5

Compliance

Promoting compliance

The ATO's compliance model

5.1 One of the key roles of the Australian Taxation Office (ATO) is to manage taxpayer compliance. If taxpayers are more willing to pay the tax that is lawfully due, and if taxpayers dispute their assessments less, the ATO's task will be much easier, and it will be a more efficient agency able to collect each dollar of tax using fewer resources. Self-evidently, the higher the compliance the lower the cost of collection and the lower the cost of the tax burden, since at present tax-compliers have to carry the burden of non-compliers.

5.2 While giving evidence at the initial biannual meeting on 20 April 2007, the Commissioner of Taxation advised the Committee that the most important factor in securing revenue is maintaining a culture of voluntary compliance:

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

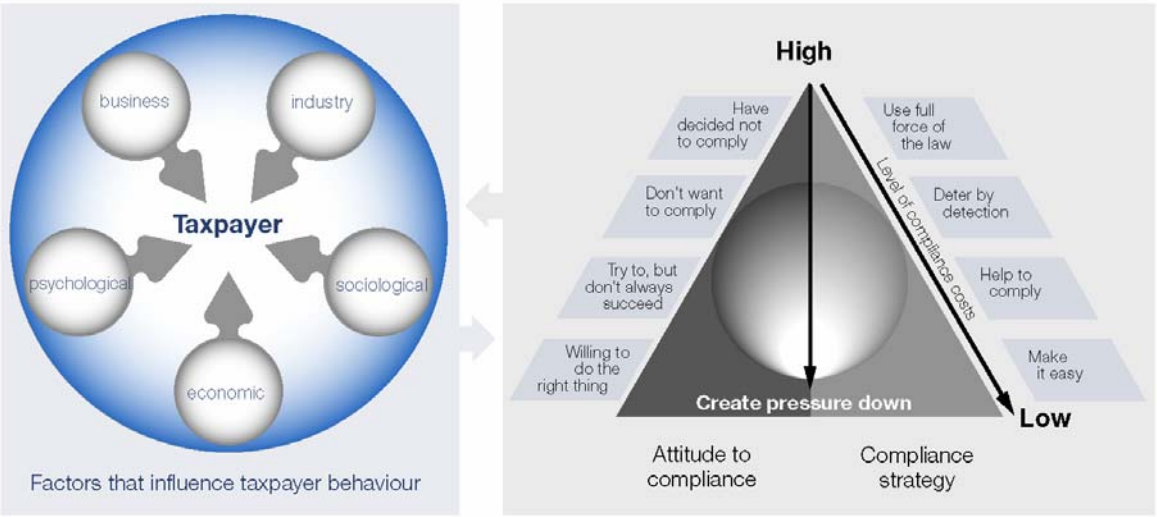
> does have, at the end of it, a very important role in trying to ensure that we support honest taxpayers by having effective deterrent strategies.[1]

5.3 The Ombudsman agreed with the Commissioner:

> In a self-assessment environment, voluntary compliance is a vital component. While this depends in part on the taxpaying community having confidence in the ATO, it also rests in large measure upon the taxpayer community being aware of its obligations, and deciding to engage in lawful, ethical and compliant behaviour. In my view, education and deterrence by the ATO have significant roles in facilitating such outcomes.[2]

5.4 The ATO manages these interactions through its compliance model, reproduced in figure 5.1:

Figure 5.1 ATO's compliance model



Source *ATO, 'Compliance model' viewed at http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm on 15 August 2007.*

5.5 The compliance model has a number of components. Firstly, it recognises that taxpayers' conduct is influenced by a number of factors, including their financial situation and the views of their peers. Further, taxpayers' attitudes lie on a continuum between wanting to do the right thing and deciding not to comply. In effect, the ATO assesses a taxpayer's particular attitude and uses this to develop a compliance strategy for that taxpayer. For compliant taxpayers, the ATO advised that it takes a cooperative,

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

2 Commonwealth Ombudsman, sub 38, p 5.

educational approach. For non-compliant taxpayers, the ATO uses legal action and investigation.[3]

5.6 An assumption in the model is that the ATO can influence taxpayer behaviour through its actions. One example of this occurring is Project Wickenby, where the ATO and other agencies are investigating the transfer of funds out of Australia to illegally evade tax. Media reports suggest that Australians are less likely to shift money offshore now that Wickenby is well established.[4] The Commissioner has reported that two offshore structures involving nearly $100 million have been abandoned.[5]

5.7 The two sides of the compliance model, assistance and deterrence, complement each other. The ATO helps compliant taxpayers and these taxpayers draw comfort that non-compliant taxpayers are subject to investigation and legal action. Compliance action also deters compliant taxpayers from reducing their compliance standards. The Commissioner stated in evidence:

> We use a lot of resources for what might sound like a big dollar return [with non-compliant taxpayers], but the big dollar return comes from taxpayers doing the right thing and paying their tax and that revenue coming into the system. A role for us which is just as important is to protect those taxpayers by saying, 'For those people who try to put you at a disadvantage, there is some level of accountability through some sensible programs that can be done.' The other side of it is acknowledging that you have so many people who do want to do the right thing. That means that we need to ensure we invest very heavily in making it as easy as possible for people to comply.[6]

5.8 In its submission, the Australian Taxation Office (ATO) stated that all but $4.2 billion of $214.9 billion received in 2004-05 was voluntarily paid.[7] In other words, 98% of tax receipts are paid voluntarily. This statistic confirms the Commissioner's evidence that, not only is voluntary compliance important, but it exists at high levels and needs to be maintained. Having said that, the Committee is aware that it would be very resource intensive and intrusive on compliant taxpayers to develop a

3 ATO, 'Compliance model' viewed on 15 August 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm.

4 Drummond M, 'Tax havens thrive despite crackdown' *Australian Financial Review* 16 August 2007, p 61.

5 O'Toole C, 'Tax chief says blitz is paying off' *Australian Financial Review* 24 August 2007, p 32.

6 D'Ascenzo M, transcript, 22 June 2006, p 17.

7 ATO, sub 50, p 1.

robust estimate of how much uncollected tax is legally due, particularly in the cash economy.[8]

5.9 The Committee regards the compliance model as a key instrument in the ATO's management of the tax system. Further, the model appears fair because the ATO adjusts its response to a taxpayer's conduct. For most taxpayers, it directs the ATO to assist and educate them. As the Ombudsman stated:

> This approach appears fair and effective, and balances the needs of the individual against those of the community as a whole.[9]

5.10 Comments about the model concerned whether the ATO was fully implementing it, rather than about the model itself.[10] The Committee supports the model and believes it will continue to play a major role in the ATO's work in future.

