



Dissenting Report

Audit Report No. 46, 1999–2000

High Wealth Individuals Taskforce

Australian Taxation Office

This dissenting report deals with the failure of the Government to legislate to deal with large scale tax avoidance and evasion techniques utilising trusts.

Introduction

The High Wealth Individuals Taskforce was established by the Commissioner of Taxation in May 1996 as an administrative response to a major problem the Australian Taxation Office (ATO) had identified late in the previous year.

Advice to the Previous Government

Trusts can provide a vehicle for a number of tax avoidance and evasion techniques. Throughout 1994 and 1995 the Treasurer's office pressed Treasury for advice on the extent of the problem and possible remedies. It was raised almost weekly but nothing was forthcoming until November 9, 1995 when the ATO advised that it had uncovered a significant problem using multiple trust structures.

The ATO had obtained software which was capable of finding patterns in large amounts of seemingly unrelated information. Using it, they had found that large numbers of seemingly unrelated trusts were related and a range of techniques were being used by high wealth individuals to reduce tax liabilities to low or negligible levels.

Treasury and the ATO worked on the issue over the next three months, eventually advising the Treasurer that it would be appropriate to make a

public announcement that the government would act to end these practices. The press release issued by then Treasurer Ralph Willis on 11 February 1996 was written directly from the Treasury and ATO advice. It was titled, *High Wealth Individuals - Taxation of Trusts*, and in full, it read:

On November 9, 1995 I was informed by the Australian Taxation Office that as part of the Compliance Enforcement Strategy, authorised by the Government, it had conducted analysis of the accumulation of wealth by certain individuals and the taxes paid by them. That analysis revealed that some high wealth individuals were employing strategies which allowed them to accumulate wealth, enjoy a lavish lifestyle, but pay little or no tax. The analysis was in its early stages but the ATO believed the revenue implications might amount to several hundred million dollars.

At my request, the ATO and Treasury provided more extensive advice and analysis on December 20, 1995. It revealed that in the 1993 financial year, 80 individuals each with a net worth of over \$30 million had returned taxable incomes of \$20,000 or less. This enabled some of them to qualify for low income rebates, Medicare exemptions, deferral of HECS payments and reduced child support payments. The tax minimisation techniques employed by these individuals mainly involved the use of trusts.

By January 19, 1996, the ATO and Treasury were able to advise that on the basis of the work undertaken to date in respect of 100 wealthy individuals alone, appropriate measures to deal with a range of specific tax minimisation techniques using trusts would produce additional revenue of at least \$500 million. Later, at a meeting on January 23, 1996, Treasury gave me verbal advice raising that estimate to \$800 million. Some amount could be forthcoming in 1996-97, but the first full year effect would be in 1997-98.

The January 19, 1996 advice also included separate revenue estimates in addition to the \$800 million for techniques involving thin capitalisation and abuses of the provisions for payments by trusts to foreign charities.

The ATO has identified a number of complex tax planning arrangements used by some wealthy individuals to avoid tax, these include:

- *the characterisation of income as capital by the use of multiple trust structures to conceal a common controlling mind. If the activities of the various trusts and associated companies were viewed as a whole, the profits of the group could be treated as trading income. The ATO has found a number of cases of wealthy individuals operating over 100 trusts;*
- *the creation of artificial losses (revenue as well as capital) to neutralise otherwise taxable profits, particularly through the use of related party transactions;*

- *distributions to wealthy individuals and family members being disguised as loans and other benefits which are claimed to be non-taxable. In relation to companies this includes exploitation of alleged weaknesses in sections 47A and 108 of the Income Tax Assessment Act 1936, of the deemed dividend provisions;*
- *the continued use of offshore trusts to hold significant funds which seem to be applied for the benefit of wealthy individuals and their families; and*
- *the use of Australian charitable trusts and overseas organisations to disguise benefits provided by family trading trusts to family members.*

Obviously these are not techniques which are practised by the overwhelming majority of trusts operated by and for Australians. Trusts provide an appropriate structure to meet a range of legitimate needs such as for charities, educational and non-profit organisations, deceased estates, a variety of family purposes, and for solicitors and other professionals. The Government will not interfere with these arrangements. The Government undertakes that the measures it will adopt will ensure that activities not involving tax avoidance are not adversely affected.

No responsible government could stand back and let blatant abuse of the tax system by extremely wealthy individuals continue. The ATO is undertaking action to test the effectiveness of the existing law to deal with some of these practices. However, it is not expected that an outcome will be achieved by this means in the near future due to the long time frames involved in testing issues before the courts. The ATO has advised that it is particularly difficult to run test cases in these areas because the individuals concerned will settle at the end of the day rather than have their private affairs or practices exposed in public.

