CHAPTER 4

THE ATO, THE MARKET AND INVESTORS

4.1 Two central considerations in the inquiry are, first, the circumstances in which scheme participants made their decision to invest in schemes and claim tax deductions and, second, the ATO's role in influencing those circumstances. Both points go to two key questions: was it reasonable for participants to believe scheme deductions complied with the law? And, what part did the ATO play in influencing the market conditions in which participants made their investment and tax deduction decisions? This chapter examines these questions.

4.2 Before so doing, the chapter traces the history of the rise of the MMS market and the ATO's response to it. This is necessary for understanding the gap in timing from when participants invested in schemes, to when the ATO decided subsequently to disallow deductions already refunded to participants.

The growth of the MMS Market and the ATO response

4.3 One of the critical factors in the debate over MMS is the apparent time delay between the growth of the MMS market and the ATO's decision to crackdown on the schemes.

4.4 The ATO's account suggests that this delay stemmed primarily from the slow build-up of the market during the early 1990s until 1995-97 when the situation changed with a 'surge' in market growth.[1] The figures in table 3.1 show the rise in claimed deductions from 1994 to 1997.[2] Table 3.2 (page 22) provides a longer range view of the ebb and flow of deductions from 1987 to 1998.

4.5 In its submission to the Committee, the ATO pointed out that its field work included investigations of individual schemes during the early 1990s. The indication from the ATO is that these investigations neither identified any significant degree of risk to cause the ATO alarm, nor did they forewarn the ATO of any impending market expansion.

4.6 However, further investigation by the Committee and information provided by the ATO show that the ATO had investigated at least 14 schemes from 1987 to 1994 and a further 14 from 1995 to 1997. The ATO used Part IVA to disallow deductions in nine of the first 14 schemes investigated with the primary reason for disallowing those deductions being limited and non-recourse financing.

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1 ATO Submission No. 845, p.2. See also Evidence, pp.470-476.

2 Figures from ATO Supplementary Submission No. 845A, p.17.

Table 3.1: Growth in Claimed Deductions 1994 to 1997

SCHEME TYPE	CLAIM DEDUCTIONS ($) for the year ended:			
	30/6/94	**30/6/95**	**30/6/96**	**30/6/97**
Agricultural	53,766,455	91,187,651	102,018,371	274,843,122
Employee benefit	17,275,953	58,854,507	115,722,987	287,189,606
Films	63,281,555	90,437,623	117,485,838	222,425,834
Scientific research	25,000	-	188,514,640	296,030.995
Book publications	4,591,397	4,999,196	21,364,795	7,402,667
Franchise	13,082,722	24,124,044	76,653,443	243,223,709
Investment	7,086,767	7,672,520	6,851,609	13,014,937
Live theatre	11,148,999	4,669,112	23,675,713	-
Videos	-	-	-	20,023,034
TOTALS	170,258,848	281,944,653	652,287,396	1,364,153,904

4.7 The ATO also admitted that it was 'inconsistent', both in its approach to disallowing abusive features and in the level of penalties imposed. For example, the ATO conceded that '[p]enalties ranged from 50% to nil in relation to schemes that involved similar levels of mischief'.[3]

4.8 The ATO submission suggests that it was not until early 1996 that the ATO recognised, on the basis of growing numbers of tax instalment variations, that a potential compliance issue existed. In 1997 research coordinated by a national project team within the ATO arrived at the view that 'mass marketed schemes were a significant and growing risk to the revenue with deductions identified at that time growing from $182 million in the 1993-94 income year to $842 million in the 1996-97 income year'.[4] The ATO indicated that the leap in deductions reflected both a rise in the numbers of investors involved in schemes[5] and more aggressive tax gearing.[6]

4.9 However, the Committee notes, as is set out in Tables 3.1 and 3.2, that in percentage terms growth in these schemes was also significant at stages in the late 1980s and early 1990s, and that the ATO took action on some occasions but not on others.

4.10 The ATO also asserts that the market changed dramatically not only in *scale* but also in the *nature* of the schemes being promoted, a change which appears to have alarmed the ATO due to the potential for exponential growth in such arrangements:

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3 ATO Supplementary Submission No. 845B, Response to Hansard Page Question on Notice: E 472-3.

4 ATO Submission No. 845, p.2. As table 3.1 shows, the deductions for the 1996-97 income year were later revised at over $1.3 billion.

5 Evidence, p.484.

6 Evidence, p.470.

> What we saw happening in around 1995 and 1996 was a move away from types of activities that were more or less restricted by access to some sort of property to grow the tea-tree or whatever primary produce they were growing. What we saw in 1995-96 was a move away from those tangible activities to more intangible activities.
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> We saw that with the Budplan scheme, which emerged out of a tea-tree plantation to be a supposed business carrying out research into the use of tea-tree oil. At about the same time that emerged, the franchise schemes that were prevalent in Western Australia also emerged. Those particular schemes were also not constrained by the need to have some form of agricultural property behind them. That combination of factors resulted in a surge in these activities in 1996 and 1997.[7]

4.11 As the ATO chronology of its actions at Appendix 3 shows, it was not until 1998 that the ATO moved decisively on a large scale to disallow deductions related to mass marketed arrangements. While it took steps in this direction in the latter half of 1997, 1998 saw major ATO initiatives to address the risk to the revenue these schemes posed and to recover deductions from scheme participants. Chief amongst the measures taken were the:

- withdrawal of previous tax instalment deduction variations (ie, 221D variations)
- issuing of position papers to a range of promoters
- over 10,000 letters sent to participants in over ten schemes
- several hundred refunds stopped in one scheme
- four major speeches (including the Commissioner's 'Beware the Magic Pudding' speech in June 1998 that is widely seen as signalling the start of the ATO campaign on mass marketed schemes)
- introduction of the Product Ruling System
- draft ruling on FBT and employee benefit arrangements issued.

