Australian Government

Inspector-General of Taxation

SUBMISSION TO THE JOINT COMMITTEE OF PUBLIC ACCOUNTS AND AUDIT

INQUIRY REVIEWING A RANGE OF TAXATION ISSUES WITHIN AUSTRALIA

by

The Inspector-General of Taxation

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1. Introduction

1.1. The Inspector-General welcomes the Committee's requirement for a submission from him based on the perspectives of his role, and appreciates the opportunity created by this Inquiry to identify ongoing improvements in administration of Australia's tax system for the benefit of all Australians.

1.2. This submission aims to identify systemic issues about the administration of the self-assessment system (and the PAYG system within it) that are relevant to the Inquiry's terms of reference. This fits well with the objectives of the Inspector-General as intended by Parliament.

1.3. The Inspector-General of Taxation's role is to undertake formal and generally in-depth reviews of systemic issues of tax administration which appear to need improvement. The points raised for consideration by the Inquiry are within the scope of the Inspector-General's role to identify systemic issues in the administration of tax laws in terms of the principles of good tax administration including simplicity, transparency, efficiency and fairness.

1.4. However, this submission is not based on in-depth Inspector-General reviews and needs to be seen in that light. The points made in the submission do not have the status of official findings as a basis for independent advice to the Minister for Revenue and Assistant Treasurer. For this reason, the submission does not make formal recommendations to the Inquiry. Rather, it raises issues which the Committee might consider and explore in the course of its Inquiry.

1.5. This submission does not seek to cover all of the ground that one could cover in the context of this broad Inquiry, but only what the Inspector-General sees as the more important issues, consistent with his role.

2. Context – The Framework of Australia's tax system

2.1. Certainty and fairness in a system of self-assessment is influenced by the responsibilities and functions of the stakeholders in the tax system. Stakeholders include the Government, Parliament, the Tax Office, the Courts and Tribunals, tax advisers, such as tax agents, accountants and lawyers, and of course, taxpayers.

2.2. It is important that each of these stakeholders appropriately recognises the responsibilities and functions of others. This division of functions is premised on the principles of the rule of law, that is, that all authorities involving in rule making are subject to, and constrained by law. It is not only important from the perspective of providing certainty to the tax system but also acts as an appropriate balance and fairness to the exercise of both legal and administrative powers.

2.3. The Government has the responsibility to develop policy and propose laws and amendments. The Parliament has the responsibility of considering and enacting those proposed laws. For both Government and Parliament it is important, for a taxpayer in a system of self-assessment, that these laws are clear and enable the majority of taxpayers, with minimal advice from third parties, to correctly calculate their tax liabilities. The tax laws should enable ordinary taxpayers to readily understand their tax obligations and for business taxpayers to manage to know their positions with certainty for their tax obligations.

2.4. The Judiciary, as the third separate branch of government, alongside with the Executive and Parliament, is responsible for exercising judicial power. Courts have the responsibility to interpret and apply those laws so as to resolve disputes between the Tax Office and taxpayers as to either or both the interpretation of fact and law. The role of the Administrative Appeals Tribunal is to provide independent merits review of administrative decisions. Clearly, if there is an ambiguity in the tax law, it ought to be the prime responsibility of the Government to ensure that the legislation is amended to overcome any so called unintended consequences. The Tax Office ought not to be expected to prop up deficient tax law by rulings and the like which at some stage or another might be withdrawn and the Tax Office change their direction.

2.5. Taxpayers have a responsibility to correctly meet their tax obligations. This requires them to take reasonable care including seeking advice from the Tax Office or their tax agent when in doubt, making full and true disclosures of all material facts when so doing.

2.6. Equally, tax agents and advisers should make reasonable enquiries to ascertain the current state of a client's tax affairs and the accuracy and completeness of the information provided. They should also endeavour to interpret and apply the tax laws correctly and explain their interpretation and application of tax laws in a manner comprehensible to clients. If a tax agent or adviser is uncertain of how a tax law applies in a particular matter, they should consider seeking clarification from relevant authorities and material, including Tax Office rulings and determinations.

