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Report 410

Tax Administration

Joint Committee of Public Accounts and Audit

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Foreword

The Australian Taxation Office (ATO) is one of the key agencies in the Commonwealth of Australia. It collects Government's revenue and maintains an official relationship with over half of the population. The Joint Committee of Public Accounts and Audit last inquired into the ATO's operations in 1993. Therefore, it is timely that the Parliament's main financial accountability committee should inquire into the agency responsible for administering the Commonwealth's revenue collection.

The ATO must maintain a balance between dealing fairly with taxpayers and operating efficiently. When the ATO does not achieve this balance, there can be downsides for both the Commonwealth and the taxpayer. In the early 1980s, when the ATO assessed tax returns under administrative assessment, the ATO was perceived as being reactive and driven by process. Further, there was little downside for taxpayers who 'gamed the system' for their own advantage. These inefficiencies led to the introduction of self assessment for individuals in 1986-87 and for corporations in 1989-90.

In the mid 1990s, scheme-promoters marketed unsophisticated avoidance schemes to 'mum and dad' investors. The schemes attempted to change income streams into capital items and reduce tax. Failure by the ATO to respond quickly to the mass marketed investment schemes, led to their exponential growth. Because of the ATO's delayed response and because they neither understood the investments nor the self assessment system, taxpayers felt they had been unfairly treated.

In this inquiry, the Committee has been mindful that the ATO needs to strike a balance between efficiency and fairness.

Sometimes, the two goals complement each other. This has occurred with the ATO's compliance model, which encourages taxpayer compliance and thereby reduces the cost of collecting tax. It also directs the ATO to be supportive of compliant taxpayers, which results in a fairer system. Under self assessment,

taxpayers must accept more responsibility and risk. In this environment, the Committee regards the compliance model as a very positive development.

A major issue discussed in the report is the complexity of the tax laws. Complex tax law produces a complex tax administration, thereby undermining the integrity of self assessment. The Committee recognises that the ATO has sought to ameliorate this by obtaining information from third parties and pre-filling tax returns. However, the Committee's preferred approach is for Treasury, Government and stakeholders to work together to develop clear, simple tax policy. This should result in clearer and simpler tax legislation and tax administration.

The Government's new review, *Australia's Future Tax System,* is an obvious vehicle through which to achieve this.

The other main substantive issue in the report is the ATO's litigation practices, in particular those evidenced in the *Essenbourne* case. In late 2002, the Federal Court handed down its decision that the particular transfer of funds in the case was not a tax deduction – an ATO win, and that it did not attract fringe benefits tax – an ATO loss. However, the ATO neither appealed *Essenbourne* nor accepted it. Instead, it took the ATO over four years to bring a test case to the full Federal Court.

The Committee is concerned by this approach. Firstly, it increases uncertainty for taxpayers. Secondly, a judicial decision is the law until overturned on appeal or changed by legislation. The Committee has recommended that the ATO should limit its discretion in this area in favour of certainty. If the ATO has concerns about a court decision, it should address the issue within 12 months by appealing the decision or referring the issue to Treasury as a policy matter. At a minimum, it should abide by court decisions.

One of the positive developments to arise during the inquiry has been the biannual meetings between the Committee and the Commissioner of Taxation. Three meetings have been held to date. They have served as useful occasions for the Committee to ask the Commissioner about developments in tax administration, to follow up recent external reviews and to publicly hold the ATO to account for its significant decisions. One aspect of public administration that is common place and therefore easily overlooked, is the time agencies can take to respond to issues. As well as prolonging those issues, the considerable time taken may result in increased costs and additional funding. A positive feature of these meetings is the ability to track the ATO's performance between meetings and to follow issues as they evolve.

This inquiry has spanned two Parliaments, with much of the evidence being taken in 2006. I would like to thank the members of the previous Committee who

undertook this work and laid the foundation for the report. I would also like to thank the members of the current Committee for their assistance in working through the evidence and developing the report. In particular, I would like to thank two retiring members of the Committee, Senator Watson and Senator Murray, whose experience and expertise greatly assisted the inquiry. I wish them well in their future endeavours.

Unfortunately, by spanning two Parliaments, this report has been delayed. The Committee in this Parliament intends to better manage its work program so as to prevent a recurrence of the delay in tabling its report*s*.

I would also like to thank the individuals and organisations who made submissions to the inquiry and gave their time to give evidence in person. Parliamentary committees draw heavily upon the expertise of witnesses; the assistance of peak bodies, individuals, scrutineers, Treasury and the ATO is greatly appreciated.

Although a common perception is that there are few winners in tax administration, the community as a whole benefits through the public services that tax revenues make possible. The committee acknowledges that the ATO has a difficult job in convincing individual taxpayers of the public benefit of revenue collection.

The report concludes that whilst the ATO is reasonably successful in balancing fairness and efficiency, there is room for improvement. The committee is optimistic that if relevant agencies implement the recommendations in the report and governments deliver simpler tax legislation, then the downsides of tax administration can be minimised.

Sharon Grierson MP
Committee Chair

Membership of the Committee

41st Parliament

Chair	Mr Phil Barresi MP (from 6/2/07)	
	Hon Tony Smith MP (from 9/2/06 until 6/2/07)	
	Mr Bob Baldwin MP (until 7/2/06)	
Deputy Chair	Ms Sharon Grierson MP	
Members	Hon Bronwyn Bishop MP (from 16/8/05)	Mr Ken Ticehurst MP (until 29/5/06)
	Mr Russell Broadbent MP	Senator Mark Bishop (from 11/5/06)
	Ms Anna Burke MP (until 12/9/05)	Senator Grant Chapman (from 23/3/07)
	Dr Craig Emerson MP (from 12/9/05)	Senator John Hogg
	Ms Jackie Kelly MP	Senator Gary Humphries
	Dr Dennis Jensen MP (from 29/5/06)	Senator Claire Moore (until 11/5/06)
	Ms Catherine King MP	Senator Andrew Murray
	Mr Andrew Laming MP	Senator Fiona Nash (from 16/8/05 until 23/3/07)
	Hon Alexander Somlyay MP (until 16/8/05)	Senator the Hon. Nigel Scullion (until 16/8/05)
	Mr Lindsay Tanner MP	Senator John Watson

Membership of the Sectional Committee

41st Parliament

Chair	Mr Phil Barresi MP (from 6/2/07)	
	Hon Tony Smith MP (from 9/2/06 until 6/2/07)	
	Mr Bob Baldwin MP (until 7/2/06)	
Deputy Chair	Ms Sharon Grierson MP	
Members	The Hon Bronwyn Bishop MP(from 16/8/05)	Senator Gary Humphries
	Dr Craig Emerson MP(from 12/9/05)	Senator Andrew Murray
	Ms Catherine King MP	Senator John Watson

Membership of the Committee

42nd Parliament

Chair	Ms Sharon Grierson MP	
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Members	Hon Bob Baldwin MP	Senator Mark Bishop
	Hon Arch Bevis MP	Senator Grant Chapman
	Mr David Bradbury MP	Senator John Hogg
	Mr Mark Butler MP	Senator Kate Lundy
	Ms Catherine King MP	Senator Andrew Murray
	Mr Scott Morrison MP	Senator John Watson
	Mr Shayne Neumann MP	
	Mr Stuart Robert MP	

Membership of the Sectional Committee

42nd Parliament

Chair	Ms Sharon Grierson MP	
Members	Ms Catherine King MP	Senator Andrew Murray
	Senator Grant Chapman	Senator John Watson

Committee Secretariat

41st Parliament

Secretary	Mr Russell Chafer
Inquiry Secretary	Mr David Monk
	Dr Glenn Worthington
Research Officer	Mr David Ryan
Office Manager	Ms Frances Wilson
Administrative Officer	Miss Emily Shum

42nd Parliament

Secretary	Mr Russell Chafer
Inquiry Secretary	Mr David Monk
Administrative Officer	Miss Naomi Swann

Terms of reference

The Joint Committee of Public Accounts and Audit resolved to inquire into and report on the following:

Part A

the administration by the Australian Taxation Office (ATO) of the *Income Tax Assessment Act 1936* and *1997* (including the amendments contained in the *Tax Laws Amendment (Improvements to Self Assessment) Bill (No. 2) 2005)* with particular reference to compliance and the rulings regime, including the following:

- the impact of the interaction between self-assessment and complex legislation and rulings;
- the application of common standards of practice by the ATO across Australia;
- the level and application of penalties, and the application and rate of the General Interest Charge and Shortfall Interest Charge; and
- the operation and administration of the Pay As You Go (PAYG) system.

Part B

The Committee shall examine the application of the fringe benefit tax regime, including any "double taxation" consequences arising from the intersection of fringe benefits tax and family tax benefits.

List of abbreviations

AAT	Administrative Appeals Tribunal
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
GIC	General Interest Charge
ICAA	Institute of Chartered Accountants in Australia
JCPA	Joint Committee of Public Accounts
OBPR	Office of Best Practice Regulation
OECD	Organisation for Economic Co-operation and Development
PAYE	Pay as you earn
PAYG	Pay as you go
PS LA	Practice Statement Law Administration
RBA	Reserve Bank of Australia
RoSA	Review of Self Assessment
SIC	Shortfall Interest Charge
TR	Taxation Ruling

List of recommendations

1 Introduction

Recommendation 1

The Commissioner of Taxation continue to make himself available twice a year to attend public hearings on the administration of the tax system with the Joint Committee on Public Accounts and Audit in order to promote an open dialogue between the ATO and the Parliament.

2 Biannual meetings

Recommendation 2

The Government ensure that tax agents who give advice on tax evasion techniques, such as phoenixing, are subject to civil penalties, either through new legislation or enforcement of existing legislation.

3 Complex legislation

Recommendation 3

The Government introduce legislation to require:

- the reporting of compliance with the *Best Practice Regulation Handbook* in all explanatory material accompanying a regulatory proposal
- a summary of the requirements of the *Best Practice Regulation Handbook* in all explanatory material accompanying a regulatory proposal

- the relevant minister to table an explanation with the relevant Bill or Legislative Instrument in either House of Parliament if this reporting of compliance does not occur.

Recommendation 4

The Senate and House of Representatives Procedure Committees examine whether to incorporate regulatory impacts as part of the standard terms of reference for bills inquiries. The Procedure Committees can consider whether to develop a checklist to assist Parliamentary Committees in assessing regulatory impacts.

Recommendation 5

The Government and Treasury improve consultation on tax measures by:

- increasing the number of public consultations compared with confidential consultations
- increasing the number of consultations conducted prior to the announcement of the policy intent
- increasing the use of exposure drafts of legislation, where practicable.

Recommendation 6

In the discussion paper for the review, *Australia's Future Tax System*, Treasury and the review panel include the topic of basing the tax system on financial relationships and economic outcomes, ahead of legal forms.

Recommendation 7

In the discussion paper for the review, *Australia's Future Tax System*, Treasury and the review panel include the topic of reducing the number of taxpayers who need to lodge a return, and simplifying the experience for those who need to lodge, in particular:

- the costs and benefits of making work related expenses deductible
- whether tax offsets, rebates and benefits should be delivered as direct payments, rather than tax measures
- examining the number of tax rates and the tax free threshold
- improving the coverage and accuracy of the withholding system
- whether, if large numbers of taxpayers were no longer required to lodge returns, it would be appropriate to provide structural adjustment assistance to tax agents.

Recommendation 8

The discussion paper for the review, *Australia's Future Tax System*, consider the benefits of harmonising with New Zealand's tax system, even if just for particular taxes like fringe benefits tax, or for particular classes of tax.

4 Rulings

Recommendation 9

The ATO, in its annual report, compare its performance in relation to the 28 day service standard for private ruling requests with information on total elapsed time for these applications.

Recommendation 10

The ATO divide the 'larger businesses' category used for its performance reporting of the timeliness of private rulings into 'medium businesses' and 'large businesses.'

5 Compliance

Recommendation 11

Where the ATO has concerns about a judicial decision, it should publicly announce these concerns in the decision impact statement and commit to resolving the issue within 12 months through one or a combination of the following public actions:

- abiding by the initial decision
- appealing the decision and abiding by any subsequent decision
- referring the issue to Treasury as a policy matter.

Recommendation 12

The ATO develop a policy to support decisions involving periods of grace where it changes its view of the law. Unless there are exceptional circumstances, no period of grace should exceed 12 months.

Recommendation 13

The ATO establish and monitor compliance of protocols for determining when an investigation is an audit, when the audit commences, and when the ATO should inform the taxpayer of the audit.

Recommendation 14

The ATO amend its policies to limit the practice of issuing assessments that are contingent on each other, and specify in what circumstances such assessments may be validly issued. In the absence of administrative change, the Government introduce legislation to this effect.

6 Penalties and interest

Recommendation 15

The ATO increase its benchmarks for the technical quality reviews of penalty and other debt decisions.

Recommendation 16

The ATO explain the reasoning behind its settlement offers for large scale disputes in its public statements.

Recommendation 17

The ATO publish in its annual report additional statistics in relation to settlements, such as the revenue collected through settlements and the proportion of amended assessments that taxpayers agree to pay. The ATO should also comment on significant variations across business lines.

Recommendation 18

The ATO include in its annual report performance information about the amount of revenue collected through penalties and interest and the amount of revenue (divided between penalties and interest) remitted back to taxpayers. Where appropriate, this should be accompanied by discussion.

Executive summary

Introduction

In December 2005, the Committee resolved to inquire into tax administration. The terms of reference included self assessment, compliance, rulings, complex legislation, penalties and interest, and pay as you go (PAYG).

Self assessment is the dominant philosophy behind tax administration in Australia. It was introduced following an efficiency audit by the Australian National Audit Office (ANAO) on the Tax Office (ATO) in 1984. The ANAO found that the system of administrative assessment, where the ATO accepted most of the risk in its relationship with taxpayers, was placing the ATO under considerable pressure. The average time the ATO spent on assessing returns was one minute for individuals and four minutes for businesses. Further, taxpayers faced no disincentive to dispute the ATO's assessments and many regularly did so. This cost the ATO additional resources.

Self assessment was introduced for individuals in 1986-87 and for companies and superannuation funds from 1989-90. One of the key elements of self assessment is that it requires taxpayers to accept a certain amount of risk. If they make an error so that there is a tax shortfall, they must not only pay this amount, but interest and possibly penalties as well.

The first crisis in tax administration under self assessment occurred with the mass marketed investments schemes and employee benefit arrangements in the 1990s. Although the ATO was legally justified in its delayed response to these avoidance arrangements, its temporary inaction appeared to set a precedent to taxpayers and led to rapid growth in the schemes. This meant that when the ATO did take action, many taxpayers felt unfairly treated.

The previous Government's response was the report on aspects of income tax self assessment (RoSA), which shifted some risk from the taxpayer back to the ATO. The ATO now has less time in which to amend some categories of assessments. A

reduced interest rate (the Shortfall Interest Charge) is applied to tax debts until the ATO issues the amended assessment.

Some submissions sought to transfer additional risk back to the ATO by arguing for a partial return to administrative assessment. Given the experience of the 1980s, the Committee did not believe this was appropriate. The lesson the Committee prefers to draw from this history is that there is a fine balance of risk between taxpayers and the ATO under self assessment. This balance needs to be regularly monitored and refined when necessary. The Committee's inquiry is an example of this ongoing process.

Biannual meetings

During the inquiry, the Committee proposed to the Commissioner of Taxation that there be biannual public meetings between the ATO and the Committee. Although the meetings give the Committee an opportunity to hold the ATO to account, they also give the ATO the opportunity to demonstrate that it performs at a high standard, to both the community and the Parliament.

The Committee has held three biannual meetings to date and is pleased with progress. On some issues, the ATO has provided a reasonable explanation of its conduct. On other matters, the ATO has demonstrated that it is taking corrective action. Often, this occurs over time. The Committee anticipates that some issues will evolve between successive meetings, such as is occurring with the superannuation guarantee.

Complex legislation

The integrity of the self assessment system depends on taxpayers having a high rate of accuracy in completing their tax returns. Currently, Australia's tax system works against this because of its complexity. In a survey of the world's 20 largest economies in 2004, Australia had the third most voluminous primary federal tax legislation. The tax amendments in 2006 that removed duplicated provisions would, all else being equal, drop Australia to fourth on this list. Tax complexity in Australia is such that 97% of businesses and 74% of individuals use tax agents.

One of the reasons for this is the judiciary have used legal definitions from other aspects of the law, such as tort and trusts, when interpreting tax legislation. The use of non-financial definitions in the tax area has made it easier for tax advisers to change the legal form of transactions to generate tax benefits for clients. Successive governments have responded with stop-gap measures to prevent this activity, which themselves create another avoidance reaction from advisors. This process has resulted in a complex system.

While commentators have questioned whether tax advisors should construct elaborate minimisation schemes, ultimate responsibility lies with the Parliament and successive governments. Instead of taking a global, long term view of the tax system, they have sought to protect the revenue over the short term. Further, they have added to complexity themselves by using the tax system to implement spending programs, rather than concentrating on efficiently collecting revenue.

Fifteen years ago, the Joint Committee on Public Accounts recommended that the best way to address complexity would be to conduct wide ranging consultations to develop bipartisan tax policy. Sound policy development would lay the foundation for simpler legislation. The current Government has announced a comprehensive tax review, *Australia's Future Tax System*. This review has the potential to deliver the necessary policy foundation for tax simplification.

Regardless of the outcome of the review, there will continue to be tax amendments. The Committee has made a number of recommendations to improve the development of tax policy and legislation. These include transparency about compliance with regulatory better practice, increasing the proportion of consultations conducted publicly, and increasing the amount of consultation conducted before governments announce their policy intent.

Rulings

Rulings had their origins in the ATO's internal policies and interpretations that it prepared to ensure consistency in decision making. As the community sought greater transparency from the ATO, it published them. Taxpayers need to obtain advice from their tax authorities and the authorities should stand by this advice. Rulings, which are binding on the ATO, are one way of accomplishing this. In a system of self assessment, where taxpayers take on appreciable risk, rulings are fundamental.

From evidence presented to the Committee and independent reviews of the ATO, it appears that the ATO is meeting the necessary technical standards in relation to both public and private rulings. The establishment of the rulings panels (which include external members) have improved perceptions of public rulings. However, the Inspector-General's recent review of private rulings has shown that a lack of ATO transparency and poor communication has affected perceptions of private rulings. Implementing the Inspector-General's recommendations will assist the ATO in this area.

The timeliness of private rulings was the main issue raised in evidence about rulings. A number of factors are responsible for the delays. For example, tax laws are so complex that taxpayers have significant potential demand for private rulings from the ATO. Because the rulings are free, private rulings could

potentially be a similar drain on the ATO as administrative assessment was in the early 1980s.

The delays act as a deterrent to taxpayers obtaining private rulings. Many taxpayers, especially in business, have a narrow time frame in which to make financial decisions. The delays in private rulings make them much less attractive to taxpayers.

The Committee's recommendations in this chapter are aimed at improving the ATO's performance reporting of timeliness of private rulings. For example, one recommendation is for the ATO to report the elapsed time for applications (the time between the application and the ATO issuing the ruling).

Compliance

Compliance work is the most sensitive area of the ATO's administration of the tax system. The Committee is satisfied that the ATO's compliance model is a suitable foundation for this because it assists compliant taxpayers and encourages taxpayers in general to comply with the tax laws.

The key issue in this chapter was the *Essenbourne* case, decided in 2002. This involved an employee benefit arrangement where a business transferred money to a trust. The three brothers who ran the business were the beneficiaries of the trust. The issues were whether the business could claim a tax deduction for the payment and whether the brothers had received a taxable fringe benefit, which would create a tax liability for the business as well.

In *Essenbourne*, the ATO won on the deduction but lost on the fringe benefits tax. The ATO declined to follow *Essenbourne* in relation to fringe benefits tax and stated that it would pursue further litigation, without appealing *Essenbourne*. In 2007, the Full Federal Court in *Indooroopilly* confirmed *Essenbourne* and criticised the ATO for not following it. The Full Federal Court suggested that the ATO's conduct raised constitutional issues.

Out of all the matters raised with the Committee during the inquiry, the Committee is the most concerned about *Essenbourne*. The Committee agrees with the Full Federal Court that a court decision is the law and should be followed. Either appealing the decision, or accepting it and referring the issue to Treasury as a policy matter, is consistent with the ATO's role as an independent administrator of the tax laws.

The Committee accepts that many of the taxpayers in employee benefit arrangements took a conscious decision to push the boundaries of legal conduct to pay less tax. But in *Essenbourne*, the ATO has allowed its critics to argue that it

pushes the boundaries of the law as well. This has endangered much of the ATO's good work in establishing, promoting and being guided by the compliance model.

Penalties and interest

The ATO has the power to impose penalties and charge taxpayers interest. The two main types of penalties involved in this inquiry relate to taxpayers incurring a tax shortfall (where the tax return understates tax payable) and failure to lodge a return or other document. The ATO has a certain amount of discretion for shortfall penalties because the penalty amount is based on the ATO's assessment of the culpability of the taxpayer's conduct.

The ATO applies interest when a taxpayer does not meet their tax liability by the required time. The interest charges are the Shortfall Interest Charge (SIC) and the General Interest Charge (GIC). The GIC is 4% higher than the SIC. Where the ATO issues an amended assessment to a taxpayer, it applies SIC to the shortfall for the period between the lodgement of the return and the amended assessment. After that, the ATO applies the GIC. In all other cases, the ATO applies the GIC. The ATO has no discretion in calculating and applying these amounts.

The ATO's discretion lies in remitting penalties and interest. It has developed a number of policies for this. They focus on the taxpayer's compliance history, the taxpayer's conduct and whether the ATO contributed to the taxpayer incurring the penalty/interest. The evidence did not indicate that substantial change to the ATO's practices was necessary.

Where a taxpayer has significant bargaining power, the ATO may negotiate a settlement with them. This might occur when the ATO faces evidence problems in litigation or the cost of litigation is out of proportion to the possible benefits. It is widely accepted that settling can be an efficient way to conclude a matter. Once again, the ATO has a policy to govern this activity and the Committee did not receive compelling evidence for change.

The main issue to arise in relation to tax debt was perceptions. For example, the Committee received statements that the ATO makes ambit claims in settlement negotiations and gives wealthy taxpayers preferential treatment. Stakeholders commented that the ATO is not consistent in its settlement offers to participants in different schemes.

Therefore, the recommendations in the chapter again concentrate on transparency. The Committee is of the view that the ATO should publish information on the revenue involved in penalties, interest and remissions. It should also explain the reasoning behind its settlement offers for large scale disputes.

Pay as you go

A long standing feature of the tax system in Australia has been for taxpayers to pay their tax throughout the year, rather than wait for the ATO to issue an assessment after the year is over. The advantage for taxpayers is that it is easier for them to manage their cash flow. Further, requiring employers to pay these amounts on behalf of their employees is more efficient than asking employees to do this themselves individually.

The ATO faces a particular challenge in collecting tax debt. It cannot withhold supply from taxpayers and so does not have many options apart from traditional debt collection activities. Therefore, the PAYG system has taken a preventive approach by encouraging overpayments that are returned to taxpayers after they lodge their return. The Committee notes that many individuals are comfortable with this sort of commitment device. Further, PAYG instalment taxpayers have the option of conducting their own 'squaring up' when they lodge their final business activity statement for each financial year. Therefore, the Committee believes that the current framework strikes a reasonable balance between the interests of taxpayers and government.

Conclusion

The main challenge in Australian tax administration is the complexity of the tax system. Under self assessment, this has imposed significant compliance costs on taxpayers and pushed large numbers of taxpayers into using tax agents. In effect, complexity has increased the tax burden. A simpler system will deliver savings to both taxpayers and government and allow entrepreneurs to focus on growing their business, rather than complying with arbitrary tax rules.

1

Introduction

Self assessment

1.1 The dominant feature of the tax environment today is the principle of self assessment. The Australian Taxation Office (ATO) has outlined how self assessment works in practice:

> Under the self-assessment system, the claims a taxpayer makes in their tax return are accepted by the Tax Office, usually without adjustment, and an assessment notice is issued. Even though we may initially accept the tax return, the return may still be subject to further review.
>
> To ensure the integrity of the tax system, the law provides the Tax Office with a period where it may review a return (and make sure all income has been included) and may increase or decrease the amount of tax payable. We may amend an assessment up to four years (or two years for shorter period of review taxpayers) after tax became due and payable under the assessment. Where anti-avoidance provisions apply, the period is extended to six years. Where the avoidance is due to fraud or evasion, there is no time limit on amending the assessment.[1]

1.2 Self assessment largely determines the way that taxpayers and the ATO interact. Self assessment has also largely determined the issues that have come before the committee during the inquiry. In particular, claims of

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1 ATO, 'Self assessment and the taxpayer' viewed on 26 March 2007 at http://www.ato.gov.au/individuals/content.asp?doc=/content/13685.htm.

unfair costs imposed on taxpayers by self-assessment emerged as a theme in three ways:

- the level of complexity of the tax system and resulting uncertainty for taxpayers
- the costs of ensuring adequate compliance with tax obligations
- the consequences for mistaking tax obligations because of a regime of interest charges and penalties.

1.3 In order to put these issues in context, this section outlines why self assessment is the current philosophy underlining tax administration in Australia.

The Australian National Audit Office's 1984 efficiency audit

1.4 The precursor to this Committee, the Joint Committee on Public Accounts (JCPA), has explained how the tax system used to work prior to the introduction of self assessment:

> …a taxpayer would lodge a return containing information from which the ATO assessors would prepare a statement (an assessment) of the taxpayer's taxable income and tax payable. A 'notice of assessment' would then be issued and the amount payable would become a debt due in accordance with the statutory period for paying taxation debts.
>
> A taxpayer had the right to object to the assessor's calculations of the debt due and the ATO was then required to review the taxpayer's case. By the early part of the 1980s this review procedure was placing considerable strain on the ATO's resources. [Much of [the] growth [in taxpayer objections] was attributable, in the ATO's view to, 'taxpayers attempting to delay or avoid payment of tax by involvement in "scheme" activities'.[2]] In 1983-84 the number of objections against assessment numbered in excess of 236,000…
>
> Moreover, with approximately 10 million income tax returns to assess annually and with quotas applying to assessors, it had been calculated that, on average, an individual taxpayer's return would have received an optimum of one minute of scrutiny by the ATO assessors. Using the historical number of staff available for performing the assessment function, the same type of calculation

2 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 19.

> suggested business returns would have been considered, on average, for four minutes…[3]

1.5 One of the problems with the previous system was how incentives operated for different parties. For example, taxpayers did not have a disincentive to dispute the ATO's assessments.

1.6 As the Inspector-General of Taxation noted, the ATO's processes at this time were unsustainable.[4] In 1984, the Australian National Audit Office (ANAO) finalised a report on four efficiency audits (now referred to as performance audits) of tax administration. In its foreword, the report stated:

> …a major contribution to resolving many of the problems faced by the Office might be made not by the provision of further staff but by the more productive and effective use of those already engaged. It appears that such an outcome could be achieved.
>
> Each of the three major audits has demonstrated a need for the ATO to take a fresh look at current practices that have outlived their usefulness, no matter how effective and essential they may once have been…
>
> But it is in connection with income tax assessing that the most fundamental questions arise. The latest annual report of the Commissioner disclosed that over 2,000 officers work as income tax assessors throughout Australia. It is observed that every effort has been made by the ATO to restrict the assessing function to the barest of essentials…
>
> However, the audit findings have raised some serious doubts about the purpose and effectiveness of the assessing processes.
>
> Audit has suggested that careful consideration be given by the ATO to the introduction of computer processing of income returns with a view to producing assessments, initially without assessor intervention. With appropriate analytical techniques, those income tax returns to which particular attention should be paid could be identified or rejected. It would then seem possible to subject only those returns most open to query of objection to the detailed physical examinations that the assessors now make of all returns.[5]

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3 JCPA, *Report 326, An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) pp 63-64.

4 Inspector-General of Taxation, sub 48, p 11.

5 ANAO, *Reports of the Auditor-General on Efficiency Audits, Controls over Processing of Income Tax Assessments* (1984) Australian Government Publishing Service, p iii.

1.7 In other words, the ANAO was advocating a change from equality of process for each taxpayer to a system of risk management. The attention a taxpayer received from the ATO would be in proportion to the risk they represented to the revenue.

1.8 In 1986-87, the Australian Government introduced a requirement for taxpayers to self-assess their tax liability. Full self assessment for companies and superannuation funds was required as of 1989-90.[6]

1.9 In line with the new approach, tax returns were simplified. Instead of showing the ATO how the taxpayer arrived at the final result, they now contain only a few important entries and some questions that help the ATO assess risk.[7] In order to make the new system more robust, the Government introduced an interest charge on unpaid tax to apply for the period between the ATO's initial assessment and any amended assessment.[8]

1.10 Recognising that many taxpayers would not necessarily have a good grasp of tax law, the Government also introduced a system whereby taxpayers could request the ATO's opinion about certain aspects of their tax liability.[9]

1.11 The impact of these mechanisms on taxpayers and their effectiveness were key issues during the inquiry.

The committee's 1993 review of self assessment

1.12 In November 1991, the JCPA began a comprehensive inquiry into the administration of tax in Australia. In November 1993, the Chair of the Committee, Mr Les Scott MP, presented *An Assessment of Tax: A Report on an Inquiry into the Australian Tax Office* in the House of Representatives.[10]

1.13 *An Assessment of Tax* began by acknowledging that the operations of the ATO regularly received parliamentary scrutiny.[11] However, the JCPA inquiry:

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6 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 65-66.

7 Cooper G et al, *Cooper Krever & Vann's Income Taxation: Commentary and Materials* (2005) Thomson, 5th Edition, p 875.

8 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 65.

9 Ibid.

10 Mr L J Scott MP, *House Hansard*, 17 November 1993, p 2,978.

11 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 3.

> …was the first major public examination of the manner in which taxation laws are administered in Australia since the passing of the *Income Tax Assessment Act 1936*.[12]

1.14 *An Assessment of Tax* was also the first major examination of the self assessment system. The Government accepted 115 of the 148 recommendations in the report. These included:

- the introduction of a Taxpayers' Charter
- making public rulings more comprehensive and accessible
- making private rulings more accessible to the public
- the establishment of a Taxation Ombudsman
- the introduction of a test case program to fund taxpayers' legal costs where the legislation is unclear.[13]

Should self assessment continue?

1.15 A number of submissions noted that self assessment allows the ATO to be more efficient in collecting tax. Resources saved on the initial assessments can be directed to audits. However, self assessment has imposed extra costs on taxpayers. They must effectively know the tax system as well as the ATO to ensure their returns are as accurate as possible to avoid the interest charges applied for making an error. Taxpayers faced much less risk before 1986-87.[14]

1.16 In some respects, the requirements imposed on taxpayers are higher than those placed on the ATO because taxpayers must accurately self assess shortly after the end of the financial year. Generally, the ATO has between two and four years after a tax return is lodged before it needs to satisfy itself that the return is correct.[15] This mismatch has resulted in 97% of businesses and 74% of individuals using tax agents.[16]

1.17 The complexity of the tax laws has compounded these issues. Self assessment requires taxpayers to correctly understand the law and many

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12 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p vii.

13 ATO, 'Final Report on the Implementation of the Recommendations of Report 326 "An Assessment of Tax'", Correspondence, 20 October 1998.

14 Chamber of Commerce and Industry of Western Australia, sub 26, p 6, Taxation Institute of Australia, sub 40, p 6.

15 CPA Australia, sub 36, p 7, Resolution Group Australia, sub 42, pp 6-8.

16 ATO, sub 50, p 35.

of these complexity costs have been borne by taxpayers.[17] In its submission, the Taxation Institute of Australia stated:

> …there remains a perception in the community that the onus for getting it right, even where the law is unclear, still lies unfairly on the least resourced member of the ATO/taxpayer relationship - the taxpayer. In light of the complexity that underlies our income tax laws, this burden remains and the Taxation Institute is of the view that this burden should be shared more equally.[18]

1.18 These factors led some groups to propose to the committee that the current self assessment system be wound back to a form of modified pre-assessment, or administrative assessment. The submissions did not explain how this might work in practice, but their general wish that the ATO play a greater initial role in tax assessment was clear.[19] For example, CPA Australia argued:

> We acknowledge that the ATO has been working very hard in recent years to try to make things easier for taxpayers and agents. However, these efforts appear to be really made within the constraints of the current system, some of which have been designed by them, rather than stepping well back to look at the underlying system.
>
> In the circumstances, therefore, it may be appropriate for the Government to consider a move to a modified self-assessment system for most individual and small business taxpayers to give them greater comfort that their returns have been assessed and relevant issues raised as appropriate before any final assessment is issued. We note in this context, however, that the recent move to a two year review period for individual and STS taxpayers goes some way towards meeting this objective.[20]

1.19 In assessing the proposal for a form of administrative assessment, the committee first noted the JCPA's comments in *An Assessment of Tax* in relation to the efficiency consequences on the ATO of a return to administrative assessment:

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17 Inglis M, 'Is Self-assessment Working? The Decline and Fall of the Australian Income Tax System', *Australian Tax Review* (2002) vol 31, pp 64-78.

18 Taxation Institute of Australia, sub 40, p 6.

19 For example, see Chamber of Commerce and Industry of Western Australia, sub 26, p 2, Fehily Loaring, sub 5, p 2.

20 CPA Australia, sub 36, p 7.

> …on the basis of cost efficiency alone the Committee concluded that it was unlikely that a return to a system of ATO assessment could be justified in terms of the consequences for revenue.[21]

1.20 The current Committee also examined the practices in other countries, in particular within the OECD. Fourteen out of 30 OECD countries use self assessment for personal income tax. These include Canada, Ireland, the UK and the USA.[22] So self assessment is commonly used in other advanced economies.

1.21 Treasury, which is the primary agency for tax policy in the Government, wished to retain self assessment. In relation to the proposal put to the Committee, it stated:

> It is unclear that such a system would provide a substantial increase in taxpayer certainty, compared with the Private Binding Ruling system, while having the clear potential to generate significant additional processing and administrative costs for the Tax Office (with implications for all taxpayers).
>
> Unlike Private Binding Rulings, which can be obtained before a transaction occurs, taxpayers using this proposed system would not be able to determine the Commissioner's view on the correct taxation treatment for a particular transaction prior to entering into the transaction.[23]

1.22 The ATO supported self assessment, both in terms of protecting the revenue and in how most people perceive it:

> I do not have those figures but, in terms of tracking to budget estimates, we have continually been at budget estimates or above, which reflects our expectations of what would be claimed as deductions and what would come in as income and it is reflected in the results. From that perspective, the system is working as expected, albeit that there are always improvements that can be made…
>
> The big iceberg to my mind works well. Most people do not see an issue.[24]

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21 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 68.

22 OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006),* October 2006, pp 57, 69-71, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf.

23 Treasury, sub 51.1, p 5.

24 D'Ascenzo M, transcript, 20 April 2007, p 1.

1.23 Finally, the Inspector-General of Taxation, who operates independently of the Government, also believed that self assessment should continue:

> Self assessment was introduced by the government in consultation with tax practitioners and there is no doubt that self assessment works well and to the benefit of the vast majority of taxpayers. It has provided efficiency gains to taxpayers. For example, those with simple affairs can lodge a return through their tax agent or e-Tax and have their assessment issued within 14 days. It has certainly benefited the Tax Office, with it no longer being required to scrutinize every tax return. There cannot be, and should not be, any question of turning back to the era of full assessment.[25]

1.24 The Committee accepts that self assessment has led to some difficulties, in particular where the tax law is complex and taxpayers must expend resources to ensure their tax returns comply with the law. Just as the ATO was under considerable pressure in the first half of the 1980s, taxpayers and tax agents are now themselves coming under pressure to comply with the tax system.

1.25 Self assessment of itself, however, has not solely been responsible for these concerns. The problem is that self assessment operates within an environment of complex legislation, public and private rulings, and administrative discretion exercised over audits, settlements, and the remission of penalties and interest. The answer to taxpayer difficulties with self-assessment is not to increase the use of tax agents, or to increase the role and function of the ATO on taxpayers' behalf, but to decrease the onus on the taxpayer by simplifying the tax law and tax process.

1.26 The subsequent chapters of this report demonstrate that tax laws, in particular, need to be simplified. Further, this chapter demonstrates that a number of reforms have been implemented that bring more balance to the ATO/taxpayer relationship. In light of these reforms and the potential to simplify the tax legislation, the Committee does not support any changes to the basic principle of self assessment.

25 Inspector-General of Taxation, sub 48, pp 4-5.

Aggressive tax planning in the 1990s

Description of the investments

1.27 The major incident involving self assessment since its inception arose during the mid-1990s in relation to mass marketed investment schemes and employee benefit arrangements. Deductions for these investments grew from $170 million in 1993-94 to $1.4 billion in 1996-97.[26]

1.28 The average tax debt under the mass marketed investment schemes was $42,000.[27] The ATO outlined to the committee the characteristics of the schemes:

- based on a public offer document (prospectus);
- were often supported by a legal opinion;
- promoted to a mass audience;
- were often aggressively marketed to participants who had no control over, and very little knowledge of, the internal workings of the arrangements; and
- may rely on common structuring features including:
  - ⇒ round robin financing;[28]
  - ⇒ limited or non-recourse loans;[29] and
  - ⇒ participant obligations limited to investment profits.[30]

1.29 The ATO came to the opinion that these schemes were established for the dominant purpose of obtaining a tax benefit, and hence applied the anti-avoidance provisions of Part IVA of the *Income Tax Assessment Act 1936*. The ATO's reasons included:

- apart from subscribing to the scheme, participants have no hands-on involvement and therefore are not carrying on a business;
- financial arrangements involve limited- or non-recourse loans, often based on round robin arrangements;
- high up-front management fees geared to create inflated tax deductions;

26 Senate Economics References Committee, *Inquiry into Mass Marketed Effective Schemes and Investor Protection, Interim Report* (2001) p 16.

27 Calculated from information presented by the Inspector-General of Taxation, sub 48, p 12.

28 Round robin financing is a circular transfer of funds between entities that leaves no change in their total cash.

29 Non-recourse loans are where the lender cannot access the borrower's other assets if the borrower defaults. Limited recourse loans are where the lender's access to the borrower's other assets is limited to the borrower's profits from the scheme.

30 ATO, sub 50.1, p 22.

- participants have little or no practical control over the scheme's management;
- limited exposure to risk; and
- in some cases, a guarantee from promoters to reverse the transaction if claimed tax deductions are not allowed.[31]

1.30 In legal terms, there is no doubt that the ATO was correct in disallowing these deductions. The Federal Court considered six cases involving mass marketed investment schemes and disallowed the deductions in all six. In two of these, the taxpayer sought to appeal to the High Court, which refused leave in both cases.[32] In its reports on these schemes, the Senate Economics and References Committee stated:

> …a large number of these schemes appeared to be designed specifically to defraud the tax system and to use ordinary taxpayers in that process. Not only have they left many taxpayers with large tax bills, but many of these schemes have ceased to exist. The Committee is of the view that few schemes represented 'a good investment' in the ordinary meaning of the term, and that without the 'tax deductibility' factor, very few would have got off the ground.[33]

1.31 Employee benefit arrangements were significantly different to mass marketed schemes. Firstly, the average tax debt was higher at $156,000.[34] These investors were more sophisticated and needed to be employers to set up the appropriate financial structures.

1.32 There was a variety of arrangements established. The ATO described the simplest of these, employee share or incentive plans, as follows:

- The employer entity establishes a special purpose company.
- Shares or membership interests are allocated to selected employees for a nominal amount in the special purpose company.
- The employer contributes a sum of money to the special purpose company, greatly increasing the value of the employees' shares or membership interests.
- The special purpose company invests the contribution amounts on behalf of the employees, often lending the contribution back to the employer entity or their associate…

31 Senate Economics References Committee, *Inquiry into Mass Marketed Effective Schemes and Investor Protection, Interim Report (*2001) p 4.

32 ATO, sub 50.1, pp 7-8, 31-33.

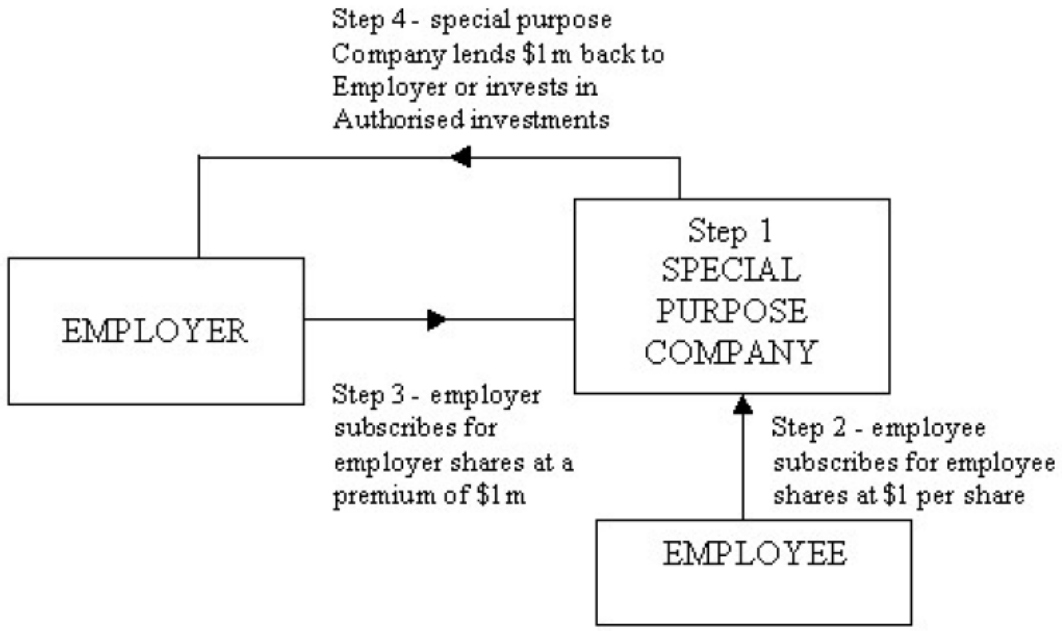
33 Senate Economics References Committee, *Inquiry into Mass Marketed Effective Schemes and Investor Protection, Interim Report* (2001) p 2.

34 Calculated from information presented by the Inspector-General of Taxation, sub 48, p 12.

> Employee share or incentive arrangements are designed to provide the employer with an effective incentive plan for employees. However, the only employees who generally participate in such plans are the controllers of the employer business.[35]

1.33 The share/incentive plan is demonstrated below.

Figure 1.1 Employee share or incentive plan



Source ATO, sub 50.1, p 25.

1.34 The taxpayers' arguments in these cases is that the employer's payment to the special purpose company is allowable as a deduction for the employer and avoids fringe benefits tax, the superannuation guarantee charge, payroll tax and workcover. Other advantages are that the employee's income is not subject to the superannuation contribution surcharge and contributions to the company are not subject to the 15% tax on superannuation contributions.[36]

1.35 The artificial nature of the arrangement becomes clear when one examines figure 1.1 and notes that the employer and employee were often the same people and providing funds to themselves. The ATO disagreed with these taxpayers on a number of issues, including:

- the employer's contributions may be subject to fringe benefits tax

35 ATO, sub 50.1, p 25.

36 ATO, sub 50.1, pp 25-26.

- the contributions may be subject to income tax for the employee
- the employer's contribution may not be allowable as a deduction.[37]

1.36 Apart from the special circumstances in the case of *Indooroopilly Children's Services*,[38] the ATO has won all the cases where it has challenged employee benefit arrangements, mainly on the grounds that the payments did not represent a deduction for the employer. As one judge stated:

> The ability of a private company employer to obtain unlimited deductions for contributions made to a superannuation fund benefiting employees who are directors and shareholders without either the trustee of the fund being liable to pay tax on the amounts contributed or the employer being liable to pay fringe benefits tax must be the holy grail for tax planners. This is what was offered to the applicant in the present proceedings ... by a well known firm of chartered accountants.[39]

1.37 Viewed as a revenue issue, mass marketed investment schemes and employee benefit arrangements have been satisfactorily resolved. The ATO has initiated court cases that have set legal precedents which confirm these investments are subject to the usual taxes. However, what set these investments apart is that a large number of investors felt they had been treated unfairly.

Why did investors feel unfairly treated?

1.38 In the case of mass marketed investment schemes, the first reason why many investors felt they had been treated poorly was that the schemes were aggressively marketed and many taxpayers were not fully aware of what they were signing up to.[40] Experience has shown that ordinary Australians often trust marketers and promoters who use written accounting and legal opinion, and/or testimonials, to give their schemes credibility. That such material is often merely opinion that has not been verified by credible authorities such as the Australian Securities and Investments Commission or the ATO, does not occur to them. As the Senate Committee discovered, the affected taxpayers felt let down when later on the tax deductions were disallowed and penalties imposed. Although it was a misguided view, such taxpayers still often blamed the

37 ATO, sub 50.1, p 26.

38 This case is discussed in chapter five.

39 Justice Hill, quoted by the ATO, sub 50.1, p 10.

40 ATO, sub 50.1, p 7.

authorities, as they felt that they had been put in a position where they could be 'conned'.