*On January 29, 1996, I wrote to the Secretary to the Treasury and the Commissioner for Taxation, asking them as a matter of urgency to develop a legislative response to cover income from the 1996-97 financial year. The new tax measures which the Government will introduce to deal with these specific areas of tax avoidance will be prospective **not** retrospective.*

One of the most important things this Labor Government has given Australia since it was elected in 1983 is a tax system based on the principles of integrity and fairness. Maintaining that basic integrity and fairness requires stamping out tax avoidance wherever and whenever it emerges.

The reason these measures are being announced today is because the Government is seeking a mandate to deal with this area of tax avoidance. We call on the other parties in this election to support these reforms. I am offering Mr Howard a briefing this afternoon from the Commissioner of Taxation.

The Government offered the briefing by the Commissioner of Taxation to the then Opposition Leader because it wanted to ensure that the

Opposition was aware of the serious risk to revenue through the abuse of trusts and to seek bipartisan support for measures to end that abuse. In announcing that it would proceed with legislation to deal with these aggressive tax planning techniques, the Government said that the revenue recovered would not be applied to any additional government spending.

Mr Cox made a formal request through the Committee Secretariat to the Treasury requesting that the JCPAA be given access to the advice provided to the previous Labor Government by Treasury and the ATO on trusts. The Executive Director of Treasury's Budget Group, Mr G J Smith, responded saying: *"...the Committee would be aware that advice provided to governments (both current and previous) by their departments is confidential in order to facilitate an effective advising relationship. Treasury considers that maintaining this confidentiality is in the public interest and is critical for the maintenance of good government."* After receiving a briefing from Mr Smith on the relevant conventions, the Committee did not proceed further with its request.

Response by the then Opposition

The then Shadow Treasurer, Peter Costello, received the briefing from the Tax Commissioner. On 15 February 1999, Mr Costello issued a press release titled *Meeting Our Commitments*, in which he said:

Naturally the Coalition regards Labor's minute to midnight detection of \$800 million a year in tax avoidance through the use of trusts as somewhat convenient after more than 13 years of tax administration. Naturally there is considerable suspicion as to whether this sum will be fully recovered.

However, if a small number of wealthy individuals are avoiding proper liability through those schemes, it would be a dereliction of duty not to collect it. The Coalition will take the necessary steps to recover the sum being unfairly avoided.

Tax Commissioner established HWI Taskforce

In May 1996, the Commissioner of Taxation announced that the ATO was developing a comprehensive compliance program to act on the unacceptable tax planning and minimisation techniques already identified in the high wealth individuals (HWI) segment of the taxpayer population.

The ATO intended to get a comprehensive understanding of the tax minimisation techniques of HWIs and continually identify, monitor and address emerging minimisation techniques.

The Commissioner noted that the package of measures to be undertaken would include, as appropriate; information collection and analysis; release of rulings clarifying the ATO's view of how the law applied to particular arrangements; litigation to test the law; audit and prosecution activity; and recommendations to the Government on appropriate legislative responses.

In the 1996 Budget papers, the Treasurer, Peter Costello, said:

The revenue at risk from aggressive tax planning and minimisation arrangements used by some high wealth individuals, has been estimated at \$800 million a year. Treasury and the ATO caution that this estimate is subject to uncertainties about wealth data, remedial measures, utilisation of losses and behavioural responses by affected taxpayers. This figure should be seen as an order of magnitude estimate of the 'revenue potentially at risk' rather than as the 'sum of gains from particular measures'.

Taskforce investigation will first identify the nature of the problem and mechanisms used, then design counter measures expected to generate revenue beyond 1997-98. [Treasurer, *Meeting our Commitments, Budget Statement*, 20 August 1996]

In the 1996 Budget, the Government allocated additional funds to the ATO (\$9.7 million in 1996-97 and \$9.5 million in 1997-98) for the operation of the HWI Taskforce. In announcing the additional funding, the Treasurer said:

Enhanced investigation activity and analysis will allow a greater understanding of the complex arrangements used by some high wealth individuals to minimise tax, and to progressively develop administrative and legislative proposals to deal with these arrangements and others that may be put in place in the future. [Treasurer, *Budget Speech 1996-97*, 20 August 1996]

In the 1998-99 Budget, the Government extended funding for the Taskforce for a further two years—allocating \$9.5 million in each of 1998-99 and 1999-2000. The Government provided this additional revenue on the basis that additional revenue of \$100 million was to be achieved each year for the additional outlay of approximately \$10 million, a ten to one ratio.

A New Tax System

The Howard / Costello Government proposed legislation to provide for the consistent treatment of entities in the document *A New Tax System* (ANTS) released before the 1998 federal election.

