

CHAPTER SEVEN

CLIENT SETTLEMENT GUIDELINES

7.1 A settlement involves the ATO agreeing with a taxpayer to compromise on a ‘disputed liability to tax’. In other words, the taxpayer’s tax assessment is amended for a lower sum than was raised in the original ATO assessment.

7.2 Although settlements are an exception to the norm that the Commissioner does not forego tax properly payable under law, the use of settlements is seen by the ATO as consistent with sound management of the tax system. This rationale, known as the ‘good management rule’, has been upheld and encouraged by the courts.

7.3 Conversely, the secrecy surrounding settlements has laid them open to the perception, both in the community and within some quarters of the ATO itself, that they are a device that can be used to provide favourable or ‘soft’ treatment to certain taxpayers, mainly big business or high wealth individuals (HWIs).

7.4 In this regard, confidentiality and secrecy present a double bind for the ATO. It follows that if a settlement remains confidential there is unlikely to be any substantive basis to support allegations of impropriety or favouritism. But the secrecy shrouding settlements means that compliance with the good management rule is not easily seen to be done and therefore allows suspicion to breed. Moreover, the secrecy provisions attached to all settlements also means that the Commissioner's hands are tied when it comes to refuting allegations of improper conduct. This lack of transparency is both a cause for concern and a compounding factor affecting public perceptions of settlements.

A new code and limited evidence

7.5 Two factors have shaped the Committee’s examination of the issue of the settlement compliance. Despite the controversy surrounding settlements, scant attention was paid to this term of reference in evidence. The primary sources of evidence on the issue, particularly criticism of the operation of settlements, came from the Ombudsman and the ATO itself.

7.6 The second major development was the issuing of a revised code of settlement practice by the Commissioner during the life of the inquiry. As the revised code was designed to overcome many of the concerns surrounding the ATO’s use of settlements, the Committee has decided not to dwell on practices under the old code. Instead of examining the issue of past compliance, the Committee believes that it is in the public interest to concentrate on the revised code and identify where it might be strengthened further.

7.7 In so doing, the Committee first notes the reason for settlements in managing the tax system and highlights the risks and concerns surrounding their application.

The ‘good management rule’

7.8 The ATO, as noted, justifies the resort to settlements on the basis of the so-called ‘good management rule’. In general, the rule applies in circumstances where settling a case is in the interests of good management of the tax system, overall fairness and the best use of

ATO and community resources. Particular circumstances that might meet these criteria include:

- where factual or quantum issues are in dispute;
- where evidentiary issues call into question the efficacy of taking a case to court or the Administrative Appeals Tribunal;
- where the case is not best suited to resolution through the courts;
- where it is established the taxpayer lacks the capacity to pay;
- where a participant or group of participants in a tax avoidance arrangement has come to accept the Commissioner's position and settlement is around the steps necessary to unwind existing structures or arrangements; and
- where settlement is a means to promoting compliance for current and future years.

7.9 An example of strengthening compliance would be where the Commissioner agrees to limit retrospective assessment action in exchange for a commitment from a section of the public or group of taxpayers to accept an ATO ruling or perspective.¹

7.10 The ATO also circumscribes settlements. Settlements are not appropriate where the ATO has a clear-cut and established view on a matter, where it is in the public interest to have the courts resolve an issue or where court action will lead to a positive impact on revenue and compliance.

7.11 In defending the ATO's use of settlements, the Commissioner defined their role in the following terms:

Settlement is not about finding a soft answer. It is about finding the most appropriate answer in the circumstances of particular cases. To fail to take that course in appropriate cases would, in my view, be an abrogation of our responsibility for proper management of the tax system and efficient use of ours and the community's resources.²

Settlement risks

7.12 On the face of it, settlements make good sense, providing the ATO with the flexibility to enter arrangements that on balance are in the overall interest of the tax system. The onus is on the Commissioner, however, to ensure that settlements are resorted to only when prescribed. If not managed and controlled the potential for settlements to be misapplied or abused is significant.

