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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.

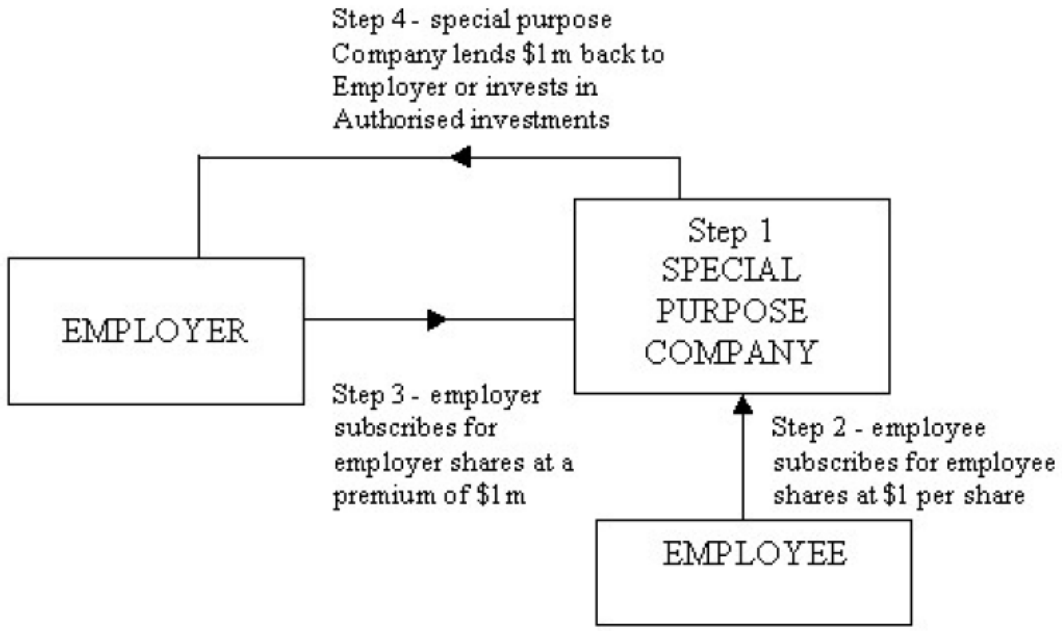
33 Senate Economics References Committee, *Inquiry into Mass Marketed Effective Schemes and Investor Protection, Interim Report* (2001) p 2.

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.