These were measures to ensure that taxpayers in similar circumstances would pay the same tax, regardless of the type of entity through which they chose to operate.

The entity taxation proposals specifically in relation to trusts, were estimated in that document to provide additional revenue of \$70 million in 1999-2000, \$900 million in 2000-2001, \$760 million in 2001-2002, and \$430 million in 2002-2003.

When the ANTS package of legislation was presented to Parliament in 1999, there was no legislation relating to the common treatment of entities. The Treasurer said that the measures relating to trusts would be deferred and dealt with in the Review of Business Taxation (RBT) conducted by Mr John Ralph.

The ANTS legislation was passed on the votes of the Australian Democrats without an entity taxation measure.

New Business Tax System

The RBT recommended as an entity taxation measure, that trusts be taxed as companies. The RBT presented two sets of estimates for the additional revenue to be derived from this measure.

The first set of estimates were based on the existing company tax rate of 36%. On that basis the measure was expected to produce revenue of \$70 million in 1999-2000, \$830 million in 2000-2001, \$930 million in 2001-2002, \$520 million in 2002-2003, \$600 million in 2003-2004, and \$620 million in 2004-2005.

The second set of estimates were based on the anticipated phasing down of company tax rates to 34% in 2000-2001 and 30% in 2001-2002. On that basis the measure was expected to produce revenue of \$70 million in 1999-2000, \$730 million in 2000-2001, \$500 million in 2001-2002, \$370 million in 2002-2003, \$390 million in 2003-2004, and \$410 million in 2004-2005.

As had been the case with the ANTS legislation, when the package of legislation for the RBT was presented to Parliament, there was no entity taxation measure to deal with trusts. This was a significant concern to the Opposition in terms of the cost to revenue of the package. There were discussions between the Shadow Treasurer and the Treasurer, and on the 24 November 1999, the Shadow Treasurer wrote to the Treasurer in the following terms:

Dear Treasurer

I am writing to set out some of Labor's concerns in relation to the business tax package and more specifically to inform you of an amendment I intend to move during the debate on the New Business Tax System (Integrity and Other Measures) Bill 1999.

Revenue neutrality

As I indicated in the course of our last two discussions, Labor is willing to pass the business tax package if it pays for itself. Labor will hold the Government to its promise on revenue neutrality. We cannot accept a reduction in business taxation at the expense of individuals and families who will be bearing the brunt of a GST, nor the use of the Budget surplus to fund business tax reforms.

This key criterion is now even more imperative given the announcements yesterday concerning the surcharge on some taxpayers to pay for the increased cost of the GST deal with the Australian Democrats.

Labor believes revenue neutrality can be achieved if the government fully implements the measures announced under Stage 2, as well as those measures in Stage 1 not yet before the Parliament, and if a stronger anti-avoidance measure is put in place to accompany the widening gap between income and capital taxation.

The first element is essentially the fulfilment of the government's commitment on the revenue measures that fund the tax cuts. As you know, many of these measures, particularly those politically sensitive to the government, are not yet before the Parliament.

'Work in progress'

In this context we welcome your announcement of 11 November in relation to the Stage 2 measures as an important step forward. However your release also acknowledges that further work and consultation is still under way on a number of measures. In essence, you are asking Labor to sign-off on what you acknowledge to be 'work-in-progress.'

For example, I note that your release states, in the context of dealing with the alienation of personal services income, that detailed criteria is still to be developed concerning what is a personal services business. Clearly this detail, and the detail of some other areas in this alienation context, will be critical to the revenue effect of the measures. An assessment of how much of a contribution this measure will make to revenue neutrality cannot be made without the fine detail being settled and the final impact known.

There is also considerable uncertainty surrounding the final detail of many of the other measures you announced on November 11. These include:

- *the proposed reduction in the 45 day rule concerning denial of franking credits—there is no firm proposal to replace this rule;*
- *the proposed new uniform capital allowance system—currently the subject of consultations; and*
- *the final design of the entity regime, especially the transitional arrangements.*

Similarly, Labor is favourably disposed to the claimed objective of strengthening the General Anti-Avoidance Rules (GAAR). However, it is not possible to evaluate the proposed new system on the basis of the announcements so far.

In this context I make special reference to the government's recent record on the GAAR in the GST legislation. Following representations from business groups the initially tough draft provisions were significantly weakened. This would not be an acceptable outcome for Labor in respect of the proposed tightening of the GAAR that you have announced for income tax purposes.

There also remains significant and understandable scepticism that the government will deliver on its 1998 promise on taxation of trusts as companies - a further reason we want the detail referred to above made available before we sign-off on the package.

Integrity measure

Addressing revenue leakage through appropriate anti-avoidance measures is obviously part of achieving revenue neutrality, particularly given the greater incentive to tax avoidance with the proposed widening of the gap between CGT and the top marginal tax rate.