2.7. The Tax Office's role in the tax system, under the leadership and authority of an independent Commissioner, is to administer the tax laws as enacted by Parliament and as interpreted by the Courts without fear or favour. In performing that duty, there is a strong community expectation that the Commissioner will be an independent and impartial administrator. There is also a strong community expectation that the Commissioner of Taxation will perform that duty in a manner that acknowledges the role of Government, the role of Parliament and the role and independence of the Judiciary.

2.8. The basic duty of the Commissioner of Taxation is to implement and manage tax and related systems to meet government objectives. In a system of self-assessment most of the responsibility to correctly meet tax obligations rests with taxpayers, themselves. The Tax Office has a subordinate but clear responsibility to provide guidance, advice and other support to taxpayers sufficient to enable them to

correctly understand, calculate and meet their tax obligations. The Tax Office responsibility is reflected in the Taxpayers Charter.

2.9. At the administrative level, the Commissioner is also responsible for the integrity of the tax system, not only in the sense of its wholeness and soundness, but also its fairness and honesty.

3. Impact of a system of self assessment on taxpayers

3.1. Self assessment was introduced in Australia in 1986/87 for individuals and in 1989/90 for companies and superannuation funds.

3.2. When introducing self assessment other changes introduced included:

- An interest charge on unpaid tax to compensate for the cost of lost revenue between the period of assessment and the issue of an amended assessment;
- The capacity of the Commissioner to amend for not only errors of calculation or mistakes of fact but also mistakes of law; and
- A mechanism for taxpayers to seek information from the Commissioner in respect of an issue affecting the taxpayer's liability at the time a return was lodged (refer para 4.9 JCPA Report 326, November 1993)

3.3. Much has been written on the operation and effectiveness of self assessment but the Committee is directed to a government white paper released on 13 December 1990 and forming part of the Tax Simplification Statement, a further government white paper issued on 20 August 1991 headed "Improvements to Self Assessment – Priority Tasks" and of course Report 326 of the Joint Committee of Public Accounts (as it then was) issued in November 1993.

3.4. The then Committee acknowledged (at Para 4.11) that one of the things different with self assessment to the previous full assessment regime was the removal of the "check" step of ATO assessment. That was the single greatest change to self assessment. Probably almost as important, was the change in the tax law allowing the Commissioner to make a (debit) amendment for a relevant prior year even if he has made a mistake of law.

3.5. The Inspector-General believes that there is a community perception that self assessment has placed on taxpayers a significant burden of responsibility and the Tax Office, in turn has been given relatively wide access to retrospective amendments with resultant interest and penalty.

3.6. Self assessment was introduced by the government in consultation with tax practitioners and there is no doubt that self assessment works well and to the benefit of the vast majority of taxpayers. It has provided efficiency gains to taxpayers. For example, those with simple affairs can lodge a return through their tax agent or e-

Tax and have their assessment issued within 14 days. It has certainly benefited the Tax Office, with it no longer being required to scrutinize every tax return. There cannot be, and should not be, any question of turning back to the era of full assessment.

4. Themes underlying this Submission

4.1. The central theme underlying this submission is that self assessment, as it operates and is administered now in Australia, is perceived to be weighted more in favour of the administrator than the taxpayer. It is the Inspector-General's view that taxpayers have a need for, and probably a right of, a high degree of certainty when they prepare and lodge their tax returns. This is particularly so where tax returns are prepared by registered tax agents for and on behalf of taxpayers.

4.2. The 13 December 1990 white paper (at Para 4.7) indicated that "A taxpayer would be able to seek from the Commissioner a private ruling concerning the taxation consequences to the taxpayer arising from a transaction, act or event which is proposed to take place or has already taken place. Private rulings would replace the existing system of advance opinions and section 169A requests"

4.3. It is understood that the concept of private rulings as originally envisaged was a mechanism for taxpayers to obtain some degree of certainty in respect of particular aspects of their tax liability. The ability to obtain a private ruling is a key feature of the self assessment system.