The role of tax agents

5.11 Tax agents play a number of important roles in the tax system. Firstly, as the Inspector-General of Taxation stated, they help taxpayers comply with a complex tax system and act as an initial check on tax returns. This makes the ATO's task much easier:

> The self-assessment system relies heavily on tax agents. Tax agents are in a sense an unofficial but professional replacement for the pre-assessment processes that the ATO undertook under the old system as previously mentioned. Taxpayers confronted with complex laws in a self-assessment system have, in practical terms, nowhere else to go for help in meeting their obligations.[11]

5.12 Secondly, a professional, educated tax agent is likely to advise taxpayers to comply with the law. This boosts compliance, once again making the ATO's task easier. The Commissioner stated in evidence:

> I start from the proposition that tax agents have been a very positive influence on tax compliance. I think that the tax office helping tax agents and supporting them does allow us to touch

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

9 Commonwealth Ombudsman, sub 38, p 7.

10 See for example the Inspector-General of Taxation's concerns about the ATO using a 'one size fits all' approach to investors in mass-marketed investment schemes, Inspector-General of Taxation, sub 48, p 12.

11 Inspector-General of Taxation, sub 48, p 9.

> many more taxpayers than we could otherwise do on an individual basis.[12]

5.13 To some extent, this compliance role places tax agents under commercial pressure. The Committee received evidence that some taxpayers expect their tax agent to reduce their tax bill regardless of the legality. They also compare the performance of each other's agent in this respect. One tax agent, Ian McKenzie, advised the Committee:

> Taxpayers talk to each other out on the street and could think: 'If Joe Bloggs can do this, how come I can't do that?' I quite often explain to the taxpayer that you are comparing apples with oranges. But there are taxpayers who deliberately seek out tax agents who will deliberately put some so-called illegal entries into the tax return, and they are comfortable with taking that risk. What I am saying is that there are taxpayers out there who deliberately take risks to get a bigger refund or a larger deduction in their tax return.[13]

5.14 This agent gave an example of two taxpayers who requested him to make illegal deductions:

> They were receiving WorkCover income, which is income not from personal exertion. The prior tax agent had been claiming travel for them for going to the doctor and all of that. That travel was already reimbursed by the WorkCover Authority. I checked with the ATO and the relevant legislation and it is just not deductible. As a result, I lost those clients.[14]

5.15 In this type of situation, a tax agent needs to balance long term and short term risks. If they agree to the taxpayer's request, they make extra income in the short term, but face the long term risk of audit by the ATO and losing their livelihood. Generally, the Committee expects that the accreditation processes for tax agents would ensure that tax agents are of sufficient calibre to resist such temptations. Professional associations expect the same of their members.[15] The ATO takes a similar view:

> We recognise that tax agents have a commercial relationship with their clients; however we expect them to act in a professional

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12 D'Ascenzo M, transcript, 22 June 2006, p 19.

13 McKenzie I, transcript, 28 July 2006, p 46.

14 Id, p 47.

15 Anderson F, 'Tax agents told to ditch dodgy clients' *Australian Financial Review*, 10 October 2007, p 17.

> manner, competently having regard to the law and to comply with their personal tax obligations.
>
> In terms of their role as agents for their clients we risk assess tax agent client bases to identify situations where there is a high potential for making common mistakes or inaccurate claims that are outside occupational or industry norms.[16]

5.16 Mr McKenzie suggested to the Committee that both tax agents and their clients are responsible for the accuracy of a tax return.[17] The Committee agrees with this view. If an agent prepares a return that they know to be wrong, they need to bear some responsibility for this. Alternatively, tax agents should not be responsible if a client is not truthful with them, despite reasonable inquiries by the tax agent.

Litigation

Essenbourne – the facts

5.17 The key litigation issue during the inquiry has concerned the ATO's response to the December 2002 decision of the Federal Court (single judge) in *Essenbourne v Commissioner of Taxation*.[18] This case involved an employee benefit arrangement where a family business (Essenbourne) transferred $252,000 to an employee incentive trust. The three brothers who worked for the business each received 84,000 units (value $1) in the trust. The amount was calculated with reference to the superannuation regulations and the business's profits. The brothers could receive payments from the trust at request and they had control over how the trust would invest the funds.[19]

5.18 The business claimed the $252,000 as a tax deduction. The ATO responded by disallowing the deduction and levying fringe benefits tax on Essenbourne as well.[20]

5.19 Justice Kiefel[21] agreed with the ATO on the deduction. She concluded it was made from the business's surplus profits, rather than being part of its

16 ATO, sub 50, p 38.
17 McKenzie I, transcript, 28 July 2006, p 48.
18 [2002] FCA 1577.
19 Id, paras 5, 11.
20 Id, paras 6, 7.
21 Now a High Court Justice.

income producing activities.[22] However, Justice Kiefel decided the payment was not subject to fringe benefits tax. Her reasoning was that the legislation requires that the payment be connected to a particular employee in relation to the benefit in question. Due the structure of the trust, the ATO could not make such a connection at the time of the payment.[23]

5.20 In practice, the ATO did not follow *Essenbourne*. In its media release of 14 March 2003, the ATO stated:

> … the Tax Office will look to testing its views on fringe benefits tax and the application of the anti-avoidance provisions to these types of arrangements in future court cases.[24]

5.21 If the ATO was not satisfied with the result in a particular case, one approach would be to appeal it to a higher court. In the media release, the ATO said that it did not appeal *Essenbourne* because it won the case on the point of the income tax deduction.

5.22 The ATO sought to challenge *Essenbourne* in future cases. In *Walstern v Commissioner of Taxation*, Hill J stated that Justice Kiefel was 'clearly right.' He also raised the principle of judicial comity, in which judges follow the decisions of judges at the same level unless the original decision is clearly wrong.[25] The reason behind this is it increases certainty in the law and, in effect, is a 'weak' system of precedent.

5.23 A number of other cases concerning similar facts also raised the principle of judicial comity and the ATO lost these on the point of fringe benefits tax. What characterised these cases was the ATO did not take them beyond a single judge in the Federal Court. The ATO's reasons for this are that it was:

> … not able to appeal from the observations in *Essenbourne* in view of the finding on the facts on the income tax case. In *Walstern* the relevant observations were obiter and there was no order against which the Commissioner could appeal. In *Caelli* the Court determined the FBT appeal in the Commissioner's favour 'on the assumption' of the correctness of *Essenbourne* and there was no order against which the Commissioner could appeal. The Commissioner has appealed the *Essenbourne* construction in each

22 *Essenbourne v Commissioner of Taxation* [2002] FCA 1577, para 36.

23 Id, paras 54, 56.

24 ATO, 'Employee benefit arrangements,' Media release Nat 03/30, viewed on 20 August 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/mr2003030.htm.

