Parliament of the Commonwealth of Australia

SENATE ECONOMICS REFERENCES COMMITTEE

INQUIRY INTO MASS MARKETED TAX EFFECTIVE SCHEMES AND INVESTOR PROTECTION

FINAL REPORT

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TERMS OF REFERENCE

On 29 June 2000 the Senate referred to the Senate Economics Reference Committee the matter of mass marketed tax effective schemes and investor protection for inquiry and report with particular attention to:

i. The adequacy of measures to promote investor understanding of the financial and taxation implications of tax effective schemes;

ii. The conduct of, and the adequacy of measures for controlling, tax effective scheme designers, promoters and financial advisers; and

iii. The ATO's approach towards and role in relation to mass marketed tax effective schemes.

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DEFINITIONS

Amended Assessment

An amended assessment is when the ATO re-assesses a taxpayer's tax liability. Amended assessments involve a more detailed review than is the case with assessments which mainly involve the ATO accepting a taxpayer's return at face value.

Deductions

Money you spend to enable you to earn income. Allowable deductions include, among other things, stationery, equipment, rent, electricity, telephone and tools. The value of the deduction is subtracted from assessable income to calculate your taxable income.

Non- and Limited- Recourse Loans

In the ATO's view, a non-recourse loan (NRL) is an arrangement where the lender has no recourse or right to reclaim the loan beyond a specified security of the borrower. Usually the 'specified security' is tied to the scheme's earnings (eg, the sale of timber in afforestation schemes). In other words, with an NRL the borrower is not personally at risk to repay the loan, apart from the specified security.

A limited recourse loan (LRL) exposes the borrower to slightly more risk than an NRL. Under an LRL the lender may have recourse to other assets of the borrower's, beyond the specified security. For instance, the borrower may be required to repay the investment loan in full, even if the income from the scheme is less than the outstanding balance on the loan.

Round Robin Financing

A round robin arrangement involves a circular 'paper flow' where little real capital is at stake. It often involves, according to the ATO, the passing of documents such as cheques, promissory notes and so on among connected parties, usually on the same day, with no change to the overall level of cash. While it creates the appearance of a financial transaction, there is little or no cash generated that can go into the underlying business of the investment.

Private Binding Rulings

Private Binding Rulings (PBRs) provide certainty on the tax benefits or consequences of an investment to *individual* investors. These rulings only apply to the individual taxpayer who requested the ruling (compare with Product Rulings below). As with Product Rulings, PBRs provide no protection in circumstances where the investment arrangement is not carried out in accordance with the information provided to the ATO.

Product Rulings

The ATO issues Product Rulings for individual investment schemes. Product Rulings are intended to provide certainty for potential investors by confirming the tax benefits of the investment. Unlike Private Binding Rulings which apply only to individuals, Product Rulings apply to all participants in the investment. Product Rulings relate only to the tax consequences of the investment. They do not involve any ATO assurance as to the investment's commercial viability, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based. A Product Ruling only applies if the arrangement is carried out in accordance with the information provided to the ATO.

Promoters

'Promoters' is a general term which can include investment scheme designers, the principals behind schemes and their managers, and those involved in the marketing and promotion of schemes.

Tax Rulings

Tax rulings provide the ATO's view on general matters of tax law (such as the deductibility of expenditure in relation to investment schemes, for instance). These have wider application than Product Rulings which relate to single investments.

PREFACE

On 29 June 2000 the Senate referred to the Committee the matter of mass marketed tax effective schemes and investor protection for inquiry and report. In September 2000, the inquiry was advertised in the national press and on the internet, and interested parties were invited to make submissions to the Committee.

The Committee received 899 submissions, as well as several supplementary submissions, particularly from the Australian Taxation Office. These are listed at Appendix I.

The Committee held the following public hearings:

- Canberra, 11 December 2000, 31 January, 3 April, 26 July, 21 and 23 August 2001;
- Melbourne, 9 March 2001;
- Kalgoorlie, 19 March 2001;
- Perth, 20 March 2001; and
- Sydney, 24-25 July 2001.

The Hansard transcripts are published on the Committee's webpage.

This is the Committee's third and final report on the inquiry. The Committee tabled an Interim Report on 25 June 2001, and a second report, *A Recommended Resolution and Settlement*, was tabled on 26 September 2001.

The Committee wishes to thank everyone who contributed to the inquiry by making submissions, providing other information or appearing before the Committee at public hearings.

LIST OF RECOMMENDATIONS

Recommendation

1.30 The Committee recommends that the Government provide the ATO with the necessary powers to enable it to apply to the courts for injunctive relief to prevent the marketing of and investment in tax abusive arrangements contrary to the law.

Recommendation

1.52 The Committee recommends that, to strengthen lines of communication with the tax industry and market, the ATO establish formal procedures for indicating its concerns about emerging compliance risks through peak bodies and other forums such as the National Tax Liaison Group.

Recommendation

1.59 The Committee recommends that the ATO include information about tax effective schemes in the *TaxPack* to improve general taxpayer awareness of the issues and potential risks surrounding tax effective schemes. This information should highlight the ATO's powers at law to review tax returns after deductions have been paid.

Recommendation

2.68 The Committee recommends that a review be conducted into the nature and extent of the public interest responsibility that tax professionals should adopt for the integrity of the tax system. The review should be conducted by an appropriately qualified person, who should consult with the Board of Taxation, the ATO, the tax profession and other relevant business and community bodies. The review should include consideration of the issues of tax planning and the mass marketed schemes episode.

Recommendation

3.36 The Committee recommends that the ATO, in consultation with the Taxation Institute of Australia, the Commonwealth Ombudsman and other relevant bodies, develop measures to educate taxpayers about their obligations and rights in the self-assessment environment. Particular attention should be given to ensuring that taxpayers are made aware of the period over which the ATO may review their returns and amend their assessments. Further to the recommendation at paragraph 1.59, information about the ATO's power to review and amend assessments, and the time periods that apply, should be clearly stated in the *TaxPack* and on notices of assessment sent to taxpayers.

Recommendation

3.48 For this reason, the Committee recommends that the test case Litigation Panel publish the criteria in the light of which it will recommend cases for funding and publish the reasons for its recommendations in particular cases.

Recommendation

3.51 The Committee recommends that the Government undertake an analysis of the adequacy of current mechanisms for obtaining judicial resolution of disputed or contentious tax law interpretation. This analysis should include consideration of whether and how the ATO might obtain a legal judgement without having to be taken to court by a taxpayer objecting to an ATO determination, and consideration of the merits of establishing a specialist federal tax court.

Recommendation

4.78 The Committee recommends that the government seek advice from both ASIC and the ACCC on the question of the adequacy of the current measures for monitoring the schemes market, with particular reference to agribusiness and franchise schemes. This advice should address matters such as the role of specific industry associations and the Australian Managed Investments Association in ensuring that compliance and disclosure obligations are met, the development and publication of further benchmarking measures which draw on industry wide standards and expertise, and any other measures required to ensure the adequate protection of investors in this sector.

CHAPTER 1

MANAGING COMPLIANCE RISKS

Introduction

1.1 Abusive tax planning arrangements pose a significant compliance risk for the Australian Taxation Office (ATO). This risk must be managed effectively if both the tax revenue and the integrity of the tax system are to be protected.

1.2 In its Interim Report of June 2001, the Committee rehearsed in detail the compliance risks posed by the rise of mass marketed schemes and discussed the ATO's response to them. In this Chapter of its third and final report, the Committee builds on that discussion in order to identify the ongoing risks posed by these types of scheme and the administrative arrangements required to manage them effectively.

1.3 The Committee examines the following issues in turn:

- Current levels of deductions and compliance risk;
- ATO communication strategies to the market; and
- ATO risk management strategy.

Current levels of deductions and compliance risk

1.4 In assessing the adequacy of ATO measures for preventing a recurrence of the mass marketed schemes crisis, the Committee has attempted to analyse developments in levels of disallowed deductions and compliance risk since the ATO's crackdown on schemes in 1998. However, the Committee is aware that it may be too early to determine accurately the effect of the ATO's campaign on the schemes market and on the compliance attitudes of those who invested in schemes.

1.5 One constraint is the variability of ATO data for recent years on levels of non-allowable deductions, which is discussed further below. The variable state of this data makes it difficult, for example, to get a firm grasp on the extent to which deductions have declined, which in turn poses problems for assessing the current level of compliance risk presented by mass marketed schemes.

1.6 The Committee notes that the Australian National Audit Office (ANAO) is planning to conduct an audit of the ATO's performance in aggressive tax planning[1] and expects the results of the audit to provide useful input to the question of the effect of ATO initiatives in this area. In the meantime, the Committee's conclusions are of a provisional nature.

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1 Evidence, p.709.

1.7 With these qualifications in mind, the Committee notes the results of an ATO internal evaluation, produced in June 2000, of its actions towards mass marketed schemes. The evaluation found that:

- After the marked increases in disallowable deductions from 1992-93 to 1996-97, deductions had levelled off;
- Despite curbing the growth in deductions, the level continued to be 'unacceptably high, at around $1 billion in 1998-99'; and
- 'the ATO had been largely successful in putting an end to schemes that use non-recourse loans, effected by a round-robin flow of funds, to artificially inflate deductions relating to tax-shelter investments'.[2]

1.8 In addressing the level of compliance risk, the evaluation concluded:

> The compliance problem has stopped growing and levelled-off. There is still a large amount of work to be done. The main problem appears to be a small group of habitual avoiders who continue to promote aggressive tax planning. The ATO needs to stay active and build on those strategies that have proven successful in the past.[3]

1.9 The evaluation estimated that ATO strategies had a major impact in containing the growth in deduction levels. ATO modelling based on the rate of growth of deductions from 1992 to 1997 calculated that non-allowable deductions may have continued to grow to around $2 billion in 1998-99 and $2.9 billion in 1999-2000. With deductions identified at June 2000 to be around $1 billion for 1998-99, it appeared that growth had been capped.[4]

1.10 In the ATO's view, the levelling off of deductions post-1998 suggested that its actions had brought about a change in taxpayer behaviour – a so-called 'voluntary compliance effect' – with taxpayers exiting the schemes market or switching to alternative allowable deductions.[5]

1.11 The ATO's highly publicised campaign to attack the schemes market, and in particular the decision to target one of the largest schemes, Budplan, appeared to have also deterred promoters from launching similar large schemes onto the market in

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2 Commissioner of Taxation, *Annual Report 1999-2000*, October 2000, p.71, reporting the results of the Small Business Schemes Evaluation Report, June 2000. See also ATO Additional Information 15 June 2001.

3 ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.5.

4 ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, pp.18-22.

5 ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.5.

1997-98 and beyond.[6] The evaluation concluded that 'some scheme types have come and gone, while others have peaked and are now in decline'.[7]

1.12 However, more recent ATO data supplied in September 2001 reveals that non-allowable deductions did *not* level off in 1998-99 but continued to *climb* to around $1.5 billion.[8] Furthermore, the current figure of $1.5 billion for 1998-99 marked an increase on the ATO estimate in May 2001 which was closer to $1 billion.[9]

1.13 The Committee questioned the ATO about the reasons for the change in figures. It also sought current ATO figures for non-allowable deductions in 1999-2000 and 2000-2001, as well as the ATO's view on the implications of the level of deductions over these years.

1.14 With regard to the variability of data on non-allowable deduction levels, the ATO stated:

> The database is constantly being updated to reflect information made available to the ATO on new schemes we identify and additional information on schemes we already knew about as we progress our investigations.[10]

1.15 In addition to the complexity involved in detecting potentially tax abusive arrangements, another factor possibly behind the shifting state of deduction levels is the delay experienced with some taxpayers lodging late tax returns. The ATO states that 'it usually takes between 3 to 6 months to gather sufficient information about a scheme in order to quantify the number of cases, deductions dollars involved, and overall nature of the scheme'.[11] Late tax returns, which reveal hitherto undetected schemes from earlier years, enable the ATO to uncover additional non-allowable deductions but with the result that earlier estimates need revising.

1.16 In terms of recent years, the ATO reported that it has identified non-allowable deductions of $527 million in 1999-2000 and $121 million in 2000-2001. Although the ATO noted that it is likely that these figures will need to be adjusted as more information comes to hand, it stated that 'we still expect a significant reduction from earlier years'.[12]

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6 ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.18.

7 ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.11.

8 See Attachment A to the Commissioner's opening statement to the Committee.

9 ATO Additional Information 22 May 2001, see Attachment G.

10 ATO Additional Information 19 September 2001, p.3.

11 ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.24.

12 ATO Additional Information 19 September 2001, p.3.

1.17 Table 1 presents these latest figures combined with the levels of non-allowable deductions across the 1990s.[13]

TABLE 1. NON-ALLOWABLE DEDUCTIONS 1990-2001

YEAR	NON-ALLOWABLE DEDUCTIONS $Millions
1990-91	2
1991-92	7
1992-93	54
1993-94	54
1994-95	176
1995-96	288
1996-97	666
1997-98	1100
1998-99	1500
1999-2000	527
2000-01	121

1.18 The $527 million for non-allowable deductions in 1999-2000 represents a two-thirds reduction compared with the previous year of $1.5 billion. In one sense, this amounts to a dramatic drop in deductions and lends support to the ATO's theory that its actions have brought about a 'voluntary compliance' effect. That is, it appears that many taxpayers who invested in mass marketed schemes have opted out of this market or switched to investing in legitimate arrangements (such as schemes with Product Rulings, for instance).

1.19 However, when compared against deduction levels for the preceding decade, the $527 million is significantly more than the level of claimed deductions for the 1990-1995 period, that is, the period before the 'outbreak' in scheme deductions from 1996 to 1999. Even the preliminary figure of $121 million for 2000-2001 represents a relatively high level of non-allowable deductions compared with the early 1990s.

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[13] Figures for 1990-91 to 1997-98 are based on ATO Submission No. 845B, Attachment 1. Figures for 1998-99 onwards are based on ATO Additional Information 19 September 2001, p.3.

However, the large falls in recent years do indicate that the action by the ATO is having results.

1.20 In interpreting the trends suggested by recent levels of non-allowable deductions, the ATO stated to the Committee:

> We have been seeing a move towards a lesser number of participants in new schemes, but a higher level of deductions claimed by each taxpayer.[14]

1.21 This is consistent with the conclusion of the ATO internal evaluation of June 2000 (cited above), that the remaining problem appears to be 'a small group of habitual avoiders' – both promoters and taxpayers – engaged in aggressive tax planning and prepared, it would seem to the Committee, to brazen out the ATO's attack on this activity.

1.22 The trend towards fewer participants but higher non-allowable deductions per taxpayer, when taken with the significant fall in overall deduction levels, also suggests that the market for 'mass' or large-scale schemes has shrunk significantly while the more specialised, 'boutique' end of the market for 'habitual avoiders' and high-risk gameplayers remains a problem.

1.23 The Committee considers that the continued significant level of non-allowable deductions has several important implications for the integrity of the tax system and the ATO's management of compliance risks. The Committee explores these, first, in relation to the promoter industry and targeting habitual avoiders, before examining ATO approaches to communicating with the market and risk management.

Promoter industry

1.24 The ongoing introduction of new abusive schemes onto the market place, as reflected in continuing significant levels of non-allowable deductions, tends to support the ATO view that 'the growth of a highly competitive entrepreneurial promoter market … has been the most significant driver of the growth in aggressive tax planning'.[15]

1.25 Assuming the ATO is correct in saying that schemes with non-recourse financing and round robin features are declining, then the emergence of new schemes suggests that promoters are devising new forms of artificial tax planning, or redesigning old models, to circumvent the ATO. According to the Commissioner:

> I would like to be able to say that we have put schemes, and the actions of promoters, behind us. I cannot. …
>
> We continue to see the emergence of so-called 'boutique schemes' which are tailored to the circumstances of larger corporates and high income

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14 ATO Additional Information 19 September 2001, p.3.

15 Evidence, p.795.

> individuals. But stripped bare of their more sophisticated sounding features and offsetting transactions, you are left with something very akin to the mass marketed schemes, inflated deductions claimed where the economic return is substantially reliant on the claimed tax benefit. Recent film schemes are examples of this.[16]

1.26 In addition to film schemes, the ATO has also detected a rise in deduction claims for schemes based on retirement villages.[17]

1.27 The continued marketing of abusive schemes in the face of ATO counter-measures highlights the need for adopting and applying sanctions that target aggressive tax planners and promoters. In particular, the Committee sees the proposal that the ATO be given powers to apply to the courts for 'injunctive relief' to stop investments in abusive arrangements contrary to the law as an important measure.[18]

1.28 The ability to seek a court injunction on the marketing and selling of tax abusive schemes would equip the ATO with the power and flexibility to respond quickly to market developments before they gained momentum and got out of hand. Such powers would help prevent a recurrence of the 'outbreak' experienced with mass marketed schemes in the mid-1990s.

1.29 The ATO's capacity to bring a matter of concern to the courts in this fashion would also send a strong and unequivocal message to the market and, in particular, the adviser industry. As is discussed later in this Chapter, being able to escalate its concerns to the level of the courts would provide the ATO with an important channel for signalling to the market that it is serious about its concerns and prepared to stand by them in court. Such a move would help dispel any notion that the ATO was avoiding having its position tested at law, as has been one of the views in currency among adviser-investor circles involved in the mass marketed schemes episode.

Recommendation

1.30 The Committee recommends that the Government provide the ATO with the necessary powers to enable it to apply to the courts for injunctive relief to prevent the marketing of and investment in tax abusive arrangements contrary to the law.

Targeting habitual tax avoiders

1.31 The Committee shares the ATO's concern about (in the ATO's words) the 'unacceptably high' level of ongoing non-allowable deductions. While the latest figures suggest that compliance risk with *mass* marketed schemes is significantly on the wane, the presence of a core group of 'habitual' avoiders participating in more sophisticated arrangements is disturbing.

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16 Evidence, p.798.

17 ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.35.

18 See the Commissioner's statement to the Committee, Evidence, p.798.

1.32 The persistent involvement of this taxpayer segment with aggressive promoters and schemes presents a particular challenge to the ATO. It appears that the broad-gauge measures used by the ATO to manage the compliance risk associated with large-scale mass marketed schemes may be less effective in addressing the tax planning behaviours of habitual avoiders. A more targeted approach would seem necessary for tackling these scheme participants.

1.33 The Committee believes that targeted strategies that have proven successful with comparable taxpayer segments may provide useful models for the schemes arena. In particular, the compliance strategies used in relation to High Wealth Individuals (HWIs) could serve as starting point for developing appropriate measures. Some of the approaches trialed effectively with HWIs have already been adopted for scheme participants. For example, the ATO is using expanded tax returns (now called current year data collection)[19] for taxpayers and promoters with two or more years participation in schemes as a means of enhancing its intelligence on market developments and tax planning techniques in this area.

1.34 To some degree the ATO is involved in a battle of attrition with habitual participants in sophisticated aggressive tax arrangements. By definition, this group appears willing to 'tough it out' in gameplaying with the ATO. The co-existence of this taxpayer segment and an aggressive promoter market points to the need for the ATO to adopt a mix of strategies that addresses both the supply-side and demand-side of this compliance problem. To combat the particular compliance risks that these groups pose will require the ATO to adopt both a long-term approach to seemingly ingrained non-compliance behaviours and one that can respond flexibly to new tax planning strategies.

1.35 The Committee discusses some broader perspectives on taxpayer cultures and compliance strategies in Chapter 2.

ATO communications strategies: warning the market?

1.36 In the Interim Report of June 2001 the Committee raised some concerns about the clarity of ATO statements and signals to the market before it moved to disallow scheme deductions in late 1997. In this report the Committee is mainly interested in finding ways of improving the ATO's communication with the market, particularly tax practitioners.

1.37 In Chapter 3 the Committee discusses the views of tax professionals towards the ATO signals on matters of law.

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[19] See the discussion on information and intelligence collection in the section on risk management later in the Chapter.

Effective signalling?

1.38 The ATO has maintained that it signalled its concerns about abusive features of schemes prior to the dramatic rise in mass marketed schemes in 1996-98. The ATO has pointed to the combination of public statements and audits on schemes that, it believed, should have at least put the market on notice that it had reservations about the legitimacy of these arrangements.[20]

1.39 Apart from the concerns mentioned in the Interim Report, the Committee questions whether the ATO's auditing of schemes and subsequent disallowance of deductions during the late 1980s and early 1990s was widely known among the ranks of the tax profession, let alone the market place. For example, one of the barristers who provided advice to scheme promoters, Mr Robert O'Connor QC, told the Committee that he was not aware that the Commissioner had disallowed deductions in the audited schemes.[21]

1.40 In the Committee's view, targeting promoter networks and their trusted advisers with field audits should have put this group on caution. But it is doubtful that news of ATO audit activity would have percolated to the middle and small tier advisory and accounting firms upon whom many of the 'average' taxpayers caught up in schemes relied.

1.41 With the benefit of hindsight, the Committee considers that a stronger signal would have been sent if the ATO had moved earlier in taking its concerns about schemes to the courts. Such a dramatic step would have been more difficult for tax practitioners to ignore, in addition to being a significant warning shot for aggressive promoters. The publicity surrounding a court action might also have alerted many investors to the ATO's concerns. It would have dispelled the notion that the ATO was attempting to change the law by way of 'fiat', or was avoiding having its position tested in the courts.

1.42 In terms of communicating its concerns to the taxpayer community, the Australian National Audit Office suggested that an effective ATO strategy would involve a mix of audit activity and educational programs. Such an approach might involve the ATO:

> sitting down and saying, 'It seems like we've got a problem in this particular area; we'd better start educating taxpayers and the general community in our expectations of them.' That could be done by putting out through speeches or through education campaigns that there is a concern with mass marketed schemes. It would not just be a case of going in there, doing audits and applying penalties.[22]

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20 See, for instance, ATO Additional Information 22 May 2001, pp.4-5.

21 Evidence, p.735.

22 Evidence, pp.707-708.

1.43 The Committee notes that the approach suggested by the ANAO reflects, to a large extent, the ATO's response to mass marketed schemes from 1998 onwards.[23] In addition to the action taken to disallow deductions, the ATO issued a number of speeches and media releases that attracted media coverage.[24] The ATO's position on aggressive tax planning in general and mass marketed schemes in particular has been a recurring theme in the Commissioner's and other senior officer speeches since 1998.[25]

1.44 Most importantly, the ATO introduced the Product Ruling system which provides for both promoters, advisers and investors alike the ATO's view on the tax benefits of investment products. Many witnesses, particularly those from the professional bodies, support the Product Ruling system for providing certainty on the tax implications of schemes. The system has also made it harder for aggressive, 'rogue' promoters and advisers to market schemes that do not have a product ruling. According to the Australian Forest Growers:

> The ATO's product ruling system has proven to be a very constructive initiative, supported by the managed investment industries, investors, accountants and advisers. Product rulings have become a standard reference for inclusion in a prospectus – without a product ruling, it is now much more difficult to attract investors. Product rulings also provide the ATO with an efficient mechanism for monitoring 'tax effective' schemes.[26]

Early warning to the market and taxpayers

1.45 The Committee has previously suggested that another way of providing certainty would be for the ATO to provide early warning to the market and community of its concerns about the tax effects of certain arrangements, even in instances where it has yet to reach a concluded view.[27] While it recognises the risks of the ATO acting precipitately and possibly distorting the market, the Committee nonetheless believes that the benefits of early warning outweigh the costs of either precipitate or, more importantly, delayed action.

1.46 It is evident that a number of peak tax bodies, such as the Institute of Chartered Accountants of Australia (ICAA) and the Taxation Institute of Australia (TIA), also see it as preferable that the ATO provide early warning to professional

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23 The ANAO framed its suggestion by referring to the ATO Compliance Model, which is discussed in Chapter 3.

24 See ATO Submission No. 845, Attachments A and B.

25 For example, Michael Carmody, Commissioner of Taxation, 'Taxation…Current Issues and Future Directions', Speech to the Australian Institute of Company Directors, Perth, 1 May 2001. See also Michael O'Neill, Assistant Commissioner of Taxation, 'Taxes, Death & Civilisation: A look at year end "tax effective products"', 15 May 2001, http://www.ato.gov.au/content.asp?doc=/content/corporate/sp200103.htm (6 June 2001).

