Qld); *Partnership Act 1891* (SA); *Partnership Act 1891* (Tas); *Partnership Act 1895* (WA). See also the *Limited Partnerships Act 2016* (WA).
[5] *Global Partners Fund Ltd v Babcock and Brown Ltd (In Liq)* (2010) 267 ALR 144, 161 [87] (Hammerschlag J) ('*Global Partners Fund*'); GT Pagone, 'Capital Gains Tax and Partnerships' (1988) 17 *Australian Tax Review* 76, 77.

> (a) so much of the individual interest of the partner in the net income of the partnership of the year of income as is attributable to a period when the partner was a resident; and
>
> (b) so much of the individual interest of the partner in the net income of the partnership of the year of income as is attributable to a period when the partner was not a resident and is also attributable to sources in Australia.

Further, partnerships are deemed to hold assets for certain taxation purposes. For example, Item 7 of s 40-40 of the *ITAA 1997* provides that a partnership, and not any particular partner, 'holds' a depreciating asset that is a partnership asset. Therefore, the deductibility of the depreciated value of such an asset[6] impacts the calculation of the partnership's income or loss in a given year (and, ultimately, each partner's assessable income).

The CGT regime in respect of partnership assets is built around ss 106-5 and 108-5 of the *ITAA 1997*.

Section 106-5(1) provides: - Partnerships.

> (1) Any capital gain or capital loss from a CGT event happening in relation to a partnership or one of its CGT assets is made by the partners individually.

Each partner's gain or loss is calculated by reference to the partnership agreement, or partnership law if there is no agreement.

> Example 1: A partnership creates contractual rights in another entity (CGT event D1). Each partner's capital gain or loss is calculated by allocating an appropriate share of the capital proceeds from the event and the incidental costs that relate to the event (according to the partnership agreement, or partnership law if there is no agreement).
>
> Example 2: Helen and Clare set up a business in partnership. Helen contributes a block of land to the partnership capital. Their partnership agreement recognises that Helen has a 75% interest in the land and Clare 25%. The agreement is silent as to their interests in other assets and profit sharing.
>
> When the land is sold, Helen's capital gain or loss will be determined on the basis of her 75% interest. For other partnership assets, Helen's gain or loss will be determined on the basis of her 50% interest (under the relevant Partnership Act).

Section 108-5 of the *ITAA 1997* provides: - CGT assets.

> (1) A CGT asset is:
>
> (a) any kind of property; or
>
> (b) a legal or equitable right that is not property.
>
> (2) To avoid doubt, these are CGT assets:
>
> (a) part of, or an interest in, an asset referred to in subsection (1);
>
> (b) goodwill or an interest in it;

[6] See *Income Tax Assessment Act 1997* (Cth) s 40-25 ('*ITAA 1997*').

(c) an interest in an asset of a partnership;

(d) an interest in a partnership that is not covered by paragraph (c).

While the assets captured by s 108-5(2)(c) (deemed proportionate interests in partnership assets) may be described without undue difficulty, the residual assets captured by s 108-5(2)(d) are less clear. A review of the history of these provisions provides some context for understanding the legislative intention behind their drafting. The precursor to s 108-5(2)(c) was proposed in the Taxation Laws Amendment Bill (No 6) 1990 (Cth). This Bill was then amended to include the precursor to s 108-5(2)(d). These sections were introduced into law in the *Taxation Laws Amendment Act 1991* (Cth) as ss 160A(d) and (e) of the *ITAA 1936* respectively.

It was observed several years before the *Taxation Laws Amendment Act 1991* (Cth) was passed that partners generally hold two kinds of assets.[7] First, interests in the assets of the partnership. Second, the bundle of rights that the partners have against each other (their rights *inter se*). These rights *inter se*, which comprise a chose in action and therefore an asset,[8] were said to be distinct from the assets of the partnership such that the 'danger in a blind application of Part IIIA may be a double counting of gains which could not have been intended by the legislature.'[9] The further supplementary explanatory memorandum to the Taxation Laws Amendment Bill 1991 (Cth)[10] confirms that this risk of double taxation inspired the introduction of s 160A(e) of the *ITAA 1936*.[11]

This explanation for the introduction of s 160A(e) sheds some light on its intended purpose. However, this section, and now s 108-5(2)(d), appear to be premised on a conception of partners as owning a percentage of a partnership 'entity' separate from the partners themselves.[12] This assumption is unknown to the general law.[13] With only a limited general law frame of reference for what this interest comprises, differentiating between the assets described in ss 108-5(2)(c) and (d) remains difficult.[14]

III THE VIEW OF PARTNERS AS FRACTIONAL INTEREST HOLDERS

The *Everett* decision concerned a determination that the assignment of a share in a partnership carries with it a present entitlement to a proportionate share of the profits of the

[7] Pagone (n 5) 81.
[8] CCH Australia, *Income Tax Assessment Act 1997 Commentary* (online at 13 November 2023) ¶152-835 ('*ITAA 1997* Commentary').
[9] Pagone (n 5) 84.
[10] The Taxation Laws Amendment Bill (No 6) 1990 (Cth) was amended and retitled the Taxation Laws Amendment Bill 1991 (Cth).
[11] Further Supplementary Explanatory Memorandum, Taxation Laws Amendment Bill (No 6) 1990 (Cth) 2. See also *Hedges v Commissioner of Taxation* [2023] FCAFC 105, [23] ('*Hedges*') (application for special leave to appeal to the High Court of Australia dismissed: *Brent Hedges v Commissioner of Taxation* [2023] HCASL 182); *ITAA 1997* Commentary (n 8) ¶152-835.
[12] N Augoustinos, 'Partnerships and CGT: An International Comparative Analysis' (1993) 1(3) *Taxation in Australia Red Edition* 126, 133.
[13] Pagone (n 5) 77.
[14] Augoustinos (n 12) 133.

partnership.[15] As such, income corresponding to that share was found not to form part of the assignor's assessable income.[16] In coming to this conclusion, the High Court majority considered the nature of a partner's interest in the assets of their partnership.

The *Everett* majority stated that the members of a partnership have 'a beneficial interest in the partnership assets, indeed in each and every asset of the partnership.'[17] The majority then qualified this statement by adding that this interest 'consists of a right to a proportion of the surplus *after* the realisation of the assets and payment of the debts and liabilities of the partnership'.[18] Two authorities were cited in support of the proposition that a partner holds a beneficial interest in each and every partnership asset:[19] the decision of Kitto J in *Livingston v Commissioner of Stamp Duties (Qld)* ('*Livingston*')[20] and the decision of McTiernan, Menzies and Mason JJ in *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* ('*Canny Gabriel*').[21]

In *Livingston*, Kitto J both recognised that a partner's interest in partnership assets was an interest in a proportion of the surplus after realisation of the assets, and, like the majority in *Everett*, that it is a 'beneficial interest' held in 'every piece of partnership property'.[22] In *Canny Gabriel*, McTiernan, Menzies and Mason JJ used similar language to that seen in *Livingston*, but went further in emphasising that an interest is held by partners in every asset of the partnership.[23] Indeed, their Honours noted that 'it has always been accepted that a partner has an interest in every asset of the partnership and this interest has been universally described as a "beneficial interest", notwithstanding its peculiar character.'[24] On that basis, it was held that partners hold an equitable interest, and not a 'mere equity' (here being a right 'to set aside or rectify a transaction by means of a court order'[25]).[26]

To these two cases one example of older High Court authority may be added: *Sharp v Union Trustee Company of Australia Ltd* ('*Sharp*').[27] In this case, Rich J stated that partners hold a proprietary interest in each item of partnership property, albeit one that is indefinite and fluctuating in proportion to the partner's share in the surplus funds upon winding up of the partnership.[28]

Notwithstanding the qualification that a partner's interest in partnership assets can only be determined upon termination of the partnership, it was the *Everett* majority's description of a partner holding a beneficial interest in each partnership asset that most clearly impacted Australian law. This is especially so in respect of the position taken by the Commissioner of

[15] *Everett* (n 1) 454.
[16] Ibid.
[17] Ibid 446. The majority cited *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321, 327-328 ('*Canny Gabriel*') and *Livingston v Commissioner of Stamp Duties (Qld)* (1960) 107 CLR 411, 453 ('*Livingston*') in support of this proposition.
[18] *Everett* (n 1) 446 (emphasis added).
[19] Ibid.
[20] *Livingston* (n 17) 453.
[21] *Canny Gabriel* (n 17) 327–8.
[22] *Livingston* (n 17) 453.
[23] *Canny Gabriel* (n 17) 327.
[24] Ibid.
[25] Ibid 328.
[26] Ibid.
[27] (1944) 69 CLR 539 ('*Sharp*').
[28] Ibid 551.

Taxation ('Commissioner') concerning the interest held by partners in partnership assets at general law, and the taxation consequences that flowed from this.

IV THE COMMISSIONER'S INTERPRETATION OF *EVERETT*

On 22 June 1989, the Commissioner published Taxation Ruling IT 2540 ('IT 2540').[29] This ruling analysed *Everett* at length and set out the Commissioner's view of the law following the judgment.[30] IT 2540 first contextualises its discussion of a partner's interest by citing the *Everett* majority's judgment as authority for the proposition that as a partnership is not a separate legal entity, title to partnership assets is legally vested in the partners:[31]

> 2. Under general law in relation to partnerships, a partnership is not a separate legal entity distinct from the individual partners who comprise the partnership. Accordingly, the partnership does not own property in its own right; title to the partnership assets is legally vested in the partners, even though an individual partner may have no separate title to specific partnership assets. This view accords with the opinion expressed by the majority (Barwick CJ., Stephen, Mason and Wilson JJ.) of the Full High Court of Australia in *F.C.T. v. Everett* (1980) 143 CLR 440 at page 446:
>
> > Although a partner has no title to specific property owned by the partnership, he has a beneficial interest in the partnership assets, indeed in each and every asset of the partnership.

A view of partners as holding a proprietary interest in *each* partnership asset is apparent throughout IT 2540. In conflict with the *Everett* majority's clarification that a partner's interest in partnership assets is merely a right to share in asset surplus on termination of the partnership, IT 2540 expresses a partner's interest as a form of direct interest in each asset.[32] The ruling makes this direct interest explicit in stating that on 'the acquisition or disposal of a partnership interest it will be necessary for a partner to account for his or her interest in the partnership assets. The disposal of the partnership interest generally means that there is a disposal of the partner's interest in each of the individual partnership assets.'[33]

IT 2540 reinforces this view by explaining that where there is a disposal of a partnership asset (to a third party), each partner disposes of 'his or her fractional interest' in the asset.[34] The ruling provides an example of such a transaction, in which a block of land, said to be purchased by a partnership comprised of 10 partners for $90,000, is sold for $150,000. The

[29] Commissioner of Taxation, *Taxation Ruling IT 2540* (22 June 1989) ('IT 2540').
[30] David J Garde, 'Capital Gains Tax and Everett Assignments' (1993) 22(1) *Australian Tax Review* 28, 29; R Krever and K Sadiq, 'Non-Residents and Capital Gains Tax in Australia' (2019) 67(1) *Canadian Tax Journal* 1, 12 nn 57.
[31] IT 2540 (n 29) [2].
[32] Ibid [18].
[33] Ibid [9].
[34] Ibid.

ruling states that if 'the partners own equal interests in the land, each will be taken as receiving $15,000 as disposal proceeds.'[35]

It has been observed that IT 2540 followed the practice of Her Majesty's Revenue Commission (as it was then known) in adopting a 'partner level' or 'aggregate theory' approach to CGT liability.[36] These terms refer to the taxation consequences of a gain or loss being accounted for at the level of the individual partners.[37] This is in contrast to treating a partnership as an entity distinct from its partners for taxation purposes, referred to as an 'entity level' or 'entity theory' approach.[38] Even in light of that choice, the assumption found throughout IT 2540 that the individual members of a partnership 'own' fractional interests in the partnership assets is surprising.[39] Further, the *Everett* majority explicitly stated that the proportionate surplus of asset proceeds that each partner is entitled to must first have the debts and liabilities of the partnership paid out of it.[40] Therefore, whenever a partnership has debts or liabilities, a partner's entitlement to the net surplus of realised assets will always be less than the fractional interest in the assets that the partner is deemed to hold.

A *Section 160A of the ITAA 1936*

IT 2540 found legislative enactment in ss 160A(d) and (e) of the *ITAA 1936*. Section 160A(d) provided that a taxpayer's interest in a partnership asset is an asset for CGT purposes. Section 160A(e) provided the same in respect of a taxpayer's interest in a partnership as was not covered by s 160A(d).