The amendment I plan to move to the New Business Tax System legislation (copy attached) seeks to include a specific new clause in the existing GAAR, Part IVA of the Income Tax Assessment act 1936. Such a provision would also be necessary in any rewriting of the GAAR.

You will recall that I raised this matter in the course of our last discussions on business tax reform. While you stated a belief that the announced arrangements were sufficient, you asked me to put forward a proposal to address the matters highlighted.

Any drafting suggestions you might have would of course be welcome.

This new provision is designed specifically to address the increased incentive for tax planning which would arise were your proposed new nominal system of taxing capital gains to be adopted.

The need for these rules has been amply demonstrated in the evidence provided to the senate inquiry, which briefly examined some of your business tax proposals. I am sure you are aware of the testimony provided by some of Australia's leading

tax academics, confirming the risks of revenue leakage contained in your current proposals.

I disagree with the sentiments expressed at page 243 of the Ralph Committee Report which states, in the context of the proposed capital gains tax changes:

“The Review endorses the existing practice of not employing the GAAR where certain taxpayer or market behaviour is an acceptable outcome of the tax law’s structure.”

This seems to recommend not employing the GAAR to schemes that would exploit tax arbitrage possibilities. Labor does not support such a recommendation.

I was also very disturbed to hear of evidence before the Committee from senior Taxation Office officials that it is “unclear” if the proposed new GAAR would apply to such arrangements. Again, this is totally unacceptable to the Opposition.

Similarly, I am also concerned about the views of some witnesses before the Senate inquiry concerning the possible abuse of the scrip for scrip rollover proposals.

The anti-avoidance measure I have proposed, will not on its own fill the revenue hole that has been highlighted in the Senate’s report on the current round of legislation. However, it is a necessary tool to ensure that the revenue is not put at serious risk due to your CGT proposals.

As you will understand from the preceding discussion, Labor is essentially seeking to ensure that the government sticks to all of its commitments on business tax reform.

To summarise, we are seeking:

- *Details on the measures not yet before the Parliament, particularly the revenue raising measures, as a level that allows us to reasonably conclude that their stated intentions will be achieved. This would ideally be in the form of draft legislation.*
- *An absolute and public guarantee that these measures, when the details are known, will be implemented in full.*
- *Support for Labor’s proposed integrity measure or some mutually agreed version which achieves the same objective.*

I would be happy to discuss these matters with you in order to progress business tax reform in Australia.

Yours sincerely

SIMON CREAN

After further discussion between the Deputy Leader of the Opposition and the Treasurer, the Treasurer signed the following letter dated 24 November 1999, agreeing to the Deputy Leader's conditions for passage of the legislation:

Dear Mr Crean

Thank you for your letter of 24 November 1999 in which you state that if we can get agreement on three points, the Opposition will pass the Government's business tax reform package.

We agree to the three points.

1. *Details on the measures not yet before Parliament are set out in the attachments.*

I expect legislation containing measures dealing with alienation of personal services income, and non-commercial losses, will be available early next year. The Government proposes to pass it prior to 30 June 2000. As I have indicated to you, I expect legislation on trusts to be prepared by 30 June next year and legislated in time to apply from 1 July 2001.

2. *The Government will introduce all the business tax changes announced in full.*
3. *I have received advice from the Australian Taxation Office that your proposed integrity measure would not add to the Government's proposed strengthening of Part IVA. Having said that, if it were re-drafted in a workable form, it would not detract from it either. If the Labor Party indicates its agreement to pass the Government legislation in the Senate, the Government would include this clause if you want it. It is your election.*

I am also enclosing copies of the two Bills which will be introduced into the Parliament tomorrow. These Bills provide incentives for investment in venture capital by non-resident tax-exempt super funds, streamline and extend small business CGT rollover relief provisions, provide scrip for scrip rollover relief and remove CGT averaging for individuals.

Since the Government has agreed to your three conditions, I look forward to your written confirmation that the Opposition will vote for the package in full.

Please confirm this as a matter of urgency.

Yours sincerely

PETER COSTELLO

The Deputy Opposition Leader provided the written confirmation the Treasurer had requested in another letter dated 24 November 1999:

Dear Treasurer

Thank you for your letter of 24 November 1999 in which you, on behalf of the government, accept all of the conditions set by Labor for passage of the business tax legislation.

As I spelled out in my letter to you and in the House today, acceptance of these conditions is essential to the achievement of revenue neutrality, the key condition set by Labor for passage of these business tax proposals.

I reiterate that Labor would not have designed the same package as the one before us, and restate our concerns about individual elements of the package outlined in the recent report of the Senate inquiry into the business tax legislation.