26 Submission No. 851, p.16.

27 Senate Economics References Committee, *Report on the Inquiry into the Operation of the Australian Taxation Office*, March 2000, pp.36-37.

bodies of its concerns about particular arrangements, including in cases where the ATO's views are only preliminary.[28]

1.47 The Committee therefore endorses the Commissioner's recent statement that the ATO intends to develop procedures to issue early public advice of its concerns about the tax issues around financial products and other arrangements. In evidence to the Committee, the Commissioner outlined the ATO's current thinking on this issue:

> at what point do we go public in expressing our concerns about particular arrangements? Going early has the advantage of putting people on notice that we may disagree as to claimed tax benefits. On the other hand, going before we have full details and are able to come to a concluded view runs the risk of commercial damage to what may prove to be a legitimate product. We have now concluded that the weight of public interest is in going earlier. For this purpose we will be developing appropriate protocols in doing that.[29]

1.48 Since making that statement the ATO has established an early warning system. On 20 December 2001 the Commissioner announced that the ATO would be issuing a Taxpayer Alert bulletin 'when we have concerns about particular arrangements but have not come to a concluded view'. The Commissioner also said that 'the Taxpayer Alerts will warn taxpayers and tax advisers that the Tax Office may not agree with the tax benefits being claimed in respect of a particular arrangement'.[30] Taxpayer Alerts can be accessed on the ATO's website.[31]

1.49 The ATO published its first Taxpayer Alert on the same day as the Commissioner's announcement. The alert addressed a home loan unit trust arrangement that the ATO said 'appears to be about seeking deductions for essentially private expenditure'.[32]

1.50 The Committee is pleased to note that, while Taxpayer Alerts will not cover all tax planning issues under ATO scrutiny, the system is intended to give early warning of 'significant and new emerging tax planning issues' under ATO risk assessment. The experience with the outbreak of mass marketed schemes in the mid-1990s highlights the importance of the ATO moving as early as possible to alert the market about new and emerging arrangements that it considers are tax abusive.

1.51 The Committee considers that the ATO's communications could be further enhanced by establishing formal procedures for indicating its view with tax professionals through peak bodies and other forums. The gaps in communication with

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28 See National Tax Liaison Group, Minutes 9 March 2001 meeting, p.14.

29 Evidence, p.799.

30 ATO, 'Early Warning – Taxpayer Alerts', Media Release – Nat01/89, 20 December 2001.

31 See www.ato.gov.au.

32 Taxpayer Alert TA 2001/1, http://law.ato.gov.au/atolaw/view.htm?docid=TPA/TA20011/NAT/ATO/00001.

the market during the mass marketed schemes experience point to the need for a formalised and targeted approach to communicating with tax professionals, rather than relying on word of mouth. The ATO's current efforts to develop, through the National Tax Liaison Group (NTLG),[33] cooperative arrangements with professional bodies in relation to aggressive tax planning indicate one avenue by which formal channels of communication could be established.[34]

Recommendation

1.52 The Committee recommends that, to strengthen lines of communication with the tax industry and market, the ATO establish formal procedures for indicating its concerns about emerging compliance risks through peak bodies and other forums such as the National Tax Liaison Group.

TaxPack warning

1.53 The Committee also believes that the ATO should include information on tax effective schemes in the annual *TaxPack*. As one of the direct channels of communication between the ATO and most individual taxpayers, the *TaxPack* should be used as a key link in ATO strategies to educate taxpayers on tax issues of concern.

1.54 Although the scale of the compliance risk associated with the schemes market has declined, the continued marketing of tax abusive schemes means that taxpayers need to remain on guard. The Committee considers that it is still necessary for the ATO to remind taxpayers of the need to tread carefully when considering investing in arrangements which claim to have tax benefits.

1.55 Communicating directly with taxpayers via the *TaxPack* would complement and reinforce the ATO's overall information and awareness-raising strategies on tax effective schemes. Those strategies have been effective in attracting media coverage and reaching target groups such as tax professionals and scheme participants. The ATO's webpage also contains important information relating to its concerns about tax-driven schemes, including regular updates on relevant developments.

1.56 Although these are necessary elements in the ATO's campaign on the issue, it is likely that sections of the community are not aware of this information or are unable to access it (eg, because they do not have internet access or are hesitant to approach the ATO). The ATO should therefore use the *TaxPack* to maximise the coverage and reach of its awareness campaigns on issues of concern such as those relating to schemes.

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33 In addition to the ATO and Treasury, the NTLG comprises representatives from the Taxation Institute of Australia; Certified Practicing Accountants; Institute of Chartered Accountants of Australia; Association Of Taxation Management Accountants; National Institute of Accountants; National Tax and Accountants Association; Taxpayers Association; and the Law Council of Australia.

34 See National Tax Liaison Group, Minutes 9 March 2001 meeting, pp.12-15.

1.57 In particular, the attention of taxpayers should be drawn to the following matters relating to tax effective schemes:

- the ATO's general concerns and position on scheme arrangements;
- the importance of Product Rulings in providing certainty;
- the penalty and interest charges that can result from ATO disallowance of non-allowable deductions;
- the fact that ATO payment of tax refunds does not mean that the ATO has *approved* the reason for the refund; and
- the ATO's legal power to investigate the validity of tax returns within varying prescribed time frames, as well as the reasons why these powers are necessary to protect the integrity of the tax base under a self assessment system.

1.58 In the Committee's view, it is crucial that the last two points – that a refund does not amount to ATO approval and the powers of review available to the ATO and period over which they apply – are highlighted in *TaxPack* information on schemes. Much of the violent taxpayer backlash against the ATO's disallowance of mass marketed schemes deductions springs from a pervasive failing by taxpayers to understand these basic features of the self assessment system. As the Committee and the Commonwealth Ombudsman have stated previously, the ATO needs to strive to raise the level of understanding among the community on these fundamentals of the Australian tax system.

Recommendation

1.59 The Committee recommends that the ATO include information about tax effective schemes in the *TaxPack* to improve general taxpayer awareness of the issues and potential risks surrounding tax effective schemes. This information should highlight the ATO's powers at law to review tax returns after deductions have been paid.

Risk Management Strategy

1.60 This section examines the ATO's management of the risk posed by mass marketed schemes.

1.61 It is crucial for risk identification, pre-emption where possible and action if necessary that the ATO's risk management strategy works effectively. A sound risk management framework involves, among other things, the following key features:

- monitoring and reassessment of existing risk areas;
- sampling and intelligence gathering to identify emerging risks;
- developing strategies to deal with the identified risks (also called risk treatment); and

- continual monitoring and review of risks.[35]

1.62 As outlined in its Interim Report, the Committee identified some problems with the ATO's management of the risks presented by mass marketed schemes in the early to mid 1990s. These related primarily to a seeming lack of coordination among the various arms of the ATO dealing with risk identification, analysis of intelligence and audit findings, and treatment of the scheme related risks.

1.63 The Committee discussed its concern about these matters with the Australian National Audit Office. The ANAO has done a number of performance audits of ATO risk management in specific areas of its operations,[36] beginning with an audit of the ATO's overall risk management framework in 1996-97.[37] Although the ANAO has not audited ATO operations in relation to mass marketed schemes, the Committee considered that its understanding of ATO approaches and practice would provide an insight into the state of ATO risk management in the early and mid 1990s.

1.64 The ANAO reported that, from 1987 to around 1994-95, the ATO was gradually developing risk management techniques in response to the introduction of self assessment. However, at this stage the ATO's approach was neither a holistic nor a formal process. In 1994-95, the ATO formalised its processes to attempt to 'identify and deal with risks at the highest level'.[38]

1.65 The ANAO's 1996-97 audit of ATO risk management concluded that while the ATO framework was close to 'cutting edge' within the public sector, 'they had a long way to go in actually capturing all the risks and putting some priority back into business operations'.[39] Three key areas were earmarked for attention:

- improving the consistency and transparency of the risk management process and resulting decisions;
- conducting a more comprehensive and better documented risk identification and assessment of risk; and
- adopting a better coordinated and holistic approach to treating high priority risks.[40]

1.66 The Committee notes, for example, that the lack of effective processes in these areas would explain, among other things, the ANAO's 1996-97 audit findings

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35 These principles were derived from the following ANAO reports: ANAO, *Risk Management in ATO Small Business Income*, Audit Report No.37 1997-98; ANAO, *Risk Management of Individual Taxpayers Refunds*, Audit Report No.27 1999-2000 and ANAO, *Risk Management in Commercial Compliance: Australian Customs Service*, Audit Report No.6 1997-98.

36 See the footnote above.

37 ANAO, *Risk Management: Australian Taxation Office*, Audit Report No.37 1996-97.

38 Evidence, p.705.

39 Evidence, p.704.

40 Evidence, p.706.

that there were communication gaps between local offices and the ATO central office such that 'not all the information was filtering to the top' of the ATO.[41] This is a problem common to large organisations, especially ones with a network of branch and local offices. However, it is also consistent with the Committee's finding from an earlier inquiry that indicated a tendency of the ATO central office to ignore or overlook intelligence from local and regional offices on emerging or localised risks.[42]

1.67 Encouragingly, the ATO's adoption of a formalised risk management strategy coincided with and was arguably responsible for a coordinated and proportionate response to a crucial local level intelligence alert. This was the alert that galvanised the ATO into escalating its approach to mass marketed schemes.

1.68 In March 1996 the Northbridge office of the ATO's Strategic and Research Analysis Unit in WA,[43] using data from locally processed 221D instalment variations, reported on the emerging compliance risk with franchise schemes using limited recourse financing.[44] It rated the risk to the revenue as '*high* and potentially *very high*'.[45]

1.69 This report set wheels in motion within the ATO that led to the establishment, under a senior level officer, of the national project team that coordinated an office-wide approach to improving the ATO's understanding of mass marketed schemes and responding to them.[46]

1.70 The Committee notes that since commencing action against mass marketed schemes the ATO has gone on to establish a management framework designed better to coordinate related activities dealing with aggressive tax planning in general. ATO functions dealing with Strategic Intelligence and Analysis and Tax Planners (as well as the High Wealth Individuals Taskforce) come under the control of a First Assistant Commissioner. The same First Assistant Commissioner also co-chairs the ATO Aggressive Tax Planning Steering Committee.[47] The ANAO has approved of this corporate governance framework.

1.71 The ATO has also centralised responsibility and coordination for monitoring new and emerging mass marketed schemes in its Pultney Office in Adelaide. A range of intelligence and information sources is used to provide coverage of market

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41 Evidence, p.708.

42 See Senate Economics References Committee, *Report on the Inquiry into the Operation of the Australian Taxation Office*, March 2000, pp.81-83.

43 SRA was the forerunner of the Strategic Intelligence and Analysis Unit.

44 SRA, 'Limited Recourse Financing: Discussion Paper', in ATO Additional Information 22 May 2001.

45 SRA, 'Limited Recourse Financing: Discussion Paper', p.8, italics in original.

46 It also led to improvements in data capture with 221D forms in order to provide the ATO with 'early intelligence on schemes'. See ATO National Office Minute, 21 August 1997, in ATO Additional Information 22 May 2001.

47 As reported in ANAO, *High Wealth Individuals Taskforce: ATO*, Audit Report No. 46, 1999-2000, p.46.

developments. For example, the ATO detected 98 new schemes for the 1998-99 financial year based on information from, among other things, Current Year Data Collection,[48] Strategic Intelligence Analysis, High Risk Refund checking,[49] applications for 221D variations and private binding rulings, and the High Wealth Individuals area.[50]

1.72 In addition, the ATO is developing a 'real time intelligence' capacity to provide it with early warning of compliance risks. This real time strategy includes seeking information on current tax planning techniques from accounting and legal firms, financial institutions and other elements of the tax and finance industry.[51]

1.73 This ability to capture information on new schemes suggests significant improvements in the ATO's ability to monitor market developments and detect emerging compliance risks. In particular, the use of private binding ruling applications to detect potentially risky schemes is in marked contrast to the pre-1998 period where a small number of applications not only failed to trigger alarm bells within the ATO but even led at times to positive ATO rulings. It also provides some support for ATO assurances that it has moved more onto the front foot in addressing risks before they escalate to alarming levels.[52]

1.74 The enhanced intelligence capability that comes from using a wide range of information sources also demonstrates the benefits of grouping related activities under a central management structure. The Committee believes that this approach is consistent with sound risk management principles and ANAO recommendations for the ATO to employ more comprehensive and coordinated measures for risk identification and assessment.

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48 Current Year Data Collection requires taxpayers involved in mass marketed schemes for two or more years to provide early lodgement of expanded responses to an ATO questionnaire. It captures both scheme participants and promoters.

49 High Risk Refund checking involves close scrutiny of large refund cases and more detailed investigation where suspect cases are detected.

50 ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.34.

51 Evidence, p.799.

52 Evidence, p.2 and p.485.

CHAPTER 2

CULTURES AND COMPLIANCE

Introduction

2.1 The Committee's reports thus far have focused on the specific measures taken by the regulatory authorities in response to mass marketed schemes, and on the extent to which further action or regulation is required in order to resolve the current problems and to curb future outbreaks of aggressive tax planning.

2.2 The academic literature on regulation and citizen compliance with taxation law, however, increasingly recognises that regulatory enforcement is only one, and not necessarily the most effective way of achieving a desired outcome. Or, putting the point differently, it recognises that tax planning and paying behaviours arise out of particular contexts or cultures. Understanding and addressing the political, social and psychological background of those behaviours may assist agencies to promote compliance far more effectively, than an approach which relies purely on the threat of enforcement or punishment.

2.3 In this Chapter, the Committee briefly outlines some of the theoretical findings on the relationship between cultures and compliance. It then analyses evidence from those involved in mass marketed schemes with a view to understanding how cultural factors affected choices to participate and responses to the ATO's action.

2.4 Finally, the Committee discusses the Commissioner's recent statements concerning the responsibility of the wider community of taxation professionals for the integrity of the tax system, the response of that community, and the extent to which appeals of that sort can be relied upon to promote a culture of compliance in relation to taxation matters.

Modelling compliance

2.5 A key issue for taxation agencies is the efficacy of punishment or deterrence versus that of persuasion or compliance in ensuring taxpayer conformity to the law. Research on regulation in a range of fields indicates that, in tax matters as in many others, a 'mix' of the two approaches produces the best outcome.[1]

2.6 One kind of theoretical model for such a mix is known as a 'regulatory pyramid'. As a result of the work of the Cash Economy Taskforce in 1997-98, the

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[1] Valerie Braithwaite and John Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in *Crimes of Privilege: Readings in White-Collar Crime*, eds. Neal Shover and John Paul Wright (New York: Oxford University Press, 2001), p.406.

ATO has adopted such a regulatory pyramid as its Compliance Model for all ATO operations.[2]

2.7 The premise of the pyramid is that regulatory action relies upon a broad base of voluntary taxpayer compliance and self-regulation, with the role of the ATO being to promote taxpayer understanding and acceptance of obligations. As the pyramid climbs and narrows towards the apex, taxpayer 'postures' or attitudes harden from acceptance to capture, to resistance and finally disengagement. The role of the ATO in managing those postures alters correspondingly, escalating through a range of sanctions to the final option of prosecution at the top. Academics from the Centre of Tax System Integrity, a joint research project involving the Australian National University and the ATO, have argued:

> Regulatory pyramids provide tax officers a set of tools that can be applied without regard to reasons for noncompliance. One starts with the expectation of cooperation, and escalation on the pyramid occurs only when one or the other becomes noncooperative or defaults.[3]

2.8 An important feature of the ATO's Compliance Model is its capacity to explain the dynamic nature of the relationship between taxpayer motivations and attitudes, and regulatory sanctions.

2.9 As noted earlier, the model posits four 'motivational postures' that may be adopted by taxpayers.

2.10 There are two 'compliant' postures, namely the postures of accommodation and capture. 'Accommodation' involves a deliberate and conscious commitment to fulfilling one's obligations under the taxation law, while 'capture' involves accepting one's taxation obligations, without necessarily embracing them or having a particular view about their value.

2.11 These two compliant postures are mirrored by the two non-compliant postures of 'resistance' and 'disengagement'. 'Resistance' is a confrontational approach to tax officers and the tax system, which sees the tax system as burdensome, oppressive and, perhaps, unfair. 'Disengagement' is like resistance, but incorporates a 'spirit of hopelessness' in addition. 'The state of disengagement is accompanied by non-

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2 Valerie Braithwaite and John Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in *Crimes of Privilege: Readings in White-Collar Crime*, eds. Neal Shover and John Paul Wright (New York: Oxford University Press, 2001), p.406. See also, Senate Economics References Committee, *Inquiry into the Operation of the Australian Taxation Office*, March 2000, p.11 and Appendix 3.

3 Valerie Braithwaite and John Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in *Crimes of Privilege: Readings in White-Collar Crime*, eds. Neal Shover and John Paul Wright (New York: Oxford University Press, 2001), p.410.

responsiveness … Cynicism about the tax system is likely to be matched by cynicism about the power of government'.[4]

2.12 The research suggests that individuals whose attitudes are characterised by accommodation and capture feel part of the regulatory community. Those who resist feel apart from the community but still want to feel respected by it, whereas those who are disengaged experience a 'psychological separation' from the community without feelings of loss.

2.13 According to this model, a serious difficulty for the regulator is that its own attempts to ensure compliance may result in taxpayer attitudes hardening through this scale and thus in taxpayers being less inclined to see themselves as part of and respected by the regulatory community. Thus:

> As regulators expose behaviour that is non-compliant, those being regulated protect themselves from disapproval by placing more social distance between themselves and their accusers. Through construing the situation in terms of 'us' and 'them', the non-compliers are able to hide in the safety of an identity that is at odds with the 'demonic' other. To sustain this protective mechanism, the social rift must be allowed to continue and grow. When non-compliers pursue this path, cooperative resolution of the problem is difficult. The challenge for the regulator then becomes one of changing the motivational posture.[5]

2.14 Importantly in the context of this inquiry, the research further indicates that:

> To the extent that social rift is manufactured through feelings of shame, offering cooperation displays the elements of social reintegration that are a necessary part of eliciting compliance in the future. Offering cooperation to resistant and disengaged non-compliers, however, may not always be the response that regulators feel like making. If regulators respond to resistance and disengagement in a like manner, they may exacerbate the social rift already in existence.[6]

2.15 The explanatory power of this model seems confirmed in many respects by the evidence to this inquiry. In the following section, the Committee employs the

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4 Valerie Braithwaite and John Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in *Crimes of Privilege: Readings in White-Collar Crime*, eds. Neal Shover and John Paul Wright (New York: Oxford University Press, 2001), pp.410-411.

5 Valerie Braithwaite and John Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in *Crimes of Privilege: Readings in White-Collar Crime*, eds. Neal Shover and John Paul Wright (New York: Oxford University Press, 2001), p.411.

6 Valerie Braithwaite and John Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in *Crimes of Privilege: Readings in White-Collar Crime*, eds. Neal Shover and John Paul Wright (New York: Oxford University Press, 2001), p.412.

ATO's Compliance Model in attempting to analyse more fully aspects of the climate in which tax effective schemes were mass marketed and to characterise the climate which has developed since the ATO's crackdown.

Culture of scheme participants

2.16 Overwhelmingly, participants whose deductions have been disallowed by the ATO told the Committee that they had always been, and had prided themselves on being, 'good' taxpayers. They said that their motives for participating in schemes could be entirely explained in terms of their desire for a long-term investment income, their desire to provide for their own retirements and to invest in Australian industries, particularly rural industries.

2.17 For example, Mr Peter and Mrs Linda Southern wrote that:

> …[we] have been enthusiastic supporters on 'buy Australian' schemes … We have always paid our taxes on time and are happy to do so, realising that this money is used to keep this country great in providing infrastructure etc.[7]

2.18 Mrs Geraldine and Mr Roger Farr submitted:

> As 'babyboomers' we have been constantly urged by politicians, academics and the media to attempt to provide for our own retirements … Like so many other families who invested in Budplan, we invested in good faith expecting an opportunity to grow our nest egg for the future.[8]

2.19 Mr Michael McGinty explained:

> As a law abiding tax paying Australian citizen I saw Budplan as an opportunity to become involved in a project which could not only provide a good investment return but also create wealth and intellectual property for this country.[9]

2.20 These quotations represent a tiny sample, selected almost at random, from the close to 900 submissions received by the Committee. The sentiments expressed in them could be multiplied more or less indefinitely.

2.21 In terms of the ATO's Compliance Model, these participants represent themselves as having had 'compliant' attitudes towards their taxation obligations. That is, their attitudes or 'motivational postures' were, at worst, postures of 'capture',

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7 Mr Peter and Mrs Linda Southern, Submission No. 415, p.1.

8 Mrs Geraldine and Mr Roger Farr, Submission No. 405, p.1.

9 Mr Michael McGinty, Submission No. 401, p.1.

and, at best, postures of 'accommodation'. On these accounts, the 'tax effectiveness' of the schemes was not a significant factor in participants' decisions to invest.

2.22 One witness, however, questioned whether participants' characterisation of their pre-scheme attitudes to taxpaying were entirely accurate. Mr Rick Shenton, who sold schemes extensively in Western Australia, told the Committee:

> When people give information to this Committee sometimes the truth and they themselves do not sit in the same seat and their recollections are convenient recollections because they feel sorry for themselves, they need to tell lies or they have to blame somebody else.[10]

2.23 Speaking of his experience in selling scheme participations at mine sites in Western Australia, Mr Shenton claimed that the prospect of a substantial tax refund 'had these clients crawling'. He said:

> I was going to mines at 8 o'clock at night and was still working at 6 o'clock the next night – honest to God! One lady in a mine … was actually bringing people to me on the half hour. They were queuing up. There was almost a fight at one stage because one man was in a queue half an hour after he thought he should have been seen. You can imagine that a $10,000 refund is a lot of money, because you have got to realise that most of these people, even against the evidence that they have given you, might earn $80,000 a year and pay $30,000 tax, but they usually spend $55,000 a year. They have usually got credit cards and a four-wheel drive or whatever, and they are usually up to their ears in debt. Desperation breeds lack of judgement.[11]

2.24 On this account, it seems unlikely that all individuals who chose to participate in this sort of scheme could be described as having motivational postures of 'accommodation' towards their taxation obligations. At best, they seem to have been 'captured' and prepared to accept an offer of 'freedom' if assured of the legality of the alternative. There may even have been an overlaying element of 'resistance' to the loss of 'hard earned income' to taxation and a preparedness to avoid such loss if possible.

2.25 The Committee notes that generalisations about the 'motivational postures' held by individuals are difficult to make and may be misleading. In particular, different kinds of scheme may have appealed to very different underlying values or sets of motivation, and the Committee does not assume that Mr Shenton's account of the attitude of some participants can be extrapolated to all.

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10 In-camera evidence, p.15.

11 In-camera evidence, p.14. That many scheme participations were sold in terms of their tax benefits is also confirmed by the sales pitch to be used for selling at least one of the mass marketed schemes. See Evidence, pp.794-797.

2.26 The evidence to the inquiry indicates that, by and large, participants want to see themselves as law-abiding citizens and as part of the regulatory community. This is true whether or not, as Mr Shenton suggests, some individuals are retrospectively 'dressing up' or excusing what they did, and indeed would explain why such 'dressing up' is required.

2.27 That desire then seems to go a large way to explaining the acute sense of outrage and shock experienced by participants at being labelled 'tax cheats' or 'avoiders' because of the ATO's crackdown on schemes. Such labelling, according to the testimony of many witnesses, has dislocated their sense of their own identity and their sense of connection with the broader taxpaying community.

2.28 From the point of view of future compliance, the danger posed by this dislocation is that participants move out of the motivational posture of 'compliance' into postures of resistance and disengagement. In the words of John and Valerie Braithwaite, quoted earlier:

> As regulators expose behaviour that is non-compliant, those being regulated protect themselves from disapproval by placing more social distance between themselves and their accusers. Through construing the situation in terms of 'us' and 'them', the non-compliers are able to hide in the safety of an identity that is at odds with the 'demonic' other.

2.29 Many participants express just such feelings of 'social distance' between themselves and the regulator, as well as a sense of loss of trust in the institutions of government. For example, Mr Michael McGinty began his submission in the following way:

> The Australian Tax Office, the Commissioner of Taxation and the Deputy Commissioner of Taxation, Mr Steve Chapman, have classified me as a tax cheat.
>
> **I AM NOT A TAX CHEAT!**
>
> I am writing this letter in the hope that my situation, as small and insignificant as it may be, may be heard without prejudice, disinterest or ulterior motive.[12]

2.30 Other participants wrote to the Committee of their 'extreme distress and bewilderment regarding the treatment afforded us by the Australian Taxation Office'. The Farr family wrote that:

> … we find we are labelled tax cheats by the ATO as it relentlessly pursues us, along with all other hapless Budplan investors … It is

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12 Mr Michael McGinty, Submission No. 401, p.1.