The relationship between IT 2540 and s 160A(d) can be seen in the explanatory memorandum accompanying the Taxation Laws Amendment Bill (No 6) 1990 (Cth) ('Explanatory Memorandum'). The Explanatory Memorandum provided the following statement concerning the purpose of introducing sub-section (d):[41]

> In relation to the application of Part IIIA to partnerships, the Commissioner of Taxation issued a ruling on 22 June 1989, IT 2540, which sets out his views on how CGT liabilities are to be calculated on the disposal of partnership assets.
>
> This approach is based on the premise that a partnership is not a separate legal entity and that legal title to partnership assets must therefore remain vested in the individual partners, even though any one of those individual partners may not have separate title to any specific asset. Because the assets are owned by the individual partners, it is to the individual partners that gains or losses accrue on the disposal of any of the partnership assets.
>
> The purpose of the amendments is to remove any uncertainty relating to the treatment of partnership assets under the provisions of Part IIIA by making it clear that it is the individual partners who will account for capital gains and losses on disposals of partnership assets. The

[35] Ibid.
[36] Augoustinos (n 12) 126.
[37] Ibid.
[38] Ibid.
[39] See, eg, IT 2540 (n 29) [4], [10], [14], [18], [31].
[40] *Everett* (n 1) 446.
[41] Explanatory Memorandum, Taxation Laws Amendment Bill (No 6) 1990 (Cth) 6 ('Explanatory Memorandum').

> amendments are not intended to alter the manner in which Part IIIA applies to such assets and instead are designed merely to clarify the existing operation of the law.

The Explanatory Memorandum's claim that s 160A(d) was intended 'merely to clarify the existing operation of the law' requires careful consideration. Academic commentary had been published prior to the passing of the *Taxation Laws Amendment Act 1991* (Cth) arguing that capital gains and losses in respect of partnership assets already applied directly to partners.[42] However, this result was not said to derive from a deeming effect in the then CGT regime. Rather, it was justified on the basis that at general law the individual partners of a partnership (and not the partnership itself) own the partnership assets and therefore the capital gains and losses on partnership assets accrue to those individuals.[43] Notably, the *Taxation Laws Amendment Act 1991* (Cth) did appear to change the operation of the law in at least one significant way: by creating 'statutory fictions that are not apparent from a study of the law of partnership such that the tax provisions must be said to exist in a parallel, but different, world from that of equity.'[44] Indeed, the innovation of this Act was to cause partners to be deemed to hold fractional interests in partnership assets for certain taxation purposes.

V THE REFINEMENT OF THE GENERAL LAW POSITION

A *Danvest and the Cases Proceeding It*

The question of whether a partner holds a proprietary interest in each partnership asset came to a head in the 2017 decision of *Commissioner of State Revenue (Vic) v Danvest Pty Ltd* ('*Danvest*').[45] The *Duties Act 2000* (Vic) ('*Duties Act (Vic)*') applied duty to certain transactions concerning 'dutiable property'. These transactions relevantly included a 'transfer of dutiable property' (pursuant to s 7(1)(a) of the *Duties Act (Vic)*) and 'any other transaction that results in a change in beneficial ownership of dutiable property' (pursuant to s 7(1)(b)(vi)).[46] 'Dutiable property' was defined in s 10(1)(a)(i) of the *Duties Act (Vic)* as including 'an estate in fee simple' in land in Victoria. The appellant Victorian Commissioner of State Revenue ('Commissioner of State Revenue') had assessed certain partners for duty upon their purchase of interests in a land-owning partnership. As summarised by Santamaria JA, 'the Commissioner [of State Revenue] relied upon statements made in a line of High Court authority, which dates back some 70 years, to contend that the interest of a partner in partnership property is a presently existing, equitable, sui generis interest in each and every asset of the partnership which is proprietary in nature.'[47] Therefore, it was argued the purchase of interests in the partnership constituted a transfer of an interest in an estate in fee-simple within the meaning of the *Duties Act (Vic)*.

Justice Santamaria, with whom Tate JA agreed, conducted a detailed analysis of seven cases relied upon by the Commissioner of State Revenue in support of the proposition that a partner

[42] Pagone (n 5) 79.
[43] Ibid.
[44] G Pearson, 'The Goodwill Roll-off Effect in Partnerships' (2000) 3(1) *Journal of Australian Taxation* 56, 57.
[45] (2017) 55 VR 190 ('*Danvest*').
[46] Ibid 193 [8].
[47] Ibid 192 [5].

holds a proprietary interest in partnership assets. His Honour found that contrary to the Commissioner of State Revenue's submissions, the principles deriving from those cases collectively support the proposition that partners do not hold a proprietary interest in individual assets. As a consequence of this analysis, his Honour determined that this interest is not an interest presently held in the assets, as it is not ascertainable prior to the termination of the partnership. As his Honour noted, 'the interest of each partner can be ascertained finally *only* upon completion of the liquidation and the identification of any surplus share'.[48]

In order to trace the development of the case law that led Santamaria JA to conclude that partners do not hold a direct interest in partnership assets, it is useful to identify the key principles in the cases reviewed. His Honour commenced his analysis by outlining the Commissioner of State Revenue's reliance on *Sharp*, *Livingston* and *Canny Gabriel.* His Honour noted that these decisions generally referred to a partner's interest in partnership assets as a species of 'beneficial interest'.[49] However, his Honour opined that this term is not sufficient to reveal the nature of the interest in question.[50]

His Honour then reviewed *Everett* and noted the 'significant weight' that its description of a partner's interest in partnership assets has had in subsequent case law.[51] The first of the post-*Everett* cases considered was *United Builders Pty Ltd v Mutual Acceptance Limited* ('*United Builders*').[52] In that case, Mason J noted the longstanding principle that a security interest over a partner's share in the partnership does not give security over the assets of the partnership.[53] Notably, Santamaria JA highlighted Mason J's articulation of a partner's interest in partnership assets:[54]

> Mason J later added that '[t]he vital consideration is that the partner's interest is in truth a chose in action, which, as *Everett* acknowledged, "consists of a right to a proportion of the surplus after the realization of the assets and payment of the debts and liabilities of the partnership"'.…
>
> The reasoning of Mason J in *United Builders* warrants attention. Having acknowledged the existence of a partner's 'special and non-specific' beneficial interest in each of the partnership assets, Mason J went further to expound the nature of such an interest: it is a chose in action which 'consists of a right to a proportion of the surplus *after* the realisation of the assets and payment of the debts and liabilities of the partnership'.

Second, Santamaria JA considered the judgment of Gibbs CJ in *Watson v Ralph* ('*Watson*').[55] In that case, Gibbs CJ found that a testatrix who had been a member of a partnership that held land as one of its partnership assets 'had an equitable interest in every asset of the partnership, including the land.'[56] However, as noted by Santamaria JA,[57] the Chief Justice then proceeded to clarify that as at her death the testatrix was 'not the owner of the freehold property', as it was 'then partnership property and she had in it the same interest as in any

[48] Ibid 214 [78] (emphasis in original).
[49] Ibid 194 [10].
[50] Ibid 194–195 [10].
[51] Ibid 208 [59].
[52] (1980) 144 CLR 673 ('*United Builders*').
[53] *Danvest* (n 45) 208 [60], citing *United Builders* (n 52) 687.
[54] *Danvest* (n 45) 209–10 [64]–[65] (citations omitted).
[55] (1982) 148 CLR 646 ('*Watson*').
[56] *Danvest* (n 45) 210 [66].
[57] Ibid 211 [70].

other partnership property'.[58] The Chief Justice specified that this interest comprised 'a half interest in the proceeds of sale of all the partnership property after payment of partnership debts, subject to any agreement between the partners as to distribution in specie.'[59]

Finally, Santamaria JA reviewed the decision of the High Court in *Commissioner of State Taxation (SA) v Cyril Henschke Pty Ltd* ('*Cyril Henschke*').[60] In his analysis of this case, Santamaria JA noted that to describe the interest a partner holds in partnership assets as a beneficial and *sui generis* interest in each asset of the partnership is 'plainly insufficient'.[61] His Honour then observed that the Court in *Cyril Henschke* stressed that the position was 'not sufficiently or accurately expressed merely by use of the term "beneficial interest".'[62] In light of this analysis, Santamaria JA concluded that the case law (and in particular, the Court in *Cyril Henschke* affirming Mason J in *United Builders*) established that the interest of a partner in partnership assets can only accurately be described by reference to the partner's interest in the surplus proceeds of assets upon realisation and after the payment of partnership debts and liabilities.[63]

Justice McLeish (with whom Tate JA also agreed) conducted a similar analysis to Santamaria JA. His Honour reviewed a range of High Court cases, including *Sharp*, *Livingston*, *Canny Gabriel*, *Livingston*, *Everett*, *United Builders*, *Watson* and *Cyril Henschke*. His Honour also considered *Perpetual Executors & Trustees Association of Australia Ltd v Commissioner of Taxation (Cth) [No 2] (Thomas' Case)*,[64] in which Kitto J endorsed the description of a partner's interest in partnership property expounded by Rich J in *Sharp*.[65] Notably, McLeish JA observed that the reasoning in *Cyril Henschke* demonstrates that 'references in the case law to partners having a "beneficial interest" in partnership assets must not be read too literally.'[66] Like Santamaria JA,[67] McLeish JA noted the authoritative endorsement in *Cyril Henschke* of Mason J's description of the interest held by a partner in partnership property in *United Builders* ('a right to a proportion of the surplus after the realization of the assets and payment of the debts and liabilities of the partnership'[68]).[69] On the basis of this analysis, McLeish JA relevantly determined that:[70]

> …the interest which a partner has in the assets of the partnership is not accurately described as presently existing, if by that is meant that a partner has a proprietary interest in those assets prior to dissolution. The equitable chose in action which the partner enjoys is rather directed to, and commensurate with, the protection of a future entitlement to a share of surplus assets. In other words, the partner has a presently existing equitable chose in action which does not, prior to dissolution, represent a proprietary interest in partnership assets.

[58] *Watson* (n 55) 655.
[59] Ibid.
[60] (2010) 242 CLR 508 ('*Cyril Henschke*').
[61] *Danvest* (n 45) 214 [78].
[62] Ibid.
[63] Ibid.
[64] (1955) 94 CLR 1 ('*Thomas' Case*').
[65] *Danvest* (n 45) 227 [133], citing *Thomas' Case* (n 64) 28.
[66] *Danvest* (n 45) 236 [155].
[67] Ibid 214 [78].
[68] *United Builders* (n 52) 688.
[69] *Danvest* (n 45) 236 [155], citing *Cyril Henschke* (n 60) 519 [28].
[70] *Danvest* (n 45) 238 [165].

This reasoning led his Honour to conclude that the interest held by a partner in 'a land-owning partnership is not an interest in an estate in fee simple in the land owned by the partnership'. [71] As noted by Tate JA, each member of the Court concluded that this interest is not dutiable property (for the purposes of ss 10(1)(a)(i) and 10(1)(ac) of the *Duties Act (Vic)*).[72] Therefore, transfer of this interest 'is thus not a transfer of dutiable property within the meaning of s 7(1)(a) or s 7(1)(b)(vi) of the Act attracting a liability to pay duty'.[73]

B *The Decision in Rojoda*

While the decision in *Danvest* provided clarification of partnership law at the intermediate appellate court level, the concept that a partner holds an interest in particular partnership assets has now been explicitly rejected by the High Court.

The majority decision in *Commissioner of State Revenue v Rojoda Pty Ltd* ('*Rojoda*')[74] concerned the application of duty by the *Duties Act 2008* (WA) ('*Duties Act (WA)*') on 'dutiable transactions'. 'Dutiable transactions' was defined by s 11 of the *Duties Act (WA)* to include a declaration of trust over 'dutiable property' (which relevantly included land in Western Australia). The majority (Bell Keane, Nettle and Edelman JJ) summarised the background to the matter as follows:[75]

> The appeal concerns declarations made in two deeds in 2013 between the partners and their successors in title of two dissolved partnerships that had not yet been wound up. The deeds provided that freehold titles registered in the names of two partners, which were part of the partnership property of the two dissolved partnerships, be held on trust for the former partners or their representatives in fixed shares according to their partnership shares. The appellant, the Commissioner of State Revenue, imposed duty upon the declarations of trust that were made in each of the two deeds.

The respondent submitted that the deeds were not a declaration of trust as they 'merely confirmed the existing position'[76] that the property 'had been held on trust for the partners in fixed shares and this position continued.'[77] The majority rejected the proposition that the former partners each held an interest in the land, finding that 'the interest of partners in relation to partnership assets is not an interest in any particular asset but is an indefinite and fluctuating interest in relation to the assets'.[78] Further, the majority emphasised that it is established that a partner's interest in a partnership asset is not an interest in any specific asset, other than a right to that partner's proportionate share of the proceeds of the sale of assets upon the termination of the partnership.[79]

The majority summarised this principle by stating that the only interest a partner has, either before or after the dissolution of the partnership, is a right to an account and distribution of

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[71] *Danvest* (n 45) 192 [1].
[72] Ibid.
[73] Ibid.
[74] (2020) 268 CLR 281 ('*Rojoda*').
[75] Ibid 291–2 [1].
[76] Ibid.
[77] Ibid.
[78] Ibid 297 [21] (Bell, Keane, Nettle and Edelman JJ).
[79] Ibid 302 [33] (citations omitted).

the proceeds of the sale of an asset. Quoting the decision of Lord Eldon in *Crawshay v Collins*,[80] the majority noted that this right is 'not to an individual proportion of a specific article, but to an account: the property to be made the most of, and divided'.[81] The majority further confirmed the general law position by noting that it aligned with the treatment of partnership assets found in the *Partnership Act 1895* (WA) ('*Partnership Act (WA)*'):[82]

> The Partnership Act also preserved equity's unique treatment of the interest of partners under the trust. The partner's unascertained interest in relation to all of the partnership property is an equitable interest, not a mere equity, but the "partner's share" is defined in s 33 as being only "the proportion of the then existing partnership assets to which he would be entitled if the whole were realised and converted into money, and after all the then existing debts and liabilities of the firm had been discharged".