4.12 Since 1998, the ATO has introduced two further significant measures. One is a set of guidelines for settlements related specifically to aggressive tax planning arrangements. The second is the key Taxation Ruling TR2000/08 which sets out the ATO's view on investment schemes.[8]

4.13 The time that elapsed from when mass marketed arrangements began and when the ATO moved against them had several important consequences. It appears that the MMS industry, despite some early ATO action in the late 80s and early 90s, operated and expanded largely unchecked for several years. During this period,

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7 Evidence, p.470.

8 TR2000/08 superseded the ATO's draft afforestation ruling TR97/D17 issued in October 1997.

investors entered into mass marketed arrangements, it seems to the Committee, without any clear warnings or signs from the ATO that these arrangements may not have been legitimate. For many investors, the refund of their initial deductions encouraged them to invest in subsequent schemes, a decision that ultimately served to increase their tax debt.[9] The time lag has also had the effect of magnifying the interest charge levied on the tax debts of participants.

4.14 The question the Committee examines here is whether ATO actions and inaction during the pre-1998 era contributed directly or indirectly to the proliferation of mass marketed arrangements and potentially misled or at least influenced 'the market' – scheme promoters, tax professionals and investors – into believing scheme deductions were legitimate. The Committee addresses these points in the next sections of this chapter.

Participant/taxpayer culpability – 'tax cheats' or 'unwitting victims'?

4.15 The Committee considers that, in this report, a key issue facing it is the question of the extent to which it is fair and reasonable for scheme participants to be bearing the tax burden currently imposed upon them. This question goes beyond the ATO's position at law and application of Part IVA measures and relates to what can be reasonably expected of a taxpayer under the self assessment system.

4.16 In addressing this point, the Committee focuses on first, the ATO's role during the rise of the MMS market and second, the conduct of scheme participants when they invested in the schemes.

4.17 In approaching both matters, the Committee notes that under the self assessment tax system the onus lies entirely with the taxpayer to ensure that their tax returns comply with the law. But it also notes the Commissioner's recent statement on the importance of the ATO providing taxpayers with the necessary information to ensure they can fulfil their obligations. He said:

> We cannot expect taxpayers to pay their taxes in a self assessment system if we do not provide them with the information to understand their obligations. We can maximise the opportunity for voluntary compliance by narrowing uncertainty. For taxpayers seeking advice from the Tax Office is often about certainty, confidence or comfort – removing the fear of getting it wrong.[10]

4.18 In the Committee' view, the ATO should be judged against, among other things, its own declared standards. Accordingly, the following section approaches the ATO's conduct from the point of whether it managed to provide certainty and adequate information for taxpayers involved in mass marketed arrangements.

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9 See, for example, Evidence, Perth, p.78.

10 Michael Carmody, 'The Integrity of the Private Binding Rulings System', Melbourne 15 November 2000, p.3.

The role of the ATO pre-1998

4.19 Based on the evidence to date, the ATO's approach towards mass marketed arrangements before it cracked down on the market appears to be one characterised mainly by limited action and sending mixed signals. In arriving at this view, the Committee notes five points in particular.

No clear ATO warning

4.20 First, there is little evidence that the ATO issued explicit advice to the community or market on whether mass marketed arrangements, with features such as limited and non-recourse financing, were acceptable or not. Although the ATO has pointed to some warning signals in the market, these were marked by their vagueness and ambiguity.

4.21 For example, the ATO referred to a public ruling (IT2195) issued in 1986 that indicated that the ATO 'did not rule out' the possibility of applying Part IVA anti-avoidance provisions in relation to non-recourse loans and round robin financing.[11] According to the ATO's Senior Tax Counsel, Mr Oliver:

> we were saying in relation to afforestation schemes that, *if part IVA does apply*—and we have said that consistently since 1986—then your deductions will be disallowed.[12] [emphasis added]

4.22 The Committee considers that a conditional statement of this nature appears at best vague, if not weak and confusing. It falls short of providing the sort of certainty required in the administration of a self assessment tax system – a point that the ATO's Mr Oliver appeared to concede before the Committee. In referring to IT2195, Mr Oliver stated:

> That was the public position that the commissioner had. You might have said—and we would undoubtedly agree—it would have been far nicer if the commissioner had said at that time in 1986, 'Just when do you think part IVA does apply? It is no good saying if it does; you have to tell us a bit more than that.'[13]

4.23 Recent information provided by the ATO indicates that it sent two further signals to the market place in the early 1990s. First, in June 1991 the Commissioner issued a press statement warning taxpayers about investing in tax shelters in primary production arrangements.[14] Apart from providing a general warning to taxpayers to check the full tax implications of such schemes, the statement did not mention the particular abusive features that taxpayers should steer clear of – namely round robin

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[11] Evidence, p.479.

[12] Evidence, p.481.

[13] Evidence, p.481.

[14] ATO Media Release, 'Tax Shelters – Why Some Umbrellas Sometimes Have Holes', 91/26, 2 June 1991.

funds flows and non-recourse and limited-recourse financing arrangements. It is debatable whether a statement of such generality would have adequately forewarned taxpayers in the years ahead of the tax risks associated with mass marketed schemes, particularly in relation to their financing methods.