4.4. In practice, most small business and individual taxpayers do not seek rulings from the Tax Office partly because of:

- the underlying cost to seek and obtain the ruling;
- the perception of Tax Office bias in favour of the revenue; and
- the perception of low risk given the trust they have in their advisers

4.5. It is recognised within the community and by the Tax Office that the taxation laws in Australia are complex. Taxpayers preparing and lodging returns and therefore self assessing their taxation liability should not have to wait for up to four years for the Tax Office to disclose its hand on the treatment of particular acts or transactions within a tax year. A shortfall of primary tax unexpectedly required to be paid several years after assessment is in effect a penalty. The short fall interest and subsequent penalties imposed on the amended assessment become absolutely crippling to many taxpayers and give rise to disputation.

4.6. A second theme within this submission is that taxpayers who have their returns prepared by tax agents should be given some form of protection bearing in mind their legitimate expectation that registered tax agents ought to know whether a particular transaction or arrangement gives rise to either tax avoidance or a liability

different to that considered by the taxpayer. The role of the tax agent can be reasonably compared to the "'check' step" referred to in para 4.11 of Report 326. JCPA, November 1993. After all, the tax agent ought to know the taxation law and be conversant with Tax Office policy more so than can be expected of the taxpayer.

4.7. A third theme is that the Tax Office must act quickly and proactively where it becomes aware of a new wave of potential "tax avoidance" activity. Relying on its right of up to 4 years of retrospective action against affected taxpayers will not provide an adequate level of certainty to taxpayers involved, will expose them to unexpected risk, and will undermine the integrity of the tax system overall. It is observed that the Tax Office's "Taxpayer Alert" is a step in the right direction.

5. Key points

5.1. In this context and within its terms of reference, some key points the Committee might consider in the course of the Inquiry are as follows.

There is a lack of compensating protections for taxpayers placed at increased risk by the self-assessment system.

5.2. For those subject to Tax Office compliance action there are disadvantages and risks that did not exist to quite the same extent before self-assessment. These additional exposures have in part been offset by improvements from RoSA and by new services introduced by the Tax Office; but there are still gaps.

5.3. Crucial differences exist for this category of taxpayer compared to their situation under the old assessment system. Under the old system, where the Tax Office saw potential problems with a tax return, these issues were usually sorted out before assessment. Risk of penalties or compounding interest did not arise from legal problems where the taxpayer fully disclosed how they had applied their view of the law in their return. As well, they had the option to make a particular disclosure under the section 169A processes mentioned above and earlier equivalent processes. Once assessments issued and barring miscalculations, taxpayers had certainty.

5.4. The Tax Office points to the PBR system as the way taxpayers can get "certainty". The PBR system is important, yes. But only 15,000 PBRs are issued each year in a complex system with millions of taxpayers. The Tax Office knows that the Small Medium Enterprise sector (SMEs) and individuals have virtually opted out of the PBR system because it takes too long and is too expensive. Tax agents seldom seek PBRs for the same reasons and because their clients refuse to bear the costs. Seen in this light, the PBR system has not, as intended, adequately replaced the opportunity to gain the pre-assessment certainty that they formerly could under the section 169A-type processes.

5.5. Under self-assessment, the Tax Office undertakes important pre-lodgement awareness strategies in some risk areas, but most Tax Office active compliance casework is done well after returns are processed, refunds issued and self-assessed

liabilities paid. Taxpayers caught up in these processes are exposed for up to 4 years to potentially having to fund unexpected bills for primary tax, compounding interest and possibly penalties. Costs of defending their reputation or explaining their position are also likely. There can be no better examples of this than the plight of thousands of taxpayers caught up in so-called mass marketed tax effective investments (MMTEIs) and employee benefit arrangements (EBA) in the late 1990s. It has been clear that managing these situations under its current approach to self-assessment has also not been easy for the Tax Office either.