Nevertheless, I welcome your personal guarantee that the government will deliver, in full, all the business tax changes announced, recognising that any slippage on these measures in the future could expose the government in terms of its commitment to maintaining the integrity of the tax system.

I also note the detail you have provided on the measures not yet before the Parliament and the significance of your statement in the House that these should be understood to constitute legislative drafting instructions.

Finally, I welcome your offer to bring forward an anti-avoidance measure that fully reflects the intention of the amendment moved by Labor earlier today.

On the basis of these commitments from the government, Labor can support the business tax legislation in the House and the Senate.

When the measures not yet before the Parliament are introduced as legislation, it is important that they include a certification by the Treasury/ATO that the revenue generated by the measures is consistent with the estimates provided in your statement of 11 November.

I look forward to the introduction of a tax package that is both revenue neutral and preserves the integrity of the tax base.

Yours sincerely

SIMON CREAN

The Treasurer produced an exposure draft of entity taxation legislation in October 2000. The exposure draft contained a concept not mentioned in the Treasurer's letter, it provided for different tax treatment for fixed

trusts compared to discretionary trusts. This would undoubtedly have had revenue implications but the exposure draft was not accompanied by an estimate of its effect on revenue.

The exposure draft met with substantial opposition from the National Party and from a number of members of the Liberal Party. On 27 February 2001 the Treasurer issued the following press release announcing that the Government would not proceed with the exposure draft:

ENTITY TAXATION

In October 2000 the Government released exposure draft legislation providing for the taxation of trusts like companies.

Following the release of the exposure draft legislation, the Government received a great number of submissions which raised technical problems particularly in relation to distinguishing the source of different distributions, and valuation and compliance issues that meant that the draft legislation is not workable.

The Government has also taken advice from the Board of Taxation which recommended that the Bill not proceed and suggested looking at alternative approaches.

As a consequence the Government is withdrawing the draft legislation and will not be legislating it. It will begin a new round of consultations on principles which can protect legitimate small business and farming arrangements whilst addressing any tax abuse in the trust area. The Board will be part of consultation.

Claims that the cost to revenue of this decision amount to \$1 billion are false. A New Tax System policy statement costed this measure in conjunction with revenue bring forward under PAYG which has already been introduced and on a 36 per cent tax rate. Stripping out PAYG which has been introduced and allowing for a reduced tax rate at 30 per cent (as will apply from 1 July 2001), the cost of this decision in the full financial year 2001-2002 is of the order of \$110 million. [Peter Costello, Treasurer, Entity Taxation, press release, 27 February 2000]

However, in the Budget that was handed down on 22 May 2001, the Government revealed that:

...the withdrawal of the entity tax exposure draft legislation—in response to concerns raised in public consultations that the existing draft legislation did not strike an appropriate balance between protecting legitimate small business and farming arrangements while addressing tax abuse in the trust area (estimated to cost \$1.1 billion over the four years from 2001-02).

[Budget Paper No.1; Budget Strategy and Outlook, 2001-02; Statement 5—Revenue, page 5-5]

In his speech responding to the budget at the National Press Club, on the 30th of May 2001, the Shadow Treasurer again offered bipartisan support on measures to address tax abuse using trusts, he said:

Why can't we agree to work together to ensure that everyone pays their fair share of tax? That's the view that drove my thinking on the business tax debate, where we offered and delivered bipartisan support. It would have been the easiest thing in the world to play politics on the issue, but I took the view that we could only achieve a genuine and lasting crackdown on tax avoidance and provide investment certainty for business, if both the government and the alternative government agreed on the measures that had to be taken.

In answer to a question after the speech, asking for elaboration on the Opposition's attitude to dealing with tax abuse using trusts, the Shadow Treasurer said:

We signed an agreement with the Government. And we will honour that agreement...we have honoured that agreement, because we delivered on it and voted for it in the Parliament. Forget all these scare campaigns that people go on with, we voted to lower tax rates, but it's part of the comprehensive package by which we got bipartisan support to crack down on tax avoidance. Why? Because the GST constraint said that whatever we did on business tax had to be revenue neutral. Not just us saying it, the Government adopted that and so did the business community. The most effective way in which you could give relief and pay for it in the revenue neutrality context, was to make people pay their fair share. And we said that we were prepared to sit with the Government and work out the most effective means by which we could crack down on the tax avoidance. We thought that the Treasurer would slither out of his commitments but he's on the record now as having written the letter to me saying that they would deliver them in full. He hasn't delivered them in full. But I note he still says he intends to introduce them. I think the question of trusts and the crackdown of them can only be done in bipartisan way. And that's why I was prepared to offer that support from Opposition to the Government to meet it. It may be in the circumstances that genuine people do get hurt. That's why we offered when we saw the Treasurer slithering away from this commitment, we offered to actually sit down and protect the genuine farms and small businesses that were going to be hurt. Did we get a response from the Treasurer? No. Was not even prepared to sit down with us and talk the issue through. So I still think bipartisanship is necessary and I don't think this can be done without bipartisan support. But we do know that this Government in Government has signed up to an agreement and we would like to test that in Government. And I note also that the Treasurer still has the intention to introduce this legislation down the track, only not just now. So we will deal with this issue in the way I've outlined in the speech. It can only be implemented in a bipartisan way and we will offer that bipartisanship to the