> difficult to fully convey the pain and embarrassment the actions of the ATO have caused us. I beseech you to consider the disastrous impact of this whole attack upon our personal integrity and financial position on our family and thousands of other well meaning Australians.[13]

2.31 Mr Ian Parkinson said 'I am very disillusioned, concerned and disappointed in our Australian Bureaucracy [for] leaving the ATO to weave its path of destruction'[14], while Mr Peter and Mrs Linda Southern wrote 'to express our disdain for the ATO in its labelling of investors in so-called "tax effective investments" as tax cheats'.[15]

2.32 In terms of the ATO's Compliance Model these expressions of disillusionment, disdain, disappointment and unfairness indicate postures of resistance tending towards disengagement on the part of these taxpayers. This supports the theory that:

> When sanctioning strategies communicate increasing disapproval to the taxpayer, the social rift between non-compliers and the regulatory culture likely increases, and the entrenchment of non-compliant regulatory postures is more likely to follow.[16]

2.33 The challenge for the ATO, then, is to try to re-establish a dialogue with scheme participants, such that interaction between the two parties can be resumed as soon as possible at the bottom of the pyramid.

2.34 The Committee notes that a complication for the ATO in this regard may be that aspects of the organisation's own culture tend towards the escalation of strong enforcement behaviour rather than towards cooperation with perceived non-compliers.

2.35 The Committee received only very limited and anecdotal evidence about the ATO's internal culture. However, that evidence did suggest the possibility that there may be tensions within the organisation between an older regulatory culture of enforcement and deterrence, and a newer culture of cooperation and dialogue in the ATO. For example, in reporting on the work of the Cash Economy Task Force, from which the ATO's Compliance Model emerged, researchers observed:

> Setting out styles of regulatory interaction was important for ATO staff. Different groups dealt with problems at different levels, and

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13 Mrs Geraldine and Mr Roger Farr, Submission No. 405, p.1.

14 Mr Ian Parkinson, Submission No. 412, p.1.

15 Mr Peter and Mrs Linda Southern, Submission No. 415, p.1.

16 Valerie Braithwaite and John Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in *Crimes of Privilege: Readings in White-Collar Crime*, eds. Neal Shover and John Paul Wright (New York: Oxford University Press, 2001), pp.413-414.

> each group had its own culture and set of beliefs as to the 'correct' regulatory style.[17]

2.36 The Committee notes that through its collaboration in the Centre for Tax System Integrity, the ATO is actively researching ways of working with taxpayers to achieve compliance through cooperation rather than punishment. In particular, the Committee notes the significance of current research into the reintegration into the regulatory community of taxpayers bruised by their experience of the ATO in its crackdown on mass marketed tax effective schemes.

2.37 The Committee commends the ATO for the initiative and creativity of its approach to compliance issues and to trying to improve its relationships with the taxpaying community.

Culture of taxation professionals

2.38 The ATO's Compliance Model focuses on the motivational postures of the general taxpaying community. Recently, the ATO has also turned its attention to the attitudes of the community of tax professionals. To borrow again from the Compliance Model, the ATO has seemingly been attempting to promote a culture of 'accommodation' amongst that group.

2.39 In speeches to the community of taxation professionals, Mr Carmody and other ATO officers have asked that community to consider its role in maintaining the integrity of the tax system and have asked for its help in monitoring and controlling the activities of aggressive tax planners. [18]

2.40 For example, in a speech to the Taxation Institute of Australia, Assistant Commissioner Michael O'Neill concluded with the following exhortation:

> If taxation is the price we pay for civilisation, we tax advisers, lawyers and accountants, each have a key role in advancing our community. Your advice will assist clients when considering the legal and financial benefits of investing in year end schemes.[19]

2.41 Mr Carmody told the Committee that:

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17 Valerie Braithwaite and John Braithwaite, 'An Evolving Compliance Model for Tax Enforcement' in *Crimes of Privilege: Readings in White-Collar Crime*, eds. Neal Shover and John Paul Wright (New York: Oxford University Press, 2001), pp.412-413.

18 See the Commissioner's speech, 'A New Tax System – Changing Cultures', 19 November 1998, Sydney, http://www.ato.gov.au/printcontent.asp?doc=/content/Corporate/sp9807.htm (25 June 2001); and, Assistant Commissioner Michael O'Neill's speech, 'Taxes, Death & Civilisation: a look at year end "tax effective products"', 15 May 2001, Brisbane, http://www.ato.gov.au/content.asp?doc=/content/corporate/sp200103.htm (6 June 2001).

19 Michael O'Neill, 'Taxes, Death & Civilisation: a look at year end "tax effective products"', 15 May 2001, Brisbane, http://www.ato.gov.au/content.asp?doc=/content/corporate/sp200103.htm (6 June 2001), p.10.

> In my view, the community's tax system would be best protected by others supporting the tax office in meeting this objective. In particular, the tax profession, which is at the coal face on a day-to-day basis, could provide a valuable role in bringing developments to our attention. There are mixed views on this in the profession, some preferring the view that their only responsibility is to their client and that this would be compromised by taking a community responsibility. This view raises for me a number of responsibility issues that are worthy of considering. In saying that, is it saying that tax professionals know or knew the schemes were ineffective but, because the tax office had yet to act, they would recommend or support claims made for them? Otherwise, why not make them available to us? If so, is there no responsibility to the community for the integrity of the tax system, even when they know or expect the arrangements will not pass muster under the law?[20]

2.42 Clearly, the ATO would like to encourage a sense of responsibility among tax professionals for the promotion of taxpayer compliance, not only with the letter of the law, but also with its spirit and policy intent. As Mr Carmody told the Institute of Chartered Accountants:

> It is one thing to approach an interpretation of the law from the perspective of advising a client, particularly where the whole objective is to minimise tax payable. It is another thing to approach the law from the perspective of a responsibility to the community for the integrity of the law.[21]

2.43 In terms of the Compliance Model outlined earlier, this strategy is part of the broader focus on fostering a community consensus on the importance of 'doing the right thing' in tax matters.

Professional response

2.44 As the Commissioner conceded in the evidence quoted above, the response of the taxation profession to this strategy has been 'mixed'. The reasons for that ambivalence are complex, and cannot necessarily be dismissed simply by assuming a lack of ethics or community spirit in the profession.

2.45 The ATO asked professional bodies at a meeting of the National Tax Liaison Group (NTLG) on 9 March 2001 whether they accepted that 'when they did come across an issue that impacted on the integrity of the tax system it would be in the

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20 Evidence, pp.798-799.

21 'A New Tax System – Changing Cultures', 19 November 1998, Sydney, http://www.ato.gov.au/printcontent.asp?doc=/content/Corporate/sp9807.htm (25 June 2001), p.5.

interests of the professional bodies and of their members to have matters drawn specifically to the ATO's attention'.[22]

2.46 Representatives of the Certified Practising Accountants of Australia (CPAA) agreed with that proposition, although they remarked that if aggressive schemes were already entrenched by the time professional bodies became aware of them, then the bodies were in a difficult position. That is:

> By the time the bodies were in a position to inform the ATO, this could result in grief for a large number of members, who in turn complain about the behaviour of their representatives.[23]

2.47 The National Tax and Accountants Association (NTAA) expressed its willingness to work with the ATO to identify schemes, so that the ATO could develop an early view of the arrangements. Likewise the Institute of Chartered Accountants of Australia (ICAA) and the Taxation Institute of Australia (TIA) said the provision of early warnings by the ATO of concerns about particular arrangements would allow them to work with members to identify the type of arrangements in question.[24]

2.48 However, the TIA also expressed the view that:

> … private practitioners were not interested in owning the tax system other than incidentally. They are in business to sell advice and make money. To overlay a community responsibility of not promoting aggressive tax planning on tax practitioners or their representative bodies was not realistic according to the TIA.[25]

2.49 The TIA said that sometimes problems with aggressive schemes start when someone is given an incorrect private ruling from the ATO which is then exploited in the development of dubious arrangements. The TIA warned:

> … tax agents or representative bodies helping the ATO or telling the ATO about the error in an isolated private ruling was frankly 'Fairyland'. Moreover, in the TIA's view, to expect a professional body to reveal the existence of resultant mass marketed schemes amounted to a conflict of interest.[26]

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22 National Tax Liaison Group, Minutes 9 March 2001 meeting, p.13, ATO Additional Information, 27 July 2001.

23 National Tax Liaison Group, Minutes 9 March 2001 meeting, p.14, ATO Additional Information, 27 July 2001.

24 National Tax Liaison Group, Minutes 9 March 2001 meeting, pp.14-15, ATO Additional Information, 27 July 2001.

25 National Tax Liaison Group, Minutes 9 March 2001 meeting, p.14, ATO Additional Information, 27 July 2001.

26 National Tax Liaison Group, Minutes 9 March 2001 meeting, p.13, ATO Additional Information, 27 July 2001.

2.50 In a similar vein, the Law Council of Australia (LCA) advised that, in its view:

> … the primary role of an adviser is to give proper advice, even where that went against the ATO view. Proper advice nevertheless included advising clients when the ATO took or was likely to take an alternative view.[27]

2.51 The Committee asked a number of witnesses to respond to the argument that tax professionals have a responsibility for the integrity of the tax system, such that they should be prepared to assist the ATO in identifying and deterring aggressive tax planning arrangements. Again, the response was mixed.

2.52 Mr Robert O'Connor QC, who advised the promoters of a number of schemes in Western Australia, gave a response to this issue which the Committee considers is worth quoting at length. He wrote:

> In my opinion, the culture of the tax advising community is *not* one of tax minimisation. The duty of a tax adviser is to advise what, in his or her opinion, is the correct interpretation of the law, based on Court decisions already given and opinion as to what views a Court would hold if the matter comes before a Court in the future … In interpreting the meaning of a law, morality is not a relevant consideration. An Opinion is being sought on what the *law* is. That is the adviser's specialisation. If an Opinion on morals or ethics is required, the person requiring an Opinion should go to a moralist or an ethicist. If morality had to be taken into account in interpreting the meaning of a law, whose morals should be applied? The answer as to what the law is would vary and depend on the morals of the particular person giving the Opinion. The appropriate course is that the adviser states what in his or her opinion is the law, and then it is up to the taxpayer to apply his or her own morals as to whether to adopt the advice given as to what the law is.[28]

2.53 Mr Richard Gelski of Blake Dawson Waldron took this point a step further, telling the Committee that:

> … not only is it our obligation to advise on the law as it is – we can be sued if we do anything else – but if we fail to advise a client that a transaction can be carried out in a more tax effective manner we can be sued for negligence by that client.[29]

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27 National Tax Liaison Group, Minutes 9 March 2001 meeting, p.13, ATO Additional Information, 27 July 2001.

28 Mr Robert O'Connor QC, Submission No. 891, pp.8-9.

29 Evidence, p.524.

2.54 Somewhat by way of contrast, Deloitte Touche Tohmatsu submitted that the professional somehow has to balance the private interests of the clients against the public interest of the community. In this sense, there are competing ethical demands at stake. Mr Michael de Palo, National Managing Partner – Tax, wrote that the Institute of Chartered Accountants' Code of Professional Conduct prescribes that:

> 'Members must at all times safeguard the interests of their clients provided that they do not conflict with the duties and loyalties owed to the community and its laws'. In this context, a tax expert, at the same time as providing client advice, is obliged to 'help to establish confidence and efficiency in, and the fair application of, the tax system'.[30]

2.55 Mr de Palo continued:

> The balance between these two ethical requirements often cannot be reached without difficulty. The professional advisor must make this judgement call often at the advisor's peril. Further, there are decided cases that say an advisor has a duty to advise his client as to how to lawfully minimise tax.[31]

2.56 The Committee notes that the complexity of this issue arises in part from the fact that the line between legal tax minimisation and avoidance which is punishable by the application of Part IVA may sometimes be difficult to find.

2.57 The Commissioner's call for an ethos of broad community responsibility or civic mindedness within the tax profession seems to be a call for an approach which is more generous in its interpretation of the overall spirit of the law. As quoted earlier, the Commissioner has said:

> It is one thing to approach an interpretation of the law from the perspective of advising a client, particularly where the whole objective is to minimise tax payable. It is another thing to approach the law from the perspective of a responsibility to the community for the integrity of the law.[32]

2.58 As is evident from the response of the profession, however, that call may be seen to conflict with other professional duties, such as duties to act in the best interests of one's client.

2.59 Further, tax professionals may well argue that precisely what they are doing is taking responsibility for the 'integrity of the law'. If certain actions are allowable

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30 Deloitte Touche Tohmatsu, Submission No. 894, p.3.

31 Deloitte Touche Tohmatsu, Submission No. 894, p.3.

32 'A New Tax System – Changing Cultures', 19 November 1998, Sydney, http://www.ato.gov.au/printcontent.asp?doc=/content/Corporate/sp9807.htm (25 June 2001), p.5.

under the law, then performing those actions even with the objective of minimising tax payable, does not undermine the law's integrity. There is, arguably, no penumbra or spirit which causes legal minimisation strategies to lack integrity simply because they do not fully conform to a broader ethic of civic-mindedness.

2.60 The Committee acknowledges that the appropriate balance between the legal rights of individuals to minimise their tax and the community's interest in the generous observance of the intent as well as the letter of taxation law may sometimes be difficult to find. However, the Committee strongly endorses the view that tax professionals do have obligations to the broader community as well as to individual clients.

2.61 The Code of Professional Conduct published by the Institute of Chartered Accountants states that:

> A distinguishing mark of a profession is its acceptance of its responsibility to the public. The accountancy profession's public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community and others who rely on the objectivity and integrity of members to maintain the ordinary functioning of commerce. This reliance imposes a public interest responsibility on members. The public interest is defined as the collective well-being of the community of people and institutions that the members serve.[33]

2.62 The Code goes on to say that the 'member's responsibility is not exclusively to satisfy the needs of an individual client or employer'.[34] In the Committee's view, these principles of professional conduct serve as an admirable benchmark for all those involved in advising on taxation matters.

2.63 The Committee is thus not convinced by those who suggest that their only responsibility is to their clients and that the law will look after itself. Clearly tax paying and planning behaviours are observed and modified, not only through the enforcement or amendment of black letter law, but also by the community's consensus about the values and expectations that surround that law and its interpretation.

2.64 The Committee considers that members of the taxation profession and their representative bodies should take responsibility for their role in shaping that consensus.

2.65 To this end, the Committee considers that a review of the sort of public interest role that the tax profession should adopt would be timely and valuable. Such a review would provide the tax profession with an opportunity to reach consensus on its

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33 'Code of Professional Conduct', Section B.1 in Deloitte Touche Tohmatsu, Submission No. 894, p.8.

34 'Code of Professional Conduct', Section B.1 in Deloitte Touche Tohmatsu, Submission No. 894, p.8.

responsibilities to the broader community, as well as the long-term interests of its clients. Without such consensus, further regulation of the profession may be required.

2.66 The Committee recommends that the Government appoint an appropriately qualified person to conduct the review. As part of the review, the appointed person should consult with the Board of Taxation, the ATO, the tax profession and other relevant business and community bodies.

2.67 The Committee also considers that, as part of the review, the role of tax professionals in the mass marketed schemes episode deserves closer analysis. This episode highlights many of the dilemmas that tax lawyers, accountants and other financial advisers face in tendering advice on grey or contested areas of the law, particularly in relation to tax minimisation (see Chapter 3). It also raises questions as to whether tax professionals, especially lawyers, should be obliged to provide advice that extends beyond the particular issues at law raised by clients to wider matters that could affect the client's interests (such as Part IVA anti-avoidance issues). All these questions relate to the broader concerns about the need for tax professionals and their representative bodies to meet responsibilities to both clients and the community.

Recommendation

2.68 The Committee recommends that a review be conducted into the nature and extent of the public interest responsibility that tax professionals should adopt for the integrity of the tax system. The review should be conducted by an appropriately qualified person, who should consult with the Board of Taxation, the ATO, the tax profession and other relevant business and community bodies. The review should include consideration of the issues of tax planning and the mass marketed schemes episode.

CHAPTER 3

SELF-ASSESSMENT, CERTAINTY AND REASONABLY ARGUABLE POSITIONS

Self-assessment and expert advice

3.1 It is by now well-established that many of those who invested in tax effective schemes did so relying on 'expert' opinions which assured them of the legality of the arrangements. The following testimony, taken in Kalgoorlie from Mr Michael Burns, is representative of much of the evidence before the Committee. Mr Burns said:

> I tried to seek the best advice available to me at the time. I did not go to any Kalgoorlie people. I went to a Perth financial adviser in order to get separate advice on this. Many of my friends and work colleagues are in the same boat as me. They all say that the financial advisers, accountants and lawyers that they talked to all said the same thing: these schemes seemed above board and quite safe and sound. They could not find anything wrong with them. I thought I would do something a little bit different and go and see a financial adviser in Perth, and he said exactly the same thing. He said the schemes were quite good; there was nothing wrong with it that he could see, and he said he was actually in it himself.
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> With respect to the scheme, I got a prospectus. In that prospectus were two signed documents from two separate QCs saying that they were above board and they could not see anything wrong with them whatsoever, including from the tax department's point of view, so everything should be spot on.[1]

3.2 Faced with testimony of this sort, the Committee was at first inclined to think that investors such as Mr Burns had been the victims of a deliberately misleading sales pitch, if not of professionally negligent advice on the part of the relevant accountants and lawyers. Those who promoted and advised on these schemes, however, dispute this conclusion.

3.3 For example, one of the salesmen who marketed the schemes aggressively in Kalgoorlie and elsewhere in Western Australia told the Committee that he himself had been convinced of the legality of the schemes. Mr Rick Shenton said:

> I am a professional salesman. I used to be a state manager of a branch of AMP and I have some background legal qualifications. I felt, and still do feel, that these schemes were legal and I promoted them as such. I believed they were legal because I had, when I was selling, a Queen's Counsel opinion, a solicitor's opinion, an accountant's opinion and usually Coopers and Lybrand – or one of the top three accountants in the world – giving

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1 Evidence, p.225.

> opinions to say that these things were legal … As I understood it, the taxation department had clearly known of these schemes and had not done anything about them.[2]

3.4 The Committee also received evidence from lawyers and accountants who provided favourable opinions in relation to schemes whose deductions have been disallowed by the ATO, and who stand by their original opinions.

3.5 For example, the Committee received a submission from the law firm, Blake Dawson Waldron, which is acting for Cabonne Management Ltd on behalf of participants in the Central Highlands Wine Grape Projects (CHWGP) 1-4. While Blake Dawson Waldron did not themselves provide the taxation opinion in the Central Highlands prospectuses, the firm argued that the favourable opinions that were provided were soundly based on existing case law. The submission stated:

> Prospectuses in relation to projects of this nature are required to contain a taxation opinion. In relation to Central Highlands Wine Grape Project No. 1 ('Project 1'), a taxation opinion was obtained from Court & Co, Chartered Accountants. In relation to Project 2, Project 3 and Project 4 a taxation opinion was obtained from Lear & Co. … We note that projects of this nature typically contain taxation opinions from 'Big 5' accounting firms. These firms have typically given a similar taxation opinion to the opinions contained in the prospectuses for CHWGP 1, 2, 3 and 4 and rely on the same income tax principles as were relied upon in the opinions for CHWGP.[3]

3.6 Both in their submission and in subsequent oral evidence to the Committee, Blake Dawson Waldron emphasised that the relevant taxation opinions relied on case law that was relevant at the time, and that 'the ATO had no published position that was contrary to these decided cases'.[4]

3.7 Mr Colin Thomas of the accounting firm, Hudson Croft Thomas, commenting on the position 'as I recall it' in 1998, told the Committee:

> In my view, no tax professional with specialist knowledge in this area believed that part IVA would apply to genuine business transactions where limited recourse or indemnified loans were used to finance these transactions … The existing rulings and tax cases gave a clear indication. It therefore follows that in some schemes participants had no reason to believe that they were entering into a scheme that did not comply with the law.[5]

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2 In-camera evidence, 21 August 2001, p.2.

3 Blake Dawson Waldron, Submission No. 852, p.3.

4 Blake Dawson Waldron, Submission No. 852, p.3; Evidence, pp.515-518.

5 Evidence, p.536.

3.8 When asked by the Committee whether 'with the benefit of hindsight' he would not have given positive opinions on schemes which have since been disallowed by the ATO, Mr Thomas said:

> With the benefit of hindsight, knowing now what I know, I still believe the tax office is wrong, and consequently I would have been advising people to go into these types of investments because, at the time, and believing the directors had done their due diligence in preparing the prospectuses, and that they believed the investments would work, consequently that they were sound investments.[6]

3.9 Fletcher Securities expressed the view that the ATO's position is not 'supported by case law or tested in the courts'.[7] For that reason:

> It is far too premature for the ATO and even the Committee's final report to consider and/or discuss the use of penalties for promoters and designers of prospectus-based schemes as the ATO's view on limited recourse funding arrangements that underpinned them is yet to be tested before the courts … Schemes that were based on real business activities … contained independent taxation opinions often provided by the same large accounting firms that the government had paid tens of millions of dollars each year for taxation advice that it relied upon. Securities advisers had a reasonable basis … for relying upon these taxation opinions in satisfying themselves and their clients that the taxation deductions outlined could be claimed to help fund their investments.[8]

3.10 One of the large accounting firms that provided taxation opinions for some mass marketed schemes was Deloitte Touche Tohmatsu. In its submission to the Committee, Deloitte Touche Tohmatsu commented that it is relatively easy to identify the extreme ends of the schemes market, but 'much more difficult to comment on the whole spectrum. This is so given the variety of arrangements, the complexity of our taxation laws and the uncertainty of their administration from time to time'.[9]

3.11 Deloitte Touche Tohmatsu informed the Committee that, while the firm never promoted schemes, it provided taxation opinions for inclusion in a number of prospectuses including Connect the World, Budplan A Series 1, Personal Budplan 4, Tracknet, and Tentas.[10]

3.12 The Committee emphasises that the point of this discussion is not to determine the merits, at law, of the ATO's decision to disallow deductions and to apply Part IVA to many of the so-called mass marketed schemes. The point, rather, is

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6 Evidence, p.548.

7 Fletcher Securities, Submission No. 652A, p.5.

8 Fletcher Securities, Submission No. 652A, p.8.

9 Deloitte Touche Tohmatsu, Submission No. 894, p.2.

10 Deloitte Touche Tohmatsu, Submission No. 894, p.7.

to show that some taxation advisers who provided advice in relation to mass marketed schemes continue to maintain that their advice was correct, notwithstanding the views of the ATO.

3.13 By way of contrast to this approach, Mr Mark Leibler, of Arnold Bloch Leibler – Lawyers and Advisers, noted that it would have been prudent for advisers to inform potential investors of the risk of the ATO taking a different view even if they considered the scheme arrangements acceptable. In other words, he advocated that advisers should take a pragmatic rather than an 'academic' approach to the question of the possible application of Part IVA, saying:

> How would you feel if I gave you advice that on balance it ought to be okay under the anti-avoidance provisions and you ended up getting an assessment from the commissioner with very heavy penalties and then, seven years later, you won your case in the High Court? I do not think you would consider that a very productive course of action.[11]

3.14 A solicitor from McKenzie Lalor in Kalgoorlie, Miss Lisa McLean, told the Committee that when potential investors *were* advised of these risks, they usually chose not to invest. She said:

> We actually do see people on occasion who have been given the opportunity to get legal advice … When they do, we give them the full picture, the possibilities of what could happen and we have not had anybody that has left our office and has actually signed up to a scheme if they have been given that opportunity.[12]

3.15 The Committee is concerned that many advisers do not seem to have taken responsibility for advising their clients of the full extent of the risks involved in investing in schemes, particularly the risk of the ATO taking a different view of the arrangements.

3.16 The difficulty for individual taxpayers is that the ATO can levy penalties against them for acting on that sometimes incomplete advice and investing in schemes whose deductions the ATO deems to be not allowable. In other words, it is the individual taxpayer rather than the adviser who ultimately bears any risk associated with the ATO taking a different view of the tax effectiveness of particular schemes.

3.17 This matter may be of less importance following the introduction of the product ruling system, which gives the investor comfort that the deduction will be available, providing the schemes is implemented in accordance with the information provided to the ATO. The issue of ATO rulings is discussed in the next section.