7.13 For example, the Ombudsman reported of settlements that appear to have been an easy way out for finalising hard cases or, alternatively, were a means by which pressure has been exerted by ATO staff on taxpayers, despite the fact that the use of threats of either

1 See sections 3.2.2, as well as 3.2.3-4 for other examples, in *Code of Settlement Practice*, p. 4.

2 Michael Carmody, Commissioner of Taxation, 'The Role of Settlements in Good Tax Administration or Don't Believe Everything You See on the Box', Speech to the Corporate Tax Association, 23 July 1998, p. 11.

prosecutions or harsh penalties is forbidden by ATO policy.³ The Ombudsman also pointed to the practice of ATO officers issuing ‘ambit claims’ to force taxpayers to settle.⁴

7.14 The Committee heard *in camera* from ATO staff concerned about the settlement of particular cases. These officers were denied access to information about the details and outcomes of cases for which they had been the original decision maker, presumably because of settlement secrecy provisions. Because the cases involved significant suspected tax avoidance and, in one instance, criminal behaviour, the lack of feedback on the nature of the settlements raised questions of propriety and probity.

7.15 Although the ATO states that the involvement of senior staff in settling cases can lead to lower level staff misinterpreting systemic checks as interference, these cases appear to highlight two different problems. The first stems from internal communication breakdowns when cases are transferred across business lines. The second is the lack of transparency covering settlements, a problem identified by both the ATO’s own internal audit function and the Ombudsman.

ATO National Audit Report

7.16 A report on client settlement procedures was conducted by the ATO’s Internal Audit in 1997.⁵ It presented highly critical findings of widespread problems with the application of the ATO’s original guidelines, which had been in operation since 1991. Chief among the audit’s findings was that the guidelines had ‘not been complied with in the majority of branches audited’ and were in need of ‘urgent review’. Additional key findings were:

- a widespread lack of awareness among staff of the guidelines, and therefore of the procedures to follow when negotiating settlements;
- a number of significant control deficiencies in the guidelines, especially in regard to segregation of duties, the exercise of discretion, documentation and quality assurance; and
- evidence of poor, and potentially improper practice, in some of the negotiated settlements audited ... Such failures serve to diminish confidence in the negotiated settlement process.⁶

7.17 In its detail the audit report represents a catalogue of weak or non-existent administrative practices of the most basic kind. In some cases, the lack of documentation and therefore absence of any audit trail obscured the basis for decisions. In others, settlements were arrived at unilaterally by individual officers without adequate approval or independent review. Compounding the general level of poor staff awareness of the guidelines was

3 Submission No. 80, pp. 19-22. See also the TIA that claims that this tactic is employed against large corporate and small taxpayers, Submission No. 17A, p. 2. Mr Liebler also noted the use of threats in settlement cases, but stated ‘in my experience such instances are rare, and I have certainly not come across the phenomenon in recent years’. Submission No. 85, p. 14.

4 See also TIA, Submission No. 17A, p. 2.

5 ATO Internal Audit, *Client Settlement Guidelines: National Audit Report*, 15 October 1997.

6 *National Audit Report*, p. 2.

evidence of staff departing from prescribed procedures or simply failing to consult the guidelines at all.⁷

7.18 Non-compliance of this nature is at the root of the causes of inconsistent treatment of taxpayers outlined elsewhere in the Committee's report. The audit report pointed to another serious implication:

The ATO is exposed to risk if staff either choose not to follow stated procedures or are not aware of their existence. There is potential for considerable loss to the Commonwealth where agreements are reached in the absence of proper and due process.⁸

7.19 The audit made a number of recommendations which are considered at paragraphs 7.25-44.

Ombudsman's view

7.20 In addition to the general problems of transparency and accountability in relation to settlements, the Ombudsman raised the following particular concerns:

- the absence of procedures on how settlement negotiations should be conducted, an omission viewed by the Ombudsman as the 'most glaring defect' in the 1991 guidelines;
- inadequate supervision in a highly devolved work environment;
- the lack of a system to monitor settlement practices across business lines; and
- the need for mandatory taping of all negotiations as a necessary transparency, supervisory and quality control measure. The Ombudsman noted that the Joint Committee of Public Accounts had recommended that all audit interviews be taped in its 1993 report, *An Assessment of Tax*.⁹

7.21 The Ombudsman also raised doubts about possibly the most contentious aspect of the settlements – 'capacity to pay'. The capacity to pay is not normally a consideration in assessing a taxpayer's liability but it can be a factor in decisions on the administrative arrangements put in place to assist a taxpayer in paying that liability. The Ombudsman called into question the fairness of the system, suggesting that it is intended to provide solutions for taxpayers with complex affairs which are not open to PAYE taxpayers, whose affairs tend to be simple.

