



INTERNATIONAL
BANKS AND SECURITIES
ASSOCIATION OF AUSTRALIA

IBSA Submission to the Review of Aspects of Income Tax Self Assessment Discussion Paper

26 May 2004

1. Introduction

As the peak industry body representing investment banks in Australia, IBSA welcomes the opportunity to contribute our views to the review of the tax self-assessment system. To be fully effective, financial markets need an efficient tax system that minimises tax compliance costs and provides certainty to taxpayers. The issues we comment on in this submission reflect members' experience as corporate taxpayers in their own right and also their experience as financial services providers who are affected by the tax system as it impacts on their business relationships with their clients.

The vast majority of business taxpayers comply with the law and have a significant vested interest in their competitors doing likewise. Therefore, there is widespread interest in the tax system working efficiently and fairly for all. Compliance with the tax law cost the community over \$10 billion in the mid-1990s,¹ so improvements to the self-assessment system stimulated by this review have the potential to deliver significant economic benefits to the community.

2. Elements of a Good Tax Self-Assessment System

In our members' experience, the key elements of an effective 'self-assessment' tax system include:

- *Good law* – Legislation crafted to implement tax policy in a certain and efficient way, comprehensible to taxpayers who must rely on it to self assess their tax liability and with no unnecessary complexity;
- *Adequate taxpayer guidance* – ATO guidance through tax rulings, tax determinations, information releases, website advice etc that target issues of concern to taxpayers and is readily accessible;
- *Efficient administration processes* – Efficient information reporting and fair tax collection processes;
- *User confidence* – Taxpayer confidence that the tax administration process will deliver an equitable and balanced tax outcome as well as government confidence that appropriate tax revenue is collected.

A deficiency on any of these fronts will be reflected as a weakness in the self-assessment system, through uncertainty and/or unnecessary tax compliance costs.

¹ *A Report into Taxpayer Costs of Compliance*, Evans, Ritchie, Tran-Nam, Walpole – cited in Review of Business Taxation, *A Tax System Redesigned*, 1999.

One of the key problems for taxpayers in a self-assessment system is uncertainty, the cost of which includes, amongst other things:

- *Loss of opportunity* - inefficient economic outcomes as taxpayers, especially those with significant reputation risk issues to manage, avoid businesses that make commercial sense but entail an uncertain tax outcome;
- *Compliance costs* – Taxpayers incur unreasonable costs investigating the application of the law to assess their probable liability where the law, or the ATO’s interpretation of it, is ambiguous;
- *Financial constraints* – To avoid disruption of business, taxpayers must manage their financial affairs so they have sufficient resources to meet any potential tax liability greater than that which they have self-assessed. This diverts resources from more productive uses.

Therefore, having regard to the more direct compliance costs imposed on banks through deficiencies in tax administration (like internal and external advice overheads), as well as the cost of uncertainty, the objectives of the review should be to identify measures to:

- Improve tax law design and minimise issues that require ATO guidance and, hence, the number of matters that enter the ruling process;
- Improve the ATO’s tax guidance process, so matters that do require ATO guidance through rulings etc are dealt with efficiently;
- Provide a fairer tax administration system for taxpayers, while preserving the integrity of the revenue base for government through penalties etc.
- Establish a process to assess the performance of the self-assessment system on an ongoing basis and maintain it at a high level – this should include a measure of tax compliance costs imposed on the community.

3. Ongoing Evaluation of the Self-Assessment System

Excessive tax compliance costs are a dead-weight loss to the economy, so it is important to measure the cost of the self-assessment system properly and assess the trend to compliance costs over time to identify weaknesses in the system. As far as we are aware, no data are available to reliably indicate the full cost of operating the current tax system.

The figures on the cost of revenue collection that we have seen quoted typically focus on the cost to the Government (through the ATO) of collecting tax revenue.² However, this is only one element of the economic cost story and can be misleading if the cost to taxpayers is relatively high or if collection costs are effectively being pushed from the revenue authorities to industry.