Opposition were we to become the Government. We would also sit down with the interested stakeholders to make sure that genuine cases were properly accounted for.

Official Estimates of the Revenue Available from Taxation of Trusts

Since the ATO identified that there was a major issue with HWIs using trusts to reduce their tax burden, the ATO and Treasury have made a number of estimates of the revenue involved.

In January 1996, the ATO's first estimate based on an analysis of 100 wealthy individuals alone was \$500 million. This was subsequently increased verbally to \$800 million by Treasury in the same month and confirmed by Treasury in writing in February 1996. That advice suggested that if prompt action had been taken it would have been possible to obtain a small amount of additional revenue in 1996-97 and the first full year effect in 1997-98.

After the 1996 change of government, no legislative changes were made but the HWI Taskforce was set up in May 1996 with an expectation that it would increase revenue by \$100 million per year.

No proposals for legislative action were forthcoming until August 1998, when the Coalition Government needed additional revenue to fund tax cuts as part of its New Tax System package of proposals. At that time the ANTS document revealed that there was still a major revenue issue with the tax treatment of trusts that needed to be addressed by legislation, and it remained a similar dimension to the problem identified by the ATO almost three years before.

The Review of Business Taxation, released in July 1999, revealed that the revenue available from taxing trusts as companies was still of that order of magnitude.

Official Estimates of Revenue Available from Trusts with Entity Taxation Measures

	99/00	00/01	01/02	02/03	03/04	04/05
Original ANTS 1998	\$70m	\$900m	\$760m	\$430m		
Ralph Report 1999—36% company rate	\$70m	\$830m	\$930m	\$520m	\$600m	\$620m
Ralph Report 1999—reducing 36/34/30% company tax rate	\$70m	\$730m	\$500m	\$370m	\$390m	\$410m

[*Tax Reform: not a new tax, a new tax system*, August 1998; *Review of Business Taxation* July 1999]

When the Treasurer abandoned his entity tax exposure draft legislation measures on 27 February 2001, he said; “...*the cost of this decision in the full financial year 2001-2002 is of the order of \$110 million.*” [Peter Costello, Treasurer, *Entity Taxation*, Press Release, 27 February 2001]

However, in the Budget handed down on 22 May 2001, it was revealed that the cost of this measure was estimated at \$1.1 billion over the four years from 2001-02.

Comment

When the Government needed funds to pay for tax cuts, it was prepared to accept the official estimates of the revenue that would be forthcoming from entity taxation measures. However, having obtained the political benefit from providing those tax cuts, and now having failed to legislate for the promised measures to pay for those tax cuts, the Treasurer tried to have the public believe that the cost of failing to pass that legislation was only \$110 million. That was not a credible estimate of the cost to revenue. The 2001 Budget papers subsequently revealed another estimate of the cost to revenue of \$1.1 billion over four years.

Trusts—the Most Significant Area of Tax Planning by HWIs

The Auditor-General set out what the HWI Taskforce had found to be the main area of tax planning activity:

On the basis of evidence gathered by the Taskforce to date, the Taskforce considers that the most significant systemic generators of tax planning by HWIs are the use of trusts and related party or intragroup transactions. The ATO expects that the Government’s proposed business tax reforms, including the taxation of trusts through the new entity tax system will address the major deficiencies in the current tax system. [ANAO Report No.46, 1999-2000, page 58]

During the JCPAA public hearing on Audit Report no 46, *High Wealth Individuals Taskforce*, Mr Cox asked: “*Can you confirm that this is the ATO’s view?*”

Mr Fitzpatrick (ATO)—*The ATO expects that some of the tax planning arrangements of some high wealth individuals will be addressed by the proposed reforms to the taxation of trusts and also by the proposed reforms - or, in some cases, already enacted reforms - to intragroup arrangements involving losses. The parliament has already enacted some measures concerning the creation and duplication of losses. In our view, those so-called integrity measures will have an impact on the arrangements entered into by taxpayers, including some high*

wealth individuals. *The proposed consolidation regime is another foreshadowed reform which, in our view, will have some impact on the tax planning arrangements we have identified.*

