

Introduction

Preamble

- 1.1 The general scope of the inquiry and this report is tax disputes. The Ombudsman provided this definition of a dispute to the Committee: 'A disagreement only becomes a dispute when one party cannot live with the consequences of the disagreement and insists on a different outcome.'¹ In other words, while it takes two parties to disagree, it only takes one person to initiate a dispute and the dispute can be genuine, regardless of the other party's views.
- 1.2 Collecting tax is important job; it can also be a difficult one. The tax laws are complex and attitudes to compliance vary. As a result, disputes are inevitable. As the Ombudsman stated, 'I think most people would agree that compelling anybody to pay more money - whether it is tax, superannuation, a parking ticket, or a speeding fine - can lead to disagreement.'²
- 1.3 Under these circumstances, what needs to happen is that disputes are resolved as quickly and fairly as possible, in full accordance with the law, and that taxpayers and the community have confidence that this is occurring.

1 Mr Colin Neave, Commonwealth Ombudsman, *Transcript of Evidence*, 24 September 2014, p. 9. Under the *Tax and Superannuation Laws Amendment (2014 Measures No. 7) Act 2015*, the Ombudsman's investigation functions in relation to the Australian Taxation Office are expected to be transferred to the Inspector-General of Taxation (IGT) on 1 May 2015. Therefore, future references to the Ombudsman in this report should be regarded as referring to the IGT, where appropriate.

2 Mr Colin Neave, Commonwealth Ombudsman, *Transcript of Evidence*, 24 September 2014, p. 9.

Role of the Inspector-General of Taxation

- 1.4 When this inquiry commenced, the Committee resolved to ask the Inspector-General of Taxation (IGT) to conduct an inquiry into tax disputes for large businesses and high wealth individuals. The Committee did this so it could focus on individuals and small to medium enterprises (collectively referred to in this chapter as SMEs). This division also reflects the differing inquiry processes and stakeholder groups.
- 1.5 On Friday, 27 February 2015, the Assistant Treasurer publicly released the IGT's report. The Committee's report refers to the IGT's document where appropriate. The IGT's report focusses on the governance issue of separation between the Australian Taxation Office's (ATO's) audit and internal review functions. The Committee covers this matter in detail in chapter 6. The views of the Committee and the IGT across the inquiry are broadly similar, including the important governance issue.
- 1.6 The Committee would very much like to thank the IGT for the assistance he has provided the Committee during the inquiry. This includes his review of tax disputes for large businesses and high wealth individuals, private briefings with the Committee, and the provision of evidence at the biannual hearings with the ATO. The IGT has also assisted the Committee through his work program over the past five years. Reports into objections (2009), compliance approaches to SMEs and high wealth individuals (2011), and the self-assessment system (2012) have given the Committee a solid foundation for its inquiry.³
- 1.7 Finally, the Committee would like to acknowledge the impact that the IGT's report on Alternative Dispute Resolution (ADR) in 2012 has made on tax disputes generally. The Committee notes that the previous Commissioner of Taxation also requested that the IGT undertake the ADR review.⁴ Many of the recent reforms made by the ATO can be traced back to this report and the Committee understands that some of the IGT's suggestions, such as in-house facilitators at the ATO, have been very successful.

Inquiry overview

- 1.8 On 4 June 2014, the Committee adopted the terms of reference provided by the then Acting Assistant Treasurer, Senator the Honourable Mathias

3 The IGT's reports are available at <http://www.igt.gov.au/content/reports.asp?NavID=9>.

4 IGT, *Review into the Australian Taxation Office's use of early and Alternative Dispute Resolution: A report to the Assistant Treasurer*, May 2012, p. v.

Cormann. The full terms of reference are detailed at the front of this report.