Our anecdotal evidence is that the cost of tax compliance to the taxpayer has increased significantly in recent years. This is of concern as estimates for taxpayer compliance costs for the mid-1990s (see table 1) found that the tax system at that time placed a heavy compliance burden on the community and taxpayers – especially business taxpayers.

² For instance, the Australian Financial Review in a front page story on 24 May 2005 states “In auditing terms, the large corporate program is the most cost effective investment for the ATO, generating \$11 for every dollar spent”.

Table 1 Australian Tax Compliance Costs 1994-95

Federal Government Taxes	Personal Taxpayers	Business Taxpayers	All Taxpayers
<i>Relative to relevant tax revenue</i>			
Social compliance cost	4.0%	17.9%	11.8%
Taxpayer compliance costs	4.0%	9.3%	7.0%
<i>In dollar terms</i>			
Social compliance cost	\$1.5 billion	\$8.9 billion	\$10.4 billion
Taxpayer compliance costs	\$1.5 billion	\$4.6 billion	\$6.2 billion

Source: *A Report into Taxpayer Costs of Compliance*, Evans et al, ATAX, UNSW 1997.

In the early 1990s, Australia's tax system fared poorly by comparison to the US and European countries for taxpayer compliance costs (see table 2) and we have seen no evidence of an improvement in this relativity over time. Australia fared better for administration costs, but that was the smaller part of the total cost of the tax system.

Table 2 International Tax Compliance Cost Comparisons

	Compliance Costs as a Percentage of Tax Revenue		
	Compliance cost	Administration cost	Total cost
Australia (1990-91)	12.1	1.1	13.2
United Kingdom (1986-87)	2.5	1.2	3.7
Canada (1986)	5.9	Unknown	unknown
USA (1990)	3.2	Unknown	unknown
Sweden (1992)	1.3	0.7	2.0
Netherlands (1990)	4.1	1.1	5.2

Sourced from John Freebairn, *Options and Prospects for Taxation Reform*, 1997 Shann Memorial Lecture, which provides detailed references for each country study.

An important message to take from the information at hand on tax compliance costs is that partial data on the cost of ATO administration are only one dimension of the cost of the self-assessment system and to gain an accurate picture of the situation it is necessary to take account of taxpayer compliance costs. Another message is that Australia's tax system is not as efficient as it should be in international terms.

In practice, we have found the ATO is willing to consider taxpayer compliance cost issues that are put to them in recommending tax law changes to the Government – for example, reduced taxpayer compliance costs provide the rationale for recent changes to the financial record keeping requirements for permanent establishments. Similarly, Treasury has taken account of compliance costs to certain measures – for example, this is the basis for the ADI and non-ADI financial institution carve out from the TOFA foreign currency provisions. These corrective measures tend to be focused on narrow areas where compliance cost imbalances are most obvious.

However, a focus on total community compliance costs needs to be adopted more widely in the context of the self-assessment system, as often the true cost to the economy of the tax system is not transparent. Hence, it can be lost sight of in the policy and law design process, even when compliance cost issues are discussed. We believe that an analysis of the full associated compliance cost should accompany revenue in all tax reform proposals to ensure proper evaluation of the likely benefits.

To ensure that accurate data on the efficiency of the self-assessment system are available on an ongoing basis, the Government should commission regular, periodic estimates of the real cost to the economy of the self-assessment system and publish the results. While this would involve a cost, it is worth pursuing as the results are necessary to assess the performance of the tax system in a critical area. It would facilitate an informed debate on policy to optimise the efficiency of the tax system and, ultimately, enhance the competitiveness of the economy.

4. Legislation

Tax legislation is not identified as a matter for consideration by the Review, but it would be remiss not to comment on the central importance of good tax law to a successful self-assessment system.

In the first instance, taxpayers should be able to assess their tax liability from the law setting out the rules governing the taxation of transactions and entities. To a significant degree, the ATO's guidance for taxpayers is necessary to cover deficiencies in the design of the law, by clarifying how it is meant to apply in certain circumstances. The increasing size and complexity of tax law as it applies to individuals and businesses places an enormous burden on the ATO in this regard. There are a number of reasons for this, one of which is the revenue protection measures sought by the ATO that significantly increase the complexity of the law.