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11 Evidence, p.145.

12 Evidence, p.264.

ATO rulings

Self-assessment

3.18 The Committee notes that there is mechanism which is expressly designed to mitigate the risk borne by the individual under the self assessment system. This mechanism is the ATO's ruling system.

3.19 Prior to 1 July 1986, tax returns were individually examined by the ATO, the tax calculated and an assessment issued. After that date, a minimalist self-assessment system was introduced, which meant that taxpayers were required to calculate their own tax liability. The ATO accepted that calculation at face value, but retained under law the right to audit returns for up to four years in ordinary circumstances and for up to six years if it determined that Part IVA applies.[13]

3.20 The Taxation Institute of Australia (TIA) noted that the decision to move to a self-assessment system 'reflected the reality that in many ATO branches assessors were being asked to process 1,000 individual returns in a standard day. Excessive manpower requirements and quality assurance were both issues under the old system'.[14] The Australian National Audit Office explained the background to the introduction of the self-assessment system in the following terms:

> Before the 1986-87 financial year, the ATO had the role of assessing every tax return submitted by every tax payer … However, in reality the assessment process was little more than *tick and flick*. With approximately 10 million income tax returns to assess annually and with quotas applying to assessors, it had been calculated that, on average, an individual taxpayer's return would have received less than 2.5 minutes of scrutiny by the ATO.[15]

3.21 As the TIA explained, however, with the introduction of a self-assessment system, there were concerns about whether taxpayers could be certain they had assessed themselves correctly, and about their exposure to penalty and interest charges in the event of mistakes which were subsequently identified by the ATO. In response to this concern, modifications to the self-assessment system were introduced in 1992. Among other things, these provided for the introduction of a rulings system through which the Commissioner could communicate how, on his view, the law would apply to particular arrangements.

3.22 Further, in response to the problems of taxpayers achieving certainty in relation to mass marketed tax effective scheme arrangements, the ATO introduced a new class of rulings in 1998. These 'product rulings' aim to give certainty about the

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13 See also Mr Ian Phillips's witty summary of this change in his Submission No. 890, p.2.

14 Taxation Institute of Australia, Submission No. 898, p.2.

15 Australian National Audit Office, *Risk Management: Australian Taxation Office*, Audit Report No. 37 1996-97, p.9.

tax effectiveness of a scheme, not just to an individual applicant but to any participating investor.

3.23 As mentioned in Chapter 1, the product ruling system has helped reduce the risk of investing in arrangements with tax benefits. However, product rulings do not provide complete protection for taxpayers. There are still some circumstances which could leave taxpayers, who have invested in a scheme with a product ruling, exposed to tax penalties. Of concern is the question of investor control over the implementation of schemes in conformity with ATO product rulings.

Conformity with a ruling and the application of Part IVA

3.24 In a speech on 15 May 2001 to the Taxation Institute of Australia, Brisbane, Mr Michael O'Neill, Assistant Commissioner of Taxation, discussed the use of the ATO's rulings in terms of investor certainty. He warned, however, of two respects in which the existence of rulings would not necessarily guarantee an investor's immunity from ATO action. First, he said:

> Where the facts presented to the ATO are not implemented on the ground then no comfort can be drawn. (This issue is particularly important for product rulings where prudent investors may seek written undertakings from the promoter that the arrangement is fully implemented).[16]

3.25 Second, Mr O'Neill observed:

> While the ATO can rule on the application of Part IVA, silence on this issue cannot be taken as consent. On complex schemes yet to be implemented it may be impossible to rule on Part IVA because some of the eight requisite factors are yet to happen.[17]

3.26 The Committee notes that, from the ATO's point of view, both these hedges seem necessary. A ruling given for one set of arrangements should not be able to be used to protect a materially different set of arrangements for which, perhaps, no ruling would have been given. Further, a ruling given in advance should not be able to prevent the ATO from determining that the anti-avoidance provisions apply to unlawful subsequent action on the part of the promoter or operator.

3.27 However, from the point of view of the individual taxpayer, these caveats make the certainty attainable through the ruling system seem highly provisional. It is questionable whether an individual investor in, say, an agribusiness scheme would have any knowledge of, let alone influence over, actions by the scheme promoter or operator which might fall foul of the scheme's product ruling or of the Part IVA

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16 Michael O'Neill, 'Taxes, Death & Civilisation: A look at year end "tax effective products"', 15 May 2001, http://www.ato.gov.au/content.asp?doc=/content/corporate/sp200103.htm (6 June 2001), p.5.

17 Michael O'Neill, 'Taxes, Death & Civilisation: A look at year end "tax effective products"', 15 May 2001, http://www.ato.gov.au/content.asp?doc=/content/corporate/sp200103.htm (6 June 2001), p.5.

provisions. Yet, if these provisions are contravened, then it is still the individual investor who is exposed to ATO recovery action.

3.28 The ATO has acknowledged the vulnerability of investors in cases where promoters 'recklessly or knowingly' fail to implement the scheme in accordance with the terms of the product ruling. It has advised that, 'in these cases, it might be appropriate for a reduced tax shortfall penalty to fall on the unwitting investors'.[18]

Matters for consideration

3.29 Based on the points raised so far in this Chapter, the Committee wishes to flag a number of suggestions or recommendations for consideration by the Government and the ATO. The Committee will discuss these suggestions under the following headings:

- increasing taxpayer understanding of self-assessment; and
- judicial resolution of differing interpretations of law.

Increasing taxpayer understanding of self-assessment

3.30 That the majority of taxpayers do not understand the implications of the self-assessment system became clearly apparent during the inquiry. Many witnesses accused the ATO of acting retrospectively by issuing amended assessments for previous tax years, despite the fact, as stated earlier, that the law explicitly allows for the ATO to amend assessments for up to four years in ordinary circumstances and for up to six years if it determines that Part IVA applies.[19]

3.31 The Committee thus considers that there is an urgent need for taxpayers to be made aware of the implications of the self-assessment system and, in particular, that 'just because they have treated an item in a particular way last year and the year before without demur by the ATO, that practice is not to be assumed to be correct or tolerated or irreversible'.[20] Indeed, as Mr Ian Phillips, a taxation consultant and former representative on the Commissioner's Self Assessment Task Force, warned:

> If the matter is at all contentious, no surety is gained for a long time and no precedents are set unless, exceptionally, the ATO is specifically bound by a ruling or other determination.[21]

3.32 Both Mr Phillips and the Taxation Institute of Australia made a number of suggestions aimed at making the self-assessment system more transparent to

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18 ATO Additional Information, 31 October 2001, p.5.

19 This was true not only of individuals, but of organisations with professional involvement in the financial area. See, for example, Van Eyk Capital, Submission No. 691, Appendix A, p.10; and, Financial Planning Association, Submission No. 705, p.3.

20 Mr Ian Phillips, Submission No. 890, p.3.

21 Mr Ian Phillips, Submission No. 890, p.3.

taxpayers. The Committee believes that these suggestions warrant careful consideration by the ATO.

3.33 First, Mr Phillips and the TIA expressed the view that the use of the word 'assessment' may itself be misleading. In Australian taxation law, 'assessment' is defined as the 'ascertainment' of the amount of taxable income and the tax payable.[22] But, as the TIA, observed:

> If the taxpayer's word is accepted without review it is difficult to see in the self-assessment environment [that] the Commissioner has 'ascertained' anything in issuing a 'Notice of Assessment'. At best a 'Notice of Assessment' is no more than a notification of liability in a self-assessment environment.[23]

3.34 The TIA suggested that the word 'assessment' be reserved for occasions where the Commissioner actually has determined a taxpayer's final liability. For example, an 'assessment' could be issued following an audit. Otherwise, the existing document named 'Notice of Assessment' should be renamed to make it clear to the taxpayer that the notice 'is merely a confirmation of the information supplied by the taxpayer'.[24] The TIA suggested the adoption of names such as 'Interim tax calculation' or 'Tax calculation sheet' while, in a similar vein, Mr Phillips suggested the use of phrases such as 'payment requirement based on your return' or 'interim payment obligation'.[25]

3.35 Similarly, the TIA was of the view that all ATO correspondence processing taxpayer instalment variations and amendment requests should 'make it plain that no actual review of the taxpayer's facts and circumstances has taken place'.[26] A positive response does not mean that the ATO agrees with the taxpayer's claim: it simply means that the taxpayer's claim has been taken at face value. Since the response may be reversed in later years, the TIA suggested that the correspondence carry a prominent 'health warning' to that effect.[27]

Recommendation

3.36 The Committee recommends that the ATO, in consultation with the Taxation Institute of Australia, the Commonwealth Ombudsman and other relevant bodies, develop measures to educate taxpayers about their obligations and rights in the self-assessment environment. Particular attention should be given to ensuring that taxpayers are made aware of the period over which the ATO may review their returns

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22 Taxation Institute of Australia, Submission No. 898, p.4.

23 Taxation Institute of Australia, Submission No. 898, p.5.

24 Taxation Institute of Australia, Submission No. 898, p.5.

25 Mr Ian Phillips, Submission No. 890, p.3.

26 Taxation Institute of Australia, Submission No. 898, p.5.

27 Taxation Institute of Australia, Submission No. 898, pp.5, 8.

and amend their assessments. Further to the recommendation at paragraph 1.59, information about the ATO's power to review and amend assessments, and the time periods that apply, should be clearly stated in the *TaxPack* and on notices of assessment sent to taxpayers.

Judicial resolution of differing interpretations of law

3.37 The Committee notes that increasing taxpayers' understanding of the self-assessment system does not do anything to provide them with greater certainty that taxation advice upon which they act will be acceptable to the Commissioner. All it does, is to make them more fully aware of the risk to which they are exposed.

3.38 The Committee received very little evidence which addressed the question of how judicial resolution of differences of interpretation of taxation law might be more comprehensively and swiftly obtained. Such resolution, however, was seen as desirable by witnesses, particularly in relation to the scope of the Part IVA provisions.

3.39 An important means of achieving judicial resolution on disputed interpretations of taxation law is via the ATO's test case program. This program provides funds to individuals or organisations to test a point of tax law in court, where a case raises issues that will affect a significant section of the tax-paying public.[28] A number of witnesses, however, were critical of the ATO's selection of cases for test case funding.

3.40 For example, the Taxation Institute of Australia was critical of the ATO's 'long-standing ban on the funding of Part IVA cases, and its reluctance to issue Part IVA assessments [in] the first place'.[29] The result of that reluctance, claimed the TIA, has been that the power of Part IVA has not been fully exposed to the community. In the TIA's view, however, 'Part IVA is a part of the tax law like any other, and artificial contracts [on] its use and testing are detrimental'.[30] Notwithstanding that criticism, the TIA noted that the ATO has won most Part IVA cases it has contested in recent times. These decisions have confirmed that the provision 'does work', and have provided some guidance to its meaning.[31]

3.41 Deloitte Touche Tohmatsu also commented upon the ATO's seeming reluctance to clarify the scope of the Part IVA provisions. Mr Michael de Palo, National Managing Partner – Tax, wrote:

> … it has been a generally held view in the tax profession that from the time when Part IVA was first introduced in 1981, and until recently the ATO has

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28 'ATO Test Case Program', http://www.ato.gov.au/printcontent.asp?doc=/content/Professionals/test_case_program… (10 October 2001), p.1.

29 Taxation Institute of Australia, Submission No. 898, p.9.

30 Taxation Institute of Australia, Submission No. 898, p.9.

31 Taxation Institute of Australia, Submission No. 898, p.8.

> evinced a clear reluctance to have the scope of the provision clarified, either by public or private rulings or decided cases. Rather, the ATO strategy seemed to have been to keep the provision hanging over taxpayers and advisers.[32]

3.42 Similar criticisms were expressed about the selection of test cases in the mass marketed schemes arena. For example, Mr Robert O'Connor QC told the Committee that test case funding for the Budplan litigation was initially refused by the ATO 'presumably because the case involved Part IVA'. The ATO finally agreed to fund the case in April 2001 but, according to Mr O'Connor, 'that decision should have been made three years ago'.[33]

3.43 On the other hand, Mr Richard Gelski, Blake Dawson Waldron, took issue with the ATO's decision to fund test cases for Budplan rather than for the Central Highlands Wine Grape Project. He said:

> … they have chosen to fund Budplan, which is a case that I would respectfully submit does not have the merits that Central Highlands does. That is not to say that Budplan should not obtain test case financing; it is to say that Central Highlands and Frankland Valley should.
>
> Here are cases which, we would submit, are completely deserving of obtaining finance, and the only reason that the Commissioner might choose to reject, as he has done at this stage – or at least not to accede to the request at this stage – in our view can only be that he is concerned that he might actually lose.[34]

3.44 The Committee notes that although the ATO's Deputy Chief Tax Counsel makes the final decision on whether to fund the case, the decision is made after consultation with a 'Litigation Panel' comprised of taxation experts from within and outside the ATO. Currently, the ATO's Litigation Panel consists of six members, four of whom come from the wider taxation profession. The ATO has said that the panel was established 'to ensure that the Tax Office has community input into the Test Case Program'.[35]

3.45 The Committee further notes that criticisms of the ATO's selection of test cases for funding should be seen in the context of the large number of schemes for which claimed deductions have been disallowed. Participants in more than 200 schemes have been subject to ATO recovery action. It is not necessary, for the purpose of establishing general principles concerning the application of the law to

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32 Deloitte Touche Tohmatsu, Submission No. 894, p.4.

33 Mr Robert O'Connor QC, Submission No. 891, p.7.

34 Evidence, p.517.

35 'ATO Test Case Program', http://www.ato.gov.au/printcontent.asp?doc=/content/Professionals/test_case_program… (10 October 2001), p.1.

broadly similar arrangements, to fund test cases in relation to each scheme. Moreover, the broader tax paying community would be disadvantaged by a decision to fund any more cases than are required to establish the relevant legal precedents.

3.46 There may, of course, be disagreement over whether the appropriate cases really have been selected for funding. The Committee considers that the Litigation Panel should help to ensure that cases selected are representative, not only from the point of view of the ATO but also of the broader taxation profession.

3.47 As an additional measure, the Committee considers that it may assist the tax profession and the wider community if the reasoning behind the selection of cases for test case funding were published. This would make transparent the reasons for the choice of some cases for funding and the rejection of others.

Recommendation

3.48 For this reason, the Committee recommends that the test case Litigation Panel publish the criteria in the light of which it will recommend cases for funding and publish the reasons for its recommendations in particular cases.

3.49 A second issue to be addressed in relation to the litigation of test cases is the often extensive delay in the court process, while a third concerns the expertise of different courts in taxation matters and the need for consistent interpretation of taxation law. The Committee notes that a measure relevant to both these issues was raised in evidence by Mrs Jennifer Batrouney SC. She commented that:

> From time to time, the spectre of a federal tax court has been raised. I am very much in favour of the idea of a federal tax court.[36]

3.50 On the other hand, the Committee notes that the whole test case model relies on the preparedness of a taxpayer to challenge the ATO through a full litigation process. This entails, among other things, that the ATO will never be able to drive this process quickly nor in such a way as to provide it with judicial certainty *before* it issues a determination in relation to a particular matter.

Recommendation

3.51 The Committee recommends that the Government undertake an analysis of the adequacy of current mechanisms for obtaining judicial resolution of disputed or contentious tax law interpretation. This analysis should include consideration of whether and how the ATO might obtain a legal judgement without having to be taken to court by a taxpayer objecting to an ATO determination, and consideration of the merits of establishing a specialist federal tax court.

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[36] Evidence, p.679.

CHAPTER 4

INVESTOR PROTECTION AND TAX EFFECTIVE SCHEMES

Introduction

4.1 In this Chapter, the Committee considers the adequacy of measures for protecting investors in the mass marketed schemes market. Since the majority of those who invested in mass marketed schemes and who gave evidence to this inquiry participated in agribusiness and franchise schemes, this Chapter focuses on the measures that regulate the establishment, operation and promotion of those types of scheme. It also examines the measures for controlling the quality of advice provided to investors.

A preliminary note – distinguishing financial from taxation protection

4.2 The ATO's role is to determine the taxation implications of participating in a particular scheme. That is, its role is to determine whether or not an investor is entitled to claim a tax deduction in relation to his or her investment in a business or project.

4.3 It is the role primarily of Australian Securities and Investment Commission (ASIC) and the Australian Competition and Consumer Commission (ACCC) to ensure that managed investment or franchise schemes are designed and operated in accordance, respectively, with the requirements of the Corporations Law and the Trade Practices Act. These requirements cover, among other things, matters such as the registration and constitution of schemes, compliance arrangements and structures, and disclosure documentation. They are designed to ensure that a participant's decision to invest in a particular business or scheme is made on the basis of adequate information, and that the business arrangements themselves are proper.

4.4 It is important to note that a scheme may be designed and operated in accordance with the requirements of Corporations or Trade Practices law, and yet an investor not be entitled to claim a tax deduction for their investment in it. Conversely, just because a scheme has an ATO product ruling does not mean that it is a good financial investment.

4.5 Clearly, however, considerations that count for a scheme being given a product ruling also count for it fulfilling the requirements of the Corporations Law. For example, one of the conditions for the tax deductibility of an investment is that it be investment in a genuine business, and the regulations for compliance, registration and so on are designed to monitor that a scheme is operating as such a business.

4.6 Comprehensive investor protection requires both that the investor can attain certainty about the ATO's view of the deductibility of expenses, and that the investor has access to information about the commercial viability of a business and is entitled

to redress if that information turns out to be inadequate, misleading, or based on false assumptions.

4.7 As discussed earlier and in the Committee's Second Report, investor protection in taxation terms is addressed by measures such as the ATO's product ruling system and proposed promoter penalties.[1] In this Chapter, the Committee concentrates on the measures in place to protect investors' financial interests.

Regulations governing schemes and conduct

4.8 There are three levels at which questions might be asked concerning the adequacy of controls on tax effective schemes, promoters and advisers. These levels are:

- the establishment and operation of the scheme itself;
- the disclosure to investors of relevant information; and
- the adequacy of advice provided to investors.

4.9 In what follows, the Committee outlines the measures currently in place to control the operation and sale of tax effective schemes at all three levels.

Scheme establishment and operation

4.10 Tax effective agribusiness schemes are a subset of managed investment schemes. Since 1 July 1998, managed investments have been governed by provisions of the Corporations Law introduced by the *Managed Investments Act 1998*.[2]

4.11 Prior to the adoption of that Act, the Corporations Law provided for a two tier regulatory framework for managed investment schemes. The funds or assets of a scheme were vested in a trustee and the scheme was managed on a day-to-day basis by a management company. Reports of both the Australian Law Reform Commission and the Companies and Securities Advisory Committee, and the Financial System Inquiry found that this two tier structure led to a confusion between the responsibilities of the trustee and the management company, with the risk of failures in information sharing and reduced investor protection. Both reports accordingly recommended that there be a single operator in relation to each scheme, to be known as a single responsible entity.[3] This recommendation was implemented through the *Managed Investments Act 1998*.

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1 The ATO has advised the Committee that it is currently consulting with community, industry and professional bodies on its proposed promoter penalties. ATO Additional Information, 31 October 2001, p.2.

2 ASIC, Submission No. 853, p.3. The Managed Investments Act is inserted as Chapter 5C of the Corporations Law.

3 The Hon. Peter Costello MP, 'Managed Investments Bill 1997: Explanatory Memorandum', pp.4-5.

4.12 Schemes that were already operating at 1 July 1998 were given two years to meet the compliance requirements of this more stringent regulatory framework, although ASIC had discretion to extend that transitional period. In particular, ASIC advised that it 'has been prepared to grant relief to well-established schemes that are not open to new investment on the basis that those schemes have been complying with the Law as it stood and it would be an unreasonable cost imposed on the scheme and its investors to require them to transition'.[4] ASIC further advised that at least one scheme established prior to July 1998 has been unable to make the transition successfully because it failed to meet the requirements for obtaining the new responsible entity licence.[5]

4.13 Under the Managed Investments Act, a responsible entity proposing to establish and operate a scheme must obtain a security dealers licence from ASIC. ASIC advised the Committee that it has published a number of criteria against which it determines whether an applicant has the capacity and expertise to carry out the duties of the responsible entity efficiently, honestly and fairly and hence whether an applicant should be licensed. The criteria include:

- capacity to carry on a business;
- education and experience;
- good fame and character;
- engagement of agents;
- compliance;
- accountability; and
- meeting minimal capital requirements.[6]

4.14 Once a responsible entity has been granted a licence, it must then apply to register a managed investment scheme under Chapter 5C of the Corporations Law. A scheme can only be registered if it has a constitution and compliance plan that satisfy the Law. Further, registration of a scheme under Chapter 5C has the following statutory consequences:

- a requirement that the responsible entity must establish a compliance committee if less than half of the directors of the responsible entity are external;
- an obligation to audit the compliance plan annually;
- broadranging statutory duties on the responsible entity and its officers;

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4 ASIC, Submission No. 853, p.9.

5 Evidence, pp.755-756.

6 ASIC, Submission No. 853, p.3.

- the ability of ASIC to conduct surveillance checks;
- the ability of members to remove the responsible entity;
- the ability of ASIC or a member to apply to a court to appoint a temporary responsible entity to substitute for the original responsible entity; and
- limitations on the ability of members to withdraw from schemes which are not liquid.[7]

4.15 ASIC also noted that three aspects of the licensing process provide additional safeguards, particularly in relation to primary production schemes. First, since about July 1999, dealers licences for primary production schemes have been subject to a special condition designed to protect the rights of investors in relation to the land on which the scheme is operated. Second, most primary production operators have been licensed only for *named* schemes, rather than for *kinds* of schemes. ASIC can thus assess the licensee's capacity to operate each new scheme proposed by that operator. Third, many of these licences have a 'key person' clause, which means that the licence holder must inform ASIC if the relevant named person leaves the employment of the scheme operator.[8]

4.16 Franchises are excluded from the definition of 'managed investment schemes' in the Corporations Law, and are accordingly not regulated under that Law. ASIC advised that the reason for the exclusion of franchises is that historically a distinction was drawn between passive investments, and arrangements in which the prospects of a business succeeding were largely dependent upon the activities of investors.[9] In ASIC's words, the 'history reflects a view that typical franchisees do not require the extent of protection appropriate for passive investors'.[10]

4.17 Despite this view, a mandatory industry code for franchising was introduced on 1 July 1998 'in recognition of the strong growth of the franchising form of business and the power imbalance between franchisors and franchisees'.[11] This Franchising Code of Conduct is enforceable under the Trade Practices Act 1974 and is administered by the ACCC.

4.18 The Code is binding on all parties to franchise agreements and sets minimum standards of disclosure by franchisors. It requires all franchise agreements to provide for a complaints handling system.[12]

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7 ASIC, Submission No. 853, p.4.

8 ASIC, Submission No. 853, p.4.

9 ASIC, Additional Information, 14 September 2001, p.2.

10 ASIC, Additional Information, 14 September 2001, pp.2-3.

11 ASIC, Additional Information, 14 September 2001, p.3.

12 ASIC, Additional Information, 14 September 2001, p.3.

4.19 Aspects of the Code apply to franchises that existed prior to 1 July 1998, and the full Code applies to both existing and new franchise arrangements from 1 October 1998.[13]

Disclosure requirements

4.20 Chapter 6D of the Corporations Law regulates the disclosure of offers of interests in registered managed investment schemes. Where investments in such schemes are offered for sale, a disclosure document such as a prospectus is required. Exceptions to this requirement are listed under s708, and include small scale offerings, and offerings to sophisticated and professional investors.[14]

4.21 Section 710 of the Corporations Law requires that prospectuses contain all the information that investors and their professional advisers would reasonably need to make a judgement about the rights and liabilities attaching to the securities offered, the assets and liabilities, financial position and performance, profits and losses of the managed investment scheme, and its commercial prospects.[15]

4.22 Mr Andrew Shearwood, Partner, Freehills, submitted that section 710 'cannot be any stronger'. He wrote:

> Disclosure requires a prospectus issuer to undertake a due diligence exercise to discover and disclose to potential investors *all* material information known to the issuer or that the issuer ought reasonably to have obtained and disclosed, by making inquiries.[16]

4.23 Section 728(3) further makes it an offence for a prospectus either to contain a misleading or deceptive statement or to omit information which has 'a materially adverse effect on an investor'. Mr Shearwood noted that there are 'significant penalties and the prospect of civil liability' if a prospectus issuer breaches the prospectus provisions of the Corporations Law.[17]

4.24 Under the current law, there is no obligation for prospectuses to include financial forecasts or projections although it is common practice to include them. Mr Shearwood informed the Committee that there is an important distinction to be drawn between projections and forecasts. Forecasts represent what the directors consider will come true, and there is a statutory liability if they are wrong. Projections are a mathematical calculation of an outcome based on certain assumptions. The

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13 Trade Practices (Industry Codes – Franchising) Regulations 1998, Section 5.