25 [2003] FCA 1428, para 87.

> of the three cases in which he has been able, being *Spotlight Stores* (where the Full Court did not determine the issue), *Cameron Brae* (the appeal is yet to be heard) and this case [*Indooroopilly*].[26]

5.24 One case that the ATO did take to the Full Federal Court was *Pridecraft v Commissioner of Taxation* in December 2004. The ATO did raise the fringe benefits tax question in that case, but did so only on the condition that the taxpayer in question did not receive a deduction for the payment to the trust. In other words, it only raised fringe benefits tax if it lost on the income tax question. The judge stated:

> The Commissioner's submissions indicated that it was only necessary to decide its appeal from the primary Judge's holding that Spotlight was not liable to pay fringe benefits tax on the contribution of $15 million to the Incentive Trust if the contribution was held to be an allowable deduction. It is therefore not necessary to deal with this appeal.
>
> A further reason for not dealing with the fringe benefits tax question is that the Commissioner challenged the correctness of the decision of Kiefel J in *Essenbourne* … and the reasoning of Hill J in *Walstern* … It is undesirable to consider whether those cases were correctly decided when it is not necessary to do so.[27]

5.25 The ATO obtained a decision on fringe benefits tax from the Full Federal Court (three judges) in February 2007. In *Commissioner of Taxation v Indooroopilly Childrens Services*,[28] the Court found in favour of the taxpayer on the fringe benefits tax issue.[29] The Court also expressed concern about how the ATO managed the litigation in the case. Instead of selecting other test cases, they viewed the ATO's options as:

- appealing *Essenbourne* (in 2002)
- following *Essenbourne*
- seeking legislative change
- seeking a declaration (an administrative law remedy) from the Full Federal Court as to the proper construction of the legislation.[30]

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26 *Commissioner of Taxation v Indooroopilly* [2007] FCAFC 16, para 45.

27 Sackville J, [2004] FCAFC 339, paras 111-12.

28 The ATO funded *Indooroopilly* from its test case program.

29 Edmonds J, [2007] FCAFC 16, paras 35-39.

30 Id, paras 3-7, 44-47.

5.26 Further, the Court stated that the ATO's conduct raised constitutional issues:

> From the material that was put to the Full Court, it was open to conclude that the appellant was administering the relevant revenue statute in a way known to be contrary to how this Court had declared the meaning of that statute. Thus, taxpayers appeared to be in the position of seeing a superior court of record in the exercise of federal jurisdiction declaring the meaning and proper content of a law of the Parliament, but the executive branch of the government, in the form of the Australian Taxation Office, administering the statute in a manner contrary to the meaning and content as declared by the Court; that is, seeing the executive branch of government ignoring the views of the judicial branch of government in the administration of a law of the Parliament by the former. This should not have occurred.[31]

5.27 Following *Indooroopilly*, the ATO expressed interest in pursuing court declarations.[32] Aronson, Dyer and Groves define a court declaration as:

> … a declaratory order or judgement is simply a court's declaration or statement resolving a dispute over the law applicable to a situation in which the applicant has a sufficient interest. The order or judgement has almost no mandatory or restraining effect at all.[33]

5.28 Declarations, therefore, appear to be of most use when there is a dispute, but the party instigating the court action does not need a remedy that involves enforcement. It is of no use to an applicant which is trying to enforce the law against someone or an agency that is refusing to act legally. Further, courts generally refrain from issuing advisory opinions, so there must be an element of dispute involved. The value of a declaration is its procedural flexibility and scope.[34]

5.29 The ATO advised the Committee that it had received advice from the Solicitor-General that court declarations will not be suitable. The argument is that the ATO needs to issue a private ruling to initiate court proceedings in relation to a taxpayer. However, once the ATO has issued the ruling, the Commissioner is bound by it. The ATO cannot change its view of the law in relation to the taxpayer's affairs even if it wished to.

31 Id, para 3.

32 Kazi E, 'ATO drops aggressive legal tactics' *Australian Financial Review*, 6 March 2007, p 1.

33 Aronson M, Dyer B, Groves M, *Judicial Review of Administrative Action* (2004) Lawbook Co, 3rd Edition, p 782.

34 Id, pp 782, 788-89.

Hence, a court would be reluctant to issue a declaration when the ATO is legally barred from changing its actions in relation to that taxpayer. Making a declaration before the ATO issues a ruling would also fail because there would be no dispute.[35]

Essenbourne – analysis

5.30 There are two main ways by which to analyse the ATO's conduct in *Essenbourne*. The first is to use the advice from the Solicitor-General that the ATO received in December 2005 and January 2006. Although the ATO did not have access to this advice until well after *Essenbourne*, it helps assess the ATO's conduct, if only from the advantage of hindsight. The Solicitor-General's principles for litigating against precedent were that an agency should:

- put on notice all parties likely to be affected by the litigation
- only litigate against precedent where it has legal advice that a decision is wrong
- ensure the seniority, robustness and credibility of the legal advice matches the issue and the seniority of the court that made the decision in question
- fund a test case
- make any challenge 'as soon as possible' after the decision.[36]

5.31 The ATO complied with the first of these points and the fourth to some extent. It put out a press release stating its views in relation to *Essenbourne.* It funded *Indooroopilly* as a test case, but not some of the earlier cases after *Essenbourne*.[37] Further, the Committee assumes that the ATO obtained suitable legal advice. The remaining question is whether the ATO made its challenge as soon as possible after *Essenbourne*.

5.32 At first glance, this does not appear to be the case. The Full Federal Court decided *Indooroopilly* over four years after *Essenbourne*. In the view of the Committee, this is ample time in which the ATO could have brought a suitable test case.

5.33 A closer examination of the decisions also raises questions about whether the ATO placed sufficient priority on resolving this matter as soon as

35 First biannual meeting with the Commissioner of Taxation, ATO, sub 3, pp 14, 48-54.

36 Inspector-General of Taxation, *Review of Tax Office management of Part IVC litigation* (2006) Commonwealth of Australia, pp 249-50, 252-54.

37 Id, p 183.

possible. As noted earlier, the ATO publicly stated that it did not appeal *Essenbourne* because the Court affirmed the ATO's decision to render the scheme ineffective by disallowing the deduction. In *Pridecraft*, its submission to the Court stated that it did not wish to pursue the fringe benefits tax question if it won in relation to the tax deduction. These cases suggest that the ATO was placing a greater emphasis on securing a favourable outcome on fringe benefits tax, rather than resolving the matter in a timely way. The Solicitor-General's advice is clear that any challenge should occur 'as soon as possible.'

