

Income Tax Self Assessment

A Submission to the Joint
Committee on Public
Accounts and Audit Inquiry
into “Certain Taxation
Matters”

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CHAMBER OF COMMERCE
AND INDUSTRY
WESTERN AUSTRALIA



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Overview

About CCI

The Chamber of Commerce and Industry of Western Australia (CCI) is the leading business association in Western Australia.

It is the second largest organisation of its kind in Australia, with a membership of 5,000 organisations in all sectors including manufacturing, resources, agriculture, transport, communications, retailing, hospitality, building and construction, community services and finance.

Most members are private businesses, but CCI also has representation in the not-for-profit sector and the government sector. About 80 per cent of members are small businesses, and members are located in all geographical regions of WA.

Introduction and Executive Summary

On 7 December 2005, the Joint Committee on Public Accounts and Audit resolved to undertake a new inquiry into “certain taxation matters”. The terms of reference to the inquiry are set out below.

- 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.
- 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.

Concerns in relation to the current system of self assessment are highlighted by the fact that there have been a number of inquiries in recent years aimed at simplifying the current system. Overall, however, only minimal changes have been made to the current system.

The most recent inquiry was undertaken by the Department of the Treasury in 2003. The *Review of Aspects of Income Tax Self Assessment* was undertaken to determine whether the self assessment arrangements struck the right balance between protecting the rights of individual taxpayers and protecting the revenue for the benefit of the Australian community.

In March 2004, the Government released a discussion paper that examined this balance in light of a number of aspects of Australia's income tax self assessment system and several comparable international arrangements. In response to the discussion paper, the Review received over 30 submissions, received a number of phone calls, emails and background papers from interested parties, and held face to face consultation with taxpayer representatives, professional bodies, and other government agencies.

On 16 December 2004, the Treasurer announced the Government's response, identifying a number of "refinements" to the self assessment system to reduce uncertainty and compliance costs for taxpayers, while preserving the ATO's capacity to collect legitimate income tax liabilities. The Treasurer announced that the Government would adopt the 30 legislative recommendations made in the Report, and that the Commissioner of Taxation had advised him that the ATO would implement the relevant administrative recommendations as soon as practicable.

On 17 March 2005, the Assistant Treasurer introduced the *Tax Laws Amendment (Improvements to Self Assessment) Bill (No. 1) 2005*, which included provisions to give effect to the recommendations in the *Report on Aspects of Income Tax Self Assessment* to reduce the rate of certain interest charges and modify some penalty rules.

The most recent inquiry made only minor changes to the current system. To achieve more lasting and significant reform, CCI considers that a review of the self-assessment system must resolve two key issues:

- the uncertainty for taxpayers, which is a result of the system itself; and
- the income tax laws, which have becoming increasingly complicated and difficult to understand, significantly increasing taxpayer compliance costs.

A measured response could involve the return to a modified pre-issue assessment regime, which would require the ATO to be more proactive in interpreting tax law in order to reduce uncertainty for taxpayers. Such a regime could also help to simplify tax laws, which have in many ways been complicated as a result of the self-assessment system.

In addition, it is clear that further work needs to be undertaken to reduce the volume and complexity of tax legislation in order to reduce uncertainty for taxpayers and the associated burden of compliance and administration. In the absence of a process whereby the policies behind the income tax laws can again be reviewed (following the Government's opposition to some of the key recommendations of the Ralph Review of Business Taxation), there remains

a clear need to look at ways in which the income tax laws themselves (not the policies behind the laws) can be simplified.

This would best be achieved through the re-establishment of the Tax Law Implementation Project – an initiative of the previous Government which was effectively shelved in 1999 so that the resources could be devoted to the GST and business tax reform process.

Finally, the Australian Government should also introduce a Taxation Administration Impact Statement in order to ensure that all relevant information is presented to decision makers when determining the impact of changes to legislation in terms of taxation compliance.

Background – Taxation Policy Framework

Objectives

Taxation is the most costly, intrusive and unwelcome facet of the interaction between government and business. Tax probably has more effect on the profitability and day-to-day operations of most businesses than any other government activity. Getting the tax structure right is the single most constructive reform that governments can do to promote a productive economy and competitive business sector.