Possibly the most negative perception, from the point of view of individual taxpayers, who provide the majority of tax revenue through the PAYE system, is that well advised businesses can obtain settlements that turn upon a range of considerations that are rarely brought to bear in the individual taxpayer context. Capacity to pay is one issue.¹⁰

7 *National Audit Report*, pp. 5, 6, 9.

8 *National Audit Report*, p. 9.

9 Submission No. 80, pp. 18-20.

10 Submission No. 80, p. 19.

7.22 This point touches on not only the issue of structural inequity of access to professional taxation advice discussed in chapter three but also the perception that settlements are an arrangement that favour the wealthy and large business. As the Ombudsman notes, secrecy provisions and a lack of ATO statistics on numbers of settlements and revenue foregone makes it difficult to assess the equity of settlements.

7.23 However, according to the ATO, the national audit of settlements conducted a sample of 39 cases which revealed that close to half involved small business.¹¹ More recent figures suggest that settlement practices are not reserved for large corporates or high wealth individuals. ATO data show that during the last half of 1999 21 audit cases and 12 litigation cases involving large business were settled. During the third quarter of 1999 (1 July-30 September) 239 cases involving individuals and small business were also settled.¹²

7.24 The Committee believes that it is important that figures showing the breakdown of settlements by taxpayer segment be made public on a regular basis. Such is the public interest in the matter that the disclosure of this information would improve the public debate about the integrity of the tax system and its administration by the ATO. The Committee makes a recommendation in relation to publishing settlement information at paragraph 7.32.

The Revised Code

7.25 The ATO issued revised settlement guidelines in September 1999. Titled 'Code of Settlement Practice', these incorporated input from several sources including the national audit report, a subsequent internal review of the existing 1991 guidelines and concerns expressed by the Ombudsman.¹³

7.26 The key changes from the 1991 guidelines contained in the new code are as follows:

- clearer definition of when settlements are appropriate and, of equal importance, are not appropriate;
- stronger emphasis on supervision and control, clearly linking settlement procedures with the ATO's established escalation measures. This addresses a crucial omission in the 1991 guidelines, which skated over supervisory controls and the role of senior staff. Furthermore, the code makes it quite plain that:

A basic principle is that there should be no unilateral decision making. This means, for example, that in a simple low value matter the officer allocated to the case will not have the authority to approve settlement. In a complex matter handled by an audit team, the team manager will need to have settlements approved by an officer at an appropriate level external to the team, such as the segment leader.¹⁴

11 Submission No. 83, p. 27.

12 Evidence, p. 304.

13 *Commonwealth Ombudsman Annual Report, 1998-99*, p. 39.

14 *Code of Settlement Practice*, p. 15.

- stricter rules on documentation, detailing what must be formally documented, a revision that addresses the concerns raised by both the national audit and the Ombudsman on the absence of audit trails and lack of transparency of process;
- a control requirement for the senior officer approving a settlement to satisfy himself or herself that the code has been followed and complied with and to sign a statement to that effect. This requirement should serve as not only a check but also strengthens the accountability of process; and
- the establishment of a central register of all settlements which will be subject to review under ATO quality assurance measures.

7.27 In general, the revised code amounts to a tightening up of settlement procedures, for example, delineating more precisely technical issues such as global settlements, issues of disputed fact and the distinction between settlements and prosecutions. To assist both the ATO and taxpayers particularly in resolving disputes, the code also signals the establishment of a Panel of Mediators. Involving a mediator is optional and requires both parties' agreement to participate and share costs.¹⁵

7.28 A further area of improvement is the code's recognition that it is 'particularly important that the original decision maker receive feedback about the way the case has been resolved and the basis for the ultimate decision'.¹⁶ This measure should help overcome the problem of lower level staff misunderstanding the involvement of senior officers in settlements, a problem acknowledged by the ATO and apparent in cases brought to the Committee's attention by ATO staff. Keeping staff informed of case outcomes is also important for individual and organisational morale and therefore operational effectiveness.