5.34 Therefore, with hindsight, it appears that the ATO did not meet the standards in this advice. As the Solicitor-General stated in subsequent advice in June 2007, 'a quicker test of the issue should probably have occurred.'[38] The ATO suggested to the Committee in April 2007 that its actions were consistent with the Solicitor-General's advice.[39] However, the later document from the Solicitor-General indicates this was not the case.

5.35 The second benchmark for the ATO's conduct is the list of options provided by the Full Federal Court in *Indooroopilly*. They suggested the ATO should have appealed *Essenbourne*, or followed *Essenbourne*, referred the issue to Treasury for legislation, or sought a court declaration on the matter (an administrative law remedy where a court declares the legal position on an issue). The ATO did not carry out any of these options. From the perspective of many taxpayers, the value in these suggested courses of action is that they would have led to a prompt resolution of the dispute. Once again there is an element of hindsight in comparing the ATO's conduct against these tests. However, they demonstrate that the ATO appears to have been trading off timeliness in administration against securing a favourable outcome on fringe benefits tax.

5.36 In explaining the principles of judicial comity, the judiciary has made it clear that they believe the benefits of certainty in the law outweigh the opportunity to reconsider a matter, unless they believe a previous decision was clearly wrong. One Federal Court judge has stated:

> The injunction to judicial comity does not merely advance mutual politeness as between judges of the same or co-ordinate jurisdictions. It tends also to uphold the authority of the courts and confidence in the law by the value it places upon consistency in judicial decision-making and mutual respect between judges.[40]

38 First biannual meeting with the Commissioner of Taxation, ATO, sub 3, p 58.

39 First biannual meeting with the Commissioner of Taxation, ATO, sub 1, p 15.

40 French J in *Hicks v Minister for Immigration and Multicultural and Indigenous Affairs* [2003] FCA 757, para 76.

5.37 In implementing the tax laws, the Committee believes that ATO needs to balance a number of priorities, including certainty, perceptions of fairness, and securing the revenue. Similar to the mass marketed investment schemes, the Committee is of the view that the ATO in *Essenbourne* and related cases has pursued the revenue above other considerations. This has damaged the reputation of the ATO.[41]

5.38 One consequence of the mass marketed investment schemes was Treasury's *Report on aspects of income tax self assessment* (RoSA), which led to a reduction in the Commissioner's discretion, in favour of taxpayers. The *David Jones Finance* case in 1990 (chapter three) led to rulings becoming legally binding on the Commissioner, which also reduced the ATO's discretion in favour of taxpayers. Similarly, *Essenbourne* has demonstrated another area in which the ATO could itself limit its discretion.

Essenbourne – conclusion

5.39 In 2006, the Inspector-General of Taxation finalised a report on how the ATO managed its litigation program. One consequence of the review is that the ATO now publishes decision impact statements after court decisions. Included in these statements is the ATO's decision, where appropriate, of whether it is likely to appeal the case or not.[42] The Committee welcomes this improvement in public administration, which will go some way to reducing taxpayer uncertainty from court cases.

5.40 During this review, the ATO obtained advice from the Solicitor-General on better practice in litigation. One item in the ATO's request was whether it needed to comply with the stricter views on precedent expressed by Justice McHugh in 2002 (when he was on the High Court). He stated:

> No doubt an Executive agency is entitled to disregard a decision where it is truly in conflict with another decision that it thinks is correct. It may sometimes also be justifiable to refuse to follow a decision that is the subject of appeal. But that has problems. Judicial decisions are not provisional rulings until confirmed by the ultimate appellate court in the system. Until set aside, they represent the law and should be followed. Moreover, the Executive can run into serious legal problems where it continues to enforce legislation that a court has ruled invalid. Even more difficult to justify is the refusal to follow a [court] ruling that is not

41 Kazi E, 'ATO drops aggressive legal tactics' *Australian Financial Review*, 6 March 2007, p 1.

42 Vos D, transcript, 9 November 2006, p 13.

> the subject of appeal merely because the agency regards it as wrong and will test it at the next opportunity.[43]

5.41 Without commenting directly on this quotation, the Solicitor-General suggested that the ATO could litigate against a decision it regards as wrong provided it met the various tests listed earlier. In other words, the Solicitor-General did not take as strict a view as Justice McHugh. The Court in *Indooroopilly* adopted the stricter line.

5.42 The courts use principles of precedent and judicial comity to increase certainty in the law at the cost of their individual discretion. Similarly, the Committee believes that the ATO should reduce the exercise of its discretion in administering its litigation program in the interests of certainty.

5.43 As Justice McHugh stated, a court decision represents the law and should be followed. The alternatives are those expressed by the Court in *Indooroopilly*. The ATO's role ends with administering the law. If a court makes a decision that the ATO regards as incorrect and it has exhausted all appeals, it is enough for the ATO to state its position publicly and refer the matter to Treasury. This way, the Courts and the Parliament are responsible for the law. This is consistent with constitutional and democratic principles.

Recommendation 11

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

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

Changes in ATO interpretations of the law

5.45 Similar to judicial changes in interpretation, the ATO may itself decide that its interpretation of the law is incorrect or may update its advice on

43 McHugh J, 'Tensions between the Executive and the Judiciary' (2002) Australian Bar Association Conference, quoted in Inspector-General of Taxation, *Review of Tax Office management of Part IVC litigation* (2006) Commonwealth of Australia, p 245.

how to comply with the law. An example of the former is agribusiness investment schemes. At the biannual meeting with the Commissioner on 20 April 2007, the ATO advised the Committee how it came to develop its new position on the law:

> What we have actually had is indications from the court—one by the Supreme Court in *Environ* and another one by the Federal Court in *Puzey*—to say that our view of the law was wrong…
>
> …it has taken some time. We then referred the matter to government because it was really a government issue of how it wanted these areas taxed. The government made its decision in relation to afforestation and decided that we should just test the law—it said it would not do anything in relation to agriculture or agribusiness. That left the tax office with views expressed by the judiciary that our previous view was not right. We have gone through an extensive process of trying to review our position. We think a better view now is that we were wrong. Therefore, we are trying now to have a test case to clarify that over the next 12 months.
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> Last week we issued a draft ruling reflecting that change of view.[44]

5.46 On 6 February 2007, the then Government announced that it would not extend the agribusiness tax concession to non-forestry schemes. The ATO's initial position was that the new legal position would apply from 1 July that year.[45] This led to significant movements in the share prices of some agribusiness firms.[46] After significant community concern, the ATO announced on 27 March 2007 that it would not apply its new view of the law until 1 July 2008.[47] In effect, it granted a 12 month transition period.

5.47 An example of the ATO updating its advice to taxpayers in relation to compliance is service entities. In the 1978 case of *Commissioner of Taxation v Phillips*,[48] the Full Federal Court dealt with a situation where a business set up a separate entity to provide administrative services to it. The service

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

45 The Hon P Dutton MP, Assistant Treasurer, 'Non-Forestry Managed Investment Schemes,' Media release, 6 February 2007, viewed on 19 May 2008 at http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2007/007.htm&pageID=003&min=pcd&Year=&DocType=0.