The *Rojoda* majority took issue with the use of the terminology of a 'beneficial interest' in respect of a partner's interest in partnership assets, stating 'a partner's equitable interest is not accurately expressed as a "beneficial interest", at least in the sense of being a right to any proportion of, or for the personal use of, or for the benefit from, any particular asset.'[83] The use of the expression 'beneficial interest' in this context has also been criticised in subsequent case law[84] and in academic scholarship.[85] As summarised in the current edition of *Lindley & Banks on Partnership*, 'the general consensus of the Australian authorities is that, at least in a technical sense, a partner does not enjoy a *beneficial* interest in the partnership assets'.[86]

This analysis has been taken a step further in some commentary, which has argued that the *Rojoda* decision, 'in denying that a partner's interest was an interest in or in relation to any specific asset and characterised as a personal estate' indicated a 'moving away from the historic position that allows a partner an equitable interest in partnership property.'[87] It should be noted, however, that the *Rojoda* majority repeatedly referred to a partner's 'equitable interest' in respect of partnership property.[88] As such, this commentary reflects a shift away from recognising partners as holding an equitable interest in *individual items* of partnership property, in favour of a view of partners as holding an equitable interest in respect of the partnership property *generally*.

Two recent cases have applied the *Rojoda* decision in a manner that confirms this trend away from recognising partners as having interests in individual partnership assets. First, Allanson J of the Supreme Court of Western Australia recently referred to the *Rojoda* decision as providing an authoritative statement of the nature of a partner's interest in partnership property.[89] Drawing on *Rojoda*, his Honour observed that in equity, like under the *Partnership Act (WA)*, a partner's interest in partnership property is 'the right to a proportion

[80] (1808) 33 ER 736.
[81] *Rojoda* (n 74) 302 [33], quoting *Crawshay v Collin* (1808) 33 ER 736, 741.
[82] *Rojoda* (n 74) 304 [38] (citation removed).
[83] *Rojoda* (n 74) 302 [33] (citations omitted).
[84] See, eg, *Doherty v Bruce Ronald Sampey administrator of the estate of Patricia Adele Addison* [2023] WASC 10, [78] ('*Doherty*').
[85] See, eg, I'Anson Banks (n 2) 784–5 [19-07]; A MacIntyre, 'Unit Trusts and Partnerships – Where Goes Equity?' (2022) 51(2) *Australian Bar Review* 211, 217–8.
[86] I'Anson Banks (n 2) 784–5 [19-07].
[87] MacIntyre (n 85) 218.
[88] *Rojoda* (n 74) 302–3 [33], [35], [38].
[89] *Doherty* (n 84) [149].

of the surplus after the realisation of the assets and payment of the debts and liabilities of the partnership.'[90]

The implications of this view are seen in Allanson J's treatment of the plaintiffs' argument that an individual partner may suffer loss in the amount of their supposed share of money received by their partnership. His Honour noted that such a claim treats money received by the partnership as having been received by each partner.[91] As such, this argument was said to misconceive the nature of partnership property.[92]

The Full Court in *Hedges v Commissioner of Taxation* ('*Hedges*') also took from the decision in *Rojoda* that at general law a partner 'does not have an equitable interest in any particular asset of the partnership.'[93] Interestingly, the Full Court also described the nature of a partner's interest in partnership property as being 'indivisible'.[94] The *indivisibility* of a partner's interest cannot refer to an inability to assign part of that interest, as the assignability of fractions of this interest was recognised in that same judgment.[95] Rather, this expression must reflect the homogeneity of the interest, in the sense of the interest not being comprised of individual parts which may be associated with particular partnership assets. This conception of a partner's interest further reinforces the general law's rejection of any view of partners as holding a fractional interest in specific partnership assets.

VI CONSEQUENCES FOR THE *ITAA 1997*

Australian taxation law has been criticised in recent years for being drafted in terms that are 'vague and imprecise, leading to uncertainty and ambiguity'.[96] It is well established that in the drafting of legislation, and especially tax legislation, imprecision 'leads to obvious problems, both social and economic' including that 'imprecise rules do not set out rights and obligations clearly', 'are inconsistent with the aspirations of the rule of law' and mean 'a heightened need for advisors, which adds to the deadweight cost of the tax'.[97] Such views are founded on established conceptions of precision contributing to the clear application of legislation,[98] and thereby supporting the principle of legality.[99]

There is demonstrable imprecision in the terminology used in s 108-5(2)(c) of the *ITAA 1997*. It makes little sense to refer to a partner's 'interest in an asset of a partnership' when prior to dissolution partners do not hold any quantifiable interest in individual partnership assets. While we can deduce that this provision has the effect of deeming partners to hold the interest

[90] Ibid.
[91] Ibid [147]–[148].
[92] Ibid.
[93] *Hedges* (n 11) [17], citing *Rojoda* (n 74) 302 [33].
[94] Ibid [18].
[95] Ibid.
[96] GS Cooper, 'Income Taxation: An Institution in Decay – Still' (2023) 52(1) *Australian Tax Review* 15, 17.
[97] Ibid 24. See also J Middleton, 'Statutory Interpretation: Mostly Common Sense?' 40 *Melbourne University Law Review* 626, 633; David Wallis, 'The Tax Complexity Crisis' (2006) 35(4) *Australian Tax Review* 274, 285.
[98] Middleton (n 97) 633; DG Hill, 'A Judicial Perspective on Tax Law Reform' (1998) 72(9) *Australian Law Journal* 685, 689.
[99] James Spigelman, S*tatutory Interpretation and Human Rights* (University of Queensland Press, 2008) 88.

referred to, there is historical evidence indicating that this provision was drafted with an assumption that partners already hold such an interest at general law. As discussed in Part IVA above, the Explanatory Memorandum (which does not refer to the provisions it introduced as having any deeming effect, despite the significance of this aspect of their operation) states: 'The amendments are not intended to alter the manner in which Part IIIA applies to such assets and instead are designed merely to clarify the existing operation of the law.' In addition, the Explanatory Memorandum's explanation for gains or losses on partnership assets accruing to individual partners is not because the partners are deemed to hold interests in those assets for taxation purposes, but because 'the assets are owned by the individual partners'.[100]

Even greater problems of uncertainty and ambiguity arise when s 106-5(1) is considered. Pursuant to s 106-5, a partner's capital gain or loss upon a CGT event in respect of a partnership asset is to be 'calculated by reference to the partnership agreement, or partnership law if there is no agreement.' However, a partner holds no fractional interest in a partnership asset under 'partnership law'. The 'value' of the chose in action that a partner holds depends on the debts and liabilities of the partnership, and the value of all other partnership assets, not just the value of the asset in question.

Accordingly, the *ITAA 1997* employs a legal fiction in order to make partners responsible for the CGT consequences of capital gains and losses on partnership assets in proportion to their partnership interests. That is, its provisions intend that partners be treated as though they hold a fractional interest in partnership assets for CGT purposes. However, the fact that this legal fiction is being employed is not stated explicitly. Against the background of partnership law, an understanding of the history and purpose of this legislation is needed to appreciate its operation. Without reform, this provision is drafted in a manner such that, like other provisions of Australian tax law, only '[t]he cognoscenti know what the section is trying to say'.[101]

This drafting is made even more opaque by the use of a second (and contradictory) legal fiction in s 108-5(2)(d).[102] As noted in Part II above, s 108-5(2)(d) draws upon a fictional view of a partnership as an entity separate from the partners, in which the partners hold an interest.[103] It has been observed that this provision is a strange juxtaposition with s 108-5(2)(c), which looks to the partners' supposed interest in the partnership assets.[104] While it may be considered that s 108-5(2)(d) is merely a 'residual category…intended to overcome the possibility of double taxation',[105] it should be noted that s 108-5(2)(c) and (d) together 'combine the elements of two contradictory tax fictions'.[106] This stands in contrast with the United Kingdom's system, 'which, in attempting to implement a consistent regime based on underlying interests in assets, has altogether ignored the concept of a partner's interest in the partnership per se.'[107]

[100] Explanatory Memorandum (n 41) 6.
[101] Cooper (n 96) 20.
[102] Augoustinos (n 12) 133.
[103] Ibid.
[104] Ibid.
[105] *ITAA 1997* Commentary (n 8) ¶152-835.
[106] Augoustinos (n 12) 133.
[107] Ibid.

There is no reason why the *ITAA 1997* cannot continue to deem partners to hold proportionate interests in partnership assets for CGT purposes. But it is noteworthy that this was not what this legislation was intended to do at the time the CGT regime was drafted. Rather, the Explanatory Memorandum describes s 160A as intending to tax gains and losses that are made by individual partners as a result of their ownership of partnership assets.[108] This surprising and apparently inadvertent change in the effect of the legislation demands careful attention. Indeed, the failure of these provisions to use what is now the dominant conception of a partner's interest in partnership assets has material consequences for the clarity and technical coherence of the legislation.

A *Judicial Consideration of the CGT Regime's Application to Partnership Assets*

The case law concerning the application of the CGT regime to partnership assets is limited. Despite this, two cases illustrate the practical difficulties that have arisen from the imprecise nature of the legislation.

White v Commissioner of Taxation concerned a dispute over the CGT consequences flowing from the sale of a pharmacy business.[109] The applicant claimed entitlement to a small business CGT concession provided for in sub-division 152-C of the *ITAA 1997* and sought to defer her resultant taxable gain under the small business roll-over provisions in sub-division 152-E.[110] Entitlement to enjoy the benefit of these provisions depended upon whether the applicant satisfied the maximum net asset value test set out in s 152-15 of the *ITAA 1997* (noting that this provision has subsequently been amended).[111]

Relevantly, the applicant had a 50% or greater interest in partnerships referred to as the 'White/Murphy Partnership' and the 'White/White Partnership'.[112] If these partnerships were entities within the meaning of that term in s 152-15(a)(ii), they would be connected with the applicant for the purposes of that provision.[113] The aggregate of the net asset values of the applicant's CGT assets and those of the White/Murphy Partnership and White/White Partnership exceeded $5,000,000 just before the sale of the relevant pharmacy business.[114] Accordingly, should a partnership be an 'entity' within the meaning of that term in s 152-15(a)(ii), the applicant would not have been entitled to a reduction in her taxable gain, nor to defer the resultant taxable gain under the small business roll-over provisions in sub-division 152-E.[115]

On 29 May 2009, Gordon J (then of the Federal Court of Australia) ordered that the issue of whether a partnership is an 'entity' within the meaning of that term as used in s 152-15(a)(ii)

[108] Explanatory Memorandum (n 41) 6.
[109] *White v Commissioner of Taxation* (2009) 178 FCR 498, 499 [5(a)].
[110] Ibid 500 [5(d)].
[111] Ibid.
[112] Ibid 500 [5(e)].
[113] Ibid 500 [5(f)].
[114] Ibid 500 [5(g)].
[115] Ibid 500 [5(h)].

be determined as a preliminary question.[116] Justice Sundberg answered that question in the negative.[117]

The applicant submitted that s 152-30, which defines where an entity is 'connected with' another entity, contains specific mechanisms for determining the existence of control in relation to companies and trusts, but not partnerships.[118] The applicant submitted that this is so because a partner does not have a right to receive any distribution of income or capital by the partnership, 'because partners have direct ownership interests in the assets of a partnership and direct responsibility for its liabilities.'[119] Thus, the applicant argued, 'they own their proportionate shares of the net assets, including the income and capital.'[120] The applicant went on to submit that 'the absence of any test for control of a partnership shows that Parliament did not intend partnerships to be included in the range of entities that can be connected with a taxpayer for the purposes of the maximum net asset value test.'[121]

Uncertainty regarding when the CGT regime intends to treat a partnership as an entity underpinned the respondent Commissioner's submissions. The Commissioner challenged the applicant's assertion that the *ITAA 1997* ignores a partnership as an entity, and argued that the CGT regime expressly treats partnerships as entities despite not treating them as taxpayers.[122] The Commissioner's evidence for this construction of the *ITAA 1997* notably included the introduction to Division 106. The introduction describes the division as setting out 'the cases where a capital gain or loss made by someone other than the entity to which a CGT event happens', and explicitly includes partnerships in a list of affected entities.[123]

Justice Sundberg considered it to be plain that s 106 treats a partnership as an entity.[124] However, having reviewed the explanatory memorandum to the *Tax Law Improvement Act (No 1) 1998* (Cth), which introduced Division 106, his Honour determined that 'the extrinsic material shows that for "control" purposes a partnership is not treated as an "entity". In other words "entity" does not mean the same thing whenever it is encountered.' This analysis demonstrates the difficulty in distinguishing between the parts of the *ITAA 1997* which intend to depart from the general law and the parts that embrace it.