5.6. While a predominantly post-issue approach is taken to compliance, there is no reason why the Tax Office could not examine problems before finalising a tax return in areas where taxpayers self-application of the law is known to be problematic. This would of course require a shift in mentality to think about risks to the taxpayer, as well as risks to the revenue.

5.7. Contrasts might be drawn with the Tax Office's approach to protecting the revenue risk on Business Activity Statements (BAS). ATO activity statement systems are set to identify high risk statements using very specific criteria. Where a potential problem is picked up, the statement is taken off-line, checked and cleared before issuing refunds. Not only is the revenue protected, but the taxpayer is not at risk of having received a wrong refund either (at least in the sense of having made a substantiated claim).

5.8. Big corporations are generally resourced and advised adequately enough to take care of themselves even in complex matters. My concerns are more with those taxpayers who are at even greater risk because they can never hope to understand the complexities of the tax laws themselves. Predominantly individuals and small businesses, often with investments, these taxpayers have little choice but to rely on their advisers, including accountants, lawyers and particularly tax agents.

5.9. Some rebalancing of the risks for these taxpayers under self-assessment has been made as part of RoSA implementation. The Shortfall Interest Charge, requirements to indicate in PBRs if Part IVA has been considered (or might apply) and shorter periods of review are significant steps forward. Other measures, such as extending the binding oral advice system, are limited to individuals with straightforward issues, leaving business taxpayers with the PBR system alone.

5.10. However, the Committee should consider if the self-assessment system fairly provides for taxpayers who are caught up in Tax Office compliance activity, but who may well have acted responsibly and reasonably, and who would not have suffered the same consequences if self-assessment had not been introduced.

5.11. The Committee might consider if the Tax Office should do more pre-issue interventions of this kind in areas of income tax that it perceives as high risk. The Tax Office will probably point to the potentially higher costs of these approaches compared to those where it takes post-issue compliance at its relative leisure. But the Tax Office has done well out of self-assessment, and it continues to be very well funded. In setting its compliance strategies, it should take a broader view which includes considerations of taxpayer risks and costs. It is also clear from the on-going

Mass Marketed schemes experience that, where things are picked up all too late, the Tax Office also incurs major additional costs, let alone a loss of reputation within the community.

5.12. In summary, the Committee might consider the following issues in the interest of reducing taxpayer risks and increasing certainty in the system:

- The extent to which the Tax Office factors in the risks for taxpayers of compounding interest and penalty, and unexpected primary tax liability when determining its compliance strategies;
- The level of pre-lodgement and pre-issue checking activity the Tax Office undertakes in known problematic areas, and if this should be increased;
- The level of automated checks and warnings currently built into the e-Tax system and if these can be increased;
- Whether there are gaps for some taxpayers in their ability to obtain a Tax Office view other than a PBR, and if there are opportunities with today's technology for taxpayers to protect themselves in the way they used to be able to (using section 169A provisions) by drawing the Tax Office's attention to potential issues in their return. The Tax Office might also be asked to consider whether such a system would have the added benefit of providing them with the intelligence to identify and respond quickly to emerging compliance issues;
- Having established that some taxpayers have reduced certainty and increased risk under a self-assessment system that they did not face before, the next key point draws attention to some perceived gaps and therefore opportunities in the current legal framework for the administration of self-assessment.

The legislative framework for administration under a self-assessment system is still incomplete .

5.13. While Promoter Penalties law and a new legislative framework for tax practitioners are part of the current legislative agenda, the administration of self assessment remains seriously deficient without them, notwithstanding that some improvements have been made through implementation of the RoSA review recommendations. The Promoter Penalties law is now before Parliament and it would therefore not be appropriate to comment on it here other than to note that, if it is effective in deterring (and if warranted, punishing) those of the ilk that led others into trouble in the schemes era, it will be a good thing.