- 1.9 The inquiry was advertised by media release, social media, Committee members' websites, and postcards. The Committee sought submissions from relevant Australian Government ministers, legal, accounting, and tax representative bodies, and tax practitioners.
- 1.10 The Committee received 34 submissions and three supplementary submissions. Seven submissions were confidential. The submissions are listed at Appendix A.
- 1.11 The Committee held nine public hearings in Melbourne, Sydney, Brisbane and Canberra. This included a teleconference with a witness in Perth. Public hearing details are listed at Appendix B.
- 1.12 The remainder of this chapter gives an overview of disputes for SMEs and some general observations by the Committee. The other chapters in the report broadly follow the Committee's terms of reference:
 - chapter 2 discusses the ATO's key performance indicators for disputes
 - chapter 3 examines possible amendments to the legal framework for disputes, including to the general interest charge and allegations of fraud or evasion
 - chapter 4 looks at how the ATO can foster early engagement between the parties in a dispute or potential dispute
 - chapter 5 considers other administrative aspects of disputes, in particular formal interviews, compensation, and ADR
 - chapter 6 covers the degree of separation between the audit (or investigation) function of the ATO against the later processes of objection and litigation

Context of SME disputes

Background

- 1.13 The Committee's inquiry covered individuals and businesses with a turnover up to \$250 million annually. It excluded high wealth individuals,

who control net assets of more than \$5 million, and businesses with a turnover of more than \$250 million.⁵

- 1.14 Disputes work differently for different market segments. The issues are different, the amount of tax at stake is different, and so are the resources available to the taxpayer. This does not mean that, because the amounts for SMEs are lower, the disputes are simpler. The Committee received evidence that SME disputes can be very complex.⁶
- 1.15 The ATO provided the Committee with a breakdown of tax disputes by market for income tax, reproduced in the following table. The plain numbers are the total number of matters in each category. The numbers in brackets are the percentage of matters that have progressed from the previous category. For example, of the total number of returns lodged by small business, 1 per cent will result in adjustments. Of those adjustments, 10 per cent will result in objections. Of those objections, 5 per cent result in cases lodged in the Administrative Appeals Tribunal (AAT) and courts, and so on. The bottom row is the average of these percentages. This is preferable to an average by total, because the latter would be dominated by the individuals' category.

Table 1.1 Income tax disputes, by number and as a percentage of previous category, 2013-14

Market	Returns lodged	Adjustments from audits	Objections	Cases lodged AAT & courts	Cases decided
Individuals	10.8 m	419,189 (4%)	16,498 (4%)	386 (2%)	44 (11%)
Small business	5.4 m	75,398 (1%)	7,705 (10%)	360 (5%)	31 (9%)
Medium business	0.2 m	4,845 (2%)	473 (10%)	75 (16%)	8 (11%)
Not for profit	12,256	743 (6%)	28 (4%)	5 (18%)	4 (80%)
Government	1,579	58 (4%)	8 (14%)	0 (0%)	0 (NA)
Large business	13,901	268 (2%)	118 (44%)	14 (12%)	16 (114%)
Total	16.5 m	500,501	24,830	840	103
Category average		(3%)	(14%)	(9%)	(45%)

Source ATO, *Submission No. 10.3*, p. 2.

- 1.16 The table shows that a small proportion of disputes travel far and that individuals and small business are the least likely to maintain a dispute. This is consistent with evidence the Committee received that SMEs have a

⁵ Although the Committee made its decision on the categories, the cut-off amounts are from the ATO. See ATO, *Annual Report 2013-14*, October 2014, pp. 58-59.

⁶ Mr Chris Wallis, *Submission No. 28*, pp. 15-18.

limit on what they will spend pursuing a matter. For example, for a dispute over \$100,000, they are unlikely to spend more than \$10,000.⁷

- 1.17 The table shows that large business is especially likely to object to an adjustment. Their disputes are likely to proceed to a decision by a tribunal member or judge if lodged with the AAT or a court. Not too much importance should be placed on the later columns for not-for-profits because the total numbers are low.
- 1.18 Mr Michael Croker from Chartered Accountants Australia New Zealand (CAANZ) advised the Committee that, given the lower revenue risk, the ATO usually prefers to develop its expertise for large business and then let that filter down the rest of the organisation.⁸ The Committee also heard that, given the smaller sums involved, SME disputes do not attract the most experienced ATO staff, and there is high staff turnover:

In dealing with small business you are routinely dealing with junior people at the tax office. Some of that reflects the administration structure within the tax office – the pyramid is much flatter and much broader at small business enterprise level and private taxpayer level... Just as staff in an accounting firm or a legal firm want to go to the fashionable areas of work, staff in the tax office want to go to the fashionable areas – and dealing with mum and dad’s fish-and-chip shop does not quite cut the mustard when the possibility is to go to large business and international. So we end up with this constant churning of staff. We get no corporate memory at the small end of the tax office.⁹

- 1.19 In terms of revenue risk, it makes sense for the ATO to allocate its best staff to large business. However, this increases the risk for an SME taxpayer that errors will be made and they will not, in effect, be treated fairly. The Committee received evidence along these lines and heard that staff with less expertise, when faced with a complex transaction, are more likely to conclude that there is questionable conduct.¹⁰ A tax barrister advised the Committee that this can have important consequences for taxpayers:

... the large corporates and their tax affairs do attract the more talented and more skilled people in the ATO... I think a lawyer would look at a loan from offshore and say, ‘Well, that’s a good

7 Mr Chris Wallis, *Transcript of Evidence*, 14 August 2014, pp. 35-36.

8 Mr Michael Croker, CAANZ, *Transcript of Evidence*, 18 August 2014, pp. 35-36.

9 Mr Chris Wallis, *Transcript of Evidence*, 14 August 2014, p. 34.

10 Mr Chris Wallis, *Submission No. 28*, p. 19.

faith attempt to use legal structuring in order to achieve an outcome.’ A layperson might look at the loan from offshore and say, ‘They are lending money to themselves – that’s fraudulent.’ I do think the fact that the well-known corporates are dealt with by the more skilled people at the ATO does result in some quite important downstream consequences. In the media we read about Chevron and its supposed transfer-pricing arrangements. If Chevron were a private individual, you would expect to see all of its assets being frozen and its bank accounts being garnished.¹¹

- 1.20 The Committee is mindful that the ATO cannot simply transfer staff and resources to SME audits to address this problem, without affecting the rest of the organisation. The Committee heard that working with the SME market is an important training opportunity for ATO staff.¹² However, the Committee will make suggestions in this report on how current arrangements could be improved to reduce fairness risk for taxpayers.

Most disputes resolve satisfactorily ...

- 1.21 As Mr Andrew Mills from the ATO stated, the ATO conducts tens of millions of transactions and few result in disputes.¹³ Similarly, most disputes are resolved satisfactorily. The Committee held an accountants’ roundtable in Sydney with a group of practitioners that specialised in small business, all of whom agreed with the following point:

We have been in practice since the early 1970s. I have to say that, in all that time, we have had very positive relationships with the ATO. Instances of disputes are very minor and infrequent. In most cases, they have been able to be resolved quite efficiently. As a practitioner dealing with the ATO on a day-by-day basis, we have some issues with communications, case management, approach and procedure, but, as I said, they are minor and infrequent issues... I am quite happy to praise them in probably 99 per cent of cases.¹⁴

- 1.22 Other witnesses agreed that most disputes are properly handled. The Ombudsman stated that, ‘generally speaking, the tax office treats those

11 Mr John Hyde Page, *Transcript of Evidence*, 29 October 2014, p. 9.

12 Mr Richard Wytkin, *Transcript of Evidence*, 29 October 2014, p. 1.

13 Mr Andrew Mills, ATO, *Transcript of Evidence*, 29 November 2014, p. 1.

14 Mr Brian Hrnjak, GHR Accountants & Financial Planners, *Transcript of Evidence*, 18 August 2014, p. 1. Mr Alan Bentwitch, Bentwitch & Co., and Mr Peter Sullivan, LCD & Co. Accounting Services, made similar comments, p. 1.

