Law Council
OF AUSTRALIA

Mr Paul McCullough
General Manager
Review of Self Assessment
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Mr McCullough,

Review of Aspects of Self Assessment

I have pleasure in enclosing a submission in response to the Treasury's review of aspects of Australia's system of self assessment for income tax.

The submission has been prepared by the Taxation Committee of the Business Law Section of the Law Council of Australia. Please note that, owing to time constraints, the submission has been endorsed by the Business Law Section but has not been considered by the Council of the Law Council of Australia.

Yours sincerely,

Peter Webb
Secretary-General

31 May 2004

Enc.

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Treasury Review Of Aspects of Income Tax Self Assessment

Submission by the Taxation Committee, Business Law Section of the Law Council of Australia

The Taxation Committee of the Business Law Section of the Law Council of Australia ('the Committee') welcomes the initiative of the Australian Federal Government and the Treasury in undertaking a review of aspects of the self assessment system.

Any system of self assessment of taxation liability by the person obliged to pay the tax requires a high level of certainty for taxpayers as to their income tax position.

The degree of certainty called for by a self assessment system is not possible if there is:

1. unclear and incomplete law; and

2. unclear and incomplete ATO guidance,

both of which are features of the current income tax system.

This uncertainty combined with:

1 penalty exposures for taxpayers in certain circumstances; and

2 a general interest charge ("GIC") which operates at an un-commercially high level,

creates an inequitable outcome for taxpayers

The Committee submits that action is required to improve the level of certainty in the current income tax system from:

1. the Treasury and Government to address, inter alia:

   - measures that have been announced by Government but have not been legislated;
   - measures that have been legislated but require technical corrections;
   - ongoing minor compliance improvements that are identified in practice;
   - the design and drafting processes for tax legislation; and
   - the uncommercial and inequitable policy settings behind the general interest charge, so that taxpayers acting reasonably (as demonstrated by taking reasonable care and having reasonably arguable positions) are not exposed to an interest rate that is admitted to have a penal component (described in some places as an incentive element).

2. the ATO to facilitate:

- a stronger focus on providing guidance to taxpayers;
- transparent identification of divergent views about the meaning of tax law to taxpayers, Treasury and the Government;
- timely and current examination of taxpayer affairs; and
- timely and current responses to taxpayer private ruling requests and general enquiries.

General comments on the design and drafting of tax law

The Committee submits that a self-assessment system cannot function properly without well designed and well drafted taxation law. The taxation law provides the foundation on which the self-assessment system is based. If the taxation law is flawed then all of the other aspects of a self-assessment system based on that law will also be flawed.

Without well designed and well drafted taxation law taxpayers will not be able to achieve the certainty they need under a self-assessment system that the interpretation they have adopted/position they have taken is the correct one. That is, if taxpayers are required to self-assess their taxation liabilities then they need certainty as to how the tax law applies to their current situation (i.e. the facts and circumstances at the time that they have to decide how the law applies). Such certainty is not possible if tax laws are neither well designed nor well drafted.

The tax law covering private rulings is a prime example of key tax law that is not well designed and can create uncertainty. In particular, the fact that the ATO is not currently compelled to reach a decision on a private ruling request within a defined period can, and based on submissions to the Review of Business Taxation (see p.141 of 'A Tax System Redesigned') does, lead to taxpayer dissatisfaction with the private ruling system.

The Review of Business Taxation thus made Recommendation 3.2(a):

> "Default issue of private rulings
>
> (a) That the tax law be amended to establish a default system for the issuing of private rulings — under which the Commissioner would be deemed to have given a ruling adverse to the taxpayer if the Commissioner has failed to make a ruling within a specified period."

The Commtitee agrees that the law should be amended to establish a default system and considers that the default position should be that the ATO is deemed to have made a positive ruling in favour of the taxpayer. Taxpayers should not be forced to take action, i.e. objecting to a deemed adverse ruling, because the ATO has failed to do something it is obliged to do under the law or fails to do so within a reasonable period.

There are also other flaws in the design of the tax law dealing with private rulings that have been revealed by a number of AAT and Court decisions. .

