MONASH University

A Model for a State Income Tax in Australia: Historical Considerations, Key Design Issues and Recommendations

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Abstract

This thesis addresses the question, would the reintroduction of income taxation at the State level in Australia be feasible at the present time? The States levied income taxes from the late nineteenth century until 1942, when the Commonwealth unilaterally enacted legislation for its 'uniform tax' scheme for centralised income taxation which made it effectively impossible for State income taxation to continue. As the States also face a significant constitutional restrictions on their ability to levy major forms of indirect taxation, the Australian federation is characterised by a very high degree of vertical fiscal imbalance and the payment by the Commonwealth of very significant amounts of grants to the States to enable them to meet their major spending responsibilities, with associated efficiency and governmental accountability costs.

As a matter of law, however, the States retain the constitutional power to impose income taxation, and the possibility of resumption of income taxation by the States has been a focus of political and tax policy discussion on many occasions. In this context, Australia's historical experience with State income taxation from its first introduction in Tasmania in 1880 to 1942 is examined in depth to determine whether there may have been administrative problems in the Australian experience of State income taxation, or ongoing practical or political factors in the country's economy or system of government, which may make reintroduction of State income taxation impracticable. The contrast on this issue with the Canadian experience is also relevant, where provincial income taxation was centralised during the War but resumed in the years thereafter.

As part of this historical study, the thesis also looks to the developments outside the specific sphere of taxation which have occurred since Federation to limit the direct constitutional powers of the Commonwealth government to exercise macroeconomic management and control over the Australian economy. The thesis concludes that centralisation of financial resources at the Commonwealth level since Federation was important as an alternative means of facilitating central management of the economy by the Commonwealth, and accordingly that on balance reintroduction of State income taxation would be feasible and is not precluded by administrative or practical considerations.

In conclusion, the thesis considers the key design issues which a State income tax in the present day would need to resolve, particularly in relation to the allocation of income of multi-State businesses between the States for tax purposes, and makes recommendations on these issues in order to develop a model for a State income tax. Australia's experience with the allocation of income issue is reviewed, along with the current practice in the US and Canada under their subnational income taxes and the current reform debate in the European Union and internationally. The thesis concludes in favour of a system of formula apportionment over separate accounting as the recommended method of allocation of income.

The research in this thesis is current to 24 September 2016.

Declaration

I hereby declare that this thesis contains no material which has been accepted for the award of any other degree or diploma at any university or equivalent institution and that, to the best of my knowledge and belief, this thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

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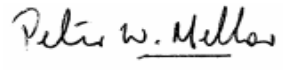

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Thesis including published works declaration

I hereby declare that this thesis contains no material which has been accepted for the award of any other degree or diploma at any university or equivalent institution and that, to the best of my knowledge and belief, this thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

This thesis includes one original paper published in a peer reviewed journal, one book chapter in a peer reviewed conference volume publication and one manuscript to be submitted for publication as a book chapter in a conference volume publication. The core theme of the thesis is the identification of the feasibility of a State income tax in Australia. The ideas, development and writing up of all the papers in the thesis were the principal responsibility of myself, the student, working within the Department of Business Law and Taxation under the primary supervision of Professor Richard Krever.

The inclusion of my principal supervisor as co-author in the published book chapter and book chapter manuscript reflects the fact that the work came from active collaboration between student and supervisor and acknowledges input into joint research. The papers were drafted by me and edited by Prof. Krever.

In the case of Chapters 2, 3 and 4 my contribution to the work involved the following:

Thesis Chapter	Publication Title	Status *(published, in press, accepted or returned for revision, submitted)*	Nature and % of student contribution	Co-author name(s) Nature and % of Co-author's contribution*	Co-author(s), Monash student Y/N*
2	'Origins of the judicial concept of income in Australia'	Published: (2010) 25(3) *Australian Tax Forum* 339-360 (ERA 2010: A) (22 pgs)	Sole authored		
3	Richard Krever and Peter Mellor, 'The Development of Centralised Income Taxation in Australia, 1901-1942'	Published: *Studies in the History of Tax Law, Vol 7*, Peter Harris and Dominic de Cogan (eds) (Oxford: Hart Publishing, 2015), 363-392 (30 pgs)	65%. Historical research and preparation of draft manuscript.	Professor Richard Krever, 35% editing and redrafting.	No
4	Richard Krever and Peter Mellor, 'From Wartime Expedient to Enduring Element of Fiscal Federalism: Centralised Income Taxation in Australia since World War II'	Submitted: *Studies in the History of Tax Law, Vol 8*, Peter Harris and Dominic de Cogan (eds) (Oxford: Hart Publishing, 2017 forthcoming)	65%. Historical research and preparation of draft manuscript.	Professor Richard Krever, 35% editing and redrafting.	No

**If no co-authors, leave fields blank*

I have ~~/ have not~~ renumbered sections of submitted or published papers in order to generate a consistent presentation within the thesis.

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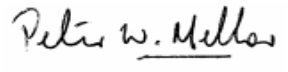

25 September 2016

The undersigned hereby certify that the above declaration correctly reflects the nature and extent of the student's and co-authors' contributions to this work. In instances where I am not the responsible author I have consulted with the responsible author to agree on the respective contributions of the authors.

Main Supervisor signature: **Date:**

25 September 2016

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Participation in a doctoral program has vividly demonstrated to me how such a project is the outcome of very significant contributions by so many other people only a few of whom it is possible to mention specifically here.

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Chapter 1

Introduction

1.1 Overview of the thesis

This thesis addresses the question, would the reintroduction of income taxation at the State level in Australia be feasible at the present time?

The States levied income taxes from the late nineteenth century until 1942, when the Commonwealth unilaterally enacted legislation for its 'uniform tax' scheme including compulsory transfer of resources for collection of the State taxes to the Commonwealth and imposition of a single centralised income tax at a level which combined the former separate Commonwealth and State taxes, making it effectively impossible for State income taxation to continue. The States were left with 'income tax reimbursement' grants from the Commonwealth of a fixed nominal amount, generally representing the average annual income tax collections of each State respectively for the years 1939-40 and 1940-41 less the cost savings brought about for the States in tax administration by the Commonwealth's move. While the arrangement was described as a temporary wartime measure at the time, the Commonwealth continued the scheme after the War and the States have not re-entered the income tax field since.

As a matter of law, however, the States retain the constitutional power to impose income taxation,[1] and the possibility of State resumption of income taxation has been a focus

[1] This was recognised by the High Court in its decision in 1942 to uphold the uniform tax scheme in the first of the two challenges by several States to the various elements of the scheme. In this context it can be noted that it is typically the State courts that in the first instance hear actions for the recovery of State (and often also federal) tax debts: it is suggested that a recipient of an assessment for State income tax under any newly enacted State income tax Act might have difficulty identifying a constitutional reason why recovery of the debt should be stayed by a court. (This is apart from any further question of such a person establishing grounds for a constitutional challenge to the tax in the High Court. Historically, the Commonwealth has 'enforced' the uniform tax scheme through an express or implied condition that payment of financial assistance grants to a State would be withdrawn if a State imposed an income tax; the High Court has interpreted the

of political and tax policy discussion on many occasions. This debate has taken place in a context where the States face an express constitutional restriction on their scope to impose *indirect* taxation, the judicial interpretation of which has also expanded since Federation to exclude the States from this field.[2] As a result, Australia's system of fiscal federalism is characterised by a pronounced degree of 'vertical fiscal imbalance' accompanied by very substantial flows of financial grant monies from the Commonwealth to the States so that they can continue to meet their wide ongoing constitutional responsibilities over major areas of social service provision in Australia.

Nevertheless, the fact that State income taxation has not been reimposed in Australia, in contrast for example to the comparable federal country of Canada, where provincial income taxes also were centralised during World War II but were re-established in the decades after the War, raises a potential presumption that there may have been administrative problems in the Australian experience of State income taxation, or that there are ongoing practical or political factors in the country's economy or system of government, which make reintroduction of State income taxation impracticable. This situation makes the detailed study of Australia's historical experience of Australian State income taxation, as carried out in Chapters 2 to 4 of this thesis, important so that conclusions can be reached about the scope for the States to exercise their constitutional powers to tax income.

As part of this historical study, the thesis also looks to the developments outside the specific sphere of taxation which have occurred since Federation to limit the direct constitutional powers of the Commonwealth government to exercise macroeconomic management and control over the Australian economy. In particular, since the early years of the Commonwealth government as newly created in 1901, narrow judicial interpretations of

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Commonwealth's taxation power not to extend to prohibiting State taxation outright.) For a discussion of some of the considerations involved in obtaining a stay of recovery of tax debts, see, e.g., Rodney Fisher, 'Constraining the recovery powers of the Commissioner: Judicial considerations in granting a stay' (2012) 41(4) *Australian Tax Review* 187-202; Wayne Gumley and Kim Wyatt, 'Are the Commissioner's Debt Recovery Powers Excessive?' (1996) 25(4) *Australian Tax Review* 186-201, 194-195.

[2] *Constitution*, s 90, conferring exclusive power on the Commonwealth to impose 'duties of customs and of excise'. Until 1997, a substantial minority view in High Court jurisprudence on s 90 favoured an interpretation of 'duties of excise' which would have allowed a State retail sales tax on goods irrespective of their place of manufacture, but after some uncertainty this view was overruled in a final decision by the majority of the Court declining to reopen the broad interpretation of the prohibition in s 90: *Ha v New South Wales* (1997) 189 CLR 465.

Commonwealth direct heads of power over the economy, and repeated failures of referendum proposals put to the people on these issues, thwarted Commonwealth economic initiatives such as direct Commonwealth control of prices and wages in peacetime, nationalisation of the banks and, except with State co-operation, effective central regulation of incorporation and other activities of companies.

While there were undoubtedly administrative deficiencies in the State income tax systems and also wartime financial needs which entered into the Commonwealth's decision in 1942 to impose the uniform tax scheme, the thesis also draws attention to the importance of the centralisation of financial resources at the Commonwealth level since Federation as an alternative means of facilitating central management and control of the economy to compensate for the lack of formal constitutional powers in this sphere. Accordingly, the thesis concludes on balance that a reintroduction of State income taxation would be feasible and is not precluded by administrative or practical considerations, but rather is a political matter for the various governments in the Australian federation.

These political considerations are in general terms outside the scope of this thesis and, apart from the brief comments below, it is not sought to join the tax reform debate generally to argue that the States should or should not levy income taxes. Moreover, such political decisions on State taxation policy also tend to become enmeshed in a focus on the narrow and detailed calculations of the expected impact of a State tax change on the distribution of grant revenue from the Commonwealth to the States under the horizontal fiscal equalisation processes determined by the Commonwealth Grants Commission, which is an artificial rather than substantive policy matter.[3]

However, it does seem appropriate only to note briefly here that an overriding consideration which is likely to inform State taxation policy in future years is the increasing

[3] In relation to the calculations used to determine allocation of general purpose grants to the States involving determination of relative tax 'effort' under established State tax bases and relative cost of service provision for each State, see Neil Warren, 'Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry', in Chris Evans, Richard Krever and Peter Mellor (eds), *Australia's Future Tax System: The Prospects After Henry* (Sydney: Thomson, 2010), 305-363; 306-310; Ross Williams, 'Fiscal Federalism: Aims, Instruments and Outcomes' (2005) 38(4) *Australian Economic Review* 351-369, 361. Since 2000, the horizontal equalisation processes have been applied to the pool of revenue collected by the Commonwealth from the goods and services tax (GST) introduced in that year, the arrangements for payment of the GST revenue to the States replacing the variously described general revenue grants paid by the Commonwealth to the States from 1942 to 2000: see Cheryl Saunders, 'Federal Fiscal Reform and the GST' (2000) 11(2) *Public Law Review* 99-105.

strain which will be placed on government revenues from an ageing society and the social transformations of the modern era, as identified by the far-reaching Henry Review of Australia's tax and transfer system conducted between 2008 and 2009.[4] Furthermore, a new and important consideration which can also now be noted in relation to the politics of State taxation reform since 2006 is the finding by the High Court in that year that the Commonwealth's constitutional power in relation to corporations does extend to the setting of minimum wage levels in peacetime,[5] in contrast to the common understanding on this issue which had been held over many decades. This development both makes reliance on concentration of fiscal resources at the national level for economic management purposes less necessary, and also therefore invites a closer questioning of the other efficiency and government accountability costs of the vertical fiscal imbalance in Australia's fiscal federalism.

More generally, in terms of tax policy, a key insight in the recent literature on tax reform is that the heavy emphasis in recent decades on adjusting the 'tax mix' in favour of indirect taxation in many countries, including Australia, and the rapidly widening levels of economic inequality in society, have now given rise to 'a pressing need to revitalise the income tax'.[6] Given their leading role both in Australia and globally in the development of income taxation a century ago, the Australian States can be considered potentially significant actors in any such revitalisation process now.

In this context, following the conclusions from the historical analysis in the thesis that State income taxation would be feasible, the thesis moves to consider the key design issues which a State income tax in the present day would need to resolve, particularly in relation to the allocation of income of multi-State businesses between the States for tax purposes. This business income allocation design issue is seen primarily to involve a choice between the use of separate accounting between units of multinational enterprises, or the use of formula

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[4] Australia's Future Tax System Review Panel (Dr K Henry, AC, chair), *Australia's future tax system: Report to the Treasurer* (Canberra, December 2009) (Henry Review).

[5] *New South Wales v Commonwealth* (2006) 229 CLR 1 ('*Work Choices case*'). For a discussion of some of the potential consequences of the case in the lead-up to the decision, see Greg Craven, 'Industrial Relations, the Constitution and Federalism: Facing the Avalanche' (2006) 29(1) *University of New South Wales Law Journal* 203-214.

[6] See Neil Brooks, 'An Overview of the Role of the VAT, Fundamental Tax Reform, and a Defence of the Income Tax', in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Wellington: Thomson Brookers, 2007), 597-658, 599.

apportionment of the overall income of a 'unitary enterprise', as formerly used in some instances by the Australian States, and at present by the US states and Canadian provinces. The thesis also makes recommendations on these design issues.

1.2 Summary of chapters

The history of State income taxation in Australia falls into three distinct time periods, which are considered in Chapters 2 to 4 of the thesis respectively.

The first period is 1880-1901 when general income taxation broadly was introduced in the States (then British colonies). There had been a number of unsuccessful attempts to introduce such taxation prior to 1880,[7] but Tasmania's limited dividend tax in 1880 represents the first established income tax in Australia. More significantly, it was followed by the landmark general income tax of 1884 in South Australia, and general income taxes in Tasmania, Victoria and New South Wales in 1894 and 1895 (coinciding with the US federal debate on that country's short-lived income tax law of 1894).

Chapter 2 analyses the experience in these years through the prism of one particular issue central to the implementation of the tax, namely definition of the scope and meaning of 'income' within the coverage of the tax. The study in Chapter 2 on this particular issue nevertheless also allows the conclusion to be drawn that establishment of income taxation in Australia at the colonial and later State level broadly can be considered successful as an example of implementation of an important, and historic, tax policy initiative. Issues such as effective means of collecting tax on corporate income and calculating business income attributable to a colony under source principles (using both separate accounting and formula apportionment approaches) were resolved and applied, although a degree of divergence in these approaches as between the colonies was an indication that different views were held on various issues and that it was not likely that a completely harmonised or unified outcome would emerge in subsequent years.

Chapter 3 moves to the key period of 1901 to 1942, the main years of Australia's experience with State income taxation and also, from 1915 to 1942, of concurrent income taxation at both State and federal levels. Chapter 3 finds some administrative difficulties in this period and repeated efforts to lessen or eliminate the complexity from State income

[7] An extremely valuable resource for the study of the various income tax Bills both unenacted and passed throughout these years is Peter Harris, *Metamorphosis of the Australasian Income Tax, 1866-1922* (Sydney: Australian Tax Research Foundation, 2002).

taxation, for example, through the two Royal Commissions on Taxation (the early 1920s and early 1930s) recommending, respectively, taxation of separate 'spheres' by the different levels of government, and a uniform approach by all jurisdictions; a single collection arrangement was also established for most personal income taxpayers in 1923, and a largely harmonised legislative approach was successfully agreed in 1936 (though with some areas of divergence in various States). Chapter 3 also looks, however, to the Commonwealth's efforts to establish the means for effective policy control over macroeconomic management, and the specific problems of war finance between 1939 and 1942, to show the importance of these factors in the ultimate decision by the Commonwealth to impose the uniform tax scheme.

Chapter 4 directly follows with an analysis of the same issues from 1942 onwards to show their continuing importance in the further developments after the War, including the Commonwealth's unilateral decision to continue uniform taxation in 1946, over the protests of the State premiers, and the many subsequent occasions on which resumption of State income taxation was considered by the various governments but did not materialise. The contrast with Canada's experience is noted, but also the greater direct powers of economic control enjoyed by the Dominion government under the Canadian Constitution. Cold War tensions formed a background to the second legal challenge to the uniform tax scheme in 1957 (also unsuccessful) and the Commonwealth's role in macroeconomic management continued to increase throughout this era. With the very substantial decline in national income tax rates from the 1980s onwards, however (which had also had the effect of leaving the States without 'room' to enter the field), and pressures on the finances of governments at all levels re-emerging particularly after the end of the mining boom of the early 2000s, the resumption of State income taxation continues to be a major subject of tax reform debate up to the present day.

Chapter 5 turns to a consideration of the key design issues which a State income tax introduced today would need to consider and resolve. The focus of this Chapter is on business income which poses greater issues of debate in the literature. The most important of these is the conceptual issue of the choice between 'residence' and 'source' based taxation. While national level income taxes typically are an amalgam of the two, it is shown that the experience of subnational income taxation in the US, Canada and also Australia is generally with the source approach, which is likely to be consistent with broader international trends towards 'territorial' taxation in any event. It is also shown that there are some increasingly important considerations which may favour a different choice of definition of tax bases by State and federal governments, rather than complete conformity (which may be a stumbling block to any arrangement for joint collection of taxes by one authority).

Chapter 5 also shows how the current international debate on reform of existing transfer pricing rules (generally based on 'separate accounting' between units of multinational enterprises) to use a greater level of formula apportionment in allocation of corporate group income suggests that formula apportionment would be an appropriate system for an Australian State income tax. Much of this international debate centres on the recent initiative in the European Union to establish a 'Common Consolidated Corporate Tax Base', which is proposed to be renewed in the near future after a short hiatus. In conclusion, this chapter considers alternative formulas for use in a formula apportionment system, drawing in particular on recent trends in the US towards use of a formula with a substantial weighting to sales (as against payroll and property), and the use of market sourcing rules to determine the place of 'sale' of goods and services.

Chapter 2

Origins of the Judicial Concept of Income in Australia

2.1 Introduction

The Australian judicial concept of 'ordinary income' is central to the scope of the modern Australian income tax. This concept is limited in many important ways, so as to be much narrower than the all-inclusive economic concept of income. In this sense, the Australian judicial concept of income has a scope similar to the approach taken under the income tax in the United Kingdom but which stands in sharp contrast to the much broader approach taken by the courts in the United States, even though the structure of the Australian legislation more closely corresponded to that of the US legislation in taxing income on a global model instead of a schedular design.

This article traces the introduction of income tax legislation in the various Australian jurisdictions (then British colonies) and development of Australia's judicial concept of income in the late nineteenth century, and finds that this narrow interpretation was by no means a certain outcome at the time. Efforts were made by the Victorian Commissioner of Taxation in particular to assess receipts such as legacies, gifts and *ex gratia* payments. These claims, if they had been upheld, had the potential to bring about a vastly different income tax system, and economy, from that which is familiar today and represented an approach which came closer to being realised than those comfortable with today's narrower understanding of the word may appreciate.

2.2 Overview

Income tax legislation was introduced in several of the Australian jurisdictions in the early phase of the emerging Progressive Era. This period saw economic and social policies enacted across a range of areas in many countries in an effort to bring about equity and social justice

reform, although no doubt the policies were also grounded to a large extent in pragmatic and realistic political considerations.[8]

In this context, it might be assumed that the form of the Australian income tax legislation would broadly follow that of the income tax of the United Kingdom, which had been in force since 1842.[9] This UK tax, however, was enacted on a 'schedular' structure which measured net profits and gains from various sources separately by way of a different schedule for each type of income. These schedules were assessed by different authorities[10] which meant that a single statement of total income was not made and which had the effect of making a progressive rate of tax impracticable. The interpretation of the legislation also came to be based on a limited concept of income imported from trust law principles which related to the entitlement of a life tenant to certain types of payment.[11] The income tax legislation introduced

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[8] See W E Brownlee, *Federal Taxation in America: A Short History*, 2nd edn (Cambridge: Cambridge University Press, 2004), 43-52 and A Mehrotra, 'Envisioning the Modern American Fiscal State: Progressive-Era Economists and the Intellectual Foundations of the US Income Tax' (2005) 52(6) *UCLA Law Review* 1793, 1849-1855. Similarly, New South Wales Premier George Reid, whose role was essential in bringing about the direct tax legislation in that colony, has been described as radical, 'symbolically, but pragmatically': B Dickey, 'The Introduction of Direct Taxation in New South Wales, 1892-1898' (1989) 74(4) *Journal of the Royal Australian Historical Society* 329, 344.

[9] 5 & 6 Vict., c 35 ('UK 1842 Act'). An earlier income tax briefly imposed in the UK between 1799 and 1802 had taxed 'income' under a return setting out 19 'Cases' (39 Geo. 3, c 13; see S Dowell, *The Acts relating to the Income Tax* (5th ed. by J Piper, 1902), xlv-xlvii).

[10] See P Soos, *The Origins of Taxation at Source in England* (Amsterdam: IBFD Publications, 1997), 152-154.

[11] See R Parsons, 'Income Taxation: An Institution in Decay' (1991) 13(3) *Sydney Law Review* 435, 436-443; J Avery Jones, L De Broe, M Ellis, K van Raad, J Le Gall, H Torrione, T Miyatake, S Roberts, S Goldberg, J Killius, G Maisto, F Giuliani, R Vann, D Ward and B Wiman, 'Treaty Conflicts in Categorizing Income as Business Profits Caused by Differences in Approach between Common Law and Civil Law' (2003) 57(6) *Bulletin for International Taxation* 237, n 3, and R Vann, 'Income as a Tax Base', in R Krever (ed.), *Australian Taxation: Principles and Practice* (Melbourne: Longman Professional, 1987), 62. See also R Krever, 'Interpreting income tax laws in the common law world', in M Achatz, T Ehrke-Rabel, J Heinrich, R Leitner and O Taucher (eds), *Steuerrecht Verfassungsrecht Europarecht: Festschrift für Hans Georg Ruppe* (Vienna: Facultas.wuv, 2007), 354, 357, noting the description of the process of interpreting tax law provisions by reference to transplanted categories as logically fallacious in N Brooks, 'The Responsibility of Judges in Interpreting Tax Legislation', in G Cooper (ed.), *Tax Avoidance and the Rule of Law* (Amsterdam: IBFD Publications in cooperation with Australian Tax Research Foundation, 1997), 93, 122-123. The view that the UK concept of taxable income was drawn from limited trust concepts as opposed to the ordinary meaning of the term has, however, also been contested: J Prebble, 'Income Taxation: a Structure Built on Sand' (2002) 24(3) *Sydney Law Review* 301.

in New Zealand in 1891 incorporated reference to the term 'income' but was also schedular in design.[12]

In contrast to the UK schedular approach, the Australian colonial legislation was based on a global structure which imposed tax on a taxpayer's total gross income of all types less specified outgoings. This model was in fact very similar to the federal income taxes imposed in the United States in the Civil War period and briefly in 1894-95.[13] The US taxes also involved a much broader scope of income which was subject to tax than applied under the UK income tax, so as to include gifts, bequests of personal property and in many cases capital gains (or what would be considered capital receipts in Australia).

There is a lack of specific evidence at some stages of the introduction of the Australian income taxes to allow definite conclusions to be drawn as to the intention of the Australian legislatures on the scope of taxable income under the legislation. For example, after a number of income tax Bills in schedular form had been considered in several colonies from as early as the 1860s, the move to a global legislative structure appears to have occurred only shortly

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[12] *Land and Income Assessment Act 1891* (NZ), enacted on 8 September 1891; the tax was imposed with effect from 1 April 1892 under the *Land-tax and Income-tax Act 1892* (NZ), enacted on 11 October 1892. The New Zealand assessment Act referred to 'income', the definition of which (in s 3) relevantly provided that that term 'means any gains or profits derived or received by any company or person...'. On the political background to the introduction of the tax, see P Goldsmith, *We Won, You Lost. Eat That! A political history of tax in New Zealand since 1840* (Auckland: David Ling Publishing, 2008), 90-91, contrasting the ease of this reform in New Zealand with the subsequent difficulties in the Australian colonies and also in the US; see also L Facer, 'The Introduction of Income Tax in New Zealand' (2006) 12 *Auckland University Law Review* 44 and R Vosslamber, 'How Much? Taxation on New Zealanders' Employment Income 1893-1984' (2009) 15(4) *New Zealand Journal of Taxation Law and Policy* 299.

[13] The *Wilson-Gorman Tariff Act*, US Statutes at Large, Vol 28, 53rd Congress, Session II, ch 349 ('US 1894 Act') was submitted to the President on 15 August 1894 and became a law without his approval on 27 August 1894. The income tax was held unconstitutional in *Pollock v Farmers' Loan and Trust Company*, 158 US 601 (20 May 1895, also upholding an earlier decision on 8 April 1895 (157 US 429) which invalidated part of the tax), on the basis that the provisions violated the requirement for apportionment of direct taxation among the states according to population. For a discussion of interpretations of the *Pollock* case, see S McMahon, 'A Law with a Life of Its Own: The Development of the Federal Income Tax Statutes Through World War I' (2009) 7(1) *Pittsburgh Tax Review* 1, 25-28. Some of the comments made in the *Pollock* decision also led to an amendment (prepared by Edmund Barton) of the proposed taxation power in Australia's draft Constitution Bill, to replace a requirement of uniformity in the imposition of taxes with a more general non-discrimination rule: Convention Debates, 3rd Session, Melbourne, 2397 (11 March 1898); referred to in J Quick and R Garran, *The Annotated Constitution of the Australian Commonwealth* ([1901 ed.] Sydney: Legal Books, 1995), 549.

before the successful enactment of the first colonial income tax legislation in South Australia in 1884,[14] without significant debate on this point.[15] Similarly, there is little indication of any serious dispute relating to the implementation of this tax in the period 1884 to 1894-95 when general income taxes subsequently came to be imposed in several of the other colonies. The structure of the Australian Acts may be considered also to suggest a limited policy merely to depart from the UK's system of taxation at the source and assessment by different authorities as opposed to a broadening of the base to include receipts outside the UK concept of income.[16]

Much evidence of an indirect nature from the period, however, does shed light on this issue and points to a broader intention as to the scope of the tax itself. For example, the timing of the Australian taxes in the 1894-95 period[17] is closely associated with the US 1894 tax, in the context of a common experience of serious economic depression. Furthermore, Tasmania's Attorney-General at the time, Andrew Inglis Clark, whose substantial interest in US affairs was an important influence in the development of Australia's federal Constitution, also had a close involvement in Tasmanian taxation policy.[18] The enactment of the Tasmanian tax took place a few years after Clark's visit to the US in 1890 to meet the eminent US jurist Oliver Wendell Holmes Jr. The Australian tax debate had in any event featured its own history of radical tax proposals to that time, such as the policy proposals for progressive land and inheritance taxes by Charles Henry Pearson and Catherine Helen Spence respectively in the 1870s.[19]

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[14] *Taxation Act 1884* (SA), enacted on 14 November 1884.

[15] Harris, *Metamorphosis of the Australasian Income Tax*, above n 7, 81-90.

[16] In this context, the Royal Commission on Taxation of 1920 (William Warren Kerr, chair), in its later rejection of a system of taxation at source, stated that 'The rejection by the United States of America of the system of Taxation at the Source, after a short experience of its disadvantages as applied in America ... seems to justify the doubt we feel as to its applicability to Australia': *Second Report of the Royal Commission on Taxation* (13 April 1922) (Melbourne, Published for the Commonwealth Government by the Government Printer for the State of Victoria, 1922), 84.

[17] *Income Tax Act 1894* (Tas), enacted on 21 August 1894, the *Income Tax Act 1895* (Vic), enacted on 29 January 1895 and the *Land and Income Tax Assessment Act 1895* (NSW), enacted on 12 December 1895.

[18] The key work in relation to the US political and economic system at the time, *The American Commonwealth* by James Bryce, was referred to extensively by the framers of the Australian Constitution; this book cited the influential US tax economists Richard T Ely and Edwin R A Seligman. On the familiarity of other colonial politicians with US law and precedents as part of the moves towards Federation in Australia, see H Evans, 'The Other Metropolis: the Australian Founders' Knowledge of America' (1998) 2 *New Federalist* 30.

[19] See, for example, C Pearson, 'On Property in Land' (1877) 2(6) *Melbourne Review* 129 and C Spence, 'Graduated Succession Duties' (1877) 2(8) *Melbourne Review* 443. Probate duties were enacted in South Australia in 1876 and a limited land tax 'of the traditional English type' in Victoria in 1877: J Smith, *Taxing*

The judicial concept of income in Australia was effectively defined by the Victorian Supreme Court in three cases in 1896. While the decisions in these cases imposed a narrow interpretation of the term income similar to that applicable under the UK legislation, so as to exclude legacies, gifts and *ex gratia* payments, the fact that these amounts had been assessed by the Victorian Commissioner, along with the broader context of the enactment of the Australian legislation, indicates that the adoption of the narrow approach was far from inevitable.

Subsequently, during the second decade of the twentieth century, the enactment of the US federal income tax on a permanent basis in 1913 may have provided an occasion for the Australian interpretation of income to be re-examined. During this period, the approach of the US courts to the concept of income was stated in the leading case of *Eisner v Macomber*, that '[i]ncome may be defined as the gain derived from capital, from labor, or from both combined' (as held in earlier Court decisions), 'provided it be understood to include profit gained through a sale or conversion of capital assets'.[20] Similarly, in 1931 Justice Holmes was to observe, in finding that a gain by a company on the purchase of its own bonds was taxable, that '[w]e see nothing to be gained by the discussion of judicial definitions. The [taxpayer] has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here'.[21]

Popularity: The Story of Taxation in Australia (Sydney: Australian Tax Research Foundation, rev. ed. 2004), 27, 33.

[20] 252 US 189 (8 March 1920) at 207, per Pitney J. See R Krever, 'The Ironic Australian Legacy of *Eisner v Macomber*' (1990) 7(2) *Australian Tax Forum* 191. Note also that in 1914 the New South Wales income tax statute had been extended to deem certain capital gains to be income subject to tax: *Income Tax (Management) Act 1914* (NSW), s 2.

[21] *United States v Kirby Lumber Company*, 284 US 1, 2 (1931). There had been a line of argument in the US in favour of a more limited concept of income, such as the judgment of Learned Hand J in *United States v Oregon-Washington R and Nav Co.*, 251 Fed. 211 (Second Circuit Court of Appeals, 24 April 1918), in which an implied distinction was found in relation to the meaning of income 'between permanent sources of wealth and more or less periodical earnings'. Seligman also favoured a meaning of income that included an 'idea of regularity', provided that income was 'supplemented' by taxation involving other tests of faculty 'in order to form a well-rounded whole': *The Income Tax*, 2nd edn, rev. and enl. (New York: Macmillan, 1921), 17, 20. However, the limited view never gained the acceptance of the US Supreme Court.

By 1920, however, use of US judicial precedents in Australia had been disapproved by the High Court, at least in the constitutional field.[22] Even so, it is notable that in 1942 the High Court was to take a broad view of income for constitutional law purposes, in part by reference to US tax law precedents.[23]

This article is set out as follows:

(a) section 2.3 describes the enactment of the income tax legislation in South Australia in 1884, and in Tasmania, Victoria and New South Wales in 1894 and 1895. The terms of the legislation and background to the introduction of the taxes are examined which provide a substantial indication that a broad application of the taxes was intended;

(b) section 2.4 explains how these taxes were interpreted in the first cases in the Supreme Courts of the then colonies, which (using in many instances flawed or unconvincing reasons) laid the basis for the modern limited concept of "ordinary income", excluding gifts, legacies and capital gains among other amounts;

(c) section 2.5 points out that there was a brief legislative response in Victoria to the cases in 1896. This reversed one element of the precedents which had been set, but an apparent decline in political momentum for the income tax policy meant that the term 'income' was otherwise not amended so that its legal meaning was to be left to the future course of judicial interpretation. Some concluding remarks are also made in this section. The comparison is made of the application of the income tax with the use of US precedents in the interpretation of Australia's federal Constitution after Federation in 1901, in which (until 1920) US authorities were considered by the High Court to be 'a most welcome aid and assistance'.[24]

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[22] *Amalgamated Society of Engineers v Adelaide Steamship Co Ltd* (1920) 28 CLR 129 (*Engineers' case*). A 1917 decision of the High Court discussed further in section 3A below also described the historical background of one particular provision of the Australian colonial taxes (relating to the taxation of imputed rent) in the context of the development of the UK meaning of income on this point, but it is arguably unclear whether this background also extended to the Australian taxes as a whole: *Harding v Federal Commissioner of Taxation* (1917) 23 CLR 119.

[23] *Resch v Federal Commissioner of Taxation* (1942) 66 CLR 198.

[24] *D'Emden v Pedder* (1904) 1 CLR 91.

2.3 The Australian colonial income taxes

2.3.1 South Australia, 1884

Apart from a limited dividend tax included in a Tasmanian measure in 1880,[25] the first Australian income tax legislation was South Australia's land and income tax enacted on 14 November 1884.

The tax debate in South Australia had already considered property taxes on several occasions from 1878, and both a property tax Bill and a land and income tax Bill in schedular form in 1883. Undoubtedly, financial difficulties in the colony were an important motivation and a new government in June 1884 (which had opposed the 1883 Bill) quickly sought to renew these taxation efforts.

At the outset, an opposition Member noted the unfavourable example of the property tax then in force in New Zealand:

> ...[this tax] appeared from all accounts to be working far from well, and might, indeed, be termed a complete failure. [The Member] thought they were too prone to copy ideas from that part of the world instead of themselves originating an idea. In the past we had initiated voting by ballot, and had given to the world the Real Property Act, measures which the world had been proud to copy, and of which we ourselves were justly proud.[26]

The Member went on to note, without reference to the different effects of global and schedular forms of income tax in this context, that 'although an income tax was to a certain extent inquisitorial England had shown us that [the tax] was workable'.[27] The need for repayment of the colony's debt also was highlighted and, in addition to comparison with England in this case, it was suggested that '[w]ith our new taxation scheme [the Member] hoped we should bear America's example in mind – how in sixteen years she had paid off nearly 200 million dollars of her debt'.[28] There was, generally during this period, a substantial flow of visitors and

[25] *Real and Personal Estates Duties Act 1880* (Tas).

[26] J Castine (Wooroora), Debates, House of Assembly, [1884], 995 (16 September 1884). The New Zealand 1879 tax, which appears to have been reproduced in the 1883 South Australian property tax Bill, was itself based on a New York statute: see Harris, *Metamorphosis of the Australasian Income Tax*, above n 7, 52 and 77.

[27] J Castine, Debates, House of Assembly, [1884], 995 (16 September 1884).

[28] J Castine, Debates, House of Assembly, [1884], 996 (16 September 1884).

information between the colonies and the US, involving matters such as trade exhibitions,[29] labour organisations[30] and religion.[31]

The South Australian *Taxation Act* contained some features which reflected the earlier schedular income tax Bill and the UK 1842 Act, such as the Preamble which referred to 'a Tax ... on the Income from Real and Personal Property, Professions, Trades, and Avocations', the inclusion of a land tax in the Act (Part I),[32] and the provision of a three-year averaging rule in the income tax[33] and deduction for 'wear and tear'.[34] A further provision specified that taxable income included imputed rent at the rate of five per cent on land used for 'the purpose of residence or enjoyment', also consistent with the then scope of the income tax under the 1842 UK Act. This provision was considered by the High Court in 1917, Isaacs J noting as follows in relation to the provision (and its counterpart introduced in the later 1895 Victorian Act, when Isaacs J had been Attorney-General in Victoria):

> Was that notion [contained in the provision] peculiar to South Australia and Victoria; or was it not an adaptation by certain Australian Parliaments of the use and connotation of the word 'income' as used by the British Parliament and British Judges for a very long period, a use and

[29] P Hoffenberg, 'Colonial Innocents Abroad? Late Nineteenth-Century Australian Visitors to America and the Invention of New Nations' (2000) 19(2) *Australasian Journal of American Studies* 4, 14.

[30] The Amalgamated Society of Engineers, for example, by the 1890s had 'several thousand North American members and a lesser number in Australia, complete with "American-Canadian" and "Australian" Councils for administration': J Finn, 'Australasian Law and Canadian Statutes in the Nineteenth Century: a Study of the Movement of Colonial Legislation Between Jurisdictions' (2002) 25(2) *Dalhousie Law Journal* 169, 179, citing the UK Royal Commission on Labour, *5th Report* (C7421) (1894), 121.

[31] Notable ministers who visited from the US such as Henry S Earl and Thomas Jefferson Gore gave sermons to large audiences including members of parliament: H Taylor, *The Story of a Century: A Record of the Churches of Christ Religious Movement in South Australia 1846-1946* (Melbourne: Austral Printing and Publishing Co., 1946), 36-39.

[32] Land taxes were part of the earlier origins of the UK income tax: see G Lehmann and C Coleman, *Taxation Law in Australia*, 5th edn (Sydney: Australian Tax Practice, 1998), 11. Furthermore, at least from the late 1880s in the case of New South Wales, colonial land tax policies were also driven in political terms by the single tax on land theories of Henry George set out in *Progress and Poverty* (1879): Dickey, above n 8, 331.

[33] *Taxation Act 1884* (SA), s 12(II); see UK 1842 Act, s 100, Case I, Rule 1 (trade, manufacture, adventure, or concern) and 16 & 17 Vict., c 34 (1853), s 48 (professions, employments, or vocations).

[34] *Taxation Act 1884* (SA), s 13(V). See M Lamb, 'Defining "Profits" for British Income Tax Purposes: A Contextual Study of the Depreciation Cases, 1875-1897' (2002) 29(1) *Accounting Historians Journal* 105, 108, describing the UK reforms in this regard in 1878.

a connotation which has come to us in that connection as part of the English language itself? It appears to me to be the latter.[35]

Significantly, many of the central provisions of the South Australian income tax were very different from the earlier schedular sources and were, in fact, much closer to the model of the US federal income taxes in the Civil War period.[36] The most important of these elements of the Act was the global taxing provision itself, which applied to 'all income derived from personal exertion' and (at a double rate) to 'all income, the produce of property'.[37] The former was defined to 'mean all income arising and accruing from any trade, or consisting of salaries, wages, allowances, pensions, or stipends', and the latter was defined to 'include all income not derived from personal exertion'.[38] Provisions similar to these were ultimately carried to the first Commonwealth income tax Act in 1915.[39] The provisions can also be seen to have retained a residue of the earlier schedular taxes, but (subject to the interpretation of the terms which was to be taken by the courts) the references to 'all income', and 'income' itself, provided the basis for a much broader global form of tax.[40]

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[35] *Harding v Federal Commissioner of Taxation* (1917) 23 CLR 119 at 138. This case involved the issue of whether the Commonwealth 1915 income tax involved more than one 'subject of taxation' in contravention of s 55 of the *Constitution*. While the decision of Isaacs J related to the provision taxing imputed rent, it is unclear whether the approach in the judgment, of 'looking at the English legislation, as well as contemporary speeches, and the subsequent judicial interpretation of the Acts as evidence of the meaning of the word "income" for legislative purposes' (at 141), was applicable to the colonial legislation as a whole. The fact that other colonies did not include the imputed rent provision, said to have been 'a matter of discretion', suggests that this enquiry would in any event not lead to consistent conclusions in all of the Australian jurisdictions. The judgments of Barton ACJ, Gavan Duffy and Rich JJ, while referring to English historical materials, do not appear to have specifically linked the Australian colonial Acts to the UK background.

[36] Act of 5 August 1861, US Statutes at Large, Vol 12, 37th Congress, Session I, ch 45 ('US 1861 Act'); Act of 1 July 1862, US Statutes at Large, Vol 12, 37th Congress, Session II, ch 119 ('US 1862 Act'). The tax was continued under subsequent statutes until discontinued in 1872.

[37] *Taxation Act 1884* (SA), ss 10(I) and 10(II).

[38] *Taxation Act 1884* (SA), s 2.

[39] *Income Tax Assessment Act 1915* (Cth), s 3 and *Income Tax Act 1915* (Cth), s 4 (which also separately charged tax on income of companies).

[40] Note that in more recent times judicial consideration of the meaning of terms such as 'income from personal exertion' generally took place *after* the amounts in question had already been found to be income for tax purposes: see, for example, *Federal Commissioner of Taxation v Dixon* (1952) 86 CLR 540 at 555, per Dixon CJ and Williams J.

A question that may be relevant at this point is whether the reference to 'income' alone in the South Australian Act was meant to be narrower than 'profits' and 'gains', on the basis for example that the US 1861 Act applied to 'annual income'[41] but the US 1862 Act applied to 'annual profits, gains, or income'.[42] The Congressional Debates on this point, however, seem to suggest that this change of wording was directed to the concern to ensure that the tax applied to net gains and not to widen the tax provision.[43] As early as 1842, 'income' had been held in a US precedent to be a gross concept to be applied without reference to the outgoing expenditure.[44]

The tax provisions relating to companies under the South Australian Act can be seen in this light, as seeking to ensure application of the tax on a net concept (whereas the later Tasmanian and New South Wales Acts included a specific definition of 'Income' referring to 'profits' and 'gains'). Under the relevant provision, the taxable amount in respect of 'a company dividing its profits amongst its members in [South Australia]' was to be 'deemed to be the amount of profits so divided, with the addition of any amount of profits carried to any reserved fund or capitalised in any way'.[45] The second part of this rule, relating to capitalised amounts, also appears similar to the US federal tax in 1864, which imposed duties on specified companies in respect of dividends and 'on all undistributed sums or sums made or added during the year to their surplus or contingent funds'.[46] A provision taxing 'gains and profits ... whether divided or otherwise' had also been held by the US Supreme Court in 1871 to include profits 'invested' in assets of the company's business (ie, as 'investments in which the stockholders are interested').[47] These contrasted with the UK legislation, which provided for taxation of

[41] US 1861 Act, s 49.

[42] US 1862 Act, s 90.

[43] Rep Lovejoy noted, for example, that 'some of the best lawyers in the House understand income to be the gross income': *Congressional Globe*, 3 April 1862 at 1532.

[44] *People v Board of Supervisors of the County of Niagara*, 4 Hill 20 (1842), Supreme Court of Judicature of New York (Bronson J).

[45] *Taxation Act 1884* (SA), s 12(XII).

[46] Act of 30 June 1864, US Statutes at Large, Vol 13, 38th Congress, Session I, ch 173 ('US 1864 Act'), s 120.

[47] *Collector v Hubbard*, 79 US 1, 18 (10 April 1871), per Clifford J. Note that the comparable provision of the Victorian 1895 tax also referred to amounts 'invested', while New South Wales required details of amounts added to capital or invested in the business to be lodged in a prescribed form of statement: *Income Tax Act 1895* (Vic), s 9(13) and *Land and Income Tax Assessment Act 1895* (NSW), s 27(II). The US 1894 Act applied to 'any other expenditure or investment' (s 32).

profits and gains of trade with no deduction for 'any Capital withdrawn therefrom; nor for any Sum employed or intended to be employed as Capital in such Trade ... nor for any Debts'.[48]

In conclusion, it can also be noted that the South Australian income tax applied on a source basis to income derived within the colony. As a basis of taxation generally preferred by debtor states,[49] this approach differed from both the US federal Civil War taxes and the UK 1842 tax, although source taxation of income was becoming more common at the state level in the US in the late nineteenth century.[50]

While not conclusive in itself, this background provides substantial evidence that a wide meaning of income was intended to apply under the South Australian Act. Under the US federal Civil War taxes, the Commissioner had determined that gifts of personal property were income.[51] Furthermore, legacies of personal property were taxed under a separate head of duty[52] and subsequently brought within the scope of taxable income in the US 1894 Act.[53] Capital gains were also taxed in the US[54] at least until a decision in 1872 which held that gains on property acquired more than one year previously were not subject to a tax to be levied 'annually upon the gains, profits, and income' of a taxpayer.[55]

Furthermore, the regulations made under the South Australian tax in January 1885 specified that the return of income from personal exertion was to include income from 'buying and selling shares of every description' and 'buying and selling land'.[56] This at least lacks any indication of a limit in the scope of a 'trade' which might be found in relation to these activities. The regulations also specified that returns were to be lodged in respect of the 1884 income year itself,[57] a precedent followed in Victoria[58] and Tasmania.[59]

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[48] UK 1842 Act, s 100, Case I, Rule 3.

[49] See, for example, K Laffer, 'Taxation Reform in Australia' (1942) 18(2) *Economic Record* 168, 169.

[50] E R A Seligman, 'The Taxation of Corporations III' (1890) 5(4) *Political Science Quarterly* 636, 656-660.

[51] Seligman, *The Income Tax*, above n 21, 469.

[52] US 1862 Act, s 111. Note that the US 1862 and 1894 Acts did not expressly tax bequests of land but such bequests were taxed under a separate head of duty in the US 1864 Act.

[53] US 1894 Act, s 28.

[54] *United States v Smith*, 27 Fed. Cas. 1175 (22 August 1870).

[55] *Gray v Darlington*, 82 US 45 (1872). The 1894 tax also excluded gains on the sale of real estate purchased more than two years previously: US 1894 Act, s 28.

[56] *South Australian Government Gazette* (22 January 1885), 210.

[57] *South Australian Government Gazette* (22 January 1885), 205, reg 21.

[58] *Victorian Government Gazette* (14 March 1895), 1020-1021, reg 12.

[59] *Income Tax Act 1894* (Tas), s 14.

In the event, the implementation of the tax appears to have occurred without leading to a significant dispute about the scope of the tax, subject only to a decision by the government in 1887 to increase the tax on companies by bringing this income within the more highly taxed property income category.[60] Much more significant developments were to occur, however, in the implementation of the income taxes in Australia introduced in 1894 and 1895.

2.3.2 Tasmania, 1894

The early 1890s saw a serious economic depression throughout the colonies which had a significant impact on colonial government finances.[61] The issue of income taxation was also returning to the forefront of political debate in the US following the election in 1892.[62] By mid 1894, there was a clear awareness in the US and Australia of tax policy developments in both countries: Catherine Helen Spence, for example, included reference to the need for 'more equitable taxation' in her New York article 'An Australian's Impressions of America',[63] while *The Bulletin* reported favourably on the contrast between the New Zealand direct tax policy and America's protective tariff.[64]

An income tax Bill had been rejected in Tasmania in 1893, which drew on the structure of the New Zealand income tax statute,[65] and also on the South Australian Act and a New South Wales Bill from 1893 which had both moved from taxing 'profits' and 'gains' to taxing 'income'.[66] Subsequently a further Bill was introduced by the Dobson government in March 1894 which would ultimately become the *Income Tax Act 1894*. At that time, Treasurer John Henry stated in relation to the Bill that:

> [t]o a considerable extent Ministers had followed the English formula, excepting that whilst in England no distinctions were made between incomes derived from personal exertion and those from realised wealth, the Ministry had recognised the necessity for making such a distinction.[67]

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[60] *Taxation Act Amendment Act 1887*, s 3.

[61] See, for example, G Patterson, *The Tariff in the Australian Colonies 1856-1900* (Melbourne: Cheshire, 1968), 159.

[62] Brownlee, above n 8, 46.

[63] 89 *Harper's New Monthly Magazine* 244, 251 (July 1894).

[64] 25 August 1894, 6-7.

[65] Harris, *Metamorphosis of the Australasian Income Tax*, above n 7, 127.

[66] Ibid, 118, 127.

[67] Debates, Assembly, 15 March 1894, *The Mercury* (16 March 1894), 3.

However, the inquisitorial nature of the tax and its effect of driving away capital from the colony were also criticised, and it was noted that '[i]t was useless to compare the imposition of the tax in England with that in Tasmania'.[68]

Before the Bill was enacted, a change of government occurred in April in which Edward Braddon became Premier, Philip Fysh was appointed Treasurer and Andrew Inglis Clark returned to the role of Attorney-General. Fysh had gained familiarity with the UK income tax during a visit to that country in 1878-79.[69] Subsequently, however, between 1887 and 1892 Clark as Attorney-General in the Fysh government had played a major role in the taxation initiatives of that period:

> ... Clark was knowledgeable in taxation and had a strong interest in further reforming the revenue laws. He may not have been the main formulator of new taxation proposals that the Ministry advanced, though from their content and his attitudes it is difficult to think he did not have a strong hand in them...[70]

It appears in this context that Clark was concerned to bring about 'a tax system on "a new and fairer basis"' that 'should above all be "equitable"',[71] but had 'strong objections'[72] to income taxation 'reiterated ... many times in his public career',[73] on grounds of both policy and administration: '[a]t least it can be said in favour of his view that equitable collection of a full income tax would at that time have been extremely difficult in the Colony with its small, scattered population and poor communications'.[74] By 1897, he expressed support for 'a

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[68] J Hamilton, Debates, Assembly, 15 March 1894, *The Mercury* (16 March 1894), 3.

[69] See Tasmanian Treasury, 'From responsible government to federation: 1856-1900, Background Information', available at: http://www.treasury.tas.gov.au/domino/HistoryW.nsf/f78b431e6c6819acca256eb400092326/b349a422d62d440bca256ebc00059a8e?OpenDocument (accessed on 13 February 2010). Fysh had previously also been Treasurer in the Kennerley Government which had been unsuccessful in its effort to enact an income tax in 1873.

[70] F Neasey and L Neasey, *Andrew Inglis Clark* (Sandy Bay, Tas: University of Tasmania Law School, 2001), 81.

[71] S Petrow, 'Andrew Inglis Clark as Attorney-General', in R Ely (ed) with M Haward and J Warden, *A Living Force: Andrew Inglis Clark and the Ideal of Commonwealth* (Hobart: Centre for Tasmanian Historical Studies, 2001), 36, 45, citing *The Mercury*, 8 June and 21 July 1888.

[72] Petrow, above n 71, 45.

[73] Neasey and Neasey, above n 70, 82.

[74] Ibid.

universal tax on all forms of wealth'.[75] While his views on the desirability of an income tax specifically did not prevail, Clark appears to have had a substantial influence on the general direction of Tasmanian tax policy at the time of enactment of the 1894 Tasmanian income tax. At the date of enactment of the tax on 21 August 1894, moreover, the US 1894 Act was apparently on President Cleveland's desk awaiting his signature.

Somewhat ironically, given his initial opposition to the income tax, Clark would later (as a Justice of the Supreme Court of Tasmania from 1898) decide a number of income tax cases. These included a judgment on a specific provision relating to calculation of tax payable by a company,[76] and a decision that, based on the use of the term 'allowance' in the UK *Bankruptcy Act*, a regular monthly gift over a period of ten years was an 'allowance' within the definition of the term 'income from business' under the *Income Tax Act 1902* (Tas).[77] More generally, after Federation a judgment of Clark J distinguished a US precedent[78] so as to find that the income tax did not contravene the requirement for free trade between the States under the Constitution.[79]

In terms of the provisions of the Tasmanian Act, the form of the key taxing provision of the South Australian 1884 Act was reproduced to a large extent, with the variation that, in addition to imposition of tax on 'all Income derived from Personal Exertion' and 'all Income the produce of Property', the Tasmanian provision also applied tax separately to 'all Income of any Company'.[80] The Tasmanian Act also included a separate definition of 'Income', which provided that that term 'includes profits, gains, rents, interest, commission, dividends, salaries, wages, allowances, fees, pensions, stipends, charges, and annuities'.[81] This provision, also included in similar form in the later New South Wales Act (without the words 'commission', 'dividends' and 'fees'), thereby retained some terminology from the earlier schedular Bills, but also ensured inclusion of the net concepts of 'profit' and 'gain' which had been found in the provision of the South Australian Act taxing companies on divided profits.

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[75] Petrow, above n 71, 45, citing *The Mercury*, 5 January 1897.

[76] *Re Mount Lyell Mining and Railway Company Limited* (1899) 1 N&S 118 (a concurring decision with Dodds CJ and McIntyre J).

[77] *Re Anonymous* (1905) 1 Tas LR 116.

[78] *McCall v California*, 136 US 104 (1890).

[79] *In re the Australasian Automatic Weighing Machine Company* (1905) 1 Tas LR 112.

[80] *Income Tax Act 1894* (Tas), ss 14(I)-14(III).

[81] *Income Tax Act 1894* (Tas), s 4.

A notable difference of the Tasmanian Act from the tax in other colonies was the application of the tax to foreign source amounts 'received in' the colony,[82] a rule which was a feature of the UK 1842 Act.[83] The enforcement against businesses in other colonies of a further provision of the Act relating to taxation of agency sales[84] also drew comment in the London press,[85] one of many implementation problems[86] which was to see the tax suspended (except in respect of dividends) between 1897 and 1902.