Mr Cox—*But the new entity tax system has not been legislated yet, has it?*

Mr Fitzpatrick—*No, that is correct. I think the draft legislation is presently out for consultation, and the government has announced the proposed reform of the taxation of trusts from 1 July next year.* [Transcript, 3 November 2000, page 92]

Size and complexity

The Auditor-General noted that the HWI Taskforce has 500 individuals on its list, including some individuals considered to be emerging or potential HWIs. To the end of March 2000, the Taskforce had examined 236 HWIs in depth and found that for 1997-98, the latest year for which a full set of tax assessments was available:

- These 236 HWIs were associated with a total of 7771 entities, including some 2171 trusts (comprising 1116 discretionary trusts, 667 fixed trusts, 31 charitable trusts and 357 where the trust type was unknown);
- 71 of these HWIs were associated with 10 or more trusts;
- on average, each of these 236 HWIs was associated with some 33 entities, including 22 companies, nine trusts and one partnership;
- average group total assets for these HWIs were over \$270 million; average group net assets were over \$110 million;
- on average, in the 1997-98 year the total tax paid by each HWI and the associated group of entities was \$1.475 million;
- 60 per cent of these HWIs returned taxable income of less than \$198 000 each in the 1997-98 financial year;
- 60 per cent of these HWIs each paid less than \$40 800 tax in the 1997-98 year;
- average tax paid as a percentage of HWI taxable income was 20 per cent;
- average tax paid by these HWIs has increased by 36 per cent from 1995 to 1998;
- 60 per cent of the groups of entities associated with these HWIs paid less than \$530 000 in tax for the group in the 1997-98 year;
- average tax paid as a percentage of group net income was 13 per cent;
- average tax paid by the groups of entities associated with these HWIs has increased by nearly 49 per cent from 1995 to 1998; and

- as at 30 June 1998, the total carried forward losses of these 236 HWI groups was \$2.7 billion, comprising \$1.7 billion in revenue losses and \$1 billion in capital losses.

Revenue at Risk

On the issue of the amount of revenue at risk, the Auditor-General said:

“When the present Government came to office in 1996, it was advised by the Treasury and the ATO of the potential impact on revenue of continuation of the tax planning and minimisation practices utilised by some HWI taxpayers. A figure of \$800 million per year, as had been disclosed by the previous Government, for revenue potentially at risk through HWI’s application of tax planning practices, had been derived as an order of magnitude estimate arising from the ATO’s initial investigation of the HWI taxpayer population mentioned at paragraph 1.2.” (This appears to refer to the same advice given to the previous government.)

“Advice to the incoming Government was that \$800 million did not represent additional revenue that could be gained from HWI taxpayers solely through application of compliance action by the ATO. The Treasury and the ATO advised the Government that the figure of \$800 million should be seen as revenue potentially at risk of being lost if no legislative action was taken against the range of tax planning and minimisation practices employed by some HWIs.” [ANAO paras. 1.8, 1.9; page 19]

At the public hearing, Mr Cox asked the ANAO: *“Did the Audit Office make an independent assessment of the revenue being lost or at risk from the activities of high wealth individuals?”*

Mr White (ANAO)—*No, we did not.*

Mr Cox—*Did you look at the advice to the previous government about the \$800 million and did you find any reason to dispute that advice?*

Mr Roe (ATO)—*Yes, we looked at the advice that was provided, and no, there was not anything to suggest that it was different from the way we reported.* [Transcript, 3 November 2000, pages 90 and 91]

At the same public hearing, Mr Kelvin Thomson asked the ATO: *“It is a highly relevant question as to what has become of the \$800 million and the \$700 million gap between what was said at the start of 1996 and what was subsequently reported as to whether the measures that are outlined here and to which you have referred have been able to generate or save the \$700 million. So my query is: do you have some feel for that?”*

Mr Fitzpatrick (ATO)—*Certainly the measures outlined here, and I have referred to previously, will have an impact on the revenue which we estimated to be at risk in respect of some high wealth individuals arrangements. From our experience it is clear that some of those taxpayers will look for other opportunities on an ongoing basis. We need to be alert to those as best we can to address whatever new opportunities arise, and that is certainly a clear focus of our intention at the moment.*

Mr Thomson—*It is not particularly satisfying to me for you to respond that it will have an impact and for me or others not to be able to get any feel for the quantum of the impact, the dimension of it, whether it goes to the \$700 million gap or it does not. I might direct the same question to Mr White from the ANAO in terms of the Audit Office investigation of this area, whether you then get from this some suggestion as to whether these legislative measures have been effective in recovering the \$800 million or whether they have not.*