1.39 As an example of the sales techniques used, the ATO provided the Committee with a transcript from an instructional tape for scheme promoters:

> Furthermore you've got a $20,000 loss which you can forward on to next year and because you're on 48.5 cents in the dollar means you'll get another $9,700 in your hand next year in July or you've got a choice of about $800 a month. Now here come the first close that I use.
>
> 'Now John, what would you prefer? $800 a month or the other $9,700 at the end of next July as a lump sum?' And shut up. Let them make the choice 'cos by them making the choice they're already going to say yes to the deal...
>
> …when you say the words 'licensee' say 'you, now owning a licence, are the licensee' – refer to them as the licensee. It also helps to gives them the impression that they've already bought because you're starting to call them the licensee.[41]

1.40 The next reason many investors felt they had been treated unfairly, for both the mass marketed schemes and the employee benefit arrangements, was that the ATO delayed its reaction to the investments.[42] If investors were able to make the deductions in one financial year and the ATO did not query them, then it tended to set a precedent for future years and the investments grew in size. This also demonstrates that many individuals do not fully understand self assessment because the ATO has the right to issue amended assessments for some period after the initial assessment.[43]

1.41 Consistent with this lack of understanding of self assessment, many investments were promoted using private rulings from the ATO. The basis of private rulings is that they bind the ATO, but only in relation to that particular taxpayer and only if the taxpayer follows the facts and processes set out in the ruling. The ATO had issued private rulings for both the schemes and arrangements and promoters used these for the investments, despite them being for different investors and sometimes for

41 ATO, sub 50.1, p 5.

42 ATO, sub 50.1, p 4.

43 Commonwealth Ombudsman, sub 38, pp 5-6.

different schemes.[44] A close reading of the rulings would often indicate that their precedent value was reduced.

Current status of the investments

1.42 Following the inquiry by the Senate Economics References Committee into mass marketed investment schemes, the ATO made a settlement offer to 'typical' investors on 14 February 2002. These tended to be people who had a good tax record, were subject to aggressive marketing and lacked full knowledge about the schemes and the tax system. Both the ATO and the Senate Committee distinguished between unsophisticated investors, and sophisticated investors and promoters. The former were offered 'gentler' settlement terms than the latter.

1.43 The offer to typical investors was open until 21 June 2002. The offer comprised:

- a tax deduction for the cash outlaid under the investment
- full remission of penalties and interest
- a two year interest free period for repayment, provided the taxpayer entered into a suitable payment arrangement.[45]

1.44 In other words, the settlement allowed the deductions for cash outlaid up until the ATO raised its concerns with taxpayers. For these investments, the self assessment system (allowing the ATO to later amend assessments) was converted back to administrative assessment (restricting the ATO to what it detects when it issues the initial assessment).

1.45 In June 2006, the ATO stated that 98% of scheme investors had finalised their dispute, with 82% having paid their tax and a further 9% with payment arrangements in place.[46]

1.46 On 5 August 2004, the Inspector-General of Taxation finalised his report into employee benefit arrangements, *Review of the Remission of the General Interest Charge for Groups of Taxpayers in Dispute with the Tax Office*. On 18 November 2004, the ATO announced settlement offers for investors involved with employee benefit arrangements. There were five types of offer depending on the taxpayer's individual circumstances. Further, each

44 ATO, sub 50.1, p 9, Senate Economics References Committee, *Inquiry into Mass Marketed Effective Schemes and Investor Protection, Interim Report* (2001) pp 23-24.

45 ATO, 'Mass marketed investment schemes – an overview' viewed on 15 February 2007 at http://www.ato.gov.au/print.asp?doc=/content/59719.htm.

46 ATO, sub 50.1, p 7.

offer varied, depending on whether the taxpayer was prepared to give up their objection and appeal rights.[47]

1.47 The most generous conditions were offered if the taxpayer relied on the ATO's advice about the arrangement and advised the ATO of their arrangement during the safe harbour period. If the taxpayer was prepared to give up their objection and appeal rights, the ATO offered the following settlement:

- only one tax (either income tax or fringe benefits tax) would be levied
- 5% penalty on the primary tax
- interest charged at 4.72%
- a payment plan could be agreed, with interest charged at 4.72%.[48]

1.48 The least generous offer was made for taxpayers who did not have any advice from the ATO and did not provide information when requested by the ATO. If the taxpayer was prepared to give up their objection and appeal rights, the ATO offered the following settlement:

- only one tax (either income tax or fringe benefits tax) would be levied
- 10% penalty on the primary tax
- full General Interest Charge applied (approximately 12%)
- a payment plan could be agreed, with interest charged at 6.28%.[49]

1.49 In June 2006, the ATO stated that 90% of arrangement investors had finalised their dispute, with 88% having paid their tax and a further 2% with payment arrangements in place.[50]

1.50 Since the problems with these investments came to light, the ATO and the Government have implemented a number of reforms that have greatly reduced the chances of such an incident re-occurring. These include:

- Since 1998, the ATO has issued product rulings, a type of public ruling, that applies only to that specific type of investment. It is now very hard for anyone to market an investment without such a ruling.[51]

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47 ATO, 'Options for employee benefit arrangement participants' viewed on 30 March 2007 at http://www.ato.gov.au/atp/content.asp?doc=/content/47656.htm.

48 Ibid.

49 Ibid.

50 ATO, sub 50.1, p 7.

51 Senate Economics References Committee, *Inquiry into Mass Marketed Effective Schemes and Investor Protection, Interim Report* (2001) p 33.

- The ATO publishes its compliance program, making public its analysis of the risks to the tax system.
- The ATO releases taxpayer alerts, which are early warnings about emerging, potential tax risks.
- Promoters' conduct after 6 April 2006 is now potentially subject to civil penalties under the *Taxation Laws Amendment (2006 Measures No 1) Act 2006*.[52]

Recent reforms to tax administration

1.51 The fairness issues raised following the mass marketed investment schemes and employee benefit arrangements led to a number of reforms. These included:

- the establishment in 2000 of the Board of Taxation, a non-statutory advisory body which provides an avenue for business and the community to contribute to the design and operation of tax laws[53]
- the establishment in 2003 of the Inspector-General of Taxation, who independently reviews the ATO's administration of tax laws[54]
- the commencement in 2006 of promoter penalties legislation, which allows the ATO to apply to the Federal Court for a civil penalty against the promoters of illegal tax schemes[55]
- the introduction in 2007 and 2008 of exposure draft legislation for a new regulatory system for tax agents.[56]

1.52 Although not explicit in some of the ANAO's reports, it appears the ANAO also responded to concerns about how the ATO treated these investments. These audits, which this report refers to where relevant, covered:

- debt recovery (1999)

52 ATO, sub 50.1, pp 13-17.

53 Treasury, sub 51, p 3.

54 Id, pp 3-4.

55 *Taxation Laws Amendment (2006 Measures No 1) Act 2006*.

56 Hon P Dutton MP, Minister for Revenue and Assistant Treasurer, 'Tax Agent Services – Release of Exposure Draft Legislation' Media Release, 7 May 2007, Hon C Bowen MP, Assistant Treasurer, Minister for Competition Policy and Consumer Affairs, 'Government Releases Draft Legislation for Tax Agent Services Regime, Media Release, 29 May 2008.

- penalties (2000)
- the rulings system (2001)
- aggressive tax planning (2004).

1.53 Probably the most important response to mass marketed investment schemes and employee benefit arrangements was the review of self assessment (RoSA).

Report on aspects of income tax self assessment

1.54 On 24 November 2003, the Government commissioned Treasury to conduct RoSA. The review reported to the Government in August 2004 and made 54 recommendations.

1.55 Treasury stated that:

> In December 2004 the Government announced that it would adopt all of RoSA's recommendations…:
>
> - The first tranche of RoSA legislation, comprising the *Tax Laws Amendment (Improvements to Self Assessment) Act (No. 1) 2005* and *Shortfall Interest Charge (Imposition) Act 2005*, received Royal Assent on 29 June 2005. Those Acts reduced the consequences of errors in assessment for taxpayers who act in good faith, by providing for a lower rate of interest for the period before they are notified of their error [the Shortfall Interest Charge], and by making refinements to the penalty regime.
> - The second tranche of RoSA legislation, comprising the *Tax Laws Amendment (Improvements to Self Assessment) Act (No. 2) 2005*, received Royal Assent on 19 December 2005. This Act increased taxpayer certainty by improving the timeliness and reliability of Tax Office advice and by reducing the time in which the majority of taxpayers' assessments can be altered by the Tax Office.[57]

1.56 In short, RoSA reduced taxpayer risk and transferred it to the ATO. Taxpayers are subject to lower interest in the period leading up to an amended assessment. They are protected from interest and not just penalties when they follow ATO advice. The ATO has less time in which it can amend taxpayer assessments.

57 Treasury, sub 51, p 4.

Conclusion

1.57 Many of the reforms to tax administration since 2000 outlined above have been influenced by the investments of the 1990s. They focus on the three main participants: the ATO, taxpayers and advisors. In particular:

- creating the office of Inspector-General places the ATO under greater scrutiny
- RoSA has required greater responsiveness from the ATO and represents a shift in the balance in the relationship between taxpayers and the ATO towards taxpayers
- the proposed changes to the regulation of tax agents and introducing promoter penalties are likely to improve standards in tax advice and hold advisors more accountable.

1.58 These legislative changes will make it much harder for investments such as mass marketed investment schemes and employee benefit arrangements to challenge the integrity of the tax system. This means that taxpayers and their advisors who wish to engage in aggressive tax planning will probably take a different path in future. The next generation of challenges facing the ATO are more sophisticated, involving:

> …confidentiality agreements, password protected web pages, the use of encryption and detection software, and payments to offshore entities, including those in tax havens.[58]

1.59 However, the prevention of aggressive tax planning in future is less likely to depend on legislation. As the history of these investments show, the legislative response takes a number of years. Rather, it is more likely to depend on the ATO's data collection, analysis, risk management, initiative and the quality of staff. Although such preventative work is unlikely to attract much public recognition, it is an important factor in the integrity of the tax system.[59]

58 ATO, *Compliance program 2007-08*, p 65.

59 For an update on the ATO's use of data matching, see ANAO, *The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration,* Audit Report No. 30 2007-08, 24 April 2008.

Performance of the ATO

Overview

1.60 In discussing the ATO's performance, it is worth noting that it is engaged in important, but difficult work. While there is a large number of agencies that spend and distribute public funds on behalf of the Government, the ATO is the main agency that collects these funds.

1.61 The ATO has a relationship with every Australian that earns an income and with every business. In total, this makes 14 million relationships that it must manage, which is probably higher than any other Australian agency, including Centrelink. In fact, with the growth in Government assistance provided through the ATO, it is fulfilling some of Centrelink's role. The Uhrig review of corporate governance of statutory authorities in 2003 noted:

> It could be argued that of all statutory authorities, the ATO has the most significant and wide-ranging relationship with the community, involving people both as individuals and also where they may be participants in business or non-profit organisations or as tax professionals.[60]

1.62 Although tax administration is often recognised as important work, the idea that governments can forcibly appropriate individuals' finances means citizens can have concerns about their quantum of tax, others' quantum of tax, how the tax is collected, and the work required of taxpayers.

1.63 Overall, the Committee is satisfied that the ATO is responding to these challenges. A number of performance statistics from the ATO's 2006-07 Annual Report demonstrate this conclusion:

- the ATO's collections exceeded the Budget forecast by 2.0%
- 82% of community members think that the ATO is doing a good job overall
- 90% of tax agent respondents indicate that it is easier now than in the past to deal with the tax system
- 87% of business respondents overall agree the Tax Office is doing a good job

60 ATO, sub 50, p 3.

- the ATO's operating expenditure was 2.3% below budget. [61]

1.64 An across the board comparison of performance statistics between national tax authorities is not feasible due to their varying roles and legislative foundations.[62] The ATO has, however, developed a positive reputation internationally. The Inspector-General of Taxation stated in evidence:

> …we are dealing with a tax office that is held up by other tax authorities around the world as one of the leading examples of best-practice tax authorities.[63]

Responses to reviews

1.65 The ATO advised the Committee that it has been subject to numerous reviews, in addition to regular accountability requirements such as Senate Estimates and performance audits by the ANAO. For example, the ATO has been subject to 11 formal external reviews in the area of aggressive tax planning alone since 1999.[64] Part of the Ombudsman's role is to specifically oversight the ATO.

1.66 Not only has the ATO been subject to these reviews and accountability requirements, but it argues it has participated in them and responded to them in good faith:

> We are committed to an open and transparent tax administration which works with the community in the care and management of Australian's tax system. We welcome feedback, collaboration and co-design where it is constructive and assists in the implementation of practical improvements to the law and to our administration…
>
> We worked constructively on those [aggressive tax planning] reviews and have adopted the thrust of the recommendations that were made. We continue to be very responsive to the guidance provided by Parliament, scrutineers and other stakeholders.[65]

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61 ATO, *Annual Report 2006-07*, pp 20, 37, 38, 48.

62 OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006),* October 2006, pp 102-03, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf. Examples of differences are variations in tax rates and structure, types of taxes, collection of social insurance contributions, and whether they are responsible for customs and investigating tax fraud.

63 Inspector-General of Taxation, *Transcript*, 9 November 2006, p 15.

64 ATO, sub 50.1, p 19.

65 ATO, sub 50.1, p 19.

1.67 The Ombudsman verified this claim. He stated that the ATO:

> …has encouraged a culture that is open to external scrutiny in relation to both the concerns of individuals and the broader community.[66]

1.68 By way of corroboration, the Committee examined how the ATO responded to a number of external reviews. In relation to complaints handling, the Commonwealth and Taxation Ombudsman completed an interim report in 1999 on how the ATO handled complaints. The Ombudsman followed this up with an 'own motion' investigation in 2003, which made six recommendations, all of which the ATO accepted.[67]

1.69 The Ombudsman advised the Committee that the ATO's complaints system now works well:

> I am pleased to say that the ATO's co-operative approach has resulted in a system reflecting best practice complaint management principles and a consistent approach across the ATO. For example, the new centralised complaint-recording system of November 2004 included an area dedicated to resolving systemic issues. While we will continue to monitor this area, the ATO's responsiveness suggests a cultural commitment to complaints resolution within the agency…
>
> While it may be impossible to create a perfect system, the ATO has worked hard to provide for fair and responsive remedial mechanisms to ameliorate any mistakes that do occur.[68]

1.70 Over the past four years, the Inspector-General of Taxation has conducted approximately four reviews annually of the ATO. In a follow-up review of six inquiries, the Inspector-General found that the ATO had accepted 65 out of 73 recommendations. Further, of these 65, the ATO had either implemented or partly implemented 62 of them.[69]

1.71 Being subject to reviews by the ANAO, Inspector-General and Ombudsman, it is clear that the ATO is under heavy scrutiny. This evidence supports the ATO's claim that it responds positively to external reviews. The Ombudsman also stated that the ATO's willingness to improve has led to better performance:

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66 Ombudsman, sub 38, p 16.

67 Ombudsman, sub 38, p 9.

68 Ombudsman, sub 38, p 9.

69 Inspector-General of Taxation, *Follow-up review into the Tax Office's implementation of agreed recommendations included in the six reports prepared by the Inspector-General of Taxation between August 2003 and June 2006* (2007) Commonwealth of Australia, p 5.

> The bulk of complaints we see now going to the ATO are perhaps best described as 'low level' or 'modest' in nature. Few complaints raise concerns of broader systemic or other significance to this office. We see very few complaints that reveal issues of institutional bias or bad faith. Most of our complaints relate to 'simple errors', such as concerns about delay or ambiguity in ATO correspondence or accounting errors, or relatively straightforward disputes about tax assessments or a taxpayer's level of debt…[70]
>
> Our observations over the ten years' operation of the Taxation Ombudsman role within the Commonwealth Ombudsman's office is that the ATO is increasingly committed to providing an administration of the tax system that strives to balance fairly the needs and interests of individual taxpayers with those of the wider community. Most importantly, the ATO has recognised that it will not always get that balance right, and so it has established internal processes that are responsive to the concerns of individual taxpayers…[71]

1.72 The Committee is satisfied that, over a considerable period, the ATO has developed systems and a culture of continuous self improvement that is now demonstrated in improved performance.

Improving accountability and communication

1.73 One of the challenges facing the ATO is gaining community trust and confidence in the tax system. One way in which this might be achieved is through increased open dialogue with Senators and MPs.

1.74 At the public hearing for the inquiry on 9 November 2006, the Committee suggested to the ATO that the Commissioner and his senior executives could attend six-monthly meetings with the Committee to give the ATO an additional opportunity to communicate with its stakeholders. The ATO could also outline the state of tax administration and describe its current challenges.

1.75 The model for the biannual hearings with the ATO is the six-monthly meetings between the Reserve Bank and the House Economics Committee. At the hearing in November 2006, the ATO agreed, stating, 'We are happy to be open and accountable'.[72]

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70 Ombudsman, sub 38, p 9.

71 Ombudsman, sub 38, p 16.

72 D'Ascenzo M, transcript, 9 November 2006, pp 31-32.

1.76 Another purpose of the hearings could be for the Committee to scrutinise the ATO's public and product rulings. On occasion, concerns have been raised that the ATO's public rulings operate in effect much like delegated legislation, but are not subject to Parliamentary oversight.[73] In *An Assessment of Tax*, the JCPA suggested that one solution would be for Parliamentary committees to examine public and product rulings.[74] The biannual meetings between the current Committee and the ATO provide this type of opportunity.

1.77 On 20 April 2007, 21 September 2007 and 30 April 2008, the Committee held the first three of these regular meetings with the Commissioner in Melbourne, Canberra and Sydney. The meetings were constructive and supplied extra information for this report. They also laid the basis for future, regular meetings. Chapter two of this report gives an overview of the proceedings.

Recommendation 1

1.78 **The Commissioner of Taxation continue to make himself available twice a year to attend public hearings on the administration of the tax system with the Joint Committee on Public Accounts and Audit in order to promote an open dialogue between the ATO and the Parliament.**

Overview of the inquiry

Conduct of the inquiry

1.79 Under section 8 of the *Public Accounts and Audit Committee Act 1951*, the Committee has the power to examine the accounts of the receipts and expenditures of the Commonwealth. On 7 December 2005, the Committee resolved to conduct the inquiry under the terms of reference listed at the front of the report. In the first week of January 2006, the Committee called for submissions by placing advertisements in the national newspapers with a due date of 24 February 2006.

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73 Scolaro D, 'Tax Rulings: Opinion or Law? The Need for an Independent 'Rule-Maker'' (2006) *Revenue Law Journal*, vol 16, pp 127-128.

74 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 112-13.

1.80 The Committee received 58 submissions for the inquiry. Submitters included the ATO, Treasury, tax groups, the ATO's external scrutineers, ex-employees of the ATO and individuals who had had difficult experiences with that organisation.

1.81 The Committee held public hearings in Canberra, Sydney, Melbourne and Launceston between June and November 2006. The Committee then commenced its biannual hearings with the ATO in April 2007. This meant that the Committee was able to obtain updates on tax administration following the initial evidence.

Bureaucratic anticipation

1.82 A feature of some committee inquiries is 'bureaucratic anticipation' where governments address inquiry issues before the committee tables its report.[75] This occurred during the inquiry. For example, Ruddicks Chartered Accountants raised the issue of Division 7A of the *Income Tax Assessment Act 1936* with the Committee during the Launceston hearings. The problem here was that loans from companies to related trusts and partnerships were deemed to be unfranked dividends (incurring tax of 48.5 cents in the dollar), even where there were legitimate cash management reasons for the transfers.[76] On 6 December that year, the then Government announced that it would introduce a number of reforms, including removing the automatic debiting of the company's franking account when there is a deemed dividend.[77]

1.83 Another example involved the ATO's general administrative practice. In its submission, the Institute of Chartered Accountants in Australia (ICAA) noted that the ATO practice statement PS LA 2003/3 stated that all draft rulings reflected the Commissioner's general administrative practice. This gave taxpayers protection against penalties and, after RoSA, interest as well. However, the Explanatory Memorandum to some of the RoSA amendments stated that a draft ruling would 'usually' reflect general administrative practice where this was the Commissioner's only public comment on an issue. This is much less certain for taxpayers. Further, they

75 Ryle G, Pryor L and Metherell M, 'Senate boss blasts PM's monarchy', *Sydney Morning Herald*, 21 June 2005, p. 1 and Holmes B, 'Both Bark and Bite: The effectiveness of Senate committees', (2005) 36th Conference of Presiding Officers and Clerks, Samoa, p. 12.

76 Leighton C, transcript, 24 August 2006, pp 4-5.

77 Hon P Dutton MP, Minister for Revenue and Assistant Treasurer, 'Amendments to the Tax Law to Reduce Compliance Costs for Small Business' Media Release, 6 December 2006, viewed on 29 May 2008 at http://assistant.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2006/089.htm&min=pcd

cannot be expected to follow all of the Commissioner's public statements.[78]

1.84 On 8 June 2007, the ATO amended its practice statement on precedential views, including general administrative practice. The statement does not confirm that draft public rulings represent the Commissioner's general administrative practice. Rather, it states that taxpayers are protected from administrative shortfall penalties and shortfall interest if they follow a draft ruling. In effect, this is the same as if draft rulings were general administrative practice.[79]

1.85 The Committee appreciates that a number of groups are responsible for bringing these issues to the attention of government. This Committee has not been the only party seeking improvements in tax administration during the inquiry. However, the Committee believes that the inquiry and the increased scrutiny of the ATO during this period has assisted in encouraging the ATO and government to expedite their responses to these issues.

Structure of the report

1.86 The report is broadly laid out according to the terms of reference:

- chapter two deals with the first three biannual meetings between the Committee and the Commissioner for Taxation
- the third chapter covers the impact on taxpayers and tax agents of self assessment and complex legislation
- chapter four examines rulings
- the fifth chapter deals with compliance
- chapter six covers penalties and interest
- chapter seven examines the pay-as-you-go (PAYG) system and other aspects of tax administration.

1.87 Part B of the inquiry dealt with the interaction between fringe benefits tax and family tax benefits. Because this issue is straightforward, it is dealt with below.

78 ICAA, sub 37, p 7.

79 ATO, 'Precedential ATO view,' PS LA 2003/3, para 41, viewed on 28 August 2007 at http://law.ato.gov.au/atolaw/view.htm?docid=PSR/PS20033/NAT/ATO/00001.

Part B – fringe benefits tax and family tax benefits

1.88 At first glance, the amount of family tax benefits payable to a parent is not affected by the tax system because the amount of benefit is not used to calculate an individual's assessable income. In other words, it is an exempt payment for income tax purposes.[80]

1.89 The Committee's concern related to fringe benefits tax and the extent to which receiving a fringe benefit (which has tax implications) could affect an individual's eligibility for family tax benefit.

1.90 Treasury argued that receiving a fringe benefit should be relevant to determining how much family tax benefit an applicant should receive. Just as fringe benefits threatened the integrity of income tax in the 1980s, they could potentially threaten the integrity of government benefits. For example, some segments of the population could arrange to receive much of their income through fringe benefits. This would reduce their incomes for the means testing of benefits, and allow them to receive higher benefits than a scheme was designed to provide.[81]

1.91 Treasury stated:

> Requiring the reporting of fringe benefits enhances the overall fairness of the taxation and welfare systems, by enabling the value of fringe benefits to be considered in income tests used to determine entitlements to certain income tested government benefits and liability to taxes, surcharges and income tested obligations.
>
> This minimises the scope for employees with access to salary packaging arrangements to avoid obligations and obtain government benefits to which they would not otherwise be entitled on the basis of their total level of remuneration. Consequently, the measures improve the equity of the taxation and social security systems. [82]

1.92 The Committee accepts this reasoning. The amount of fringe benefits an individual receives is factored into the income tests for a range of Commonwealth Government systems, including child support, HECS repayments, the Medicare levy surcharge and family tax benefits.[83]

80 House of Representatives Standing Committee on Family and Human Services, *Balancing Work and Family*, December 2006, p 66.

81 Treasury, sub 51, pp 16-17.

82 Treasury, sub 51, p 17.

83 Treasury, sub 51, pp 17-18.

1.93 In its submission, Treasury assured the Committee that fringe benefit amounts are not included in calculations of income tax. As Treasury stated, 'the reporting of fringe benefits does not result in double taxation.'[84]

Conclusion

1.94 In 1984, the ANAO completed an efficiency audit on the ATO. It found that the system of administrative assessment, where the ATO accepted most of the risk in its relationship with taxpayers, was placing the ATO under considerable pressure. This led to the introduction of self assessment, which is the driving principle of tax administration in Australia.

1.95 Self assessment requires taxpayers to accept a certain amount of risk. If they make an error so that there is a tax shortfall, they must not only pay this amount, but interest and possibly penalties as well.

1.96 This allocation of risk to taxpayers became very apparent following the mass marketed investments schemes and employee benefit arrangements in the 1990s. Although the ATO was legally justified in its delayed response to these avoidance arrangements, its temporary inaction appeared to set a precedent to taxpayers and led to rapid growth in the arrangements. This meant that when the ATO did take action, many taxpayers felt unfairly treated.

1.97 The main response was RoSA, which shifted some risk from the taxpayer back to the ATO. The ATO now has less time in which to amend some categories of assessments. A reduced interest rate (the Shortfall Interest Charge) is applied to tax debts until the ATO issues the amended assessment.

1.98 Perhaps as a consequence of these schemes, some submissions sought to shift some risk back to the ATO by arguing for a return to administrative assessment. Given the experience of the 1980s, the Committee did not believe this was appropriate. The lesson the Committee prefers to draw from this history is that there is a fine balance of risk between taxpayers and the ATO under self assessment. This balance needs to be regularly monitored and refined when necessary.

84 Treasury, sub 51, p 17.

2

Biannual meetings

Introduction

2.1 At its hearing with the Australian Taxation Office (ATO) for the inquiry on 9 November 2006, the Committee raised with the Commissioner the possibility of holding regular, biannual meetings. The Committee noted that the ATO would benefit from having a formal occasion to have ongoing and regular communication with the community.

2.2 The House of Representatives Standing Committee on Economics, Finance and Public Administration has set a precedent in its meetings with the Reserve Bank. This Committee believes such a model can be adapted to the ATO.[1]

2.3 In response, the Commissioner stated, 'We are happy to be open and accountable.'[2] He also said:

> We talk about an open and accountable tax administration and that is part of the accountability processes. In fact, the way I see things is that generally—and I do not think anybody disputes this—there is a good message, a positive story to be told, about the standard of tax administration in this country. We might be able to garner the support of people such as the parliament to say that we have a tax administration that is rated as amongst the best in the world and that means we should have some confidence and trust

1 Other examples are the relationships between the Joint Standing Committee on Electoral Matters and the Australian Electoral Commission and the Parliamentary Joint Committee on Corporations and Financial Services and the Australian Securities and Investments Commission.

2 D'Ascenzo M, transcript, 9 November 2006, p 32.

> in the system, albeit we cannot be complacent and albeit there is always room for improvement.[3]

2.4 The Committee held its first public hearings with the Commissioner in Melbourne on 20 April 2007, in Canberra on 21 September 2007, and in Sydney on 30 April 2008. The transcripts of proceedings and the ATO's submissions are available on the Parliament's website.[4]

2.5 The biannual hearings will provide an important forum for Parliament to discuss key and emerging issues with the ATO. They will also provide an opportunity for the Commissioner to outline the ATO's forward plans.

2.6 The conduct of these meetings is likely to evolve over time with changes in tax policy, legislation, administration and technology. The Committee is open to feedback and comment from the public in maximising the value of these hearings.

Risks for the Tax Office

A compliance culture among taxpayers

2.7 At the commencement of the first hearing, the Committee asked the ATO what the greatest risk to the revenue is. The Commissioner argued that the most important task for the ATO was to promote a compliance culture among taxpayers. He stated:

> I think the greatest risk to revenue is if we ultimately do not maintain and enhance the high levels of voluntary compliance that we have in this country. The trick to good tax administration is to focus on how you maintain that culture of good compliance, both within your own country and with people who interact with the country. To do that you need high levels of confidence. Those high levels of confidence are reflected by a very well-rounded program that has not just focus on active compliance or enforcement activities but also on providing support, assistance and education. It also focuses on trying to make it easy for taxpayers to comply. It does have, at the end of it, a very important role in trying to

3 Id, pp 31-32.

4 See http://www.aph.gov.au/house/committee/jpaa/reports.htm.

> ensure that we support honest taxpayers by having effective deterrent strategies.[5]

2.8 The Commissioner expanded on this during the third meeting, suggesting that developing a compliance culture is a community-wide responsibility:

> It would be to get that cultural change in the community—it cannot be led by the tax office but it can be led by people who are influential in the community—to indicate that basically the tax and super systems are there to support Australians. The way that they should operate both at an administrative level and at an individual level should not be adversarial. If things are seen to be disadvantageous to the system and to the community as a whole, people should stand up and make sure that they are counted. I think people have stood back and said, 'It is not my responsibility.'[6]

2.9 As part of the compliance culture overview during the first meeting, the Commissioner noted three priority risks for the ATO:

- restructuring, mergers and acquisitions in the large business sector
- non-reported cash payments between consumers and firms in the small business sector
- supporting the compliance model in the small business sector, such as ensuring small businesses know how to comply and making it easier for them to do so.[7]

The superannuation guarantee

2.10 In its submission to the first meeting, the ATO identified employers' compliance with the superannuation guarantee as an increased risk for 2007-08. The issue is that some employers do not pay their employees' superannuation, as required by law.[8]

2.11 The following statistics demonstrate that this is a major concern for the ATO:

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5 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 20 April 2007, p 4.

6 Third biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 30 April 2008, p 30.

7 Id, p 5.

8 First biannual meeting with the Commissioner of Taxation, ATO, sub 1, p 29.

- In 2006-07, the ATO raised $349.8 million in superannuation guarantees and collected $237.8 million of this [9]
- 20% of the complaints that the Ombudsman receives about the ATO relate to the guarantee (the highest category of all complaints) [10]
- it receives approximately 10,000 complaints per annum on employers' compliance with the guarantee [11]
- the ATO investigated over 20,000 cases in 2006-07.[12]

2.12 In evidence, the ATO stated that the area with the most compliance issues was the non-incorporated business sector.[13] It also noted that it is educating taxpayers to monitor their superannuation more often. Notifying the ATO earlier means that it is in a better position to assist taxpayers:

> One of the frustrations for us is that we often do not hear from employees until after they have left employment. So apart from the fact that we are, with this additional funding, covering 100 per cent of any complaints to us, we are also trying to market very strongly to employees to check their contribution statement every year and to talk to us quickly if they are having no success with their employer. We cannot check every employer in the community. We certainly are lifting our game in relation to the number of employers we can look at, but we also need that help in terms of people letting us know more quickly, before things have developed.[14]

2.13 The ATO gave an indication of the practical difficulties they face in following up many of these complaints:

> I would say that one of the challenges we have is that something like 60 to 65 per cent often come in after the person has left the employment. A typical example I could give you is a complaint I

9 ATO, *Annual Report 2006-07*, p 138.

10 Commonwealth Ombudsman, sub 38.2, p 1.

11 First biannual meeting with the Commissioner of Taxation, Granger J, transcript, 20 April 2007, p 8.

12 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 20 April 2007, p 8.

13 Ibid.

14 First biannual meeting with the Commissioner of Taxation, Granger J, transcript, 20 April 2007, p 22.

looked at recently which came in in 2006 but was for the 10 years up to 2002.[15]

2.14 The 2007 Budget allocated $125.7 million over four years in new funding for the ATO to further pursue tax debts and unpaid superannuation.[16] The ATO stated in evidence that this would allow it to pursue every superannuation debt down to $100.[17] The ATO reported at the third meeting that there has been a decrease in the number of outstanding superannuation guarantee debt cases.[18]

2.15 The Government and Parliament have made it easier for the ATO to manage these complaints. Under section 45 of the *Superannuation Guarantee (Administration) Act 1992,* the ATO is unable to divulge an employer's superannuation affairs to someone else. This also applies to investigating complaints about the superannuation guarantee.

2.16 In 2007, the Government and Parliament inserted section 45A into the Act. This section allows the ATO to give information to an employee or past employee who has made a complaint against their employer. The information must relate to the complaint, including the following:

- the ATO's actions to investigate the complaint
- the ATO's actions under the *Superannuation Guarantee (Administration) Act 1992* and the *Taxation Administration Act 1953* (for example, to assist it in enforcing compliance)
- the ATO's actions to recover the superannuation amounts.

The cash economy

2.17 In its submission for the first meeting, the ATO stated that the cash economy was an increased risk in 2007-08, in particular for business to consumer transactions. The ATO also noted that this risk was endemic and would require attention well into the future.[19]

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15 Second biannual meeting with the Commissioner of Taxation, Vivian R, transcript, 21 September 2007, p 7.

16 Hon P Dutton MP, Minister for Revenue and the Assistant Treasurer, 'Tax Office debt collection enhancement — Reducing taxation debt and outstanding superannuation guarantee charge payments', Press Release, 8 May 2007, viewed on 4 July 2007 at http://assistant.treasurer.gov.au/pcd/content/pressreleases/2007/055.asp.

17 Second biannual meeting with the Commissioner of Taxation, Crawford M, transcript, 21 September 2007, p 10.

18 Third biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 30 April 2008, p 2.

19 First biannual meeting with the Commissioner of Taxation, ATO, sub 1, p 29.

2.18 The Committee asked the ATO whether it would be able to quantify the size of the cash economy or the amount of tax lost through the cash economy. The ATO stated that the Australian Bureau of Statistics has done some work in the area, but it prefers to manage the risk, rather than focus on the amounts involved.[20] Further, the ATO said that there is currently a debate over how to measure the tax gap and there are high costs on honest taxpayers:

> The US does surveys which are based on random audits. The difficulty for us in doing that and why we have gone down the other methodology path has been that to have a statistically relevant sample would be very resource intensive in terms of the overall program and it would also mean auditing people who are compliant, which we feel would be an unacceptable community cost. Having said that, there is an OECD working party of which we are members that is working through what ought to be a standard approach to measurement, whether it is done by a revenue authority or outside a revenue authority. As you can imagine, there is a fair bit of debate about what will be in those processes. We are part of that working party and we are engaging in what might be a good measure.[21]

2.19 The Committee supports the ATO's involvement in this international research and believes there would be value in developing a robust estimate of the cash economy and foregone tax more generally. Achieving international consensus should help in producing a robust methodology.

Release 3 of the Change Program

2.20 Over the past few years, the ATO has been updating its information technology processes and systems. The ATO describes this major project as its Change Program. The ATO finalised the first component, Release 1, in 2005. Release 2 followed in 2006 and Release 3 was scheduled to commence in January 2008. These projects are increasing in scale. The number of person days they have required has increased from 24,000 for Release 1 to 68,000 person days and 290,000 person days respectively.[22]

20 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 20 April 2007, p 6.

21 First biannual meeting with the Commissioner of Taxation, Granger J, transcript, 20 April 2007, p 13.

22 Second biannual meeting with the Commissioner of Taxation, ATO, sub 1, p 5.

2.21 Following Release 2, the ATO obtained advice from Capgemini, a consultancy, on its performance. Capgemini reported that the ATO had managed this large-scale project well:

> The ATO should be pleased that such a complex systems deployment, both in terms of functionality and numbers of end users, has been largely successful. To put the scale of this deployment into perspective, the rollout to over 10,000 ATO staff is some ten times larger than what we typically see in the Australian marketplace, where Siebel based systems deployments are usually more staged, and involve user communities of only 1,000 to 2,000 in each 'drop' of functionality. As far as we can ascertain, this is the largest rollout of Siebel Case functionality globally.[23]

2.22 The ATO has identified various aspects of the Change Program as risks.[24] Release 3 places additional risk on the ATO because of its scale and because it involves replacing all of the ATO's core processing systems. The ATO reports that it has mitigating strategies in place and has been consulting with tax professionals and small business on possible impacts. Recognising that the transition will not be seamless, the ATO has lowered some service standards for 2007-08.[25]

2.23 Although the Change Program involves costs in 2007-08, the aim is for the ATO to be more efficient in the long term. Capgemini has confirmed this:

> The 'pain' associated with the introduction of such complex systems, however, is balanced by the advantages to be gained long term by the ATO through the establishment of new enterprise wide process models. The software provides the ATO with a long term infrastructure platform on which to further develop functionality and deploy new processes throughout the organisation.[26]

2.24 The Committee awaits the roll out of Release 3.

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23 First biannual meeting with the Commissioner of Taxation, Capgemini, correspondence, 22 November 2006, exhibit 12, p 1.

24 First biannual meeting with the Commissioner of Taxation, ATO, sub 1, p 32.

25 Second biannual meeting with the Commissioner of Taxation, ATO, sub 1, p 5.

26 First biannual meeting with the Commissioner of Taxation, Capgemini, correspondence, 22 November 2006, exhibit 12, p 2.

E-commerce

2.25 The development of new technologies and new markets raises the question of whether they represent new risks to the revenue. The Committee asked the ATO whether electronic commerce and internet transactions had created new risks for the ATO. The agency responded that it is monitoring e-commerce, but it does not represent a high risk at this stage:

> Australia has been at the forefront of doing some early thinking in the area of e-commerce. In fact, we drafted the OECD's two reports on e-commerce back in the late nineties. We have found that the impact of e-commerce has not been as dramatic in the Australian context as we had expected. At the moment it is not high on our lists in terms of risk to the revenue. It is something that has to be monitored. The recent newspaper articles that saw our activity in connection with people using internet type transactions shows that we are active in that field, but at this stage in aggregate figures it has not been as much of a concern to Australia as was predicted. But it is one of those areas that could very easily inflate over time.
>
> One of the things about e-commerce is that, if it is in relation to goods and services, you do have something tangible that you can apply your own activities to. So the risk to e-commerce comes more at the services, copyrighting, tangible end of our activities. If it is done through large companies, it falls within transfer pricing reviews that remain a high priority for us.[27]

Specific issues discussed during the hearings

Agribusiness managed investment schemes

2.26 Managed investment schemes are commercial arrangements where investors put funds into a plantation to secure an interest in a pooled enterprise. Members do not have day to day control over the scheme and pay management fees to a service company. These fees tend to be very high in the first year of operation. The main attraction of the investment is

27 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 20 April 2007, p 5. Transfer pricing occurs where related entities make an international transaction and, for example, adjust the price to reduce the profit of the Australian entity and reduce tax paid in Australia.

that these initial fees are often tax deductible as expenses, rather than needing to be depreciated over time. In practice, the main legal requirement that taxpayers needed to meet to qualify for the deduction was they had to demonstrate that they were carrying on a business.[28]

2.27 The Committee understands that the schemes can be useful to taxpayers with an unexpectedly high income in a financial year. Taxpayers can easily lower their income for that year through the one-off deduction.

2.28 The two main types of investment in these schemes are in forestry and agribusiness (for example olives, almonds and avocados). One reason behind the tax advantage for forestry plantations is that establishment costs are high, but the plantation only earns cash at harvesting, many years later. An early tax deduction helps offset the long period before the taxpayer earns income.[29]

2.29 In December 2006, the previous Government announced that it would continue the tax advantage for forestry managed investment schemes, provided the schemes met certain conditions. The Government stated it would introduce a specific clause in the tax law to allow the deduction. Taxpayers would not need to demonstrate that they were carrying on a business.[30]

2.30 However, in February 2007, the Government announced that it would not continue the deduction for agribusiness. It noted that the ATO had changed its view of the law to the effect that taxpayers investing in these schemes were not carrying on a business. The ATO would stop issuing product rulings allowing the deduction from 1 July 2007 and would release a draft ruling to reflect its new view of the law.[31]

2.31 The announcement sparked considerable debate. Shares in agribusiness companies dropped significantly. In policy terms, some argued that the schemes distorted markets and the Government should drop the

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28 ATO, 'Income tax: Registered agricultural managed investment schemes' TR 2007/D2, paras 3, 5, viewed on 4 July 2007 at http://law.ato.gov.au/atolaw/view.htm?DocID=DTR%2FTR2007D2%2FNAT%2FATO%2F00001.

29 Nielson L, Hicks P, *Tax Laws Amendment (2007 Measures No. 3) Bill 2007*, Bills Digest no. 159 2006-07, 23 May 2007, Department of Parliamentary Services, p 20.

30 Hon P Dutton MP, Minister for Revenue and Assistant Treasurer, Hon Senator E Abetz, Minister for Fisheries, Forestry and Conservation, 'Review of the taxation of plantation forestry,' Press Release, 21 December 2006, viewed on 4 July 2007 at http://assistant.treasurer.gov.au/pcd/content/pressreleases/2006/097.asp.

31 Hon P Dutton, Minister for Revenue and Assistant Treasurer, 'Non-forestry managed investment schemes,' Press Release, 6 February 2007, viewed on 4 July 2007 at http://assistant.treasurer.gov.au/pcd/content/pressreleases/2007/007.asp.

deduction. Others argued that the tax advantage helped regional Australia cope with the drought.[32]

2.32 Stakeholders also criticised the process. One agribusiness firm alleged that the Government did not meaningfully consult with industry. This was despite the Government and the ATO holding discussions with the industry in 2006, where the ATO advised the industry of its new view of the law.[33] On 27 March 2007, the ATO announced that it would extend the transition period by 12 months to 30 June 2008.[34]

2.33 The Committee asked the ATO to account for its conduct in this matter:

> What we have actually had is indications from the court—one by the Supreme Court in *Environ* and another one by the Federal Court in *Puzey*—to say that our view of the law was wrong…
>
> [This] has taken some time. We then referred the matter to government because it was really a government issue of how it wanted these areas taxed. The government made its decision in relation to afforestation and decided that we should just test the law—it said it would not do anything in relation to agriculture or agribusiness. That left the tax office with views expressed by the judiciary that our previous view was not right. We have gone through an extensive process of trying to review our position. We think a better view now is that we were wrong. Therefore, we are trying now to have a test case to clarify that over the next 12 months.[35]

2.34 The Committee accepts that, once the ATO has decided that its previous view of the law is incorrect, it needs to commence a process to introduce its new view of the law. As discussed previously in this report, the Committee believes that giving taxpayers up to 12 months to adjust to new arrangements is a good base position.

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32 Irvine J, 'Plantation tax lurk gets chop, shares crash,' *Sydney Morning Herald*, 8 February 2007, p 24.

33 Ibid, Hon P Dutton, Minister for Revenue and Assistant Treasurer, 'Non-forestry managed investment schemes,' Press Release, 6 February 2007, viewed on 4 July 2007 at http://assistant.treasurer.gov.au/pcd/content/pressreleases/2007/007.asp.

34 ATO, 'Transitional arrangements for agribusiness managed investment schemes,' Media release 2007/09, viewed on 20 March 2008 at http://www.ato.gov.au/corporate/content.asp?doc=/content/00095911.htm.

35 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 20 April 2007, pp 12-13.

Allegations of BAS and identity fraud

2.35 Prior to the hearing on 20 April 2007, the media reported that criminal interests had received $5 billion since 2003 in fraudulent BAS claims. Once a taxpayer is registered for GST, they can claim large amounts of GST in business supplies that the ATO credits to them. If they do not collect GST in business sales to offset GST paid, then the ATO pays them a refund. The media reports alleged that the ATO did not have sufficient controls on taxpayers initially registering for GST.[36]

2.36 The Commissioner rebutted the allegations as follows:

> It was in a report by an ex-officer which extrapolated figures that did not have any firm basis. There does not seem to be any dip of anything like that order in our collections. We have a range of specific checks and balances and in fact some of the claims that were made in that report are not correct or do not reflect the level of checks and balances that we have. We have had ANAO review … our refund approaches and, again, that did not indicate any defect of the order that was mentioned. My answer to that is: we have not seen any reliability in that figure and we do have checks and balances that we think are working reasonably well.[37]

2.37 The ATO stated that refunds are occasionally delayed due to the checking processes it has installed to reduce the incidence of fraud.[38]

2.38 One of the key tests in a taxpayer registering for GST is for them to confirm their identity. The ATO stated that it is educating the community about the need for individuals to protect their private information. Further, it continues to monitor identity fraud:

> We have said in terms of this area of refund fraud that one of our real concerns is also the associated identity fraud that goes on. You may well have heard that we campaign quite a bit with both the agents and the community more generally about the care they need to take with their private information. To put identity fraud in context when we are talking about this issue, there were about 120 cases we investigated last year. So it is not big numbers but it is the kind of thing that everyone needs to be vigilant about. As I

36 Baker R, 'Crime gangs rort $5 billion in tax office refunds,' *Age*, 26 March 2007, p 3.

37 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 20 April 2007, pp 6-7.

38 First biannual meeting with the Commissioner of Taxation, Granger J, transcript, 20 April 2007, p 7.

> said, we have significant checks, but that is something that is under continuous scrutiny for us.[39]

2.39 The Committee notes that the ATO monitors BAS and identity fraud and supports it continuing to review and investigate suspicious activity.

Private equity buyouts

2.40 There has been debate in Australia about private equity buyouts of public companies. One aspect of the debate was whether the Australian Government loses revenue overall. Firstly, the profitability of these companies (and the tax they pay) is reduced in the short term by paying higher interest charges on the debt raised to purchase them. Further, the previous Government took a policy decision not to tax capital gains when foreign investors sell local businesses at a profit. On the other hand, the Government will receive extra revenue up front if shareholders make a profit when they sell out to the private equity team.[40]

2.41 The Committee asked the ATO whether these buyouts are subject to the anti-avoidance provisions in the tax legislation. The ATO responded that private equity buyouts are usually legitimate financial arrangements:

> I am not sure that they are necessarily arrangements of that ilk. If they are for the purpose of avoiding tax and if our anti avoidance provisions apply then we will apply them, but if it is just someone who has a loan from overseas, and pays interest on that loan, to acquire a business activity in Australia for the purpose of deriving assessable income then that deduction would be deductible.[41]

2.42 The Senate Standing Committee on Economics has recently completed an inquiry into private equity, including its revenue implications.[42]

Communication with tax agents and their clients

2.43 The Committee raised with the ATO the issue of how it communicated with tax agents and their clients. In particular, the Committee was concerned about instances where the ATO sent notices to clients but not to their agent. The Committee suggested to the ATO that it could send

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39 Ibid.

40 Knight E, 'How privateers can sail through the tax system,' *Sydney Morning Herald*, 23 March 2007, p 21.

41 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 20 April 2007, p 17.

