Resolution Group

27 May 2005

The Secretary
Senate Economics Legislation Committee
Suite SG.64
Parliament House
CANBERRA ACT 2600.

Submission to the Inquiry into the Tax Laws Amendment (Improvements to Self Assessment) Bill (No. 1) 2005 and the Shortfall Interest Charge (Imposition) Bill 2005

Aim of legislation

The aim of the proposed legislation is to remove the inequity of the current self-assessment system and improve fairness and certainty. In recommending the proposed legislation, Treasury has recognized that the current system is inequitable and uncertain. The issue is whether the proposed legislation as presented rectifies the inequity, unfairness and uncertainty of the current system in a timely and adequate manner.

Background

The self-assessment system was introduced in the 1986/87 income year. Under self-assessment the Commissioner does not review tax returns at lodgment but is able to review and amend returns:

- Within four years after lodgment in every case;
- Within six years after lodgment in circumstances where the Commissioner considers that the provisions of Part IVA of the Income Tax Assessment Act are applicable; and
- Over any period where the Commissioner alleges fraud or evasion.

As a consequence, lodgment of a tax return and receipt of an assessment notice from the Commissioner does not mean certainty in relation to the tax liabilities for any year. Taxpayers remain at risk, over the aforementioned periods, of receiving amended assessments that require payment of primary tax, penalties of up to 75% of the primary tax and General Interest Charge (GIC) (currently at 12.63%). Even where a tax shortfall is identified by the taxpayer and amended under self-amendment the taxpayer is still liable to a 5% culpability penalty and GIC at the full rate under the

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current system. This is a disincentive to self-amendment and in many cases after discovery of an error taxpayers are forced to decide between the risk of discovery by the Commissioner and the ability of the entity to pay the penalty and GIC.

Although, it is recognized that the proposed legislation will reduce the current GIC disincentive of self-amendment for the future, the proposed legislation fails to remove that disincentive for 2003/04 and prior years where taxpayers may still self-amend.

Since the introduction of self-assessment there have been several notable disputes between large groups of taxpayers and the Commissioner. In every case the disputes have arisen because the Commissioner has altered position in relation to well established arrangements and has retrospectively applied that altered position to impose tax liabilities comprising, primary tax, penalties as high as 50% and GIC of around 13.72%. The resulting liability imposed an impossible burden upon thousands of taxpayers, some of whom committed suicide, lost homes and families or went bankrupt. After intervention by a Senate Committee a settlement was negotiated in which the majority of taxpayers were given a full remission of the penalties and the interest. Many others in identical circumstances were excluded from the remission and were either forced to pay the full amounts or remain in dispute.

Despite the lessons of that first large group dispute, the Commissioner again altered position, withdrew rulings and retrospectively applied the altered position against 7200 small businesses with Employee Benefit Arrangements. Like before the burden of the GIC has made it impossible for many businesses to even contemplate payment and liquidation has been the only option. The Commissioner claims that the tax rulings issued by the ATO were either fraudulent or incorrect. However, the Commissioner has not taken any responsibility for the allegedly fraudulent or incorrect rulings, advices and advance opinions. Instead, the taxpayers are being forced to pay the price for the Commissioner's mistakes. In addition, from the Commissioner's perspective, the current system provides a windfall in revenue from the GIC and there is an incentive for tardiness in identifying tax shortfalls and a decided advantage from waiting as long as possible to issue amendments. The question that arises, is it fair and equitable that the Commissioner is rewarded for incompetence, mismanagement or tardiness while taxpayers are made to bear the liability?

In 1999 the Commissioner altered position in relation to investments in Retirement Villages and retrospectively applied that altered view. In these arrangements the Commissioner accepts that the deductions are properly allowable, however the Commissioner disputes the timing. Because of the retrospective nature of the Commissioner's actions in many cases taxpayers have received amended assessments in one past year disallowing the deduction in that year and another amended assessment in a subsequent past year allowing the deduction. The net result of the amended assessments is that the taxpayer is only liable to repay the penalty amount and the GIC amount calculated between the dates of the amended

assessments. These cases are a clear example of the Commissioner exploiting the current GIC legislation to improperly increase revenue.

Because of these ongoing problems with the self-assessment system and the Commissioner's failures to administer the system in a fair and equitable manner, the Treasurer Mr Costello, requested Treasury to conduct a review of the self-assessment system in November 2003. In December 2004 Treasury's Report was released and the Report contained 54 recommendations for legislative and administrative changes to improve the balance of equity, fairness and certainty for taxpayers.