who come to it fairly.’¹⁵ Mr David Hughes from Small Myers Hughes commented, ‘the current Commissioner of Taxation is doing a very good job, as are the majority of ATO officers.’¹⁶ Dr Niv Tadmor from the Tax Institute provided a related observation that, ‘we have not seen the Commissioner going after a business in order to get it down.’¹⁷

- 1.23 In addition, the Committee received consistent evidence that the ATO’s performance is improving. The Ombudsman advised the Committee that complaints overall to the Ombudsman in 2013-14 were down 24 per cent on the previous year.¹⁸ CPA Australia’s submission stated that the change across the ATO was substantial and reduced costs for taxpayers:

As an overall comment we strongly believe that the Commissioner should be commended for the recent performance of the Australian Taxation Office (ATO) in resolving tax disputes through negotiation and the use of Alternate Dispute Resolution (ADR) processes. This has involved a considerable paradigm shift by all parties and our members note that its roll-out across all market sectors including SMEs has typically led to the more expeditious resolution of disputes by the ATO.

It should be noted that the rollout of ADR processes is a crucial development as our members find that the vast majority of cases concerning SMEs do not involve a ‘test case’ involving technical issues... Moreover, for all but the most aggressive of taxpayers, avoiding litigation is both the most desirable and economically sensible outcome.¹⁹

- 1.24 The Tax Institute, the Institute of Public Accountants (IPA), and the Law Council of Australia made similar comments to the Committee.²⁰

... but some do not

- 1.25 The Committee received evidence that, once the ATO decides a taxpayer has an outstanding liability, the balance of power in SME disputes is very much in favour of the ATO. This balance of power exists at the legal,

15 Mr Colin Neave, Commonwealth Ombudsman, *Transcript of Evidence*, 24 September 2014, p. 12.

16 Mr David Hughes, Small Myers Hughes, *Transcript of Evidence*, 16 October 2014, p. 15.

17 Dr Niv Tadmor, Taxation Institute, *Transcript of Evidence*, 14 August 2014, p. 13.

18 Commonwealth Ombudsman, *Submission No. 14*, p. 3.

19 CPA Australia, *Submission No. 7*, p. 1.

20 The Tax Institute, *Submission No. 11*, p. 1; Mr Tony Greco, IPA, *Transcript of Evidence*, 14 August 2014, p. 6; Law Council of Australia, *Exhibit No. 2*, p. 3.

commercial, and emotional levels and raised the question of whether taxpayers withdraw from disputes due to attrition.²¹ Mr Tony Fittler from HLB Mann Judd stated:

... our concern is the fact that there is a lot going in the commissioner's favour and not much in the favour of the taxpayer. The taxpayer, when they are faced by an audit, is involved in cost and concern about their situation. If the matter ultimately goes to assessment, immediately they are in a position where they need to object, quite often within a short time frame, and also the tax becomes due.

While there is a practice of deferring recovery of tax, provided you pay 50 per cent, quite often that is a difficult position to be in if you are an individual or a small business. It is a substantial sum of money and the difficulty there is that, even while the matter is going on, interest is accruing at the rate of, essentially, penalty rates – 9.69 per cent currently. So the matter is escalating and there is really no pressure on the commissioner for the matter to be resolved quickly... The small-business taxpayer does not have the resources, is emotionally attached and, I guess, has other pressures on them as well.

When there is a tax assessment raised, one of the issues is how you get financing. The first thing you will be asked for in seeking financing is a copy of what you owe the tax office, so that immediately becomes a limitation on borrowing. There is collateral damage. It brings into account personal relationships, what you tell your family and other obligations where you have borrowed from friends and family.²²

- 1.26 The Committee accepts that the ATO needs strong powers to administer the tax system. The question is how these powers are applied and the checks and balances that exist to ensure that the legally correct amount of tax is paid, while taxpayers feel that they are being treated fairly and with respect.
- 1.27 The Committee heard that, under current laws and systems, it is too easy for the ATO's powers to be misapplied.²³ Similarly, the Committee heard