The problematic drafting of s 106-5 was also highlighted in the decision of the Full Court in *Hedges*. In particular, the Full Court noted the vagueness of the reference to 'partnership law' as a means by which a capital gain or loss on a partnership asset may be calculated.[125] This case concerned an appellant who retired from a partnership of solicitors. The appellant's retirement involved his receipt of 'retirement moneys' comprised of payment for partnership goodwill, work in progress and other sums owed to him and repayment (by the appellant) of a deficit in his capital account.[126] The Commissioner assessed the goodwill component of this

[116] Ibid 499 [4].
[117] Ibid 509 [55].
[118] Ibid 503 [17].
[119] Ibid.
[120] Ibid.
[121] Ibid.
[122] Ibid 504 [21].
[123] Ibid 504 [21], 508 [46].
[124] Ibid 508 [48].
[125] *Hedges* (n 11) [25].
[126] Ibid [5]–[6].

calculation as capital proceeds subject to CGT (after applying a 50% CGT discount).[127] The appellant argued that the source of the funds he received was the retirement deed he entered into with his partners.[128] As such, he contended the retirement moneys did not include a sum in respect of the disposal of a share of goodwill for the purposes of s 116-20 of the *ITAA 1997*.[129]

As this appeal turned on the interpretation of the appellant's partnership deed and retirement deed, the Full Court was not required to consider how 'partnership law' would calculate a partner's gain or loss in respect of a partnership asset. However, the Full Court stated that it may be 'fortunate' it did not need to construe s 106-5.[130] It was observed that the reference in s 106-5(1) to 'partnership law' 'must be a reference to the general law of partnership', and that the general law sits out of alignment with the CGT provisions in the *ITAA 1997*.[131]

The Full Court's observation that the reference in s 106-5(1) to 'partnership law' must be to the general law of partnership appears to be correct. However, the second example under s 106-5 implies otherwise, stating:[132]

> For other partnership assets [i.e. assets for which the partnership agreement does not provide the specific interests held by each partner], Helen's gain or loss will be determined on the basis of her 50% interest (under the relevant Partnership Act).

In light of the equal splitting of the asset provided in the example, the reference to a partner's gain or loss being calculated under the relevant Partnership Act appears to be a reference to s 24(1)(1) of the *Partnership Act 1892* (NSW) and the corresponding provisions in each of the other Partnership Acts. Section 24(1)(1) provides that subject to any agreement between the partners, all partners are entitled to share equally in the capital and profits of the business (and must contribute equally towards its losses). However, connecting the calculation of a partner's interest in a partnership asset with s 24(1)(1) (which concerns the equal sharing of capital and profits) conflates a partnership's capital with its assets. Even with the assistance of this provision, it is unclear how 'partnership law' would calculate a partner's supposed gain or loss.

VII POTENTIAL REFORMS

Arguments have been made for legislative amendment to change the CGT regime's approach to assessing CGT at the partner level to doing so at an entity level.[133] Reform of this kind would provide an opportunity to clarify and refine the alignment of the CGT regime and the law of partnership. It has also been argued that the regime should adopt specific entity level approaches for taxing particular transactions. For example, modelling the entity level approach taken in the United States and Canada in regard to the contribution of partnership

[127] Ibid [7].
[128] Ibid [10].
[129] Ibid.
[130] Ibid [25].
[131] Ibid.
[132] *ITAA 1997* (n 6) s 106-5 (emphasis added).
[133] Augoustinos (n 12) 136.

property by a partner.[134] Such reforms would allow for a more targeted improvement in the aspects of the current regime that are unclear or imprecise.

There are two further approaches that may be taken in the short-term that would have a material impact on the clarity and precision of the CGT regime without requiring the significant and time-consuming step of large-scale legislative reform. These are the amending of IT 2540 and the revising of ss 106-5 and 108-5(2) in a limited way to clarify the operation of the current regime.

A *Amendments to IT 2540*

Three changes may be made to IT 2540 in order to clarify the Commissioner's interpretation of how the (existing) CGT regime interacts with partnership law:

1. In respect of s 108-5(2), the ruling should state *explicitly* that partners are deemed to hold fractional interests in partnership assets.
2. In respect of s 106-5, the ruling should state:
    a. in calculating a partner's gain or loss made on a CGT event 'by reference to the partnership agreement':
        i. a partner's capital gain or loss will be calculated according to the terms of any partnership agreement that specifies the partner's share of surplus capital generated by the disposal of that asset; and
        ii. if no agreement concerning the specific asset in question exists, the partner's capital gain or loss will be equated with the terms of any partnership agreement that specifies the partner's share of surplus capital upon the termination of the partnership;
    b. in calculating a partner's gain or loss made on a CGT event by reference to 'partnership law if there is no agreement', a partner's capital gain or loss will be equated with that partners' proportionate entitlement to share in surplus capital upon the termination of the partnership.

In light of the analysis above, these amendments would clarify the operation of the CGT regime, albeit only in the form of a statement as to how the Commissioner interprets the legislation and intends to enforce it.

B *Amendments to the* ITAA 1997

More consequential improvements to the regime could be made via legislative amendment, even without significantly altering large parts of the legislation. In particular, the tests used for calculating a partner's capital gain or loss on the occasion of a CGT event as described in points 2.a and 2.b above are simplistic, and a comparison with the approach to this issue taken by HMRC in the United Kingdom illustrates how these tests may be improved. While

[134] Ibid 134–5.

this approach derives from HMRC policy, lessons may be taken from it relevant to legislative reform in Australia.

1 *The Approach in the United Kingdom*

In the law of the United Kingdom, the interest of partners in partnership assets is ordinarily conceived of as a 'proportion of the partnership assets after they have been all realised and converted into money, and all the debts and liabilities have been paid and discharged'.[135] Section 59 of the *Chargeable Gains Act 1992* (UK) ('*Chargeable Gains Act*') provides for the taxing of partners for capital gains made on partnership assets. However, the details of the United Kingdom's CGT regime is governed by the practice of HMRC. This practice is set out in published 'statements of practice'. Like Australian Taxation Office rulings, these statements provide a guide to taxpayers and their advisors as to how the United Kingdom's regime will be enforced.

In 'Statement of Practice D12: Partnerships', HMRC embraces the deeming of partners as holding fractional interests in partnership assets for taxation purposes, but quantifies these interests as emphasised below:[136]

> 2.1 Where an asset is disposed of by a partnership to an outside party, each of the partners will be treated as disposing of his fractional share of the asset. In computing gains or losses, the proceeds of disposal will be allocated between the partners in the ratio of their share in asset surpluses at the time of disposal. Where this is not specifically laid down, the allocation will follow the actual destination of the surplus as shown in the partnership accounts; regard will of course have to be paid to any agreement outside the accounts.
>
> 2.2 If the surplus is not allocated among the partners but, for example, put to a common reserve, regard will be had to the ordinary profit sharing ratio, which is likely to be indicative in the absence of a specified asset-surplus-sharing ratio.

Statement of Practice D12 has been called 'superior' to IT 2540 in a number of respects.[137] One is that the Statement of Practice covers ground 'that is ignored by the Australian tax ruling' (IT 2540).[138] This includes 'the tax outcomes applicable in circumstances such as the division of partnership assets among the partners, revaluation of partnership assets followed by changes in partnership sharing ratios and payments made by partners outside the accounts.'[139]

As is apparent, Statement of Practice D12 describes the particular interest that is used in computing capital gains ('in the ratio of their share in asset surpluses at the time of disposal'[140]) with far greater specificity than s 106-5. This approach provides a greater level

[135] *Brake v Swift* [2020] 4 WLR 113, 25 [123], citing *Sandu v Gill* [2006] Ch 456, [19]; I'Anson Banks (n 2) 785–6 [19-08] and the cases there cited.
[136] His Majesty's Revenue & Customs, 'Statement of Practice D12: Partnership', *Gov.UK* (Policy Paper, updated 14 September 2015) [2.1] (emphasis added) <https://www.gov.uk/government/publications/statement-of-practice-d12/statement-of-practice-d12>.
[137] Augoustinos (n 12) 131.
[138] Ibid.
[139] Ibid.
[140] IT 2540 (n 29) [2.1].

of cohesion between HMRC practice and partnership law. It also provides greater clarity to taxpayers and professionals looking to interpret this practice. The HMRC practice also diverges from the Australian approach by employing a 'waterfall' mechanism in order to determine the ratio in which partners share the CGT implications of a capital gain or loss. That is, the capital gain or loss is apportioned to each partner:[141] (1) in the ratio of their share in asset surpluses at the time of disposal (if specified in the partnership deed or other agreement); (2) in accordance with the actual destination of the surplus in the partnership accounts; and (3) where the surplus is placed into a common reserve, in accordance with the ordinary profit ratio.

2 *Reforming ss 106-5 and 108-5(2)*

Problematically, s 106-5 (unlike s 59 of the *Chargeable Gains Act*), requires a partner's capital gain or loss to be calculated by reference to 'partnership law', where no partnership agreement provides an answer. As such, it does not appear open to the Commissioner to issue a taxation ruling which implements a test for a partner's capital gain or loss by reference to the allocation of funds in the partnership accounts or by reference to the ordinary profit ratio. Such an approach would appear to require s 106-5 to be amended.

Further, s 106-5 could be made more precise by stating explicitly that a partner's gain or loss for CGT purposes is calculated by reference to the partner's proportionate share in asset surpluses at the time of disposal and after payment of partnership debts and liabilities. Undoubtedly, stating the interest partners hold in partnership assets with this level of specificity could be seen to increase the complexity of the section's drafting. However, it is well established that the need for precision in defining when and how a tax will be imposed gives rise to a level of complexity that is unavoidable.[142]

These reforms could be made in the following manner:[143]

> Section 106-5 Partnerships
>
> (1) Any capital gain or capital loss from a CGT event happening in relation to a partner's interest in a partnership or one of its CGT assets is made by the partners individually.
>
> (2) Subject to any partnership agreement, each partner is deemed, for the purposes of Part 3-1, to hold an interest in each asset of the partnership, equal to the partner's proportionate entitlement to the surplus of the realisation of the assets and payment of the debts and liabilities of the partnership.
>
> (3) Each partner's gain or loss in respect of a CGT asset is calculated by reference to the partnership agreement, or partnership law if there is no agreement where that agreement specifies the partner's interest relative to the other partners.

In order to account for circumstances in which no partnership deed exists, or where a partnership deed does not specify the allocation of capital between the partners, the fall-back

[141] His Majesty's Revenue & Customs (n 136) [2.1]–[2.2].
[142] Wallis (n 97) 285.
[143] Numbering has been added to the chaussette of s 106-5, and the proposed sub-section which accompanies it, for clarity.

quantification methods adopted by HMRC would also provide greater clarity to the Australian regime:

> (4) Where a partner's interest in a CGT asset relative to the other partners is not specified in a partnership agreement, any capital gain or loss is allocated between the partners in accordance with the actual destination of the surplus in the partnership accounts.
>
> (5) Where a partner's gain or loss in respect of a CGT event cannot be determined in accordance with sub-section (3) and the surplus capital generated by a GCT event is placed into a common reserve, the surplus capital is allocated between partners for CGT purposes in accordance with the ordinary profit ratio.

In a similar vein, s 108-5(2)(c) could be made clearer by the provision being amended to explicitly state that a partner is deemed to hold an interest in each asset of their partnership as provided in s 106-5:

> (2) To avoid doubt, these are *CGT assets*:
>
> (a) part of, or an interest in, an asset referred to in subsection (1);
>
> (b) goodwill or an interest in it;
>
> (c) the deemed interest a partner holds in each asset of the partnership pursuant to s 106-5 an interest in an asset of a partnership;
>
> (d) an interest in a partnership that is not covered by paragraph (c).

VIII CONCLUSION

A view of partners as holders of fractional interests in partnership assets was influential in the design of the CGT regime. It has been demonstrated by reference to recent case law that partners do not hold any such interest in partnership assets. Resultantly, the CGT regime lacks a principled basis guiding when it embraces, or diverges from, partnership law. This problem is exacerbated by the regime also failing to identify with clarity when it intends for such a divergence to occur.

Sections 106-5 and 108(2) of the *ITAA 1997* are ripe to be reformed. If it is proposed that the *ITAA 1997* continues to deem partners to hold fractional interests in partnership assets for CGT purposes, this should be done with clarity and technical precision. Foremost, this should be done by making explicit the deeming effect of the legislation. This article provides a proposed model for re-drafting these sections based on the United Kingdom's CGT regime. Even if the *ITAA 1997* is not revised, there is little stopping the Commissioner from beginning the process of clarifying the operation of this legislation by amending IT 2540. In the meantime, it appears likely that the inadvertent divergence in the law created by the current CGT regime will continue to be wrestled with by judges and practitioners.