4.24 A further problem with this 1991 press statement concerns the advice it provides to taxpayers. The Commissioner is quoted in the statement as saying:

> I would strongly recommend that in order to be assured of their tax position, investors obtain detailed and comprehensive advice on the full tax implications from promoters or their own advisers prior to committing funds.[15]

4.25 In hindsight, this advice seems rather misplaced. If the ATO's assessment is accepted, that scheme promoters are the driving force behind aggressive tax planning,[16] then the recommendation above could be seen as delivering investors into the arms of the very elements that perpetrated the mass marketed schemes tax crisis. As is discussed later in this chapter, several witnesses claim to have done due diligence tests on schemes before investing but did not discover anything untoward about them.

4.26 The second warning signal the ATO mentions was 'Pre-Ruling Consultative Document 9' (PCD 9) in relation to afforestation schemes issued in December 1995. This document was the forerunner of draft Ruling TR 97/D17 issued in October 1997. While the ATO is correct in saying PCD 9 flagged its concerns on the deductibility of fees in afforestation arrangements, the document does not appear as quite the clear cut warning that the ATO suggests. For one, it is questionable whether circulating what was little more than a discussion paper constitutes sending a strong 'signal', let alone a clear statement to the market of the ATO's position on schemes. Indeed, the document itself stated:

> The only purpose of Pre-Ruling Consultative Documents (PCDs) is to initiate discussion and consultation, and to obtain comments. PCDs are not statements of the views of the Australian Taxation Office…[17]

4.27 As with the Commissioner's 1991 press statement discussed above, PCD 9 also omitted any mention of round robin arrangements and only skirted around the issue of non- or limited-recourse financing arrangements. The circumscribed treatment of these financing techniques seems at odds with the ATO's later view of non/limited

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15 Ibid.

16 ATO Submission No. 845, p.13.

17 PCD 9, 'Afforestation Schemes – Deductibility of Fees and Capital Gains Tax Issues', 20 December 1995.

recourse financing as potentially abusive *per se*.[18] An internal ATO report noted this shortcoming in early 1996. This report stated:

> The PCD does not significantly address the limited recourse financing issue other than with respect to early termination of the loan and the application of section 82KL.[19]

4.28 In sum, the Committee is not convinced that any of these signals provided sufficient warning to taxpayers of the particular risks associated with mass marketed arrangements. IT2195 left the question of Part IVA's application hanging. Neither of the two 'signals' in the early 1990s made explicit mention of the ATO's concerns about non/limited-recourse finance and round robin funds arrangements. In view of the ATO's current emphasis on these financing arrangements as major abusive features of schemes, it seems odd that the ATO is now trying to point to these two statements as fair warning of its concerns. Although it may have been reasonable at the time for the ATO to omit mentioning these features while it was still determining its view on them, it cannot now claim that the market in general and taxpayers in particular should have been aware of its concerns about the technicalities of scheme financing.

4.29 The absence of any explicit warning on the financing arrangements of schemes is not a trivial factor. If the Commissioner's statement above is to be accepted, then there is a question about the legitimacy of holding taxpayers to account for decisions made in an environment where the ATO had not clearly indicated its view.

Action relative to risk

4.30 The adequacy of the signals discussed above is further thrown into doubt when the level of scheme deductions during the late 1980s and early 1990s is taken into account. As ATO figures in Table 3.2 reveal, deductions leaped from $13 million in 1987 to $113 million in 1988 – a 'surge'[20] in deductions that would seem to have warranted stronger ATO attention given its apparent misgivings about Part IVA at the time and the fact that it had taken audit action on some schemes.

4.31 As stated earlier, the ATO recently provided the Committee with information showing that as a result of investigations in the late 1980s it disallowed deductions for about 14 schemes.[21] While this shows that it was not inactive on the issue, it does raise the question why the ATO did not issue a tax ruling clarifying the relationship between Part IVA and these arrangements. Furthermore, while this evidence also

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18 For example, see TR2000/8, especially paragraphs 64-67.

19 See Attachment A, ATO Additional Information of 22 May 2001, p.7.

20 While the overall level of deductions in 1988 is overshadowed by the level in 1998, the relative rate of growth in deductions in 1987-88 (an almost ninefold increase) exceeds that in 1996-97 (less than double).

21 ATO Supplementary Submission No. 845B, Attachment 4.

raises questions about the response of promoters and tax practitioners to this ATO activity, the degree of inconsistency towards deductions and culpability penalties[22] would also have sent mixed signals to the market about the ATO's position.

4.32 Alternately, if the ATO was only reserving its position with IT2195, then the same question applies as to why it did not act sooner to clarify the issue in order to both provide certainty and close off a possible loop hole.

4.33 Even in 1994 – before the market 'surge' of 1996-97 – both the growth and level of deductions would appear to have demanded stronger ATO action: deductions *tripled* in 1993-94, from $54 million to $176 million, a rate of growth greater than that in 1996-97 (which was less than double). If the Commissioner saw reason to issue a press statement about schemes in 1991 when deductions were $7 million, why did he not make a similar public announcement in the face of this much greater threat to the revenue in 1994?

4.34 In the Committee's view, the ATO's muted response to the growing risk posed by mass marketed schemes casts doubt over its internal coordination of the information from field audits and taxpayer returns. The limited action taken and the absence of any warning on financing arrangements in response to dramatic increases in deductions in 1987-88 and 1993-94 in particular point to possible failings with ATO systems for risk identification and risk management.