42 Senate Standing Committee on Economics, *Private equity investment in Australia* (2007)

notices to both groups. The ATO responded that tax agents have a fair degree of control in managing this correspondence:

> We consult with tax agents and have been consulting with them for five or six years about this topic. We have built a facility which allows them to specify the postal address for different types of notices if they choose to do so, and they do use it a lot. Some agents, for example, ask that all pay-as-you-go withholding material, which applies to a taxpayer's employment obligations, go directly to the taxpayer, because they are not interested in being a part of that. However, it still comes up from time to time. It plays out in two ways. Firstly, sometimes agents complain to us that we send them a lot of material about new initiatives such as choice and super guarantee and things of that nature. We have sent it to the postal address and they do not necessarily want it; they have to send it on. Secondly, we also have to be careful because taxpayers sometimes complain that we send material to their agent and it is not forwarded on to them. Sometimes warnings that we send out are not forwarded. So we make judgements about some particular mail-outs. The general rule, though, is that accountants are able to control the direction of the great majority of our correspondence.[43]

2.44 The Committee supports the ATO's consultations in this area and believes the ATO should continue to discuss these issues with tax agents.

Phoenixing

2.45 While discussing compliance with the superannuation guarantee charge, the ATO raised the problem of 'phoenixing'.[44] This occurs when a business owner intentionally lets their firm fail, along with its debts. When the owner commences a new business, it is difficult for past debtors to collect the money owing to them. This is because the owner's assets reside in a different entity (the new business) from that which the debtor has a contractual relationship (the old business).

2.46 The ATO stated that phoenixing was a significant problem:

> Phoenixing is a blight on the Australian economy and a not insignificant burden on the tax system. We have officers who

43 First biannual meeting with the Commissioner of Taxation, Konza M, transcript, 20 April 2007, p 18.

44 Second biannual meeting with the Commissioner of Taxation, Vivian R, transcript, 21 September 2007, p 8.

> chase up very significant phoenix cases and try and get criminal prosecutions for fraud and that sort of thing, but a $10,000 super guarantee debt would not figure very highly. But it is a very significant problem.[45]

2.47 The ATO also noted that phoenixing mainly occurred amongst micro and medium firms, but was not limited to any one industry:

> I think it is mainly in the micro and medium segments of the economy because the larger businesses cannot afford the risk to their reputations. In the past, you could almost have said it was rife in the building and construction industry, but we have put a lot of effort into that over the last seven or eight years. We think that the practice has declined a bit in that industry, but it has spread to other industries—labour hire firms are one example that comes to mind. There are some accountants, for example, who advise people on how to do this, so it is perpetuating mischief in that respect.[46]

2.48 The Committee is concerned that some accountants are advising clients on how to phoenix their businesses. Currently, the main sanction against such conduct in the tax agent legislation is cancellation or suspension of registration.[47] The exposure draft legislation for tax agent regulation released this year proposes a Code of Conduct that includes a requirement for agents to behave honestly and with integrity. Breaches of the Code attract a wider range of sanctions, including:

- a written caution
- completing a course of training
- an order to provide only certain types of tax agent services
- an order to provide services only under the supervision of a particular tax agent.[48]

2.49 In the view of the Committee, there is a discrepancy between the approach taken in the promoter penalties legislation and the proposed arrangements for tax agents. In particular, promoters of tax evasion schemes can be subject to civil penalties of 5,000 penalty units for an individual to

45 Second biannual meeting with the Commissioner of Taxation, Konza M, transcript, 21 September 2007, p 9.

46 Second biannual meeting with the Commissioner of Taxation, Konza M, transcript, 21 September 2007, p 10.

47 Section 251K of the *Income Tax Assessment Act 1936*.

48 Treasury, Exposure draft, *Tax Agents Services Bill 2008*, clause 30-20.

25,000 penalty units for a corporation if they are promoting a tax exploitation scheme.[49] Promoting a scheme may be potentially more damaging to the compliance culture and the revenue (compared with only advising a client base). However, the Committee is of the view that misconduct in advising clients of evasion schemes such as phoenixing is sufficiently serious to warrant the same type of penalty. If an advisor's clients are sufficiently wealthy, then the revenue and public confidence in the tax system can be compromised to a similar extent. Civil penalties should be available for advisors who engage in misconduct such as instructing clients in phoenixing and similar practices.

2.50 There may be other legislation that would result in these accountants being subject to civil penalties. The Australian Securities and Investments Commission may have a role as well. Alternatively, the promoter penalties legislation may have wide operation. In any event, the main outcome that the Committee is seeking is for these advisers to be subject to civil penalties and that they are enforced in practice. The Committee is content for the Government to determine the best way of achieving this, be it via legislation or a change in regulatory focus.

Recommendation 2

2.51 **The Government ensure that tax agents who give advice on tax evasion techniques, such as phoenixing, are subject to civil penalties, either through new legislation or enforcement of existing legislation.**

2.52 The ATO gave the Committee some data on the extent of its Phoenix compliance work:

> During the period July 2001 to March 2008 we finalised 1,118 audits of businesses which were involved in serial Phoenix behaviour.
>
> During the year ended 30 June 2007, Phoenix Project teams raised over $93 million in tax and penalties from the finalisation of 234 cases, of which $76 million was in respect to tax and $16.1 million was in respect to penalties and interest.

49 Sections 290-50 and 290-65 of the *Taxation Administration Act 1953*. Under section 4AA of the *Crimes Act 1914*, the current value of a penalty unit is $110. Broadly, a tax exploitation scheme is an arrangement entered into with the sole or dominant purpose of reducing tax and is not reasonably arguable at law.

> In the past few years 10 company directors have been successfully prosecuted for participating in Phoenix-related activities. The Courts have showed wide variation in the sentences handed down. For example, in 2001 a bricklaying contractor was gaoled for 7 years 8 months for defrauding over $7 million in pay as you earn (PAYE) monies. In a more recent case a previously banned and bankrupted formwork contractor received 9 months 'home detention' plus a Reparation Order of $50,000 for failing to remit $1.6 million in PAYE monies. His home detention 'conditions' actually permitted him to continue to visit his work premises on a daily basis.[50]

2.53 The Committee strongly disapproves of phoenixing. It fully supports ATO efforts to investigate and prosecute any reported instances of such practices.

Liechtenstein bank records

2.54 In early 2008, the media reported that an ex-employee of a Liechtenstein bank, LGT Group, had sold client information to the German authorities.[51] Liechtenstein is a declared tax haven[52] and this information has a high potential value to tax authorities around the world.

2.55 The ATO has received some of this information and has commenced 20 audits in response.[53] In evidence, the ATO confirmed that it had received the information and was acting on it.[54] Given that this data is potentially stolen goods, the Committee asked the ATO to confirm that its conduct was appropriate. The ATO stated:

> Sometimes we get information from a range of people who may have got it through other means. Often we do not go behind the information that is provided to us. Provided we are not party to the illegal means, the [legal] advice … is that we should be using it.[55]

50 Third biannual meeting with the Commissioner of Taxation, ATO, sub 2, p 2.

51 Drummond M, 'Send a thief to catch a thief,' *Australian Financial Review*, 1 March 2008, p 30.

52 ATO, *Tax havens and tax administration*, (2007) p 8.

53 Third biannual meeting with the Commissioner of Taxation, ATO, sub 1, p 12.

54 Third biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 30 April 2008, p 6.

55 Third biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 30 April 2008, p 8.

2.56 The Committee also raised the issue of how the ATO would use the information. In relation to whether the data would be admissible in court, the ATO responded:

> I think there are questions about admissibility. I do not think we have got a yes or no answer there. The proposition in Australia is that it is up to the discretion of the judge, and so it will be a matter of how the judge sees the circumstances of this information, if we were to use it in the legal sense.[56]

2.57 However, the ATO may not need to present this information in court, but instead use it as a way of conducting investigations that produce admissible information. The ATO noted:

> I think it is important to make the point that the first way in which we use any information we obtain is to undertake a risk assessment, and it will be one of a number of factors. We do profiling and have a look and then approach the taxpayer, depending on the circumstances of the case. So it is not just a question of: is information available to use in court; the very first place it gets used is to evaluate whether there is a tax risk here that needs to be investigated further. By the time you might get to an outcome and where there is going to be any dispute, that may not necessarily be a source of information we need to rely on.[57]

2.58 The Committee again disapproves of taxpayers using tax havens to fraudulently avoid their Australian tax obligations. However, the use of potentially stolen material is a delicate matter. The Committee encourages the ATO to not only ensure that it is acting within the letter of the law but that the wider community will view its actions as fair and appropriate.[58]

Security of taxpayer information

2.59 In December 2007, the ATO announced that it had commissioned PricewaterhouseCoopers to review its information security practices. The ATO decided to undertake the review following some minor incidents at

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56 Ibid.

57 Third biannual meeting with the Commissioner of Taxation, Granger J, transcript, 30 April 2008, p 8.

58 For an overview of the ATO's operations in relation to tax havens, see ANAO, *The Australian Taxation Office's Strategies to Address Tax Haven Compliance Risks*, Audit Report No. 36 2008-09, 29 May 2008.

the ATO and a major incident at its counterpart in the United Kingdom where the details of 25 million taxpayers were reportedly lost in the post.[59]

2.60 The ATO released the full report on 8 May 2008, shortly after the third biannual meeting. At the meeting, the ATO gave the Committee a summary of the review's findings:

> The PricewaterhouseCoopers review reinforced to us that our current policies and practices were generally very sound. We have a very strong culture of protecting sensitive information within the tax office. That was reinforced by the fact that even when we have incidents people talk about those and will openly come forward and say, 'This was an incident,' so that we can then look at what the root causes were.
>
> The review emphasised that we need to raise awareness further in our officers and confirm that arrangements with other agencies in terms of interchange are sound and up to the current environment. Ten years ago, we would not have exchanged information to the extent that we do today. There are a number of broad-ranging recommendations, but there is nothing fundamentally broken within our existing policies and procedures. It is more about reinforcement, training and so forth.[60]

2.61 The Committee congratulates the ATO for actively addressing this potentially serious matter.

The Inspector-General's report on private rulings

2.62 In February this year, the Inspector-General of Taxation finalised his report on potential bias in complex private rulings. Following a review of the ATO's processes, the Inspector-General concluded that there was no evidence of undue revenue bias.[61]

2.63 However, the Inspector-General found clear evidence of perceptions of ATO bias among taxpayers and taxation bodies. The Inspector-General concluded that this was due to a lack of ATO transparency and communication with taxpayers. Part of this problem was caused by the ATO's relationship with Treasury, in particular the confidentiality of the

59 O'Toole C, 'Tax Office checks security after bungles,' *Australian Financial Review*, 6 December 2007, p 6.

60 Third biannual meeting with the Commissioner of Taxation, Gibson B, transcript, 30 April 2008, p 9.

61 Inspector-General of Taxation, *Review of the potential revenue bias in private binding rulings involving large complex matters* (2008) Commonwealth of Australia, p 3.

communications between them. The ATO declined to implement the Inspector-General's recommendation to advise taxpayers of the content of its discussions with Treasury. However, it did agree to advise taxpayers when these consultations were occurring.[62]

2.64 At the third biannual meeting, the ATO gave a number of reasons for maintaining confidentiality. The first was that communications between government and administration need to be confidential. The Commissioner stated:

> While it is put as advice to Treasury, when we are talking to Treasury we are talking to government. It is independent, but we are saying: 'Government, this is what we are seeing in terms of the law. We suggest that you may want to change the law one way or the other.' In providing advice to government, the normal protocol is that those communications between administration and government are confidential. That is the protocol that has always been in force. Otherwise, you would get into a situation where you have the government put under some pressure with the administration saying, 'You need to change the law here,' when the government does not want to change the law. You need to have that confidentiality when we are advising the government. It is the normal advice that government will accept from external parties or internal parties on a confidence basis. They say, 'We will listen to this advice if it's confidential.'[63]

2.65 In the view of the Committee, there are two counter arguments. Firstly, the ATO's communications with government often involve a third party, namely a taxpayer. The Committee accepts that governments conduct confidential policy discussions with stakeholders regularly. One reason to accept confidentiality is that these discussions are often hypothetical. But once a taxpayer is involved, the discussions take a practical character. It is difficult for the ATO to demonstrate that a taxpayer has received natural justice when they are unaware of information contained in these communications between the ATO and Treasury.

2.66 Secondly, the Commissioner appears to be stating that the ATO should not put the government under pressure through Treasury to change the law if the government does not wish to. If the ATO is an impartial administrator of the law, then the government's reluctance to change certain laws may not necessarily be relevant to the ATO's conduct.

62 Id, pp 4-7, 124.

63 Third biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 30 April 2008, p 18.

Government, which represents the democratic majority, may be a better institution to be responsible for these decisions. Another institution that represents the democratic majority is the Parliament. There may be scope in future for this Committee to use the biannual meetings and its developing relationship with the ATO to work through some of these legal and policy issues. Ultimately, Parliament makes the tax laws.

2.67 The Commissioner made further arguments in favour of the confidentiality of ATO and Treasury communications at the hearing.[64] On this occasion, it is not necessary for the Committee to make a conclusion, apart from stating that there are arguments both for and against the confidentiality of discussions between the ATO and Treasury. Any further examination will most likely depend on the extent to which it is raised in future by taxpayers, the Inspector-General and other scrutineers.

Conclusion

2.68 The Committee is pleased with the progress of the biannual meetings. The Committee has been able to hold the ATO to account in relation to topical tax issues and the ATO has had the opportunity to present its side of the story.

2.69 In some cases, such as the Liechtenstein bank records and allegations of BAS and identity fraud, the ATO has provided a reasonable explanation of its conduct. On other matters, such as the security of taxpayer information and the superannuation guarantee, the ATO has demonstrated that it is taking corrective action.

2.70 The biannual process demonstrates to the Committee that the ATO addresses some issues over time. For example, at the first meeting the superannuation guarantee was a high profile problem.[65] At the second meeting the ATO had received extra funding to address it and at the third meeting the ATO was reducing the backlog. The Committee will be able to track progress on issues like this at each hearing and looks forward to continuing the process in future.

64 Id, pp 19-23.

65 Kazi E, 'ATO warns dodgy bosses' *Australian Financial Review,* 21 April 2007, p 3.

3

Complex legislation

Measuring complexity

Bipartisan complaints

3.1 One of the common themes during the inquiry was the complexity of tax laws and the uncertainty and costs this imposes on the community. Major stakeholder groups, including the Taxation Institute of Australia, CPA Australia, the Institute of Chartered Accountants in Australia (ICAA), the National Institute of Accountants and Taxpayers Australia, made this claim.[1] The Inspector-General of Taxation and the Ombudsman also stated that complex tax laws are imposing significant costs on taxpayers and tax agents.[2]

3.2 The Committee also received evidence that, as our economies and financial arrangements become more complicated, our tax laws will reflect this and become more complicated themselves. The Ombudsman noted:

> Nuanced and sophisticated legislation may be required if administrators are to be able to adequately deal with the variety of different taxpayer entities and interactions, and to achieve government objectives of ensuring that taxation contributes sufficient revenue to fund necessary social and community services.[3]

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1 Taxation Institute of Australia, sub 40, p 2, CPA Australia, sub 36, pp 5-6, Noroozi A, transcript, 28 July 2006, p 66, Cantamessa S, transcript, 28 July 2006, National Institute of Accountants, sub 31, p 2, Greco A, transcript, 25 August 2006, pp 17-18, 23.

2 Inspector-General of Taxation, sub 48, pp 10-11, Commonwealth Ombudsman, sub 38, pp 3-5.

3 Commonwealth Ombudsman, sub 38, p 4.

3.3 The Committee accepts that complex tax laws will occasionally be required. However, the breadth of complaints during the inquiry about complexity, and the comments that stakeholders have made over the last 20 years, demonstrate that this complexity has exceeded necessary levels. For example, Senators and Members across the political spectrum have complained about or acknowledged tax complexity.[4]

3.4 For a number of years, the judiciary has also expressed concern about the complexity of tax laws. In 1990, Justice Hill stated that one provision on which he was ruling was drafted:

> …with such obscurity that even those used to interpreting the utterances of the Delphic oracle might falter in seeking to elicit a sensible meaning from its terms.[5]

3.5 In 1991, a High Court Justice criticised the complexity of the capital gains tax:

> The provisions of s.160M(5), (6) and (7) of the *Income Tax Assessment Act 1936* ('the Act') and provisions to which they are related are extraordinarily complex. They must be obscure, if not bewildering, both to the taxpayer who seeks to determine his or her liability to capital gains tax by reference to them and to the lawyer who is called upon to interpret them … successive administrations have allowed the Act to become a legislative jungle in which even the non-specialist lawyer and accountant are likely to lose their way.[6]

3.6 In 2000, Justice Kirby noted the Court's long standing concern about the complexity of tax legislation:

> This appeal from the Full Court of the Federal Court of Australia concerns the construction of the *Income Tax Assessment Act 1936* ('the Act'). The complexity of the Act has long been the subject of comment and complaint.[7]

3.7 In 2002, a Member of the Administrative Appeals Tribunal found that any deficiency with the way the Australian Taxation Office (ATO) exercised

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4 Hon A Cadman MP, *House Hansard*, 9 October 2006, p 111, Hon P Costello MP, Treasurer, *House Hansard*, 22 June 2006, p 1, Hon D Kerr MP, *House Hansard*, 22 June 2006, p 1, Senator Hon H Coonan, *Senate Hansard*, 20 June 2005, p 15, Mr C Hayes MP, *House Hansard*, 16 August 2006, p 46.

5 Hill J, *FCT v Cooling* (1990) 90 ATC 4472, 4488.

6 Deane J in *Hepples v FCT [No. 2]* (1991) 65 ALJR 650, 657.

7 Kirby J, *FCT v Scully* [2000] HCA 6, para 43.

the Commissioner's discretion was based on the complexity of the legislation:

> The rules are complex and rigid. They cry out for simplification … If blame is to be apportioned, a large part of it must rest with the legislation provisions that dictate the result in this case. At the very least, they are inherently difficult to explain.[8]

3.8 Based on this evidence, the Committee concludes that complexity in tax legislation is a widely recognised problem. The broad political spectrum recognises this complexity. Further, the judiciary has expressed concern about complexity for at least 15 years. This suggests that there are a number of long standing reasons that have contributed to complexity. The report considers this issue further below.

Amount of legislation

3.9 One method of measuring the complexity of a tax system is to count the number of pages of tax legislation. The Committee accepts that this is not a perfect method. For example, the Ombudsman noted that the volume of rulings also needs to be taken into account.[9] Nevertheless, the Committee believes that the number of pages of tax legislation gives a good initial overview of the degree of complexity.

3.10 Figure 3.1 on the next page gives time series data on the number of pages of income tax legislation since the Parliament first passed the 1936 Act. The first point to note from the chart is that this data has not been collected on a systematic basis, so there is a large number of gaps in the data.

3.11 The second point to note is that, sometime after 1970, the rate at which the tax legislation grew started to accelerate. This rate of growth in the income tax legislation appeared to accelerate again in the late 1990s, apparently due to A New Tax System and the plain English rewrite. The latter commenced in 1993, with the Parliament passing the first legislation in 1997.

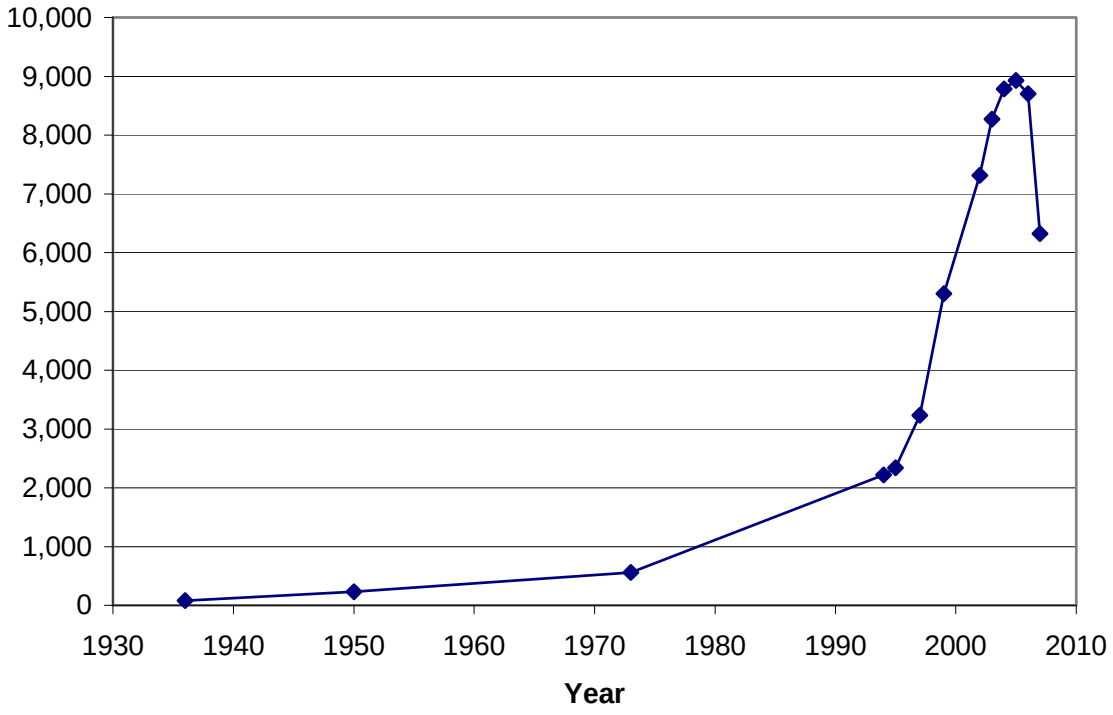
3.12 Since 1997, there have been two main income tax Acts: the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*. These two pieces of legislation contained duplicated provisions, which partially accounted for the increase in the volume of legislation. In November 2005,

8 Associate Professor McCabe, AAT hearing of *Trustee for the Estate of EV Duke v FCT* (2002) 50 ATR 1060, quoted in Wallis D, 'The tax complexity crisis' *Australian Taxation Review* (2006) vol 35, p 278.

9 Commonwealth Ombudsman, sub 38, p 4.

the Treasurer released the Board of Taxation's review of how the income tax laws could be rationalised. The Board did not support a merger of the two Acts, particularly because no consensus existed on the method by which it would be achieved. Instead, the Board recommended that the Parliament repeal the duplicated or inoperative provisions in the 1936 Act.[10]

Figure 3.1 Number of pages of income tax legislation, Australia, 1936 to 2006



Source *Kobetsky M, Dirkis M, Income Tax (1997) Federation Press, p 40 and recent editions of the Income Tax Assessment Act 1936 and Income Tax Assessment Act 1997.*

3.13 The repeal of these inoperative provisions occurred in 2006. This is shown as the drop at the end of the graph.

3.14 There has been some debate about whether this decrease in the volume of the tax legislation has reduced complexity. In its submission, CPA Australia argued that the tax law is effectively unchanged, so the compliance burden remains the same:

> While the Treasurer's recent announcement that the Government would move to reduce tax law by 30% through the removal of inoperative provisions is necessary and useful, the impact on the

10 Board of Taxation, *Identification and possible repeal of the inoperative provisions of the 1936 and 1997 Income Tax Assessment Acts*, (2005) Commonwealth of Australia, p 5.

> overall compliance burden on taxpayers and their advisers of such a change is unlikely to be significant given that the provisions being removed are generally no longer relevant.[11]

3.15 The alternative view is that reducing the volume of legislation must help taxpayers and tax agents to some degree, especially when they do not have a large body of tax experience to draw on. As David Wallis commented, CPA Australia's argument:

> …is based on an assumption of preconceived familiarity with the legislation. What of those who do not know that the provisions are inoperative; who do not know to ignore them? When even without these pages the legislation is of considerable length, their 'inoperative' presence must nonetheless operate overwhelmingly to labour, misdirect, and bemuse the reader who vainly searches the pages in hope of assistance. For new practitioners involved in taxation, the official declaration of inoperative provisions will no doubt prove to be of assistance.[12]

3.16 The Committee is of the view that repealing the inoperative provisions in the tax law has had a significant effect in reducing tax complexity. The fact is that law is law, whether inoperative or not, and remains in force until repealed. There is considerably more work to be done, but the reduced volume of tax laws has been of assistance.

3.17 In 2004, PricewaterhouseCoopers and the World Bank published a comparison of the number of pages of tax legislation of the 20 largest economies in the world. Australia, ranked 13th, was included. The results are displayed in Figure 3.2.

3.18 The graph shows that, by international comparisons, Australia has a highly complex tax system. In 2004, Australia was ranked third out of the 20 largest economies in the world in terms of the volume of tax legislation. Only India and the United Kingdom had bulkier tax laws.

3.19 The figure also shows the effect of the repeal of inoperative tax laws in 2006 with an additional entry for Australia in 2007. Assuming all other countries stayed at their 2004 levels, the repeal means that Australia dropped one ranking to fourth, below Japan. This is consistent with the Committee's earlier conclusion that the repeal of inoperative provisions will be beneficial in addressing tax complexity, but that more is required.

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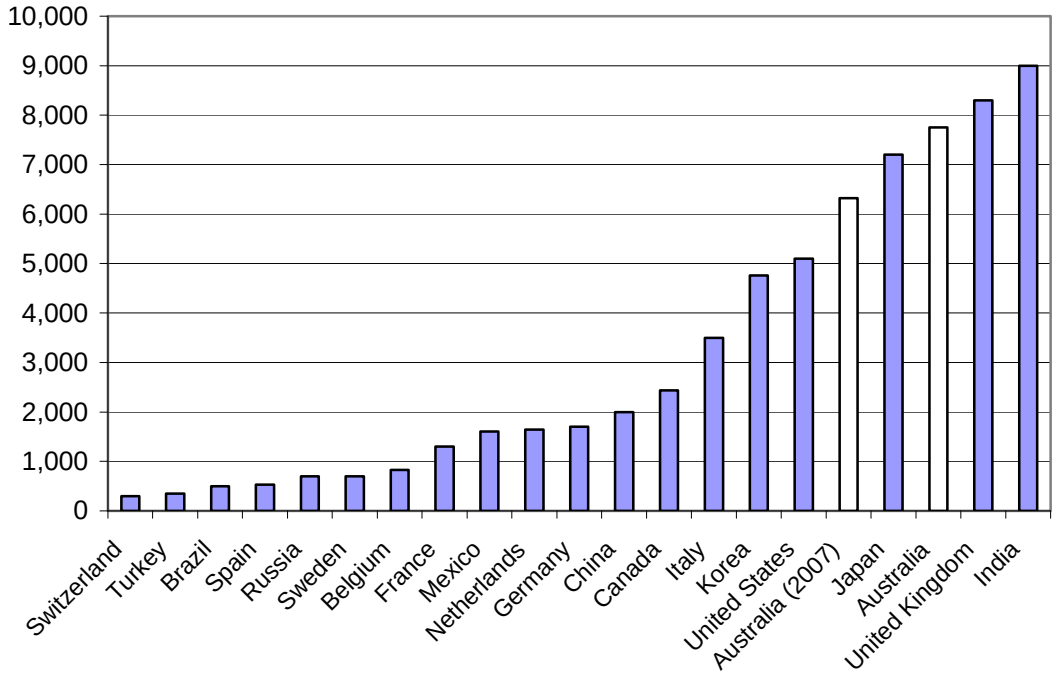
11 CPA Australia, sub 36, p 5.

12 Wallis D, 'The tax complexity crisis' *Australian Taxation Review* (2006) vol 35, pp 277-78.

Figure 3.2 Number of pages of primary federal tax legislation of the top 20 nations by GDP, 2004



Source *PricewaterhouseCoopers, The World Bank, Paying Taxes: The global picture (2006) PricewaterhouseCoopers, p 16, viewed at http://www.doingbusiness.org/documents/DB_Paying_Taxes.pdf on 31 January 2007.*

3.20 Finally, the graph gives an indication of the scale of work remaining. Although international comparisons must always be done cautiously, a possible goal for Australian legislators and governments would be to place Australia at the middle of these rankings. In 2004, the middle ranked countries were Germany and the Netherlands, with 1,700 and 1,640 pages of tax laws respectively. Therefore, a long term goal would be to reduce Australia's tax legislation to approximately one quarter of its current length (from 6,000 pages to 1,500 pages).

Conclusion

3.21 The Committee received evidence that, as financial arrangements become more complex, our tax system must respond and become more complex as well. The Ombudsman stated:

> While clarity and simplicity are admirable goals in legislation and administration, the reality of tax reform may be that the complex nature of our modern life — especially insofar as it involves

> commercial activities and financial transactions — in some senses mandates a degree of complexity.[13]

3.22 The Committee agrees with this comment and accepts that some complexity is inevitable in the tax system. However, the long standing and bipartisan concerns expressed within the community, the large volume of legislation by international standards, and the considerable amount of time spent by tax agents on keeping up to date demonstrates that tax complexity has gone too far. Both Parliament and the Government need to change current practices to deliver a more practical system in the medium to long term.

Causes of complexity

Historical development of tax laws

3.23 In his 2003 paper, Professor Rick Krever gives a historical overview of how Australia's tax laws became so complex. The main theme in the paper is that each participant in the tax system has acted in a logical manner from their own perspective. No particular group has claimed responsibility for the tax system overall, leading to the current arrangements. The groups best placed to have taken overall responsibility for the tax system have been successive parliaments, who must take ultimate responsibility.[14]

3.24 For example, the judiciary has taken a conservative, precedent-driven approach to interpreting tax legislation. Although this is normal judicial practice, it has had unintended consequences. For example, the courts have used principles from the law of trusts to define income for tax purposes. Therefore, some gains that have clear economic benefit are not traditionally defined as income, such as gains from selling investment assets. Another example is the principle of vicarious liability in tort law to decide whether a worker is an employee or not. Vicarious liability revolves around the amount of control that the 'employer' exercises over the 'employee.' However, this test does not examine the economic nature of the relationship, which is probably more relevant for tax purposes.

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13 Commonwealth Ombudsman, sub 38, p 4.

14 Krever R, 'Taming Complexity in Australian Income Tax' *Sydney Law Review* (2003) vol 25, p 468.

3.25 Although these judicial methods have made tax law more difficult to apply, Professor Krever notes that parliaments (and implicitly governments, who usually introduce the legislation) have authority to overturn these decisions by legislation.[15]

3.26 Another key group is the advisers. Many pieces of tax legislation over the years have distinguished particular entities or transactions for the purpose of delivering a tax benefit. Often, accountants and lawyers have changed the legal character of their clients' affairs to obtain this benefit for their clients. One example among many was in the 1970s, where the gains on the sale of shares were tax free. Taxpayers, therefore, sought to extract value from shareholdings on this basis, rather than by receiving dividends. In economic terms, these ways of extracting value from shares are similar. Therefore, it was not difficult to change the legal appearance of the transaction to fit the tax law.

3.27 Some commentators have argued that advisers should exercise professional responsibility and not devise these arrangements. However, where the transactions are legal, the legislature must also bear responsibility for establishing the framework within which these transactions occur.[16]

3.28 Professor Krever also expresses concern about how various public sector groups in the political process have approached tax issues:

- legislative drafters continue to use complex terms and structures in drafting legislation
- Treasury has tended to take 'stop-gap' solutions to legislative repairs, rather than more fundamental reforms
- elected representatives have preferred 'stop-gap' solutions, partially due to the three-year election cycle
- elected representatives have used the tax system to achieve social and economic policy goals, rather than efficiently collect revenue.[17]

3.29 In many cases, the combination of these factors has led to a vicious circle where a legal distinction is enacted and then advisers seek to exploit it:

> Using, or more accurately, misusing, the income tax law as a spending vehicle is undoubtedly one of the largest sources of complexity in the legislation. It has proved impossible to

15 Id, pp 470-72.
16 Id, pp 480-83.
17 Id, pp 483-88.

> deliberately distort investment or consumption behaviour by lowering the tax burden on preferred activities and not invite abuse. Tax law never specifies the intended recipients of concessions; at best it seeks to define the types of transactions or investments that will qualify for tax expenditures. However tightly the boundaries of desired activities and assets are defined, it is inevitable that they will be breached by well advised taxpayers recharacterising the transactions and investments to qualify for the subsidies. This activity, in turn, will lead to complex anti-avoidance measures intended to protect the integrity of the original subsidy scheme. The new legislation will lead to further planning which will lead to further legislation, and the cycle will continue for many years until either the concession is abandoned or is buried within dozens of complex anti-avoidance provisions.[18]

3.30 The idea that a large number of groups are responsible for the current state of affairs was confirmed in evidence. The Taxation Institute of Australia stated:

> I do not point the finger at anyone in particular because all of us are in fact guilty parties in allowing the laws to get to that kind of level in some areas.[19]

3.31 Given that many of the issues of tax complexity stem from tax policy and legislation, addressing it probably needs to occur at a high level. There may be scope for detailed review by a parliamentary committee in future into tax complexity and the means by which simplification can be achieved.

3.32 The ANAO recently examined the use of the tax system to implement spending programs in its recent audit on the tax expenditures statement. In 2006-07, tax expenditures totalled $41 billion. The audit found a number of deficiencies in current practice, including a lack of standards to govern the integrated reporting of outlays and tax expenditures, unreported categories of tax expenditures, and in many cases a lack of reliable estimates for tax expenditures. The ANAO also noted a succession of reviews of tax expenditures. The ANAO stated, 'few of the recommendations of these reviews have been adopted.' This meant each review tended to make the same findings and recommendations as the review before it.[20]

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18 Id, p 488.

19 Mills A, transcript, 28 July 2007, p 54.

20 ANAO, *Preparation of the Tax Expenditures Statement*, Audit Report No. 32 2007-08, 8 May 2008, pp 10-14.

3.33 These long standing difficulties suggest that reform of tax expenditures is overdue. Tax concessions, exemptions and allowances distort and complicate the tax system. Equity and efficiency is often served when the system is made simpler. In February 2008, the Minister for Finance announced a program-by-program review of government spending and tax concessions with a focus on efficiency, transparency and accountability.[21]

The use of exemptions

3.34 Occasionally, drafters of tax legislation have the choice between listing specific items that will attract tax consequences, or to make the arrangement more general and then list a number of exemptions. During the inquiry, the Committee received evidence that the exemption approach is often used and is much more difficult for practitioners to apply. In relation to Fringe Benefits Tax, the Tax Institute of Australia stated:

> The New Zealand model, as originally designed, was quite simple. They asked: 'Where are 90 per cent of the fringe benefits arising?' They then said: 'Let's go after that. Let's make it very specific. They're the bits that we want to tax, and by hitting the employers we'll try and encourage them to cash it out.' That is essentially what the driver was under the original fringe benefit tax rules. The difficulty is that our approach was to go global … and to try and capture everything within the web and then only let little bits out.
>
> By doing that, we have created all these very complex rules… We have really got to the point where we need to ask: 'Where are the big dollars in this stuff? What are the things that we want to chase? Are the little ones really worth it from the collection side?'[22]

3.35 Further, legislators have the choice of deciding how many exemptions to allow for a particular arrangement. These exemptions also add to complexity. The ICAA commented in relation to pay as you go:

> The pay-as-you-go instalment system is probably another one of those examples where we had legislation that was brought in and the effect of it was realised after the event … At the end of the day, now you have a base legislation with so many carve-outs that is extraordinarily complex legislation to read. Something that was

21 Id, p 14.

22 Dirkis M, transcript, 28 July 2006, p 61.

> basically fairly simple for companies and for individuals is now extraordinarily complicated.[23]

3.36 The Committee accepts that governments and legislators make the final decision on structuring taxes. They also introduce exemptions for sound policy reasons. However, the Committee believes that exemptions need to be more widely recognised as a source of tax complexity.

Frequency of changes

3.37 The Committee also received evidence that the rate of changes to the tax laws have added to complexity. In its 2004 pre-election survey, the Australian Chamber of Commerce and Industry asked businesses what are their most critical issues generally. The overall complexity of the tax system was ranked second. The frequency of changes to tax laws and rules was ranked fifth.[24]

3.38 The National Institute of Accountants also argued that the frequency of legislative change has made it harder for the ATO to effectively administer the law, with consequences for taxpayers and tax agents:

> The NIA [National Institute of Accountants], however, believe that the problem lies in the number of new measures introduced at any one time. While this appears contradictory to the NIA's position on supporting personal tax reform, it does however highlight the capacity of taxpayers, tax agents and the ATO to continue to adopt reforms. In other words, for taxpayers and their representative to have certainty in self-assessment, there needs to be a degree of stability in the law.[25]

3.39 Once again, the Committee accepts that governments and legislators are required to meet the needs of the community as they arise and that, on occasions, this may involve large scale or frequent tax changes. However, the Committee believes that there is value in governments and parliaments recognising that such changes significantly add to the compliance burden for taxpayers and tax agents.

Perspective of tax agents

3.40 In November 2004, Dr Margaret McKerchar from the Australian School of Taxation (Atax) at the University of New South Wales conducted a survey

23 Cantamessa S, transcript, 28 July 2006, p 68.

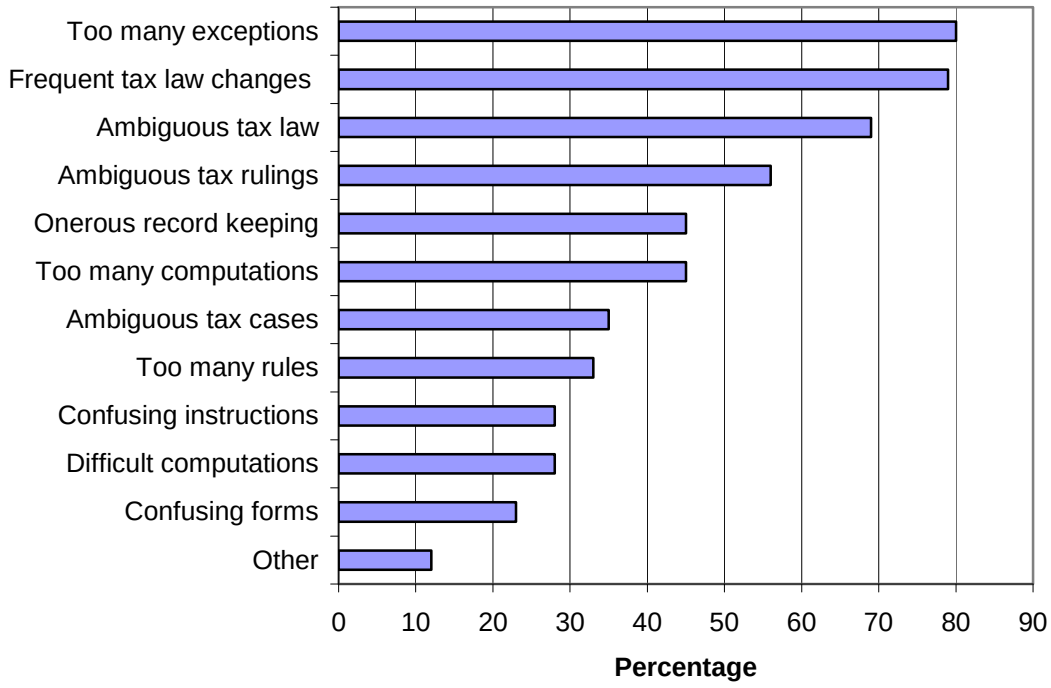
24 Australian Chamber of Commerce and Industry, sub 43, p 5.

25 National Institute of Accountants, sub 31, p 3.

on the complexity of the tax system. She sent an electronic link to the survey to tax agents through the ATO's electronic newsletter, *E-link*.[26] At the time, over 20,000 tax agents received *E-link*. Atax received 221 responses. Although this may not be a statistically valid sample, the results give a useful indication of tax agent experiences.

3.41 The survey included questions about what aspects of the tax system caused the most complexity to them. The results are shown in figure 3.3.

Figure 3.3 Causes of complexity experienced by tax agents, 2004 (%)



Source *McKerchar M, 'The Impact of Income Tax Complexity on Practitioners in Australia' Australian Tax Forum (2005) vol 20, p 538.*

3.42 This survey confirms the earlier discussion. The most commonly cited cause of complexity is the high number of exceptions, closely followed by frequent changes to the tax law.

3.43 The next most common cause of complexity is ambiguity in tax law and rulings. Uncertainty is a particular risk under the self assessment system. Taxpayers are responsible for correctly lodging their return, typically with the assistance of a tax agent. Where taxpayers make an error, they face the prospect of paying penalties and interest if the ATO issues an amended assessment.

26 McKerchar M, 'The Impact of Income Tax Complexity on Practitioners in Australia' *Australian Tax Forum* (2005) vol 20, p 538.

3.44 This resulting complexity has a number of consequences on taxpayers, tax agents, the wider community and the Government. These consequences are discussed next.

Consequences of complexity

Compliance costs

3.45 One of the disadvantages of a complex tax system is that compliance costs increase. One approach in measuring compliance costs is to quantify the time and money spent by taxpayers in meeting their tax obligations and offset this amount by the tax benefits and cash flow effects attached to tax compliance.

3.46 It appears that Atax was the last group to conduct such research (in 1997), funded by the ATO. For the 1994-95 income year, Atax found that net taxpayer compliance costs (that is, excluding the ATO) was $6.2 billion, comprising 7.0% of relevant tax revenue and 1.36% of GDP.[27]

3.47 Extrapolating this result to the present is difficult. On one hand, the tax system has probably become more complicated through growth in tax legislation. On the other hand, the ATO has implemented a number of technological innovations such as e-tax, electronic portals and pre-populated returns that reduce complexity from the taxpayer's perspective. Assuming a pro-rata increase compared with GDP, net taxpayer compliance costs would be $14.2 billion in 2006-07.[28] This is a considerable sum.

Integrity of self assessment

3.48 The system of self assessment places responsibility on taxpayers to ensure their tax returns are correct. However, this principle breaks down when tax law is too complex for taxpayers to understand and imposes prohibitive research costs on tax agents. It is inherently unfair for the ATO to issue an amended assessment with penalties and interest when taxpayers were unable to initially comply.

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27 Evans C et al, *A report into Taxpayer Costs of Compliance* (1997) Commonwealth of Australia, p ix.

28 Australian Bureau of Statistics, *Australian National Accounts: National Income, Expenditure and Product, December Quarter 2007* (2008) Cat No 5206.0, p 21.

Integrity of the legal system

3.49 The legal principle, 'ignorance of the law is no excuse,' dates from Roman times. The rationale for the principle is to prevent parties subject to legal proceedings from avoiding responsibility by stating they were unaware of the relevant law. The traditional assumption underlying the rule is that legislation is properly published and distributed.[29] In the context of this inquiry, however, the assumption now becomes that the law cannot be too complex.

3.50 The Taxation Institute of Australia stated in evidence:

> …one has to query: is it appropriate to have laws that have been criticised by the courts as being horrendously complex and beyond the comprehension of the ordinary taxpayer? …We cannot expect people to comply when it can be nigh impossible to understand the law, and it makes a mockery of the principle that ignorance of the law is no excuse.[30]

Tax agents

3.51 In its submission, the National Institute of Accountants stated that a major cause of complexity in the tax system is the rate at which new provisions are introduced.[31] One measure of the cost of complexity is to assess how much time tax agents spend keeping up to date.

3.52 Margaret McKerchar's 2004 survey of tax agents, discussed earlier, included a question on this. Respondents stated that they spent an average of six hours per week keeping up to date with income tax matters. The survey asked tax agents why they did not spend more time on this activity. The main response (79%) was that they had other work commitments to attend to. Only 7% stated they were fully up to date.[32]

3.53 The Committee accepts that tax agents need to stay up to date with tax laws and that it is something they should do regularly. However, the Committee believes that six hours a week, or 15% of a 40 hour week, places too great a burden on tax agents.

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29 '*Ignorantia juris non excusat,*' Wikipedia, viewed on 7 August 2007 at http://en.wikipedia.org/wiki/Ignorantia_juris_non_excusat.

30 Mills A, transcript, 28 July 2006, p 54.

31 National Institute of Accountants, sub 31, p 3.

32 McKerchar M, 'The Impact of Income Tax Complexity on Practitioners in Australia' *Australian Tax Forum* (2005) vol 20, p 542.

3.54 The Inspector-General of Taxation expressed concern about the sustainability of this compliance burden on tax agents. His submission gives a number of reasons why tax agents find the work unattractive:

> Practitioners are frustrated by the amount of non-value-adding work that they are required to do for the Tax Office and other agencies such as ASIC. Duplication of information gathering across agencies compounds this.
>
> Practitioners are leaving the tax industry for more lucrative fields such as financial planning and valuations.
>
> Practitioners are, as a group, an ageing population. This is compounding the gradual exodus.
>
> Tax practitioner numbers are not replenishing due to overwhelmingly more attractive opportunities and remuneration. People with accounting and related skills are in great demand. Smaller tax practices cannot attract new professional staff and few practitioners have succession plans for their businesses.[33]

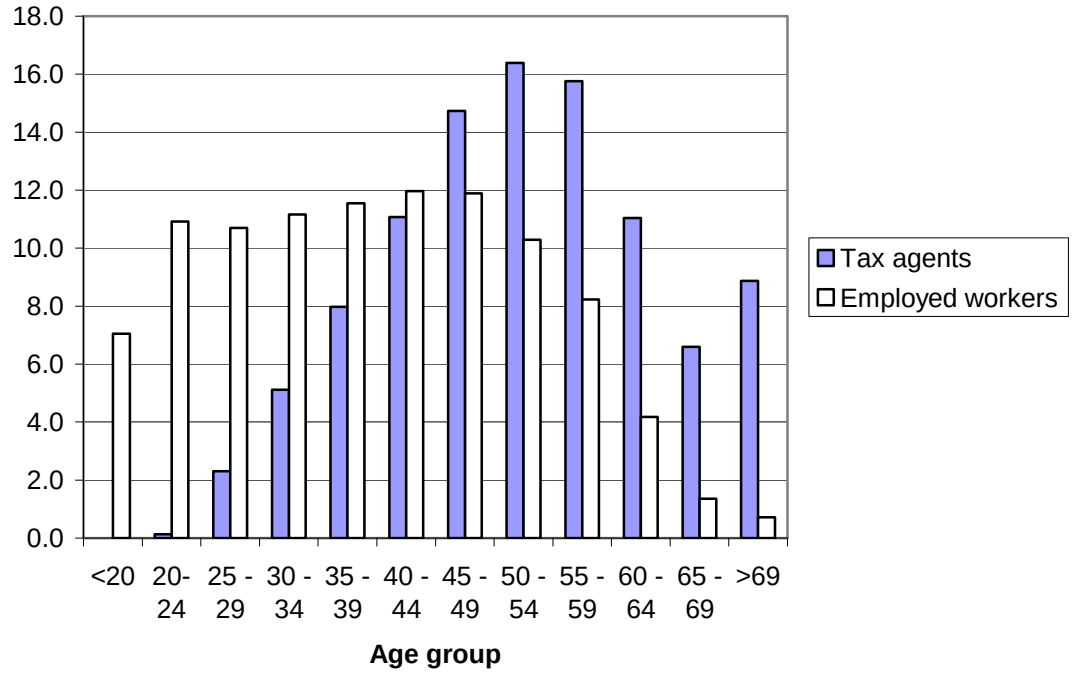
3.55 This burden may have been affecting tax agent numbers. The ATO presented data on the age profile of tax agents to the Committee. Figure 3.4 on the next page compares the age of tax agents against the age profile of the working population. It shows that, on average, tax agents are older than the general population of employed workers. In particular, the main employment ages across the economy are from 20 to 54. For tax agents, this age group is from 40 to 64. Admittedly, the educational requirements for tax agents mean they are unlikely to be fully qualified by the age of 25. However, one would expect significant representation among the 30 to 34 and 35 to 39 age groups.