POLITICAL DONATIONS AND TAX DEDUCTIONS IN AOTEAROA NEW ZEALAND AND AUSTRALIA

LISA MARRIOTT AND MAX RASHBROOKE*

Abstract

This study examines the different approaches to tax concessions for political donations in Australia and Aotearoa New Zealand (NZ). In Australia, a tax deduction may be claimed for a moderate donation to a political party. Conversely, in NZ no tax concessions are available for donations to political parties.

The study concludes that while there are several benefits of using the tax system to facilitate political donations, the two different policies align with the two countries general approaches to using the tax system to influence behaviour. An analysis of tax expenditures is used to support this argument. Reference to tax expenditures in Australia shows a longer timeline of acceptance of tax expenditures, alongside a more comprehensive regime of included activities. In NZ, the absence of tax concessions for political parties is aligned with NZ's general approach to using the tax system to change behaviours, which is minimal state intervention.

I INTRODUCTION

Political parties need funds to access voters and communicate their policies while campaigning. However, who provides the funding, how much funding is generated, and what, if anything, is purchased with the funding makes many components of the funding system contentious.

Political party funding needs to be fair and transparent, encourage electoral participation and, in Aotearoa New Zealand (NZ), uphold the principles of Te Tiriti o Waitangi.[1] It also needs to protect the integrity of government, including preventing corruption or undue influence, support parties to discharge their functions, and respect political freedoms, in particular

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[1] Ministry of Justice, Proactive release – Advancing Electoral Law Reform (15 December 2021) <https://www.justice.govt.nz/assets/Documents/Publications/Advancing-Electoral-Reform-papers-combined.pdf>.

freedom of political expression and freedom of political association.[2] The purpose of regulating political party funding is to achieve at least some of these objectives, and to facilitate a level playing field for parties. As will be discussed in this article, the tax system can also help to achieve some of the aims.

In NZ, political parties in government receive state funding to provide support for parliamentary operations, including communications, research, general office expenditure and support staff. Parliamentary parties received NZ$187 million in annual appropriations and other expenses in the 2021/22 budget.[3] However, for non-parliamentary operations, such as campaigning and policy development, there is only one form of state funding, which is the election broadcasting allocation. This is administered by the Electoral Commission to political parties, who can use it for campaign advertising. For all other non-Parliamentary work, parties need to raise their own funds. Currently the primary mechanism to do this is through private donations. It is these funds that are the focus of discussion in this article.

In Australia, individuals are incentivised to make moderate donations to Federal or State political parties and independent candidates or members, as this expenditure may be claimed as a tax deduction.[4] Donations are capped at A$1,500 for contributions to a registered political party plus a further A$1,500 for contributions to an independent candidate or member.[5] A membership subscription to a registered political party is also allowed as a tax deduction for an individual. These deductions are only available to natural persons and are not available to a company.[6] Additional state funding is provided to registered political parties based on votes received in an election, plus some expenditure reimbursement.

The article questions why political donations are not tax preferred in NZ, as they are in Australia. The article focuses on political donations for campaign funding and does not canvass other tax benefits such as income tax, fringe benefit tax or goods and services tax exemptions. Note that the subject of the research is political party funding, rather than candidate funding. However, from time to time we refer to candidates where it assists with more accurately capturing background information.

Extending donation tax credits or tax deductions to political donations, essentially introduces a partial state subsidy to political party finances. As noted, state funding is largely absent in the NZ environment. We question the NZ approach and show that New Zealanders are open to at least some state funding of political parties.[7] We surmise that NZ's approach follows its characteristic approach to using, or more specifically not using, the tax system to influence

[2] Joo-Cheong Tham, 'Regulating Political Contributions: Another view from across the Tasman' (2010) 6(3) *Policy Quarterly* 26.
[3] New Zealand Government, The Supplementary Estimates of Appropriations 2021/22: Vote Parliamentary Service <https://budget.govt.nz/budget/pdfs/suppestimates/suppest22parser.pdf/>, 707. This includes capital expenditure.
[4] Australian Tax Office, Claiming Political Contributions and Gifts (25 July 2017) <https://www.ato.gov.au/non-profit/gifts-and-fundraising/in-detail/fundraising/claiming-political-contributions-and-gifts/>. There are rules around the timing of contributions or gifts to independent candidates in an election.
[5] Income Tax Assessment Act 1997 (ITAA 1997), s 30.243.
[6] ITAA 1997, s 30.242(3A)(b).
[7] Max Rashbrooke and Lisa Marriott, Money for Something: A report on political party funding in Aotearoa New Zealand (November 2022) <https://www.wgtn.ac.nz/business/research/researchers/more-featured-researchers/supporting-political-party-funding-law-reform/money-for-something-final-report.pdf>.

behaviour, except for a small number of situations. We contrast this position with Australia's, using tax expenditure statements to support our arguments.

The article commences with a discussion on some of the issues that exist with political donations. Many of these issues generate support for greater state funding for political parties. Section three discusses tax expenditure statements in NZ and Australia, as these are used to frame the later discussion. Sections four and five outline the current approach to political party donations in Australia and NZ, respectively. Section six discusses tax and politics within the context of political party donations, drawing on tax expenditure statements in support of arguments made. Conclusions are drawn in section seven.

II POLITICAL DONATIONS

This section commences with a discussion of some of the general trends in political party campaign finance reforms, before discussing the issues related to political donations. This is followed by an outline of the scholarly writing on the advantages and disadvantages of tax concessions for political party funding.

A *Political party campaign finance reform*

There have been significant reforms of campaign finance over recent years. All developed countries regulate the supply of private money to political parties, at least to some extent. This may take the form of a financial cap or, as in New Zealand, it may be in the form of transparency in naming donors who donate above a specified threshold. Some countries only allow donations from natural persons or enrolled voters, while others prohibit donations from types of entities, such as companies with state contracts. Other forms of regulation include demand-side measures intended to promote equality between parties, typically in election years.

Alternative forms of assisting with campaign finance include reimbursement of election expenses. However, this advantages incumbent parties and has the potential to encourage unnecessary spending. The United Kingdom provides policy grants that are earmarked for parties to develop policies. A method used in Australia is per-vote funding, where funds are allocated based on measures typically proportional to votes received at the previous election, with some other adjustments that benefit smaller parties. This method is clear and provides a direct connection between votes and taxpayer funding. The Netherlands allocates funds to political parties partly based on membership numbers. This is beneficial from the perspective of incentivising engagement with a broader public. Yet another method is adopted in Germany, which provides a co-contribution for small individual donations. Tax credits are used successfully in Canada. Small donations are heavily subsidised but higher levels of donation receive smaller tax credits that are fully abated at around NZ$1,600.

Campaign finance reform has also impacted on other aspects of donations. Analysis of 32 developed countries shows that 17 require publication of a donor's identity when donating over NZ$5,000, while nine mandate disclosure for donors giving over NZ$1,500 and three

require all donor identities to be disclosed.[8] Many countries set maximum annual donation amounts, with seven of the 32 countries reporting a restrictive cap of NZ$5,000, and a further four of NZ$15,000. The caps can be as low as NZ$850 (Belgium) or NZ$2,100 (Canada). Around one-third of countries (11), including New Zealand and Australia, allow unlimited donations.[9]

A further form of regulation is with reference to who is permitted to donate. Eleven countries ban donations from both corporations and trade unions, while a further four ban them only from corporations and two only from trade unions. Thirteen countries, including New Zealand, have no such restrictions. Another tool is to cap election spending limits. This is in place in 18 out of 32 countries, including New Zealand among them. Australia does not limit political party campaign spending.

Among the many funding choices, the most common method of funding is per-vote funding, although it is not uncommon for countries to combine different funding methods. Funding policies typically consider smaller parties and are structured so that larger incumbent parties are not advantaged. A common method to support smaller parties is the provision of a lump-sum payment alongside the per-vote allocation, where parties have attracted a fairly low level of votes at a previous election or are a new party.

B *The issues with political donations*

Perhaps the most well-established concern with reference to donations to political parties is the potential for these payments to result in influence. This is particularly relevant for larger donations, which have been identified as posing "a risk to democracy because they may allow the giver to obtain undue influence over the political process".[10] The risk associated with donations is captured in the suggestion that "donations open powerful doors", thereby generating access to those who have influence, even if obvious influence cannot be identified.[11]

With reference to larger donors, Australia's political parties rely on a small number of major donors. In 2020-21, 39% and 57% of the Coalition's and Labor's declared donations, respectively, came from five donors, generating the claim that "these donors can achieve significant access and influence".[12] Wood, Griffiths and Chivers also observe the small group of donors that typically contribute the bulk of political party funds or the "pay for access" fundraising events in Australia.[13] Furthermore, highly regulated industries contribute the biggest share of political donations in Australia.[14]

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[8] Ibid.
[9] Ibid.
[10] Shane Leong and James Hazelton, 'Improving Corporate Political Donations Disclosure: Lessons from Australia' (2017) 37(3) *Social and Environmental Accountability Journal* 190.
[11] Kate Griffiths and Owain Emslie, "$177 million flowed to Australian political parties last year, but major donors can easily hide" (February 2022) *The Conversation* <https://theconversation.com/177-million-flowed-to-australian-political-parties-last-year-but-major-donors-can-easily-hide-176129>.
[12] Ibid.
[13] Danielle Wood, Kate Griffiths and Carmela Chivers, *Who's in the room? Access and influence in Australian politics* (Grattan Institute, 2018).
[14] Ibid.

In NZ, there are distinct patterns with who is funding specific parties. Chapple and Anderson report that the National Party receives over half of reported business donations (55%) while Labour receives 29%.[15] Labour receives 88% of the trade union donations, but union donations have declined over the past two decades and are no longer the significant source of political funding they once were. In reporting on donations by "ideological" perspective, Chapple and Anderson show that several businesses donate across the spectrum, usually to National and Labour, but in three instances also to combinations of the Green Party, the ACT Party and the New Zealand First Party. In identifying that these donors are large businesses, operating with "a degree of monopoly in an environment where either government purchasing or regulation is an important consideration", Chapple and Anderson suggest that "[t]he purpose of cross-spectrum donors is unlikely to be ideological. Rather they more likely seek to gain access to politicians to protect some form of vested interest".[16]

Wood, Griffiths and Chivers report on access and influence in Australian politics.[17] Their 2018 study reports that Australia is vulnerable to policy capture, i.e., when special interests manage to influence policy in their favour, at the expense of the public interest. Their justification for this position is because of the resources and incentives of special interest groups, opportunities to influence facilitated by current rules, and weak checks and balances on influence in some areas.[18] As the authors observe, even if policy makers views are appropriately balanced, the perception that some interests may be impacting on policy-making is also problematic, as it undermines trust in government.

A further point is raised by Wood, Griffiths and Chivers concerning undue influence. They suggest that when a small number of large donors have an influence on policy, policy makers may end up with a narrow perspective, which excludes some groups, such as young or disadvantaged groups that may have reduced ability to organise for involvement in policy discussions.[19]

Possible reasons for donating to political parties are offered in the academic literature. For example, purchasing access to politicians through one-on-one meetings or invitations to events.[20] In 2017, the Australian Senate established a Select Committee into the Political Influence of Donations to inquire into the motivations and reasons why entities give donations to political parties and political candidates.[21] By way of explanation for the donations, several donors advised their primary motivation was to support the democratic process.[22] Others expressed a desire to engage in policy discussions as the motivation for their political donations.[23] A further explanation provided was "building and maintaining relationships with key political stakeholders".[24] This included attending business forums and

[15] Simon Chapple and Thomas Anderson, 'Who's donating? To whom? Why? Patterns of party political donations in New Zealand under MMP' (2021) 17(2) *Policy Quarterly* 14.
[16] Ibid, 18.
[17] Wood, Griffiths and Chivers (n 13).
[18] Ibid, 11.
[19] Ibid, 25.
[20] Iain McMenamin, 'Business, Politics and Money in Australia: Testing economic, political and ideological explanations' (2008) 43(3) *Australian Journal of Political Science* 377; Wood, Griffiths and Chivers (n 13).
[21] The Australian Senate, Select Committee into the Political Influence of Donations (Commonwealth of Australia, 2018).
[22] Ibid, at 3.56.
[23] Ibid, at 3.62.
[24] Ibid, at 3.67.

other party or candidate events, that provided the opportunity to "engage with Members of Parliament on matters relevant to their industry".[25] Despite this last motivation for donating, the Select Committee report notes that donors assured the committee that there was no expectation of preferential access or direct benefit.