5.14. A major concern is that there have been extreme delays in putting in place the new rules for tax practitioners (the process began in the early '90s and was announced as Government policy in 1998). These delays are no doubt explainable because the intervening period includes the introduction of Tax Reform, extensive consultation periods and many other legislative demands.

5.15. However, the Committee may want to consider if these delays have over recent years denied the benefit of the safe harbour proposals that are part of the policy, to some taxpayers which might have applied to them if they had been implemented earlier and in line with the policy statements.

5.16. Taking advantage of the delays in putting these safe harbour laws into place, there is an opportunity to reconsider their adequacy in light of the schemes experiences over the last few years.

5.17. 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.

5.18. The policy announcement made by the Government in 1998 (see Press Release by the then Assistant Treasurer, No AT/14, 6 April 1998) said that:

> "The concept of reasonable care is central to the responsibilities of tax agents and taxpayers under self assessment. Tax agents and taxpayers for the first time can be confident that they will not to be penalised where they satisfy this standard…. A taxpayer will be considered to have exercised reasonable care where the taxpayer can demonstrate that a tax shortfall is not due to failure by the taxpayer to:

- provide the tax agent with a copy of the last lodged return, including schedules;
- meet the record keeping requirements of the law;
- provide accurate and complete information in response to questions asked by the agent;
- conform with the tax agent's advice; and
- bring to the tax agent's attention all the information they could have been reasonably expected to have known was relevant to the preparation of the return."

5.19. The policy statement provides a blanket protection from all administrative penalties where reasonable care conditions are met. This would include penalties applied in tax avoidance cases.

5.20. A situation where the complexities of Part IVA are involved and a taxpayer has acted with reasonable care as outlined above, is precisely the situation where the proposed protections are required. In situations where a tax agent or, indeed other regulated adviser has actively been involved in advising the taxpayer on the arrangement in question, these protections would be even more relevant, providing the potential for collusion is excluded.

5.21. The policy is silent on what interest might apply to tax shortfalls where a taxpayer has taken reasonable care. Presumably, the Shortfall Interest Charge (SIC) introduced as a RoSA improvement would apply. The Committee might like to consider if there should be any liability at all for interest in these circumstances. On the basis already outlined, that tax agents are effectively a proxy for the Commissioner in these matters, a mistake by a tax agent should receive the same

treatment as a mistake by the Commissioner – that is, full exemption from interest and, potentially from the primary tax amount as well (although this submission does not suggest going that far).

5.22. In summary on this point, the new tax Commissioner has acknowledged that the tax system is complex. He has acknowledged that there is a heavy reliance by both the Tax Office and ordinary taxpayers on well-regulated advisers to cope with this complexity. So much is obvious - without them, the system would not function. The Committee might like to consider a contention that the Commissioner cannot therefore have it both ways – on the one hand to accept that people cannot cope without going to tax practitioners; but on the other, not accept that they should be unequivocally protected when they do.

5.23. The third key point also flows from the recognition by all parties that the tax system relies in large part on tax practitioners to operate at all.

The administration and operation of the tax system may be at serious risk of breakdown within the next decade because of a failure to address an unsustainable reliance on tax practitioners.

5.24. This issue is the tax administration equivalent of global warming. It has been known for years by the Tax Office and the tax professions to be a serious problem. Only the well resourced, large and self contained entities are likely to be unaffected. Tax practitioners themselves raise these concerns constantly:

5.24.1. In spite of major improvements to Tax Office services for practitioners that have improved efficiency such as the tax agent portal, and in spite of significant new services such as e-Tax to help encourage self-preparation of income tax returns, practitioners have been overwhelmed with work and complexity since tax reform and superannuation changes, if not before.