3.56 The ATO advised the Committee that, over the past few years, the total number of tax agents has stayed constant. This occurred even though many agents have indicated that they would like to retire in the near future. In 2003, 13% of tax agents stated they would like to retire in the next two to three years. This figure increased to 17% in 2005 and 19% in 2007.[34]

33 Inspector-General of Taxation, sub 48, p 11.

34 ATO, sub 50.3, p 41, D'Ascenzo M, transcript, 20 April 2007, p 3, 'A positive future: The latest research results', *the Taxagent*, December 2007, p 5.

Figure 3.4 Age profile comparison: employed workers and registered tax agents, July 2006 (%)



Source *ATO, sub 50.3, p 41, Australian Bureau of Statistics, 'Labour Force, Australia, Detailed - Electronic Delivery, July 2007,' Cat No 6291.0.55.001, viewed at http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6291.0.55.001Jul%202006?OpenDocument.*

3.57 The ATO also presented to the Committee some of its research into tax agents' job satisfaction. In 2005, 65% of tax agents reported that they were either very satisfied or fairly satisfied with their work, which rose to 73% in 2007. Only 16% and 13% respectively stated they were either fairly dissatisfied or very dissatisfied.[35] This data, combined with the stable number of tax agents overall, suggests that the problem is attracting new personnel to the industry, rather than encouraging tax agents not to leave the industry.

3.58 In evidence, the ATO stated that it has been developing a strategy along these lines:

> There is a focus, which the commissioner has been working through with CEOs [of the accounting and tax professional bodies], on attracting young people to tax work. I am not sure whether there is an issue about attracting people to the accounting profession or the legal profession. The versatility of those degrees these days means that they are very attractive to graduates for a

35 ATO, sub 50.3, p 134, 'A positive future: The latest research results', *the Taxagent*, December 2007, p 5.

> range of opportunities … attracting them to tax compliance work is certainly something we want to engage in.[36]

3.59 Tax agents are important to the tax system for a number of reasons. Firstly, 97% of businesses and 74% of individuals use them,[37] partially due to reasons of complexity. A shortage of tax agents will lead to higher error rates as more taxpayers complete and lodge their own tax returns. Tax agents also encourage an attitude of compliance among taxpayers.[38] A significant drop in the number of tax agents will have a corresponding effect on the integrity of the tax system.

3.60 The Committee is concerned that, if tax work remains relatively unattractive for too long, the industry will eventually lose significant numbers of staff.

3.61 Shortages may increase tax agent rates and attract some people to the industry. However, the Committee is concerned that the unattractiveness of tax work, compared with other work available to law and accounting graduates, means this will only be a partial solution. Reducing the complexity of the tax system will allow practitioners to focus on the core business and financial issues facing their clients, which will make the work more attractive. How governments and future parliaments might achieve this is discussed below.

Addressing complexity

Regulation impact statements

3.62 In *An Assessment of Tax* in 1993, the Joint Committee on Public Accounts (JCPA) expressed concern about the high compliance costs of the Australian tax system compared with the United Kingdom (UK). There, the JCPA estimated that compliance costs in Australia were five to 11 times higher than in the UK. The JCPA recommended that all future tax legislation be supported by a Taxation Impact Statement, which would include compliance costs and an assessment of simplification effects.[39]

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36 Granger J, transcript, 20 April 2007, p 4.

37 ATO, sub 50, p 35.

38 Id, p 46.

39 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 90-91.

3.63 The ATO implemented this recommendation in 1996. Later that year, the previous Government announced a requirement for regulation impact statements for any regulatory proposal affecting business. Although the process for tax measures is roughly the same as for other proposals, they have been given some exemptions from processes due to their commercial sensitivity.[40]

3.64 In January 2006, the Taskforce on Reducing Regulatory Burdens on Business finalised its report, *Rethinking Regulation*. The Taskforce noted a number of reasons affecting the quality of regulations. One particularly relevant to this inquiry is that the costs of regulation are diffuse and 'off-budget.' In other words, a large number of individuals and businesses incur a relatively small amount of compliance costs each, but which add up to a large sum across the economy.[41] The Atax compliance cost study in 1997 demonstrates this has occurred in the tax industry.

3.65 Further, the move to self assessment made taxpayers responsible for accurately complying with tax legislation. This meant that taxpayers bore many of the costs of following complicated tax laws. Moving this responsibility 'off-budget' reduced the incentive for governments and parliaments to enact simple legislation. Because the ATO does not need to initially assess each return, it does not use the tax laws in the same way as taxpayers who experience the full costs of complexity. One commentator has likened the ATO's role to being, 'an armchair critic.'[42]

3.66 The Taskforce concluded that systems such as regulation impact statements have not delivered the benefits initially anticipated. Further, this is common across the country:

> … most governments in Australia have introduced disciplines to limit the effect of these and other influences on the extent and quality of regulation, most notably the Regulation Impact Statement requirements. However, … while sound in principle, the requirements have often been circumvented or treated as an

40 D'Ascenzo M, 'Response to Regulation Impact Statements (RISs) and Compliance Costs' viewed on 7 March 2007 at http://www.ato.gov.au/super/content.asp?doc=/content/22860.htm&pc=001/001/001/002/002&mnu=9861&mfp=001/007&st=&cy=1.

41 Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006) Commonwealth of Australia, p 15.

42 Inglis M, 'Is Self-assessment Working? The Decline and Fall of the Australian Income Tax System' *Australian Tax Review* (2002) vol 31, p 65.

> afterthought in practice. The upshot is that they have often not realised their potential to improve the quality of regulation.[43]

3.67 This assessment is consistent with submissions made to the inquiry. Both the Australian Chamber of Commerce and Industry and the Taxation Institute of Australia argued there should be better regulation impact statement processes. Instead of trying to address individual complexity issues the Chamber preferred a systemic approach through improved consultation and regulation assessments.[44]

3.68 The Taskforce made a number of recommendations to strengthen regulation impact statements and regulation in general, including:

- mandating a compliance costing tool in assessing proposed regulations
- tightening 'gate-keeping' requirements for regulatory proposals
- developing broader performance indicators for regulators
- improving consultation with stakeholders, such as establishing consultative bodies and protocols on consultations.[45]

3.69 The previous Government agreed to most of the recommendations, including all those listed above.[46] The Office of Best Practice Regulation (OBPR) has released a range of material that builds on these documents, including the *Best Practice Regulation Handbook*.

3.70 The OBPR, which is now part of the Finance and Deregulation portfolio, has become Government's internal advisor on compliance with the new requirements for regulatory impact statements and associated processes. Generally, they now comprise:

- decision makers such as ministers receive OBPR advice on whether the assessment requirements have been met before making decisions
- the Department of Prime Minister and Cabinet needs the Prime Minister's permission to circulate Cabinet material that does not comply with the assessment processes

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43 Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006) Commonwealth of Australia, p 15.

44 Australian Chamber of Commerce and Industry, sub 43, p 5, Taxation Institute of Australia, sub 40.1, p 4.

45 Id, pp 145-75.

46 Australian Government, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business, Australian Government's Response* (2006) pp 75-89, viewed on 7 March 2007 at http://www.treasury.gov.au/contentitem.asp?ContentID=1141&NavID=.

- where a measure is implemented that has not complied with the assessment requirements, any relevant explanatory material should include reference to this non-compliance
- non-compliant measures should be subject to a post-implementation review within one to two years of implementation
- OBPR reports publicly about compliance with the requirements in its *Best Practice Regulation Report*.[47]

3.71 The Committee appreciates that governments have introduced a number of reforms in regulation assessment. However, the Committee is concerned that many of the incentives to over regulate and to move risks 'off-budget' will remain. The *Handbook's* status as a policy, rather than legislation, means that compliance is placed at greater risk.

3.72 The Committee accepts that converting the *Handbook's* requirements into legislation is excessive. From time to time, the community expects governments to move quickly in addressing important issues. What is important is that governments are accountable to the community when they decide to override regulatory assessment processes. Section 39 of the *Legislative Instruments Act 2003* requires explanatory statements to be tabled with legislative instruments. If this does not occur, the relevant minister is to table an explanation for non-compliance. A similar approach can be taken here.

Recommendation 3

3.73 **The Government introduce legislation to require:**

- **the reporting of compliance with the *Best Practice Regulation Handbook* in all explanatory material accompanying a regulatory proposal**
- **a summary of the requirements of the *Best Practice Regulation Handbook* in all explanatory material accompanying a regulatory proposal**
- **the relevant minister to table an explanation with the relevant Bill or Legislative Instrument in either House of Parliament if this reporting of compliance does not occur.**

47 Office of Best Practice Regulation, *Best Practice Regulation Handbook* (2007) Commonwealth of Australia, pp 32, 34-37.

3.74 As Professor Krever noted, Parliament is ultimately responsible for the tax law, and by implication the law overall. In the view of the Committee, the individual Houses of Parliament can improve their own processes in examining legislation. When Bills are referred for committee review, the standard terms of reference are broad. That is, that the provisions of the bill are referred and any other relevant matters. Therefore, regulatory impacts often do not get considered.

3.75 Some Parliamentary review of regulatory proposals already exists, such as the Senate Standing Committee on Regulations and Ordinances. However, this tends to focus more on the status of the provisions as delegated legislation, rather than the Parliament being a gate-keeper.[48] The Committee would like to see Bills and other regulatory proposals being subject to regulatory impact analysis by the Parliament, even if in the early stages it covers more basic topics, such as the consultation process, compliance with the *Best Practice Regulation Handbook* and the robustness of any cost-benefit analysis.

3.76 Therefore, without limiting the right of the two chambers to set terms of reference for Bill inquiries as they determine, the Committee makes the following recommendation.

Recommendation 4

3.77 **The Senate and House of Representatives Procedure Committees examine whether to incorporate regulatory impacts as part of the standard terms of reference for bills inquiries. The Procedure Committees can consider whether to develop a checklist to assist Parliamentary Committees in assessing regulatory impacts.**

3.78 The Committee also wishes to ensure that agencies respond to regulatory assessment requirements by improving their processes at an early stage in policy and legislative development. The earlier agencies enhance their processes, the more likely they are to deliver results.

3.79 The Committee would like to confirm that agencies make these changes to their internal processes, preferably through reporting by an external scrutineer. It appears that the best agency to make such assessments would need direct access to agency records. The agency that has both

48 Senate Regulations and Ordinances Committee, 'Guidelines on the Committee's application of its Principles,' viewed on 11 June 2008 at http://www.aph.gov.au/Senate/committee/regord_ctte/guidelines.htm.

expertise in relation to public sector processes and can access agency records is the Australian National Audit Office (ANAO). The ANAO may wish to consider whether this would be a suitable topic for a performance audit in future.

Drafting styles

3.80 A large part of the tax debate has revolved around whether drafting styles can improve tax laws. In 1990, the then Government investigated whether the tax laws could be simplified through drafting alone. A joint ATO and Treasury taskforce concluded that this would not be effective without first simplifying tax policy. The Government deferred the matter.[49]

3.81 In 1993, the JCPA's report, *An Assessment of Tax,* recommended redrafting the *Income Tax Assessment Act 1936*. This led to the Tax Law Improvement Project (TLIP), commencing in 1993, which developed a radically new way of drafting tax legislation. The *Income Tax Assessment Act 1997* features plain English, diagrams, flow charts, cross references, and examples. The *Taxation Administration Act 1953* also now includes some of these features.[50]

3.82 However, there have been a number of issues in relation to this rewrite. Firstly, a number of parties have argued that, where tax policy is complex, plain English legislation does not reduce this complexity. Rather, it tends to show more clearly the complexity of the tax system. [51] Sir Anthony Mason, a previous Chief Justice of the High Court, has stated, 'plain language on its own is a passport to nowhere.'[52]

3.83 In response, Treasury argued as follows:

> When you say that plain English has not helped, the Tax Law Improvement Project, which resulted in the 1997 act, I think is universally—even by the practitioners—regarded as clearer law to understand than its predecessor in the 1936 act.
>
> When I was a law student it was often said that certain paragraphs of the 1936 act were incomprehensible. They may have been shorter in the sense that they were of fewer pages in length, but it

49 Krever R, 'Taming Complexity in Australian Income Tax' *Sydney Law Review* (2003) vol 25, p 491.

50 Id, p 492.

51 Id, p 493.

52 Taxation Institute of Australia, sub 40.1, p 3.

> is very difficult when you have paragraphs that go without a comma for half a page or a page.[53]

3.84 Perhaps the best way to resolve this debate is to recognise that plain language drafting is a necessary, but not sufficient step in tax law simplification. Deleting inoperative provisions made tax laws clearer but still left much work to be done. The Committee views plain language drafting the same way.

3.85 The second issue is that in 1993 the JCPA did not support a plain English rewrite. Rather, the JCPA supported a tax policy review, which would result in simpler tax policy and then be reflected in legislation. The report states:

> The Committee is of the view, that any attempt to redraft the Act must necessarily look at broader, structural issues within the total taxation system. Simplification, in this context, should concentrate on achieving a tax system which is fair, equitable and economical. The objective must be to reduce the total cost of the taxation system. Consequently a redraft of the Act, while crucial, cannot be successfully achieved in the absence of a fundamental review of the administrative, political and social implications of changes in the Act.
>
> The Committee received evidence concerning a proposal to redraft a particular Division of the Act in a plain English style. The Committee noted the merits of such an attempt but was also cognisant of the significant difficulties raised by such an exercise. In particular, evidence from the Commonwealth's First Parliamentary Counsel highlighted the difficulties of major redrafting, particularly the importance of establishing the underlying policy of the Act and the need to maintain, where necessary, precision.
>
> Consequently, in performing a redraft, the Committee believes the fundamental assumptions underlying the Act, including the basis on which the Act is to be administered and the policy decisions inherent in the Act, should be evaluated, discussed and clarified.[54]

3.86 Earlier in the chapter, the Committee noted the high level of concern in submissions and in evidence about the complexity of tax laws. It is not surprising that the plain language rewrite of the tax laws, occurring under

53 McCullough P, transcript, 9 November 2006, p 53.

54 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 82-83.

successive governments, has not addressed the bulk of the problem. In a comparative analysis of tax reform in the United States, United Kingdom, Australia and New Zealand, Margaret McKerchar from Atax stated:

> In terms of drafting legislation, the experiences of the US, Australia and the UK… clearly demonstrate that improving the readability of the tax laws per se is largely ineffective or at best superficial where the underlying policies are not also reviewed. That is, complex policy, or policy where the objectives are not well articulated, impede the drafting of simple and less voluminous legislation.[55]

3.87 Sir Anthony Mason has taken the view that a number of factors are necessary for tax simplification. He argued that, in New Zealand, successful tax legislation is developed through the following:

> …coherent and consistent policy formulation, transparent consultation, drafting by a drafting unit within the Policy and Advice Division of the Tax Office (not by Parliamentary Counsel or Treasury), purposive clauses and extra-statutory references, general rules to overarch more specific rules and a commitment to modern drafting techniques and to plain language.[56]

3.88 The Committee accepts that principles-based (or purposive) drafting will have a role to play in simplifying tax laws. However, a number of factors are also required. Perhaps the most important of these is consultation on tax policy.

Consultation in legislation

3.89 In *An Assessment of Tax*, the JCPA expressed a strong desire that any legislative rewrite should be done in a spirit of consensus:

> During the Inquiry the Committee noted proposals for the establishment of a specialist committee to oversee a redraft of the Act. The Committee considered such a committee to be too limited given the fundamental significance of the proposal for a redraft. The Committee has concluded that a broadly based task force drawing upon a wide cross-section of skills, experience and the

55 McKerchar M, Meyer K, Karlinsky S, 'Making Progress in Tax Simplification: A Comparison of the United States, Australia, New Zealand and the United Kingdom,' chapter 20 in McKerchar M, Walpole M (eds) *Further Global Challenges in Tax Administration* (2006) Fiscal Publications, p 374.

56 Taxation Institute of Australia, sub 40.1, p 3.

> professions, would represent a suitable vehicle for the performance of this significant duty…
>
> Such a rewrite however, would only be possible with the absolute commitment of all political parties, the bureaucracy, the taxation industry, business and taxpayers generally.[57]

3.90 The current Committee agrees with these sentiments. The best way for government to develop a consensus is to engage with stakeholders and the community. In other words, governments should consult on tax proposals.

3.91 In 2002, the Board of Taxation finalised a report on consultation, which included some recommended principles. These included government:

- committing to consult on developing all substantive tax legislation, unless exceptional circumstances apply
- obtaining early external input in identifying and assessing overall policy and implementation options (before publicly announcing the policy)
- obtaining input from external stakeholders in developing policy and legislative detail
- clearly articulating the policy intent of each new measure at the initial announcement
- releasing a consultation plan for each new tax measure.[58]

3.92 In the *Rethinking Regulation* report, the Taskforce noted that the previous Government adopted the Board's recommendations and this had led to significant improvements in consultation. However, the Taskforce also noted that more needed to be done:

> Nevertheless, based on industry feedback, the Taskforce believes that there is scope to further improve the tax consultation process and to apply more rigorously the Board of Taxation's recommendations.
>
> For example, business has advised that some tax legislation is still being introduced into Parliament with little effective consultation. Any amendments subsequently required can be costly for business to implement and costly for government in terms of the resource-intensive parliamentary processes.

57 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 83.

58 Board of Taxation, *Government Consultation with the Community on the Development of Taxation Legislation* (2002) Commonwealth of Australia, p iv.

> Other amendments are often made 'just in time', which creates difficulties for businesses developing information technology systems and for business planning and advice.[59]

3.93 Consistent with the Taskforce's findings, the Committee received mixed reports on how Treasury was consulting on new tax measures. The National Institute of Accountants wished to, 'publicly acknowledge the good work the Treasury is doing.'[60] CPA Australia stated in evidence:

> With some exceptions we have written to the board of tax on separately as part of their review of consultation, generally speaking we have quite a healthy consultative environment on a suite of things…[61]

3.94 The Taxation Institute of Australia and ICAA put a different view. In particular, they were concerned that the Government's announcements were too detailed at an early stage. They argued that the Government's initial statement should be more general and that consultation should be used to fill in the policy details. The ICAA stated in evidence:

> One of the problems is maybe even a bit earlier in the piece. We do not get consulted at the pre-policy setting stage, so by the time we get involved the policy has already been set… I think that probably the most important one is that pre-policy setting stage, because once the policy is set your hands are a bit tied. For example, one of the things that were introduced last year … was the loss recoupment measure and the introduction of a $100 million ceiling on whether you can pass the same business test. We do not believe that that measure was properly thought through. The policy behind it is not clear. A review was then ordered of how they can improve the same business test. As I say, sometimes you almost need to go a couple of steps back to the policy setting stage to make sure that what follows is appropriate.[62]

3.95 The Taxation Institute agreed:

> At an earlier stage ministers often come out and make a statement about a change to the tax law and then give a whole lot of detail in relation to it, rather than saying, 'Hang on. The principle or the

59 Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006) Commonwealth of Australia, pp 112-13.

60 National Institute of Accountants, sub 31, p 3.

61 Drum P, transcript, 25 August 2006, p 30.

62 Noroozi A, transcript, 28 July 2006, pp 62-63.

> response to a problem that we are trying to achieve is X. Let us then announce that and go away.'[63]

3.96 The Australian Chamber of Commerce and Industry also supported improved consultation.[64]

3.97 Another practice the Committee noted during the inquiry was confidential negotiations between professional associations and Treasury. This occurred in relation to the new legislation regulating tax agents. The Committee understands that Treasury has been conducting confidential negotiations with these groups for two years.[65] Confidential consultations can only represent the views of the individuals that work for the associations and not the views of the members that the associations are meant to represent.

3.98 In evidence, Treasury argued that the particular nature of tax laws means there cannot always be as much consultation as some stakeholders may wish for. In particular:

> Consultation cannot be mandated for every change to the tax system, particularly in cases where there is commercial or market sensitivity, or revenue risk due to tax avoidance. Also, the flexibility government requires in managing the timing of policy change will at times determine the extent and form of consultation that can be undertaken.[66]

3.99 The Committee is concerned that this view might remove an important discipline on Treasury and the Government when developing tax legislation. One of the by-products of consultation is that Treasury is obliged to defend the Government's proposals. The Committee would much prefer this occurred before a Bill enters Parliament. Addressing errors and making adjustments is much easier to achieve during initial development, rather than after a proposal becomes law.

3.100 During the inquiry, the Board of Taxation released a further report on consultation, *Improving Australia's Tax Consultation System*. This report originated in recommendation 7.1 in the *Report of Aspects of Income Tax Assessment* (RoSA). The recommendation was that the Board, in conjunction with Treasury, review international practices with a view to suggesting improvements to the Australian system.[67]

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63 Mills A, transcript, 28 July 2006, p 63.

64 Australian Chamber of Commerce and Industry, sub 43, p 5.

65 Evans A, 'Transparency on training' *Australian Financial Review*, 20 July 2007, p 79.

66 Treasury, sub 51, p 2.

67 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, p 69.

3.101 The Board's 2007 report is different to the 2002 report because it represents an agreed position between Treasury and the Board. The 2002 report stated the Board's views alone. The new report places less emphasis on consultation before announcing the policy intent. The 2002 report stated that government should consult generally unless there are compelling reasons not to do so and that one component of this would be to consult before announcing the policy intent. In contrast, the 2007 report states that government should consult on the detail of tax policy unless there are compelling reasons not to do so. It then adds that government should 'consider whether consultation may be appropriate' prior to announcing the policy intent.[68] In light of the evidence to the inquiry, the Committee prefers the Board's 2002 report on this issue.

3.102 The 2007 report gives some data on confidential consultations. Given the inherently public nature of the tax system, the Committee expects a significant level of public consultation to occur on tax measures. However, of the 58 measures legislated in 2005 on which consultation took place, the Board of Taxation reports there was:

- targeted confidential consultation for 33 measures
- a combination of both open public consultation and targeted confidential consultation or targeted public consultation for 18 measures
- targeted public consultation for five measures
- open public consultation for two measures.[69]

3.103 In other words, 57% of tax consultations in Australia are confidential. The Committee regards this figure as too high. The report itself makes a cogent argument for reducing the number of confidential consultations:

> In recent years a significant proportion of consultations have been conducted as targeted confidential consultations, as distinct from public consultations. While this is appropriate in some cases, there are substantial advantages in public consultations wherever possible. Public consultation ensures that everyone in the community has the maximum opportunity to provide information

68 Board of Taxation, *Improving Australia's Tax Consultation System* (2007) Commonwealth of Australia, pp vi, 3-5, Board of Taxation, *Government Consultation with the Community on the Development of Taxation Legislation* (2002) Commonwealth of Australia, p vi.

69 Id, p 11.

> for government consideration. This potentially improves the quality of the information available to government.[70]

3.104 The Committee agrees with these sentiments. The recommendation in the 2007 report, that consultations be public 'wherever appropriate,' is not sufficient.[71] Treasury and the Government need to take positive steps to conduct tax consultations in public more regularly.

3.105 The Government is aware of these concerns. On 8 February 2008, it announced the appointment of a tax design review panel to investigate these issues, in particular:

- reducing the delay between policy announcement and introducing legislation
- increasing consultation, in particular during the earlier policy development phase
- increasing consultation in prioritising changes.[72]

3.106 The panel is chaired by Mr Neil Wilson of PriceWaterhouseCoopers. It was scheduled to report to government on 30 April 2008.

3.107 This Committee also has its own views of the consultation process for tax laws from the perspective of its members' roles as Senators and MPs. Parliamentarians, including ministers, are not professionally trained in tax law and need help in assessing these laws. Therefore, in addition to devices like Explanatory Memoranda and Bills Digests, the Parliament's committee review system is very important in exposing potential problems with proposed law. However, it appears to the Committee that once Cabinet approves tax proposals, governments expect they will be implemented by all parties, without Parliamentary change. Indeed, much tax law is rushed or waved through. The Committee believes that a more considered and measured approach in Parliament is necessary, including the use of exposure drafts where appropriate.

3.108 In order to improve the consultation process throughout the full development phase of tax laws, and to increase the longevity and stability of legislation, the Committee makes the following recommendation.

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70 Id, p 41.

71 Board of Taxation, *Improving Australia's Tax Consultation System* (2007) Commonwealth of Australia, p 4.

72 Hon C Bowen MP, Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, 'Tax Design Panel to Look at Ways to Streamline Process for Changing Tax Laws,' Media Release, 8 February 2008.

Recommendation 5

3.109 **The Government and Treasury improve consultation on tax measures by:**

- **increasing the number of public consultations compared with confidential consultations**
- **increasing the number of consultations conducted prior to the announcement of the policy intent**
- **increasing the use of exposure drafts of legislation, where practicable.**

The review, Australia's Future Tax System

3.110 On 11 May 2008, the Government announced a wide ranging review into the tax system. It will be chaired by the Secretary to the Treasury, Dr Ken Henry and other external members. The terms of reference for the review cover topics relevant to this inquiry, in particular 'simplifying the tax system' (3.5) and 'reducing tax system complexity and compliance costs' (4.4).[73]

3.111 In *An Assessment of Tax*, the JCPA argued that a wide-ranging debate on tax policy fundamentals was a necessary foundation to addressing tax complexity.[74] *Australia's Future Tax System* has the potential to provide this sort of debate and give effect to the JCPA's recommendations from 15 years ago.

3.112 During the inquiry, a number of topics were raised which had a bearing on tax complexity and administration but were not directly within the terms of reference. Given that the Committee received limited evidence on them, the best way forward would be further consultation. The new review is an ideal vehicle for this.

73 Treasury, 'Terms of reference: Australia's future tax system' viewed on 26 May 2008 at http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1376.

74 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 81-84.

Reflecting the economics of a transaction in tax legislation

3.113 As Professor Krever has noted, much tax legislation has established differing tax consequences based on legal distinctions. Tax lawyers and accountants have often been able to change the legal form of transactions to generate a tax benefit. Professor Krever argues that insufficient policy development leads to a reliance on legal forms over economic substance, which leads to avoidance opportunities.[75] On the other hand, Treasury has stated that commercially sensitive and avoidance measures should not be subject to public consultation.[76] It appears that, in some cases at least, Treasury is concerned that an earlier release of a policy may facilitate avoidance opportunities.

3.114 In the view of the Committee, a more robust policy underlying a tax proposal is less likely to present such avoidance opportunities. In other words, Treasury in the past may have been seeking to protect the revenue from insufficiently developed policy.

3.115 The Committee notes that Treasury has recognised the problems caused by basing the tax law on legal forms rather than economic effect.[77] Further, the previous Government made a concerted effort to introduce this type of reform through the tax value method after the Ralph Review. Professor Krever notes that the drawbacks of the tax value method were that some of its internal definitions were not consistent, it retained all existing concessions, and the scale of change was too large to be achieved in a single round of reform.[78]

3.116 The reduction in compliance costs from successfully introducing this type of reform will be billions of dollars annually. Given these potential benefits, the Committee is of the view that it should be canvassed in the discussion paper. If all parties draw on the experience of the tax value method, then the chances of successful reform on this occasion will be increased.

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75 Krever R, 'Taming Complexity in Australian Income Tax' *Sydney Law Review* (2003) vol 25, pp 480-83.

76 Treasury, sub 51, p 2.

77 Hon P Costello MP, Treasurer, *Exposure Draft of the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2006, Explanatory Material*, pp 3-8.

78 Krever R, 'Taming Complexity in Australian Income Tax' *Sydney Law Review* (2003) vol 25, pp 498-99.

Recommendation 6

3.117 **In the discussion paper for the review, *Australia's Future Tax System*, Treasury and the review panel include the topic of basing the tax system on financial relationships and economic outcomes, ahead of legal forms.**

The requirement to lodge a tax return

3.118 In Australia, almost 100% of individual taxpayers lodge tax returns. This is high by international standards. For example, in the United Kingdom, the rate is 37%. In New Zealand it is 31%.[79] In approximately half of OECD countries, the vast majority of taxpayers are not required to lodge returns.[80]

3.119 Because lodging tax returns occurs across the economy, reducing the number of taxpayers who do this is likely to generate large reductions in compliance costs. There is scope for *Australia's Future Tax System*, to inform and stimulate debate on reducing the number of taxpayers who need to lodge tax returns.

3.120 The OECD reports that a number of revenue bodies are assisting taxpayers by pre-populating tax returns so that much of the information is already filled in.[81] The ATO has also commenced this practice. The tax system is not necessarily simpler, but it masks complexity from the taxpayer's perspective. Although it is addressing the symptoms of complexity, rather than the causes, this is the most the ATO can do as the implementer of tax legislation.

3.121 In order to remove the need for taxpayers to lodge returns, the key requirement is that there should be no end of year 'squaring-up.' In other words, the amounts withheld throughout the year should equal the amount that the revenue authority would issue as a tax assessment following the lodgement of a return.

3.122 Professor Chris Evans at Atax has listed the four main requirements to achieve this result:

- a simple rate structure, such as a low number of tax rates

79 Evans C, 'Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia' *Australian Tax Review* (2004) vol 33, p 169.

80 OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006)*, October 2006, p 6, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf

81 Ibid.

- a comprehensive and accurate withholding regime
- no work-related deductions or, as the OECD, the *Australian Financial Review* and others have suggested, a standard amount for this[82]
- a limited interaction between the tax and social security systems.[83]

3.123 The Committee received a number of submissions that supported reducing the number of taxpayers who needed to lodge returns.[84] In evidence, Taxpayers Australia and the National Institute of Accountants gave in principle support to reducing the requirement to lodge.[85] In the past, CPA Australia has also supported this view.[86]

3.124 The first of the four requirements is an extension of what traditionally occurs at most Budgets, namely an adjustment of income tax rates. Professor Evans at Atax has conducted research that demonstrates it is possible to generate community support for these changes by setting the rates at the appropriate level and having a low income tax offset.[87] Adjusting rates will also be relevant to the workforce participation goals of *Australia's Future Tax System.*[88] For example, the Committee for Economic Development of Australia (CEDA) has commissioned research showing that increasing the tax free threshold raises workforce participation across the economy.[89]

3.125 Changing the withholding regime is administrative in nature. Simplifying tax rates (while maintaining a progressive system) and improving the withholding regime appear to be matters of implementation.

3.126 The remaining two requirements, however, have more difficulties. For example, work-related deductions are very popular because taxpayers see them as delivering a sizeable tax refund each year. In 2000, the ATO commissioned research on this topic. The researchers concluded:

82 OECD, Economic Survey of Australia, 2006, (2006) Policy Brief, p 6 viewed on 10 August 2007 at http://www.oecd.org/dataoecd/43/35/37201820.pdf, 'Tax-returns system needs simplifying' *Australian Financial Review* 31 January 2007 (editorial) p 54.

83 Evans C, 'Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia' *Australian Tax Review* (2004) vol 33, pp 175-76.

84 Fehily Loaring, sub 5, p 4, Morris B, sub 35, p 1.

85 Greco A, transcript, 28 July 2006, p 72, Ord G, transcript, 25 August 2006, p 7.

86 Colman E, 'Heavies weigh in to call for tax reform' *The Australian* 21 April 2006, p 4.

87 Evans C, Tran-Nam B, 'Towards systemic reform of the Australian personal income tax: developing a sustainable model for the future' Personal Income Tax Reform Symposium (2007) Paper 3, p 3-25, viewed on 8 May 2007 at http://www.atax.unsw.edu.au/research/pitr-symposium-07/papers/Paper_03-Evans-Tran-Nam.pdf.

88 Clause 4.1 in the terms of reference.

89 Lateral Economics, *Tax Cuts for Growth: The impact of marginal tax rates on Australia's labour supply,* (2006) CEDA Information Paper 84, pp 1, 14.

> Refunds are what the personal tax system is all about for most taxpayers. Maximizing one's deductions is the only thing that makes the system 'work' for ordinary PAYEs because this is the only way to maximize their refund. Certainly, a personal income tax system without refunds would be unpopular. Individual taxpayers are keen to preserve access to refunds because it helps them to preserve a sense of control and a feeling that they have at least a chance to get their 'fair share back' in the form of a refund.[90]

3.127 This view was confirmed in evidence. Taxpayers Australia stated:

> Studies have been done. As far as taking that away from the public is concerned, I think you will get a lot of objections, because it brings closure to the year. They find out how much tax they have actually paid and there is the opportunity to claim work deductions.[91]

3.128 On the other hand, there is a number of significant, valid reasons to discontinue them. Firstly, it will reduce compliance costs through fewer taxpayers lodging returns.

3.129 Secondly, they present a risk to the revenue in the longer term. These deductions have been growing faster than incomes for a considerable period.[92] For example, taxpayers now claim over $10 billion in work related deductions annually. Recent annual increases have been of the order of 9%.[93] If unabated, governments may need to change the rules to support the integrity of the tax system.

3.130 Thirdly, they are the largest deduction claim for individuals and cost the ATO significant resources in the compliance work needed to monitor them.[94]

3.131 Finally, if any such measure is revenue neutral, taxpayers will be better off because they will have a wider choice of items on which to spend the extra amounts of after tax income, rather than being limited to work expenses. Although there is community support for work-related deductions at present, the advantages of removing them should be debated. *Australia's Future Tax System*, is an ideal place to do this.

90 Pedic F et al, *Simplifying Income Tax: A Report on Forty Community Consultations* (2000) p 57, quoted in Evans C, 'Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia' *Australian Tax Review* (2004) vol 33, p 180.

91 Greco A, transcript, 28 July 2006, p 74.

92 Ibid, Baldry J, 'Personal Income Tax Deductions in Australia, 1978-79 to 1990-91' *Economic Record* (1994) vol 70, pp 424-33.

93 ATO, sub 50, p 20.

94 Ibid.

3.132 The final requirement to reduce the number of taxpayers who lodge tax returns is to limit the interactions between the tax system and government benefits, including social support payments. In Australia, the interactions happen in two ways. Firstly, family tax benefits and other similar payments use the tax system to check each recipient's income estimate so that the Government may apply a means test. The Committee received evidence from Taxpayers Australia that this income test pulls a large number of low income people into the tax system:

> One problem that I see is that the interaction between Centrelink and the tax system complicates everything. People are required to lodge returns because of their Centrelink benefits yet they are well below the tax threshold.[95]

> Every time that we get something like a childcare tax offset it increases the complexity of returns and it means that those people under $20,000 are firmly entrenched, because the only way that they can recover it is to lodge a tax return.[96]

3.133 The other way in which government payments complicate the tax system is through tax offsets and credits. In 2005-06, these amounted to $16 billion for individual taxpayers, out of total net tax payable for this group of $108.7 billion.[97] Examples of the policy areas are private health insurance, seniors, low income, spouses, and medical expenses. Non-personal taxpayers are also entitled to tax offsets and credits. One example is the research and development tax offset.

3.134 Professor Evans has stated that Australia has a large number of tax offsets and credits, particularly in comparison with New Zealand, which has low rates of mandatory lodgement of tax returns:

> … modern tax systems are often used, not merely as the revenue collecting vehicles for which they were primarily designed, but also as agencies for the achievement of the social and political goals for which they were *not* designed. This inevitably causes greater complexity than would otherwise be the case. New Zealand has not escaped this 'modern' trend, but it is less prevalent than is the case with Australia … there is less evidence of the tax offsets, rebates and all manner of other tax expenditures

95 James B, transcript, 24 August 2007, p 49.

96 Culberg A, transcript, 24 August 2007, p 49.

97 ATO, *Taxation Statistics 2005-06* (2008) Commonwealth of Australia, pp 18-20.

> designed to deliver political or social advantage to particular groups that characterise the Australian tax system.[98]

3.135 In its submission, CPA Australia noted the complexity these arrangements impose on taxpayers. It suggested that the Government review its strategy of using the tax system as a delivery vehicle for these payments and benefits.[99]

3.136 In its *Rethinking Regulation* report, the Regulation Taskforce listed a number of design principles for tax legislation. One of these was that direct expenditure, rather than adjusting tax rates, should be used to achieve policy objectives. The Taskforce explained its reasoning as follows:

> Tax is a relatively blunt instrument and is often less efficient in achieving equity objectives than direct expenditures and grants. For example, individual taxable income can be a crude method of identifying taxpayer need, as there are many low-income taxpayers in high-income households. On the other hand, the social security system and payment of grants can use broader eligibility criteria than taxable income, such as family income and assets, to better target those in need.
>
> The tax system is only likely to be preferable when seeking to achieve relatively broad equity outcomes (for example, the use of progressive marginal income tax rates).[100]

3.137 The Committee supports these arguments. Another reason put forward for these changes is that most of these benefits are effectively payments. If they are payments, they should be paid under an appropriation Act. The Committee accepts that there are transparency measures in place for revenue measures such as the budget papers and the ATO's taxation statistics. Revenue measures also usually have a legislative base. However, if an arrangement is essentially a payment made under certain circumstances, then it may be preferable for it to be managed as a special appropriation.

3.138 The final reason why the Committee supports extracting benefits and offsets from the tax system is that, for many of these items, Centrelink already has this role. Using the tax system to deliver them raises questions of duplication.

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98 Evans C, 'Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia' *Australian Tax Review* (2004) vol 33, p 176.

99 CPA Australia, sub 36, p 12.

100 Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business* (2006) Commonwealth of Australia, p 112.

3.139 The Committee accepts that there are a number of reasons why governments have used the tax system to deliver these benefits and offsets. Firstly, the ATO holds reasonably accurate information about taxpayers' incomes. It is administratively efficient to use this information when verifying income amounts for applying a means test. Further, the Government can administer many different benefits and offsets from one location. In other words, the ATO has become a 'one stop shop' for government benefits.

3.140 The price of these efficiencies, however, has been to shift considerable costs on to tax agents. The Committee is concerned that governments have taken these decisions with reference only to their own costs and benefits, without considering the impact on tax agents. The Committee reiterates the earlier point that successive governments and parliaments have not taken responsibility for the tax system overall. Rather, they have made decisions on what best suits them and allowed the compliance burden in the community to grow. The profession of tax agent has become less attractive and is attracting fewer entrants. *Australia's Future Tax System* needs to take these issues into account.

3.141 A matter incidental to reducing the number of taxpayers who need to lodge returns is the future of the tax agent industry. During the inquiry, the National Institute of Accountants supported reducing the number of taxpayers required to lodge returns. However, the Institute also suggested that, if this occurred, there should be a structural adjustment package to compensate tax agents for the reduced business.[101]

3.142 The Committee recognises this argument. Successive governments have created the tax agent industry by making their services tax deductible and creating a tax system that requires them. The other view is that tax agents would be well placed to adapt to such a change due to their education and commercial experience.

3.143 On balance, any such structural adjustment would depend on how demand changes for tax agent services, and this depends on how many taxpayers are no longer required to lodge returns. At this stage, it would be sufficient for *Australia's Future Tax System* to recognise this issue.

101 Ord G, transcript, 25 August 2006, pp 12-13.

Recommendation 7

3.144 **In the discussion paper for the review, *Australia's Future Tax System*, Treasury and the review panel include the topic of reducing the number of taxpayers who need to lodge a return, and simplifying the experience for those who need to lodge, in particular:**

- **the costs and benefits of making work related expenses deductible**
- **whether tax offsets, rebates and benefits should be delivered as direct payments, rather than tax measures**
- **examining the number of tax rates and the tax free threshold**
- **improving the coverage and accuracy of the withholding system**
- **whether, if large numbers of taxpayers were no longer required to lodge returns, it would be appropriate to provide structural adjustment assistance to tax agents.**

Harmonising with New Zealand's simpler business tax system

3.145 In evidence, the Taxation Institute of Australia advised the Committee of the different rationales behind the Australian and New Zealand fringe benefits tax systems. In New Zealand, the tax is aimed at the areas likely to generate the most revenue. These include motor vehicles, low interest loans, free or subsidised goods and services, and employer contributions to sickness funds, insurance and superannuation schemes. The Australian approach is to have a global tax and then to make a number of exemptions or 'carve-outs' from this. In practice, the Australian approach is more complicated and imposes more compliance costs.[102]

3.146 A similar outcome occurred with the GST. Australia based its legislation on the New Zealand model but included a much greater number of exceptions. In 2001, the relevant New Zealand legislation totalled 200 pages, but its Australian equivalent ran to 800. This increased volume of legislation increased complexity.[103]

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102 Dirkis M, transcript, 28 July 2006, p 61, New Zealand Inland Revenue, 'Fringe benefit tax on specific categories of benefits' viewed at http://www.ird.govt.nz/fbt/categories/ on 26 May 2008.

103 Stitt R, 'GST and Financial Services,' *Tax Specialist* (2001) vol 4, p 236. The Committee understands that the current GST law is 490 pages long.

3.147 Data on compliance costs suggests that New Zealand has more success than Australia in managing tax complexity. In an OECD comparison of tax systems, the New Zealand authorities overall spent $0.81 to collect $100 of revenue. In Australia, the cost was $1.05.[104] PricewaterhouseCoopers and the World Bank published some compliance indices for national tax systems (a lower score indicating reduced compliance costs). It gave Australia an index of 107 and New Zealand an index of 70 for hours per year compliance time. New Zealand performed significantly better in relation to GST and company tax.[105]

3.148 The Committee believes that there are a number of benefits to examining whether to harmonise aspects of Australia's tax system with New Zealand's. Firstly, there is the potential to reduce compliance costs. Secondly, it will help foster trade between the two countries. Thirdly, it may encourage the development of uniform business taxes in the South Pacific more generally. Although the GST has been excluded from *Australia's Future Tax System*, other taxes could be harmonised with New Zealand's. These points should be raised in the review's discussion paper.

Recommendation 8

3.149 **The discussion paper for the review, *Australia's Future Tax System*, consider the benefits of harmonising with New Zealand's tax system, even if just for particular taxes like fringe benefits tax, or for particular classes of tax.**

3.150 At the very minimum, it should be possible for the Australian and New Zealand Governments to arrange for their Treasuries and tax authorities to exchange staff so that both countries may benefit from each others' experiences in tax law and administration.

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104 OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006)*, October 2006, p 109, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf. Generally, care must be exercised in this type of comparison due to the differing functions of national tax authorities. The New Zealand and Australian authorities, however, appear to be sufficiently similar in their operations for this comparison to be useful.

105 PricewaterhouseCoopers, The World Bank, *Paying Taxes: The global picture* (2006) PricewaterhouseCoopers, p 16, viewed on 31 January 2007 at http://www.doingbusiness.org/documents/DB_Paying_Taxes.pdf.

Conclusion

3.151 Among developed economies, Australia's tax system is one of the most complex. This has occurred because each set of interest groups have approached the tax system from their own particular perspective, instead of viewing it as a way of efficiently collecting revenue. Tax advisors have sought to minimise their clients' liabilities and the judiciary have applied established legal definitions from other parts of the law to it. Parliaments have sought to implement spending programs through the tax system and introduced stop-gap approaches as remedial measures.

3.152 While political expediency affects policy decisions, a global perspective would have been more appropriate. The need to take a global view is why many tasks are placed with the public sector. The ATO has responsibility for tax measures that operate in a similar way to the social spending programs that Centrelink is specifically designed to administer. This raises questions of duplication and inefficiency. It has also transferred much of the compliance work to tax agents and taxpayers.

3.153 Another problem with this approach is that Australia has a system of self assessment. Taxpayers accept a certain amount of risk that the ATO may amend their assessments and apply interest and penalties at a later point. A complex system increases the chance of taxpayer error and increases taxpayer risk. The tax system's complexity undermines its own integrity.

3.154 In *An Assessment of Tax*, the JCPA recommended a wide ranging tax review to develop widely agreed policies on tax, which would then form the foundation for tax simplification. Without articulating clear policies, tax simplification is very difficult. The Government's review, *Australia's Future Tax System*, could be the type of review that the JCPA called for in 1993. It could be the most important development in tax simplification.

3.155 Regardless of the outcome of *Australia's Future Tax System*, the tax system will be subject to change in the years ahead. Therefore, the Committee has made a number of recommendations to improve the development of tax policy and legislation. Again following *An Assessment of Tax*, perhaps the most important of these is to improve consultations on specific measures. This includes government consulting before the announcement of the policy intent and increasing the proportion of consultations that are conducted publicly. These changes should help reduce the amount of stop gap measures and help stop the vicious circle of amendment and taxpayer reaction.

4

Rulings

The history of rulings

Binding by choice

4.1 The rulings system has developed over time to become more formal and have greater coverage. It had its origins in the 1930s, when the Commissioner for Taxation released Income Tax Orders, which published the Commissioner's interpretation of the tax laws.[1] The Australian Taxation Office (ATO) issued other guidance as well, including public information bulletins and ATO memoranda.[2]

4.2 The first proposal for a formal system was made in the 1975 Asprey Review, which recommended creating a system of private binding rulings on a fee for service basis.