Table 3.2: Increasing Scheme Deductions 1987-1998

YEAR	SCHEME DEDUCTIONS $M
1987	13
1988	113
1989	73
1990	2
1991	7
1992	54
1993	54
1994	176
1995	288
1996	666
1997	1095
1998	960

Source: ATO Supplementary Submission No. 845B, Attachment 1[23]

22 ATO Supplementary Submission No. 845B, Response to Hansard Page Question on Notice: E 472-3.

Ambiguity over non-recourse financing

4.35 Third, adding to the air of uncertainty over Part IVA is evidence that the ATO had *ruled out* its application in some instances involving non-recourse financing. It is possible that promoters and participants interpreted the ATO's position on those cases as setting a general precedent. As Mr Leibler of Arnold Bloch Leibler stated:

> Notwithstanding the Commissioner's current stance in relation to non-recourse lending arrangements and Part IVA, the Tax Office has, in the past, given positive rulings where such arrangements, or similar arrangements, have existed. I refer to up front payments in relation to infrastructure bonds, film schemes and research and development syndicates. In other words, it could not be automatically assumed that the Commissioner would, at the relevant times, have determined that Part IVA was applicable merely because non-recourse arrangements were in place.[24]

4.36 A relevant case of the ambiguity surrounding Part IVA and non- or limited-recourse financing is provided by the Private Binding Rulings (PBRs) issued to a scheme known as Maincamp. The ATO issued favourable rulings on the scheme to four taxpayers in the knowledge that it involved limited-recourse financing.[25] Although the ATO subsequently claimed that the full details of the financing (mainly the scheme's round robin funds flow) were not disclosed when it made the rulings (which therefore invalidates the rulings), this example does suggest that the position on limited- or non-recourse financing was not straight forward.

ATO issuing of Private Binding Rulings

4.37 Although only a small number of PBRs were issued, it appears that promoters and designers exploited them to market schemes *en masse*. Common practice included using a PBR to market later versions of a scheme or schemes with comparable features. While promoters misused PBRs in this fashion,[26] it seems that many scheme participants relied upon them as a seal of ATO approval or saw them as representing the ATO line on schemes in general.

4.38 The ATO has attempted to counter this view by pointing out that only a handful PBRs were issued, four of which related solely to one scheme and, more importantly, two of those did not rule out the application of Part IVA.[27] The ATO asserts that investors and the market should have taken heed of the 'heavily qualified'

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23 It should be noted that the annual scheme deductions in Table 3.2 do not include deductions for EBAs. This accounts for the difference in yearly figures between tables 3.2 and 3.1 (the latter includes EBA deductions).

24 Supplementary Submission No. 22A, p.3.

25 ATO Supplementary Submission No. 845B, Answer to Hansard Page Question on Notice E478.

26 A PBR only covers the individual who applied for it from the ATO; that is, PBRs cannot be relied upon or interpreted by others as indicating ATO approval for a particular scheme's tax benefits. For an explanation of PBRs, see 'The Integrity of the Private Binding Rulings System'.

27 Evidence, pp.478-479.

nature of the latter two PBRs, particularly when it is recognised that some of the tax opinions included in scheme prospectuses also cautioned investors in regard to Part IVA.[28]

4.39 However, the Committee is unconvinced that the matter is as straightforward as the ATO suggests. For one thing, the four PBRs issued to the one scheme were inconsistent, suggesting that the ATO itself was experiencing administrative problems in coming to grips with mass marketed arrangements. The Committee notes the Ombudsman's criticism that the inconsistencies and other defects evident in the case of these PBRs 'can undermine public confidence in the tax system'.[29] In particular, the Committee finds it hard to reconcile the ATO's responsibility for promoting certainty under self assessment and the failure to address adequately the applicability of Part IVA in the PBRs issued.

4.40 The Committee also notes that the ATO experienced similar problems during the late 1980s with defective advance opinions issued for Financing Unit Trusts,[30] a point that suggests the ATO had failed to learn from its earlier mistakes in this instance.

4.41 More importantly, the Committee questions whether it is reasonable or realistic to expect that the bulk of investors would have been sufficiently versed in the complex nature and arcane language of PBRs and tax opinions to pick up these purported warnings, especially when many advisers were endorsing the schemes to their clients.

4.42 If the ATO expected the market and investors in particular to see the warning signals in these PBRs, then it also seems reasonable to ask why the ATO did not see requests for these PBRs as a warning sign of a looming aggressive tax planning threat. Rather than leaving the question of the applicability of Part IVA in relation to schemes and non-recourse finance in limbo, the request for PBRs should have provided an opportunity for the ATO to test and resolve the matter.

4.43 However, according to the Ombudsman, the ATO staff responsible for these PBRs addressed neither the application of the anti-avoidance provisions to the scheme's financing arrangements, nor the scheme's 'broader significance because of the potential number of participants in the arrangement'.[31] These omissions may have been partly symptomatic of administrative weaknesses in PBR system at the time.[32]

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28 Evidence, pp.485-486.

29 Commonwealth Ombudsman, *The ATO and Maincamp*, January 2001, p.14.

30 See the discussion of Financing Unit Trusts in the later section in this chapter on 'Prospective versus Retrospective Action'.

31 Commonwealth Ombudsman, *The ATO and Maincamp*, January 2001, p.14.

32 See the report by Mr Tom Sherman AO, *Report of an Internal Review of the Systems and Procedures relating to Private Binding Rulings and Advance Opinions in the Australian Taxation Office*, 16 November 2000. As the report notes, the Commissioner of Taxation authorised the review following 'media criticism of aspects of the system' (p.1).

But it could also indicate that the prolonged ambivalence surrounding Part IVA and scheme arrangements meant that there was no internal ATO view that might have guided those officers dealing with the PBR applications in this case.

