The Institute of Chartered Accountants in Australia

10 March 2006

Mr Russell Chafer
Committee Secretary
House of Representatives
Parliament House
CANBERRA ACT 2600

By email: Bronwen.jaggers.reps@aph.gov.au

Dear Sir

Inquiry into taxation matters

1. Introduction

Thank you for inviting The Institute of Chartered Accountants in Australia (the Institute) to provide its comments to the Joint Committee of Public Accounts and Audit (the Committee) on its inquiry into taxation administration matters.

The Institute is Australia's premier accounting body, which represents over 40,000 members who are fully qualified Chartered Accountants working either in the accounting profession providing auditing, accountancy, taxation and business consultancy service or in diverse roles in business, commerce or government.

2. Scope of our submission

2.1 Part A

The objective of Part A of the inquiry is to look at the administration by the Australian Taxation Office (ATO) of the *Income Tax Assessment Act 1936* and *1997* with particular reference to compliance and the rulings regime, including:

- 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 (GIC) and shortfall interest charge (SIC) and
- the operation and administration of the pay-as-you-go (PAYG) system.

Our comments focus mainly on the ATO's administration of the rulings regime as opposed to its administration of compliance more generally. The Institute has made numerous submissions to various bodies over the years dealing with aspects of ATO administration, most recently in its submission to the Inspector-General of Taxation's "Review into Aspects of the ATO's business active compliance activities". A copy of that submission is attached as Appendix 1.

27–29 Napier Close
Deakin ACT 2600
Tel: 1300 137 322
Fax: 02 6282 9800

L1/200 Mary Street
Brisbane QLD 4000
Tel: 07 3233 6500
Fax: 07 3221 0856

L11/1 King William Street
Adelaide SA 5000
Tel: 08 8113 5500
Fax: 08 8231 1982

TCCI, 30 Burnett Street
North Hobart TAS 7000
Tel: 1800 014 555
Fax: 03 9670 3143

L3/600 Bourke Street
Melbourne VIC 3000
Tel: 03 9641 7400
Fax: 03 9670 3143

Grd/28 The Esplanade
Perth WA 6000
Tel: 08 9420 0400
Fax: 08 9321 5141

The Institute of Chartered Accountants in Australia
ABN 50 084 642 571
Incorporated in Australia Members' Liability Limited
Level 14, 37 York Street Sydney NSW 2000

GPO Box 3921 Sydney NSW 2001

Tel: 1300 137 322 / 61 2 9290 1344
Fax: 61 2 9262 1512

www.icaa.org.au

In relation to the ATO's administration of the taxation system generally we also note that the Institute surveys its members annually for the purpose of determining their top 10 administrative bugbears. The most recent survey findings are set out in our 29 July 2005 letter to the Inspector-General, a copy of which is attached for your information (Appendix 2). Most of the issues included in the list are being dealt with by the ATO through its various consultative committees and, with limited exceptions, are not dealt with in our comments below.

2.2 Part B

Part B of the inquiry is to look at the application of the fringe benefits tax (FBT), including any "double taxation" consequences arising from the intersection of FBT and family tax benefits.

As our fundamental concerns with the FBT system are legislative as opposed to administrative in nature, we have not addressed this part of the inquiry. However, we have provided a brief summary of the Institute's activities to address its fundamental concerns. We also attach as Appendix 23a copy of a submission made by the Institute and a number of other professional bodies to the Government on 4 August 2004 in relation to the cost of compliance and other difficulties faced by employers as a consequence of the FBT legislation.

3. Recent reviews

At the outset we note that aspects of the rulings systems have been subject to a number of reviews since their introduction. These include a Review of Aspects on Income Tax Self Assessment Report (commonly referred to as the ROSA review) by Treasury that culminated in the Report on Aspects of Income Tax Self Assessment in December, 2004 (the ROSA Report). In addition to the rulings system, the ROSA Report also considered the appropriateness of applying the GIC to additional tax imposed as a result of an amended assessment between the time of the original and amended assessment, i.e. the pre-amendment period.

The legislative recommendations of the ROSA Report were accepted by the Government and have since been enacted. There were also a number of administrative recommendations arising from the review that the Commissioner accepted and has implemented, or is in the process of implementing, in consultation with stakeholders.

In addition, the ATO itself commissioned Mr Kevin Burges to report on the concerns of a number of the largest companies in the Large Business Segment with ATO audit, investigation, and advice procedures. The Burgess Report dated April 2005 has been publicly released.

As a result of the recommendations arising from the ROSA review in particular, many of our concerns associated with both the rulings systems and the rate of interest imposed on underpayments of tax in particular circumstances have been, or are in the process of, being addressed. Particularly in the case of the administrative changes, it may take some time to assess their effectiveness.

4. Executive summary

4.1 Interaction between self-assessment, complex legislation and public rulings

The Institute recommends that:

- The ATO, if it does not already do so, review the cause of delays in relation to the finalisation of public rulings that have taken substantially longer to finalise than originally contemplated.

- To the extent that long delays in finalising public rulings are associated with complex matters, any systemic issues identified by the Inspector-General of Taxation in relation to his review of the ATO's handling of complex matters be addressed by the ATO.

- The ATO confirm that, as indicated in Practice Statement PS LA 2003/3, all publicly issued draft rulings reflect the Commissioner's general administrative practice. If this is not always the case, the Commissioner should indicate in a draft ruling if the ruling does not represent his general administrative practice.

- Alternate views expressed by the professional bodies, the external members of the Rulings Panels or which are otherwise available, should be included in public rulings in all cases.

- As was also recommended in the ROSA Report, that all aspects of a public ruling that are capable of binding the ATO be made binding.

4.2 Interaction between self-assessment, complex legislation and private rulings

The Institute recommends that, in addition to the ATO enhancing its published performance reporting on private rulings (commonly referred to a private binding rulings or PBRs) as recommended in the ROSA Report, the ATO also review the cause of delays in relation to PBRs which have taken a substantial time to complete by reference to total elapsed time from application to finalisation.

4.3 The application of common standards of practice by the ATO across Australia

The Institute is not aware of any significant issues that have arisen which would suggest a lack of common standards of administrative practice by the ATO across Australian in the rulings area.

4.4 The level and application of penalties

In relation to the level and application of penalties we recommend that:

- The ATO, in revising its rulings on what constitutes reasonable care and a reasonably arguable position, which is relevant to the quantum of penalties imposed in respect of tax shortfalls, have regard to the matters outlined in 5.3.1 below. In particular, in determining whether a taxpayer has exercised reasonable care, due weight should be given to the volume and complexity of the law.

- ATO officers different from those dealing with an audit or technical dispute be responsible for decisions regarding the imposition/remission of a penalty.

- There be put in place a formal ATO procedure for internal review of imposition/remission decisions that may be activated by the ATO officer or the taxpayer.

- Given the complexity of many new measures that are introduced, consideration be given to introducing an automatic penalty remission policy for a specified period after the commencement of such measures. In the absence of an automatic penalty remission policy in respect of new measures, full remission should be considered in respect of particularly complex measures, including the forex rules.

- The ATO clarify whether false or misleading statements are confined to situations where the statement omits a material fact or includes something which is not factually correct.

- The ATO provide further guidance on what constitutes its general administrative practice and hence the circumstances in which taxpayers will be statutorily protected from penalties and, for the 2005 and subsequent years, interest when they rely on such practice.

4.5 The application and rate of the general interest charge (GIC) and shortfall interest charge (SIC)

We recommend that:

- The factors set out in 5.4 be taken into account by the ATO in formulating its guidelines on the remission of GIC and SIC.

- Consistent with our recommendations in respect of penalties, the decision to impose/remit GIC or SIC be made by tax officers different to those dealing with the audit or technical dispute and a mechanism be put in place for that decision to be reviewed by the ATO.

4.6 The operation and administration of the pay-as-you-go (PAYG) system

There are a number of operational and administrative issues associated with the PAYG system and the tax agents' portal. These issues are being addressed by the ATO, in consultation with stakeholders, in conjunction with the rollout of a new system.

4.7 Other administration matters

- Clarification of the protection afforded by various categories of ATO advice – as a consequence of the implementation of the recommendations of the ROSA report, we recommend that the ATO revise its practice statement(s) and other ATO publications to reflect the status of various categories of written and oral advice as legally or administratively binding, the level of protection provided in respect of both penalties and interest and the consequences of the withdrawal of such advice.

- ATO discretions – to the extent that there remain discretions in the tax legislation following the scheduled review of Commissioner discretions by Treasury, it is recommended that the ATO provide guidance as to how those discretions will be exercised.

- Voluntary disclosure and audits – it is recommended that the ATO review its procedures to require ATO staff to notify a taxpayer, preferably in writing, when a post-assessment compliance activity will commence and whether that activity, however described, is a tax audit for the purpose of the penalty provisions.

Part A

5. Administration by the ATO of the *Income Tax Assessment Act* 1936 and 1997 with particular reference to compliance and the rulings regime

5.1 The impact of the interaction between self-assessment and complex legislation and rulings

The object of the ATO providing rulings to taxpayers is to provide taxpayers with an enhanced level of certainty and fairness in a self assessment regime which relies on taxpayers understanding complex legislation in order to self assess their income tax liability. Our comments in relation to public rulings and PBRs are set out below.

5.1.1 Public rulings

(a) Identification and prioritisation of topics

The ATO has in place a mechanism under which tax officers may nominate topics for inclusion on the Public Rulings Program (the Rulings Program) through their business line's escalation process. As we understand from Practice Statement PS LA 2002/20, a topic is only placed on the Rulings Program once resources have been allocated for its preparation within the time frames specified. The relevance and performance of the Rulings Program is monitored by the National Tax Liaison Group and topics for the program may be submitted through tax and industry representatives.

The consequence of this is that, while we do not have any major concerns with the process by which topics for public rulings are identified and prioritised, there are instances where the time taken to finalise public rulings appears, on the face of it, to be excessive (see (b) below).

(b) Timeliness

The ATO publishes on its website the Rulings Program (covering both rulings and determinations) in which it states that:

- as a general rule, a draft ruling is to be issued within six months of the date of notification on the Rulings Program and a final ruling is to be issued within six months of its issue in draft form and
- a draft determination is to be issued within three months of the date of notification on the Rulings Program and a final determination is to be issued within three months of its issue in draft form.

In terms of elapsed time from notification to finalisation, the target is therefore twelve months for rulings and six months for determinations.

When a ruling or determination is placed on the Rulings Program, the planned date of completion of the draft and final ruling or determination is generally set to reflect the expected turnaround time. As a matter progresses, those planned dates are revised. We are not aware of the ATO maintaining as a public performance measure details of time elapsed between notification of a ruling or determination and its finalisation or the time taken to finalise a ruling or determination over and above the original time frame specified in the Rulings Program.

Of the proposed income tax and FBT rulings and determinations on the list at 2 February 2006[1], about 44 of a total 86 or approximately 50% had been on the list for longer than six or twelve months. Of those 86 rulings and determinations, the number which are highlighted as being delayed (presumably beyond the previously revised planned date) is as follows:

Topic	Number	Number delayed	Delayed topics not yet at draft stage
Income tax			
Income tax	30	10	5
Consolidation	25	19	1
Capital gains tax	4	1	
International	16	8	2
Superannuation	7	3	3
FBT	4	2	2
Total	86	43	13

[1] This excludes GST and Miscellaneous rulings.

In effect, 65% of income tax and FBT rulings and determinations were identified as being subject to delay. To get some idea of the time elapsed from the time of notification of those 43 rulings and determinations, one was notified in 2003, ten were notified in 2004 and the balance in 2005 and the year to date.

The consequence of long delays in the finalisation of public rulings and determinations is that taxpayers are subject to longer periods of uncertainty during which:

- they have no protection from primary tax;
- they are statutorily protected from penalties but only if the draft ruling represents the Commissioner's "general administrative practice"[2] (see 5.1.1(c) below);
- for 2005 and subsequent years, they are statutorily protected from GIC or SIC but again, only if the draft ruling represents the Commissioner's general administrative practice[3]. This follows a recommendation of the ROSA Report. For 2004 and earlier years taxpayers are forced to rely on the Commissioner's discretion to remit GIC;

Where a listed matter has not reached the stage of a draft ruling or determination, taxpayers are required to adopt a reasonably arguable position to preclude the imposition of penalties and the Commissioner's discretion in relation to remission of GIC or SIC. Alternatively, they may seek a PBR which, given the listing of the matter on the Rulings Program, may not be forthcoming within a reasonable time frame.

We acknowledge that, given the complexity of the law, some delays are inevitable. However, in our view, there are instances where the time taken to finalise a ruling or determination is difficult to justify. Recent examples (which have not yet been finalised) include:

- TR 2005/D5 dealing with the deductibility of service fees paid to associated service entities (notified 30 January 2004), including the accompanying draft booklet. The Institute's views in relation to this ruling are set out in our submission to the Inspector-General of Taxation in relation to his review of the ATO's handling of complex matters. A copy of that submission (excluding appendices) is attached as Appendix 4.

- TR 2006/D1 (notified 24 May 2005) dealing with special income derived by complying superannuation entities. The draft ruling in fact replaces an earlier draft ruling on the same topic, TR 2000/D11 released on 19 July 2000. In effect, TR 2006/D11 has been over five years in the making.

We recommend that the ATO, if it does not already do so, review the cause of delays in relation to the finalisation of public rulings that have taken substantially longer to finalise than originally contemplated.

We also recommend that, to the extent that long delays in finalising public rulings are associated with complex matters, any systemic issues identified by the Inspector-General of Taxation in relation to his review of the ATO's handling of complex matters also be addressed by the ATO.

We considered whether an alternative may be to treat draft rulings and determinations as not reflecting the Commissioner's general administrative practice if they have been outstanding longer than, say, six months and twelve months for determinations and rulings respectively. On balance we do not recommend this alternative as it is unlikely that the ATO would be responsive to a PBR application in these circumstances within a reasonable time frame. In these circumstances, a taxpayer's ability to act with any degree of certainty is further reduced.

[2] Section 284-215 of *Taxation Administration Act 1953*

[3] Section 361-5 of *Taxation Administration Act 1953*

(c) Protection afforded by draft rulings

As indicated in (b) above, protection from penalties and interest afforded to a taxpayer depends upon whether the draft ruling reflects the Commissioner's general administrative practice.

The circumstances in which a draft ruling or determination represents the Commissioner's general administrative practice is set out in the Explanatory Memorandum to *Tax Laws Amendment (Improvements to Self Assessment) Act (No 2) 2005* which implemented the Review's recommendations in relation to ATO advice. It indicates (at 3.130) that a draft ruling will "usually" represent the Commissioner's general administrative practice where the draft ruling represents the Commissioner's only public statement on an issue.

This suggests that where there exists both a draft ruling and a contrary public statement, neither document represents the Commissioner's general administrative practice. (However, the Commissioner, using his general power to administer the tax laws, is not obliged to amend assessments of taxpayers that were raised consistently with a practice in place at a particular time.) By contrast, Practice Statement PS LA 2003/3 indicates that all draft publicly issued rulings set out the Commissioner's general administrative practice.

If the comments in the Explanatory Memorandum are an indication of how the Commissioner will apply the law in this area, then taxpayers have no clear guidance on whether a draft ruling represents the Commissioner's general administrative practice either because it is an exception to the general rule or there is in existence a contrary public statement by the Commissioner.

If not all draft publicly issued rulings reflect the Commissioner's practice then, in our view, the Commissioner is best placed to determine which ones do not represent his general administrative practice either generally or because there are no contrary public statements.

We also foreshadow that what constitutes the Commissioner's general administrative practice will be a fertile ground for dispute in the future, not only in relation to draft rulings, but also in the variety of other circumstances mentioned in the abovementioned Explanatory Memorandum. This is discussed in more detail in 5.3.2(d) below in relation to penalties.

We recommend that the ATO confirm that, as indicated in Practice Statement PS LA 2003/3, all publicly issued draft rulings reflect the Commissioner's general administrative practice. If this is not always the case, the Commissioner should indicate in a draft ruling if the ruling does not represent his general administrative practice.

(d) Comprehensiveness and clarity

The abovementioned Review made a number of administrative recommendations in relation to public rulings that have a bearing on their comprehensiveness and clarity. In particular, it recommended that:

- all aspects of a public ruling that are capable of binding the ATO, including for example, worked examples) should be collected together and clearly labelled as binding. Alternate views need not be addressed if these are likely to confuse the reader. Where competing views are raised in consultation and not addressed in the ruling, the ATO should provide feedback directly to people contributing those views (Recommendation 2.4)
- ATO general written advice, including public rulings, be written in plain language with a minimum of qualifying statements (Recommendation 2.8).

We are aware that to improve the clarity of rulings and, in particular, which aspects of the public ruling are binding it is proposed that the format of public rulings be changed to:

- clearly segregate those parts of a public ruling which are binding as opposed to explanatory in nature and
- cater for the inclusion of competing views in an appendix.

We commend any attempt to clearly identify those parts of a ruling that are binding and to make the binding part as complete as possible. It is too early too assess the extent to which these recommendations have been effectively implemented.

However, we recommend that the explanation part of a ruling, traditionally treated as non-binding, should form part of the ruling that is made binding. Essentially, the explanation part is often the critical part of a ruling and provides an insight into how the ATO has arrived at its interpretation.

We would also prefer that alternate views be included in public rulings in all cases, and not simply where the ATO is of the view that to do so will not confuse the reader. In our opinion, alternate views raised in submissions, by the Public Rulings Panels or elsewhere, increase public confidence in the public rulings system and should assist to allay concerns of revenue bias.

We recommend that alternate views expressed by the professional bodies, the external members of the Public Rulings Panels or which are otherwise available, be included in public rulings in all cases. We also concur with the recommendation of the ROSA Report that all aspects of a public ruling that are capable of binding the ATO be made binding.