4.3 Although the then Government did not adopt this recommendation, the advent of freedom of information (FOI) legislation in 1982 required a more systematic approach to rulings. At that time, the ATO was using a range of internal guidance to ensure that decisions were accurate and consistent. Under FOI, taxpayers would have a claim to these documents, so it made sense to publicly release them and avoid processing many FOI requests. These published guidelines (income tax rulings and miscellaneous tax rulings) were the precursors to public rulings.

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1 Discussion derived from ANAO, *The Australian Taxation Office's Administration of Taxation Rulings,* Audit Report No. 3 2001-02, 17 July 2001, pp 173-201.

2 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 98.

4.4 In 1986, the Government introduced self assessment for individual taxpayers. Because taxpayers were subject to financial loss, through penalties and interest, if their returns led to a tax shortfall, they were given a mechanism for clarifying their position with the ATO. Section 169A of the *Income Tax Assessment Act 1936* stated that a taxpayer could bring an aspect of their tax affairs to the attention of the Commissioner at the time of lodging the return. The Commissioner would be required to 'give attention to that question.'

4.5 The ATO normally considered itself bound by an opinion formed in response to a section 169A request. If the Commissioner later wished to amend the assessment under section 170 of the *Income Tax Assessment Act 1936,* the taxpayer would still be liable for primary tax. Liability for penalties would depend on the taxpayer's conduct overall, as would remission of interest. The Commissioner would not permit section 169A to be used as a means of taxpayers indefinitely delaying their tax liabilities.[3]

4.6 In 1988, the ATO clarified its advisory system. It announced it would issue two types of rulings. The first was taxation rulings, which were similar to public rulings. The second was advance opinions, which were responses to taxpayer queries about proposed transactions.[4] The latter were similar to private rulings. Both types of decisions were administratively binding on the Commissioner. They had no force of law, but the Commissioner adhered to them unless there were exceptional circumstances, such as new legislation or a new court decision.[5]

Binding by law

4.7 In 1990, the Federal Court handed down its decision in *David Jones Finance v Commissioner of Taxation*.[6] There, the ATO departed from its practice of the previous 30 years of allowing taxpayers who were not registered shareholders to claim a benefit available to 'shareholders.' The ATO relied on the 1976 High Court case of *Commissioner of Taxation v Patcorp*

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3 ATO, 'IT 2616, Income tax: Self-assessment – Questions concerning taxpayers liability to tax – Subsection 169A(2) requests' viewed on 14 May 2007 at http://law.ato.gov.au/atolaw/view.htm?locid='ITR/IT2616/NAT/ATO'&PiT=99991231235958.

4 Section 169A covered completed transactions.

5 ATO,'IT 2500, Taxation ruling system: Policy governing issue of income tax rulings: Status of rulings: Advance opinions' viewed on 14 May 2007 at http://law.ato.gov.au/atolaw/view.htm?locid='ITR/IT2500/NAT/ATO'&PiT=19940616000001.

6 (1990) 12 ATR 1506.

Investments[7] and won. The *David Jones Finance* case reminded taxpayers of the limits of 'administratively binding.'[8]

4.8 Following this, the then Government commenced a review of the self assessment system, which culminated in the *Taxation Laws Amendment (Self Assessment) Act 1992*. The major changes to the rulings system were that:

- rulings now became legally binding on the Commissioner
- if a taxpayer disagreed with a private ruling, they could appeal the ATO's decision to the Administrative Appeals Tribunal (AAT) and the Federal Court
- the Commissioner's power to issue rulings was expanded from income tax to cover the Medicare levy, withholding taxes, franking deficit tax and fringe benefits tax.

4.9 Previously, ATO advice was not binding on the Commissioner. For example, if a taxpayer obtained an advance opinion about a transaction and followed that advice, there was the risk that the ATO could apply a different interpretation of the law. There was no legal protection. These changes, however, gave the taxpayer legal protection if they complied with the private ruling.

4.10 Section 169A was amended so that taxpayers only had the option of making such a request if they were precluded from applying for a private ruling on the matter. These changes effectively discontinued the option of a section 169A request, as private rulings were available for both completed and proposed transactions. The ATO has stated that, until this time, it was receiving approximately 50,000 requests annually under section 169A.[9]

An Assessment of Tax

4.11 In 1993, the Joint Committee on Public Accounts (JCPA) released its report on tax administration, *An Assessment of Tax*. The report covered a number of themes in relation to rulings.[10] The first theme was that rulings should

7 (1976) 140 CLR 247.

8 Cooper G et al, *Cooper Krever & Vann's Income Taxation: Commentary and Materials* (2005) Thomson, 5th Edition, p 885.

9 House of Representatives Standing Committee on Employment, Education and Workplace Relations, Employee Share Ownership in Australian Enterprises, D'Ascenzo M, transcript, 11 May 2000, p 350.

10 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 95-121.

be freely available and well known amongst the relevant stakeholders. The ATO supported these recommendations. They included:

- a requirement to publish public rulings in the Commonwealth Gazette and table them in Parliament
- access to the ATO's public rulings database
- access to the ATO's private rulings database, with identifying features on each ruling deleted.

4.12 The JCPA also wished to ensure that rulings maintained the distinction between the law and the Commissioner's interpretation of the law, the latter of which was represented in the ruling. The relevant recommendations, which the ATO supported, were to detail alternative views in public rulings and to refrain from making contentious rulings where the law needs clarification.

4.13 Another major theme in the report was that taxpayers should not automatically incur penalties for not following a private ruling or a determination (a more specific public ruling). The Committee argued that, if the taxpayer made it clear in their tax return that they had diverged from the ATO's advice, then such penalties were unnecessary. The ATO did not support these recommendations.

4.14 The JCPA noted that private rulings could be seen as free legal advice to taxpayers and argued that this could mean that the ATO would not have sufficient resources to meet demand. The Committee recommended that the Commissioner be given the discretion to charge a fee for private rulings for proposed transactions. The ATO declined this recommendation as well.[11]

Product rulings

4.15 In 1998, the ATO introduced product rulings. These are a type of public ruling that apply only to a specific investment product. Previously, investors relied on private legal opinions sought by the investments' promoters. However, the experience of mass marketed investment schemes and employee benefit arrangements demonstrated there were risks in this approach.

4.16 Investment promoters, rather than investors, apply for product rulings. Chapter one noted that it is difficult now to market an investment without

11 ATO, 'Final Report on the Implementation of the Recommendations of Report 326 "An Assessment of Tax'", Correspondence, 20 October 1998.

a product ruling. These rulings do not advise on the commercial viability of an investment. They are limited to an investment's tax implications.

Review of business taxation

4.17 In 1999, the review of business taxation (the Ralph review) finalised its report, *A tax system redesigned*. The review was wide ranging and did not go to the details of the rulings system. However, it did make some significant recommendations:

- the scope of public and private rulings be expanded to allow the Commissioner to be legally bound on matters of administration, procedure, collection, conclusions of fact, and the operation of Pt IVA of the *Income Tax Assessment Act 1936* (the general anti-avoidance rule)
- the Commissioner to be taken to have issued an adverse private ruling if the Commissioner fails to make a ruling within a specified period
- rules for penalties be changed so that a taxpayer who declines to follow a private ruling is subject to the same penalties as a taxpayer who does not follow a public ruling
- the ATO charge fees for rulings, in particular where there are significant amounts of revenue at stake, significant ATO resources are involved, and where the taxpayer is able to pay.[12]

4.18 Some of these recommendations were raised by the JCPA in 1993. The previous Government did not implement these recommendations. Its actions focussed instead on issues such as tax rates and calculations.

ANAO's performance audit

4.19 In 2001, the ANAO finalised a comprehensive performance audit on rulings. The ANAO found that the ATO managed public rulings much better than private rulings:

> The processes for the production of **public** rulings of high technical quality operate effectively overall but the collection, analysis and use of performance information could be enhanced in some areas. The administrative processes for **private** rulings have operated poorly in many respects. Our assessment for **private** rulings confirmed the findings of administrative inefficiencies noted in reports prepared for the ATO over a number of years…

12 Review of Business Taxation, *A tax system redesigned* (1999) Commonwealth of Australia, pp 137-45.

> The quality (and reliability) of the systems that operate for public and private rulings bear directly on the systems' capacity to deliver fair treatment to taxpayers and maintain consistency over time, and across ATO regions. So too, do the legal and institutional frameworks that shape them. We conclude, overall, that the mechanisms in place for public rulings substantially provide for consistent and fair treatment for taxpayers. This positive assessment for public rulings contrasts with the situation for private rulings where, at the time of the audit, the lack of integration of systems and inadequate systems controls undermine certainty, fairness and consistency of treatment for taxpayers.[13]

4.20 The ANAO made 12 recommendations including improvements to performance information, monitoring by management, data security, and prioritising public rulings.

4.21 In 2004, the ANAO completed a follow up audit. The ANAO reported that the ATO had implemented all 12 recommendations.[14]

Class rulings

4.22 Also in 2001, the ATO introduced class rulings. These are a subset of public rulings and operate in cases where an individual entity applies for a ruling seeking advice about the operation of an arrangement for a group of persons. They reduce the need for multiple taxpayers to request private rulings where their circumstances are largely the same.[15]

4.23 Class rulings bear a number of similarities to product rulings, as they are both public rulings, requested by the members of the community involved in a particular arrangement, that reduce the need for multiple private rulings. The main difference between the two is that product rulings have an element of marketing or promotion.

A 'reasonably arguable' position

4.24 Section 284-90 of the *Taxation Administration Act 1953* provides that a penalty of 25% of the shortfall amount will apply if a taxpayer does not

13 ANAO, *The Australian Taxation Office's Administration of Taxation Rulings,* Audit Report No. 3 2001-02, 17 July 2001, pp 16-17.

14 ANAO, *Administration of Taxation Rulings Follow-up Audit*, Audit Report No. 7 2004-05, 9 August 2004, p 10.

15 ATO, 'What is a class ruling?' viewed on 16 May 2007 at http://www.ato.gov.au/businesses/content.asp?doc=/content/34038.htm&page=1&H1=&pc=&mnu=4280&mfp=001&st=&cy=.

apply a reasonably arguable treatment, and if the shortfall amount is more than the greater of $10,000 or 1% of the taxpayer's income tax liability.

4.25 Section 284-15 defines a position as reasonably arguable when, having regard to the relevant authorities, it is 'about as likely to be correct as incorrect.' Without limitation, the relevant authorities are tax laws, statutory interpretation materials, court and AAT decisions, and public rulings. Some commentators have expressed concern that independent legal opinions are not relevant authorities. If the area is grey because there are no court decisions, then the concern is that a court will only examine the public ruling in determining whether a taxpayer has taken a reasonable position.[16]

4.26 The Federal Court examined this issue in *Walstern v FCT*.[17] The Court considered the previous section 222C of the *Income Tax Assessment Act 1936*, which is very similar to the new section under discussion.[18] There, the ATO argued that legal opinions could not constitute relevant authorities. However, Justice Hill stated:

> It is true that opinions of counsel are not referred to in the definition of 'authority'. On the other hand it may be said that the definition is inclusory so that recourse to the opinions of counsel is not necessarily ruled out by the definition. It is unnecessary in the present case to decide this question, although I am inclined to think that the opinion of eminent counsel practising in the field,… if directed at the actual facts of a case, might well fall within the definition.[19]

4.27 In other words, the list of authorities relevant to determining whether a taxpayer has taken a reasonably arguable position can include legal opinions. This is a fair approach. The ATO does not have a monopoly on legal tax advice. Taxpayers are entitled to approach private sector advisors as a means of demonstrating that they have acted reasonably. If they could not, this would be an unreasonable restriction on taxpayers' personal liberties. It would also potentially breach competition policy.

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16 Scolaro D, 'Tax Rulings: Opinion or Law? The Need for an Independent 'Rule-Maker'' (2006) *Revenue Law Journal*, vol 16, pp 119-20, Corporate Tax Association and Ernst & Young, RoSA submission 27, p 17, viewed on 9 May 2007 at http://selfassessment.treasury.gov.au/content/_download/Submissions/27_cta_ey.pdf.

17 [2003] FCA 1428.

18 In section 284-15, the list of authorities operates without limitation. In section 222C, the authorities include those listed. Both sections list the same authorities.

19 *Walstern v FCT* [2003] FCA 1428, para 112.

4.28 If a court were to subsequently rule that such opinions are not relevant authorities, then the Committee's view is that this matter should be corrected through legislation. The Committee also expects there would need to be exceptional circumstances for the ATO to challenge Justice Hill's comments.

Review of self assessment

4.29 The next major investigation of the rulings system was Treasury's Review of Aspects of Income Tax Self Assessment (RoSA), completed in 2004. RoSA made 54 recommendations, 25 of which applied to rulings and other ATO advice. The previous Government accepted all of RoSA's legislative recommendations and the ATO agreed to implement all of the administrative recommendations.[20]

4.30 RoSA addressed many of the issues that had been outstanding in relation to rulings. One important recommendation was to clarify the extent to which taxpayers can rely on ATO advice. For example, taxpayers are protected from interest, and not just penalties, where they follow:

- long standing ATO administrative practice
- oral advice from formal inquiry centres
- all written advice, unless it is labelled non-binding.[21]

4.31 Other key recommendations included:

- expanding the category of public and private rulings to cover administration, procedure, collection, and ultimate conclusions of fact
- where the ATO changes long standing practice to the detriment of taxpayers, the change should be prospective and, where necessary, from a future date to allow taxpayers to adjust their affairs
- where taxpayers rely on draft public rulings, they should be exempt from penalties and interest where the final ruling is to their detriment
- in private rulings, the ATO should state whether it has considered Part IVA (the avoidance provisions) and, if there has been full disclosure, the ATO be prevented from reopening an assessment

20 Hon P Costello MP, Treasurer, 'Outcome of the review of aspects of income tax self assessment', press release, 16 December 2004, viewed on 15 May 2007 at http://www.treasurer.gov.au/tsr/content/pressreleases/2004/106.asp.

21 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, p 10.

- for private ruling applications older than 60 days, taxpayers be able to request that the ruling be finalised within 30 days. If no ruling is given, the ATO is taken to have made a negative response, triggering appeal rights
- abolishing the penalty for a tax shortfall resulting from a failure to follow a private ruling.[22]

4.32 RoSA considered whether the ATO should be able to charge for private rulings, but decided against making such a recommendation. This conclusion was based on:

- the general opposition to such an arrangement
- taxpayers have a right to understand how the tax laws apply to them
- concerns about whether paying for a ruling increases the taxpayer's chance of success.[23]

4.33 *The Tax Laws Amendment (Improvements to Self Assessment) Act (No 2) 2005* implemented the RoSA legislative recommendations in relation to rulings. The legislation completely re-wrote the provisions in relation to rulings.

Inspector-General of Taxation's review

4.34 RoSA noted the perception in the tax community that the ATO's private rulings were biased in favour of the revenue. The data was not necessarily consistent with this perception. In 2002-03, the ATO 54% were wholly favourable to the applicant, 16% were partially favourable and 29% were unfavourable.[24] However, due to the strength of the perception, RoSA recommended that the Inspector-General conduct a review of possible bias in private rulings.[25]

4.35 The Inspector-General's report in February 2008 confirmed that there were significant perceptions of ATO bias in the tax community. Most stakeholders did not consider this bias to be undue. Rather, they thought it was the sort of approach to be expected of a revenue agency. The few examples given of undue bias occurred when the ATO was applying a legal interpretation that it thought best represented the policy intent of a law.

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22 Id, pp 11-26.

23 Id, p 23.

24 Figures do not add up to 100 due to rounding.

25 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, pp 17-18.

4.36 Similar to the ANAO performance audit, the review examined the ATO's processes, rather than examining the legal correctness of particular rulings. The Inspector-General found no evidence of bias. Rather, what the review found was that the ATO neither communicated effectively nor was sufficiently transparent in its dealings with taxpayers. Where the ATO did something unusual without explanation, such as delaying a ruling while it confidentially conferred with Treasury, taxpayers concluded that this was evidence of bias.[26]

4.37 The Inspector-General made a number of recommendations designed to improve ATO transparency and communication in relation to private rulings. The ATO accepted all recommendations, either wholly or in part. In the response to the recommendations, the ATO agreed to:

- advise taxpayers when it is consulting with Treasury
- keeping taxpayers up to date of the progress of their applications
- including the ATO's understanding of the policy intent of legislation in the private ruling where this is relevant to the ATO's decision
- issuing private rulings regardless of whether the technical issue is or may be the subject of a future public ruling.[27]

Committee comment

4.38 Australia's arrangements in relation to rulings are similar to those in other countries. For example, the OECD's comparison of tax systems amongst its member countries shows that the tax administrations in all but one of the 30 OECD countries issue public rulings and of these, the rulings are binding in 23 countries. The tax administrations in 28 OECD countries issue private rulings and of these, the rulings are binding in 24 countries.[28] As RoSA noted, 'The Australian system is unexceptional on most points of comparison.'[29]

4.39 Simply, it appears that taxpayers have a basic need to obtain advice from their tax authorities and it is only fair that the tax authorities stand by this advice. Rulings are one way of meeting this need. Given the risks that

26 Inspector-General of Taxation, *Review of the potential revenue bias in private binding rulings involving large complex matters* (2008) Commonwealth of Australia, pp 3-4.

27 Id, pp124-126.

28 OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006)*, October 2006, p 87, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf.

29 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, p 3.

taxpayers potentially face under self assessment, a formal system of rulings is fundamental to the tax system. As the Inspector-General of Taxation stated, 'The ability to obtain a private ruling is a key feature of the self assessment system.'[30]

The quality of rulings

Public rulings

4.40 In 2006-07, the ATO finalised 369 public rulings. This comprised 132 class rulings, 119 product rulings and 118 public rulings and tax determinations (84 final and 34 draft).[31]

4.41 The evidence to the Committee during the inquiry about public rulings was largely positive. For example, the Institute of Chartered Accountants in Australia (ICAA) advised the Committee that the public rulings panels, which include external experts, have improved the standard of public rulings:

> …the establishment of a Public Rulings Panel and an International Public Rulings Panel, which include external tax experts, to supplement a public consultation process, in which professional bodies participate, has gone some way to ensure the quality of public rulings and, more particularly, public confidence in these rulings.[32]

4.42 CPA Australia agreed that public rulings have a reasonable standard of technical accuracy:

> …while the Commissioner can withdraw a ruling or change it should his interpretation of the law change, this is not a frequent event, and in general where it has occurred the changes have not been in dispute.
>
> The tax, accounting and legal professional bodies, amongst others, are also involved in the ongoing review of draft rulings and determinations. It is not the norm for there to be significant

30 Inspector-General of Taxation, sub 48, p 5.

31 ATO, Annual Report 2006-07, p 96.

32 ICAA, sub 37, p 8.

disagreement with the Commissioner's/ATO's interpretation of the law.[33]

4.43 Further, the system used for prioritising public rulings has industry support[34].

Private rulings

4.44 Year by year, the ATO has been issuing fewer private rulings. In 2006-07, the ATO issued 12,398 private rulings, down from 13,888 in 2005-06 and 14,387 in 2004-05. The *Annual Report 2006-07* showed that just under half of these (5,055) related to individuals. The next largest category was for GST (2,411).[35] This appears to be a low level of usage, given the complexity of the tax system and that there are 12 million taxpayers.[36]

4.45 Consistent with the Inspector-General's findings in the review of private rulings, the Committee received evidence of perceptions of bias from organisations such as CPA Australia.[37] The ICAA also took this view and argued that the statistics in relation to private rulings did not tell the whole story. Firstly, only 2% of private rulings involved a precedent. These were the key rulings because the ATO had to come to a considered decision, whereas with the other 98% it only had to follow previous decisions.[38]

4.46 Further, applying for a private ruling tended to bring the applicant to the ATO's attention. If the ATO issued an unfavourable private ruling, then the taxpayer would almost certainly be subject to litigation if they did not comply with the ruling. On the other hand, if the taxpayer was confident in their legal advice and could take the risk of losing any possible litigation, then it made more sense to apply the preferred tax treatment and not advise the ATO.[39] One implication from this is that any sample of private rulings will be biased because many taxpayers will only make a private ruling application where they expect a favourable outcome.

33 CPA Australia, sub 36.1, p 1.

34 ICAA, sub 37, p 5.

35 ATO, *Annual Report 2004-05*, p 65, ATO, *Annual Report 2005-06*, pp 111, 118, ATO, *Annual Report 2006-07*, pp 96, 112.

36 ATO, sub 50, p 35.

37 CPA Australia, sub 36, p 7.

38 ICAA, sub 37, pp 63-65.

39 Ibid.

4.47 However, despite these strong perceptions of bias, the ICAA acknowledged that it did not have evidence from its members of actual bias in private rulings.[40]

Conclusion

4.48 In his submission, the Tax Ombudsman stated that he has 'not discerned any issues of systemic concern' in relation to rulings.[41] This is consistent with the evidence during the inquiry and reviews by the ANAO and the Inspector-General. Therefore, the Committee decided to focus on the managerial aspects of rulings, in particular delays in issuing private rulings.

Timeliness of private rulings

The extent of delays

4.49 In some respects, private rulings represent a return to the pre-self assessment period. Under administrative assessment, taxpayers gave the ATO the circumstances of their case in the tax return. The ATO spent resources assessing it and gave the taxpayer their view in the notice of assessment. With private rulings, taxpayers give the ATO their circumstances in an application form and the ATO gives its view in the private ruling.

4.50 Both administrative assessment and private rulings present resource problems for the ATO. In each case, the taxpayer is obtaining something from the ATO without payment. In the case of administrative assessment, the ATO's response was to apply a token level of resources to each taxpayer, resulting in 1-minute assessments for individuals. For private rulings, one approach the ATO uses is for tax agents to do as much preliminary work as possible and then provide that information to the ATO. CPA Australia stated:

> My understanding is that the tax office might have a habit of asking for that type of information and encouraging taxpayers to submit that in an effort to ensure that they meet their targets, and it helps facilitate arriving at the answer and getting the private binding ruling back to the taxpayer in a timely manner. As you

40 Ibid.

41 Commonwealth Ombudsman, sub 38, p 10.

> know, the private binding ruling system is meant to work in a 28-day turnaround…[42]

4.51 Tax agents can sometimes expend significant resources on a private ruling application to no ultimate benefit to their client, but at a cost to themselves. Ruddicks Chartered Accountants advised the Committee as follows:

> The ATO said that they could only rule on the matter if we were able to say how much the dividend was going to be. We said, 'This company has not been formed yet; we don't know what the dividend is going to be. That will depend on the profits made by the company and various other things … In the end, the ATO refused to rule, because we were not able to give information in advance as to what the dividends might be for the next 20 years…
>
> We spent about $8,000 worth of time on that. We billed our client $400 for that time, because we obviously did not expect it to be so difficult; we did not explain to the client that we were going to be stymied at every point … this particular case was not a complex situation …[43]

4.52 Another resource management strategy that the ATO uses for private rulings is delay. Lack of timeliness was the most common and serious comment raised during the inquiry in relation to private rulings. The list of participants who raised this issue included the Ombudsman, the ICAA, CPA Australia, the Taxation Institute of Australia and the National Institute of Accountants.[44] Treasury also reported it in RoSA.[45]

4.53 Because of the delays, less people are using private rulings. Taxpayers Australia stated:

> The evidence suggests that the number of people that seek a private binding ruling is not very high and that, if we operate under a very complex system, why is it that there are not a lot more private binding rulings? I agree with some of the earlier comments in the sense that time and costs work against the taxpayer. In essence, taxpayers do not have the luxury of time and a lot of transactions need to be dealt with on a real-time basis, especially with GST issues. You cannot wait 28 days for a private

42 Drum P, transcript, 28 July 2006, p 36.

43 Leighton C, transcript, 24 August 2006, p 23.

44 Commonwealth Ombudsman, sub 38, p 10, ICAA, sub 37, p 8, CPA Australia, sub 36, p 7, Taxation Institute of Australia, sub 40.1, p 4, National Institute of Accountants, sub 31, p 4.

45 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, p 18.

> binding ruling on something like GST where you need to know today to assess your tax implications. Because of the time, the cost and what is required from the ATO, you might put in a request for a private binding ruling and then they will come back and ask for more information and delay the process. That all costs time and money. At the end of the day, it works against the taxpayer. In principle, it is good that you have got access to that system but, from a practical point of view, not a lot of taxpayers access that avenue.[46]

4.54 These delays harm businesses because they sometimes lose opportunities. The Taxation Institute of Australia noted that there is often a restricted window in which to sign off on a project which can be missed through the delay in obtaining a private ruling:

> …the time taken is too long given that many business or investment decisions which may be best served by obtaining a PBR have a shortish lead time (eg it is uncommercial for a taxpayer acquiring an asset or a business to have to wait two months for a ruling on the proposed arrangement).[47]

4.55 The ICAA made a similar argument:

> We also note that the Burges Report, which focused on the largest companies in the Large Business Segment, indicated that all the companies interviewed reported great difficulty in obtaining timely PBRs, to the extent in many cases of rendering the private binding ruling concept virtually useless to them.[48]

4.56 Both the Taxation Institute of Australia and the ICAA stated that the ATO was taking remedial action, including a fast tracking system for priority private rulings.[49]

4.57 Under Practice Statement Law Administration 2005/10, the ATO applies case management principles to priority requests for private rulings. These include pre-lodgement meetings with the applicant and developing a case plan. Further, the ATO applies its various areas of expertise simultaneously to a priority request, rather than each section handling it in turn. Priority requests need to meet a number of criteria, including

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46 Greco A, transcript, 25 August 2006, p 17.

47 Taxation Institute of Australia, sub 40.1, pp 4-5.

48 ICAA, sub 37, p 9.

49 ICAA, sub 37, p 9, Taxation Institute of Australia, sub 40.1, p 5.

being time sensitive, prospective, of major commercial significance, and being a board level transaction.[50]

4.58 Following RoSA, there are new delay provisions in the tax laws. Where an application for a private ruling is older than 60 days (subject to some extensions), the taxpayer can request the ATO to determine their application within 30 days. If the ATO does not respond, the taxpayer can object as if they had received a negative response. The taxpayer's objection must include a draft private ruling.[51] The ICAA was uncertain whether this new arrangement would help taxpayers:

> Given that the purpose of obtaining a PBR is to obtain certainty relatively quickly, we consider that triggering formal objection and review procedures will do little to address the lack of timeliness of PBRs.[52]

4.59 Overall, the ICAA suggested that it was too early to determine if these measures would be effective.[53]

4.60 Given these concerns about delays, the Committee decided to examine what objective measures existed in relation to the ATO's performance.

Performance reporting of timeliness

4.61 Overall, the ATO's service standard for responding to private ruling requests is 28 days. However, there are qualifications to this:

- the ATO must receive all necessary information
- if the ATO needs more information, it has 14 days in which to contact the taxpayer and request the information
- if the request is 'particularly complex' and will take more than 28 days, the ATO will contact the taxpayer within 14 days to negotiate an extended deadline.[54]

4.62 In 2006-07, the ATO's target for meeting the 28 day standard was 83% and it exceeded this target with a performance level of 93.3%.[55] This data

50 ATO, 'Priority Private Binding Rulings', PS LA 2005/10, viewed on 22 May 2007 at http://law.ato.gov.au/atolaw/view.htm?Docid=PSR/PS200510/NAT/ATO/00001.

51 Section 359-50 of the *Taxation Administration Act 1953*.

52 ICAA, sub 37, p 9.

53 ICAA, sub 37, p 9.

54 ATO, 'Our service standards' viewed on 22 May 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/25940.htm.

55 ATO, *Annual Report 2006-07*, p 40.

suggests that the ATO is performing well. However, the situation is more complex.

4.63 Firstly, the ATO commonly requests additional information from taxpayers. The National Institute of Accountants stated in evidence:

> The ATO states that the majority are handled within 28 days, but we have quite a lot of feedback from members that suggests that is not necessarily correct. The ATO may respond within 28 days and seek further information, then the clock starts again on the 28-day test.[56]

4.64 The ATO also negotiates an extension of the deadline. The ICAA noted that the ANAO, in its 2001 performance audit on rulings, had questioned the value of the ATO's performance standard:

> …as noted in the…ANAO report, the 'negotiated extended timeframe' is a limited target or standard by which performance can be assessed. Stakeholders consulted at the time of the ANAO review felt that they had little choice but to agree to the ATO's proposed extension of time for satisfying the PBR request. We would be surprised if taxpayers feel any differently today.[57]

4.65 From the point of view of the ATO, the current 28 day performance measure is fair. If a taxpayer does not sufficiently explain an application, then the ATO should be able to extend the deadline by asking for more information. If a taxpayer has a complex issue that has significant revenue implications and agrees to an extension, then the ATO can also argue it is performing appropriately.

4.66 However, the 28 day measure is much less relevant to taxpayers. The commercial world has its own rate of progress and does not wait for the ATO. In other words, the current service standard only tells the ATO's side of the story. The Committee is concerned at this arrangement because private rulings are there to assist taxpayers. The Committee is of the view that a performance measure of total elapsed time, in addition to the 28 day standard, is necessary to present the whole picture.

4.67 In its 2001 performance audit on rulings, the ANAO noted that taxpayer uncertainty increased where the ATO took longer to consider an application in total elapsed time. The ANAO recommended that the ATO review its service standards for both internal and external reporting,

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56 Ord G, transcript, 25 August 2006, p 5.

57 ICAA, sub 37, p 9.

including the measurement of total elapsed time as an internal management tool.[58]

4.68 In its 2004 follow-up audit, the ANAO reported that the ATO was using total elapsed time as an internal reporting measure. The target for 2003-04 was that 100 per cent of cases should be completed within 90 days of receipt. The ANAO noted that the ATO had made significant progress:

> Between February 2003 and January 2004, the total number of cases on hand was reduced by 55 per cent and the number of over 90 days cases was reduced by 60 per cent.[59]

4.69 Recently, the Inspector-General of Taxation completed a review of the ATO's private rulings. From this review, it appears that the ATO continues to improve its elapsed time performance. For large business private ruling applications, the average elapsed time has decreased from 92 days in 2005-06 to 74 days in 2006-07. Similarly, the proportion that met the 90 day benchmark increased from 65% to 70% over the same period.[60]

Committee comment

4.70 The Committee recognises that the ATO is taking action to improve its performance in relation to delays in private rulings, such as prioritising commercially important applications. However, the Committee is also concerned that the ATO's high performance against the 28 day service standard bears little resemblance to taxpayers' reality. Given this discrepancy, the Committee believes the ATO should also publish performance information on total elapsed time for private rulings. It need not be presented as a service standard, but should be compared against the service standard to more fully explain to the community the ATO's operations.

4.71 In the recent review of private rulings, the Inspector-General recommended that the ATO publish elapsed time statistics. The ATO declined this recommendation, arguing that 'some delays can be caused by the taxpayer'. It also noted that, with priority private rulings, much of

58 ANAO, *The Australian Taxation Office's Administration of Taxation Rulings,* Audit Report No. 3 2001-02, 17 July 2001, pp 150, 154.

59 ANAO, *Administration of Taxation Rulings Follow-up Audit*, Audit Report No. 7 2004-05, 9 August 2004, p 41.

60 Inspector-General of Taxation *Review of the potential bias in private binding rulings involving large complex matters* (2008) Commonwealth of Australia, p 5.

the work is done before the taxpayer lodges the application. Therefore, an elapsed time statistic would be 'an irrelevant measure'.[61]

4.72 In response, the Committee notes that the ANAO and the Department of Finance and Administration jointly published a better practice guide on annual performance reporting in 2004. That document noted that agencies can be achieving shared outcomes in partnership with other agencies or 'players external to government'. The guide's preferred approach is for agencies to report performance overall and then identify their areas of influence within those operations. In other words, the presumption is to present information provided that, after explanation, it helps the reader.[62]

4.73 If an agency such as the ATO is not prepared to report performance information where it has shared responsibility for an activity, the result would be that no-one would take responsibility for joint projects. Therefore, it is preferable that agencies involved in joint projects report on the performance of these projects and explain how they and other participants contributed to the final result.

4.74 The Committee understands that an elapsed time statistic, on its own, would not be fair on the ATO. However, with suitable explanation and adjustment for special cases such as priority applications, this extra information will assist readers of the ATO's annual report and present a more balanced view of the ATO's work.

Recommendation 9

4.75 **The ATO, in its annual report, compare its performance in relation to the 28 day service standard for private ruling requests with information on total elapsed time for these applications.**

The RoSA reforms of performance reporting of timeliness

4.76 During RoSA, Treasury noted widespread concerns about delays in private rulings. Treasury made a number of recommendations, including 2.14, which stated:

> The Tax Office should enhance its published performance reporting on PBRs to distinguish response times to individuals

61 Inspector-General of Taxation, *Review of the potential bias in private binding rulings involving large complex matters* (2008) Commonwealth of Australia, pp 51-52, 126.

62 ANAO and Department of Finance and Administration, *Better Practice Guide: Better Practice in Annual Performance Reporting* (2004) Commonwealth of Australia, p 10.

> and very small business from those for larger businesses, and separately report agent and non-agent case statistics.[63]

4.77 The Committee supports this recommendation. For example, data from 1998 to 2000 shows that approximately 80% of individuals' requests were handled within a total elapsed time of 28 days. This figure dropped to 45% for small business and less than 30% for large business. Approximately 25% of large business applications took more than 232 days. [64]

4.78 The ATO first released updated figures in response to RoSA recommendation 2.14 in its 2006-07 annual report. The percentage within the ATO's 28 day service standard exceeded 90% for all categories.[65] At first glance, this is a high level of performance. However, the ATO appears to have restructured its categories. In its 2005-06 Annual Report, the 'Large Business and International' business line issued 261 private rulings and the 'Small Business' business line issued 2,782 private rulings. In the ATO's 2006-07 Annual Report, the 'larger business' category completed 1,069 cases and the 'micro enterprises' category completed 2,174 cases.[66] Against the general trend of reduced volume in private rulings, it appears that rulings from medium enterprises have been transferred from 'Small Business' to 'larger business.'

4.79 The effect of this potential transfer has been to group the large business private ruling applications (approximately 250) with the more voluminous medium business applications (approximately 750). On average, large business applications are the most problematic. Therefore, if the ATO is still having difficulty in managing the timeliness of these large applications, it is less likely to be shown by the new data in the annual reports. While the Committee acknowledges the achievement by the ATO in implementing this recommendation from RoSA, the community and the Parliament will have greater assurance about the ATO if its performance in relation to large business is individually reported.

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63 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, p 18.

64 The sample period for large business was 1993 to 2000. ANAO, *The Australian Taxation Office's Administration of Taxation Rulings,* Audit Report No. 3 2001-02, 17 July 2001, pp 151-52.

65 ATO, *Annual Report 2006-07*, p 112.

66 ATO, *Annual Report 2006-07*, p 112, ATO, *Annual Report 2005-06*, p 118.

Recommendation 10

4.80 **The ATO divide the 'larger businesses' category used for its performance reporting of the timeliness of private rulings into 'medium businesses' and 'large businesses.'**

Conclusion

4.81 The rulings system has been subject to review and refinement since its introduction with self assessment in 1986. These reviews have become more positive over time. In 2001, the ANAO found that the ATO's processes for public rulings were sound but expressed concern over private rulings. In 2008, the Inspector-General of Taxation made a positive finding overall for the processes for private rulings. Further, the Committee received evidence from stakeholders that the public ruling system is working well overall. Therefore, the Committee did not find it necessary to raise technical issues about rulings in the report.

4.82 The timeliness of private rulings was the main issue raised in evidence about rulings. A number of factors are responsible for the delays. Under self assessment, taxpayers are expected to fully understand the tax implications of their financial affairs. However, tax laws are so complex that taxpayers have significant potential demand for private rulings from the ATO. Because the rulings are free, private rulings could potentially be a similar drain on the ATO as administrative assessment was in the early 1980s.

4.83 The delays act as a deterrent to taxpayers obtaining private rulings. Many taxpayers, especially in business, have a narrow time frame in which to make financial decisions. The delays in private rulings make them much less attractive to taxpayers.

4.84 Combined with poor communication and a lack of transparency by the ATO, these delays have led to perceptions of bias about private rulings. The Committee's recommendations in this chapter have been aimed at improving the ATO's performance reporting so that the debate can focus on the proven issues such as delays, rather than perceived issues such as bias.

4.85 Although delays are an issue, the Committee notes that the ATO is responding in various ways, such as applying case management practices to priority applications. However, the ATO is constrained by the

legislative framework that Parliament gives it. Simplifying tax laws, as discussed in chapter three, will give taxpayers more certainty, reduce the potential demand for rulings, and give the ATO more scope to implement a fair and efficient tax system.

5

Compliance

Promoting compliance

The ATO's compliance model

5.1 One of the key roles of the Australian Taxation Office (ATO) is to manage taxpayer compliance. If taxpayers are more willing to pay the tax that is lawfully due, and if taxpayers dispute their assessments less, the ATO's task will be much easier, and it will be a more efficient agency able to collect each dollar of tax using fewer resources. Self-evidently, the higher the compliance the lower the cost of collection and the lower the cost of the tax burden, since at present tax-compliers have to carry the burden of non-compliers.

5.2 While giving evidence at the initial biannual meeting on 20 April 2007, the Commissioner of Taxation advised the Committee that the most important factor in securing revenue is maintaining a culture of voluntary compliance:

> I think the greatest risk to revenue is if we ultimately do not maintain and enhance the high levels of voluntary compliance that we have in this country. The trick to good tax administration is to focus on how you maintain that culture of good compliance, both within your own country and with people who interact with the country. To do that you need high levels of confidence. Those high levels of confidence are reflected by a very well-rounded program that has not just focus on active compliance or enforcement activities but also on providing support, assistance and education. It also focuses on trying to make it easy for taxpayers to comply. It

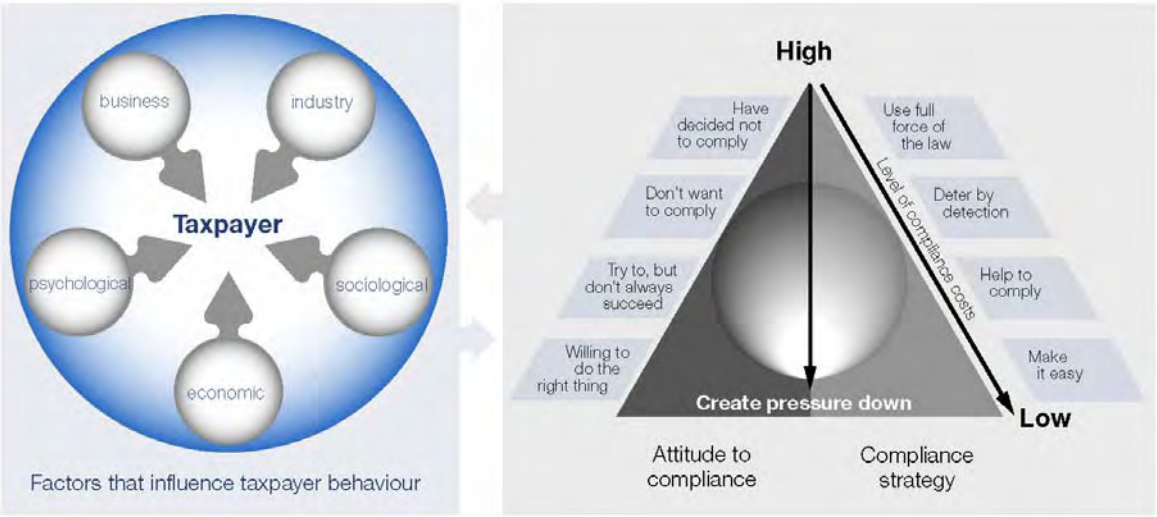
> does have, at the end of it, a very important role in trying to ensure that we support honest taxpayers by having effective deterrent strategies.[1]

5.3 The Ombudsman agreed with the Commissioner:

> In a self-assessment environment, voluntary compliance is a vital component. While this depends in part on the taxpaying community having confidence in the ATO, it also rests in large measure upon the taxpayer community being aware of its obligations, and deciding to engage in lawful, ethical and compliant behaviour. In my view, education and deterrence by the ATO have significant roles in facilitating such outcomes.[2]

5.4 The ATO manages these interactions through its compliance model, reproduced in figure 5.1:

Figure 5.1 ATO's compliance model



Source *ATO, 'Compliance model' viewed at http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm on 15 August 2007.*

5.5 The compliance model has a number of components. Firstly, it recognises that taxpayers' conduct is influenced by a number of factors, including their financial situation and the views of their peers. Further, taxpayers' attitudes lie on a continuum between wanting to do the right thing and deciding not to comply. In effect, the ATO assesses a taxpayer's particular attitude and uses this to develop a compliance strategy for that taxpayer. For compliant taxpayers, the ATO advised that it takes a cooperative,

1 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, transcript, 20 April 2007, p 4.

2 Commonwealth Ombudsman, sub 38, p 5.

educational approach. For non-compliant taxpayers, the ATO uses legal action and investigation.[3]

5.6 An assumption in the model is that the ATO can influence taxpayer behaviour through its actions. One example of this occurring is Project Wickenby, where the ATO and other agencies are investigating the transfer of funds out of Australia to illegally evade tax. Media reports suggest that Australians are less likely to shift money offshore now that Wickenby is well established.[4] The Commissioner has reported that two offshore structures involving nearly $100 million have been abandoned.[5]

5.7 The two sides of the compliance model, assistance and deterrence, complement each other. The ATO helps compliant taxpayers and these taxpayers draw comfort that non-compliant taxpayers are subject to investigation and legal action. Compliance action also deters compliant taxpayers from reducing their compliance standards. The Commissioner stated in evidence:

> We use a lot of resources for what might sound like a big dollar return [with non-compliant taxpayers], but the big dollar return comes from taxpayers doing the right thing and paying their tax and that revenue coming into the system. A role for us which is just as important is to protect those taxpayers by saying, 'For those people who try to put you at a disadvantage, there is some level of accountability through some sensible programs that can be done.' The other side of it is acknowledging that you have so many people who do want to do the right thing. That means that we need to ensure we invest very heavily in making it as easy as possible for people to comply.[6]

5.8 In its submission, the Australian Taxation Office (ATO) stated that all but $4.2 billion of $214.9 billion received in 2004-05 was voluntarily paid.[7] In other words, 98% of tax receipts are paid voluntarily. This statistic confirms the Commissioner's evidence that, not only is voluntary compliance important, but it exists at high levels and needs to be maintained. Having said that, the Committee is aware that it would be very resource intensive and intrusive on compliant taxpayers to develop a

3 ATO, 'Compliance model' viewed on 15 August 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm.

4 Drummond M, 'Tax havens thrive despite crackdown' *Australian Financial Review* 16 August 2007, p 61.

5 O'Toole C, 'Tax chief says blitz is paying off' *Australian Financial Review* 24 August 2007, p 32.

6 D'Ascenzo M, transcript, 22 June 2006, p 17.

7 ATO, sub 50, p 1.

robust estimate of how much uncollected tax is legally due, particularly in the cash economy.[8]

5.9 The Committee regards the compliance model as a key instrument in the ATO's management of the tax system. Further, the model appears fair because the ATO adjusts its response to a taxpayer's conduct. For most taxpayers, it directs the ATO to assist and educate them. As the Ombudsman stated:

> This approach appears fair and effective, and balances the needs of the individual against those of the community as a whole.[9]

5.10 Comments about the model concerned whether the ATO was fully implementing it, rather than about the model itself.[10] The Committee supports the model and believes it will continue to play a major role in the ATO's work in future.

The role of tax agents

5.11 Tax agents play a number of important roles in the tax system. Firstly, as the Inspector-General of Taxation stated, they help taxpayers comply with a complex tax system and act as an initial check on tax returns. This makes the ATO's task much easier:

> The self-assessment system relies heavily on tax agents. Tax agents are in a sense an unofficial but professional replacement for the pre-assessment processes that the ATO undertook under the old system as previously mentioned. Taxpayers confronted with complex laws in a self-assessment system have, in practical terms, nowhere else to go for help in meeting their obligations.[11]

5.12 Secondly, a professional, educated tax agent is likely to advise taxpayers to comply with the law. This boosts compliance, once again making the ATO's task easier. The Commissioner stated in evidence:

> I start from the proposition that tax agents have been a very positive influence on tax compliance. I think that the tax office helping tax agents and supporting them does allow us to touch

8 First biannual meeting with the Commissioner of Taxation, Granger J, 20 April 2007, p 13.

9 Commonwealth Ombudsman, sub 38, p 7.

10 See for example the Inspector-General of Taxation's concerns about the ATO using a 'one size fits all' approach to investors in mass-marketed investment schemes, Inspector-General of Taxation, sub 48, p 12.

11 Inspector-General of Taxation, sub 48, p 9.

> many more taxpayers than we could otherwise do on an individual basis.[12]

5.13 To some extent, this compliance role places tax agents under commercial pressure. The Committee received evidence that some taxpayers expect their tax agent to reduce their tax bill regardless of the legality. They also compare the performance of each other's agent in this respect. One tax agent, Ian McKenzie, advised the Committee:

> Taxpayers talk to each other out on the street and could think: 'If Joe Bloggs can do this, how come I can't do that?' I quite often explain to the taxpayer that you are comparing apples with oranges. But there are taxpayers who deliberately seek out tax agents who will deliberately put some so-called illegal entries into the tax return, and they are comfortable with taking that risk. What I am saying is that there are taxpayers out there who deliberately take risks to get a bigger refund or a larger deduction in their tax return.[13]

5.14 This agent gave an example of two taxpayers who requested him to make illegal deductions:

> They were receiving WorkCover income, which is income not from personal exertion. The prior tax agent had been claiming travel for them for going to the doctor and all of that. That travel was already reimbursed by the WorkCover Authority. I checked with the ATO and the relevant legislation and it is just not deductible. As a result, I lost those clients.[14]

5.15 In this type of situation, a tax agent needs to balance long term and short term risks. If they agree to the taxpayer's request, they make extra income in the short term, but face the long term risk of audit by the ATO and losing their livelihood. Generally, the Committee expects that the accreditation processes for tax agents would ensure that tax agents are of sufficient calibre to resist such temptations. Professional associations expect the same of their members.[15] The ATO takes a similar view:

> We recognise that tax agents have a commercial relationship with their clients; however we expect them to act in a professional

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12 D'Ascenzo M, transcript, 22 June 2006, p 19.