For example, there is an inability to use information apart from that supplied by the taxpayer (see Case 17/98 98 ATC 233). This failing was also criticised by the Review of Business Taxation (see pp. 141-142 of 'A Tax System Redesigned') and resulted in it making Recommendation 3.2(b):

"Use of facts from other sources

(b) That when making a private ruling the Commissioner be allowed in certain circumstances to rely on information other than that provided by the applicant, with the effect that:

(i) the Commissioner be able to use information readily available, in addition to the facts provided by the applicant;

(ii) such information be made known to the applicant before being used to make the ruling; and

(iii) where the Commissioner cannot convey this information to the applicant (for reasons of privacy or confidentiality):

- the Commissioner be unable to provide a ruling, and
- the taxpayer be advised accordingly."

Other failings of the law dealing with private rulings have been identified by a number of commentators over the years. In this regard, the discussion paper that Professor Graeme S. Cooper prepared for the ASCPA in December 1998 sets out at pages 38 through 48 a number of problems with the private ruling system and is a useful summary and analysis of these issues - which he groups together under the following headings/subheadings:

1. Delay in Securing Rulings
2. Limitations on Available Issues (Matters of Fact, Application of Part IVA)
3. Issues of Collection, Tax Administration and Procedure (Writing and Actions Not Amounting to Rulings, Problem of Embargoed Topics, Quality of Private Rulings and Procedures)
4. Incontestable in Reality (Which Facts and Information can be Considered?, What do Those Facts Prove?, The Impact of Delays on Contestability)
5. Time Limits on Rulings
6. A Generally Uncooperative Approach

The operational/legal difficulties with the private ruling system have also been recently highlighted by Justice Hill in *Corporate Business Centres International Pty Ltd* v *Commissioner of Taxation* [2004] FCA 458. Whilst the taxpayer in that case was associated with a former ATO officer, Mr Petroulias, the observations that Justice Hill makes in this case about the private ruling process are relevant to all taxpayers. In this regard, the following extracts from Justice Hill's judgment in that case seem particularly apt in light of our comments above:

> *When Parliament in 1992 amended the Taxation Administration Act 1953 ("the Act") to permit, for the first time, the making, by the respondent Commissioner of Taxation ("the Commissioner"), of binding private rulings on the application of taxpayers, it may be assumed that it did so on the understanding that it was legislating for a mechanism which would provide certainty to taxpayers, particularly in the context of self assessment...*
>
> *The procedure for obtaining a ruling was not particularly complex ... [and one] might be excused for thinking that procedural complexities ought not to arise and that an application for ruling would ... produce*

a ruling which would comply with the Act and which would, if ...[it] dissatisfied the applicant lead to an objection, which if disallowed would give rise to an appeal ... In such an appeal, the Court could concentrate upon determining the correctness or otherwise of the Ruling and not need to determine matters going to the validity of the ruling. That is, unfortunately, not the present case.

...It is therefore necessary to set out in some detail the course of dealings between the parties that has led to proceedings of some melancholy complexity for which all parties must share some responsibility. However, I am bound to say that the Commissioner hardly distinguished himself with glory in the way he has approached the subject matter of the present proceedings.

Justice Hill's disparaging comments about the private ruling system leads into another area of the current self-assessment system that the Committee has some observations on – the uncertainty for taxpayers created by the way in which the ATO administers the tax laws.

General comments about the ATO administration of the tax law

For self-assessment to work taxpayers need certainty not only as to how the tax law applies to their current situation (i.e. the facts and circumstances at the time that they have to decide how the law applies) but also certainty as to how the ATO will administer the law based on those facts and circumstances.

Certainty is compromised if the ATO is able to issue and update, with retrospective effect, non binding guidance material (like the consolidation reference manual) which is relied on and followed by many taxpayers - despite the fact that the ATO does not consider it legally or administratively binding.

This situation is exacerbated if updates on pre-existing materials are not identified as such by the ATO to indicate that a change has occurred.

All advice given/guidance material issued by the ATO should, at the very least, be covered by something like the Commissioner's TaxPack guarantee and all updates to that advice must be highlighted.

Taxpayer certainty is also compromised by the ATO being able to take lengthy periods to answer taxpayer technical interpretation/ruling requests. That is, the inherent flaw in the tax law in failing to prescribe time limits within which a technical interpretation/ruling request must be answered is exacerbated by the ATO taking the time it does to respond to some taxpayer requests.