14 ASIC, Submission No. 853, p.5.

15 Freehills, Submission No. 669, pp.1-2.

16 Freehills, Submission No. 669, p.2.

17 Freehills, Submission No. 669, p.2.

assumptions may either be 'best estimate' or 'hypothetical', and the accuracy of the projection depends upon the validity of the assumptions.[18]

4.25 Under the Financial Services Reform Act, some changes to the disclosure regime have been made. First, the concept of a prospectus or disclosure document is replaced with that of a 'product disclosure statement'. Second, the Act prescribes the content of certain standard information in the product disclosure statement, and additional information may be prescribed by the regulations. Mr Shearwood commented that under this regime the information required to be provided to investors could be made narrower than under section 710 of the Corporations Law, but there is also scope for the law to require the provision of industry specific information which would allow easier comparison between schemes in the same industry.

4.26 In a similar vein, ASIC noted the merits of requiring a 'key data summary' to be put in prospectuses so that investors have easy access to the promoter's contact details, and can compare fees, commissions, forecasts and so on between offerings.[19]

4.27 In recent years, the legislation concerning the monitoring of compliance with these requirements has gone through a number of changes. Historically, prospectuses were *registered* by the Corporate Affairs Commissions in each Australian state or territory and the registration process involved a comprehensive review of each prospectus against a checklist of content requirements. This process could take a significant amount of time, and when the Australian Securities Commission was established on 1 January 1991, the law concerning the registration of prospectuses was altered.

4.28 While prospectuses were still registered with ASC and, later, ASIC the onus of responsibility shifted. Rather than the regulator registering a prospectus only when it was satisfied that it met a detailed list of requirements, ASIC was required to register a prospectus within 14 days after lodgement. It could refuse to register a prospectus only if it was satisfied that the prospectus did *not* comply with the law. In place of a prescriptive checklist to be monitored by the regulator, investors were to be protected by the introduction of civil liabilities for the issuers of prospectuses which contained misstatements or serious omissions.

4.29 From 13 March 2000, the *Corporate Law Economic Reform Program Act 1999* (CLERP) introduced further amendments to the disclosure regime. Under CLERP, the issuer of a prospectus need only *lodge* (not register) the prospectus with ASIC. There is a 7 to 14 day period after lodgement during which both ASIC and the market are given time to review the document and during which 'an offeror must not accept applications for non-quoted securities … under the disclosure document'.[20]

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18 Freehills, Submission No. 669, p.2.

19 Evidence, p.765.

20 ASIC, Submission No. 853, p.6.

4.30 As ASIC explained to the Committee:

> The history of law reform in this respect suggests a parliamentary intention to reduce the involvement of the regulator in reviewing disclosure documents, but correspondingly an increase in the responsibility for promoters.[21]

4.31 Quoting from Ford's Principles of Corporations Law, ASIC noted that the philosophy behind the new disclosure requirements is that investors should be provided with the information they require if they are to make 'an intelligent decision without the government having to adopt a paternalistic stance of judging the merits of the particular security'.[22]

4.32 Further amendments to Corporations Law in the Financial Services Reform Act continue this policy trend, with the removal of the requirement even to lodge prospectuses for unlisted managed investments.[23] Mr Ian Johnston, Executive Director, Financial Services Regulation, ASIC, told the Committee that under the FSR Act, 'We would be notified that a product disclosure statement had been issued, but it would not be lodged with us'.[24]

4.33 Questioned about the wisdom of that amendment, Mr Johnston commented that:

> … we have gone to great lengths to explain that we do not approve prospectuses, that we do not register prospectuses. There is an argument that says that the lodging of a prospectus with the regulator seems to create the impression in the minds of some investors that the regulator has had a role to play in somehow giving it a tick or otherwise … The disclaimer that is put in the prospectus, which at the moment says 'ASIC takes no responsibility for the contents of this prospectus', might in fact in some perverse way create the impression: 'That means they must have looked at it, if they are excluding their liability' … But the whole path down which the law is going is that it is a disclosure based regime and that the investor is supposed to make their own due inquiries, et cetera. It is not a regime that we designed, of course, but it is something that we would implement.[25]

4.34 Notwithstanding this policy trend, ASIC does review some 'high-risk' prospectuses in detail. It informed the Committee that in the period between 13 March 2000 to 17 November 2000 (since the introduction of CLERP) 61 primary production scheme prospectuses were lodged with ASIC and that, of these, 35% were identified

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21 ASIC, Submission No. 853, p.7.

22 ASIC, Submission No. 853, p.5.

23 Evidence, p.745.

24 Evidence, p.746.

25 Evidence, p.761.

as falling within the high risk category.[26] The issue of the compliance problems associated with primary production prospectuses and possible remedies will be addressed in detail later in this Chapter.

4.35 The Franchising Code of Conduct sets minimum standards of disclosure with the aim of achieving transparency in dealings between franchisors and franchisees. The disclosure document takes the form of an 'information memorandum', not a prospectus.

Quality of advice and sale of financial products

4.36 The final set of measures for controlling the operation and sale of tax effective schemes are the provisions regulating the conduct of those who advise on and deal in financial products.

4.37 In the main, investors in tax effective schemes took advice and purchased their investments through scheme promoters, or licensed financial advisers or their representatives.

4.38 Under the Managed Investments Act, scheme promoters must hold a licence to operate the scheme and must obtain a separate authorisation in order to give advice relating to a scheme.[27] Under the Corporations Law, financial advisers must be licensed by ASIC to provide advice to retail customers. ASIC may grant a licence only where it is satisfied that the relevant individual has appropriate educational qualifications and experience.[28]

4.39 Licensed financial advisers must disclose to their clients all commissions attached to the sale of particular financial products and hence any possible conflicts of interests. Further, under Section 851 of the Corporations Law, the so-called 'know your client' provisions require advisers to recommend products in the light of their knowledge of clients' individual needs and circumstances.[29]

4.40 The law allows a licensed dealer or adviser to issue a 'proper authority' to a representative, who is thereby authorised to act on behalf of the licensee. Responsibility for ensuring that such representatives comply with the law and possess appropriate educational qualifications and experience lies with the licensed dealer.[30]

4.41 Further, under the FSR regime, the licence holder must notify ASIC of any proper authorities that they issue and be responsible for ensuring that such

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26 ASIC, Submission No. 853, p.7.

27 There was a transition period between July 1998 and July 2000 designed to give scheme operators time to meet the competency requirements for obtaining an adviser's licence. During that time, operators were able to give advice without such a licence, but only in relation to their own schemes. Evidence, p.758.

28 Freehills, Submission No. 669, p.8.

29 Financial Planning Association of Australia Ltd (FPA), Submission No. 705A, p.8.

30 Evidence, p.758.

representatives meet ongoing training requirements. ASIC will maintain a register of all proper authority holders.[31] It advised that, at 10 September 2001, the number of proper authority holders registered with ASIC is 38 894.[32] No proper authority is required by those selling franchise arrangements.

4.42 There are a number of channels through which investors may seek redress if they believe they have been given inappropriate or negligent financial advice. These include internal dispute resolution schemes, external dispute resolution schemes (such as the Financial Industry Complaints Service), professional bodies (such as the Financial Planning Association) and ASIC.[33]

4.43 In relation to lack of compliance with the regulatory framework by financial advisers and their representatives, ASIC told the Committee that 'in the year before last' it had banned 50 investment advisers for 'a range of misconduct or misbehaviour, some of which would fall outside the ambit of this inquiry'. Mr Sean Hughes, Director, Financial Services Regulation (Regulatory Operations), ASIC, said:

> … we also took action in the civil courts, restraining some of those advisers from continuing to give advice to their clients, and in one case that springs to mind we had the person prosecuted and that person received a conviction.[34]

4.44 The Financial Planning Association (FPA) advised that its own disciplinary committee, which is chaired by an independent legal practitioner, also has the power to investigate investors' complaints and to impose sanctions ranging from censure, to fines, suspension or termination of FPA membership, and other educational or professional development training. The manager of FPA's Investigations Professional Standards section, Mr Michael Butler, stated that:

> Allegations to date in regard to these tax-effective investments represent only a very small portion of the complaints received. They are investigated in the same manner as any other complaint. The most recent finalised case resulted in the disciplinary committee suspending the membership of the member for a period of two years when charges relating to a failure to obtain sufficient client information to enable a suitable recommendation to be made and the failure to disclose risks in a manner the client could understand were upheld by the committee.[35]

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31 Evidence, p.760.

32 ASIC, Additional Information, 14 September 2001, p.6.

33 Evidence, p.637.

34 Evidence, p.746.

35 Evidence, p.638.

Compliance and tax effective schemes

4.45 In this section, the Committee outlines some of the concerns raised about the compliance of some tax effective schemes with the relevant regulatory requirements and the remedial or disciplinary action that has been taken against them.

4.46 In evidence to the Committee, ASIC expressed its concern primarily about agribusiness tax effective schemes, saying that 'certain agricultural investment schemes often marketed as tax driven schemes leave much to be desired in terms of their marketing, promotion and operation'.[36] ASIC told the Committee that, as a percentage of the managed investments industry as a whole, the compliance problems in the agribusiness schemes area were high. In fact, according to ASIC:

> … we expend a disproportionate amount of our resources on these schemes: some 30 per cent of our managed investment surveillance capacity for what is perhaps only five or six per cent of the managed investments market.[37]

4.47 The problems occur at the licensing, disclosure and operational stages, and relate to both past and present experience. For example, ASIC's submission related the following figures:

- 10% (19 of 187) primary production licence applications refused between 1 July 1998 and 30 November 2000 due to serious deficiencies;
- 21 out of 57 primary production prospectuses received over the 1999-2000 financial year required remedial action;
- since December 1998, ASIC has finalised 40 surveillances of primary production responsible entities. Of these, 18 entities were required to improve operational procedures and the compliance plan, 4 had additional licence conditions placed on them, and 6 had their licences revoked.[38]

4.48 More recently, since January 2001, ASIC took action over the following problems in this area:

- of six primary production licence applications received, one was refused, two were withdrawn, one was approved and two are still under assessment;
- of eight surveillances of primary production responsible entities, three required remedial action in the form of a licence returned, a condition placed on a licence and a change to operations and procedures;
- in relation to prospectuses, there were 11 interim stop orders (mainly issued because entities had no reasonable basis for projections made in their

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36 Evidence, p.39.

37 Evidence, p.744.

38 ASIC, Submission No. 853, pp.4-9.

> prospectuses), one final stop order and supplementary disclosure documents required from 44 entities.[39]

4.49 In addition to structural or organisational arrangements, two major areas of concern in agribusiness schemes which emerged from the evidence were:

- high up-front management fees and commissions; and
- overly optimistic projections and forecasts.

Fees and commissions

4.50 In relation to the question of high fees and commissions, there are two reasons for concern. One relates primarily to investor protection, and the other relates to the protection of the taxation revenue.

4.51 Van Eyk Capital, an independent agribusiness research house, has suggested that a 'fundamental problem' in the agribusiness sector is 'the unacceptable and unsustainable levels of remuneration earned by the promoters, and by the people who actually sell the product contained within the offering document (ie. the financial advisers)'.[40]

4.52 According to van Eyk, despite the existing disclosure requirements in the Corporations Law, the real levels of fees and commission can still be hidden by a variety of means. The result is 'a significant imbalance between the returns offered to investors, and the often exorbitant returns accruing to both the promoters and their sales force'.[41] Van Eyk submitted:

> It is inconceivable to us how any project, or any business for that matter, can expect to be successful when between 70% and 80% of the funds invested are immediately diverted into what is basically non-productive expenditure … [W]e find it difficult to understand how both the ATO and ASIC rationalise such schemes to be 'commercial ventures' on a pre-tax basis when such a high proportion of the funds are not in fact utilised in actually growing or producing the crop.[42]

4.53 In short, van Eyk argued that the majority of agribusiness schemes are likely to fail commercially because not enough of the funds raised are 'going into the ground'. Investors will thus gain no return on the investment and a potentially viable industry sector will be brought into disrepute.

4.54 In addition to these alleged risks to the long-term viability of many agribusinesses and, hence, to investor returns, inflated up-front fees may also pose a

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39 Evidence, p.744.

40 Van Eyk Capital, Submission No. 691, p.5.

41 Van Eyk Capital, Submission No. 691, p.5.

42 Van Eyk Capital, Submission No. 691, p.8.

risk to the taxation revenue. That is, the higher the establishment and initial management fees, the greater the tax deduction able to be claimed by the investor. The ATO has submitted that in some cases these costs may be artificially geared so that, no matter what happens to the business itself, investors are guaranteed at least a 'tax profit' from their investment. That is one of the factors that is relevant to a determination that the investor's 'dominant purpose' in making the investment was to obtain a tax benefit, and hence to a determination that Part IVA applies.[43]

4.55 Witnesses from a range of agribusinesses disputed van Eyk's assessment of this matter. In particular, they disputed the claim that the agribusiness sector as a whole systematically overcharges for management fees and commissions. For example, representatives from The Barkworth Group, a mass marketed scheme growing and producing olive products, argued that van Eyk's reports did not address the reasons for some high up-front fees. Mr Mark Troy, Managing Director, acknowledged that the Barkworth prospectuses 'are notorious for having the highest charges'. He went on to say, however, that its charges were justified because Barkworth had committed itself not only to producing olives, but to establishing a brand in the marketplace. He claimed:

> We had to have a lot of investment in preparation for the major groves coming on stream. This required that we establish two or three years early the processing and marketing operations, and the prospectus provides that investors expect from us to buy in fruit from existing groves and process that produce into branded products and then market those products.[44]

4.56 In a similar vein, Great Southern Plantations Ltd also suggested that van Eyk did not sufficiently consider the whole life cycle of the businesses it criticised. Mr John Young, Chairman and Managing Director, said:

> They look at certain issues such as stumpage, which they have mentioned, and up-front establishment costs. What they do not look at is the long-term viability of the businesses, the cash flows and liquidity, the borrowing levels, the balance sheet, the whole box and dice. So we feel that their research is flawed in that regard …[45]

4.57 A difficulty in addressing this 'problem', to the extent that it exists, is that in general terms the level of fees and commissions is a matter for the market and what the market will bear. From ASIC's point of view, investor protection requires only that investors be *fully informed* of what those fees and commissions are. Even if, as van Eyk maintains, the profits made by some scheme promoters far outweigh the

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43 ATO, Submission No. 845, Attachment C, p.5.

44 Evidence, p.551.

45 Evidence, p.594.

returns on investment, there is in Mr Johnston's words 'no prohibition against charging high commissions'.[46]

4.58 ASIC conceded, however, that 'these schemes are generally sold on their tax benefits' and that 'on occasion, they are missold on those benefits'.[47] For that reason, ASIC has recently initiated action on two fronts to increase investor protection in this area. First, it has embarked upon a process of issuing 'safety checklists' for people considering investing in agribusinesses. For example, ASIC recently released such a checklist for the olive oil industry. The list contains, among other things, benchmarks for operating and establishment costs.

4.59 Second, ASIC is developing a campaign to target financial advisers who habitually 'recommend high risk or high commission paying products to determine whether they have met their obligations under the law to give advice which is appropriate to the need of their clients, with full and proper disclosure'.[48]

4.60 In other words, although there is no prohibition against schemes charging high establishment and management fees, there may be a prohibition against advisers recommending such products to clients if they do so solely for the sake of the commission they would receive. It is at that point in the market that ASIC may be able to exert some regulatory control.

4.61 From the ATO's point of view, the issue of allegedly excessive fees is also complex. As with ASIC, the ATO has 'no authority to limit the amount of profit that forms part of a particular fee'.[49]

4.62 According to the ATO, numerous Australian court judgements have 'made it plain that the role of the Tax Office is not to tell a person how to run their business, or how much they should pay'. The ATO continued:

> It is well established law that even business decisions the Tax Office may not agree with can still properly achieve a tax deduction. See for example the *Cecil Bros. Case* (1964) 111 CLR 430 – in this matter it was common ground that the taxpayer had quite deliberately made particular arrangements to purchase goods, from a non-arm's length company, at a price above that otherwise available in the market. However, the Full High Court allowed the claimed deductions to stand.[50]

4.63 For this reason, in determining whether a fee structure is such that a taxpayer's 'dominant purpose' for investing was to obtain a tax benefit, the ATO must

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46 Evidence, p.748.

47 Evidence, p.745.

48 Evidence, p.745.

49 ATO, Submission No. 845A, Attachment 1, p.1.

50 ATO, Submission No. 845A, Attachment 1, p.1.

consider the fees to be 'grossly excessive'. 'Grossly excessive' indicates, according to the ATO's submission, 'a level above – indeed perhaps several levels above fees that are merely excessive'.[51] Further,

> the Full Federal Court did not say that 'grossly excessive' fees are not deductible, only that they may be indicative of some other purpose, which may not support deductibility.[52]

Projections and forecasts

4.64 In relation to the question of projections and forecasts, van Eyk Capital again expressed concern that many agribusinesses make excessively optimistic, if not misleading, projections of future product yields and marketability in their prospectuses.[53]

4.65 As with the question of high up-front establishment costs, the accuracy of agribusiness projections and forecasts poses issues for both ASIC and the ATO. ASIC has a role in protecting investors against being misled about likely future returns, and the ATO must assess the validity of claims about the long-term profitability of a venture in order to satisfy itself that deductions are granted for expenses in a business with overall profit making intent.

4.66 The Committee took some evidence which supported van Eyk's assessment of problems in this area. For example, the Australian Managed Investments Association (AMIA), while advocating self-regulation by the agribusiness managed investments industry, conceded that:

> … this is anecdotal – during that period of genuine projects on the market, to sometimes compete with the more flamboyant projects on the market some sometimes had to not cook the books but certainly take a very rosy view of the likelihood of profits in the business and therefore may have put in not inflated figures but certainly more favourable figures than they would have done had the regulators been doing their jobs.[54]

4.67 The Committee also heard, however, that the mere failure of a project to meet its prospectus projections does not by itself demonstrate that those projections were irresponsibly inflated. For example, Mr Douglas Pollard, Managing Director, The Barkworth Group told the Committee:

> When we entered the industry in 1997, the supermarket audit of extra-virgin olive oils across the board revealed that the price was $14 per litre. That is the retail price of the packaged product … The dollar at that stage was about

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51 ATO, Submission No. 845A, Attachment 1, pp.1-2.

52 ATO, Submission No. 845A, Attachment 1, p.2.

53 Van Eyk Capital, Submission No. 691, pp.4-5.

54 Evidence, p.728.

> US72c. The dollar, as we all know, is about US51c at the moment. One would reasonably have expected the price of olive oil to be a lot dearer in Australian terms. In fact, across the board a supermarket audit reveals that it is now about $10 per litre. Taking into account the difference in the value of the currency, the price of olive oil has halved, so there has been dumping, which has made it harder for us to sell it …[55]

4.68 ASIC's guide for investors in olive schemes states that over the ten-year period (1990-2000) the price for olive oil on the Milan Bourse, the major trading centre for olive oil, fell 100 per cent in real terms, from AUD$8 to AUD$4.[56]

4.69 ASIC reported to the Committee that it has recently tightened its monitoring of prospectus forecasts and projections. Mr Johnston said:

> Since we last appeared before the committee, ASIC has issued a new interim policy statement on the use of forecasts and projections in disclosure documents. ASIC requires that any forward looking statements must be made on a reasonable basis. We have indicated that, where the forecast goes beyond two years, either a report by an expert or the existence of forward contracts supporting a stated price would satisfy the requirement. Somewhat ironically, many in the industry have criticised ASIC's policy as being too tough to meet.[57]

4.70 In addition to this requirement, both ASIC and some industry associations are developing benchmarks and codes against which particular scheme projections can be assessed.

4.71 For example, Mr Robert Rawson, General Manager, Forest Industries Group, Department of Agriculture, Fisheries and Forestry – Australia (AFFA), told the Committee that the plantation forestry industry is developing a code of practice for afforestation managed investment schemes. The code, he said, 'aims to have all the relevant information for a forestry project outlined in a manner that would allow investors to make a meaningful comparison between schemes. Particular emphasis is to be placed on the independent expert reports to back the predictions of future wood growth and timber royalties'.[58] Australian Forest Growers, the national association representing and promoting private forestry in Australia, emphasised its commitment to implementing the Code of Practice for Afforestation Managed Investment Schemes and its 'willingness to adopt a transparent and effective system of self-regulation'.[59]

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55 Evidence, p.550.

56 ASIC, Media Release, 21 August 2001.

57 Evidence, p.744.

58 Evidence, p.690.

59 Australian Forest Growers, Additional Information, 22 August 2001.

4.72 The Committee notes that ASIC's compliance focus is on trying to ensure that investors are not misled at the outset, and that non-compliant schemes are unable to get established.

4.73 ASIC told the Committee that if 'tax driven promoters breach the law we can take enforcement action (civil, administrative and criminal) but this can only take place after a thorough investigation, if we suspect an offence has been committed'.[60] It appears to the Committee that ASIC may lack the resources to pursue such investigations.

4.74 As outlined earlier in this Chapter, ASIC has undertaken quite extensive surveillance of agribusiness schemes since 1998, but the Committee is unaware that ASIC has prosecuted any promoters of mass marketed schemes whose investors have had their deductions disallowed by the ATO.

4.75 In expressing frustration at the high proportion of remedial action and surveillance activity expended on the agribusiness managed investments sector, ASIC noted that 'the question could be asked whether these schemes should be regulated in some other way'. Mr Ian Johnston said:

> We note that, in some jurisdictions, public offering of these types of investments is not permitted. While not at this stage advocating such a position in Australia, we do note that as a regulator we conduct a policy, disclosure and conduct regime which achieves particular results in the case of much of the regulated managed investments population but which does not achieve those results with this sector.[61]

4.76 The Committee endorses the development of industry benchmarks by both ASIC and industry associations, as well as ASIC's recent initiatives in relation to forecasting and the regulation of experts' reports. The Committee considers that these measures, combined with the ATO's product ruling system and the development of promoter penalties, should greatly improve the levels of investor protection in the mass marketed schemes market.

4.77 However, the Committee is concerned at ASIC's reports of the disproportionately high level of problems that continue to be associated with primary production schemes and at the apparent lack of resources for investigations and prosecutions where necessary. The Committee is also concerned that the current regulatory regime may be inadequate to control the promotion of franchise schemes.

Recommendation

4.78 The Committee recommends that the government seek advice from both ASIC and the ACCC on the question of the adequacy of the current measures for

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60 ASIC, Additional Information, 14 September 2001, p.4.

61 Evidence, p.745.

monitoring the schemes market, with particular reference to agribusiness and franchise schemes. This advice should address matters such as the role of specific industry associations and the Australian Managed Investments Association in ensuring that compliance and disclosure obligations are met, the development and publication of further benchmarking measures which draw on industry wide standards and expertise, and any other measures required to ensure the adequate protection of investors in this sector.

Senator the Hon Brian Gibson
Acting Chairman

MINORITY REPORT

Preface

1.1 The Committee has already issued two reports on the Mass Marketed Tax Effective Schemes fiasco.

1.2 The first – the Interim Report (June 2001) – was highly critical of the ATO's management of and approach to the mass marketed schemes affair.

1.3 The second report (September 2001) proposed an alternative resolution and settlement option with a view to allowing taxpayers and the ATO to resolve their differences without proceeding to court.

1.4 The recommended resolution and settlement was proposed following consultations with taxpayers and the ATO.

1.5 Despite giving a commitment to respond to the second report promptly, the ATO are yet to advise the Committee of their views on the recommendations.

1.6 Many of the issues canvassed in the Interim Report have become clearer and only add to the concerns initially raised by the Committee.

1.7 The ATO is the manager of Australian Taxation Law and as such is required to interpret and apply those laws – fairly and equitably.

1.8 Under the self-assessment tax system, taxpayers are required to abide by the law and the ATO view of the law, although they do have a right to challenge the ATO view in the Courts.

1.9 This type of system places great onus on the ATO to ensure clarity in both the law and their view of the law.

1.10 The ATO's task can be made more difficult by government policy objectives, which may impact on the application of the law.

