CHAPTER 4

The Evidence

Overview

4.1 The Committee received in excess of 140 submissions, the majority of which were from individuals, small businesses and accounting firms who had participated in mass marketed tax schemes and other 'boutique' tax schemes. These individuals and companies had received amended assessments and penalties from the ATO. Other submissions were received from groups such as the Certified Practicing Accountants of Australia and the Taxation Institute of Australia.

4.2 Many submissions received welcomed the initiatives in the bill and were supportive of the introduction of the new shortfall interest charge (SIC). The majority of the individual submissions and many of those from accounting firms and advocacy groups argued for the legislation to have retrospective effect, although not all agreed with this view. Commonly, submissions argued for the SIC to be backdated to the commencement of self assessment in the early 1990s, although others contended that the changes should be put in place to have effect on any amended assessments issued after the bills were introduced.

4.3 The evidence received by the Committee and discussed in this chapter addresses the following areas in the bills:

- the date of effect;
- SIC and GIC interest margins;
- the threshold for objecting against remission decisions;
- grounds for remission; and
- the definition of reasonably arguable.

Date of effect – the retrospectivity issue

4.4 The SIC will only apply to the 2004-05 income year and later years. In cases where the ATO amends assessments for prior years, the GIC premium (or uplift factor) of 7 per cent over the ninety day bank bill rate will continue to apply.

4.5 Currently, the GIC is approximately 12.5 per cent, a level which the Explanatory Memorandum acknowledges as a high rate. It is set at this level 'to encourage prompt payment of tax liabilities'.[1] The reasoning behind the decision to

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1 Explanatory Memorandum, p. 12.

introduce the SIC is that taxpayers are generally unaware that they have a shortfall, and are not in a position to respond to the incentive to pay promptly.

4.6 The Treasury review notes that the uplift factor which applies to the GIC 'is not intended … to serve as a penalty for having engaged in blameworthy conduct'.[2] Nonetheless, the effect of this interest rate over a protracted period of re-assessment is significant, and as the review report acknowledges, more than doubles a tax debt over a six year period. As such, it is seen by many as punitive.

4.7 Submissions arguing for the bills to have retrospective effect fall into two broad categories: those who argue that the introduction of the SIC constitutes an acknowledgement by Treasury that applying the GIC to taxpayers before they are notified that they have a tax debt is inequitable; and those who consider that the application of settlement arrangements to many mass marketed scheme participants has itself created inequalities between taxpayers which can be reduced by applying the SIC retrospectively.

4.8 The National Tax and Accountants' Association (NTAA) argued that having recognised the inequity associated with the GIC, the situation should be corrected with effect on any future assessments of prior income years:

> If these amendments only apply to the 2004-05 and later income years then taxpayers will still be subject to the penal GIC rate for many years to come … Although the Government has recognised the inequity of the current application of the full GIC rate the amendment will not have effect in many cases for some years to come. Having recognised that the current application of the GIC is inequitable the NTAA strongly recommends that the inequity be removed now rather than progressively over the coming years. To continue with the inequity is … itself inequitable.[3]

4.9 The Corporate Tax Association was also among those that believed that some consideration needed to be given to applying the SIC in earlier assessments:

> The proposed amendments, most notably the proposed SIC, will only apply to amendment of assessments for the 2004–05 income year and later years. For income years prior to 2004–05, the existing GIC regime will continue to apply. Given this, we believe that further consideration needs to be given to the impact of the existing GIC regime on those prior years, particularly in the context of amended assessments in large case audits and the Commissioner's policy regarding the remission of GIC.[4]

4.10 Many of the other submissions received by the Committee were sent by people who had been involved in mass marketed and other tax schemes, and who had

2 The Treasury, Report on Aspects of Income Tax Self Assessment, p. 49.

3 Submission 129, National Tax and Accountants' Association.

4 Submission 119, Corporate Tax Association.

received amended assessments which included a GIC component which exceeded the original penalty. The effects on some of these people of the GIC were unquestionably severe. Resolution Group Australia, a taxpayer advocacy group, noted that:

> …the burden of GIC has made it impossible for many businesses to even contemplate payment and liquidation has been the only option.[5]

4.11 In addition, a number of the individual submissions the Committee received gave accounts of mental and marital breakdowns, homes and businesses being lost, and cases of suicide.