(e) The quality of advice contained in rulings/perceived revenue bias in rulings

In the case of public rulings, the establishment of a Public Rulings Panel and an International Public Rulings Panel, which include external tax experts, to supplement a public consultation process, in which the professional bodies participate, has gone some way to ensure the quality of public rulings and, more particularly, public confidence in these rulings.

Despite this, there are a number of instances where draft rulings are finalised which do not adequately address the concerns raised in submissions and which are not otherwise satisfactorily addressed in the ATO's response to submissions lodged.

The ATO and taxpayers may legitimately differ as to the proper application of the law. However, as previously indicated, the inclusion in public rulings of alternate views, can only enhance public confidence in the public ruling process by demonstrating that those views have been considered but not regarded as the preferred view.

Consistent with our above recommendation, in our opinion, alternate views expressed by the professional bodies, the external members of the Rulings Panels or which are otherwise available, should be included in public rulings in all cases.

5.1.2 Private rulings

In relation to PBRs, the Review made a number of administrative recommendations. These are summarised in Appendix 5. In particular, in accordance with Recommendation 2.13, the Government requested the Inspector-General to evaluate whether the pattern of PBRs indicates a pro-revenue bias. Our letter to the Inspector-General in relation to his review, which has yet to be completed, is attached as Appendix 6.

Many of the recommendations of the ROSA Report revolve around the time taken to obtain a PBR. The Taxpayers' Charter timeliness standard of finalising PBR applications is 28 days of receiving all information, with scope to negotiate an extended deadline if necessary in complex cases. If all the information required to make a decision is not provided, the Tax Office aims to contact the taxpayer within 14 days to request further information.

In response to concerns by tax agents as to the turnaround time for PBRs and suggestions that the ATO had too much latitude to request arguably unnecessary additional information to restart the time target, it was recommended that:

- Recommendation 2.14 - the ATO enhance its published performance reporting on PBRs to distinguish response times to individuals and very small business from those for larger businesses, and separately report agent and non-agent case statistics.

  In a similar vein, the 2001-2002 report of the Australian National Audit Office (ANAO) on *The Australian Taxation Office's Administration of Taxation Rulings* saw merit in, and recommended that, the ATO consider supplementing the Taxpayers' Charter with a standard which reflected a more realistic target for complex PBRs.

- Recommendation 2.16 – among other things, the ATO refrain from ruling on issues not directly raised in PBR applications without the taxpayer's agreement or including appropriate caveats.

It was also recommended, and the law has been changed to reflect, that taxpayers who have supplied all information required by the ATO whose PBR application is older than 60 days may request that the ATO determine their application within 30 days. Failure to do so results in the taxpayer being taken to have received a negative response, thus triggering their objection and appeal rights.

Given that the purpose of obtaining a PBR is to obtain certainty relatively quickly, we consider that triggering formal objection and review procedures will do little to address the lack of timeliness of PBRs. Instead, much will depend upon the ATO setting realistic timeliness standards, as recommended in the ROSA Report, and adhering to those standards. Even then, as noted in the abovementioned ANAO report, the 'negotiated extended timeframe' is a limited target or standard by which performance can be assessed. Stakeholders consulted at the time of the ANAO review felt that they had little choice but to agree to the ATO's proposed extension of time for satisfying the PBR request. We would be surprised if taxpayers feel any differently today.

The solution proposed by the ANAO was to improve internal performance monitoring of PBRs. It recommended that the ATO consider supplementing existing performance standards with a standard reflecting the total elapsed time taken to issue PBRs. Although the ATO agreed with the recommendation we are not aware of whether it was implemented.

We also note that the Burges Report, which focused on the largest companies in the Large Business Segment, indicated that all the companies interviewed reported great difficulty in obtaining timely PBRs, to the extent in many cases of rendering the private binding ruling concept virtually useless to them. It was also reported to be almost impossible to obtain meaningful non-binding indications of ATO concerns, which would be helpful in saving time and expense during the planning stage of major transactions.

The ATO has responded to the concerns of these companies by initiating a fast tracking system for priority PBRs, i.e. PBRs associated with transactions which, among other things, are time sensitive, complex or have major commercial significance where tax is critical (see Practice Statement PS LA 2005/10).

At this time is too early to assess the effectiveness of the measures implemented or to be implemented as a consequence of the ROSA and Burges' Reports. However, we make the following recommendation.

The Institute recommends that, in addition to the ATO enhancing its published performance reporting on PBRs as recommended in the ROSA Report, the ATO also review the cause of delays in relation to PBRs which have taken a substantial time to complete by reference to total elapsed time from application to finalisation.

5.2 The application of common standards of practice by the ATO across Australia

Common standards are applied by the ATO to the issue of public rulings. However, we are not aware of whether common standards of practice are adopted across Australia in respect of private rulings. However, no significant matters have been brought to our attention that indicate a lack of common standards by the ATO across Australia in the area of private rulings.

5.3 The level and application of penalties

We note that the current scale of penalties in the *Taxation Administration Act 1953* was not criticised in submissions made as part of ROSA. As a result, it was concluded in the ROSA Report that the scale of penalties need not be adjusted.

The ROSA Report made various recommendations in relation to the administration of penalties by the ATO. These included:

Recommendation 4.1

> *"The Tax Office should revise its rulings on reasonable care and reasonably arguable position, with a view to providing clearer guidance and further examples as to what conduct will, or will not, attract a penalty."*

Recommendation 4.4

> *"The Tax Office should explain more fully, for example in a ruling or Practice Statement, how it exercises the discretion to remit tax shortfall penalties, including in Part IVA cases."*

Recommendation 4.6

> *"The Tax Office should further explain in a ruling or Practice Statement what understatements of liability it regards as immaterial for tax shortfall purposes."*

The ATO has partially addressed some of these recommendations through the release of ATO Practice Statement PS LA 2006/2 "Administration of shortfall penalty for false or misleading statement" and we expect that further ATO guidance will be forthcoming. Accordingly, it is, to an extent, premature to comment on the administration of penalties without having first given the ATO an opportunity to implement the recommendations proposed in the ROSA Report.

However, some of the main aspects of the recommendations that we believe the ATO should consider are discussed below.

5.3.1 Recommendation 4.1 - meaning of "reasonable care" and "reasonably arguable"

(a) Reasonable care

We believe the ATO needs to provide guidance on some of the factors that might be taken into account in determining whether reasonable care has been exercised. These include:

- ATO contribution to a mistake, e.g. an ATO officer gives incorrect or misleading oral advice from a call centre. Provided the taxpayer has records to evidence the advice received, we are of the view that this should be taken into consideration in establishing whether the taxpayer has exercised reasonable care.[4]

[4] This is consistent with Practice Statement PS LA 2002/17 which indicates (at paragraph 6) that if a person honestly follows oral advice provided by the ATO which turns out to be incorrect, they will not be subject to penalties or interest.

- Reliance on ATO guidance materials. Taxpayers, not represented by tax agents, who rely on ATO fact sheets and other material on the ATO's website should be taken to have exercised reasonable care.
- Australia's taxation laws are now so voluminous and so complex that practitioners often despair that as professionals they are expected to be "all knowing", both in terms of the higher standard expected of taxpayers who use a tax agent when the ATO applies penalties and also their civil law obligations vis-à-vis their taxpayer client. This complexity and uncertainty should be a factor in determining whether a taxpayer or their tax agent has taken reasonable care. The Institute is aware of wide concern amongst practitioners that the ATO does appear to give due weight or consideration to this in practice.

Other issues with the test of reasonable care include:

- Is the test of reasonable care an objective test? In other words, if a taxpayer does what a reasonable person might be expected to do to exercise reasonable care, is this sufficient to demonstrate reasonable care?
- Who makes the determination as to what is reasonable care in the circumstances, and what recourse is available for an affected taxpayer?
- Reliance on general administrative practice. As indicated above, there needs to be clarification of this term.
- Although not strictly within the terms of reference of the inquiry, a distinction needs to be made between the remission of penalties for income tax and indirect taxes such as GST. In relation to indirect taxes, a taxpayer that underpays tax on a transaction and is called upon to adjust under audit is unlikely to be able to recover the underpayment from the customer. Where the taxpayer is unable to recover the indirect tax involved, the payment of the tax would itself be a fiscal penalty on the taxpayer and contrary to the legislative scheme of such taxes, which intends that the tax be ultimately borne by the consumer.

(b) Reasonably arguable position

A significant concern amongst our members is to what extent they can rely on various ATO guidance materials to establish a reasonably arguable position. For example, public rulings are typically divided into two parts – the first is the actual ruling, which is binding – and the second is the explanation that supports the ruling, which is currently non-binding. However, it is the explanation to a ruling that is most often referred to by taxpayers in determining the application of the ruling to their particular circumstances. Clarification is required on whether a taxpayer that relies upon extracts from the explanation of a ruling can establish a reasonably arguable position. Similar concerns arise in relation to reliance on ATO Interpretative Decisions.

We recommend that the ATO, in revising its rulings on what constitutes reasonable care and a reasonably arguable position, which is relevant to the quantum of penalties imposed in respect of tax shortfalls, have regard to the abovementioned matters. In particular, in determining whether a taxpayer has exercised reasonable care, due weight should be given to the volume and complexity of the law.

5.3.2 Recommendation 4.4 – remission

Once again, our understanding is that the ATO is currently undertaking action in respect of this recommendation. Some issues that we would encourage the ATO to consider are set out below.

(a) Independence of officers considering imposition/remission

There should be independence between the officers considering imposition/remission of a penalty and the officers dealing with an audit or technical dispute. This will ensure independence, transparency and consistency in the penalty imposition/remission process.

There should ideally be a formal ATO procedure for internal review of remission decisions, at the request of the ATO officer or the taxpayer. This procedure would precede the right of the taxpayer to pursue external review through review and appeal procedures.

We recommend that ATO officers different from those dealing with an audit or technical dispute be responsible for decisions regarding the imposition/remission of a penalty. We also recommend that there be put in place a formal ATO procedure for internal review of imposition/remission decisions which may be activated by the ATO officer or the taxpayer.

(b) New measures

When the New Tax System was introduced on 1 July 2000, the ATO recognised the difficulties that many taxpayers and their advisers would face in understanding and implementing that system, and the impact it would have on other taxation obligations. Accordingly, the ATO released Practice Statement PS LA 2000/9, which adopted a more relaxed remission policy for penalties and general interest charge arising from mistakes made during the transition to the New Tax System. The transition period during which this more supportive approach was taken was extended under Practice Statement PS LA 2002/8 because the ATO considered it was not "unreasonable to expect that there will continue to be misunderstandings and problems, despite the ATO's efforts to assist taxpayers in meeting their tax obligations."

Similarly, in the context of the introduction of the consolidation rules, the ATO, on 5 December 2003, issued a media release (Media Release - Nat 03/117), which stated, amongst other things, that:

> *"During the transitional period for consolidation (1 July 2002 to 30 June 2004) the Tax Office will adopt an approach to the remission of penalties consistent with that outlined in the Tax Office Practice Statement PS LA 2002/008.*
>
> *The Tax Office acknowledges that with a major new measure like consolidation, mistakes will be made and it will take some time for the rules to bed down.*
>
> *Taxpayers who have made a genuine attempt to meet their obligations will have any shortfall penalties remitted in full, unless there is clear evidence to the contrary. Taxpayers will be liable for the general interest charge except where it is remitted in accordance with the Tax Office Receivables Policy."*

Unfortunately, the ATO has rejected several submissions by the Institute and other professional bodies that the complexity and uncertainty associated with the foreign exchange or 'forex' rules (in Division 775 of the *Income Tax Assessment Act 1997*) should also warrant an automatic entitlement to penalty remission where every attempt has been made to comply with the rules but inadvertent errors have been made.

The forex rules had effect from 1 July 2003. Just over 2 years later, there are still over 50 unresolved forex issues some that can be resolved administratively and others that require legislative amendment. Accordingly, in addition to having to come to terms with a major new measure, taxpayers and their advisers have been forced to contend with considerable complexity and uncertainty in relation to various aspects of that measure.

In these circumstances, we believe that the ATO should automatically consider the remission of penalties where a taxpayer has made every effort to comply with the forex rules but inadvertent mistakes have been made.

More generally, we consider that, whenever a new measure is introduced, there should be an automatic penalty remission policy for the longer of the first 12 months after the commencement of, and any transitional period associated with, the new measure.

Given the complexity of many new measures which are introduced, we recommend that consideration should be given to introducing an automatic penalty remission for a specified period after the commencement of such measures. In the absence of an automatic penalty remission policy in respect of new measures, full remission should be considered in respect of particularly complex measures, including the recently introduced forex rules.

(c) False and misleading

Administrative shortfall penalties imposed under subsection 284-75(1) of the *Taxation Administration Act 1953* are dependent upon there being a shortfall amount which is the result of a statement by a taxpayer (or the taxpayer's agent) which is "false or misleading in a material particular, whether because of things in it or omitted from it".

Paragraph 28 of the Practice Statement PS LA 2006/2 and the accompanying Example 1 make references to the relevant statements as being of "mixed fact and law" and this may give the impression that such statements can be false or misleading if wrong in either fact or law. This conflicts, however, with the Commissioner's earlier comments in Taxation Ruling IT 2141 "False or Misleading Statement" (refer to paragraphs 14, 18 and 19) which was released in March 1985 following the introduction of the statutory penalty regime in *Taxation Laws Amendment Act 1984*. Paragraph 14 of IT 2141, for example, states:

"14. A statement as to a particular view of the proper operation of the law is not false or misleading even though it may be inaccurate. In context, and as a matter of the proper interpretation of the expression "false or misleading statement", it is clear that the legislature is directing its attention to statements of fact that that are false or misleading and not to statements as to the application or interpretation of the law … While there will be some situations where the distinction is not entirely clear, it is unlikely to be difficult to make in the vast majority of practical situations. Where there is some doubt, fine distinctions are not to be made and the statement should be treated as one of law and not penalisable …"
Clarification is therefore required on whether false or misleading statements are confined to situations where, viewed objectively, the particular statement omits a material fact or includes something which is not factually correct.

We recommend that the ATO clarify whether false or misleading statements are confined to situations where the statement omits a material fact or includes something which is not factually correct.

(d) General administrative practice

Under subparagraph 284-215(1)(b)(ii) of the *Taxation Administration Act 1953*, a taxpayer's shortfall amount is reduced to the extent that its treatment of a taxation law agrees with general administrative practice of that law. Although PS LA 2006/2 defines a "general administrative practice" as "a practice adopted by the Commissioner which applies to a class of entities or to a specified group within a class", we believe there needs to be further clarification of what constitutes a general administrative practice. Issues that still need to be addressed include:

- Does the practice need to be documented?
-
- If the Commissioner's practice is not to exercise a power, how does this differ from a general administrative practice where the Commissioner does exercise a power?
- In relation to private rulings, if the ATO has issued private rulings on the same situation to other taxpayers, and the taxpayer is aware of this, the taxpayer should be entitled to rely on this as evidence of ATO practice.

What constitutes the Commissioner's general administrative practice is also relevant in the context of the interest.

We recommend that the ATO provide further guidance on what constitutes its general administrative practice and hence the circumstances in which taxpayers will be statutorily protected from penalties and, for the 2005 and subsequent years, interest when they rely on such practice.

5.4 The application and rate of GIC and SIC

As a result of the ROSA report, we understand that the ATO is also reviewing its guidelines for remission of the general interest charge ("GIC"). Some of the issues that we believe the ATO should consider as part of that review are set out below.

(a) Initiation by the Commissioner

We consider that GIC remission should be initiated by the ATO in more circumstances. Furthermore, the circumstances in which the Commissioner can exercise his discretion to remit GIC as set out in section 8AAG of the *Tax Administration Act 1953* should be expanded to encompass, for example, the complexity and uncertainty of the law involved and whether the ATO contributed to any delay or mislead the taxpayer.

(b) Lack of consistency

There seems to be considerable concern that there is a lack of consistency between how different ATO officers apply the current remission policy. The development of remission guidelines, say, in a practice statement, would assist in promoting a more uniform approach to remission within the ATO.

The Institute has been also concerned, in previous years, with the inconsistency in settlement terms offered to participants in various mass marketed arrangements.

(c) ATO reasons

The ATO should give reasons for a decision not to remit GIC. Whilst this is not legislatively required, such an approach would be consistent with the Taxpayers' Charter in which the Commissioner has given an undertaking to the community to explain his decisions without the need for a request from the taxpayer.

(d) GIC as an inducement to settle

There seems to be a perception that the ATO has, in some cases, used the threat of GIC and penalties to induce settlement in audit cases. If this is the case, then this would be in contravention of the ATO's Code of Settlement Practice, which states, at paragraph 5.1.7, that "[i]t is ATO policy that officers must never use threats, either implied or actual, of imposing penalties or interest as a lever to settle cases". We recommend the ATO review its procedures and how it communicates the imposition of GIC and penalties to reduce the risk that taxpayers may feel compelled to settle merely because these charges.

(e) Factors to be taken into account in remission decisions

The following are some factors (not an exhaustive list) that should be taken into account in remitting GIC, some of which are consistent with the recommendations of the ROSA Report.

ATO delays

The grounds for remission of GIC should be expanded to include where there has been an inappropriate or unreasonable delay by the ATO. Remission should be full unless the taxpayer has also contributed to the delay. For example, we are aware of some instances where long delays by the ATO in issuing amended assessments resulted in significant increases in the amount of GIC payable.

This was recognised by the former Commissioner of Taxation, Michael Carmody, in a speech given on 13 September 2005, in which he announced a new ground for remission based on

an expectation that it is reasonable for a large corporate audit to be concluded within two years of the notification of its commencement. Pre-amendment GIC (and the new SIC) will be remitted to the "base rate" (currently 5.62%) for the period the audit goes beyond two years.

We consider that the two-year period may be too conservative in some cases. If this is so, the two-year period should be reduced and the ATO must confront the need for it to manage the audit in a timely and efficient manner.

We also consider that a similar concession should apply where a "non-large" audit is not concluded within a reasonable period after notification of the audit.