5.24.2. Apart from the continuing growth of tax laws, practitioners point also to the flood of new legal opinions (Tax Office interpretive decisions, rulings, tax determinations, etc) as compounding the complexity of administration and compliance. Most say that there is no way that they can keep abreast of these developments, raising questions about their ability to provide good advice across the board.

5.24.3. Practitioners note that the Tax Office “trots out“ agents that are managing to show that it can be done. But they note that the Tax Office actively encourages agents to drop “troublesome” clients who impede an agent’s performance. Practitioners are concerned that, not surprisingly, this short term thinking is creating a black hole of non-compliance where recalcitrant or incompetent taxpayers disappear from radar, only to reappear in burgeoning non-lodgement figures.

5.24.4. Practitioners are frustrated by the amount of non-value-adding work that they are required to do for the Tax Office and other agencies such as ASIC. Duplication of information gathering across agencies compounds this.

5.24.5. Practitioners are leaving the tax industry for more lucrative fields such as financial planning and valuations.

5.24.6. Practitioners are, as a group, an ageing population. This is compounding the gradual exodus.

5.24.7. Tax practitioner numbers are not replenishing due to overwhelmingly more attractive opportunities and remuneration. People with accounting and related skills are in great demand. Smaller tax practices cannot attract new professional staff and few practitioners have succession plans for their businesses.

5.24.8. Practitioners perceive that the Tax Office's approach to them reflects an unwillingness to trust their judgement on problems with their clients, and on operational imperatives. Practitioners perceive that the Tax Office prefers instead to rely on computer systems and other approaches which may be out of touch with contemporary reality.

5.24.9. Penalty regimes in the tax system and those administered by other agencies increasingly are impinging on practitioner profits and relationships with their clients. Often, it is the practitioner who pays these fines on behalf of their clients.

5.25. In the 1980s, the Tax Office was internally sinking in unproductive and ineffective processes which were clearly seen as unsustainable. The result was a major shift in tax administration with the move to self-assessment. The Committee might consider that if the issues raised by agents and their foreboding for the future are anywhere near true, then tax administration is currently facing a similar watershed, especially where complex laws and self-assessment interact.

5.26. The Tax Office should at least be demonstrating that it has in place a program of practical changes and investments that, for its part will contribute to sustaining a healthy tax practitioner industry as a major part of the system's infrastructure. It may have the view that smaller tax practices are a dying breed and that the market will specialise and adapt as they disappear. That is unlikely to be the whole answer, and the issue is too important to leave it to hope.

5.27. Some of the problems may be beyond the capacity of the Tax Office alone to address, and the Committee may want to consider a broader approach if it concludes that they are. The new legislative framework for tax practitioners even taken as a whole, will not in my view do very much to help resolve this part of the outlook. More far-reaching arrangements may need to be considered.

5.28. The fourth point goes to the Committee's consideration of common standards of practice by the Tax Office:

Tax Office compliance approaches appear to be inconsistent across both compliance issues and classes of taxpayer.

5.29. Any interested observer can look back over recent years and see that the Tax Office has applied markedly different treatments to major compliance issues it has encountered. The following factual précis of key examples provide the contrasts:

Mass Marketed Tax Effective Investments (MMTEIs)

5.30. These arrangements involved around 42,000 individual taxpayers and $1.8 billion in tax. The history of these matters is well known, including to members of the Committee. The Inspector-General of Taxation is on record as saying that they represent a black period in the Tax Office's administration over the last decade.

5.31. Essentially, the Tax Office's compliance treatment was that all affected taxpayers were targeted for audit and were initially subject to full primary tax, penalties and interest. This approach was a "one size fits all'' which did not distinguish between different types of taxpayers and different types of schemes. It also did not recognise that the Tax Office's conduct had contributed to the proliferation of these arrangements or that these taxpayers had relied on the advice of tax practitioners that the arrangements were tax effective.