2.3.3 Victoria, 1895

The Victorian income tax, which followed shortly after the Tasmanian Act, provided the most significant basis for the development of Australia's judicial concept of income. The period since 1856 had already seen legislation in Victoria in a range of areas, the enactment of which featured prominent discussion of the American experience. These areas included, for example, 'land policy, immigration, tariffs, railway construction and education, as well as miscellaneous issues like state aid to religion, temperance (Maine), votes for women (Wyoming), irrigation, agricultural colleges, dog and gun licensing'; it was nevertheless noted in this context that admiration of the US example 'was not always clearly reflected in the text of the legislation passed' and further that, as a result of assimilation of the ideas 'to local legal and administrative traditions and to peculiar local pressures', the American source was 'often obscured'.[87] Victoria's tariff between 1880 and 1892 was also described shortly after that period as 'quasi-American'.[88]

Press reports in Melbourne during the debate of the Budget of the Patterson government in August 1894 also discussed the moves to introduce income taxation in the US at that time.[89] A commentary from the UK in October on the tariff in the US 1894 Act also provided a forewarning, however, of a political move away from the liberalising policy in that Act, in an

[82] *Income Tax Act 1894* (Tas), s 14.

[83] Harris, *Metamorphosis of the Australasian Income Tax*, above n 7, 110.

[84] *Income Tax Act 1894* (Tas), s 23(X).

[85] 'New Taxation Projects in Australia', 53 *The Economist* 42, 43 (12 January 1895).

[86] See I vanden Driesen and R Fayle, 'History of income tax in Australia', in R Krever (ed.), *Australian Taxation: Principles and Practice*, above n 11, 27, 27-29.

[87] N McLachlan, '"The Future America": Some Bicentennial Reflections' (1977) 17(68) *Historical Studies* 361, 381.

[88] W Reeves, 'Protective Tariffs in Australia and New Zealand' (1899) 9 *Economic Journal* 36, 39.

[89] See, for example, *The Argus* (8 August 1894), 4 and *The Australasian* (11 August 1894), 241.

observation that 'all the signs seem to point to a reaction towards Protection in 1896'.[90] This development was also perhaps suggested by the landslide change of government in US Congressional elections in November 1894.

Following the defeat of the Patterson government in Victoria at an election in September 1894, the incoming Turner government introduced a land and income tax Bill on 7 December 1894.[91] This Bill contained elements from the New Zealand income tax Act and an earlier unsuccessful Victorian income tax Bill in 1893 which had been 'essentially a more detailed version' of the South Australian 1884 Act.[92] A press report at this stage also noted that 'Victoria was greatly indebted to the Government of New Zealand for having offered to lend us the commissioner of taxes of that colony to show our taxers - the treble taxers - how to oppress the people most effectually'.[93]

The land and absentee tax proposals contained in this latest Bill would ultimately be blocked by Victoria's Upper House, leaving[94] a free-standing 'Act to Impose a Tax on Income', in a modern global form at progressive rates. One difference can be noted from the income taxes of the other colonies, namely the decision to exempt locally-based companies from the tax so as to bring the dividends of such companies to tax in the hands of shareholders at the progressive tax rate on property income applicable to those taxpayers.[95]

The enactment of Victoria's income tax was reported in the New York press,[96] and US academic commentary emphasised the progressive character of the reform, in the observation that '[w]hatever conservative influences may have determined the course of English legislation at home, in the colonies the radical element of modern industrial democracy has had

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[90] 'The New American Tariff', 156 *Blackwood's Edinburgh Magazine* 573 (October 1894).

[91] Debates, Assembly, Vol 75, 879.

[92] Harris, *Metamorphosis of the Australasian Income Tax*, above n 7, 122. An earlier 1876 Victorian Bill had also been drawn on a schedular basis so as to apply to land, and also to 'annual gains or profits' from property, from 'any profession, trade or vocation' or from 'any source of income arising elsewhere than Victoria': ibid, 40-41.

[93] 'The Taxation Proposals, Growing Feeling of Discontent, Defeat Probable', *The Argus* (12 November 1894), 5.

[94] Following re-introduction of a new Bill on 15 January 1895: Debates, Assembly, Vol 76, 1593.

[95] *Income Tax Act 1895* (Vic), s 2. The US 1864 Act was based on conduit taxation of corporations, and the Commissioner had made efforts under the US 1862 Act (which contained graduated rates) to assess dividend income of individuals at the higher applicable rate: S Bank, *From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present* (New York: Oxford University Press, 2010), 14, 21-22.

[96] 60 *The Nation* 83 (31 January 1895).

comparatively free swing'.[97] It was also suggested that 'in the methods adopted there is a strange mixing of distinct and incompatible purposes which is likely to give rise to unexpected consequences and new difficulties'.[98] This view would be borne out in the events that followed in the implementation of the Victorian income tax and the decision of the Victorian Commissioner (from February 1895, Thomas Prout Webb) to assess legacies, gifts and *ex gratia* payments, a decision which does not appear to have been constrained by a contrary South Australian practice or precedent, or any view that a limited scope of taxable income had been intended.

2.3.4 New South Wales, 1895

As in the other colonies, New South Wales had already seen efforts to introduce income taxation on a number of occasions by the time an election in July 1894 brought George Reid to office as Premier, on a platform that included income and wealth taxation.

The tax debate throughout 1894 canvassed issues of social justice and economic reform,[99] while comparisons were also made in Parliament with tax policy in New Zealand. It was argued in this context that greater reliance on indirect taxation may have been appropriate as New Zealand had retained customs duties in conjunction with 'a tax upon incomes, professional and otherwise, a tax upon absentees, and a tax upon land' so as to 'reach all classes'.[100] It was stated in response, however, that:

> That is exactly what is proposed here – to impose direct taxation so that those who derive most benefit from the country, but who contribute nothing to the cost of its government, may be called upon to pay their fair share.[101]

The political debate on economic policy and free trade continued in early 1895, at which stage another Member critical of direct taxation pointed to the outcome of the US Congressional elections in November 1894 to support greater protectionism. Perhaps

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[97] 'Notes', 3(2) *Journal of Political Economy* (March 1895), 220. This Note also set out the detail of the Victorian tax proposal (including the land and absentee taxes) as reported in *The Economist* article in January 1895, referred to at n 85 above.

[98] 'Notes', 3(2) *Journal of Political Economy* (March 1895), 221.

[99] Dickey, above n 8, 334.

[100] E O'Sullivan (Queanbeyan), Debates, Assembly, Vol 74, 2757 (27 November 1894).

[101] S W Moore (Bingara), Debates, Assembly, Vol 74, 2760 (27 November 1894).

ironically, it was suggested in this regard that '[i]f we follow the example of America, we shall be on safe lines'.[102] After a further election in July 1895, which returned Reid in a coalition government, a number of compromises on the land and income tax Bill allowed its enactment in December of that year. The outcome was, nevertheless, 'a symbol of radicalism as everyone understood it'.[103]

The New South Wales income tax contained some differences from the South Australian and Victorian model. The tax was imposed at a flat rate, without distinction between personal exertion and property income. The tax applied in respect of:

(i) income '[a]rising or accruing to any person wheresoever residing, from any profession, trade, employment or vocation carried on in New South Wales, whether the same be carried on by such person, or on his behalf, wholly or in part by any other person';

(ii) certain New South Wales public service salaries, allowances and pensions;

(iii) income derived from Crown land; and

(iv) income from property and 'from any other source whatsoever in New South Wales'.[104]

The Assessment Act also included a definition of 'Income' so as to include 'profits', 'gains' and other amounts[105] along the lines of the comparable provision in the Tasmanian 1894 Act. In contrast to the Tasmanian Act, however, there was no definition of the term 'trade' so as to include a business generally.

With the enactment of the New South Wales Act, the main part of the long-running political battle in the colonies to introduce income taxation reached its conclusion.[106] The stage was also set for the question of the scope of taxable income to move to the Australian courts.

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[102] J See (Grafton), Debates, Assembly, Vol 77, 6551 (29 May 1895).

[103] Dickey, above n 8, 344.

[104] *Land and Income Tax Assessment Act 1895* (NSW), ss 15(I)-15(IV). The New South Wales Act included reference to both 'income' and 'incomes'. The tax was imposed on 'all incomes exceeding two hundred pounds per annum' in s 15 under the specified heads, while the 'taxable amount' was also defined in the Act to be 'the total amount of taxable income ... from all sources' (s 27(6)). The statutes in the other colonies and the US also used 'incomes' in some provisions.

[105] *Land and Income Tax Assessment Act 1895* (NSW), s 68.

[106] General income taxation in Queensland and Western Australia would occur after Federation, in 1902 and 1907 respectively.

2.4 The scope of the tax base in the courts

Unlike the South Australian Act, the later colonial income tax Acts arrived in the courts almost immediately after their enactment.

A relevant point to note in relation to colonial Supreme Court cases was that the decisions were subject to appeal to the Privy Council in London. This would not have meant an inevitable application of an interpretation of the income taxes along the lines of the approach taken to the UK 1842 Act. For example, in an appeal in 1900 involving the source rules under the New South Wales Act, the Privy Council recognised that the UK income tax legislation differed from the colonial Act 'in language, and to some extent, in aim'.[107] Nevertheless, the Privy Council[108] (arriving at a conclusion similar to that of an earlier Victorian Supreme Court decision[109]) and the High Court[110] were later to take divergent views as to whether the US 1819 case of *McCulloch v Maryland*[111] should be applied in relation to the constitutional issue of intergovernmental immunities in Australia (it has been suggested in relation to this issue that 'there was something to be said for the view that an opinion tailored for America in 1819 was not necessarily appropriate to Australia in 1904'[112]).

In this context, however, the Tasmanian Act at least appears to have made a promising start, as the Supreme Court in the *Income Tax Appeals* of 14 January and 11 March 1895 found gains on the value of shares to be taxable on an accruals basis. This applied on the basis of the difference between the 'value or market price on the first day of the year and the price realized during the year; and the appreciation and depreciation of shares during the fiscal year should enter into that years estimate of income as any other mercantile stock in trade, this applying not only to a regular sharebroker, but also the occasional dealer'.[113] These findings appear, however, to have been reversed by legislative amendment in October 1895.[114]

The reception of the Victorian income tax into the Supreme Court of that colony in 1896 was not nearly so favourable. Three cases in particular in that year took a narrow view

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[107] *Commissioners of Taxation v Broken Hill Proprietary Co.* (1900) 21 NSWR 154 at 157, per Lord Davey (also reported as *Commissioners of Taxation v Kirk* [1900] AC 588).

[108] *Webb v Outtrim* (1906) 4 CLR 356.

[109] *In re Income Tax Acts (No 4)* (1902) 28 VLR 357 (*Wollaston's case*).

[110] *Deakin and Lyne v Webb* (1904) 1 CLR 585.

[111] 4 Wheat. 316.

[112] C Howard, *Australian Federal Constitutional Law*, 3rd edn (Sydney: Law Book Co., 1985), 147.

[113] *Tasmanian Digest 1856-1896*, col. 46.

[114] *Income Tax Act 1895* (Tas), ss 7 and 8.

of the scope of the legislation which set the future course for Australia's limited judicial concept of 'ordinary income'.

The Victorian Commissioner's assessment of a legacy in money received by the next-of-kin of an intestate was held invalid by the Full Court in the case of *In re Everitt* on 20 February 1896.[115] While a unanimous decision in the result, the judgment of Chief Justice Madden appears to have been treated as a dissent at least in relation to one finding,[116] namely the conclusion in relation to the Act that because the definition of income from personal exertion referred to amounts derived from the taxpayer's 'own personal exertion', therefore income from property must also be taken to refer to amounts derived from a taxpayer's own property. This finding would be overturned by a specific legislative amendment in December 1896 (following a political debate about the income tax treatment of legacies which had emerged in mid-1895),[117] but it is not clear how far the reasoning involved was necessary in the meantime to the finding by the Chief Justice as to the application of the *Everitt* case in the subsequent case of *In re Paterson* discussed below. In any event, Madden CJ concluded that '[a] person who receives a lump sum by the kindness of another, is not to be treated as receiving income the result of personal exertion or the produce of property', and also that 'Acts imposing a burden on the subject should be construed strictly'.[118]

The other Justices in *Everitt* reached the same conclusion that the legacy was not taxable. Justice Holroyd found that a legacy was 'uninvested capital' and that 'in considering questions of this kind, we must bear this in mind, that the Legislature did not intend to tax capital and income, and did not intend to tax income twice over'.[119] A'Beckett J concluded that 'I wish to avoid expressing a further opinion as to what "income derived from the produce of property" may include, but I feel that these words cannot in any sense include a sum of money derived from the produce of property within Victoria coming to the next-of-kin of an intestate'.[120]

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[115] (1896) 21 VLR 481, 2 Argus LR 33 (Madden CJ, Holroyd and A'Beckett JJ).

[116] See the comment in Parliament by Premier Turner that '[h]e was told by a gentleman who was in the court at the time that [the other Judges] dissented from the Chief Justice's reading of the sections': Debates, Assembly, Vol 84, 4406 (15 December 1896).

[117] See section 2.5, *Concluding remarks*, below.

[118] (1896) 21 VLR 481 at 487.

[119] (1896) 21 VLR 481 at 488.

[120] (1896) 21 VLR 481 at 488.

No reference appears to have been made to the issue of whether the amount involved in the *Everitt* case had separately been subject to probate duty.[121] Although wage receipts were also subject to (nominal) receipts duty in Victoria at the time,[122] an open question is whether the separate tax treatment of bequests may also have provided grounds for a narrow implied exclusion of all or some of these amounts from the income tax, along the lines of the judgment of A'Beckett J which did not express an opinion on excluding all capital amounts from the concept of income.

The case of *In re Paterson* involved a gift of money received by a taxpayer from his mother and was decided in favour of the taxpayer by Madden CJ on 12 June 1896.[123] At this point, reference to the UK judicial interpretation of the phrase 'salary or income' in the *Bankruptcy Act 1869* appears to have entered into argument. In the result, the Chief Justice found that, while the case *Ex parte Wicks*[124] 'could not be said to rule the present case because it was upon an entirely different Statute', the 'principle of that decision' was nevertheless 'very much in evidence in the present case'.[125] Despite the different approaches taken by the members of the Court in the *Everitt* case, the decision in *Everitt* was also interpreted as supporting the view that 'the Legislature was aiming at income arising out of capital of some sort, whether in the shape of property or the capacity for personal exertion, and did not mean income in the wide generic sense of the term',[126] and as a result that 'the word "income" was not to be too rigidly interpreted, because the term, according to its popular use, embraced many ramifications which it could not have been the intention of the Legislature to include'.[127]

The most significant finding in this case, however, may be considered to be the further conclusion that, because the definition of income from personal exertion referred to amounts which 'all indicated ordinarily recurring payments derived as of right', therefore income from personal exertion and income from property should both be interpreted the same way, so as to refer to 'regularly recurring amounts' excluding 'a lump sum or gift coming by chance to the

[121] *Administration and Probate Act 1890* (Vic), Part V, which covered real and personal property and provided a 50 per cent concession for certain bequests under an intestacy (s 116).

[122] *Stamps Act 1892* (Vic), schedule Item VII. Gifts under deed were also subject to duty (Item VIII).

[123] (1896) 2 Argus LR 152.

[124] (1881) 17 Ch D 70 (Court of Appeal). In this decision, a voluntary allowance to a debtor was found not to be 'income' for the purposes of the *Bankruptcy Act*.

[125] (1896) 2 Argus LR 152 at 153.

[126] (1896) 2 Argus LR 152 at 152.

[127] (1896) 2 Argus LR 152 at 153.

taxpayer'. This reasoning is flawed and in any event gives no weight to the definition of income from property in the Act as 'all income ... not derived from personal exertion'. Nevertheless, this conclusion (as opposed to the then popular meaning of income) appears to have been the basis for the element of regularity in the legal view of income which has continued to the present.

The third significant decision in that year was *In re A.B.*, a judgment of Williams J dated 10 August 1896.[128] This case involved a recurring gratuity paid by a company to the widow of a company officer. The decision to make the payment was embodied in the Articles of Association of the company and the amount was expressed to be payable quarterly for a period of ten years from 1891. The case featured more extensive argument in relation to the UK bankruptcy cases, in which the Commissioner noted that the decision in the case *In re Huggins*[129] had not depended on a finding of an enforceable right to the payment in that case. The decision by Williams J in this case was, however, based on a separate, and again flawed, view. This was that because the Victorian income tax Act did not tax local companies directly on their income (but instead taxed dividends of such companies in the hands of shareholders), therefore an *ex gratia* payment received by a taxpayer also should not be found taxable merely to make up for what was considered to be a *casus omissus* in the Act. The payment from the company represented profit 'given away' which 'ought to be taxed as against the Company'.[130]

In this way, after the first years in operation, the Victorian income tax was left with a much narrower application than it might otherwise have had. Furthermore, one element that was missing from the findings of the Court was an explicit statement that the Victorian legislature had merely intended to follow the judicial interpretation of the UK 1842 Act. Instead, several much less convincing arguments were employed. As a result, the 1896 decisions might be considered good examples of the cases referred to by Justice Holmes, which involve 'some accident of immediate overwhelming interest which appeals to the feelings and distorts the judgment. These immediate interests exercise a kind of hydraulic pressure which makes what previously was clear seem doubtful, and before which even well settled principles of law will bend'.[131]

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[128] (1896) 2 Argus LR 199.

[129] (1882) 21 Ch D 85, 51 LJ Ch 935. The *Huggins* case involved a pension which depended on an annual legislative vote, Jessel MR holding (at 92) that '[t]he word "income" is as large a word as can be used'.

[130] (1896) 2 Argus LR 199 at 201.

[131] *Northern Securities Co. v United States*, 193 US 197, 400-401 (14 March 1904).

2.5 Concluding remarks

Victoria's legislative response in 1896 to the *Everitt* case, although couched in restricted terms, also provides a notable discussion of the intention in relation to the original income tax measure. The 1896 amendment provided that income the produce of property was to 'be deemed to have included and shall include income of the taxpayer although the same has not been derived from his own property' (with a corresponding amendment in relation to the meaning of income from personal exertion).[132]

The Victorian Commissioner's decision to assess legacies, along with endowment policies of assurance maturing in 1894, appears to have come to the attention of the Legislative Council as early as 30 July 1895. The government was questioned at this stage as to its intention at the time of enactment of the income tax (including whether legacies should be subject to both income tax and probate duty) and whether it would 'take steps to make legacies and such policies free of income tax';[133] these questions hinted at the political trouble to come.

The Solicitor-General's reply at this stage was that '[a]s to what was the intention of Parliament in passing an income tax measure, he could only say that the intention of Parliament was to be found in the words of the Act' and further that '[i]f, according to the law in England, legacies were subject to income tax, then the framers of the Victorian Act probably had the English legislation before them'.[134] It was speculated that a yearly payment under a bequest should be considered income, but he otherwise declined to comment on a matter which was *sub judice*.

The issue returned to the Council with a motion on 27 August 1895 to declare that, in the opinion of the Council, tax should not be charged on legacies and matured life assurance policies. It was suggested at this point that the Solicitor-General's previous explanation on the issue had been 'rather vague',[135] and that while the Commissioner's approach 'might be technically and legally correct ... it was certainly never the intention of Parliament that legacies ... should be subject to income tax'.[136] It was added that as the original Bill had been rushed '[t]here was no doubt that in the Council the Bill did not receive that attention which so important and novel a taxation measure deserved', so that 'Honorable members were perfectly

[132] *Income Tax Act 1896* (Vic), s 4.

[133] T Wanliss, Debates, Council, Vol 77, 1199.

[134] H Cuthbert, Debates, Council, Vol 77, 1199.

[135] T Wanliss, Debates, Council, Vol 78, 1609.

[136] C Ham, Debates, Council, Vol 78, 1618.

justified in saying that the Council had not the slightest idea or intention of making legacies taxable, and that they unintentionally passed a law that went a great deal further than they intended'.[137]

An amending Bill introduced on 8 December 1896[138] was limited to overriding the comments of Madden CJ on the one point of interpretation in *Everitt* and not to varying the majority decision in the case that legacies were not taxable. Premier Turner made a detailed explanation at this stage, stating that the result (in the absence of the amendment) that a yearly payment to a family member would not be taxable 'clearly was not the intention of Parliament'.[139] However, in response to claims that the particular legacies and gifts considered in the cases to that stage would become taxable as a result of the amendment, it was stated in precise terms that '[t]hat is not the intention'.[140] The Premier otherwise disputed the need to exclude such amounts expressly, stating that '[t]he word 'income' will still have its legal meaning' but further that 'I could not specify everything. If I were to attempt to do so I might leave out some item of importance'.[141]

As a result, while the limited nature of the amendment seems to reflect a loss of political momentum for the income tax measures, the debates on the amendment were significant in not answering the question of what the intention as to legacies had been at the outset, and also in leaving the meaning of the term 'income' generally to the future course of judicial interpretation.

In any event, after the enactment of the 1896 amending Act, further court decisions followed which also took a narrow view of the concept of income. For example, capital gains were held not to be income,[142] and capital losses[143] and outgoings[144] not to be deductible. The early income tax cases led to the following notable statement in 1901 as to the meaning of 'income' for Australian tax purposes:

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[137] F Sargood, Debates, Council, Vol 78, 1618.

[138] Debates, Assembly, Vol 84, 4124.

[139] Debates, Assembly, Vol 84, 4394 (15 December 1896).

[140] Debates, Assembly, Vol 84, 4394.

[141] Debates, Assembly, Vol 84, 4407 (15 December 1896).

[142] *In the Matter of the Income Tax Acts (No 4)* (1899) 25 VLR 679 (Madden CJ, Holroyd and Hood JJ). See also *Mooney v Commissioners of Taxation* (1905) 3 CLR 221 (Griffith CJ, Barton and O'Connor JJ).

[143] *Foreman v Commissioners of Taxation* (1898) 19 NSWR 197 (Darley CJ, Stephen and Cohen JJ).

[144] *In re the Income Tax Acts (No 5)* (1902) 28 VLR 431 at 433 (Madden CJ, Holroyd and A'Beckett JJ).

> Primarily 'income' means everything that comes in, but the Court has placed certain limitations on that meaning. The first limitation is that it shall not include moneys received by accident, such as gifts. The second is that to be taxable it must be in its nature probably recurring – something that would happen yearly. These limitations would exclude a legacy, or the value of a gold mine discovered by an owner on his land, or money received for the sale of property for an increased price, but if the owner worked the mine any profit so received would be taxable. If a man, not a horse-dealer, were to receive money for the sale of a horse, that would not be taxable, but if he were frequently to buy and sell a number of horses the profits might be income liable to tax, although not made in his regular business.[145]

In conclusion, in contrast to the approach taken in tax cases, the High Court took a favourable view of US precedents in the constitutional field at least until 1920.[146] It is significant, however, that even after this time, a decision in which the High Court took a broad view of 'income' for constitutional law purposes[147] was arrived at in part by reference to US tax precedents,[148] and also to the 1882 UK case of *In re Huggins*[149] (which had been relied upon unsuccessfully by the Commissioner in the 1896 Victorian Supreme Court case *In re A.B.*). These cases illustrate how close a broad view of the meaning of income for tax purposes also came to being established in Australia at the time that the income tax laws were first introduced.

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[145] *In re the Income Tax Acts (No 2)* (1901) 27 VLR 39 at 41-42, per Hood J. See also *Scott v Commissioner of Taxation* (1935) 35 SR (NSW) 215 at 219 (per Jordan CJ) in which it was observed that '[t]he word "income" is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind...'.

[146] See nn 22 and 24, above.

[147] *Resch v Federal Commissioner of Taxation* (1942) 66 CLR 198 involving the meaning of the 'one subject of taxation' for the purposes of s 55 of the *Constitution*.

[148] *Resch v Federal Commissioner of Taxation* (1942) 66 CLR 198 at 225 per Dixon J.

[149] (1882) 21 Ch D 85, 51 LJ Ch 935, referred to in *Resch v Federal Commissioner of Taxation* (1942) 66 CLR 198 at 213 per Starke J.

Chapter 3

The Development of Centralised Income Taxation in Australia, 1901–1942

3.1 Introduction

> *This is trenching on the doctrine of Unification, but the whole development of commerce, business, and finance throughout the world tends today towards centralization.*[150]

> *The Federal Government ought to resist the tendency to be loaded up with duties which the States should perform. It does not follow that because something ought to be done the National Government ought to do it.*[151]

The national government's takeover of the income taxes of Australia's States in 1942 was one of the most significant events in the history of Australia's federal system of government. While expressed at the time to be a wartime measure only, centralised income taxation has remained in place in Australia to the present day, and, along with the exclusive imposition of the goods and services tax also at the national level, accounts for the very high degree of vertical fiscal imbalance in Australia compared to most other major federal countries.

This chapter highlights the key steps in the centralisation of direct (income) tax and indirect taxation in Australia in the first half of the twentieth century. The chapter also identifies a range of factors that led ultimately to the takeover of the income tax field by the central government in 1942 and, importantly and in contrast to other jurisdictions such as Canada which also saw a consolidation of taxing power at the central government level during the war, the continuation of a centralised system after the War.

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[150] W Finlayson (Brisbane), *Commonwealth Parliamentary Debates*, House of Representatives (CPDHR), Vol 78, 6223–6224 (27 August 1915).

[151] President C Coolidge, Address to the College of William and Mary, Williamsburg, Virginia (15 May 1926), quoted by H Gregory (Swan), CPDHR, Vol 152, 1366–1367 (28 October 1936).

Different protagonists stand responsible for Australia's unique revenue centralisation and consequent level of vertical fiscal imbalance. The shift of indirect taxation to the central government is mostly attributable to the judiciary, which in a series of judgments that follow through until recent times progressively narrowed the States' tax bases by characterising various State levies as 'excise' taxes, reserved exclusively to the national (Commonwealth) government. The broad interpretation of excise taxes to encompass charges far outside the conventional understanding of the term stands in stark contrast to, say, the work of the Canadian Supreme Court to ensure tax bases for Canadian provinces in a not dissimilar constitutional division of taxing rights. By means of a creative interpretation of the term 'direct taxes', the Canadian Supreme Court allocated to provinces many levies, including sales tax, that clearly fall outside the scope of direct taxes as the term is understood in economic and, outside Canada, legal circles.[152]

The shift of income taxes to the Commonwealth, in contrast, is entirely the work of the federal government, albeit endorsed after the fact by the country's High Court. The appropriation of State taxing powers by the central government in the midst of the Second World War is usually explained as a short-term response to war-time fiscal needs and economic imperatives that for a variety of reasons remained in place following the end of hostilities until today. A closer look at the political and economic struggles in Australia in the preceding decades, however, suggests the most important reasons for the move involved Australia's institutional response to the emerging views worldwide about the importance of economic management at the national government level, and the establishment of sufficient fiscal and constitutional powers at that level to be able to carry out that role.

3.2 The introduction of federal income taxation in Australia

3.2.1 The emerging issue of control of the economy

The Commonwealth government's first serious forays into national economic management following Federation involved first a move to regulate interstate trade and commerce and second an attempt to control the problem of monopolies smothering efficient competition. A newly appointed High Court viewed federal intervention in the economy with scepticism and

[152] *Atlantic Smoke Shops, Ltd. v Conlon* [1943] AC 550. For discussion of this case and the direct-indirect tax distinction, see A Schenk and O Oldman, *Value Added Tax: A Comparative Approach* (Cambridge: Cambridge University Press, 2007), 5–6, citing N Brooks, *The Canadian Goods and Services Tax: History, Policy, and Politics* (Sydney: Australian Tax Research Foundation, 1992), 141.

both initiatives failed. First to go was the Commonwealth's legislative power to regulate employment conditions of State railway employees as part of interstate trade and commerce, struck down by the Court in a 1906 decision setting out a narrow reading of the central government's commerce powers.[153] Three years later, the Court found key elements of the government's anti-trust legislation, modelled directly after the successful US *Sherman Act 1890*, unconstitutional. Even after the outbreak of the First World War, Australian States exercising the legislative power over prices and wages[154] they held as part of their plenary legislative powers as self-governing British Colonies[155] and retained under the Constitution, remained the governments that played the predominant role in social and distributional policy. This would remain the case for the next two and a half decades.[156]

The Commonwealth government's initial response to judicial interpretations restricting its economic powers was to pursue constitutional amendment via national referenda. In the following decade, referendum proposals to grant the central government greater powers over monopolies,[157] trade and commerce,[158] corporations,[159] and industrial matters[160] all failed to pass under the strict constitutional requirements to obtain a majority of the population overall, and also a majority of the population in a majority (four or more) of the six States. The

[153] *Federated Amalgamated Government Railway and Tramway Service Association v New South Wales Railway Traffic Employees Association* (1906) 4 CLR 488 (High Court of Australia) (*Railway Servants Case*).

[154] Wages were the first to be controlled by the Australian Colonies, in the late nineteenth century; extensive price controls, particularly in New South Wales, followed at the outset of the First World War: H Wilkinson, *State Regulation of Prices in Australia: A Treatise on Price Fixing and State Socialism* (Melbourne: Melville & Mullen, 1917), 19. The Commonwealth's power to control prices *in war-time* under the defence power was upheld by the High Court in *Farey v Burvett* (1916) 21 CLR 433.

[155] The powers were not unfettered; see K Booker, 'Plenary Within Limits: *Powell v Apollo Candle*', in G Winterton (ed.), *State Constitutional Landmarks* (Sydney: Federation Press, 2006), 52.

[156] J Smith, *The Changing Redistributional Role of Taxation in Australia Since Federation*, PhD thesis, Australian National University (2002), ch 4.

[157] 26 April 1911 (nationalisation), 31 May 1913 (trusts and nationalisation), 1915 (trusts and nationalisation, withdrawn 4 November), 13 December 1919 (temporary extension of power in relation to trusts, nationalisation), 4 September 1926.

[158] 26 April 1911, 31 May 1913, 1915 (withdrawn 4 November), 13 December 1919 (temporary extension of powers).

[159] 26 April 1911, 31 May 1913, 1915 (withdrawn 4 November), 13 December 1919 (temporary extension of powers), 4 September 1926.

[160] 31 May 1913, 1915 (withdrawn 4 November); also 13 December 1919 (temporary extension of powers) and 4 September 1926.

Commonwealth government's attempts to establish central economic powers through cooperation and negotiation also floundered. A 1915 war-time referendum to provide the Commonwealth with nationalisation powers was withdrawn[161] after agreement had been reached with the States for them to make a referral of the powers to the Commonwealth instead, but in the end only New South Wales followed through with the referral.[162] Weeks after a parallel agreement by the States for the Commonwealth to become sole borrower on overseas markets for all Australian governments for two years to fund its war operations, New South Wales announced its decision not to accede to a specific limit on its borrowings.[163]

3.2.2 Taxation Powers and Vertical Fiscal Imbalance

At the time of Federation, customs duties and income from land sales were the major sources of government revenue. Apart from some detailed constitutional provisions to deal with revenue allocation in the first decade after Federation and the essential requirement of the federal compact that customs and excise duties should become exclusively national imposts, the Constitution included few provisions limiting the scope of taxation by either level of government.

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[161] Then Prime Minister W M Hughes (West Sydney), CPDHR, Vol 79, 7265–7266 (4 November 1915). After the bitterness of the debate on these measures, Hughes 'came to the conclusion that it was inexpedient to introduce this discordant element into the political life of the country': E Scott, *Australia During the War: Official History of Australia in the War of 1914–1918*, 1st edn (Sydney: Angus & Robertson, 1936) Vol XI, 308.

[162] *Commonwealth Powers (War) Act 1915* (NSW), enacted on 21 December 1915: see P Tate SC, 'New Directions in Co-operative Federalism: Referrals of Legislative Power and Their Consequences', delivered at the Constitutional Law Conference, Sydney, 18 February 2005, 6, available at: http://www.gtcentre.unsw.edu.au/sites/gtcentre.unsw.edu.au/files/mdocs/5_PamelaTate.pdf.

[163] Premier W Holman (Cootamundra), *New South Wales Parliamentary Debates*, Assembly, Vol 61, 4108–4109 (1 December 1915). Over half of all New South Wales borrowings in 1915 were expended on railways: Government of New South Wales, *Official Year Book of New South Wales 1916* (1917), 428. The railways were explained at the time to be essential to expansion of the State's wheat yield: Premier Holman, quoted in 'Wheat Yield, Railway Factor', *Sydney Morning Herald* (17 January 1916), 10; the railways have also been shown to have been an 'extremely profitable investment' over the whole period 1853 to 1920: B Davidson, 'A Benefit Cost Analysis of the New South Wales Railway System' (1982) 22(2) *Australian Economic History Review* 127, 144–145. Nevertheless, New South Wales' subsequent decision to proceed with a £2 million bond placement in London on 4 January 1916 led to a 'not unnatural feeling, on the part of the Commonwealth and the five States which were parties to the agreement of November, that their claims were prejudiced': Scott, above n 161, 491–492.

A long-running debate in the lead-up to Federation between 'free traders' (predominantly in New South Wales), favouring a lower federal tariff and greater reliance on direct taxation, and 'Protectionists' was effectively settled in a compromise at a secret Premiers' conference in 1899 that effectively bought off the free-trade camp with a constitutional measure that guaranteed redistribution of three-quarters of Commonwealth customs revenue to the States for 10 years.[164] Numerous prominent figures, including Edmund Barton, Frederick Holder and George Reid, stated views immediately after Federation that the Commonwealth should only resort to direct taxation in an emergency.[165] High federal tariff rates were also immediately established with the Commonwealth's first Tariff Act in 1902.[166]

The other main constitutional provision addressing the imbalance established a permanent mechanism for 'surplus revenue' of the Commonwealth to be returned to the States.[167] A transfer of funds by the Commonwealth to trust accounts of its own instead of their return to the States (associated with the introduction of a Commonwealth old-age pension scheme) was, however, upheld as valid by the High Court in October 1908,[168] a finding which has entrenched the fiscal imbalance ever since.

The transfer of principal tax bases to the central government while State governments retained full power over economic management and social programs meant the new nation almost from day one would face a substantial fiscal imbalance in favour of the new Commonwealth government unless the States alone expanded land and income taxation to

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[164] See C Saunders, 'Vertical Fiscal Imbalance: Constitutional Origins', in D Collins (ed.), *Vertical Fiscal Imbalance and the Allocation of Taxing Powers* (Sydney: Australian Tax Research Foundation, 1993), 55, 60–61. A federal takeover at Federation of the substantial State debts accumulated to that time also did not eventuate, in part through the opposition of the free-traders: C Saunders, 'Government Borrowing in Australia' (1989) 17(2) *Melbourne University Law Review* 187, 189.

[165] Barton had been a prominent opponent of free trade in the Federation debate as a member of the New South Wales Parliament before becoming Australia's first Prime Minister on 1 January 1901; Frederick Holder was Premier of South Australia before being elected to the first Australian Parliament in March 1901 as a member of the Free Trade Party and becoming the first Speaker of the House of Representatives, and George Reid was Premier of New South Wales for a large part of the 1890s as a proponent of free trade and became Australia's fourth Prime Minister in 1904. See the discussion of their comments in the later debate on the Land Tax Assessment Bill 1910: L Groom (Darling Downs), CPDHR, Vol 56, 2605–2606 (6 September 1910).

[166] P Lloyd, '100 Years of Tariff Protection in Australia' (2008) 48(2) *Australian Economic History Review* 99, 122.

[167] *Constitution*, s 94.

[168] *New South Wales v Commonwealth* (1908) 7 CLR 179 (21 October 1908) (*Surplus Revenue Case*).

replace their lost customs duties.[169] Income taxation in some form had already been introduced by all of the Australian States in their capacity as separate British colonies by the time of Federation in 1901[170] and as long as the Commonwealth stayed out of the field, there would be room for increased State reliance on income taxation as a growing source of revenue.

3.2.3 The Commonwealth Moves into the Direct Tax Field, 1910–1915

The initial Commonwealth entry into the direct tax field had no fiscal objective. A progressive land tax to break up large land holdings and facilitate 'closer settlement' was an important plank in the Labor party's 1910 election platform in keeping with political debate in Australia throughout the late nineteenth century, and soon after the election the newly installed Labor government led by Prime Minister Andrew Fisher introduced legislation to adopt the tax.[171] The debate both during the election campaign and afterwards in Parliament was fierce. Critics included the former Prime Minister Deakin and Sir John Forrest, by that stage the last remaining member of the Commonwealth Parliament of the six then colonial Premiers who had attended the secret conference of 1899.[172] Deakin's advocacy in particular was attacked by proponents of the tax as inconsistent with his alleged true views.[173]

While land taxes were used in some States, none had a progressive land tax in place and in this sense the Commonwealth tax did not overlap fully with the State imposts. The political, as opposed to revenue, significance of the overlap that did exist was not lost on critics, however. In the debate in the Senate over the Bill introducing the tax, the primary criticism

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[169] Saunders, 'Vertical Fiscal Imbalance', above n 164, 59–61.

[170] For discussion of the introduction of these taxes, see vanden Driesen and Fayle, 'History of income tax in Australia', above n 86, 27–31; Harris, *Metamorphosis of the Australasian Income Tax*, above n 7.

[171] See C Goodwin, *Economic Enquiry in Australia* (Durham, NC: Duke University Press, 1966) 121–122; C Coleman and M McKerchar, 'The History of Land Tax in Australia', in J Tiley (ed.), *Studies in the History of Tax Law* (Oxford: Hart Publishing, 2010) Vol 4, 281–288.

[172] See text at nn 164–165, above; George Reid had resigned his seat on 24 December 1909. A photograph of Premiers Forrest, Kingston, Reid, Turner, Dickson and Braddon at the 1899 Conference is reproduced at http://constitution.naa.gov.au/stories/argy-bargy/pods/premiers-conference-1899/index.html.

[173] In the election campaign, Fisher pointed out that in 1908 Deakin had once indicated hypothetical support for a federal land tax – see 'Mr. Deakin and the Land Tax, Mr. Fisher's Researches in "Hansard"', *Sydney Morning Herald* (4 April 1910), 8. A similar point was made in the parliamentary debate over the Tax Bill by Attorney-General Hughes in response to Deakin's quotation of renowned Columbia University economist Professor Edwin Seligman as an authority who opposed land taxation as a federal government source of revenue – see W M Hughes, CPDHR, Vol 58, 4471–4472 (12 October 1910); Deakin was quoting Seligman in 'The Relations of State and Federal Finance' (1909) 190(648) *North American Review* 615, 617: CPDHR, Vol 58, 4454–4455.

voiced by critics was a thin-edge-of-the-wedge concern: the tax would start a process that would inexorably lead to unification and centralisation of land taxes.[174]

Subsequent to enactment of the tax, it was attacked on constitutional grounds, on the basis that the Commonwealth's power of taxation could not be exercised in this way for a purpose other than purely revenue-raising.[175] The High Court rejected the argument and the door was open to the use of national taxes as tools of national economic management.

The Commonwealth's second foray into the direct tax field came in December 1914, half a year into the First World War, when a Commonwealth probate duty was enacted (together with a significant increase in the previously enacted land tax). This time revenue need was a key factor behind the proposal. While Australia was one of only two nations participating in the First World War that did not adopt conscription, it was a full participant in the War, with the national government bearing most of the costs of the war effort. With all countries borrowing to wage war, the scope for funding the war by debt was limited and by late 1914 the Commonwealth was looking for ways to supplement its revenues. With probate duties in effect at the State level, this initiative marked the first true overlap between central and State tax bases. At this point, the move was strongly criticised by Forrest and others in the Parliament, on the issue of 'double taxation' and breach of the Federal compact,[176] decrying the increase in general government expenditure and lack of economy that made the tax necessary. A motion led by former Prime Minister Joseph Cook to have the probate tax expressly limited to the duration of the War failed[177] and protests at the State level failed to deter the Commonwealth government.[178]

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[174] See, for example, the comments of Senator E Millen (New South Wales), *Commonwealth Parliamentary Debates*, Senate (CPDS), Vol 58, 4767 (19 October 1910).

[175] *Osborne v Commonwealth* (1911) 12 CLR 321 (31 May 1911). Some uncertainty over the extent of this power resulting from the earlier split decision against the Commonwealth on a similar point in *R v Barger* (1908) 6 CLR 41 (26 June 1908) was finally dispelled by the High Court decision in *Fairfax v Federal Commissioner of Taxation* (1965) 114 CLR 1. It is now accepted as the established rule; see P Hanks, 'Constitutional issues of Australian taxation', in R Krever (ed.), *Australian Taxation: Principles and Practice*, above n 11, 37–39.

[176] Forrest, for example, stated that 'I am quite certain this dual taxation was never contemplated by the framers of the Constitution, nor do I regard it as justifiable or reasonable': CPDHR, Vol 75, 1543 (10 December 1914).

[177] See, for example, W Watt (Balaclava) and J Cook (Parramatta), CPDHR, Vol 75, 1627 and 1701 (11 and 12 December 1914).

[178] Protests included a motion against the permanent nature of the tax tabled by the Opposition in the Tasmanian Parliament (see 'The New Federal Taxation, Land and Probate Duties, Federal Powers of Taxation', *The Leader*

3.3 Concurrent income taxation, 1915–1932

In mid-1915, half a year after the federal probate duty was adopted, the government proposed its third foray into the direct tax field, the adoption of an income tax. With continuing competition for borrowings, revenue needs were growing and expanding war time profits were an obvious source of income. Tariff revenues remained robust, contrary to the expectations of some that war would lead to a decline in customs receipts[179] and notwithstanding major changes to the structure of the tariff that were in many respects consistent with a shift from a protective tariff to one aimed only at revenue raising,[180] as the 'free traders' from the Federation debate might have hoped.[181] However, the costs of waging war were well above the cost of peacetime governance and the revenue shortfall was growing. At the same time, Commonwealth attempts to intervene more forcefully in the national economy had been stymied by the courts declaring Commonwealth legislation unconstitutional, rebuffed by voters turning down referenda proposals to provide the federal government with explicit economic powers, and undermined by State governments backtracking from cooperative commitments. The land tax experience suggested that the only path to expansion of economic powers might be through tax laws.

Prime Minister Fisher's announcement on 22 July 1915 of the plan to introduce a national income tax (coinciding with debate on a war loan Bill) to operate in parallel with the separate State income taxes provoked strong criticism in many quarters[182] and prescient predictions that the impact of concurrent income taxation on the ability of the States to service

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(12 December 1914), 25). The Victorian Premier stated that that the move was 'disconcerting to the State Treasurers'; see report on the comments of Sir Alexander Peacock in 'Federal Probate Duty, Disconcerting to States', *Bendigo Advertiser* (5 December 1914), 10.

[179] Scott, above n 161, 481; see also Commonwealth Bureau of Census and Statistics, *Trade and Customs and Excise Revenue of the Commonwealth of Australia for the Year 1915–16* (Melbourne, 9 May 1917), Table XI.

[180] See, for example, L Groom, CPDHR, Vol 75, 1664–1665 (11 December 1914). Debate on the changes was truncated due to the exigency of the War (see G Sawer, *Australian Federal Politics and Law, 1901–1929* (Melbourne: Melbourne University Press, 1956), 194, fn 83). Falls in effective tariff rates during and after the War proved to be brief and were quickly reversed in the 1920s: Lloyd, above n 166, 123, Table 5.

[181] For insights into the views of the free-traders at Federation, see M Booker, *The Great Professional: A Study of W. M. Hughes* (Sydney: McGraw-Hill, 1980), 50–51, citing W M Hughes and W T Dick, *Federation as proposed by the Adelaide Convention: set forth, discussed and illustrated by diagrams* (Sydney: [s.n.], 1897).

[182] Sir J Forrest (Swan) in particular spoke out against concurrent taxes on bases that were not envisaged as being available to the federal government at Federation; see CPDHR, Vol 78, 5244 (22 July 1915).

their substantial borrowings would lead to a Commonwealth takeover of State debts and, ultimately, the income tax field.[183]

While the government presented the law as a 'war measure', it readily admitted support for Commonwealth income taxation was based on its non-tax objectives and noticeably made no mention of timelines or any plans for a limited life for the statute.[184] One of the most significant aspects of the Commonwealth income tax was the unambiguous signal it gave as to the relationship the government envisaged between national and State tax laws going forward. This was evidenced from the treatment adopted for interest payments on Commonwealth- and State-issued debt. The legislation provided an exemption from tax for interest on specified Commonwealth war bonds[185] but not for interest on State bonds, at a time when most States exempted interest on their own bonds from their income taxes.[186] At the same time, the Commonwealth enacted national legislation, subsequently upheld by the High Court, that exempted interest on Commonwealth bonds from all State income taxes.[187] The combined effect of the measures was to devalue immediately all outstanding State debts and raise State borrowing costs relative to Commonwealth borrowing costs.[188] After 1923, Commonwealth

[183] Ibid; see also the detailed discussion of Forrest's statements in 'Double Taxation', *Sydney Morning Herald* (27 July 1915), 8.

[184] The Attorney-General in his Second Reading speech described the tax as an 'instrument of social reform': W M Hughes, CPDHR, Vol 78, 5844–5845 (18 August 1915); see also R Fisher and J McManus, 'The Long and Winding Road: A Century of Centralisation in Australian Tax', in J Tiley (ed.), *Studies in the History of Tax Law* (Oxford: Hart Publishing, 2004), 313, 318.

[185] See, in the legislation as enacted, *Income Tax Assessment Act 1915* (Cth), s 11(e), enacted on 13 September 1915.

[186] *Income Tax Act 1915* (Vic), s 17(h).

[187] *Commonwealth Inscribed Stock Act 1915* (Cth), s 5, enacted on 16 August 1915. The validity of this provision was later upheld by the High Court in *Commonwealth v Queensland* (1920) 29 CLR 1.

[188] W Fleming (Robertson), CPDHR, Vol 78, 6565 (1 September 1915) noted the proposal would cause State debt to 'depreciate in value to a very great extent; and as the indebtedness of the States is very heavy, those which are not possessed of sinking funds or redemption moneys will be in a very difficult position'. In the event, while interest on State securities was not made exempt under the 1915 Commonwealth income tax, collection of the tax on this income was not enforced until 1923, which presumably lessened the impact on State bond prices which might otherwise have been brought about. See the terms of an undertaking given in 1916 by the Acting Prime Minister [Senator G Pearce] to the Premier of New South Wales, subsequently set out in Commonwealth Government, *Conference of Commonwealth and State Ministers: Memoranda, Report of Debates, and Decisions Arrived At* (Melbourne, May-June 1923), 39 (published in *Commonwealth Parliamentary Papers*, Second Session 1923, Vol 2, Pt I).

and State loans were made expressly subject to Commonwealth income taxation,[189] but a reciprocal provision making Commonwealth loans subject to State income tax was never proclaimed to commence.[190]

The Commonwealth's 1915 income tax drew elements from the income tax legislation of each of the various States, none of which mirrored the legislation of any other State. The Commonwealth's move thus guaranteed a lack of harmonisation of State and federal income tax laws for residents in every State. The differences were often profound, with taxes levied on different bases,[191] different legislative foundations,[192] and fundamentally different approaches to relieving shareholders of double taxation on distributed company profits.[193] One important feature of the new law, in stark contrast to the UK precedent, was the adoption of a global income model that aggregated all types of income and expenses together to determine taxable

[189] *Taxation of Loans Act 1923* (Cth), s 3.

[190] *Taxation of Loans Act 1923* (Cth), s 4. By 1923, the availability of tax-free government securities had come to be seen as a 'great boon' to high-income investors, and there was also concern that the issuance by the Commonwealth of taxable loans would lead to large movements of capital to tax-free State loans instead; this was also described as 'rather a serious question' for those States which taxed their own loans: Sir W Lee (Tasmania), in Commonwealth Government, *Conference of Commonwealth and State Ministers: Memoranda, Report of Debates, and Decisions Arrived At* (Melbourne, May-June 1923), above n 188, 41. Internal advice to the Victorian Government as late as 1930 suggested that the Commonwealth 'should be pressed' to allow State taxation of Commonwealth securities; it was recognised, however, that obtaining the agreement of the Commonwealth to this move may have depended on Victoria ending its exemption for its own loans: Commissioner of Taxes (Vic), Memorandum to the Under Treasurer, 'Income Tax Act – 1930 Amendments' (31 October 1930), 2, Public Record Office, VPRS 10265/P/O Unit 21.

[191] For example, the Commonwealth tax did not extend to 'casual profits' on asset transactions, but these were fully taxed in New South Wales from 1914 (*Income Tax (Management) Act 1914* (NSW), s 2(3)). The Commonwealth tax included an amount in respect of 'imputed income' of owner-occupiers of land (*Income Tax Assessment Act 1915* (Cth), s 14(e)), as did the income taxes of Victoria (*Income Tax Act 1915* (Vic), s 11) and South Australia (*Taxation Act 1915* (SA), s 22(VIII)). Lottery winnings were taxable in the Commonwealth law (*Income Tax Assessment Act 1915* (Cth), s 14(h)) and that of Tasmania (*Land Tax and Income Tax Act 1910* (Tas), s 3(b)) but not elsewhere.

[192] A single law described the tax base and imposed tax at specific rates in three States while separate assessment and imposition Acts were used in New South Wales, Western Australia and, from 1910, Tasmania, as well as federally where the split was required by the *Constitution,* s 55.

[193] The Commonwealth tax provided a dividend deduction system while Western Australia used a dividend imputation system and other States had dividend exemption regimes. See J Taylor, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia' (2003) 57(8) *Bulletin for International Fiscal Documentation* 346.

income. A possible motivation for rejection of the UK schedular model may have been commitment of Australian politicians to the goal of progressivity based on progressive rates applying to a taxpayer's total income.[194]

Even before the Commonwealth 1915 income tax had been enacted discussion on the relationship between State and Commonwealth income taxation had commenced. During the debate on the Commonwealth's constitutional amendment proposals in September 1915, then Attorney-General Hughes noted that, in May of that year, an Opposition member had 'declared that there ought to be Unification, so far, at any rate, as taxation goes, only one taxing power in Australia'.[195]

Almost immediately after the adoption of Commonwealth income taxation, intergovernmental conferences of ministers and officials began discussions on the problems of concurrent income taxation. There was general agreement by all parties that the income taxes should be 'unified' in the sense of using a common base and a single administration in each State collecting taxes on behalf of the State and Commonwealth, but no agreement on which level of government should be responsible for that administration or on which base should be adopted as the common base.[196]

By 1920 it had become clear that concurrent income taxes using different tax bases and administered by different tax offices was both inefficient from the perspective of revenue collection and unnecessarily costly to all parties. The 'mere patchwork' of efforts to address the situation up to 1920 had accomplished little[197] and the Commonwealth adopted two initiatives in response, seeking cooperative tax administration agreements with the States and appointing a Royal Commission on Taxation to find a more lasting solution to the problems of concurrent taxation. Initially, agreement was reached with one State only, with Western Australia agreeing that the Commonwealth could collect both Commonwealth and Western Australian income and land taxes.

The wide-ranging Royal Commission on Taxation (William Warren Kerr, chair), established in 1920, issued five reports over its life. The first, released in 1922, adopted the

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[194] See J A L Gunn, *Commonwealth Income Tax Law and Practice* (Sydney: Butterworth & Co., 1943), 2–3.

[195] CPDHR, Vol 78, 6223–6224 (27 August 1915).

[196] R Maddock, 'Unification of Income Taxes in Australia' (1982) 28(3) *Australian Journal of Politics and History* 354.

[197] D B Copland, 'Some Problems of Taxation in Australia' (1924) 34(135) *Economic Journal* 387, 388, reproduced in W Prest and R L Mathews (eds), *The Development of Australian Fiscal Federalism: Selected Readings* (Canberra: Australian National University Press, 1980), 35.

recommendations of many prominent witnesses, and recommended ending concurrent taxation by allocating income tax exclusively to the Commonwealth.

The second report of the Royal Commission issued the following year dealt with the question of federal-state financial relations, with the third through fifth reports issued in the first half of that year addressing other issues. The second report set out forcefully the case for the Commonwealth's exclusive jurisdiction over income tax,[198] relying on two primary arguments. The first was the importance of progressivity as an objective of the income tax. It was thought that progressivity would be harder to achieve where income was derived and taxed across different States. The second, derived from the work of the leading US public finance economist at the time, Professor Edwin Seligman from Columbia University, was the 'complications of inter-State taxation and the difficulty of getting at the income derived from inter-State sources'[199] if separate State taxes were retained. Seligman had set out his views early in 1915, two years after the adoption of individual income tax in the United States, when teething problems were still being ironed out. Ironically, and apparently unknown to the Royal Commission, Seligman had later reversed his views. Noting improvements in state tax administrations and the successful establishment of the US federal income tax, Seligman began to advocate concurrent state and federal income taxation in the United States, with state taxes based on the federal return,[200] a system subsequently adopted in Canada.