Reasons for taxpayer delay

Many practitioners, particularly smaller ones, often have difficulty meeting some of the deadlines imposed by the ATO. With the considerable amount of tax reform that has taken place in recent years, such practitioners may find it difficult to keep abreast of new developments and the multiple taxpayer compliance obligations arising under income tax, GST and FBT (and other State and Federal legislation). We consider that such circumstances should also be taken into account in determining whether remission is appropriate in the case of taxpayer delay.

Reliance on ATO guidance material and administrative practice

The ATO needs to provide guidance on the remission of GIC in situations where taxpayers have relied, and acted in good faith, upon:

- views of the ATO contained in other guidance material issued by the ATO or
- a general administrative practice of the ATO.

We believe that full remission of GIC would be warranted in these circumstances.

GST and indirect taxes

As indicated in relation to penalties, although the Committee's inquiry is limited to income tax and FBT matters, in our view the ATO needs to recognise, in the context of remission, the differences between income tax on the one hand and GST, Luxury Car Tax (LCT) and Wine Equalisation Tax (WET) on the other. This is because if a taxpayer underpays GST, LCT or WET on a transaction and is called upon to adjust (e.g., as a result of an audit), it is most unlikely that the taxpayer will be able to recover the underpayment from the customer (unless the customer is known to the taxpayer and, with GST, would be entitled to a corresponding input tax credit). Where the taxpayer is unable to recover the indirect tax involved, the payment of the tax would itself be a fiscal penalty on the taxpayer and contrary to the legislative scheme of such taxes that intends that the tax is to be ultimately borne by the consumer. In such cases, GIC on the shortfall should be wholly remitted unless the taxpayer has a poor compliance history or has been reckless in meeting his responsibilities.

Once again, in relation to indirect taxes, in our view the ATO needs to recognise that there can be overpayments as well as underpayments but because of section 39 of the TAA (and Division 17 of the *A New Tax System (Wine Equalisation Tax) Act 1999),* the taxpayer may not get a credit for its overpayments. In these circumstances, the ATO obtains the benefit of the overpayments and this should be taken into account in determining penalties. In other words, GIC should apply only to the net amount underpaid after taking the overpayments into account. Furthermore, the underpayments may be covered by the circumstances described in the preceding paragraph and warrant full GIC remission in any event.

Announced but unenacted provisions

In Private Ruling 22184, the ATO would not rule on an announced but unenacted law (the share tainting rules in this case).

Where the ATO is unwilling to provide a ruling or advice on an announced but unenacted provision, we consider that this should be viewed as a case for full remission of GIC and SIC during the period where the taxpayer has acted in good faith and has complied with the existing laws without further ATO guidance. This is consistent with the ROSA report.

Protective assessments

Concern has been expressed with the Commissioner raising a 'protective' assessment as a fall back position in the event his main argument fails. For example, the Commissioner may raise an amended income tax assessment (denying a deduction and increasing tax payable) and a protective FBT amended assessment (increasing the taxable value of fringe benefits and the amount of FBT by say $45) at the same time in relation to the same matter. But for the protective FBT assessment, the taxpayer would have been entitled to a refund of FBT (say $20). Even though the ATO does not enforce payment of the protective assessment, the taxpayer will remain in an FBT payable position until such time as the main income tax matter is settled. At this time, the protective FBT assessment is withdrawn and the taxpayer returns to a $20 refund position. However, the taxpayer is not entitled to interest from the time of the amended assessment to the time the protective assessment is withdrawn as the his account has always been in a payable position.

In our view, in such circumstances, the delayed refund should attract interest in the same way as interest on overpayments.

We recommend that the abovementioned factors be taken into account by the ATO in formulating its guidelines on the remission of GIC.

Consistent with our recommendations in respect of penalties, the decision to impose/remit GIC or SIC be made by tax officers different to those dealing with the audit or technical dispute and a mechanism be put in place for that decision to be reviewed by the ATO.

5.4 The operation and administration of the PAYG system

The PAYG system comprises the PAYG withholding system and the PAYG instalment system.

The current PAYG withholding system applies to payments made on or after l July 2000 and requires persons who make certain kinds of payments, including payments of salary and wages to employees, to withhold amounts from the payment and pay those amounts to the Commissioner. The current PAYG system replaced a number of separate systems for withholding, including the pay-as-you-earn (PAYE) system. It also imposed new withholding requirements in respect of a number of areas.

The PAYG instalment system replaced the provisional tax and company tax instalment systems from 1 July 2000. In broad terms it requires that most taxpayers within the system pay a quarterly instalment after the end of the quarter to which it relates based on the income derived during that quarter. Some taxpayers pay annually rather than quarterly.

For quarterly (annual) payers, a PAYG instalment is calculated by multiplying the taxpayer's "instalment income" for a quarter (year) by an "instalment rate" given by the Commissioner (or a rate chosen by the taxpayer). Rather than calculating their quarterly instalment income, taxpayers who satisfy certain criteria can have their quarterly instalments based on prior year income adjusted for any movement in GDP.

In broad terms, instalment income is a taxpayer's gross business and investment income. In simple terms the instalment rate is based on a taxpayer's last assessment and represents tax paid on taxable income (subject to certain exceptions) as a percentage of instalment income based on a taxpayers last assessment.

In relation to the PAYG system we are aware that:

- there are a number of administrative issues in the tax agents' portal. However, these issues are being addressed by the ATO in consultation with stakeholders as part of its rollout of a new system scheduled for completion in 2008. Accordingly, we expect that they will be dealt with in due course
- certain features of the provisional tax system that operated prior to 1 July 2000 were not carried over to the PAYG instalment system, inadvertently in our view. As realigning the rules requires a legislative change we have written to Treasury regarding our concerns. We would be pleased to provide the Committee with a copy of our submission should you require.

Apart from administrative issues associated with the PAYG system and the tax agents' portal, we are not aware of any significant administrative issues with the ATO's operation and administration of the PAYG system.

5.5 Other administrative matters

5.5.1 Clarification of the protection provided by various types of ATO advice

As a consequence of implementation of the recommendations of the ROSA report, the protection afforded by various categories of ATO advice has changed.

We therefore recommend that the ATO revise its practice statement(s) and any other ATO products to clarify the status of various categories of written and oral advice as legally or administratively binding (thereby protecting a taxpayer from primary tax) and the level of protection provided in respect of penalties and interest.

We also recommend that the ATO provide guidelines as to the position when documents that provide a level of protection are withdrawn. For example, the withdrawal of ATO Interpretative Decision ATO ID 2003/554 (dealing with the application of the capital gains tax where a discretionary trust transfers assets to another trust) caused considerable concern to practitioners regarding their position following its withdrawal.

As a consequence of the implementation of the recommendations of the ROSA report, we recommend that the ATO revise its practice statement(s) and other ATO publications to reflect the status of various categories of written and oral advice as legally or administratively binding, the protection provided in respect of both penalties and interest and the consequences of the withdrawal of such advice.

5.5.2 Review of income tax discretions

As highlighted by the Review, the law includes provisions that give the ATO the power to make decisions by exercising discretions. The concern expressed by practitioner and industry groups was that, absent the Commissioner issuing a public ruling on how a discretion will be exercised or a taxpayer obtaining a PBR, self assessment cannot work properly where the calculation of a taxpayer's liability depends on a decision or determination of the ATO.

The majority of submissions favoured retaining some discretions, especially those that empower the Commissioner to relieve the taxpayer of the effects of not complying with every detail of specific regimes.

The Review recommended[5], and Treasury has included in its planned activities for the first half of 2006, a detailed review of discretions that go to the determination of a taxpayer's liability and, wherever practical, recommend replacement tests that a taxpayer can apply at the time of lodgment.

[5] Refer recommendation 6.3.

Following that review by Treasury, we recommend that the ATO review remaining discretions in the law and, where necessary, issue public rulings or practice statements dealing with how those discretions will be exercised.

It is recommended that, to the extent that there remain discretions following the scheduled review by Treasury, the ATO review those discretions with a view to publishing guidance as to how those discretions will be exercised.

5.5.3 Notification of tax audits and voluntary disclosure

The notification by the ATO to a taxpayer that a tax audit is to be conducted of his affairs is significant because:

- voluntary disclosures of underpayments of tax prior to being notified of a tax audit results in an 80% reduction in penalties where the underpayment is more than $1,000 and a 100% reduction where the underpayment is less than $1,000
- voluntary disclosures of underpayments of tax after notification of a tax audit result in a 20% reduction in penalties providing that the disclosure can reasonably be estimated to have saved the Commissioner a significant amount of time or resources in the audit.

The Commissioner also has a discretion to treat voluntary disclosures made after a taxpayer has been advised of a tax audit as being made before that time.

The ATO has issued a public ruling, TR 94/6, which deals with tax shortfall penalties where there is voluntary disclosure. The concept of voluntary disclosure is also discussed in Practice statement PS LA 2006/2, dealing with the administration of shortfall penalties under the new tax system.

Despite this, many members have expressed concerns and uncertainty as to:

- the nature of the various post-assessment compliance activities conducted by the ATO and which of these activities constitute an audit.
- the fact that Practice Statement PS LA 2004/5 indicates “The Tax Office will generally notify a taxpayer about a compliance activity and give a date for the commencement of the audit. Notification will normally be in writing or may be made orally”. In practice this does not always happen.
- related to the abovementioned points, the fact that taxpayers are not always advised when an ATO activity, which did not commence as a tax audit, becomes one.

Clarity around these issues should enable taxpayers to take advantage of reduced penalties by reviewing their tax affairs prior to take advantage of the reduced penalties where the voluntary disclosure saves the ATO time and resources.

It is recommended that the ATO review its procedures to require ATO staff to notify a taxpayer, preferably in writing, when a post-assessment compliance activity will commence and whether that activity, however described, is a tax audit for the purpose of the penalty provisions. The ATO should also review, in consultation with stakeholders, its public ruling and, in particular, the circumstances in which a disclosure will be regarded as voluntary.

Part B
The application of the FBT

The Institute, together with a number of other professional associations, made a submission to the Government on 4 August 2004 in relation to cost of compliance and other difficulties faced by employers as a consequence of the FBT legislation. That submission contained a number of legislative, as opposed to administrative, recommendations to ease those difficulties.

The Institute has since commissioned Atax, from the University of New South Wales, to review international precedents for the taxation of fringe benefits and to identify a best

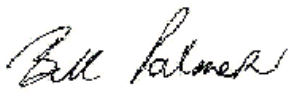
practice approach for Australia. The primary focus for the study is on developing a strategy to restore fairness and to make the tax simpler to administer.

The preliminary findings support an approach that makes fringe benefits taxable in the hands of individuals. While this approach would have a revenue cost to the Government, the reform has the potential to address an area of tax reform long sought by businesses and professional organisations. From an employee's perspective, this would allow for fringe benefits to be taxed at the employee's applicable marginal tax rate, rather than at the top rate and, as such, is more equitable.

As both the recommendations made in the joint submission and the Atax report involve legislative change, they are outside the scope of the Committee's inquiry. However, we have attached as Appendix 2 a copy of the joint submission made to the Government and would be happy to provide the Committee with a copy of the Atax report when it is publicly releases.

If you have any questions in relation to the abovementioned submission please call Susan Cantamessa on 02 9290 5625.

Yours faithfully



Bill Palmer FCA
General Manager Standards & Public Affairs

List of appendices

Appendix 1	The Institute's submission dated 17 January 2005 to the Inspector-General of Taxation (IGOT) in respect of his review into aspects of the ATO's business active compliance activities.
Appendix 2	The Institute's letter dated 29 July 2005 to the IGOT summarising the results of its most recent bug bear survey.
Appendix 3	Joint submission of professional bodies dated 4 August 2004 in relation to FBT.
Appendix 4	The Institute's submission dated 23 December 2005 to the IGOT in respect of his review of the ATO's handling of complex matters.
Appendix 5	Private binding rulings – administrative recommendations of the Report on Aspects of Income Tax Self Assessment.
Appendix 6	The Institute's submission dated 26 September 2005 to the IGOT in respect of his review into whether the pattern of private binding rulings indicates a pro revenue bias.

Appendix 1

The Institute of Chartered Accountants in Australia

Submission to the Inspector-General of Taxation

Review into Aspects of the ATO's Business Active Compliance Activities

17 January 2005

The Inspector General of Taxation

Submission by the Institute of Chartered Accountants in Australia

1. INTRODUCTION

The Inspector-General of Taxation (IGT) is conducting a review into aspects of the ATO's business active compliance activities. In particularly, the IGT is reviewing the length of time taken to complete Tax Office active compliance activities and the ATO's general approach to compliance activities. The IGT review also includes a review of whether the application of penalties and interest to businesses during active compliance activities is consistent.

The IGT has invited the Institute of Chartered Accountants in Australia (ICAA) to provide comments and the ICAA welcomes the opportunity to do so.

The ICAA is the leading professional accounting organisation in Australia, representing 40,000 members in public practice, commerce, academia, government and the investment community. The ICAA's members are advisers to businesses at all levels, from small and medium sized businesses to the largest global corporations operating in Australia and overseas.

2. EXECUTIVE SUMMARY

ICAA member feedback indicates that certain areas of the ATO's active compliance is in need of review. A general observation is the need to create greater awareness of the Taxpayers' Charter amongst ATO officers in relation to penalties and other areas. This would assist in eliminating many of the concerns raised in the submission.

The ICAA in September 2004, surveyed its members online requesting them to select their top ten tax administrative "bug bears" – issues affecting the administration of the tax system that they would like to see improved.

The online survey offered members 20 suggested bug bears and the opportunity to add additional bug bears if their concerns were not in the 20 listed bug bears. The ICAA had 177 responses in total.

The survey results indicated that **49%,** of members felt that "***the approach to the imposition of penalties and interest is unreasonable",*** **36%** of the members indicated that ***"the administrative cost to business of an ATO audit is high",*** and **19%** felt that ***"the time taken to complete a GST audit is too long".***

The ICAA also recognises that ATO needs to continually strive towards improving its compliance activities and to ensure they are conducted efficiently, fairly and reasonably.

Discussed below in more detail, the ICAA makes the following recommendations:

- Taxpayers and their agents are entitled to know the scope of an audit and to receive regular updates on the progress of an audit. The ICAA recommends that the ATO should adopt some process and procedures to ensure that this occurs. Additionally, where there is a change in the scope of the audit or where a tax audit may be delayed the ATO should issue a formal notification to the taxpayer to advise them of this.

- The ATO's internal administration procedures in relation to the notification of audit letter are in need of review. The review should ensure that the letters are issued to taxpayers within a reasonable time.

- The ATO needs to put appropriate arrangements in place to ensure sufficient time is provided to taxpayers to gather the requested information. This could include improved communication channels internally between departments (for example between audit and lodgement) and processes to ensure time requests for information are reasonable and fair.

- The ATO should review the information it requests and adopt better targeting practices. This could be in the form of written guidance provided to ATO officers as to what level of information and documentation is appropriate to be requested in order to verify various transaction/s.

- The ATO should consider implementing appropriate policy and procedures to streamline and improve the co-ordination of income tax and GST audit activities. This would eliminate the unnecessary duplication and significantly reduce costs of compliance.

- The ATO needs to issue appropriate protocols requiring ATO staff to notify the relevant taxpayer either in writing or orally (preferably in writing) when an audit activity will commence. The various forms of compliance activities (enquiries, verification, reviews) and whether they constitute an audit should also be clearly articulated and incorporated into the Taxpayers' Charter or in a Practice Statement. This would alleviate confusion and any misunderstanding.

- The ATO should also implement appropriate procedures to overcome delays in the issuing of amended assessments and the processing of GIC/penalty amounts after an audit. The ATO should issue amended assessments and GIC/penalty amounts within a reasonable time and include adequate explanations of how the amounts were calculated. Where "significant delays" have being caused by the ATO the Commissioner should exercise his discretion to remit some of the penalty.

3. ICAA COMMENTS

3.1 ATO PERFORMANCE

Some tax practitioners have expressed concerns in relation to the ATO's performance and processes. They include the following:

3.1.1. Intended scope of an audit & the progress of an audit

ICAA member feedback indicates that the ATO's current procedures in ensuring taxpayers are informed of the scope and progress of an audit is inconsistent, and and in need of review.

The Taxpayers' Charter, outlines that the ATO *"will indicate the information and records that will be required"*, for the purpose of completing the compliance activity in the most efficient manner for all parties. This however is not always the case.

At the ATO's Tax Practitioner Forum (ATPF) meeting held on 19 November 2004, the professional bodies rasied concerns that in most circumstances a taxpayer will be notified of the ATO's intention to make enquiries or conduct an audit of his/her tax affairs. However, there have been some cases observed where taxpayers have been advised of a particular ATO audit, made appropriate preparation of the records required, only to find that at the meeting with the ATO a different audit activity was presented to the taxpayer.

An example cited was a taxpayer in the restaurant industry who was advised that the ATO intended to audit the restaurant's BAS for a particular period. The ATO however not only audited the BAS but also presented the taxpayer, without warning, an asset betterment statement and asked the taxpayer to comment.

A recurring issue that is voiced by ICAA members in the bug bear survey is that they are often *"not being kept informed of the progress of GST audits."*

The Taxpayer Charter booklet *"If you are subject to enquiry or audit",* sets out the ATO's requirements with respect to advising the client of the result of an enquiry or audit. It states that the ATO will *"keep you informed of the progress of the enquiry or audit" and will "provide notification of the outcome of the enquiry or audit within seven days of making our decision."*

The ICAA believes that taxpayers and their agents are entitled to know the scope of an audit and to receive regular updates on the progress of an audit. The ICAA recommends that the ATO should adopt some process and procedures to ensure that this occurs. Additionally, where there is a change in the scope of the audit the ATO should issue a formal notification to the taxpayer to advise them of this.