The law that the ATO must administer and provide guidance to taxpayers on is an output of the tax legislation design process and we make three comments here on the design of tax law legislation:

- *The Tax Commissioner's discretionary power under the law to unilaterally override some of its provisions is incompatible with a self-assessment system and should be avoided.*

For example, the New Business Tax System (Debt and Equity) Act 2001 contains a range of provisions that allow the Commissioner to adopt a contrary view to core provisions in the law.³ Taxpayers who issue instruments that satisfy the explicit conditions in the law for a debt or equity instrument may for some reason have this position overturned by the Commissioner. Thus, a taxpayer could never be assured about the standing of an instrument as debt or equity under the law.

Moreover, use of this power may not be transparent, the inherent discipline in the process is weaker than for the rulings or Part IVA processes and there is no method to ensure consistency in application. The discretionary power seems to reflect doubt about the effectiveness of the associated debt/equity provisions, but the appropriate remedy would have

³ Provisions that grant the Commissioner discretionary power include:

s. 974-15 - Meaning of *debt interest*

s. 974-60 - Debt interest arising out of obligations owned by a number of entities

s. 974-65 - Commissioner's power

s. 974-70 - Meaning of *equity interest* in a company

s. 974-150 - Schemes

been to correct the design of those provisions rather than granting the Commissioner discretion at the expense of taxpayer certainty.

- *Smart tax law design can reduce the potential for dispute between taxpayers and the ATO.*

For example, the arms length rule for capital allocation under the thin capitalisation regime introduced in 2001 requires a number of subjective judgements and is difficult to implement – it is a recipe for dispute between financial institutions and the ATO. This problem is substantially overcome by the use of safe harbours available under the law that provide a certain and easily assessable tax outcome. This reduces the administrative burden both on taxpayers and the ATO.

It follows that tax design flaws can lead to impractical tax administration outcomes. Thus, resources placed into good tax law design pays dividends in terms of good taxpayer compliance at a low cost to the community.

- *A more efficient legislative process is necessary to support self-assessment.*

Timeliness of legislation needs to be improved, as tax administration problems and policy initiatives that require legislative amendment often take far too long to be implemented after announcement, leaving both the ATO and taxpayers in limbo. Government press releases, while helpful to confirm an intended change, do not resolve this problem.

For instance, Treasury acknowledge that the TOFA foreign currency exemption for ADIs and non-ADI financial institutions does not operate as intended for all banks and money market corporations. The problem is that the TOFA rules do not integrate effectively with the tax consolidation regime, which generates a penal compliance cost for affected banks. However, even though this problem was identified when the New Business Tax System (Taxation of Financial Arrangements) 2003 Act was in Bill form, we still have no official confirmation that the problem will be fixed and no indication of the likely timing of amending legislation.

5. Chapter 2 - Tax Rulings

An effective tax rulings process is important for two reasons. First, it should provide taxpayers with guidance that enables them to securely self-assess their tax liability. Self-assessment requires stable tax law to work effectively and the ATO's guidance is particularly important in a changing tax environment, as we have at present. Second, it should provide a valuable means for the ATO to improve its dialogue with taxpayers and to keep abreast of business and market developments. This would assist the ATO with its real time identification and management of risk in the tax system.

Private Binding Rulings (2A, 2C, 2E)

Members have reported concerns about the process for private binding rulings that weaken the effectiveness of the self-assessment system, including:

- Difficulty in obtaining a ruling due to unexplained ATO concerns that transactions may involve a perceived ‘tax benefit’, even if that tax benefit is incidental to the overall investment objective;
- Delay in ATO reaching and releasing its conclusions, especially in relation to complex matters;
- Concern that seeking a ruling may prompt unwarranted ATO attention, or otherwise lead to unnecessary complications for the taxpayer;
- Difficulty in obtaining a private binding ruling on matters that may involve Part IVA, especially in relation to prospective transactions.

We acknowledge that the reasons for these problems may be complex and need careful consideration, but a better framework would deliver an improved tax system, with benefits to both taxpayers and the tax authorities.