7.29 The code also clarifies explicitly the central role of senior staff in settlements. This is important for several reasons, not least that it should dispel the misapprehension that senior officers are interfering, appropriately or otherwise, in resolving issues. The input of senior managers is also critical as a control measure and, as seen in the context of the High Wealth Individuals Program, for expediting complex cases where necessary.¹⁷

7.30 The central settlement register is another key measure. It will enable the ATO to monitor quality and compliance with the new code, identify defects and inconsistency and take remedial action where necessary. It should address the problems raised by the national audit report and Ombudsman over the lack of systematic quality assurance measures and centralised oversight.

7.31 Although not stated explicitly in the revised code, the ATO indicated to the Committee that the register is intended to also play an important transparency role. The register will be used as a source of information for reporting on settlement practices in the Commissioner's annual report to the Parliament.¹⁸ The Committee welcomes this initiative which it sees as addressing the Ombudsman's concern that settlements have not in the past

15 *Code of Settlement Practice*, p. 9; Submission No. 83, p. 29; and Evidence, pp. 44-45.

16 *Code of Settlement Practice*, p. 16.

17 See Submission No. 85, pp. 11-12.

18 Submission No. 83, p. 29.

been publicly accountable. In view of community concerns about the equity of settlement practices, the Committee believes it is important that the Commissioner include in the annual report statistics that show not only the number of cases settled per annum but also cases disaggregated by business line and the revenue impact of settlements.¹⁹

Recommendation

7.32 The Committee recommends that the Commissioner include in his annual report statistics that show:

- **numbers of cases settled per annum;**
- **cases identified by business line;**
- **the difference between tax assessed and paid (by business line); and**
- **an explanation of why there are differences between the amounts assessed and paid.**

7.33 Importantly, the ATO has indicated that the new code and guidelines will be audited after 12 months of operation. The Committee sees such a review as crucial for quality assurance, early problem identification and transparency. The original 1991 guidelines included a requirement that they be reviewed within their first year of operation. That failed to happen until 1997, when a review occurred subsequent to the national audit report.²⁰ The gravity of the problems identified in the national audit serve as a salutary reminder of the importance of auditing the new guidelines sooner rather than later.

7.34 The proposed audit of the revised code will be a crucial test of not only the effectiveness of the new procedures but also compliance with them. It should provide ATO management with valuable information on matters that warrant being made public.

Recommendation

7.35 The Committee recommends that, to promote transparency and provide assurance about the administration of tax settlements, the ATO report the findings of the forthcoming audit of the new Code of Settlement Practice in the Commissioner's annual report to the Parliament.

Further issues

7.36 The Committee considers the new code to be a significant step forward in improving the accountability and management of settlements, particularly in terms of strengthening supervisory controls and quality assurance. Nonetheless, the Committee sought further clarification from the ATO to ensure that the Code met all the concerns identified by the national audit and Ombudsman.

19 See Submission No. 83, p. 23.

20 *National Audit Report*, p. 4.

Devolution and defining limits of officer discretion

7.37 The national audit report raised concerns about the absence of any procedures circumscribing the discretionary powers of ATO officers in negotiating settlements. Defining the limits of those powers was recommended as a ‘prudent control measure’.²¹ However, the Code does not define discretionary powers, leaving it to be sorted out by business line. While devolving the definition of officer powers enables business lines to assign responsibility to the appropriate officers, the Committee was concerned that this could lead to divergence from the Code and inconsistent application of its principles.

7.38 The Commissioner stated that allowing business lines the autonomy to assign settlement powers to officers would not enable them to override or depart from the Code’s guidelines. The central register of cases and quality review process will provide the oversight and controls necessary to detect and remedy any inconsistency if it were to arise.²² The Committee expects that the intended audit of the new code will also provide an added level of scrutiny to address any potential disparity between the code and its implementation by business lines.