4.12 Following a report of the Senate Economics References Committee on Mass Marketed Tax Effective Schemes and Investor Protection which was tabled in the Senate on 11 February 2002, many mass marketed scheme participants were offered settlement terms that fully remitted GIC and penalties.

4.13 During the current inquiry, the ATO advised the Committee that the totality of the mass market investment scheme participants was 42,000, of which 87 per cent - about 38,000 - settled on a nil penalty, nil interest arrangement with two years to pay without any interest.[6]

4.14 However, there were other taxpayers who were involved in other schemes who claimed not to have been offered such settlement terms, and others who chose not to settle on those terms. For them the impact of GIC remains significant. Many taxpayers in these categories see the application of a lower interest charge for the period leading up to when the ATO reassessed them as potentially reducing their problems.

4.15 Evidence received from Mr Anthony Kalogerou of Nexia Court and Co, a firm of chartered accountants which acted on behalf of many taxpayers involved in mass-marketed schemes, explains why mass marketed scheme participants and their advisers seek to have the legislation applied retrospectively. Mr Kalogerou submitted that the settlements offered to some taxpayers and not others meant that, in his view, an inequity was created between those who benefited from the reduced penalties and those who did not:

> The issue is that certain taxpayers are treated differently depending on the particular circumstances of some of these tax based investments that they made investments in over various years … Taxpayer A may have invested in a 'scheme', if we can use that terminology, whereby the Commissioner of Taxation has stated that that is a scheme that would be eligible for the mass-marketed concessions and their position would be that they would not be assessed for interest and penalties; whereas that taxpayer may also have invested in another scheme in that particular year whereby he does not get

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5 Submission 118, Resolution Group Australia, p. 2.

6 *Proof Committee Hansard*, 14 June 2005, p. E23.

> the mass-marketed obligations when, as far as that taxpayer is concerned, both investments were marketed quite widely to the public. Therefore, one scheme gets quite draconian amounts of interest and penalties to pay, and yet if the same investor went into a different scheme he gets no interest or penalties to pay.[7]

4.16 The Committee questioned Mr Kalogerou about how he saw retrospective application of the legislation as addressing the problem he identified. He responded that:

> That would give some equity as to the treatment that he [the taxpayer] would enjoy under the proposed bill.[8]

4.17 Mr Clive Ross, representing Resolution Group Australia, a taxpayer advocacy organization, made a similar point, arguing that applying the legislation retrospectively would serve to 'level the playing field'. When the proposition was put to him that to do this could be hugely expensive, he said that this might not be the case, as a large group had already had their penalties and interest waived.[9]

4.18 Committee members asked Mr Michael Dirkis of the Taxation Institute of Australia to respond to the calls for retrospective application of the legislation. He pointed out that applying the legislation retrospectively could create a new set of inequities between those who had concluded their assessments and those who had not:

> If there is a settled arrangement already that is in a particular year of income and a different set of rules is applied to somebody who is detected later making an omission, that creates a perceived inequity, in that they happened to be assessed at the right point of time, which is in the year following the introduction of the legislation rather than in a later year. That makes it difficult when you talk about going back a bit retrospectively.[10]

4.19 Mr Paul McCullough of Treasury told the Committee that adopting an earlier date of effect would not assist many of those caught up in tax schemes. He said that many of these had already received remissions of penalties and interest to nil, and others to a rate below the proposed SIC:

> Going through the submissions, the first thing that comes up is the date of effect. There has been a lot of discussion about that. Simply put, to adopt a date of effect of 1994 was in one of the submissions. That would not actually help many of the taxpayers that evidence has been given about. One of the witnesses even made the point that the tax office has already used its existing power under the law to deal with remission of the general

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7 *Proof Committee Hansard*, 14 June 2005, p. E2.