Continued refunding of deductions after the 1996 alert

4.44 The Committee also finds it puzzling that the ATO continued to process and pay deductions *after* the alert was raised in 1996 about the dramatic rise in deductions and while an ATO taskforce was simultaneously investigating the potential risk the schemes posed. On the face of it, this approach appears somewhat contradictory.

4.45 A more prudent approach to a potential risk of this magnitude (claimed deductions had already at this point more than *doubled* between 1995 and 1996)[33] might have been to put on hold the refunding of scheme-related deductions until the taskforce had completed its work and reported its findings. Such an approach would have avoided the risk of acting too late or too precipitately (ie, sending signals that might potentially distort the market before the ATO has reached a concluded view on a matter).[34]

ASIC warnings

4.46 The ATO has also claimed that the Australian Securities and Investments Commission (ASIC) issued public cautions to investors on the risks associated with mass marketed schemes. Mr Peter Smith, Assistant Commissioner (Small Business) of the ATO stated:

> There were messages out there at the time being put out by ASIC—the ‘too good to be true’ type message, when you look at these things where you are getting a $30,000 or $40,000 tax deduction for a $10,000 cash outlay.[35]

4.47 However, ASIC’s[36] warnings to the market pre-1998 did *not* convey *tax* cautions as Mr Smith suggested. While ASIC did issue notices during 1996 and 1997 concerning ‘shonky tax-driven schemes’, these focused on the unsound *commercial* nature of the investment rather than their tax features.[37] In other words, ASIC’s focus was the reverse of that of the ATO. As noted in chapter 2, the ATO’s concern addresses the taxation effect of the financing structure of mass marketed

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33 Claimed deductions went from $281,944,653 for the 1995-96 financial year to $652,287,396 for the 1996-97 financial year. See ATO Supplementary Submission No. 845A, p.17.

34 See the statement by ATO Assistant Commissioner, Peter Smith, on constraints the ATO faces in issuing early warnings to the market place: ‘[I]f we make our call too early we can leave ourselves subject to commercial damages if we get it wrong’, Evidence, p.485.

35 Evidence, p.485.

36 ASIC was called the Australian Securities Commission (ASC) at that time.

37 See, for example, ‘ASC puts shonky tax scheme promoters on notice’, 21 April 1997 (Media Release ASC 97/00); and ‘ASC declares war against shonky tax-driven schemes’, 20 May 1996 (Media Release ASC 96/85).

arrangements, whereas ASIC's concerns addressed the business or commercial structure of such arrangements.

4.48 The Committee considers that the ATO is overstating the extent to which ASIC's public statements could have warned investors about the *tax risks* associated with schemes. As the next section about scheme participants shows, many investors were cautious about investing in various schemes and did take steps to verify the business merits and commercial viability of what was on offer. But it is mistaken to claim that participants had been cautioned about the tax side of these investments, particularly insofar as ASIC's role is concerned.

Conclusion

4.49 The Committee considers that the key points to emerge from the above discussion are not whether the ATO was inactive in relation to mass marketed schemes in the late 1980s, early 1990s and pre-1998 period. It is clear that the ATO was active to a degree. The point is, however, whether the actions taken by the ATO were appropriate and adequate relative to the level of risk emerging at the time, and whether the steps taken were sufficient to provide certainty for taxpayers.

4.50 The Committee is not convinced, at this stage, that the measures adopted by the ATO went far enough in addressing its own growing concerns about the abusive features appearing in some schemes. For instance, it is not apparent to the Committee that the ATO's public statements made clear its misgivings about the financing arrangements used in schemes for which it had, on the basis of field audits, disallowed deductions. The combination of the findings from these audits and the rapid growth in deductions at several points prior to the 1997 'surge' suggests that firmer steps should have been taken.

4.51 The Committee intends to explore these questions in detail in its final report.

Did investors act reasonably?

4.52 In examining the evidence it strikes the Committee that several factors worked together to create a climate in which many participants had apparently sound reasons for believing that the deductions were permissible. As can be seen from the previous section, the market environment pre-1998 did not have the benefit of a clear ATO position on mass marketed arrangements. To the extent that the ATO had issued advice to the market, this was in the form of PBRs that at the very least conveyed a sense of approval for the schemes (qualifications and omissions on Part IVA notwithstanding), albeit for only a handful of investors in relation to two schemes.[38]

4.53 Many participants invested on the basis of advice from financial advisers, including certified financial planners, accountants and lawyers. Understandably, many placed great store on the fact that leading accounting and legal firms, including QCs,

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[38] A point also noted by Mr Leibler, Supplementary Submission No. 22A, p.4.

had provided tax opinions supporting the benefits advertised as within the law. As the Commissioner himself has stated: ‘Many investors relied on the existence of glossy prospectuses and on the advice of financial and other investors’.[39]

4.54 Many participants, nonetheless, also claim that they took precautionary steps to check the bona fides of the schemes in which they invested. In so doing, most believed that they had done all that was reasonably possible and could be expected of them under the self assessment system – in other words, they believed that they had acted with *due diligence* before investing in the schemes. In the view of one witness:

> Let us say that I go to a registered tax agent and he introduces me to a scheme which has a tax opinion from Robert O’Connor QC and endorsement from Norton and Smailes, who are solicitors. I then also ring the franchise company and speak to them. A friend of mine rings the Australian Securities and Investments Commission. She also rings the ATO. Is that due diligence? I believe it is. In fact, I believe that is over and above due diligence. I think that shows I have been extremely careful with my investment.[40]