13 McKenzie I, transcript, 28 July 2006, p 46.

14 Id, p 47.

15 Anderson F, 'Tax agents told to ditch dodgy clients' *Australian Financial Review*, 10 October 2007, p 17.

> manner, competently having regard to the law and to comply with their personal tax obligations.
>
> In terms of their role as agents for their clients we risk assess tax agent client bases to identify situations where there is a high potential for making common mistakes or inaccurate claims that are outside occupational or industry norms.[16]

5.16 Mr McKenzie suggested to the Committee that both tax agents and their clients are responsible for the accuracy of a tax return.[17] The Committee agrees with this view. If an agent prepares a return that they know to be wrong, they need to bear some responsibility for this. Alternatively, tax agents should not be responsible if a client is not truthful with them, despite reasonable inquiries by the tax agent.

Litigation

Essenbourne – the facts

5.17 The key litigation issue during the inquiry has concerned the ATO's response to the December 2002 decision of the Federal Court (single judge) in *Essenbourne v Commissioner of Taxation*.[18] This case involved an employee benefit arrangement where a family business (Essenbourne) transferred $252,000 to an employee incentive trust. The three brothers who worked for the business each received 84,000 units (value $1) in the trust. The amount was calculated with reference to the superannuation regulations and the business's profits. The brothers could receive payments from the trust at request and they had control over how the trust would invest the funds.[19]

5.18 The business claimed the $252,000 as a tax deduction. The ATO responded by disallowing the deduction and levying fringe benefits tax on Essenbourne as well.[20]

5.19 Justice Kiefel[21] agreed with the ATO on the deduction. She concluded it was made from the business's surplus profits, rather than being part of its

16 ATO, sub 50, p 38.
17 McKenzie I, transcript, 28 July 2006, p 48.
18 [2002] FCA 1577.
19 Id, paras 5, 11.
20 Id, paras 6, 7.
21 Now a High Court Justice.

income producing activities.[22] However, Justice Kiefel decided the payment was not subject to fringe benefits tax. Her reasoning was that the legislation requires that the payment be connected to a particular employee in relation to the benefit in question. Due the structure of the trust, the ATO could not make such a connection at the time of the payment.[23]

5.20 In practice, the ATO did not follow *Essenbourne*. In its media release of 14 March 2003, the ATO stated:

> … the Tax Office will look to testing its views on fringe benefits tax and the application of the anti-avoidance provisions to these types of arrangements in future court cases.[24]

5.21 If the ATO was not satisfied with the result in a particular case, one approach would be to appeal it to a higher court. In the media release, the ATO said that it did not appeal *Essenbourne* because it won the case on the point of the income tax deduction.

5.22 The ATO sought to challenge *Essenbourne* in future cases. In *Walstern v Commissioner of Taxation*, Hill J stated that Justice Kiefel was 'clearly right.' He also raised the principle of judicial comity, in which judges follow the decisions of judges at the same level unless the original decision is clearly wrong.[25] The reason behind this is it increases certainty in the law and, in effect, is a 'weak' system of precedent.

5.23 A number of other cases concerning similar facts also raised the principle of judicial comity and the ATO lost these on the point of fringe benefits tax. What characterised these cases was the ATO did not take them beyond a single judge in the Federal Court. The ATO's reasons for this are that it was:

> … not able to appeal from the observations in *Essenbourne* in view of the finding on the facts on the income tax case. In *Walstern* the relevant observations were obiter and there was no order against which the Commissioner could appeal. In *Caelli* the Court determined the FBT appeal in the Commissioner's favour 'on the assumption' of the correctness of *Essenbourne* and there was no order against which the Commissioner could appeal. The Commissioner has appealed the *Essenbourne* construction in each

22 *Essenbourne v Commissioner of Taxation* [2002] FCA 1577, para 36.

23 Id, paras 54, 56.

24 ATO, 'Employee benefit arrangements,' Media release Nat 03/30, viewed on 20 August 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/mr2003030.htm.

25 [2003] FCA 1428, para 87.

> of the three cases in which he has been able, being *Spotlight Stores* (where the Full Court did not determine the issue), *Cameron Brae* (the appeal is yet to be heard) and this case [*Indooroopilly*].[26]

5.24 One case that the ATO did take to the Full Federal Court was *Pridecraft v Commissioner of Taxation* in December 2004. The ATO did raise the fringe benefits tax question in that case, but did so only on the condition that the taxpayer in question did not receive a deduction for the payment to the trust. In other words, it only raised fringe benefits tax if it lost on the income tax question. The judge stated:

> The Commissioner's submissions indicated that it was only necessary to decide its appeal from the primary Judge's holding that Spotlight was not liable to pay fringe benefits tax on the contribution of $15 million to the Incentive Trust if the contribution was held to be an allowable deduction. It is therefore not necessary to deal with this appeal.
>
> A further reason for not dealing with the fringe benefits tax question is that the Commissioner challenged the correctness of the decision of Kiefel J in *Essenbourne* … and the reasoning of Hill J in *Walstern* … It is undesirable to consider whether those cases were correctly decided when it is not necessary to do so.[27]

5.25 The ATO obtained a decision on fringe benefits tax from the Full Federal Court (three judges) in February 2007. In *Commissioner of Taxation v Indooroopilly Childrens Services*,[28] the Court found in favour of the taxpayer on the fringe benefits tax issue.[29] The Court also expressed concern about how the ATO managed the litigation in the case. Instead of selecting other test cases, they viewed the ATO's options as:

- appealing *Essenbourne* (in 2002)
- following *Essenbourne*
- seeking legislative change
- seeking a declaration (an administrative law remedy) from the Full Federal Court as to the proper construction of the legislation.[30]

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26 *Commissioner of Taxation v Indooroopilly* [2007] FCAFC 16, para 45.

27 Sackville J, [2004] FCAFC 339, paras 111-12.

28 The ATO funded *Indooroopilly* from its test case program.

29 Edmonds J, [2007] FCAFC 16, paras 35-39.

30 Id, paras 3-7, 44-47.

5.26 Further, the Court stated that the ATO's conduct raised constitutional issues:

> From the material that was put to the Full Court, it was open to conclude that the appellant was administering the relevant revenue statute in a way known to be contrary to how this Court had declared the meaning of that statute. Thus, taxpayers appeared to be in the position of seeing a superior court of record in the exercise of federal jurisdiction declaring the meaning and proper content of a law of the Parliament, but the executive branch of the government, in the form of the Australian Taxation Office, administering the statute in a manner contrary to the meaning and content as declared by the Court; that is, seeing the executive branch of government ignoring the views of the judicial branch of government in the administration of a law of the Parliament by the former. This should not have occurred.[31]

5.27 Following *Indooroopilly*, the ATO expressed interest in pursuing court declarations.[32] Aronson, Dyer and Groves define a court declaration as:

> … a declaratory order or judgement is simply a court's declaration or statement resolving a dispute over the law applicable to a situation in which the applicant has a sufficient interest. The order or judgement has almost no mandatory or restraining effect at all.[33]

5.28 Declarations, therefore, appear to be of most use when there is a dispute, but the party instigating the court action does not need a remedy that involves enforcement. It is of no use to an applicant which is trying to enforce the law against someone or an agency that is refusing to act legally. Further, courts generally refrain from issuing advisory opinions, so there must be an element of dispute involved. The value of a declaration is its procedural flexibility and scope.[34]

5.29 The ATO advised the Committee that it had received advice from the Solicitor-General that court declarations will not be suitable. The argument is that the ATO needs to issue a private ruling to initiate court proceedings in relation to a taxpayer. However, once the ATO has issued the ruling, the Commissioner is bound by it. The ATO cannot change its view of the law in relation to the taxpayer's affairs even if it wished to.

31 Id, para 3.

32 Kazi E, 'ATO drops aggressive legal tactics' *Australian Financial Review*, 6 March 2007, p 1.

33 Aronson M, Dyer B, Groves M, *Judicial Review of Administrative Action* (2004) Lawbook Co, 3rd Edition, p 782.

34 Id, pp 782, 788-89.

Hence, a court would be reluctant to issue a declaration when the ATO is legally barred from changing its actions in relation to that taxpayer. Making a declaration before the ATO issues a ruling would also fail because there would be no dispute.[35]

Essenbourne – analysis

5.30 There are two main ways by which to analyse the ATO's conduct in *Essenbourne*. The first is to use the advice from the Solicitor-General that the ATO received in December 2005 and January 2006. Although the ATO did not have access to this advice until well after *Essenbourne*, it helps assess the ATO's conduct, if only from the advantage of hindsight. The Solicitor-General's principles for litigating against precedent were that an agency should:

- put on notice all parties likely to be affected by the litigation
- only litigate against precedent where it has legal advice that a decision is wrong
- ensure the seniority, robustness and credibility of the legal advice matches the issue and the seniority of the court that made the decision in question
- fund a test case
- make any challenge 'as soon as possible' after the decision.[36]

5.31 The ATO complied with the first of these points and the fourth to some extent. It put out a press release stating its views in relation to *Essenbourne.* It funded *Indooroopilly* as a test case, but not some of the earlier cases after *Essenbourne*.[37] Further, the Committee assumes that the ATO obtained suitable legal advice. The remaining question is whether the ATO made its challenge as soon as possible after *Essenbourne*.

5.32 At first glance, this does not appear to be the case. The Full Federal Court decided *Indooroopilly* over four years after *Essenbourne*. In the view of the Committee, this is ample time in which the ATO could have brought a suitable test case.

5.33 A closer examination of the decisions also raises questions about whether the ATO placed sufficient priority on resolving this matter as soon as

35 First biannual meeting with the Commissioner of Taxation, ATO, sub 3, pp 14, 48-54.

36 Inspector-General of Taxation, *Review of Tax Office management of Part IVC litigation* (2006) Commonwealth of Australia, pp 249-50, 252-54.

37 Id, p 183.

possible. As noted earlier, the ATO publicly stated that it did not appeal *Essenbourne* because the Court affirmed the ATO's decision to render the scheme ineffective by disallowing the deduction. In *Pridecraft*, its submission to the Court stated that it did not wish to pursue the fringe benefits tax question if it won in relation to the tax deduction. These cases suggest that the ATO was placing a greater emphasis on securing a favourable outcome on fringe benefits tax, rather than resolving the matter in a timely way. The Solicitor-General's advice is clear that any challenge should occur 'as soon as possible.'

5.34 Therefore, with hindsight, it appears that the ATO did not meet the standards in this advice. As the Solicitor-General stated in subsequent advice in June 2007, 'a quicker test of the issue should probably have occurred.'[38] The ATO suggested to the Committee in April 2007 that its actions were consistent with the Solicitor-General's advice.[39] However, the later document from the Solicitor-General indicates this was not the case.

5.35 The second benchmark for the ATO's conduct is the list of options provided by the Full Federal Court in *Indooroopilly*. They suggested the ATO should have appealed *Essenbourne*, or followed *Essenbourne*, referred the issue to Treasury for legislation, or sought a court declaration on the matter (an administrative law remedy where a court declares the legal position on an issue). The ATO did not carry out any of these options. From the perspective of many taxpayers, the value in these suggested courses of action is that they would have led to a prompt resolution of the dispute. Once again there is an element of hindsight in comparing the ATO's conduct against these tests. However, they demonstrate that the ATO appears to have been trading off timeliness in administration against securing a favourable outcome on fringe benefits tax.

5.36 In explaining the principles of judicial comity, the judiciary has made it clear that they believe the benefits of certainty in the law outweigh the opportunity to reconsider a matter, unless they believe a previous decision was clearly wrong. One Federal Court judge has stated:

> The injunction to judicial comity does not merely advance mutual politeness as between judges of the same or co-ordinate jurisdictions. It tends also to uphold the authority of the courts and confidence in the law by the value it places upon consistency in judicial decision-making and mutual respect between judges.[40]

38 First biannual meeting with the Commissioner of Taxation, ATO, sub 3, p 58.

39 First biannual meeting with the Commissioner of Taxation, ATO, sub 1, p 15.

40 French J in *Hicks v Minister for Immigration and Multicultural and Indigenous Affairs* [2003] FCA 757, para 76.

5.37 In implementing the tax laws, the Committee believes that ATO needs to balance a number of priorities, including certainty, perceptions of fairness, and securing the revenue. Similar to the mass marketed investment schemes, the Committee is of the view that the ATO in *Essenbourne* and related cases has pursued the revenue above other considerations. This has damaged the reputation of the ATO.[41]

5.38 One consequence of the mass marketed investment schemes was Treasury's *Report on aspects of income tax self assessment* (RoSA), which led to a reduction in the Commissioner's discretion, in favour of taxpayers. The *David Jones Finance* case in 1990 (chapter three) led to rulings becoming legally binding on the Commissioner, which also reduced the ATO's discretion in favour of taxpayers. Similarly, *Essenbourne* has demonstrated another area in which the ATO could itself limit its discretion.

Essenbourne – conclusion

5.39 In 2006, the Inspector-General of Taxation finalised a report on how the ATO managed its litigation program. One consequence of the review is that the ATO now publishes decision impact statements after court decisions. Included in these statements is the ATO's decision, where appropriate, of whether it is likely to appeal the case or not.[42] The Committee welcomes this improvement in public administration, which will go some way to reducing taxpayer uncertainty from court cases.

5.40 During this review, the ATO obtained advice from the Solicitor-General on better practice in litigation. One item in the ATO's request was whether it needed to comply with the stricter views on precedent expressed by Justice McHugh in 2002 (when he was on the High Court). He stated:

> No doubt an Executive agency is entitled to disregard a decision where it is truly in conflict with another decision that it thinks is correct. It may sometimes also be justifiable to refuse to follow a decision that is the subject of appeal. But that has problems. Judicial decisions are not provisional rulings until confirmed by the ultimate appellate court in the system. Until set aside, they represent the law and should be followed. Moreover, the Executive can run into serious legal problems where it continues to enforce legislation that a court has ruled invalid. Even more difficult to justify is the refusal to follow a [court] ruling that is not

41 Kazi E, 'ATO drops aggressive legal tactics' *Australian Financial Review*, 6 March 2007, p 1.

42 Vos D, transcript, 9 November 2006, p 13.

> the subject of appeal merely because the agency regards it as wrong and will test it at the next opportunity.[43]

5.41 Without commenting directly on this quotation, the Solicitor-General suggested that the ATO could litigate against a decision it regards as wrong provided it met the various tests listed earlier. In other words, the Solicitor-General did not take as strict a view as Justice McHugh. The Court in *Indooroopilly* adopted the stricter line.

5.42 The courts use principles of precedent and judicial comity to increase certainty in the law at the cost of their individual discretion. Similarly, the Committee believes that the ATO should reduce the exercise of its discretion in administering its litigation program in the interests of certainty.

5.43 As Justice McHugh stated, a court decision represents the law and should be followed. The alternatives are those expressed by the Court in *Indooroopilly*. The ATO's role ends with administering the law. If a court makes a decision that the ATO regards as incorrect and it has exhausted all appeals, it is enough for the ATO to state its position publicly and refer the matter to Treasury. This way, the Courts and the Parliament are responsible for the law. This is consistent with constitutional and democratic principles.

Recommendation 11

5.44 **Where the ATO has concerns about a judicial decision, it should publicly announce these concerns in the decision impact statement and commit to resolving the issue within 12 months through one or a combination of the following public actions:**

- **abiding by the initial decision**
- **appealing the decision and abiding by any subsequent decision**
- **referring the issue to Treasury as a policy matter.**

Changes in ATO interpretations of the law

5.45 Similar to judicial changes in interpretation, the ATO may itself decide that its interpretation of the law is incorrect or may update its advice on

43 McHugh J, 'Tensions between the Executive and the Judiciary' (2002) Australian Bar Association Conference, quoted in Inspector-General of Taxation, *Review of Tax Office management of Part IVC litigation* (2006) Commonwealth of Australia, p 245.

how to comply with the law. An example of the former is agribusiness investment schemes. At the biannual meeting with the Commissioner on 20 April 2007, the ATO advised the Committee how it came to develop its new position on the law:

> What we have actually had is indications from the court—one by the Supreme Court in *Environ* and another one by the Federal Court in *Puzey*—to say that our view of the law was wrong…
>
> …it has taken some time. We then referred the matter to government because it was really a government issue of how it wanted these areas taxed. The government made its decision in relation to afforestation and decided that we should just test the law—it said it would not do anything in relation to agriculture or agribusiness. That left the tax office with views expressed by the judiciary that our previous view was not right. We have gone through an extensive process of trying to review our position. We think a better view now is that we were wrong. Therefore, we are trying now to have a test case to clarify that over the next 12 months.
>
> Last week we issued a draft ruling reflecting that change of view.[44]

5.46 On 6 February 2007, the then Government announced that it would not extend the agribusiness tax concession to non-forestry schemes. The ATO's initial position was that the new legal position would apply from 1 July that year.[45] This led to significant movements in the share prices of some agribusiness firms.[46] After significant community concern, the ATO announced on 27 March 2007 that it would not apply its new view of the law until 1 July 2008.[47] In effect, it granted a 12 month transition period.

5.47 An example of the ATO updating its advice to taxpayers in relation to compliance is service entities. In the 1978 case of *Commissioner of Taxation v Phillips*,[48] the Full Federal Court dealt with a situation where a business set up a separate entity to provide administrative services to it. The service

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44 First biannual meeting with the Commissioner of Taxation, D'Ascenzo M, Quigley B, transcript, 20 April 2007, pp 12-13.

45 The Hon P Dutton MP, Assistant Treasurer, 'Non-Forestry Managed Investment Schemes,' Media release, 6 February 2007, viewed on 19 May 2008 at http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2007/007.htm&pageID=003&min=pcd&Year=&DocType=0.

46 Whyte J, 'ATO takes axe to money trees,' *Australian Financial Review*, 8 February 2007, p 25.

47 ATO, 'Transitional arrangements for agribusiness managed investment schemes,' Media release 2007/09, viewed on 20 March 2008 at http://www.ato.gov.au/corporate/content.asp?doc=/content/00095911.htm.

48 (1978) 8 ATR 783.

entity was owned by the business owner's family and, by directing profits from the business to the entity, was a form of income splitting. The Court permitted the arrangement because the entity provided the services at commercial rates.[49]

5.48 In that case, the service entity used a mark up of 50% on the direct costs of the employees providing the administrative services. The ATO released a short ruling (IT 276) after *Phillips* where it accepted the result, but did not make reference to specific mark ups. The Inspector-General of Taxation has reported that the ATO's internal assessing manuals, publicly released in 1985, accepted the 50% benchmark on staff costs.[50]

5.49 In 2002, the ATO formally decided to address compliance issues related to service entities. It released draft guidance in 2005 and finalised it in 2006. In addition to other measures, the guidance limited the mark up on direct staff costs to 30%. The ATO announced that taxpayers had a 12-month period of grace in which to change their existing arrangements to meet the new standards.

5.50 In his report, the Inspector-General concluded that the ATO had changed its administrative practice. The ATO disagreed with this conclusion. The Committee does not wish to consider such matters of interpretation. What is important to note is the ATO gave taxpayers 12 months in which to comply with the new standards. The Committee believes that such periods of grace, when used appropriately, are fair on taxpayers.

5.51 The Committee accepts that the ATO may change its opinion of the law or may establish new benchmarks for complying with the law to accommodate changes in business practices. The Committee also believes that, once it has come to such a conclusion, the ATO needs to act promptly to satisfy taxpayers that it is enforcing the law. Firstly, this involves making a public announcement of its change of view. Secondly, the ATO may need to give taxpayers a period of time in which to change their affairs. Unless there are exceptional circumstances, such a period should be no longer than 12 months. This will be long enough for any adjustment, but any longer period would lead to doubts that the ATO is committed to enforcing the law. The length of the adjustment period will depend on the circumstances in each case and may need to be varied to take into account timing issues such as the end of the financial year.

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49 Cooper G et al, *Cooper Krever & Vann's Income Taxation: Commentary and Materials* (2005) Thomson, 5th Edition, pp 395-97.

50 Discussion drawn from Inspector-General of Taxation, *Review of Tax Office's management of complex issues – Case study on service entity arrangements* (2007) Commonwealth of Australia, pp 3-5.

5.52 Such a decision involves considerable discretion. The Committee is of the view that the ATO should develop a policy to ensure that these decisions are robust.

Recommendation 12

5.53 **The ATO develop a policy to support decisions involving periods of grace where it changes its view of the law. Unless there are exceptional circumstances, no period of grace should exceed 12 months.**

Managing non-compliance

Introduction

5.54 The management of non-compliance, such as through investigations and audits, is a sensitive area in tax administration. The Ombudsman advised the Committee that a large number of complaints involve compliance activities:

> The ATO's compliance activities are an area about which the Ombudsman's office receives a substantial number of complaints — generally over five hundred complaints each year (or about a third of all tax complaints). Most complaints relate to assessment, audit and recovery action.[51]

5.55 In examining the ATO's compliance activities, the Committee found that the most suitable benchmark is fairness. In some respects, this is not surprising. The ATO investigates and audits taxpayers, amends their assessments and takes some taxpayers to court. This is similar to police action and prosecution. Therefore, it is natural to apply principles of legal fairness to the ATO's compliance activities.

5.56 Earlier in the chapter, the Committee noted evidence that the main benefit of compliance work is it ensures that the proportion of compliant taxpayers remains high. Its secondary purpose is to raise revenue. The ATO advised the Committee that the return on compliance overall is $15 in revenue raised for every dollar spent on compliance work.[52]

51 Commonwealth Ombudsman, sub 38, p 5.

52 Granger J, D'Ascenzo M, transcript, 9 November 2006, pp 47-48.

Audit strategies

5.57 The ATO stated that it takes a risk-based approach to audit and investigation:

> … the way we select for audit activity is on the highest risk. The whole approach is to try and focus on outliers as a way of protecting the voluntary compliance of those who are doing the right thing.[53]

5.58 A large component of this work involves data collection and analysis. The ATO's submission stated:

> We verify compliance by reviewing high-risk cases and businesses with more complex arrangements. Our interactions with businesses range from checking claims by telephone and written requests through to intensive audits. Identifying high-risk cases involves matching large volumes of data to identify omitted transactions and businesses operating outside industry or economic norms.
>
> We use the same techniques to identify businesses that represent little or no risk to the revenue system so that we avoid intruding on their affairs unnecessarily.[54]

5.59 The Committee supports the ATO reducing its compliance focus on law abiding taxpayers. The Commissioner gave an example of a conversation he had with a newsagent that shows there are costs involved in exposing compliant taxpayers to investigations:

> I was in charge of the area that was looking at it at the time. He said to me: 'Your people audited me. They did a good job, they were very professional and I did not have a problem, but I am really dark on the tax office and I will remain dark forever on them.' When I asked why, he said, 'Because you audited me and I have been trying to do the right thing, but you did not audit the person across the street, who is a crook.' So there is a perception there that, if you just do randoms and you pick the wrong people, it actually reduces community confidence rather than increases it.[55]

53 Granger J, transcript, 9 November 2006, p 47.

54 ATO, sub 50, pp 32-33.

55 D'Ascenzo M, transcript, 22 June 2006, pp 16-17.

5.60 The Committee supports the ATO's risk-based approach to compliance. It directs the ATO's resources to the areas of greatest need and does not burden compliant taxpayers.

Amended assessments

5.61 In chapter one, the Committee discussed the various reasons why taxpayers in the mass marketed investment schemes felt the ATO had unfairly treated them. One of the main reasons was the ATO's delayed reaction to the schemes. If taxpayers were not picked up by the ATO within 12 months of them lodging a return, it tended to create a precedent for the future. In its report on the schemes, the Senate Committee stated:

> Although the ATO advised that it acted within 12 to 18 months to deny deductions claimed in up to 90 per cent of cases, in some instances the time lag was approximately two to three years, and in others the delay reached up to six years.[56]

5.62 Around this time, the ATO had significant powers to amend a taxpayer's assessment. The standard period was four years. For taxpayers with a shorter period of review, the time was two years. These taxpayers needed to be individuals with simpler affairs, such as only deriving withholding income, using a limited range of deductions and incurring no capital gain or loss. In 2004, the ATO estimated there were 1.5 million taxpayers in this group. The standard period extended to six years where the ATO invoked Part IVA of the *Income Tax Assessment Act 1936* (the general anti-avoidance provision).[57]

5.63 As part of RoSA in 2004, Treasury recommended that these time limits be reduced. In particular, businesses that elect to participate in the Simplified Tax System and individuals should have an amendment period of two years. Treasury recommended that partners of partnerships and beneficiaries of trusts that have not elected to participate in the Simplified Tax System should be excluded. Taxpayers subject to Part IVA (the general anti-avoidance provisions) had their amendment period reduced from six years to the standard four years.

5.64 The Parliament amended the tax laws in the *Tax Laws Amendment (Improvements to Self Assessment) Act (No. 2) 2005* to give effect to these proposals. Under section 170 of the *Income Tax Assessment Act 1936*, the

56 Senate Economics References Committee, *Inquiry into Mass Marketed Effective Schemes and Investor Protection, Interim Report* (2001) p 6.

57 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, pp 27-28.

ATO has an unlimited period in which to amend an assessment if the Commissioner is of the opinion there has been fraud or evasion. This power is unchanged.

5.65 One of Treasury's recommendations in RoSA was that it should further investigate the specific legislative instances where the ATO has an unlimited period to amend an assessment. There are over 100 of these. Treasury has released a discussion paper on this, proposing to group the provisions into four categories:

- converting to the standard two and four year assessment periods
- having a longer, finite period such as eight years
- where the provision relies on a contingent event, changing to two years after the event
- remaining an unlimited period.[58]

5.66 In RoSA, Treasury noted most individual taxpayers have very simple affairs. For them, the main compliance activity that the ATO conducts is processes such as income matching.[59] It is straightforward for the ATO to complete this within two years, especially now that data matching has reached a sophisticated and comprehensive stage.[60] Hence, the RoSA recommendations sensibly balance the requirements of ATO systems and the needs of taxpayers.

5.67 The Committee also supports the principles behind the recent Treasury Discussion Paper, which states:

> Improving taxpayer certainty is a key goal for tax administration. The length of time that elapses before assessments can no longer be amended represents an aspect of risk and uncertainty for taxpayers. Unlimited amendment periods represent an extreme case of uncertainty, as the time to amend extends indefinitely. If that time can be limited without prejudicing the integrity and function of the system overall, the 'costs' of risk and uncertainty would be reduced.[61]

58 Treasury, *Review of Unlimited Amendment Periods in the Income Tax Laws* (2007) Discussion Paper, Commonwealth of Australia, pp 9-15.

59 Comparing the income figures on a taxpayer's return with those provided by third parties such as banks.

60 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, pp 29-30, ANAO, *The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration,* Audit Report No. 30 2007-08, 24 April 2008, pp 17-18.

61 Treasury, *Review of Unlimited Amendment Periods in the Income Tax Laws* (2007) Discussion Paper, Commonwealth of Australia, p 7.

5.68 Tax stakeholders supported the announcement of this review.[62] It is still ongoing, so the Committee sees no need to make a recommendation.

Commencing audits

5.69 The date at which an audit starts is important because it affects the value to a taxpayer of making a voluntary disclosure to the ATO.

5.70 Where a taxpayer incurs a tax shortfall amount, their conduct may warrant the imposition of an administrative penalty. The ATO decreases the base penalty if the taxpayer tells the ATO about the shortfall. The reduction depends on when the taxpayer makes the disclosure. If the taxpayer does so before an audit commences, then the reduction is 100% for a shortfall of less than $1,000 or 80% for a shortfall of $1,000 or more. If the taxpayer tells the ATO after an audit starts, the reduction is 20% if the disclosure saves the ATO significant time or resources.[63]

5.71 In 2005, the Inspector-General of Taxation released two reports that referred to taxpayer confusion over whether certain ATO compliance activities were audits and their commencement date. For instance, the report into audit timeframes stated:

> A review of sample cases revealed that an audit commencement letter or phone call had not been sent or made in 11 out of 203 (5.42 per cent) audit case files reviewed where it was appropriate to notify taxpayers of the commencement of audits and where the case file was adequately maintained.[64]

5.72 The audit timeframe report noted that the ATO was resolving this issue in consultation with tax professionals through the Accountants Tax Practitioners' Forum Audit Working Group. It recommended that the ATO ensure it complied with its procedures on notification of audits.[65] The penalties and interest report recommended that the ATO provide clearer guidance on when an audit starts and give taxpayers an opportunity to make voluntary disclosures prior to an audit formally commencing.[66]

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62 Anderson F, 'ATO may face deadlines for tax audits,' *Australian Financial Review* 23 August 2007, p 3.

63 ATO, sub 50, p 45. See also section 284-225 of the *Taxation Administration Act 1953*.

64 Inspector-General of Taxation, *Review into Tax Office audit timeframes* (2005) Commonwealth of Australia, p 27.

65 Id, pp 26, 29.

66 Inspector-General of Taxation, *Review into the Tax Office's Administration of Penalties and Interest Arising from Active Compliance Activities* (2005) Commonwealth of Australia, p 36.

5.73 In submissions, the ICAA[67] and the Taxation Institute of Australia expressed concern about how to ascertain when some audits start. The latter stated there was:

> … considerable confusion at present about whether an ATO compliance activity constitutes an audit or not, with ramifications for whether a taxpayer can make a voluntary disclosure and seek to minimise the impact of any penalties. The ATO needs to put in place protocols for advising taxpayers about whether or not a particular compliance activity is an audit, and if so, when the audit commences. Although work has progressed in the ATO, resolution has stalled …[68]

5.74 The Committee appreciates that not all taxpayers should be told when an audit into their affairs commences. However, the Committee believes that taxpayers should be advised as often as possible, including borderline cases. This is consistent with legal principles of fairness. The Committee also notes that the ATO has commenced rectifying this problem but has not finalised the task. This should be completed as soon as possible.

Recommendation 13

5.75 **The ATO establish and monitor compliance of protocols for determining when an investigation is an audit, when the audit commences, and when the ATO should inform the taxpayer of the audit.**

Conditional assessments

5.76 A feature of the ATO's response to employee benefit arrangements was that it issued assessments for the transactions which were conditional on each other. In its press release for *Essenbourne*, the ATO stated that it did not pursue the fringe benefits tax assessment because it rendered the scheme ineffective by disallowing the income tax deduction.[69] In *Pridecraft* in the first instance, the ATO's submission stated it would not follow up the fringe benefits tax assessment if it was successful in relation to the income tax deduction.[70]

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67 ICAA, sub 37, p 4.

68 Taxation Institute of Australia, sub 40, p 7.

69 ATO, 'Employee benefit arrangements,' Media release Nat 03/30, viewed on 20 August 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/mr2003030.htm.

70 [2004] FCAFC 339, para 111.

5.77 The use of conditional (or multiple) assessments provoked a strong response from some taxpayers during the inquiry.[71] For instance:

> The issuing of multiple assessments had participants amassing levels due to the ATO up to ten times the level of the actual participating sums. What a disgrace that any creditor let alone the ATO can take such a scatter gun approach. Every company and every participant has their 'breaking point' and the ATO did their best to find it.[72]

5.78 In evidence, the ATO stated that its goal was to ultimately pursue one assessment:

> … our ongoing position is that we will settle on one point. If a case is in the court and the person has decided not to settle, we still put before the court the full range of options. But our position has been all along that we only collect on one taxing point and we only settle on one taxing point.[73]

5.79 The ATO also advised the Committee in 2006 that it would be reducing the fringe benefits tax assessments to nil:

> Now that the courts in *Essenbourne, Kajewski* and *Spotlight/Pridecraft P/L* have clearly found the arrangements not to be effective for income tax purposes there is minimal risk to the revenue in amending to nil the FBT assessments for cases with similar facts. We expect about 400 cases will be affected with 200 already having been amended to nil.[74]

5.80 The Committee has significant concerns about the ATO's practice of issuing conditional assessments. The quotation above demonstrates that the ATO issued the assessment based on revenue calculations.

5.81 In the case of employee benefit arrangements, the ATO did have other approaches available. For example, the Full Court in *Indooroopilly* noted that the ATO would be able to tax the payment of funds from the investment trust (in that case, a Carers' Share Plan) to the recipients as taxable income.[75] In other words, the ATO was taxing the flow of funds one transaction too early. Given the precedent set in *Essenbourne*, it would have been defensible for the ATO to argue that it would wait until

71 Panek P, sub 17, p 2, name withheld, sub 32, pp 6-7.

72 Applied Executives, sub 55, p 1.

73 Martin S, transcript, 22 June 2006, p 48.

74 ATO, sub 50.1, p 11.

75 Edmonds J, *Commissioner of Taxation v Indooroopilly* [2007] FCAFC 16, para 39.

individual taxpayers received funds from the investment trusts. It could then assess these as income tax and litigate test cases if necessary.

5.82 If the ATO had concerns about issues of fairness in relation to taxing the same transaction twice, it would have had at least two ways of not pursuing the debt. Firstly, in some cases the imposition of fringe benefits tax may have caused hardship on a taxpayer. In Division 340 in Schedule 1 to the *Taxation Administration Act* 1953, the Commissioner has a general power to release a taxpayer from fringe benefits tax where it would cause serious hardship.

5.83 Secondly, section 34 of the *Financial Management and Accountability Act 1997* gives the Minister for Finance and Administration a general power to waive debts due to the Commonwealth.[76] The Committee has previously argued that the ATO should publicly transfer to Treasury responsibility for tax policy questions arising out of litigation. Similarly, transferring a debt collection issue to this Minister is appropriate where there are significant policy and fairness issues about pursuing a tax debt.

5.84 In its submission, Resolution Group made the following recommendation:

> The ATO should be prohibited from issuing multiple assessments, either original or amended and whether primary or alternative. The ATO should be required by law to determine the appropriate assessment and only issue and, if necessary, contest that one.[77]

5.85 The Committee would prefer the ATO implemented the spirit of this proposal. Firstly, the Committee wishes to preserve the Commissioner's discretion where possible. Secondly, when there are many complex transactions, it is difficult to determine which assessment copies another. Rather, the issue with the ATO's conduct in employee benefit arrangements was that some assessments that were contingent on its success with other assessments. As an implementer of the tax laws, the ATO should determine what the law requires it to assess as income and then pursue these amounts.[78]

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76 ATO, 'ATO Receivables Policy, Part B, The Collection of Taxation Debts,' paras 25.1-25.5, viewed at http://law.ato.gov.au/atolaw/view.htm?DocID=RMP%2FRP0025 on 27 August 2007.

77 Resolution Group, sub 42, p 15.

78 Vos D, Inspector-General of Taxation, transcript, 28 July 2006, p 3.

Recommendation 14

5.86 **The ATO amend its policies to limit the practice of issuing assessments that are contingent on each other, and specify in what circumstances such assessments may be validly issued. In the absence of administrative change, the Government introduce legislation to this effect.**

A pro-revenue bias?

5.87 Over the years, a number of stakeholders have alleged that the ATO is biased towards collecting revenue, rather than collecting tax in accordance with the law. This perception is in the eye of the beholder. The Committee is alert to the fact that such criticisms can be self-serving when made by those caught out as having failed on tax compliance. In its performance audit on rulings in 2001, the ANAO reported allegations by taxpayers that the ATO was biased.[79] The Inspector-General of Taxation has reported that 72% of large corporate taxpayers consider the ATO to be biased in relation to private rulings.[80]

5.88 Sometimes this view is expressed as a perception of bias amongst the community. For example, in RoSA Treasury noted a widespread perception of bias in relation to private rulings. RoSA recommended that the Inspector-General of Taxation investigate this matter.[81] In his recent review, the Inspector-General examined the ATO's systems and files and found no evidence of bias in the ATO's private rulings. The Inspector-General confirmed that the perceptions of bias were widespread, but these were due to the way the ATO dealt with applicants. This included requesting taxpayers to withdraw applications, making requests for additional information that did not always appear warranted, and discussing issues with Treasury without advising taxpayers. By not being open with taxpayers about these delay-causing behaviours, taxpayers concluded from the information available to them that the ATO was exercising the sort of bias that would be expected from a revenue agency.[82]

79 ANAO, *The Australian Taxation Office's Administration of Taxation Rulings,* Audit Report No. 3 2001-02, 17 July 2001, p 95.

80 Vos D, Mihail T, 'The Importance of Certainty and Fairness in a Self-Assessing Environment,' para 112, viewed at http://www.igt.gov.au/content/media/sp20060420.asp on 20 August 2007.

81 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, pp 17-18.

82 Inspector-General of Taxation, *Review of the potential revenue bias in private binding rulings involving large complex matters* (2008) Commonwealth of Australia, pp 3-8, 125.

5.89 In its performance audit on rulings, the ANAO was not able to conclude about whether the ATO's private rulings showed a pro-revenue bias. Rather, the report focussed on whether the ATO's processes supported robust decision-making:

> The ATO rejects this view and it is difficult to determine whether this view is valid…
>
> The ATO disagrees and it is difficult to conclude one way or the other about user/stakeholder perceptions…
>
> We note that some rulings are contentious and we appreciate that views may differ on matters of legal interpretation (sometimes very important matters of legal interpretation) because that is the nature of the interpretative process. However, in view of our discussion and conclusions relating to the public rulings production processes … we conclude that the processes are in place to assure reasonably the legal quality of the ATO's public rulings.[83]

5.90 The ATO's third external scrutineer is the Ombudsman. The Committee asked the Ombudsman of the culture of ATO staff and whether they adopted a pro-revenue bias:

> If we see the Taxation Office through the prism only of the individual complaints that we receive and the contact we otherwise have, the evidence from that contact does not substantiate the general criticisms that are made. But I think what we do see is that every issue has two sides to it …
>
> There are complaints and difficulties if the Taxation Office has labels that are pejorative such as 'aggressive tax planning promoter' or whatever. On the other hand, it says it is failing in its response to calls from the public if it does not do that to differentiate between those who are innocent and genuine, committed and acting in good faith and those who are not. I think that is the general experience that we find. One can point to an issue or an example to substantiate a general point, but it is quickly counterbalanced by experience of a different kind or by imagining what the alternative is going to be if you take the other line.[84]

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83 ANAO, *The Australian Taxation Office's Administration of Taxation Rulings,* Audit Report No. 3 2001-02, 17 July 2001, pp 95-96.

84 McMillan J, transcript, 28 July 2006, p 25.

5.91 The Ombudsman's point about two sides to every story is very relevant. If a taxpayer disagrees with or engages in a dispute with the ATO and is unsuccessful, they are likely to be dissatisfied. With the support of democratic processes, they are also entitled to complain. Every case where a taxpayer is dissatisfied has the potential to be a public, high profile criticism of the ATO.

5.92 The other side of the story is where a taxpayer disagrees with or engages in a dispute with the ATO and is successful. Any such taxpayer is likely to be satisfied but will have little incentive to announce this outcome. The public is unlikely to hear about these cases. The ATO has publicly stated that it ultimately accepts taxpayers' arguments in many cases.[85]

5.93 In the view of the Committee, proving systemic bias in the ATO will be methodologically difficult undertaking. The sort of process that would be required would be to take a statistical sample of the ATO's decisions and then assess whether each one demonstrated a revenue bias, a taxpayer bias, or was neutral. Arguably, for an allegation of revenue bias to be valid, the examples of a revenue bias would need to outweigh the examples of taxpayer bias.

5.94 In *An Assessment of Tax*, the JCPA argued that, whenever there was doubt over an interpretation of the law, the ATO should give the taxpayer the benefit of the doubt.[86] Under this approach, one decision by the ATO with a revenue bias would arguably be sufficient to demonstrate a revenue bias overall. Clearly, this is not practical. The analysis then becomes an exercise in determining what proportion of the ATO's decisions is permitted to demonstrate a revenue bias.

5.95 The ATO has already implemented processes to achieve much of this analysis through its technical quality reviews. In these reviews, the ATO selects a statistical sample twice a year of its different types of decisions and then conducts internal peer review. Generally, the ATO's benchmark for a pass rating is 95%. The ATO achieved a performance of 97.0% for August 2006 to January 2007, up from 95.8% from February 2006 to July 2006.[87]

5.96 If the Committee were to cite the examples of where there may be evidence of a pro-revenue bias, it would raise the following:

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85 Kazi E, 'ATO drops aggressive legal tactics' *Australian Financial Review*, 6 March 2007, p 6.

86 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 284.

87 ATO, *Annual Report 2006-07*, p 42.

- the ATO issuing conditional assessments in employee benefit arrangements
- prior legislative arrangements where the ATO could automatically apply penalties to taxpayers who did not follow private rulings (chapter three)
- the ATO's conduct in *Essenbourne*
- the ATO arguing in *Walstern* that private opinions were not relevant authorities to support a taxpayer's claim for a reasonably arguable position (chapter three)
- the combination of the ATO's delays and compliance response in the mass marketed investment schemes.

5.97 The common thread in these examples is fairness. Simply put, the ATO engaged in conduct in these instances that most observers would describe as unfair. However, this does not necessarily demonstrate a pro-revenue bias or a general unfairness on the part of the ATO. This agency makes hundreds of complex decisions daily. To cite five occasions over 10 or more years does not demonstrate bias.

5.98 What these decisions demonstrate is the importance of fairness in dealing with taxpayers and the seemingly disproportionate effect that an unfair decision can have. Each decision has the potential to reduce the reputation of the ATO. This could then affect the number of taxpayers who decide to be compliant and, in turn, could affect the security of the revenue. The ATO itself noted this in its submission where it stated:

> Procedural fairness, courtesy and integrity underpin a world class tax administration.[88]

5.99 In the view of the Committee, what would assist the ATO is a mechanism whereby there would be a fairness check on all significant decisions dealing with taxpayers. To some extent, the mechanisms for this are already in place. The ATO has the *Taxpayers' Charter*, which requires the ATO to act fairly and reasonably with taxpayers.[89] The ATO also has technical quality reviews. In its 2004 performance audit on the *Taxpayers' Charter*, the ANAO recommended that the ATO implement systematic, supplementary quality assurance processes. These processes would include compliance with Charter principles.[90]

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88 ATO, sub 50, p 1.

89 ATO, *Taxpayers' Charter – Expanded Version* (2007) Commonwealth of Australia, p 3.

90 ANAO, *Taxpayers' Charter,* Audit Report No. 19 2004-05, 17 December 2004, pp 64-66.

5.100 In June 2008, the ANAO finalised a follow-up audit on the *Taxpayers' Charter*. The ANAO found that the ATO had met the intent of this recommendation by implementing an integrated quality framework based on recognised standards. The ATO conducted internal consultations to ensure that the framework complies with Charter principles. In time, the framework will replace technical quality reviews.[91]

5.101 While the Committee regards all of the principles in the *Taxpayers' Charter* as important, perhaps the most important of them is the ATO's commitment to act fairly. The Committee trusts that the integrated quality framework will further raise the visibility of this Charter principle in ATO decision-making.

Conclusion

5.102 Compliance work is the most sensitive area of the ATO's administration of the tax system. The Committee is satisfied that the ATO's compliance model is a suitable foundation for this because it assists compliant taxpayers and encourages taxpayers in general to comply with the tax laws.

5.103 Much of this chapter has concentrated on how the ATO managed employee benefit arrangements, including the *Essenbourne* case. Out of all the issues raised with the Committee during the inquiry, the Committee is the most concerned about *Essenbourne*. It took the ATO four years to accept the Federal Court's decision in that case. The Committee agrees with Justice McHugh and the Full Federal Court in *Indooroopilly* that a court decision is the law and should be followed. Either appealing the decision or accepting it and referring the issue to Treasury as a policy matter is consistent with the ATO's role as an independent administrator of the tax laws.

5.104 The Committee accepts that many of the taxpayers in employee benefit arrangements took a conscious decision to push the boundaries of legal conduct to pay less tax but still enjoy the many public facilities that tax revenue provides. But in *Essenbourne*, the ATO has allowed its critics to argue that it pushes the boundaries of the law as well. This endangered

91 ANAO, *Taxpayers' Charter – Follow-up Audit*, Audit Report No. 40 2007-08, 11 June 2008, pp 53-55.

much of the ATO's good work in establishing, promoting and being guided by the compliance model.

6

Penalties and interest

Penalties

How the ATO determines the penalty amount

6.1 There is a long list of matters for which the Australian Taxation Office (ATO) can issue penalties. These include a failure to keep or retain records, failing to issue a tax invoice and failing to withhold as required.[1] These are called administrative penalties because the ATO can issue them itself, rather than needing to take a taxpayer to court.

6.2 There were two main penalties that concerned the Committee during the inquiry. The first was for statements and unarguable positions that lead to a shortfall of tax. That is, where the ATO believes that the taxpayer has a greater tax liability than is shown in the return. The second was for failure to lodge a return or other document.

6.3 Shortfall penalties largely depend on the taxpayer's conduct. The main penalties are calculated as a percentage of the taxpayer's shortfall amount. Table 6.1 shows the various penalty amounts.

6.4 The two key definitions in the table are 'reasonable care' and 'reasonably arguable.' Section 284-15 states that a taxpayer has taken a reasonably arguable position where their tax return is, 'about as likely to be correct as incorrect.' The ATO advised the Committee on the difference between exercising reasonable care and a failure to do so:

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1 Division 288 in Schedule 1 to the *Taxation Administration Act 1953*, ATO, sub 50, p 46.