8 *Proof Committee Hansard*, 14 June 2005, p. E2.

9 *Proof Committee Hansard*, 14 June 2005, p. E8.

10 *Proof Committee Hansard*, 14 June 2005, p. E12.

> interest charge to remit a lot of the penalties and interest in those cases to nil. Even in some of the other mass-marketed scheme cases interest has been reduced to 4.72 per cent. Nil and 4.72 per cent are both below the benchmark rates of this new shortfall interest charge. That is a logical problem that I have. I do not see how that is going to affect those particular taxpayers.[11]

4.20 Ms Stephanie Martin of the ATO advised that of the mass marketed scheme participants and subsequent boutique scheme and EBA participants, around 80 per cent are better off under the settlement arrangements they have been offered than had the SIC rate been applied to them.[12]

4.21 Ms Martin provided the Committee with the following update about the current initiatives in relation to outstanding cases:

> Subsequent to the Inspector-General of Taxation's report on GIC, the commissioner announced four improvements last November. These were focused primarily on EBA type arrangements. One was the rewrite of the remission guidelines. Another was the setting up of a settlement panel to oversight consistency for settlement arrangements for widely based schemes. Another was a cap on the amount of GIC for those EBAs, and the other was for a new set of guidelines for remission for EBAs taking into account individual circumstances. We sent out letters to all the participants and up to about mid-May we had received about 926 applications—this is at 17 May-for further remission of interest and/or penalties. At that time we had completed 261 of those. For 110 of those we had asked people for some information that they had not provided but they had not responded. For 125 of those we had granted a further remission, while 26 had received no remission. The others are still being processed. The sorts of things that are looked at in there include the compliance history of people-whether they have been involved with other schemes or whether this was a one-off; the extent to which they may have sought to rely on advice and the nature of that advice, whether it was to them or held more generally; and the financial impacts. Those guidelines are public, and we also put on the web site how we apply those guidelines.[13]

4.22 The Committee adopts the views expressed by Treasury and the ATO. It is of the view that extending retrospective application of the SIC, while desirable from some viewpoints, would of itself create new inequities and also has a number of significant practical difficulties.

4.23 The Committee questioned officers about whether the measures that were in the bills and other announced measures would address the problems that had been encountered in the mass marketed schemes episode. Mr McCullough responded:

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11 *Proof Committee Hansard*, 14 June 2005, p. E18.

12 *Proof Committee Hansard*, 14 June 2005, p. E23.

13 *Proof Committee Hansard*, 14 June 2005, p. E23.

> I do not think anything would stop mass marketed schemes. People are going to try and avoid tax from now till kingdom come.[14]

SIC and GIC interest margins

4.24 While welcoming the SIC initiative, a number of submitters argued that the SIC rate was still punitive and should be reduced to zero. Taxpayers Australia was among those who contended that the 3 per cent premium was still too high:

> In respect of the SIC there should be no premium built into the rate. Until the taxpayer's increased liability, if any, is established, then such a premium cannot act as an incentive to resolve the case except in those instances where the taxpayer knowingly is aware of their underpayment of tax. In those cases it is the opportunity to have a lower culpability penalty through co-operation and voluntary disclosure that acts as the incentive to resolve the case quickly. In all other instances the taxpayer has to await the outcome of the audit or review before their increased tax liability, if any, is known.[15]

4.25 Resolution Group Australia made a similar point, pointing out that the Commissioner already has the power to impose culpability penalties of up to 75 per cent. It argued that the penalty provisions already provide sufficient disincentive to those who seek to take advantage of the system [by incurring tax debts instead of borrowing], and that accordingly, the rate should be the same as the bank rate.[16]

4.26 Mr Ross maintained that even at 3 per cent, the uplift factor still constitutes a penalty:

> In our submission, the uplift factor of three per cent is a penalty. I note that in the explanatory memorandum Treasury goes to some pains to say it is not a penalty, but surely it is. There is no other reason for having it there.[17]