3.1.2. Notification of audit outcome

ICAA member feedback indicates that there are unreasonable delays by the ATO in issuing taxpayers with the notification of audit letter. Some members reported instances of clients not receiving the letter for up to 3 months after the audit. The Taxpayers' Charter outlines that the ATO *"will seek to minimise cost and inconvenience to"* a taxpayer and requires the ATO to provide the the taxpayer with a *"written notification of the outcome of the enquiry or audit"* within seven days after the audit is complete.

The delays in finalising the audit often mean the taxpayer is kept unaware of what is

happening for an extended period of time creating unnecessary uncertainty and aggravation.

The ICAA is of the view that the ATO's internal administration procedures in relation to the notification of audit letter are in need of review. The review should ensure that the letters are issued to taxpayers within a reasonable time.

3.1.3. Time allowed for requested information

Some members have expressed concerns in relation to the time provided to them by the ATO for requested information. In some cases, the members have indicated that the ATO officer has insisted the requested information be compiled, reconciled and remitted on dates that either are unreasonable, coincide with key lodgement program dates or are at a time when accountants are attending to year end tax matters for clients i.e. the last week of June.

There does not appear to be regard given on some occasions to the workloads of tax agents.

Below is an example provided by an ICAA member, to illustrate a case where unreasonable time was provided:

"A GST auditor contacted me and left a voice mail. I then left two voicemails with the auditor and finally when the auditor rang back he indicated that if he did not get an answer to the request he had within 72 hours, he would have to send in a full audit team. The auditor said that the 72-hour rule (is there such a rule?) could not be extended. I do not know what to do."

Such requests are contrary to the Taxpayers' Charter where the ATO outlines that it will *"seek to minimise cost and inconvenience to"* the taxpayer.

The ICAA believes that the ATO needs to put appropriate arrangements in place to ensure sufficient time is provided to taxpayers to gather the requested information. This could include improved communication channels internally between departments (for example between audit and lodgement) and processes to ensure time requests for information are reasonable and fair.

3.1.4. Level of information requested from the ATO

Many members have expressed concerns in relation to the level of information and documentation the ATO is requesting from them to evidence certain transactions.

In many cases the tax practitioner can anticipate the information that the ATO may request based on previous requests in relation to a verification/audit activities of similar transactions. Accordingly, the tax practitioners collect what they feel is the appropriate level of information, only to find that the ATO requests other documentation that would have been readily available at the time of the transaction but may, not, however be readily available at the time of the request. The following examples were cited at the ATPF meeting held on the 27 February 2004 to illustrate the problem:

"Example 1:

A taxpayer regularly makes large purchases of commercial property. The input tax credit refund is almost always questioned by the Tax Office so the tax practitioner asks the client to always forward a copy of the tax invoice to save time when the Tax Office requests further information. However, the Tax Office, when verifying the transaction asks for specific pages from the contracts, title deeds and evidence of payment of the purchase price (including

deposit) as well as the tax invoice.

Example 2

A taxpayer regularly changes their fleet of cars. The tax practitioner prepares justifying documentation expecting verification activities. Rather than requesting information specific to the transaction, the Tax Office requests an electronic copy of the entire accounting system transactions of the entity."

Taxpayers are often confused as to why the ATO is requesting this level of detail for these transactions. In Example 1, the taxpayer is only legally obligated to hold a valid tax invoice, and in Example 2, the complete electronic copy of the accounting system transactions will evidence far more than the transaction in question.

The ICAA sees merit in the ATO reviewing the information it requests and adopting better targeting practices. This could be in the form of written guidance provided to ATO officers as to what level of information and documentation is appropriate to be requested in order to verify various transaction/s.

3.2 DURATION OF ATO AUDITS

The Taxpayers' Charter booklet entitled: *"If you are subject to enquiry or audit",* states that the ATO will *"seek to complete the enquiry or audit in the shortest possible time".*

Members have expressed concerns that the ATO is taking a long time to complete some audits. Often there is no explanation provided for these delays and members perceive the delays as unnecessary.

The below examples of ICAA member feedback illustrates there sentiments:

Member 1

"The audit is in its third month and is still in progress. I have been continually asked for records on items that were not in the initial letter from the ATO. It is costing the client a few extra thousand dollars in tax agent fees and the ATO has only thus far found corrections in favour of the client. The ATO is giving no indication of when they might complete the audit or a reason for the delays and extension to the initial scope of the GST audit".

Member 2

"I have a client who has been "asked" to front a GST audit covering four BAS's. The audit was scheduled for today. The client has a restaurant and had engaged additional staff to cover the absence of the principal and the manager for the afternoon – the audit was to be at my office. Two hours before the audit was meant to commence we had a phone call from the ATO saying that the auditor was ill, and the audit was off. My client is obviously out of pocket with the staff costs, which adds insult to the injury of the audits.

Can my client claim the staff costs back from the ATO, or is this just another one of the add-on costs we all enjoy from tax "reform"?"

Member 3

"The Tax Office is overloading agents with correspondence, information demands and

telephone calls. There is little regard for the time pressures we are under and the fact our clients and the agents are bearing considerable costs to meet the audit requirements. It is especially annoying when the ATO demands copies of returns etc that it already should have and for mostly irrelevant information. My solution probably won't get very far however I believe that the ATO should be forced to make a contribution to the agents fees for providing the information requested in an audit. The more information they request the more they will have to pay to the agent/ client. This will at least make the ATO think a little before making irrelevant requests and help address the massive imbalance between the vast resources the ATO has been given by the Government and taxpayers who for the most part are trying to doing the right thing."

These examples further exemplify the unnecessary time and monetary costs imposed by tax audits on taxpayers and tax practitioners.

The ICAA would like to see the IGT investigate options in cases where tax audits are delayed on the part of the ATO. Where a delay will or has occurred the ATO should as a matter of priority issue a letter to the taxpayer outlining the reasons for the delay. A letter should also be sent in cases when the ATO anticipates or believes an audit may be delayed or go beyond the time frame initially estimated.

Furthermore, there are instances when the ATO performs a GST and income tax audit at the same time for a particular taxpayer. The taxpayer often receives requests for the same information and documentation from separate ATO officers. The taxpayer effectively has to produce the same information for each of the ATO officers. This places constraints on a taxpayer's resources and time and ultimately increases their costs of compliance.

It should also be noted that, the ICAA bug bear survey results showed that **19%** of the members felt that ***"the time taken to complete a GST audit is too long".*** Perhaps a better co-ordination of GST and income tax audit might improve this situation.

The ICAA believes that the IGT should recommend to the ATO that they implement appropriate policy and procedures to streamline and improve the co-ordination of income tax and GST audit activities. This would eliminate the unnecessary duplication and significantly reduce costs of compliance.

3.3 AUDIT vs. REVIEW vs. VERIFICATION

Many members have expressed concerns and uncertainty as to the nature of the various post-assessment compliance activities conducted by the ATO. In particularly, which of these activities constitutes an audit.

The Taxpayers' Charter booklet, entitled: *"If you're subject to enquiry or audit"* does not clarify this matter and simply indicates that it applies to *"face-to-face enquiries and audits*" conducted by the ATO.

The distinction becomes critical for taxpayers in that they need to be aware of when an audit has commenced or is about to commence. This clarity is required given that certain rights are available to taxpayers in respect to ATO audits including the right for additional time in which to make a voluntary disclosure to the ATO.

The legislation provides that where a taxpayer makes a voluntary disclosure before being told that a tax audit is to be conducted, the penalty that would otherwise be imposed for a shortfall amount is:

- reduced to nil if the shortfall amount is less than $1,000;
- reduced by 80% if the shortfall amount is $1,000 or more.

If the voluntary disclosure is made after this time, the penalty is reduced by 20%. These reductions are not remissions but are the penalty amounts specified in Subdivision 284-D of Schedule 1 to the Tax Administration Act 1953.

Furthermore, paragraph 37, of Practice Statement, PS LA 2004/5 states that *"The Tax Office will generally notify a taxpayer about a compliance activity and give a date for the commencement of the audit. Notification will normally be in writing or may be made orally."* This does not always happen and a review can turn into an audit and the taxpayer is unaware. This can present a missed opportunity for the taxpayer to make a voluntary disclosure.

It is recommended that the ATO issue appropriate protocols requiring ATO staff to notify the relevant taxpayer either in writing or orally (preferably in writing) when an audit activity will commence. The various forms of compliance activities (enquiries, verification, reviews) and whether they constitute an audit should also be clearly articulated and incorporated into the Taxpayers' Charter or in a Practice Statement. This would alleviate confusion and any misunderstanding.

3.4 GIC AND PENALTY CONSIDERATIONS

Various concerns have also being raised in relation to delays of processing GIC adjustments/penalties and the imposition of penalties that are not in line with ATO policy.

These concerns were also raised at the NTLG meeting held on 3 December 2004. In particular concerns were raised in relation to additional penalties been levied as a result of taxpayers seeking legal or other advice during an ATO audit. The rationale provided by the ATO was that seeking advice was a demonstration of a lack of cooperation and a delay tactic warranting additional penalty.

This practice appears to be contrary to the Taxpayers' Charter where it states that the ATO will *"allow you to choose someone to act on your behalf or to attend interviews with you".* Given that the taxpayer does not unreasonably delay the seeking of the advice, and the tax practitioner does not unreasonably delay the providing of the advice to the taxpayer, it is difficult to understand why this would warrant an increase in the level of any shortfall penalty.

ICAA recommends that the ATO need to implement internal training to create greater awareness and to reinforce the Taxpayers' Charter amongst ATO officers in relation to penalties. This would greatly assist in minimising instances where penalties have being levied as a result of taxpayers seeking legal or other advise in relation to an audit.

Members have also expressed other concerns in relation to unnecessary and unexplainable delays in processing GIC amounts.

Below are some examples provided by ICAA members, to illustrate some of the concerns in relation to the GIC processing:

Member 1

"I would like to report a most unusual occurrence in relation to GIC. Recently our firm went through a GST audit by ATO field auditors. Five months later, after seeking "technical advice", the ATO finally determined that we had not paid sufficient GST on some transactions reviewed. Although their assessment was based on a ridiculous technicality, we paid the alleged GST owing (we simply claimed it back from the recipient anyway, so what a waste of everyone's time and effort). Three months after that, with our balance date approaching, the ATO still hadn't told us what the GIC (if any) might be.

So I emailed the officer to find out. They apologised for the delay and assured me that we would not be assessed GIC on at least some of the period the alleged GST was outstanding (post-audit) "due to ATO's slowness in reviewing the case".

Member 2

"Our company has been waiting in excess of 6 months for an application to remit interest because the GST auditor has not yet filed his report!"

The ICAA recommends that the ATO implement appropriate procedures to overcome delays in the processing of GIC and penalty amounts after an audit. The ATO should issue GIC and penalty amounts within a reasonable time and include adequate explanations of how the amounts were calculated. At the very least, the ATO should issue a letter to the relevant taxpayer to advise of any delays and the reasons for the delay.

Significant delay in issuing amended assessments

The ICAA commonly hears of significant delays in audits and issuing amended assessments. These all result in significant GIC accumulating in addition to the primary tax.

The compounding nature of the GIC makes the impact particularly harsh. Where an audit is drawn out over an even greater period, the GIC payable can exceed the tax shortfall.

Paragraph 93.5.33 of the ATO Receivables Policy states *"[t]he Commissioner may partly remit GIC for late payment based on significant delay."* While the paragraph continues to explain that an example of this is where "*the Commissioner has by a particular date gathered all the information and evidence that is necessary for the issue of the amended assessment, but the issuing of the amendment is delayed for a significant period of time beyond that date"*, there are many situations similar to this where the there has been a major delay and the GIC has not been remitted.

The ICAA would like to see the ATO implement appropriate arrangements to overcome delays in issuing amended assessments. Amended assessments should be issued within a reasonable time frame. Where "significant delays" have being caused by the ATO the Commissioner should exercise his discretion to remit some of the penalty.

CONTACTS

Ali Noroozi
Tax Counsel
(02) 9290 5623
anoroozi@org.au

Maria Benardis
Tax Specialist
(02) 9290 5761
mariab@icaa.org.au

Appendix 2

The Institute of Chartered Accountants in Australia

29 July 2005

Mr David R Voss AM
Inspector-General of Taxation
GPO Box 551
Sydney NSW 2001

R V*By email:* DVos@igt.gov.au

Dear David,

Re: ICAA "bug bear" survey

The Institute of Chartered Accountants in Australia ("ICAA") last month surveyed its members online requesting them to select their top ten tax administrative "bug bears" – issues affecting the administration of the tax system that they would like to see improved.

The online survey offered members 13 suggested "bug bears" and the opportunity to add additional "bug bears" if their concerns were not in the 13 listed "bug bears". The ICAA had 116 responses in total. Below are the "bug bears" in order of importance to our members.

Please note that the "bug bears" have been forwarded to the ATO's Tax Practitioner Forum for ATO consideration. A further report has also been sent to the ATO Tax Practitioner Forum providing examples on some of the issues, which our members have provided.

The survey results were as follows:

Position	*%*	*Bug Bear*
1	68%	When an account is in credit, there is no automatic refund, or at least an advice of such a credit being provided to the taxpayer:
2	57%	The ATO does not proactively and promptly advise the tax agent / taxpayer if a refund is being held back, and the reason why.
3	44%	Difficulty finding experts at the ATO or receiving different answers to the same question from different ATO staff.

27–29 Napier Close
Deakin ACT 2600
Tel: 1300 137 322
Fax: 02 6282 9800

L1/200 Mary Street
Brisbane QLD 4000
Tel: 07 3233 6500
Fax: 07 3221 0856

L11/1 King William Street
Adelaide SA 5000
Tel: 08 8113 5500
Fax: 08 8231 1982

TCCI, 30 Burnett Street
North Hobart TAS 7000
Tel: 1800 014 555
Fax: 03 9670 3143

L3/600 Bourke Street
Melbourne VIC 3000
Tel: 03 9641 7400
Fax: 03 9670 3143

Grd/28 The Esplanade
Perth WA 6000
Tel: 08 9420 0400
Fax: 08 9321 5141

The Institute of Chartered Accountants in Australia
ABN 50 084 642 571
Incorporated in Australia Members' Liability Limited
Level 14, 37 York Street Sydney NSW 2000

GPO Box 3921 Sydney NSW 2001

Tel: 1300 137 322 / 61 2 9290 1344
Fax: 61 2 9262 1512

www.icaa.org.au

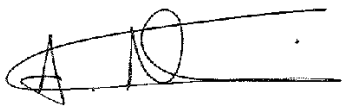
Position	*%*	*Bug Bear*
4	42%	The approach to the imposition of penalties and interest in unreasonable.
5	39%	Not receiving an acknowledgement or response to written correspondence within a reasonable time, or not at all.
5	**39%**	**Difficulty with meeting the deadlines in the lodgement programme.**
6	33%	The large quantities of unnecessary or irrelevant information delivered to tax agents.
7	28%	Family Tax Benefit - difficulty getting information needed to prepare the claim from Centrelink.
7	28%	The administrative cost to business of an ATO audit is high.
7	28%	ATO staff not calling back within a reasonable time, or not at all.
8	20%	The professional skills and experience of ATO auditors is limited or inadequate.
9	**19%**	**Dissatisfaction with the level of service I am receiving from my ATO relationship manager.**
10	18%	The time taken to complete GST audit is too long.

* Note the % column is the percentage of respondents that indicated this "bug bear" was in their top ten.

Please note that the issues not in bold are already on the "bug bear" list in the ATO Tax Practitioner's Forum. However, they have reappeared suggesting that they continue to be of concern to our members. The items in bold are the new items that have entered the top ten "bug bears". You will also note that at bug bear numbers 5 and 7 some issues received the same percentage ranking.

We would be delighted to discuss the above "bug bears" with you. Please do not hesitate to contact myself on 02 9290 5623 or Maria Benardis, on 02 9290 5761 to arrange a time to discuss.

Yours faithfully



Ali Noroozi
Tax Counsel

Appendix 3

4 August 2004.

The Hon Mal Brough MP
Assistant Treasurer and Minister for Revenue
Parliament House
Canberra ACT 2600

Dear Hon Mal Brough,

RE: Fringe Benefits Tax and Cost of Compliance Issues

This submission is presented on behalf of the professional bodies (in alphabetical order), The Institute of Chartered Accountants in Australia, Law Council of Australia, National Tax & Accountants Association Limited, National Institute of Accountants, Taxpayers Australia Inc and Taxation Institute of Australia.

The submission outlines the cost of compliance and other difficulties faced by employers as a consequence of the Fringe Benefits Tax (FBT) legislation. A common and consistent theme in feedback received from members of all the professional bodies is the compliance burden, which they regard as excessive and inappropriate that FBT places on business.

The Professional Bodies also see merit in the Government undertaking a review of the FBT Laws with the aim of rectifying the issues by amending the Legislation.

Below are some immediate areas where the professional bodies see the need for the Government to consider and implement urgent solutions. These are as follows:

SUMMARY OF RECOMMENDATIONS

1. Car Parking: An optional standard valuation for car parking benefits could be provided in the legislation.

2. Travel Costs for Employees working in one city and living in another: These should be exempt from FBT altogether as they are not remuneration related but a business cost of getting the right employees in the right place.

3. Optional 50/50 split for recreational expenditure: employers should have the option to adopt the 50/50 split method in respect of all recreation expenditure, as is the case for meal

entertainment and entertainment leasing facility benefits.

4. Reportable Benefits confined to Remuneration Benefits only: Only benefits that are part of a remuneration package or award should be reported on payment summaries. The excluded benefits would include the travel costs referred to in 2 above. In addition, the law should be amended to provide for an exception from the usual reporting rules where it is impossible to fairly allocate the value of a fringe benefit to individual employees. At a bare minimum, a short-term solution would be to provide clearer guidance as to an acceptable set of rules for the valuation and attribution of shared cars between employees.

As an alternative, or in addition to, the above recommendations the following are suggested:

- Where a car is used by more than one employee, the employer be given the option to calculate the statutory formula for the car separately for each employee based on the annualised kms for the period of use by each employee.

- The work related exemption for utilities and panel vans be extended to all cars.