While now viewed as an important document from the long-term point of view, in the short term the Royal Commission's findings in relation to federal-state income tax arrangements did not have significant impact. At the Premiers' Conference of May-June 1923, the Commonwealth government put forward a Memorandum which took the opposite approach to that of the Commission and proposed a withdrawal of the Commonwealth from income taxation, except in relation to companies and high income individuals, and discontinuation of the *per capita* grants which had been in place since 1910. The States countered with a seemingly ambitious proposal for the Commonwealth to withdraw from all income taxation

[198] Royal Commission on Taxation (W Warren Kerr, chair), *Second Report of the Royal Commission on Taxation* (13 April 1922), above n 16, 79.

[199] E R A Seligman, 'Newer Tendencies in American Taxation' (1915) 58 *Annals of the American Academy of Political and Social Science* 1, 9–10 (March), cited in Warren Kerr Royal Commission, *Second Report of the Royal Commission on Taxation*, above n 16, 77.

[200] E R A Seligman, 'The Next Step in Tax Reform', *Presidential Address to the Ninth Annual Conference of the National Tax Association* (11 August 1915), 12, reproduced in the 9th edn of Seligman's work, E R A Seligman, *Essays in Taxation* (New York: Macmillan Co, 1921).

and receive financial assistance from the States. In the event, a compromise outcome was reached (New South Wales dissenting, and Tasmania absent),[201] but was not implemented (in part pending availability of further tax statistics), and the alternative path was taken of providing for agreements to be made for Commonwealth income tax to be collected by the States and State income taxes to be collected by the Commonwealth where taxpayers derived income derived in more than one State.[202] The Melbourne office of the Commonwealth Commissioner of Taxation assumed the latter responsibilities.

While a single agency in each State was responsible for the collection of State and Commonwealth income taxes from 1923, separate tax bases and returns were a continuing concern for taxpayers.[203] A related area of concern was the growing risk of double State taxation in addition to the concurrent State and Commonwealth taxation. In the absence of agreements on the source of income, businesses operating across State borders could find the same income subject to tax under more than one State income tax law. In May 1929, at the prompting of his State Commissioner of Taxation, the New South Wales Acting Premier proposed joint State government action on the multi-State income issue through a conference of Commissioners, a proposal which was immediately endorsed by the Victorian Premier[204] and separately sought by the Associated Chambers of Commerce.[205]

State Taxation Officers met in Melbourne in October and agreed on a common formula for apportionment of profits on inter-State sales.[206] The agreement by administrators failed to

[201] Commonwealth Government, *Conference of Commonwealth and State Ministers Held at Melbourne, May-June, 1923: Memoranda, Report of Debates, and Decisions Arrived At*, above n 188.

[202] *Income Tax Collection Act 1923* (Cth), enacted on 1 September 1923. This was taken up by all of the States except Western Australia, for which the Commonwealth collected income tax.

[203] See, e.g., 'Double Income Tax', *The Register* (17 March 1926), 8, reporting calls by the Associated Chambers of Commerce for 'the Federal Government to retire from the field of income taxation', but noting also the concerns expressed about possible loss of the *per capita* grants to the States.

[204] Ernest Buttenshaw, Acting Premier of New South Wales, to Sir William McPherson, Premier of Victoria (Circular), 13 May 1929; McPherson to Buttenshaw, 22 May 1929, Public Record Office VPRS1207/P1/Unit 110. McPherson had also previously been President of the Melbourne Chamber of Commerce.

[205] (1929) 6(12) *Monthly Journal of the Melbourne Chamber of Commerce* (June), 284.

[206] The common formula split the income between States where a trader sold in another State through a branch or agent while allocating 100 per cent of the profit to the State of sale where items were sold by independent branches that imported and maintained their own stock. A separate rule applied to manufacturers with 66.6 per cent of the profit attributed to the State of manufacture and 33.3 per cent to the State of sale where the goods were sold through an agent or branch.

attract universal political support, however, and in the end was only adopted in South Australia and Victoria.[207] A suggestion by the Victorian Commissioner that abolition of the Commonwealth Central Tax Office (located in Melbourne and responsible for collection of taxes of taxpayers with income in more than one State) would benefit large taxpayers led to no action.[208]

Income tax administration concerns continued to distract the business community and individual taxpayers as the Depression took hold. In 1930, special State income taxes for unemployment relief began to appear[209] and, at the same time, the Commonwealth moved to introduce a federal wholesale sales tax.[210] Reductions in the tax-free threshold brought lower income ranges into the individual income tax system, and this in turn led to the development of a formal collection machinery based on tax stamps.[211]

A political spat in 1930 also highlighted to the Commonwealth an unanticipated risk from the shared tax administration system then in place. One significant outcome which was achieved by the Premiers Conference of mid-1923 was the establishment of the voluntary Loan Council to co-ordinate the substantial borrowings of the Australian governments. The idea was prompted in part by the difficulties the Commonwealth had encountered when seeking to roll over maturing war loans to ordinary borrowings between April and June 1923.[212] The State and

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[207] *Taxation Act 1930* (SA), s 30, enacted 6 November 1930; *Income Tax Acts Amendment Act 1931* (Vic), s 7, enacted 30 December 1931.

[208] Deputy Commissioner on behalf of R M Weldon, 'Duplication of Taxes', dated 7 February 1930, Public Record Office VPRS1207/P1/Unit 110. The second Royal Commission on Taxation, discussed in section 3.4, *The Path to Uniformity*, below, in 1934 would also reject abolition of the Central Office: Royal Commission on Taxation (Justice D Ferguson, chair), *Third Report of the Royal Commission on Taxation* (12 April 1934) (Canberra, Commonwealth Government Printer, 1934), 162.

[209] See, for example, the lengthy and complicated *Unemployment Relief Act 1930* (Vic), enacted on 2 June 1930. For discussion of the 'Depression taxes' and their impact on the lower wage and income earners, see Smith, *The Changing Redistributional Role of Taxation in Australia Since Federation*, above n 156, 40–42.

[210] *Sales Tax Assessment Act (No. 1) 1930* (Cth), enacted on 18 August 1930.

[211] The first of these was an instalment system process involving tax stamps introduced in South Australia in 1931: *Taxation Act 1931* (SA). See T Hytten, 'Collecting Income Tax at the Source' (1932) 8(2) *Economic Record* 278, reproduced in W Prest and R L Mathews (eds), *The Development of Australian Fiscal Federalism*, above n 197, 283; see also S J Butlin and C B Schedvin, *War Economy, 1942–1945* (Canberra: Australian War Memorial, 1977), 571–575. The Commonwealth's own tax stamps in 1942 seem to have led to evasion, with illicit stamps trading at a discount of up to 50 per cent: ibid, 573.

[212] R Gilbert, *The Australian Loan Council in Federal Fiscal Adjustments, 1890–1965* (Canberra: Australian National University Press, 1973), 62–63.

Commonwealth governments agreed that the Loan Council would assume responsibility for all borrowings by the States and Commonwealth and established an informal arrangement to this effect in 1923. The election of fervently anti-federalist State premier Jack Lang led to the withdrawal of New South Wales from the voluntary arrangements in 1925 but following the fall of the Lang government in 1927, the Loan Council was formally established as a statutory body controlled by the Commonwealth in 1927 and the imposition of compulsory Loan Council arrangements followed.[213]

However, after taking office again on 4 November 1930, Lang refused to participate in Loan Council activities and attempted to repudiate the State's debt. While the Commonwealth had been granted relief on war debts to the United Kingdom by the British Government in April 1931,[214] New South Wales' debtors were not willing to abandon their claims and rather than risk default that could affect the entire country's credit rating, the Commonwealth stepped in and met payments due to creditors.[215] Under 'severe financial pressure',[216] Lang joined an agreement in the context of a June 1931 economic plan adopted by the Commonwealth and Premiers (the 'Premiers' Plan'), which included a process of 'voluntary conversion' of local indebtedness and continued commitment to repayment of overseas State debts,[217] but while the Prime Minister put forward the agreement as 'one indivisible plan', Lang maintained that he had only agreed to one component of the Plan, relating to the internal conversion loan.[218]

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[213] Ibid, 191–194.

[214] See 'War Debt Relief, Britain Helps Australia, Postponement of Payments, Announcement in House of Commons', *Sydney Morning Herald* (17 April 1931), 11. The report noted that 'Mr. Lang stated at Adelaide yesterday that the British Government's decision would greatly hearten those who were working for the adoption by the Federal Government of the Lang plan'.

[215] A Twomey, 'The Dismissal of the Lang Government', in G Winterton (ed.), *State Constitutional Landmarks*, above n 155, 129, 143.

[216] Saunders, 'Government Borrowing in Australia', above n 164, 196.

[217] G Sawer, *Australian Federal Politics and Law, 1929–1949* ([1963] Melbourne: Melbourne University Press, 1967), 11–12, 21–22.

[218] See 'Premiers' Conference Ends, £556,000,000 Conversion Loan, Approved by Loan Council, Proposed Temporary Loan of £8,500,000' and 'Mr. Scullin's Statement', *Sydney Morning Herald* (11 June 1931), 9–10. The latter report noted that Prime Minister Scullin had proposed that a further sub-committee be formed to look at the issue of the earlier default by New South Wales (and the associated failure of the Savings Bank of New South Wales); Lang reportedly replied that he was 'prepared to go on with it', and that he was 'not particularly anxious to be a martyr and go to gaol, but if you insist on putting me there, I shall go quite cheerfully and quite unrepentant'. Lang later also noted that the Loan Conversion Agreement was the only document which had been placed before the conference for signature: J Lang, *The Turbulent Years* ([Sydney]: Alpha Books, 1970), 135.

In any case, the State made no effort to repay the Commonwealth for debts already covered by the central government and the relationship between the Commonwealth and New South Wales quickly deteriorated following a further default by New South Wales in early 1932. Justifying its actions by reference to the Loan Council agreement,[219] the Commonwealth directed New South Wales taxpayers to pay all State income tax direct to the Commonwealth[220] and banks to deliver up funds in State bank accounts; Lang responded by ordering the closure of the State Tax Department and directing State government employees not to bank State revenue.[221] When Lang refused to withdraw this direction, the New South Wales Governor, Sir Philip Game, dismissed Lang's government and State collection of Commonwealth income tax resumed.[222]

Concerns over the efficiency of tax administration, inconsistent Commonwealth and State income tax bases, and the absence of agreement on taxing rights over cross-border sales eventually prompted the Commonwealth government to appoint a second Royal Commission

[219] The newly installed Lyons Government also enacted Commonwealth legislation to put beyond doubt that its payments to creditors on behalf of New South Wales were in fact the result of a legal obligation (the bonds themselves legally still being only between the bond-holders and New South Wales) and so would be legally repayable by New South Wales to the Commonwealth: Sawer, *Australian Federal Politics and Law, 1929–1949*, above n 217, 51. See *Financial Agreements (Commonwealth Liability) Act 1932* (Cth).

[220] See 'State Income Tax, Payable to Commonwealth Bank, Official Directions', *Sydney Morning Herald* (8 April 1932), 9. The report noted that the direction had been given by way of a Proclamation by the Governor-General under the Financial Agreements Enforcement Act published in a special issue of the *Commonwealth Gazette* requiring payment of the State tax to the Commonwealth Treasurer or persons authorised by the Treasurer; a further publication of the Gazette at the same time set out a notice by the Treasurer (also Prime Minister, J Lyons), specifying that the Commonwealth Bank, at its head office in Sydney, was such an authorised person, and taxpayers were from that date required to make payment of the tax at that location. The report pointed out that pursuant to these directions, payment of the tax in the specified manner would be a good discharge of the liability but that payment in any other way would not, but would 'involve [the taxpayer] in liability to heavy penalty'.

[221] Twomey, 'The Dismissal of the Lang Government', above n 215, 146–148.

[222] Ibid, 152–154. The financial restrictions placed on New South Wales were also lifted, after it was reported that immediate assurances were to be given by the incoming Premier that 'steps will be taken as early as possible to repay to the Commonwealth the amounts that have had to be paid on the State's behalf': see 'Attachment of State Revenues, May Soon Cease', *Sydney Morning Herald* (14 May 1932), 14; *Emergency Legislation Suspension Act 1932* (Cth), enacted on 17 May 1932.

on Taxation in 1932 to develop a blueprint for 'uniform and simplified' income tax legislation across the country.[223]

3.4 The path to uniformity

The second Royal Commission on Taxation announced in September 1932 comprised retired New South Wales Supreme Court justice (from June 1934, Sir) David Ferguson and Melbourne accountant E V Nixon. The Royal Commission quickly began hearings, taking evidence on income tax in Sydney in November 1932. The Royal Commission also heard evidence in all other capitals.

Evidence presented to the Royal Commission included both technical advice[224] and an emphatically presented[225] report from the business community offered by State Chambers of Commerce.[226] A number of witnesses at the Sydney hearings advanced a scheme for centralised income tax presented some years before by leading Professor R C Mills, Dean of the Faculty of Economics at the University of Sydney.[227] The Commission also made use of, and extensively quoted from, a report[228] offered to a 1932 Premier's Conference by Victoria's newly appointed Assistant Minister of Railways, Colonel Harold Cohen.[229] Referring to the

[223] Prime Minister J Lyons, CPDHR, Vol 135, 96 (1 September 1932).

[224] Important in this respect was a report prepared by accountant J A L Gunn who would emerge as an important author of early guides to income taxation in Australia. See 'Taxation Laws, "A Dreadful Maze", Injustices to Companies, Instalment System Advocated', *The Argus* (19 July 1933), 9.

[225] One account described Sydney Chamber of Commerce President Spencer Watts being joined at the evidence table by two other witnesses, 'each in turn hammering home, with a sheaf of documents, what they regarded as the glaring weaknesses and complexities of the present system': 'Tax Reform, Royal Commission, "Harassing Industry", New System Urged', *Sydney Morning Herald* (23 November 1932), 9.

[226] 'Simplification of Tax Laws', *News* (29 November 1932), 1.

[227] The proposal had first been articulated by Mills in 1928 in a speech delivered in Hobart that was subsequently published as R C Mills, 'The Financial Relations of the Commonwealth and the States' (1928) 4(1) *Economic Record* 1, reproduced in W Prest and R L Mathews (eds), *The Development of Australian Fiscal Federalism*, above n 197, 63. For an account of the use of the arguments by witnesses before the Royal Commission, see 'Finance Problems, Commonwealth: States, By Professor R. C. Mills of Sydney University', Lecture No 5 to the Summer School at Robertson, *Sydney Morning Herald* (13 February 1933), 4.

[228] 'Memorandum Submitted by the State of Victoria in Respect of Income Taxation on Interstate Trading', Record of the Conference of Commonwealth and State Ministers, held in Melbourne, from 24th to 29th October, 1932 (unpublished), App E, 13–15, National Archive Series A463 Control Symbol 1963/2246.

[229] Ibid.

1929 Resolution of State Taxation Commissioners for a uniform profit apportionment formula to avoid double taxation of income derived in cross-State border sales (a proposal only adopted by Victoria and South Australia), Cohen castigated, albeit in subdued language, the political failure of other States to adopt a uniform scheme, foreshadowing external (presumably Commonwealth) intervention to address the problem.

The first report released by the Royal Commission, in late 1933,[230] dealt with technical tax design issues, recommending adoption of an imputation system to relieve double taxation of profits derived through a company[231] and restriction of the then existing Commonwealth undistributed profits tax to private companies. The Royal Commission's second report addressed the issue of concurrent income taxation by the Commonwealth and States while a third report addressed further technical issues. The problems of concurrent taxation, the Royal Commission concluded, derived not from the two layers of tax but rather from inconsistent legislation. The solution, it argued, was adoption of a uniform tax across all taxing jurisdictions.[232] The Royal Commission envisaged a single law with the possibility of some purely local provisions,[233] but generally based on a subjection of State policy to the policy of the common legislation. The Commonwealth Act was seen as the appropriate basis for the uniform Act, as a result of the 'sounder principles' underlying the Commonwealth Act and the greater familiarity of residents of all States with that Act as against the legislation of any State other than their own.[234]

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[230] Royal Commission on Taxation (Justice D Ferguson, chair), *First Report of the Royal Commission on Taxation* (28 August 1933) (Canberra, Commonwealth Government Printer, 12 January 1934). It can also be noted that the release of this Report came shortly after the formal establishment of the Commonwealth Grants Commission by an Act of 30 May 1933. By this stage, the approach to fiscal assistance to weaker States was based on the concept of fiscal capacity rather than specific disabilities incurred as a result of Federation, and a range of enquiries had been held and special assistance payments made to Tasmania, South Australia and Western Australia in the late 1920s and early 1930s: see J Smith, 'Redistribution and Federal Finance' (2002) 42(3) *Australian Economic History Review* 284, 299–302 (suggesting that '[t]he interests of the smaller States had increasingly come to lie in a system that centralized income taxation').

[231] Taylor, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia', above n 193, 348.

[232] Royal Commission on Taxation (Justice D Ferguson, chair), *Second Report of the Royal Commission on Taxation* (5 February 1934) (Canberra, Commonwealth Government Printer, 1934), 55–56.

[233] Ibid, 57.

[234] Ibid, 58.

The Royal Commission was remarkably cavalier in its rejection of State interests in its pursuit of uniformity. States' rights, it asserted, were secondary to the aim of uniformity,[235] with the State interests dismissed as 'abstract constitutional rights'.[236]

The report of the Royal Commission set out in some detail its preferred design for uniform legislation. Recommendations included a mandatory common deduction rule to prevent concessional deductions for locally favoured industries and adopting uniform concessional deductions for individuals. Somewhat imperiously, the report set out the social policies the authors viewed as appropriate national objectives that might be favoured by way of concessional deductions, rejecting the New South Wales concession for dental expenses,[237] for example, while endorsing the Commonwealth and Western Australia concessional treatment of donations to health research, for example.[238] In contrast to its concessional health deduction, New South Wales' core inclusion provision was the optimal model for assessing 'casual profits' (i.e. capital gains), in the view of the Royal Commission.[239]

On the key issue of apportionment of income of multi-State businesses, the Royal Commission heard evidence of the anomalous and inconsistent formulae used across the country[240] and recommended universal adoption of a single general formula[241] modelled on the 1929 scheme,[242] which had since been taken up in South Australia and Victoria.[243]

Separately, the Royal Commission recommended on the basis of what was recognised to be limited evidence[244] that the profit of banks be apportioned between the States based on the proportion of assets and liabilities in the State as against total assets and liabilities, the formula then used by Queensland and Tasmania.[245]

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[235] '[T]he rights which any Government would be asked to suspend or surrender as a result of agreeing to the adoption of a uniform Act are not of real importance': ibid, 57.

[236] Ibid, 60.

[237] Ferguson Royal Commission, *Third Report of the Royal Commission on Taxation*, above n 208, 106. See *Income Tax (Management) Act 1928* (NSW), s 19(2)(d)(i).

[238] Ferguson Royal Commission, *Third Report of the Royal Commission on Taxation*, above n 208, 107.

[239] Ibid, 129.

[240] Ferguson Royal Commission, *Second Report of the Royal Commission on Taxation*, above n 232, 78, 80.

[241] Ibid, 83.

[242] See section 3.3 above, *Concurrent Income Taxation, 1915–1932*, text at nn 204–207.

[243] Ferguson Royal Commission, *Second Report of the Royal Commission on Taxation*, above n 232, 84.

[244] Ferguson Royal Commission, *Third Report of the Royal Commission on Taxation*, above n 208, 144.

[245] Ibid, 144.

The Royal Commission was well aware of the problems of potential double taxation resulting from international cross-border taxation. The Commonwealth, but not the States, had signed up to a UK Dominion Income Tax Relief scheme that provided unilateral UK tax relief from double taxation of income derived by UK residents where the income had been subject to Commonwealth tax and other mechanisms were available to provide relief in the United Kingdom for State taxes, but there was no need for comprehensive reciprocal relief as Australian jurisdictions only taxed local source income. This had changed in 1930 when the Commonwealth moved to tax residents on world-wide income. At the time, the Commonwealth proposed an exemption for income derived from (and presumably taxed in) the United Kingdom but in the course of parliamentary debate the government realised singling out the United Kingdom could upset other allies and the exemption was eventually modified to apply to income from all jurisdictions where it had been taxed in those jurisdictions.[246] From 1931, many of the State income taxes began to include different types of foreign-source income derived by residents, sometimes providing relief from double taxation with foreign tax credits.[247] The Report explicitly avoided any recommendation in respect of the significant revenue losses resulting from the unilateral exemption system used to avoid double taxation[248] but did propose a uniform rule for determining the Australian-source profits of non-resident enterprises doing business in Australia or selling goods in Australia.[249] Finally, the Royal Commission recommended the establishment of a joint authority to collect all income taxes[250] and, in its third report released the following year, recommended harmonised arrangements for taxpayers' objections and appeals and creation of a specialised tax court.[251]

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[246] See Gunn, *Commonwealth Income Tax Law and Practice*, above n 194, 157–58.

[247] See, e.g., *Income Tax Acts Amendment Act 1931* (Vic), ss 2–3, subjecting to tax income of a resident derived while temporarily engaged in service overseas for a Victorian employer, with a foreign tax credit available.

[248] Ferguson Royal Commission, *Second Report of the Royal Commission on Taxation*, above n 232, 74. The exemption system finally adopted in the uniform law remained in place until replaced with a general foreign tax credit system in 1987. A specific inclusion and foreign tax credit system for dividends had been adopted in 1947.

[249] The proposal would deem the Australian profit of a non-resident manufacturer to be the sale amount in Australia less the wholesale value of the goods in similar circumstances in the home country, and expenses of transportation and sale (subsequently described as the 'home consumption value method'). For other non-resident merchants, the profit would be the sale amount less purchase price and such expenses. See Ferguson Royal Commission, *Second Report of the Royal Commission on Taxation*, above n 232, 75.

[250] Ibid, 63.

[251] Ferguson Royal Commission, *Third Report of the Royal Commission on Taxation*, above n 208, 156.

Given the difficulties that had been encountered in the 1929 attempt to devise a common profit apportionment rule for cross-border sales, reactions to the Royal Commission report were surprising. Following release of the proposed model legislation, a number of conferences with participation by Commonwealth and State Ministers and Taxation Commissioners and officials were held, with the members of the Royal Commission also invited to participate, and by 1935 the participants had agreed on almost all key elements of a model law. Alternative suggestions put forward in other fora, most notably the view of then Victorian Attorney-General and Deputy Premier (and future conservative Prime Minister) Robert Menzies, expressed at a February 1934 Conference of Commonwealth Ministers and State Premiers, that the Commonwealth should retire from the income tax field, had no apparent impact on the harmonisation process. Almost all changes from the model released by the Royal Commission, for the most part made to bring the provisions of the draft into closer agreement with the acts of some of the States, and thus achieve a larger measure of uniformity, were endorsed by the Royal Commission members participating in harmonisation meetings.[252]

The Commonwealth version of the law was introduced into the Commonwealth Parliament in late 1935, with debate following in early 1936. It was clear throughout the parliamentary debate that many Opposition members, at least, did not see the harmonisation process as the end of the matter,[253] with suggestions that genuine uniformity could only be achieved with one taxation measure and a single controlling authority.[254] The law passed easily, however, and the States then followed with their versions of the harmonised income tax law.[255]

Tasmania was first off the mark with legislation at the beginning of 1936,[256] before the Commonwealth had passed into law in mid-year. However, perhaps disappointingly for local taxpayers, this took the form of an amending Act providing for section by section replacement

[252] See the Second Reading Speech to the Income Tax Assessment Bill 1935, Treasurer R Casey (Corio), CPDHR, Vol 148, 2716–2718 (5 December 1935).

[253] See, e.g., J Leckie (Victoria), CPDS, Vol 150, 1885 (20 May 1936).

[254] E J Harrison (Wentworth), CPDHR, Vol 150, 975 (29 April 1936).

[255] *Income Tax Assessment Act 1936* (Cth), enacted on 2 June 1936; *Income Tax Assessment Act 1936* (SA), enacted on 22 October 1936; *Income Tax (Management) Act 1936* (NSW), commenced (by Proclamation) on 1 November 1936; *Income Tax Assessment Act 1936* (Qld), commenced on 21 December 1936; *Income Tax (Assessment) Act 1936* (Vic), commenced on 12 January 1937; *Income Tax Assessment Act 1937* (WA), commenced on 24 December 1937. Unlike the Commonwealth Act, the State Acts generally continued to be imposed on a source basis and contained exemptions for out-of-state income.

[256] *Land and Income Taxation Act 1935* (Tas), enacted on 16 January 1936.

and renumbering of the provisions of that State's existing 1910 Act (as amended),[257] rather than enactment of a new Act as implemented in the other jurisdictions. Tasmania's early adoption of a harmonised law had pre-empted further negotiations between taxation officials during 1936, and was prepared in the middle of a lengthy period when a statute law revision process was being carried out in that State, so that the tax Act was immediately subject to numerous revisions, some by Proclamation which may even have created doubts as to the legal validity of the changes.[258]

Several recommendations of the second Royal Commission on Taxation were not adopted in some or all jurisdictions. The proposal for a joint administrative authority did not proceed and existing arrangements for State collection of Commonwealth income tax were continued (and vice versa in Western Australia). Similarly, the proposal for a taxation review court did not eventuate,[259] although Tasmania subsequently enacted its own rules allowing arrangements to be made for the Commonwealth's Board of Review to carry out appeal functions under the Tasmanian Act.[260] The Commonwealth and all States other than New South Wales, concerned about any shift to a wider deduction formula[261] and rejecting criticism by the Opposition leader,[262] adopted a stricter nexus requirement for one limb of the expense recognition measure allowing deductions for outgoings 'necessarily incurred' in carrying on a business.[263] New South Wales retained its broader prior deduction rule.[264] New South Wales also refused to jettison its existing concessional deduction for dental expenses.[265]

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[257] *Land and Income Taxation Act 1910* (Tas).

[258] See *Proclamations Confirmation Act 1937* (Tas).

[259] A Commonwealth Bill for this purpose seems by June 1937 to have been dropped; see CPDHR, Vol 153, 307 (23 June 1937).

[260] *Land and Income Taxation Act 1938* (Tas), s 2(XVI).

[261] They were described as 'unwilling to run the risk' of broadening the deduction rule; see A McLachlan (South Australia), CPDS, Vol 150, 1844–1855 (19 May 1936).

[262] CPDHR, Vol 150, 964 (29 April 1936).

[263] See *Income Tax Assessment Act 1936* (Cth), s 51(1). This wording was apparently intended to overcome the effect of the High Court decision in 1930, *Federal Commissioner of Taxation v Gordon* (1930) 43 CLR 456, allowing deduction by a grazier of fees to the relevant industry association.

[264] *Income Tax (Management) Act 1936* (NSW), s 60(1). As it turned out, the Commonwealth subsequently (in 1944) endorsed the New South Wales approach and adopted the rule nationally: *Income Tax Assessment Act (No. 2) 1944* (Cth), s 6, introducing s 160(2)(d) to the Commonwealth 1936 Act.

[265] *Income Tax (Management) Act 1936* (NSW), s 89(1)(f).

Significantly, only four of the six States adopted directly the recommended 1929 scheme for allocation of income of multi-State businesses. The proposal for a scheme of apportionment of profits of banks based on assets and liabilities was legislated by all States. Tasmania had enacted a variation of the 1929 scheme in respect of other businesses in 1934[266] but Queensland maintained its approach of taxing 50 per cent rather than 33 per cent of profit on in-State sales of goods manufactured in another State used by other States.[267] The Commonwealth and all States apart from New South Wales adopted the approach recommended by the Royal Commission for computation of profits from the sale of goods by overseas manufacturers as the difference between sales price and wholesale price in the manufacturer's home jurisdiction,[268] while New South Wales applied a calculation that yielded higher profit measurements.[269] South Australia also retained a unique deeming rule relating to in-state treatment of profits on the sale of imported minerals.[270]

The States maintained a variety of divergent approaches to taxation of dividends received by shareholders. New South Wales, for example, taxed dividends on a source basis and allowed rebates to shareholders on a similar basis to the (shareholder relief) scheme adopted by the Commonwealth.[271] In Victoria, however, dividends continued to be exempt.[272] The Commonwealth also amended its undistributed profits tax provisions so as to apply only to private companies,[273] while the practice of the States in this regard also varied: New South

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[266] See *Land and Income Taxation Act (No. 2) 1934* (Tas), s 2(VI), and new s 111(1)(ii) in *Land and Income Taxation Act 1935* (Tas).

[267] *Income Tax Assessment Act 1936* (Qld), s 28(7). Queensland regarded the 66.6 per cent allocation to the State of manufacture as an appropriation of revenues that should belong to the State where the item is sold; even its 50 per cent allocation was generous, in the view of the Queensland Premier; see *Queensland Parliamentary Debates*, Vol 170, 1904 (2 December 1936).

[268] See, e.g., *Income Tax Assessment Act 1936* (Cth), s 38.

[269] *Income Tax (Management) Act 1936* (NSW), s 36. See the views of then New South Wales Assistant Treasurer (later a member of the Committee appointed by the Commonwealth in 1942 to consider uniform taxation) E S Spooner, cited in 'Financial, Overseas Manufactures, Assessment of Income Tax', *Sydney Morning Herald* (8 July 1936), 17; 'Income Tax, Oversea Manufacturers, Mr. Spooner Explains', *Sydney Morning Herald* (9 July 1936), 6.

[270] *Income Tax Assessment Act 1936* (SA), s 53. The provision specified taxable income from this activity to be 10 per cent of the actual cost of treatment including a reasonable charge for land, buildings and machinery.

[271] *Income Tax (Management) Act 1936* (NSW), ss 52–56.

[272] *Income Tax (Assessment) Act 1936* (Vic), s 14(v).

[273] *Income Tax Assessment Act 1936* (Cth), ss 103–109 (Div 7).

Wales and Tasmania took a similar approach to the Commonwealth,[274] but other States such as Victoria and South Australia made no specific provision for such profits.

In reality, thus, the 'harmonised' income tax was something of a hybrid. While all States had adopted most of the central design features of the common law, there were enough differences to defeat the key goals of harmonisation in terms of reduced taxpayer and tax administration compliance burdens and reduced distortions from State to State.

3.5 Australia at war, 1939–1942

On 3 September 1939, Britain and France declared war on Germany due to its invasion of Poland two days earlier. Within hours of the announcement from London, Australian Prime Minister Robert Menzies declared Australia also at war with Germany. In the early years of the War, the Commonwealth seems to have favoured loan finance as a source of funds and been slow to increase taxation, so that even by the time of its November 1940 Budget, Treasurer Arthur Fadden was able to show that Commonwealth taxation at the time was only slightly higher than the 1932–33 level as a percentage of national income.[275] In absolute terms, however, taxation revenue was growing as the national income rose from depression levels to wartime levels, and in nominal terms, the 1940 Budget, along with a tax increase earlier in the year, would have almost doubled the Commonwealth income tax take.[276] There was, at the same time, a widespread perception that tax burdens were increasing, perhaps exacerbated by rises in income and shifts to higher marginal tax rates and the Commonwealth government was conscious of political risks with reliance on taxation to fund more of the war effort.

Two factors complicated the picture further. The first was a proliferation of special taxes on different types of income, apart from the primary income tax. Only half of the tax revenue realised by the States from taxes imposed on income was attributable to the primary income tax,[277] and the incomplete harmonisation of the primary legislation had no impact on the anomalies and administrative and compliance burdens from the multitude of different taxes across the nation. At the same time, harmonisation of the primary income taxes started to

[274] *Income Tax (Management) Act 1936* (NSW), ss 135–146 (Div 9); *Land and Income Taxation Act 1910* (Tas), ss 77–84 (Div VIII).

[275] S J Butlin, *War Economy, 1939–1942* (Canberra: Australian War Memorial, 1955), 363–364.

[276] Estimated tax of £34 million, including £14 million from a May mini-budget, and the government proposed raising an additional £31 million: ibid.

[277] Maddock, 'Unification of Income Taxes in Australia', above n 196, 357.

disintegrate as the Commonwealth and States introduced unilateral changes from the harmonised scheme. Significant departures included changes in the Commonwealth[278] and New South Wales[279] rules for shareholder taxation and the reimposition of an undistributed profits tax on public companies by the Commonwealth.[280]

The second was the growing risk of a backlash over perceptions of varying contributions across the country as a result of widely diverging tax rates. Two States (Queensland and Tasmania) had top rates substantially above the average, and up to almost double the rates of the lowest top rate State (Victoria).[281] In an effort to ameliorate the problem, the Commonwealth committed to a combined State and Commonwealth top marginal tax rate of 70 per cent, but achieving this was problematic. The Commonwealth law had, since its introduction in 1915, allowed a deduction for State income taxes, which reduced taxable income for Commonwealth purposes.[282] The value of Commonwealth relief thus depended on a taxpayer's marginal Commonwealth tax rate.

A proposed solution offered by former Prime Minister and influential Labor spokesperson James Scullin was to replace the *deduction* for State taxes at the Commonwealth level with a *credit* for State taxes, an approach that would have the effect of fully equalising tax burdens across the country.[283] The compromise, he conceded, would allow the States to increase their rates 'on the ground that such action would not injure the taxpayers … the only effect being the loss of a certain amount of revenue by the Commonwealth'[284] - in effect, State taxes could rise to crowd out completely any Commonwealth tax without any rise in the combined tax burden. Scullin's proposal for uniformity achieved through differential sharing of tax revenue, offered in the interest of political compromise, appears not to have been his

[278] *Income Tax Assessment Act 1939* (Cth), s 3.

[279] *Income Tax (Management) Amendment Act 1939* (NSW), s 2(1)(a), enacted 7 November 1939.

[280] *Income Tax Assessment Act 1940* (Cth), s 11, enacted on 27 May 1940. The undistributed profits tax continued to apply to public companies until 1951: Y Grbich and B Cooper, *Undistributed Profits Tax: A Critical Analysis* (Sydney: Taxation Institute Research and Education Trust, 1979), 9.

[281] Butlin, above n 275, 384.

[282] Ibid, 364; *Income Tax Assessment Act 1915* (Cth), s 18(b).

[283] Butlin, above n 275, 385.

[284] J Scullin (Yarra), CPDHR, Vol 165, 991–992 (12 December 1940).

preferred option. Unification, in the sense of a Commonwealth takeover of income taxation, offered a more direct solution.[285] The view was shared by some in the conservative camp.[286]

Scullin's credit for state taxes proposal and a proposed modification he suggested to cap the credit at the level of 1940–41 State tax rates was rejected by the government at this point, which for the moment appeared to have no fall-back position. However, by mid-1941, the conservative camp had evidently shifted to the view that unification (a Commonwealth takeover of income taxation) offered the simplest solution to the dilemma. Faced with growing budgetary pressures, frustrated over the fragmentation of fiscal policies and laws across the country, and unable to set significantly higher tax rates in the face of widely divergent State marginal rates, the Commonwealth government proposed that the States temporarily vacate the income tax field.[287]

The proposal was quickly rejected by the States.[288] The Commonwealth government responded with a plan for a compulsory national loan scheme (in effect a tax that would be repaid after the war) incorporated in the September 1941 Budget. The advantage of the 'loan' characterisation was that it would allow the Commonwealth to impose different rates in different States in response to different State tax rates without breaching the constitutional requirements for non-discriminatory taxation across the Commonwealth.

The Budget failed to pass, a victim of rambunctious politics within the governing conservative camp. The Prime Minister, Robert Menzies, had spent the first third of 1941 in

[285] Ibid. Scullin declared that 'he had no hesitation in asserting that the most effective way to deal with the problem is to amend the Commonwealth Constitution with the object of achieving real unification'. He also noted the alternative of seeking voluntary agreement of the States for a withdrawal from the taxation of higher incomes.

[286] See, e.g., the comments of E S Spooner in the debate following presentation of Scullin's proposed credit for State tax compromise: 'what action the Commonwealth might take under its war-time emergency powers is a matter for consideration, and I am convinced that if uniformity is reached in this way, the public, after the war, will not permit a return to the present system': ibid, 995–996. Spooner would be appointed to cabinet a few months later.

[287] See 'Income Tax, State Withdrawal Supported, Division Hampers War Effort', *Canberra Times* (27 June 1941), 4.

[288] See 'States Reject Uniform Tax Plan, Commonwealth to Decide Next Step, Mr. Fadden Disappointed, Mr. Forgan Smith's Alternative', *Sydney Morning Herald* (28 June 1941), 13. The report noted Fadden's statement of regret at the decision, '[b]ecause I feel that the States viewed the matter from an angle of undue and unwarranted fear that the Commonwealth was seeking power to usurp the functions of the States, and that they looked upon the proposal as a permanent surrender of rights, rather than as a temporary measure'.

the United Kingdom to support Britain's war effort. He returned to Australia to discover political support within his party had evaporated and he was forced to cede the Prime Ministerial post to the Treasurer and leader of the junior Country Party partner in the conservative coalition, Arthur Fadden. Two independent members of the lower House, however, upset over the coalition's treatment of Menzies, voted against the Budget, leading to the fall of the government. Following agreement by the independents to support a Labor government, Labor Opposition Leader John Curtin accepted and assumed the post of Prime Minister on 7 October 1941.

The Commonwealth political turmoil provided the New South Wales Labor government, newly elected in May 1941, with the opportunity to pursue an overhaul and increase of State taxes, in part to compensate for a substantial cut in the State's loan allocation from the Loan Council for works for non-war purposes.[289] Following the defeat of the Commonwealth Budget, New South Wales enacted a replacement income tax that incorporated previously separate unemployment relief and social services taxes. The tax incorporated a broad range of changes that deviated dramatically from the harmonised tax model including, significantly, the introduction of full residence taxation of worldwide income together with the use of a foreign tax credit rather than the exemption used in the Commonwealth tax;[290] a new concessional deduction; restrictions on charitable deductions;[291] and also, significantly, the narrowing of the scope of exemptions for interest on Commonwealth and State loans.[292] The harmonised profit allocation rule for cross-border sales was also replaced with a measure that taxed 100 per cent of profit on sales in the State by out-of-state manufacturers together with a rebate payable to those manufacturers, capped for taxes paid in the State of manufacture.[293] By the time the newly appointed Commonwealth Labor government introduced its Budget on 30

[289] See, e.g., 'Defence of Loan Cut, Mr. Fadden Replies to Premier', *Sydney Morning Herald* (1 September 1941), 6.

[290] *Income Tax Management Act 1941* (NSW), s 204, enacted on 24 October 1941.

[291] *Income Tax Management Act 1941* (NSW), s 87(2)(b). An unlimited deduction was later added, however, for gifts to a public fund established to purchase a ship to replace the HMAS Sydney: *Income Tax Management (Amendment) Act 1942* (NSW), s 2(1)(b)(ii).

[292] The exemption was removed in respect of dividends paid wholly and exclusively out of interest from Commonwealth and State loans; interest itself in both cases remained exempt: *Income Tax Management Act 1941* (NSW), s 19(k). See discussion in text at nn 185-190 above.

[293] *Income Tax Management Act 1941* (NSW), s 39.

October 1941 to replace the failed conservative Budget,[294] State-Commonwealth harmonisation was dead.[295]

The end for State income taxation came quickly. In January, as the Australian press suggested Canada, which like Australia had both federal government and State (or provincial in the case of Canada) income taxes, would move to a uniform levy at the federal level,[296] the Commonwealth government explored the unification option.[297] Initial surveys indicated the likelihood of strong opposition to the idea[298] and it became clear that the Commonwealth would need something to bolster its case if unification were to have any chance of crossing political hurdles. The Japanese bombing of Darwin on 19 February 1942 provided a perfect backdrop for the Commonwealth government's planned approach and on 23 February, four days after the Japanese attack, the Commonwealth appointed a Committee on Uniform Taxation, commissioned to provide prompt advice on wartime finances in a fiscal and military emergency.[299] Importantly, the Commonwealth took great care to ensure its plans were not

[294] See 'Chifley Budget Hits Higher Incomes, £8,500,000 More Required From Companies, Measures to Control Banks', *The Mercury* (30 October 1941), 1.

[295] E S Spooner, a conservative federal politician who would later serve on the committee appointment to devise a unified income tax, said of the New South Wales changes, 'There went the result of our work': E S Spooner, in F Bland (ed.), *Changing the Constitution: Proceedings of the All Australian Federal Convention, 25–26 July 1949* (Sydney: New South Wales Constitutional League, 1950), 67, cited in Gilbert, above n 212, 247–248.

[296] See, e.g., 'Income Tax in Canada, Federal Monopoly', *Sydney Morning Herald* (20 January 1942), 3.

[297] Commonwealth Government, Memorandum, 'Uniformity of Commonwealth and State Income Taxes', January 1942, National Archive Series A571/166 Control Symbol 1943/1468, cited in C Saunders, 'The Uniform Income Tax Cases', in H P Lee and G Winterton (eds), *Australian Constitutional Landmarks* (Cambridge: Cambridge University Press, 2003), 62, 67. One press report at the time, ahead of a Loan Council meeting on 3 February, cited 'official circles' as confirming that 'no further direct taxation is contemplated this year' but pointing to the likelihood of increases in *indirect* taxation 'to meet increased pensions and other inescapable commitments': see 'Enlarged War Bill May Increase Indirect Taxation, £35 Million Loan Next Month', *Canberra Times* (23 January 1942), 4.

[298] The Memorandum, ibid, reported the views of the State Premiers on the proposed compensation, indicating opposition in general to the scheme from all of them, except the Premier of South Australia.

[299] Committee on Uniform Taxation (Professor R C Mills, chair), *Report of the Committee on Uniform Taxation* (28 March 1942) (Canberra, Commonwealth Government Printer, 1942), 1. See 'Uniform Taxes, For War Period, Committee Appointed to Formulate Plan', *Canberra Times* (26 February 1942), 2 (reporting that '[t]he committee will thoroughly explore the income tax field of the Commonwealth and the States and seek a formula for their amalgamation into a uniform scheme under one taxing authority to meet the essential revenue requirements of the Commonwealth and the States'). While the Committee was appointed on 23 February, the Commonwealth withheld a public announcement until 25 February.

presented as a takeover of State taxation. Rather, as the name of the Committee suggested, the move was presented as an equity initiative to replace inconsistent tax burdens across the States with a fair and uniform nation-wide tax regime.

Membership of the three-person Committee was carefully chosen to engender bipartisan support. The Committee's Chair, Professor R C Mills, was the recently appointed chairman of the Commonwealth Grants Commission.[300] The Rt Hon J Scullin was, as noted previously, a senior and well-respected Labor MP who had been 'recognised on both sides of the House as technically expert and shrewd in taxation matters'.[301] The Hon E S Spooner was a Minister in the conservative Menzies and Fadden governments and previously Assistant Treasurer in the conservative government of New South Wales. A little over a month later, on 28 March 1942, the Committee's report was issued.[302] The Committee's Report concluded that, in the context of the need for the Commonwealth to exercise its revenue-raising capacity to the fullest in war-time without the restriction of the States being present in the income tax field, uniform taxation should be imposed by the Commonwealth for the duration of the War and one year thereafter.[303] The fiscal position of the States, the Committee suggested, could be protected by the payment of grants calculated as the average of income tax collections in the State in 1939–40 and 1940–41 (less cost savings as a result of the scheme), with a procedure for the States or the Commonwealth to submit a claim for adjustment of the compensation from 1942–43, to be referred to an independent authority for investigation and report.[304]

The proposal for a single Commonwealth income tax was endorsed by the federal Cabinet in mid-April[305] and presented to a Premiers' Conference soon after, on 22 April. Not surprisingly, the Commonwealth usurpation of income tax powers was opposed by all the States.

Ignoring State views, the Commonwealth pressed ahead with its uniform income tax scheme, enacting legislation to implement the scheme on 7 June. The Commonwealth scheme was implemented by way of four separate laws:

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[300] For discussion of Mills' role on the Grants Commission, see P Groenewegen, 'R. C. Mills (1886–1952) and Australian Fiscal Federalism, with Special Reference to the Methodology of the Grants Commission' (2001) 36 *History of Economics Review* 66, 72.

[301] Butlin, above n 275, 384.

[302] Committee on Uniform Taxation, above n 299.

[303] Ibid, 2.

[304] Ibid, 4.

[305] Saunders, 'The Uniform Income Tax Cases', above n 297, 65.

- the *Income Tax Assessment Act 1942*, containing the Commonwealth's uniform tax assessment law and a rule giving priority to payment of Commonwealth income tax over State income tax;
- the *Income Tax (War-time Arrangements) Act 1942*, providing for transfer of State taxation office equipment and staff to the Commonwealth to administer the expanded Commonwealth income tax;
- the *States Grants (Income Tax Reimbursement) Act 1942*, providing for payment of financial assistance to the States conditional on States' abandoning State income taxation; and
- the *Income Tax Act 1942*, imposing the tax at a uniform rate across the country.

The laws placed no legal constraints on States' power to impose income taxation. If upheld as constitutionally valid, they would, however, have had the practical effect of ending State income taxation. They provided for Commonwealth income tax rates high enough to generate revenues for Commonwealth and State expenditures. There was, thus, no room for additional income taxes that would be needed by any State that opted out of the scheme.

The Commonwealth laws were, as expected, immediately challenged in the High Court in what became known as the *First Uniform Tax Case*. Only four of the six States joined the action, however, with New South Wales and Tasmania declining to join the High Court challenge. New South Wales Labor Premier William McKell was in a particularly difficult position as a strong opponent of the scheme personally, but forced to withdraw by his party's State conference in June. McKell is reported to have said at this conference that '[i]t has been the States, particularly New South Wales and Queensland, that have been in the vanguard of social legislation … The very moment you accept these proposals you settle for all time the possibility of any State giving you any social legislation of any value'.[306]

While the laws followed the recommendation of the Committee on Uniform Taxation, establishing arrangements for the duration of the war and one year following the end of the

[306] D Rawson, 'McKell and Labor Unity', in M Easson (ed.), *McKell: The Achievements of Sir William McKell* (Sydney: Allen & Unwin, 1988), 26, 44, citing *Sydney Morning Herald* (15 June 1942). It has also been noted, however, that the McKell government was the first to transfer constitutional powers (as opposed to finance) to the Commonwealth in planning for post-war reconstruction (*Commonwealth Powers Act 1942* (NSW), 24 December 1942): K Turner, 'William (later Sir William) John McKell', in D Clune and K Turner (eds), *The Premiers of New South Wales, Vol 2 1901–2005* (Sydney: Federation Press, 2006), 251, 266.

war, the form which the legislation for the uniform tax scheme took in four separate Acts meant that the determination of the validity of the Acts did not proceed solely in relation to the Commonwealth's defence power, but also the Commonwealth's taxation and grants powers and the question whether the four Acts could be considered collectively as a scheme involving an impermissible purpose of interfering with the powers of the States.[307] Six weeks after its enactment, on 23 July, the High Court dismissed the States' challenge, upholding the constitutional validity of all four laws,[308] though different members of the Court dissented on particular elements.[309]

While the High Court took care to note that the ruling in no way constrained the constitutional power of the States to impose separate income taxes, it conceded that the scheme was one that in practical terms left the Commonwealth with virtually limitless *de facto* power to assume responsibility for programs that had been States' responsibilities. The constraint on the exploitation of that power, the Chief Justice said, could only be political, determined by the voters who elected the Commonwealth government; the grants power in the Constitution imposed no constitutional restriction on this outcome.[310]

The High Court's decision appeared to garner widespread support among the general public and was applauded in some quarters as putting to rest a contentious fiscal distraction, allowing the government to move on with war-time policies.[311] It had not gone unnoticed, however, that the key laws in the scheme had been upheld by the High Court on grounds apart from the Commonwealth's defence power, an outcome that could allow the Commonwealth constitutionally to continue its wartime arrangements after the War.[312]

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[307] Saunders, 'The Uniform Income Tax Cases', above n 297, 72–74.

[308] *South Australia v Commonwealth* (1942) 65 CLR 373 (*First Uniform Tax Case*).

[309] Chief Justice Latham and Justice Starke dissented as to the validity of the *War-time Arrangements Act* (providing for transfer of State taxation office equipment and staff) under the defence power, and Justice Starke also dissented as to the validity of the *Grants Act* which provided for payment of conditional financial assistance to the States under section 96 of the *Constitution*. Furthermore, Justice McTiernan only upheld the priority rule in the Assessment Act under the defence power.

[310] *South Australia v Commonwealth* (1942) 65 CLR 373, 429 (*First Uniform Tax Case*).

[311] 'The High Court's Decision' (editorial), *Sydney Morning Herald* (24 July 1942), 4.

[312] K Bailey, 'The Uniform Income Tax Plan (1942)' (1944) 20(2) *Economic Record* 170, 187, reproduced in W Prest and R L Mathews (eds), *The Development of Australian Fiscal Federalism*, above n 197, 309, also discussed in Saunders, 'The Uniform Income Tax Cases', above n 297, 69.

3.6 Conclusion

The prediction of some made during the debate on the uniform tax legislation in 1942 that the temporary wartime scheme might become permanent[313] proved to be accurate. An examination by Commonwealth and State Treasury officials in 1953 of 'the technical problems involved in the resumption of income tax by the States',[314] for example, did not lead to any specific proposal for resurrecting State income taxation,[315] and the uniform scheme would survive the further High Court challenge in 1957 largely intact.[316] The foundation for the vertical fiscal imbalance that has shaped the Australian geo-political landscape since proved enduring.

While the decision to enact the legislation for the uniform income tax scheme may have seemed to the casual observer at the time to have been made and implemented very quickly in the war-time conditions of 1942, it might be asked whether centralised income taxation and consequent Commonwealth control over economic and social programs was an inevitable outcome in Australia simply waiting for the appropriate implementation trigger. On the one hand, the intergovernmental agreements in 1923 for collection of Commonwealth and State income tax by the States, the 1927 agreement for centralisation of government borrowing, the 1929 agreement for allocation of the income of multi-State businesses, and the enactment of income tax legislation by the Commonwealth and all States in 1936–37 on largely harmonised lines all appear to indicate that political compromises to address the problems of concurrent income taxation could be achieved. At the same time, the deviations from the agreements in

[313] See Saunders, 'The Uniform Income Tax Cases', above n 297, 69 and references there cited.

[314] See Commonwealth and State Treasury Officers, 'Resumption of Income Tax by the States', in W Prest and R L Mathews (eds), *The Development of Australian Fiscal Federalism*, above n 197, 347. The Commonwealth Solicitor-General, Crown Solicitor for New South Wales, Solicitor-General of Victoria and Commonwealth Commissioner of Taxation were also consulted as part of this inquiry.

[315] A later commentary on the process noted that Commonwealth officials had been particularly obstructionist in relation to this process: '[t]he Commonwealth Treasury exercised great ingenuity in raising difficulties and feeding them backstage to Under-Treasurers of States which were opposed or lukewarm to resumption'. See J A Maxwell, 'Another Look at Resumption of Income Taxation by the States' (1966) E1(22) *Economic Papers* 1, also cited in W Prest and R L Mathews (eds), *The Development of Australian Fiscal Federalism*, above n 197, 360.

[316] *Victoria v Commonwealth* (1957) 99 CLR 575 (*Second Uniform Tax Case*). One finding of the *First Uniform Tax Case* was overruled, however (with three judges dissenting), namely that the provision of the *Income Tax Assessment Act 1942* (Cth) which had conferred priority for payment of Commonwealth income tax over State income tax was valid.

each case might suggest Australian States and the Commonwealth were (and are) incapable of reaching the level of compromise and agreement needed for a genuinely sustainable federal jurisdiction capable of providing the level of social and economic leadership required in the second half of the twentieth century and beyond. With the benefit of hindsight, some commentators explain the Commonwealth takeover of income taxation solely in terms of macroeconomic policy, with no mention of wartime financial needs as a factor.[317] It remains an open question whether the experience of the evolution of a centralised income tax system in the period 1915 to 1942 is the story of inevitability or coincidence of circumstances.

[317] See, e.g., P Smyth, 'The Historical Context for Action', in A McClelland and P Smyth (eds), *Social Policy in Australia: Understanding for Action*, 3rd edn (Melbourne: Oxford University Press, 2014), 81, 90.

Chapter 4

From Wartime Expedient to Enduring Element of Fiscal Federalism: Centralised Income Taxation in Australia since World War II

4.1 Introduction

From not long after Federation and the creation of Australia in 1901, the federal Labor party adopted an agenda of centralisation of economic powers. Time and again they were stymied by the Constitution which had vested primary economic powers with the States. Attempts to rewrite the economic powers in the Constitution by way of Labor-sponsored referenda failed in 1911, 1913, and 1915, as did referenda sponsored by a coalition government formed in part with a breakaway Labor faction in 1919 and 1926. The gateway to federal control was provided first by the German invasion of Poland in 1939 with Australia's subsequent declaration of war enabling the central government to invoke constitutional wartime powers that were interpreted to include most economic powers, and then by the Japanese attacks on Hong Kong, Singapore and Malaya in December, 1941, bringing Australia into war on a new front, opening the door to federal monopolisation of income tax. In 1942, shortly after the Japanese airforce bombed the port of Darwin, a Labor-led Australian federal government moved unilaterally to appropriate concurrent income tax powers from state governments for the duration of the war.

Presented as a temporary wartime fiscal measure, but more likely attributable to the government's agenda for broader economic control during the war, if not beyond,[318] the federal government's move was immediately challenged in the courts by the States, fearful of losing a major revenue source and distrustful of the federal government's promises of offsetting grants. A ruling by the High Court in July, 1942 confirmed the legal legitimacy of the tax usurpation and the central government moved quickly to implement the change.