5.32. During 2000 – 2002, the Senate Economics References Committee inquired into the manner in which these arrangements had been handled by the Tax Office and made a number of recommendations. Following this Committee's second report (September 2001), the Tax Office announced different settlement terms for 3 broad groups of taxpayers.

5.33. The first group of MMTEI taxpayers (the vast majority) were those who were investors who took advice from others and who had a good tax record. These taxpayers were able to settle their tax dispute on the basis of a deduction being allowed for their actual cash outlay, no interest or penalties and a two year interest free time period within which to pay any underpaid tax.

5.34. The other two groups of MMTEI investors were promoters, financial planners and tax advisers. Those in this group who derived fees from other people investing in MMTEIs received the worst settlement offer which consisted of a deduction being allowed for their cash outlay and the imposition of full interest and penalties. Tax advisers and financial planners who did not directly benefit from putting others into these arrangements were allowed to settle on the basis of a deduction for their cash outlay, interest at the reduced rate of 4.72% and a reduced penalty.

Employees Benefit Arrangements (EBAs).

5.35. Employee benefit arrangements involve around 7600 groups of taxpayers (over 9000 separate taxpayers) and, according to the Tax Office, around $1.4 billion of tax. Here again the Tax Office sought to tackle all affected taxpayers. In this case, however, not only was an amount of primary tax, interest and penalties levied, but for many groups of taxpayers, depending on the nature of schemes involved, these amounts were generally levied multiple times, although the Tax Office did say that it

would only seek to collect tax on one of the relevant assessments. The multiple assessments arose because the Tax Office sought to levy fringe benefits tax as well as additional income tax on the provider of the benefits and also sought to levy income tax on the recipients of the benefits.

5.36. In 2003, after a court case, the Tax Office made a concessional settlement proposal to around 3,500 of these taxpayers who had been involved in controlling superannuation arrangements. This proposal involved the levy of one amount of primary tax, interest at the reduced rate of 4.72% and no penalty. In 2004, after a review by my office of the Tax Office's policies for remitting interest for these and other groups of taxpayers, taxpayers in all EBAs were given an interest cap of 70% of the primary tax and were offered a process under which they could seek a review of the amount of interest and penalties that were levied based on their individual circumstances. These arrangements were expected to lead to interest being reduced to 4.72% for some or all of the period for which interest applied.

Service Entities (Phillips arrangements).

5.37. With service entities, the Tax Office has adopted a selective audit approach. Initially, in the period from around 1999 to 2004, it completed audits on the service entity arrangements for 2 large accounting firms. However, in 2005 it announced that it would not audit prior year returns for other accounting or legal firms (or for other businesses with service entity arrangements such as medical practitioners and pharmacists) if they passed one of the 3 tests and restructured their service arrangements by the end of June 2006 to conform with the terms of a draft ruling and booklet on service arrangements which the Tax Office had, by then, issued.

5.38. The 3 tests, one of which a business had to pass to be eligible for this treatment, were that the amount of fees paid to its service entity was less than $1 million, the service entity did not receive more than 50% of the gross fees of the relevant business and the service entity did not derive more than 50% of the total net profit of the combined entities. The Tax Office has not publicly explained the basis for this selective audit approach.

Research and Development (R & D Syndicates).

5.39. The Tax Office has been actively undertaking compliance work on these arrangements since the early '90s, although some taxpayers still being pursued say they were not informed of the issue until 10 years after they claimed the tax deductions.

5.40. Originally around 245 syndicates were involved with total tax shortfalls for core technology and related R&D expenditure of around $3.7 billion estimated by the ATO. Individual company shortfalls ranged from $0 to $143 million. Similar to Service Trusts, the Tax Office seems to have taken a highly pragmatic or expedient approach to the majority of taxpayers. Those with estimated tax shortfalls under $3 million have effectively been "let off". Most were never even informed that there was an issue.

5.41. The Tax Office is continuing to pursue settlement with less that 40 large entities on the basis that, if they cannot satisfy the ATO that they are compliant they should agree to settle for 50% of the amounts involved plus full interest capped at 6 years.