Note that the above two recommendations are for fringe benefits tax generally and not just for reportable benefits.

5. Reportable Fringe Benefits and Recreation: All recreation expenditure should be excluded from the FBT reporting requirements, as is currently the case for meal entertainment expenditure and entertainment facility leasing expenses.

6. Reportable Fringe Benefits Threshold: The threshold should be increased from $1,000 to $2,000.

7. Interaction of GST and FBT and Financial Supplies: The provisions of Division 71 of the GST Act should be reviewed and overhauled.

8. Reconciliation Difficulties: Difficulties in accounting for fringe benefits would be reduced if taxpayers could record the GST-exclusive value of benefits in the FBT return.

9. Capping Thresholds: this area requires re-visiting with the view of re-writing these provisions.

10. Road Tolls: The accounting for road toll fringe benefits is cumbersome and costly. It is suggested that amendments to Section 136(1) of the FBTAA 1986 be made to include 'bridge and road tolls' within the definition of a 'car expense'.

11. Minor and infrequent rule: The $100 threshold for minor and infrequent exempt benefits is too low. To allow real compliance savings this threshold should be increased to at least $200. This threshold should also be indexed each year.

12. Election to group: Companies should be able to have the option to elect to group their FBT obligations and thus only lodge one FBT return.

GENERAL COMMENTS

By way of background, the FBT legislation was enacted in 1986 in order to overcome the perceived inadequacies of Section 26(e) of the Income Tax Assessment Act 1936 (ITAA 1936). This Section sought to subject to income tax the value of non-cash benefits received by employees as a consequence of their employment.

The fundamental difference between Section 26(e) of the ITAA 1936 and the FBT legislation was that employers are now liable to taxation in respect of benefits provided to employees.

Since 1986, numerous amendments have been made to the original FBT legislation. Most of these 'band aid' amendments were designed to rectify flaws in the original FBT legislation, widen the scope of the FBT legislation and simplify the application of the legislation or to reduce the costs of complying with the FBT legislation. These amendments and the sheer volume of the legislation and complex definitions, however, have lead to the FBT laws becoming inequitable, too complex and too costly to comply with.

Small and large business and tax practitioners continue to experience real problems in complying with the requirements imposed under the FBT legislation. The employer and not the employee is continually under pressure to get it right and is ultimately left exposed, in terms of penalties, for FBT record keeping errors and any fraud perpetrated by the employee.

Also, many of the provisions have failed to keep up with business change and result in employers being requested to make decisions using legislation that does not reflect modern practices, technology or the intention of other legislation.

The ATO on several occasions has resorted to applying administrative solutions to overcome legislative defects. However, this is not an ideal way to be addressing flaws and inflexibilities in the Law. An example of this is, the extension to the minor benefit exemption, as reported in the NTLG-FBT 15 November 2002 minutes, whereby the professional bodies contended that there were particular compliance difficulties for reporting purposes in these situations. The 'meal entertainment' component is not reportable yet the 'recreational entertainment' component, for example a band, would be reportable where the 'associated benefits' exceeded, in total, $100 per employee. The ATO acknowledge this concern and put in place an administrative solution by granting an increase to the threshold from $100 to $125 for some functions where the function includes the provision of a band or entertainment ('recreational entertainment' rather than 'meal entertainment').

SPECIFIC COMMENTS

1. Car Parking

Ideally the professional bodies would like to see 'on premise' car parking removed from the FBT coverage, as these benefits are difficult to determine, value and attribute to individuals or at the very least the rules need to be simplified.

Car parking is a classic case of the 80/20 rule where tax practitioners and taxpayers spend 80% of their time on something that adds 20% value at the end of the day. There is a real need to simplify this area in order to reduce the cost of compliance for businesses.

The cost of determining the lowest car parking fee at a commercial parking station within one kilometre of employer provided parking can be quite large, either in terms of time commitment from an employee undertaking the necessary investigation, or in paying an external consultant to provide the information. The same issue arises in determining whether or not there is a parking station within one kilometre that charges more than the threshold amount. It is also not uncommon for a commercial car park to give out inaccurate information in respect of its car parking rates.

Alternatively, in most cases an exemption applies and there is no FBT liability, so the benefit might well be made totally exempt.

The professional bodies recommend that an optional standard valuation for car parking be implemented to assist in resolving the existing issues that are faced by businesses.

2. Travel Costs for Employees

In today's economic climate, it is not unusual for an employee to reside in one capital city and to be required to move on a permanent basis (or for a 12 or 18 month project time period) to a different capital city. If their family wish to reside in the old location, it is also not unusual for that employee to travel to that capital city on Monday and return home on the Friday. This is a similar situation to politicians spending weekdays in Canberra and returning home for weekends.

In accordance with the information contained in Miscellaneous Taxation Ruling 2030, such employees would be considered to be living away from their usual place of residence and accordingly any accommodation provided to them near their current workplace would be exempt from Fringe Benefits Tax. However, the travel costs on the Monday and the Friday would not be exempt from Fringe Benefits Tax on the basis it was travel to and from work.

We consider with today's highly mobile workforce, it would be reasonable to treat these travel costs as also being exempt from FBT on the same basis as the accommodation costs would be exempt. Paying FBT on the mere cost of getting the right staff to be in the right place is bad enough but the cost of analysing the individual circumstances, for each such employee with varied arrangements, to determine the correct FBT treatment needs to be reduced by simplifying and modernising rules.

The professional bodies would be happy to work with Government to devise workable solutions.

3. Optional 50/50 split method for recreational expenditure

In relation to meal entertainment expenditure and entertainment facility leasing expenses, employers have the option to value this expenditure for FBT purposes using the 50/50 split method.

This method significantly reduces compliance costs for employers because it reduces the need to maintain detailed records to split the expenditure between employees, associates and non-employees (for example, clients and contractors).

Under the 50/50 split method, FBT is only payable on 50% of the employer's total expenditure on meal entertainment and entertainment facility leasing expenses.

The 50/50 split method is not available in relation to recreation expenditure that does not qualify as entertainment facility leasing expenses. The professional bodies submit that employers should have the option to adopt the 50/50 split method in respect of all recreation expenditure. Further, the professional bodies believe that the risk to Government revenue would be negligible, if any at all. In addition, we submit that this measure should be implemented without affecting the application of the minor benefits exemption under Section 58P of the FBTAA 1986.

4. Reportable Fringe Benefits confined to Remuneration Benefits only

The reporting provisions have resulted in increased compliance costs imposed on employers, particularly small businesses. The employer with several hundred motor vehicles used by different employees on different days and garaged at different locations each day is only one example of the administrative nightmare created by the law. The very essence of the design of FBT to impose one single liability on the employer in such a case is abrogated by this reporting legislation.

The legislation provides grounds for industrial disputes and disputes between employees. It has the potential to become fertile ground for litigation between employers and employees over the allocation of benefits.

The cost of tracking benefits to particular employees for reporting purposes can be burdensome. As this sort of information is not generally captured by an employer's accounting system, employers are effectively required to run another system that will maintain the information required. This is particularly an issue with (recreational) entertainment expenditure, as it can be difficult, for example, to know who attended a particular function.

Furthermore, the human resource cost of dealing with disgruntled staff, which may have lost government benefits as a result of benefits received as a condition of employment, impacts on the superannuation surcharge and medicare levy. For example, an employee receives a car fringe benefit as a condition of employment and once the benefit is included on his or her payment summary, the employee is ineligible to receive family allowance for the year. The employee becomes out of pocket by at least the amount of any lost benefit and has no recourse against their employer.

It is assumed that all fringe benefits confer a benefit on the employee and are a substitute for remuneration. The reality is that the bulk of fringe benefits tax is collected on benefits that confer no personal benefit on the employee. The professional bodies would have no trouble in accepting the taxing of benefits relating to an employee on a car benefit included in a salary sacrifice package. However, we see difficulties taxing lower and middle-income earners provided with tool of trade cars that are provided as part and parcel of their work activity.

Below are some examples, which demonstrate some of the practical difficulties that are currently experienced by tax practitioners and taxpayers:

Example 1

An employer has a car that is used by a salesperson for work. The first driver's annualised kilometres are calculated to be more than 15,000 up to the time of when he leaves his or her employment. A new driver is employed and his or her annualised kms for the use of the same car is calculated to be less than 15,000. At the end of the year the taxable value is calculated using the statutory formula method and allocated to the two employees' payment summaries, the result being that the first driver is disadvantaged because the first happened to clock up more than 15,000 annualised kms but the second driver did not use the car enough to bring the actual kms to above 15,000 kms. The first driver has no right against the employer and has to wait until he or she receives an assessment before being able to lodge an objection.

Example 2

A district nurse is required by her employer to take the car home because parking is not available at the employer's premises and the employee is required to be on call. Private use of the car is restricted to travel to and from work. The employee has a private vehicle and providing car parking for the employer's vehicle is an inconvenience. In this case, there is a fringe benefit borne and paid for by the employer. There is no personal benefit to the employee for using the employer's car. Yet the benefit must still be reported on the employee's payment summary and in turn this affects their liability to the medicare levy, (and/or) superannuation surcharge and the employee's entitlement to family allowance payments. In our view, the recording of the benefit on the employee's payment summary is both unfair and inequitable.

Example 3

A further example to demonstrate difficulties with allocating the amount of certain benefits to employees is where the employees of tax-exempt bodies (such as universities) are required to host visitors, for example, taking overseas visitors to 'Healesville Sanctuary' (which results in a expense payment benefit, residual benefit, or tax exempt body entertainment benefit). This isn't remuneration, nor is it (predominantly) meal entertainment, nor might it be particularly enjoyable,

especially after a number of visits. Yet this amount would ultimately end up on the payment summary for that employee.

Determining the allocation of shared cars creates an unnecessary high cost of compliance for businesses. The legislation refers to the need to consider any 'relevant matter' (Section 5F(3) and (4) of the FBTAA 1986) when determining the employee's share. Although this is sufficiently broad to allow an employer to consider a range of factors which impact on the use of the shared car, the broad nature of the provisions further adds to the cost of compliance, particularly where employees have a vested interest in understanding the determination of the apportionment of the taxable value and the reporting of this value on their payment summaries (as is the case due to reportable fringe benefits).

The current legislation creates the need to assess the various factors/matters which impact on the provision of the benefit, such as an attribution based on days used, kilometres driven, percentage of use, operating costs v statutory method and so on. These various permutations are necessary to ensure that there is an equitable allocation of the taxable value of the car. This becomes even more difficult where the use of the car changes between employees. For example, one employee uses the car primarily for business use and uses a log book, one uses it primarily for private use but does high kilometres and a third employee rarely uses the car at all. The varied use of the car and the combinations of the calculations of the car fringe benefit need to be considered before an assessment can be made as to how to value the car and attribute this value to each employee.

The professional bodies recommend that only benefits which are part of a remuneration package or award should be reported on payment summaries. This would thus avoid the inequitable recording of benefits such as in the examples above. The professional bodies also submit that there ought to be an exemption from these rules in such situations. Excluding non-remuneration benefits would achieve this most desirable outcome i.e. for examples 2 and 3 above.

The professional bodies further recommend that the law be amended to provide for an exception from the usual reporting rules where it is simply impossible to allocate fairly the value of a fringe benefit to individual employees. As is the case in example 1 above.

As an alternative to the above recommendations, the following are suggested as a means to solve the problems in each of the examples above:

- Where more than one employee uses a car, the employer be given the option to calculate the statutory formula for the car separately for each employee based on the annualised kilometres for the period of use by each employee.

- The benefit that employees obtain from the occasional use of a car to drive home when they use the car for employment is marginal. It is suggested that the work related exemption for utilities and panel vans be extended to all cars. If the Government is concerned about employees using this to obtain an inappropriate tax benefit by salary packaging the use of such cars, they could include provisions in the legislation that require the employer to have a well-regulated system of enforcing the no non-work related use of the cars.

At a bare minimum, and as a short-term solution, clearer guidance is required as to an acceptable set of rules for the valuation and attribution of shared cars between employees. This would assist in partly resolving some of the concerns outlined above.

It is also anomalous that a 1.9417 gross up factor is used on fringe benefits where the effective tax rate of employees and indeed the salary sacrifice required by the employees of the FBT

exempt and rebateable employers is less. This disadvantages employees who receive benefits, rather than being tax neutral.

5. Reportable Fringe Benefits and Recreation Expenditure

At present, recreation expenditure (except for entertainment facility leasing expenses) is subject to the FBT reporting requirements. 'Recreation' includes expenditure on any of the following:

- engaging an entertainer (eg, band, DJ, and comedian) for a social function;
- a game of golf or tennis;
- sightseeing tours; and
- tickets to a movie, theatre or sporting event (eg, AFL football match).

From a practical perspective, the requirement to trace every item of recreation expenditure to employees creates a compliance nightmare for employers.

This is especially the case where recreation expenditure involves an employer separately engaging an entertainer (eg, a band and/or comedian) for a social event, such as a gala dinner, award dinner or similar function.

To satisfy the reportable fringe benefits requirements in these circumstances, the employer would need to:

- determine the amount of recreation expenditure (eg, cost of the band and/or comedian);
- determine the identity of each person attending the social function; and
- allocate the total taxable value of the recreation expenditure to the employees.

The current legislation also leads to ridiculous situations, some of which were highlighted during the recent Rugby World Cup. An employee could be invited to attend the Rugby World Cup final in the company's corporate box and, whilst FBT would be payable on the benefit of the ticket, there would be no reportable fringe benefit on that employee's payment summary. However, if the company who leased the corporate box ran out of seats in that box, they could go out and purchase two tickets to exactly the same event. However, the recipients of those tickets, if they were employees, would have a reportable fringe benefit on their payment summary.

Other complications arise where there is a lack of information as to which employees attended, and whether an employee's associate also attended. The ATO has partly acknowledged this concern, by issuing an administrative concession to increase effectively the minor benefit exemption threshold to $125 to deal with incidental recreation in the above circumstances (refer to the NTLG - FBT minutes of meeting dated 22 February 2001).

However, in many cases, the cost of such a function per employee (including associates) would be greater than $125.

Having regard to the above compliance issues, the professional bodies strongly submit that all recreation expenditure should be excluded from the FBT reporting requirements, as is currently the case for meal entertainment expenditure and entertainment facility leasing expenses. Alternatively, to ensure that there is no abuse of the system, the exclusion could be limited to benefits provided in actually viewing a sporting event or participating in such an event (for example: a golf game, where the reportable issue arises with individual green fees).

6. Reportable Fringe Benefit Threshold too low

Under the reportable fringe benefits requirements, compliance costs have increased for employers, as they now have to record every benefit received by each employee to determine

employees who receive over $1,000 worth of benefits. The $1,000 limit is too low and should be higher to avoid the compliance costs of recording what are relatively small amounts.

For Example:

An employee may receive an occasional $100 (note that the $100 is only an illustrative amount) expense payment fringe benefit at the start of the year. As the year progresses, the expense payment fringe benefit is received more regularly and when all benefits are totalled, they exceed the $1,000 threshold.

The professional bodies recommend that the reportable fringe benefit threshold be increased to a greater amount of at least $2,000 to reduce the cost of complying with the reporting requirements.

7. Interaction of the GST & FBT and Financial Supplies

The GST/FBT interaction is leaving many tax practitioners and taxpayers open to major exposure because it is difficult to comply with. This is the case, for example, for input taxed suppliers i.e. financial institutions. This issue arises because providers of financial supplies have to establish whether a benefit is considered a remuneration benefit or not. This is required to determine whether FBT will apply. The ATO has issued some guidelines in GSTR Rulings GSTR 2000/22 and GSTR 2001/3 to assist with determining the treatment. This was required because of the existing inflexible and complicated FBT laws.

In order to establish whether something is subject to FBT, taxpayers and tax practitioners have to ask themselves whether the benefit falls within one of three broad classes: those that relate wholly to remuneration benefits; those that result partly in a remuneration benefit (with some FBT payable); and those that relate only to work benefits (where no FBT is payable on the supply of the benefit).

In general terms, remuneration benefits are provided as a reward for services, whereas work benefits are provided to meet the business needs of the employer.

In summary, acquisitions that relate ***wholly to remuneration benefits*** are not subject to Division 71 of the GST Act. For example, reimbursements of employees' private expenditure are remuneration benefits. This is because such benefits are purely of a private nature.

Acquisitions that result in benefits that are ***partly work benefits and partly remuneration benefits*** (some FBT payable) will be subject to Division 71 of the GST Act. For example, an asset such as a car is used partly for work purposes and also privately, or where the employer imposes restrictions on use (even where the benefit is essentially private), the benefit will be both a work and a remuneration benefit. This will also be the case where the FBT benefit value is reduced by the 'otherwise deductible rule' (because of the work activities).

Acquisitions that result ***only in work benefits*** where FBT is not payable on the supply of the benefit will not be subject to Division 71 of the GST Act. In many cases, this will be because the benefit arising is merely a by-product of normal enterprise activities. For example, Section 47(3) of the FBTAA 1986 provides that a residual benefit, provided to an employee, which consists of the use of property (other than a motor vehicle) that is ordinarily located on business premises, and is wholly or principally used directly in connection with business operations of the employer, is an exempt benefit. The private use of a work telephone by an employee is an exempt benefit under Section 47(3) of the FBTAA 1986. The use of the telephone merely results in a benefit to the employee as part of work activities.

Acquisitions that result only in work benefits where FBT is payable will be subject to Division 71 of the GST Act. For example, an employee is required to take a client out for a meal. Whilst paragraph 56 of GSTR 2001/3 lists entertainment as a remuneration benefit, we understand the

ATO's interpretation is that entertainment is an example of something that may be a remuneration benefit but that there will also be cases where entertainment is a work benefit according to the general definition of a work benefit in that ruling.

The professional bodies recommend that these rules be completely overhauled and simplified and a new set of rules be drafted. The professional bodies would be happy to work together with the ATO and Government to come up with some workable rules.