1.11 The mass marketed schemes debacle is a good example of how things can go horribly wrong where a lack of clarity and action exists.

1.12 There is no question that ATO administrative practices have been found wanting on these matters for some time.

Background

1.13 Evidence to the Committee clearly shows that the ATO was aware of problems associated with claimed deductions in mass marketed schemes as early as 1982.

1.14 Indeed the ATO audited some twenty-eight schemes between 1987 and 1997. Fourteen of those audits were completed by 1994 with nine schemes having deductions disallowed primarily on the basis of round robin non-recourse financing.

1.15 As can be seen from the table below, scheme deductions grew at an exponential rate from 1993 to 1998, but it is worth noting significant increases in 1987 and 1988.

Table 1: 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[1]

1.16 Furthermore, historical evidence shows that both Governments and the ATO had concerns over claimed deductions associated with mass marketed schemes.

1.17 A press release from the Federal Treasurer as far back as the 30th December 1982 shows that the very problem used by the ATO in 1997-1998 to support retrospective action was a concern then. The press release says:

> "On 30 December 1982 I announced that the Commissioner of Taxation, who has independent statutory responsibility for administration of the income tax law, had decided to take assessing action under the general anti-avoidance provisions of Part IVA of the Income Tax Assessment Act to disallow claims arising from participation in certain film production arrangements **where deductions are substantially leveraged by associated loan arrangements**"(emphasis added).

1.18 Moreover, during the 1980s the media regularly featured articles on tax effective investments. These articles, as shown below, clearly demonstrate that knowledge and concern about such activities did exist.

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[1] It should be noted that the annual scheme deductions in Table 1 do not include deductions for EBAs.

1.19 *The Australian*, March 1981:

> "Several schemes involve costs **related to special loans to investors which are structured so as to induce them into projects at no real financial cost to themselves**"(emphasis added).

1.20 *The Financial Review*, December 1984:

> "Even the Federal Government implicitly recognises the extent of the investment distortion caused by high marginal tax rates by two blatant examples of tax shelters for high marginal tax payers – the film tax deductibility rort and the licensed management investment companies (MICs)…In recognition of these factors the previous Government introduced what may have been seen by some as extremely generous tax concessions so that the industry could be funded through the tax system and by direct government handouts."

1.21 Furthermore, in relation to the history of agribusiness investments in particular, the same article went on to say:

> "The combination of tax shelter and capital gain has produced widespread interest in a variety of primary industry pursuits. The conventional route is to buy a rundown farm, build it up with tax deductibility investments over some years, sell it for a capital gain during a good season. There has been investment in angora goats, avocadoes, guava fruit, mangoes, macadamia nuts, afforestation, jojoba nuts, the babaco fruit from Ecuador, lychee fruit, blueberries or the pepino."

1.22 *The National Times*, 7th of June 1985 said:

> " PAY TAX OR GROW A FOREST? – very attractive taxation benefits."

1.23 Added to that was the 1991 statement by then ATO Commissioner Boucher, which said in part,

> "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."[2]

1.24 In many cases the financing structures designed for schemes during the 1980s were exactly the same, and had the same objectives, as those now subject to retrospective action. That is, they aimed to limit the investor's risk, leverage a tax deduction, and by doing so make the overall investment much more attractive.

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

1.25 Given the concerns raised by the Federal Treasurer in 1982, ATO statements and numerous newspaper articles, it is difficult to accept the ATO argument that it lacked information on or knowledge of Mass Marketed Schemes and their alleged abusive features when they emerged during the 1990s.

Effective Signalling

1.26 The ATO maintains that its concerns about abusive features in schemes were obvious to the market place well prior to the prolific growth in claimed deductions in the years 1993-1998.

1.27 However, evidence would suggest differently with the ATO's position being ambiguous at best. This is highlighted by the ATO approving thousands of 22ID applications, and issuing a number of Private Binding Rulings which approved the deductions sought in schemes now subject to the application of Part IVA. Moreover, a pre ruling consultative document (PCD9) issued by the ATO in December 1995 and claimed by them to represent a signal also fails the test of providing clarity and certainty to taxpayers.

1.28 This failing was pointed out in a 1996 internal ATO report which focused on the very issue of limited recourse financing. The 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."

1.29 As stated earlier, the ATO did conduct some audit activity in the late 1980s-early 1990s. The following list outlines some of the schemes audited by the ATO and the reasons their deductions were disallowed.

Scheme 24 – Viticulture / Horticulture Scheme
1987

- **Part IVA Application**
- Investors were not carrying on a business
- Expenditure by investors was of a capital nature
- Arrangement was a sham
- **Non-Recourse Financing**
- **Round-Robin Transactions**

Scheme 25 – Viticulture / Horticulture Scheme
1988

- **Part IVA Application**
- **Round-Robin Transactions**
- **Non-Recourse Financing**

Scheme 21 – Viticulture / Horticulture Scheme
1989

- **Part IVA Application**

- Taxpayers were not carrying on a business
- Taxpayers were passive investors
- **Borrowers borrowed 100% of the funds from an in-house financier**

Scheme 28 – Crayfish Breeding
1989

- ATO disallowed deductions claimed
- **Financing arrangements were considered artificial flowing in a round-robin between the in-house finance company, the borrower and the manager.**

Scheme 26 – Afforestation Scheme
1992-93

- **Scheme had a mixture of full and non-recourse loan arrangements**
- **Non-Recourse loan element was not allowed**

Scheme 22 – Viticulture / Horticulture Scheme
1993-94

- **Part IVA Application**
- Significant artificial management fee
- **Income as a result of round-robin and non-recourse financing**
- **Whole scheme based on round-robin and non-recourse financing**

1.30 Again the question arises that following the disallowance of deductions in nine out of fourteen schemes on the basis of non-recourse finance and large upfront fees, why didn't the ATO issue a tax ruling? Why did the ATO allow schemes with exactly the same non-recourse financing and fee elements to continue throughout the 1990s to the extent that so called non allowable deductions rose to $1.5 billion in 1998/1999? Finally, why did it take until 1998 before any decisive action was taken?

1.31 Across the board evidence presented to the Committee suggests that, at best, confusion reigned supreme and, at worst, the management and application of the tax laws of this country was downright incompetent.

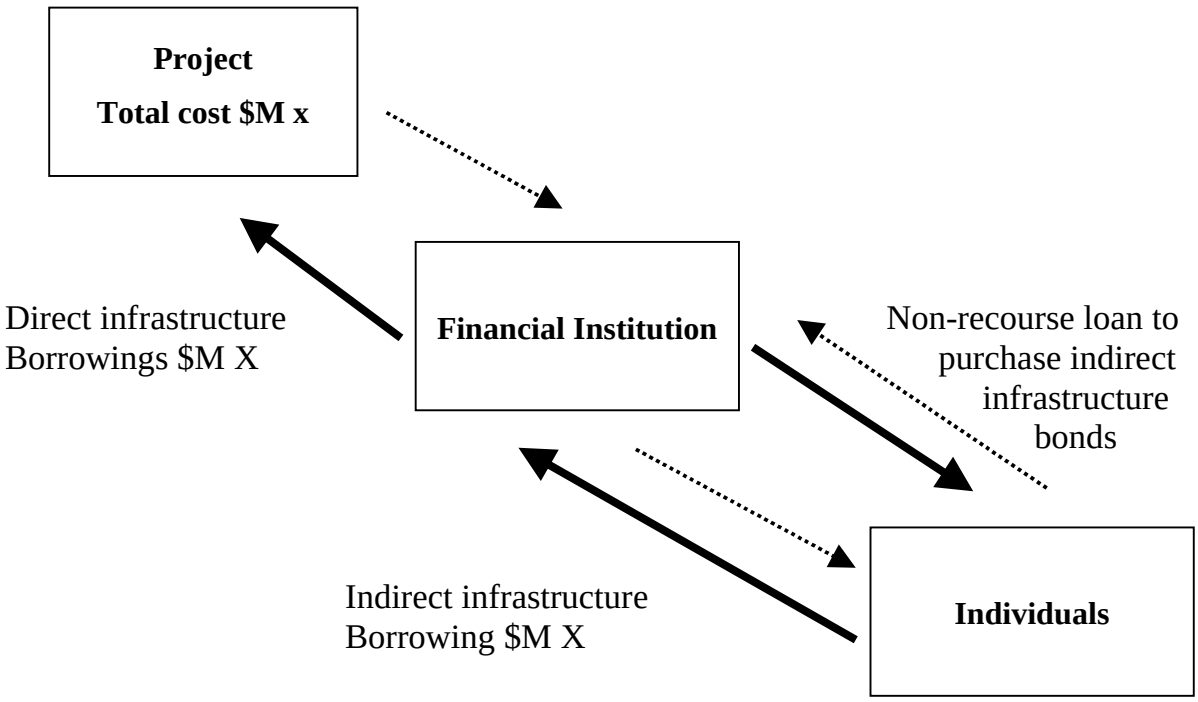
1.32 What is also clear now is there has been no consistent application of Part IVA, and the obligation on the ATO to provide certainty and security for taxpayers has not been met in many areas. A demonstration of such inconsistency arises in the Infrastructure Bonds and Unit Trusts areas.

Infrastructure Bonds

1.33 During the early 1990s the Federal Government adopted a number of legislative and policy initiatives through the establishment of Infrastructure Bonds. Combined with generous legislative based tax concessions the objective was to facilitate and promote greater investment in large infrastructure developments. While essentially based on good policy and sound initiatives, infrastructure investments were viewed as a favourable way to invest, as the adoption of certain financing

arrangements or structures allowed not only for a leveraged tax deduction but also a limited level of risk to the investor.

1.34 The structure and financing arrangements of infrastructure bonds were provided to the Committee by the ATO and illustrated by Figure 1.[3]



1.35 As Figure 1 shows the financing structures developed to market infrastructure bonds to retail investors are not dis-similar to those employed within the mass marketed area. In essence the retail investor took out a non-recourse loan, which achieved two objectives. Firstly, the investor could not only limit their overall risk but claim an immediate tax deduction. Secondly, the loan in many instances would have been paid out through proceeds often derived after the completion of the project; for instance, from tollgate revenue on a freeway project.

1.36 Many large organisations were involved in Infrastructure Bonds including, for example:

The Commonwealth Bank

1.37 The Commonwealth Bank's 'Infrastructure Investment Package for Develop Australia Bonds' is one such example worthy of investigation. In their Offering Memorandum dated the 23rd of April 1996 the Commonwealth Bank stated:

> "The loan provided by CBA (Commonwealth Bank of Australia) is non-recourse to the investor".

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3 Economics References Committee Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection, Written Reply by Mr Fitzpatrick to the Committee dated 15 June 2001.

1.38 The investment was constructed in such a way as to provide an investor with:

> "an entitlement to a tax deduction for management fees incurred on the investment and interest on the loan".[4]

1.39 Furthermore, the Offering Memorandum went on to say:

> "For a cash outlay of $70,048 by 14 June 1996, an investor should be able to obtain a tax refund of $80,048".

1.40 The last point is a clear issue of leveraging which should surely bring into question the 'dominant purpose' of any investor. However, as far as I am aware not one investor in these investments was ever issued with an amended assessment – similar to the current ATO action – on the grounds that their dominant purpose was to obtain a tax deduction or that the loan arrangements were designed to limited the investor's overall risk.

Legal and General

1.41 Another relevant example is an offering from Legal and General Financial Services, in relation to the following products:

'Legal and General Infrastructure Fund 1996-2';
'Legal and General Infrastructure Fund 1996-3';
'Infrastructure Investment Offer'; and
'Taxation Advice – Individual Investors'

1.42 Advice on these products from Price Waterhouse, dated 27 May 1996, stated:

> "The financing facility will be repaid from the redemption proceeds of the units in the Infrastructure Funds and the expected non-assessable distribution of $25,000 per unit made to the unit holders. The financing facility will be non-recourse to the investors."[5]

1.43 As mentioned previously, the ATO has consistently argued that in many instances the nature of the financing arrangements in the current mass marketed area resulted in little if any risk to the investor and hence warranted the application of Part IVA. However, both the Commonwealth Bank and Legal and General Infrastructure investments sought exactly that – to limit the investors exposure to risk through the use of non-recourse financing. It could also be argued that, in both these cases, high fees were set in order to leverage a substantial tax benefit for the investor.

1.44 There also appear to be inconsistencies in the ATO's treatment of infrastructure bonds relative to mass marketed schemes on the issue of their

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4 Commonwealth Bank, 'Infrastructure Investment Package for Develop Australia Bonds', Offering Memorandum 1996:2. (See also page 5 where they say the Loan is non-recourse to the borrower).

5 Advice from Price Waterhouse to Legal and General Financial Services Limited on 27 May 1996, p5.

underlying commerciality. First Assistant Commissioner Kevin Fitzpatrick, in response to questions put to him by the Committee in regard to Infrastructure Borrowings, said:

> "Infrastructure borrowings are distinguishable from mass marketed tax schemes. In the latter, round robin, non-recourse financing arrangements have the effect that little of the funds find their way into any productive activity."[6]

1.45 If, as Mr Fitzpatrick alludes, the main reason for the ATO applying Part IVA to mass marketed schemes is the fact that money **does not go** into 'productive activity', why then have commercially successful schemes which export their products world wide and which pay large amounts of company tax to the Commonwealth, had all of their investors' claimed deductions disallowed under Part IVA?

1.46 It is farcical for Mr Fitzpatrick to promote such an argument. If it were the case that the ATO assessed the application of Part IVA on the grounds of commerciality or that funds actually find their way into productive activity, then surely it would have been better for the ATO to have 'sifted the wheat from the chaff' in regard the mass marketed schemes sector. Instead, the ATO has issued amended assessments to any investor or scheme based not on commerciality but on the financing and fee structures.

Macquarie Bank – Geared Equity Investment Portfolio

1.47 Further inconsistencies in ATO action are evidenced by a number of Macquarie Bank Investment portfolios. Macquarie's 'Geared Equity Investment' is one such example. In the first instance, the promotional material for the investment clearly shows investors that the investment portfolio is 'APPROVED' by the ATO with a Product Ruling (PR 2000/70).[7] More importantly though, the promotional material says:

> "A Geared Equities Investment from Macquarie is an ideal way to build wealth over the long term through the share market. Macquarie will lend your clients 100% of the value of their selected portfolio…Best of all, your clients don't need to take any capital risks…Macquarie offers your clients 100% protection against the risk of losing their loan capital, giving them maximum peace of mind." [8]

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6 Economics References Committee Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection, Reply by Mr Fitzpatrick to the Committee dated 15 June 2001.

7 Macquarie Geared Equities Investment – Macquarie Bank Ltd. Sourced: http:///www.macquarie.com.au/adviser/geared_equities_investment.htm, p1.

8 Ibid, 1.

Macquarie Bank – Apollo Trust

1.48 Macquarie Bank has another investment highlighting similar anomalies and complexities in the ATO's administration of the tax law. The Apollo Trust is an investment which allows investors to access returns subject to the performance of hedge funds. With the Apollo Trust, Macquarie offers investors two loan facilities, of which one, a 'Capital Protected Loan':

> "fully protects themselves (the investor) against any fall in the value of their investment capital (provided their units are not redeemed before maturity).[9]

1.49 Furthermore, in relation to risk specifically, Macquarie Bank's promotional material goes on to say:

> "The structure of the investment aims to offer you an opportunity to increase the returns from your investment portfolio, **while reducing your overall portfolio risk**".[10]

Concluding remarks

1.50 In assessing these issues it is understandable why investors caught up in the mass marketed agribusiness investment fiasco feel the 'big end of town' has gained preferential treatment from the ATO. This point has further credence when the ATO themselves point out that 97 per cent of all investors now issued with amended assessments in relation to the Mass Marketed schemes area – with associated penalties and interest – sought the advice of a tax agent in making their claims.[11] Questions relating to what actually constitutes due diligence by the ATO need to be seriously addressed, particularly given the onus placed on individual tax payers by a self assessment tax system. With this to one side, the point still remains that the financing structures used by many of the current scheme designers have been utilised for over 20 years with only spasmodic and inconsistent application of Part IVA.

1.51 The reasons for the ATO applying Part IVA are complex but are summarised in a speech by Second Commissioner Mr Michael D'Ascenzo to the Taxation Institute of Australia on 22-24 March 2001. He argued that there are a number of aspects which trigger the application of Part IVA namely:

i. Grossly excessive/inflated fees;
ii. The mechanisms employed to discharge investor liabilities;
iii. Financing arrangements;
iv. Investor business risk;
v. Source and amount of cash funds applied to the underlying activity;

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9 Macquarie Bank 'Apollo Trust' Prospectus – Investment Highlights, 8

10 Ibid, 9.

11 Second Commissioner Mr D'Ascenzo, Senate Economics References Committee Hearings, Hansard 23-08-01, p.826.

vi. Commerciality of the project; and
vii. The financial position of the promoter and promoter related entities.

1.52 Similarly, Mr D'Ascenzo made the following comment before the Senate Committee hearings on 23 August 2001:

> "Again, the existence of non-recourse finance is a factor that we take into account. We make it very clear that, when we see non-recourse financing, the level of risk associated with the activity starts to give rise to whether or not what you are really after is a tax deduction."[12]

1.53 It is undoubtedly the case that a number of schemes and investors now having Part IVA applied, entered into non-recourse financing arrangements. This subsequently leveraged a tax deduction to the investor and limited their overall financial risk. However, so did a number of schemes marketed in the mid to early 1980s.

Infrastructure Borrowings and Part IVA

1.54 On the 14th of February 1997 the Federal Treasurer Peter Costello issued a statement, which said in part:

> " a number of measures [are being introduced] to prevent abuse of the infrastructure borrowings (IB) taxation concession instituted by the Labor Government, which if left unchecked would pose a major threat to the revenue."

1.55 At the time IBs approved by the Development Allowance Authority (DAA) had an estimated value in excess of $4 billion dollars. According to the Treasurer, the DAA had been monitoring applications and found that:

i. schemes being proposed are exploiting the concession for tax minimisation schemes; and
ii. these additional taxation benefits are principally being accessed by financial packagers and high marginal tax rate investors.

1.56 Essentially, a legitimate process designed to encourage infrastructure development was being leveraged and aggressively marketed to such an extent that the Treasurer felt legislation had to be implemented to curb the abuse. The Treasurer alluded to this abuse in the same Press Release saying that:

> "As a result of this transaction (i.e the re-engineering of the accepted model), for an investment of $36,000, they (the investor) get $85,000 worth of tax deductions."

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12 Ibid, p.820.

1.57 The fact that Part IVA was never applied to infrastructure investments, despite such evidence of aggressive leveraging, must seem remarkably unjust to those investors in mass marketed schemes who have had deductions disallowed and Part IVA penalties applied. This is particularly so, given that many invested in projects that are still operating and in many instances making good profits.

1.58 From a legal perspective the abusive developments of IBs and the associated concerns raised by the Treasurer bring into question the 'dominant purpose' of investors. Did they invest to see infrastructure projects developed or to gain a tax deduction? This question is answered by the Development Allowance Authority's findings that IB schemes were being exploited for tax minimisation purposes and taken up by high marginal tax rate investors.

1.59 Lastly, it could be argued that the abusive concerns in regard to IBs raised by the Treasurer himself in 1997, trigger all 7 points which facilitate the application of Part IVA, as identified by Second Commissioner Mr Michael D'Ascenzo in his speech to the Taxation Institute in 2001. Why then were the Government and the ATO content – in the case of IBs – only to implement legislation to curb tax abuse but not address whether Part IVA applied as it does in the case of mass marketed schemes?

1.60 In fact, First Assistant Commissioner Kevin Fitzpatrick, in written evidence to the committee on June 15 2001, said that in one particular IB scheme, Part IVA did apply. He said:

> "I am advised that we obtained advice from Senior Counsel in respect of one [IB] project in which counsel concluded on the facts of that case that there were reasonable prospects for the operation of Part IVA to some of the retail investors."[13]

1.61 To my knowledge, however, the ATO did not apply Part IVA penalties to any of the retail investors alluded to by Senior ATO counsel. Furthermore it must be noted that given the sheer size of many infrastructure projects, one IB scheme alone could involve hundreds of millions of dollars worth of investment capital. Again why was Part IVA not applied either to scheme designers or retail investors in this instance? This argument gains momentum when one considers the fact that investors involved in IBs could in most instances be considered 'sophisticated investors', unlike the great bulk of investors in the mass marketed schemes.

1.62 In many respects the inconsistencies in treatment between IBs and mass marketed schemes goes to the heart of the self assessment tax system and what the ATO constitutes as due diligence.

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[13] Senate Economics References Committee into Mass Marketed Tax Effective Schemes and Investor Protection. Written evidence from First Assistant Commissioner Kevin Fitzpatrick in response to Committee questions, 15th June 2001, p.3.

MMS and Part IVA

1.63 The inconsistencies in applying Part IVA have engendered a serious public image problem for the ATO, as well as confusion in the market. For instance, Colin Thomas from Hudson Croft and Thomas Accounting firm in Sydney argued in evidence to the Committee:

> "In my view no tax professional with specialist knowledge in this area believed that Part IVA would apply to genuine business transactions where limited recourse or indemnified loans were used to finance the transactions. This is on the basis that the loans were properly documented and the funds flowed to evidence the transactions. The existing rulings and tax cases gave a clear indication."[14]

1.64 In support of this view Robert K. O'Connor QC argued in evidence provided to the Committee that:

> "In my opinion, the ATO failed to ensure that new laws were introduced to amend the Tax Act to overcome tax schemes. At law, the Courts had held that round-robin transactions are valid. Similarly, non-recourse funding was accepted in Lau's case (1984) 84 ATC 4929."[15]

1.65 Other aspects that need to be raised in regard to the inconsistencies and vagueness of the ATO's action are the following.

1.66 In October 2001, the Committee asked Assistant Commissioner Peter Smith why Part IVA was never applied to a plantation timber company which, in offering investors investment opportunities, clearly exhibited a round-robin financing structure.

1.67 In answering the Committee's concerns Mr Smith said:

> "In considering the application in respect of the year ended 30 June 1997, it was evident that the loans involved a round robin arrangement but due to the size of the fees and the full recourse nature of the loans this was not considered to be a problem at the time."[16]

1.68 According to tax ruling TR 2000/8 a round robin arrangement "includes any mechanisms employed to effect the discharge of liabilities…".[17] Furthermore TR 2000/8 questions the use of round robin arrangements by asking: "Are mechanisms of this kind commercially explicable and not part of arrangements to inflate, or

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14 Senate Economics References Committee Enquiry into Mass Marketed Tax Effective Schemes and Investor Protection, Sydney Hearings 24-07-2001, Hansard transcript, p.535.

15 Robert K. O'Connor, written submission to the Senate Economics References Committee Enquiry into Mass Marketed Tax Effective Schemes and Investor Protection, 25 July 2001, para 14, p.4.

16 Assistant Commissioner Mr Peter Smith, Response to the Senate Economics References Committee 19 September 2001, p.1.

17 Taxation Ruling TR 2000/8, clause 27

artificially create, tax deductions?"[18] In conclusion, the answer given by Mr Smith raises the question that if the up-front fees had been higher, or, in the ATO terms, were 'Grossly Excessive', would the ATO have applied Part IVA in regard to this project? The answer to this question is clearly NO and the following section demonstrates why.

Grossly Excessive Fees

1.69 The ATO has been repeatedly asked by the Committee to verify what it considers to be grossly excessive in regard to commercial rates and fees described in TR 2000/8. The Committee has also asked the ATO to explain how it determines, through Product Rulings, the validity of claimed tax deductions and, therefore, how it assesses the question of Part IVA's application and the investors' dominant purpose. The Chair of the Economics Committee asked Senior ATO representatives:

> "I would specifically like to know how you determine what are commercial rates, fees and charges."[19]

1.70 Mr Bersten (former Deputy Chief Tax Counsel of the ATO) answered:

> "Senator if I can refer you to paragraph 134 of the ruling itself, it says: A commercially realistic rate is usually fixed by looking at fees charged by bona fide operators in respect of the actual activity and range of services to be provided."[20]

1.71 In addition, Mr Peterson (Assistant Commissioner for Small Business) pointed to such things as **'a fair margin'**, or **'what you would normally expect to find in the market place'** and so forth.[21] However, in discussing the level of management fees and up-front charges and the associated deductibility of these fees, Mr Peterson emphasised that the ATO assesses such fees within a **'fairly broad band width'.**[22]

1.72 This 'band width', in regard to vineyard investments, according to Mr Peterson:

> "is probably anywhere like several hundred thousand dollars."[23]

1.73 In other words, the ATO will allow claimed deductions for an investment in a vineyard anywhere from the average fee, let's say $40,000 to $340,000!