[318] See Chapter 3, sections 3.2.1 and 3.6.

The Australian experience was not unique. War time finance needs and a desire to centralise economic powers during the conflict prompted the Canadian government to appropriate the provincial income tax field in that country. Importantly, however, income taxation at the subnational level was resumed in Canada in stages following the war and was restored to its role as a significant (and ultimately the main) source of revenue for provincial governments. In Australia, however, the temporary appropriation of State income taxes remains in effect, seemingly with bipartisan support at the federal level. The result has been an unequalled inter-government fiscal imbalance (States have retained key social spending responsibilities while only the federal government has access to the tax revenue needed to pay for those programs[319]) and possibly the only case worldwide where a central government has fully commandeered taxing powers constitutionally allocated to another level of government.

Retention of the income tax for some time after the end of the war might be explicable by political ideology – the Labor party remained in power for almost half a decade following the war – but this explanation cannot apply to the period from 1950 when a conservative government whose leader once called for a transfer all federal income tax powers to the States came to power, holding it for over two decades.[320]

A range of factors might explain the Australian government's desire to monopolise the income tax field in the post-war era, particularly the macro-economic policy challenges it faced in a nation stretching across a vast area and encompassing widely divergent needs and resources and the intensity of the Cold War that followed on the heels of Germany's surrender in 1945. The same factors were present to an equal degree in Canada, however, a country

[319] It can be noted that during World War II and through to the 1950s, income taxation had completed its transition to a 'mass tax', in Australia as in other major Western economies: on this issue in the US, see A K Mehrotra, 'Reviving Fiscal Citizenship' (essay on L Zelenak, *Learning to Love Form 1040: Two Cheers for the Return-Based Mass Income Tax* (2013)), (2015) 113(6) *Michigan Law Review* 943, 957, n 53 and references there cited; on Canada, see S Tillotson, 'Warfare State, Welfare State, and the Selling of the Personal Income Tax, 1942-1945' (2015) 63(1) *Canadian Tax Journal* 53, 56; and similarly Australia, see R L Mathews and W R C Jay, *Federal Finance: Intergovernmental Financial Relations in Australia Since Federation* (Melbourne, Thomas Nelson, 1972), 176-177, while early moves to expand the income tax had undoubtedly also occurred before the War at the State level: J Smith, 'Australian state income taxation: a historical perspective' (2015) 30(4) *Australian Tax Forum* 679. For a summary of the general revenue assistance arrangements between the Commonwealth and State governments over the period covered by this Chapter, see Appendix Table 1 to this thesis.

[320] A schedule of the years of government of each major political party in Australia (Commonwealth and States) in the postwar period is set out in Appendix Table 2 to this thesis.

larger than Australia and with more geographic and socio-economic diversity and with Cold War military ties to the US paralleling those of Australia. The explanation for the very different path followed by the Australian central government, even during long periods of government by a conservative party traditionally committed to State economic rights, must lie in fiscal factors unique to Australia and their impact on federal politics, although random 'political accidents' cannot be ruled out of the equation.[321] This chapter explores those factors.

Key themes in the analysis will be, first, to highlight the great importance placed on ensuring the Australian central government's power to conduct macroeconomic policy, with Cold War developments always in the background; and also, perhaps more significantly, to show that while this policy objective looms large throughout the story and centralised income taxation has largely come to be regarded by the public as a 'fixture' of the Australian governmental landscape, much evidence also suggests that centralisation of the income tax nevertheless seems to have come surprisingly close to unravelling at many points after its establishment in 1942.

4.2 The post-World War II transition: the resumption of provincial income taxes in Canada

As was the case in Australia, Canada's tax system prior to World War II included personal and corporate income taxation by the federal government and most of the subnational (provincial) governments, commencing from as early as 1876,[322] and which from 1917 operated

[321] Shortly after the War, an eminent Canadian scholar suggested diverging paths would be explained both by immediate fiscal needs and 'political accidents': J A Maxwell, 'Recent Intergovernmental Fiscal Relations in Australia and Canada' (1947) 32(5) *Bulletin of the National Tax Association* 138 (reproducing an address delivered in Cleveland, 27 December 1946).

[322] J H Perry, *Taxation in Canada*, 2nd edn (Toronto: University of Toronto Press, 1953), 15-19; C Campbell, 'J.L. Ilsley and the Transformation of the Canadian Tax System: 1939-1943' (2013) 61(3) *Canadian Tax Journal* 633, 650. Note that in terms of the development of income taxation as a revenue source to the Dominion and provincial governments in Canada up to World War II, in 1939 the personal and corporate income tax represented only around one-fifth of principal revenues in Ontario, for example, and a somewhat higher 28 per cent of Dominion tax and non-tax revenue in that year, as each level of government had other significant sources of revenue. In Australia, by contrast, in 1938-39, income taxes represented only 16.1 per cent of Commonwealth government tax revenue but a much higher 59 per cent of total State tax revenue (and State income tax revenues represented nearly one-quarter of total Commonwealth and State tax revenue overall). Accordingly, leaving aside any adjustments to revenue to take account of grants, royalties, railway revenues and borrowings, income taxes were a relatively much more significant revenue source to the Australian States

concurrently with the federal (Dominion) government's income tax enacted in that year.[323] Provincial retail sales taxes were slower to emerge, in the face of the constitutional allocation to the provinces of power only to impose 'direct taxation'.[324] However, a Privy Council decision in 1943 opened the door to provincial retail sales taxes (and eventually provincial goods and services taxes) when it characterised a sales tax as a type of direct tax imposed on purchasers, with the vendors liable for payment of the tax described as agents for the Crown.[325]

On its face, the Canadian Constitution provided for far more power to the central government than Australia's. Indeed, the desire of the Australian colonies to avoid the level of apparent centralisation in Canada informed many of the decisions made in the drafting of the (later) Australian Constitution of 1901.[326] Two features in particular gave the appearance of greater central powers in Canada: a constitutional provision which transferred the power of disallowance of provincial enactments from the Sovereign in the UK to the Governor General in Canada,[327] a feature deliberately omitted from the Australian Constitution, and a far broader

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themselves than to the Canadian provinces at that time. See respectively J H Perry, *Taxes, Tariffs, & Subsidies: A History of Canadian Fiscal Development*, Vol 2 (Toronto: University of Toronto Press, 1955), Tables 6 and 16, and Mathews and Jay, *Federal Finance: Intergovernmental Financial Relations in Australia Since Federation* above n 319, 152, Table 19.

[323] See R Krever, 'The Origin of Federal Income Taxation in Canada' (1981) 3(2) *Canadian Taxation* 170.

[324] See now *Constitution Act 1867* (Can.), s 92(2).

[325] *Atlantic Smoke Shops, Ltd v Conlon* [1943] AC 550, 30 July 1943.

[326] See, for example, L Zines, 'The Federal Balance and the Position of the States', in G Craven (ed.), *The Convention Debates 1891-1898: Commentaries, Indices and Guide* (Sydney: Legal Books, 1986), 75, 76, noting that the Canadian Constitution enacted in 1867 was rejected in Australia in the lead-up to Federation in 1901 as a comprehensive model for the Australian federal system, on the basis of being 'too centralised' particularly in comparison with the US model.

[327] *Constitution Act 1867* (Can.), s 90. Even before the official constitutional debates began in Australia, it had been established in Canada that this power could be used by the federal government to disallow provincial enactments on a much broader range of grounds than the UK government might have done to laws of former Canadian colonies: see G V La Forest, *Disallowance and Reservation of Provincial Legislation* ([Ottawa]: Department of Justice, 1955), 28-33, 101, noting in particular the views in 1876 of then UK Colonial Secretary Lord Carnarvon that the disallowance provision did not extend to validly enacted *intra vires* provincial legislation, rejected however by Justice Minister Edward Blake. While the power was last actually used in Canada in 1943, against an Albertan law dealing with a matter which 'should, in wartime, be dealt with exclusively by the Federal Government', and as recently as 1976, Prime Minister Pierre Trudeau suggested use of the power against provincial laws cutting 'directly across' federal laws or creating 'serious disorder', Canadian Supreme Court decisions have since held that the power has fallen into disuse: P W Hogg, *Constitutional Law of Canada*, 5th edn (Toronto: Carswell, 2015 looseleaf), sect. 5.3(e). In the case of the

reading of the federal government's power to make laws for 'peace, order and good government' than has been accorded to the corresponding constitutional provision in Australia.[328] In practice, Canadian provinces have achieved a degree of sovereignty which vastly exceeds that enjoyed by Australian States, while retaining full responsibility for social sectors such as health and education that have been largely shifted to the federal government in Australia. In contrast with the judicial decisions on the Australian Constitution, however, at key points in the country's fiscal history crucial court rulings on the Canadian Constitution affirmed the Canadian central government's claim to hold powers of economic management that had been denied to the Australian government in similar circumstances. The differing outcomes of court challenges to federal economic powers play a key role in explaining the divergent paths of fiscal federalism in the two nations.

Unlike their Australian counterparts, Canadian provincial leaders were forced to recognise the possibility of centralisation of the income tax early in the course of the war following the release in 1940 of the final report of a Royal Commission on Dominion-Provincial Relations which recommended centralisation of personal and corporate income taxes.[329] While the Report was strongly criticised by provincial Premiers, the prospect of centralisation was real. When the central government indicated it would appropriate the income tax field for the duration of the war, the provincial Premiers, unlike their Australian counterparts, acceded to the proposal,[330] agreeing to cede tax collection powers to the central

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Australian States, by contrast, the power of disallowance remained with the Sovereign in the UK after Federation, until the power was ended entirely in its application to the States by the Australia Acts of 1986: *Australia Act 1986* (Cth), s 8, enacted on 4 December 1985. A UK disallowance power over Commonwealth government legislation, however, continues: *Constitution*, s 59. See on this topic A Twomey, *The Australia Acts 1986: Australia's Statutes of Independence* (Sydney: Federation Press, 2010), 279-283.

[328] For a discussion of the history of usage of this provision in the UK's North American and Australian colonies, and possible limitations on legislative power from the words in the Australian Constitution, see I D Killey, '"Peace, Order and Good Government": A Limitation on Legislative Competence' (1989) 17(1) *Melbourne University Law Review* 24 (noting, at 25 and 49, usage of this or similar wording in instructions to governors in North America 'from at least 1673', referring to L W Labaree (ed.), *Royal Instructions to British Colonial Governors 1670-1776 Vol 2* (1935), 812).

[329] Canada, *Report of the Royal Commission on Dominion-Provincial Relations* (Rowell-Sirois Commission) (King's Printer, Ottawa, 1940).

[330] Campbell, 'Transformation of the Canadian Tax System', above n 322, 658, noting that all agreements had been signed by 27 May 1942. The agreement included specific provision for the Dominion government to lower its tax rates after the end of the agreement, in particular to lower the rate of corporation tax by 10 per cent.

government on a temporary basis on the condition that the provinces received compensatory grants known as 'tax rental payments' equal to the lost revenue.[331] The agreement provided for suspension (rather than termination) of the relevant provincial taxes for the war period, so that they would resume automatically after the end of the war.[332]

By late 1944, it was clear that the Dominion government had reached the view that to achieve full employment and high income goals, it 'required exclusive possession of the personal income tax, corporation tax, and succession duty fields',[333] and that it would be likely to have strong public support not to implement the tax rate reduction provided for in the intergovernmental agreement to enable restoration of provincial taxation after the war.[334] At a Dominion-Provincial conference in August 1945, three months after the surrender of Germany, and coincidentally starting on the day of the Hiroshima nuclear attack, the provincial Premiers pressed the case for provincial fiscal autonomy,[335] but federal negotiators showed little inclination to retreat. Circumstances changed significantly in the following six months. With the surrender of Japan, Canada shifted from a wartime footing to a civilian environment and revenue needs fell with the winding back of war expenditures. At the same time, a decision of

[331] See the Australian press report of this development in, e.g., 'Income Tax in Canada, Federal Monopoly', *Sydney Morning Herald*, 20 January 1942, 3, noted in Chapter 3, above n 296. Similarly, the Canadian government seems to have maintained a watching brief on Australian income tax developments from 1942, including reciprocating the Australian interest in Canadian fiscal moves in 1946 referred to in n 348 below. See Canadian Government, 'Miscellaneous Taxations, Australia Income Tax' (1942-1948), Canadian Archive LAC File T-12053, and Canadian Government, 'Australia – Taxation, Income Tax, Uniform Taxation System, Commonwealth-State Agreement' (1946), Canadian Archive LAC File 402-108-1-2.

[332] See *Dominion-Provincial Taxation Agreement Act 1942*, 6 Geo. VI, c 13 (Can.), enacted on 28 May 1942, and also, e.g., Ontario's *Corporations and Income Taxes Suspension Act 1942*, 6 Geo. VI, c 1, enacted on 27 March 1942, which provided (in s 5(1)) for tax not to be levied under the province's *Corporations Tax Act 1939* until termination of the intergovernmental agreement (which was to occur automatically on cessation of the war unless terminated sooner by the province). In Australia, New South Wales enacted a similar suspending statute in 1942 to suspend its income tax, expressed to terminate on the same basis as the Commonwealth legislation after the conclusion of the war: *Income Tax Suspension Act 1942* (NSW), enacted on 17 November 1942, s 7. The latter Act seems not to have been subsequently amended until eventually repealed in 1976 (*Statute Law Revision Act 1976* (NSW), Sch 1), while the *Income Tax (Management) Act 1941* (NSW) itself was finally repealed in 2002: *Statute Law (Miscellaneous Provisions) Act 2002* (NSW).

[333] C Campbell, 'J.L. Ilsley and the Transition to the Post-War Tax System: 1943-1946' (2015) 63(1) *Canadian Tax Journal* 1, 21, citing a draft Dominion government memorandum of 30 September 1944.

[334] Campbell, 'Transition to the Post-War System', ibid, 24, citing a revised memorandum dated 8 March 1945.

[335] Campbell, 'Transition to the Post-War System', ibid, 31.

the Privy Council in January 1946 on federal government regulation over the national liquor market indicated the federal government had residual constitutional powers to regulate the national economy generally, and thus providing an avenue for federal government intervention without the need to hold all taxing powers.[336] Subsequent decisions confirmed the breadth of power conferred on the federal government, including its power to control prices.[337]

Ongoing negotiations between the provinces and federal government had yielded no agreement on taxing powers but even in the absence of any agreement to return taxing rights, it was clear that high wartime rates were not sustainable in peacetime and in its June, 1946 Budget the federal government reduced personal and company tax rates, including a significant 10 per cent cut in the corporation tax rate, as envisaged in the 1942 intergovernmental agreement.[338] The Budget also provided for resumption of provincial corporate taxation at a

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[336] *Attorney-General for Ontario v Canada Temperance Federation* [1946] AC 193. Similarly, in the US, the judicially recognised scope for governmental price regulation had expanded prior to World War II, and the cases on the wartime regulation of prices of utilities and firms in other industries, based on application of the principles of the constitutional requirement for 'just compensation' for a taking of private property, have been described as establishing the scope of the modern constitutional doctrine of price regulation, based on the factors of justification for the regulation, its duration and the scope for withdrawal of firms from the field: J N Drobak, 'Constitutional Limits on Price and Rent Control: The Lessons of Utility Regulation' (1986) 64(1) *Washington University Law Review* 107, 109-110.

[337] *Reference re Anti-Inflation Act* [1976] 2 SCR 373 (Supreme Court of Canada). This case was still itself an important precedent as the scope of the Canadian federal government's residual economic powers was not completely settled after the *Canada Temperance* decision: see P H Russell, 'The *Anti-Inflation* case: the anatomy of a constitutional decision' (1977) 20(4) *Canadian Public Administration* 632, 636-638. Nevertheless, apart from price and wage control powers per se, it had also been established in the period from the late nineteenth century to the inter-War years that the Dominion government possessed wide powers to regulate and control monopolies and anti-competitive corporate conduct (under the constitutional head of power in respect of criminal law) of the kind which had been invalidated in Australia in the *Huddart Parker* decision of 1909 (referred to further at n 346 below). On the development of the scope of these powers in Canada, see C S Goldman, QC, J D Bodrug, N Joneja and C Margison (eds), *Competition Law of Canada*, Vol 1 (looseleaf) (New York: Juris Publishing, 2013), 1.01[8] and 1.05[1]. Canada did not, however, see the establishment of formal centralised government borrowing arrangements of the kind achieved in Australia in 1927 (see text at n 213 above).

[338] J A Maxwell, *Recent Developments in Dominion-Provincial Fiscal Relations in Canada* (New York, National Bureau of Economic Research, March 1948), 16 (noting that the personal income tax exemption levels were raised for single and married taxpayers, and personal tax rates were lowered across the schedule so as to reduce average tax by 10 to 15 per cent 'for the majority of taxpayers'); Campbell, 'Transition to the Post-War System', above n 333, 49. See *Income War Tax Amendment Act 1946*, 10 Geo. VI, c 55; *Income War Tax*

rate of up to 5 per cent,[339] with a corresponding reduction in the tax rental payments, which would have yielded no fiscal benefit to provinces or incentive to restore provincial taxes.

Provincial acquiescence to the federal takeover of taxation and wholesale usurpation of all amounts exceeding the level of pre-war revenues that were returned to the provinces effectively ended nine months later. Following a pointed criticism of the federal government for its failure to reach agreement on ending the wartime tax appropriation, Ontario resumed its own corporate taxation at a rate of 7 per cent in its March, 1947 Budget.[340] Other provinces gradually followed with provincial company and personal income tax regimes, in most cases avoiding duplication of administrative resources by relying on the federal tax agency to collect the taxes. Seven decades later, income taxes are the primary revenue sources for provincial governments.

4.3 Post-war Australia under Labor

The grants formula adopted by the federal government to accompany its appropriation of State income tax powers initially led to no financial detriment to the States – the formula guaranteed the States the average net revenue they had received from their income taxes in the years immediately prior to the federal takeover. As the economy grew, however, State grants fell further and further behind the revenue they would have enjoyed had they retained their income tax powers and with the end of hostilities in Europe and Japan, State politicians in Australia

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Amendment Act 1947, 11 Geo. VI, c 63 and *Income Tax Act 1948*, 11-12 Geo. VI, c 52 (Can.). Further personal income tax cuts were made in the April 1947 Budget of approximately 29 per cent on average, i.e., 54 per cent at the lowest rate, 7 per cent at the highest: Maxwell, ibid; see also an Australian press report on this Budget and detailed comparisons with the Australian federal tax cut of 26 per cent, in '29 Per Cent. Tax Cut in Canada on July 1 Next', *Courier-Mail* (1 May 1947), 1.

[339] Campbell, 'Transition to the Post-War System', above n 333, 49: *Dominion-Provincial Tax Rental Agreements Act 1947*, 11 Geo. VI, c 58 (Can.), s 3(2)(b).

[340] Treasurer L Frost, Budget Address, Legislative Assembly of Ontario, 11 March 1947 (Toronto: King's Printer, 1947), 31. Ontario and Quebec also introduced special corporate levies in 1947 on capital and place of business amounting in effect to income taxes of about 1.5 per cent: D B Perry, *Financing the Canadian Federation, 1867 to 1995: Setting the Stage for Change* (Toronto: Canadian Tax Foundation, 1997), 43. Note that the discussion here of the fact of resumption of Canadian provincial income taxation after the war is not by any means to downplay the intensity of the political struggles and controversy which have nevertheless surrounded the issue in Canada throughout the postwar decades, including the cultural factors involved in the status of Quebec: see D V Smiley, *Canada in Question: Federalism in the Seventies*, 2nd edn (Toronto: McGraw-Hill Ryerson, 1976), chs 5 and 6.

turned their attention to the return to the States of income tax powers. Return of the tax was a central goal of State Premiers at the first post-war federal-state finance conference held in January, 1946.

The conference opened with strong protestations by State premiers of the continuation of centralised income taxation, known at the time as the 'uniform' income tax, with the premiers calling for swift return of income tax powers to the States. They emphasised the importance of income taxation as a State revenue source which would allow them to pursue policies for economic growth and development.[341] While not endorsed by some sectors of the community,[342] the proposal put forward by the States envisaged a system of joint taxation in which income tax would be imposed on a uniform base while States retained autonomy over the rates imposed for State income tax.[343]

From the outset, however, the States were stymied by the adamant refusal of federal Labor Prime Minister Ben Chifley to relinquish the taxing powers the federal government had unilaterally confiscated from the States three and a half years earlier. For the duration of the war, the government had exercised unprecedented command over the economy. But while the High Court had granted the central government control of income tax on the basis of general constitutional powers,[344] authority for federal assumption of State economic powers in other key areas of the economy, in particular price controls, was recognised by the Court on the basis of the federal government's defence powers.[345] Pre-war litigation had shown the federal government had no legitimate claims to assume these powers in general[346] and it had become clear the government could not alter those limitations by way of a referendum authorising a

[341] See Commonwealth Government, *Conference of Commonwealth and State Ministers, Canberra, 22-25 January 1946, Proceedings of the Conference* (unpublished); National Archive Series A461, Control Symbol BM326/1/3 Part 1.

[342] The editorial of the *Sydney Morning Herald* for 24 July 1942, for example, had criticised the conduct of the states in opposing the move by the federal government and noted that '[i]t may be seriously doubted whether the public, after experience of single and straightforward assessment, will desire after the war to see a revival of separate State income taxes, with all the complexities and anomalies they involve'.

[343] See 'States Want Tax Powers Back, Uniform System Criticised, Mr Chifley Rejects Plan', *Sydney Morning Herald*, 23 January 1946, 4.

[344] *South Australia v Commonwealth* (1942) 65 CLR 373 (*First Uniform Tax Case*); see Saunders, 'The Uniform Income Tax Cases', above n 297, 68-69.

[345] *Farey v Burvett* (1916) 21 CLR 433.

[346] *Huddart Parker and Co Pty Ltd v Moorehead* (1909) 8 CLR 330.

widening of federal constitutional powers.[347] The only certain path to continuing federal government exercise of what constitutionally appeared to be state economic powers was by retaining primary taxing rights and controlling the purse strings.[348]

The federal government made it clear to State premiers that it had no intention of returning tax powers to the States or risking any moves that might threaten its control over income taxation.[349] Instead, it indicated it would retain sole power to impose income taxation and put forward a plan to update the formula it had adopted in 1942 for distribution of appropriated tax revenues.[350] The original formula provided States with grants equal to the

[347] Referendum questions on the scope of federal economic powers were submitted on numerous occasions, all unsuccessfully: 26 April 1911 (nationalisation), 31 May 1913 (trusts and nationalisation), 1915 (trusts and nationalisation; withdrawn 4 November), 13 December 1919 (temporary extension of power in relation to trusts; nationalisation), 4 September 1926; 6 March 1937 (marketing; aviation). A referendum was, however, passed on 17 November 1928 to provide for the validation of the Financial Agreement of 12 December 1927 under which the Loan Council was established and government borrowing centralised.

[348] A referendum for temporary conferral of several constitutional powers on the federal government had also failed on 19 August 1944. Commentary since this time has often debated whether the legal proceedings by the States in the midst of the war and consequent establishment of the constitutional validity of the federal government legislation undermined prospects for resumption of State income taxation after the war, in contrast to the position of the Canadian provinces which did not launch such a challenge (given also that the judgment in 1942 was relied upon as a precedent by the High Court in the second challenge in 1957): see, for example, R Fisher, 'A Tale of Two Systems: The Divergent Tax Histories of Australia and Canada', in J Tiley (ed.), *Studies in the History of Tax Law* (Oxford: Hart Publishing, 2007) vol 2, 335.

[349] See *Sydney Morning Herald*, editorial of 24 July 1942, n 342 above; see also 'Uniform Tax, Continuance After the War, Govt. Confident of Powers', *Canberra Times* (7 September 1942), 2, noting that the government's view that 'it already has the necessary power to retain the uniform tax plan indefinitely after the war' was its cited reason for not including the income tax question in a constitutional referendum proposed at that time.

[350] Queensland Premier Cooper noted at the outset, for example, that the Commonwealth would no longer need to maintain the high level of military expenditure of the war. South Australian Premier Playford meanwhile referred initially to a matter in dispute of moneys collected by the Commonwealth relating to the period prior to commencement of the uniform scheme, and which were apparently to be retained by the Commonwealth: '[n]ot even that great Australian, Ned Kelly, put over anything worse than that'. (This issue also resurfaced in September 1950, when argument at the then conference of Commonwealth and State leaders as to the amount of a proposed Commonwealth grant increase viewed as inadequate led the Premiers to counterclaim 'with unexpected demands for repayment of £7 million [arrears of tax], owing to them since 1942'; the Commonwealth Treasurer's view was that there had been 'an understanding it would be repaid when the States returned to their former taxing methods', but in any event reportedly the 'Premiers claimed afterwards, however, that this provision had been deleted from the uniform tax agreement': see 'States get £12 Million More,

average of their income tax revenues over the two fiscal years prior to the federal takeover. The 1946 variation established fixed entitlements for each state with provision for adjustments for population change, weighting for remote area residents (which favoured the less urbanised states), and increased by half of the percentage amount of any increase in national average wages.[351]

Following a number of subsequent meetings between federal and State officials, but not politicians, State representatives made clear the States' continuing opposition to continued federal monopolisation of the field. However, less than two months after the end of the conference the government introduced legislation to enact its tax retention and revenue distribution proposals.[352] The intended permanence of federal income tax appropriation was reinforced by the inclusion in the law of a schedule of intended variations to the base amount for the following decade. The annual uplift factor ensured ongoing declines in state grants

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Premiers' Bitter Outbursts', *Canberra Times* (7 September 1950), 1). Playford then moved to a comparison with a Canadian grant proposal at that time which, it was pointed out, 'displays an anxiety on the part of the central government to ensure that the Provinces shall be treated generously'; Commonwealth Government, *Conference of Commonwealth and State Ministers, Canberra, 22-25 January 1946, Proceedings of the Conference*, above n 341, 15, 17, 77. A Commonwealth government (Department of Post-War Reconstruction, Melbourne) note on the plan for continuation of uniform taxation also claimed that there was an important reason for the policy 'not mentioned, for obvious reasons, in the submission – namely the influence of financial relations between the Commonwealth and the States on the general question of Commonwealth/State relationships': Commonwealth Government, 'Continuation of Uniform Taxation, Notes on Commonwealth (Treasury) Submission to Premiers' Conference – Agenda Item No 1'; National Archive Series CP80/1, Control Symbol Bundle 20/S821, Part 1.

[351] For such a scheme to continue effectively on a long-term basis (at least in times of inflation), arguably it would need to express a tax share for the States as a *proportion* of overall revenue from time to time rather than involving a distribution of a nominal amount or an amount calculated by reference to collections in a fixed base period (see further discussion in section 4.5 below, *'New Federalism', 1976-1983*, on the tax sharing model adopted in the 1970s with provision for top-up State own-income tax surcharges – but at a time, however, when the personal income tax included indexation for inflation). The German federation has constitutionally fixed arrangements for allocation, in the first instance, of specified proportions of total personal and corporate income tax revenue between federal and subnational governments: J Schnellenbach, 'German federalism at the crossroads: renegotiating the allocation of competencies in a new financial environment', in R Eccleston and R Krever (eds), *The Future of Federalism: Intergovernmental Financial Relations in an Age of Austerity* (Cheltenham, UK and Northampton, MA: Edward Elgar, forthcoming), sect. 6.4.1.

[352] *States Grants (Tax Reimbursement) Act 1946* (Cth), enacted on 13 April 1946. The law received royal assent three weeks later and the 1942 Act that had governed distributions was repealed under the same legislation.

relative to the increase in appropriated income revenue accruing to the federal government as the economy continued to grow.

Complementing its plan to retain income tax revenues, the government introduced its Budget for 1946-47 (the Australian fiscal year runs from July to June) with reduction in the highest personal tax rate on personal exertion income from its war-time peak of 92.5 per cent to 72.5 per cent. The company tax rate remained unchanged, as did a company tax surtax. As was the case in many jurisdictions, Australia had also adopted a war-time excess profits tax in addition to the ordinary personal and company income taxes to sweep up windfall profits from war contracts and this tax was brought to an end on 30 June 1947.[353] The change in personal income tax rates had little impact on finances. Apart from a small dip in overall income tax collections in 1946-47 from the 1945-46 level (more than offset by a jump in customs and excise revenue that year), personal income tax revenues (including the separately identified 'social services contribution' from 1 July 1945) otherwise continued to increase steadily after the end of the war years as did company tax revenues.[354]

The decision to keep tax rates and revenues largely intact, with the exception of windfall war personal income tax and company income tax rates, contrasted sharply with the Canadian experience where federal tax cuts left room for unilateral provincial tax action to re-establish income taxation. There remained no room for unilateral State action in Australia.

At the same time the federal government moved to retain primary economic power indirectly through control over the revenue, it signalled its intention to seek direct control with a mid-1946 financial statement indicating its plan to retain war-time economic powers, particularly price controls. While some controls that could only be justified by the war were removed in the post-war period (for example, restrictions on the supply of state and local government services ended in 1947, clothes rationing in 1948, controls over some building

[353] *War-time (Company) Tax Assessment Act 1940* (Cth), enacted on 17 December 1940; discontinued after the 1 July 1946-30 June 1947 financial year by the *War-time (Company) Tax Assessment Act 1947* (Cth), enacted on 27 November 1947.

[354] Between 1946-47 and 1950-51, personal income tax and social security contribution revenue was as follows: £159.3m (45-46), £154.4m (46-47), £163m (47-48), £199.4m (48-49), £196m (49-50) and £228m (50-51 est.), while company tax and excess profits tax revenues were: £55.3m (45-46), £53.4m (46-47), £69.8m (47-48), £72.9m (48-49), £83.7m (49-50) and £84m (50-51 est.): Commonwealth, *Budget, 1946-47* (Canberra, November 1946), 19, Table 5 and *Budget, 1950-51* (Canberra, October 1950), 19, Table 5.

materials in 1949 and tea rationing in 1950, after a change in government),[355] the government pursued what it viewed as key economic powers with vigour. As federal control of aspects of the economy such as price controls were based only on war-time constitutional powers, ongoing explicit retention of economic power in the key areas would require constitutional change, which the government sought in a series of post-war referenda. The referenda – to bestow power on the government to market agricultural products (1946), control employment contracts (1946) and to retain price controls and rent controls (1948) all failed to pass. With the election of a conservative government in late 1949 and the end of over eight years of Labor rule, the States seemed poised to regain much of their economic and possibly fiscal power.

4.4 The give and take of the conservatives

The return to federal government of a conservative coalition in 1949 under Robert Menzies, a long-time critic of centralised income taxation, albeit one who was aware of the practical issues to be resolved before it could be unwound,[356] led many to believe a change in policy towards centralisation of power and revenue was imminent. The conservative coalition's position on Labor's three referenda proposals to increase federal powers had been at best messy and ambiguous[357] and prominent coalition politicians had strongly criticised the Labor government for its ongoing retention of State income tax powers.[358]

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[355] This process of transition is described in detail in Butlin and Schedvin, *War Economy, 1942-1945*, above n 211, ch 25, and S Macintyre, *Australia's Boldest Experiment: War and reconstruction in the 1940s* (Sydney: NewSouth Publishing, 2015). For a closer examination of the interaction between government and expert advisers in relation to post-war reconstruction policies, see also C Holbrook, 'The Collaboration of Intellectuals and Politicians in the Postwar Reconstruction: A Reassessment' (2016) 47(2) *Australian Historical Studies* 278.

[356] Menzies in debate on States Grants Tax Reimbursement Bill, CPDHR, Vol 186, 667 (27 March 1946), where he indicated he was 'still opposed to it in principle' but conceded its immediate repeal was 'not practical politics'.

[357] Sawer, *Australian Federal Politics and Law, 1929-1949*, above n 217, 173. In the case of the 1946 referendum proposals, the Liberal party (member of the coalition) ultimately gave no party direction to voters on the questions: 'Menzies Outlines Liberal Party's Policy, Australia Must Expand, Issue Before Electors', *Sydney Morning Herald* (21 August 1946), 5.

[358] For example, in debate on the Bills for the 1948 referendum proposal, Harold Holt referred to the claimed breach by the government of its undertaking to bring uniform taxation to an end, 'because that constitutes one of the tests which may be applied to the Government in order to judge of its good faith in regard to the exercise of constitutional powers': CPDHR, Vol 195, 2999 (2 December 1947).

The fiscal significance to the States of losing the ability to tax incomes was highlighted in the final days of 1949 when the High Court read the constitutional restriction on State imposition of 'duties of excise'[359] broadly, establishing a precedent that over time would lead to the removal of States' power to levy any type of indirect tax.[360] Alternative funding sources available to the States if income taxes were not returned were shrinking.

It was, therefore, not surprising when, at his first meeting with the Premiers in September 1950, nine months after assuming office in December, 1949, Menzies indicated to the States that he was prepared to consider the resumption of income taxation by the States and offered to convene a special conference on federal-state financial relations in general.[361] The premiers' responses to the offer were surprisingly mixed and overshadowed to a large extent by the more immediate issue of securing an increase in the amount of the grants for the year.[362] The premiers' opening gambit was a call for repayment of £7 million 'arrears of tax' owing to them since 1942, with the claim that the 1942 agreement had omitted a distribution to which all parties had agreed.[363] On the key point of income tax, the Labor New South Wales Premier strongly pressed for the prompt return of State taxing powers, supported by the Liberal Premier of South Australia, but was not supported by the Labor Premiers of Queensland and Tasmania or the conservative governments of Western Australia or Victoria.[364] The positions of the non-supporting States varied; Queensland and Tasmania apparently were opposed outright, while in other cases the leaders indicated they were not opposed to centralised income tax provided

[359] *Parton v Milk Board (Vic)* (1949) 80 CLR 229, 21 December 1949.

[360] Perhaps not fully appreciating the implications of the *Parton* case, in an address in Sydney on 16 March 1951, former wartime Prices Commissioner D B Copland, who had also had a longstanding interest and involvement in fiscal federalism prior to the War, suggested the States should turn to sales or turnover taxation to replace lost income tax revenues: D B Copland, 'A Comprehensive Plan for the Control of Inflation', in D B Copland, *Inflation and Expansion: Essays on the Australian Economy* (Melbourne: F W Cheshire, 1951), 120, 128.

[361] 'Premiers Seek Funds; Clashes With Menzies', *Canberra Times* (6 September 1950), 1.

[362] The premiers' claim for a further £25 million was rebuffed by the Prime Minister with the Commonwealth only agreeing to an increase of £5 million, in addition to the further £7 million accruing under the statutory formula: 'States Get £12 Million More, Premiers' Bitter Outbursts', *Canberra Times* (7 September 1950), 1.

[363] 'States get £12 Million More, Premiers' Bitter Outbursts', *Canberra Times* (7 September 1950), 1.

[364] 'Menzies and Premiers Clash On Uniform Tax Payments', *Sydney Morning Herald* (6 September 1950), 1, noting also that the New South Wales Premier sought appointment of a royal commission on the issue and a 'special Commonwealth payment of £47 million pending restoration of the States' taxing power'; the motion 'lapsed for want of a seconder'.

the amount of distributions were increased and a new distribution formula adopted, or were content to wait until longer term federal-state fiscal relations were settled.[365]

Following Menzies' proposal early in this meeting for the special finance conference separately to consider federal-state fiscal issues, in the absence of State agreement on the return of income taxation, it was subsequently agreed that a separate finance conference would be organised following initial meetings of State and federal Treasury officials.[366] The 1950 meeting ended with a continuation of the status quo, subject to an increase in grants that year.

An initial meeting of officials was held early in 1951 but no progress was made on the organisation of a fiscal conference.[367] The Treasury officials' report on the deliberations commissioned in 1950 was finalised, although never published, in August 1951[368] when a further federal-state Premiers meeting was convened. Menzies renewed his offer of returning income tax powers to the States[369] but once again there was no State consensus on the issue. In the political turmoil of the post-war period, the disagreement between States over resumption of State income taxes may not have actually been about this issue. Rather, their positions may have been bargaining chips to obtain support for economic issues that seemed much more important to particular States at that moment. A dispute between New South Wales and other States over the deregulation of butter prices, for example, seemed to be of more pressing concern.[370] Other urgent concerns were cost blow-outs related to rising inflation and the federal government's decision to reduce borrowing on behalf of the States (States' borrowing powers had been centralised in 1927).[371]

No doubt an important factor contributing to the States' growing divisions over return of their income tax powers was the shifting nature of the federal government's grants. From the time of the takeover of state taxation, the federal government had supplemented its general

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[365] Ibid.

[366] 'Federal-State Conference To Be Held On Finance', *Canberra Times* (8 September 1950), 1, noting that the decision had been reached at a private meeting on the evening of the third day of the conference and 'came as a complete surprise' after the earlier impasse on grants increases.

[367] 'Mr. Menzies To Ask Premiers To Cut Works Programmes', *Sydney Morning Herald* (27 February 1951), 1, reporting the officials' meeting the prior day.

[368] Mathews and Jay, *Federal Finance: Intergovernmental Financial Relations in Australia Since Federation*, above n 319, 214; W Prest and R L Mathews (eds), *The Development of Australian Fiscal Federalism*, above n 197, 271.

[369] Mathews and Jay, *Intergovernmental Financial Relations in Australia Since Federation*, ibid.

[370] 'Premiers' Deadlock On Price Of Butter', *Sydney Morning Herald* (17 August 1951), 1.

[371] 'Rail, Power Jobs May Be Cut, Effects Of Loan Council Vote, *Sydney Morning Herald* (18 August 1951), 1.

grants program (the program that initially substituted for lost income tax revenue based on net collections prior to the takeover) with 'special assistance' grants funded from the additional income tax from the growing economy that now accrued exclusively to the federal government. These grants, which started in the midst of the Depression, amounted to a form of fiscal equalisation and were paid to the less prosperous States (South Australia, Tasmania and Western Australia). The federal government also provided the States with funding from 'specific purpose' grants such as roads programs or university education and these accrued unevenly to States. The view of States on the merit of recapturing income tax rights depended in part on whether they saw themselves as net winners or losers from the redistribution of income tax revenues through the special assistance and specific purpose grants.

In any event, the conference in August 1951 was quickly overshadowed by the federal government's 'panic Budget' in September, which introduced significant income tax increases to deal with an inflation crisis: individuals faced a surcharge of an additional 10 per cent of the tax payable under the existing rates, and companies an increase in the rate to 35 per cent and introduction of a special levy of 10 per cent, although the undistributed profits tax was removed.[372] These 10 per cent additional levies were only imposed for that one financial year, however, and in 1953-54 the highest individual income tax rate on personal exertion income was also lowered to 70 per cent.

[372] 'Sweeping Tax Rises In Budget, Big Surplus Planned, Company, Sales, Income Tax Up', *Sydney Morning Herald* (27 September 1951), 1; also page one editorial, 'Panic Budget Will Stun Nation', ibid. It has been noted that the economy reacted quickly to this policy in terms of the fall in inflation; in subsequent years the entrenchment of inflationary expectations made any response slower and in general fiscal policy 'proved to be much less flexible than was anticipated in the 1945 White Paper on Full Employment': see M Keating, 'The evolution of Australian macroeconomic strategy since World War 2', in S Ville and G Withers (eds), *The Cambridge Economic History of Australia* (Melbourne: Cambridge University Press, 2015), 438, 443-444. With 'partial exceptions' such as 1952-53 and 1960-61, monetary policy was the only policy 'actually used' for stabilisation purposes, even though itself limited by a policy approach de-emphasising interest rate and exchange rate moves: ibid. Inflation had been building the year before and the Menzies government made an attempt ahead of the federal election in April 1951 to restore controls on capital issues under 'defence preparations' legislation in the context of a perceived international emergency in the growing risk of a general war: see J Boyd and N Charwat, 'Ideology and the Economy: Capital Issues Controls, Inflation and the Menzies Government' (2014) 60(4) *Australian Journal of Politics and History* 503, 510-514.

The following Premiers Conference in July 1952 brought yet another offer by the federal government to return income tax space to the States.[373] Once again, the States did not agree on the merits of regaining income tax powers. The New South Wales and Victorian Premiers (loser States under the combined grants regimes) once more supported resumption of State income taxation. The South Australian and Queensland Premiers were 'lukewarm' about the return of their income tax power and the Western Australian and Tasmanian Premiers saw more merit in revision of revenue distribution than a return of income tax powers.[374] The meeting ended with agreement by the State and federal governments to commission a further conference and study by the Treasury officials of 'technical problems' involved in the return to State income taxation.[375]

State finances remained problematic. In the absence of sufficient tax revenues or transfer payments from the federal governments, the States had increasingly turned to debt finance to fund public works projects but this funding source declined further in 1953 as the federal government made major cuts to loans for State use. While newspaper articles had suggested the fiscal pressures would lead to the demise of centralised income tax by the time of the next Premiers' Conference, scheduled for February 1953, the Treasury Secretaries' study to devise a process for resumption of State income tax became mired in discussions on asserted difficulties and unresolved questions in the proposal (on-supplied with 'great ingenuity' by federal Treasury officials to the political leaders of reluctant States).[376]

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[373] 'Tax Power For States: Menzies's Offer', *Sydney Morning Herald* (8 July 1952), 1; see also 'Ministers Say The Government Is Not Bluffing', *Sydney Morning Herald* (8 July 1952), 1, quoting 'senior ministers in the Federal Government' saying that 'the States will not be allowed to "slide out from under" the proposal'.

[374] 'Views Of The Premiers', *Sydney Morning Herald* (8 July 1952), 1. While the *Herald* editorialised the developments under the title 'Beginning of the End of Uniform Taxation', further reports were also carried in that day's edition suggesting political opposition was already developing: 'Obstacles Seen In Restoring State Taxation' (reporting comments by Professor F A Bland, chairman of the NSW Constitutional League), and 'Risk Of Higher Taxes' (quoting C A Sindel, president of the Taxpayers Association of NSW, that 'any move to hand back taxing powers to the States would be "fraught with difficulties"'), although Opposition Leader Treatt and former conservative Premier B S B Stevens favoured the proposal: ibid, 2, 3.

[375] 'Commonwealth Move To Quit Uniform Tax Field By 1953, Conference To Study Return Of Tax Powers To States', *Canberra Times* (8 July 1952), 1. See Maxwell, 'Another Look at Resumption of Income Taxation by the States', above n 315, 1, citing the Report by Commonwealth and State Treasury Officers, *Resumption of Income Tax by the States* (19 January 1953), App A.

[376] Maxwell, 'Another Look at Resumption of Income Taxation by the States', ibid.

It is difficult to judge the sincerity of Menzies' repeated offers to return income tax capacity to the States. Inflation had spiked in the early 1950s and some States had, sometimes reluctantly, established State price controls to protect consumers.[377] The political costs of doing so were high, however,[378] and Menzies had made it clear that the federal government had no interest in recovering the power to regulate prices by way of legislative referral of power by the State governments;[379] the federal government had no interest in inheriting the political difficulties the States faced with their limited price controls. In contrast, there was no apparent political cost to retention of income tax powers and this, combined with control of borrowing powers for loans to be used by States, left the federal government with an unparalleled means of controlling government expenditures across all levels of government.

Centralisation of the income tax also made it possible for the conservative government to wind back the progressivity of the personal income tax. Apart from the reduction in the top rate, progressivity was undermined by the conversion in December 1950 of rebates for various concessions into income tax deductions, yielding the now well-known 'upside-down' benefit this approach provides to higher income claimants.[380] The removal of the higher tax rate on 'income from property' as against 'income from personal services' followed in October, 1953.[381] When the property income differential was originally introduced with the federal income tax in 1915, the tax rates applicable to property income were about 70 per cent higher

[377] New South Wales Premier McGirr claimed a majority of those attending were in favour of Commonwealth resumption of controls: '"Inflation Forum": Premiers' Views', *Sydney Morning Herald* (1 August 1951), 1; three of the Premiers, however, 'expressed reservations … or opposed it': 'Premiers Differ On Price Control Transfer', *Sydney Morning Herald* (1 August 1951), 4. Menzies had explained the prior day that 'price control could not be effective without the other controls which made it "broadly successful" during the war': 'Conference On Inflation Opened, Menzies On Price Control', *Sydney Morning Herald* (31 July 1951), 1.

[378] See, e.g., reports of '[t]hreats of militant action by bakers' in New South Wales if not granted a price increase by the State government in January 1950: 'Bread [Subsidy] Sought, McGirr Asks Menzies', *Sydney Morning Herald* (31 January 1950), 3.

[379] 'Price Control Is Rejected By Commonwealth', *Canberra Times* (16 August 1951), 1, noting at this point that four premiers supported Commonwealth price control including those of New South Wales and Victoria who were prepared to make a transfer for three to five years.

[380] *Income Tax and Social Services Contribution Assessment Act 1950* (Cth), 14 December 1950, s 12. This was a reversal of the conversion from deductions to rebates which had been a feature of the move to centralisation in 1942.

[381] *Income Tax and Social Services Contribution Act 1953* (Cth), enacted on 26 October 1953.

than that imposed on other income.[382] The gap widened to more than 100 per cent prior to World War II,[383] when it began to decline due to the general rise in rates necessitated by the War. The differential dropped to 25 per cent by the time the distinction was abolished in 1953.[384] When the property income surcharge was briefly re-introduced by a federal Labor government in the 1970s following 23 years of conservative rule, a 10 per cent differential was adopted.[385]

Significantly, the Commonwealth income tax did not extend to capital gains due to the historically limited interpretation of the income concept by the courts in Australia (the separate 'casual profits' provisions of the New South Wales income tax,[386] for example, also having been a victim of the centralisation in 1942), and while this may not have been particularly significant in the context of the highly controlled wartime economy, it no doubt grew in importance with post-war de-control, exacerbating the limitations on progressivity of the income tax.

The February 1953 federal-state Premiers' Conference got off to a rocky start, starting only week after State elections in both New South Wales and Western Australia which saw the re-election of the Labor government in the former and a shift of government from conservative to Labor in the latter. The Premiers' Conference – described as a 'fiasco' in one editorial[387] – proved to be another fruitless exercise in terms of resolving the income tax issue. Yet another

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[382] *Income Tax Act 1915* (Cth), First and Second Schedules.

[383] See, e.g., *Income Tax Act 1938* (Cth), First and Second Schedules. The Commonwealth generally used separate formulas for calculation of the rate on income from personal exertion and income from property which produced a tapering differential as income of each kind (and the corresponding rate) increased. The Royal Commission on Taxation report of 12 April 1934 noted there was 'good ground' for such an approach as the sources of higher earned incomes could take on a character to some extent analogous to that of 'the accumulated capital of the investor': Ferguson Royal Commission, *Third Report of the Royal Commission on Taxation*, above n 208, 93. The original State income taxes varied in their approach: the Victorian income tax applied a double rate to income from property while the New South Wales income tax made no distinction. See *Income Tax Act 1895* (Vic), s 5 and *Income Tax Act 1895* (NSW), s 1.

[384] *Income Tax and Social Services Contribution Act 1952* (Cth), First and Fifth Schedules.

[385] *Income Tax Act 1974* (Cth), s 8.

[386] *Income Tax (Management) Act 1941* (NSW), ss 104-117. These provisions extended to shares and real property but excluded premises 'owned and solely used' as a taxpayer's principal place of abode for a period of four or more years.

[387] 'Conference On Taxes And Works Was A Fiasco', *Sydney Morning Herald* (23 February 1953), 2: '[i]n the long series of such meetings, no more futile gathering of Commonwealth and State leaders has been held than that staged at Canberra last weekend. The conference got precisely nowhere'.

reference was given to Treasury officials to investigate state taxation, this one more broadly considering all possible tax fields,[388] and the federal government undertook to prepare a precise plan quickly.[389]

The absence of any tangible outcome from yet another Premiers' Conference in August of that year led to reports that 'authorities' by this stage had concluded that return of income tax powers to the States was 'a dead issue',[390] a conclusion reinforced by the scant attention the issue received at the following federal-state Premiers' Conference in mid-1954.[391] The uniform tax issue stayed alive, however. In January, 1955, Sir John Latham, the retired former Chief Justice of the High Court who had presided over the Court in its 1942 decision affirming the right of the federal government to effectively usurp State income taxes,[392] delivered an address on national radio warning that without a return of income tax powers to the States or a radical overhaul of the federal grant system, the independence of the States was under threat.[393] Shortly before the mid-1955 federal-state Premiers' Conference, the Labor government in Victoria had been replaced by a conservative government under the leadership of Henry Bolte. The political alignment of Premier and Prime Minister did not reduce tensions at the meeting, however, and the federal government's announcement of tax reimbursement grants was 'condemned' by all of the premiers, with the Prime Minister and Victorian Premier Bolte in strong disagreement as to whether the proposal would leave Victoria with, respectively, a budget surplus for the year of £2 million or deficit of £4 or £5 million. What was clear to Bolte and the other premiers was that for 22 years the same three States (Tasmania, South Australia and Western Australia) had been the recipients of special assistance (equalisation) grants paid for from income tax revenues that disproportionately came from taxpayers in the other

[388] 'Premiers Shelve Uniform Tax Until 1954 Poll', *Canberra Times* (23 February 1953), 1.

[389] Statement by Prime Minister Menzies to the House of Representatives, CPDHR, Vol 221, 396ff (26 February 1953).

[390] 'Restoration Of Uniform Taxation Now Regarded As Dead Issue', *Canberra Times* (12 August 1953), 1.

[391] See, for example, 'States Get £8 Mil. More From Uniform Taxation', *Sydney Morning Herald* (1 July 1954), 3. Some discord between the States remained evident on the amount to be paid in financial assistance grants, however, as any unanimity in a claim for an additional £163 million overall was quickly lost when the South Australian Premier said that '£150 million would be enough', a proposal described by the New South Wales Premier as 'selfish' in terms of its disproportionate impact on the larger states.

[392] *South Australia v Commonwealth* (1942) 65 CLR 373 (*First Uniform Tax Case*).

[393] 'Independence Of States Threatened – Sir John Latham', *Canberra Times* (24 January 1955), 2, reporting the ABC's 'Guest of Honour' broadcast of the previous evening.

States.[394] Bolte indicated that Victoria was now 'fully prepared to accept the Prime Minister's offer of three years ago that the States could have back their powers'.[395] But at the same time, the New South Wales government, which had supported the return of State income taxation at federal-state premiers' conferences, seemed to be wavering on the issue, with the Premier indicating the State would only resume income taxation if the federal government continued to tax the lower personal incomes below a specified level of annual income (£800).[396]

By the end of the year, Victoria was prepared to act alone and in December, 1955 the State moved unilaterally to break the deadlock, bringing an action against the federal government before the High Court, Australia's final court of appeal and the court of first (and last!) instance in the case of constitutional challenges by one level of government against the other. Reports indicated the case was expected to be heard early in 1956.[397] The motive for unilateral action had become clear by the beginning of 1956, when it was revealed that the combination of inflation and inadequate transfers from the federal government had led to Victoria's financial position becoming 'increasingly acute'.[398]

In May, 1956, when the case had yet to be argued before the court, the federal Liberal party executive called for tax powers to be given back to the States immediately, reaffirming a plank in its party platform.[399] At that time it was expected that the case would be heard in the October sittings of the Court with a decision before the end of 1956.[400]

Although it faced serious financial problems and had previously also called for the return of State income tax powers, the Labor government of New South Wales sat on the sidelines initially, waiting to see how the Victorian action proceeded. By November 1956, however, with still no end in sight to the case brought by Victoria, New South Wales, facing

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[394] J Head, 'Financial Equality in a Federation: A Study of the Commonwealth Grants Commission in Australia' (1967) 26 *Finanzarchiv* 470, 480.

[395] 'Premiers Claim Tax Allowances Short Of Needs', *Canberra Times* (24 June 1955), 1.

[396] 'Mr. Cahill's Sincerity On Tax Queried' (quoting claims by then Opposition Leader Robert Askin of a 'previous offer' by Cahill to this effect), *Canberra Times* (8 September 1955), 2; see also 'Mr. Cahill Says NSW Not Seeking Restoration Of State Taxation Powers', *Canberra Times* (12 October 1955), 1.

[397] 'Uniform tax "costly"', *The Argus* (24 December 1955), 5.

[398] 'Loan Council Called For February 1st', *Canberra Times* (10 January 1956), 1.

[399] 'Liberal Executive Declares For State Taxation', *Canberra Times* (31 May 1956), 3, reporting also comments in federal Parliament the prior day by the Minister for External Affairs (R G Casey) critical of the perverse financial incentives on the States under the uniform taxation arrangements, and his view that '[y]ou can't sustain illogical anomaly indefinitely in any country all the time'.