46 Whyte J, 'ATO takes axe to money trees,' *Australian Financial Review*, 8 February 2007, p 25.

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

48 (1978) 8 ATR 783.

entity was owned by the business owner's family and, by directing profits from the business to the entity, was a form of income splitting. The Court permitted the arrangement because the entity provided the services at commercial rates.[49]

5.48 In that case, the service entity used a mark up of 50% on the direct costs of the employees providing the administrative services. The ATO released a short ruling (IT 276) after *Phillips* where it accepted the result, but did not make reference to specific mark ups. The Inspector-General of Taxation has reported that the ATO's internal assessing manuals, publicly released in 1985, accepted the 50% benchmark on staff costs.[50]

5.49 In 2002, the ATO formally decided to address compliance issues related to service entities. It released draft guidance in 2005 and finalised it in 2006. In addition to other measures, the guidance limited the mark up on direct staff costs to 30%. The ATO announced that taxpayers had a 12-month period of grace in which to change their existing arrangements to meet the new standards.

5.50 In his report, the Inspector-General concluded that the ATO had changed its administrative practice. The ATO disagreed with this conclusion. The Committee does not wish to consider such matters of interpretation. What is important to note is the ATO gave taxpayers 12 months in which to comply with the new standards. The Committee believes that such periods of grace, when used appropriately, are fair on taxpayers.

5.51 The Committee accepts that the ATO may change its opinion of the law or may establish new benchmarks for complying with the law to accommodate changes in business practices. The Committee also believes that, once it has come to such a conclusion, the ATO needs to act promptly to satisfy taxpayers that it is enforcing the law. Firstly, this involves making a public announcement of its change of view. Secondly, the ATO may need to give taxpayers a period of time in which to change their affairs. Unless there are exceptional circumstances, such a period should be no longer than 12 months. This will be long enough for any adjustment, but any longer period would lead to doubts that the ATO is committed to enforcing the law. The length of the adjustment period will depend on the circumstances in each case and may need to be varied to take into account timing issues such as the end of the financial year.

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49 Cooper G et al, *Cooper Krever & Vann's Income Taxation: Commentary and Materials* (2005) Thomson, 5th Edition, pp 395-97.

50 Discussion drawn from Inspector-General of Taxation, *Review of Tax Office's management of complex issues – Case study on service entity arrangements* (2007) Commonwealth of Australia, pp 3-5.

5.52 Such a decision involves considerable discretion. The Committee is of the view that the ATO should develop a policy to ensure that these decisions are robust.

Recommendation 12

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

Managing non-compliance

Introduction

5.54 The management of non-compliance, such as through investigations and audits, is a sensitive area in tax administration. The Ombudsman advised the Committee that a large number of complaints involve compliance activities:

> The ATO's compliance activities are an area about which the Ombudsman's office receives a substantial number of complaints — generally over five hundred complaints each year (or about a third of all tax complaints). Most complaints relate to assessment, audit and recovery action.[51]

5.55 In examining the ATO's compliance activities, the Committee found that the most suitable benchmark is fairness. In some respects, this is not surprising. The ATO investigates and audits taxpayers, amends their assessments and takes some taxpayers to court. This is similar to police action and prosecution. Therefore, it is natural to apply principles of legal fairness to the ATO's compliance activities.

5.56 Earlier in the chapter, the Committee noted evidence that the main benefit of compliance work is it ensures that the proportion of compliant taxpayers remains high. Its secondary purpose is to raise revenue. The ATO advised the Committee that the return on compliance overall is $15 in revenue raised for every dollar spent on compliance work.[52]

51 Commonwealth Ombudsman, sub 38, p 5.

52 Granger J, D'Ascenzo M, transcript, 9 November 2006, pp 47-48.

Audit strategies

5.57 The ATO stated that it takes a risk-based approach to audit and investigation:

> … the way we select for audit activity is on the highest risk. The whole approach is to try and focus on outliers as a way of protecting the voluntary compliance of those who are doing the right thing.[53]

5.58 A large component of this work involves data collection and analysis. The ATO's submission stated:

> We verify compliance by reviewing high-risk cases and businesses with more complex arrangements. Our interactions with businesses range from checking claims by telephone and written requests through to intensive audits. Identifying high-risk cases involves matching large volumes of data to identify omitted transactions and businesses operating outside industry or economic norms.
>
> We use the same techniques to identify businesses that represent little or no risk to the revenue system so that we avoid intruding on their affairs unnecessarily.[54]

5.59 The Committee supports the ATO reducing its compliance focus on law abiding taxpayers. The Commissioner gave an example of a conversation he had with a newsagent that shows there are costs involved in exposing compliant taxpayers to investigations:

> I was in charge of the area that was looking at it at the time. He said to me: 'Your people audited me. They did a good job, they were very professional and I did not have a problem, but I am really dark on the tax office and I will remain dark forever on them.' When I asked why, he said, 'Because you audited me and I have been trying to do the right thing, but you did not audit the person across the street, who is a crook.' So there is a perception there that, if you just do randoms and you pick the wrong people, it actually reduces community confidence rather than increases it.[55]

53 Granger J, transcript, 9 November 2006, p 47.

54 ATO, sub 50, pp 32-33.

55 D'Ascenzo M, transcript, 22 June 2006, pp 16-17.

5.60 The Committee supports the ATO's risk-based approach to compliance. It directs the ATO's resources to the areas of greatest need and does not burden compliant taxpayers.

Amended assessments

5.61 In chapter one, the Committee discussed the various reasons why taxpayers in the mass marketed investment schemes felt the ATO had unfairly treated them. One of the main reasons was the ATO's delayed reaction to the schemes. If taxpayers were not picked up by the ATO within 12 months of them lodging a return, it tended to create a precedent for the future. In its report on the schemes, the Senate Committee stated:

> Although the ATO advised that it acted within 12 to 18 months to deny deductions claimed in up to 90 per cent of cases, in some instances the time lag was approximately two to three years, and in others the delay reached up to six years.[56]

5.62 Around this time, the ATO had significant powers to amend a taxpayer's assessment. The standard period was four years. For taxpayers with a shorter period of review, the time was two years. These taxpayers needed to be individuals with simpler affairs, such as only deriving withholding income, using a limited range of deductions and incurring no capital gain or loss. In 2004, the ATO estimated there were 1.5 million taxpayers in this group. The standard period extended to six years where the ATO invoked Part IVA of the *Income Tax Assessment Act 1936* (the general anti-avoidance provision).[57]

5.63 As part of RoSA in 2004, Treasury recommended that these time limits be reduced. In particular, businesses that elect to participate in the Simplified Tax System and individuals should have an amendment period of two years. Treasury recommended that partners of partnerships and beneficiaries of trusts that have not elected to participate in the Simplified Tax System should be excluded. Taxpayers subject to Part IVA (the general anti-avoidance provisions) had their amendment period reduced from six years to the standard four years.