The objectives of tax policy are:

- to raise the tax revenue necessary to finance appropriate government expenditures while imposing the least cost in terms of economic efficiency or unintended social or environmental consequences;
- to avoid undue compliance costs on taxpayers, or administrative costs on tax authorities; and
- to minimise the scope for avoidance or evasion.

Principles of Taxation

There are five key principles commonly identified as being necessary to achieve these objectives. These broad principles which shape policy on taxes and charges are:

- **equity** – horizontal equity requires that taxpayers in similar circumstances should face a similar tax burden; while vertical equity requires that taxpayers with different abilities to pay remit taxes in proportion to their exposure to the tax base;
- **efficiency** – the system should be administratively efficient so that the cost of managing and complying with a tax are not excessive relative to the revenue raised; and it should be economically efficient so that that distortions caused by people changing behaviour because of tax are minimised;
- **transparency** – a transparent tax system identifies clearly what is to be taxed and how the liability is calculated. Both taxpayers and those meeting the real costs of taxation should be able to identify how much tax they are paying;
- **adequacy** – taxation should be adequate to finance appropriate levels of government expenditure; and
- **competitiveness** – the size and structure of the tax burden should not discourage people and businesses from locating and doing business in WA rather than in alternative locations.

Issues

Taxation Compliance and Administration

Despite the significant reforms to Australia's taxation system, compliance costs remain a key concern for Australian businesses. Compliance is of greater concern amongst smaller businesses, which have fewer resources to devote to dealing with the demands of the ATO.

Business believes that governments and the ATO pay insufficient attention to the compliance difficulties created by extra legislation, particularly the total burden rather than the measures taken individually.

This was reinforced in the Australian Chamber of Commerce and Industry's (ACCI) 2004 *Pre-Election Survey* of almost 1,700 businesses, which found business regulation to be primary among the concerns of Australian businesses. Of the ten most important issues for business, tax issues ranked first (level of taxation), second (overall complexity of the taxation system), fourth (personal tax) and fifth (frequency of changes to tax laws and rules).

A small business survey conducted by Certified Practicing Accountants (CPA) Australia in March 2003 indicated that 62 per cent of accountants resent the time needed to comply with tax obligations and 41 per cent feel the paperwork burden has increased to the point where they question staying in business.

The Chairman of the Productivity Commission, Gary Banks, raised a number of concerns with regulation at an ACCI function in 2003:

- more and more pieces of legislation or regulation are being passed relative to previous periods;
- these Acts are on average longer in length than what they used to be, and consequently are more complex and impose greater compliance stipulations;
- there are more departments, agencies, ministerial councils and national standard setting bodies designing and implementing regulation than ever before;
- governments have not improved their performance in making regulations 'nonprescriptive, clear, and concise';
- the methodology used by Commonwealth agencies (i.e. Regulatory Impact Statements (RISs) in estimating the economic costs of proposed regulation is not yet to a satisfactory standard;
- RISs are too often used as a means to justify the introduction of a regulation rather than a means to impartially assess whether it is suitable or not; and
- regulations often do not differentiate between small, medium and large businesses.

These concerns are of particular relevance to small business. Because of their limited resources, small businesses do not always have the capacity (time, money, and skills) to decipher and comply with all regulation. The effect is that the regulatory compliance cost burden, when compared with dollars per turnover, has a greater, disproportionate impact upon small firms. In other words, compliance costs are regressive.

Self Assessment System

The introduction of self-assessment in 1986-87 relieved the ATO of the responsibility to examine returns lodged by taxpayers in the process of assessment. Taxpayers are now required to lodge their tax return, with any claims made by a taxpayer generally accepted by the ATO, usually without adjustment, before issuing an assessment notice. However, even though the ATO may initially accept the tax return, the return may still be subject to further review.

As this system requires taxpayers to have a good understanding of the tax law in order to fulfil their taxation obligations, the ATO's role has shifted to providing advisory services such as private rulings to improve taxpayer knowledge of the application of the tax law to individual circumstances. In addition, resources devoted to post-assessment checking has increased through audit activity.