[400] 'Tax challenge ruling before Christmas', *The Argus* (26 July 1956), 8.

immediate financial difficulties,[401] commenced a parallel case, applying shortly afterwards for an immediate hearing of the action.[402] The Premier of Queensland also reaffirmed that that State was also seeking a return of 'full taxing powers', although he indicated Queensland would not join the litigation.[403]

The High Court heard the Victorian and New South Wales cases together in April and May, 1957.[404] Outside the Court, the federal Treasurer called for the return of taxing powers to the States.[405] Given the unambiguous decision of the High Court in the initial 1942 appeal by the States against the federal takeover of income taxation, there was little point in the States disputing the federal tax directly. Instead, the main argument put forward by Victoria and New South Wales was that the federal law governing distribution of the revenues[406] was unconstitutional, meaning that if the State action succeeded, the collapse of the legislation governing distribution of tax revenues could lead to a return to the States of income tax powers;[407] even if that were not achieved, it would at worst necessitate the enactment of a more permanent revenue-sharing arrangement and possibly prevent expansion of the use of 'tied' grants.[408]

The High Court's decision, delivered in August, 1957 was a further resounding loss to the plaintiff States. All seven members of the Court confirmed the validity of the federal grants

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[401] 'Living Costs Rise 9/- For Quarter', *Canberra Times* (20 October 1956), 1, noting that the increase, due largely to 'phenomenal' price increases in potatoes and onions, was largest in New South Wales at 11/- per week and would flow on to that state's government through its automatic wage increase provisions and 'wipe out the State's carefully balanced Budget'. The State's Opposition Leader considered that the increase had 'blown the State Budget sky-high' and he also pointed out the likelihood of industrial unrest due to the divergence between wages under federal and state awards (a reported 'loophole' in the Commonwealth Statistician's report also raised the possibility that New South Wales workers may only receive a basic wage increase of a little over half the actual increase at this time).

[402] Saunders, 'The Uniform Income Tax Cases', above n 297, 70, citing High Court transcript of proceedings, 21 February 1957.

[403] 'Q'land Wants Full Taxing Powers', *Central Queensland Herald* (29 November 1956), 10.

[404] *Victoria and another v Commonwealth* (1957) 99 CLR 575, 23 August 1957 (*Second Uniform Tax Case*).

[405] 'Treasurer Out To Abolish Uniform Tax', *Canberra Times* (15 April 1957), 2, reporting Treasurer Fadden's address to the annual conference of the Australian Country Party in Rockhampton the prior day.

[406] *States Grants (Tax Reimbursement) Act 1946* (Cth).

[407] By this time the war-time forcible transfer of State tax offices to the Commonwealth had expired; *Income Tax (War-time Arrangements) Act 1942* (Cth) (this Act has not at any stage however formally been repealed).

[408] P Hanks, P Keyzer and J Clarke, *Australian Constitutional Law: Materials and Commentary*, 7th edn (Sydney: LexisNexis Butterworths, 2004), [9.6.12].

law which provided for payment of grants on the condition that the States had not in the relevant year 'imposed a tax upon incomes'.[409] The Court by a majority did find in favour of the States on one point, holding that the federal provision requiring taxpayers to give priority to payment of federal income tax over any State income tax was not supported by the federal government's taxation power.[410] In the context of still significant federal government income tax levels, however, this provided little relief to the States in respect of the practical problem of how to create 'room' for their own income taxes to be reimposed in the field.

While Australia's geo-political situation in 1957 was far different from that in 1942 when the Japanese forces were attacking Australian territory and the first constitutional challenge to the federal takeover of income taxes was decided, the 'peacetime' environment was at best unsettling. In 1957, as the High Court was drafting its decision on the second constitutional challenge to the federal takeover of income taxes, the Cold War was reaching new peaks. In June, 1957 the US test launch of its Atlas missile failed.[411] A month later the US and Australia signed a further defence agreement[412] to supplement the ANZUS defence agreement Australian had entered into in 1952 and two days before the judgment was handed down the Soviets successfully tested the world's first intercontinental ballistic missile.[413]

Notwithstanding the tense international circumstances, the 1957 case brought to an end any debate about the legal 'peacetime' validity of the centralised income tax system, while raising the crucial question, why did the case proceed to trial in the first place? The suit was brought by States seeking a return of income tax powers. On the other side of the case was a federal government controlled by a Prime Minister who had offered time and again to return taxing powers, echoing a central plank in his party's platform. Why did the conservative government feel compelled to fight the action and preserve its power to control the distribution of income tax revenues to the States?

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[409] *States Grants (Tax Reimbursement) Act 1946*, s 5.

[410] *Income Tax and Social Services Contribution Assessment Act 1936*, s 221(1)(a), introduced by *Income Tax Assessment Act 1942*. The former s 221 of the 1936 Act, relating to assessment of income of estates of deceased persons subject to the *Estate Duty Assessment Act 1914-1928*, had previously been repealed by the *Income Tax Assessment Act 1941*, enacted on 3 December 1941, s 28.

[411] R A Divine, *The* Sputnik *Challenge* (New York: Oxford University Press, 1993), 26.

[412] W Reynolds, 'Loyal to the End: The Fourth British Empire, Australia and the Bomb, 1943-57' (2002) 33(119) *Australian Historical Studies* 38, 53.

[413] Divine, above n 411, 32.

The answer may turn on the impact of the schemes used by the federal government to distribute the income tax revenues it had monopolised. The 1946 'reimbursement' Act provided limited annual increases based on population (weighted according to population density, which favoured the less economically developed states) and part of the national increase in average wages. The definition of the base pool in nominal terms left the States consistently exposed to ever-increasing inflation costs as wages were fixed by conciliation and arbitration process that regularly adjusted salaries for cost of living changes. The same inflation continually boosted federal income tax revenues which in turn could be used partly for special assistance (equalisation) grants, which could reach levels of almost half the general grants, and partly for special purpose grants. The latter grew increasingly important in terms of both amount and their role in allowing direct federal intervention in State responsibilities. Universities, for example, were State-owned bodies created by State legislation but would eventually become entirely federally-funded and federally-run institutions. Similarly, social welfare payments and regulation including setting eligibility conditions, constitutionally the responsibility of States, would eventually become solely a federally funded and controlled process. While federal Labor governments were traditionally centralist and the federal conservative governments nominally backed State autonomy and professed support for return of taxing powers, at the end of the day, it seemed both were committed to horizontal equalisation and the redistribution of economic resources that entailed. Both also seemed to enjoy the use of appropriated resources to direct spending programs in States.

The position of the conservative government was confirmed in the wake of the second judicial victory for appropriation. Despite his State's defeat in the High Court, in January 1959 ahead of the 1959 Premiers' Conference, Victorian Premier Bolte called once again for the return to the States of income tax powers.[414] To put pressure on the government, Victoria and Queensland indicated they would seek to join South Australia, Western Australia and Tasmania as 'claimant' States needing special assistance under the fiscal equalisation processes administered by the Commonwealth Grants Commission, which would have left New South Wales as the sole provider to the other States at least in a relative sense.[415] The attempt was unsuccessful in gaining revenue for the two States but it did have two lasting impacts. First, it signalled *de facto* recognition by almost all States that fiscal equalisation would be an important element of the distribution of appropriated income tax revenue. Second, it triggered a redesign

[414] 'Bolte To Seek Return Of State Taxing Powers', *Canberra Times* (6 January 1959), 2.

[415] Head, 'Financial Equality in a Federation', above n 394, 479-482.

of the general grants formula by the federal government and increase in the base pool. This was done by modifying the formula so it looked at actual population rather than using a density-weighted value and provided annual increases based on increases in national average wages including an uplift of 10 per cent of that increase.[416] The express condition of no State income tax was no longer stated, but nevertheless this requirement continued to be understood.[417] As the formula for allocation of the base funding pool was based on the proportions of prior year general *and special* assistance grants, however, the new scheme still included an ongoing element of bias in the distribution in favour of the less industrialised States.[418] In any event, by 1959, the larger effort to 'reset' the system for payments of grants was put into effect. The federal government's hope was that the new rule would be sufficiently generous to have a prospect of being long-lasting.[419] Victoria (represented at that point by Deputy Premier Arthur Rylah) responded by agreeing that Victoria would not seek to become a 'claimant' State under the equalisation arrangements for the six years leading up to the specified review date provided for in the 1959 legislation enacting the new formula.[420] Queensland also voted to accept the plan (that it and South Australia would only make claims for special assistance in exceptional circumstances).[421]

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[416] D James, 'Federal-State Financial Relations: The Deakin Prophecy', Australian Parliament Research Paper 17, 4 April 2000, 15, https://www.aph.gov.au/binaries/library/pubs/rp/1999-2000/2000rp17.pdf (also in G Lindell and R Bennett (eds), *Parliament: The Vision in Hindsight* (Sydney: Federation Press, 2001), 210). Average wages were now calculated by reference to the mean number of males represented in employer payroll tax returns to the Commonwealth, and 60 per cent of the corresponding number of females (previously 50 per cent): *States Grants Act 1959*, s 4(2)(a).

[417] Saunders, 'The Uniform Income Tax Cases', above n 297, 76.

[418] Mathews and Jay, *Intergovernmental Financial Relations in Australia Since Federation*, above n 368, 241-243.

[419] See, e.g., the comments at the conference of Commonwealth Trade Minister John McEwen, in Commonwealth, *Conference of Commonwealth and State Ministers, Canberra, 23 and 24 June, 1959: Proceedings of the Conference* (Commonwealth Government Printer, Canberra), 27 ('I am sure that what we have achieved under this new arrangement represents an even greater measure of equity as between the components of the Federation and there is certainly a more liberal element of provision for State finances. In effect, the States now enjoy, to a measure never previously enjoyed, a guarantee of their future financial arrangements over the years ahead').

[420] Head, 'Financial Equality in a Federation', above n 394, 481.

[421] Commonwealth, *Conference of Commonwealth and State Ministers, Canberra, 23 and 24 June, 1959: Proceedings of the Conference* above n 419, 27.

As with its predecessors, however, the States grants formula proved wholly inadequate for the needs of the States. While post-war inflation, and consequent cost increases for States, had subsided by the late 1950s and would not become a serious problem again for more than a decade, the funds flowing to States through the formal grants formula were insufficient to cover State spending requirements. Special assistance (equalising) grants made to three States and the special purpose grants covering an ever widening range of fields such as science and technical training, housing, and other matters,[422] covered some, but not all, of the shortfall and State premiers regularly called for more federal funds.

Finally, in 1964 the conservative government in Victoria announced it would introduce a 'marginal income tax' with a request to the federal government to collect the impost[423] under the residual joint administration provisions of the income tax legislation.[424] The Commonwealth refused to collect the impost, however,[425] and State interest in the plan quickly died.

State complacency with the federal dominated fiscal system changed in the early 1970s as the country encountered the first of what would prove to be a much greater series of difficulties both for Australian fiscal federalism and the economy as a whole. Inflation was beginning to build again and with it pressures on State finances. The States took the opportunity at a Premiers' meeting in Adelaide in early 1970 to develop a detailed case for introduction of independent State income taxation along Canadian lines, with a final plan

[422] Special purpose funding for roads was also a long-standing area of Commonwealth assistance which had begun prior to the Second World War and resumed in 1948. States grants for universities began in 1951.

[423] See James, 'Federal-State Financial Relations: The Deakin Prophecy', above n 416, 14.

[424] *Income Tax and Social Services Contribution Assessment Act 1936-1964*, s 15 (the Governor-General and Governor in Council of a State 'may make arrangements … for the collection by the Commonwealth on behalf of the State of income tax … on a taxable income ascertained in accordance with this Act or an Act of that State'). This provision was repealed with the introduction of New Federalism state income tax surcharge legislation in 1978 (see section 4.5 below, *'New Federalism', 1976-1983*), but not reinstated when the 1978 Act was repealed in 1989.

[425] CPDHR, Vol 44, 2559, 30 October 1964. Ontario had previously also enacted a provincial personal income tax in 1950, but did not proceed to proclaim the law after the Dominion government refused to collect it: see F Vaillancourt and D Guimond, 'Setting Personal Income Tax Rates: Evidence from Canada and Comparison with the United States of America, 2000-2010', in V Ruiz Almendral and F Vaillancourt (eds), *Autonomy in Subnational Income Taxes: Evolving Powers, Existing Practices in Seven Countries* (Montréal and Kingston: McGill-Queen's University Press, 2013), 100, 101.

presented to the Prime Minister a month later.[426] Ironically, the presentation occurred just days after the High Court invalidated yet another State indirect tax, once more shrinking the range of taxes potentially available to the States.[427] Some relief was provided in the following year when the federal government abandoned the payroll tax field, allowing the States to impose the tax and in an expansion of direct federal government spending in areas outside its specific areas of legislative power following the election of a federal Labor government in 1972.[428] Escalating inflation fed in part by the extremely inflationary oil shocks of 1973 and 1974 brought matters to a head. In mid-1974 the acting Premier of New South Wales floated a proposal for 'limited' resumption of State income taxation,[429] and both the New South Wales and Victorian Premiers in early 1975 issued proposals for States to receive a 'fixed share' of income tax.[430] The Queensland Premier limited his State's request at that time to a call for 'much more substantial funds to allow state departments to carry on their operations'.[431]

A February leaders' conference produced agreement with the federal government for additional temporary assistance payments, in a mood of apparent cooperation,[432] although it subsequently emerged that the Queensland Premier's party attending the conference had included an armed bodyguard.[433] However, all six States then seemed to change tack in April, calling for indexation of grants.[434] Soon afterwards, in the lead up to a further Premiers'

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[426] See J Bennetts, 'Premiers' meeting inconclusive', *Canberra Times* (27 February 1970), 1. The memorandum left open whether such State taxation would be applied only to individual incomes or also extended to company incomes, but the conference focused only on the former as the data for personal collections to that point showed this to be the much stronger source of growth in revenue: see D A Dixon, 'The Premiers' Conference, February 1970: A View of Federal-State Financial Relationships in Australia' (1970) 42(2) *Australian Quarterly* 47, 52-53.

[427] *Western Australia v Chamberlain Industries Pty Ltd* (1970) 121 CLR 1, 19 February 1970.

[428] This took place predominantly under the Australian Assistance Plan': see M Crommelin and G Evans, 'Explorations and Adventures with Commonwealth Powers', in G Evans (ed.), *Labor and the Constitution 1972-1975: Essays and Commentaries on the Constitutional Controversies of the Whitlam Years in Australian Government* (Melbourne: Heinemann, 1977), 24, 25-45.

[429] See '"Threat" of new State taxes', *Canberra Times* (22 June 1974), 3, quoting Acting Premier Sir Charles Cutler.

[430] 'States want fixed share of tax', *Canberra Times* (8 January 1975), 1.

[431] 'Qld seeks more aid', *Canberra Times* (10 January 1975), 3.

[432] 'United in Adversity' (editorial), *Canberra Times* (15 February 1975), 2.

[433] 'PM's Press Conference, Premiers "have no world standing", "Bodyguard" at talks', *Canberra Times* (19 February 1975), 14.

[434] 'States want guarantees', *Canberra Times* (24 April 1975), 1.

Conference in June, 1972 some New South Wales country shires took up a call for a 5 per cent share of income tax revenues, to be paid to them 'via the State governments'.[435]

The news at a pre-conference meeting of experts in June that the federal government's offer would contain less than satisfactory increases in assistance and would include an expectation that the States would increase their own taxes and charges led however to very harsh reactions from the premiers – the four non-Labor Premiers were reportedly 'furious about the terms', having anticipated non-confrontational 'meaningful negotiations'.[436] In August 1975 the federal government released its proposed annual Budget (ultimately blocked in the Senate, the upper house of Parliament) containing announcements which spread the austerity more widely beyond the States, with significant cuts also to federal expenditures.[437]

In the aftermath of the Budget announcements, the opposition Coalition parties at the federal level made a major announcement at a 'Constitutional Conference' held in Melbourne in late September, 1975 of proposed 'New Federalism' policies which included a commitment to provide the States with 'permanent access to revenue raised through personal income tax' and a proposed discretion to impose a surcharge or rebate, with an earmarked fixed percentage for distribution through the States to local government.[438] Few details of the proposal were provided (e.g., the percentage share was not specified). Four State Premiers were in attendance, with the Victorian Premier suggesting to the media that it was 'the most important occurrence which we have ever taken part in'.[439] A few days later the Queensland Premier affirmed his support for the proposal, citing the success of the Canadian revenue-sharing system.[440]

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[435] 'Shires call for percentage of income tax', *Canberra Times* (4 June 1975), 3.

[436] 'States Not To Get Extra Tax Funds', *Canberra Times* (13 June 1975), 3. New South Wales Premier Lewis in particular was reported to be 'staggered' at the Commonwealth's offer given that money was 'flowing like a torrent into the Commonwealth coffers from the rip-off from income tax immensely stimulated by inflation'.

[437] G Davidson, 'Beer, Tobacco, Petrol Up, New tax system announced', *Canberra Times* (20 August 1975), 1.

[438] G Davidson, 'States to be given access to income-tax funds', *Canberra Times* (25 September 1975), 10.

[439] B Juddery, 'Opposition Policy on Federalism: Fraser Avoids Specifics', *Canberra Times* (25 September 1975), 10.

[440] 'State Budget increases "could be last"', *Canberra Times* (29 September 1975), 6. The article reported the Premier's observation that the policy would end 'the Federal Government's "lurk" of collecting taxes for both itself and the States but keeping an increasing share' and the Whitlam government's practice of 'doling out money to the States as Section 96 grants, where a refusal to accept socialist strings meant no money', and also noted that the Premier would become 'the first Queensland Premier to attend a meeting of the New South Wales cabinet, in Sydney on October 20'.

4.5 'New Federalism', 1976-1983

Five months later, in December, 1975 the conservative Coalition was elected into government and almost immediately began plans to implement its 'New Federalism' fiscal proposals.
It planned to shift to the new arrangements in two phases. 'Phase 1' of the plan enacted two 'personal income tax sharing' Acts in November 1976, that provided for a share of net personal income tax collections to be paid to the States for their use and a further share to be provided to States for distribution to local governments according to the findings of Local Government Grants Commissions to be established by the States.

Importantly, the legislation also included detailed provisions setting minimum entitlements based on prior year grant levels, or which would have applied under the previous grants legislation, and allowing for the federal government to declare any imposts to be surcharges which would be outside the sharing pool. The health levy (an income tax supplement) adopted to fund the national health system established by the predecessor Labor government was specifically designated as being outside the pool.

While a reform to fiscal federalism of far-reaching significance in terms of its principles, the key practical feature of the system of importance to the States, namely providing in effect for access to a 'growth tax' commensurate with their spending responsibilities under the Constitution, was largely undermined by the federal government's decision immediately prior to Phase 1 to implement the recommendation of a tax reform committee that thresholds for personal income tax rates be indexed.[441] A number of personal income tax increases were also made during the period by way of special surcharges, at least one of which was declared to be outside the system. In all, with inflation having peaked in Australia in 1975 but nevertheless continuing at high levels throughout the remainder of the 1970s, these developments in themselves would inevitably have brought about the extensive reliance which did in fact need to be placed by all of the States at various times on the minimum entitlements throughout the era of the policy, rather than being able to make forward expenditure plans and simply rely on the revenue share alone.

In addition, however, the situation was not helped by the increase in the late 1970s of extreme levels of tax avoidance and evasion impacting both company tax and personal tax

[441] Automatic indexation was converted to discretionary increases in 1978, and ended in 1981: C Terry, *Personal income tax indexation* (Sydney: Australian Tax Research Foundation, 1983), 47, 55-56.

collections[442] in the context of the extreme literalistic approach of the High Court at the time, an approach described by one member of that Court (in dissent) as 'an open invitation to artificial and contrived tax avoidance'.[443] Reduced staffing levels at the time in the Australian Taxation Office and a focus on 'cost-effective' compliance activities have also been noted and criticised in contributing to the excessive avoidance levels.[444]

The pressure of all of these various factors would only have been eased to some extent by the move to increase the proportion of prior year personal income tax collections in the funding pool from 33.6 per cent to 39.87 per cent in mid-1978,[445] which accompanied the next stage of the New Federalism plan, while the shift from personal income tax sharing to total tax sharing in 1981 (of 20.72 per cent)[446] was described by one observer shortly afterwards as 'an arrangement which on past experience is likely to be less favourable to the states'.[447]

The troubles encountered by the tax sharing arrangements set the scene for the introduction in June, 1978 of 'Phase 2' of the New Federalism program, a legislated arrangement providing for States to impose their own income tax surcharges or rebates on the

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[442] See, for example, T Boucher, *Blatant, artificial and contrived: Tax schemes of the 70s and 80s* (Canberra, Australian Taxation Office, 2010), https://www.ato.gov.au/printfriendly.aspx?url=/General/Gen/Blatant,-artificial-and-contrived--Tax-schemes-of-the-70s-and-80s/.

[443] *Federal Commissioner of Taxation v Westraders Pty Ltd* (1980) 144 CLR 55, 80, per Murphy J.

[444] See A Freiberg, 'Enforcement Discretion and Taxation Offences' (1986) 3(1) *Australian Tax Forum* 55, 69-72. On the subsequent reforms to the applicable civil and criminal penalty regimes, see also A Freiberg, 'Ripples from the Bottom of the Harbour: Some Social Ramifications of Taxation Fraud' (1988) 12(3) *Criminal Law Journal* 136, discussed in M McKerchar and C Coleman, 'Avoiding Evasion: An Australian Historical Perspective', in J Tiley (ed.), *Studies in the History of Tax Law* (Oxford: Hart Publishing, 2012) vol 5, 381, 388-389.

[445] C Saunders and K Wiltshire, 'Fraser's New Federalism 1975-1980: An Evaluation' (1980) 26(3) *Australian Journal of Politics and History* 355, 356; *States (Personal Income Tax Sharing) Amendment Act 1978* (Cth), enacted on 22 June 1978, backdated to 1 July 1977.

[446] *States (Tax Sharing and Health Grants) Act 1981* (Cth), enacted on 18 June 1981.

[447] P Groenewegen, 'Tax Assignment and Revenue Sharing in Australia', in C E McLure Jr (ed.), *Tax assignment in federal countries* (Canberra: Centre for Research on Federal Financial Relations in association with The International Seminar in Public Economics, 1983), 293, 305. The States seem to have been hoping for future gains from the inclusion of Commonwealth oil and gas levy, but revenue from these sources had peaked at that stage, thus continuing the suggested trend since World War II in which 'the States have nearly always backed losers' in national financial arrangements: R L Mathews, 'Intergovernmental Relations', in R L Mathews (ed.), *Australian Federalism 1981* (Canberra: Australian National University Centre for Research on Federal Financial Relations, 1985), 163-164.

federal income tax base, and for the federal tax administration to act in accordance with State legislation for the purpose.[448] Needless to say, any impression which these provisions may have created that this machinery was legally necessary for imposition of a State income tax, and limited the form that such a tax could take, would have been quite inaccurate, as the States had always retained the constitutional power in their own right to impose income taxation in any form. The legislation was important as a signal though that State income taxation in the specified form would not bring about action to reduce grants to the States in retaliation.

The federal government was very keen over the ensuing 18 months to see this particular opportunity taken up by the States, although suggestions that cuts to other State funding were intended to force this result were denied.[449] Western Australia did in fact make an initial move to list a bill for an income tax on its parliamentary notice paper, but this 'quickly and mysteriously disappeared',[450] as a range of doubts about the scheme very quickly became apparent.

Prime amongst these was the simple fact that the federal government's own top marginal income tax rate on individuals remained at 65 per cent, a high level by historical standards, which cut in at a then middle income level of $28,250.[451] The federal government made no move to adjust any of its personal income tax rates to provide 'tax room' for the States, and so afford any political benefit or cover to a State imposing a surcharge of such an amount or less. The 'optics' of this situation would be effectively impossible for the States in any

[448] *Income Tax (Arrangements with the States) Act 1978* (Cth). As a consequence, section 18 of that Act repealed the then existing provision of the income tax law allowing arrangements for Commonwealth collection of a State income tax. For discussion of the debate in Parliament on the Bill, see C Sharman, 'Changing Federal Finance: The Politics of the Reintroduction of State Income Taxes', in D J Collins (ed.), *Vertical Fiscal Imbalance and the Allocation of Taxing Powers*, above n 164, 221, 228-229.

[449] 'Tax Sharing is too generous: Howard', *Canberra Times* (7 December 1979), 21, reporting proposed cutbacks in payments to the States ahead of a premiers conference discussion, but also that Treasurer Howard 'rejected suggestions that the Commonwealth was forcing the States to adopt Stage 2 of the Government's federalism policy'. Earlier that year, Queensland Premier Bjelke-Petersen had criticised excessive federal government taxation: *Canberra Times* (16 August 1979), 3, but separately suggested 'the only good tax is a Commonwealth tax': B Galligan, 'Federalism and the Constitution', in I McAllister, S Dowrick and R Hassan (eds), *The Cambridge Handbook of Social Sciences in Australia* (Cambridge: Cambridge University Press, 2003), 234, 239.

[450] Saunders and Wiltshire, 'Fraser's New Federalism', above n 445, 357.

[451] *Income Tax (Rates) Act 1976* (Cth), Sch 1.

context, and have invariably been cited since as the main reason for the failure of 'New Federalism' as a whole.

Furthermore, commentary at the time emphasised the depressed condition of the economy which, as in many other countries, was mired in 'stagflation'. As a result, the federal government's policy was open to the particular political attack that it was merely a ploy to deflect blame for the recession onto the States as the parties unwilling to take up the role of tax-and-spend Keynesian pump-primers, rather than a genuine attempt to reform the federation.[452] The government's further, but ultimately unsuccessful, move to absorb some specific purpose grants enthusiastically expanded in the Labor government period 1972-1975 into the income tax sharing payments without commensurate transfers of income reinforced this view.[453]

4.6 The end of New Federalism: closing the door on State income taxation

The Coalition's notional return to the States, however insincere it may have been in reality, of income tax powers remained in place initially following the Labor party's return to government in early 1983. The report of a tax review committee in Victoria released in 1983, calling for broader and more equitable taxation by the States[454] and the call by a State task force in New South Wales in 1988 for a State personal income tax surcharge[455] had no apparent impact on the views of the federal government. The catalyst for change came March 1989 with a renewed push by the federal opposition Coalition to allow increased State scope for taxation.[456] The Labor Treasurer Paul Keating immediately responded by announcing the repeal of the previous government's legislation facilitating the return of income tax powers to the States[457] characterising such plans as an attempt to allow the States to avoid implementing expenditure cuts sought by the federal government.[458] Keating's move was strongly criticised by the then

[452] See G Sawer, 'New Federalism? Isn't it just a return to the Old Federalism?', *Canberra Times* (28 June 1978).

[453] Saunders and Wiltshire, 'Fraser's New Federalism', above n 445, 359-370.

[454] Committee of Inquiry Into Revenue Raising in Victoria (J P Nieuwenhuysen, chair), *Report of the Committee of Inquiry Into Revenue Raising in Victoria* (Melbourne, 1983), Vol 1, xliii-xlvii.

[455] New South Wales Tax Task Force (Associate Professor D J Collins, chair), *Review of the State Tax System* (August 1988), xxv.

[456] A Fraser, 'Libs to look at state taxes', *Canberra Times* (13 March 1989), 1.

[457] *Income Tax (Arrangements with the States) Repeal Act 1989* (Cth), enacted on 21 June 1989.

[458] Hon P Keating (Treasurer), Second Reading speech on the Bill, CPDHR, Vol 166, 2539 (11 May 1989).

Opposition Leader John Howard but by the time of the debate on the repeal Bill in May 1989, a Coalition leadership change had also occurred, and the new leader Andrew Peacock stepped back from the issue. The measure was passed into law a month later.

4.7 The return of the conservatives and adoption of tax mix change

While it was no doubt Treasurer Paul Keating's hope that the repeal of the previous government's facilitating law would mean 'the end of state involvement in personal income tax for the foreseeable future',[459] in the course of debate on the repeal Bill, shadow Treasurer Hewson had pointed out that the States did not need the legislation about to be repealed to impose their own income taxes.[460] Keating's 'foreseeable future' came much sooner than he had anticipated. In 1991 the Hawke government launched its own 'New Federalism' agenda. Under this plan, and also due to increasing fiscal pressures on the States and the serious problem of rapidly rising unemployment, a series of 'Special Premiers' Conferences' were convened during 1991, culminating in a proposed conference in November, 1991 in Perth to discuss federal-state tax reform. A '100-page options paper' prepared by federal and State officials on the vertical fiscal imbalance issue had reportedly identified three revenue options for consideration (resumption of income tax powers at the State level; provision of a fixed percentage of federal revenue to the States, and providing the States with extra income from the tobacco, alcohol and petroleum excise).[461] In the lead-up to the Conference scheduled for November, 1991 in Perth, at which the key discussion relating to federal-state tax reform was to take place, however, the Premiers apparently abandoned any plan to seek *independent* state income tax powers under the reform proposals.[462] Subsequently, the Commonwealth also dropped the income tax *sharing* option,[463] a move which seems to have been the catalyst for the November Conference then being called off by the Premiers,[464] organising their own 'rebel' meeting for the same dates in Adelaide.[465]

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[459] See Sharman, n 448 above, 231.

[460] Dr J Hewson (Wentworth), CPDHR, Vol 167, 2824ff (24 May 1989).

[461] T Wright, 'PM drops deal with the states, Keating supporters claim a win', *Canberra Times* (5 November 1991), 1.

[462] 'Premiers to Hawke: jobs top priority', *Canberra Times* (28 October 1991), 1.

[463] Wright, 'PM drops deal with the states, Keating supporters claim a win', above n 461.

[464] 'Premiers revolt: PM humbled, Meeting cancelled over tax issue', *Canberra Times* (12 November 1991), 1.

[465] As reported in 'Dawkins backs Hawke stand on tax sharing', *Canberra Times* (14 November 1991), 15.

Federal participation in these conferences in any event was muddied by ongoing political rivalry at the time over leadership of the Labor party (the party replaced Prime Minister Bob Hawke with his former deputy and Treasurer Paul Keating, a month later).

Perhaps the most valuable outcome of the argument to this point was an explicit articulation by the Treasurer in the lead-up to the conference of the underlying sympathy of the federal government for a concentration of revenue resources at the centre and distribution down from the federal government to States. Keating supported Australia's level of vertical fiscal imbalance as a structural outcome which was 'something we should prize and fight to keep' rather than a 'design fault' of the Constitution.[466] Shortly afterwards as Prime Minister he described the federal government's monopolisation of income tax as 'the glue that holds the federation together'.[467]

The opposition Coalition declined to accept this view as a bipartisan held sentiment, however, and along with its *Fightback!* election manifesto, released in November, 1991, reportedly indicated that it was 'favourably disposed' to provision of a permanent share of income tax to the States.[468] This position seems to have coincided with efforts by the premiers at their Adelaide rebel conference to formulate a 'rescue plan' to 're-include [the Prime Minister] in the conference process', although the means to overcome the impasse was not clearly indicated at this point or whether the income tax sharing plan (by this stage having been specified as a 6 per cent fixed share) would still be pursued.[469]

In any event, the replacement of the Prime Minister in December and refusal of new Prime Minister Keating to countenance income tax sharing brought the matter to an end at this point. Similarly, the Coalition was unsuccessful at the next election in 1993 and when it was returned to power in 1996 it was silent on the issue. Soon afterwards, the States suffered a serious revenue setback. The High Court's broad reading of 'excise' tax, reserved to the federal

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[466] Hon P Keating, speech to the National Press Club, 22 October 1991 cited in B Galligan, 'Federal Renewal, Tax Reform and the States', Proceedings of the Tenth Conference of the Samuel Griffith Society, Brisbane, 7-9 August 1998, http://www.samuelgriffith.org.au/papers/html/volume10/v10chap9.htm.

[467] Hon P Keating (Prime Minister), address to the Australian National University *Reshaping Australia's Institutions* Project, Canberra 1994, cited in Galligan, 'Federal Renewal, Tax Reform and the States', ibid.

[468] As reported in T Connors, 'Tax-sharing: move and countermove', *Canberra Times* (22 November 1991), 1; see also R Albon and J Petchey, 'Federalism Aspects of Fightback!', in J Head (ed), *Fightback!: An Economic Assessment* (Sydney, Australian Tax Research Foundation, 1993), 551, 563, n 3.

[469] Ibid.

government under the Constitution,[470] which had already led to disallowance of almost all State indirect taxes, gradually confining State revenue from the commodities field to increasingly narrow 'business franchise fees', was further refined in a key 1997 judgment[471] on regulatory licence fee imposts, effectively invalidating over $5 billion in State revenue sources. This outcome provoked immediate and dire warnings from the States as to problems they faced as a result of the even greater 'vertical fiscal imbalance' which had been created and its projected further worsening over the following decade. Leaked draft working documents from a State Treasury officials' working group tabled by the Opposition in the Queensland Parliament showed State governments had considered a range of extreme spending and taxation measures to cover the expected shortfalls over time including a 50 per cent cut in overall State spending ('equivalent to ceasing *all* of the states' expenditure on health and education'), increasing then existing conveyance stamp duties 'by a factor of 10', and '[t]ransferring tax powers' so as to allow a 14 per cent State personal income tax using the existing federal income tax base.[472]

The federal government's immediate response was to enact federal excise duty increases on the relevant commodities to replicate the invalidated taxes, with further retrospective legislation imposing tax on any taxpayer obtaining a refund of the impost that had been found to be unconstitutional.[473] A short term crisis was averted but a longer solution needed. The federal government's response was to announce in August 1998 its own substantial further move into the indirect tax field with a proposal for introduction of a broad based goods and services tax (GST) to replace its existing wholesale sales tax, and assignment of all revenue from that tax to the States.[474] While presented as a 'growth tax' for the States,[475]

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[470] *Constitution*, s 90.

[471] *Ha v New South Wales* (1997) 189 CLR 465.

[472] Western Australian Government, 'Officials' Steering Group: State/Territory Taxation Reform, 10 September Meeting, VFI Issues Paper (Western Australian Contribution)' (Draft), emphasis in original, tabled in the Queensland Parliament by Opposition Leader P Beattie, 7 October 1997, *Queensland Parliamentary Debates*, Vol 344, 3578; cited in D Hamill, *The Impact of the New Tax System on Australian Federalism* (Sydney: Australian Tax Research Foundation, 2006), 123.

[473] See Hamill, ibid, 114-115; *Franchise Fees Windfall Tax (Collection) Act 1997* (Cth), s 6.

[474] Australian Treasury (circulated by Hon P Costello, Treasurer), *Tax Reform: Not a New Tax, A New Tax System* (Canberra, August 1998), 83.

[475] Then Treasurer Costello's press release stated that 'the GST will provide the States and Territories with a secure source of revenue that grows as the economy grows to fund essential services, such as schools, hospitals and roads': Hon P Costello (Treasurer), 'A New Tax System for All Australians', *Media Release*, 13 August 1998,

the prospects for the tax keeping pace with economic growth and revenue needs were always in doubt given its initial exclusions of most health and education services[476] and the later exclusion of food[477] in the context of an aging society and the federal government's plan to reduce other transfer payments when the proposed GST came into effect (planned for mid-2000). Argument broke out between net donor and donee States as to whether the GST revenue should be distributed using the horizontal fiscal equalisation formula used for other grants or an alternative formula returning higher revenues to source States should be adopted.[478] A compromise agreement saw a two-year post-GST transitional period envisaged in which the federal government would guarantee no net reduction in payments to any State and use of the horizontal fiscal equalisation formula after that period.

The introduction of the GST was accompanied by some significant lowering of federal income taxation in some areas. A 50 per cent concession was introduced on the taxation of capital gains on assets held for 12 months and individual and company income tax rates were lowered, along with the adoption of a number of concessions, particularly for small business[479] and dramatic concessions for private pension benefits, with no tax on earnings or distributions from the pension plans.[480]

4.8 Post-GST fiscal federalism

Given their limited bargaining power, it would be unfair to say the States blindly accepted the conservative federal government's tax mix change agenda as a tool to address fiscal federalism problems. At best it was a rearrangement of the deck chairs with broader indirect taxes substituting for a narrower predecessor sales taxes. While some might assert the States 'backed a loser'[481] in accepting a share of the GST in lieu of broader reform, it is clear that some premiers signed on to the agreement believing the federal assertions that the States had been

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http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/1998/079.htm&pageID=003&min=phc&Year=1998&DocType=0. See Hamill, above n 472, 127.

[476] Australian Treasury, above n 474, 93-94.

[477] For a very detailed history of the introduction of the GST in Australia, see K James, *The Rise of the Value-Added Tax* (New York: Cambridge University Press, 2015).

[478] Ibid, 131-133.

[479] *New Business Tax System (Integrity and Other Measures) Act 1999* (Cth), Sch 9; *New Business Tax System (Income Tax Rates) Act (No 1) 1999* (Cth).

[480] *Tax Laws Amendment (Simplified Superannuation) Act 2007* (Cth), Sch 1, enacted on 15 March 2007.

[481] Mathews, 'Intergovernmental Relations', above n 447, 163-164.

handed a growth tax[482] and it has also since been claimed that the agreement came with the understanding that it would be an end to States' attempts to recover their income tax power.[483]

The failure of GST revenue to grow while State spending responsibilities continued to climb prompted the States into action. In July, 2007 Queensland commissioned a consultant report on funding options and received a recommendation that a State personal income tax be reinstated, a proposal quickly rejected by the State cabinet.[484] Two months later, New South Wales commissioned a review of State taxes to be carried out by a State tribunal,[485] which ultimately concluded there was little scope for resumption of income taxation by the States.[486] Following a change in government in late 2007 and the election of the first Labor Prime Minister in over a decade, the federal government announced in its May, 2008 Budget that it would proceed with a 'root and branch' taxation review. The 'Henry Review', as it became known after its chairperson, the Secretary of the Department of the Treasury, organised a major international academic conference in June, 2009 which highlighted, among other things, the feasibility of State co-occupancy of the income tax field with the federal government in a manner similar to the system used in Canada, which was assessed as having 'worked well'.[487]

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[482] Former Queensland Premier and 1999 Agreement signatory Peter Beattie, for example, claimed, 'what the States were promised was a growth tax, it's as simple as that.' Former Queensland Premier P Beattie, interview on Sky News, *PM Agenda*, 24 December 2015 (author recollection).

[483] See, for example, the view of Western Australian Premier Barnett that 'if you go back to the start of the GST under John Howard, it was put in place where the states were to get the GST collection, all of it, and in return the states gave up their constitutional right on income tax and company tax'. See 'WA Premier fires the first salvo ahead of COAG meeting', *ABC 7.30*, transcript of interview, 10 December 2015, http://www.abc.net.au/7.30/content/2015/s4370083.htm.

[484] S Parnell, 'Queensland open to levying income tax', *The Advertiser* (20 August 2009), http://www.adelaidenow.com.au/news/queensland-open-to-levying-income-tax/story-e6frea6u-1225764347440.

[485] Hon M Iemma (Premier), 'Review to examine ways to improve NSW taxes, State Plan Priority P5: Maintain NSW AAA credit rating', *News Release* (16 August 2007), http://www.ipart.nsw.gov.au/Home/Industries/Other/Reviews_All/Taxation/Review_of_State_Taxation.

[486] Independent Pricing and Regulatory Tribunal of New South Wales (Dr M Keating, AC, chair), *Review of State Taxation, Report to the Treasurer* (Sydney, October 2008), 38: 'over time, Commonwealth government policy decisions and the High Court's interpretation of the Constitution have effectively removed the States' ability to impose income tax'.

[487] R Bird and M Smart, 'Assigning State Taxes in a Federal Country: the Case of Australia', in Melbourne Institute of Applied Economic and Social Research, *Melbourne Institute – Australia's Future Tax and Transfer Policy Conference, Proceedings of a Conference* (Melbourne, 2010), 72, 77, 87. A separate conference in June 2010, shortly after release of the report of the Henry Review, included commentary on the disincentives for

At least one State was subsequently reported to be interested in pursuing the State income tax option,[488] although other significant commentary at the time also emphasised the lack of any community pressure at that point for a change to centralised taxation arrangements.[489] The review reported in December, 2009, only noting that sharing of the personal income tax base between the federal government and States was constitutionally possible.[490]

The federal government's decision in May 2010 to proceed with a central recommendation of the review, adoption of a resource rent tax on mineral super profits,[491] led to considerable political turmoil and, eventually, a change in leadership of the governing Labor party, which was returned to Parliament heading a minority government in August that year before enacting a watered-down version of the tax. Seeking to build bridges with two key independent members of Parliament on whose votes the government relied to retain power, the government agreed in March, 2011 to host a tax forum[492] in October of that year. At the forum, the Treasurer of Queensland brought a proposal for State access to income tax,[493] and income

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State tax reform posed by the Commonwealth Grants Commission's fiscal equalisation methodology, and the scope for reforms to State taxation such as expansion of the payroll tax or access to personal income taxation: see, respectively, Warren, 'Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry', above n 3; J R Kesselman, 'Payroll Tax, GST, and Cash Flow Tax: Reforming State Indirect Taxes', in Evans, Krever and Mellor (eds), *Australia's Future Tax System: The Prospects After Henry*, above n 3, 273.

[488] S Parnell, 'Queensland open to levying income tax', n 484 above.

[489] Hon Sir G Brennan, 'The Parameters of Constitutional Change' (2009) 35(1) *Monash University Law Review* 1, 4, 11; Hon Sir A Mason, 'Constitutional Advancement: Some Reflections', in H P Lee and P Gerangelos (eds), *Constitutional Advancement in a Frozen Continent: Essays in Honour of George Winterton* (Sydney: Federation Press, 2009), 283, 294.

[490] Henry Review, above n 4, Pt 2, Vol 2, 682.

[491] Hon K Rudd (Prime Minister) and Hon W Swan (Treasurer), 'Stronger, Fairer, Simpler: A Tax Plan for Our Future', *Media Release*, 2 May 2010.

[492] See P Darby, 'The 2011 tax forum and the 1985 tax summit', Australian Parliament, *FlagPost* (23 March 2011), http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/FlagPost/2011/March/The_2011_tax_forum_and_the_1985_tax_summit.

[493] C O'Brien, 'Qld push for income tax access', *ABC Online* (4 October 2011), http://www.abc.net.au/news/2011-10-04/qld-pushed-for-income-tax-access/3208468; Australian Treasury, Tax Forum, Day One, 4 October 2011, transcript of Session 2: State Taxes, http://www.treasury.gov.au/Policy-Topics/Taxation/Tax-Forum/Videos-and-Transcripts/Session-2 (comments of then New South Wales Treasurer Mike Baird).

tax sharing was also suggested by New South Wales but there was no follow up at subsequent federal and State Premiers' meetings.

The fiscal fortunes of the states changed completely following the return to power of the conservative Coalition in the second half of 2013 under the leadership of Prime Minister Tony Abbott. The new government's first Budget in May, 2014 signalled the most significant shake up of federal fiscal relations in decades based on a reduction in payments to the States in the areas of health and education of $80 billion over the following 10 years. This was followed in March 2015 by the release by the federal government of a taxation discussion paper indicating it was a priority for the States to reform their existing limited tax bases.[494] The clear implication was that the only long term solution to the vertical fiscal imbalance would be a significant reduction in government health and education services with a shift to private providers paid directly by consumers.

The lead party in the Coalition government subsequently replaced the Prime Minister in September 2015 and in the following weeks an announcement was made by the new Prime Minister, Malcolm Turnbull, that all tax reform options were back 'on the table' for consideration.[495] A month later he presided over a federal-state summit[496] that considered reform of income tax concessions[497] or an increase in the rate of the GST as possible options,[498] as well as extension of the GST to fresh food, health and education.[499] There was no

[494] Australian Government, *Re:think, Tax discussion paper* (Canberra, March 2015), 154-155. http://bettertax.gov.au/files/2015/03/TWP_combined-online.pdf.

[495] See 'Prime Minister Malcolm Turnbull will lead tax reform if states don't agree', *news.com.au* (12 December 2015), http://www.news.com.au/finance/work/leaders/prime-minister-malcolm-turnbull-will-lead-tax-reform-if-states-dont-agree/news-story/3aa59f2d0240e15ddbe6a4bc2b59fbe6.

[496] See KPMG Australia, 'Tax Reform Summit overview: continuing the debate', http://www.kpmg.com/au/en/issuesandinsights/articlespublications/afr-tax-reform-summit/pages/tax-reform-summit-overview.aspx.

[497] P Coorey, 'Turnbull's summit greenlights super tax reform', *Australian Financial Review* (1 October 2015), http://www.afr.com/news/politics/turnbulls-summit-greenlights-super-tax-reform-20150930-gjyn5p.

[498] P Coorey, 'Malcolm Turnbull confirms GST increase on the table', *Australian Financial Review* (28 October 2015), http://www.afr.com/news/politics/malcolm-turnbull-confirms-gst-increase-flags-nuclear-industry-20151027-gkkapt.

[499] J Rolfe, 'Experts argue the GST exemption on fresh food is outdated and means the government misses out on $6.4 billion in revenue', *News.com* (6 December 2015), http://www.news.com.au/lifestyle/food/experts-argue-the-gst-exemption-on-fresh-food-is-outdated-and-means-the-government-misses-out-on-64-billion-in-revenue/news-story/ba19b8580cd49253dca7d439412f370d; D Conifer, 'GST: Fresh food, healthcare and

commitment to pass any consequent revenue on to the States, however. To the contrary, the federal government's inclination seemed to be to use any revenue increases to fund rate reductions in the income tax. By contrast, some States called for an increase in federal income tax by way, for example, of a higher rate on the hypothecated income tax used to fund the national health system to provide additional State funding,[500] or a partial switch from division of GST revenue to a guaranteed share of the federal personal income tax.[501] In the face of divisions among the States and a campaign against such an increase by the federal opposition, early in 2016 the Coalition government ruled out increases in the GST.[502] A concerted campaign by the States and the education and medical sectors for restoration of the $80 billion of cuts to payments to the States to fund health and education services led to a surprise announcement by Prime Minister Turnbull in early April that a policy of allowing the States to return to the income tax field would be a central feature of discussions at the federal-state Premiers' meeting scheduled for the middle of that month.[503]

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education to cost billions more if tax broadened, PBO finds', *ABC News online* (10 December 2015), http://www.abc.net.au/news/2015-12-09/pbo-models-gst-scenarios-finds-extra-21-billion/7015616.

[500] J Massola, 'GST to dominate agenda at COAG', *Sydney Morning Herald* (2 December 2015), http://www.smh.com.au/federal-politics/political-news/gst-to-dominate-agenda-at-coag-20151202-gldeqs.html.

[501] Hon J Weatherill (Premier), Address to the American Chamber of Commerce iiNet Business Luncheon, Adelaide, 26 November 2015, http://www.premier.sa.gov.au/images/speeches/20151126_AmCham-iiNet_Business_Luncheon.pdf. Under this proposal, it was suggested (at 14) that '[a]ll non-GST Commonwealth grants to the States – excluding infrastructure payments and on-passed grants – would be converted to a share of the income tax base'; the suggested 17.5 per cent income tax share, and the method of allocation of that revenue to each state, would need to be compared by each State to existing non-GST (e.g., health and other) grants, and a calculation also made of whether there would be any flow-on effect under the horizontal fiscal equalisation formula on the existing GST grants to the state, to determine any initial net gain or loss on the proposal, apart from the longer-term income tax growth gains envisaged.

[502] S Anderson and E Borrello, 'GST increase not being taken to election by Malcolm Turnbull', *ABC News online* (16 February 2016), http://www.abc.net.au/news/2016-02-16/turnbull-rules-out-gst-change-election-policy/7172294.

[503] M Kenny, 'Malcolm Turnbull's tax revolution: Hand income taxing powers to the States', *Sydney Morning Herald* (30 March 2016), http://www.smh.com.au/federal-politics/political-news/malcolm-turnbulls-tax-revolution-hand-income-taxing-powers-to-states-20160330-gnu2f0.html; C Chang, 'Prime Minister Malcolm Turnbull asked whether income tax reform is a "double tax"?', *News.com* (31 March 2016), http://www.news.com.au/finance/economy/australian-economy/prime-minister-malcolm-turnbull-asked-whether-income-tax-reform-is-a-double-tax/news-story/6f41849085e0f1581f9e9f1708a49545. It was also noted at this time that Malcolm Turnbull had published commentary opposing the then State income tax surcharge proposals put forward by Malcolm Fraser in the mid-1970s: L Oakes, 'The puff adder bites: Prime Minister

Apart from the Western Australian Premier, however, the State leaders showed no enthusiasm for the proposal. Helping to derail the idea was the almost immediate association of the proposal with a suggestion by Prime Minister Turnbull that the Commonwealth would only continue to be involved in funding of private schools and withdraw from funding of State government (public) schools.[504] The State income tax proposal was, not surprisingly, quickly dropped from the discussion at the federal-state Premiers' meeting. Instead, a proposal for income tax sharing[505] was referred to a federal-state financial cooperation body, the Council on Federal Financial Relations, for further analysis with a progress report to be presented at the 2017 federal-state Premiers' meeting.[506] A poll of voters reported a few days after the 2016 meeting found that 58 per cent 'strongly oppose[d] giving states the power to levy their own income taxes'.[507]

4.9 Will the resumption of state income taxation ever see the light of day?

More than 73 years have passed since the Australia federal government 'temporarily' appropriated State income tax powers in the midst of the Second World War. Subsequent litigation showed there are no legal or constitutional impediments to the enduring effective retention of State income tax powers, the consequent vertical fiscal imbalance, the forced fiscal equalisation by way of redistribution of taxes, or the direct intervention in State economic and social responsibilities through the use of special purpose grants tied to implementation of federally mandated policies. The only constraints, it seems, are political. Labor governments since 1942 have been adamant that income tax powers will never be returned to the States. Economic control through control over revenue has been an aim of Labor since Federation. Until recently, Conservative coalition governments, in contrast, have regularly offer to return income tax powers to the States. The sincerity of the offers has never been tested, however, in

Malcolm Turnbull borrowing from Malcolm Fraser', *The Herald-Sun online* (2 April 2016), http://www.heraldsun.com.au/news/opinion/laurie-oakes/the-puff-adder-bites-prime-minister-malcolm-turnbull-borrowing-from-malcolm-fraser/news-story/4d29355bbf8727c6228b36d9b4a4b23d.

[504] Kenny, ibid.; Chang, ibid.

[505] See n 501, above.

[506] COAG Communiqué, 1 April 2016, http://www.coag.gov.au/sites/default/files/COAG_Communique.pdf.

[507] D Crowe and P Hudson, 'For voters, it's a big no to Malcolm Turnbull's income tax big idea', *The Australian* (5 April 2016), http://www.theaustralian.com.au/national-affairs/for-voters-its-a-big-no-to-malcolm-turnbulls-income-tax-big-idea/news-story/1554ac324db9840d379980f21a5d1083.

the absence of State unanimity to negotiate the package of reduced grants and increased State taxing power needed to give effect to a return of State income taxes.

There are a number of factors that make unanimity difficult to achieve. The net winners from fiscal equalisation fear a reduction in equalisation payments if a greater share of income tax revenues flow to the States that generated the revenue. There is also concern that inter-state competition could lead to a race to the bottom if States start to cut rates to attract investment or business activities. There is a concern about the difficulty of reaching agreement on the alignment of State and federal taxes to reduce compliance costs. There is concern about the difficulty in negotiating an administration agreement with the federal government to ensure taxpayers only have to deal with a single income tax administrator. And finally, there is concern about the difficulty in reaching an agreement among States on a single formula for distributing taxing rights in the case of enterprises across State borders.

The pre-War experience, particularly from 1936 to 1942 when tax bases were largely harmonised (though with some areas of divergence in various States), tax administration agreements were in place, an income attribution scheme for cross-border transactions by a single entity was in place, and the federal government provided equalisation payments, shows that all these issues can be managed or overcome. The real question is whether vertical fiscal imbalance will grow to the point that States see no better alternative to reaching a consensus to recapture their taxing rights. The fact that the State income tax option continues to be advocated by State or federal representatives as a solution after 73 years illustrates clearly that its time has not passed. Restoration of State income taxation remains an option on the Australian fiscal federalism table.

Chapter 5

Key Design Issues and Recommendations

5.1 Introduction and scope of this chapter

The historical experience of Australian State income taxation up to 1942, as described in Chapters 3 and 4, serves both to discount as far as possible any claims that State income taxation is impracticable in Australia and to indicate from a tax policy perspective that in view of the recent expansion of the Australian central government's direct powers over the economy some unwinding of the extreme levels of concentration of tax powers at the central level may now be warranted.[508] Accordingly, this chapter now turns to an identification of the key design features that would most appropriately be incorporated in a model for a State income tax.

At the outset, it is emphasised that all of the elements of such a process, and the decision whether to introduce a State income tax at all, are in the first instance political in nature, and the chapter does not seek to prescribe taxation policy decisions which should be made as part of that process.[509] However, it can be noted that income taxation (personal and corporate) and

[508] In particular, the High Court found in 2006 that the Commonwealth is constitutionally empowered to set minimum wage levels, a decision which expanded the interpretation of the 'corporations' power of the Australian *Constitution* and overturned the belief that Commonwealth government powers in relation to corporations did not extend to direct price and wage setting (which had been the impetus for numerous referenda on this issue between 1911 and 1973, during which time Australian fiscal federalism also became heavily centralised): *New South Wales v Commonwealth* (2006) 229 CLR 1 (*Work Choices case*). In this context, Commonwealth reliance on monopolisation of fiscal resources as a means of compensatory indirect economic control is less justifiable, given the democratic accountability costs (at the least) which have been identified as flowing from the centralisation of finance and subsequent necessity to distribute very substantial amounts of 'tied' and general purpose grant funding to the States: see Cheryl Saunders, 'Cooperative arrangements in comparative perspective', in Gabrielle Appleby, Nicholas Aroney and Thomas John, *The Future of Australian Federalism: Comparative and Interdisciplinary Perspectives* (Cambridge: Cambridge University Press, 2012), 414-431, 421, 429-430.