Negotiations

7.39 As noted above, the Ombudsman considered the lack of written procedures on settlement negotiations to be the major weakness of the old guidelines. The Commissioner, both before the Committee and in other forums, foreshadowed that this would be addressed, at least partially, by the requirement for a senior officer independent of the case to be involved in any settlement negotiations. In instances where disagreements arise between the senior officer and case officer/leader, the matter is to be subject to further review by an ‘appropriately senior officer’.²³

7.40 While the Code does not specify this requirement explicitly, the Commissioner emphasised that as a guiding principle ‘through the consultation process inside and outside [of the ATO] is the requirement that there be no unilateral decision making and that a person at a senior level not involved in the case countersign’.²⁴ The Commissioner considers that the ATO’s peer review and escalation processes, in addition to the acumen of senior officers, are sufficient to ensure that if serious disagreements arose over a settlement, the matter would be passed on for further review.

Tape recording of meetings

7.41 The Ombudsman’s latest annual report indicated that the Commissioner had given an assurance that the concern that negotiations be taped had been satisfied under the new code. However, in its current form the taping of negotiations, which the Ombudsman saw as mandatory, appears to be optional in the code.

21 *National Audit Report*, p. 5.

22 Evidence, pp. 304-305.

23 Submission No. 83, p. 28. See also Commissioner of Taxation, ‘The Role of Settlements in Good Administration’, p. 10.

24 Evidence, p. 304.

7.42 The Commissioner indicated to the Committee that the code is to be amended to promote the recording of settlements. The ATO does not have the power under the law to impose mandatory recording of settlements, and it appears that there is little interest among taxpayers to agree to recording. Nonetheless, the ATO intends to encourage taxpayers that it is in their interests as well as the ATO's that negotiations be recorded as an important transparency measure.²⁵

7.43 The Committee considers that it should be mandatory for settlement negotiations to be taped for cases involving significant amounts of revenue and/or persistent tax avoiders, tax debtors and aggressive scheme promoters. In these potentially vexatious cases, a taped record of any negotiations would be a valuable reference source for both the negotiating parties and quality assurance reviews. As the Ombudsman has suggested, it 'would inject a greater discipline to the process and assist in assessing the behaviour of both ATO officers and taxpayers/advisers in the event of disputes'.²⁶

7.44 Legislation would be necessary to empower the ATO to tape record settlement negotiations.

Recommendation

7.45 The Committee recommends that the ATO consider formulating advice to the Government on legislative measures necessary to empower it to tape settlement negotiations, particularly in cases involving significant amounts of revenue and/or persistent tax avoiders, tax debtors and aggressive scheme promoters.

Freedom of Information Act

7.46 By agreeing to a settlement, taxpayers are obliged 'not to seek disclosure under the Freedom of Information Act of ATO documents in relation to issues agreed as part of the settlements'.²⁷ This was seen as a denial of a basic right provided by law to Australian citizens.²⁸

7.47 However, the Commissioner stated to the Committee that it is basic to the philosophy of settlements that once the ATO and a taxpayer agree to the terms of a settlement it is not open to further negotiation: 'When two parties come together and settle an issue that is the end of it'.²⁹

7.48 The only ground for review subsequent to the settlement is in relation to whether the ATO followed appropriate administrative procedures, eg, that officers complied with the settlement and other guidelines, such as the Taxpayers' Charter. The code has been amended to remove any clauses that might be construed as excluding the Ombudsman's ability to investigate the administrative practices adopted in a settlement case. The Ombudsman has

25 Evidence, pp. 283-284.

26 Submission No. 80, p. 20.

27 Section 8.2.2 VI, *Code of Settlement Practice*, p. 19

28 Taxation Institute of Australia, Submission No. 17B, p. 5.

29 Evidence, p. 305.

reported that the Commissioner has satisfied his concerns that the ATO cannot exclude or oust his power to investigate administrative actions.³⁰

30 *Commonwealth Ombudsman Annual Report, 1998-99*, p. 39.