Since the commencement of the first group dispute involving what the Commissioner of Taxation categorized as mass marketed schemes, there have been several enquiries into the dispute. The most notable was the enquiry by the Senate Economics References Committee resulting in the majority receiving a settlement. Prior to the Senate Enquiry, the Commonwealth Ombudsman had initiated an enquiry, however, the Commissioner ignored the Ombudsman's findings and recommendations. More recently, the Inspector-General of Taxation (IGT) reviewed the same issues but again the Commissioner ignored the findings and negotiated with the IGT for a new offer to taxpayers. The ROSA Report from Treasury has essentially covered the same ground but once again the taxpayers affected by the inequity and uncertainty, are being ignored. In every enquiry the Commissioner has been found to be at fault. However, despite the unanimous findings against the Commissioner the Government is still allowing the same mal-administration to continue.

In every case the Commissioner has taken action against the taxpayers and has been forced to retreat from the original position. It is clear that had the Commissioner taken a more reasonable approach at the onset, the disputes would not have escalated to the current levels and the costs of the various enquiries as well as the ongoing litigation and administration costs would have been avoided.

The Commissioner maintains that this process has been a learning experience. What the Commissioner has failed to acknowledge is that the learning experience for his administration has taken several years over which taxpayers have continued to accumulate crippling interest costs and the community has had to bear the overall costs of the various enquiries and administration of the matter.

Does the proposed legislation achieve the aim?

The short answer is, no it does not. This is because the taxpayers currently affected by the problems with the self-assessment system are excluded from the remedy.

Additionally, the proposed legislation is purported to remedy the defects identified by Treasury for taxpayers immediately. In reality the legislation does not bring relief until at least four years into the future. Under the current system there is a time lag between the lodgment of returns and review and amendment by the Commissioner.

Because the Commissioner has time to review the most recent returns, while time is running out for earlier returns, responsible management requires that the focus must be on older returns. In addition, as previously mentioned there is an incentive in terms of revenue to be gained by leaving amendments outstanding where there is still time. For all of those reasons it is unlikely that 2004/05 returns, to which the proposed legislation applies, will be amended until any time before 2008 or 2009.

For every taxpayer whether currently in dispute or not, who lodged tax returns in 1999 for example the legislation neither provides relief nor protection from the defects in the self-assessment system that the proposed legislation purports to immediately rectify. Between now and 2010/11 the Commissioner is free to continue to apply the old legislation to amendments that are likely to be made to the earlier years not protected by the legislation, especially because these are the years for which the time limit be will be running out and they will still be under review. The only way that the proposed legislation can properly rectify the defects identified by Treasury is to have the date of application made retrospective to at the very least cover all of the periods over which the Commissioner still has time to issue amendments under the legislation.

Asserted Difficulties of Retrospective Application of the Legislation

The Assistant Treasurer Mal Brough asserts that there are practical difficulties with making the legislation retrospective. This practical difficulty is solely concerned with repayment of GIC unfairly imposed by the current legislation. In other words Government is more concerned with the revenue aspect than genuinely rectifying the defects identified by Treasury. At the same time Government is misleading the public by introducing legislation that will not have practical application for four or more years while allowing and in fact encouraging the Commissioner to continue to collect GIC under the system that has been identified as unfair and inequitable. To the extent that the proposed legislation purports to immediately rectify the defects identified by Treasury, that representation is at the very best disingenuous and at worst dishonest.

Retrospective legislation that imposes a burden is unfair, improper and should not be allowed. However, the Commissioner has been retrospectively imposing burdens upon taxpayers and will continue to do so. In cases where the Commissioner has altered position, that has generally involved a change in the interpretation and application of the legislation, which arguably amounts to de-facto retrospective application of legislation. A relevant example is the Controlling Interest Superannuation EBA arrangements. In order to alter these arrangements, Government introduced legislation with prospective effect and the Commissioner simultaneously applied his altered view retrospectively to disallow the arrangements. The net effect of this combined action was that the arrangements were disallowed retrospectively and in the future. There seems a level of hypocrisy in maintaining that Government must not introduce retrospective legislation but a Government instrumentality may achieve the same results through alternative means and do so with impunity.

More importantly, there is a distinction between retrospective legislation that imposes a burden and retrospective legislation that remedies a defect or corrects a wrong. The latter is a responsible and necessary action by Government. Furthermore, Government may be excused from not taking action to rectify defects of which they were not aware but cannot be excused responsibility to rectify defects which have been brought to their notice and which they have recognized as requiring correction. This introduction of what for all practical purposes is “deferred” legislation is misleading to taxpayers who believe that the system is being immediately rectified and the Senate must not condone or allow such a ploy.

Another argument against retrospective application of the proposed legislation is that it would be neither practical nor appropriate. The rationale apparently is the “system governs the respective rights and obligations of the parties at a particular time and it is not appropriate to change those rights and obligations after the event”. That statement is fully supported by all taxpayers and it has been the cornerstone of their complaint that the Commissioner’s actions have demonstrated that he is neither bound nor recognises those principles. In fact the ROSA legislation is meant to achieve that result and the legislation is required because the Commissioner has acted contrary to that principle.

