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Report 410

Tax Administration

Joint Committee of Public Accounts and Audit

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Foreword

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sharon Grierson MP
Committee Chair



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Senator Gary Humphries


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Senator Andrew Murray

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(from 16/8/05 until 23/3/07)

Senator the Hon. Nigel Scullion
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Senator John Watson



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42nd Parliament

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



Terms of reference

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

Part A

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

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

Part B

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



List of abbreviations

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



List of recommendations

1 Introduction

Recommendation 1

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

2 Biannual meetings

Recommendation 2

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

3 Complex legislation

Recommendation 3

The Government introduce legislation to require:

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

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

Recommendation 4

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

Recommendation 5

The Government and Treasury improve consultation on tax measures by:

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

Recommendation 6

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

Recommendation 7

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

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

Recommendation 8

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

4 Rulings

Recommendation 9

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

Recommendation 10

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

5 Compliance

Recommendation 11

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

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

Recommendation 12

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

Recommendation 13

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

Recommendation 14

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

6 Penalties and interest

Recommendation 15

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

Recommendation 16

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

Recommendation 17

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

Recommendation 18

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



Executive summary

Introduction

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

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

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

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

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

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

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

Biannual meetings

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

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

Complex legislation

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

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

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

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

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

Rulings

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

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

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

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

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

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

Compliance

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

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

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

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

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

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

Penalties and interest

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

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

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

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

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

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

Pay as you go

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

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

Conclusion

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