21 Mr Gary Kurzer, *Transcript of Evidence*, 18 August 2014, p. 47.

22 Mr Tony Fittler, HLB Mann Judd, *Transcript of Evidence*, 18 August 2014, p. 1.

23 Mr David Hughes, Small Myers Hughes, *Transcript of Evidence*, 16 October 2014, p. 15.

that a taxpayer's audit experience depends almost entirely on the auditor.²⁴

1.28 Specific claims about ATO conduct made to the Committee during the inquiry include:

- bullying and unprofessional conduct
- a refusal to apologise
- raising trivial points late in an audit after a taxpayer successfully rebuts the initial ATO position
- behaving like 'zealots'
- reneging on informally agreed settlements
- pressuring taxpayers into settling
- a presumption of guilt and that the taxpayer is hiding something
- that audits are conducted like 'fishing expeditions' rather than with a specific focus
- refusing to meet a taxpayer or their representatives
- giving insufficient time to respond to requests whilst delaying the ATO's responses.²⁵

The costs can be high

1.29 The costs of conducting a dispute with the ATO can be very high. The Committee heard from a retired builder, Mr Grahame Pilgrim, who stated that his \$500,000 liability (including penalties and interest) was reduced to \$100,000. Mr Pilgrim stated that the dispute had a substantial negative effect on both his marriage and his business:

We went from 2007 through to 2010. The whole of our life was put on hold. My business suffered because I did not know from one day to the next whether I was going to be in business—I didn't know if the ATO was going to send me bankrupt. It cost me my

24 Mr Richard Wytkin, *Transcript of Evidence*, 29 October 2014, p. 1.

25 Mr Rob Salisbury, *Submission No. 21*, p. 3; Mr Chris Wallis, *Submission No. 28*, p. 22; Mr Andre Spnovic, BDO, *Transcript of Evidence*, 24 September 2014, p. 3; Mr David Hughes, Small Myers Hughes, *Transcript of Evidence*, 16 October 2014, p. 15; Commonwealth Ombudsman, *Submission No. 14*, p. 7; Mr Colin Neave, Commonwealth Ombudsman, *Transcript of Evidence*, 24 September 2014, p. 10; Mr Wayne Graham, *Transcript of Evidence*, 1 October 2014, p. 5; Mr Ian Hashman, *Transcript of Evidence*, 24 September 2014, p. 5; Mr Richard Wytkin, *Transcript of Evidence*, 29 October 2014, p. 4.

business and also my marriage, that part of it... I spent months backwards and forwards with the ATO, disputing the facts with my figures. That is why they reduced it back to that amount of money.²⁶

- 1.30 Ms Judy Sullivan from PricewaterhouseCoopers (PwC) advised that taxpayers have committed suicide at the conclusion of a tax dispute:

I am sure you will be hearing from a number of taxpayers about the emotional toll of these sorts of things. I have had clients in the past who have committed suicide after coming out the other end of an audit for a very serious allegation that was in fact settled. There is stress on families because of the length of time and things like that. You see a lot of marriage break-ups and emotional stress from these sorts of allegations.²⁷

- 1.31 Disputes also cost a substantial amount in advisers' fees, especially if a matter is to proceed to the AAT. At the accountants' roundtable in Sydney, the Committee heard that many taxpayers will withdraw their claim if their objection fails, rather than proceed to the AAT, because the costs exceed the amount of tax in question. The alternative is to simply avoid legal arrangements that have some risk.²⁸
- 1.32 Mr Ian Hashman advised the Committee that his series of disputes with the ATO cost him \$250,000 in advisers' fees. The ATO withdrew its claim before the matters proceeded to the AAT.²⁹
- 1.33 The ATO is well aware that tax disputes can have a severe effect on taxpayers. The Commissioner stated, 'We do know that delays in dispute resolution have real, physical and sometimes paralysing impacts for business and individuals.' He also stated that he is reforming the ATO by 'putting our clients at the centre of everything that we do.'³⁰
- 1.34 The ATO has also apologised for its conduct in some disputes. Second Commissioner Andrew Mills stated, 'For those who have been adversely affected by our poor handling of their disputes, I would like to extend my sincere apologies.'³¹