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18 ibid, clause 61 (iii) Financing Arrangements.

19 Senate Economics References Committee into Mass Marketed Tax Effective Schemes and Investor Protection Hearings 11 December 2000, Hansard transcript E5.

20 Ibid, E5.

21 Ibid, E6.

22 Ibid, E7.

23 Ibid, E7.

1.74 Of greater concern was Mr Peterson's **suggested 'band width'** for an investment in Paulownia plantations. He argued that the band width acceptable in this area was as narrow as $500 or $600.[24]

1.75 However, the ATO has issued Product Rulings for Paulownia plantations with subscriptions ranging up to $52,500 per hectare, which is clearly outside the band width set by the ATO. This amount would also seem to fall into the grossly excessive fees category, as it in no way reflects normal market rates.

1.76 Given that the ATO has, on numerous occasions, used 'grossly excessive fees' as a justification for applying Part IVA, it is puzzling as to why they have issued Product Rulings for projects, such as Heritage Paulownia, which appear to have fees which exceed the market norm.

1.77 Moreover, it demonstrates that failings continue to exist in the ATO when it comes to dealing with mass marketed tax effective schemes.

1.78 It also highlights the major failings that existed within the ATO's risk assessment process in regard to earlier scheme deductions now the subject of Part IVA action.

Additional Concerns

1.79 Throughout this saga the ATO has sought to lay the blame squarely at the feet of promoters, advisers, scheme developers and investors. However, and as previously stated, the evidence simply does not support that position.

1.80 The ATO and some members of the Committee promote a view that to allow deductions for investors involved in mass marketed schemes to stand would be unfair on the rest of the community. There are two things that need to be said about that view.

1.81 Firstly, the general community were never offered the opportunity to participate but had they been offered, most would have probably taken the offer given the approach taken in the promotion of them and the type of professional people involved in the process.

1.82 The reality is, though, that the great bulk of the community does not have the level of income necessary to attract these types of investment offers.

1.83 It is my view that this approach is simplistic and seeks to avoid the real issue behind the problem.

1.84 The culture of tax professionals and taxpayers has been drawn more into focus as a result of the ATO's actions relating to mass marketed schemes. A number of issues need to be considered in this context.

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[24] Ibid, E7.

1.85 As stated in the main report, the ATO has turned its attention to the attitudes of the culture of tax professionals.

1.86 In speeches to the community of taxation professionals, Mr Carmody and other ATO officers have asked that community to consider its role in maintaining the integrity of the tax system and have asked for its help in monitoring and controlling the activities of aggressive tax planners.[25]

1.87 In addition, a speech to the Taxation Institute of Australia by Assistant Commissioner Michael O'Neill concluded with the following exhortation:

> "If taxation is the price we pay for civilisation, we tax advisers, lawyers and accountants, each have a key role in advancing our community. Your advice will assist clients when considering the legal and financial benefits of investing in year end schemes."[26]

1.88 Mr Carmody told the Committee that:

> "In my view, the community's tax system would be best protected by others supporting the tax office in meeting this objective. In particular, the tax profession, which is at the coalface on a day-to-day basis, could provide a valuable role in bringing developments to our attention. There are mixed views on this in the profession, some preferring the view that their only responsibility is to their client and that this would be compromised by taking a community responsibility. **This view raises for me a number of responsibility issues that are worthy of considering. In saying that, is it saying that tax professionals know or knew the schemes were ineffective but, because the tax office had yet to act, they would recommend our support claims made for them? Otherwise, why not make them available to us? If so, is there no responsibility to the community for the integrity of the tax system, even when they know or expect the arrangements will not pass muster under the law?"** (emphasis added)[27]

1.89 Additionally, Mr Carmody told the Institute of Chartered Accountants:

> "It is one thing to approach an interpretation of the law from the perspective of advising a client, particularly where the whole objective is to minimise tax payable. It is another thing to approach the law from the perspective of a responsibility to the community for the integrity of the law."[28]

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25 See the Commissioner's speech, "A New Tax System – Changing Cultures", 19 November 1998, Sydney; and Assistant Commissioner Michael O'Neill's speech, "Taxes, Death & Civilisation: a look at year end "tax effective products", 15 May 2001, Brisbane.

26 Michael O'Neill, "Taxes, Death & Civilisation: a look at year end "tax effective products", 15 May 2001, Brisbane.

27 Evidence, pp.798-799.

28 "A New Tax System – Changing Cultures", 19 November 1998, Sydney.

1.90 The statement in this last paragraph is interesting in that it seems to seek to confuse the responsibility of the tax professional to their client and an act of breaking the law.

1.91 Under the self-assessment tax system, it is the responsibility of the tax professional to advise their client of every deduction to which the client is legally entitled – that after all is what they are paid for.

1.92 Responsibility to the rest of the community and the integrity of the law can only be at issue when the tax professional advises the client to break the law.

1.93 These are clearly two different things and it is simply not good enough for the ATO to endeavour to muddy the water by mixing the two together.

1.94 If the Commissioner and the ATO believe that tax professionals have knowingly advised clients to break the law, then they should prosecute them or support action by taxpayers for breach of duty against the tax professionals so involved.

1.95 The self-assessment system also allows for a reassessment of a taxpayer's affairs for up to four years in general terms and up to six years if the ATO deems that Part IVA applies and indefinitely in cases of fraud. Where the law is clear and concise, these measures should suffice for the ATO to collect the revenue to which it is entitled.

1.96 Any effort to employ morality as a solution to the interpretation of tax law is doomed to failure as has been witnessed over the life of the self-assessment tax system. Two witnesses to the Committee made important points in this regard.

1.97 Mr Robert O'Connor QC stated:

> "If morality had to be taken into account in interpreting the meaning of the law, whose morals should be applied? The answer to what the law is would vary and depend on the morals of the particular person giving the opinion."[29]

1.98 Mr Richard Gelski of Blake Dawson and Waldron said:

> "…not only is it our obligation to advise on the law as it is – we can be sued if we do anything else – but if we fail to advise a client that a transaction can be carried out in a more tax effective manner we can be sued for negligence by that client."[30]

1.99 The Committee Report draws on a submission by Mr Michael de Palo from Deloitte Touche Tohmatsu as contrast to the above views. In my view, Mr de Palo's

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29 Mr Robert O'Connor QC, Submission No. 891, pp.8-9

30 Evidence, p. 524

comments are not at odds with these remarks, but represent another way of stating the same thing.

1.100 Moreover, no number of reviews into the nature and extent of the public interest responsibility that tax professionals should adopt for the integrity of the tax system will adequately replace clarity in the law.

1.101 Clarity in the law is the key solution, and where clarity does not exist then it should be sought or determined by the Courts or legislation.

1.102 In the case of tax effective investment products, the law should be amended to require ATO approval for the products prior to their public marketing and sale.

1.103 If this had been the case in the past the thousands of investors now caught in the ATO action would not be in that position and at least $1.5 billion of tax revenue would not be at risk.

Summary

1.104 As has been highlighted in earlier parts of this report, abusive tax activity is not a new phenomenon and the ATO has had plenty of experience in dealing with it.

1.105 What is interesting is how the ATO have dealt with past problems. In areas such as Unit Trusts and Infrastructure Bonds, the ATO, Government or both moved to end abusive activities but in both cases they did it prospectively, not retrospectively.

1.106 When this was raised with the ATO, they argued there were important differences between Unit Trusts and Infrastructure Bonds and Mass Marketed Schemes.

1.107 The ATO stated that in relation to afforestation schemes, the ATO public position was that deductions would not be allowable if Part IVA applied, but that it had not made any comparable statement in respect of Unit Trusts and as such a clear signal existed in one area and not in the other.

1.108 The ATO also stated that the prospective decision on Unit Trusts was based on the arrangements being implemented in line with the information provided to the ATO on which it based its advanced opinions.

1.109 In contrast, the ATO allege that in the case of Private Binding Rulings for Mass Marketed Schemes, the promoters neither provided all of the facts nor implemented the arrangements according to the facts presented.

1.110 However, the ATO never produced any evidence to support these claims and it was remiss of myself and the Committee not to have pursued this matter further as it is fundamental to the equitable application of our tax laws.

1.111 Moreover even without greater scrutiny, the ATO position is found wanting. For example, in the case of one Private Binding Ruling issued to an investor in Main

Camp Tea Tree Oil, the investor provided what can only be considered as all relevant information, including information that the investments involved limited/non-recourse financing. Indeed, the applicant asked the ATO if they needed any further information to which they responded in the negative.

1.112 Moreover, if the ATO felt that it didn't have all the relevant information, why didn't it ask for it?

1.113 Why didn't the ATO – given their alleged concern about financing arrangements - specifically ask about them?

1.114 To try and hide behind a position that a clear signal existed in one area over another simply because you have mentioned Part IVA does not hold water.

1.115 There is no requirement for the mentioning of Part IVA for it to apply, indeed Part IVA is there for the purpose of dealing with breaches of the tax law, the "general anti-avoidance provision".

1.116 In addition, I doubt the ATO ever investigated all of the arrangements associated with Unit Trusts to determine whether or not they were implemented exactly in accordance with the advance opinions issued.

1.117 As is cited earlier in this report on Infrastructure Bonds, the government took prospective action in bringing to an end the rorts occurring in that area, which given the nature of the abuse as highlighted by Treasurer Costello, makes the ATO action in the Mass Marketed area even more questionable. In my view, it smacks of the old 'Animal Farm' theory.

Concluding Remarks

1.118 There is no doubt that many features of the Mass Marketed Tax Effective Schemes were tax abusive and needed to be stopped. However there is also no doubt that such activities developed and flourished as a result of identical or similar practices in other areas of the market place. Add to that a systemic failure by the Tax Office to clarify their position 'at law' and therefore their application of the law, and you have a recipe for disaster which is what happened.

1.119 One could be forgiven for concluding that the ATO's action in the Mass Marketed area had more to do with the Government's February 1997 decision in regard to Infrastructure Bonds than anything else! It is also a fact that – from a historical perspective - where the ATO has not formulated a view on the application of the law, or where the ATO or Government have changed their view in regard to particular taxpayer action, they have consistently acted prospectively!

1.120 The ATO and its Commissioners have an obligation under the Taxpayers Charter to treat all taxpayers equally and equitably, and it is my view that this obligation must be upheld at all cost. It is also my considered view that the ATO is

seeking to treat one group of taxpayers (the Mass Marketed group) in an entirely different fashion to those involved in the same or similar activities in other areas.

1.121 Consequently the ATO's action should be condemned and viewed as unjust, and the Government should request the ATO to refrain from taking any further action against these taxpayers. The ATO's action goes to the very heart of the integrity of the tax system and if allowed to continue, will only increase the distrust in both the tax system and ATO now so evidently clear.

The Managed Investment Industry – Product Rulings

Protecting the Commonwealth Revenue

1.122 Over the past 22 years threats to the tax revenue have operated in various forms, with the use of certain financing structures and high management and lease fees perhaps the most prominent examples. It is now clear that high wealth individuals have consistently been able to gain large net cash benefits through a range of varied investments by leveraging tax deductions through the use of limited and non-recourse financing.

1.123 Such activities occurred in the issuing of Infrastructure Bonds (IBs), Unit Trusts as well as Mass Marketed Agribusiness and Franchise schemes. Of most interest is the fact that in 1997 the Government moved to block abuses in the IB area where investors were leveraging large tax benefits and in some instances gaining a net cash benefit after tax. Similarly, in 1998 the ATO moved to end exactly the same problems evident in the MMS area. It is clear that limited and non-recourse financing and excessively high management and lease fees were the more common tools used for leveraging large tax deductions.

1.124 In June 1998 the ATO introduced the Product Ruling system which was designed to better protect the revenue base while providing greater certainty for taxpayers. Whether this has been achieved is highly questionable and is an issue now canvassed by this report.

Commissions

1.125 Even though the Corporations Act clearly stipulates that commissions must be disclosed this area of corporate governance still exhibits many transparency related concerns. The Australian Securities and Investment Commission (ASIC) told the Committee that out of 91 prospectus documents investigated by ASIC:

> "30% did not disclose the commissions payable or the percentage of commission payable."[31]

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[31] Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection, Sydney Hearing 25 July 2001 p.601.

1.126 A further illustration of this is found in a 2000-2001 Prospectus for one of Australia's largest plantation timber companies where the percentage or level of commissions paid by the company to associated entities is unclear. The prospectus says:

> "In addition, from their own funds, the responsible entity or other companies within the same group of companies might pay additional fees to licensed dealers in securities who have provided particular assistance of an administrative or promotional nature in connection with the projects."[32]

1.127 It is difficult to sustain a legal argument that this vagueness over fees breaches Section 849 of the Corporations Act. However, it does go to the heart of mandatory disclosure and the right of an investor to know exactly how the responsible entity spends or uses their money. The investor should be entitled to know exactly how much the company is paying in commissions to outside entities. Is it 10% or 25% in total? Only then can an investor make an informed judgement as to how much of their money is actually going into the project.

Recommendation

1.128 Legislative changes need to be implemented which force responsible entities and directors etc to clearly disclose the total amount of commissions payable. It is clear that in a number of circumstances the softer parts of the law are exploited by promoters to hide the true extent of fees and commissions paid.

Large Up front Fees

1.129 Concerns with disclosure and transparency are similarly evident with the use of large up-front management and lease fees by companies. In the first instance, while classified as 'Management and Lease fees', close scrutiny shows that in reality only a very small proportion of the up-front fee exhibits a management and lease fee component. In fact, a significant proportion of the fee – sometimes in excess of 40-50% – is used by the company to purchase land or other assets to establish the project. This is rarely disclosed to investors and raises a number of serious concerns.

1.130 In regard to blue gum plantations, some plantation companies charge investors an up-front fee in excess of over $9,090 per hectare. Credible research from Government agencies such as the Department of Conservation and Land Management (CALM) in Western Australia, and academic departments such as ANU Forestry, show that it should cost no more than about $3,000 (maximum) to establish one hectare of blue gums on leased land over a 10-12 year rotation period.[33]

1.131 Allowing large up-front management and lease fees to be charged poses a number of problems. In the first instance, there is significant drain on the

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32 Ibid, 21-08-01, p.761.

33 Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection, Dr Ryde James ANU Forestry, Canberra Hearing 31 January 2001, p.119.

Commonwealth revenue by allowing scheme promoters to classify the funds contributed by investors as management and lease fees, when in most instances nearly half of the money is used to purchase land as a capital item. Consequently scheme managers use someone else's money in the guise of management and lease fees, to buy land which they can sell and take a profit.

1.132 In essence the whole arrangement is an inefficient mechanism by which the Commonwealth helps facilitate investment and therefore is not dissimilar to the concerns and comments made by the Treasurer in 1997 when putting a stop to the abuses found with IBs. On this point the Treasurer said:

> "Now, I want to make it clear that the Government is not being critical in any sense of the projects. The vice, however, with infrastructure borrowings is that the taxpayer is not getting value. This is a very expensive way of getting money into those projects. It's tax expensive because instead of, as was the original plan, the borrower foregoing their right to have a tax deduction and the tax foregone by the borrower equalling the tax benefit received by the lender on some kind of symmetric one-to-one ratio, you're getting in these sorts of examples ratios of one-to-seven or higher. That is, the benefit to high marginal taxpayers in terms of their ability to save themselves tax is extreme multiples of the tax rights foregone by the borrowers. What that means is that this is not an effective scheme for taxpayers." [34]

1.133 The concern with this arrangement should, in theory, be picked up by the Managed Investments Act. However, scheme promoters are able to smartly side step the legislative provisions. Under the MIA Act any land bought by the scheme or through investments by investors in the scheme should be classified as 'Scheme Property'. However, scheme managers (ie, the responsible entity) are able to circumvent Section 601 FC, *Duties of responsible entity*, of the MIA Act. Section 601 FC states:

> (1) In exercising its powers and carrying out its duties, the responsible entity of a registered scheme must:
>
> (i) ensure that scheme property is:
>
> (i) clearly identified as scheme property; and
> (ii) held separately from property of the responsible entity and property of any other scheme.

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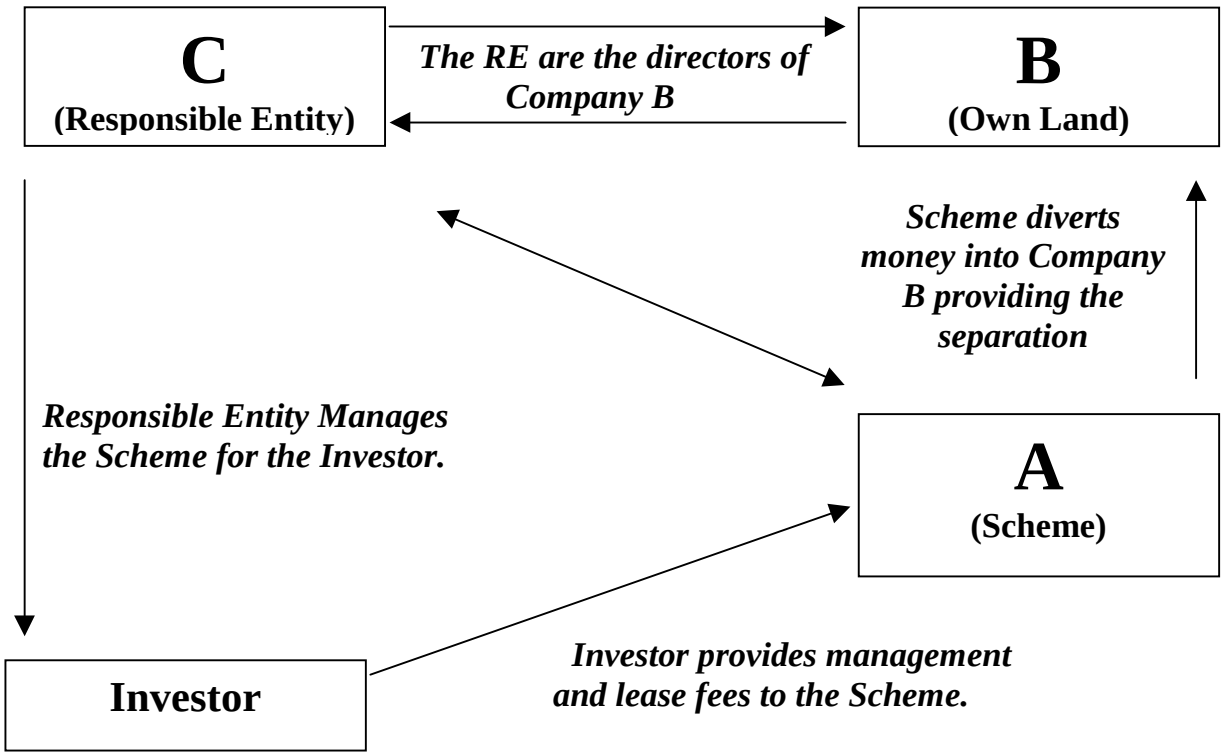
[34] Transcript of Press Conference, The Hon Peter Costello, Treasurer, 14 February 1997 Parliament House Canberra, 2.

Diagram 1



1.134 As per diagram 1, to circumvent Section 601 FC the responsible entity – or directors of the parent company running the scheme – divert investor funds into a sister company, of which the Directors of the parent company are themselves the principal shareholders. The directors then use these funds to buy land to establish the project. While technically the company complies with the law and there is no scheme property, the ethics of the transaction are questionable because of the lack of transparency. In most instances, it is nearly impossible to find acknowledgment of this process in any prospectus. Investors are therefore unlikely to be aware that up to 50% of their funds are going into the purchase of land which they do not own or have any control over. Consequently, the tax system is essentially paying for scheme managers to accumulate land assets which only they own.

1.135 The ability of scheme managers to circumvent legal obligations in this manner raises concerns about the adequacy of the rules for disclosing what a company does and does not do with investors' money. ASIC Policy Statement 56 'Prospectuses' in section 56.119 says:

> "Subsection 1021(6) specifies a more substantive information requirement, that is, the prospectus must disclose the interests of directors, proposed directors and experts in the promotion of, and the property to be acquired by, the corporation (s1021 (6))."

1.136 Furthermore, ASIC general disclosure requirements state that, except when s1022AA applies, a prospectus must contain all information investors and their professional advisers would reasonably require and reasonably expect to find in the prospectus. It is obvious that investors would 'reasonably' expect to know how every dollar of their investment monies is spent.

Registration and Review of Prospectuses

1.137 ASIC in evidence to the Committee said:

> "We have power to review prospectuses but, practically, we do not have the resources to look at all of them. The Government specifically removed the requirement to register a prospectus so our ability to stop prospectuses at the registration stage was removed." [35]

1.138 Currently ASIC vet only a small proportion of all prospectuses lodged with them and assess prospectuses only in regard to their compliance with the Corporations Law. ASIC therefore do not verify the forecasts and projections contained in prospectus documents or the validity of expert opinions.

1.139 This is a serious shortcoming which will inevitably get worse once the reforms initiated under the Financial Services Reform Act are implemented in March 2002. Under the new laws the responsible entity of a managed investment scheme will not be required to lodge a prospectus with ASIC. Instead the onus to comply with the law will rest solely with the responsible entity. This is a serious problem, especially given that under the current regime ASIC say:

> "ASIC found that some RE's had inadequate compliance monitoring and reporting systems that, in some cases, led to breaches of the law by the RE. Our findings demonstrated a lack of active implementation of compliance arrangements and a lack of strong management commitment to implementing them in some organisations."[36]

1.140 In analysing the FSR Act it is clear that the legislative changes were adopted to appease large financial institutions with diverse investment portfolios. However, the legislation has failed to clear up a number of anomalies at the lower end of the investment market that rely on issuing prospectus documents.

1.141 It is clear from ASIC statements that they simply do not have the resources to adequately monitor this sector and therefore provide investors with adequate protection. Without a significant increase in resources it can be predicted that the problems currently experienced by the regulator will get worse.

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35 Senate Economics References Committee, ASIC Answers to questions , 19 September 2001.

36 ASIC Information Release on Surveillance Outcomes for Responsible Entities, Wednesday 1 August 2001.

Recommendation

1.142 It is therefore recommended that the law be changed, or the implementation of the Financial Services Reform Act be delayed for a further 2 years until a review of compliance is conducted.

'Experts'

1.143 Another anomaly which must be addressed is the use of expert opinions in prospectus or offer documents. Investors understandably place a great deal of trust in not only the financial forecasts and projections included in a prospectus but also in the expert reports contained in them. However as the *Business Review Weekly* reported on August 30 2001:

> "Few investors would suspect, for example, that some promoters of investment products shop around for sympathetic professional opinions for their prospectuses." [37]

1.144 ASIC Practice Note 55, 'Prospectuses – citing experts and statement of interests', sets out clear guidelines on the use of expert opinions in prospectuses.

1.145 Practice Note 55 states that the expert is accountable for their advice cited in a prospectus,[38] and that the expert must give their written consent for their opinion to be cited.[39] If such consent is withheld but the expert opinion is nevertheless cited in the prospectus, then the directors are liable to indemnify the expert.[40]

1.146 While Practice Note 55 is fairly extensive, a number of serious concerns remain. First, the Practice Note does not stop promoters from shopping around for a favourable opinion. Second, ASIC do not at any stage verify whether the expert cited in a prospectus is in fact an 'expert'. Consequently, ASIC say:

> "If a prospectus mentions a person's view on a matter, the ASC will normally take the prospectus as holding the person out to be an expert on that matter." [41]

1.147 This raises serious questions as to the validity of claims of expertise. Who is an expert and how qualified are they to make judgements?

1.148 In the case of plantation forestry, this is a serious problem, particularly as nearly all 'experts' will endorse the Mean Annual Increment (MAI) growth rates reported in prospectuses. The MAI's underpin the forecasted returns to investors. The

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37 *Business Review Weekly*, August 30 – September 5, 2001, Michael Laurence, 42.

38 ASIC Practice Note 55 Prospectuses – citing experts and statement of interests, clause PN55.6.

39 ibid, PN 55.4 (c).

40 ibid, PN 55.6 (d).