> Reasonable care for a taxpayer is determined by the individual circumstances of that taxpayer taking into account age, health, education, culture and other individual factors. It is not intended to be difficult for the taxpayer to exercise reasonable care…
>
> Generally a taxpayer has failed to take reasonable care if they have not done what a reasonable person in similar circumstances would do.[2]

Table 6.1 Base penalty amounts for tax shortfalls as a percentage of the shortfall amount

Taxpayer's conduct	Penalty
Intentional disregard of a tax law	75%
Recklessness as to the operation of a tax law	50%
Scheme with the sole or dominant purpose of reducing tax	50%
Entered into a scheme where the treatment was reasonably arguable	25%
Lack of reasonable care	25%
Treatment not reasonably arguable and the shortfall amount is more than the greater of $10,000 or 1% of the taxpayer's total income tax liability for that year	25%
Reasonable care	Nil

Source *ATO, sub 50, p 44, Subdivision 284-C of the Taxation Administration Act 1953.*

6.5 The ATO advised the Committee that it increases the base penalty by 20% if the taxpayer:

- took steps to prevent or obstruct the Commissioner from finding out about the shortfall
- became aware of the shortfall but did not inform the Commissioner in a reasonable time, or
- was previously liable to a penalty for having a tax shortfall.[3]

6.6 The ATO decreases the base penalty if the taxpayer tells the ATO about the shortfall. The reduction depends on when the taxpayer makes the disclosure. If the taxpayer does so before an audit commences, then the reduction is 100% for a shortfall of less than $1,000 or 80% for a shortfall of $1,000 or more. If the taxpayer tells the ATO after an audit starts, the reduction is 20% if the disclosure saves the ATO significant time or resources.[4]

2 ATO, sub 50, p 44.

3 ATO, sub 50, p 45. See also section 284-220 in Schedule 1 to the *Taxation Administration Act 1953*.

4 ATO, sub 50, p 45. See also section 284-225 in Schedule 1 to the *Taxation Administration Act 1953*.

6.7 The commencement of an audit is a key date for taxpayers. Chapter five discusses the need for the ATO to communicate more clearly with taxpayers about the start of an audit.

6.8 The base penalty for failure to lodge a return or other document is one penalty unit for each 28 day period, or part thereof, past the due date. A penalty unit is $110.[5] The maximum number of penalty units under the legislation is five. The ATO multiplies the base amount by two if the taxpayer is a medium enterprise (for example, it has a total annual tax liability between $1 million and $20 million). The ATO multiplies the base amount by five for large enterprises (for example, a tax liability over $20 million).[6]

6.9 The ATO advised the Committee that it is prepared to take taxpayers' previous good conduct into account in applying penalties for failure to lodge:

> We recognise that even with the best intentions events will arise that mean people will not always meet their lodgement obligations on time. Consequently, penalties will not generally be applied in isolated cases of late lodgement unless we have already contacted taxpayers because the document was not lodged and issued them with a warning.[7]

6.10 The legislation and the ATO's approach to penalties help reinforce a compliance culture among taxpayers. For example, the penalties for both a shortfall amount and a failure to lodge are reduced or eliminated where taxpayers approach the ATO first, rather than waiting for the ATO to come to them. The Ombudsman noted:

> …the current differential levels of penalty applied by the exercise of judgment informed by fact, law and administrative guidelines is both a fair and reasonable response to individual acts of non-compliance and an effective means of encouraging greater voluntary compliance.[8]

Are penalty amounts appropriate?

6.11 The Committee sought to compare tax penalties in Australia with overseas countries to determine if the amounts in Australia were excessive or too

5 Section 4AA of the *Crimes Act 1914*.

6 ATO, sub 50, p 45. See also section 286-80 of the *Taxation Administration Act 1953*.

7 ATO, sub 50, p 45.

8 Commonwealth Ombudsman, sub 38, p 15.

low. For convenience, the Committee selected all English-speaking OECD countries for comparison. The results are in table 6.2 on the next page.

6.12 Overall, it appears that tax penalties in Australia are broadly in line with the other comparison countries. For tax shortfalls, the maxima range from 50% to 200%. The maximum in Australia is 75%.

Table 6.2 Tax penalties, English-speaking OECD countries, 2006

Country	Shortfall amount	Failure to lodge
Australia	25% (lack of reasonable care) to 75% (deliberate acts)	$A110 per 28 days late, up to $A550. Multiplied by 2 and 5 for medium and large taxpayers
Canada	Up to 50%, depending on the seriousness of the offence	5% of unpaid tax, plus an extra 1% per month of delay
Ireland	Up to 100% for neglect and up to 200% for fraud	5% if less than 2 months late (€12,000 max), or 10% over 2 months (€63,000 max)
New Zealand	20% for lack of reasonable care and up to 150% for serious fraud	$NZ50 to $NZ500, depending on the taxpayer's income
United Kingdom	Up to 100%, depending on the seriousness of the offence	£100 for late returns, extra £100 for 6 months late and 100% of tax if not filed within one year
United States	20% to 75%, depending on the seriousness of the offence	5% per month or part thereof delayed, up to 25%

Source *OECD, Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006), October 2006, pp 57, 69-71, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf. This series is published every two years.*

6.13 For failure to lodge, the penalty is calculated either as a percentage of the tax liability or as a dollar amount which increases in line with the extent of the delay. The percentage approach gives a greater penalty, especially for large taxpayers. The failure to lodge penalty in Australia is higher than that in New Zealand. Where the delay is less than one year, Australia's penalty is higher than in the United Kingdom.

6.14 In the Review of Self Assessment (RoSA), Treasury noted that submissions did not criticise the scale of penalties.[9] The same occurred in this inquiry. The Committee agrees that penalty amounts in Australia appear satisfactory overall.

6.15 CPA Australia did express concern about the timing method used for calculating failure to lodge penalties:

> A potential problem with the current … arrangements is that the penalties for those taxpayers who lodge later than the due date for lodgement … seem to be more severe than in the case of a

9 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, p 44.

> taxpayer who either fails to lodge at all or lodges very late. This is because the maximum penalty under the current … system arises when a return is 113 days overdue, although the general interest charge … continues to apply to any amount that remains unpaid after this period.[10]

6.16 However, the Committee does not wish to suggest any changes to the structure of failure to lodge penalties. The main reason is that tax liabilities are much more collectable when they are recent. For instance, the Australian National Audit Office (ANAO) found that the ATO collected as much tax debt (after lodgement and assessment) in 1998-99 within 30 days as it did in the next 330 days.[11] A similar principle probably applies where taxpayers fail to lodge a return. The longer the delay in lodging, the less collectable any potential debt is likely to be. It is likely that any significant delay greatly increases the chance that the taxpayer is non-compliant. Therefore, targeting failure to lodge penalties within the first six months of the due date appears to be an appropriate strategy in promoting taxpayer compliance.

Consistency across the ATO

6.17 In its 2000 performance audit on penalties, the ANAO found that ATO senior management could not be sure that the ATO was applying penalties consistently and as described in the legislation. The ANAO stated:

> We found that, although penalties are an important enforcement strategy featured in the ATO Compliance Model, the ATO lacks appropriate control structures to oversight the accountability, consistency and effectiveness of its penalty administration. Currently, ATO management is unable to provide assurance to the Commissioner that penalties are being applied consistently and in accordance with the legislation.[12]

6.18 The ATO agreed to all of the ANAO's recommendations. The ones that related to consistency were:

- establishing organisation-wide quality assurance of the ATO's penalty administration

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10 CPA Australia, sub 36, p 15.

11 ANAO, *The Management of Tax Debt Collection*, Audit Report No. 23 1999-2000, 20 December 1999, p 74.

12 ANAO, *Administration of Tax Penalties*, Audit Report No. 31 1999-2000, 16 February 2000, p 11.

- including guidance in the ATO's technical training material on the application of penalties to different scenarios in the compliance model
- investigating a web-based decision making tool for staff.[13]

6.19 In 2005, the Inspector-General of Taxation completed a review of the ATO's administration of penalties and interest arising from active compliance. The Inspector-General noted that the ATO had deferred investigating a web-based decision making tool because of the introduction of major tax reform at the time of the ANAO report. To assist implementing the reforms, the ATO applied concessions to penalties, which resulted in reduced usage.[14]

6.20 The Inspector-General reported that the ATO was conducting an internal review of penalties, which had resulted in a draft report at that stage. Its topics included quality assurance over penalty decisions, staff expertise, and the relevant systems and infrastructure. The Inspector-General's main recommendations in relation to penalties were that the ATO:

- implement all remaining recommendations from the ANAO report
- develop uniform governance arrangements for penalties to apply across all business lines
- consider the various improvements suggested by stakeholders during the review (for example, better training, communication with taxpayers and decision making tools).[15]

6.21 During this inquiry, however, the Committee received evidence that concerns still remain about the imposition of penalties. The Taxation Institute of Australia stated:

> There is a perennial problem in respect of the imposition of penalties … by the ATO. Often they are imposed arbitrarily, without due regard to whether a taxpayer has a reasonably arguable case or special circumstances…
>
> This view is reflected in many court and AAT [Administrative Appeal Tribunal] cases where the level of penalty is reduced on appeal. It appears that it is mainly in egregious scheme cases that the courts and the AAT uphold the penalties imposed.[16]

13 Id, p 15.

14 Inspector-General of Taxation, *Review into the Tax Office's Administration of Penalties and Interest Arising from Active Compliance Activities* (2005) Commonwealth of Australia, pp 4-5.

15 Id, pp 5, 7, 36-37.

16 Taxation Institute of Australia, sub 40, p 9.

6.22 To help improve consistency in applying penalties, the Institute of Chartered Accountants in Australia (ICAA) recommended that staff making decisions about penalties should be separate from those conducting audits in the ATO. The ICAA also suggested that the ATO should have a formal, internal review procedure for penalty decisions at the request of either the ATO or the taxpayer.[17]

6.23 In *An Assessment of Tax*, the Joint Committee on Public Accounts (JCPA) recommended that staff who made penalty decisions should be legally qualified and be independent from audit staff. The Committee's concern was that combining investigations with punishment placed too much power in audit staff. Its first preference was to remove the ATO's power to impose administrative penalties. [18] The division of duties was its alternative recommendation. The ATO declined these proposals.[19]

6.24 ATO administration has improved since the JCPA's 1993 *An Assessment of Tax* report, and the law is fairer after various reforms, including those under RoSA. Currently, the Committee believes that penalties play an important role in helping the ATO to promote a compliance culture among taxpayers. On this basis, the Committee believes that the ATO should retain the power to impose administrative penalties.

6.25 The ATO provided the Committee with data on the technical quality reviews of its penalty decisions. Twice a year, the ATO samples its interpretive decisions and subjects them to internal peer review. The ATO analyses the results to target areas for improvement. It also publishes the results in its annual report.[20] Whether a taxpayer complains or not does not affect the technical quality review. The focus is on the quality of the decision itself.

6.26 For the period from August 2006 to January 2007, 92.1% of penalty decisions received an 'A' rating and 97.2% received a 'Pass' rating. The ATO's benchmarks for penalty and other debt decisions (such as shortfall interest remissions) are 85% and 95% respectively.[21] While this is a competent level of performance, it implies that 2.8% of taxpayers who receive a penalty probably did not receive fair treatment. The Committee regards this as too high.

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17 ICAA, sub 37, p 12.

18 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, pp 299-300.

19 ATO, 'Final Report on the Implementation of the Recommendations of Report 326"An Assessment of Tax'", correspondence, 20 October 1998.

20 ATO, *Annual Report 2006-07*, p 42.

21 First biannual meeting with the Commissioner of Taxation, ATO, sub 3, p 21.

6.27 The Committee accepts that the ATO has made significant progress since the ANAO's performance audit in 2000. It appears that the ATO is now at the stage of refining its practices, rather than radical change. Therefore, the Committee does not believe it is necessary to stipulate new processes for the ATO. Instead, it proposes two courses of action.

6.28 Firstly, the ATO needs to increase its performance targets. The current pass benchmark of most technical quality reviews in the ATO is 95%,[22] whereas for penalty and other debt decisions it is 85%. The Committee sees no reason why the ATO should be achieving a significantly lesser standard for penalty decisions. The ATO should develop new targets and use these as a focus for further improvement.

Recommendation 15

6.29 **The ATO increase its benchmarks for the technical quality reviews of penalty and other debt decisions.**

6.30 Secondly, the Committee believes that it may be prudent for the ATO's external scrutineers (the ANAO, Inspector-General of Taxation and the Ombudsman) to conduct additional work on the ATO's penalty and debt practices to ensure that the ATO's performance continues to improve over time. For example, the Inspector-General's review of GST audits for large taxpayers found issues with the ATO's decisions on shortfall penalties. These included a significant number of cases where the ATO:

- concluded that a taxpayer was reckless, despite the matter being arguable at law
- applied the penalty at the full rate, despite prior disclosure by the taxpayer
- applied a different penalty rule to large and small taxpayers.[23]

6.31 The Committee believes penalty and debt decisions warrant continued external scrutiny.

22 ATO, *Annual Report 2006-07*, p 42.

23 Inspector-General of Taxation, *Review of the Tax Office's Administration of GST audits for Large Taxpayers* (2008) Commonwealth of Australia, p 5.

Interest

How the ATO calculates interest

6.32 There are two interest charges for overdue amounts. The interest charge applied in most circumstances is the general interest charge (GIC). The Government introduced it in 1999 to replace a large number of interest charges and penalties. It is tax deductible. Penalty payments are subject to GIC once they become overdue.[24]

6.33 The *Taxation Administration Act 1953* sets the GIC at a high rate to encourage taxpayers to promptly pay their tax debts and prevent them from using the ATO as a source of cheap finance. The GIC is set at the Reserve Bank's (RBA's) monthly yield of 90-day Bank Accepted Bills plus 7%.[25] It has generally been between 11% and 14%.[26] Due to recent changes in interest rates by the RBA, the GIC was 14.69% for the June quarter of 2008.[27]

6.34 GIC is calculated on a daily basis. The GIC is divided by the number of days in the year and then this figure is applied to the taxpayer's outstanding balance each day.[28] This calculation technique increases the GIC. For example, a 12.5% rate compounds to 13.3% over 12 months.

6.35 The other interest liability is the shortfall interest charge (SIC), which arises following an amended assessment. It applies to tax shortfalls in the period between the first day when the taxpayer was due to pay income tax and when the ATO notifies the taxpayer of the shortfall. The SIC commenced on 1 July 2005 in relation to the 2004-05 financial year.[29] It is also tax deductible.[30]

6.36 Treasury recommended the introduction of the SIC in RoSA. Its reasoning was that the incentive for taxpayers to avoid the GIC through prompt payment did not apply during the period before an amended assessment.

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24 Treasury, sub 51, p 10, section 298-25 in Schedule 1 to the *Taxation Administration Act 1953*.

25 Ibid.

26 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, p 50.

27 ATO, 'General interest charge (GIC) rates,' viewed on 18 March 2008 at http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/2832.htm&mnu=4823&mfp=001/005.

28 Section 8AAD of the *Taxation Administration Act 1953*.

29 Section 280-100 in Schedule 1 to the *Taxation Administration Act 1953*, ATO, sub 50, p 47.

30 ATO, *RoSA in brief – Shortfall interest charge* (2007) Commonwealth of Australia, p 4.

Taxpayers generally would not be aware that they had a shortfall during this time.[31]

6.37 In RoSA, Treasury argued that the philosophy behind the SIC should be that taxpayers should not receive a loan benefit from a shortfall. Therefore, the SIC is set at the Reserve Bank's monthly yield of 90-day Bank Accepted Bills plus 3%. In other words, the SIC is 4% less than the GIC.[32] The SIC is also calculated on a daily basis and compounds, increasing an 8.5% rate to 8.9% at the end of one year.

6.38 The ATO gives taxpayers who receive an amended assessment requesting payment of a shortfall amount 21 days in which to pay. SIC applies to the debt up to the date of the amended assessment. If a taxpayer does not repay the debt by the payment date, then GIC will apply to the unpaid amount.[33]

6.39 The Committee supports the introduction of the SIC. Taxpayers should not be subject to high interest rates for tax shortfalls where the ATO has not notified them of their tax status. The National Institute of Accountants described the SIC as a 'welcome policy initiative.'[34]

6.40 The ATO does not have discretion in applying these interest charges. The *Taxation Administration Act 1953* requires the ATO to do so. The ATO may remit the interest charges at a later date and has considerable discretion. This topic is discussed below.

Are the interest rates appropriate?

6.41 In considering this issue, the Committee compared the interest charges in Australia against other OECD countries, in particular those where English is an official language. The results are in table 6.3.

6.42 The first observation is that New Zealand has much higher rates than all the other countries in the table and appears to be an outlier. Apart from this, Australian rates are very similar to those in other countries. The one exception to this appears to be the GIC, which edges higher than other countries' rates as time progresses. However, the Committee does not believe that rates in Australia overall are sufficiently different to these comparison countries to warrant change.

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31 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, pp 51-54.

32 Id, pp 53-54, Treasury, sub 51, p 11.

33 Treasury, sub 51, p 11.

34 National Institute of Accountants, sub 31, p 6.

Table 6.3 Interest charges for late payment of tax, English-speaking OECD countries, 2006

Country	Calculation method	Effective rates		
		3 months	*6 months*	*1 year*
Australia (SIC)	RBA's bank bill rate plus 3%	2.1%	4.3%	8.9%
Australia (GIC)	RBA's bank bill rate plus 7%	3.2%	6.4%	13.3%
Canada	90-day Treasury bills plus 4%	2%	4%	8%
Ireland	0.0322% per day	3%	6%	12.5%
New Zealand	5% of tax, plus 2% per month	11%	17%	29%
United Kingdom	5% of tax, plus 5% after 6 months	5%	10%	10%
United States	0.5% of tax per month	1.5%	3%	6%

Source *OECD, Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2006), October 2006, pp 57, 69-71, viewed on 31 January 2007 at http://www.oecd.org/dataoecd/43/7/37610131.pdf.*[35] *This series is published every two years.*

6.43 The National Institute of Accountants suggested to the Committee how the interest charges might operate differently. It suggested that the legislation split the GIC into two components. The first would be a base rate of the RBA's bank bill rate (historically between 4% and 7%). The second would be the uplift factor (7% for the GIC and 3% for the SIC). The ATO would apply the base rate in all cases and the uplift factor where the taxpayer has committed some wrongdoing.[36]

6.44 The Institute's argument was that:

> While the NIA understands the need for the GIC and to have the GIC set at a rate that discourages the use of public funds as an alternate source of finance, many taxpayers to whom the GIC has and will apply to, do not have the intention of using public funds as a source of finance and nor have they benefited from being late in paying their tax liability.[37]

6.45 Although the Committee appreciates that some taxpayers may not benefit from incurring the GIC, there are several reasons why the Committee does not support the proposal. The first is that it would turn the interest charges into penalties. There is already a straightforward system of penalties in place which, in the view of the Committee, does not need significant change.

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35 Australian bills rate was approximately 5.5% in 2006, see Treasury, sub 51, p 10. Canadian bill rate in 2006 was approximately 4%, Bank of Canada, 'Treasury Bill Auction - Average Yields - 3 Month,' viewed at http://www.bankofcanada.ca/pdf/annual_page3_page4.pdf on 1 June 2007.

36 National Institute of Accountants, sub 31, p 6.

37 Ibid.

6.46 The second reason is that some taxpayers do use the ATO as a source of finance. Treasury made this argument,[38] as did the ATO in evidence:

> In fact, one of the reasons we have concerns about debt at the microbusiness end of small business is that, because they do not need to apply and they do not need security, they can pay off their suppliers using amounts that should have been used to pay off tax debts…
>
> Research we have done is that one of the reasons the debt figure tends to be higher in small business, particularly microbusiness, is that the facility of incurring the debt by not paying the tax is convenient to them…[39]
>
> Low-doc and no-doc loans are secured against real estate—that is how they work—whereas these people often have their assets fully charged and … this is a very easy line of credit to obtain.[40]

6.47 The Committee does not believe this category of taxpayer should benefit from accessing cheap finance from the ATO. Further, the Committee can foresee that there would be considerable difficulties in distinguishing between taxpayers who intended to use the ATO as a cheap source of finance and those who did not. Instead, taxpayers who have a good record and make a reasonable attempt to meet their tax obligations will have a good case for requesting the ATO to remit the interest charges.

6.48 Generally, the Committee would prefer that the systems for penalties and interest remain as simple as possible. The Commissioner has discretion for remitting penalties and interest and this is the stage where the system can take individual factors into account.

Remissions

How the ATO remits penalties

6.49 Section 298-20 in Schedule 1 to the *Taxation Administration Act 1953* gives the Commissioner wide discretion to remit penalties. The only requirement the section makes of the Commissioner in making a decision

38 Treasury, sub 51, p 10.

39 D'Ascenzo M, transcript, 20 April 2007, p 6.

40 Konza M, transcript, 20 April 2007, p 6.

is that the ATO must give an explanation if it does not remit the entire penalty.

6.50 The ATO has drafted policies on remitting penalties. In relation to a tax shortfall, the main factor relevant to remitting a penalty is whether the taxpayer has a good compliance history. This occurs where the taxpayer:

- meets all lodgment obligations
- pays all non-disputed debt or has a payment arrangement in place
- has no recent history of a shortfall penalty.

6.51 The ATO notes that taxpayers who demonstrate that they have taken reasonable care will not receive a penalty in the first place. Requests for remitting a shortfall penalty will come from taxpayers who, at the minimum, have not exercised reasonable care. The ATO sees little likelihood of remitting a penalty involving recklessness or intentional disregard.

6.52 The sort of example where the ATO envisages that it might remit a penalty for lack of reasonable care would be where the taxpayer:

- has a good compliance history
- makes an isolated, unintended record keeping mistake
- the mistake is not related to an extraordinary event (e.g. a large or infrequent transaction).[41]

6.53 In relation to a penalty for failure to lodge a document, the taxpayer must usually demonstrate that this occurred due to circumstances beyond their control. They should also explain why they were unable to request an extension from the ATO. However, if a taxpayer cannot meet these requirements, the ATO will still consider the request for remission. The relevant criteria are:

- the length of time the document was overdue
- the taxpayer's and tax agent's circumstances
- the taxpayer's lodgment history
- any relevant contact with the ATO before the document was due.[42]

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41 ATO, 'Administration of shortfall penalty for false or misleading statement,' PS LA 2006/2, paras 136-58, viewed on 4 June 2007 at http://law.ato.gov.au/atolaw/print.htm?DocID=PSR%2FPS20062%2FNAT%2FATO%2F00001&PiT=99991231235958.

42 ATO, 'ATO Receivables Policy, Part F, Penalties and interest relating to receivables activities,

How the ATO remits interest charges

6.54 In the case of tax shortfalls and the SIC, the legislated principles that the ATO must take into account are:

- to remit where it would be fair and reasonable to do so
- not to remit just because the taxpayer's shortfall benefit during the period is less than the SIC
- to remit where the Commonwealth has contributed to the SIC.[43]

6.55 The ATO has published its policy on shortfall interest in Law Administration Practice Statement 2006/8. The main reason for remission is delay. For example:

- ATO delay in commencing an audit or completing an audit leads to remission of interest charges to the base rate for that period
- unreasonable delay by the ATO in conducting an audit leads to full remission
- delay at the request of the taxpayer, if agreed by the ATO, leads to remission to the base rate
- where the taxpayer requests a delay due to circumstances outside their control, there can be full remission.[44]

6.56 There are also some circumstances where the ATO will remit interest as a matter of course. For instance, the ATO remits small amounts of interest automatically because the administrative costs of collection outweigh the revenue benefits. Another example relates to tax shortfalls from 2003-04 and earlier years. These taxpayers are legally required to pay the GIC on these debts. However, the ATO remits enough of the interest so these taxpayers are only paying the equivalent of the SIC from 1 July 2005 (the SIC's start date).[45]

6.57 The ATO will also remit shortfall interest in full where legal change or incorrect ATO advice creates a shortfall. Examples of these situations are:

Lodgment penalty,' paras 98.4.16-98.4.23, viewed on 4 June 2007 at http://law.ato.gov.au/atolaw/view.htm?DocID=RMP%2FRP0098.

43 Section 280-160 in Schedule 1 to the *Taxation Administration Act 1953*.

44 ATO, *Remission of shortfall interest charge and general interest charge for shortfall periods*, PS LA 2006/8, pp 9-13.

45 Id, pp 8, 18.

- where the ATO gives incorrect advice or has an incorrect general administrative practice
- where a taxpayer relies on an interpretive decision that is later found to be incorrect
- where a taxpayer relies on a judicial or tribunal decision which is overturned on appeal
- where a tax return is accurate at the time of lodgement, but later events trigger an additional liability.[46]

6.58 For the GIC, section 8AAG of the *Taxation Administration Act 1953* outlines four main criteria for remission:

- the taxpayer did not cause the GIC accruing and they have attempted to mitigate the situation
- the taxpayer caused the GIC accruing, they have attempted to mitigate the situation, and it would be fair and reasonable to remit
- there are special circumstances making it fair and reasonable to remit
- it is otherwise appropriate to remit.

6.59 The ATO's receivables policy explains these criteria. For example:

- factors beyond the control of the debtor are limited to specific matters such as natural disasters[47] and industrial action, rather than general economic conditions
- taxpayers must take mitigating action promptly
- it would be fair and reasonable to remit where compliant taxpayers who meet their obligations would consider it fair and reasonable to do so for the taxpayer in question
- the ATO can take into account a taxpayer's compliance history
- the ATO is most likely to use the 'otherwise appropriate to remit' category for a group of taxpayers. One example would be the mass marketed investment schemes.[48]

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46 Id, pp 19-21.

47 The ATO has made allowance for taxpayers and tax agents affected by the Hunter Valley and Central Coast floods in June 2007. See ATO, 'Tax help for people affected by the NSW floods,' Media release 2007/25, viewed on 15 June 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/85462.htm.

6.60 The receivables policy also outlines a number of particular circumstances where the ATO will remit some GIC. For instance, the ATO can remit GIC where a taxpayer is on social security and has no assets. Another example is where a taxpayer is in dispute with the ATO and pays all non-disputed tax and 50% of disputed tax. The ATO will remit 50% of the GIC on the unpaid disputed tax in these circumstances.[49]

Groups of taxpayers in dispute with the ATO

6.61 In 2004, the Inspector-General of Taxation finalised a report on how the ATO remitted the GIC for groups of taxpayers in dispute with the ATO. The report focussed on employee benefit arrangements. The Inspector-General's main findings were that the ATO:

- was taking a narrow approach to remitting GIC, with the implication that it could remit more widely
- should differentiate how it remits GIC in relation to interest accruing before and after an amended assessment
- should base remission decisions on taxpayers' individual circumstances, rather than a 'one size fits all' approach
- should establish internal reviews of remission decisions involving large groups of taxpayers
- had inconsistently treated taxpayers between different employee benefit arrangements.[50]

6.62 In contrast, the ATO argued that it was acting as the law required and that it did not have scope to compensate for inappropriate legislation. If there were problems with the tax laws, that was a matter for Parliament. However, the ATO agreed to establish a review panel of senior ATO officers to oversee remission decisions involving large numbers of taxpayers.[51] Following the Inspector-General's report, the ATO made various settlement offers to taxpayers depending on their individual circumstances (discussed in chapter one).

48 ATO, 'ATO Receivables Policy, Part F, Penalties and interest relating to receivables activities, General interest charge,' paras 93.5.6- 93.5.24, viewed on 5 June 2007 at http://law.ato.gov.au/atolaw/view.htm?DocID=RMP%2FRP0093

49 Id, paras 93.6.2, 93.6.7.

50 Inspector-General of Taxation, *Review of the Remission of the General Interest Charge for Groups of Taxpayers in Dispute with the Tax Office* (2004) Commonwealth of Australia, pp 6-10.

51 Id, pp 68-69.

6.63 The Government addressed the issue of the rate at which interest accrues prior to an amended assessment by introducing the SIC.

6.64 The Ombudsman advised that the ATO responded constructively to the Inspector-General's report:

> It is also important to acknowledge the ATO's positive response to the [Inspector-General of Taxation's] review in relation to areas over which it had some responsibility and ability to provide remedies. For example, the ATO undertook a review of its remission guidelines and established a panel of senior tax officers to consider when widely-based settlement offers are appropriate. It invited participants in [employee benefit arrangements] to apply for remission of interest and penalties based on their individual circumstances, and prepared guidelines outlining the circumstances that would lead to a remission being granted. We regard this as a tailored and appropriate response.[52]

6.65 The Committee would prefer that situations such as the mass marketed schemes and employee benefit arrangements occur as rarely as possible. They threaten the integrity of the tax system. Further, the ATO's delayed response caused immense difficulty to the unsophisticated taxpayers involved. The consequences included suicide, broken marriages and acute personal distress.

6.66 The ICAA has also argued that settlement offers to participants in various schemes have not always been consistent.[53] As a solution, the Inspector-General of Taxation suggested to the Committee that the ATO should better explain how it constructs these offers:

> The challenge for the Tax Office is to provide the rationale(s) behind these apparently different treatments and to demonstrate that they are consistent, and have a sound basis in fairness and good public administration. It needs to do this, because the community has developed negative perceptions that the Tax Office is not fulfilling its role as fair administrator and worse, that it is biased in favour of certain kinds of taxpayers.
>
> Part of the Tax Office's explanation for these different compliance treatments may turn on its categorisation of the compliance behaviours involved.[54]

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52 Commonwealth Ombudsman, sub 38, p 14.

53 ICAA, sub 37, p 14.

54 Inspector-General of Taxation, sub 48, p 14.

6.67 In relation to mass marketed investment schemes, the ANAO noted that taxpayers were confused about some aspects of the settlement:

> Although the ATO has not set out its rationale for making such distinctions in specific detail, its basis for judgement in relation to participants is suggested in sufficiently clear terms in the press release announcing the settlement and the Commissioner's letter of 15 February 2002 to scheme investors. In respect of the types of schemes, the rationale for limiting the settlement offer to only [mass marketed investment schemes] … is not explicitly enunciated other than to allude to 'unique circumstances' in which the [schemes] were sold.
>
> We are aware, from discussions with stakeholders and representatives of some of the tax professional bodies, that some investors have questioned the exclusion from the settlement process of certain 'mass marketed schemes' in which they were involved.[55]

6.68 The Committee admits that the offers have logic in that they are graded in terms of taxpayer compliance. However, the community pays a great deal of attention to these offers and taxpayers have, in the past, been confused about some aspects of these settlements. It appears that further explanation from the ATO is necessary to provide additional assurance to taxpayers that ATO decisions for large scale disputes are consistent.

Recommendation 16

6.69 **The ATO explain the reasoning behind its settlement offers for large scale disputes in its public statements.**

Settlements

Introduction

6.70 Settlements occur where there is a dispute between the taxpayer and the ATO and the parties resolve the dispute through agreement rather than

55 ANAO, *The ATO's Management of Aggressive Tax Planning,* Audit Report No. 23 2003-04, 29 January 2004, p 102.

court action. In its annual report for 2006-07, the ATO outlines its philosophy behind settlements:

> A settlement involves an agreement or arrangement between parties to finalise their matters in dispute where it is in the best interests of the Commonwealth to do so. While the Commissioner's basic duty is to administer tax law through assessing and collecting taxes and determining entitlements, he also has an obligation to administer the tax system efficiently and effectively.[56] Settlements usually involve the need to balance competing considerations, and call for judgment and common sense.[57]

6.71 In 2006-07, the ATO settled 1,580 cases relating to schemes (including mass marketed investment schemes and employee benefit arrangements) and 225 non-scheme cases.[58] This report has already discussed these schemes and the settlement process. For example, the large number of affected taxpayers in those schemes meant that a settlement was administratively efficient. Significant ATO delay in responding to mass marketed schemes and the fact many (mostly unsophisticated) taxpayers were subject to heavy, inaccurate marketing was also relevant to the ATO making a settlement offer.

6.72 For non-scheme cases, the top three reasons for settlement were:

- the cost of litigating was out of proportion to the possible benefits, including the likelihood of success
- the cases were complex or the ATO faced evidence problems
- settlement was a cost effective way of securing taxpayer compliance in future.[59]

6.73 In *An Assessment of Tax* in 1993, the JCPA noted complaints that the ATO lodged ambit claims with taxpayers prior to negotiation. The JCPA reported evidence that sometimes taxpayers paid and settled, just to get the process completed.[60]

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56 Section 44 of the *Financial Management and Accountability Act 1997* requires chief executives to use agency resources in an efficient, effective and ethical manner.

57 ATO, *Annual Report 2006-07*, p 113.

58 Id, p 114.

59 Ibid.

60 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 280.

6.74 In that report, the JCPA observed that settlements were an efficient way of balancing the competing priorities of taxpayer obligations under legislation and the cost of litigation and difficulty sometimes in obtaining sufficient evidence. Where the law is unclear, the JCPA argued that the ATO should fund test cases. Where the law is clear, the ATO should conduct settlements supported by robust processes. In particular, the JCPA recommended that three ATO officers be present at settlement negotiations and that the ATO take audio recordings of them.[61] The ATO advised the Committee in 1998 that it had two or three officers attend settlement negotiations, depending on the complexity of each case. The ATO stated that it provided audio tapes of settlement negotiations to taxpayers on request.[62]

6.75 In 2000, the Senate Economics References Committee tabled its report, *Operation of the ATO*. That Committee noted that settlements can be a two-edged sword:

> The use of settlements is seen by the ATO as consistent with the 'good management rule', which has been upheld and encouraged by the courts.
>
> However, the secrecy surrounding settlements has laid them open to the perception, both in the community and within some quarters of the ATO itself, that they are a device that can be used to provide favourable or "soft" treatment to certain taxpayers, mainly big business or high wealth individuals…
>
> On the face of it, settlements make good sense, providing the ATO with the flexibility to enter arrangements that on balance are in the overall interest of the tax system. The onus is on the Commissioner, however, to ensure that settlements are resorted to only when prescribed. If not managed and controlled the potential for settlements to be misapplied or abused is significant.[63]

6.76 The Senate Committee made recommendations to make the process more robust and transparent. In particular, it suggested that the ATO have the legislative power to record settlement negotiations, rather than relying on a taxpayer's consent. Further, it argued that the ATO should publish the following performance information on settlements:

- numbers of cases settled per annum

61 Id, pp 281-82.

62 ATO, 'Final Report on the Implementation of the Recommendations of Report 326"An Assessment of Tax'", correspondence, 20 October 1998.

63 Senate Economics References Committee, *Operation of the ATO* (2000) p xiv.

- cases identified by business line
- the difference between tax assessed and paid (by business line)
- an explanation of why there are differences between the amounts assessed and paid.[64]

6.77 The Senate is yet to receive a response to the Senate Committee's recommendations. While the issue of government responses to Senate committee inquiries is a matter for the Senate, this Committee is concerned that significant committee work is not being acknowledged in a meaningful way by the Executive.

6.78 The ATO reported to the Senate its progress in implementing the report as follows:

> The Australian Taxation Office has carefully considered the recommendations that relate to it, but several of the recommendations were overtaken by legislative and other developments. A report showing the current status of the recommendations is currently being prepared.[65]

Code of settlement practice

6.79 The ATO's main policy in relation to settlements is the Code. The ATO first issued settlement guidelines in 1991. These guidelines were ineffective, due to control weaknesses and low levels of compliance within the ATO.[66] The ATO then revised the guidelines and retitled the document as the Code in 1999, with a further revision in 2001. The ATO released the current Code in February 2007.[67]

6.80 The Code lists a number of reasons where it may be appropriate to settle a matter. They include the factors that the ATO's annual report lists, namely problems with evidence, complexity, securing taxpayer compliance in future, and costs of litigation outweighing the likely benefits. There are two other main reasons. The first is where the matter involves unique and special features making it unsuitable for litigation, such as a dispute over the valuation of an asset. The second is where taxpayers engaged in

64 Id, p 75.

65 'Government Responses to Committee Reports,' tabled by the Hon Senator Vanstone, *Senate Hansard*, 7 December 2006, p 113.

66 Senate Economics References Committee, *Operation of the ATO* (2000) p 71.

67 ATO, 'Code of Settlement Practice,' Background, viewed on 26 February 2007 at http://www.ato.gov.au/print.asp?doc=/content/8249.htm.

avoidance accept the ATO's view and settlement helps them unwind existing arrangements.[68]

6.81 The document also gives a number of reasons for which it would not be appropriate to settle. They generally focus on implications of settlement for the tax system overall and the strength of the ATO's case. The reasons include:

- settlement would be contrary to policy reflected in the law
- the ATO wishes to internally escalate the matter to settle its view
- the matter is clear cut and none of the reasons to settle exist
- settlement would treat taxpayers inconsistently
- litigation could have a significant compliance effect for other taxpayers.[69]

6.82 The Code sets out a number of processes to ensure internal accountability within the ATO for settlements:

- only certain senior officers with the appropriate delegations can authorise settlements
- the settlement process must be fully documented
- the ATO maintains a corporate register of settlements
- the ATO reviews a sample of settlements under its technical quality reviews.[70]

6.83 Widely based disputes comprise a special category of settlements. The Code requires ATO officers to follow the principles and procedures described in Law Administration Practice Statement 2007/6 for the settlement of widely based tax disputes.[71] A dispute must involve at least 20 taxpayers for the ATO to regard it as widely based.[72]

6.84 The main additional procedural requirements for ATO officers involved in widely based disputes is that they must:

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68 Id, para 26.

69 Id, para 25.

70 Id, para 6.

71 Id, Background.

72 ATO, 'Guidelines for settlement of widely-based tax disputes,' PS LA 2007/6, para 3, viewed on 26 February 2007 at http://law.ato.gov.au/atolaw/view.htm?DocID=PSR/PS20076/NAT/ATO/00001&PiT=99991231235958.

- obtain advice from the ATO's Tax Counsel Network
- seek advice from the widely based settlement panel
- discuss the advice with the Chair of the panel if they do not accept it.[73]

6.85 The guidelines state that ATO officers are to divide a widely based settlement proposal into three parts. The first is the base settlement proposal. The other stages are to identify different grades of offer for groups of taxpayers and to establish procedures for the ATO to take into account individual taxpayers' circumstances.[74]

6.86 In developing the proposal, ATO officers need to take into account the following factors:

- the cost to revenue
- the impact of settlement on compliance, both with the taxpayers involved and the wider community
- justifiability of the settlement to the wider community, including comparisons with previous settlements
- the taxpayers' circumstances, including the nature of the advice they received
- whether the legal status of the tax arrangement is clear or not
- whether either party has rejected previous proposals to settle.[75]

6.87 These guidelines reflect the ATO's experience with employee benefit arrangements. Then, the Inspector-General of Taxation criticised the ATO for not sufficiently differentiating between taxpayers. The Code and other guidance mean that, if another widely based dispute arises, taxpayers are more likely to receive a settlement offer commensurate with their circumstances.

Discussion

6.88 The Committee agrees that the ATO will need to settle disputes with taxpayers on a regular basis. Given the costs and uncertainty of litigation and the value of maintaining taxpayer compliance, settlements have a role in effectively and efficiently managing the tax system. The Full Federal

73 Id, paras 6, 8, 28, 32.

74 Id, paras 23-26.

75 Id, para 40.

Court has stated that settlements are consistent with the Commissioner's role:

> Perhaps further discussions between the parties and their legal advisers will result in a sensible adjustment of the matters … The alternative is probably further protracted litigation with its consequent delay and expense. We realise that the Commissioner is mindful of the important public duty which he has in administering the Act. Nevertheless, if this were a commercial dispute, there would be much to be said for the view that a further attempt at settlement should be made, perhaps with the aid of an appropriate mediator. We see no reason associated with the Commissioner's powers and duties which should dissuade him from that course if he thought it otherwise an appropriate one for him to follow.[76]

6.89 The Taxation Ombudsman made a similar comment:

> My office has taken a restrained approach in this area. We accept that while settlement proposals and processes fall within our broad jurisdiction, provided the settlement process is reasonably fair, open and equitable, settlement matters involving negotiation are often best left to the parties in dispute.[77]

6.90 The Committee agrees. As long as the appropriate processes are in place, then settlements can be an effective, efficient and fair method of resolving uncertain and complex disputes, delivering a fair outcome to taxpayers entering into schemes marketed by others that are found to be non-compliant, or managing widely based disputes.

6.91 Therefore, the Committee considered whether current processes are sufficiently robust. Despite updates to the Code of Settlement, submissions raised the traditional concerns in relation to settlements. These were that the ATO makes ambit claims to encourage taxpayers to settle,[78] and that the ATO is inconsistent, including giving wealthy taxpayers preferential treatment.[79] The ambit claim allegation is

76 Sheppard, Foster and Whitlam JJ, *Grofam Pty Ltd v FCT* [1997] 660 FCA (26 March 1997) viewed at http://www.austlii.edu.au/au/cases/cth/federal_ct/1997/660.html on 15 June 2007.

77 Commonwealth Ombudsman, sub 38, p 12.

78 National Institute of Accountants, sub 31, p 7, name suppressed, sub 32, p 1, ICAA, sub 37, p 14, Resolution Group, sub 42, p 16. In 2007, the ATO settled a $515 million case with Rio Tinto for one third of the ATO's initial claim: Kazi E, 'ATO repays $42 million in tax to Rio Tinto,' *Australian Financial Review*, 15 June 2007, p 33.

79 Seage C, sub 23, pp 2-6, ICAA, sub 37, p 14, Resolution Group, sub 42, p 16, Robinson D, sub 45, p 2, Fitton R, sub 53, pp 1-2.

concerning, given that previous versions of the Code have stated that penalties and interest are not to be used as a lever to settle cases.[80]

6.92 On the other hand, the Taxation Ombudsman noted the concern over consistency but was positive about how the ATO manages the process overall:

> Inconsistency in ATO practices is often alleged in complaints about the ATO's handling of settlements, particularly in cases involving tax avoidance. In our experience, there have been some deficiencies and inconsistencies in the ATO's approach, particularly at the time this office prepared reports into the ATO's administration of the Budplan and Main Camp schemes. My office has since observed improvements in ATO practice that have resulted in a more coordinated, consistent and comprehensive approach. Now, the prevailing issue for my office mostly relates to delays in process rather than more 'substantive' concerns such as inequity or arbitrariness in decision-making.[81]

6.93 Despite the Ombudsman's positive overall assessment, the Committee is concerned at the negative perceptions about settlements. The Committee is of the view that the ATO's processes need further improvement, particularly with a view to showing taxpayers and the general community that it conducts its settlements fairly and consistently.

6.94 One way of addressing perceptions is to increase transparency. Currently, the ATO reports on the number of cases settled and divides them according to whether they are scheme or non-scheme matters.[82] However, this information does not meet the concerns that wealthy taxpayers get treated more leniently or that the ATO uses penalties and interest as a lever to settle.

6.95 In 2000, the Senate Economics References Committee recommended that the ATO should publish more data on settlements, including the difference between the tax assessed and what was paid and differentiating the results between business lines.[83]

6.96 Such data would help meet negative perceptions about settlements. The differences between business lines would show whether wealthy taxpayers receive preferential treatment. The difference between the tax assessed and what is paid would show whether the ATO uses penalties

80 ICAA, sub 37, p 14.

81 Commonwealth Ombudsman, sub 38, p 12.

82 ATO, *Annual Report 2006-07*, p 114.

83 Senate Economics References Committee, *Operation of the ATO* (2000) pp xiv-xv.

and interest as a negotiating tool. If particular patterns show up in the data, then the ATO has the opportunity to explain them in its annual report. It can also be held accountable for the information at the biannual meetings with this Committee or at Senate Estimates.

6.97 Currently, the Code of Settlement Practice lists a number of processes as promoting accountability and transparency. These include a register of settlements and fully documenting each settlement.[84] The Committee agrees that these make settlements more robust, but they focus on internal accountability, rather than making the ATO more accountable externally. Therefore, the Committee reiterates the recommendation of the Senate Economics References Committee in 2000.

Recommendation 17

6.98 **The ATO publish in its annual report additional statistics in relation to settlements, such as the revenue collected through settlements and the proportion of amended assessments that taxpayers agree to pay. The ATO should also comment on significant variations across business lines.**

Transparency

6.99 In discussing this chapter, the Committee considered it would be helpful to establish how much revenue was involved in relation to penalties, interest and remissions. In its 2000 performance audit on penalties, the ANAO reported that the ATO imposed approximately $1 billion annually in penalties from 1995-96 to 1998-99. It generally remitted $200 million of this amount each year.[85]

6.100 The Committee saw value in reproducing recent data on penalties, interest and remissions but it appears little information is publicly available. The ATO does not publish this data in its annual report, apart from its financial statements. There, the ATO has a line for 'penalty remission expense', which was approximately $1 billion in 2005-06 and $1.6 billion in 2006-07.[86]

84 ATO, 'Code of Settlement Practice,' para 6, viewed on 26 February 2007 at http://www.ato.gov.au/print.asp?doc=/content/8249.htm.

85 ANAO, *Administration of Tax Penalties*, Audit Report No. 31 1999-2000, 16 February 2000, p 21.

86 ATO, *Annual Report 2006-07*, p 332.

6.101 The management of penalties, interest and remissions is a major aspect of the ATO's interactions with taxpayers. It plays a key role in the ATO's compliance model. In the view of the Committee, the ATO should be producing regular public information on this activity as a matter of course.

Recommendation 18

6.102 **The ATO include in its annual report performance information about the amount of revenue collected through penalties and interest and the amount of revenue (divided between penalties and interest) remitted back to taxpayers. Where appropriate, this should be accompanied by discussion.**

Conclusion

6.103 In this chapter, the Committee has concluded that many of the policy settings for tax debt are appropriate. Further, the ATO's practices are generally adequate; the ATO has largely satisfied its external scrutineers. However, concerns about perceptions remain. For example the Committee received statements that the ATO makes ambit claims in settlement negotiations and gives wealthy taxpayers preferential treatment.

6.104 Therefore, the Committee has chosen to concentrate on transparency in its recommendations in this chapter. Decisions about penalties and, in particular, remissions and settlements involve the ATO applying its discretion in its decisions. If the ATO's practices are appropriate, it is now up to the ATO to demonstrate this to its stakeholders. Better reporting of its activities and raising its technical quality benchmarks for penalty and debt decisions so that they are the same as for the rest of the ATO's operations are important first steps in addressing these perceptions.