There would appear to be no reason, for example, why the ATO could not implement an administrative policy to the effect that unless a private ruling request has been answered (favourably or unfavourably) within, say, 60 days of it being received by the ATO, a positive response must be given to the taxpayer on the 61st day.

If such an administrative policy was in place some of the taxpayer dissatisfaction with the private ruling system mentioned above could dissipate as taxpayers will know that a response, even an unfavourable one, will issue within a set period – with the ability, in the case of an unfavourable response, then to appeal against the private ruling.

It would also send a message to taxpayers that the ATO was listening to and acting on the concerns raised by them without waiting for a change in the law.

In this regard, other useful messages that the ATO could send to taxpayers would include:

1. providing early notice to taxpayers that it has decided to audit them; and

2. an extension of the areas covered by pre assessment agreements to cover, for example, the systems that a taxpayer has in place to determine its capital allowance claims.

Changed Facts and Circumstances

The self-assessment system would operate more efficiently if the law and its administration allowed flexibility to accommodate the changed facts and circumstances of a taxpayer at a later point – especially if those facts and circumstances are changed as a result of actions by the ATO or a third party.

For example, if a public unit trust is required under the Managed Investments Act 1998 to replace its separate trustee and manager with a single responsible entity, complying with that Act may entail the appointment of a new Trustee for the trust. The fact that there is a new Trustee however, should not mean that the new Trustee cannot rely upon private rulings issued to the 'old' Trustee of the trust because it is not the taxpayer to whom they were issued.

The law dealing with private rulings, and the ATO in administering that law, should be flexible enough to allow any party in the role of Trustee of the trust to be able to rely upon those private rulings.

Extra Statutory Concessions

Legislative space needs to be found for an annual tax technical corrections bill. As noted below, the Committee considers that a self assessment system requires the rule of law not ATO lore. Two observations are offered in this context.

First, in relation to matters that go to substantive tax liability, if the ATO does not wish to pursue particular areas of tax minutiae or inequitable outcomes then these should be openly identified to the taxpayer community. However it is important that such ATO actions are followed up by appropriate legislative corrections as soon as practicable.

Secondly, in relation to compliance and procedural matters, the ATO should, in a transparent manner, permit taxpayer shortcuts wherever possible. The Committee believes that the ATO is already granted sufficient power by the Taxation Administration Act 1953 and the 1936/1997 Income Tax Assessment Acts to allow administrative compliance related shortcuts. The Law Council recommends that the ATO clearly explain its powers and the intent and approach which it will use in this area so that there is no uncertainty on the part of its officers and the taxpayer community. A useful first step was mentioned in the recent comments of Second Commissioner Michael D'Ascenzo[1].

> "Recently the National Tax Liaison Group asked whether the ATO could do more than interpret legislation in this purposive way. They suggested an administration approach akin to the notion of

[1] "Making Choices: Risk Management in Action, To the Corporate Tax Association's 2004 Convention, Sydney, 4 May 2004

extra-statutory concessions which operates in the UK tax environment. The ATO's response has been to consider whether the practice which operates in the UK adds anything or is different to the purposive approach we adopt in Australia. In doing so we also looked to the approach of our colleagues in the Inland Revenue in New Zealand where we found that legislative guidance is given to the Commissioner there about what may be taken into account in delivering practical compliance outcomes in tax administration. While in the UK, the "power" to offer practical compliance solutions is not embodied in any specific provisions in the Acts the Commissioners administer, it has a long history of support in the case law. In the Australian context we also need to be mindful of responsibilities under the *Taxation Administration Act* and the *Financial Management and Accountability Act* which require that the Commissioner apply ATO resources in an efficient, effective and ethical way"

Specific comments on Chapter 2 – Rulings and other ATO advice

Introduction

The Committee considers that a self assessment system requires the rule of law not ATO lore. Reliance on ATO concessions, discretions and shortcuts is likely to cause significant uncertainty and commercial challenges. For example, taxpayers may consider that they are entitled to ATO concessions but find that they fall outside those concessions because they are either not binding on the ATO or are not applicable to the precise circumstances of that taxpayer.