4.27 The Taxation Institute of Australia also submitted that the SIC uplift factor was too high, arguing that it should not exceed two per cent.[18]

4.28 The Corporate Tax Association viewed the proposed amendments as being very positive. However, it too highlighted the punitive aspect of the uplift factors applied, particularly in relation to the GIC:

> The crux of the issue is that the GIC does not integrate properly with the policy for tax penalties, primarily because it includes a substantial effective

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14 *Proof Committee Hansard*, 14 June 2005, p. E20.

15 Submission 72, Taxpayers Australia Inc, p. 2.

16 Submission 118, Resolution Group Australia, p. 6.

17 *Proof Committee Hansard*, 14 June 2005, p. E6.

18 Submission 74, Taxation Institute of Australia, p. 2.

> penalty component, particularly for large taxpayers, as its rate is far in excess of their marginal borrowing rate. This, combined with significant time delays in completing large case audits, has resulted in the imposition of GIC having a very broad punitive-like effect for large taxpayers.[19]

4.29 The question of whether setting the uplift factor at too high a rate could be counterproductive also arose, and was explored with the Taxation Institute of Australia witness, Mr Dirkis.

> **Senator WATSON:** I just have a concern from the point of view of small taxpayers who have no capacity to pay. I acknowledge the generous change, as it appears, and the introduction of SIC with a three per cent margin. But in terms of taxpayers who have limited resources and a limited capacity to pay the penalty and the tax as a result of an inadvertent error, I think we are tending to have two classes of taxpayers: those who can pay, who will pay the rate plus three per cent; and those who have no capacity to pay, who have to pay at the general rate plus seven per cent. So we do tend to distinguish between those taxpayers who have the means and those who do not have the means. I wonder about this from an ethical point of view.[20]

Mr Dirkis responded that in a lot of cases, people were forced into a longer term arrangement with the ATO to pay off their debt. He pointed out that the tax law is complex and that this leads to mistakes, as opposed to fraud or evasion. For example, in relation to the fee that agencies may charge nurses or other workers when making job placements:

> So we would say that a lot of people, given the nature of our current work force with people seeking agency employment and the fees being charged, would not realise that that fee that they have handed over is not deductible. That is the sort of example that you are getting at, where people just do not understand the law. The law is not clear-and that is what we originally argued in our first submission here-and on those grounds you really need to look very carefully at imposing any charge.[21]

4.30 Taxpayers Australia also addressed the difficulty that taxpayers who are unable to respond to the incentive to pay promptly face:

> … if the taxpayer does not have the capacity to pay nor the ability to borrow then it has the opposite effect. The end result is that taxpayers without the capacity to pay are locked into an ever increasing tax debt.[22]

4.31 Mr McCullough of Treasury explained the reasoning behind the setting of the uplift factors:

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19 Submission 119, Corporate Tax Association, p. 2.

20 *Proof Committee Hansard*, 14 June 2005, p. E15.

21 *Proof Committee Hansard*, 14 June 2005, p. E15.

22 Submission 72, Taxpayers Australia, Inc, p. 2.

> The reasoning is very simple: why should making an honest mistake put a taxpayer in a more beneficial situation than that of a taxpayer who got it absolutely right? That is the effect that the submissions which go to reducing the rate below what has been chosen at the moment could have. If it came down to nil you would have a situation where a taxpayer who got something wrong had a better situation—in not having to pay that money, not having to borrow that money and not having to incur any interest—than a taxpayer who did absolutely the right thing. That is the reason for setting it at the base rate plus three. It is designed to neutralise loan benefits for a benchmark case. It will not neutralise loan benefits for an individual who otherwise could not have deducted the interest. They will still be significantly better off. On the other end of scale, it is set at a benchmark rate for business. Some businesses that are very large and are able to borrow at lower rates might be able to do better than the benchmark, but the point of a benchmark is that it has got to be applied to the whole tax-paying population.[23]

The threshold for objecting against remission decisions

4.32 The amendments provide for a right of objection appeal where the unremitted shortfall interest charge exceeds 20 per cent of the tax shortfall. Several organisations contended that this threshold was inappropriate and argued that the taxpayer should always have a right of appeal, or for a monetary threshold to be set.