26 Mr Grahame Pilgrim, *Transcript of Evidence*, 16 October 2014, p. 22.

27 Ms Judy Sullivan, PwC, *Transcript of Evidence*, 18 August 2014, p. 29.

28 Mr Brian Hrnjak, GHR Accountants & Financial Planners, Mr Peter Sullivan, LCD & Co. Accounting Services, Mr Alan Bentwitch, Bentwitch & Co., *Transcript of Evidence*, 18 August 2014, p. 43.

29 Mr Ian Hashman, *Transcript of Evidence*, 24 September 2014, p. 5.

30 Mr Chris Jordan, Commissioner of Taxation, *Transcript of Evidence*, 16 July 2014, p. 1.

31 Mr Andrew Mills, ATO, *Transcript of Evidence*, 26 November 2014, p. 1.

Committee comment

- 1.35 The Committee's main finding from the inquiry is that some taxpayers have not been treated fairly by the ATO during their tax dispute. Although the frequency is low, the consequences for taxpayers can be severe and taxpayers have limited recourse when this happens. The Committee believes that changes to the tax laws and ATO practices are warranted, in addition to the reforms that the Commissioner is already undertaking.
- 1.36 One of the causes of the lack of fair treatment is that taxpayers are occasionally assessed as a higher revenue risk than they are in actual fact. This can include cases where a taxpayer does owe tax, but the ATO overestimates the liability and/or imposes excessive penalties and interest.
- 1.37 Further, it appears that the ATO can misinterpret a taxpayer's willingness to challenge an ATO decision. The Ombudsman stated, 'I cannot emphasise enough that auditors need to listen to the issues because the disagreement may be a call for help, rather than an attempt to hide.'³² Further, there are insufficient checks and reviews when these events occur.
- 1.38 The stakes can be high in a tax dispute. Unfortunately, much of the thinking in a dispute revolves around who is right. Given that many disputes revolve around highly technical issues,³³ and there is a great deal of uncertainty, this is not a constructive approach. The ATO would be better served by ensuring that its actions stand up to scrutiny, regardless of who is legally successful.
- 1.39 The Committee notes that improved perceptions of fairness assist taxpayer compliance. They are also important to individual taxpayers. Mrs Sarah Blakelock from the law firm McCullough Robertson stated to the Committee, 'Resolving disputes is a journey, and taxpayers need to go along the journey in the same way as the ATO needs to go along the journey.'³⁴ Not all taxpayers will be satisfied with the outcome of their dispute, but they have the right to be satisfied that they had a fair go.
- 1.40 The ATO has already embarked on reforms that will improve the tax system and the taxpayer experience. Mr Neil Olesen from the ATO stated that industry bodies are giving them positive feedback:

32 Mr Colin Neave, Commonwealth Ombudsman, *Transcript of Evidence*, 24 September 2014, p. 9.

33 Mr Graham Halperin, *Transcript of Evidence*, 14 August 2014, p. 18.

34 Mrs Sarah Blakelock, McCullough Robertson, *Transcript of Evidence*, 24 September 2014, p. 10.

They can see the direction in which we are heading, they can see what we are trying to do and they are saying to us across the table like this, 'Your people at the front line are in fact starting to get it.' That is encouraging feedback to hear from them. I absolutely accept we have more work to do, but the strongest thing they said to us only two weeks ago was, 'We can see that your people in the field on the front lines understand the direction you are going in and we can see the changes in behaviours starting to take effect.'³⁵

- 1.41 The Committee is confident that the ATO can enhance its current reform program through the recommendations in this report and build a fairer tax system.

35 Mr Neil Olesen, ATO, *Transcript of Evidence*, 16 July 2014, p. 6.