This is illustrated in high-profile cases such as:

1. Bellinz (capital allowances for assets under hire purchase arrangements); and

2. David Jones Finance (dividend rebate for nominee shareholders).

It is inappropriate to expect ATO practical guidance to substitute for:

1. unclear and incomplete tax law;

2. the absence of tax regulations covering an area;

3. discretions granted to the ATO that are not well drafted; and/or

4. tax law that is not flexible enough to allow, inter alia, extensions to time limits for the lodgement of notices/elections or the making of administrative shortcuts.

Whilst Committee acknowledges that some ATO compliance short cuts and extra statutory concessions may be necessary, the Committee views systemic ATO shortcuts or extra statutory concessions as undesirable. They are no substitute for properly designed and drafted legislation - which is the responsibility of Treasury and the Government.

Is ATO advice accessible?

A transparent sharing of its analytical materials with taxpayers, including problematical materials, is part of the ATO responsibility in a self assessment environment. This sharing with taxpayers should not create inappropriate revenue risks provided the ATO is copying its taxpayer communications to Treasury and the Treasury processes for legislative corrections and amendments are properly resourced.

The ATO should also consider streamlining its array of advice products into three categories:

1. legally binding – notably tax rulings;

2. administratively binding – bringing together the current ATO IDs and other guidance material; and

3. discussion papers that are not binding in any way.

The third category could then be used by the ATO to signal to taxpayers, in a non-binding way, its draft opinions, working materials, concerns and reservations pending their being binding. This may be particularly useful in the interval prior to law receiving Royal Assent, a period during which the ATO does not currently appear to issue materials.

Whenever the ATO changes its guidance material (in particular, ATO IDs and the Consolidation Reference Manual) the precise nature of the change should be marked so that taxpayers can understand when and how the ATO changed its view. Otherwise the ATO is at a major advantage to taxpayers who do not keep continuously updated mirrors of the ATO website showing all historical updates.

There is also a concern that taxpayers will tend to distrust the ATO and their relative position in the self assessment system if updates are not flagged.

Should ATO advice indicate whether Part IVA applies to a particular arrangement as a matter of course or only on request?

The Committee considers that the ATO should be compelled to provide Part IVA indications upon a taxpayer's request. Further, the ATO should be obliged to let a taxpayer know if it does have some Part IVA concerns about a transaction even if not asked. Taxpayers are at a disadvantage to the ATO in many instances and are unaware of the internal thinking of the ATO on Part IVA matters.

In addition, and coupled with a responsibility to bring concerns to a resolution (see below), the Committee recommends that where the ATO has general concerns about particular transactions or types of transactions then, using the model of the Taxpayer Alerts, the ATO should transparently identify for all taxpayers its reservations and concerns.

Coupled with the foregoing, the Committee notes that there is an obligation with Taxpayer Alerts and similar cautions for the ATO to proceed in a timely manner to resolve its reservations and concerns by progressing Taxpayer Alerts into rulings or litigation.

Accuracy, objectivity, bias and confidence in ATO advice

The Committee recognises that the ongoing tax reform of the Australian tax system creates challenges for the ATO. At the same time however, to discharge its function as the tax administrator the Law Council submits that the ATO should be appropriately resourced and structured so as to deliver timely advice in relation to the operation of the tax system.

The Committee perceives that the ATO has struggled in recent years with a combination of different pressures:

1. the pressure to introduce a high level of quality in relation to its formally legally binding tax rulings. This pressure has seen a demonstrable increase in the quality of tax rulings but can lead to significant delays in the issue of those rulings;

2. a pressure to issue guidance material in relation to tax reform and ongoing developments. This has resulted in some apparent tension within the ATO with a series of different ATO products including:

    - Tax Determinations
    - ATO Interpretive Decisions

- Practice Statements on Law Administration (intended to operate as practical guidelines - often in areas where the law is somewhat unclear);

3. a pressure for probity following various concerns about ATO officers acting inappropriately. This has resulted in the ATO instituted additional probity rules arising from the Sherman Report - which require cross checking, approvals and disclosures. This process no doubt improves the probity around tax decisions but it adds delays to the process and appears to diffuse the responsibility for issue of rulings and advice; and

4. the pressure arising from the transfer of legislative responsibility to the Federal Treasury.