5.64 The Parliament amended the tax laws in the *Tax Laws Amendment (Improvements to Self Assessment) Act (No. 2) 2005* to give effect to these proposals. Under section 170 of the *Income Tax Assessment Act 1936*, the

56 Senate Economics References Committee, *Inquiry into Mass Marketed Effective Schemes and Investor Protection, Interim Report* (2001) p 6.

57 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, pp 27-28.

ATO has an unlimited period in which to amend an assessment if the Commissioner is of the opinion there has been fraud or evasion. This power is unchanged.

5.65 One of Treasury's recommendations in RoSA was that it should further investigate the specific legislative instances where the ATO has an unlimited period to amend an assessment. There are over 100 of these. Treasury has released a discussion paper on this, proposing to group the provisions into four categories:

- converting to the standard two and four year assessment periods
- having a longer, finite period such as eight years
- where the provision relies on a contingent event, changing to two years after the event
- remaining an unlimited period.[58]

5.66 In RoSA, Treasury noted most individual taxpayers have very simple affairs. For them, the main compliance activity that the ATO conducts is processes such as income matching.[59] It is straightforward for the ATO to complete this within two years, especially now that data matching has reached a sophisticated and comprehensive stage.[60] Hence, the RoSA recommendations sensibly balance the requirements of ATO systems and the needs of taxpayers.

5.67 The Committee also supports the principles behind the recent Treasury Discussion Paper, which states:

> Improving taxpayer certainty is a key goal for tax administration. The length of time that elapses before assessments can no longer be amended represents an aspect of risk and uncertainty for taxpayers. Unlimited amendment periods represent an extreme case of uncertainty, as the time to amend extends indefinitely. If that time can be limited without prejudicing the integrity and function of the system overall, the 'costs' of risk and uncertainty would be reduced.[61]

58 Treasury, *Review of Unlimited Amendment Periods in the Income Tax Laws* (2007) Discussion Paper, Commonwealth of Australia, pp 9-15.

59 Comparing the income figures on a taxpayer's return with those provided by third parties such as banks.

60 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, pp 29-30, ANAO, *The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration,* Audit Report No. 30 2007-08, 24 April 2008, pp 17-18.

61 Treasury, *Review of Unlimited Amendment Periods in the Income Tax Laws* (2007) Discussion Paper, Commonwealth of Australia, p 7.

5.68 Tax stakeholders supported the announcement of this review.[62] It is still ongoing, so the Committee sees no need to make a recommendation.

Commencing audits

5.69 The date at which an audit starts is important because it affects the value to a taxpayer of making a voluntary disclosure to the ATO.

5.70 Where a taxpayer incurs a tax shortfall amount, their conduct may warrant the imposition of an administrative penalty. The ATO decreases the base penalty if the taxpayer tells the ATO about the shortfall. The reduction depends on when the taxpayer makes the disclosure. If the taxpayer does so before an audit commences, then the reduction is 100% for a shortfall of less than $1,000 or 80% for a shortfall of $1,000 or more. If the taxpayer tells the ATO after an audit starts, the reduction is 20% if the disclosure saves the ATO significant time or resources.[63]

5.71 In 2005, the Inspector-General of Taxation released two reports that referred to taxpayer confusion over whether certain ATO compliance activities were audits and their commencement date. For instance, the report into audit timeframes stated:

> A review of sample cases revealed that an audit commencement letter or phone call had not been sent or made in 11 out of 203 (5.42 per cent) audit case files reviewed where it was appropriate to notify taxpayers of the commencement of audits and where the case file was adequately maintained.[64]

5.72 The audit timeframe report noted that the ATO was resolving this issue in consultation with tax professionals through the Accountants Tax Practitioners' Forum Audit Working Group. It recommended that the ATO ensure it complied with its procedures on notification of audits.[65] The penalties and interest report recommended that the ATO provide clearer guidance on when an audit starts and give taxpayers an opportunity to make voluntary disclosures prior to an audit formally commencing.[66]

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62 Anderson F, 'ATO may face deadlines for tax audits,' *Australian Financial Review* 23 August 2007, p 3.

63 ATO, sub 50, p 45. See also section 284-225 of the *Taxation Administration Act 1953*.

64 Inspector-General of Taxation, *Review into Tax Office audit timeframes* (2005) Commonwealth of Australia, p 27.

65 Id, pp 26, 29.

66 Inspector-General of Taxation, *Review into the Tax Office's Administration of Penalties and Interest Arising from Active Compliance Activities* (2005) Commonwealth of Australia, p 36.

5.73 In submissions, the ICAA[67] and the Taxation Institute of Australia expressed concern about how to ascertain when some audits start. The latter stated there was:

> … considerable confusion at present about whether an ATO compliance activity constitutes an audit or not, with ramifications for whether a taxpayer can make a voluntary disclosure and seek to minimise the impact of any penalties. The ATO needs to put in place protocols for advising taxpayers about whether or not a particular compliance activity is an audit, and if so, when the audit commences. Although work has progressed in the ATO, resolution has stalled …[68]

5.74 The Committee appreciates that not all taxpayers should be told when an audit into their affairs commences. However, the Committee believes that taxpayers should be advised as often as possible, including borderline cases. This is consistent with legal principles of fairness. The Committee also notes that the ATO has commenced rectifying this problem but has not finalised the task. This should be completed as soon as possible.

Recommendation 13

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

Conditional assessments

5.76 A feature of the ATO's response to employee benefit arrangements was that it issued assessments for the transactions which were conditional on each other. In its press release for *Essenbourne*, the ATO stated that it did not pursue the fringe benefits tax assessment because it rendered the scheme ineffective by disallowing the income tax deduction.[69] In *Pridecraft* in the first instance, the ATO's submission stated it would not follow up the fringe benefits tax assessment if it was successful in relation to the income tax deduction.[70]

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67 ICAA, sub 37, p 4.

68 Taxation Institute of Australia, sub 40, p 7.

69 ATO, 'Employee benefit arrangements,' Media release Nat 03/30, viewed on 20 August 2007 at http://www.ato.gov.au/corporate/content.asp?doc=/content/mr2003030.htm.

70 [2004] FCAFC 339, para 111.