4.55 As this evidence indicates, in some instances participants sought advice from ATO offices on the legitimacy of particular schemes before they committed to investing in them.[41] While it does not appear that ATO offices issued advice approving the tax benefits of schemes, some participants were reassured that if they performed due diligence tests they would not face penalties if deductions were later disallowed. In the case of one witness:

> Initially, when I invested in Satcom, I rang the ATO to discuss what the implications were. I discussed the scheme at length with a tax officer. The ATO told me that they were not in the business of saying whether something was a legitimate deduction or not and it was up to me to seek a legal opinion. They explained the self-assessment and suggested that I check the viability of the scheme, legal opinions, accountants’ opinions, and the legal qualifications of the person giving the opinion. They also explained that if I did these things and went through a CPA, this would be due diligence and if, at a later date, it was not found to be a legitimate deduction, there would be no penalty, but the deduction would be disallowed.
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> Subsequently, I checked the qualifications of the legal opinion from Robert O’Connor, which was supplied to me from Satcom. I called the Law Society shopfront lawyer for advice. I called the University of Western Australia legal lecturing department, and they said that Robert O’Connor QC was an eminent QC and his opinion was one of the highest you could obtain. There was no such thing as product rulings at this time. I asked my accountant for

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39 ATO Supplementary Submission No. 845B, p.1.

40 Evidence, p.120.

41 Evidence, p.211.

> his opinion—he is a highly respected accountant in South Perth—and he told me that it was a good investment.[42]

4.56 In the event, despite following the ATO's original advice, this witness had both his deductions disallowed and penalty tax and interest charges imposed as well. In this particular case, the Committee considers that prima facie it is unfair for tax office staff to say one thing and then for the ATO to renege on that original advice. As the witness concerned stated:

> I thought that by ringing the ATO and asking for their opinion I was fairly safe, and I took their advice on face value.[43]

4.57 In considering the circumstances in which taxpayers invested in mass marketed schemes, the Committee believes that the influence on investor perceptions of PBRs used to market schemes needs to be recognised. Insofar as PBRs were used as marketing tools to encourage participants to believe they represented a general ATO position, participants were poorly served by both promoters and advisers, particularly tax practitioners who would have known that this was an improper use of PBRs and that no certainty existed for anyone except the PBR applicant. This matter will be canvassed further in the Committee's main report.

4.58 However, the Committee considers that a reasonable person unaware of the PBR restrictions or their qualified nature could be forgiven for thinking that they amounted to ATO acceptance of the deductions or that they represented a general ATO view, particularly when the tide of legal and accounting opinion supporting the schemes is also taken into account (see below). The fact that the ATO did not take prompt action to review and withdraw these PBRs also lulled participants into investing in later schemes. Would it not have been reasonable for investors to believe that if the ATO had concerns about an earlier scheme then it would have indicated so already and moved to disallow deductions or withdraw the PBRs? In this regard, it is salutary to note the ATO's admission to the Committee that in its own view many of the schemes appeared acceptable on the surface:

> It would be the case in not just one but in very many arrangements that, if we have a look at the arrangement on paper, in the glossy prospectus that is used to sell the scheme it may at face value look reasonable.[44]

4.59 The Committee considers that it is untenable for the ATO to claim, in self-defence of its inaction and delays, that in its eyes schemes appeared 'reasonable' on the surface, but to insist that scheme participants failed to take due care in investing in schemes and claiming what in many cases appeared to be 'reasonable' tax deductions. To put it another way, the ATO cannot seek to use one standard to justify its own

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[42] Evidence, Perth, p.119.

[43] Evidence, Perth, p.121.

[44] Evidence, p.485.

behaviour and then disregard that standard when making assessments of taxpayer behaviour.

Conclusions

4.60 The Committee considers that the ATO needs to give more consideration to the significant evidence that participants entered schemes on the basis that the arrangements and associated deductions were allowable and that the ATO would not later move to disallow them. Most appear to have had reasonable grounds for believing the schemes to be above board. Many took extra steps to reassure themselves of the soundness of their investment – in the Commissioner's words, to 'remove the fear of getting it wrong'.

4.61 The Committee also considers that the absence of any clear warning or sign of disapproval – as has been the ATO's recent practice – of the schemes would have also been significant for participants. Combined with the existence of Private Binding Rulings for some participants and endorsement from legal and accounting practitioners, this would have led many to believe that their investments were inside the law.

4.62 A taxpayer who took all responsible steps to act within the law, who took advice on which they were entitled to rely, who did normal due diligence, who took professional advice from professional accountants or lawyers, who relied on tax rulings (even if draft), who relied on professional tax and financial planners, and who has a previously good tax record, can be justified in arguing that they acted in good faith.

4.63 In light of the above, the Committee believes it may be unreasonable for the ATO to maintain that the dominant purpose of all participants was to seek a tax advantage. Such a view simplifies the motives of many participants and overlooks the mitigating circumstances affecting many of them. As such, the imposition of tax penalties under Part IVA on those scheme participants who largely appear to have been caught unwittingly in mass marketed arrangements, and who exercised reasonable care or due diligence, raises serious questions about the equitable application of the tax law.