This combination of factors means that for many taxpayers their experience of dealing with the ATO under self assessment has:

1. not enabled them to resolve uncertainty and ambiguity when considering new transactions;

2. resulted in difficulties in obtaining clear advice from their advisers including members of the Law Council of Australia;

3. not allowed them to identify precisely their tax return filing positions; and/or

4. involved lengthy delays in achieving resolution of tax disputes with the ATO.

The above pressures need not however, always result in negative outcomes for the ATO and taxpayers. For example, the Committee considers that the devolution of policy responsibility to the Federal Treasury can have a number of positive outcomes by:

1. allowing the ATO to operate "without fear or favour" as an interpreter of the tax law (i.e. as it is no longer a policy maker the ATO does not need to be 'opaque' in relation to gaps in the law); and

2. creating a better linkage between the ATO and the Treasury due to the number of former ATO personnel now in Treasury.

In other words the ATO can act as a transparent adviser on the state of the law - which is an approach understood to have been taken by both the New Zealand and the UK Revenue Authorities. (The ATO would, of course, continue to advise the government of defects in the law - as do its New Zealand and UK counterparts to their governments).

It would appear however, that the establishment of appropriate networking between the ATO and Treasury is still developing.

Other key points regarding ATO advice include:

1. there are not significant problems with the accuracy of tax advice that is actually communicated by the ATO. Rather the problems are with the ATO tendency not to communicate or disclose advice or positions that will not suit its interests;

2. there has been an understandable implicit pro revenue bias in ATO management of issues due to its dual role, in the past at least, as both administrator and policy maker. Changing this bias will require recognition by the ATO that its role is now that of an administrator;

3. it is critical that the ATO is timely in its review of issues and proactive in advising Treasury and Government of any gaps in the law. Otherwise, there will inevitably be repeats (which no one wants) of such problems as:

   - the belated attack on tax shelters implemented by unsophisticated taxpayers;
   - belated attacks on taxpayers undertaking arrangements which had been informally or otherwise cleared by the ATO in various forums; and/or
   - ATO project groups being formed to dispute matters that are several years old; and

4. the Committee supports ATO advice transparently outlining conflicting areas of the law particularly in public documents.

It is accepted that not all taxpayers will want or need such technical analysis. Larger taxpayers and their advisers will however, wish to understand the proper application of the law. The ATO can determine the best practice mechanism for such guidance which might include:

1. addendums to general advice products identifying the tax analysis, or

2. materials retained in the ATO legal data base

Compliance shortcuts

The Committee is not attracted to untrammelled ATO discretions. Reliance on ATO discretions and shortcuts is likely to cause significant uncertainty and commercial challenges. One important objective of the self-assessment regime was to reduce ATO discretions so that taxpayers could properly self assess their obligations.

The Committee recognises that in some areas there might be:

1. failures/omissions in terms of setting out the precise compliance obligations of taxpayers in relation to the law; and/or

2. small gaps in the legislative provisions and regulations in certain parts of the law.

As to the first issue, the Committee supports the exercise by the ATO of its administration powers to allow taxpayers various compliance shortcuts. The ATO should, in a transparent manner, permit taxpayer compliance shortcuts wherever possible. The Committee considers that the ATO has ample powers under the Taxation Administration Act 1953 to grant such shortcuts but notes the references from time to time by senior ATO officers to the Financial Management Accountability Act 1997 and other perceived issues in relation to limitations on the ATO power to issue these shortcuts. Whilst the Committee does not consider it prima facie necessary for a new statutory power to be granted to the ATO to allow it to grant/issue compliance shortcuts, it would welcome a resolution of this issue once and for all – so that it is clear to the ATO that it has the power(s) to provide taxpayers with easier compliance mechanisms.

As to the second issue, if the ATO does not wish to pursue particular areas of tax minutiae or inequitable outcomes then these should be openly identified to the taxpayer community. However it is important that such ATO actions are followed up by appropriate legislative corrections as soon as practicable.