[509] The political analysis of recent tax policy relating to business income taxation and interjurisdictional allocation of income is undoubtedly a significant and expanding field in its own right: see, for example, Annelies Roggeman, Isabelle Verleyen, Philippe Van Cauwenberge and Carine Coppens, 'Did the Economic

indirect taxation are identified under the traditional 'Musgravian' theory of multilevel public finance as appropriate taxes at the intermediate government level in a federation (although the income tax most effectively carries out its role in relation to the income distribution function at the national level).[510] A compelling insight in the literature is also that the policy focus on expansion of indirect taxation in Australia and other countries in recent decades, including the widespread introduction of goods and services taxes, now gives rise to 'a pressing need to revitalise the income tax'.[511]

In this context, given that indirect taxation at the State level in Australia is precluded for constitutional reasons,[512] this thesis proceeds on the basis that additional taxation at the state level must be considered as a reform option with public expenditure responsibilities fixed at the state level and only likely to increase in monetary terms in future years, and income taxation is an appropriate form of tax to be considered for assignment to the States.[513]
More specifically, it is noted that complete analysis and resolution of a number of economic issues relating to state income taxation is beyond the scope of this work. The most important of these issues are set out below; however it is also suggested that such general responses to them as has been possible in this context (along with the long term continuing existence of subnational income taxes in many jurisdictions worldwide) indicates that none of these factors

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Impact of a Common Consolidated Corporate Tax Base (CCCTB) Affect the Voting Behaviour of the Members of the European Parliament?' (2015) 163(1) *De Economist* 1-23; Jamie Morgan, 'Corporation tax as a problem of MNC organisational circuits: The case for unitary taxation' (2016) 18(2) *British Journal of Politics and International Relations* 463-481; Leonard Seabrooke and Duncan Wigan, 'Powering ideas through expertise: professionals in global tax battles' (in Special Issue, 'Ideas, political power, and public policy'), (2016) 23(3) *Journal of European Public Policy* 357-374. Much attention has also recently focused on assessing 'state capacity' and identifying political pathways to achieving tax reform: see Richard Eccleston and Ian Marsh, 'The Henry Tax Review, Cartel Parties and the Reform Capacity of the Australian State' (2011) 46(3) *Australian Journal of Political Science* 437-451.

[510] Richard A Musgrave and Peggy B Musgrave, *Public Finance in Theory and Practice*, 5th edn (New York: McGraw-Hill Book Co., 1989), 470-471.

[511] See Brooks, 'An Overview of the Role of the VAT, Fundamental Tax Reform, and a Defence of the Income Tax', above n 6, 599.

[512] *Constitution*, s 90; *Ha v New South Wales* (1997) 189 CLR 465.

[513] See generally Henry Review, above n 4, Pt 2, Vol 2, 678. The Henry Review noted that a State level personal income tax 'appears to be constitutionally possible' and should be given consideration as one potential longer term reform direction for State taxation: ibid, 680, 682.

(which are often in the forefront of any debate involving reimposition of state income taxation) would substantially undermine the viability of a State income tax.

(i) *Interjurisdictional mobility will lead to 'harmful' interstate tax competition*

The question of interjurisdictional mobility of taxpayers and the scope for 'harmful' tax competition to emerge as a result of such mobility is a very large and significant area of analysis in relation to national and international tax policy in general and it is not feasible to seek to reach definitive conclusions here in relation to the impact of this issue on an Australian State income tax. Nevertheless, the issue is so frequently the subject of claims casting doubt on the scope for subnational income taxation, in particular of corporations, that it is appropriate that some observations are made, drawing on the literature in this field, as a result of which it is possible to discount the dangers from this issue, at the least in the Australian context.

The modern debate on the question of the impact of interstate tax competition, at the broadest level, is usually framed as a contest between the principles of public choice theory, which supports a system allowing citizens to choose between different combinations of public goods provided by governments and the forms of taxes to pay for them,[514] in the process promoting efficiency in the government budget process, and more recent concerns in the context of globalisation and market liberalisation that corporations and the sources of capital income in particular (ie, mobile factors of production) will relocate between jurisdictions solely on the basis of taxation burden and so drive tax rates down to a level below the appropriate rate.[515]

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[514] Charles M Tiebout, 'A pure theory of local expenditures' (1956) 64(5) *Journal of Political Economy* 416-424; this is subject to a corrective national role in the imposition of the relevant tax in the presence of interjurisdictional 'spillovers' of public goods: John G Head, *Public Goods and Public Welfare* (Durham, NC: Duke University Press, 1974), 270-278.

[515] Relevant also to this issue is the important theoretical question of the economic incidence of taxes, such as the corporation income tax and payroll tax, and certain economic equivalences which are recognised between particular forms of tax. It has been noted that the question of the incidence of the corporate income tax is a matter which is to date 'still very largely unresolved': see John G Head and Richard Krever, 'Australian Business Income Tax Reform in Retrospect: An Analytical Perspective', in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Sydney: Thomson, 2009), 17-38, 22. A corporate income tax imposed on profits in a jurisdiction calculated according to formula apportionment is typically seen as being able to be decomposed into a tax on the relevant factors (e.g., property, sales or labour) included in the formula: Charles E McLure, Jr., 'The State Corporate Income Tax: Lambs in Wolves' Clothing', in Henry J Aaron and Michael J Boskin (eds), *The Economics of Taxation* (Washington, DC: Brookings

In the latter context, the popular and often-cited examples of the harmful element of the process can be dismissed at the outset. These are, in terms of the mobility of individuals, Queensland's decision in 1977 to abolish its State-level bequest tax which was followed by large-scale migration of retirees to that State and the rapid abolition of those taxes by all the other States and, in terms of the mobility of businesses, the claimed continuous process by all States of adding exemptions and concessions to the payroll tax rendering it much less effective as a revenue source than it should be.

Evidence from shortly after Queensland's abolition of the bequest tax suggests that the State in fact increased its taxation revenue in the course of its migration influx due to higher receipts from other taxes,[516] suggesting that the impact of removal of the bequest tax may be overstated or may be taken into consideration by taxpayers over an irrationally long timeframe. In any event, the issue of factors involved in the migration of retirees is a field of study which is emerging as a separate area in its own right.[517]

Similarly, the revenue collection data for payroll tax do not immediately suggest a noticeable declining trend in this revenue source: 1.5 per cent of GDP and 5.8 per cent of tax collections in 1975 (shortly after the States took over payroll tax from the Commonwealth) and 1.4 per cent of GDP and 5.1 per cent of tax collections in 2013.[518]

In more general terms, however, the detailed review of Australia's taxation system conducted by the Henry Review in 2008-09, while noting that some States had broadened the

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Institution, 1980), 327-346. This finding affects 'only slightly' the analysis as to impact of the corporation tax on mobile capital and investment decisions, in that the impact will be felt in accordance with the sensitivity of each factor to taxation rather than of those capital investment decisions as a whole: Charles E McLure, Jr., 'Assignment of Corporate Income Taxes in a Federal System', in Charles E McLure, Jr. (ed.), *Tax assignment in federal countries*, above n 447, 101-124, 110.

[516] It was reported in 1981, for example, then Queensland Premier Joh Bjelke Petersen's 'record as a tax-cutter' relied only on abolition of this tax (then less than 2 per cent of State revenue) and that four years after its abolition 'the amount forgone in revenue has been raised in land tax and other State Government charges on the people attracted from other States and overseas to death-duty-free Queensland': A Stewart, 'A few cracks in the Premier's "invincible" facade', *Canberra Times*, 1 March 1981, 2.

[517] See, for example, Karen Smith Conway and Andrew J Houtenville, 'Elderly Migration and State Fiscal Policy: Evidence from the 1990 Census Migration Flows' (2001) 54(1) *National Tax Journal* 103-123, noting that the level of death taxes explains some level of migration of the elderly but that sales tax exemption for food in the destination state is the only 'consistently important' taxation variable.

[518] OECD, *Revenue Statistics* (2010), Annex Table 20; OECD, *Revenue Statistics* (2015), Annex Tables 19 and 20.

base of their payroll taxes, in general was critical of the payroll tax as an efficiency-distorting revenue source (in the context of some shifting of the burden to mobile capital) and highly complex form of tax in part as a result of a lack of interstate harmonisation,[519] and also identified the need for reductions in Australia's headline national corporate income tax rate over the longer term in the context of concerns about international business tax competition and the mobility of capital.[520] This is a debate which continues to play out at the Australian domestic level and also internationally, in a context where it has been found that country competition does account for some amount of the reduction in company tax rates implemented by a number of countries in recent years,[521] but it can be noted for present purposes that the Henry Review's pessimism in relation to the impact of capital mobility is by no means universally accepted.[522] It is also clearly the case that locational decisions by businesses and individuals between jurisdictions will involve a range of factors other than simply the rate of tax (so that a higher tax and higher public services jurisdiction may be favoured).[523]

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[519] Henry Review, above n 4, Pt 2, Vol 2, 293-302.

[520] Ibid, Pt 2, Vol 1, 166-167.

[521] Michael P Devereux, Ben Lockwood and Michela Redoano, 'Do countries compete over corporate tax rates?' (2008) 92 *Journal of Public Economics* 1210-1235.

[522] For example, the conventional national-level corporate income tax has been defended as a tax which can be 'safely imposed on location-specific rents without causing an outflow of capital' (in the international context) and more generally that '[e]mpirical studies clearly show that the international supply of capital is not in general highly elastic, either for large or small countries': Head and Krever, 'Australian Business Income Tax Reform in Retrospect: An Analytical Perspective', above n 515, 29-30. In the subnational context, doubt was also expressed about the extent to which Australian conditions would be conducive to business mobility in 1977, in Bhajan S Grewal and Russell L Mathews, 'Intergovernmental Tax Competition and Co-ordination', in Russell L Mathews (ed.), *State and Local Taxation* (Canberra: Australian National University Press and Centre for Research on Federal Financial Relations, 1977), 83-93, 86, although a subsequent study 'suggested that the fully integrated capital market case is more applicable to Australia': Jeffrey D Petchey and Perry Shapiro, 'State Tax and Policy Competition For Mobile Capital' (2002) 78(241) *Economic Record* 175-185. More recently, a study of German conditions suggested that large municipal tax concessions would be needed to induce even low levels of corporate migration: Sasha O Becker, Peter H Egger and Valeria Merlo, 'How low business tax rates attract MNE activity: Municipality-level evidence from Germany' (2012) 96 *Journal of Public Economics* 698-711.

[523] A study of individual migration, for example, noted factors such as overall household income growth, cost of living, climate, hazardous waste sites and pollution and government spending on primary and secondary education in addition to the state tax burden: Richard J Cebula and Gigi M Alexander, 'Determinants of Net Interstate Migration, 2000-2004' (2006) 36(2) *Journal of Regional Analysis and Policy* 116-123.

In conclusion, a more important factor for the purposes of the assessment of an Australian State income tax as a policy option is that the relevant consideration of questions of mobility and tax effects should be made over the long term rather than merely one business cycle or 'era' of commercial conditions. It is clear that corporation taxes both emerged and increased at the state level in the US in the late nineteenth century in response to conditions and community attitudes much different from those of the present, so that there is no basis to conclude that interstate 'tax competition' will at all times over the cycle be downward. Over very long timeframes, strong local-level government and financing of the provision of basic services 'overwhelmingly from taxes on property, wealth, and income' has also been argued to be at the core of creating a development path for a society that includes strong levels of society equality overall.[524]

In any event, to conclude on a very brief practical note, the data for US state tax collections across various types of tax has shown that '[f]or decades, the distribution of state tax collections by tax category has remained relatively constant', at least suggesting no particular relative strength or weakness of any one form of tax compared with another.[525]

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[524] Kenneth L Sokoloff and Eric M Zolt, 'Inequality and Taxation: Evidence from the Americas on How Inequality May Influence Tax Institutions' (2006) 59(2) *Tax Law Review* 167-242, 240 (cited in Hon Michael Kirby, 'Down with *Hubris*! A Message on Tax Reform for Australian Tax Specialists', paper presented to the National Tax Conference 2011, Institute of Chartered Accountants in Australia, Melbourne, 7 April 2011, fn 48, and Hon Michael Kirby, 'Of "Sham" and Other Lessons for Australian Revenue Law' (2008) 32(3) *Melbourne University Law Review* 861-878, 877), discussing the example of US and Canadian development in contrast to the experience of many Latin American countries which exhibit very high and entrenched levels of social inequality.

[525] Cheryl Lee, Edwin Pome, Mara Beleacov, Daniel Pyon and Matthew Park, US Census Bureau, 'State Government Tax Collections Summary Report: 2014', *Economy-Wide Statistics Brief: Public Sector*, 16 April 2015, 1. State corporation net income taxes were a (perhaps surprisingly low) 5.3 per cent of total state government tax collections in 2014, compared with 35.9 per cent for the personal income tax and 31.3 per cent for the sales and gross receipts taxes, although corporations also contributed a further nearly 1 per cent of the total in the form of licence taxes: ibid. The corresponding levels in Canada seem to be slightly more balanced, with personal income tax revenue for 2013 less than four times greater than corporation tax revenue: OECD, *Revenue Statistics* (2015), above n 518, Annex Table 44. The proportion represented by corporation taxes is also higher in the New York City municipal tax system, where USD 4.7 billion (9.8 per cent of total taxation) was levied from corporations in 2014 (and a further USD 1.9 billion, 4.0 per cent, from unincorporated businesses) as compared with USD 10.2 billion (21 per cent) from personal income taxes: Fiscal Policy Institute, 'New York City Taxes – Trends, Impact and Priorities for Reform', Fiscal Policy Institute Report, 13 January 2015, 12, http://fiscalpolicy.org/wp-content/uploads/2015/01/NYC-Tax-Report-Jan-13-2015.pdf.

Moreover, as far as the potential for the particularly highly mobile group of taxpayers of high-wealth individuals to be driven away by high taxes is concerned, it has recently also been found for the New York City tax system (including personal and corporate income taxes) that:

> ...[r]ather than showing an exodus of wealthy households, tax data show that the number of New York City households with incomes of $1 million or more rose much faster between 2000 and 2011 than in the US as a whole. Also, the total income of those high-earners rose much faster in New York City than in the US overall over the decade. Wealthy residents seem to see taxes as akin to high real estate prices: the cost of being here.[526]

(ii) *Corporate income taxation should be conceptually reformed to a new model: for example, cash flow, 'allowance for corporate equity', or dual income taxation*

Building on research in relation to the capital mobility issue, much of the tax reform debate in recent times has also been focused on whether the existing traditional corporate income tax as levied in Australia and many other countries should be replaced by any one of a range of alternative forms of business or capital taxation or even, to the extent that a corporation tax is seen ultimately as only a form of withholding at the source of tax on the income of shareholders, abolished altogether.

Such alternative types of corporation tax include, on the one hand, the 'allowance for corporate equity' system which provides for taxation of profit only as calculated above a specified rate of return on debt and equity and, on the other, a comprehensive business income tax which does not allow deduction for the cost of equity or debt.[527] All of these proposals also overlap with structural reform options for integration of corporate and shareholder taxation, such as dividend exemption and dividend imputation systems, and the optimal taxation of capital income overall, which might be achieved through a 'dual income tax' or schedular approach, with significantly lower rates of tax on defined categories of capital income at the shareholder level as has found some success in Scandinavian countries.

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[526] Fiscal Policy Institute, 'New York City Taxes – Trends, Impact and Priorities for Reform', Fiscal Policy Institute Report, ibid, 3. The report nevertheless found that the city's heavy reliance on property taxation created a highly regressive tax system and that 'the main priority should be to further enhance the income tax's progressivity'; it was also suggested that the business tax base should be broadened and the many substantial business tax expenditures reviewed (72-74, 76-78).

[527] Henry Review, above n 4, Pt 2, Vol 1, 164.

An important caveat that the Henry Review noted in relation to the alternative forms of corporate taxation themselves is the limited experience overall with any of them in any country's taxation system, and the Review recommended that Australia at the national level retain the existing corporate income tax at least over the short to medium term.[528] Beyond this conclusion itself, the traditional corporate tax can be considered highly durable and successful in Australia and other comparable countries such as the US and Canada in a historical sense, including at the subnational level.

In this context, it is considered that the traditional corporate income tax constitutes a feasible and appropriate system for an Australian State income tax and it is not proposed in this thesis to assess the appropriateness of any alternative form of taxation of business income.

(iii) *Concurrent federal and state income taxation will lead to second-round 'vertical tax externalities' in the federal system*

In conclusion, it can also be noted that some potential drawbacks have been identified in the literature from concurrent occupation of the income tax field by both national and subnational levels of government in a federation. These could be seen to arise as 'externalities' to the costs of taxation to the one level of government, in that the lowering of net income from the tax may lead the other level of government to overtax the same base in order to raise a given amount of income.[529]

While concurrent taxation has historically often been criticised as less than ideal in practical terms,[530] the specialised study of vertical externalities seems to be a relatively new field of fiscal federalism research and has the potential to bring into consideration much wider economic issues in the policy interaction of the levels of government in a federation. For example, it has also recently been noted that concurrent income taxation may lead to the under-provision of key public goods by subnational governments where part of the gains from those

[528] Ibid, 165.

[529] See Michael Keen, 'Vertical Tax Externalities in the Theory of Fiscal Federalism' (1998) 45(3) *IMF Staff Papers* 454-485.

[530] In Australia, for example, see the report of the Royal Commission on Taxation in 1922 recommending a 'delimitation of spheres' between Commonwealth and State governments in relation to the various forms of taxation, discussed in Chapter 3 (text at n 198 ff): Warren Kerr Royal Commission, *Second Report of the Royal Commission on Taxation*, above n 16.

goods accrue to the national government, thereby providing a case for matching federal grants for state infrastructure provision.[531]

It is not proposed to consider this very wide issue in detail in this thesis, in part as the questions of multilevel governance and taxation are political issues, and also due to the likely impracticability of a complete 'delimitation of spheres' being achieved in relation to intergovernmental financial relations in Australia.

(iv) *'Business income' is derived by a variety of different legal entities in addition to corporations, leading to the potential for distortions in business decisions if inconsistent tax rates and rules apply to such entities*

The question of the appropriate taxation treatment to apply to 'business income' as derived in each case by various different legal entities historically has been a longstanding issue in income tax design and continues to be a subject of controversy amid the potential for tax avoidance, for example through the recharacterisation of individual personal services income as corporate revenue in order to pay a lower corporate rate or gain access to a more advantageous expense deduction regime.

In general, Australia's current national corporate income tax treats business income of individuals as part of the personal income tax (with anti-avoidance provisions to deem certain income derived through other entities as personal services income[532]), and also taxes trusts and partnerships as flow-through entities. Public trading trusts and limited partnerships, however, are taxed as companies.[533]

Some variations in approaches to this issue is also seen in the US state and municipal income taxes. Generally, the states follow the entity taxation rules of the US federal tax system, so as to treat partnerships and trusts on a conduit basis and attribute the income from these entities to the individual partners or beneficiaries (in respect of distributed income) under the state personal income tax.[534] US federal 'S' corporations, which are treated as flow through entities so that the shareholders are taxed on the entity income, are often taxed in the same way

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[531] See Bev Dahlby and Leonard S Wilson, 'Vertical fiscal externalities in a federation' (2003) 87(5-6) *Journal of Public Economics* 917-930.

[532] *Income Tax Assessment Act 1997* (Cth), Div 87.

[533] Kerrie Sadiq, Cynthia Coleman, Rami Hanegbi, Sunita Jogarajan, Richard Krever, Wes Obst, Jonathan Teoh and Antony Ting, *Principles of Taxation Law 2015* (Sydney: Thomson, 2015), paras 19.19 and 21.20.

[534] Jerome Hellerstein and Walter Hellerstein, cont. auth. Joan M Youngman, *State and Local Taxation: Cases and Materials*, 6th edn (St Paul: West Publishing, 1997), 897, 901.

at the state level, on the relevant share of the entity income attributable to the state.[535] New York State, however, imposes additional requirements on such a corporation in order to qualify for flow through treatment (rather than being taxed as a general corporation),[536] while New York City does not recognise the federal S corporation election at all, and subjects such entities to the general corporation tax and the applicable formula apportionment rules.[537]

New York City is also an example of a subnational jurisdiction which imposes a separate 'unincorporated business tax' on entities deriving business income such as individuals and trusts.[538]

In the case of an Australian State income tax, it may be that in general the federal tax rules could be applied to the relevant entities. However, while this would import the existing issue subject to extensive debate in the federal tax of 'income splitting' and income streaming under the trust rules, it would also give rise to a further issue for the state level tax only of potential attribution of trust income to out-of-State beneficiaries and of undistributed trading income to out-of-State trustees. Attention to this issue would certainly be warranted in the implementation of a State income tax, whether through anti-avoidance rules or rules similar to those in the national level income tax relating to foreign income attribution. However, apart from being noted here this issue is beyond the scope of this study, which generally will use the term 'business income' throughout this chapter as a reference to income of corporations proper.

5.2 Historical development of the source principle for subnational business income taxation

Both in the case of countries at the national level, and subnational governments within countries, the conceptually identical question arises of whether a tax on business income should be imposed on a source or residence basis. Most national-level income taxes in the present day include elements of both, while the US and Canadian subnational income taxes have generally evolved into residence and source taxes for individuals and source taxes for corporations.

[535] See, e.g., New York State, Department of Taxation and Finance, 'S corporations – tax years beginning on or after January 1, 2015', https://www.tax.ny.gov/bus/ct/s_corporations_post.htm.

[536] Ibid.

[537] New York City, Department of Finance, 'General Corporation Tax (GCT)', https://www1.nyc.gov/site/finance/taxes/business-general-corporation-tax-gct.page.

[538] See New York City, Department of Finance, 'Unincorporated Business Tax (UBT)', http://www1.nyc.gov/site/finance/taxes/business-unincorporated-business-tax-ubt.page. The apportionment formula under the tax is 10 per cent property, 10 per cent payroll and 80 per cent sales.

Much of the current debate as to possible reforms to international taxation to deal with the problems of 'base erosion and profit shifting' involves as a preliminary matter the emphasis which should be placed on each of these taxation principles,[539] and then as a secondary issue the most effective means for implementing the relevant system.

As discussed in prior chapters, Australia's historical experience at the State level has shown a clear focus on the source basis for business taxation, but also that residence taxation is constitutionally and politically feasible, as the move by New South Wales to residence and source taxation of all taxpayers in 1941 demonstrates. Moreover, the existence of some double taxation agreements at the subnational level, such as the *entente* between Quebec and France, and the various tax agreements entered into by Hong Kong, also indicates that national-level arrangements for avoidance of double taxation can be reproduced at the subnational level. Accordingly, this key element of state income tax design must also be recognised in the first instance as being a political issue.

Nevertheless, a consideration of the broader historical experience of income taxation, in the 'Anglo' countries at least, suggests that the source principle is likely to be the more important focus for any newly designed State income tax today. That experience suggests both

[539] One important contribution to the US debate, for example, has advocated use of the residence principle exclusively for the national income tax as a means of overcoming problems of allocation of income to territorial sources: see Robert A Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993) 79(1) *Cornell Law Review* 18-86, cited in John Tiley and Glen Loutzenhiser, *Advanced Topics in Revenue Law* (Oxford: Hart Publishing, 2013), 368, n 2. Such an approach has been argued to offer the best prospect of strengthening the international tax system overall, although in Australia's case recent increases in outbound investment have also been cited in support of a residence approach to income taxation: Richard J Vann, 'Australia's Future Tax Treaty Policy', in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect*, above n 515, 401-416. Developing countries however may lose under existing treaty models which do not provide sufficient protection of source taxation rights: Kim Brooks and Richard Krever, 'The Troubling Role of Tax Treaties', in Geerten M M Michielse and Victor Thuronyi (eds), *Tax Design Issues Worldwide* (Alphen aan den Rijn: Kluwer Law International, 2015), 159-178. Both principles can be defended on economic efficiency grounds, as meeting criteria such as 'capital export neutrality' (residence principle) or 'capital import neutrality' (source principle); the source principle provides a stronger basis for meeting the requirements of interjurisdictional equity, such as benefits provided by a jurisdiction and an entitlements to 'rental' income from exploitation of above-normal gains from capital scarcity: see Richard A Musgrave and Peggy B Musgrave, 'Inter-nation equity', in Richard M Bird and John G Head (eds), *Modern Fiscal Issues: Essays in Honor of Carl S Shoup* (Toronto: University of Toronto Press, 1972), 63-85, 72-73.

some variation in the importance of each principle at different times, but arguably also a larger trend to the source principle overall.

The UK income taxes of 1799 and 1842 which adhered to the residence principle were introduced in an era of the British Empire at its widest extent, and also in the pre-Industrial Revolution years before manufacturing had expanded. Protection of laws in accordance with the location of central management of a company was seen as the key principle justifying imposition of income tax,[540] and in the early 'mercantile' years of the nineteenth century the emergence of the more limited basis of taxation according to 'remittance' of profits to the UK was not a limitation of principle, but of administrative convenience in accordance with the systems of payment involved in international trade. Such payment arrangements invariably involved London at some point in any transaction at that time.[541]

While the US federal income taxes of the Civil War period were also expressed to apply on a residence and source basis,[542] the years after the Civil War economically were a period of retrenchment and unwinding of wartime conditions. The US federal income tax came to an end in 1872 (for the time being), and the years 1873-1896 in both the UK and US have since been described as a 'great depression'.[543] The remittance basis of UK income taxation also

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[540] See John Avery Jones, 'Taxing Foreign Income from Pitt to the Tax Law Rewrite - the Decline of the Remittance Basis', in John Tiley (ed.), *Studies in the History of Tax Law* (Oxford: Hart Publishing, 2004), 15-56, 40, n 119, discussing *De Beers Consolidated Mines Ltd v Howe* (1906) 5 TC 198 at 213 (HL) in relation to a company managed in the UK in contrast to the earlier decision of *Colquhoun v Brooks* (1889) 2 TC 490 at 492 (HL), in which Lord Herschell noted that the remittance basis was justified in principle where a foreign business was subject to the protection of the laws of the foreign jurisdiction and not the UK.

[541] Ibid, 17-18.

[542] The Civil War income tax as initially introduced in 1861 applied only to income (including dividends) of individuals. The 1864 tax also applied to banks and insurance companies, in respect of dividends paid and also 'on all undistributed sums, or sums made or added during the year to their surplus or contingent funds' (see Chapter 2, n 47, above), and to railroad, canal and similar companies, in respect of interest or coupons paid, dividends declared and 'all profits of such company carried to the account of any fund, or used for construction': *Revenue Act of 1864*, 38th Congress, Session I, ch. 173, ss 120 and 122 (30 June 1864), https://memory.loc.gov/cgi-bin/ampage?collId=llsl&fileName=013/llsl013.db&recNum=252, https://memory.loc.gov/cgi-bin/ampage?collId=llsl&fileName=013/llsl013.db&recNum=312.

[543] See Matthias Morys, 'Cycles and Depressions', in Roderick Floud, Jane Humphries and Paul Johnson (eds), *The Cambridge Economic History of Modern Britain, Vol 2: 1870 to the Present* (Cambridge: Cambridge University Press, 2014), 229-254, 242; significant deflation in commodity prices occurred in the years after the 'Panic of 1873'. Much modern debate (e.g., in the US) involves the possible need for an increase in territorial (foreign source exemption) taxation: see, for example, Daniel N Shaviro, 'Moving to a Territorial System and

developed into a basis for income tax deferral for the wealthy at this time,[544] as new trade and payment mechanisms meant that the profits of foreign ventures may have been held offshore or reinvested, and full residence taxation, at least for foreign investment income, would only be re-established in 1914.[545]

Important developments in income taxation were occurring at the state level in the US at this time as part of the emergence of the Progressive Era and building of the modern industrialised economy, but the taxes which did emerge were limited to a source basis in terms of business income, and remained in that form by the time of the next global economic expansion in the early twentieth century, when US federal income taxation returned with taxation of worldwide income of individuals and corporations. Two key US state tax laws, Pennsylvania's 1868 tax on capital stock[546] and New York's 1880 tax on capital stock[547] were both levied in an amount which increased in accordance with the rate of the company's dividend and so can both be considered a form of income tax.[548]

Reforming the Corporate Tax', in *Towards Tax Reform: Recommendations for President Obama's Task Force* (Falls Church, VA: Tax Analysts, 2009), 78-80; such debate may be considered to arise from economic conditions in the aftermath of the global financial crisis of 2008 similar to the late nineteenth century.

[544] This interpretation of the income tax provisions relating to a foreign trade were also upheld by the House of Lords in 1889: *Colquhoun v Brooks* (1889) 14 App Cas 493.

[545] Avery Jones, 'Taxing Foreign Income from Pitt to the Tax Law Rewrite', above n 540, 44-45.

[546] Pennsylvania, L. 1868, c. 69, *Laws of the General Assembly of the State of Pennsylvania*, Sess. 1868, 108, https://archive.org/stream/lawsofgeneralass1868penn#page/n5/mode/2up. The tax was re-enacted by statute of 1874: *Laws of the General Assembly of the State of Pennsylvania*, Sess. 1874, 68 (Act no. 31): https://archive.org/stream/lawsofgeneralass1874penn#page/68/mode/2up. See Edwin R A Seligman, 'The Taxation of Corporations I' (1890) 5(2) *Political Science Quarterly* 269-308, 298-299; Seligman, 'The Taxation of Corporations III', above n 50, 654.

[547] New York, L. 1880, c. 542, s 3, in A G Cognant (ed.), *Statutes at Large of the State of New York*, Vol X (1882), 1054ff.

[548] Seligman notes that the tax on dividends and the tax on capital stock according to dividends '[e]conomically speaking … are the same': Edwin R A Seligman, 'The Taxation of Corporations II' (1890) 5(3) *Political Science Quarterly* 438-467, 454; however (ibid, 444-445), while the Pennsylvanian courts themselves regarded the tax on capital stock according to dividends as a property tax (in, e.g., *Phoenix Iron Co. v Commonwealth*, 59 Pa. 104 (1868); *Commonwealth v Standard Oil Company*, 101 Pa. St. 119 (1882)), the US Supreme Court in 1887 considered New York's tax on capital stock (as amended in 1881, c. 361, to provide that the tax was 'for the privilege of exercising … corporate franchises') to be 'a tax upon [a corporation's] franchise based upon its income': *Mercantile Bank v New York*, 121 US 138, 160 (1887).

In a key judicial finding in relation to the Pennsylvania tax, it was held by the Pennsylvanian Supreme Court in 1882 (in the case involving a corporation incorporated in a state outside Pennsylvania) that the tax was limited to capital stock within the state.[549] New York's capital stock tax of 1880 was apparently only amended in 1885 to provide an express limitation of the scope of the tax to capital stock employed within the state.[550]

It was in this context that the early Australian income taxes were introduced, adopting the source basis: for example, South Australia's individual and corporation income tax in 1884, Queensland's dividend duty of 1890 (payable in respect of that amount of the dividend which was proportionate to the 'average capital of the company employed in Queensland'[551]). Note, however, as an initial exception, that Tasmania's tax of 1880 on companies in respect of dividends declared was expressed in that Act to apply to 'any Company carrying on business in Tasmania',[552] and only limited under the subsequent amending Act later that year in respect of companies not having their head office or chief place of business in Tasmania to dividends payable to 'shareholders being upon the Tasmanian register of shareholders'.[553]

[549] *Commonwealth v Standard Oil Company*, 101 Pa. St. 119 (20 November 1882), Sharswood CJ, Mercur, Gordon, Paxson, Trunkey, Sterrett and Green JJ; Gordon, Trunkey and Sterrett JJ dissenting. See Seligman, 'The Taxation of Corporations III', above n 50, 648, described in terms of being of general application, after also having previously been 'long the custom' in that state.

[550] Seligman, 'The Taxation of Corporations III', above n 50, 648, citing L. 1885, c. 501. For a comparison of New York and Pennsylvania corporation taxes generally as these taxes subsequently developed in the early twentieth century, see Dante J Scala, 'Taxing the Intangibles: How States Pursued Corporate Wealth in the Early Twentieth Century' (1998) 27(2) *Business and Economic History* 431-443, noting that the differing treatment of manufacturing and other industries in these neighbouring states tends to contradict the notion of a 'race to the bottom' occurring in these circumstances.

[551] *Dividend Duty Act 1890* (Qld), ss 7 and 8. The relevant proportion of average capital was defined by reference to the corresponding proportion of the total assets of the company wherever situate (s 9). See further discussion in section 5.4.2.3 below.

[552] *Real and Personal Estates Duties Act 1880* (Tas) (enacted on 26 February 1880), Sch B.

[553] *Real and Personal Estates Duties Act Amendment Act 1880* (Tas) (enacted on 1 November 1880), s 3. Tasmania's general income tax of 1894 also extended to income 'received in' the State: *Income Tax Act 1894* (Tas), s 14.

It seems also that at around the same time as the reintroduction of the US federal income tax in 1909 (corporations)[554] and 1913 (individuals and corporations),[555] the US general income taxes being developed at the state level continued to tax business income on a source basis, initially pursuant to a legislative direction in each case to allocate income between in and out of state sources,[556] and subsequently by the further development of formulas for apportionment which had been used for the capital stock taxes and taxes on specific corporations such as railroads.[557] It seems that this line of development was only first informed by a specific decision of the US Supreme Court in 1903 that state taxation could be invalidated for extraterritoriality (unless a sufficient nexus to the state could otherwise be identified), although prior to that time limitations on state taxation power were found under various circumstances such as the prohibition on taxation of out of state property on the basis of jurisdiction.[558]

In the late nineteenth century, the Australian colonial legislatures were considered to be subject to a constraint preventing extraterritorial laws (although this was a 'limitation of

[554] *Tariff Act of 1909*, s 38, 36 Stat. 11, 112-113; see Ajay K Mehrotra, 'The Public Control of Corporate Power: Revisiting the 1909 US Corporate Tax from a Comparative Perspective' (2010) 11(2) *Theoretical Inquiries in Law* 497-538, 506; Marjorie E Kornhauser, 'Corporate Regulation and the Origins of the Corporate Income Tax' (1990) 66(1) *Indiana Law Journal* 53-136.

[555] *Tariff Act of 1913*, 38 Stat. 114, also (at 172) substantially re-enacting the provisions of the 1909 corporation tax: Note, 'Taxable "Net Income" under the Corporation Excise Tax Law of 1909' (1917) 17(2) *Columbia Law Review* 149-151.

[556] See, for example, the Wisconsin general income tax of 1911, described in National Industrial Conference Board, *State Income Taxes, Vol I: Historical Development* (New York, 1930), 33-34. The discussion on this issue refers only to business income as such; dividends and interest may have been treated differently under a residence approach, as described in relation to the Wisconsin tax in 1931, for example, in Edmund B Shea, 'Limits on State Power to Tax Incomes of Foreign Corporations' (1934) 18(2) *Marquette Law Review* 67-79, 68.

[557] See, for example, the apportionment methods of the 1915 Connecticut income tax based on the in-state proportion of total property (or total gross receipts for companies deriving net profits principally from intangible property), upheld in *Underwood Typewriter Co v Chamberlain*, 254 US 113 (15 November 1920). See also Joe Huddleston and Shirley Sicilian, 'History and Considerations for Combined Reporting: Will States Adopt a Model Combined Reporting Statute?' (2008) *State and Local Tax Lawyer, Symposium Edition* 3-20, 5-6.

[558] Jerome R Hellerstein and Edmund B Hennefeld, 'State Taxation in a National Economy' (1941) 54(6) *Harvard Law Review* 949-976, 956, citing, on the jurisdiction finding, *Hays v Pacific Mail Steamship Co*, 58 US 596 (1854). See also Jerome R Hellerstein, 'State Taxation Under the Commerce Clause: The History Revisited', in Charles E McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination* (Stanford: Hoover Institution Press, 1984), 53-81, 64.

obscure origins and extent'[559]), but there is no evidence to suggest that such a constraint in itself was the cause of the widespread adoption of the source principle in the colonial income taxes.

Needless to say, if the rule may have impacted an attempt to tax a local resident in relation to income earning transactions or things elsewhere, it may also have had possible implications under the source principle itself, on efforts to tax an out of jurisdiction person on matters or things arising within the colony. In this context, it can be noted that a New South Wales duty Act of 1899, which applied to companies incorporated outside the colony and carrying out mining or agricultural business in the colony and sought to impose a duty in respect of the death of a shareholder 'wheresoever such member may have been domiciled',[560] apparently did not receive the Governor's Assent but was referred to London.[561]

The main changes of substance in an amending Act in 1900 (as subsequently incorporated in a re-enacted consolidated law of 1901, giving rise to an Act which was 'in a form acceptable to the United Kingdom Government'[562]), however, seem to have been merely to provide an exemption for low-value shareholdings and to provide a further exclusion in relation to companies carrying on pastoral or agricultural production, where such a business related to property holdings falling into the hands of the company on foreclosure or conveyance in connection with a mortgage debt,[563] rather than to deal with any concern as to extraterritoriality. Accordingly, it seems that the main considerations in terms of income tax design, leading to use of the source principle only, were more likely to have involved enforceability and collection of tax in relation to overseas persons or assets, and the balance of revenue available depending upon the level of inbound investment (which for the Australian colonies was invariably significant).

In any event, the High Court brought any lingering uncertainty on the legal validity point to an end in 1937 with a clear confirmation that both source and residence forms of income taxation were open to the then State governments, with only a requirement for a

[559] Twomey, *The Australia Acts 1986*, above n 327, 10.

[560] Companies (Death Duties) Bill 1899 (NSW), cl 7.

[561] Twomey, *The Australia Acts 1986*, above n 327, 12.

[562] Ibid.

[563] *Companies (Death Duties) Amendment Act 1900* (NSW), s 4. The 1899 Act had already excluded companies carrying on pastoral business as mortgagee in possession generally.

connection of a minimal degree of the subject of the tax to the jurisdiction.[564] To the extent that any speculation can be made on the impact of this issue, it is perhaps notable that the move by New South Wales to include residence taxation in its general income tax occurred very shortly after this judgment, in 1941.

It can also be noted in this context, discussed further in section 5.4.2.2 below, in a contrast of some degree with the US state income taxes, that the Canadian provincial corporate income taxes such as that in Ontario introduced by 1937 adopted a residence based approach, elements of which remain in modern Canadian legislation today. This example may be useful in the Australian case if future conditions permitted such an approach, but it seems unlikely that it would cause an Australian State to seek to use residence taxation of corporations alone and abandon source based taxation altogether.

In conclusion, it can be noted that different considerations may arise in whether an income tax on individuals should be imposed on both a residence and source basis. Taxation of individuals on a residence basis for example facilitates progressive taxation on total income. This may be one factor which would support the conversion of the existing Australian State payroll taxes (as, in effect, flat source taxes on labour income in the State, with deduction based on the size of the employer rather than the income level of the employee) to income taxes imposed on individuals directly, although this may be considered appropriate in any event.

Recommendation 1

Practical and historical considerations support the conclusion that a State income tax on business income should be imposed on a source basis.

A State may consider it appropriate in future circumstances additionally or alternatively to tax business income on a residence basis, for example if a general move emerged internationally to place greater reliance on residence taxation or reform the international tax system to use this basis alone.

[564] *Broken Hill South Ltd (Public Officer) v Commissioner of Taxation (NSW)* (1937) 56 CLR 337. The provision in that case involved taxation of interest received by a non-resident company from another non-resident company under a debenture listed on the company's out of State register but secured on property wholly or partly in New South Wales.

5.3 Conformity of state and federal bases

In debate as to whether subnational income taxation is appropriate, conformity of the subnational tax base with the federal tax, and as a concomitant the establishment of joint tax return arrangements, is usually considered to be essential. The support of influential economist Edwin R A Seligman for state income taxation in 1915, after earlier opposition to the idea, was conditioned upon the existence by that stage of the federal level tax, and 'the hitherto entirely unsuspected prospect of a state income tax being able to lean up against the federal tax, so as to avail itself of the federal returns and to be able in this way to minimize a great part of the difficulties which would otherwise attach to an independent state income tax'.[565] Direct tax sharing was seen, by contrast, to involve 'considerable' political and administrative difficulties which could be obviated 'by a system of state income taxes, largely patterned upon the federal tax and utilizing as far as possible the federal returns'.

Similarly, in Australian debate, it has been noted that if the States had resumed income taxation in the aftermath of World War II, as had occurred in Canada, 'undoubtedly it would have been necessary to co-ordinate the assessment regimes and to adopt a single return, to avoid the complexity that had been the cause of such criticism in the 1930s'.[566] In general, most of the reform proposals for Australian State income taxation to date have focused attention on the personal income tax option, either in whole or in part, as a State impost 'at the margin',[567] and these are usually expressed to be subject to a 'common base definition' constraint of some kind,[568] or more generally to being viable overall because such a reform 'can be done without losing the advantages of a unified system of assessment and collection',[569] as well as maintaining the further elements of the status quo of 'the Commonwealth's capacity to pursue what it views as national objectives, including with respect to macroeconomic policy', and 'the established system for equalising fiscal capacity between the States'.[570]

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[565] Seligman, 'The Next Step in Tax Reform', address to the Ninth Annual Conference of the National Tax Association, 11 August 1915; see Chapter 3, above n 200.

[566] Saunders, 'The Uniform Income Tax Cases', above n 297, 77.

[567] See, in this regard, for example, Jim Hancock and Julie Smith, *Financing the Federation* (Adelaide: South Australian Centre for Economic Studies, 2001), 77.

[568] Ibid.

[569] Cliff Walsh, 'Vertical Fiscal Imbalance: The Issues', in D J Collins (ed.), *Vertical Fiscal Imbalance*, above n 164, 31-54, 51.

[570] Ibid.

Nevertheless, some recent commentary has drawn attention to potential drawbacks in federal and subnational base conformity.[571] These flow primarily from the widespread presence in federal income taxes, increasingly now in the modern era, of a range of 'tax expenditures' and other politically motivated reductions in the tax base,[572] which strict base conformity automatically translates to the tax of the subnational jurisdiction, with both democratic and revenue implications. Subnational 'add-backs' to a conformed tax may also encounter political problems by focusing attention or suspicion on the state tax.[573]

It can be noted in this context that in the case of the Australian State experience prior to World War II, many of the differences which created the 'complexity' which generated so much politically costly press attention were related to genuine differences in the policy of particular jurisdiction as to the appropriate scope of the tax base, rather than being differences 'for their own sake'. Examples would include New South Wales' taxation throughout the early twentieth century of capital gains from transactions in property, and the taxation in Victoria and South Australia at times of the 'imputed' rent derived by owner occupiers of residential real estate.

More specifically, the US experience in some states with past attempts to introduce base conformity to an income tax which was not conformed to the federal tax show that unacceptable levels of revenue volatility can be generated where the attempt coincides with introduction by the federal government of substantial tax concessions at various points in its own political cycle. Oregon in 1969, for example, saw its personal income tax base conformity measure immediately overtaken by federal reforms which generated large unanticipated state

[571] Ruth Mason, 'Delegating Up: State Conformity with the Federal Tax Base' (2013) 62(7) *Duke Law Journal* 1267-1348.

[572] See Neil Brooks, 'The Under-Appreciated Implications of the Tax Expenditure Concept', in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect*, above n 515, 233-258; Richard Krever, 'Analysing Implicit Tax Expenditures' (2011) 35(2) *Melbourne University Law Review* 426-448; Neil Brooks, 'The Case Against Boutique Tax Credits and Similar Tax Expenditures' (2016) 64(1) *Canadian Tax Journal* 65-134.

[573] Mason, above n 571, 1325-1326, noting the political costs from 'endowment effect' perceptions where residents do not possess the same tax entitlements as neighbouring jurisdictions, in the same way that the repeal of tax expenditures at one level of government can generate greater adverse political reaction once initially introduced than if not created in the first place.

deficits, initially absorbed but subsequently (with further federal reforms) leading to the repeal of the measure until a more limited move could again be attempted in 1975.[574]

While in Australia at present significant fiscal benefits are provided to voters separately from the tax system through transfer payments, and to corporations through direct subsidies, rate cuts and deals, the federal tax base itself is also vulnerable to gaps and carve-outs being created, such as the across the board small business tax asset write-offs of the May 2015 federal budget.

Perhaps also, in a larger sense, the global and local trend is towards a more 'optimised' approach to income taxation in place of the longstanding acceptance of 'comprehensive' income taxation.[575] If so, there is certainly no reason to believe that the optimal income tax base in one State, with its own specific locational characteristics and sources of economic rents, would be the same as that in any other State. Administrative considerations would in this case need to be balanced against the wider efficiency and equity factors in tax policy.

In conclusion, while this is again a political matter, recommendations for an Australian State income tax would in general need to recognise that administrative considerations are likely to be predominant in relation to personal income taxation, in pointing to conformity of the state and federal tax base. Greater flexibility is likely to be available, and appropriate, in the case of the corporate income tax, however.

Recommendation 2

An Australian State income tax should, in respect of personal taxpayers, be imposed on the same tax base as the federal income tax base.

Each State should, however, decide upon the most appropriate base for the corporation income tax which should apply in its own circumstances, for example, an automatically conforming base, or one that is amended on a case by case basis, or which is designed entirely independently.

[574] Otto G Stolz and George A Purdy, 'Federal Collection of State Individual Income Taxes' [1977] *Duke Law Journal* 59-141, 119-120.

[575] See Richard Vann, 'Never-ending tax reform and financial services' (2011) 14(4) *Tax Specialist* 186-198, 187-188, noting the key shift from a comprehensive tax approach to a welfare economics analysis of individual reforms in the 'watershed' Henry Review of 2008-2010.

5.4 Allocation of business income: separate accounting or formula apportionment?

5.4.1 Overview

A major debate in the international taxation sphere in recent times has been the question whether to reform the rules for allocation of business income of multinational enterprises among countries, as required to give effect to the source component of national income taxes, from the existing longstanding rules based on separate accounting and the 'arm's length standard' for intragroup transactions, to a system of 'formula apportionment' of total enterprise income to each jurisdiction. Related systems may involve 'profit splits' or apportionment by reference to particular enterprise transactions rather than across the group as a whole.[576]

In addition to the substantial literature has developed on this question, in practical terms the reform was also examined closely in the European Union as part of the proposal originally dating to the early years of this century (and recently reintroduced) to introduce a 'Common Consolidated Corporate Tax Base' (CCCTB) for Member State corporate income taxes. As has already been briefly noted in section 5.2 above, formula apportionment was also historically used at times in the Australian State income taxes (along with a harmonised transactional profit split system agreed in 1936[577]) and is used among the US states and at the Canadian provincial income tax level.

A closer preliminary examination of the subnational Australian and North American experiences will be important, before moving to the modern literature and EU proposals to reach a more conclusive set of recommendations as to whether a resumed State income tax should incorporate formula apportionment or separate accounting in its allocation rules.

Two further issues can also be noted at the outset. First, a related issue which arises in a proposed application of formula apportionment at any level of government is whether the rules should also allow, or require, 'combined reporting' by the multinational taxpayer enterprise, so as to include all separate legal entities which form part of the group into the common enterprise over which apportionment is calculated. This additional step is employed in many US states, but not in the Canadian provinces, which apportion only across single entities and branches.

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[576] See Stanley S Surrey, 'Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions' (1978) 10(2) *Law and Policy in International Business* 409-460, 416-417.

[577] See further Chapter 3, section 3.3, text at nn 204-207; on early Australian formula apportionment, see also this chapter, section 5.2, text at n 551.

A second issue, which only arises in the case of formula apportionment at the subnational level, is whether to apportion business income on a worldwide basis, or stop the calculation at the 'water's edge' and only apportion business income already attributed to the national jurisdiction under the existing international separate accounting norm. It can be noted that 'worldwide apportionment' in this instance does not bring foreign income to tax locally per se, but involves a different and larger conception of the 'unitary enterprise' for apportionment purposes. This increases the income available for apportionment, but also the denominator of the relevant factor portions in the formula, and as a result either a larger or smaller taxable income overall may result in the relevant state, as the case may be.

5.4.2 Experience with formula apportionment in North America and Australia

5.4.2.1 US

The emergence of formula apportionment methods of calculation of a tax base at the state level in the US in the late nineteenth century were closely linked to the implementation of the source principle of taxation under corporate capital stock taxes, as described in section 5.2 above, which applied to 'capital employed within the state'. It can be noted that 'capital stock' under the Pennsylvania business tax at least was viewed in its widest sense, to include the 'entire property, assets, earning capacity, and franchises of a company' rather than just issued shares.[578] In terms of state property taxes in general, the most prominent examples of the use of formulas to calculate taxable property within a jurisdiction involved the railroad companies, which apportioned property on the basis of length of track within the state to the total across all states covered.[579]

The 'unit rule' approach in the US seems to have been taken up widely in various states as general income taxes became a common type of taxation in the twentieth century, although some authorities such as various Committees of the National Tax Association maintained a preference for separate accounting for some years where adequate corporate records were

[578] Roswell C McCrea, 'The Taxation of Personal Property in Pennsylvania' (1906) 21(1) *Quarterly Journal of Economics* 52-95, 53, citing the administration of the tax, and the judicial interpretation set out in the *Standard Oil* decision and other cases. Seligman also notes a corporate income tax in Baden, Germany of 20 June 1884 which apportioned income to the jurisdiction based on the proportion of the amount of capital employed in the state: Seligman, 'The Taxation of Corporations III', above n 50, 660.

[579] *State Railroad Tax Cases*, 92 US 575 (1 October 1875). See James H Peters and Benjamin F Miller, 'Apportionability in State Income Taxation: The Uniform Division of Income for Tax Purposes Act and *Allied-Signal*' (2006) 60(1) *Tax Lawyer* 57-161, 60-66; Huddleston and Sicilian, 'History and Considerations for Combined Reporting', above n 557, 5-6.

kept.[580] Nevertheless, from the 1920s, debate in the US on achieving uniformity in state approaches to income apportionment also centred on the then 'Massachusetts' three-factor formula of sales, property and payroll.[581] A 'Uniform Division of Income for Tax Purposes Act' was subsequently developed in 1957 by the National Conference of Commissioners of Uniform State Laws and approved by the American Bar Association,[582] embodying the three-factor approach, with separate attribution of certain types of non-business investment income such as interest, dividends and capital gains according to location for real property and state of domicile otherwise.[583]

Complete uniformity of approach in practice did not eventuate however, as some states have continued to allow separate accounting,[584] while in broader terms other states have imposed alternative forms of corporation tax altogether to the classical variety, alternatives which may be based on direct calculation of in-state sales or wages instead, such as an addition type value-added tax[585] or gross receipts tax;[586] some US states also impose no corporate income tax at all.[587]

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[580] Hellerstein and Hellerstein, *State and Local Taxation*, above n 534, 445-448, 445-446. Commentators from at least 1931, however, were drawing attention to the substantial expense involved to taxpayer companies in maintaining such records, for branches or subsidiaries: ibid, 446.

[581] The Committee on the Apportionment Between States of Taxes on Mercantile and Manufacturing Business which reported in 1922 recommended an equal weighting of business and property in the state, with the business factor comprising both sales and costs of labour and materials: Carl S Lamb, H H Burbank, Wm S Elliott, R M Haig, Alexander Holmes, Henry B Nelson, Frank D Strader and J F Zoller, 'Report of the Committee on the Apportionment Between States of Taxes on Mercantile and Manufacturing Business', *Proceedings of the Annual Conference of the National Tax Association Vol 15*, 18-22 September 1922, 198-215, 204-208. This Committee also recognised (at 214-215) that separate accounting should be permitted as an option: Hellerstein and Hellerstein, *State and Local Taxation*, above n 534, 445.

[582] Arthur D Lynn, Jr., 'The Uniform Division of Income for Tax Purposes Re-examined' (1960) 46(6) *Virginia Law Review* 1257-1268, 1263; John S Warren, 'UDITPA – A Historical Perspective' (2005) 38(2) *State Tax Notes* 133-136 (3 October).

[583] Ibid, 1263-1264.

[584] Hellerstein and Hellerstein, *State and Local Taxation*, above n 534, 448, noting the then continuing preference of the state of Mississippi for separate accounting.

[585] See James, *The Rise of the Value-Added Tax*, above n 477, 341, n 11, describing Michigan's one time 'Business Activities' Tax.

[586] In Ohio, for example, see the description of the state's 'Commercial Activity Tax' at http://www.tax.ohio.gov/commercial_activities.aspx.

[587] These states at present appear to include Washington, Nevada and Wyoming.