Prospective versus retrospective action

4.64 The Committee raised the matter of whether the ATO's actions over mass marketed arrangements amounted to a divergence from the general ATO principle of not applying policy changes retrospectively, when such changes represent a departure from a previous ATO view or practice. In previous cases where the ATO has had a well established view or position on the law's application, any change to its position has been introduced on a prospective as opposed to retrospective basis. For instance, the Committee notes three examples where the ATO adopted prospectively new positions on matters at variance to its earlier treatment of them:

- Utilisation of prior year company losses where shares are held by trustees or discretionary trusts;
- Taxation of retirement village owner; and
- Financing unit trusts.[45]

4.65 In considering these examples, the Committee makes particular note of the ATO's explanation for applying a new treatment of financing unit trusts prospectively from the date that new treatment came into effect. The relevant Taxation Ruling, IT2512, states:

> The view contained in this ruling as to how the law operates in relation to financing unit trusts is at variance with advance opinions that this office gave in a small number of particular cases. …it appears that the advance opinions given in those cases were disseminated in the financial/building industries and among their taxation advisers as evidencing a general Taxation Office approach. *Although not authorised to be used in that way the result was that some parties entered into these arrangements believing that they generally had a form of official clearance*. [emphasis added][46]

4.66 On the face of it, it seems to the Committee that the circumstances cited in IT2512 are similar to those that faced many scheme participants, particularly in cases where PBRs were used in the marketing of particular schemes.

4.67 When the Committee raised the matter of the ATO ruling prospectively, the ATO confirmed that its policy is that a change in its view will only have prospective effect. According to Mr O'Neill:

> … in circumstances in which the ATO has led the community, or a particular section of the community involved in financing unit trusts, into the error that they thought that they were safe in respect of those investments, our policy has always been that a change of ATO view on the tax implications of that arrangements should be prospective.[47]

4.68 However, the ATO disagreed that it had changed its view on mass marketed schemes and thus disagreed that its current rulings should only be applied prospectively.[48] It rejected the analogy between mass marketed arrangements and the three cases cited above, arguing that there were two important differences between them.

4.69 First, the ATO stated that whereas in relation to afforestation schemes its public position was that deductions would not be allowable if Part IVA applied, it had

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45 See the attachment to Supplementary Submission No. 22A, pp.5-6.

46 Supplementary Submission No. 22A, p.6.

47 Evidence, p.482.

48 Evidence, pp.477-483.

made no comparable statement on financing unit trusts (FUT).[49] Thus, according to the ATO, a clear signal of its position was present in the case of afforestation schemes which was lacking in the case of FUTs.

4.70 Second, the ATO noted that the prospective effect of the ruling for FUT was conditional on the arrangements being implemented in line with the information provided to the ATO on which it based its advance opinions.[50] In contrast, the ATO claimed that in the case of PBRs for mass marketed arrangements, the promoters neither provided all the facts to the ATO nor did they implement the arrangements according to the facts presented.[51] For that reason, the ATO asserted that even the schemes that had been approved in principle by the PBRs were not allowable in fact.

4.71 As has already been discussed, the claim that public ruling IT2195 which stated that 'if Part IVA does apply' then deductions claimed in relation to afforestation schemes would be disallowed hardly sends an unambiguous signal to the market about afforestation schemes, let alone about any other kind of investment.[52] Further, the implication that the market was not misled by PBRs which were issued on the basis of inadequate information and hence which were not legitimate seems nonsensical. How were individual investors in a position to know whether a particular PBR had been obtained from the ATO, as it were, under false pretences? Aside from the fact that it was the existence of the PBR itself which misled investors, it also raises questions about checks and balances in the system.

4.72 The Committee considers that the question of whether the ATO should be acting retrospectively or prospectively in the case of mass marketed schemes is a complex matter, warranting closer examination. At this stage, however, the Committee has grave concerns about the ATO's justification for the retrospective application of its current view. This matter is at the heart of taxpayer complaints about how the ATO is treating them. It is therefore vital that the ATO and the Courts (if it is a question that they are addressing), and as far as possible the Committee, try to determine the extent to which retrospective action is warranted and in what circumstances.

Drawing A Line in the Sand

4.73 A common view put to the Committee is that the ATO should, in the interests of both fairness and good administration, declare an amnesty on participants who invested in schemes before the ATO signalled its intentions to disallow deductions. Based on the large numbers of taxpayers caught unwittingly in mass marketed

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49 Evidence, p.481.

50 IT2512 states: 'this Ruling will not disturb any prior advice given by this office as to the tax implications of a particular case where the arrangement is carried into effect on the factual basis on which the advice was formulated'. Supplementary Submission No. 22A, p.7.

51 Evidence, p.478.

52 See Evidence, p.481.

arrangements and the questions surrounding the ATO's administration of the matter, it is suggested that the ATO consider foregoing and remitting penalty tax and interest charges and only seek to recoup the primary tax involved with the original claimed deductions. In short, the recommendation is that the ATO 'draw a line in the sand' and move forward.

4.74 The ATO, however, told the Committee that it rejected that proposition on the grounds that: 'That sort of approach creates an expectation that we will do that again next time, and I think that is itself a driver of tax avoidance'.[53] The point was elaborated by Mr Michael O'Neill, Acting First Assistant Commissioner, ATO, who said:

> It seems to me a balancing question between the interests of those who have done the right thing throughout the period of time and those who may have taken advantage of a glitch in the law, a misunderstanding by the tax office about how the law applies. If we said that any new announcement of policy would have only prospective effect, that would have a very deleterious effect on the confidence in the system because any taxpayer who had always been doing the right thing would thereby suffer disadvantage and it would, in fact, encourage people to always be seeking the lowest common denominator.[54]

4.75 The Committee considers that there are some legitimate criticisms of this kind of argument. The first relates to the question of equity between taxpayers who were involved in the schemes and those who were not. The Committee acknowledges that were a 'line in the sand' to be drawn, taxpayers who have had no involvement in mass marketed schemes would bear a cost that they otherwise would not, just in virtue of the fact that the prospective application of the ATO's ruling would involve a cost to the revenue.