Financial Product Rulings (2A, 2C, 2E)

There is greater awareness of tax risk amongst the providers of financial products and their clients following the ATO’s action against aggressive tax schemes, amongst other things. The ATO has actively encouraged the use of product rulings by industry and they have become an important marketing feature of widely offered financial products. This provides the ATO with a valuable insight into developments in the market and reduces risk to revenue, but it also places an obligation on the ATO to manage the product rulings process in a fair and efficient manner.

We believe that in a self-assessment system, it is important for the ATO to use product rulings to minimise the uncertainty faced by taxpayers to the greatest extent possible. In this regard, members have experienced inadequacies in recent years, including:

- Delays in the issuance of product rulings, which in exceptional cases can distort market competition; and
- Insufficient flexibility about the conditions under which a product ruling can be issued – banks report difficulty in obtaining rulings for complex financial products.

We are aware through our liaison process with the ATO that it has endeavoured to improve the efficiency of the product ruling process, with some success. In recent years, the number of ruling applications has increased and the time taken by the ATO to process rulings has declined significantly. There is scope for further improvement and the ATO has taken on board comments from IBSA and is working on this.

However, there are still some areas of concern. The range of product rulings remains narrower than is desirable. The ATO has been unwilling to issue rulings where the issue in question is being investigated/researched by another part of the ATO. This increases uncertainty for taxpayers, who do not know when the ATO is likely to come to a conclusion on their views.

In addition, it is not certain that the system will respond well when subject to a ‘stress test’ – for example, it stalled in April 2003 when the market for capital protected products was effectively stifled for over a month while the ATO

considered if it was possible to issue rulings consequent to a government announcement. Not for the first time, the ATO appeared insufficiently prepared to deal fully with the consequence of a public announcement that it was actively involved with.

We need a definitive framework from the Government and the ATO prescribing how the rulings process will work, how long the process will take and the parameters within which the ATO will respond to issues raised in an application. This would build on progress to date and require resourcing of the relevant ATO units so its officers are well placed to understand the market and the products emerging from it. Amongst other things, this would help to ensure taxpayers who are first to apply for a ruling on a new issue are not disadvantaged and it would enhance taxpayer confidence in the tax system.

Other Comments (2C, 2L)

Other general comments we make on rulings are as follows:

- An effective tax rulings system is dependent on the ATO having sufficient resources and expertise to deal with the issues presented to it – tax reform presents a continuing challenge in this regard and any deficiencies should be dealt with, as the costs to the community of any inadequacies in the rulings system would be significant.
- The suggestion that the ATO should charge for its advice through rulings should not be taken up. Taxpayers ought to be able to rely on clarity in the law and the need for rulings reflects a deficiency on this front that is not the fault of the taxpayer. If frivolous or poor quality rulings applications by taxpayers are a concern, a good screening process should discourage them.
- The provision of ATO guidance on tax law provisions that are amended at or around the time of amendment is helpful, as there is greater clarity on the relevant tax policy issues, no positions have been taken and exposures are limited and there is an existing dialogue with industry through which matters can be efficiently resolved.

6. Chapter 3 - Loss and Nil Tax Assessments (3B, 3C, 3F)

The longer the period for ATO amendment of an assessment, the greater is the uncertainty faced by taxpayers and the higher is the cost of tax compliance. The tax law permits the ATO to amend a taxpayer's self-assessment of their tax liability within time limits from the date of assessment, as set out in the law. For companies the review period is usually 4 years or 6 years if Part IVA is invoked but, as outlined in the discussion paper, it can often be longer.

The tax law needs to be improved to enhance taxpayer certainty in this area. In particular, there is a significant equity gap in the tax rules that apply to loss and nil liability returns. In effect, the ATO has an *unlimited* period to review the affairs of taxpayers who make nil or loss returns. This is because the time limitations apply from the time when tax becomes due and payable under an assessment and the ATO considers that there is no deemed assessment when a company lodges a non-taxable return.

In practical terms a tax assessment is simply the determination of a number and, in principle, the size of the number should not matter to the amendment period available to the ATO. Loss and nil assessments should be treated as an assessment with a statute of limitation to amendment and the law should be changed to reflect this position for taxpayer certainty.