8. Reconciliation Difficulties

The requirement to report GST-inclusive values for FBT purposes, when accounting systems generally record the GST-exclusive values (because the GST component is coded to the GST account) can be very onerous. It is difficult to determine which values need to be grossed-up to their GST-inclusive values and which items did not include GST i.e. because they were GST-free or input taxed purchases. The time costs in identifying all this information is considerably high.

The professional bodies recommend that amounts be recorded as GST-exclusive in the FBT return.

9. Capping Thresholds

Fringe benefits that are exempt under Section 57A of the FBTAA 1986 are capped by the legislation. For public hospitals, non-profit hospitals and government employees performing duties in connection with such hospitals, the limit is $17,000 per employee, per year and for public benevolent institutions the threshold is $30,000.

The capping of benefits for certain employers is a difficult concept when it comes to completing the FBT return and determining any aggregate non-exempt amount or aggregate non-rebateable amount. Without professional assistance, the employers affected would find it difficult to complete these sections accurately, and obviously, this comes at a cost. These provisions present a major cost of compliance and not-for profits do not have the resources to deal with such complexities.

The professional bodies are of the view that this area requires re-visiting with the view of re-writing these provisions.

10. Road Tolls

At present the ATO's view and practice in relation to road tolls is that road tolls do not fall into the category of 'car expenses' under Section 53 of the FBTAA 1986 and that they are not included in the narrow definition of a 'car expense' under Section 136(1) of the FBTAA 1986.

The ATO is of the view that road tolls will either be an expense payment fringe benefit under Section 20 of the FBTAA 1986 (where the employee incurs an expense) or a residual fringe benefit under Section 45 of the FBTAA 1986 if the obligation to pay the road tolls is the employer's. However, there will be many factual matters that will ultimately determine the correct FBT outcome.

Where an expense or residual fringe benefit arises, an employee may lodge a declaration to show the extent to which road tolls paid or otherwise provided by an employer are for business use. An employer may, where the facts relevantly allow the same, prepare a 'business use only' declaration in accordance with Sections 20A and/or 47A of the FBTAA 1986.

Where road tolls are provided on an infrequent and irregular basis, the minor benefits exemption can be applied. Obviously, where an employee uses a car to travel predominantly for business purposes and is permitted to use an e-TAG or transponder to pay road tolls in relation to trips between home and work on a regular basis, the minor benefits exemption would not apply.

In accordance with the new FBT reporting requirements, fringe benefits need to be allocated to particular employees for the purposes of reporting benefits on employees' payment summaries, subject to some exclusion. If tolls paid on behalf of employees are to be included in this requirement where no exemption applies, accurate records will need to be kept indicating both whether tolling expenditure incurred on a journey was of a personal or business nature, and which employee was using the car. We, therefore, submit that simpler administrative arrangements are required if employers are expected to comply with these rules.

This varied treatment creates unnecessary extra work and the need to consider different section of the FBT laws to determine which provision should be applied for ultimately the same outcome.

It will be very difficult for employers to monitor vehicle use on an employee-by-employee basis, for the purposes of allocating benefits between employees and satisfying the new fringe benefits reporting requirements. Tolling expenditure is measured per account, rather than per employee or vehicle. For small business, two account options are available:

Option 1

When different employees use different vehicles, all of this usage will be recorded on the one account. How will the employer's breakdown this information down per employee for the FBT reporting requirements?

A solution could be to keep a logbook with each vehicle, recording who undertook and the purpose of, each tolled journey. If more than one employee is involved, apportioning of toll expense for FBT purposes may be required if there is any personal use of the vehicle. However, we submit that this method of recording by employees and the subsequent analysis by employers will be administratively burdensome.

Option 2

The second option for small business is to share one e-TAG or transponder amongst up to four registered vehicles of the same class that are attached to the Standard Toll Account. The same recording issues as above will exist. In addition, if one logbook is kept with the mobile e-TAG or transponder to record all journeys, employers will have the additional complexity of accurately recording trips taken in the other registered vehicles, which do not have the e-TAG or transponder with them for that journey.

A solution in this instance may involve having a logbook in each of the four registered vehicles, recording every journey. Once the toll account is received, the employer will need to cross-reference this with the logbooks and determine whether any private usage occurred. The relevant amounts for FBT will then be able to be calculated and allocated accurately between employees. Employers may need to be mindful of the additional fee incurred by registered vehicles that use toll-ways for example; CityLink in Melbourne without an e-TAG will incur such fees and need to incorporate these into any FBT calculations they perform. This would be a complex task to administer accurately and in turn a compliance nightmare.

If more than one employee uses the motor vehicle (eg pooled cars) and there is some private use, employers will need to decide how they are going to calculate the FBT allocation. Will apportioning between travellers be required, or allocated against a particular employee.

A further issue, for employers with mixed vehicle fleets, relates to the fact that vehicles exempt under Section 8(2) or 47(6) FBTAA 1986 are exempt from FBT, for example, where they are panel vans or utility trucks (either greater or less than 1 tonne carrying capacity). However, a fringe benefit can still arise from the employer paying or reimbursing the bridge or road toll and

FBT will be payable on any private use. This FBT treatment seems to be at variance with the original intention of the Act, that is, to exempt this type of vehicle from FBT in the first instance.

The professional bodies recommend an urgent review of the current FBT treatment of the payment by employers of bridge and road toll expenditure incurred by their employees. We suggest that the best solution would be to amend Section 136(1) of the FBTAA 1986 to include within the definition of a car expense, 'the payment of bridge and road tolls by employers'. We believe that the resulting exemption under Section 53 of the FTAA 1986 would be the most sensible approach.

Accordingly, these car expenses would be treated as exempt benefits under Section 53 of the FBTAA 1986 and, therefore, would be excluded from the reportable fringe benefits requirements. This would significantly reduce compliance costs for employers.

11. Minor and Infrequent rule

This rule as set out in Section 58P FBTAA 1986 allows for the exemption of fringe benefits, which are both minor and provided on an infrequent and irregular basis. The question of what is minor is set out in Subsection 58P(1)(e) of the FBTAA 1986. The question of what is infrequent and irregular is, however, much more subjective and can result in much time assessing the tests set out in subsection 58P(1)(f) of the FBTAA 1986. In addition, this causes much concern for employers and employees alike.

It is our view that the various tests set out in Subsection 58P(1)(f) of FBTAA1986 are highly subjective and create a compliance burden for employers when assessing whether the exemption applies. This has become more of an issue since the introduction of reportable fringe benefits, as employees now have a much greater interest in understanding the basis for the FBT treatment of particular benefits.

The professional bodies consider that the $100 threshold for minor and infrequent benefits is too low. It is recommended that the threshold be increased to at least $200. This amount should also be indexed each year to account for inflation. We note that no account for inflation has occurred since its introduction in 1986.

12. Election to group

At the present time there is no ability for companies that are a part of a group to elect to consolidate/group their FBT obligations.

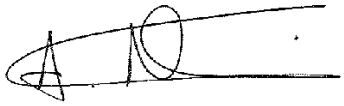
Other parts of the tax legislation allow for companies to group. For example: GST grouping and consolidations. In our view companies in a group should have the ability to group. Furthermore, their needs to be consistency in practice across all taxes to ensure compliance costs are kept to a minimum.

The professional bodies recommend that companies should be able to have the option to elect to group their FBT obligations and thus only lodge one FBT return. We, therefore, recommend that the legislation be amended to permit this.

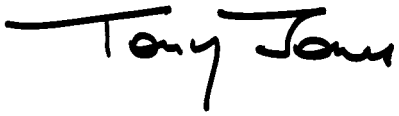
CONCLUSION

The professional bodies look forward to working together with the ATO and Government to progress and resolve these recommendations. Should you require any further clarification on this matter, please do not hesitate to contact Ali Noroozi (on 9290 5623) or Maria Benardis (on 9290 5761) of the Institute of Chartered Accountants, the co-ordinating professional body.

Yours sincerely



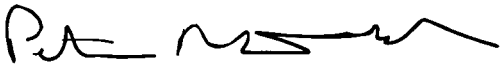
Ali Noroozi
Tax Counsel
The Institute of Chartered Accountants in Australia



Tony Jones
Chief Executive Officer
National Tax & Accountants Association Limited

Peter Webb
Secretary-General
Law Council of Australia

Gavan Ord
Technical Policy Manager
National Institute of Accountants



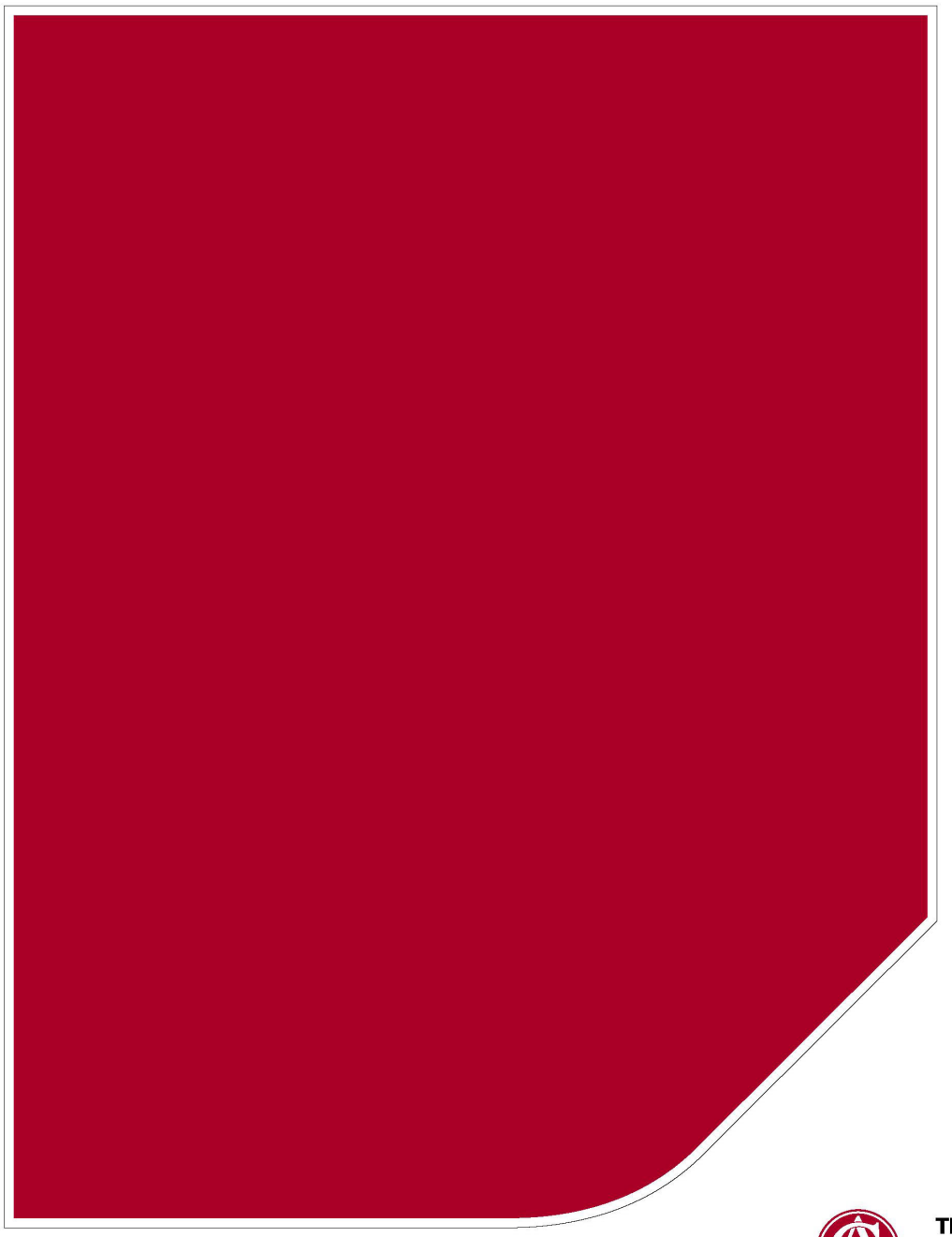
Peter McDonald
National Director
Taxpayers Australia Inc

Neil Earle
President
Taxation Institute of Australia

Appendix 4

Review into the Tax Office's Ability to Identify and Deal with Major, Complex Issues within Reasonable Timeframes

23 December 2005



The Institute of Chartered Accountants in Australia

www.icaa.org.au

About The Institute

The Institute of Chartered Accountants in Australia (The Institute) was established by royal charter in 1928.

It is Australia's premier accounting body, which represents over 40,000 members who are fully qualified Chartered Accountants working either in the accounting profession providing auditing, accountancy, taxation and business consultancy services; or in diverse roles in business, commerce, and government.

The Institute is focused on leadership, protecting the standards and reputation of the accounting profession and influencing the policies and regulations that affect the industry.

Our principal areas of interest encompass:

- Education of young accounting graduates through the CA program (current enrolments comprise approximately 10,000 students);
- Continuing professional education for accountants in practice and commerce;
- Technical support in the areas of accounting, auditing, taxation, superannuation, financial planning and financial advisory services. This technical support is provided by way of regular newsletters to members on changes to legislation and other developments, and also through the provision of a call up advisory line;
- Lobbying and advocacy on behalf of members with respect to accounting and auditing standards, taxation, corporate law, superannuation and retirement incomes, and financial services;
- Thought leadership associated with our areas of primary focus with a view to enhancing the standing and reputation of accountants and providing input into public policy;
- Quality control through an extensive program of inspections covering members operating in public practice;
- Administration of a professional conduct regime whereby members whose activities or actions could lead the profession into disrepute are called to account and disciplined appropriately; and
- The establishment and promulgation of standards of professional conduct with particular emphasis on ethical behaviour

Unlike other accounting bodies, the Institute does not include candidates/students in its membership figures. Membership is based on tertiary graduation, completing the Institute's CA program and meeting the highest educational, professional and ethical standards.

For further information about the Institute of Chartered Accountants in Australia visit www.icaa.org.au

Review into the Tax Office's Ability to Identify and Deal with Major, Complex Issues within Reasonable Timeframes

Contents

Review into the Tax Office's Ability to Identify and Deal with Major, Complex Issues within Reasonable Timeframes

Executive Summary

The three case studies selected exhibit very different fact patterns. However, common themes that emerge from The Institute's experience with service entity arrangements and member comments in relation to the other case studies include:

- the time taken to identify issues, or perceived issues, and/or the time taken to deal with those issues is too long and, on the face of it, does not appear reasonable in the circumstances. We acknowledge that there will be factors contributing to Tax Office delays of which we are not aware.

- in the case of service entity arrangements and, we suspect, R&D syndication arrangements, part of the lengthy time frame is attributable to an initial refusal to accept that the actions of the Tax Office played any part in the situation in which taxpayers found themselves once the Tax Office has decided to take action. The "carve out" from retrospective activity in the case of service entities, the settlement offer for taxpayers involved in R&D syndication arrangements and the withdrawal of living away from home allowance rulings all appear to have taken too long to eventuate.

- an unwillingness by the Tax Office to back down or admit error. Reinforcing this view is the fact that, at least in the case of service entity arrangements, the Tax Office issued a questionnaire based on the draft booklet which at that stage was still the subject of confidential consultation.

- a perception that it is not until a matter is escalated to the highest levels within the Tax Office and significant public pressure is brought to bear that real decisions are made.

- uncertainty creates costs for taxpayers, both in terms of professional fees and management time. It can also create other problems such as the possibility of insolvency or bankruptcy.

- unlimited amendment periods such as in the case of R&D exacerbate the problems which otherwise arise. For example, the longer it takes to resolve an issue the more likely it is that taxpayers will face evidentiary problems. (We note that there is to be a Treasury review of unlimited amendment periods next year as a result of the recommendations of the Report on Aspects of Income Tax Self Assessment).

- the Tax Office's communications do not necessarily have the effect intended. For example, nothing in the "warnings" given in relation to service entity arrangements foreshadowed the approach which would be adopted by the Tax Office in TR 2005/D5 and the draft booklet. Anecdotal evidence is that there was no formal Tax Office communication to taxpayers involved in R&D syndication arrangements until 2004.

We recommend that the Tax Office reviews its practice and procedures with a view to shortening the time taken to deal with matters, such as the three which are the subject of this review. We also recommend that middle to high ranking officials at the Tax Office be empowered to rule in favour of

taxpayers, where this is supported by the law, before it is escalated to the very highest levels and public pressure mounts.

1. Introduction

The Institute of Chartered Accountants in Australia (The Institute) is pleased to participate in the Inspector-General of Taxation's review into the Tax Office's ability to identify and deal with major, complex issues within reasonable timeframes.

The objective of the review is to identify any systemic deficiencies which, if rectified, might prevent prolonged timeframes occurring in the future by drawing upon the experiences encountered in relation to the following three areas or case studies:

- service entity arrangements
- living away from home allowances and
- research and development syndication arrangements.

We have set out below our comments in relation to each of the abovementioned areas, focusing on the matters identified in the Terms of Reference which the Inspector-General will be addressing, namely:

- the timeframes to identify and deal with the issue
- the nature and cause of those timeframes, and if they were reasonable in the circumstances
- the extent and cause of uncertainty to affected taxpayers, including any initial Tax Office guidance or representations
- the Tax Office's approaches to the issue, the reasons form them, and if they were reasonable in the circumstances, including:
  (i) its compliance, legal and resolution approaches and
  (ii) its communications with members of the community
  the adverse impacts and costs that the Tax Office's approaches and timeframes may have had on businesses and other areas of the community.

2. Service entity arrangements

Service entity arrangements have their origins in the establishment by the then chartered accounting firm, Fell & Starkey, of a trust to provide staff and facilities to the partnership for a fee, generally based on cost plus an appropriate mark-up. The beneficiaries of the trust were family members.

The purpose of the arrangement was to provide asset protection to partners by shifting income that would otherwise be received by partners to family members. This allowed wealth to be created in the hands of family members that was outside the reach of creditors and potential litigants of the partnership, and hence partners, whose liability is joint and several. A consequence of shifting income to family members was that it was subject to less tax than if derived by the partners themselves.