41 ibid, 55.14.

concern is that most plantation companies forecast returns to investors on an average MAI of 30/c.m/ha/yr. This is extremely misleading, firstly, because an average MAI of 30 means that some of the trees will grow at a MAI of around 40. These figures are inflated. Sound evidence shows that in even the best growing conditions an average MAI of around 20-22 is achievable but very unlikely.[42] If the lower figure were used, the forecasted return to investors would be seriously diminished. However, so-called experts still sign off on average MAI's of 30. This is why some tax specialists argue that:

> "…independent expert opinions are so heavily qualified that their conclusions are almost meaningless."[43]

1.149 In short, reliable evidence demonstrates the misleading nature of many projections in prospectuses, which in turn casts into doubt the credibility of 'expert opinions' used to support the claims of such prospectuses.

Recommendations

1.150 Like most aspects of the managed investment industry the area of expert opinion lacks integrity. It would seem that often experts are 'friends' or close business associates of the RE and therefore paid to give a favourable opinion. The entire system requires stronger measures to improve independence and objectivity. It is therefore recommended that ASIC consider either establishing a board of experts or a system for registering experts. Under this regime it should be mandatory for experts to disclose any conflict of interest in relation to the schemes for which they provide opinions. For investors these measures would provide a greater degree of certainty that the expert is indeed an expert. Currently no one including ASIC is in a position to assess claims to expertise.

1.151 It is further recommended that ASIC be given statutory responsibility for issuing expert opinions for all Mass Marketed investment schemes. The onus will be on the scheme promoters, designers and/or managers to provide ASIC with the investment proposal so that the proposal can be independently and 'expertly' assessed. An ASIC report on the proposal should include advice on general market conditions, the going market rates for establishment of the project, the yields and returns that could be realistically expected and the projections for the future of the industry. Furthermore, the ASIC report must be included in the final prospectus, or any other marketing information related to the project, and a copy must be provided to the ATO.

Product Rulings and Grossly Excessive Fees

1.152 A further concern is that the PR system is unable to support credible business investments and at the same time protect Commonwealth revenue. This is because the process by which the ATO determine whether management and lease fees are

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42 Evidence from Dr Ryde James ANU Forestry, see Hansard Transcript 30 –01 2001, p119.

43 *Business Review Weekly*, August 30 – September 5, 2001, Michael Laurence, p.46.

'Grossly Excessive' is seriously flawed. As a consequence the PR system is unable to prevent schemes which are extremely expensive and which exhibit unrealistic or un-commercial fees and charges from going ahead. Investors are then afforded tax deductibility for outgoings and the Commonwealth props up overly expensive schemes.

1.153 It is not the role of the ATO to determine how much a company can charge or how much an investor should outlay. Nevertheless, the ATO does have a responsibility to clearly assess whether scheme managers are charging fees that are, as the then Deputy Chief Tax Counsel Mr Bersten said in evidence, 'commercially realistic rates'.[44] The Part IVA anti-avoidance provisions require the ATO to examine the level of fees in arrangements with tax benefits. Grossly excessive fees are one of the eight factors that can trigger the application of Part IVA.[45] The problem is, however, that while the ATO cites grossly excessive fees as the reason for applying Part IVA in some cases, it continues in other cases to provide product rulings for schemes with management and lease fees far above the market norm.

Product Rulings and Business

1.154 The ATO has argued consistently that the PR process is primarily concerned with protecting investors not facilitating the needs of business. At the outset this position is accepted in that investors need greater protection and certainty. However, the fact that the PR process is not overly responsive to business requirements is of concern.

1.155 There are delays in processing PR applications which vary from 28 days to 2 years. Such inconsistencies pose considerable problems and frustration for businesses particularly those involved in the agri-business sector which rely heavily on planting regimes aligned to seasonal conditions.

1.156 The delays experienced by business from the application date of a PR to finalisation are exacerbated by the structure of PR drafting. The best way to explain this is to provide an example of what can occur.

PR Process Example – the 28 day clock

Example 1

- Promoters/Managers apply for a PR;
- Forward PR application to Melbourne ATO office;
- Application is assessed;
- Further information may be sought;

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44 ibid, E5.

45 As mentioned previously. See Deputy Commissioner Mr Michael D'Ascenzo, "Guidance provided by the ATO on the application of Part IVA" to the Taxation Institute on 22-24 March 2001.

- Further assessment;
- Melbourne office forwards the application to Perth for peer review;
- Further information may be sought;
- Perth office sends the application back to Melbourne for changes;
- Peer reviewer may well require to view changes before the Melbourne office sends the application to Brisbane for review by the Centre for Excellence;
- The Centre for Excellence may require more information and changes to be made;
- The Brisbane office then sends the application back to Melbourne with accompanying recommendations;
- Melbourne then send it to the applicant for their approval;
- For the PR to be gazetted in Canberra on a Wednesday the Melbourne office will have to have the application finalised in Melbourne the previous Tuesday.

Example 2

- Scheme has already been granted 2 PRs for the previous 2 years;
- Manager applies for an additional but identical PRr to expand the existing operation;
- Applicant has to go through the entire process again as listed in example 1.

1.157 The above two examples actually occurred to a medium to large agri-business company during the years 1999, 2000 and 2001. It is clear therefore that the PR 'sausage machine' is antiquated and very inefficient. In addition to delays is processing applications, the PR system suffers from serious communication breakdowns often experienced between the ATO and PR applicants, chronic staff shortages – our estimate is that the PR system has no more than 30 ATO staff working on PRs nationally. Serious questions need to be asked about the PR system and it's ability to respond to Australian business.

Time taken to produce PRs

1.158 The systemic inconsistencies and time delays experienced between the initial application date and the finalisation of the requested PR are unacceptable. As a consequence the entire PR system lacks credibility with the business sector because on many occasions the ATO give verbal guarantees to finish a PR within a set period of time but nearly always fail to deliver. This is exacerbated by the ATO consistently requesting new information from the PR applicant. On many occasions the applicant would question the ATO as to why they failed to ask for the information at the outset.

Structural concerns - The need to centralise the PR Process

1.159 The argument for centralising the PR system must, as a consequence, be seriously addressed. One solution would be to have two main offices, one in either Sydney or Melbourne and one in Perth dealing specifically with PRs. While specific

locations can be negotiated and discussed at a later stage, the main objective should be to improve the integrity of the PR process for investors, with a greater commitment to designing a system which better responds to the needs of modern business.

Concluding comments

1.160 The constant delays evident in the PR process cause a number of problems. It unnecessarily constrains business and inhibits investment to the extent that investors – particularly international investors – may view the consistent delays as evidence of non-compliance with tax laws by scheme managers, rather than a sloppy bureaucratic process. As a consequence, schemes often lose investment capital and investor confidence.

1.161 There is no reason why the PR process cannot be redesigned to better facilitate business while continuing to provide investors with excellent protection. If the ATO addresses the time delays, communication and resourcing issues, there is no reason why the PR process could not be one of the best in the world in providing investors with protection and business with certainty.

Recommendations

1.162 It is recommended that the ATO adopt a similar time frame or commerciality approach with PRs as they have done with Private Rulings. The ATO gives an undertaking to provide a Private Ruling within 28 days from the application date. With PRs 28 days is simply not long enough. However, the ATO could realistically in most cases draft a PR from application to finalisation within a period of 3 to 4 months. The time period in essence however is irrelevant. What is relevant to business is that they are given some sense of certainty. As it stands they are inundated throughout the process with requests for more information and have absolutely no idea at all when the PR will be finalised. For most businesses it wouldn't matter if each PR took 6-8 months as long as they knew. Only then can they forward plan their PR application according to the investment market and seasonal planting regimes.

1.163 Furthermore, it is recommended that the ATO be given a 28 day period starting from the application date to request further relevant information. As it stands the ATO consistently return to scheme managers with requests for more information some 6 months into the process. Most find this terribly frustrating particularly when they apply for back to back PRs for exactly the same investment project.

1.164 It is recommended that it be an offence, under the Trade Practices Act, to market and sell an investment product involving tax benefits without first obtaining a Product Ruling from the ATO.

1.165 It is recommended that the ATO disallow any part of a claimed deduction which relates to the purchase of a capital asset i.e. land – irrespective of whether that land is purchased for the investor or another party.

Senator Shayne Murphy

Senator the Hon Peter Cook

Senator for Western Australia
Australian Labor Party

Senator the Hon Brian Gibson
Acting Chairman
Senate Economics References Committee
Parliament House
CANBERRA WA 2600

8 February 2002

Dear Senator Gibson

RE: INQUIRY INTO MASS-MARKETED TAX-EFFECTIVE SCHEMES AND INVESTOR PROTECTION

At the Committee meeting on 5th February, I left open the prospect of supporting Senator Murphy's Minority Report.

I believe Senator Murphy picks up the issues of the ATO's role in these matters as well as the issues of prospectuses, product rulings and promoters' commissions much better than your report.

However, I remain in support of the general thrust of your report and believe it does progress the issues and make many valuable points and recommendations.

It would have been preferable to combine them into one report if possible, but the time constraints don't allow both this and my continued preference for it's release in the period of the 39th Parliament.

I will be a signatory of the main report and record while I hold some reservations about some of the reasoning in the Murphy report, I endorse its broad thrust.

Yours sincerely

SENATOR PETER COOK

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Canberra ACT 2600
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APPENDIX I

SUBMISSIONS RECEIVED

Submittor	Submission Number
Abbey, Mr Graeme, WA	198
Abbott, Mr Craig, VIC	702
Abel, Mr Colin, SA	410
ADVA Limited	799
Albinson, Messrs Peter & Andrew, WA	763
Alford, Mr Colin, WA	309
Allan, Mr David	559
Allday, Mr Mark, WA	325
Allen, Mr Richard, QLD	423
Allen, Mr Stuart	505
Allison, Ms Lynette, WA	593
Anderson, Mr Neil, WA	33
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August, R, WA	245
Australian Agribusiness Group Research, VIC	481
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Australian Managed Investments Association Ltd, ACT	622
Australian Managed Investments Association Ltd, ACT	622A
Australian Native Foods Management Ltd, QLD	520
Australian Plantation Timber Limited, NSW	668
Australian Rural Group Limited, NSW	661
Australian Securities and Investments Commission (ASIC), NSW	853

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Australian Securities and Investments Commission (ASIC), NSW	853A
Australian Taxation Office, ACT	845
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Bailey, Mr Michael, WA	225
Ball, Mr Allan, WA	75
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Ball, Ms Shirley, SA	301
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Barnard, Mr Gordon, WA	707
Barnes & Kohler, Messrs, WA	448
Batrouney SC, Ms Jennifer	889
Batten, Mr Christopher, NSW	893
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Blades, John and Diane, WA	244
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Boni, Mr Angelo, WA	692
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Brown, Robert and Claire, WA	281
Bruce, Mr Graham J, WA	61
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C Pope and Associates	64
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Campbell, Mr Charles, WA	233
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Caraven, Mr Phillip	583
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Carlisle, K W and M , WA	205
Carpenter Owens Chartered Accountants, NSW	874

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Carpenter, Mr Andrew, NT	843
Carpenter, Mr Gavin B, NT	71
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Certified Practising Accountants, WA	65
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Crowe, D G, WA	775
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D'Rozario, Richard and Anna, WA	310
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David Hicks & Co, NSW	869
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De Lecq Le Montais, Mr Craig, WA	418
Deague, Mr Neville, WA	539
Dearle, Mr & Mrs G, WA	374
Decleva, Mr Mark, VIC	430
Delfante, Mr Robert, WA	787
Del-Fante, Mr Vincent, WA	776
Dellar, Mr Bevan, WA	602
Deller, Mr Wayne Edward, WA	194
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Department of Agriculture, Fisheries and Forestry - Australia, ACT	856
Devlin, Mr Greg, WA	791
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Dexon, Steven & Karelle, WA	399
DiCicco, Mrs Tracey, WA	62
Dickinson, Mr Jeff	805
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Dickman, Mr Russell, Qld	840
Digby, Mr B J, WA	672
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Douglas, Mr Murray, WA	671
Doyle, Mr James J, VIC	824
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Drabble, Mr Ross, WA	452
Dragovich, David & Raylene, WA	619
Drinkwater, Mr Trevor, WA	42
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Elite Business Management Services	866
Ellery, Chris	641
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Elphick, Mr Grant	98
Eng, Mr Raymond	121
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Essex, Mr A & Mrs M, WA	765
Evans, Mr Adrian,	600
Fairweather, Mr Maurice, WA	370
Farr, Roger & Geraldine, WA	405
Farrell, Mr Anthony Guy, NSW	85
Faulkner, Mr Wayne, WA	200
Fench, Mr Simon, WA	467
Fergie, Mr Peter John, WA	223
Fergie, Ms Alison Jean, WA	211

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Ferialdi, Mr MB, WA	53
Fernihough, Mr Alan, WA	589
Fetton, Mr Robert, WA	728
Fielding, Mr Andrew, WA	729
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Fisher, Mr Raymond Darral, WA	149
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Fletcher, Mr Steve, WA	315
Florkiewicz, Ms Elizabeth, WA	591
Fonda, Mr Oliver, WA	445
Forest Enterprises Australia	584
Foureur, Mr Michael, WA	586
Frame, Mr George, WA	453
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Gertos & Co Accountants & Advisors, NSW	873
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Gilbert, Mr Keith, WA	240
Gilchrist, N and D, WA	143
Gillies Olver Design Pty Limited, WA	585
Goldfields Community Legal Centre, WA	860
Goliger, Mr Steve, Perth	339
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Gosling, Mr Robert	350
Gouge, Mr Ronald, WA	730
Gray, Mr Andrew, WA	571
Great Southern Plantations Limited, WA	427
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Greater Western Financial Services Co. Pty Ltd, SA	855
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Greatrex, Mr Phillip Michael, WA	241
Green, G J, WA	774
Green, Mr Brian, WA	466
Green, Mr Peter, WA	59
Greenhalgh, Dr Steven James, WA	323
Greenslade, Mr Geoff, Qld	842
Greenwood, Mr Karl, WA	581
Greer, Mr Scott, WA	687
Gregory, Miss M, WA	413
Grgich, Mr Peter, WA	299
Grimbly, Ms Karen, WA	333
Groth-Marnat, Mr Gary, WA	10
Gudden, Mr Henry, WA	156
Guidotti, Carlo and Sandra, WA	261
Gunning, Mr Donald, England	695
Guy, Mr Christopher, NSW	4
Guy, Mr Peter, WA	1
Guyt, Mr Leo, WA	815
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Haast, Mr Brian	108
Hack, Geoffrey & Helen, WA	342
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Haines, Mr Stewart	175
Hajda, Stanislaw, WA	538
Hall, M J, WA	73
Hallas, Duane, WA	625
Hamersley, Mr David, WA	813
Hanks, Mr Gavin David, WA	317
Harder, Mr Michael, WA	629
Hardingham, Mr Don	340
Harris, Mr Mark, WA	872
Harrold, Mr Stephen Grant, WA	209
Hars, Mr John, WA	552
Hars, Ms Jacqueline, WA	128
Hart, Michael & Rhonda, WA	465

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Hartcher, Mr William J, WA	173
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Hastie, Mr Geoff	3
Hawkins, Jamie D	330
Hay, Mr & Mrs K, WA	731
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Haywood, Mr Jeff	91
Heap, Mr David	699
Heath, Mr Jim, WA	13
Henare, Mr Mark, WA	732
Henderson, Mr Douglas, SA	733
Henderson, Mr Geoff, NSW	734
Henderson, Mr Lawrence, WA	492
Henry, Mr Rod M, SA	57
Henseon, David & Karen, WA	343
Henzell, Tony and Gail, WA	67
Herz, Ms Jenny, NSW	735
Hewett, Mr Milton Roland, WA	232
Hicks, Mr Greg & Mrs Carol, WA	666
Hill, Mr Stephen Thomas, WA	801
Hills, Mr Kevin, WA	681
Hodge, Mr R C, WA	131
Hodson, Mr Dave	344
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Holdsworth, Mr Keith, WA	395
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Hopkins, Mr Gareth	499
Horrigan, Mr Terry	820
Hoskin, Mr Norm	331
Howard, Mr Mathew	381
Howe, K R, WA	82
Hubbard, Mr Frank	167
Hudson Croft Thomas Chartered Accountants, NSW	888
Huish, Mr David, WA	429
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Hurst, Mr Martin, WA	160
Hutchings, Ms Roweena, WA	163
Hutson Duddy Accountants, WA	830
International Banks and Securities Association of Australia, NSW	603

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Irvine, Mr Colin, WA	353
Ismail FRCA, Ms Glenys	326
James, Mr Craig and Julianne, WA	126
James, Mr Michael, WA	655
Jarvis, Mr Richard, QLD	560
Joachim, Mr Ron, QLD	100
Johannes, Mr Greg, WA	96
John, Vivian, WA	527
Johnston, Mr James F, WA	136
Jones, Mr Gavan, WA	242
Jones, Mr Michael G K, WA	282
Jones, Mr R G, WA	513
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Jonshagen, Mr Bjorn, WA	300
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JP Management Consulting (Asia-Pacific) Pty Ltd, ACT	839
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O'Sullivan, Mrs R, WA	462
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Part, Mr Stephen, QLD	598
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Pynor, Dr Martin J, SA	749
Quest Investments Pty Ltd, WA	501
Raven, Ms Gail and Johnston, Mr Graeme, WA	844
Rawlinson, Mr John, WA	484
Rear, Glen and Pasqua, WA	295
Reeby, Mr Robert, WA	461
Rees, G M, WA	285
Rees, Mr James, WA	204
Reeve, Mr Colin, WA	346
Reeves, Mr Steve, WA	762
Reid, James and Patricia, WA	312
Reid, M W J & R, SA	760
Resolutions Holdings, WA	896
Richard, V L, WA	789
Richards, Mr David, WA	638
Richards, R N, WA	319
Rickie, Mr Greg J, WA	94
Riordan, J K, WA	754
Roberts, Mr Martin, NSW	613
Roberts, Mr Phil, WA	795
Robinson, Mr Lance, WA	97
Roney, Mr Kevin, WA	371
Rosher, Malcolm & Judith, WA	701
Ross College, WA	653
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Rossier, Mr & Mrs J	793
Rowen, G & S K, NSW	751
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Ryan, Mr Laurie, QLD	739
Ryan, Mr Malcolm, TAS	821
Ryper, Mr Lawrence Edwin, WA	863
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Salmon, Mr Robert	524
Sandell, Rod and Jan, WA	133
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Sandilands, Mr Stephen, WA	375
Saunders, Mr Craig, WA	421

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Scattini, Mr Noel John, WA	886
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Scherl, Mr Oscar, NSW	17
Schilo, JP, Mr James A, WA	275
Schofield, Mrs Lynnsey, WA	70
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Shaw, Mr Paul, NT	753
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Sleight, Mr Kevin, WA	690
Slowther, Mr Phil, WA	165
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Spencer, Mr Steve, WA	618
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Staffa, Mr Kevin & Mrs Myra, WA	756

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Stals, Mr Andrew, NSW	858
Standen, Mr David, WA	69
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Strauss, R B, WA	439
Stuart, Ms Coleen Mary, WA	215
Suba, Mr Stephen, NSW	11
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Taxation Institute of Australia, NSW	899
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Tilbrook, Mr Neil, WA	140
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Tingle, Mr Ian, WA	777
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Torrance, Mr Charles, WA	203
Touchell, Mr Michael Thomas, WA	154
Treagust, Dr David, WA	391
Treloar, Mr & Mrs K, WA	782
Trew, Mr Richard John, WA	222
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Trippe, Mr Rick	549
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Trust, McDermott & Summerell	572
Tuckerman, Mr Graham	841
Tully, Errol and Miriam, NSW	328
Tunnercliffe, T J, WA	246
Turley, Mr Patrick John, WA	770
Turner, Steve and Loretta, WA	105
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UNICORP Group Pty Limited, NSW	530
University of Western Sydney, NSW	297
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Van Den Beuken, Mr Brian, WA	700
Van den Bos, Dr Hans, SA	708
Van Elst, Joe and Machell, WA	102
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Van Tuyl, Mr John, WA	283
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Vicziany, S J, WA	112
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Walker, A F, WA	812
Wall, Mr Barry, WA	829
Walmsley, Mr Peter, VIC	627
Walsh, Mr John, WA	356
Ward, Francis and Jeanett	127
Ward, Lynley and Roley, WA	292
Ward, Mr David, WA	573
Wardle, John & Diana, WA	434
Wardle, Mr John, WA	597
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Webster, R W and B M, WA	207
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West, B J and J J M, WA	316
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Willcocks, Mr Chris, WA	665
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Yates, M G, WA	607
Young, Mr Thomas, WA	336
Zmak, Dario, WA	599

APPENDIX II

PUBLIC HEARINGS AND WITNESSES

Tuesday, 24 July 2001, Sydney

Taxation Institute of Australia
Dirkis, Mr Michael James, Tax Director
Rowland, Mr Noel James, Chief Executive Officer
McCleary, Ms Alice, National President

Blake Dawson Waldron
Gelski, Mr Richard, Partner

The Barkworth Group
Haley, Mr John Kevin, Deputy Managing Director
Pollard, Mr Douglas, Managing Director
Troy, Mr Mark S., Managing Director

Hudson Croft Thomas
Thomas, Mr Colin Gwyn, Principal

Wednesday, 25 July 2001, Sydney

Batrouney, Mrs Jennifer, SC (Private capacity)

Financial Planning Association of Australia Ltd
Butler, Mr Michael John, Manager, Investigations Professional Standards
Hristodoulidis, Mr Con, Senior Manager, Public Policy

CPA Australia
Drum, Mr Paul Joseph, Senior Tax Counsel

Institute of Chartered Accountants in Australia
Macdonald, Ms Margaret Heather, Taxation Manager
Sheppard, Mr Brian Kenneth, Tax Counsel

Van Eyk Capital Pty Ltd
Marshall, Mr David John, Managing Director
Sookias, Mr Hyrapiet, Associate Director

Great Southern Plantations Ltd
Mews, Mr Jeffrey Arthur Sydney, Director (Non-Executive)
Young, Mr John Carlton, Chairman and Managing Director

Tax Agents Board, South Australia
Yates, Mr Alan Nicholas, Chair

Australian Aloe Ltd and Australian Aloe Marketing Ltd
Young, Mr Warwick Raymond, Director, Australian Aloe Project

Thursday, 26 July 2001, Canberra

Australian National Audit Office
Cochrane, Mr Warren John, Group Executive Director
Cronin, Ms Anne Rosemary, Senior Director, Performance Audit Services Group
Hansen, Mr Jonathan Christopher, Director, Performance Audit Services Group
White, Mr Peter, Executive Director, Revenue Branch

North Queensland Essential Oils Cooperative Association Limited
Dunigan, Mr Brian, Vice-Chairman

Australian Managed Investments Association Ltd
Gear, Mr George, Chairman
Hennessy-Hawks, Mr Robert James, Director
Sleight, Mr Kevin Phillip, Director
Young, Mr Warwick, Director

Department of Agriculture, Fisheries and Forestry – Australia
McCarthy, Mr Michael John, Policy Adviser
O'Loughlin, Mr Stephen James, Manager, Forest Industries Group
Rawson, Mr Robert Norman, General Manager, Forest Industries Group
Townsend, Mr Philip Vernon, Assistant Director, Forest Industries Group

O'Connor, Mr Robert, QC (Private capacity)

Tuesday, 21 August 2001, Canberra

Batten, Mr Christopher James
Carnovale, Mr Frank, Barrister representing Mr Batten

Australian Securities and Investments Commission
Hughes, Mr Sean Bernard, Director, Financial Services Regulation (Regulatory Operations)
Johnston, Mr Ian Alexander, Executive Director, Financial Services Regulation
McShane, Mr Darren Mark, Director, Legal and Technical Operations, Financial Services Regulation

Department of Agriculture, Fisheries and Forestry
McCarthy, Mr Michael John, Policy Adviser
O'Loughlin, Mr Stephen James, Manager, Forest Industries Group

Rawson, Mr Robert Norman, General Manager, Forest Industries Group
Townsend, Mr Philip Vernon, Assistant Director, Forest Industries Group

Thursday, 23 August 2001, Canberra

Australian Taxation Office
Carmody, Mr Michael Joseph, Commissioner of Taxation
D'Ascenzo, Mr Michael, Second Commissioner
Fitzpatrick, Mr Kevin James, First Assistant Commissioner
O'Neill, Mr Michael, Assistant Commissioner
Smith, Mr Peter Gerard, Assistant Commissioner