Notwithstanding the assurances provided by donors to the Australian Select Committee, there is no shortage of academic literature or mainstream media that connects business contributions to political parties to corruption.[26] It has been observed that "donations build relationships and a sense of reciprocity. And the fact that industries in the cross-hairs of policy debate sometimes donate generously and then withdraw once the debate has moved on suggests they believe, perhaps rightly, that money matters".[27] Tham and Young write "the steep fees involved in purchasing political access also mean that ordinary citizens are not in a position to buy such access".[28] Tham and Young argue that businesses should not be permitted to donate: this should be the domain of individuals, as citizens.[29] While there is no maximum amount for business donations to political parties in either Australia or NZ, the tax concession that is available in Australia is not available to businesses.

The question of whether charitable giving is politically motivated has recently been examined in France. In France, charitable and political donations are eligible for a 66% tax credit, but only charitable donations are eligible for a 75% wealth tax credit, up to a limit of €50,000 per annum.[30] Taxpayers may choose which tax credit they apply for. Amendments to the wealth tax credit in 2017 resulted in significantly fewer households being eligible for the wealth tax credit, thereby increasing the price of charitable donations, but not political donations, for those who were claiming the wealth tax credit. As a result of the increased price to these households of charitable giving, the authors show that charitable and political donations are substitutes. The study reports that a one per cent increase in the price of charitable giving results in an increase of around 0.12% in political donations. The authors also show that an increase in the price of charitable donations does not benefit all political parties in a similar way, and mostly benefits pro-business political parties. However, the drop in charitable donations is larger for charities whose purpose is political than for those where it is not political, leading to the suggestion that there is political motivation behind charitable giving. The authors ask if donations to charities are at least partly driven by political considerations, whether it is relevant to have different tax deductions for charitable and political giving, as is the case in NZ.

We note the "cartel party thesis" could be applied to the use of the tax system to support political parties in Australia. For nearly 30 years, this theory has proposed that political parties function like cartels, using state resources to limit political competition and increase

[25] Ibid, at 3.67.
[26] Joo-Cheong Tham and Sally Young, *Political Finance in Australia: A skewed and secret system* (Democratic Audit of Australia, 2006) 32.
[27] Wood, Griffiths and Chivers (n 13) 3
[28] Tham and Young (n 26) 32.
[29] Ibid.
[30] Julia Cage and Malka Guillot, 'Is charitable giving political? New evidence from wealth and income tax returns' (June 30, 2021) < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3881112>.

their own chances of electoral success.[31] Katz and Mair observe the blurring of the boundaries between parties and the state which, in Australia, supports the presence of political donations for parties, despite them not having charitable status, as donations typically benefit incumbent and larger parties.

III THE TAX SYSTEM AND POLITICAL PARTY FUNDING

There are several ways in which the tax system can support political donations, although we acknowledge the differing positions on whether this is a valid use of the tax system. Tax systems can provide partial subsidies under circumstances and this article examines the different approaches in the two countries. This section starts with a discussion on tax deductions and tax credits. This is followed by a discussion on other options that are used globally to illustrate the range of ways in which the tax system is used to support political parties.

A *How the tax system can support political parties.*

Tax deductions and tax credits are two common methods used to provide support for political parties. Tax deductions allow for the donor to treat the donation as an expense, which reduces taxable income. Tax credits offset income tax that is due to be paid. Table 1 provides an illustration of the difference, under two different tax rate scenarios.

Table 1: Illustration of tax deductions and tax credits

Tax Deduction			**Tax Credit at 33.33c/$**		
Tax rate	**45% tax ($)**	**20% tax ($)**	**Tax rate**	**45% tax ($)**	**20% tax ($)**
Income	10,000	10,000	Income	10,000	10,000
Donation (deduction)	1,000	1,000	Tax payable (calculated on income)	4,500	2,000
Taxable income	9,000	9,000	Donation	1,000	1,000
Tax payable (calculated on taxable income)	4,050	1,800	Tax credit	330	330
Tax – assuming no donation	4,500	2,000	Tax payable (tax - tax credit)	4,170	1,670
Tax ‘saving’	450	200	Tax ‘saving’	330	330
Cost of donation to donor	**550**	**800**	**Cost of donation to donor**	**770**	**770**

[31] Richard S Katz and Peter Mair, “Changing models of party organization and party democracy: the emergency of the cartel party” (1995) 1(1) *Party Politics* 5; Richard S Katz and Peter Mair, “The Cartel Party Thesis: A restatement” (2009) 7(4) *Perspectives on Politics* 753.

This example assumes that the whole donation is eligible for the tax credit or deduction, which may not always be the case in practice. The rate of 33.33 cents for each dollar donated is selected for the tax credit, as this is the current tax credit permitted in NZ for donations to approved charitable organisations.

The benefit to the taxpayer in both scenarios is an overall reduction in the individual's tax paid. However, under the tax deduction, tax is calculated on income after the donation has been deducted, reducing the tax payable. Whereas with the tax credit, tax is calculated on income before the donation is deducted and a tax credit must usually be applied for after the donation has been made. Therefore, there are timing and compliance advantages with a tax deduction. There is some evidence to suggest that many people do not apply for tax credits related to donations made, with nearly half of eligible tax credits unclaimed in Canada.[32]

Table 1 shows that a tax deduction provides a greater benefit to a higher income earner, that is, someone who is paying a higher marginal income tax rate. Whereas the tax benefit from a tax credit accrues equally to all donors. While it may therefore appear that a tax credit is preferable on equity grounds, some have argued that a tax credit system may reduce the financial incentive for wealthier individuals to donate, when compared to a system that involves deductions.[33] However, tax credits for political donations usually have relatively low upper thresholds, so this argument is less relevant for political donations than, say, donations to the arts.

There are several other ways that the tax system is used to support political parties. For example, in Italy, there are no direct state subsidies, but indirect assistance is provided whereby taxpayers can donate 0.2% of their income tax as a contribution to an eligible political party.[34] Indirect assistance is also provided in France, where donors receive up to 66% tax relief on donations, as donations are tax deductible.[35] In Portugal, political parties are exempt from corporate income tax and several other taxes.[36] And, in Finland donations received by political parties and candidate support groups are exempt from tax[37] while in Greece and Malta, political parties also have a tax exemption.[38]

In other situations, countries use the tax system to place constraints on political donations. For example, in Lithuania the total amount of political donations by an individual must be less than 10% of the donor's previous annual income.[39] Another example is visible in Bulgaria where donations are prohibited from persons registered in a preferential tax

[32] Harold J Jansen and Lisa Young, 'State subsidies and political parties' *Policy Options* (2011) <http://irpp.org/wp-content/uploads/assets/po/the-new-normal-majority-government/jansen.pdf>.
[33] David C Throsby and Glenn A. Withers, *The economics of the performing arts* (St Martin's Press, 1979).
[34] European Parliament, Financing of Political Structures in EU Member States: How funding is provided to national political parties, their foundations and parliamentary political groups, and how the use of funds is controlled (June 2021) <https://www.europarl.europa.eu/RegData/etudes/STUD/2021/694836/IPOL_STU(2021)694836_EN.pdf> 26.
[35] Ibid, 87.
[36] Ibid, 108.
[37] Ibid, 186.
[38] Ibid, 208 / 257.
[39] Ibid, 20.

regime.[40] In Cyprus, entities with outstanding tax obligations cannot make donations greater than €5,000 per annum.[41]

A further variation is when a direct connection is made between tax revenue and political party funding. By way of illustration, political parties receive state funding in Croatia. Total available funding is 0.075% of the previous year's tax revenue, which is equally distributed to all members of the Parliament.[42]

IV THE IMPACT OF TAX CONCESSIONS ON DONATIONS

A body of scholarly work has investigated the effect of tax concessions on charitable contributions. Note, however, that this research primarily focuses on donations to charities, rather than donations to political parties.[43] There is general agreement that tax incentives change patterns of charitable donations, with tax incentives increasing the value of donations.[44] By way of example, research on charitable giving to a private liberal arts college in the United States finds that wealthy donors who live in states that allow tax deductions for charitable donations are more generous than donors who reside in states that do not provide tax deductions.[45]

Research from South Korea shows that taxpayers are more sensitive to tax incentives in the form of a tax deduction, rather than a tax credit.[46] This is intuitive because, as noted above, a higher earner can usually gain greater benefit from a tax deduction. However, the authors also report that those who donate larger amounts are less sensitive to tax incentives. This may result from the likelihood that larger donors have higher incomes, which may mean the financial incentive of a tax incentive is not as strong as it may be for someone who is restricted to a modest donation.

A field experiment undertaken in the United States of America compared the impact of a matching contribution and a tax deduction. The study finds that matching subsidies result in larger total donations to charities than tax deductions.[47] This finding is perhaps also intuitive as a matching contribution requires little additional effort by the taxpayer, whereas a tax deduction requires, at a minimum, completion of a tax return along with a time delay in receiving the benefit.

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[40] Ibid, 76.
[41] Ibid, 80.
[42] Ibid, 77.
[43] In particular, there is little scholarly work on tax deductions for campaign finance.
[44] M Almunia, I Guceri, B Lockwood and K Scharf, 'More giving or more givers? The effects of tax incentives on charitable donations in the UK' (2020) *Journal of Public Economics* 183, 104114; T Blumkin and E Sadka, 'A case for taxing charitable donations' (2007) *Journal of Public Economics*, 91 (7-8) 1555.
[45] J Holmes, 'Prestige, charitable deductions and other determinants of alumni giving: Evidence from a highly selective liberal arts college' (2009) *Economics of Education Review* 28, 18.
[46] YoungRok Kim, 'Effects of tax benefits on the price elasticity of charitable contributions in South Korea' (2022) *Pacific Economic Review* (2022) https://doi.org/10.1111/1468-0106.12387.
[47] C C Eckel and P J Grossman, 'Subsidizing charitable contributions: a natural field experiment comparing matching and rebate subsidies' (2008) 11(3) *Experimental Economics*, 234.

Research from Canada, prior to current tax policy changes, finds that individuals are responsive to the "cost" of donating, and donations increase when the cost is reduced.[48] However, the authors also report that when marginal tax rates are reduced, individuals will contribute more to charity than the amount of the tax saving.[49] Similar findings are reported in Singapore, with research showing that the tax price of giving is an important determinant of charitable donations by individuals.[50]

Not all researchers concur that tax concessions impact on donations. For example, Fink explores patterns of donations from businesses to political parties where there are tax concessions. Fink reports that the tax treatment of donations does not explain differences in donation patterns and instead reports that differences seen are more likely to result from the motives of an organisation.[51]

V TAX EXPENDITURES

This study uses the different approaches adopted to tax expenditures by NZ and Australia to support the proposal that the different treatments follow the two countries approaches to using the tax system to change behaviour. This section provides some contextual information on tax expenditures in both countries.

Tax expenditures are foregone revenue.[52] NZ's Tax Expenditure Statement (TES) describes tax expenditures as taking the "form of an exemption, allowance, preferential tax rate, deferral or offset that reduce a tax obligation to achieve a specific policy objective".[53] The New Zealand Accounting Standards Board of the External Reporting Board provide a different definition that perhaps better captures the characteristics of a tax expenditure: "preferential provisions of the tax law that provide certain taxpayers with concessions that are not available to others".[54]

A *New Zealand*

New Zealand started regularly reporting a TES in 2010.[55] The 2010 TES was the first tax expenditure statement since 1985, and it "focused, in the first instance, on a narrow subset of

[48] R Hood, S Martin and L Osberg, 'Economic Determinants of Individual Charitable Donations in Canada' (1977) 10 *The Canadian Journal of Economics*, 653.
[49] Ibid.
[50] V Chua and C Wong, 'Tax incentives, individual characteristics and charitable giving in Singapore' (1999) 26(12) *International Journal of Social Economics* 1492.
[51] Alexander Fink, 'Donations to political parties: Investing corporations and consuming individuals?' (2017) 70.2 *Kyklos* 220.
[52] External Reporting Board, PBE IPSAS 23 Revenue from Non-Exchange Transactions, <https://www.xrb.govt.nz/standards/accounting-standards/not-for-profit-standards/standards-list/pbe-ipsas-23/>, at 74.
[53] New Zealand Treasury, *2010 Tax Expenditure Statement* (New Zealand Treasury, 2010) 1.
[54] External Reporting Board (n 52) at 7.
[55] New Zealand Treasury, *2022 Tax Expenditure Statement* (New Zealand Treasury, 2022). Prior to this time only one was previously released in 1984.

tax expenditures that bear a distinct fiscal cost and represent a clear policy-motivated exemption to current tax practice".[56] This TES was described as a "first step towards providing additional transparency around policy-motivated 'expenditures' made through the tax system".[57] The aim was to increase transparency in government financial reporting and closer align this to OECD best practice. The first document was referred to as a "preliminary list" with the caveat that it "should not be taken as exhaustive or complete list of all current tax expenditures".[58]

Unlike most OECD countries, NZ has no legal requirement to report tax expenditures, but now does so in the annual budget.[59] Moreover, compared to G20 or OECD countries, NZ has few tax expenditures, reported as 10 in 2018, compared to, for example, Latvia's 321.[60]

As tax expenditures are not intended to raise revenue, they have different objectives than those typically attached to Inland Revenue's work. Instead, they are "significantly motivated by non-revenue policy objectives".[61] NZ's TES has social expenditures, business expenditures and 'other' expenditures that are "not expressly introduced to achieve social or business economic policy objectives".[62]

Unlike most tax expenditure statements, NZ's also includes some spending in the list of tax expenditures, such as Working for Families tax credits. The TES clarifies that while they do not meet the definition of a tax expenditure, they are included for transparency purposes.[63] NZ's quantified tax expenditures are in Table 2, which shows actuals for the four periods from 2016/17 to 2019/20, and estimates for the following two years.