4.33 The Taxation Institute of Australia (TIA) submitted that the absence of appeal rights where the SIC is less than 20 per cent of the shortfall is 'harsh and unjustified'. The TIA contended that there should be no monetary limit to a review of the Commissioner's discretion, just as there is no monetary limit in respect of an objection to an ordinary assessment. By way of example, the TIA pointed out that '19 per cent of one million dollars is a substantial amount that should always be open to review'.[24]

4.34 Mr Dirkis elaborated on this point at the public hearing:

> If you request a review or object to a shortfall interest charge and it is remitted back and it happens to fall to 19 per cent or 19.99999 per cent, then you should have the right to take that process forward and seek resolution. Obviously, you are going to make that decision based upon the cost of going through that process versus the amount of money that is involved, but it does not seem to make a great deal of sense or equity that you cannot seek further redress if you believe that you were in a situation that required full remission.[25]

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23 *Proof Committee Hansard*, 14 June 2005, p. E19.

24 Submission 74, Taxation Institute of Australia, p. 2.

25 *Proof Committee Hansard*, 14 June 2005, p. E13.

4.35 Mr Ross of Resolution Group Australia also argued that the threshold had been set too high. He told the Committee that the threshold should be specified as a dollar amount, $500 or $1000:

> It needs to be a fixed sum, because then it will be a real right of review. I will add to that that taxpayers are reasonable people. They are not going to go to appeal or review for $500 or $1,000. The excuse of cost is not something that is really going to happen.[26]

4.36 Addressing concerns about the appeal threshold, Mr McCullough of Treasury pointed out that this right of review was a new right. The Explanatory Memorandum similarly points out that under the current law, a taxpayer can only challenge a remission decision through certain judicial review mechanisms in administrative law. Mr McCullough explained that having too low a threshold would create an undue administrative burden on the ATO:

> In summary, on the 20 per cent point it is the introduction of a new right. Practically, there are so many remission cases where the commissioner could potentially remit the tax that to have an unfettered objection right would be an undue burden on the administration, and there is a good reason for not having a remission right down to dollar one in the first place. This is based on the fact that individuals should not have a zero interest component even in inadvertent situations
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> …
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> It recognises that there has to be some interest, otherwise people who do the wrong thing, even inadvertently, get a benefit. Practically, it has got to focus on where the amount of the interest could have a penalty-like effect on a taxpayer. It does not occur at one percent, two per cent or three per cent, and so a figure was chosen to represent what would be a figure over a few years.[27]

Grounds for remission

4.37 Schedule 1, item 1 subsections 280-160(1) and (2) provide the Commissioner with a discretion to remit part or all of the SIC where the Commissioner considers it fair and reasonable to do so, and set out the principles that the Commissioner must have regard to in making such a decision.

4.38 The Taxation Institute of Australia argued that the illustration of cases that would satisfy a remission should also include ATO inaction, where the ATO was

26 *Proof Committee Hansard*, 14 June 2005, p. E7.

27 *Proof Committee Hansard*, 14 June 2005, p. E19.

aware of a problem but failed to take any action; and that remission should also be considered where there is a retrospective change in ATO interpretation.[28]

4.39 Australians for Tax Justice also raised an issue in relation to this section, arguing that a body independent of the ATO should consider remission requests.[29]

4.40 Paragraph 2.68 of the Explanatory Memorandum points out that the cases given in relation to remissions are not intended to be exhaustive, and that the Commissioner has a broad discretion to remit.[30]