The service entity arrangement put in place by Fell & Starkey was challenged by the Tax Office but unanimously accepted by the Full Federal Court as being tax effective in *Federal Commissioner of Taxation v Phillips (1978) 36 FLR 399*. Although at first instance the Tax Office challenged the arrangement both on the basis that the service fee was not deductible to the partnership under the general deduction section and also on the basis that the then anti-

avoidance provision contained in section 260 applied, the latter argument was not pursued before the Full Federal Court.

Following the decision in *Phillips* case, the Tax Office issued a ruling, IT 276, which essentially accepted the decision in *Phillips* case.

Since then, service entity arrangements have generally been used by professional practices for asset protection purposes on the basis that such arrangements were acceptable to the Tax Office. As various professions have moved to allow their members to practice via companies or trusts, practices established after that time may have used a different form of structure to achieve that outcome.

Set out in Appendix 1 is a summary of events which have occurred since the decision in *Phillips* case which is indicative of the Tax Office's approach to service entity arrangements over the years.

(a) Timeframes to identify and deal with the issue

As the timeline in Schedule 1 indicates, service entity arrangements have been around since the late 1970s. Between then and the issue of the Commissioner's 2001 Annual Report some 20 years later, the Tax Office would undoubtedly have untaken a number of audits and responded to a number of requests for advance opinions or private binding rulings in relation to service entity arrangements. As the self-assessment regime was only introduced from 1986-87, for the greater bulk of this time, the Tax Office was required to apply the law to each taxpayers circumstances.

Despite this, the Tax Office did not formally identify service entity arrangements as an emerging issue until the release of its 2001 Annual Report when service entity arrangements fell for discussion under the banner of "Aggressive tax planning". This was surprising particularly as certain features of these arrangements which were not (or arguably were not) on all fours with the facts in *Phillips* case, and which were included in the issues of concern to the Tax Office around this time, had been a feature of service entity arrangements for many years, e.g. the use of discretionary as opposed to fixed trusts as the service entity and the employment of professional staff within the service entity once permitted by the rules of The Institute (and possibly other professional bodies).

Even then, the 2001 Annual Report, the subsequent Commissioner's speech in July 2002 and the various comments at the National Tax Liaison Group were couched in terms of findings from a limited number of cases.

It was not until the release on a confidential basis of the preliminary version of the draft ruling on service entities in May 2004 that the full extent of the Tax Office's views became apparent to the professional bodies. At this time the disparity between those views, the views of the professional bodies and what practitioners could reasonably have contemplated in the light of earlier comments on the need for commerciality became apparent.

The draft booklet, also released on a confidential basis, did nothing to allay concerns about the draft ruling. It required a level of documentation not previously required outside a large transfer pricing context and suggested safe harbour mark-ups the calculation of which were far from transparent and demonstrably too low. Significantly, the draft booklet did not suggest a safe harbour using a cost plus methodology, being the simplest, most commonly employed method and, notably, the method used in *Phillips* case itself.

Despite the lengthy consultation period and the joint submission of most major taxation bodies expressing their dissatisfaction, the draft ruling and booklet issued for public comment in May and June 2005 in a form which was still unsatisfactory to The Institute in a number of very significant ways. A copy of The Institute's submission dated 5 October 2005 is attached as Appendix 2.

Between the time of issue of the draft ruling in May 2005 and the draft booklet in June 2005 the Commissioner indicated to the Senate Economics Legislation Committee on 2 June 2005 that the Tax Office would generally give taxpayers 12 months to review their arrangements in the light of the guidance to be provided in the yet-to-be published practical booklet. However, it would continue its ongoing audit activity in "high risk cases" identified as being where the service fees were over $1 million and 50% or more of the gross income of the firm was paid by way of service fee.

This "carve out" from retrospective audit activity was affirmed in the Tax Office's press release dated 29 June 2005 accompanying the public release of the draft booklet and also in the draft booklet itself. In that press release the Tax Office also indicated that, based on its analysis of legal and accounting firms which indicated that over 90% of cases were below the $1 million/50% threshold, it expected that its examination of high risk cases would add 40 taxpayers to the 40 already underway.

The Institute raised concerns that the $1 million/50% threshold would encompass many medium to large sized firms, particularly where the practice was city based and/or the service entity employed professional staff (which, contrary to early papers and speeches, the draft ruling did not rule out). However, it was reassured by the Commissioner that the Tax Office's analysis was correct.

Subsequently, at the Senate Budget Estimates on 3 November 2005, the Commissioner added an additional criterion to the circumstances in which taxpayers would be audited retrospectively, namely, that the service entity earns more than 50% of the combined profits of the practice and service entity. This was the result of constructive consultation between the Tax Office and The Institute. The addition of this third criterion has not been formally advised to taxpayers by the Tax Office by way of press release.

At the time of writing, neither the draft ruling nor the booklet had issued in final form, whittling the time taxpayers have to get their affairs in order from an original 12 months to less than 6 months. However, we continue to constructively work with the Tax Office and are hopeful of an improvement.

(b) Nature and cause of those timeframes, and if they were reasonable in the circumstance

As indicated above, the Tax Office has taken upwards of 20 years to identify that service entity arrangements allegedly posed a risk to the revenue, another 5 years to issue a draft ruling and booklet and upwards of five years for those documents to be finalised.

It is surprising that during the first 20 or so years the Tax Office garnered so little intelligence on service entity arrangements given that the self assessment regime operated for only the latter part of that period and the Tax Office would have conducted a number of audits and given a number of rulings in respect of service entity arrangements during those years.

All up, on the face of it, the timeframes do not appear reasonable in the circumstances.

(c) The extent and cause of uncertainty to affected taxpayers, including any initial Tax Office guidance or representations

We would expect that most affected taxpayers who are members, or clients of members of The Institute, have been aware since around 1991 that the tax and accounting profession, including service entity arrangements, were being scrutinised by the Tax Office.

Feedback from many of our members would suggest that, up until the release of the draft ruling and, more significantly, the draft booklet, nothing published by the Tax Office caused them a major concern. This was because, by and large, they regarded their service entity arrangements as conforming to case law, an existing ruling and practice that, in the circumstances described above, any person could reasonably expect the Tax Office to be aware of.

The issue of the draft ruling and booklet has caused considerable concern not only for taxpayers who face the prospect of retrospective audit activity, but also for those taxpayers who are required to get their house in order but who, to this date, do not know exactly what that means or the timeframe in which this has to be done given that we are now half way through the 2006 income year. This is despite the fact that the Tax Office continues to assert that it has not changed its view of service entity arrangements.

For taxpayers facing retrospective audit activity, it has been something of a merry-go-round as a result of changes in the criteria.

Anecdotal evidence would suggest that, given the uncertainty surrounding service entity arrangements, the limited asset protection which can be achieved based on the artificially low margins and the compliance costs involved in complying with the draft booklet, a number of firms have restructured. Even more are investigating alternate structures.

(d) The Tax Office's approaches to the issue, the reasons for them, and if they were reasonable in the circumstances, including:

(i) its compliance, legal and resolution approaches and

(ii) its communications with members of the community

The approach of the Tax Office since discovering a limited number of service entity arrangements with which it had a concern was to reinforce in speeches and articles given by the Tax Office the need for commerciality as demonstrated in *Phillips* case and set out in IT 276. No indication was given as to what the Tax Office considered was a commercial charge or how to go about establishing that the fee was commercial.

As indicated in the National Tax Liaison Group (NTLG) minutes of 26 March 2003, there followed a period during which the Tax Office sought detailed information about the use of service entities from which to issue a discussion paper and/or ruling setting out the Tax Office's view on the way forward.

In the interim, taxpayers understandably took their cue from *Phillips* case where, using salaries as an example, the service charge was calculated by applying a mark up on costs with the mark up simply being the rate used by a client of the firm.

There was no indication, by way of addendum to IT 276 or otherwise, that anything more that the relatively simple approach adopted in *Phillips* case was required and, prior to the issue of the booklet, no suggestion that taxpayers were expected to embark on a sophisticated and costly transfer pricing analysis to justify mark-ups. Nor was there any formal indication that, as IT 276 issued prior to the introduction of the new general anti-avoidance provision in Part IVA, the Tax

Office would look to applying that Part where features of the service entity arrangement, including the use of discretionary trusts and the employment of professional staff, alone or in combination with other factors may have, in the Tax Office's eyes, Part IVA implications.

The reality is that, until the draft ruling and booklet are finalised, the actions of the Tax Office have amounted to a fact finding mission with a view to determining what it will regard as acceptable on an ongoing basis.

We do not have an issue with the approach ultimately adopted by the Tax Office once it had established, however late, that there may be features of service entity arrangements which it regarded as a risk to the revenue. Our concerns with its approach and communications may be summarised as follows:

- the Tax Office's refusal to recognise that its draft ruling and booklet went further than IT 276 and that, in these circumstances, any retrospective application of the draft ruling and booklet was inappropriate.

- the revenue bias reflected in the draft ruling, particularly in relation to its failure to recognise *Phillips* case as the most relevant precedent but also in its manifest misinterpretation of what asset protection means.

- in relation to the retrospectivity issue, the Tax Office would argue that it gave taxpayers an early warning of its position as early as 1993. However, this must be viewed in the context that there already existed a case directly on point, a public ruling accepting the decision in that case, upwards of 20 years water under the bridge and that the warnings, by and large, simply reinforced that the Tax Office would apply the ruling which the vast majority of taxpayers considered they were already following. Whilst The Institute welcomed the warning, it cannot be viewed in the same light as an early warning in the case of, for example, a tax scheme issued prior to the Tax Office reaching a concluded view on the law. If the Tax Office expected taxpayers to adjust anything other than the most obvious deviations in its arrangements from those in *Phillips* case, it should have said so more clearly.

- notwithstanding the Tax Office's stance that the draft ruling and booklet reflected the position it had always adopted, it consulted on a confidential basis with key stakeholders in relation to the draft ruling and booklet. Whilst we consider that such consultation was appropriate, we are concerned that the Tax Office issued a questionnaire during this period where the questions appeared to be taken from the booklet which at that stage was still confidential. This has resulted in a perception amongst our members that the consultation process was largely one in name only.

(e) the adverse impacts and costs that the Tax Office's approaches and timeframes may have had on businesses and other areas of the community

Where taxpayers have restructured their arrangements to maintain an appropriate level of asset protection, minimise compliance costs and obtain certainty they will have incurred costs which may have been avoided had the issue of service entities been resolved in a shorter timeframe.

The number of newspaper articles, seminars and calls to The Institute would also suggest that a number of firms will have incurred costs in relation to the impact of the draft ruling and booklet on their service entity arrangements and/or restructuring advice which potentially could have been avoided had the matter been finalised within a shorter timeframe.

More importantly, however, unless the draft booklet is revised to provide realistic documentation requirements as well as simple and easy to apply safe harbours set at reasonable levels, costs will be incurred particularly by firms seeking to restructure or undertaking sophisticated and expensive benchmarking studies to justify more realistic mark-ups. Obviously, the impact of those costs will be felt more acutely by smaller firms. There appears to be a lack of appreciation that the bulk of affected taxpayers are small businesses, something recognised by the Tax Office in relation to transfer pricing where a different standard applies.

3. Living away from home allowances

The historical background to living away from home allowances (LAFHAs) is set out in the attachment to the Terms of Reference and Consultation Plan. The following responses reflect the views of those members who have provided feedback.

(a) The timeframes to identify and deal with the issue

The issue in question of the ability to salary sacrifice LAFHAs is not new. In fact, this has been relatively standard practice since FBT was first introduced in 1986. We understand that the practice of salary sacrificing LAFHAs in the "labour hire" industry is also not new and has also been in existence for many years.

It seems that the Tax Office, to the best of our knowledge, initially expressed some interest in this particular topic in this particular industry in late 1998. Arguably therefore, it may have taken the Tax Office took 12 years to "identify…….the issue".

Our understanding is that the issue has now been clarified, and as it was first identified in 1998, it has therefore taken 7 years for the matter to be concluded.

(b) The nature and cause of those timeframes, and if they were reasonable in the circumstances

We are of the view that the question of salary sacrificing LAFHAs is not a complex one and that 7 years is not a reasonable timeframe within which to deal with the matter. Whilst the Tax Office needs to satisfy itself that the positions that have been taken within the industry are reasonable, the matter could have been concluded in a much shorter time frame. We comment further below on the dominant reasons for the time taken to conclude the matter, but in summary, our comments revolve around the Tax Office's apparent unwillingness to act quickly where the correct interpretation of the law gives rise to a favourable position for taxpayers.

(c) The extent and cause of uncertainty to affected taxpayers, including any initial Tax Office guidance or representations

The Tax Office's inquiry into this matter caused considerable uncertainty within the industry. During the course of this matter, the Tax Office issued and then retracted TA 2002/07, and similarly issued and subsequently withdrew TD 2000/D5. The disruption and uncertainty that this type of action gives rise to in the particular industry in question is difficult to estimate. However, it stands to reason that the disruption and uncertainty would have been significant.

(d) The Tax Office's approaches to the issue, the reasons for them, and if they were reasonable in the circumstances

As mentioned previously, the matter of salary sacrificing LAFHAs is neither new nor complex. Our feedback suggests that the Tax Office's approach to the issue has been one-sided, failing to recognize the strength of the taxpayers' position which seems to be reasonable in the circumstances.

(e) The adverse impacts and costs that the Tax Office's approaches and timeframes may have had on businesses and other areas of the community

The Tax Office's unpreparedness to accept merit in counter arguments gave rise to considerable professional costs to the industry. It is not possible to quantify these costs without a great deal of effort but clearly over the period of 7 years involved, the costs incurred by various taxpayers in professional fees, let alone in senior management time, would have been material. The perception has been that the Tax Office has been unwilling to change its position regardless of the facts and reasonable interpretation of the law.

4. Research and development (R&D) syndication arrangements

The historical background to R&D syndication arrangements is also set out in the attachment to the Terms of Reference and Consultation Plan. The Institute received limited feedback from members in relation to the Tax Office's handling of R&D syndication arrangements. The following comments reflect the views expressed.

(a) Timeframes to identify and deal with the issue

Despite the fact that between 1990 and 1996 the Tax Office issued a number of advance opinions and private binding rulings on the tax consequences of a large number of R&D syndication arrangements involving billions of dollars, it was not until the report of the Australian National Audit Office (ANAO) in 1993 that its commenced a review of a number of arrangements focusing on whether, in respect of the acquisition of core technology:

- the parties were acting at arms length and
- if not, whether the price paid was in excess of the amount which would have been paid had the parties been acting at arm's length.[1]

The legislation was changed in 1996 to close R&D syndication arrangements. However, the Tax Office's i approach to dealing with pre-existing arrangements is still not resolved some twelve years after the ANAO report.

Indeed, whereas one might reasonably expect in these circumstances that the Tax Office would seek to obtain judicial resolution of the abovementioned matters as early as possible, it was not until 4 September 2002 that the first decision dealing with a R&D syndication arrangement was handed down by the Administrative Appeals Tribunal – see *Re Zoffanies Pty Ltd and Federal Commissioner of Taxation* [2002] AATA 758. The Tribunal found in favour of the taxpayer both in respect of the question of whether the parties were acting at arms length and also whether the price paid was in excess of market value. It also held that Part IVA did not apply. On appeal to the Full Federal Court but only in respect of the latter issue, the Court

[1] These requirements applied from 25 May 1992. . The explanatory memorandum to Tax Laws Amendment Act 1992 which made the change indicates that before this time, deductions for core technology that were artificially inflated may attract the general anti-avoidance provisions.

found that the Tribunal had erred and the matter was remitted to the Tribunal – see *Federal Commissioner of Taxation v Zoffanies Pty Ltd* [2003] FCAFC 236.

As we understand it, on 14 April 2004 the Tax Office withdrew from the new Tribunal hearing, the day before a speech given by Commissioner (Appendix 3) in which he addressed, amongst other things, the application of Part IVA to legislative concessions and, in particular, the R&D concessions. In summary, he indicated that the tax outcome for the cost of core technology would be determined by the application of the specific anti avoidance provisions contained within the R&D provisions and that general anti avoidance provision, Part IVA, would have no application. The Commissioner noted that the s73B provisions were a particularly difficult are of the law to apply. The Commissioner also indicated that to assist resolving the Tax Office's approach in this area, it had been engaged in a lengthy mediation process with a taxpayer in relation to one R&D syndicate from which a set of guidelines would be developed that could be applied by the Tax Office to resolve disputes and, in particular, whether the dealings were at arm's length and, if not, the principles to be applied in determining the appropriate arm's length price. Those guidelines were publicly released on 6 September 2004 (Appendix 4).

The Tax Office subsequently contacted taxpayers involved in syndicated R&D arrangements in September 2004 attaching a copy of the guidelines and proposing a settlement offer for taxpayers in circumstances where core technology expenditure was:

- incurred on or after 19 December 1991 and
- $10 million or more and the taxpayers share of that expenditure was $3 million dollars or more.

That term of that offer are set out in the sample letter attached as Appendix 5.

The Terms of Reference and Consultation Plan indicate that the settlement offer was made to 40 taxpayers and that around 30 major cases remain unresolved.

(b) Nature and cause of those timeframes, and if they were reasonable in the circumstance

We are not aware of and cannot comment on the specific cause of the abovementioned timeframes, although the 1993 ANAO report sheds some light on the cause of the delay up until the time of that reportNor are we aware of the extent to which the extended timeframe has been influenced by the fact that the Tax Office has an unlimited time in which to amend a taxpayer's assessment in relation to R&D deductions and whether this has influenced the priority afforded this matter within the Tax Office.

On the face of it, even bearing in mind the complexity of the issues involved, the time it has taken to reach the stage at which things are currently appears difficult to justify. In particular, it is difficult to understand why it took for the Tax Office so long to progress this matter through the courts.