5.77 The use of conditional (or multiple) assessments provoked a strong response from some taxpayers during the inquiry.[71] For instance:

> The issuing of multiple assessments had participants amassing levels due to the ATO up to ten times the level of the actual participating sums. What a disgrace that any creditor let alone the ATO can take such a scatter gun approach. Every company and every participant has their 'breaking point' and the ATO did their best to find it.[72]

5.78 In evidence, the ATO stated that its goal was to ultimately pursue one assessment:

> … our ongoing position is that we will settle on one point. If a case is in the court and the person has decided not to settle, we still put before the court the full range of options. But our position has been all along that we only collect on one taxing point and we only settle on one taxing point.[73]

5.79 The ATO also advised the Committee in 2006 that it would be reducing the fringe benefits tax assessments to nil:

> Now that the courts in *Essenbourne, Kajewski* and *Spotlight/Pridecraft P/L* have clearly found the arrangements not to be effective for income tax purposes there is minimal risk to the revenue in amending to nil the FBT assessments for cases with similar facts. We expect about 400 cases will be affected with 200 already having been amended to nil.[74]

5.80 The Committee has significant concerns about the ATO's practice of issuing conditional assessments. The quotation above demonstrates that the ATO issued the assessment based on revenue calculations.

5.81 In the case of employee benefit arrangements, the ATO did have other approaches available. For example, the Full Court in *Indooroopilly* noted that the ATO would be able to tax the payment of funds from the investment trust (in that case, a Carers' Share Plan) to the recipients as taxable income.[75] In other words, the ATO was taxing the flow of funds one transaction too early. Given the precedent set in *Essenbourne*, it would have been defensible for the ATO to argue that it would wait until

71 Panek P, sub 17, p 2, name withheld, sub 32, pp 6-7.

72 Applied Executives, sub 55, p 1.

73 Martin S, transcript, 22 June 2006, p 48.

74 ATO, sub 50.1, p 11.

75 Edmonds J, *Commissioner of Taxation v Indooroopilly* [2007] FCAFC 16, para 39.

individual taxpayers received funds from the investment trusts. It could then assess these as income tax and litigate test cases if necessary.

5.82 If the ATO had concerns about issues of fairness in relation to taxing the same transaction twice, it would have had at least two ways of not pursuing the debt. Firstly, in some cases the imposition of fringe benefits tax may have caused hardship on a taxpayer. In Division 340 in Schedule 1 to the *Taxation Administration Act* 1953, the Commissioner has a general power to release a taxpayer from fringe benefits tax where it would cause serious hardship.

5.83 Secondly, section 34 of the *Financial Management and Accountability Act 1997* gives the Minister for Finance and Administration a general power to waive debts due to the Commonwealth.[76] The Committee has previously argued that the ATO should publicly transfer to Treasury responsibility for tax policy questions arising out of litigation. Similarly, transferring a debt collection issue to this Minister is appropriate where there are significant policy and fairness issues about pursuing a tax debt.

5.84 In its submission, Resolution Group made the following recommendation:

> The ATO should be prohibited from issuing multiple assessments, either original or amended and whether primary or alternative. The ATO should be required by law to determine the appropriate assessment and only issue and, if necessary, contest that one.[77]

5.85 The Committee would prefer the ATO implemented the spirit of this proposal. Firstly, the Committee wishes to preserve the Commissioner's discretion where possible. Secondly, when there are many complex transactions, it is difficult to determine which assessment copies another. Rather, the issue with the ATO's conduct in employee benefit arrangements was that some assessments that were contingent on its success with other assessments. As an implementer of the tax laws, the ATO should determine what the law requires it to assess as income and then pursue these amounts.[78]

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76 ATO, 'ATO Receivables Policy, Part B, The Collection of Taxation Debts,' paras 25.1-25.5, viewed at http://law.ato.gov.au/atolaw/view.htm?DocID=RMP%2FRP0025 on 27 August 2007.

77 Resolution Group, sub 42, p 15.

78 Vos D, Inspector-General of Taxation, transcript, 28 July 2006, p 3.

Recommendation 14

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

A pro-revenue bias?

5.87 Over the years, a number of stakeholders have alleged that the ATO is biased towards collecting revenue, rather than collecting tax in accordance with the law. This perception is in the eye of the beholder. The Committee is alert to the fact that such criticisms can be self-serving when made by those caught out as having failed on tax compliance. In its performance audit on rulings in 2001, the ANAO reported allegations by taxpayers that the ATO was biased.[79] The Inspector-General of Taxation has reported that 72% of large corporate taxpayers consider the ATO to be biased in relation to private rulings.[80]

5.88 Sometimes this view is expressed as a perception of bias amongst the community. For example, in RoSA Treasury noted a widespread perception of bias in relation to private rulings. RoSA recommended that the Inspector-General of Taxation investigate this matter.[81] In his recent review, the Inspector-General examined the ATO's systems and files and found no evidence of bias in the ATO's private rulings. The Inspector-General confirmed that the perceptions of bias were widespread, but these were due to the way the ATO dealt with applicants. This included requesting taxpayers to withdraw applications, making requests for additional information that did not always appear warranted, and discussing issues with Treasury without advising taxpayers. By not being open with taxpayers about these delay-causing behaviours, taxpayers concluded from the information available to them that the ATO was exercising the sort of bias that would be expected from a revenue agency.[82]

79 ANAO, *The Australian Taxation Office's Administration of Taxation Rulings,* Audit Report No. 3 2001-02, 17 July 2001, p 95.

80 Vos D, Mihail T, 'The Importance of Certainty and Fairness in a Self-Assessing Environment,' para 112, viewed at http://www.igt.gov.au/content/media/sp20060420.asp on 20 August 2007.

81 Treasury, *Report on aspects of income tax self assessment* (2004) Commonwealth of Australia, pp 17-18.

82 Inspector-General of Taxation, *Review of the potential revenue bias in private binding rulings involving large complex matters* (2008) Commonwealth of Australia, pp 3-8, 125.

5.89 In its performance audit on rulings, the ANAO was not able to conclude about whether the ATO's private rulings showed a pro-revenue bias. Rather, the report focussed on whether the ATO's processes supported robust decision-making:

> The ATO rejects this view and it is difficult to determine whether this view is valid…
>
> The ATO disagrees and it is difficult to conclude one way or the other about user/stakeholder perceptions…
>
> We note that some rulings are contentious and we appreciate that views may differ on matters of legal interpretation (sometimes very important matters of legal interpretation) because that is the nature of the interpretative process. However, in view of our discussion and conclusions relating to the public rulings production processes … we conclude that the processes are in place to assure reasonably the legal quality of the ATO's public rulings.[83]

5.90 The ATO's third external scrutineer is the Ombudsman. The Committee asked the Ombudsman of the culture of ATO staff and whether they adopted a pro-revenue bias:

> If we see the Taxation Office through the prism only of the individual complaints that we receive and the contact we otherwise have, the evidence from that contact does not substantiate the general criticisms that are made. But I think what we do see is that every issue has two sides to it …
>
> There are complaints and difficulties if the Taxation Office has labels that are pejorative such as 'aggressive tax planning promoter' or whatever. On the other hand, it says it is failing in its response to calls from the public if it does not do that to differentiate between those who are innocent and genuine, committed and acting in good faith and those who are not. I think that is the general experience that we find. One can point to an issue or an example to substantiate a general point, but it is quickly counterbalanced by experience of a different kind or by imagining what the alternative is going to be if you take the other line.[84]

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83 ANAO, *The Australian Taxation Office's Administration of Taxation Rulings,* Audit Report No. 3 2001-02, 17 July 2001, pp 95-96.