4.41 The Committee was also advised that the ATO remission guidelines are under review.[31]

The definition of reasonably arguable

4.42 For large items,[32] taxpayers must not only take reasonable care, but must also adopt a reasonably arguable position. A position is reasonably arguable if it would be concluded in the circumstances, having regard to relevant authorities, that it is at least as likely to be correct as incorrect.[33]

4.43 The Corporate Tax Association supports the amendment:

> Clarification around the words 'reasonably arguable' is important as those taxpayers who can establish a 'reasonably arguable' position for a large item are not subject to the penalty for a tax shortfall resulting from taking a position that is not reasonably arguable.[34]

4.44 In evidence, Mr McCullough of Treasury advised that the changes to the 'reasonably arguable' provisions change the balance on the reasonably arguable position to the taxpayer's favour.[35]

4.45 The Committee also notes that the change does not appear to represent any change in ATO practice. (see paragraphs 3.14 and 3.15).

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28 Submission 74, Taxation Institute of Australia, p. 2.

29 Submission 6, Australians for Tax Justice, supplementary no. 3.

30 Explanatory Memorandum, p. 26.

31 *See* Ms Martin, *Proof Committee Hansard*, 14 June 2005, p. E23; *see also* Mr McCullough, *Proof Committee Hansard*, 14 June 2005, pp E20 and E22.

32 Large items are tax shortfalls exceeding the greater of $10,000 or 1% of the income tax payable.

33 The Treasury, *Report on Aspects of Income Tax Self Assessment*, August 2004, p. 42.

34 Submission 119, Corporate Tax Association.

35 *Proof Committee Hansard*, 14 June 2005, p. E21.

4.46 However, the Taxation Institute of Australia (TIA) suggested that rather than having the same meaning as in section 222C of the *Income Tax Assessment Act 1936*, the amendment alters the meaning of 'reasonably arguable' because it establishes a more stringent test whereby the prospects that the taxpayer's treatment of a matter as being the correct treatment must be greater than 50 per cent.[36] The TIA does not consider that the change goes far enough. The TIA recommended that the words in s 284-15(1) ('or is more likely to be correct than incorrect') be deleted to restore the clear s222C meaning. The Institute maintained that the correct interpretation of what is 'reasonably arguable' has been clearly set out by Hill J in Walstern v FCT [2003] FCA 1428, and was confirmed on appeal.

4.47 The Committee notes that the Treasury review also referred to this case.[37] The matter was not pursued at the public hearing.

Conclusions and Recommendation

4.48 The Committee notes that these bills are the first in a series that will, over a period of time, implement the recommendations of the Treasury review of income tax self assessment. They are of limited scope.

4.49 The initiatives in the bills and the bills to follow will not satisfy everyone. As the large number of submissions the Committee received indicates, there are still outstanding matters to be resolved in relation to mass marketed and other tax schemes, and disagreements within the taxpayer and financial community about how the ATO should approach its task. However these are not matters that can be dealt with in this legislation. There was also a degree of discontent on the part of organisations that made submissions to the Treasury review, and who were disappointed to see that their views were not taken up. As Mr McCullough of Treasury noted in evidence about one particular submission, views to that inquiry were not overlooked, they were considered in detail, but they were not accepted by the Government.[38]

4.50 Nonetheless, the Committee considers that these bills represent a positive step in giving taxpayers more certainty in relation to the operation of tax self assessment, and improve a number of the perceived shortcomings of this system.

4.51 The introduction of the SIC recognises that taxpayers who are unaware that they have had their liabilities reassessed are not in a position to respond to incentives to settle quickly that are part of the current GIC. The Committee also regards the abolition of penalties for failing to follow a private ruling and the introduction of a requirement for the Commissioner to provide reasons for penalties and for not remitting penalties as significant improvements.

36 Submission 74, Taxation Institute of Australia.

37 The Treasury, Report on Aspects of Income Tax Self Assessment, p. 41.

38 *Proof Committee Hansard*, 14 June 2005, p. E 20.

Recommendation

The Committee recommends that the Senate pass the bills without amendment.

Senator George Brandis
Chair