Compliance shortcuts do not replace the need for clarity and completeness in the law

As noted in our introductory comments, the Committee believes that a self-assessment system cannot function properly without well designed and well drafted taxation law as it is the taxation law that provides the foundation on which the self-assessment system is based. If the taxation law is flawed then all of the other aspects of a self-assessment system based on that law will also be flawed.

There should be no need for the ATO to grant/issue compliance shortcuts if the law is well designed and drafted.

In this regard, the Committee would be pleased to work with Treasury on the design and drafting of new law.

Should all the advice that it issues be legally binding on the ATO?

As mentioned above, the Committee submits that all advice given/guidance material issued by the ATO should, at the very least, be covered by something like the Commissioner's TaxPack guarantee.

The Committee believes that main reason for the pressure on the ATO to issue legally binding advice arises from the interaction of the incorrect level of the GIC and the penalty regime. That is, taxpayers taking positions are effectively subject to two levels of penalties – a penalty interest rate on the outstanding tax plus the penalties for making an incorrect statement(s) in their returns.

The Committee suggests that if the GIC was reduced to a more commercial level than much of the pressure on the ATO for legally binding advice would reduce.

An additional reason for the pressure on the ATO for legally binding tax advice arises from the timeliness of the ATO in:

1. reviewing income tax returns; and

2. issuing guidance generally.

If the ATO were to speed up its review of tax returns and was faster in issuing guidance material then taxpayers would have an increased confidence in the tax system, which would reduce some of the pressure for legally binding ATO opinions.

Should the ATO charge for the advice it gives to taxpayers?

The Committee does not believe that the ATO should be allowed to impose fees for private ruling requests.

The Committee does recognise that class and product rulings are a different category to private rulings. As the arrangers of products make money from the success of the products, fees could be expected.

Specific comments re Chapter 3 - Review and amendment of returns

A major cause of the entire self assessment debate and taxpayer dissatisfaction is late ATO reviews and audits.

ATO delays in compliance action, such as audits and risk reviews, cause:

1. delayed feedback to taxpayers to alter their behaviour if needed;
2. delayed signals to government about necessary improvements in the law; and
3. needless escalation of penalties (which both infuriate and intimidate taxpayers).

The Committee, therefore, submits that:

1. there should be a two year limitation to amendments increasing the liability of individuals and very small businesses whilst retaining the four year limit for larger taxpayers;
2. the amendment period for all taxpayers subject to ATO Client risk Reviews or High Net Wealth Individuals questionnaire processes should be four years;
3. the ATO should be legislatively required to commence a large corporate taxpayer audit within two years of the issue of an assessment to a taxpayer or else forego the right to audit that taxpayer;
4. pre assessment agreements should be extended to cover, inter alia, the systems that a taxpayer has in place to determine its capital allowance claims;
5. a taxpayer with a nil liability tax return/assessment should have the same time limits for an amended assessment as a taxpayer with a $1 liability or a $1 million liability;
6. taxpayers should have remedies against the ATO for unreasonable delays by the ATO in issuing amended assessments after it has the necessary information;
7. any changes arising from the discussion in Chapter 3 should immediately be implemented through administrative actions by the ATO – but with follow up legislative amendments to give maximum 'protection' to taxpayers.

Chapter 4 – Penalties and self assessment

The Committee considers that:

1. the phrase 'reasonable care' requires clarification; and
2. that taxpayers should not be penalised for failing to follow a private ruling they had sought if they have indicated that a private ruling has been issued or they have objected to either the assessment or the ruling.

Penalties for failure to take reasonable care

Prior to the action that the ATO took in *MLC Limited* v *Deputy Commissioner of Taxation* [2002] FCA 1491 ("the MLC Insurance case"), taxpayers may have considered that the definition of the phrase "reasonable care" was clear. Unfortunately however, this case has caused some doubt as to the meaning of that phrase.

In that case Justice Hill strongly criticised the stance that the ATO took in relation to the imposition of the reasonable care penalty. The Committee considers that this judgment sheds light on the circumstances in which this penalty should be imposed and that the ATO should issue a ruling or practice statement confirming, by express reference to the MLC Insurance case, its approach to the definition of reasonable care.

Not following a private ruling

Taxpayers who do not follow a private ruling should not be penalised provided that the existence of the private ruling is disclosed by ticking a box or by objection.