As will also be discussed further in section 5.4.2.2 below, the US experience has also differed from that in Canada and Australia in that the process involves the concept of a 'unitary business enterprise' (rather than simply the corporate legal entity itself), which once identified defines the scope of the business income which is subject to apportionment. A related, but nevertheless distinct, issue is whether other legal entities are included in this unitary enterprise, under a process of 'combined reporting'. This practice appears to have emerged in the 1930s in California in response to the establishment by Hollywood movie production companies of separate distribution companies (rather than branches) in other US states, particularly Nevada, so as to lower California source income of the parent entities.[588] Only some states currently employ the system, however. Combined reporting involving offshore entities has also been held by the US Supreme Court to be constitutionally valid.[589]

As will be discussed further in section 5.5.2 below, combined reporting, and the use of a sales factor in general in an apportionment formula, also gives rise to the issue of determination of nexus of a transaction with a state in order to create liability to taxation. It can be noted, however, that the general rule turns on the destination of the goods under a sale (provided there is some sufficient 'presence' of the vendor within that state), which has largely overtaken earlier methods in some states relating to origin of the goods, location of sales office or location of sales activity.[590]

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[588] Huddleston and Sicilian, 'History and Considerations for Combined Reporting', above n 557, 6-7; Joann M Weiner, 'Combined Reporting and the Unitary Business Principle: A Doctrine That Has Not (Yet) Made the Atlantic Crossing' (2008) *State and Local Tax Lawyer, Symposium Edition* 179-203, 182. For a discussion of the rejection by the US Supreme Court of simple 'bright line' tests in general as a method for defining a unitary business enterprise, see also Joann M Weiner, 'Using the Experience of the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level', US Treasury Office of Tax Analysis Paper 83, April 1999, 30-34, https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-83.pdf.

[589] *Barclays Bank plc v Franchise Tax Board of California*, 512 US 298 (20 June 1994).

[590] Hellerstein and Hellerstein, *State and Local Taxation*, above n 534, 619. In Australia's case, the Royal Commission on Taxation in the 1930s recommended a test of agency or 'instrumentality' in the state of sale, although (subject to establishment of a satisfactory apportionment regime between the states) some business associations had been 'prepared to waive technical considerations, as, for instance, the relation between the principal and agent, and accept liability to pay tax to a State on all sales made to residents of that State which involved delivery of the goods therein', a test which the Royal Commission considered would be 'too severe': Ferguson Royal Commission, *Second Report of the Royal Commission on Taxation*, above n 232, 79.

5.4.2.2 Canada

The early Canadian experience points to some similarities in relation to allocation methods for business income to those in the US. Taking Ontario as a representative example for provincial corporation tax purposes, that province under initial approaches such as the 1927 corporation tax enacted specific provisions to tax different types of corporations, such as banks, insurance companies, railways and gas and electric companies, with relevant rules to apply the tax to revenue 'earned within Ontario', 'premiums received … in respect of the business transacted in Ontario', and so forth.[591]

By 1937, however, Ontario had also imposed a general tax on net revenue applicable to companies more broadly, which at that point was expressed to be on a residence basis with no allowance in relation to out of province earnings.[592] Such an allowance was included in the 1939 tax, in relation to the amount of any tax liability to another province on out of province income, but in the general case only on a deemed amount of the out of province income calculated by reference to the proportion of out of province gross sales or gross revenue of the company to total sales or revenue.[593]

An underlying residence based approach to provincial company income taxation continued after World War II. An important development in this context was the introduction in 1956-57 of the 'permanent establishment' concept, somewhat ironically as the primary basis for creation of liability to the residence based tax. Under the federal-provincial 'tax sharing' arrangements reached through negotiations in 1955-56, all provinces except Ontario and Quebec agreed to national collection of corporate income tax and allocation of revenue based on a 'standard corporation income tax' model deeming income from the tax according to 'the

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[591] *Corporations Tax Act*, Revised Statutes of Ontario 1927 Vol 1, c 29, https://archive.org/stream/v01revisedstat1927ontauoft#page/386/mode/2up.

[592] *Corporations Tax Act*, Revised Statutes of Ontario 1937 Vol 1, c 29, s 4, https://archive.org/stream/v01revisedstat1937ontauoft#page/512/mode/2up. The tax on net revenue applied to 'every incorporated company having its head or other office in Ontario, or which holds assets in Ontario, or which transacts business in Ontario whether under its own name or through an agent'; net revenue was defined to be included 'whether derived from a source within Ontario or elsewhere'.

[593] *Corporations Tax Act 1939* (Ont.), enacted on 14 April 1939, s 14(7)(d); https://archive.org/stream/statutesofprovin1939onta#page/84/mode/2up.

income earned within the province by each corporation that maintained a permanent establishment within the province on the last day of its taxing year'.[594]

Separately, Ontario's independent re-enacted corporation tax at that time also incorporated the 'permanent establishment' concept, imposing income tax on profits sourced in the jurisdiction rather than all income on the basis of residency. A formula apportionment regime was used to allocate income between Ontario and any other jurisdiction (worldwide) in which a permanent establishment was maintained, with the formula based on the aggregate of the relevant proportions of gross revenue and of salaries and wages paid to employees.[595] The trigger for liability was the presence of a permanent establishment; in the absence of a permanent establishment no profits were attributed to jurisdictions in which sales were made. The enactment of the 'permanent establishment' concept for participating provinces in the 1956 Dominion Act appears to have occurred with little debate in the Dominion Parliament.[596]

In the corresponding current Canadian enactment governing allocation of business income among the provinces participating in the arrangements for collection of the tax by the Dominion government (*Income Tax Regulations*, CRC c 945, Part IV) the permanent establishment concept has been retained, although a general limitation now applies to the taxable income of a company which is not a resident of Canada to 'taxable income earned in in Canada'.[597] The apportionment formula for non-resident companies also includes a 'water's edge' limitation in respect of the relevant apportionment factors.[598]

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[594] *Federal-Provincial Tax-Sharing Arrangements Act 1956* (Can.), 4-5 Eliz. II, c 29, s 2(1)(d). See Perry, *Financing the Canadian Federation*, above n 340, 54-61.

[595] *Corporations Tax Act 1957* (Ont.), 5-6 Eliz. II, c 17, s 4(5); https://archive.org/stream/statutesofprovin1957onta#page/82/mode/2up.

[596] See, for example, the comments of opposition member George Nowlan (Nova Scotia) requesting clarification from Finance Minister Walter Harris of the concept of permanent establishment by reference to the example of a branch in one province with a sales manager and salesmen, as he could 'think of a dozen other minutiae like that that are going to determine how much each province gets'; Minister Harris noted that the matter had been agreed between Dominion and provincial government officials and the relevant regulations were 'fully understood and appreciated by the various officials in the several governments': House of Commons Debates, Third Session, Twenty-Second Parliament, 4-5 Elizabeth II, Vol VI, 1956, 6401 (24 July 1956). The Ontario 1957 Act, s 2, provided a definition of permanent establishment by reference to specified facilities and other 'fixed places of business'; a subsidiary company did not of itself give rise to a permanent establishment for the parent company.

[597] *Income Tax Regulations* (Can.), reg 413(1)(b).

[598] *Income Tax Regulations* (Can.), regs 413(1)(a) and 413(2).

As noted in section 5.4.2.1 above, the Canadian provincial income taxes do not include provisions for 'combined reporting' and apportionment of business income across a unitary enterprise as in many US states. This gives rise to some opportunity for Canadian multi-provincial corporations to establish separate legal entity subsidiaries in place of branches and so take business income out of the parent entity province's tax system, or relocate permanent establishments of the enterprise to lower-tax provinces and make sales in other provinces in a manner which does not give rise to a permanent establishment there. Even in the absence of tax planning, it has been noted that economic changes over time since agreement on the allocation rules have resulted in a reduction in the number of permanent establishments which a multi-provincial business may need to maintain, making an updating of the allocation rules important.[599]

Recent economic studies otherwise suggest that undue weight should not be placed on such tax planning risks in an evaluation of the provincial income allocation system, given the multiplicity of other factors that may enter into these corporate decisions.[600] (It can be noted that there may in any event be a role for application of existing provincial anti-avoidance rules in relation to any tax planning of this kind: for reporting purposes at least, for example, the Ontario Ministry of Finance requires corporations intending to change jurisdiction to seek a 'consent to continue' letter.[601])

5.4.2.3 Australia

As noted in section 5.2 above, the early Australian colonial income taxes in many cases included apportionment methods from the outset as part of the policy decision to impose the tax on a source basis. The first enactment setting out a specific apportionment formula seems to have been Queensland's dividend duty of 1890, based on capital employed in the colony. The definition of relevant assets (worldwide) for this purpose specified 'the gross amount of

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[599] Technical Committee on Business Taxation (Professor Jack M Mintz, chair), *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, December 1997), 11.9-11.10.

[600] See Canada, Ministry of Finance, 'Interprovincial Tax Planning by Corporate Groups in Canada: A Review of the Evidence', in *Tax Expenditures and Evaluations 2014* (24 February 2015), 71-87, 87. Nevertheless, proposals for introduction of combined reporting have on occasion been made: see, for example, Ontario, Fair Tax Commission, *Fair Taxation in a Changing World* (Toronto: University of Toronto Press, 1993), 415-416.

[601] Ontario, Ministry of Finance, 'Corporations Tax, Changing jurisdiction', http://www.fin.gov.on.ca/en/tax/ct/index.html (accessed 2 August 2016).

all the real and personal property of the company of every kind, including things in action, and without making any deduction in respect of any debts or liabilities of the company'.[602]

In explaining the above provisions in the context of banks, Treasurer McIlwraith referred to the necessity for rules for measuring profit attributable to Queensland, and stated that 'we have devised a means of reaching the dividend that we consider accrues out of the profits made in Queensland in a way that is equitable'.[603] The underlying assumption was noted, 'taking year with year, that a bank that does business here, having its head office in London, for instance, and doing business in all the other colonies, makes its profits equally, and makes its profits in proportion to the amount of capital it employs'; it was also noted that bank deposits (i.e., liabilities) should be excluded from the calculation as 'it would be an easy matter for the bank to transfer those deposits' to other colonies.[604] In Victoria, however, similar provisions for apportionment of dividends of foreign companies specified the use of gross receipts from all sources for non-bank companies, and both assets and liabilities for banks.[605]

A contrasting approach to Queensland and Victoria can be noted however in the case of Western Australia's companies duty of 1899.[606] The Bill for this duty originally seems to have been drafted with apportionment provisions along the lines of the Queensland duty, but was changed to impose duty on foreign companies on profits generally made in Western

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[602] *Dividend Duty Act 1890* (Qld), s 9; see n 551, above. Assets were subsequently held by the Privy Council to include the underlying interest of a company in secured property in Queensland, where the advances had been made in Melbourne and the head office of the company was in London: *Walsh v The Queen* [1894] AC 144. Similarly, it can be noted that under South Australia's general income tax, the Supreme Court in that colony held that a profit on sale of property located outside the colony, pursuant to a contract made in London, where payment also was made in London, did not give rise to 'income arising from or accruing in or derived from South Australia': *In re Ivanhoe South Goldmining Company*, *South Australian Register*, 13 May 1896, 7 (decided 12 May 1896; Way CJ, Boucaut and Bundey JJ). Justice Bundey agreed with the other members of the Court only on the basis of giving the benefit of doubt to the taxpayer, and questioned whether the term 'accruing in' South Australia may not have been broad enough to cover the proceeds of sale as the product of growth of capital accumulated in the colony. More generally, Chief Justice Way also discussed the problems of double taxation of colonists resident in the UK in the context of the UK's residence-based income tax, and noted that the 'hardship of the universal application' of the UK rule in relation to foreign businesses had led to the finding by the House of Lords in *Colquhoun v Brooks* [(1889) 14 App Cas 493] that the remittance basis applied to income from such businesses.

[603] Parliamentary Debates (Qld), Assembly, 796 (7 October 1890).

[604] Ibid, 797.

[605] *Income Tax Act 1895* (Vic.), s 10(4) and *Income Tax Regulations 1895*, reg. 17.

[606] *Companies Duty Act 1899* (WA).

Australia only (presumably calculated on a separate accounting basis). This was due largely to concerns that such companies might be making significant losses outside the colony (and so perhaps would not declare a dividend), or might be carrying on business in the colony with 'scarcely any capital'.[607]

While initially Premier Forrest had noted that '[a]lthough only a little Bill, it has been rather troublesome to prepare, especially in regard to companies having operations in this colony and in other countries',[608] a government member later stated that the calculation for foreign companies 'was only a question of book-keeping, and [he] was certain that there was not a single company trading in this colony which was not able to tell exactly the amount of profit made in this colony'.[609]

In the general income taxes of the colonies (and subsequently States), however, separate accounting was generally given preference in the calculation of business income,[610] where appropriate accounts were maintained, over apportionment or presumptive taxation methods. The emergence, however, of widespread double taxation of multi-state businesses during the 1920s led to the determined efforts to reach an agreed methodology, based on the transactional profit split rules initially proposed in 1929 and ultimately enacted by most States in the harmonised legislation of 1936.

These rules provided for a 67:33 split of profit on manufacture and sale of goods by the one company (manufacturer) as between State of manufacture and State of sale, and a 50:50 split of the profit from sale of goods in the State by a company (other than the manufacturer), where the goods were sold in the course of a business carried on in another State.[611] Separate

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[607] Colonial Secretary George Randell, Western Australian Parliamentary Debates, Council, 1369 (20 September 1899).

[608] Western Australian Parliamentary Debates, Assembly, 402 (19 July 1899).

[609] Alfred Morgans (Coolgardie), ibid, 703 (3 August 1899).

[610] At an early stage New South Wales also legislated to provide specifically that activities such as mining and manufacturing of products for export were deemed to constitute trades carried on in New South Wales so as to give rise to a source in the colony for income tax purposes, with the relevant amount of income being the value of the product at time of export less specified deductions: *Land and Income Tax (Declaratory) Act 1898* (NSW), s 1. The definition of source as including such activities was consistent with the subsequent decision of the Privy Council in appeal proceedings in one of a number of disputes which had been on foot during this period: *Commissioners of Taxation v Kirk* [1900] AC 588.

[611] See, for example, *Income Tax (Management) Act 1936* (NSW), ss 37-41. See Chapter 3, section 3.3, text at nn 204-207.

rules also provided generally for full attribution of profits from primary production or mining to the State in which those activities were carried out.

While the agreement between the States to these provisions was reached on a political basis, in legal terms it can be noted that the High Court had granted a wide latitude to the States in terms of the use of divergent approaches to apportionment in the face of the constitutional requirement for trade between the States to be 'absolutely free'.[612] Queensland's provision for formula apportionment based on sales was upheld as constitutionally valid in 1935 without reference to its interaction with apportionment provisions of any other State,[613] even though it was clear during this period that double taxation was occurring in at least some situations.[614] In general terms, the High Court maintained that the apportionment of business income was a factual matter and did not give rise to questions of law.[615]

5.4.3 Modern international debate and EU reform proposals

5.4.3.1 1970s and 1980s

While formula apportionment had received some consideration at an international level in the 1920s and 1930s, the model approach developed by the expert panels of the League of Nations was strongly based in a market approach of transfer pricing rules and arm's length pricing of

[612] *Constitution*, s 92.

[613] *Australasian Scale Co Ltd v Commissioner of Taxes (Qld)* (1935) 53 CLR 534.

[614] Prior to 1936 in New South Wales, for example, in the case of goods manufactured in the State and sold by the manufacturer in another State, the Commissioner typically considered that 75 per cent of the profit was derived in New South Wales: Ferguson Royal Commission, *Second Report of the Royal Commission on Taxation*, above n 232, 80.

[615] For example, the Commonwealth Taxation Board of Review upheld a manufacturer taxpayer's claimed 50 per cent apportionment of income on export sales under the *Income Tax Assessment Act 1915-1921* (Cth), where separate accounts were not kept, in place of the apportionment based on FOB costs in Australia to overseas costs under Departmental Order No 816; the Commissioner's appeal to the High Court in this case was dismissed for lack of a question of law: 1 CTBR Case 42; *Federal Commissioner of Taxation v Lewis Berger & Sons (Australia) Ltd* (1927) 39 CLR 468 (Starke J). The Court (at 471) noted that the 'Commissioner's real aim is to elevate his formula into a fixed and rigid rule. It is not a rule of law however, and is at best a rule of convenience. It cannot be applied to all cases in all circumstances…'. In a subsequent first instance hearing by the High Court, this precedent was followed in the case of a wool and skins exporting business also to impose a 50 per cent apportionment in place of the Commissioner's rule: *Michell v Federal Commissioner of Taxation* (1927) 46 CLR 413 (Starke J).

transactions between entities.[616] Importantly, it has been shown that this approach was grounded in a concept of the firm in which residual profits accrued to the centre of management after deduction of the costs of the transactions to other entities.[617]

While the arm's length approach thereafter became established in the national income tax legislation of many countries and in the provisions of the expanding network of bilateral tax treaties, by the early 1970s debate began substantially to increase as to the effectiveness of these rules in the taxation of multinational enterprises. The US Treasury considered changes to its rules in this period,[618] and the United Nations also increased its attention to this issue[619] in some difference of approach with a greater emphasis on source taxation to the emerging treaty standards of the Paris-based Organisation for Economic Co-operation and Development

[616] Michael J Graetz and Michael M O'Hear, 'The "Original Intent" of US International Taxation' (1997) 46(5) *Duke Law Journal* 1021-1110, 1074-1089, discussing the 1923 Report of the four member panel of experts appointed by the League, the Technical Report in 1925 and the subsequent conferences in 1927 and 1928 convened to produce draft taxation conventions; these embodied the concepts of permanent establishment (as a determinant of source) and arm's length allocation rather than apportionment, even though key US delegate Thomas S Adams had previously worked on such methods in both Wisconsin and in the US federal government: ibid, 1089, n 275.

[617] Richard J Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World' (2010) 2(3) *World Tax Journal* 291-346, 321, discussing the views of author of the relevant rules Mitchell B Carroll in *Taxation of Foreign and National Enterprises – Vol IV, Methods of Allocating Taxable Income* (Geneva: League of Nations, 1933), para 677 in the context of formal development of the firm theory by Ronald H Coase in 'The Nature of the Firm' (1937) 4(16) *Economica* 386-405.

[618] See the discussion of this background in Comptroller General of the United States, *Report To The Chairman, House Committee On Ways And Means of the United States: IRS Could Better Protect US Tax Interests In Determining The Income Of Multinational Corporations* (Washington, DC, 30 September 1981), vii, http://www.gao.gov/assets/140/135312.pdf. A stricter approach by the US Internal Revenue Service had begun from the late 1950s: Stanley I Langbein, 'The Unitary Method and the Myth of Arm's Length' (1986) 30 *Tax Notes* 625-681, 646.

[619] See discussion of the UN's 1973 report, *Multinational Corporations in World Development*, in editorial note, 'Multinational Corporations and Taxation' (1973) 1(6) *Intertax* 165-175.

(OECD).[620] The consequent need for an 'international tax body to coordinate and harmonize international tax relationships' was also identified.[621]

The issue re-emerged at a much more significant level in the early to mid-1980s, at a point when California's use of unitary combination on a worldwide basis came to cause a severe backlash from other countries hosting multinationals with subsidiaries in that state, and a campaign had begun to seek a Congressional prohibition on the practice by the states.[622] Some countries such as the UK objected to the potential for 'double taxation' to occur on interaction of the unitary tax with their taxation systems using the own arm's length calculation, in part due to the multinational parent company paying income tax in its resident country jurisdiction, and then having its revenue (on a pre-tax income tax basis) also included in the California subsidiary's calculation of unitary income (albeit both as part of the overall income 'pie' and in the denominator of the apportionment factors), and also due to the potential for a local loss in the US state to become a taxable profit on inclusion of a component of profits from operations in other countries, and in general the impact of high wage costs and property values in the US state.[623] Other countries also noted the 'excessive administrative burdens' involved for the multinational entities concerned;[624] in some quarters this was even described as an issue

[620] Mary Bennett, 'The 50th Anniversary of the OECD Model Tax Convention' (2008) 2(2) *World Commerce Review* 20-23, http://www.worldcommercereview.com/publications/article_pdf/59; Winand Quaedvlieg and Hanni Rosenbaum, '40 years of OECD Guidelines for Multinational Enterprises' (2016) *World Commerce Review*, http://www.worldcommercereview.com/html/quaedvlieg-and-rosenbaum-40-years-of-oecd-guidelines-for-multinational-enterprises.html.

[621] Surrey, 'Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions', above n 576, 455.

[622] Langbein, 'The Unitary Method and the Myth of Arm's Length', above n 618, 627, 672.

[623] See Robert D Wallingford, 'British Retaliation Against the California Unitary Tax: The Needed Impetus for a Federal Solution' (1986) 8(3) *Journal of Comparative Business and Capital Market Law* 345-371, 345, 349, citing UK government member John Moore and then opposition member for Sedgefield Tony Blair in Parliamentary debate, 9 July 1985, on a 1985 Finance Bill which with bipartisan support sought to enact retaliatory denial of dividend tax credit entitlements in the UK to subsidiaries of US-based multinationals. Europe-based multinationals in general had been incurring losses by their newly established California subsidiaries at the time in efforts to break into the US market: Sol Picciotto, 'Taxing Multinational Enterprises as Unitary Entities' (2016) 82 *Tax Notes International* 895-916, 898, n 8 (30 May).

[624] See then US-Canada treaty note, quoted in Richard M Bird, 'The Interjurisdictional Allocation of Income' (1986) 3(3) *Australian Tax Forum* 333-354, 345.

of sovereignty for the home countries.[625] Other US commentators, however, were cautious about immediate acceptance of these various arguments against California's approach.[626]

In the academic debate more generally at the time, disagreement emerged between eminent contributors at the time in the first instance as to the appropriateness of the corporate income tax as a revenue source for subnational governments at all (as noted in the introduction to this chapter, a merits argument which in the Australian context is no longer relevant). On the one hand, it was argued that the corporate income tax on either a residence or source basis would create unjustifiable distortions in terms of locational and investment decisions, and apart from the issue of proper attribution of income itself the broader conclusions were not substantially altered by use of formula apportionment as against separate accounting;[627] conversely a clear argument in principle was seen for the corporate income tax at the intermediate government level on the basis of benefit principle entitlements of subnational jurisdictions 'which retain some degree of sovereignty' to revenue from corporations.[628]

On the business income allocation issue, while an important contribution found that in economic terms formula apportionment might confer advantages on multistate firms,[629] there was, however, some conflict of opinion on the 'double taxation' question.[630] Others also

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[625] Then Shell Oil Company Vice-President and General Tax Counsel David R Milton, 'Worldwide Unitary Taxation: A Kaleidoscope of Inconsistencies and Double Taxation' (1984) 3(1) *Journal of State Taxation* 15-24, 16; the difficulties of determining foreign company income on a basis consistent with US taxable income were also noted.

[626] Langbein, 'The Unitary Method and the Myth of Arm's Length', above n 618, 627, 672: 'We should be careful when foreign governments assert principles of international comity to compel us to draw distinctions which favour their nationals over our nationals in matters involving the allocation of the exactions of our governments'.

[627] McLure, 'Assignment of Corporate Income Taxes in a Federal System', above n 515, 109-112.

[628] Peggy B Musgrave, 'Commentary on Charles E McLure, Jr.: Assignment of Corporate Income Taxes in a Federal System', in Charles E McLure, Jr. (ed.), *Tax assignment in federal countries*, above n 447, 127-128.

[629] Roger H Gordon and John D Wilson, 'An Examination of Multijurisdictional Corporate Income Taxes Under Formula Apportionment', NBER Working Paper 1369, June 1984, http://www.nber.org/papers/w1369 (also as 'An Examination of Multijurisdictional Corporate Income Taxation under Formula Apportionment' (1986) 54(6) *Econometrica* 1357-1373).

[630] See discussion in George N Carlson and Harvey Galper, 'Water's Edge Versus Worldwide Unitary Combination', in Charles E McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination*, above n 558, 1-40, 38, n 111 and references there cited. In recent times, the potential for 'asymmetries' to arise from a unilateral formula apportionment approach, from interaction either with an arm's length approach or with another formula apportionment system using a different formula, tends to have found

emphasised the lack of development of an effective cost accounting method for implementing an 'impartial manager' transfer pricing outcome, even after a long period of study.[631] Similarly, in general the position of 'increasingly outflanked national tax administrations' under the existing arm's length transfer pricing system was otherwise seen as 'bleak'.[632]

5.4.3.2 Further US debate, early 1990s to 2000

The stand-off over California's use of worldwide combined reporting was resolved through US domestic political means rather than national legislation or implementation of steps in a damaging 'tax war', as the Californian administration ultimately made a decision, in the face of significant federal government pressure, unilaterally to alter its formula apportionment system in 1986 to allow a 'water's edge' option restricting apportionment to US source income only.[633] (Legally however the issue dragged on into the early 1990s in the form of taxpayer disputes over refund claims for years dating back to the early 1970s, with the Supreme Court finally rejecting taxpayer arguments that worldwide combined reporting necessarily entailed exposure to 'constitutionally intolerable multiple taxation' or was unconstitutional as an interference in the ability of the US to 'speak with one voice' in international affairs.[634])

Conversely, however, while the *Barclays Bank* decision brought the issue for taxpayers to that point to an end, by the early 1990s wider academic debate was in fact resuming over the

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much greater acceptance; see, for example, J Clifton Fleming, Jr., Robert J Peroni and Stephen E Shay, 'Formulary Apportionment in the US International Income Tax System: Putting Lipstick on a Pig?' (2014) 36(1) *Michigan Journal of International Law* 1-57, 32-34.

[631] Langbein, 'The Unitary Method and the Myth of Arm's Length', above n 618, 673.

[632] Bird, 'The Interjurisdictional Allocation of Income', above n 624, 354; Richard M Bird and D J S Brean (1986), 'The interjurisdictional allocation of income and the unitary taxation debate' (1986) 34(6) *Canadian Tax Journal* 1377-1416.

[633] *Barclays Bank plc v Franchise Tax Board of California*, 512 US 298, 306, 324-328 (20 June 1994).

[634] *Barclays Bank plc v Franchise Tax Board of California*, 512 US 298 (20 June 1994). The Court's findings on the multiple taxation issue were based on an acceptance that double taxation could occur (in the case, for example, of an enterprise with foreign affiliates in low wage or low property value jurisdictions) but that such a risk was not inevitable and in any event would also arise under separate accounting so that a state could not practically eliminate the risk by changing its taxation system: *Barclays Bank plc*, 318-320. On the foreign affairs issue, for a recent analysis of the expanding role of the US states generally in this field, including in relation to taxation, see Michael J Glennon and Robert D Sloane, *Foreign Affairs Federalism: The Myth of National Exclusivity* (New York: Oxford University Press, 2016), also discussing the *Barclays Bank* case (166-167). By some estimates the amount which had been at stake for California in the case was 'in excess of $4 billion by 1995': Daniel Sandler, 'Slicing the shadow – the continuing debate over unitary taxation and worldwide combined reporting', [1994] 6 *British Tax Review* 572-597, 572 and references there cited.

weaknesses of the existing international arm's length taxation system and potential benefits of formula apportionment, in the context of the significant ongoing relocation of US domestic manufacturing activities offshore. Initial contributions in this phase were cautious, as the briefing notes for one conference in 1991, for example, suggested: that each participant develop a reform proposal that would be 'more than incremental' but 'not so radical that its chances of being adopted in the next decade are minimal';[635] discussion centred on use of formula apportionment only for allocation of residual profits not accounted for after allowing a rate of return to the various units of a multinational enterprise,[636] or enhanced administration and enforcement of existing US tax regulations.[637]

As the debate progressed during the 1990s, commentators came to much stronger conclusions in favour of formula apportionment: that the crisis in manufacturing should be addressed urgently through unilateral US adoption of a sales-only formulary system;[638] that tax changes were necessary in the context of the then newly-minted North American Free Trade Agreement and formula apportionment offered 'sufficient systemic advantages' as to warrant further close policy analysis in this context;[639] and empirical findings that the US was forgoing significant revenue which would otherwise have been available under the then existing pattern of multinational operations if formula apportionment had been used.[640] A significant contrary

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[635] See (1992) 54 *Tax Notes* 719 (10 February), introductory note to Stanley I Langbein, 'A Modified Fractional Apportionment Proposal for Tax Transfer Pricing', 719-730 and Charles H Berry, David F Bradford and James R Hines, Jr., 'Arm's Length Pricing: Some Economic Perspectives', 731-740.

[636] Langbein, ibid.

[637] Berry, Bradford and Hines, above n 635.

[638] Reuven S Avi-Yonah, 'Slicing the Shadow: A Proposal for Updating US International Taxation' (1993) 58 *Tax Notes* 1511-1515 (15 March). A comprehensive study by the author in 1995 led to the further conclusion that the arm's length system had become 'defunct in practice', primarily due to the lack of comparable independent arm's length transactions: Reuven S Avi-Yonah, 'The Rise and Fall of Arm's Length: A Study in the Evolution of US International Taxation' (1995) 15(1) *Virginia Tax Review* 89-159, 135, 147.

[639] Paul R McDaniel, 'Formulary Taxation in the North American Free Trade Zone' (1994) 49(4) *Tax Law Review* 691-744, 738 (in *Colloquium on NAFTA and Taxation*); Michael J McIntyre, 'The Design of Tax Rules for the North American Free Trade Alliance' (1994) 49(4) *Tax Law Review* 769-794, 769: '[t]he best way for the three amigos to avoid damaging competition over corporate taxation is to adopt a formulary apportionment system that gives each country its fair share of tax revenues from profits arising in North America', also citing that author's testimony on the issue to the US Senate Committee on Foreign Affairs and with Robert S McIntyre to the US Senate Committee on Governmental Affairs (1992-1993).

[640] Douglas Shackelford and Joel Slemrod, 'The Revenue Consequences of Using Formula Apportionment to Calculate US and Foreign-Source Income: A Firm-Level Analysis' (1998) 5(1) *International Tax and Public*

view, however, that the US should focus its reforms on much greater implementation of the residence approach to company taxation, in view of international capital mobility, did not offer much support for unitary taxation as an alternative to arm's length pricing under which source-based taxation could be continued more effectively.[641]

5.4.3.3 From the turn of the millennium: the debate shifts to the European Union

While the debate primarily in the US on formula apportionment described above had been continuing, economic integration had also been progressing in Europe during the 1990s, with the establishment of the single market in 1993 and Schengen zone for free movement in 1995.[642] Finally, once the monetary union and Euro single currency had been successfully established on 1 January 1999, attention in the European Union quickly moved on to identifying possible reforms to capital income taxation including enhancing harmonisation of the corporate income taxes of the various Member States and the possible implementation of formula apportionment under a Common Consolidated Corporate Tax Base (CCCTB).[643] An early scoping study in this process noted that an important advantage for EU businesses from any such reform would be that '[t]ransfer pricing problems within the group of companies would disappear, at least within the EU'.[644]

By this point, the US debate itself seems to have subsided somewhat, against a backdrop in the late 1990s of the signal success of the Clinton administration's economic policies more generally in building substantial government budget surpluses even under the existing transfer

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Finance 41-59. Significantly, the study also found that US multinationals reported US income as a share of total global income which was lower than the corresponding shares of any of sales, payroll or assets.

[641] Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises', above n 539, 69-70: '[t]he success of unitary taxation and formula apportionment at the state level in the United States (and in other countries with federal systems) does not demonstrate that it would be successful at the international level', but also that the case for this approach at the international level would 'become stronger as international business operations become increasingly integrated across national boundaries'.

[642] For a brief overview, see European Commission, *20 years of the European Single Market – Together for new growth* (Luxembourg, 2012), http://ec.europa.eu/internal_market/publications/docs/20years/achievements-web_en.pdf.

[643] Sijbren Cnossen, 'Taxing capital income in the European Union: summary and discussion', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford University Press, 2000), 1-14, 1.

[644] Commission of the European Communities, 'Company Taxation in the Internal Market', Commission Staff Working Paper, COM(2001)582 final, Brussels, 23 October 2001, 14, para [65].

pricing rules system.[645] Closer studies of the formulas themselves used in US state apportionment systems also showed the potential for suboptimal ('Nash' equilibrium') divergences in state formulas to become entrenched,[646] and for unilateral state changes to their formulas to impose significant negative externality costs on other states.[647] More generally, lurid accounts soon also began to emerge of exploitation of state governments by large multinational enterprises during the 1990s through negotiations over investment location decisions, including to seek changes in state income tax apportionment formulas to the 'single sales factor' approach.[648] The rapid development of technology and electronic commerce was also seen as significantly aggravating many of the inherent problems in state income taxation and, in particular, the 'difficulty of including "crown jewel" intangibles in the property factor' of an apportionment formula.[649]

In this context, much early commentary and policy advice to European audiences did not provide strong encouragement for an introduction of formula apportionment and the CCCTB reform. The competing considerations under both the existing rules and formula apportionment were extensively reviewed in 2002, noting that while by that stage no longer 'as far-fetched as a few years ago', adoption of formula apportionment on a global basis was still

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[645] Brooks Jackson, 'The Budget and Deficit Under Clinton', *FactCheck.org*, 3 February 2008, http://www.factcheck.org/2008/02/the-budget-and-deficit-under-clinton/.

[646] Bharat N Anand and Richard Sansing, 'The Weighting Game: Formula Apportionment as an Instrument of Public Policy' (2000) 53(2) *National Tax Journal* 183-199.

[647] Austan Goolsbee and Edward L Maydew, 'Coveting thy neighbor's manufacturing: the dilemma of state income apportionment' (2000) 75(1) *Journal of Public Economics* 125-143.

[648] Greg LeRoy, *The Great American JobsScam: Corporate Tax Dodging and the Myth of Job Creation* (San Francisco: Berrett-Koehler Publishers, 2005), 9-14, describing, for example, 'Scam #1: Job Blackmail or How to Get Paid to Do What You Planned to Do Anyway'. See generally also, Nicholas Kusnetz, 'State Integrity 2015: Only three states score higher than D+ in State Integrity Investigation; 11 flunk', report on Center for Public Integrity and Global Integrity study, 9 November 2015, https://www.publicintegrity.org/2015/11/09/18693/only-three-states-score-higher-d-state-integrity-investigation-11-flunk; the corresponding 2012 report is discussed in Glennon and Sloane, above n 634, 55-56. Perhaps ironically, recent research (see further section 5.5.2 below, n 697) indicates that states in fact make few significant economic activity gains from a change to the single sales factor approach: Kimberly A Clausing, 'The US State Experience Under Formulary Apportionment: Are There Lessons for International Reform?' (2016) 69(2) *National Tax Journal* 353-386.

[649] Charles E McLure, Jr., 'Implementing State Corporate Income Taxes in the Digital Age' (2000) 53(4/3) *National Tax Journal* 1287-1305.

'not imminent'.[650] Further reviews of US state practice highlighted the many inconsistencies in their approaches,[651] even with the availability of a single (federal) income tax base as a starting point not similarly open to European Union Member States, and also noting the much more pronounced issues of national sovereignty at stake in the European context than within a federal country, leading to the emphatic recommendation by the US authors, 'Don't do what we do'.[652]

An important theoretical contribution to the field at this time also focused on the potential for a transaction-based approach to international allocation employing a pre-determined 'profit split', an approach also seen as offering the significant benefit of representing an evolutionary reform of the existing international tax system rather than an overturning of it.[653]

In any event, after the initial doubts expressed following the EU proposals, a number of very significant studies focused attention again on the potential justifications for a move to

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[650] Charles E McLure, Jr., 'Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment' (2002) 56(12) *Bulletin for International Taxation* 586-599, 597.

[651] The otherwise very open discussion by commentators in one important contribution, for example, nevertheless included the recommendation that the Canadian formula apportionment model was the only one which the EU should consider: Charles E McLure, Jr. and Joann Weiner, 'Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income', in Sijbren Cnossen (ed.), *Taxing Capital Income in the European Union*, above n 643, 243-292.

[652] Walter Hellerstein and Charles E McLure, Jr., 'The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States' (2004) 11(2) *International Tax and Public Finance* 199-220, 217-218; Walter Hellerstein and Charles E McLure, Jr., 'Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Taxation Proposals' (2004) 58(3) *Bulletin for International Taxation* 86-98, 98, n 64. A European Commission report in 2003 also noted, in addition to wide support for the proposal, the total opposition to it of some parties, both from the business sector and among tax administrations: Commission of the European Communities, *An Internal Market without Company Tax Obstacles: Achievements, Ongoing Initiatives and Remaining Challenges*, COM(2003)726, 24 November (Bolkestein Report), 19, cited in Michael P Devereux and Simon Loretz, 'The Effects of EU Formula Apportionment on Corporate Tax Revenues' (2008) 29(1) *Fiscal Studies* 1-33, 2.

[653] Jinyan Li, 'Global Profit Split: An Evolutionary Approach to International Income Allocation' (2002) 50(3) *Canadian Tax Journal* 823-883; see also subsequently François Vincent, 'Transfer Pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just Don't Say Formulary Apportionment)' (2005) 53(2) *Canadian Tax Journal* 409-416; and, setting out a detailed proposal for multilateral advance pricing agreements, Eduardo Baistrocchi, 'The Transfer Pricing Problem: A Global Proposal for Simplification' (2006) 59(4) *The Tax Lawyer* 941-979.

the CCCTB, from gains in terms of tax simplification at the very least,[654] to the increasing importance of formula apportionment and combined reporting as an effective replacement in a substantive sense for the failing arm's length approach,[655] and the opportunities for the EU to improve upon US state practice in the realisation of a 'uniform and equitable' formula.[656] Similarly, it was emphasised at this stage that introduction of a system of formula apportionment in itself would not mean an end of the tax sovereignty of Member States, as policy independence would be retained through setting of the company tax rate.[657]

Empirical studies also showed the potential for formula apportionment to be applied so as to mitigate the risk of tax competition between jurisdictions (through application to non-mobile formula factors such as labour rather than the mobile factor of firm capital, although in this case allowing capital to escape any burden of the tax),[658] and more importantly the prospect for substantial increases in company tax revenue overall with compulsory participation of firms in the proposed CCCTB system (but also for revenue losses under an optional system).[659]

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[654] Jack Mintz, 'Corporate Tax Harmonization in Europe: It's All About Compliance' (2004) 11(2) *International Tax and Public Finance* 221-234.

[655] Michael J McIntyre, 'The Use of Combined Reporting by Nation States' (2004) 35 *Tax Notes International* 917-948, 947 (6 September), noting that '[m]any commentators have defended the arm's length/source-rule system and disparaged combined reporting. After years of experience with the arm's length/source-rule system, however, the case for continuing it is not easily made'; Kerrie Sadiq, 'The Traditional Rationale of the Arm's Length Approach to Transfer Pricing: Should the Separate Accounting Model be Maintained for Modern Multinational Entities?' (2004) 7(2) *Journal of Australian Taxation* 196-250, emphasising the fictional character of a transactional approach in the context of large corporate groups, particularly banks.

[656] Walter Hellerstein, 'The Case for Formulary Apportionment' (in *Symposium, Income Allocation in the 21st Century: The End of Transfer Pricing?*) (2005) 12(3) *International Transfer Pricing Journal* 103-111, 111.

[657] Joann Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* (New York: Springer, 2006), 106.

[658] Dietmar Wellisch, 'Taxation under Formula Apportionment – Tax Competition, Tax Incidence, and the Choice of Apportionment Factors' (2004) 60(1) *Finanzarchiv* 24-41; these findings built on the earlier research of Professor McLure ('The State Corporation Income Tax: Lambs in Wolves' Clothing', above n 515) showing that the incidence of the corporate income tax under formula apportionment tends to be shifted to the factors represented in the formula. A later study extended the analysis by Wellisch to find that it would generally also be optimal for the apportionment formula to include application to mobile capital, whether in a centralised or decentralised policy-setting environment: Marco Runkel and Guttorm Schjelderup, 'The Choice of Apportionment Factors under Formula Apportionment' (2011) 52(3) *International Economic Review* 913-934.

[659] Devereux and Loretz, above n 652.

The onset of the global financial crisis from 2006 and emergence of widespread corporate exploitation of tax havens and 'secrecy jurisdictions' as a major political issue seemed to offer much more favourable conditions for the acceptance of formulary taxation as a replacement for arm's length transfer pricing, and the European focus of the issue once again became internationalised through a number of further contributions at this time.[660] Perhaps surprisingly, however, strong counter-arguments continued to be voiced at the theoretical level,[661] while in practical terms the EU proposal began to encounter the political headwinds which had been anticipated years earlier.[662]

The Commission's CCCTB proposal ultimately put to the European Parliament was based on the optional (for eligible companies) participation model, and survived the vote for a legislative resolution in favour of a Council Directive, but only with further substantial

[660] See, for example, Kimberly A Clausing and Reuven S Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, Brookings Institution, Hamilton Project, Discussion Paper 2007-08, Washington, DC, June 2007; Kerrie Sadiq, 'The Taxation of Multinational Banks: Alternative Apportionment Through a Unitary Taxation Regime Aligning with Economic Reality' (2007) 13(4) *New Zealand Journal of Taxation Law and Policy* 640-672; Michael Kobetsky, 'The Case for Unitary Taxation of International Enterprises' (2008) 62(5) *Bulletin for International Taxation* 201-215; Ilan Benshalom, 'Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method' (2009) 28(3) *Virginia Tax Review* 619-671; Vann, 'Taxing International Business Income: Hard-Boiled Wonderland and the End of the World', above n 617.

[661] Julie Roin, 'Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment' (2008) 61(3) *Tax Law Review* 169-240; Rosanne Altshuler and Harry Grubert, 'Formula Apportionment: Is It Better Than The Current System and Are There Better Alternatives?' (2010) 63(4/2) *National Tax Journal* 1145-1184; Antony Ting, 'Multilateral formulary apportionment model – A reality check' (2010) 25(1) *Australian Tax Forum* 95-136; James R Hines, Jr., 'Income misattribution under formula apportionment' (2010) 54(1) *European Economic Review* 108-120. The 'uncertainty and inflexibility of broad global cooperation efforts' were also highlighted as considerations favouring an incremental approach to reforms: Susan C Morse, 'Revisiting Global Formulary Apportionment' (2010) 29(4) *Virginia Tax Review* 593-644, 641. A more specific study also noted the potential for the problems of transfer pricing and tax havens to migrate into a risk of selective enforcement of tax obligations under formula apportionment, undermining gains otherwise ideally available: Johannes Becker and Clemens Fuest, 'Tax enforcement and tax havens under formula apportionment' (2010) 17(3) *International Tax and Public Finance* 217-235.

[662] See observations in the Bolkestein Report of 2003, referred to at n 652 above. See also the call for a more limited common corporate tax base (without consolidation) detailed in Erik Röder, 'Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment' (2012) 4(2) *World Tax Journal* 125-150.

amendments including, for example, reservation of the rights of Member States to implement tax incentive measures.[663]

Shortly after the European resolution, however, the multinational enterprise tax avoidance issue stepped up in importance to become an immediate priority for international action, as demanded by the G20 leaders at their June 2012 meeting in Los Cabos, Mexico. The OECD responded immediately to the G20 call with establishment of the wide-ranging and ongoing Base Erosion and Profit Shifting (BEPS) project, issuing its first progress report in February 2013,[664] and continuing its work with identification of fifteen Action Plan areas for policy development, including multinational enterprise reporting and drafting of a multilateral treaty instrument to supplement existing double taxation agreements.

Perhaps ironically, a collateral effect of the intense global BEPS debate was that the formula apportionment debate itself became subsumed within the larger policy issue. Studies focused on the specific reform of formula apportionment continued,[665] but they were joined by more direct discussions heralding the 'end of transfer pricing' in general and likening the scale of the shift in thinking to that at the end of the acceptance of the Ptolemaic model of planetary motion in the sixteenth century,[666] and others emphasising that formula apportionment would not in any event address the more important problems of international offshoring of economic activity and deferral of foreign income recognition.[667] At a practical level, the picture was also

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[663] European Parliament legislative resolution of 19 April 2012 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011)0121-C7-0092/2011-2011/0058(CNS), Amendment 9, http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P7-TA-2012-0135+0+DOC+XML+V0//EN. For an analysis of the political factors involved in the vote, see Roggeman, Verleyen, Van Cauwenberge and Coppens, 'Did the Economic Impact of a Common Consolidated Corporate Tax Base (CCCTB) Affect the Voting Behaviour of the Members of the European Parliament?', above n 509.

[664] OECD, *Addressing Base Erosion and Profit Shifting* (12 February 2013), https://www.oecd.org/tax/beps/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm.

[665] Reuven S Avi-Yonah and Ilan Benshalom, 'Formulary Apportionment – Myths and Prospects: Promoting Better International Tax Policies by Utilizing the Misunderstood and Under-Theorized Formulary Alternative' (2011) 3(3) *World Tax Journal* 371-398; Thomas A Gresik, 'Assessing the Normative Differences Between Formula Apportionment and Separate Accounting', in Wolfgang Schön and Kai A Konrad (eds), *Fundamentals of International Pricing in Law and Economics* (Berlin: Springer, 2012), 257-265; Ilan Benshalom, 'Rethinking the Source of the Arm's Length Transfer Pricing Problem' (2013) 32(3) *Virginia Tax Review* 425-459.

[666] Robert Couzin, 'Policy Forum: The End of Transfer Pricing?' (2013) 61(1) *Canadian Tax Journal* 159-178.

[667] Fleming, Peroni and Shay, 'Formulary Apportionment in the US International Income Tax System: Putting Lipstick on a Pig?', above n 630; J Clifton Fleming, Jr., Robert J Peroni and Stephen E Shay, 'Getting Serious

complicated by moves by OECD members the UK and Australia to break ranks and unilaterally enact anti-avoidance measures directed at multinational enterprises, the effectiveness of which is as yet however untested.[668] The US in May 2015 also released a new model double tax treaty with significantly enhanced 'limitation of benefits' provisions.[669]

In the midst of this debate, efforts by the Council of the European Union to formulate the CCCTB Directive stalled, necessitating an effort by the European Commission to devise a strategy in June 2015 for a 're-launch' of the initiative.[670]

5.4.3.4 Renewal of the debate?

The final outcomes of the OECD's Base Erosion and Profit Shifting Project were released on 5 October 2015 in the form of reports for 15 proposed 'Actions' to deal with international tax avoidance. While the political intensity of the multinational tax avoidance debate has at least to some extent since subsided, commentators have found in the OECD recommendations (and the draft proposals leading up to the final reports) the potential seeds for the longer term move to formula apportionment to take place on a global basis.[671] In particular, the 2014 draft on 'Use of Profit Splits in the Context of Global Value Chains' as a direction for reform of transfer

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About Cross-Border Earnings Stripping: Establishing an Analytical Framework' (2015) 93(3) *North Carolina Law Review* 673-740.

[668] The UK's 'diverted profits tax' was enacted on 26 March 2015 in *Finance Act 2015*, c 11, Pt 3; Australia has amended its existing general anti-avoidance rule (GAAR) to provide specific application to multinational avoidance of a 'taxable presence' in Australia, and a diverted profits tax has also been announced, to apply from 1 July 2017. An unfortunate but perhaps inevitable feature of detailed anti-avoidance rules is that they create a presumption that the rules 'cover the field' and that no further development of purposive judicial interpretative doctrines is permissible: see, in the Australian context, Richard Krever and Peter Mellor, 'Australia', in Michael Lang, Jeffrey Owens, Pasquale Pistone, Alexander Rust, Josef Schuch and Claus Staringer (eds), *GAARs – A Key Element of Tax Systems in the Post-BEPS World* (Amsterdam: IBFD Publications, 2016), 45-64, 47, and decisions there cited.

[669] Reuven S Avi-Yonah, 'Full Circle? The Single Tax Principle, BEPS and The New US Model' (2016) 1 *Global Taxation* 12-22, 17 (May).

[670] See Shafi U Khan Niazi, 'Re-Launch of the Proposal for a Common Consolidated Corporate Tax Base (CCCTB) in the European Union: A Shift in Paradigm', forthcoming, discussing the European Commission's Action Plan of June 2015, A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas of Action and the suggestion in that proposal that the new initiative again may be sought to be taken forward through the enhanced cooperation procedures by a limited group of EU members, but this time in several stages and with a view to mandatory participation.

[671] Yariv Brauner, 'Formula Based Transfer Pricing' (2014) 42(10) *Intertax* 615-631; Robert Robillard, 'BEPS: Is the OECD Now at the Gates of Global Formulary Apportionment?' (2015) 43(6-7) *Intertax* 447-453.

pricing methodology has been seen as a report which 'crystallizes the philosophical shift toward formulary-like approaches for international pricing'.[672] Importantly, the shift has seen a take-up in China, for example, but with a potential for an additional selective focus on 'location specific advantages' in that country,[673] which may herald some divergence in outcomes more generally at the international level.

Furthermore, the need for reforms to improve the equity in the international system towards developing nations' share of taxation revenues continues to be stressed,[674] while views from the tax practitioner community continue to note practical concerns, but also recognise that formula apportionment is an approach which 'has much to recommend it in the international area'.[675] In the meantime, ongoing work in the field also provides further findings suggesting that some of the earlier concerns about state competition to alter formulas to a sales-only approach may have been overstated.[676]

In this context, the realisation of significant reforms in the direction of formula apportionment both within the EU and globally seems increasingly likely.

5.4.4 The Australian State income tax context: recommendations

While the extensive literature on the choice between formula apportionment and separate accounting as means for allocating business income, and the various episodes in which this debate has flared into international confrontation or crisis, suggest that significant considerations are involved in the issue at the international level, the conclusions from these

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[672] Robillard, ibid, 451.

[673] See, e.g., Chi Cheng, John Kondos, Simon Liu and Kelly Liao, 'China's new transfer pricing guidelines and BEPS', *International Tax Review*, 4 December 2015, discussing the State Administration of Taxation's draft discussion document, 'Special Tax Adjustments' of 17 September 2015, http://www.internationaltaxreview.com/Article/3511707/Chinas-new-transfer-pricing-guidelines-and-BEPS.html.

[674] Picciotto, 'Taxing Multinational Enterprises as Unitary Entities', above n 623.

[675] Peter L Faber, 'A State and Local Practitioner's Insights on Formulary Apportionment' (Letter to the Editor), (2016) 82 *Tax Notes International* 985-986 (6 June); views which are still not necessarily unanimous, however: David Spencer, 'The Future of Tax Policies in Developing Countries and the Role of Civil Society Organizations' (2016) 1 *Global Taxation* 39-47 (June), setting out suggested considerations as to why the US state apportionment systems would not be a good global model and why global apportionment would be prejudicial to developing countries, and David Spencer, 'Picciotto's Dilemma: What is Unitary Taxation?' (2016) 83 *Tax Notes International* 411-416 (1 August).

[676] Clausing, 'The US State Experience under Formulary Apportionment: Are There Lessons for International Reform?', above n 648.

sources for an Australian State income tax in the modern era seem much clearer, in favour of the formula apportionment methodology.

Key factors in this outcome are the important features of a federal nation (as opposed to multiple independent nations at the global level) of a common monetary system, eliminating the complication of exchange rate movements in the application of a fixed formula, and a unifying central level of government with at least the potential to impose some degree of harmonisation of formulas and a common judicial interpretation of the rules.

Moreover, although transactional or 'profit split' approaches continue to be examined in a global context, and seem quite similar to the '66:33' rule for division of profit on sale of manufactured goods agreed by the Australian States in 1936, it seems undoubtedly the case that economic and enterprise integration in the Australian 'common market' has progressed significantly since the 1930s, including as a result of the finding that the constitutional prohibition against State 'excise duties' extends to any indirect tax on goods, in furtherance of an objective of securing free trade in goods throughout Australia.[677]

Recommendation 3

It is recommended that an Australian State income tax employ rules for the allocation of business income based on a system of formula apportionment.

These rules should include unitary combination, but with a mandatory 'water's edge' limitation to prevent inclusion of foreign entities in a combined reporting entity.

The Commonwealth government should be empowered to implement harmonisation measures if required.

5.5 Selection of apportionment factors and their weighting

5.5.1 Introduction

This section considers the identification of the appropriate factors to be used in the formula for apportionment of business income under an Australian State income tax, and the weighting to be attributed to each of those factors. From a practical point of view, this analysis can most

[677] *Ha v Commonwealth* (1997) 189 CLR 465 at 497 and prior High Court decisions supporting a wide view of 'duties of excise' in keeping with *Parton v Milk Board (Vic)* (1949) 80 CLR 229.

appropriately draw guidance from the relevant formulas and factor weightings employed in historical and current practice in Australian and overseas jurisdictions.

As a preliminary matter, however, it is recognised that the establishment of the relevant formula, or the several formulas if an industry-specific approach is adopted, will always be subject to both:

(a) political considerations, in the enactment of any formula by the state legislature in question, and also in the control or harmonisation of state approaches by the federal jurisdiction (in Australia's case, the Commonwealth government);[678] and

(b) overarching legal and constitutional considerations, as to the validity of the method of apportionment in accordance with the provisions of the federal Constitution. In the US, for example, these considerations have taken the form in particular of a requirement that an apportionment method be 'fair', although in modern times it has been noted that the US Supreme Court has allowed a wide latitude to individual states to make this determination, absent Congressional intervention, even if a lack of uniformity, and therefore the possibility of 'double taxation' may arise.[679] More importantly, it is this legal approach which has underpinned the expansion in recent years of the US of 'sales only' apportionment methods,[680] although there are always grounds to question how far

[678] Similarly, in the EU the CCCTB Working Group in its deliberations in 2007 on the sharing mechanism for the proposed company tax reforms discussed various details of 'a possible apportionment mechanism' but declined to consider factor weightings, which it considered was not a technical issue and recommended should be discussed at the 'political level': European Commission, Common Consolidated Corporate Tax Base Working Group, 'CCCTB: possible elements of the sharing mechanism', working document CCCTB/WP060, 13 November 2007, 2.