Anecdotal evidence is that:

- progression in the *Zoffanies* case was driven more by the taxpayer than the Tax Office
- it is the Tax Office that is delaying resolution of the outstanding cases by failing to respond to submissions within reasonable time frames
- a significant cause of the delay in resolving this matter can be attributed to the unwillingness of the Tax Office to back down or admit error and that the matter would have benefited (and may still benefit) from a change in the staff dealing with this matter. For example, we understand that the Tax Office in seeking to apply Part IVA was acting

contrary to the advice of the Part IVA Rulings Panel. Whilst we acknowledge that the Tax Office is required to make its own decisions, this may suggest an implacable attitude on the part of the officers dealing with this matter.

(c) The extent and cause of uncertainty to affected taxpayers, including any initial Tax Office guidance or representations

We do not have a break up of the type of taxpayers involved in R&D syndication arrangements. However, it is likely that whilst some taxpayers may have been sufficiently sophisticated to appreciate that approval from the IR&D Board and an advance opinion/private binding ruling (which would not have dealt with valuation issues and, in many cases, Part IVA[2]) did not insulate them future Tax Office amendments, there will undoubtedly have been many who viewed these arrangements as watertight.

To our knowledge there was no formal notification to affected taxpayers of the ATO's concerns in relation to R&D syndication arrangements until 2004. Assuming that all of these taxpayers were aware of the situation following the ANAO report in 1993, they have faced a prolonged period of uncertainty which was not resolved until 2004 for many (and is ongoing for others).

The delay in bringing this matter to a head has meant that taxpayer documents may no longer be available and parties involved at the time are no longer available. Certainly, in the absence of written documents, memories would be stretched. All of these factors have the potential to impact on the ability of a taxpayer to demonstrate satisfaction with the guidelines or pursue the matter before the courts.

(d) The Tax Office's approaches to the issue, the reasons for them, and if they were reasonable in the circumstances, including:

(i) its compliance, legal and resolution approaches and

(ii) its communications with members of the community

Even following the 1993 ANAO report, we understand that the Tax Office continued to give rulings between 1993 and 1996 which declined to comment on the appropriateness of the valuation methodology or warn participants that the Tax Office had concerns with the valuation of core technology.

Nor do we have detailed knowledge of the reasons why, following the ANAO report, the Tax Office approached this matter in the way it did. Accepting that its approach of testing the limits of the law through the courts was appropriate, it should have been done within a shorter timeframe.

The Tax Office's use of mediation in the case of a particular taxpayer to develop guidelines for resolution of issues is to be commended. Hopefully, lessons learnt from this experience will mean that this mechanism can be used as a circuit breaker in appropriate cases on a go forward basis and earlier than in the case in question.

Such guidelines if produced shortly after the enactment of the legislation may have avoided at least some of the disputes.

As far as the Tax Office's communications with affected taxpayers is concerned, we understand that there was no formal communication to affected taxpayers until 2004, a decade plus after the ANAO report.

[2] As we understand it, at least some rulings stated that "Part IVA would not appear to apply".

(e) the adverse impacts and costs that the Tax Office's approaches and timeframes may have had on businesses and other areas of the community

An obvious adverse impact arising from the Tax Office's approaches and timeframes is the lengthy period of uncertainty faced by taxpayers who participated in R&D syndication arrangements, including those quarantined from the settlement arrangements in September 2004.

In relation to costs, again it is not possible for us to quantify these. Clearly, however, over the years concerned, the costs incurred by various taxpayers in professional fees and, where relevant, management time, would have been material. For the 30 unresolved cases, those costs are ongoing.

Significantly, the researcher in most syndicates indemnified the investors for the value of tax deductions claimed and may face insolvency or bankruptcy. In addition, to the extent that syndicates have been collapsed, the researchers will now own the original investor companies. Therefore, if the Tax Office is ultimately successful, it will be the researcher who will be ultimately liable for the deductions denies and possibly also any penalties or shortfall interest. Again, this is likely to result in insolvency or bankruptcy for many.

APPENDIX 1

Summary of Tax Office activities in relation to service entity arrangements

Date		Description
1977		Decision of Full Federal Court in *Federal Commissioner of Taxation v Phillips (1978) 36 FLR 399*
7 August 1981 (original issue)		Issue of IT 276 (Annexure 1)
March, 1994		Paper presented at a Tax Institute of Australia Convention by Peter O'Donohue from the Tax Office restating the principles in *Phillips* case guidelines and indicating that the Commissioner is not specifically targeting service trust arrangements in the audit program at this time. Raises the potential application of Part IVA (Annexure 2)
November, 1998		Paper entitled "Service Entities (Trusts/Companies) The Commissioner's Perspective" presented at a Tax Institute of Australia Seminar by Chandra Sharma, Tax Counsel, Australian Taxation Office. Raises the potential application of Part IVA to arrangements entered into after 27 May 1981, particularly where the service entity employs professional staff (Annexure 3)
2001		The Commissioner's 2001 Annual Report, in the chapter dealing with "Aggressive tax planning", the Commissioner noted that the Tax Office had reviewed some tax planning by some accounting and legal firms and many of their partners, including the use of service entity arrangements. After commenting that, in accordance with IT 276, payments to service trusts which are commercially realistic would not be challenged, the Commissioner indicated that the Tax Office had concerns in some cases under examination whether the service trust arrangements were commercial and effective for tax purposes. The Commissioner indicated that its continuing real-time focus on the firms was aimed at identifying emerging risks. (Annexure 4)
29 July, 2002		Speech by the Commissioner of Taxation at a Financial Review leaders' luncheon where he said: *"The Phillips' Case authorised the use of service trusts to provide administrative services to professional partnerships .. Lately we have seen cases where the arrangements have varied significantly from those reflected in Phillips' Case… We are not seeking to re-open the Phillips' decision, but we are examining whether features of the king outlined tip the scale beyond what was accepted in that case as explicable on commercial grounds".* (Annexure 5)
5 September, 2002		At a National Tax Liaison Group (NTLG) meeting the following comment was made in connection with the Commissioner's AFR leaders' luncheon speech: "The kind of features of service trust arrangements outlined in the Commissioner's speech have been seen in a small number

		of cases currently under examination as part of the Tax Office's accounting and legal service project." *(Annexure 6)*
26 March, 2003		Discussed at a NTLG meeting. The minutes record that questionnaires would be sent to many tax and accounting partnerships seeking detailed information and would follow up this process by publishing its view. (Annexure 6). The Tax Office also provided a table summarising some of the differences between the service arrangement in Phillips case and the arrangements encountered by the Tax Office which, *"taken together, tip the scale beyond what seems to be explicable on commercial grounds"*. (Annexure 7)
16 June 2003		Reference to a speech by the Commissioner is made in circulars sent to accounting and legal firms. The text of that speech is not readily available (see following item).
June 2003		Circulars issued to approximately 50 accounting and legal firms
19 May 2004		Release on a confidential basis of the preliminary version of the draft ruling for consultation
August, 2004		Issue of 2004-05 Compliance Program which indicated that, in the section dealing with Small to Medium Enterprises: *Service trust arrangements within the legal and accounting professions continue to be of concern. We are examining arrangements for a number of firms, focusing on whether charges made for services have a realistic commercial value. This activity will be supported by an educational program following the issue of a public ruling supplementing Taxation Ruling IT 276 on this matter. The program may include tax officers visiting firms to discuss their service entity arrangements.* A similar comment was made in the section dealing with Large Business
21 September 2004		The Institute, Law Council of Australia, Taxation Institute of Australian, NTAA, CPA Australia and the National Institute of Accountants wrote jointly to the Commissioner of Taxation expressing its concerns in relation to the process to date in relation to service entity arrangements and seeking executive level intervention to set the project on a proper path.
4 May 2005		Public release of TR 2005/D25 (Annexure 8)
25 May 2005		Release on a confidential basis of draft booklet to accompany TR 2005/D5 for consultation
2 June 2005		Commissioner indicated to Senate Economics Committee (SEC) that the Tax Office would not audit prior years where the service fee was < $1 million *and* < 50% of gross fees (Annexure 9)
7 June 2005		At the National Tax Liaison Group meeting on this date the Commissioner confirmed the carve-out from retrospective audit activity referred to at the SEC. The minutes of that meeting have yet to be published on the Tax Office website.

29 June 2005		Public release of draft booklet to accompany TR 2005/D25. The draft booklet confirmed the extent to which the Tax Office would audit prior years as per comments to the SEC. It also indicated that an additional 40 firms would be subject to retrospective audit activity, in addition to the 40 already being audited (Annexure 10)
9 July 2005		The Institute raised concerns that the announced carve-out from prior year audit activity would leave more than 80 taxpayers exposed. It queried whether the carve out should be where service fees were < $1m service fees *and* the net profit of the service entity was <50%. Commissioner confirmed accuracy of comments to the SEC
August 2005		Issue of 2005-06 Compliance Program indicating that the Tax Office will use its profiling and review work to identify professional service business that use Phillips-type arrangements and indicating that it will generally allow taxpayers 12 months to review their arrangements in the light of TR 2005/D5 and the draft booklet. However, cases where the service fees are significant and represent over 50% if the gross fees earned by the firm.
3 November 2005		Commissioner indicated to SEC that prior year audit activity would now be limited to where service fees were < $1m *and* < 50% of gross fees *and* < 50% of net profits (Annexure 11)

Appendix 5

Private binding rulings – administrative recommendations of the Report on Aspects of Income Tax Self Assessment

Recommendation No	Details	Status
2.12	In PBRs where Part IVA could apply having regard to the facts provided in the PBR application, the Tax Office should indicate whether Part IVA has been considered. This indication may be by way of substantive comment on Part IVA's application, or by disclaimer. Where Part IVA has been substantively addressed and there has been a full and true disclosure of all material facts, the Tax Office should be prevented from reopening an assessment. Taxpayers can advise in their PBR application that Part IVA need not be considered.	Too early to comment
2.13	The Government should request the Inspector-General of Taxation to evaluate whether the pattern of PBRs indicates a pro-revenue bias.	In progress
2.14	The Tax Office should enhance its published performance reporting on PBRs to distinguish response times to individuals and very small business from those for larger businesses, and separately report agent and non-agent case statistics.	Too early to comment
2.16	The Tax Office should refrain from ruling on issues not directly raised in PBR applications without the taxpayer's agreement. In cases where other aspects of the tax law could impact on the accuracy of the Tax Office's response, the response should contain appropriate caveats or statements that the advice is issued subject to certain assumptions or limitations.	Too early to comment
2.18	The Tax Office should continue to modify its PBR application forms and processes to reduce the need for taxpayers to conform to complex procedures, or for the Tax Office to seek additional information from taxpayers.	Too early to comment
2.20	PBRs should contain an answer written in plain language, with a minimum of qualifying statements. In addition to the plain explanation, the Tax Office may provide a more detailed or technical statement of its position, where it is necessary to do so.	Too early to comment

Appendix 6

The Institute of Chartered Accountants in Australia

26 September 2005

Revenue bias in PBRs
Inspector-General of Taxation
GPO Box 551
SYDNEY NSW 2001

By email: rulings@igt.gov.au

Dear Mr Vos,

Review of the potential revenue bias in private binding rulings involving large complex matters

1. We refer to the review being conducted by the Inspector-General of Taxation in relation to the potential revenue bias in private binding rulings (PBRs) involving large complex matters focusing on, amongst other things, the basis for any perception of revenue bias in dealing with PBRs. In this regard we make the following observations.

Private binding ruling data

2. Information provided by the Australian Taxation Office (ATO) in relation to the Review of Aspects of Income Tax Self Assessment (the Review of Self Assessment) indicates that large business is not a major user of the PBR system, accounting for less than 3% of the 7,631 PBRs issued during 2002/03 (177 out of a total of 7,631).

3. Moreover, having regard to data provided by the ATO in relation to the Sherman Review, the absolute number of PBRs sought also appears to have continued to decline since 1999/00 despite implementation of a number of recommendations arising out of that Review (see table in Appendix 1).

Reasons for low usage by large business

4. Anecdotal evidence would suggest that the reasons large business has not been a large user of the PBR system in the past is attributable to a number of factors. Apart from a perception of revenue bias these factors include:

- the length of time taken to obtain a PBR on complex matters;
- the general reluctance of the ATO to rule on Part IVA;
- the fact that, prior to recent legislative changes, failure to follow an unfavourable PBR gave rise to a 25% penalty;
- problems with procedural aspects of seeking and objecting against a negative PBR.

5. Data provided in respect of the Review of Self Assessment also indicates that in 2002/03 3,674 applications were finalised without issuing rulings (usually because the application was withdrawn, deemed invalid or because the ATO refused to rule). No indication is given as to the reason for the withdrawal of PBRs.

27–29 Napier Close
Deakin ACT 2600
Tel: 1300 137 322
Fax: 02 6282 9800

L1/200 Mary Street
Brisbane QLD 4000
Tel: 07 3233 6500
Fax: 07 3221 0856

L11/1 King William Street
Adelaide SA 5000
Tel: 08 8113 5500
Fax: 08 8231 1982

TCCI, 30 Burnett Street
North Hobart TAS 7000
Tel: 1800 014 555
Fax: 03 9670 3143

L3/600 Bourke Street
Melbourne VIC 3000
Tel: 03 9641 7400
Fax: 03 9670 3143

Grd/28 The Esplanade
Perth WA 6000
Tel: 08 9420 0400
Fax: 08 9321 5141

The Institute of Chartered Accountants in Australia
ABN 50 084 642 571
Incorporated in Australia Members' Liability Limited
Level 14, 37 York Street Sydney NSW 2000

GPO Box 3921 Sydney NSW 2001

Tel: 1300 137 322 / 61 2 9290 1344
Fax: 61 2 9262 1512

www.icaa.org.au

6. As a consequence of legislative recommendations made in the Report on Aspects of Income Tax Self Assessment that have been, or are in the process of being legislated by the Government, some of these issues have been addressed. The ATO has also taken on board the administrative recommendation of the Report and, independently, has introduced measures to address some of these concerns, e.g. the introduction of the priority private binding ruling system as outlined in PS LA 2005/10.

7. However, in our view, the perception of revenue bias remains. Whilst the ATO has indicated that of the 7,631 PBRs issued in 2002/03, 4,150 were wholly favourable, 1,246 partially favourable and 2,235 unfavourable these statistics need to be read in the context of all PBRs issued of which less than 3% were to large business and only 2% required a precedent to be established.

8. The basis for this perception in our view lies primarily in the fact that:

- there is a general belief, evidenced in many of the submissions made to the Review of Self Assessment, that protection of the revenue is the ATO's primary function and hence adopting a pro revenue stance is to be expected. To expect otherwise in relation to complex interpretative issues is generally regarded as naïve;
- many public rulings (despite the public rulings panel) and other non-binding ATO advice exhibit a pro revenue bias. Taxpayers and advisers do not expect a different standard to apply, particularly in the case of large and complex PBRs where the law is not clear cut; and
- for large business tax is simply another risk to be managed. Given the perception of a pro revenue bias and the other factors outlined in paragraph 4 above, other options for risk management are often used. In the case of large business, this most commonly involves obtaining an opinion from tax counsel.

9. The pros and cons of obtaining a PBR have been discussed in a number of published articles over the years. Whilst we have not sought to identify all such articles, the following extract from an article entitled "Priority private binding rulings – whether to apply for one or not?"[1] gives a flavour of the considerations which come into play in deciding whether to obtain a PBR:

Where the ruling considers the tax treatment of past events, taxpayers should weigh up the risks carefully eg if strong expert opinion supports the taxpayer's preferred position or there is a large saving of tax and the transaction is one-off. It the tax issues are complex, why risk the possibility that the Tax Office may disagree with your expert's opinion? In circumstances where the taxpayer's organisation is prepared to litigate the matter, applying for a private ruling may simply increase the likelihood of litigation.

Alternatively, if an organisation values certainty and is happy to abide by the Tax Office's decision, applying for a private ruling may be the way to go.

A private binding ruling may be an appropriate way of managing tax risk where a tax treatment has been adopted which will have ongoing significance. There is only a slight risk that an alternative tax treatment will apply, bit if it does, this will have serious, ongoing consequences.

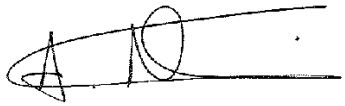
Applying for a private binding ruling is also recommended in situations where there is a very debatable issue as to when income or deductions from a continuing activity should be recognised. If the time of recognition is eventually contested by the Tax Office, this may cause complex recalculations of taxable income over several years.

[1] ATP Weekly Tax Bulletin, Issue 31, 22 July 2005

In the absence of any evidence of revenue bias in dealing with large and complex PBRs provided by members, we have limited our comments to the very real perception in the business community that the ATO adopts a pro-revenue stance.

If you wish to discuss any of our comments please call me on 9290 5623 or Susan Cantamessa on 92990 5625.

Yours faithfully



Ali Noroozi
Tax Counsel

APPENDIX 1

Private binding ruling data

	INB	SBI	LBI	Subtotal	Super	GST	Total
Sherman report[1]							
1997/98	1401	1045	297	2743	118		2861
1998/99	1776	967	240	2983	96		3079
1999/00	2027	859	183	3069	79	4987	8135
	5204	2871	720	8795	293	4987	14075
Review of Aspects of Income Tax Self Assessment[2]							
2002/03	4816	2638	177	7631			

Source:

1. Report of an Internal Review of the Systems and Procedures relating to Private Binding Rulings and Advance Opinions in the Australian Taxation Office, Tom Sherman, 7 August 2000
2. Review of Aspects of Income Tax Self Assessment at page 16

Notes:

1. INB = individual non-business; SBI = small business income; LBI = large business and international
2. For comparative purposes we have assumed that the data provided to the Review of Income Tax Self Assessment excludes PBRs in relation to Super and GST. We also note that the number of PBRs of 2638 shown as issued to SBI in fact represents rulings issued other than to INB and LBI. It may not therefore be strictly comparable with data provided to the Sherman Report.