CHAPTER 2

NATURE AND SCALE OF THE PROBLEM

Risk to the tax system

2.1 The MMS matter is of major significance in terms of number of schemes, participants and the risk to the integrity of the tax system. In its November 2000 submission to the inquiry, the ATO reported that it had taken action on 231 schemes involving 57,667 participants and claimed deductions totalling $4.3 billion. An additional 45 schemes involving 8425 participants and totalling $555 million were also under examination.[1] The potential risk to the revenue is about 40 per cent of the overall claimed deductions of approximately $4.8 billion.

2.2 The ATO groups 'mass marketed tax effective schemes' into the following three categories:

- round-robin schemes, including non-recourse financing, often in agriculture, afforestation and franchises;
- certain film schemes, with guaranteed returns that are, in effect, a return of part of the invested funds; and
- employee benefit arrangements (EBAs).[2]

2.3 In this report the Committee's focus is on the first two categories. The evidence to the Committee concentrates overwhelmingly on the first category of schemes, namely the agribusiness sector (eg, vineyards, olives and tea tree and timber plantations) and franchise arrangements, although some participants are involved in a mix of schemes which include film projects. The Committee intends to address EBAs in its final report.

2.4 In the ATO's view, the fundamental compliance problem or 'tax mischief' common to these schemes relates to their *financing* as distinct from their commercial nature or business activity. The ATO contends that in many cases participants' investments were largely or wholly funded through tax deductions. Relatively little private capital is said to have been at risk. As the Commissioner of Taxation stated:

> The underlying [business] activity is not itself the issue of concern here. What is of concern to us [the ATO] in a range of cases are the financial arrangements associated with the investments. These often have the effect

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[1] ATO Submission No. 845, p.1.

[2] ATO Submission No. 845, p.1.

> that the financing of the activity is significantly funded by taxpayers generally from the tax system.[3]

2.5 In some cases, the tax deductions claimed by scheme participants often exceeded the amount of money invested; that is, the schemes were geared in such a way as to generate a 'tax profit' for participants.[4]

2.6 In disallowing participants' deductions, the ATO cites a number of defining characteristics found in mass marketed arrangements, including:

- apart from subscribing to the scheme, participants have no hands-on involvement and therefore are not carrying on a business;
- financial arrangements involve limited- or non-recourse loans, often based on round robin arrangements;
- high up-front management fees geared to create inflated tax deductions;
- participants have little or no practical control over the scheme's management;
- limited exposure to risk; and
- in some cases, a guarantee from promoters to reverse the transaction if claimed tax deductions are not allowed.

2.7 Owing to a combination or all of these factors, the ATO maintains that the participants invested in mass marketed schemes for the 'dominant purpose' of obtaining a tax benefit, and because of that the anti-avoidance provisions of Part IVA of the Tax Act apply. By applying Part IVA the ATO has imposed penalty tax, in addition to disallowing participants' deductions and levying interest charges dating back to when the participant claimed their deduction.

2.8 It should be noted that, while the ATO has applied Part IVA to all the schemes under consideration, the level of penalties imposed is not uniform but ranges from 50 per cent to 5 per cent, depending on the level of tax mischief involved. According to the ATO:

> Because Part IVA does apply, the penalty provision imposes a statutory penalty of 50 per cent. We recognise that in most cases that statutory penalty of 50 per cent would not be appropriate for these taxpayers and we looked at opportunities of being able to reduce that. The way we did that was to give

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3 Michael Carmody, 'Beware the Magic Pudding', Commissioner's address to the Australian Society of CPAs, 12 June 1998, p.3.

4 See in particular the examples in Attachment D to ATO Submission No. 845. See also the example cited in Senate Economics References Committee, *Inquiry into the Operation of the Australian Taxation Office*, March 2000, p.31. According to the ATO, the example indicates a 'typical' arrangement in which a participant on the top marginal tax rate received a tax refund of $14,000 for an initial $10,000 investment, generating a profit or 'bonus' of $4000.