5.42. Two of these areas, Service Trusts and R & D Syndicates are currently under full review by the Inspector-General as case studies into why the Tax Office takes so long to resolve major, complex issues. I will therefore have more to say on those matters when my reports on them are completed and released by the Minister in due course.

5.43. The challenge for the Tax Office is to provide the rationale(s) behind these apparently different treatments and to demonstrate that they are consistent, and have a sound basis in fairness and good public administration. It needs to do this, because the community has developed negative perceptions that the Tax Office is not fulfilling its role as fair administrator and worse, that it is biased in favour of certain kinds of taxpayers.

5.44. Part of the Tax Office's explanation for these different compliance treatments may turn on its categorisation of the compliance behaviours involved.

6. PAYG issues

6.1. The last part of this submission is about the operation and administration of the PAYG system, and raises the issues which could be addressed under the third part of this Inquiry's Terms of Reference.

6.2. At a broad level, many question whether the original intent and aspiration for the PAYG system, announced as part of the ANTs tax reform package, has been fulfilled in its implementation.

6.3. The ATO is improving its systems and its services in this area. Account information is now much more user friendly, and providing tax agents real time access to their clients PAYG accounts using the tax agent portal have been major steps forward. Nevertheless, tax agents continue to complain bitterly about non-value adding processes, inflexibly adhered to by the ATO which exacerbate their time-poor lives.

6.4. The committee will no doubt receive input from many sources on the vagaries of the Tax Office's approach to PAYG procedures, informing people of their obligations and how they arise, and the economic impacts of the system on small business.

6.5. The main focus, however, should be about some broad aspects of the PAYG system in operation; its fairness and operational efficiency. This submission's sixth and final point therefore is to draw the Committee's attention some potential inequities in the PAYG system which need fixing.

There are inequities within the PAYG system.

6.6. The following facts demonstrate the observed inequities and raise other issues within the PAYG system:

- The PAYG system (both PAYG withholding and PAYG instalments) consistently over-collect tax at the macro level each year by around 13%, or around $15 billion p.a. in current money. This is simply the amount refunded to individuals from their PAYG payments when their returns are processed after year end.
- No interest is paid when these over-collections are refunded.
- The PAYG (Instalments) system demands that taxpayers provide for the possibility of an end of year tax shortfall by paying instalments quarterly or annually.
- If PAYG instalments are not paid on time, full and compounding GIC (currently 12.61%) is payable.
- Even if the end of year position shows that the taxpayer did not need to provide for a liability, the compounded GIC charged on unpaid instalments remains compounding on the taxpayers PAYG account. Effectively, this is interest on monies that were never needed to be paid. Taxpayers can apply for remission; even if they get it, this can involve cost and delay.
- Taxpayers can vary their instalments or the amounts withheld by their employers; but these processes are cumbersome and risky – full GIC applies if mistakes are made.
- Paying tax instalments by withdrawing investment capital results in loss of income for taxpayers. Accountants say that PAYG is fleecing small business of its capital.

6.7. This adds up to a system of administration that leans only one way – heavily in favour of the tax collector. It doesn't recognise or compensate for over-collecting, but applies interest for under payments.

7. Conclusion

7.1. The self-assessment system and the PAYG system as part of it are what we have and their application to taxpayers must always be under review for improvements. There can be no question of returning to the past.

7.2. Many improvements have been made progressively and most recently by implementing the RoSA recommendations. More is in hand with the Promoter Penalty laws. The safe harbour provisions announced in 1998, when introduced, will further provide protections for honest taxpayers provided that they are implemented without exception.

This submission has suggested areas and issues which might be considered for further improvements to reduce risks to taxpayers and increase certainty and fair treatment. Some of these might require changes to administrative aspects of the tax laws; but many are within the powers and capability of the Commissioner and the Tax Office.

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Inspector-General of Taxation

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