Under the system of self-assessment, the ATO has been able to move from the position of having to understand and be able to apply the income tax law on a consistent basis, to instead passing on that responsibility to taxpayers and their advisers. As highlighted by Michael Inglis:

“...the ATO was able to move from what had become the uncomfortable position of having itself to understand, and be capable of genuinely applying on a consistent Australia-wide basis, the income tax law, to the more comfortable position of armchair critic. The full burden of getting and staying up to speed on, and contending day by day with, the newly expanded and more complicated income tax laws (not to mention existing ones) was thus taken off the shoulders of the ATO and put onto the shoulders of taxpayers and their advisers.”¹

This is in stark contrast to the previous system of full assessment, where ATO officers were able to gain ongoing first-hand experience and knowledge of whether the income tax law was workable or not when issuing assessments.

The system of self-assessment has been made all the more difficult for taxpayers given that the tax laws have become increasingly complex and lengthy, with over 8,500 pages of legislation spread over three different Acts (*Income Tax Assessment Act 1936*, *Income Tax*

¹ Inglis, M, “Is Self Assessment Working?”, *Australian Tax Review*, June 2002.

Assessment Act 1997, Schedules to the Taxation Administration Act 1953) and many more thousands of pages in general public rulings².

In part, the increased amount of detailed income tax legislation has been an attempt to clarify all possible events or circumstances that can arise to increase certainty for taxpayers. However, it has had the opposite effect. The average taxpayer now finds it more difficult to understand and comply with the tax laws.

Such is the complexity of the system, the ATO has reported that around 75 per cent of all tax returns and activity statements are lodged with either complete or partial involvement of a tax professional. This is the highest of any country in the world.

The pressures on taxpayers and tax advisers to fulfil their tax obligations are compounded due to the uncertainty as to whether they will be audited for incorrectly completing their tax returns (potentially requiring payment of additional tax plus interest), or, worse still, avoiding tax (which can attract large penalties). This level of uncertainty is an unwelcome aspect of the system of self-assessment.

Despite the ATO's best efforts and intentions in providing rulings when requested, the practical issues for taxpayers and tax agents means that, for many reasons, the need for an ATO ruling may not be identified or, if it is considered, it may not be sought for any number of valid pragmatic reasons (not to do with minimising tax). By doing this, however, the onus on the taxpayer has now meant the ATO does not have to take a position on a tax matter until after the event.

The shift in obligations and responsibilities away from the ATO, combined with the threat of penalties at audit if a taxpayer gets it wrong, is seen as the key concern with self-assessment.

² Inglis, M, "Is Self Assessment Working?", Australian Tax Review, June 2002.

Options for Reform

The system of self-assessment is in need of reform. It has brought about a clear shift in accountability and responsibility towards the taxpayer which in some cases, the taxpayer cannot reasonably comply with. The increasingly complex income tax laws and the threat of audit if taxpayers incorrectly complete their tax affairs, creating an uncertain environment.

While the ATO's efforts to provide taxpayers with information in order to explain complicated tax law and its application are to be commended, this has not improved the system. If anything, the flood of additional information has complicated matters further.

As a result, CCI believes that a review of the self-assessment system needs to resolve two key issues:

- the uncertainty for taxpayers, which is a result of the system itself; and
- the income tax laws, which have becoming increasingly complicated and difficult to understand for taxpayers and tax advisers.

In addition, the Australian Government should also consider introducing a Taxation Administration Impact Statement in order to ensure that all relevant information is presented to decision makers when determining the impact of changes to legislation in terms of taxation compliance.

Addressing these fundamental issues would also help address the issues outlined in the terms of reference to the Inquiry.

Modifying the System

In relation to the system of self-assessment, a measured response could be a move to a modified pre-issue assessment regime, possibly involving a pre-assessment issue computer check of returns using the same (or similar) parameters now used to identify possible audit cases.

In doing this, ATO assessors could then decide whether it should amend the returns (for simple errors of calculation) or seek further information from the taxpayer. If further information is necessary, then the taxpayers identified during this process would then have to substantiate or explain any issues raised before an assessment is issued.

This would allow the ATO to be more proactive in interpreting tax law and resolving issues at an earlier stage, rather than after assessments have been issued.

This should not reduce the obligations on taxpayers and agents to correctly identify and classify tax issues in their tax returns. Nor would it mean that the ATO could not audit a taxpayer's affairs after an assessment had been issued (just as they did prior to the introduction of self-assessment).

Such a process would give the most taxpayers and agents some comfort that returns had been assessed and relevant issues raised as appropriate before any assessment issued.

