CHAPTER 6

TEST CASES AND OBJECTIONS

6.1 In situations where taxpayers dispute the ATO's interpretation and application of tax law and consequent assessments of their tax liability, taxpayers have a legal right to seek an independent, external review of the ATO's decisions. Avenues for review include:

- the Administrative Appeals Tribunal (AAT);
- the Federal Court;
- the Commonwealth Ombudsman; and
- the Privacy Commissioner.

6.2 Of these, decisions by the Federal Court and the AAT are binding on the ATO, although either party can appeal decisions in a higher court. The process of a court or tribunal ruling on key points of law is generally referred to as a 'test case', as this creates precedents that may be used by other courts, the legal profession and taxpayers about how the law should subsequently be interpreted and applied.

6.3 While independent review is a legal right, in reality taxpayers face substantial obstacles in challenging the ATO's decisions, largely because of the high cost of legal representation. Few individual taxpayers can afford the costs associated with protracted court action against the ATO. As Mr Mike Hutson of Hutson Duddy Solicitors noted:

> For all we know, the Tax department is wrong... But it is going to take, as I said earlier, a fair amount of courage and an awful lot of money to test it. That is the big stick that the tax department waves for which we have no defence.[1]

6.4 Further, the delay involved in seeking a review instead of settling can result in an inflated tax debt if taxpayers lose their case. Interest charges on outstanding debts compound daily. As a result, many taxpayers may face significant financial disincentives that preclude them from exercising their legal rights.

6.5 Nonetheless, it is inescapable that the ATO's disallowance of deductions sought in relation to these schemes needs to be tested in the courts for the sake of establishing the legitimacy of its actions and maintaining taxpayer confidence in the ATO's interpretation of the law. While the ATO maintains that its interpretation of the law and in particular its use of Part IVA is appropriate, a significant number of lawyers, promoters and investors are just as emphatic that the ATO is wrong. There

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1 Evidence, p.243.

appears to be widely divergent opinion between the ATO and parts of the legal and financial community about the legitimacy of the arrangements loosely referred to as tax effective investment schemes:

> After all, you have to appreciate that a large part of the tax laws is subject to interpretation, and there is nothing we can do about that. That is the nature of the beast. But still we come down to this problem of the tax department and the professionals being poles apart.[2]

6.6 The ATO and other witnesses advised the Committee that a number of test cases related to several mass marketed schemes are imminent and more are pending. In particular, cases regarding the Budplan arrangements commenced in the Federal Court on June 4.

6.7 Mr Frank Wilson, of Perth barristers and solicitors Wilson and Atkinson also advised the Committee that his firm is mounting a number of cases in both the Federal Court and the AAT, the first trial being set for August 2001.[3] The Committee understands that Wilson and Atkinson cases include five agricultural arrangements and a further two franchise arrangements.

Test case litigation program

6.8 Recognising the need for clarification of significant legal issues and the obstacles faced by taxpayers in mounting challenges, particularly in the Federal Court, the ATO operates a test case litigation program. Under this program, the ATO will undertake to fund the legal costs of individuals involved in test cases, provided they meet certain criteria. However, it appears that the ATO will only fund test cases in very limited circumstances.

6.9 Minter Ellison, a legal firm representing some Budplan participants, applied for test case funding in August and September 1998 but the ATO litigation panel recommended that funding be refused 'because of the tax avoidance implications of these cases and the potential application of Part IVA of the Income Tax Assessment Act 1936'.[4] The ATO did, however, in January 2000, offer test case funding to four Budplan participants of its own selection, although at least three of these persons had not themselves sought funding.[5] The Committee understands that only one accepted, but too late for the case to be included in the impending hearing.

6.10 Aside from the offers made to the four Budplan participants, the ATO had not, until late April 2001, made funding available for any tax effective schemes test cases. The ATO has now announced that it will be funding from 20 April onwards four Budplan test cases and 'a representative group of cases' in relation to a film

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2 Mr Mike Hutson, Evidence, p.238.

3 Evidence, Perth, p.91.

4 Letter from Deputy Chief Tax Counsel, ATO to Minter Ellison, 21 October 1998.

5 The status of the fourth is unclear.

scheme 'provided we do not experience any further delays'. The ATO has also indicated that it will consider funding further test cases if they raise materially different principles.[6] This matter may require further consideration by the Committee.

Deferring recovery action pending the outcome of legal action

6.11 The ATO's policy in respect of action to recover money assessed as being payable under amended assessments is apparently to allow tax in dispute to remain unpaid until objections are determined, providing the revenue is not at risk.

6.12 However, on 20 July 2000, the Taxation Commissioner announced that the ATO's strategy of generally holding off on determining objections and, in some cases, amending assessments while pursuing representative test cases would not be continued.[7]

6.13 The ATO explained that this decision was a consequence of the experience at that stage in a number of arrangements that an appropriate range of representative cases was not getting before the courts 'as early as the ATO would like'.

6.14 The ATO also argued that deferring debt recovery would send the wrong signals to potential participants in what it identified as aggressive arrangements:

> …any long delays are putting off the hard edge of reality of participating in aggressive schemes. This could be a factor in the continuing participation in such arrangements.[8]

6.15 The ATO advised the Committee that, accordingly, the office would continue to issue amended assessments unless matters put forward by taxpayers or their representatives, such as realistic offers of settlement were still under consideration. The ATO indicated, however, that given previous commitments and the fact that test cases are now listed for hearing before the Federal Court, it would continue to hold off on determining objections in the Budplan cases.