There is no basis in tax policy to distinguish between a nil or loss return and an assessed positive tax liability, so we can see no compelling reason to retain the current situation. To the extent there may be a higher tax risk associated with these returns (which we think would be more illusory than real), the ATO should deal with this by allocating its investigative resources accordingly. The ATO's current unfettered right to disturb those assessments makes the task of managing the tax risk difficult for taxpayers if a year can never be "closed off" from a tax perspective other than in an audit situation.

More generally, the period for ATO amendment of corporate tax returns should be limited to 4 years in all cases, with a view to shortening this period over time as the ATO moves towards 'real time' tax reviews. In addition, if there is an unreasonable delay in the ATO amending a return after all information has been made available to it, then reduced penalties should apply.

7. Chapter 4 – Penalties (2I, 4A)

The existence of a penalty for failing to follow an ATO private binding ruling creates a reluctance to seek private rulings unless it is absolutely necessary. Combined with a concern that the ATO will rule conservatively or fail to give a ruling on a complex issue, this can be a disincentive to taxpayers using the rulings process.

The ATO has not been faultless in its interpretation of the law, as judged by the courts. Therefore, having regard to the comments above, the interpretation offered by the ATO in relation to a private binding ruling should just be one of the opinions that a taxpayer should reasonably be able to take into account in finalising its position. Thus, the penalty of 25% for not following a private binding ruling should be removed and reliance placed on a test of whether the taxpayer has taken reasonable care and adopted a reasonably arguable position.

8. Chapter 5 - General Interest Charge (5A, 5B, 5C)

In principle, the General Interest Charge (GIC) should be set to compensate the ATO for the failure by the taxpayer to pay its tax liability on time – thus, the Government (through the ATO) would be compensated for the time value of money foregone. However, any penalty or culpability aspect should be dealt with under a separate penalty regime.

If a penalty element is to be retained in the GIC, then a number of reasons support a significant reduction in the 'uplift' factor:

- The law places the ATO in a privileged and highly advantageous position as a creditor, having legal preference to other creditors, so its credit risk is commensurately small in relative terms;

- Under the current GIC, the size of the penalty imposed on a taxpayer depends on the ATO's efficiency in reviewing their return and amending their assessment;
- The GIC is inconsistent with the ATO's position on arms length and commerciality through its administration of the Tax Act;
- The interest rate charged to banks and other highly rated entities exceeds their general cost of debt funds by a large margin;
- The fault causing a tax underpayment giving rise to a GIC may not sit predominantly with the taxpayer – the Government has a responsibility to write law in a manner that is accessible to diligent and reasonably informed taxpayers, while the ATO has a responsibility to offer the necessary guidance to enable taxpayers to reliably self-assess their tax liability;
- The charge is excessive by international standards (ref. table 5.1 in the discussion paper).

We acknowledge the need for an incentive in the tax administration system to encourage taxpayers to meet their full tax liability in a timely manner. However, the size of the penalty in the current GIC is disproportionate to this need and should be reduced significantly. Having regard to the arguments outlined above, we suggest:

- Set the GIC at the bank bill rate and apply a separate penalty regime to deal with culpability issues;

OR

- Amend the GIC to contain the penalty element in the following manner:
 - (i) *To promote accurate self-assessment by taxpayers* - Set GIC at the bank bill rate *plus* 3 percentage points, with a reduction for entities with a high credit rating, so the penalty element is more equally applied to taxpayers. For example, a bank that is rated AA should pay a GIC equal to the bank bill rate *plus* 1 percentage point; and
 - (ii) *To promote more efficient management of assessment by the ATO* - The maximum GIC that can be charged in respect of an assessment should be limited to 2 years interest on the shortfall (consistent with approach B in the discussion paper).

9. Conclusion

The matters covered by the review are important and there is significant goodwill towards an exercise that might improve self-assessment and enhance the efficiency and fairness of the tax system. In this context, IBSA is grateful for the opportunity to provide feedback on the issues raised in the discussion paper and would be happy to respond to any questions arising from our comments.