4.76 However, the Committee is not convinced that the cost borne by non-involved taxpayers is sufficient to offset the very great costs that must be borne by those involved unwittingly in allegedly abusive schemes if the ruling applies retrospectively. Moreover, the sheer number of those involved in these schemes and the evidence of their general unwittingness of any wrongdoing indicates that, to some extent, all taxpayers are potentially vulnerable to making serious mistakes under the self-assessment system. In that sense, it is at least arguable that all taxpayers are served by a taxation office that is prepared to exercise its discretionary powers to the full extent possible in such situations.

4.77 The second criticism relates to the issue of the integrity of the self-assessment system itself. The ATO's concern is that if those who market and engage in aggressive tax planning are allowed simply to 'get away with it' whenever there is no definitive ATO ruling on the legitimacy of individual schemes, then it is likely that more and

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[53] Evidence, pp.505-506.

[54] Evidence, p.480.

more inventive tax avoidance schemes will be devised and flourish. The long term risk to the revenue is then very great.

4.78 While noting the force of this argument, the Committee considers that it overlooks several important factors that would combine to contain the risk posed by future attempts to engage in aggressive tax planning, particularly on a scale comparable to the case of mass marketed arrangements. First, the introduction of the Product Ruling system is widely considered to have been a positive development in that it provides both the ATO and the market with a mechanism for enhancing certainty about the tax implications of arrangements.[55] The view put to the Committee in the evidence is that the presence of Product Rulings has made it extremely difficult for promoters to market schemes unless the scheme has such a ruling. As the ATO stated:

> The introduction of the Product Rulings system … has forced most promoters of mass marketed investments to come to the ATO before marketing investments.[56]

4.79 With appropriate levels of investor education and vigilant field audits of issued rulings, the Committee considers that investors are less likely to be misled into aggressive schemes *on a large scale* as they were in the past. This is not to say that the Product Ruling system cannot be improved. While it has clearly helped clean up the market, the Committee considers that more can be done to strengthen the role of Product Rulings. The Committee intends to discuss this matter in its final report.

4.80 The second factor constraining the potential outbreak of large scale aggressive tax planning is the expected sanctions being developed for aggressive promoters. Currently the absence of effective sanctions on aggressive promoters is a major loophole in the system. The ATO considers that 'more immediate prospects for financial detriment to promoters and marketers is the single most important lever in putting a check on aggressive tax planning'.[57]

4.81 The Commissioner indicated that the ATO expected to have advice to the government about promoter sanctions by the middle of May this year.[58] The range of measures under consideration include measures adopted or being developed in the United States and Canada to penalise promoters and others developing and marketing schemes; splitting penalties between promoters and participants; and penalising promoters for implementing schemes in a manner not according to the facts disclosed to the ATO.[59]

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55 ATO Submission No. 845, p.4.

56 ATO Submission No. 845, p.13.

57 ATO Submission No. 845, p.13.

58 Evidence, p.503.

59 Evidence, pp.503-504 and ATO Submission No. 845, p.12.

4.82 The Committee notes that this matter was discussed in its previous inquiry into the operations of the ATO. At that time also the ATO indicated that it was developing measures to deal with promoters. The Committee is concerned that, despite its recommendations on this matter in its March 2000 report, no concrete measures have yet been announced.[60]

4.83 Third, the ATO claims that as a result of its recent experience with aggressive tax planning the ATO has moved to a more proactive footing in monitoring the market and detecting compliance risks. In particular, the ATO has enhanced its strategic intelligence capabilities, both internally and with the market. This drive to develop the ability to respond in 'real time'[61] to market trends is crucial if the ATO is to be in a position to pre-empt risks to the revenue before they get out of hand.

4.84 The Committee also considers that the experience of the mass marketed arrangements affair should provide lessons not only to the ATO but also the market, the tax industry and taxpayers. It considers that the personal trauma many scheme participants have experienced as a result of the ATO's actions will have provided more than enough 'downside' to ensure that they will exercise the utmost caution in approaching investment schemes in the future. Similarly, the ATO's actions will have concentrated the minds of tax practitioners and financial advisers on the importance, when advising clients, of seeking certainty about the ATO's view on the application of the law. While stronger measures and penalties for promoters are still in the wings, the Commissioner's frequent public statements signalling the ATO's intention to attack aggressive tax planning has put the more extreme promoters on notice that they can no longer take the ATO and investors for granted. There are some reports that aggressive tax planning has declined as a result.[62]

4.85 In sum, the Committee considers that, given the combination of checks now present and envisaged, schemes on the scale witnessed with mass marketed arrangements prior to 1998 could not arise again. For that reason, the Committee considers that a partial or full amnesty on penalties and interest for appropriate cases does not set a precedent which will be able to be exploited by aggressive tax planners in the future. Taxpayers who can be shown to have acted in good faith – as outlined above in paragraph 4.62 – would be likely candidates for a partial or full amnesty. That is to say, the Committee is not proposing a blanket amnesty but rather one which takes into account the many taxpayers who believed they were acting on sound advice and within the law. An amnesty would obviously not extend to those participants who have knowingly invested in blatantly abusive schemes or who have a history of persistent tax avoidance. As difficult as it always is, there is a need to ensure that outcomes are as fair and just as possible.

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60 See Senate Economics References Committee, *Inquiry into the Operation of the Australian Taxation Office*, March 2000, p.xii.

61 Evidence, p.485.

62 Evidence, p.139.

4.86 The Committee will monitor the ATO's approach to this issue and may consider making recommendations in its final report.