Table 2: Quantified tax expenditures (income tax years April – March)[64]

	Actual	**Actual**	**Actual**	**Actual**	**Estimate**	**Estimate**
	2016/17	**2017/18**	**2018/19**	**2019/20**	**2020/21**	**2021/22**
	$M	$M	$M	$M	$M	$M
Charitable / other public benefit gifts by a company (deduction)	30	46	34	32	32	32
Charitable / other public benefits (tax credit)	262	277	286	289	298	297
Independent earner tax credit	242	243	245	233	211	211
Māori Authority donations	4	4.5	4.9	4.4	5.7	5.7

[56] Ibid 1.
[57] Ibid.
[58] Ibid 2.
[59] Agustin Redonda and Tom Neubig, Assessing Tax Expenditure Reporting in G20 and OECD Economies (November 2018) <https://www.cepweb.org/assessing-tax-expenditure-reporting-in-g20-and-oecd-economies/>.
[60] Ibid, 11.
[61] New Zealand Treasury (n 55) 3.
[62] Ibid 8.
[63] Ibid 5.
[64] Ibid.

Appropriated spending through the tax system (fiscal years July-June)						
Child tax credit	0.9	0.8	0.1	0.1	0	0
Family tax credit	1,728	1,639	2,131	2,189	2,103	2,108
In-work tax credit	548	515	613	621	573	542
Parental tax credit	30	28	8	1	0	
Minimum family tax credit	13	12	14	18	13	15
Best Start payment	0	0	48	184	271	339
KiwiSaver tax credit	743	807	867	885	916	978
R&D tax credit	0	0	40	213	250	497
Interest on income equalisation reserve scheme deposits	5.1	4.6	5	6.5	6.5	7
Interest on environmental restoration account deposits	1.6	1.6	1.5	1.4	1.4	1.4
Unquantified tax expenditures (fiscal years: July-June)						
Bloodstock	0	0	0	0.2	1.9	2.7
M-bovis cull income tax adjustment	0	0	0	0	1.5	0.75
Donated trading stock (COVID-19 concession)	0	0	0	0	2	5
	3,607.6	3,578.5	4,297.5	4,677.6	4,686	5,041.55

It is possible to replicate the NZ TES in Table 2 as it is brief, unlike Australia's which runs to 188 pages.

B *Australia*[65]

In Australia the Tax Expenditure Statement is reported as a Tax Benchmarks and Variations Statement. A tax benchmark variation is when there is a difference in revenue between the actual and benchmark treatments, the benchmark treatment being the "standard taxation treatment that applies to similar taxpayers or types of activity".[66] Following the approach

[65] For a comprehensive discussion of the history of tax expenditures in Australia, refer to Kerrie Sadiq, 'The implementation of social and economic policy through the tax regime: a review of Australia's tax expenditures program' (2008) *Australian Tax Forum* 23: 339.

[66] Commonwealth of Australia, Tax Benchmarks and Variations Statement 2021 (January 2022) < https://budget.govt.nz/budget/pdfs/taxexpenditure/b22-taxexpstmt.pdf>, 1.

typically adopted in the OECD, Australia's approach is to primarily disclose revenues foregone.

In 2008, Sadiq reported that there were over 300 different tax expenditures worth in excess of A$50 billion in the 2006-07 financial year.[67] Sadiq further notes the upward trend in both the real cost and the number of tax expenditures, since the first report in 1986.[68] In the 2021 Tax Benchmarks and Variations Statement, the number remains similar at 298 tax expenditures across a broad range of expenditure types.[69] However, expenditures are now in excess of A$200 billion.[70]

Among the tax expenditures is A$5 million for deduction of expenses by election candidates.[71] This tax expenditure exists because deductions would not typically be available for expenses where there is not a nexus to an income-earning activity. However, some expenses incurred by candidates contesting elections are tax deductible.

Australia's approach does not capture all revenue implications associated with behavioural changes resulting from the tax expenditure.[72] However, estimates of the impact of revenue gain for the 10 largest tax expenditures are included in the TES. Further, not all tax benchmarks can be quantified, usually due to data limitations. In 2021/22 for example, 153 of the 298 tax benchmark variations could not be quantified. In these instances, an order of magnitude is provided instead.

C *Tax expenditures and donations*

Notwithstanding the difficulty in measuring tax expenditures, the value of tax expenditures for charitable donations in NZ and Australia are outlined in Table 3. When adjusting for population size, the Australian tax concessions are two and a half times those of NZ's.

[67] Sadiq (n 65).
[68] Ibid.
[69] Commonwealth of Australia (n 66) 159.
[70] Ibid 16. Note that corresponding revenue gains for these large, measured benchmark variations were estimated at nearly A$69 billion.
[71] Ibid 24.
[72] Ibid 2.

Table 3: Tax expenditures for charitable purposes ($M)[73]

NZ (NZ$ million)	**2017/18 Actual**	**2018/19 Actual**	**2019/20 Actual**	**2020/21 Estimated**	**2021/22 Estimated**
Charitable or other public benefits gifts by a company (deduction)	46	34	32	32	32
Charitable or other public benefits (tax credit)	277	286	289	298	297
Total	**323**	**320**	**321**	**330**	**329**
Australia (A$ million)					
NFP hospitals and public ambulance services	1,550	1,650	1,600	1,750	1,850
NFP private health insurers income tax exemption	115	95	110	30	100
NFP rebate	55	60	60	50	45
Radiocommunication taxes exemptions	9	9	9	9	10
Deduction for gifts to deductible gift recipients	1,625	1,680	2,030	1,950	1,835
Deduction for gifts to private ancillary funds	385	445	240	260	260
Refund of franking credits for certain income tax exempt philanthropic entities	1,575	1,490	2,095	0	0
Total	5,314	5,429	6,144	4,049	4,100

VI AUSTRALIA

This section provides a brief outline of election funding in Australia. The focus of this section is on campaign funding for federal parties. However, we note that there are more detailed regulations and public funding provisions at the state level. It also includes discussion on the general tax treatment of donations.

A *Election funding*

[73] New Zealand Treasury (n 55); Commonwealth of Australia (n 66).

Election funding in Australia comes from three primary sources: public funding (roughly one-third), private funding – donations and other receipts, such as income from investments or payments from fundraising events (roughly one-quarter), and "unitemised" funding (around 40%).[74] Australian political parties receive higher levels of donated funds than NZ, A$177 million in 2020-21.[75] In the same period, NZ political parties received NZ$2.7 million in donations.[76] With adjustment for the different population sizes, Australia has approximately 13 times the value of political donations than NZ.

Election funding is payable to a registered political party for an endorsed candidate who receives at least four per cent of the total formal first preference votes cast in the election.[77] The amount of funding payable is calculated by multiplying A$3.125 by the number of formal first preference votes given for the candidate in the election.[78] Funding over A$11,426 is capped at the amount of actual expenditure incurred by the candidate or the registered political party endorsing the candidate.[79] Funding is also available in a Senate election to candidates who are not endorsed by a registered political party, where the person receives at least four per cent of the total number of formal preference votes case in the Senate election. The same amount of funding applies for endorsed candidates.

B *Charities*

The definition of charity is provided in the Charities Act 2013 as: a not-for-profit entity; and all the purposes of the entity are charitable purposes that are for the public benefit; or purposes that are incidental or ancillary to, or in furtherance of, this; none of the purposes are disqualifying purposes; and the entity is not an individual, a political party or a government entity.[80] Therefore, a political party is explicitly excluded from the definition of a charity. In addition, the purpose of promoting or opposing a political party or a candidate for political office is included in the definition of a disqualifying purpose.[81] However, this exclusion does not apply where the purpose is distributing information, or advancing debate, about the policies of political parties or candidates for political office, such as assessing, critiquing, comparing or ranking those policies.[82]

C *Deductible gift recipient*

[74] Wood, Griffiths and Chivers (n 13).
[75] Griffiths and Emslie (n 11).
[76] Electoral Commission, Party Donations and Loans by Year (January 2023) <https://elections.nz/democracy-in-nz/political-parties-in-new-zealand/party-donations-and-loans-by-year/>.
[77] Commonwealth Electoral Act 1918, Part SS, s 292G.
[78] Australian Electoral Commission, Election Funding Rates (January 2023) <https://www.aec.gov.au/Parties_and_Representatives/public_funding/Current_Funding_Rate.htm>. This rate is for the period covering 1 January 2023 to 30 June 2023.
[79] Ibid.
[80] Charities Act 2013, Part 2, Div 1, s 5.
[81] Charities Act 2013, Div 3, s 11.
[82] Ibid.

A deductible gift recipient (DGR) is an organisation that can receive donations that are tax deductible to the donor.[83] Not all charities may have DGR status: this decision is made by the Australian Tax Office. However, from December 2021, most DGR organisations are required to be registered charities. To receive DGR endorsement, the eligibility criteria must be met or, in exceptional cases, the entity may have their name specifically identified in tax law.[84]

Tax deductions can usually only be claimed for donations to organisations that have DGR status. Political parties are not DGR's. When a DGR is a registered charity, it risks its DGR endorsement if it promotes or opposes a political party or a candidate, as this is a disqualifying purpose under the Charities Act 2013.[85] The entity's charity registration would also be at risk, along with its income tax exemption and related tax concessions.[86]

A further category of donations is a "contribution". A contribution is when a material benefit is received in return for the amount given, such as paying to attend a fundraising dinner. Similar eligibility requirements apply for a contribution, i.e., it must be made to a DGR, for an "eligible fundraising event", and also comply with any extra conditions that apply to some DGRs. Tax deductions for contributions may only be claimed by an individual taxpayer. Fundraising events held by political parties are not eligible for this concession.

There are several restrictions to natural person's claiming income tax deductions on contributions to political parties, candidates and members. First, the recipient must be one of the following:

- A political party registered under the Commonwealth Electoral Act 1918 or
- An independent member[87] of, or an independent candidate[88] for, the Commonwealth Parliament, a state Parliament, the Legislative Assembly of the Northern Territory or the Legislative Assembly of the Australian Capital Territory

The deduction is only available to individuals. Business taxpayers are not permitted to claim deductions for gifts or contributions to political parties, independent members and independent candidates.[89]

At December 2022, there were 34 registered political parties.[90] Some of the larger parties, e.g. the Australian Greens, the Australian Labor Party, the Liberal Party and the National

[83] Australian Charities and Not-for-profits Commission, Deductible Gift Recipients and the ACNC, https://www.acnc.gov.au/tools/factsheets/deductible-gift-recipients-and-acnc.
[84] Ibid.
[85] Australian Tax Office, *Australian Taxation Office Submission: Inquiry into and report on all aspects of the conduct of the 2016 Federal Election and matters related thereto* (2018) < https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Electoral_Matters/2016Election/2016_election_report>.
[86] Ibid.
[87] An independent member is not a member of a registered political party.
[88] An independent candidate is one who is not endorsed by a registered political party or under state or territory electoral legislation. It includes an endorsed candidate of an unregistered political party. Australian Tax Office, Giving to independent candidates and members, https://www.ato.gov.au/Non-profit/Gifts-and-fundraising/In-detail/Fundraising/Claiming-political-contributions-and-gifts/.
[89] Commonwealth of Australia (n 66).
[90] Australian Electoral Commission, Register of Political Parties https://www.aec.gov.au/Parties_and_Representatives/Party_Registration/Registered_parties/index.htm.

Party, have state registrations, although these are not counted separately in the count of 34 registered parties.

VII NEW ZEALAND

While regulation has limited the use of money or goods and services at election time since 1858, up until the mid-2010s election financing in NZ remained relatively light touch.[91] There were no constraints on political party funding sources or limits on donations to political parties, with disclosure only required of a donor's identity if they had donated more than NZ$10,000 in the previous year.[92]

In 2005, the government reviewed the existing arrangements for charitable giving. The effect of the changes resulted in the ability for people and companies to claim rebates and deductions for charitable donations up to the level of their annual income. The purpose of the changes was to encourage greater giving to charities and to encourage "a culture of generosity in New Zealand".[93] The forecast cost of the concession was around NZ$25 million a year in foregone revenue from 2009/10.[94] As shown in Table 3, the concession is now more than ten times this original forecast. Note that donations for political purposes did not attract any tax concessions.