84 McMillan J, transcript, 28 July 2006, p 25.

5.91 The Ombudsman's point about two sides to every story is very relevant. If a taxpayer disagrees with or engages in a dispute with the ATO and is unsuccessful, they are likely to be dissatisfied. With the support of democratic processes, they are also entitled to complain. Every case where a taxpayer is dissatisfied has the potential to be a public, high profile criticism of the ATO.

5.92 The other side of the story is where a taxpayer disagrees with or engages in a dispute with the ATO and is successful. Any such taxpayer is likely to be satisfied but will have little incentive to announce this outcome. The public is unlikely to hear about these cases. The ATO has publicly stated that it ultimately accepts taxpayers' arguments in many cases.[85]

5.93 In the view of the Committee, proving systemic bias in the ATO will be methodologically difficult undertaking. The sort of process that would be required would be to take a statistical sample of the ATO's decisions and then assess whether each one demonstrated a revenue bias, a taxpayer bias, or was neutral. Arguably, for an allegation of revenue bias to be valid, the examples of a revenue bias would need to outweigh the examples of taxpayer bias.

5.94 In *An Assessment of Tax*, the JCPA argued that, whenever there was doubt over an interpretation of the law, the ATO should give the taxpayer the benefit of the doubt.[86] Under this approach, one decision by the ATO with a revenue bias would arguably be sufficient to demonstrate a revenue bias overall. Clearly, this is not practical. The analysis then becomes an exercise in determining what proportion of the ATO's decisions is permitted to demonstrate a revenue bias.

5.95 The ATO has already implemented processes to achieve much of this analysis through its technical quality reviews. In these reviews, the ATO selects a statistical sample twice a year of its different types of decisions and then conducts internal peer review. Generally, the ATO's benchmark for a pass rating is 95%. The ATO achieved a performance of 97.0% for August 2006 to January 2007, up from 95.8% from February 2006 to July 2006.[87]

5.96 If the Committee were to cite the examples of where there may be evidence of a pro-revenue bias, it would raise the following:

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85 Kazi E, 'ATO drops aggressive legal tactics' *Australian Financial Review*, 6 March 2007, p 6.

86 JCPA, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) Report 326, p 284.

87 ATO, *Annual Report 2006-07*, p 42.

- the ATO issuing conditional assessments in employee benefit arrangements
- prior legislative arrangements where the ATO could automatically apply penalties to taxpayers who did not follow private rulings (chapter three)
- the ATO's conduct in *Essenbourne*
- the ATO arguing in *Walstern* that private opinions were not relevant authorities to support a taxpayer's claim for a reasonably arguable position (chapter three)
- the combination of the ATO's delays and compliance response in the mass marketed investment schemes.

5.97 The common thread in these examples is fairness. Simply put, the ATO engaged in conduct in these instances that most observers would describe as unfair. However, this does not necessarily demonstrate a pro-revenue bias or a general unfairness on the part of the ATO. This agency makes hundreds of complex decisions daily. To cite five occasions over 10 or more years does not demonstrate bias.

5.98 What these decisions demonstrate is the importance of fairness in dealing with taxpayers and the seemingly disproportionate effect that an unfair decision can have. Each decision has the potential to reduce the reputation of the ATO. This could then affect the number of taxpayers who decide to be compliant and, in turn, could affect the security of the revenue. The ATO itself noted this in its submission where it stated:

> Procedural fairness, courtesy and integrity underpin a world class tax administration.[88]

5.99 In the view of the Committee, what would assist the ATO is a mechanism whereby there would be a fairness check on all significant decisions dealing with taxpayers. To some extent, the mechanisms for this are already in place. The ATO has the *Taxpayers' Charter*, which requires the ATO to act fairly and reasonably with taxpayers.[89] The ATO also has technical quality reviews. In its 2004 performance audit on the *Taxpayers' Charter*, the ANAO recommended that the ATO implement systematic, supplementary quality assurance processes. These processes would include compliance with Charter principles.[90]

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88 ATO, sub 50, p 1.

89 ATO, *Taxpayers' Charter – Expanded Version* (2007) Commonwealth of Australia, p 3.

90 ANAO, *Taxpayers' Charter,* Audit Report No. 19 2004-05, 17 December 2004, pp 64-66.

5.100 In June 2008, the ANAO finalised a follow-up audit on the *Taxpayers' Charter*. The ANAO found that the ATO had met the intent of this recommendation by implementing an integrated quality framework based on recognised standards. The ATO conducted internal consultations to ensure that the framework complies with Charter principles. In time, the framework will replace technical quality reviews.[91]

5.101 While the Committee regards all of the principles in the *Taxpayers' Charter* as important, perhaps the most important of them is the ATO's commitment to act fairly. The Committee trusts that the integrated quality framework will further raise the visibility of this Charter principle in ATO decision-making.

Conclusion

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

5.103 Much of this chapter has concentrated on how the ATO managed employee benefit arrangements, including the *Essenbourne* case. Out of all the issues raised with the Committee during the inquiry, the Committee is the most concerned about *Essenbourne*. It took the ATO four years to accept the Federal Court's decision in that case. The Committee agrees with Justice McHugh and the Full Federal Court in *Indooroopilly* that a court decision is the law and should be followed. Either appealing the decision or accepting it and referring the issue to Treasury as a policy matter is consistent with the ATO's role as an independent administrator of the tax laws.

5.104 The Committee accepts that many of the taxpayers in employee benefit arrangements took a conscious decision to push the boundaries of legal conduct to pay less tax but still enjoy the many public facilities that tax revenue provides. But in *Essenbourne*, the ATO has allowed its critics to argue that it pushes the boundaries of the law as well. This endangered

91 ANAO, *Taxpayers' Charter – Follow-up Audit*, Audit Report No. 40 2007-08, 11 June 2008, pp 53-55.

much of the ATO's good work in establishing, promoting and being guided by the compliance model.