6.16 A number of witnesses including individual participants and representatives of the legal profession called for the ATO to cease its recovery action against people whose assessments have been amended pending the outcome of test cases.

6.17 Mr Frank Wilson of Wilson and Atkinson, was amongst those who called for the ATO to suspend the process of recovering money before test cases are concluded. Mr Wilson's argument is that the financial and personal consequences that recovery action has on taxpayers who are disputing their assessments is severe. He points out that even if the taxpayer wins the case, the ATO's recovery action may well have caused significant and irreversible harm:

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6 Backgrounder to ATO media release 01/30, dated 26 April 2001.

7 ATO, Submission No. 845, p.9.

8 ATO, Submission, No. 845, p.9.

> I think it is unconscionable and pernicious that the commissioner should be out there attempting to take recovery action and bankrupt people pending the determination of these test cases, which are likely to find that a large majority of these people do not owe the tax office anything. It is a pyrrhic victory for a taxpayer if, after being bankrupted and having his life destroyed, the commissioner finds that, 'Actually, all this time you had done nothing wrong. Sorry. Here is your money back.'[9]

6.18 Some witnesses also questioned the consistency of the ATO's approach in this regard. For example, the Committee received evidence about the Foodland case, a Part IVA case where the ATO had apparently agreed not to pursue payment 'until the matter is settled or, alternatively, FAL [Foodland Associated Limited] has exhausted all rights of appeal'. The assessments totalled $27m in tax and a further $24.7M in penalties and interest.[10] This type of agreement appears to contrast with the ATO's approach towards participants caught up in the mass marketed schemes issue.

6.19 While it must be acknowledged that the ATO's policy concerning recovery of tax debt does contain guidelines on when recovery action should proceed, the perception may be created that the ATO applies a different, harsher standard in respect of small and relatively defenceless individual taxpayers.

6.20 On 26 April 2001, the ATO announced that it was changing its approach:

> …we will agree not to take recovery action on outstanding debts in all mass marketed abusive tax effective investment scheme cases where an objection has been lodged provided there is no evidence of action such as dissipation of assets to avoid meeting their tax liability. We will review this position based on the decisions handed down. A lack of progress or continuing withdrawal of cases will also cause us to review the position.[11]

6.21 Interest will continue to accrue on outstanding debts. The Tax Commissioner has, however, announced that the ATO will reduce the interest charges from 13.86% to 5.86% for 'some investments' in schemes. It is unclear at the time of writing how widely the ATO will apply this concession. The ATO has indicated that it will consult with community representatives 'to develop reasonable guidelines for determining who should be entitled to a reduction in interest'.[12]

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9 Evidence, Perth, p. 98.

10 Foodland Associated Ltd, ASX-Signal -G, 1.2.2001.

11 Backgrounder to ATO media release 01/30, dated 26 April 2001, p.5. The ATO is continuing to issue notices of amended assessment in cases where it has disallowed scheme deductions. These are not to be confused with the final amended assessment at which point payment is required. The ATO states that those receiving notices of amended assessment may still lodge an objection with the ATO and recovery action will be suspended in accordance with the 26 April announcement.

12 ATO media release Nat 01/30. See the discussion in chapter 5 on this measure.

Test case delays

6.22 There have been very significant delays in mounting test cases for mass marketed schemes. Moves to test one particular arrangement, Budplan, commenced in 1998 but have yet to be heard. The reasons and responsibility for these delays have been subject to claim and counterclaim.

6.23 For its part, the ATO says that there have been difficulties associated with identifying representative test cases and that promoters have stalled the process. Lawyers representing the Budplan litigants paint a different picture, attributing at least part of the blame to the ATO, pointing to ATO refusal to accept certain nominated cases, a refusal to provide test case funding[13] and delays in issuing notices of decisions on objections.

6.24 In the Committee's view it appears that both parties to the litigation have contributed to the delays and that neither the ATO nor the litigants is blameless.

6.25 The controversy now surrounding test cases has led to the Ombudsman investigating the matter as an issue of taxpayer complaint in its own right. The outcome of the Ombudsman's report of his investigation is pending.

Conclusions

6.26 The Committee welcomes the ATO's apparent change of heart in relation to the funding of test cases, but notes that it is only part funding the Budplan case. Given the number of people involved in these schemes and the long running nature of the dispute, it is difficult to understand why the ATO has been so reluctant to fund test cases.

6.27 The Committee also welcomes the ATO's decision to suspend recovery action until representative cases are resolved. The Committee is of the view that the ATO's action to move to recover debts before any test cases could be determined left it open to the charge that its approach was inconsistent with that adopted in relation to large taxpayers and companies.

6.28 Notwithstanding these positive initiatives, the Committee questions whether interest charges should continue to accrue while test cases are pending. Taxpayers who have received amended assessments already face substantial and in many cases very substantial tax debts. To continue to apply interest during the test case program may increase pressure on participants to withdraw, not because they do not believe their cases are winnable but rather for financial reasons. The withdrawal of participants under such conditions could stall the test case program.

6.29 The Committee would be concerned if financial pressures on participants lead to further delays in test cases. This would be unacceptable because, in the

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[13] The first application for test case funding was lodged on 31 August 1998 and refused by the ATO.

Committee's view, this matter can only be satisfactorily resolved after the Courts decide a number of representative cases. The Committee therefore believes that there may be grounds for suspending the accrual of interest for participants involved in the test case program.