Mr White (ANAO)—*Our report in discussing the \$800 million makes it clear from the information we saw from the Tax Office that the \$800 million is an order of magnitude estimate of revenue that could be gained from both audit activity but also from various legislative changes if they were to occur. What we did as part of—*

Mr Cox—*Whether it occurred in the last five years, yes.*

Mr White (ANAO)—*What we did as part of the audit was to specifically look at the direct and indirect revenue measures that the government required for the additional funding, the outcomes, and we reported back on that. We commented in the audit report that the Taskforce had contributed to various legislative changes. We were unable to quantify a financial amount in terms of the legislative changes, the impact thereof. I think it would be a fairly difficult thing to do.*

Mr Thomson—*Nevertheless, one of considerable public interest as to whether the \$800 million has been addressed or whether it has disappeared and the high wealth individuals are still not paying their fair share of tax. In the legislative changes which are proposed here, there is the reference to entity taxation and, as David Cox mentioned, this legislation has not yet been passed. It stands to reason, doesn't it, that the delay in entity taxation must be costing the revenue money, given that it is identified as a way of addressing tax avoidance.*

Mr Fitzpatrick (ATO)—*To the extent to which high wealth individuals or other taxpayers use trusts to minimise tax, that would be correct. [Transcript, 3 November 2000, pages 98–99]*

Advice to Government by HWI Taskforce

On this issue, Mr Cox asked the ANAO at the public hearing: *"Did the Audit Office look at the specific advice that the Taskforce had given to the government in relation to the need for tax reform and legislative change?"*

Mr Roe (ANAO)—*We looked at a number of submissions that were made by the Taskforce which were then coordinated through the tax office to Treasury. We did not itemise those and check them against changes that were made. But, yes, we saw evidence of advice that was being provided on an ongoing basis.*

Mr Cox—*And it was a substantial volume of advice?*

Mr Roe (ANAO)—*It was.* [Transcript, 3 November 2000, page 91]

Mr Cox then asked the ATO whether it had given advice about the need for changes to legislation in areas where it had had to resort to use of the general anti-avoidance provisions.

Mr Fitzpatrick (ATO) responded: *"We have advised the government, as is noted in the report and in our annual report, on areas of the law where we believe that people are able to minimise tax—some quite legally, certainly. We have attempted to identify the systemic drivers of tax planning, looking for systemic approaches to addressing some of these practices through legislative change—not piecemeal, ad hoc changes to the law. That is not, in my view, the way to go in order to develop a more certain tax code which is more understandable for taxpayers generally. We have looked at the tax planning practices over the period of time and, as the Auditor-General's report notes, at the systemic areas of weaknesses in the law and provided advice accordingly. It is for government and the Parliament to decide whether it wishes to change the law to remedy what we see as areas where taxpayers are able to minimise tax - as I said, some quite legally.*

Mr Cox—*At the moment there are a number of outstanding areas where you have submitted advice to government and it has not been acted on yet?*

Mr Fitzpatrick (ATO)—*We have provided advice to government over a period of time. The Government has announced changes to law and the Parliament has passed changes to law in respect of some of that advice. It has foreshadowed reforms arising out of the Ralph Review of business tax. Some of those measures have been enacted. I mentioned before those loss integrity measures in particular. Others have been foreshadowed by government.*

Mr Cox—*Or deferred.*

CHAIRMAN—*Has it ever been any different from that?*

Mr Fitzpatrick (ATO)—*In general terms, no.*

Mr Cox—the issue is whether there is a significant volume of advice going from the tax office to the government that the government is choosing not to pursue, and whether a substantial amount of revenue is being put at risk or remains in jeopardy because of that lack of action.

CHAIRMAN—*May I suggest you ask the Treasurer that.* [Transcript, 3 November 2000, page 95]

Comment

The ANAO found that there was significant revenue at risk, of an order of magnitude of around \$800 million, as a result of the tax planning arrangements of HWIs. Addressing that issue requires legislation as well as audit activity by the ATO. Legislation needs to address the systemic drivers of unacceptable tax planning arrangements, entity taxation measures for trusts have clearly been identified as a major area for urgent attention. The ATO has provided a large amount of advice on possible legislative action over a long period. Some major pieces of legislation identified as necessary to address these issue, have still not been put before the Parliament. After more than five years of inaction revenue previously considered potentially at risk is being lost.

Recommendation

We recommend that:

1. The Government recognise the necessity for bipartisan support for measures to deal with tax abuse in the trust area;
2. The Government open discussions with the Opposition on measures to address tax abuse in the trust area which protect legitimate small business and farming arrangements; and
3. The Government honour the Treasurer's agreement of 24 November 1999 to legislate to address any tax abuse in the trust area.

David Cox

Julia Gillard

Kelvin Thomson

7 August 2001