A further argument is that it would be impractical to have the legislation extend to every past amendment and unfair to other taxpayers to have the legislation only extended to particular groups. The settlement that resulted from the Senate Enquiry has already established a precedent and good reasons why particular groups of taxpayers must be treated differently. In each of the current group disputes there are clearly distinguishable issues of retrospective application of changes in position by the Commissioner. In each of these cases the groups have disputed the matter and been the catalyst for the proposed changes. Accordingly, it is not difficult to identify specific groups that should be covered by the retrospective application of the legislation. The arguments of impracticality and unfairness are therefore hollow and without substance and are only being used as a convenient excuse.

Example demonstrating inadequacy of proposed legislation

The following calculation demonstrates why the proposed legislation fails to achieve the aims of Treasury’s recommendations. The theoretical example is based on an individual taxpayer.

Deduction claimed in:	2001/02	2002/03	2003/04	2004/05
Amount of Deduction:	$200,000	$200,000	$200,000	$200,000
Original Assessment:	1/10/2002	1/10/2003	1/10/2004	1/10/2005
Amended Assessment:	1/10/2006	1/10/2006	1/10/2006	1/10/2006
Marginal Rate:	48.50%	48.50%	48.50%	48.50%
Penalty Rate:	50.00%	50.00%	50.00%	50.00%

	Current Rules Continue to Apply			New Rules
Income Year:	2001/02	2002/03	2003/04	2004/05
Primary Tax	$97,000	$97,000	$97,000	$97,000
Penalty	$48,500	$48,500	$48,500	$48,500
Current GIC	**$93,094**	**$66,315**	**$46,967**	N/A
Notional SIC	$57,804	$42,349	$30,602	
Proposed SIC				$13,113
Total Amount Payable				
Current Law	$238,594	$211,815	$192,467	N/A
If New Law applicable	$203,304	$187,849	$176,102	$158,613
Difference	$35,291	$23,966	$16,365	N/A

As can be seen from above, current taxpayers who are already “locked in” to transactions remain liable to future amendments under the old rules. It is incomprehensible that having recognised that the current law is unfair it will be allowed to be applied for a further four to six years.

Interest rate

The proposed legislation will apply interest on the shortfall amount at the average bank bill rate plus a 3% uplift factor. The current legislation applies the bank rate plus 7% uplift. It is recognised that the revenue must be compensated for the “cost of the money over the period outstanding”. However, compensation should be the cost of the money i.e. the bank rate. The uplift factor is in reality a penalty or disincentive factor to deter those who may attempt to exploit the system by obtaining “low interest loans”. However, the legislation already provides the Commissioner with the ability to impose a culpability penalty of up to 75%. The penalty provisions are the appropriate means to deter those who may take advantage of the system. Consequently, the rate should be the bank rate without an uplift factor as this only introduces a second penalty component to the system for the same event.

Theoretically there are two types of taxpayers. The first category, are those whose tax shortfall arises out of a genuine mistake, reasonably arguable position or because of uncertainty in interpretation or application of the tax legislation. The second category, are those who are serial offenders and who disregard or exploit the tax legislation or submit false returns. In the first case there is no reason why any additional penalty should be applied and repayment of the primary tax plus the bank rate would be equitable and appropriate. In the second case, the legislation allows the Commissioner to apply culpability penalties of up to 75% of the primary tax. In cases

where there is evidence of misconduct an appropriate culpability penalty plus the bank rate would be appropriate.

By maintaining a separation between the penalty aspect and the cost of the money, taxpayers would be more understanding and receptive to the interest component because it only reflects the cost of the money in the same way as any loan from any financial institution. It is the imposition of the penalty factor that makes taxpayers who have acted genuinely feel unfairly penalised and likely to become non-compliant.

Because the shortfall interest only applies to the pre-amendment period, taxpayers who do not pay the tax by the due date will then become subject to the GIC and the applicable uplift factor to encourage prompt payment.

Request to the Senate Committee

Date of Application

The Committee is requested to recommend that the date of application of the proposed legislation be altered to apply to income tax returns from the 1994/95 income and subsequent years.

Applicable Rate of Interest

The Committee is requested to recommend that the interest rate be set at the applicable bank rate only without any uplift factor.

Application to specific groups

The Committee is requested to recommend that the legislation be recognised as having specific application to taxpayers in the various group disputes including Mass Marketed (and similar arrangements classified as boutique arrangements and thereby excluded by the Commissioner from the Senate recommended settlement) Employee Benefit Arrangements, Retirement Village Arrangements, Stapled Stock, Equity Linked Bonds and Security Lending Arrangements.

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