7

Pay as you go and common standards of practice

Pay as you go – introduction

7.1 The previous Government introduced the pay as you go system (PAYG) in 2000 as part of the 'A New Tax System' reforms. It introduced two main approaches to tax payments, PAYG withholding (generally employees) and PAYG instalments (generally recipients of business and investment income). PAYG replaced nine other payment systems. Treasury explained the benefits of PAYG over previous arrangements:

> These former collection systems duplicated obligations or were inefficient and outdated in their own right. In particular, the former PAYE [pay as you earn] system relied on outmoded ideas to define obligations and had not kept pace with labour market trends. Instead, the PAYG withholding system specifies the types of payments from which amounts are required to be withheld. It also caters more effectively for new work practices through the introduction of new rules to cover payments under labour hire arrangements (which can be extended to new work arrangements as they emerge)…[1]

7.2 PAYE was introduced for the 1944-45 income year.[2] By requiring taxpayers to contribute to their tax obligations as they earn the relevant income, both PAYG and PAYE decreased the risk of taxpayers defaulting

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1 Treasury, sub 51, p 12.

2 Joint Committee of Public Accounts, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 206.

on these debts. In its submission, Treasury gave an overview of the advantages of PAYG:

> The PAYG system ensures that most taxpayers pay income tax … 'as they go' during the income year. Although the amounts are paid before an annual assessment is made, they are paid after the related income has been derived. The PAYG system provides a more even stream of revenue to the Government to fund services throughout the year, as well as smoothing business cash flow. It also avoids taxpayers accruing large tax liabilities on assessment which they may have difficulty paying as a lump sum.[3]

7.3 PAYG and its predecessors have had other benefits. For example, requiring employers to pay tax on behalf of their employees is more efficient than requiring each employee to do this themselves.[4]

7.4 Submissions that discussed the PAYG system generally focussed on the over collection of tax. This is the amount of tax collected under PAYG but returned to taxpayers after the reconciliation process that occurs when taxpayers lodge their returns. Although fundamental reform is possible in the long term, this chapter concludes that over collection is a necessary aspect of the tax system as it currently stands.

Legal framework

Pay as you go withholding

7.5 The *Taxation Administration Act 1953* gives the legal framework for PAYG. Section 12-35 requires an entity (employer) to withhold an amount from salaries, wages and similar payments paid to an employee. Sections 12-80 to 12-90 make the same requirement in relation to superannuation and unused leave paid to an individual.[5]

7.6 There are three main legal questions in this requirement. The first is the definition of an 'employee.' The Australian Taxation Office (ATO) has addressed this in Taxation Ruling TR 2005/16. The Ruling discusses the difference between an employee and a contractor. Relevant factors include:

3 Id, p 12.

4 Id, p 13.

5 Discussion on PAYG withholding and instalments derived from Cooper G et al, *Cooper, Krever & Vann's Income Taxation, Commentary and Materials* (2005) Thomson, pp 867-75.

- the way in which the entity exercises control over the individual's work
- the extent to which payment depends on results
- the extent of the individual's power to delegate
- the amount of risk borne by the individual
- to what extent the individual provides their own tools and equipment and pays business expenses.[6]

7.7 The second issue is the type of payments from which an employer must withhold tax. The Act has a number of exemptions. These include exempt income and both cash and non-cash fringe benefits.

7.8 The third question is how much tax employers should withhold. Sections 15-10 and 15-25 in Schedule 1 to the *Taxation Administration Act 1953* give the Commissioner the power to draw up withholding schedules. Section 15-30 requires the Commissioner to have regard to the legislated tax rates and family tax benefit in drafting the schedules. In practice, the ATO sends the schedules to employers, who apply them. The ATO builds a 'very small' amount of over withholding into the schedules.[7]

7.9 Section 16-25 states that if an employer does not withhold an amount as the Act requires, or does not pass on this amount to the ATO, they are liable to a penalty of 10 penalty units ($1,100).[8] Large employers must pay withholding amounts on Mondays and Thursdays, generally within a week and a half of the payment to the employee. Small employers pay the least often. They are liable for a single amount quarterly.[9]

7.10 Employees can vary the rate at which their employer withholds tax. Section 15-15 allows the Commissioner to vary the withholding rate for an employee or class of employees. The ATO has created an application form for this process. Employees can vary their withholding rates upwards or downwards. The ATO reported that common reasons for variation are:

- high levels of deductible expenditure to be claimed against an allowance which would normally be taxed
- losses from rental properties or other ventures…

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6 ATO, 'Income tax: Pay As You Go - withholding from payments to employees,' TR 2005/15, viewed on 18 June 2007 at http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR200516/NAT/ATO/00001.

7 ATO, sub 50.3, p 18.

8 Section 4AA of the *Crimes Act 1914* sets the amount of a penalty unit at $110.

9 Section 16-75 in Schedule 1 to the *Taxation Administration Act 1953*. Although the legislation refers to the size of the withholding amounts, rather than the number of employees, the two will usually be closely correlated.

- preference for [an] end of year refund.[10]

7.11 The ATO has systems to manage the risk that taxpayers may set low withholding levels as a means of avoiding or postponing tax. It does so by placing a number of requirements where applicants request a downward variation. In addition to providing all necessary information, applicants must:

- not have any outstanding tax returns
- not have had a debit assessment on their last tax return, if that return involved a PAYG withholding variation
- not have any outstanding tax debts to the Government or any other debt under an Act administered by the Commissioner.[11]

7.12 Where taxpayers' circumstances change following a variation, the ATO requires them to make a new application where they are likely to have a debit assessment of more than $500.[12]

Pay as you go instalments

7.13 Section 45-15 in Schedule 1 to the *Taxation Administration Act 1953* states that taxpayers are liable to pay an instalment amount once they have received an instalment rate from the Commissioner. Further, once they receive this rate, section 45-20 requires them to report their income to the Commissioner. If taxpayers do not report their income, or under report their income, they are liable for a failure to lodge penalty (see chapter five).[13]

7.14 There are two key issues with PAYG instalments. The first is how many instalments the taxpayer is liable for. Section 45-50 implies that instalment taxpayers pay quarterly. This is the base position.

7.15 There are two variations to this base position. Section 45-140 allows taxpayers to instead pay annually if they meet a number of conditions. The main ones are that the taxpayer must not be registered for GST or need to register for GST, and must have a notional tax (tax on instalment income) of more than $8,000. Section 45-134 gives the second variation.

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10 ATO, sub 50, p 57.

11 ATO, 'PAYG withholding – varying your PAYG withholding, Downwards variations,' viewed on 27 June 2007 at http://www.ato.gov.au/businesses/content.asp?doc=/content/00096541.htm&page=3&H3=&pc=001/003/024/002/010&mnu=9898&mfp=001&st=&cy=1.

12 Ibid.

13 Section 45-25 in Schedule 1 to the *Taxation Administration Act 1953*.

Quarterly payers are allowed to pay twice a year if they are either farmers or 'special professionals,' namely sportspersons, authors, entertainers and inventors.

7.16 Section 45-80 states that late payments are subject to the general interest charge (GIC). Failure to lodge penalties also apply.

7.17 In 2006-07, there were 2.3 million PAYG instalment payers, of which 86% paid quarterly. The ATO issued 71,963 failure to lodge penalties to 48,803 taxpayers with a PAYG instalment obligation. Therefore, 2% of PAYG instalment payers incurred a failure to lodge penalty. The ATO applies a seven day period of grace to taxpayers so they do not incur the penalty if they are a few days late in lodging.[14]

7.18 The second main issue with PAYG instalments is the amount taxpayers pay at each instalment. The Act has several options. The first is to pay an amount based on last year's tax, adjusted for changes in GDP. This is the base position for the following quarterly payers:

- individuals
- companies and superannuation funds with less than $2 million income in the previous year
- entities that meet the criteria to be annual payers but have chosen not to do so.[15]

7.19 The legislation requires all other quarterly payers to calculate their payment on their income for the current period multiplied by an instalment rate that the Commissioner determines (the instalment income method). The instalment rate is an approximation of the taxpayer's income tax rate. Quarterly payers who meet the criteria to pay on the basis of a GDP adjusted amount can also request to use the instalment income method.[16]

7.20 Annual payers have two initial choices in determining their payment amounts. They may use the instalment income method or they may elect to base the amount on last year's tax, without adjusting for GDP.[17]

7.21 Similar to PAYG withholding, instalment taxpayers may vary their instalment amounts as long as they notify the Commissioner of this variation. However, taxpayers must exercise care in this because they are

14 ATO, sub 50.4, pp 4-5.

15 Deutsch R et al, *Australian Tax Handbook 2007* (2007) Thomson, pp 1753-54.

16 Id, p 1,747.

17 Id, p 1,759.

subject to GIC for any understatement of income each quarter greater than 85% of their actual income. Broadly, the GIC applies to the difference between the tax calculated on the 85% figure and the tax calculated on their predicted income. There is a 'fair and reasonable' test for remitting this GIC.[18]

7.22 By way of observation, the Committee received evidence from the Institute of Chartered Accountants in Australia that the PAYG legislation was substantially amended shortly after it came into effect. The Institute stated this made it 'extraordinarily complex legislation to read.'[19] The Committee concurs with this assessment. This piece of legislation lacks clarity and is difficult to read.

Over collection of revenue

The amounts involved

7.23 The Inspector-General of Taxation and CPA Australia expressed concern to the Committee about the level of tax that the ATO collects through PAYG but then later refunds to taxpayers.[20] For example, in 2006-07, the ATO collected $133.6 billion from all individuals and repaid $19.3 billion in refunds. The refund rate, as a percentage of tax initially paid, is 14.5%. The refund rate over the past few years has increased slightly. In 1995-96 it was 12.4%. In 2000-01 it was 12.5%.[21]

7.24 During the inquiry, the ATO provided a breakdown of these refunds for the Committee. It analysed individuals' tax returns lodged in 2004-05 for the 2003-04 tax year. This comprised 8.4 million tax returns. Refunds totalled $13.7 billion. In order, the main causes of refunds were:

- deductions and prior year losses of $5.2 billion
- withholding mismatches of $3.8 billion
- refundable tax offsets and credits of $2.7 billion (for example, the dividend imputation credit)

18 Sections 45-115, 45-205, 45-210, Subdivision 45G in Schedule 1 to the *Taxation Administration Act 1953.* Arguably, varying the payment amounts constitutes a third method of calculating PAYG instalments.

19 Cantamessa S, transcript, 28 July 2006, p 68.

20 Inspector-General of Taxation, sub 48, p 15, CPA Australia, sub 36, p 16.

21 ATO, *Annual Report 2006-07*, p 21, ATO, *Annual Report 2004-05*, p 39.

- Family Tax Benefit of $1.1 billion
- tax offsets of $0.8 billion (for example, the termination payment rebate).[22]

7.25 The ATO made a distinction between two types of refunds. The first, or 'true' refunds, involved returning an amount that a taxpayer has already paid. The main types under this category included PAYG withholding and PAYG instalments. It totalled $9.9 billion for the period in the ATO's analysis.[23]

7.26 The remainder, or $3.8 billion, comprise Family Tax Benefit and tax offsets and credits. Taxpayers do not pay an initial amount to qualify for these, so they are not strictly refunds, although they are included in the definition.[24]

7.27 The ATO broke down these tax returns into three groups, according to taxpayers' level of withholding and instalments, calculated on gross income, and how this compared with their tax liability. The Committee has summarised the results of this research in table 7.1.

Table 7.1 Characteristics of tax refunds by level of withholding and instalments, 2003-04

PAYG against actual gross income	Average gross and taxable incomes	Higher proportion of taxpayers	Main cause of refunds	Total refunds	Total tax-payers	Per capita refund
No PAYG	$14,398 $6,949	Seniors and investors	Refundable tax offsets	$0.747 b	0.77 m	$970
Under paid	$56,034 $42,637	Business and investors	Deductions and losses	$5.593 b	3.02 m	$1,850
Over paid	$31,533 $30,138	Employees and youth	Withholding mismatches	$7.332 b	4.56 m	$1,610

Source ATO, sub 50.3, pp 19, 106-07.

7.28 The group that does not withhold at all tends to have a higher representation of seniors and investors. In per capita terms, they have the lowest refunds. On average, they have the lowest income of the three groups. Even though they did not put any funds into PAYG, they received enough through refundable tax offsets and Family Tax Benefit to receive a tax refund.

7.29 The second group is those individual taxpayers whose level of withholding and instalments was less than that suggested by their gross income. They tended to be higher income earners and have a higher

22 ATO, sub 50.3, pp 18-19.

23 ATO, sub 50.3, p 18.

24 Ibid.

representation of business people. They mainly used deductions and prior year losses to reduce their taxable income so that, at the end of the financial year, they received a refund. Even though they under paid under the PAYG system, their significant levels of deductions meant that this group received the highest per capita refund of the three categories.

7.30 The final group is individual taxpayers whose level of withholding and instalments was higher than that indicated by their gross income. They tended to be middle income earners and had a higher representation of employees and young people. The ATO has advised the Committee that the PAYG withholding schedules have a small amount of over-withholding built into them, which would appear to explain why this group is mainly made up of employees. The main cause of refunds for this group is withholding mismatches that the withholding schedules do not cater for. For example, employees may only work for part of the year, they may have a second job taxed at the highest marginal rate, and some people receive promotions part of the way through the year.[25]

Is over collection appropriate?

7.31 The Committee believes that, for the foreseeable future, a 'squaring up' tax process at the end of each financial year will be necessary to manage deductions and withholding mismatches.

7.32 In determining whether some over collection is appropriate, the Committee considered the example of Family Tax Benefits (FTB). The previous Government introduced the benefits on 1 July 2000 and the payment amount depends on the recipient's estimated income. As with all estimates, recipients occasionally make errors, which has led to a squaring up process (or reconciliation) at the end of the financial year for recipients who choose to receive it fortnightly. The Government obtains final income figures for these recipients through tax returns, which leads to a debt or credit. The ATO factors this debit or credit into taxpayers' final tax position.

7.33 This squaring up process had significant financial implications for the previous Government. For 2000-01, the Australian National Audit Office (ANAO) reported that 34% of recipients who received FTB fortnightly incurred a reconciliation debt. Out of total fortnightly FTB payments of $10.1 billion, the value of these debts was $584 million (5.8%). In July 2001,

25 ATO, sub 50.3, p 20.

the then Government announced a one-off waiver of all debts less than $1,000 per recipient. This reduced the reconciliation debt to $225 million.[26]

7.34 The squaring up process also had significant implications for families. Those that underestimated their income had significant debts that they found difficult to repay.[27]

7.35 The previous Government responded by introducing supplements for the FTB. In 2003-04, it introduced the FTB Part A supplement of $600 per child. In 2004-05, it introduced the FTB Part B supplement of $300 per family. The ANAO found that reconciliation debt for FTB became considerably less, largely due to the supplements:

> The ANAO found that the incidence of reconciliation debt had reduced from approximately 33%of the FTB population during the first two years of the program to under 10% of the FTB population in the most recent two years. The ANAO also found that the introduction of the FTB part A supplement in 2003-04 and the FTB Part B supplement in 2004-05 significantly reduced the number of FTB customers who incurred a reconciliation debt. Without the Part A supplement, 27% of customers would have incurred a reconciliation debt in 2003-04. However, with the supplement only 10% actually incurred a reconciliation debt for that FTB year. In 2004-05, 15% would have incurred a reconciliation debt but for the Part A and B supplements – only 5% actually incurred a reconciliation debt for that year.[28]

7.36 This example bears many similarities to PAYG. Taxpayers have an income estimate that the Government uses to determine their eligibility for a credit or debit. The Government uses the tax refund as a form of insurance for taxpayers. If their circumstances change and their tax liability increases, then the refund is some extra money that the taxpayer can draw on to either meet the liability of decrease the debt.

7.37 If the Government eliminates over collection in aggregate, there will be less taxpayers in credit and more taxpayers with a tax debt. The Committee's concern is that they will have similar difficulties in paying this debt as the recipients of FTB did in paying their reconciliation debt. To

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26 ANAO, *Management of Family Tax Benefit Overpayments*, Audit Report No. 12 2006-07, 28 November 2006, pp 13-16, 39, Department of Family and Community Services, 'Annual Report 2000-01, Output Group 1.1: Family Assistance,' viewed on 26 June 2007 at http://www.facsia.gov.au/annualreport/2001/2/1/1.1.html.

27 Dunlevy S, 'Catch 22 debt trap snaps shut,' *Daily Telegraph*, 19 February 2003, p 21.

28 ANAO, *Management of Family Tax Benefit Overpayments*, Audit Report No. 12 2006-07, 28 November 2006, p 21.

expect taxpayers to focus on their tax position throughout the year and adjust their spending in response is not realistic.

7.38 Rather, people tend to make decisions intuitively and, recognising this, then make other arrangements to compensate. As one commentator has stated:

> …people tend to favour immediate benefits over more distant, less certain costs.
>
> This means humans often make choices they come to regret. They have a problem with self-control, which ranges from spoiling your appetite by eating too many nuts before dinner to …being unable to save…
>
> Because they recognise their self control problem, people commonly resort to what behavioural economists call 'commitment devices' intended to constrain their future behaviour in desirable ways.
>
> Conventional economists would regard most of these devices as irrational – for instance, failing to claim certain tax concessions through the year so they are returned as a higher annual tax refund, which is more likely to be saved.
>
> Given people's desire to overcome their own frailties, however, to label these efforts irrational merely demonstrates the labeller's incomprehension.[29]

7.39 In hearings, the Committee received evidence consistent with this. The ATO stated that taxpayers enjoy receiving a refund at the end of the financial year:

> The other thing that may be of interest to you there is those comments in relation to preference for a refund, because …you can adjust and finetune what is being withheld from your pay. But we did some research a few years ago—and it did surprise us—around whether, if it was very small amounts, people would prefer not to be lodging tax returns. The answer came back that, even if it was only a $10 refund, they would prefer to have a refund, in general, but if it was a $10 debt it would be okay not to lodge a tax return…[30]

29 Gittins R, 'Our nanny state's bright idea: ban the light bulb' *Sydney Morning Herald*, 26 February 2007, p 21.

30 Granger J, transcript, 22 June 2006, p 12.

7.40 The ATO's research showed that taxpayers believed that the refund was 'their one chance to recoup "their" money from the system.'[31]

7.41 Academic research confirms taxpayers' preference for lodging a return and receiving a refund. Atax at the University of New South Wales conducted a survey of people under the age of 24. They concluded:

> Although the participants were superficially attracted to the concept of not needing to lodge a return, virtually everyone decided that they would prefer to stay with the current system after thinking about the concept further. Many participants independently used the word 'control' in relation to that decision…[32]

7.42 This evidence and the example of FTB suggests to the Committee that not only is a measure of over collection in PAYG prudent for both the Government and taxpayers, but that taxpayers prefer it as well. Therefore, the Committee believes that the ATO should maintain a modest level of over collection in PAYG.

Interest on over collections

7.43 Generally, the ATO pays interest on tax related amounts where the taxpayer has lodged a document and crystallised a tax amount. Interest is not paid under PAYG or where a taxpayer receives a tax credit. The interest rate is the base rate discussed in chapter six, namely the Reserve Bank's monthly average yield of 90-day Bank Accepted Bills. During 2006, the base rate was approximately 5.5% and it is now approximately 7.7%.[33]

7.44 The ATO is required to pay overpayment interest in the following circumstances:

- a taxpayer pays the tax required in their assessment, and the ATO then amends the assessment, reducing the tax liability
- the ATO takes more than 30 days to pay an income tax refund after a taxpayer lodges their return

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31 Coleman C, 'Tax refund versus tax return?' Atax UNSW, Personal Income Tax Reform Symposium, April 2007, p 10, viewed on 8 May 2007 at http://www.atax.unsw.edu.au/research/pitr-symposium-07/papers/Paper_13-Coleman.pdf.

32 Id, p 11.

33 Treasury, sub 51, p 15, Reserve Bank of Australia, 'Interest Rates & Yields: Money Market & Commonwealth Government Securities,' viewed on 19 March 2007 at http://www.rba.gov.au/Statistics/HistoricalInterestRatesYields/2008.xls.

- the ATO takes more than 14 days to refund a running balance account following the lodgement of a correct business activity statement (BAS).[34]

7.45 Following an income tax assessment, taxpayers receive early payment interest where they pay the amount more than 14 days before the due date.[35] The Committee understands that the ATO usually gives taxpayers at least 21 days to pay an amount under an assessment.[36]

7.46 CPA Australia[37] and the Inspector-General of Taxation raised concerns that the ATO withholds large amounts of funds that are eventually repaid to taxpayers ($19.3 million in 2006-07[38]), which do not attract any interest. The Inspector-General argued this constituted an anomaly in relation to PAYG. If a taxpayer does not meet their PAYG obligations or make a sufficiently large error in calculating their PAYG amounts, they are subject to GIC. However, the Government does not pay interest on PAYG refunds and only pays interest in the circumstances listed above. The Inspector-General also noted that:

- Even if the end of year position shows that the taxpayer did not need to provide for a liability, the compounded GIC charged on unpaid instalments remains compounding on the taxpayers PAYG account. Effectively, this is interest on monies that were never needed to be paid. Taxpayers can apply for remission; even if they get it, this can involve cost and delay…
- Paying tax instalments by withdrawing investment capital results in loss of income for taxpayers. Accountants say that PAYG is fleecing small business of its capital.[39]

7.47 The Committee considered whether the ATO should pay interest on tax paid that is ultimately refunded to taxpayers. However, the Committee decided against this approach for a number of reasons. For example, the relationship between taxpayer and the ATO is not the same as that between a bank and a client. In the context of debt recovery, the ANAO summarised the taxpayer/ATO relationship as follows:

> Taxpayers' relationship to the ATO is different to the relationship between a private sector firm and those to whom that firm extends credit. Taxpayers' relationship to the ATO is not a market-based relationship. People are required by law to pay tax and the ATO is

34 Treasury, sub 51, p 15.
35 Treasury, sub 51, p 15.
36 Section 204 of the *Income Tax Assessment Act 1936*.
37 CPA Australia, sub 36, p16.
38 ATO, *Annual Report 2006-07*, p 39.
39 Inspector-General of Taxation, sub 48, p 15.

> in no position to withhold supply as a means of collecting debt, as are other creditors.[40]

7.48 Banks paying interest on deposits is based on the economic principles of trade and exchange. Banks lend on the basis of their deposits and earn revenues and profits on this lending. This dynamic does not apply to tax, where taxpayers have a legal obligation to pay.

7.49 Another reason why the Committee does not support the ATO paying interest on over collections of tax is that the Government will have to increase taxes to pay for it. For example, in 2006-07, the ATO refunded $19.3 billion to taxpayers. Using the ATO's 2004-05 data above, 61.3% of total refunds involve refunds on money paid by taxpayers. Applying this figure to $19.3 billion gives a total of $11.8 billion subject to interest. Assuming the ATO holds these funds for an average of 12 months[41] and pays 7.7% interest, the Government and Parliament will need to increase the ATO's budget by $909 million. The Committee is not convinced that it should impose an additional revenue burden on the community of almost a billion dollars so the ATO can pay interest on PAYG refunds.

7.50 Another reason why the Committee does not support the ATO paying interest on PAYG refunds is that many taxpayers enjoy receiving a refund in the first place. If taxpayers are happy to receive the refund as a form of enforced saving (see above), then the Committee does not see why the ATO needs to provide an additional benefit to taxpayers in the form of interest.

7.51 The final reason why the Committee does not support interest on refunds is that the system gives taxpayers a way of changing their PAYG amounts. As noted earlier in the chapter, this applies for both PAYG withholding and instalments.

7.52 The Committee notes that PAYG instalment taxpayers face significant risks in changing their PAYG amounts. If their instalment amounts are less than 85% of their final tax, they are subject to GIC. The National Institute of Accountants stated:

> The tax agents know that they could vary an instalment but often they do not because of the risk of penalties. If you vary the instalment and, for instance, the end result of the year is that your

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40 ANAO, *The Management of Tax Debt Collection*, Audit Report No. 23 1999-2000, 20 December 1999, p 41.

41 This equates to taxpayers lodging their returns six months after the end of the financial year. It is assumed that taxpayers overpay evenly throughout the financial year. In effect, this means that they make a single overpayment half way through the financial year in question.

> tax is not within 85 per cent of the varied amount you are going to pay then you are up for penalties. Members that I speak to do not recommend a variation instalment, unless it is to nil—where they know that someone has gone into a loss situation. The issue is around this 85 per cent threshold and the risks that threshold creates.[42]

7.53 The problem for many taxpayers appears to be planning and managing their cash flow and tax liabilities. For example, in both its debt collection report in 1999 and its micro-business debt report in 2007, the ANAO stated that cash flow was a major contributor to tax debt.[43]

7.54 In other words, it appears that many PAYG instalment taxpayers prefer not to reduce their overpayments due to the challenges in predicting and managing their cash flow. Businesses that are better at planning and monitoring their cash will enjoy a competitive advantage because less of their resources will be held by the ATO.

Common standards of practice

Compliance issues

7.55 Parties to the inquiry interpreted this term of reference in one of two ways. Some believed this topic referred to the ATO's compliance activities (such as audits and remitting penalties and interest). Others looked more widely at the ATO's operations overall, including its advice role.

7.56 Where submissions expressed concern about common standards of practice, they focussed on the consistency of the ATO's compliance activities.[44] This report examines compliance activities such as audits in chapter five. In chapter six, it examines the ATO's approach to remitting penalties and interest. The remainder of its operations appeared to be of less concern due to it rationalising its operations.[45]

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42 Ord G, transcript, 25 August 2006, p 8.

43 ANAO, *The Management of Tax Debt Collection*, Audit Report No. 23 1999-2000, 20 December 1999, p 42, ANAO, *The ATO's Administration of Debt Collection – Micro-business,* Audit Report No. 42 2006-07, 12 June 2007, p 41. The ATO defines a micro-business as having an annual turnover of less than $2 million (p 11 of the micro-business report).

44 Taxation Institute of Australia, sub 40, pp 7-8, Resolution Group, sub 42, pp 11-15, Inspector-General of Taxation, sub 48, pp 12-14.

45 CPA Australia, sub 36, p 14, Institute of Chartered Accountants in Australia, sub 37, p 3, National Institute of Accountants, sub 31, p 6.

Rationalisation of ATO operations

7.57 Over the last 10 years, the ATO has moved from a regional structure (duplicating the same expertise in each state) to a national structure where a certain expertise may only exist in one or a few states. In its submission, CPA Australia gave an overview of this process:

> [Consistency] may have been a problem to a greater extent in the past when the ATO operated via semi-autonomous state offices in which various ATO services (eg issue of rulings) were effectively duplicated in each office. One upshot of this administrative arrangement appeared to be a lack of co-ordination in the issue of rulings such that different rulings could be issued in some cases by different state offices on the same or similar topics.
>
> Problems of this kind in the private binding rulings area may have contributed to some of the problems with mass marketed schemes in the mid-1990s. However, as part of the clean up of those issues, the ATO moved to a new administrative framework whereby rulings and other ATO services are now provided on a single national basis notwithstanding that such services are still being provided on an operational basis via state offices.
>
> Insofar as we are currently aware, the ATO generally appears to adopt uniform administrative practices across the whole of Australia, although we note that individual cases are sometimes brought to our attention where matters may have 'slipped through the cracks.'[46]

7.58 This rationalisation and increased consistency has come at a cost. At the Launceston hearings, one accountant stated that reducing the breadth of ATO expertise in Tasmania made it more difficult to build links with it:

> In 1985, there was a fully functioning tax office in Hobart, and it had complex audit, high-level advice areas, individual advice areas and so forth. All tax agents in this state knew exactly who was in what area, and they could resolve their issues. Our firm even got the tax officers to come along to our training days to train us on things, to work out issues and so forth. Here we are 21 years later, with exceptionally complex tax legislation, and we do not know anybody in our tax office with whom we can speak to resolve an issue. That cannot be productive…[47]

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46 CPA Australia, sub 36, p 14.

47 Wright I, transcript, 24 August 2006, p 22.

7.59 At a Senate Estimates hearing in 2007, the ATO noted there are management efficiencies in moving away from a regional structure. The ATO discussed the example of closing down a four-person debt legal team in Hobart:

> … when you do not have a critical mass and you have people who go on leave and you have four covering a small group of people, it is hard to manage that effectively. There is an issue of having specialisations in areas where you can have more of a critical mass in Melbourne. On the other hand, we are trying to build Hobart as a centre for a lot of our superannuation work, and you will have to find people in Melbourne who will have to put up with people from Tasmania going there on some of their superannuation processes. When you run a large organisation across the country and you have a system that is nationally based and not regionally based, you have a whole range of those issues. What you have to do is try to make sure that you have a number of bases covered. One base is of course the level of service you can provide, and that has to be satisfactory. Secondly, you also have to make sure that you have a critical mass to go forward. You have to have some sort of succession planning and some level of specialisation. And the smaller the group the harder it is to provide that, even in terms of their own training and development.[48]

7.60 In summary, the shift away from a regional structure has had benefits in producing efficiencies for the ATO and ensuring that its advice and administrative practice are more consistent. However, it has made tax agents less efficient through reduced local links with the ATO. On balance, the Committee is of the view that the ATO has taken the right decision, mainly because greater consistency is fairer on taxpayers.

Conclusion

7.61 The ATO faces a particular challenge in collecting tax debt. It cannot withhold supply from taxpayers and so does not have many options apart from traditional debt collection activities. Therefore, the PAYG system has taken a preventive approach by encouraging overpayments that are returned to taxpayers after they lodge their return. The Committee notes that many individuals are comfortable with this sort of commitment

48 Senate Standing Committee on Economics, Budget Estimates, D'Ascenzo M, transcript, 29 May 2007, p 42.

device. Further, PAYG instalment taxpayers have the option of conducting their own 'squaring up' when they lodge their final BAS for each financial year. Therefore, the Committee believes that the current framework strikes a reasonable balance between the interests of taxpayers and government.

Sharon Grierson MP
Committee Chair

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Appendix A – Submissions

1	Name Withheld
1.1	Name Withheld
2	Mr Peter Schnall
2.1	Mr Peter Schnall (supplementary to Submission No. 2)
3	GW Roberts
4	Ms WD Domjan
4.1	Ms WD Domjan (supplementary to Submission No. 4)
4.2	Ms WD Domjan (supplementary to Submission No. 4)
4.3	Ms WD Domjan (supplementary to Submission No. 4)
4.4	Ms WD Domjan (supplementary to Submission No. 4)
4.5	Ms WD Domjan (supplementary to Submission No. 4)
5	Fehily Loaring Pty Ltd
6	Taxpayers Australia
7	Australians for Tax Justice Inc

7.1	Australians for Tax Justice Inc (supplementary to Submission No. 7)
7.2	Australians for Tax Justice Inc (supplementary to Submission No. 7)
7.3	Australians for Tax Justice Inc (supplementary to Submission No. 7)
7.4	Australians for Tax Justice Inc (supplementary to Submission No. 7)
8	Ms Julie Scarff
9	RENARD
10	Mr Brendan Torazzi
11	Ms Kimberli Ayers
12	Mr Kevin Cox
13	Mr Nick Gerrans
14	Mr Ian McKenzie
14.1	Mr Ian McKenzie (supplementary to Submission No. 14)
15	Ms Debra Jones
16	Dr Renata Maruszczyk
17	Mr Peter Panek
18	Mr Ken O'Brien
19	Mr Phillip O'Hara
20	Mr Leighton Jenkins
21	Mr Richard James
22	Mr Bjorn Jonshagen
23	Mr Christopher Seage
24	Mr Gavin Carpenter
25	Energy Supply Association of Australia
25.1	Energy Supply Association of Australia (supplementary to Submission No. 25)

25.2 Energy Supply Association of Australia
(supplementary to Submission No. 25)

26 Chamber of Commerce & Industry Western Australia

27 Mr Ronald & Mrs Valerie Stracey

28 Mr Richard Burnell

29 Mr Paul Burke

30 Mr Noel McCrorie

31 National Institute of Accountants

31.1 National Institute of Accountants
(supplementary to Submission No. 31)

31.2 National Institute of Accountants
(supplementary to Submission No. 31)

31.3 National Institute of Accountants
(supplementary to Submission No. 31)

32 Name Withheld

33 Restaurant & Catering Australia

34 Ms Kay Hewitt

35 Mr Ben Morris

36 CPA Australia

36-2 CPA Australia
(supplementary to Submission No. 36)

36.1 CPA Australia
(supplementary to Submission No. 36)

37 Institute of Chartered Accountants

38 Office of the Commonwealth Ombudsman

38.1 Office of the Commonwealth Ombudsman
(supplementary to Submission No. 38)

38.2 Office of the Commonwealth Ombudsman
(supplementary to Submission No. 38)

39 Australian National Audit Office

40 Taxation Institute of Australia

40.1	Taxation Institute of Australia (supplementary to Submission No. 40)
41	Name Withheld
42	Resolution Group Australia
43	Australian Chamber of Commerce and Industry
43.1	Australian Chamber of Commerce and Industry (supplementary to Submission No. 43)
44	Mr David Lethbridge
44.1	Mr David Lethbridge (supplementary to Submission No. 44)
45	Mr David Robinson
46	Australian Innovation Association
47	Department of Families Community Services and Indigenous Affairs
48	Inspector-General of Taxation
49	Mr F H Smith
50	Australian Taxation Office
50.1	Australian Taxation Office (supplementary to Submission No. 50)
50.2	Australian Taxation Office (supplementary to Submission No. 50)
50.3	Australian Taxation Office (supplementary to Submission No. 50)
50.4	Australian Taxation Office (supplementary to Submission No. 50)
51	The Treasury
51.1	The Treasury (supplementary Submission No. 51)
51.2	The Treasury (supplementary to Submission No. 51)
51.3	The Treasury (supplementary to Submission No. 51)

51.4	The Treasury (supplementary to Submission No. 51)
52	Mr Don Randall MP
53	Mr Bob Fitton
54	Wilson & Atkinson
55	Applied Executives Pty Ltd
56	Mr Kevin & Mrs Vicky Mackey
57	Mckays Chartered Accountants
58	Tony Ferguson Weightloss Centre

B

Appendix B – Exhibits

1 Australian National Audit Office
Audit Report No.7 2004-05
(Related to Submission No. 39)

2 Australian National Audit Office
Audit Report No.3 2001-02
(Related to Submission No. 39)

3 Australian National Audit Office
Audit Report No.19 2002-03
(Related to Submission No. 39)

4 Australian National Audit Office
Audit Report No. 19 2004-05
(Related to Submission No. 39)

5 Australian National Audit Office
Audit Report No. 31 1999-2000
(Related to Submission No. 39)

6 Australian National Audit Office
Audit Report No. 23 1999-2000
(Related to Submission No. 39)

7 Australian National Audit Office
Audit Report No.21 2005-06
(Related to Submission No. 39)

8 Australian National Audit Office
Audit Report No.21 2004-05
(Related to Submission No. 39)

9 Australian National Audit Office
Audit Report No. 33 2003-04
(Related to Submission No. 39)

10 Australian National Audit Office
Audit Report No. 34 1998-99
(Related to Submission No. 39)

11 Australian Taxation Office
The Commissioner of taxation annual report 2004-2005
(Related to Submission No. 50)

12 Australian Taxation Office
Strategic statement 2003-05
(Related to Submission No. 50)

13 Australian Taxation Office
Managing the revenue System (February 2006)
(Related to Submission No. 50)

14 Australian Taxation Office
Compliance program 2005-06
(Related to Submission No. 50)

15 Australian Taxation Office
Large business and tax compliance
(Related to Submission No. 50)

16 Australian Taxation Office
DIY Super - Its your money..but not yet!
(Related to Submission No. 50)

17 Australian Taxation Office
Making it easier to comply 2005-06
(Related to Submission No. 50)

18 Australian Taxation Office
Information technology program 2005-06
(Related to Submission No. 50)

19 Australian Taxation Office
Operations program 2005-06
(Related to Submission No. 50)

20 Australian Taxation Office
People and place programe 2005-06
(Related to Submission No. 50)

21 Australian Taxation Office
Law program 2005-06
(Related to Submission No. 50)

22 Australian Taxation Office
Tax Office integrity framework
(Related to Submission No. 50)

23 Australian Taxation Office
Taxpayers' charter-in detail
(Related to Submission No. 50)

24 Australian Taxation Office
Taxpayers' charter-what you need to know
(Related to Submission No. 50)

25 Australian Taxation Office
Taxation Statistics 2002-03 (CD-Rom)
(Related to Submission No. 50)

26 Australian Taxation Office
e-record CD-Rom
(Related to Submission No. 50)

27 Australian Taxation Office
Employee handbook
(Related to Submission No. 50)

28 Taxation Institute of Australia
Beyond 4100

29 Institute of Chartered Accountants
Fringe benefit tax design: decision time

30 Institute of Chartered Accountants
Research and recommendations on defition of small business

31 *Facsimile from Simon P Clark (Chartered Accountant to Senator Watson dated 25/8/06*

32 Mr Simon Hegarty
Client sample letter from ATO re reviews and audits

33 Australian Chamber of Commerce and Industry
ACCI Review June 2004 Number 112. "pre-election results: taxation issues dominate business concerns"

34 Australian Chamber of Commerce and Industry
Results from the ACCI Pre-Election Survey of 2004

35 Australian Chamber of Commerce and Industry
ACCI Review "Social Issues"

36 Inspector-General of Taxation
IGT'S Briefing notes on the "Moving On" document

37 Australian Taxation Office
Third meeting of the OECD forum on Tax Administration, 14-15 September 2006

38 Australian Taxation Office
Risk Management Approach

39 Australian Taxation Office
ATO 2006-07 Compliance Program

40 Institute of Chartered Accountants
Collection of documents relevant to Submission No. 37
(Related to Submission No. 37)

41 Office of the Commonwealth Ombudsman
Documents relating to Submission No. 38
(Related to Submission No. 38)

42 Taxation Institute of Australia
Attachment to Submission No. 40
(Related to Submission No. 40)

43 Office of the Commonwealth Ombudsman
Taxation Ombudsman Activities 2006
(Related to Submission No. 38)

C

Appendix C – List of public hearings

Thursday, 22 June 2006 – Canberra

Australian Taxation Office

Mr Michael D'Ascenzo, Commissioner of Taxation

Mr Kevin Fitzpatrick, Acting Second Commissioner

Ms Jennie Granger, Second Commissioner of Taxation

Mr Mark Konza, Deputy Commissioner, Small Business

Ms Stephanie Martin, First Assistant Commissioner, Aggressive Tax Planning

Ms Raelene Vivian, Deputy Commissioner of Taxation, Superannuation

The Treasury

Mr Ian Douglas, Senior Advisor, Tax System Review Division

Mr Paul McCullough, General Manager, Tax System Review Division

Friday, 28 July 2006 – Sydney

Individuals

Mr Ian McKenzie, Registered Tax Agent

CPA Australia

Mr Paul Drum FCPA, Senior Tax Counsel

Inspector-General of Taxation

Mr David Vos AM

Institute of Chartered Accountants

Ms Susan Cantamessa, Tax Consultant, Standards & Public Affairs

Mr Ali Noroozi, Tax Counsel

Office of the Commonwealth Ombudsman

Mr Damien Browne, Senior Assistant Ombudsman

Professor John McMillan, Commonwealth Ombudsman

Taxation Institute of Australia

Dr Michael Dirkis, Senior Tax Counsel

Mr Andrew Mills, President

Taxpayers Australia

Mr Tony Greco, Chief Executive Officer

Thursday, 24 August 2006 – Launceston

Individuals

Mr Kenneth Davey

Mrs Janine Healey

Mr Simon Hegarty

Mr Robert Watson

Mr Ian Wright, WHK Garrotts

Garrott's Chartered Accountants

Mr Robert Eastoe, Principal

Howell Accounting

Mr Hugh Howell

Ruddicks Chartered Accountants

Mr Craig Leighton, Partner

Mr Bob Ruddick

Taxpayers Association Inc

Mr Tony Culberg, President, Tasmanian Division

Mr Bruce James, Committee Member, Tasmanian Division

Mr John Taylor, Committee Member, Tasmanian Division

Monday, 25 September 2006 – Melbourne

CPA Australia

Mr Paul Drum FCPA, Senior Tax Counsel

Energy Supply Association of Australia

Mr Brad Page, Chief Executive Officer

KPMG

Mr Richard Turner, Director Tax

National Institute of Accountants

Mr Gavan Ord, General Manager, Technical Policy

Taxpayers Australia

Mr Tony Greco, Chief Executive Officer

Thursday, 9 November 2006 – Canberra

Australian Chamber of Commerce and Industry

Mr Michael Potter, Director, Economics and Taxation

Australian Taxation Office

Ms Margaret Crawford, Chief Operating Officer

Mr Michael D'Ascenzo, Commissioner of Taxation

Mr Kevin Fitzpatrick, Acting Second Commissioner

Ms Jennie Granger, Second Commissioner of Taxation

Mr Mark Konza, Deputy Commissioner, Small Business

Inspector-General of Taxation

Mr David Pengilley, Senior Adviser

Mr David Vos AM

The Treasury

Mr Ian Douglas, Senior Advisor, Tax System Review Division

Mr Martin Jacobs, Acting General Manager, Individuals

& Exempt tax Division

Mr Paul McCullough, General Manager, Tax System Review Division

D

Appendix D – Submissions for the biannual hearings

Friday, 20 April 2007 – Melbourne

1 Australian Taxation Office

2 Australian Taxation Office

3 Australian Taxation Office

Friday, 21 September 2007 – Canberra

1 Australian Taxation Office

Wednesday, 30 April 2007 – Sydney

1 Australian Taxation Office

2 Australian Taxation Office

3 Australian Taxation Office

4 Australian Taxation Office

E

Appendix E – Exhibits for the biannual hearings

Friday, 20 April 2007 – Melbourne

1 Australian Taxation Office

Opening Statement by Commissioner of Taxation

(Related to Submission No. 1)

2 Australian Taxation Office

Tax Office Service Standards (as at February 2007)

(Related to Submission No. 1)

3 Australian Taxation Office

Corporate Plan (Australian Taxation Office)

(Related to Submission No. 1)

4 Australian Taxation Office

Strategic Statement 2006-10

(Related to Submission No. 1)

5 Australian Taxation Office

The Outcome Outputs and Enabling Outputs Frameworks 2006-7

(Related to Submission No. 1)

6 Australian Taxation Office

2006-07 Making it Easier to Comply

(Related to Submission No. 1)

7 Australian Taxation Office

2006 Large Business and Tax Compliance

(Related to Submission No. 1)

8 Australian Taxation Office

2006 Large business and tax compliance (booklet)

(Related to Submission No. 1)

9 Australian Taxation Office

Corporate management practice statement - Fraud control and the prosecution process

(Related to Submission No. 1)

10 Australian Taxation Office

Application of Precedent to Tax Cases

(Related to Submission No. 1)

11 Australian Taxation Office

Draft Taxation Ruling

(Related to Submission No. 1)

12 Australian Taxation Office

Correspondence

Friday, 21 September 2007 – Canberra

1 Institute of Chartered Accountants

National Tax Liaison Group Agenda for the meeting of 5 September 2007

2 Institute of Chartered Accountants

National Tax Liaison Group Agenda for the meeting of 20 March 2007

3 Institute of Chartered Accountants

National Tax Liaison Group Agenda for the meeting of 28 June 2007

Wednesday, 30 April 2007 – Sydney

Australian Taxation Office, Strategic Statement 2006-10

2 Australian Taxation Office

Australian Taxation Office Corporate Plan 2008-9

3 Australian Taxation Office

Plenary Governance Forum, Corporate Plan 2007-08 (Sub-plan third-quarter performance)

4 Australian Taxation Office

Tax Office Corporate Planning Model

5 Australian Taxation Office

Corporate Planning Timetable for 2008-09

6 Australian Taxation Office

Tax Office management arrangements

7 Australian Taxation Office

Tax havens and tax administration, Australian Taxation Office

8 Australian Taxation Office

Large business and tax compliance 2006, Australian Taxation Office

9 Australian Taxation Office

Australian Taxation Office, Compliance Program 2007-08

10 Australian Taxation Office

Wealthy and Wise: A tax guide for Australia's wealthiest people, Australian Taxation Office

11 Australian Taxation Office

Taxation Ruling TR2007/08: Income Tax: registered agricultural managed investment schemes

12 Australian Taxation Office

Australian Taxation Office, Reconciliation Action Plan

F

Appendix F – List of biannual public hearings

Friday, 20 April 2007 - Melbourne

Australian Taxation Office

Mr Michael D'Ascenzo, Commissioner of Taxation

Ms Jennie Granger, Second Commissioner of Taxation

Mr Mark Konza, Deputy Commissioner, Small and Medium Enterprises

Ms Stephanie Martin, Deputy Commissioner, Aggressive Tax Planning

Mr Bruce Quigley, Second Commissioner of Taxation, Law

Friday, 21 September 2007 - Canberra

Australian Taxation Office

Ms Margaret Crawford, Chief Operating Officer

Mr Michael D'Ascenzo, Commissioner of Taxation

Ms Jennie Granger, Second Commissioner of Taxation

Mr Mark Konza, Deputy Commissioner, Small and Medium Enterprises

Mr Bruce Quigley, Second Commissioner of Taxation, Law

Mr Shane Reardon, Deputy Commissioner

Ms Raelene Vivian, Deputy Commissioner of Taxation, Superannuation

Wednesday, 30 April 2008 - Sydney

Australian Taxation Office

Mr Michael D'Ascenzo, Commissioner of Taxation

Mr Bill Gibson, Acting Second Commissioner, Easier, Cheaper and More Personalised Program

Ms Jennie Granger, Second Commissioner of Taxation

Mr Bruce Quigley, Second Commissioner of Taxation, Law

Ms Raelene Vivian, Chief Operating Officer