A question such as:

> "Have you been issued a private binding ruling that applies to this year of income that has not been followed? If you have, please identify the area(s) where you have <u>not</u> followed the terms of that ruling."

could be included in tax returns.

Specific comments on Chapter 5 – General interest charge ("GIC")

Whilst the Committee notes that the objective of the Chapter is stated as being to focus on shortfall GIC, the Committee takes this opportunity to resubmit the attached paper (previously lodged with Treasury by the Committee) that provides comments on the general concept of the GIC and its application as a whole.

General Interest Charge inappropriately operates as a penalty

At the time of its introduction, it was said that the GIC was to be compensatory in nature – not to act as a penalty. It is inappropriate to have the GIC as a penalty. The penalty regime adequately deals with the unconscionable behaviour of taxpayers by focusing on whether they have used reasonable care in preparing their returns and have adopted reasonably arguable positions. If it is considered that the penalty regime is not an adequate disincentive for taxpayers to remit the correct amount of tax, then it is the penalty regime that should be re-addressed.

The Committee would also like to point out that even if the true objective of the GIC is to dissuade taxpayers from using the ATO as a low interest lender, which it does not accept, the rate is excessive as it does not distinguish between different types of taxpayers.

In the Committee's view therefore, the GIC should be remitted down to a cap, as the delay in discovery of a shortfall should not further disadvantage a taxpayer.

In addition, the Committee submits that there should be no uplift factor above the base rate of GIC. Any culpability should be dealt with via the penalty provisions (as stated above and in the paper attached). If, counter to this view, Treasury considered that some uplift was necessary then for corporate taxpayers the total GIC should be no greater than the bank bill rate plus 2% per annum - with compounding calculated on a basis consistent with commercial practice unlike the current skewed compounding formula in the GIC mechanism.

The Committee further believes that if an issue on which the ATO and a taxpayer are in dispute is being judicially reviewed, the taxpayer should be able to request a stay in the imposition of the GIC for the period of time during which the issue is being resolved.

Simplicity of changes versus different market segments

In relation to whether priority should be given to simplicity in considering any changes to the current GIC regime the Committee's initial response would be yes. If different market segments are to be treated differently (and thus presumably equitably) for GIC purposes however, the Committee's desire for simplicity may need to be tempered.

That is, if the rate is not universally lowered to reflect its compensatory nature (which should happen) then different market segments will need to be treated differently to reflect the different costs of finance each segment faces. Taxpayers will thus need to know what market segment they are in before they can anticipate/calculate their potential GIC liability.

If there were a universal lowering of the rate however, there would be no need to move away from a single comprehensive system and the penalty system could be adjusted to focus on the individual facts and vary the amount to be paid based on the culpability of each taxpayer.

Remission of the GIC by the ATO

The Committee does not recommend improving the GIC regime by a stronger focus on remission of the GIC by the ATO (refer above and as per the attached discussion paper). Any unconscionable/unreasonable behaviour by the taxpayer should be dealt with by penalties and, as such, should not be a relevant factor in considering the application of the GIC.

In the case of a taxpayer-initiated remission of the GIC, the Committee submits that taxpayers should be able to go through normal objection channels and not have to use administrative law challenges to obtain relief.

There is no need for differential tax adjustments

The GIC should remain deductible at the relevant taxpayer's marginal tax rate to reflect the fact that it was not intended to be a penalty. In particular, if it were made non-deductible it would likely have implications from a Directors' disclosure perspective as it may be considered to be more like a penalty.

If the law relating to the GIC is amended to operate equitably in the manner described above, the Committee does not consider that further differential marginal tax adjustments will be needed.

ATTACHMENT 1

GENERAL INTEREST CHARGE: INEQUITY CURRENTLY PREVAILS

The purpose of this submission is to illustrate the inefficacy of the general interest charge ("GIC") regime introduced in 1999 and to stimulate discussion and review of the nature of its imposition with the Australian Taxation Office ("ATO").