While this would increase the time with which the ATO would take to issue assessments, this would be a small price to pay if there was a greater degree of certainty that future audits would not give rise to any significant issues.

A modified pre-issue assessment regime could also help simplify the income tax laws, which have in many cases evolved as piecemeal responses to problems identified under the system of self-assessment.

Simplifying Income Tax Law

Few taxpayers or tax professionals would disagree with the proposition that the income tax laws have become too complex and difficult to understand.

Under the previous system, the ATO issued income tax assessments determined by ATO assessors on the basis of their own understanding and application of the income tax law to various facts and circumstances. In doing so, the ATO gained on-going first hand experience and knowledge as to whether the income tax law was workable or not.

The removal of this vital feedback element from the Australian tax system has been a key factor behind the development of complex and detailed income tax laws that are often practically unworkable.

In order to ensure a satisfactory system of tax administration, the law should be clear and taxpayers should know, without difficulty, when tax will be payable and when it will not. The system should also be stable and not subject to constant change. The cost and inconvenience to the taxpayer of complying with the law should also be kept to a minimum.

The income tax laws fall far short of achieving a satisfactory system of tax administration. As a result, reform is necessary in order to make the income tax law accessible and clear, and easier to apply and less burdensome to comply with than the present law.

This is best achieved through a fundamental review of the income tax laws, including the policies behind the laws – a process that was undertaken as part of the Ralph Review of Business Taxation. Indeed, the Ralph Review proposed a number of reforms not supported by the Government that would have greatly simplified the income tax laws, particularly the proposed Tax Value Method (TVM). The Board of Taxation noted in 2002 that tax law based on the TVM could reduce the current law by around 40 per cent.³

³ Board of Taxation Press Release, “Current Income Tax Laws Unsustainable – Tax Board Chairman Tells Convention”, 15 March 2002.

In the absence of policy-driven reforms to the income tax system, such as the proposed TVM, there remains a clear need to simplify the existing tax laws within the current policy boundaries.

It is noted that the previous Government initiated a process aimed at simplifying the income tax law when it established the Tax Law Improvement Project in 1993. The results of this project was the *Income Tax Assessment Act 1997* which contained many key sections of the *Income Tax Assessment Act 1936* rewritten in plain English using shorter and clearer sentences and improved presentation through increased use of maps, graphics, tables and examples.

However, the current Government effectively shelved this program in 1999, with the resources devoted to the GST and business taxation reform process. While the subsequent legislation giving effect to the business tax reforms provided a more integrated design processes and a more principle-based legislative framework, a more fundamental look at reducing the complexity of the current income tax laws was not addressed.

Many tax professionals and advisers felt that the Tax Law Implementation Project was making real progress in improving the style of the drafting of tax legislation and in improving comprehension.

With the project incomplete, the result is that the old Act is still in operation to the extent that the new Act is still not yet a completed revision of the old Act. Therefore, Australia now has two systems of income tax law that can be operating in tandem or even in conflict with one another where neither Act deals exclusively with the relevant tax problem.

It is therefore important that a process that began with the Tax Law Implementation Project be restarted to finish the rewrite of the 1936 Act.

Taxation Administration Impact Statement

The Government should consider adopting similar measures in assessing the provisions of the Tax Act by introducing a Tax Administration Impact Statement (the TAIS) to be administered by the Inspector General of Taxation⁴.

This process would be similar in scope to the current RIS process, but with a focus on the impact of changes to legislation in terms of the administration of taxation.

This should include:

- surveys of the time and money that business spends on complying with the Tax Act;

⁴ This is consistent with the position adopted by the Australian Chamber of Commerce and Industry in its *Taxation Reform Blueprint: A Strategy for the Australian Taxation System 2004-2014*.

- the introduction of a range of initiatives to assist business to identify, understand and implement new and existing taxation requirements. Information programs for small business in particular should involve all components of the small business network;
- a requirement that quantitative estimates of compliance costs, based on detailed proposals for implementation and administration, be attached to any new tax proposal. Estimates should be based on consistent methodology in line with international best practice;
- regular reviews of the accuracy of compliance estimates in the TAIS for regulations with a major impact on business;
- greater education, skill development, resources and priority within agencies. The Inspector General, in conjunction with the Commissioner of Taxation, needs to address the corporate culture within the ATO to ensure that the TAIS is carefully constructed when each new tax change is proposed.