[679] See Jerome R Hellerstein, 'State Taxation Under the Commerce Clause: The History Revisited', in Charles E McLure, Jr. (ed.), *The State Corporation Income Tax: Issues in Worldwide Unitary Combination*, above n 558, 53-81, 59-60, discussing *Western Live Stock v Bureau of Revenue*, 303 US 250 (1938) and *Complete Auto Transit, Inc. v Brady*, 430 US 274 (1977). State apportionment rules typically include provision for a taxpayer to petition the revenue authority for an alteration of the result determined under the formula in the case of a 'manifest misallocation' or similar claimed outcome.

[680] Ibid, referring with some criticism to the decision upholding Iowa's then single sales factor apportionment method in *Moorman Mfg. Co. v Bair*, 437 US 267 (1978), although otherwise noting that the Supreme Court's reticence on the issue reflects 'wise judicial statesmanship'.

'out onto the limb' this process may continue to go consistently with the underlying fairness requirement.[681]

While the Australian High Court's jurisprudence on the issue of source of income itself has centred on the question of identifying the location of the 'essence' of the business activity,[682] as noted in section 5.4.2.3 above, there has been little specific consideration of the limits of State legislative competence to enact apportionment methods for this purpose, although as in the US the latitude can be considered wide.[683]

5.5.2 Key elements of the proposed formula

As the review of subnational income taxation in the various jurisdictions has shown, a variety of specific factors have been used in apportionment formulas at different times. These include, for example, under various descriptions and combinations:

(a) assets;

(b) assets and liabilities;

(c) loans and deposits;

(d) sales, revenue or receipts;

(e) labour, as determined by salaries and wages (payroll costs);

(f) labour, as determined by number of employees;

(g) capital employed;

(h) various industry specific measures, such as 'track miles' for railways, 'revenue plane miles flown' for airline corporations, 'number of kilometres driven' for bus and truck

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[681] See, for example, Cara Griffith, 'Single Sales Factor Apportionment May Be Inevitable, But Is It Fair?', *Forbes.com*, 18 September 2014, http://www.forbes.com/sites/taxanalysts/2014/09/18/single-sales-factor-apportionment-may-be-inevitable-but-is-it-fair/#226051ae5331.

[682] See Robert Deutsch and Róisín Arkwright, 'Taxation of Non-Residents', in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect*, above n 515, 417-430, 425-426, discussing *Commissioners of Taxation (NSW) v Meeks* (1915) 19 CLR 568.

[683] For example, a sales only apportionment method (applicable as a fall-back if the relevant amount of in-State profits could not be 'satisfactorily determined' or relevant information obtained from the taxpayer) was not invalidated by the High Court on one particular ground, ie that it might have interfered with the constitutional requirement for free trade between the States, in *Australasian Scale Co. Ltd v Commissioner of Taxes (Qld)* (1935) 53 CLR 534. Similarly, on the issue of potential state legislative extraterritoriality, the High Court's test has encompassed residence, carrying on business or 'even remoter connections': *Broken Hill South Ltd v Commissioner of Taxation (NSW)* (1937) 56 CLR 337, 375.

operators, 'miles of pipeline' for pipeline operators, and 'port-call-tonnage' for ship operators;

(i) deemed amounts from specified activities as taxable income within a state, such as the activity of treatment of metals or minerals by a person who imports the commodities into a State and on-sells them after treatment;[684]

(j) deemed sourcing of all profits from certain activities as income within the state, such as the activities of primary production or coal mining.

A useful starting point for development of the model in the Australian case is the standard equally-weighted 'three-factor' formula for US states set out in the 'Uniform Division of Income for Tax Purposes Act' (UDITPA) which was approved by the American Bar Association for adoption by all states on a uniform basis in 1957.[685] This three-factor formula, comprising 'property', 'payroll' and 'sales',[686] is well-known, having been taken up in whole or in part at some stage by the majority of US states[687] and also reflected (with one key variation as to calculation, in that 'labour' is determined according to both payroll and number of employees equally) in the formula proposed for the European Commission's proposed Directive for the CCCTB in 2011.[688]

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[684] *Income Tax Assessment Act 1936* (SA), s 53. See Chapter 3, text at n 270.

[685] See http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf. The allocation rules in UDITPA were subsequently included in the Multistate Tax Compact of the Multistate Tax Commission, 1966, Art IV, http://www.mtc.gov/The-Commission/Multistate-Tax-Compact. While uniformity of formula approaches has obvious advantages in terms of minimisation of complexity and risks of over-taxation, it can also be noted that there may be advantages for expected enterprise group income where some uncertainty exists as to the formulas adopted in each jurisdiction: see Regina Ortmann, 'Uncertainty in Weighting Formulary Apportionment Factors and its Impact on After-Tax Income of Multinational Groups', WU International Taxation Research Paper Series 2015-10, 2015.

[686] UDITPA, s 9, http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf.

[687] See Hellerstein and Hellerstein, *State and Local Taxation*, above n 534, 567-568, Table 1.

[688] European Commission, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, 49, proposed Article 86, http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf. The European Parliament amended the Commission's CCCTB proposal in a number of respects in 2012, including a change to the recommended formula to 10 per cent sales, and 45 per cent each to labour and capital: see Khan Niazi, above n 670. This chapter will focus discussion on the European Commission proposal.

Under the UDITPA provisions, 'sales' is determined on a destination basis as tangible personal property delivered to a person in the state,[689] or shipped from an office in the state where the taxpayer is not taxable in the state of delivery ('throwback rule'[690]); where the sale is not of tangible personal property, the sale is considered to be in the state if all or the majority of the income-producing activity is carried out in the state.[691] As will be discussed further in this section, however, this 'income-producing activity' test for location of sale of services has been modified to some extent towards the destination approach as a result of the adoption by

[689] For an early criticism of use of the sales factor on a destination basis, see Floyd E Britton, 'State Taxation of Extraterritorial Value: Allocation of Sales to Destination' (1960) 46(6) *Virginia Law Review* 1160-1171, 1166: '[i]t is not readily perceived how income can be considered as being earned in a state simply because of shipments into the state'. It has also been noted that Nobel laureate economist William Vickrey 'thought a sales factor had no role to play in an apportionment formula': Richard D Pomp, 'Reforming a state corporate income tax' (2014) 32(2) *Journal of State Taxation* 21-33, n 5 (noting also more generally that Vickrey considered the three-factor formula itself as having the appearance of 'having been concocted by a committee of lawyers who had forgotten anything they were ever taught about statistics or economics', as quoted from 'The Corporate Income Tax in the US Tax System', 73 *Tax Notes* 597, 602 (1996) by the hearing officer at the 2012 public consultations by the Multistate Tax Committee on the revisions to UDITPA). It has more recently very relevantly been noted, however, that '[a]s a matter of practical politics, however, it is a rare (probably nonexistent) state or nation that would unilaterally refrain from asserting that it is entitled to tax persons selling products in its marketplace, at least to the extent that there is a practical mechanism for enforcing such a tax': John A Swain, 'Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts' (2008) 83(2) *Tulane Law Review* 285-358, 296, and references there cited. The 'market' approach emphasises the importance of the 'demand' side of transactions to the creation of income, in addition to the 'supply' side: ibid, 295-296. For further supporting arguments for a market approach in the context of development of electronic commerce, see also McLure, 'Implementing State Corporate Income Taxes in the Digital Age', above n 649, 1287-1305; and for discussion of various recent state-specific rules, Laurie H Beaudet, Kristen Cove and Jordan M Goodman, 'Finding the "Market": Practical Approaches to Market-based Sourcing', presentation to National Multistate Tax Symposium, 4-6 February 2015, http://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-finding-the-market-practical-approaches-to-market-based-sourcing-012715.pdf.

[690] See Vernon B Savoie and Michael L Burr, 'The Throwback Rule: Concepts, Components and Planning Opportunities' (1983) 2(1) *Journal of State Taxation* 19-35, 20-21, noting that the rule 'attempts to insure that 100 percent of a multistate corporation's sales are assigned to a state that has jurisdiction to tax the corporation' so that the apportionment factors sum to 100 per cent.

[691] UDITPA, ss 16-17.

some states of model apportionment regulations issued by the Multistate Tax Commission for certain industry services, such as financial services.[692]

Importantly, however, as has been discussed previously in this chapter, many US states have departed from the UDITPA formula model in more recent times by providing a greater weight for the sales factor over the other factors, including up to an use of sales as the only factor. A further area of development has been the implementation of 'market-source' rules for the sale of services and intangible property to determine the place of sale in these cases.[693] As a consequence, in 2014 and 2015, the Multistate Tax Commission also settled upon revisions to its Multistate Tax Compact in 2014 and 2015 which included a recommended double-weighting for the 'receipts' factor (i.e., the receipts factor to be set at 50 per cent and property and payroll at 25 per cent each), and providing formally for the location of receipts other than from tangible personal property to be in the state 'if the taxpayer's market for the sales is in [the relevant] state', as determined under further detailed provisions.[694]

Most recently, both New York State and New York City have enacted substantial reforms to their respective corporation taxes, including in the City's case the substantial alignment of provisions with the State tax and the merger of the general corporate tax and bank tax so that banks will be subject to the same single sales factor apportionment approach as under the general tax in place of the three-factor formula of the former Banking Corporation Tax (BCT).[695]

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[692] In this case, the regulation specifies the relevant place of supply as the location of the borrower or real property collateral: Swain, above n 12, 319, citing Multistate Tax Commission, *Recommended Formula for the Allocation and Apportionment of Net Income from Financial Institutions* (1994).

[693] See, for example, Michael Schadewald, 'Pennsylvania provides guidance for sourcing sales of services' (2015) 33(3) *Journal of State Taxation* 21.

[694] Model State Compact, as revised in 2014 and 2015, Art IV, ss 9 and 17, http://www.mtc.gov/getattachment/The-Commission/Multistate-Tax-Compact/Model-Multistate-Tax-Compact-with-Recommended-Amendments-to-Art-IV.PDF.aspx.

[695] See New York City, Department of Finance, 'Summary of the New York City Corporate Tax Reform Legislation', April 2015, https://www1.nyc.gov/assets/finance/downloads/pdf/15pdf/corporate-tax-reform.pdf (accessed 7 August 2016). The general New York State corporation rate is 6.5 per cent and the City general rate 8.85 per cent (and former BCT rate 9 per cent): see, respectively, Nicole Kaeding, 'State Corporate Income Tax Rates and Brackets for 2016', Tax Foundation Fiscal Fact No 497, January 2016, http://taxfoundation.org/article/state-corporate-income-tax-rates-and-brackets-2016; and New York City, Department of Finance, 'Business Tax Highlights', http://www1.nyc.gov/site/finance/taxes/business.page (accessed 7 August 2016). On the 2014 New York State reforms, see Joseph Henchman, 'New York Corporate

In contrast with the recent New York City approach of enacting compulsory single sales factor apportionment for banks to match the corresponding pre-existing rule for other businesses, California State's major tax reform initiative of 2009 introduced only optional single sales factor apportionment for most businesses and did not extend this option to specified financial services providers and certain other types of businesses, which continue to be subject to the conventional three-factor apportionment formula with combined reporting.[696]

In this context, while provision of incentives to manufacturing is invariably put forward as an important motivation by US states in their moving to single sales factor apportionment,[697]

Tax Overhaul Broadens Bases, Lowers Rates, and Reduces Complexity', Tax Foundation Special Report No 217, April 2014, http://taxfoundation.org/sites/taxfoundation.org/files/docs/SR217.pdf (noting generally, at 3, that 'New York is not a low-tax state, and its economic success is because of strengths that overcome a challenging tax environment').

[696] Javier Ramirez and Christian J Burgos, 'California's Move to Single Sales Factor', *The Tax Adviser*, 1 November 2010, http://www.thetaxadviser.com/issues/2010/nov/clinic-nov10-story-09.html; John Harper, Marianne Evans and Rick Najjar, '*Harley-Davidson*, Factor Presence Nexus, and Market Sourcing: How California's Expansive and Evolving Definitions of "Financial Corporations" and "Doing Business" Create Unforeseen Hazards for Taxpayers' (2016) 29(3) *Journal of Taxation and Regulation of Financial Institutions* 19-32, 22. California also maintains a higher tax rate for bank and financial corporations (10.84 per cent) compared to general corporations (8.84 per cent): California, Franchise Tax Board, 'What are the tax rates for corporations?', https://www.ftb.ca.gov/businesses/faq/717.shtml. The Los Angeles city level business tax, applies on receipts only, but may be considered to impose a lower burden on relatively more profitable businesses such as banks, by being levied on a *gross* receipts basis, although at differentiated industry rates (0.475 per cent for 'professions and occupations' businesses not elsewhere specified): City of Los Angeles, Office of Finance, 'Tax Information Booklet', http://finance.lacity.org/content/taxinfobooklet.htm and Business Tax Rate Table, http://finance.lacity.org/form/TaxRateTable_2016.pdf. (Interestingly, Los Angeles also provides public information as to 'Top Delinquent Taxpayers': http://finance.lacity.org/form/delinquencies.pdf. For a discussion of the effectiveness of such measures, see Ken Devos, 'The Deterrent Impact of Public Disclosure: An Australia/Norway Comparison' (2014) 9(2) *Global Conference on Business and Finance Proceedings* 175-184, http://www.theibfr.com/ARCHIVE/ISSN-1941-9589-V9-N2-2014.pdf.)

[697] See, for example, the comments of the Hearing Officer at the 2012 public consultations by the Multistate Tax Committee on the revisions to UDITPA, discussed in Pomp, above n 689, although, as also noted in section 5.4.3.3 above, the emerging evidence is now tending to suggest that such gains in this sector are limited: Clausing, 'The US State Experience under Formulary Apportionment: Are There Lessons for International Reform?', above n 648; see also Jamie Bernthal, Dana Gavrila, Katie Schumacher, Shane Spencer and Katherine Sydor, 'Single Sales-Factor Corporate Income Tax Apportionment: Evaluating the Impact in Wisconsin', University of Wisconsin-Madison Workshop in Public Affairs, May 2012; Charles W Swenson, 'The Cash Flow and Behavioral Effects of Switching to a Single Sales Factor on State Taxation' (2015) 37(2) *Journal of the American Taxation Association* 75-107 (finding 'that SSF increased employment only for locally

a further rationale which can be hypothesised (albeit on limited evidence at this stage) is that states with a substantial banking headquarters presence have sought to retain to the extent possible some degree of property and payroll factor apportionment, while the remaining states have been keener to adopt a sales only approach, including the market source rule for services, to capture as much as possible of the value of financial services provided in to residents of their states. A further example in this scenario might also be North Carolina which retains the three-factor approach for all businesses, with a double weight for sales, and is host to banking behemoth Bank of America in Charlotte along with a number of other banks.[698] While having only one top-ten bank by total assets, California otherwise seems to have the largest number of banks based there overall of any state[699] and no doubt many Pacific coast regional offices. However, apart from the later timing of its shift to sales only apportionment, it is recognised that the New York City BCT current sales only apportionment may also be viewed as contrary evidence to this analysis given the City's hosting of five of the top ten largest banks in the US. It can also be noted that the valuation rules for financial institutions under the proposed CCCTB in the EU specified inclusion of only 10 per cent of the value of financial assets in 'assets' and 10 per cent of the value of receipts from financial assets in 'sales', apparently leaving apportionment in the financial sector to be based primarily on the labour factor.[700]

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based firms, resulting in economically insignificant aggregate employment gains'); Phineas Baxandall, 'The Single Sales Factor Tax Break: Has It Worked?', Massachusetts Budget and Policy Center, 27 January 2016, http://massbudget.org/report_window.php?loc=The-Single-Sales-Factor-Tax-Break-Has-It-Worked.html; William F Fox and Zhou Yang, 'Destination Taxation: Road to Economic Success?' (2016) 69(2) *National Tax Journal* 285-314. For a detailed empirical investigation into the factor contributions of firm profitability in the EU, supporting a three-factor approach for the CCCTB, see Annelies Roggeman, *Essays on the Common Consolidated Corporate Tax Base*, doctoral thesis, Faculty of Economics and Business Administration, Ghent University, March 2015, ch 3, https://expertise.hogent.be/files/15075748/Essays_on_the_CCCTB_Annelies_Roggeman_final.pdf.

[698] See https://en.wikipedia.org/wiki/List_of_largest_banks_in_the_United_States; https://en.wikipedia.org/wiki/Category:Banks_in_the_United_States_by_state.

[699] At least 55 banks and 27 credit unions: https://en.wikipedia.org/wiki/Category:Banks_in_the_United_States_by_state.

[700] European Commission, 'Proposal for a Council Directive on a Common Consolidated Corporate Tax Base', COM(2011) 121/4, 53, Art 98, http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/com_2011_121_en.pdf.

Nevertheless, the US outcome suggests the possibility that a similar divergence in preferred apportionment methodology may emerge between Australian States under a State corporate income tax, particularly given the concentration of the business establishments of financial institutions in Sydney and Melbourne.

Accordingly, while the issue could benefit from further empirical research into firm factor contributions to profitability, a recommendation as to an appropriate apportionment formula approach for Australia would in the first instance be to seek a compromise outcome between the extremes of the three-factor and sales-only approaches, most straightforwardly the three-factor formula with a double weighting for sales.

5.5.3 Further considerations: labour and property factors

In the case of the labour factor, two further considerations which arise are whether this factor contribution to income should be measured by reference to total compensation (payroll) or simple headcount, and whether to use a narrow or broad formulation of 'employment'. The EU's CCCTB proposal divides the labour factor into further equal sub-factors of both compensation and headcount. The EU proposal also adopts a broader view of employment than generally in US systems to include certain sub-contractors performing 'tasks similar to those performed by employees',[701] but otherwise allows Member States to determine the scope of the employment concept that will apply[702] (an element which has been argued to create the potential for harmful non-conformity in Member State approaches and firm location decisions, if the CCCTB were to be mandatory[703]).

In the Australian context, the existence of the uniform national personal services attribution regime under the federal income tax (deeming a range of contractor arrangements

[701] European Commission, 'Proposal for a Council Directive on a Common Consolidated Corporate Tax Base', COM(2011) 121/4, 53, Arts 90(1) and 91(3); KPMG International, The KPMG Guide to CCCTB (2012), Pt 3, 1, https://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/ccctb-part3.pdf.

[702] European Commission, 'Proposal for a Council Directive on a Common Consolidated Corporate Tax Base', COM(2011) 121/4, 53, Art 90(3).

[703] Eva Eberhartinger and Matthias Petutschnig, 'CCCTB: the employment factor game', *European Journal of Law and Economics* (online advance, 12 June 2015), http://link.springer.com/article/10.1007/s10657-015-9505-0. For an analysis suggesting that a labour factor should not be included, on the view of taxable [corporate] income primarily as a return on capital, but otherwise supporting the division of the labour component into payroll and headcount elements, see also Patrick J Weninger, 'The Labour Apportionment Factor for a Common Consolidated Corporate Tax Base: A Double-Edged Sword' (2008) 15(5) *International Transfer Pricing Journal* 213-219.

to give rise to employment relationship for income tax purposes) should minimise any distortions that might otherwise arise from a strict definition of employment for labour factor purposes as in the US. The issue of measurement of the labour contribution is more problematic, however. Very wide disparities in remuneration levels between executives and other employees may create doubt as to the reliability of salary data alone as a proper measure of employment activity and contribution to firm income. For present purposes, it can be noted that problems of wage disparities between eastern and western European Member States of the EU led to the recommendation for inclusion of a headcount component in the labour calculation for the CCCTB. Similarly, in Australia, it seems that compensation values alone would risk skewing business income allocation to the location of the corporate headquarters, and a further recommendation therefore is for the labour component to be split equally between compensation and headcount as in the EU's proposal.[704]

Very briefly also in relation to the assets component of the formula, a similar risk can be identified that property values within major metropolitan centres in Australia no longer bears any meaningful relativity to property values in any other locations. However, it is suggested that this may be a problem in general terms more for residential real estate than corporate property, and that income generating assets such as mines may have their own valuations that do provide an adequate reflection of contribution to income generation. It would be a matter for further research whether from a timing point of view some valuation averaging provisions were considered appropriate to smooth out the impact of cyclical variations in asset values, but otherwise no further recommendation is made in relation to the property factor of the proposed apportionment formula.

5.5.4 Possible industry-specific rules: mining and primary production; non-retail banks

As a preliminary matter, it seems that a proliferation of industry-specific apportionment rules and definitional provisions of those industries should be avoided if only on grounds of minimising complexity.

Nevertheless, the history of Australian State allocation rules and the nature of mining and primary production output markets suggests that the sales-weighted formula approach may not be appropriate in these cases. In relation to these markets, it seems likely that a significant

[704] For a proposal for the labour component of the formula for financial institutions also to include separate weightings for different *categories* of staff (i.e., traders, management, sales staff and support personnel), see Lindsay C Célestin, *The Formulary Approach to the Taxation of Transnational Corporations: A Realistic Alternative?*, doctoral dissertation, Faculty of Law, University of Sydney, October 2000, 397-400.

proportion of sales by mining companies would be to offshore markets (including sales to related company offshore marketing hubs[705] which has become a common practice for Australian resource companies in recent years), in which case the water's edge methodology of the apportionment formula would exclude such sales from both numerator and denominator. However, arrangements under which property in minerals passes onshore (including intra- and inter-State sales, such as of domestically-consumed oil and gas) would be likely to enter a sales-based formula calculation. Given the non-renewable nature of the minerals supplied from the source state, a market state approach may be less relevant and a specific source attribution rule appropriate for such industries.[706] The CCCTB proposal of the EU includes an industry-specific rule in the resources sector, but only for oil and gas exploration and production.[707]

While it would require further factual information to reach a definitive conclusion, it seems that such considerations may have been one consideration in the development in Canada of the 'permanent establishment' approach to allocation of business income. As mineral-heavy provinces Alberta and Saskatchewan are landlocked, and British Columbia also does not have an LNG conversion facility,[708] it may be that sales of minerals typically occurs at some stage prior to export (but not necessarily within the source province itself), but if the extraction company does not maintain a permanent establishment in another province, attribution will still be captured by the source province.

It can also be noted that Saskatchewan further captures value from the gains of extraction of some commodities through profit-based royalties,[709] so the allocation of business

[705] Neil Chenoweth, 'How BHP and Rio Tinto channelled billions through Singapore', *Australian Financial Review*, 7 April 2015, http://www.afr.com/business/legal/how-bhp-and-rio-tinto-channelled-billions-through-singapore-20150405-1mezkc.

[706] A specific source rule for *treatment* of mineral ores, however, as was applied in South Australia prior to 1942 (see n 684 above, and Chapter 3, text at n 270) seems less justifiable in the context of a comprehensive formula apportionment system.

[707] European Commission, 'Proposal for a Council Directive on a Common Consolidated Corporate Tax Base', COM(2011) 121/4, 54, Art 100.

[708] See Alberta Government, 'Royalty framework, How does Alberta compare?', http://www.alberta.ca/royalties-compare.aspx.

[709] See, for example, Government of Saskatchewan, 'Uranium Information Circulars, Uranium Royalty System Overview', http://www.economy.gov.sk.ca/UraniumInfo/Circs.

income in Australia also may be seen to be augmented by an appropriate State mineral royalty regime.[710]

Banks have historically also been a subject of industry-specific rules, in particular the asset-based formula scheme in Australia in 1936, although the recent decision in New York City to end the separate Banking Corporation Tax and subsume this tax within the General Corporation Tax under a sales only apportionment approach is a recent example of efforts to include banks within the trend to general apportionment based on sales.[711]

While a bank-specific approach based on assets now seems outdated, the problems in the modern era of identifying a specific location of bank electronic trading activities have also been emphasised, leading to a suggested formula with a weighting to the labour factor and drawing on US Internal Revenue Service transfer pricing agreements to include elements for risk and activity level.[712] It is suggested that such bank-specific formulas may be appropriate in the case of banks which do not have a substantial retail output to which such trading profits could be attributed.

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[710] Profit-based royalties at the State level generally are not imposed, perhaps due in part to concerns that the levy may then be characterised as a tax and therefore also an 'excise duty' which may contravene section 90 of the Constitution. Profit-based royalties have been applied in New South Wales, however, 'three times between 1906 and 2012': see New South Wales Parliamentary Research Service, 'A history of mineral and petroleum ownership and royalties in NSW', Issues Backgrounder 5, October 2012, 7, https://www.parliament.nsw.gov.au/researchpapers/Documents/a-history-of-mineral-and-petroleum-ownership-and/A%20history%20of%20mineral%20and%20petroleum%20royalties%20in%20NSW,%20Issues%20Backgrounder%20Oct%202012.pdf.

[711] The New York City Banking Corporation Tax (still applicable, only for flow-through 'S' financial corporations) was based on a three-factor apportionment formula of payroll, receipts and deposits, and a single factor formula from 2009 of receipts for banks substantially providing 'management, administrative or distributive services to investment companies': New York City, Department of Finance, 'Banking Corporation Tax (BCT)', http://www1.nyc.gov/site/finance/taxes/business-banking-corporation-tax-bct.page.

[712] See Sadiq, 'The Taxation of Multinational Banks: Alternative Apportionment Through a Unitary Taxation Regime Aligning with Economic Reality', above n 660, 668-670. For a proposal for a multilateral tax treaty approach to taxation of international banks, see also Michael Kobetsky, *Taxation of branches of international banks: towards a multilateral tax treaty*, unpublished PhD thesis, School of Law, Deakin University, 2003.

Recommendation 4

It is recognised that the selection of the apportionment formula and factor weightings by each Australian State would be primarily a political matter. Nevertheless, on the basis of the above considerations, it is recommended that:

(a) each State employ a three-factor formula of sales, assets and labour, with a double-weighting of the sales factor (i.e., in total, 50 per cent sales, 25 per cent assets and 25 per cent labour);

(b) the sales factor be calculated according to a 'market state' approach for services and intangibles, rather than place of contract or cost of performance approach;

(b) the labour factor be further divided into equal components of compensation and number of employees for the calculation of this formula factor;

(c) consideration be given to industry specific source rules in the case of mining, primary production and non-retail banking, where there are substantial sales of these products to onshore markets or domestic activities in these industries.

Chapter 6

Conclusion

Studies of Australian constitutional law and history invariably cite the centralisation of income taxation in 1942 as one of the most significant events of the twentieth century to impact on the development of the Australia's federation and intergovernmental financial relations. The long-term focus of the Henry Review of Australia's tax and transfer system conducted in 2008 and 2009 points to the fact that tax reform will continue to be an important issue in the public sphere in Australia also in the decades to come in this century, which will inevitably include consideration of State government finances and access by the States to sources of revenue thus drawing fiscal federalism into this tax reform process.

This thesis has considered whether the resumption of income taxation by the States would be feasible as one such tax reform, and has concluded on the basis of a close historical analysis of the experience of the State income taxes which were levied between 1880 and 1942 that on balance it would be feasible.

In reaching this conclusion, the thesis has examined the various issues and administrative challenges encountered both in the introduction of State income taxation in Australia in the late nineteenth century and in the continuation of the taxes throughout the first four decades after Federation. Chapter 2 focused in particular on the period 1880-1901 and one highly significant issue resolved in these years, namely the establishment of the judicial concept of income which has continued to the present day under the Commonwealth's national income tax, as the core concept in the statute of 'ordinary income'.

Chapter 3 moved to the years 1901-1942, which included many periods of extreme economic and social circumstances such as the newly-established Commonwealth's heavy taxation requirements when it joined the States in the income tax field in 1915, and the sharpened intergovernmental conflicts of the Depression era. This chapter also examined broader considerations relating to the efforts by the Commonwealth to pursue an objective of developing a role in macroeconomic management, and the perceived need for centralisation of fiscal resources to fulfil this role, in the face of setbacks before the courts and in referendum

proposals casting doubt on its direct constitutional powers over the economy in peacetime. This analysis led to the key conclusion that this economic management issue and wartime financial needs were likely to have been more important than any administrative shortcomings in the State income taxes in motivating the Commonwealth's move to impose the 'uniform tax scheme' in 1942 and take over the field for itself, upheld by the High Court against the States in that year.

Chapter 4 followed on with similar analysis for the years 1942 to the present during which the 'temporary' uniform tax scheme was in fact continued indefinitely after the war but resumption of State income taxation was a subject of constant debate, and a further unsuccessful legal challenge in 1957. An important contrast was also drawn with the Canadian experience in the postwar years when that country's similar centralisation of provincial income taxes during the war was in fact unwound, but the greater direct constitutional powers of the Dominion government were seen as a key factor in making this possible.

Nevertheless, some difficulties of administrative complexities and lack of harmonisation in the income tax policies of the States undoubtedly were incurred in this historical experience, including, for example, early differences between the States as to the types of receipts and gains considered income, a need for duplicate income tax returns during the initial years of concurrent taxation starting in 1915, until agreement was reached for joint administration of the income tax for most personal taxpayers by the States from 1923, and lack of agreement to a common approach for allocation of income of multi-State businesses leading in some situations to double taxation. A large degree of harmonisation was achieved, however, in the agreement by all States in 1936 to enact income tax legislation largely along uniform lines.

In the above context, the thesis proceeded in Chapter 5 to consider the key design issues involved in development of a model for a State income tax and made recommendations on these issues. It was noted at the outset that any decision to reimpose State income taxation would be a political one, although the expansion in recent years of the Commonwealth's direct legislative powers to control the economy in peacetime, and the importance of revitalising the income tax after many years of reform to the 'tax mix' in favour of indirect taxation, would be important factors favouring State income taxation in any such political process.

Chapter 5 noted that both personal and corporate income taxes would be useful components and revenue sources in a renewed State income tax. On the key structural issue of whether to employ a residence or source approach to income taxation, the personal income tax would be able to apply the familiar combined approach of the national income tax in Australia

and elsewhere; the corporate income tax would be better suited to a source-based approach only. The administrative complexities of Australia's historical experience highlight the advantages that would be gained from a fully harmonised approach by all States, including common definition of the tax base and method of allocation of income of multi-State businesses, perhaps facilitating joint collection of the tax by a single administrative agency. Against these considerations, however, from a political point of view, must be set the importance of ensuring that policy goals of each jurisdiction can be met and the risk which recent literature has emphasised that a common tax base (e.g., simple enactment of the existing Commonwealth tax base) may be far from the ideal of a comprehensive and equitable tax base free from politically motivated 'tax expenditure' exemptions.

The design issue identified as most important in Chapter 5 involves the method used to allocate income of multi-State businesses between jurisdictions, as between separate accounting of units of corporate groups and a formula apportionment system using a formula comprising various possible factors applied to a unitary enterprise under a combined reporting requirement. The Australian historical experience included both such approaches at various times, while in the US and Canada formula apportionment has become established as the primary method of allocation under the subnational income taxes in those countries (subject to a discretion for the revenue authority to accept an alternative allocation in cases of unfairness). In analysing this issue, the chapter also examined the reform debate on the corresponding issue of allocation of business income between nations which has taken place over many decades both internationally and in the European Union, most recently in the context of the proposal that EU member states adopt a Common Consolidated Corporate Tax Base (CCCTB). This debate is seen ultimately to favour formula apportionment as the appropriate approach to adopt in the design of a model for a State income tax.

The further issue of selection of appropriate formula factors (primarily as between sales, assets and payroll or labour cost) and their weighting was shown to be subject to a range of considerations, and variation in approach in the case of many US states but a largely common approach in Canada. While also a political matter, the trend in the US towards a greater weighting of the sales factor as against the other factors was seen to have merit, and a formula comprising 50 per cent for sales, and 25 per cent for each of assets and payroll was favoured. In the case of services, determination of the location of sales could also be made using the increasingly common method in the US of a 'market source' approach. Payroll could further be calculated using equal weights for total salary cost and number of employees, as suggested in the EU, with some scope also retained for industry-specific formulas where more

appropriate. However, the area of definition of the apportionment formula as a whole is certainly a matter which could benefit from much further research.

Appendix Table 1

Australia, Key Cth-State General Grants Enactments and Provisions, 1 July 1942* – 31 December 2000

(*** 1927-30 June 1942**: no general grants to the States - *per capita* grants 1910-1927 subsumed into the Commonwealth sinking fund contributions under the Financial Agreement of 1927.)

1 ***States Grants (Income Tax Reimbursement) Act 1942***, enacted 7 June 1942 with effect from 1 July 1942.

Provided for payment of specified nominal cash amounts set out in Schedule: understood these were calculated as the average of State income tax collections for 39-40 and 40-41 less cost of collection, adjusted during parliamentary debate for a slight increase to WA and larger increase for Tasmania. Conditional on no State income tax in prior year.

Expressed to last until the end of the first full financial year after the War.

Repealed by *States Grants (Tax Reimbursement) Act 1946*.

2 ***States Grants (Tax Reimbursement) Act 1946***, enacted 13 April 1946 with effect from 1 July 1946.

Provided for payment in first year of specified nominal cash amounts as set out in First Schedule. Combined reimbursements for income tax and entertainments tax. The *States Grants (Entertainments Tax Reimbursement) Act 1942* had had a condition that a tax not be imposed by a State on admissions to entertainments whereas the 1946 Tax Reimbursement Act just had the condition of no income tax in respect of the whole amount of the grant. The base pool of the 1946 Act set at £40 million (increasing the then total by £5,745,000) on account of social service spending and service spending needs of the States.

Subsequent years, the total grant pool to be adjusted according to population change, and increased by half of the percentage amount of any increase in national average wages.

Pool then divided according to a further formula applying a sliding scale declining through to the 1957 calendar year for division according to the same proportion as the base year division, and division according to 'adjusted population' with weighting for remote area residents.

The formula initially proposed by Commonwealth at the January 1946 conference provided for the grants to be not less than the existing grant plus the excess of calculated 'adjusted social service expenditure' over its 1944-45 level. The condition was also expressed of continuing to vacate the entertainments tax field. Victorian Premier Cain put forward a counterproposal which was not accepted and ultimately a sub-conference of Commonwealth and State officials

agreed on the formula in the Act. Premier McKell put this to PM Chifley as the basis that would be used, subject to an overall qualification of not accepting uniform taxation in principle.

Expressed to provide for optional review after 30 June 1953 but otherwise open-ended. Further general grant payments provided for by reference to the 1946 Act under *States Grants (Tax Reimbursement) Act 1947* and *States Grants (Tax Reimbursement) Act 1948* (which also changed the average wage adjustment from 50% to 100%).

1946, 1947 and 1948 Tax Reimbursement Acts repealed by *State Grants Act 1959*.

Further single year general grant Acts 1950-1958 also enacted as follows: *States Grants (Additional Tax Reimbursement) Act 1950*; *States Grants (Special Financial Assistance) Act 1951*; *States Grants (Special Financial Assistance) (No 2) Act 1951* (generally providing top-up grants to achieve a newly specified aggregate grant pool if higher than that which would have resulted under the Tax Reimbursement Act 1946); *States Grants (Special Financial Assistance) Act 1952*; ditto 1953; 1954; 1955; 1956; 1957 (20 November 1957); *States Grants (Additional Assistance) Act 1958* and *States Grants (Special Financial Assistance) Act 1958*.

Generally in these years, payments to some States only were made under "States Grants" Acts for that year. From 1959, these specific payment Acts became ad hoc *States Grants (Special Assistance)* Acts or 'Special Assistance to X' Acts in various years.

3 ***States Grants Act 1959***, enacted 1 December 1959.

Provided for payment of specified nominal cash amounts to the various States for the year commencing 1 July 1959. Expressed to be open-ended, and in subsequent years the nominal grant to each State was to be adjusted according to population change, and also by the amount of any increase in average wages (uplifted by 10% as betterment factor). Subject to optional review after 30 June 1965. No condition included about absence of a State income tax in any year. Victoria under obligation not to become a 'claimant state' for special assistance purposes for six years, 1959-65.

Division of the new base pool (£242.5m) based on percentage of (general+special) grants received in prior year, thus incorporating a running bias into general grant allocation in favour of smaller states over following years (Mathews and Jay, 1972).

Further single year general grant Acts 1959-1965 also enacted as follows: *States Grants (Additional Assistance) Act 1962* (generally in the form of specified further nominal grant amounts to each State); *States Grants (Additional Assistance) (No 2) Act 1962*; *States Grants (Additional Assistance) Act 1963*; *States Grants (Additional Assistance) Act (No 2) 1963*;

Note also the general ongoing grants to all States provided for under the *States Grants (Petroleum Products) Act 1965*.

Repealed by the *States Grants Act 1965*.

4 ***States Grants Act 1965***, enacted on 4 December 1965.

Provided for payment of grants to each State on ongoing basis; in the first year (1965-66) carrying over the amount of the grant payable under the 1959 Act for the 1964-65 year, except Queensland which was that amount + £1 million (uplifted on a similar basis for the 1966-67 and 3 following years) and Victoria which was uplifted by £600,000 just for the 1965-66 year.

After the 1965-66 year, grants were to be adjusted by population change and any increase in average wages, and an uplift by a factor of 1.2 of the *sum of those two amounts*. D James (2001, above n 416, p 15) and D James, 'Commonwealth Assistance to the States Since 1976' (1997), http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/Publications_Archive/Background_Papers/bp9798/98BP05.

Further single year general grant Acts 1966-1970 also enacted as follows: *States Grants Act 1967*; *States Grants Act (No 2) 1967* (nominal dollar grants for the 1967-68 year and amendment of rolling uplift to Queensland to $2 million); *States Grants Act 1968* (adding uplift to WA for 68-69 and 69-70 years of $15.5 million less any assistance in the 68-69 year under the Special Assistance Act 1967 – appears to be $15.518 million??); *States Grants (Special Financial Assistance) Act 1969* ($12 million between all States); *States Grants (Special Financial Assistance) Act 1970* ($14.5 million between all States and a further $1.5 million for Tasmania).

Note also *States Grants (Receipts Duty) Act 1970*.

Repealed by *States Grants Act 1970* (also repealing the 1967, 1967 (No 2) and 1968 Acts).

5 ***States Grants Act 1970***, enacted on 11 November 1970.

Provided a similar rollover of grants arrangements as did the 1965 Act, with the difference that the uplift factor would be 1.2 for the 1970-71 year and 1.8 for subsequent years. The Act also provided a range of further grant arrangements for specific States: Qld, a continuation of the $2 million uplift for the 1971-72 year and 3 subsequent years; $40 million further for the 1970-71 year between all States; Tasmania, $10 million for the 1970-71 year; NSW and Vic, 1970-71 year and four following years, $(2 *x* State population); WA, $32.5 million allocated over the 1970-71 and four following years.

Optional review after 30 June 1975.

Note also *States Grants (Capital Assistance) Act 1970* ($200 million between all States in specified amounts for capital spending, to be borrowed by the Commonwealth); also in subsequent years (e.g., 1971: $209.8 million etc). The direct 'capital assistance' grants began at the point where State indebtedness to the Commonwealth itself under the Loan Council arrangements had reached an unacceptable level and part of the loan allocation to the States

was converted to grants instead; the Commonwealth also took over a further $1 billion of State debt (Saunders, 'Government Borrowing in Australia', above n 164, 202).

Further single year general grant Act 1971 also enacted as follows: *States Grants Act 1971* (includes payroll tax transfer transitional provisions, restatement of base year grants in nominal terms and uplift of general additional grant to $43 million).

Repealed by *States Grants (No 2) Act 1971*.

6 ***States Grants (No 2) Act 1971***, enacted on 16 December 1971.

Further restatement of base year grant amounts and deduction from that of prior notional payroll tax administration costs that they would have incurred; further grants to Qld, SA, WA and Tas for the 1971-72 year of a further 50% of their allocation from the general additional grant pool for that year.

Further additional grants in: *States Grants Act 1972*; *States Grants (No 2) Act 1972* (also removed NSW and Vic population uplift).

Repealed by *States Grants Act 1973*.

7 ***States Grants Act 1973***, enacted on 27 November 1973.

Restatement of nominal base grant amounts and rollover of similar adjustment provisions for population and average wages (and 80% uplift).

Note also *States Grants (Capital Assistance) Act 1973*: $278.307 million; 1974 Act (for 1974-75): $326.618 million; no Act in 1975; 1976 Act (for 75-76): $430.333 million.

Also: *Financial Agreement Act 1976* – new specified sinking fund payments by Cth and States; *States Grants (Hospital Operating Costs) Act 1976* ($315 million between all States).

Also: *States Grants Act 1974* (further $15 million to Tasmania); *States Grants Act 1975* (further $220 million to all States for 1975-76 in same proportions [NB no capital assistance Act in 1975]; also carried forward optional review date to after 30 June 1980).

Repealed by *States (Personal Income Tax Sharing) Act 1976*.

D James (2001, p 15) also notes that the Whitlam had pledged to the States to increase the betterment factor to 3%, and although it lost office before this could be implemented state grants generally increased after 1976 and the arrangement was insisted on by the states in agreeing to New Federalism.

8 ***States (Personal Income Tax Sharing) Act 1976***, enacted on 24 November 1976, commencing year from 1 July 1976.

Provided for 33.6% share of PIT revenue to be divided between the States based on each State's proportion of adjusted population, i.e., indexed according to a scale, with Vic = 1 and the others a range from NSW = 1.0274, to Qld, SA, WA above that and up to Tas = 2.00188. Also subject to specified minimum entitlements based on prior year or notional current year grants under former legislation – these minimums were invoked in the case of most/all States (Saunders and Wiltshire 1980). Compulsory review required before 30 June 1981.

Amended by: *States (Personal Income Tax Sharing) Amendment Act 1978*, enacted on 22 June 1978, to increase share to 39.87% and specify the pool for 1977-78 as $4,336,100,000.00; *States (Personal Income Tax Sharing) Amendment Act 1980*, to provide for indexation of minimum entitlements;

Also *Local Government (Personal Income Tax Sharing) Act 1976* – defined 'base figure' as 1.52% of the pool for the States (PITS) Act, and established Local Government Grants Commissions in each State.

NB *States Grants (Capital Assistance) Act (No 2) 1976* also enacted, 19 October 1976, $452 million capital grants; *States Grants (Roads Interim Assistance) Act 1977* ($118.750 million); *States Grants (Capital Assistance) Act 1977* ($477.933 million); *States Grants (Roads) Act 1977* (approx $190 million); *States Grants (Schools Assistance) Act 1977* ($303 million); ditto Tertiary Education Assistance, $538.876 million; Capital Assistance 1978 ($477.933m).

Last special assistance grants to claimant states provided in this period: SA and Qld, 1975, Qld, 1979-81; then incorporated into six state standard used by CGC in general grant calculations from 1982.

Repealed by *States (Tax Sharing and Health Grants) Act 1981*.

9 ***States (Tax Sharing and Health Grants) Act 1981***, enacted on 18 June 1981.

Provided for 1981-82 year grant pool to be in effect a specified nominal amount, increased in accordance with population changes for the 82-83, 83-84 and 84-85 years. Also added NT as a recipient (under some provisions only), provided for certain levies to be excluded from the calculations (some were), and also provided for partial deduction from health grants of amounts determined by the Treasurer that the State should have been raising as fees from public hospitals.

Amended by 1982, 1982 (No 2), 1983, 1983 (No 2) and 1984 amending Acts.

Note: "capital assistance" Acts seem to have become "Works and Housing Assistance" from 1985. (No Act in 1984.)

Repealed by *States Grants (General Revenue) Act 1985*.

10 ***States Grants (General Revenue) Act 1985***, enacted on 5 December 1985.

Provided for general financial assistance grants for 1985-86 by reference to a pool of $9,058,428,568 distributed according to State share of adjusted population, payments for 86-87 and 87-88 including a 2% pool increase. Similar formula for health grants.

Amended by *States Grants (General Revenue) Amendment Act 1987*, providing for new base pool amount, and added condition to the grants that the State "pay to the Commonwealth an amount representing the State's share of the costs of any unfunded superannuation entitlements of higher education institutions in the State".

Repealed by *States Grants (General Revenue) Act 1988*.

11 ***States Grants (General Revenue) Act 1988***, enacted on 24 November 1988.

Provided for financial assistance grants on formula including nominal base pool amount, with *deduction for* share of hospital grants (to be provided from now by identified special purpose grant) and 'extra payroll tax revenue'. [Explanatory Memorandum indicates this is a clawback of 90% of revenue from removal of exemption for Commonwealth business entities.] Imposed condition of State observance of global borrowing limit.

Repealed by *States Grants (General Purposes) Act 1989*.

12 ***States Grants (General Purposes) Act 1989***, enacted on 18 December 1989.

Provided base assistance amount (pool) and similar formula, with extra payroll tax revenue replaced by adjusted extra state revenue.

Repealed by *States Grants (General Purposes) Act 1990*.

13 ***States Grants (General Purposes) Act 1990***, enacted on 18 December 1990.

Similar formula for calculation of grants; also provided for adjustment by reference to debits tax revenue forgone by the Commonwealth; and imposed condition relating to imposition of higher education fees.

Repealed by *States Grants (General Purposes) Act 1991*.

14 ***States Grants (General Purposes) Act 1991***, enacted on 20 November 1991.

Dropped state revenue variable from grant formula; also seems to have dropped the 'higher education funding conditions'.

Repealed by *States Grants (General Purposes) Act 1992*.

15 ***States Grants (General Purposes) Act 1992***, enacted on 11 December 1992.

16 ***States Grants (General Purposes) Act 1993***, enacted on 30 November 1993.

Reintroduced a 'higher education funding condition'.

17 ***States Grants (General Purposes) Act 1994***, enacted on 27 September 1994.

Maintained a 'higher education funding condition'.

Amended by *States Grants (General Purposes) Amendment Act 1995*; *States Grants (General Purposes) Amendment Act 1996*; ditto 1997 and (No 2) 1997; 1998; 1999.

Repealed by *A New Tax System (Commonwealth-State Financial Arrangements – Consequential Provisions) Act 1999*, enacted on 10 September 1999.

18 ***A New Tax System (Commonwealth-State Financial Arrangements) Act 1999***, enacted on 10 September 1999.

Appendix Table 2

Australian governments, Cth & State, party in office and dates of change* 1 January 1942 – 24 September 2016

(* elections: change of government and some other election dates only)

	Cth	NSW	Vic	Qld	SA	WA	Tas
As at 1/1/42	**ALP (Curtin)**	**ALP (McKell)**	**C'try (Dunstan) NB Cain, 4 days, 9/43**	**ALP (Forgan Smith)**	**Lib&C'try (Playford)**	**ALP (Willcock)**	**ALP (Cosgrove)**
16/9/42				**ALP (Cooper)**			
21/8/43 Cth election							
15/4/44 Qld election							
27/5/44 NSW election							
13/7/45	**ALP (Chifley)**						
31/7/45						**ALP (Wise)**	
21/11/45 (Vic election 10/11)			**ALP (Cain)**				
7/3/46				**ALP (Hanlon)**			

28/9/46 Cth election							
6/2/47		**ALP (McGirr)**					
1/4/47 (WA election 15/3)						**Lib (McLarty)**	
3/5/47 NSW/Qld elections							
20/11/47 (Vic election 8/11)			**Lib (Hollway)**				
19/12/47							**(Brooker, 19/12-24/2/48; Cosgrove)**
19/12/49 (election 10/12)	**Lib (Menzies)**						
29/4/50 Qld election							
27/6/50			**C'try (McDonald) Incl. 3 days, Hollway, 10/52**				
28/4/51 Cth election							
15/1/52				**ALP (Gair)**			
2/4/52		**ALP (Cahill)**					

	Cth	NSW	Vic	Qld	SA	WA	Tas
17/12/52			ALP (Cain)				
14/2/53 NSW election							
23/2/53 (WA election 14/2)						ALP (A Hawke)	
7/3/53 Qld election							
29/5/54 Cth election							
7/6/55 (Vic election 28/5)			Lib (Bolte)				
10/12/55 Cth election							
3/3/56 NSW election							
19/5/56 Qld election							
12/8/57 (Qld election 3/8)				Country (Nicklin)			
26/8/58							ALP (Reece)
22/11/58 Cth election							
2/4/59						Lib (Brand)	

(WA election 21/3)							
23/10/59		**ALP (Heffron)**					
30/4/64		**ALP (Renshaw)**					
10/3/65 (SA election 6/3)					**ALP (Walsh)**		
13/5/65 (NSW election 1/5)		**Lib (Askin)**					
26/1/66	**Lib (Holt)**						
1/6/67					**ALP (Dunstan)**		
17/1/68				**Country (Pizzey)**			
17/4/68 (SA election 2/3)					**Lib/CP (Hall)**		
1/8/68				**Lib (Chalk)**			
8/8/68				**CP/NP (Bjelke-Petersen)**			
26/5/69 (Tas election 10/5)							**Lib (Bethune)**
2/6/70 (SA election 30/5)					**ALP (Dunstan-Corcoran)**		

	Cth	NSW	Vic	Qld	SA	WA	Tas
3/3/71 (WA election 20/2)						ALP (JTonkin)	
3/5/72 (Tas election 22/4)							ALP (Reece)
23/8/72			Lib (Hamer-Thompson)				
5/12/72 (Cth election 2/12)	ALP (Whitlam)						
8/4/74 (WA election 30/3)						Lib (C Court-O'Connor)	
3/1/75		Lib (Lewis-Willis)					
31/3/75							ALP (Neilson)
11/11/75 (Cth el'n 13/12	Lib (Fraser)						
14/5/76 (NSW el'n 1/5)		ALP (Wran-Unsworth)					
1/12/77							ALP (Lowe-Holgate)
18/9/79 (SA election 15/9)					Lib (DTonkin)		
8/4/82 (Vic election 3/4)			ALP (Cain Jr)				

26/5/82 (Tas election 15/5)							**Lib (Gray)**
10/11/82 (SA election 6/11)					**ALP (Bannon)**		
25/2/83 (WA election 19/2)						**ALP (Burke-Dowding)**	
11/3/83 (Cth election 5/3)	**ALP (Hawke)**						
1/12/87				**NP (Ahern-Cooper)**			
25/3/88 (NSW el'n 19/3)		**Lib (Greiner)**					
29/6/89 (Tas election 13/5)							**ALP (Field)**
7/12/89 (Qld election 2/12)				**ALP (Goss)**			
12/2/90						**ALP (Lawrence**	
10/8/90			**ALP (Kirner)**				
19/12/91	**ALP (Keating)**						
17/2/92 (Tas election 1/2)							**Lib (Groom-Rundle)**
24/6/92		**Lib (Fahey)**					

	Cth	NSW	VIC	QLD	SA	WA	TAS
4/9/92					ALP (Arnold)		
6/10/92 (Vic election 3/10)			Lib (Kennett)				
16/2/93 (WA election 6/2)						Lib (R Court)	
13/3/93	Cth 'Fightbk' election						
14/12/93 (SA election 11/12)					Lib (Brown)		
4/4/95 (NSW election 25/3)		ALP (Carr)					
19/2/96 (Qld election 15/7/95; by-el'n 3/2/96)				NP (Borb'dg			
11/3/96 (Cth election 2/3)	Lib (Howard)						
28/11/96					Lib (Olsen-Kerin)		
26/6/98 (Qld election 13/6)				ALP (Beattie)			
14/9/98 (Tas election 29/8)							ALP (Bacon)

20-29/6/99 ANTS ag. signed	Howard	Carr	Kennett	Beattie	Olsen	R Court	Bacon
10/9/99 Assent, ANTS ag Act							
19/10/99 (Vic election 18/9)			ALP (Bracks)				
16/2/01 (WA election 10/2)						ALP (Gallop-Carpenter	
5/3/02 (SA election 9/2)					ALP (Rann)		
21/3/04							ALP (Lennon)
3/8/05		ALP (Iemma)					
30/7/07			ALP (Brumby)				
13/9/07				ALP (Bligh)			
3/12/07 (Cth election 24/11)	ALP (Rudd)						
26/5/08							ALP (Bartlett)
5/9/08		ALP (Rees-Keneally)					
23/9/08						Lib (Barnett)	

	Cth	NSW	Vic	Qld	SA	WA	Tas
24/6/10	ALP (Gillard-Rudd)						
2/12/10 (Vic election 27/11)			Lib (Baillieu-Napthine)				
23/1/11							ALP (Giddings)
28/3/11		Lib (O'Farrell – Baird)					
21/10/11					ALP Weatherill		
26/3/12 (Qld election 24/3)				Lib Newman			
18/9/13 (Cth election 7/9)	Lib (Abbott-Turnbull)						
31/3/14 (Tas election 15/3)							Lib (Hodgman
4/12/14 (Vic election 29/11)			ALP (Andrews)				
14/2/15 (Qld election 31/1)				ALP Palasz'k			
2/7/16 Cth election	Lib (Turnbull						
24/9/16	Turnbull	Baird	Andrews	Palasz'k	Weatherill	Barnett	Hodgman