> them the opportunity to make voluntary disclosures and in some cases we also exercised the statutory discretion to reduce the penalty to five per cent. We also invited taxpayers to present their individual circumstances. That may be relevant in some cases.[5]

2.9 The application of Part IVA is one of the most contentious issues in the inquiry for several reasons. The first is due to the penalty charges included in the tax debt many taxpayers face. The second reason from the participants' view is the inference under Part IVA that they are 'tax cheats'. The Committee examines the ATO's application of Part IVA in later sections of the report.

The human and social cost of the problem

2.10 Based on the revenue and number of participants involved in mass marketed arrangements, the average tax debt per participant is over $75,000. While the amount of debt is obviously spread unevenly across participants, this average figure in its own right indicates the high individual burden for large numbers of those affected.

2.11 In terms of the magnitude of the human cost at stake, the Committee heard disturbing evidence of the wider ramifications that this large-scale debt represents. In brief, on a personal scale the evidence to the inquiry points to the:

- wipe out of personal and family savings and retirement funds;
- selling off of major assets, particularly homes and in some cases private vehicles and furniture;
- in some cases, selling of businesses;
- increasing likelihood of widespread bankruptcy among participants, which in some cases may disqualify people from certain jobs, eg, the police force;
- growing incidence of stress, depression and related illness;
- workplace risks due to the impact on concentration and stress;
- relationship/marriage breakdown and;
- threats of suicide, including anecdotal evidence of some suicide.

2.12 The Committee considers that the above side-effects are not random and isolated but are endemic and widespread amongst the affected population. A witness from an accounting firm with 800 clients caught up in mass marketed arrangements, stated:

> These clients … have now received amended notices of assessment going back up to six years, leaving them with often massive tax debts, which they dispute, and a full recourse loan in some cases. So far we are aware of four

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5 Evidence, p.486.

> suicides directly caused by this situation—thankfully not our clients. Two of our clients have gone bankrupt and another into part 10 administration.[6]

2.13 Reports of wider social and community repercussions would tend to support the conclusion that the personal toll of this problem is commonplace. For instance, the Committee notes the following report based on survey findings from the Goldfields Community Legal Centre in Kalgoorlie:

> Now I would like to tell you a few stories of the devastation. In general terms, they refer to financial ruin, failed retirement plans, insufficient time to recover, given the percentage of people who are over 50 or even over 45, and the fear they have of having to live on a benefit. They speak of the loss of esteem, confidence and their friends. They speak of broken relationships and they speak of the cost of these to them and their families in human health terms and in monetary terms. They fear the loss of their homes—more than anything they fear this. Many of them are unable to borrow from banks because they have insufficient equity. They speak of selling assets to repay the debt, and within that there are shares, savings, superannuation, jewellery, family heirlooms, antiques and cars. Often they have downgraded their homes and their vehicles in order to be able to fulfil the ATO obligations.[7]

2.14 The scale of the tax debt behind the financial, human and social costs cited above is symptomatic of several factors. The debt comprises primary tax (ie, the tax related to the original deductions) and additional penalty tax and interest charges (as detailed in paragraph 2.7). The interest component is obviously a function of the time that has passed since the deduction was claimed and the disallowance notice issued by the ATO.

2.15 The Committee believes that two points are relevant in this matter. The first is the size of the tax debt, particularly the high compounding interest component, and the lengthy time lag from when participants invested in schemes and claimed deductions to when the ATO eventually moved to disallow those deductions. Although the ATO advised that it acted within 12 to 18 months to deny deductions claimed in up to 90 per cent of cases, in some instances the time lag was approximately two to three years, and in others the delay reached up to six years. The factors behind those delays are discussed in chapter 4. It should be noted that under the self assessment tax system the ATO does have the legal right to conduct such reassessments (as is discussed in the next chapter).

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6 Evidence, Perth, p.69.

7 Evidence, p.211.