In NZ, a company is allowed a deduction for a charitable or other public benefit gift made to a donee organisation.[95] The total deduction allowable in an income year is limited to the amount of the company's net income in the corresponding tax year.[96] As this section supplements the general permission in the Income Tax Act 2007, there is no need for a company to demonstrate a nexus with the income earning process. A similar provision applies for Māori authorities.[97]

A tax credit is available for charitable donations made by an individual to an organisation with donee status. To qualify for donee status, the charity must be registered with Charities Services. In addition, the donation must be to "a society, institution, association, organisation, or trust that is not carried on for the private pecuniary profit of an individual, and whose funds are applied wholly or mainly to charitable, benevolent, philanthropic, or cultural purposes within New Zealand".[98] Other entities, such as tertiary education institutes are specifically referred to in the legislation.[99]

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[91] Andrew Geddis, *Electoral Law in New Zealand: Practice and policy, 2nd edition* (LexisNexis, 2014).
[92] Ibid. Geddis writes that "in practice this disclosure regime was so riddled with loopholes as to operate on a virtually voluntary basis; any donor who wishes to keep her or his identity secret could do so easily and completely legally" (Ibid, 156).
[93] Inland Revenue, Greater tax incentives for charitable donations, https://www.taxtechnical.ird.govt.nz/en/new-legislation/act-articles/other-policy-matters/greater-tax-incentives-for-charitable-donations.
[94] New Zealand Government, Fostering a culture of charitable giving (May 2007) <https://www.beehive.govt.nz/release/fostering-culture-charitable-giving>.
[95] Income Tax Act (ITA) s DB 41(2).
[96] ITA s DB 41(3).
[97] ITA s DV 12.
[98] ITA s LD3(2)(a).
[99] ITA s LD 3(2)(bc).

The credit is 33.33 cents for every dollar donated to an approved charity.[100] Donations can be claimed up to the amount of the taxable income of the person during the tax year.[101] However, while NZ legislation does not allow for income splitting, it is possible to split donations with a spouse or partner, where donations are more than taxable income.

Tax credits may be claimed when the donation is NZ$5 or more, was made to an approved charity, did not provide any direct benefit to the donor or their family, and was not the result of a bequest in a will or by way of debt forgiveness.[102] Tax credits may be claimed by an individual. Specific exclusions include a company, a public authority, an unincorporated body and a trustee liable for income tax.[103]

In NZ, political parties cannot be a charity and therefore cannot be an approved donor for the purposes of receiving tax credits. Nor would donations to political parties qualify as a tax deduction in NZ, as the expenditure would not meet the required nexus with the income earning process.

VIII TAX AND POLITICS

There is a body of literature supporting the politicised nature of taxes both in Australia and globally.[104] Martin has written of the political influence on tax and charitable donations in Australia.[105] However, the topic is not one well canvassed in NZ. Martin suggests that the tax deductibility of donations in Australia arose in an ad hoc manner, influenced by the personal concerns and ideologies of influential politicians.[106] Martin also suggests that public opinion on charities was important, and the tax deductibility introduction was influenced by views that tax deductions would motivate donations, as well as valuing the public good of charities and a desire to encourage their activity.[107] However, there is little known about why tax deductions are provided for political parties. We acknowledge that in the two cases we examine in this study that campaigning in the Mixed Member Proportional voting system in NZ is likely to be less resource intensive than in Australia where a party contests 151 seats in the House of Representatives and eight Senate elections.

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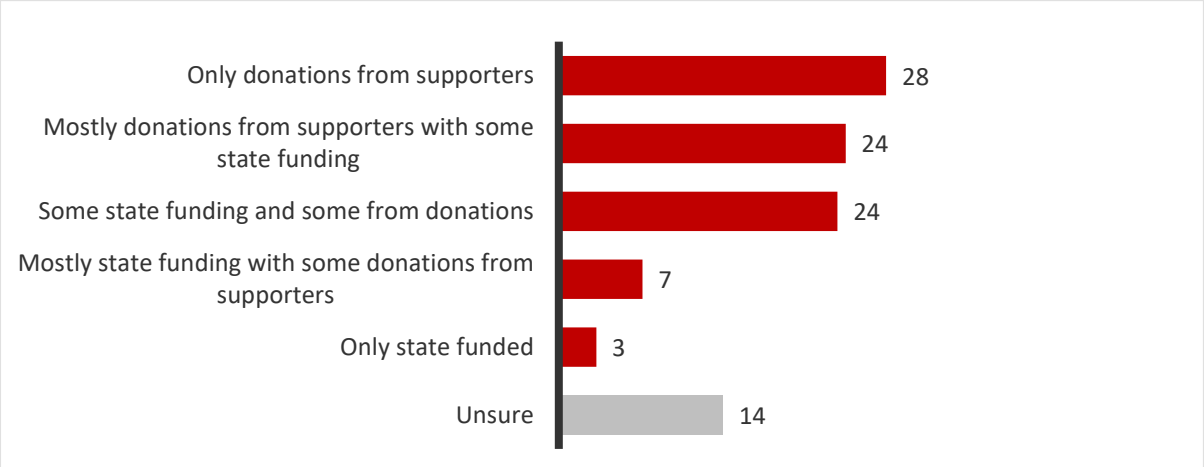
[100] ITA s LD 1(2).
[101] Tax Administration Act 1994 (TAA) s 41A(3).
[102] ITA s LD 3.
[103] ITA s LD 2.
[104] See, for example, Richard Eccleston, *Taxing Reforms: The politics of the consumption tax in Japan, the United States, Canada and Australia* (Edward Elgar Publishing, 2007); E Sainsbury, R Magnusson, A M Thow and S Colagiuri, 'Explaining resistance to regulatory interventions to prevent obesity and improve nutrition: a case-study of a sugar-sweetened beverages tax in Australia' (2020) 93 *Food Policy* 101904; Richard Eccleston, 'The tax reform agenda in Australia' (2013) 72(2) *Australian Journal of Public Administration* 103; C Alley, D Bentley and S James, 'Politics and tax reform: a comparative analysis of the implementation of a broad-based consumption tax in New Zealand, Australia and the United Kingdom' (2014) 24(1) *Revenue Law Journal* 1; S Wilson, 'Not my taxes! Explaining tax resistance and its implications for Australia's welfare state' (2006) 41(4) *Australian Journal of Political Science* 517.
[105] Fiona Martin, 'Tax deductibility of philanthropic donations: Reform of the specific listing provisions in Australia' 2018 33 *Australian Tax Forum* 533.
[106] Fiona Martin, 'The socio-political and legal history of the tax deduction for donations to charities in Australia and how the public benevolent institution developed' (2017) 38(1) *Adelaide Law Review* 195.
[107] Ibid.

In NZ the justification for exclusion of political activity from inclusion as a charity was established in submissions to a recent review of the Charities Act 2005. These submissions generally concurred that charitable organisations should not undertake partisan political activities, or advocate for a purpose that is outside their stated charitable purpose.[108]

Survey data from NZ, as replicated in Figure 1, shows support for state funding. The response with the largest support (28%) was that political parties should only get funding from supporters. However, 58% indicated at least some support for state funding.

Figure 1: What is the right balance for where political parties should get their money?[109]



Australia's approach to allowing small tax concessions for political donations is aligned with its approach to tax expenditures. The 298 tax expenditure items cover a broad range of activities with quantification of the estimate where possible. In contrast, NZ has few tax expenditures and no tax concessions for political donations. However, when it comes to political donations and tax concessions, as Australia provides state funding for political parties, it might be expected that a tax concession is not also needed. In contrast, it might be expected that NZ would use the tax system to encourage political donations, due to the relative absence of state support.

There are several other policies that can be highlighted to support NZ's lack of appetite for using the tax system to influence behaviour, in contrast to that of Australia. These include retirement savings, where the 2021 Australian TES documents: A$2.6 billion in concessional taxation of capital gains for superannuation funds; A$20.5 billion in concessional taxation of employer superannuation contributions; A$1.4 billion in concessional taxation of personal superannuation contributions; A$22.6 billion in concessional taxation of superannuation entity earnings; A$660 million in concessional taxation of unfunded superannuation; and A$160 million in superannuation measures for low-income earners.[110] By way of contrast,

[108] Department of Internal Affairs, Modernising the Charities Act 2005: Summary of submissions (December 2019) <https://www.dia.govt.nz/diawebsite.nsf/Files/Modernising-the-Charities-Act-2005-Summary-of-submissions/$file/Modernising-the-Charities-Act-2005-Summary-of-submissions.pdf>.
[109] Rashbrooke and Marriott (n 7).
[110] Commonwealth of Australia (n 66).

NZ's TES discloses NZ$978 million in KiwiSaver tax credits. Adjusted for population size, Australia's tax concessions for retirement savings are approximately nine times that of NZ's.

While the difference in dollar values is significant, equally significant is what is included in the TES. The broad range of activity outlined in the Australian TES, together with attempts to quantify most of these activities, shows a greater tendency to use the tax system for purposes other than revenue generation. The fact that NZ does not have a legal obligation to report a TES and has only done so for just over 10 years, compared to Australia's 37-year history, is indicative of the ways in which the tax system is used to influence behaviour.

Many of the Australian tax expenditures are intended to change behaviours or, in some cases, facilitate behaviours that are generally considered pro-social, such as working. As well as the concessions for retirement saving mentioned in the previous paragraph, there are various concessions related to childcare, to facilitate parents returning to work; or an exemption of payments made under the First Home-Owner Grant scheme, to facilitate purchase of an owner-occupied home. The Australian TES also includes non-expenditures, such as where taxes are increased to aim to change behaviour. One example is the luxury car tax, which is included in the TES, as certain vehicles are subject to a luxury car tax of 33%.

There are some well-established advantages from allowing tax credits or deductions for political donations, such as the potential to encourage small donations and diversification of the funding base.[111] While the tax advantage is gained by the taxpayer, rather than the political party,[112] to the extent that new donations arise from the presence of the tax benefit, there is a gain to the political party.

Many of the concerns with reference to private donations to political parties arise due to the potential for greater access to decision-makings by donors or actual influence on policy. However, research tends to show that access or influence may result from large donations, whereas there is no research to suggest that small donations achieve the same result.[113]

However, there are also several issues, including that the ability to donate to political parties is typically those who have higher disposable incomes. Therefore, this potentially leads to a lack of representation among those who are donating. Where donations are small, this is less problematic. It is when they become larger that the potential for policy influence arises.[114] Therefore, a large number of small donors is preferable to a small number of large donors. The provision of a tax deduction for a political donation can assist with greater political engagement. Membership of political parties has been declining in NZ[115] and in Australia.[116]

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[111] Tham (n 2) 138.
[112] Ibid.
[113] James Gluck and Michael Macaulay, 'Trading in influence: a research agenda for New Zealand?' (2017) 13(2) *Policy Quarterly* 49.
[114] Kate Griffiths and Iris Chan, 'Big money was spent on the 2022 election – but the party with the deepest pockets didn't win' (February 2023) *The Conversation.*
[115] Simon Chapple, C P Duran and Kate Prickett, *Political donations, party funding and trust in New Zealand: 2016 to 2021* (2021) Institute for Governance and Policy Studies working paper 21/14, 5
[116] Anne Davies, 'Party hardly: why Australia's big political parties are struggling to compete with grassroots campaigns' *The Guardian,* 12 December 2020 <https://www.theguardian.com/australia-news/2020/dec/13/party-hardly-why-australias-big-political-parties-are-struggling-to-compete-with-grassroots-campaigns>.

Reducing the "cost" of a political donation has the potential to broaden the donor base and thereby potentially increase participation in political issues.

One of the aims of a tax deduction is to encourage donations to approved organisations. However, the extent to which the presence of a tax concession elicits greater donations than would otherwise exist, is not clear. However, Canada can be used as an example of a natural experiment. In 2004, the upper limit of the 75% political contribution tax credit doubled from C$200 to C$400, along with other upward adjustments to the scale of credit for donations above the C$400 value.[117] This resulted in "a huge increase in funding available to parties, despite their reduced capacity to attract large contributions from unions, corporations or individuals".[118] Therefore, there appears to be at least some potential for increased support for political parties from individuals where a tax incentive is provided.

IX CONCLUSION

NZ provides minimal state funding for political parties and there are no deliberate tax concessions, in contrast to Australia. However, political parties need funds to develop policies and to communicate these to the public, not only in an election year. The involvement of "big money" in politics has historically in NZ led to suggestions of political corruption.[119] However, encouraging small donations to political parties can be facilitated through the tax system. To the extent that robust policy development, and the ability for political parties to communicate these policies to potential voters, is valued, NZ may wish to review the way it supports political parties.

[117] Antony M Sayers and Lisa Young, Election Campaign and Party Financing in Canada (January 2004) <https://www.researchgate.net/profile/Anthony-Sayers/publication/228457739_Election_Campaign_and_Party_Financing_in_Canada/links/53d7d7f80cf2e38c632de558/Election-Campaign-and-Party-Financing-in-Canada.pdf>.
[118] Ibid.
[119] Rashbrooke and Marriott (n 7).