Background:

Part IIA Division 1, which introduced the GIC was inserted into the Tax Administration Act 1953 ("the TA Act") in 1999[2] and became effective from 1 July 1999. It was said that the reason it was introduced was to make the regime of late payment penalties, which existed in the various tax laws before that date, more streamlined. The GIC replaced 52 penalties on 1 July 1999, including the late payment penalty and the late lodgment penalty for non-instalment taxpayers. It was also said that the GIC is a more commercial approach whereby taxpayers who pay late are required to compensate the Government (via the ATO) for the time value of money.[3]

Executive Summary:

1. <u>GIC rate is currently too high:</u>

   The rate at which the GIC is currently imposed is far from being merely compensatory in nature, nor does it reflect a commercial approach. The rate should be lowered, to reflect its compensatory nature. The rate should replicate either the rate paid by the ATO for the overpayment of tax (see below), or it should be no more than the market rate charged by financial institutions;

2. <u>Discrepancy between overpayment of tax rate and GIC:</u>

   Currently, the interest to be received by the taxpayer from the ATO where an overpayment of tax has occurred differs significantly in terms of both the prevailing rate of interest and the methodology used to calculate it to the interest received by the ATO via the GIC. This difference illustrates the inequity and inappropriateness of the GIC rate, and indeed the method of calculation. The GIC rate should be equal to the rate received by taxpayers on monies refunded by the ATO where the taxpayer has made an overpayment of tax. The method of calculating the GIC charge should also be calculated in the same manner as any overpayment of tax interest is calculated. As a minimum, there should be netting off during periods of mutual indebtedness between the taxpayer and the ATO.

3. <u>Retrospective application:</u>

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[2] Inserted by Act No 11 of 1999 (Taxation Laws Amendment Bill (No 5) 1998)

[3] The Auditor General paper "Administration of Tax Penalties" presented by the Australian Taxation Office at the Australian National Audit Office Canberra 2000 (Audit Report No. 31) at page 10

Due to the nature of the tax law, there are frequently instances where taxpayers may interpret the law, and its application to their particular factual circumstances, differently to that of the ATO. The taxpayer should be able to request a stay in the imposition of the GIC so that it is not effectively retrospective in instances where there is a review process being undertaken, the necessity for which has arisen due to the complexity of the tax law. It should also be available where the ATO has contributed to any delay in the resolution of the issue. In the instances where the issue is being run as a test case by the ATO, there should be an automatic stay.

As an alternative, the taxpayer should be able to request a deferral of the due time, which would effectively result in a deferment of the start time of the imposition of the GIC, until a tax matter that is under review is resolved.

4. Impact of Consolidations Regime:

The exposure to GIC under the new consolidations legislation for the transitional year regarding PAYG instalment variations is greater than what it is under the existing legislation. An administrative solution is required to replace the 25% allocation of the consolidated group's actual tax liability, as this is inconsistent with PAYG principles.

Detailed Discussion:

Whilst it is an established principle that one of the elements of determining whether a sanction is equitable is whether it is applied consistently,[4] there are several aspects of the current GIC regime that are incongruous with the concept of equity and the purported intention that it be of a compensatory nature.

1. Rate of GIC:

The GIC is generally payable if a person has failed to pay an amount to the Commissioner on time. The operative provisions of the GIC, including the formula for its calculation, are found in the TA Act. The Commissioner may remit all or part of the GIC in particular circumstances; for example where the person did not cause the delay in payment or where it would be fair and reasonable to remit the change (section 8AAG of the TA Act). We note however, that ATO staff have been instructed to remit penalties only in "exceptional circumstances" although remission may be exercised more frequently during transitional periods.[5]

The rate at which the GIC is imposed is however, far from merely compensatory in nature. The GIC is worked out daily on a compounding basis, using the base interest rate for a day of the monthly average yield of 90 day Bank Accepted Bills published by the Reserve Bank of Australia as a starting point. The applicable rate depends on the quarter of the year in which the day falls.[6] The GIC rate for a day is then worked out by adding 7 percentage points to the base interest rate for that day and dividing that total by the number of days in the calendar year.[7] GIC rate currently applicable is 11.84% (March 03 quarter) and is tax deductible.

This rate should be compared with the market rate, which is charged by (say) financial institutions in circumstances of an overdraft. The business overdraft rate is in the vicinity (February 2003) of 7.47%[8] to 7.64%[9].

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[4] Ibid

[5] Auditor General Administration of Tax Penalties – Australian Taxation Office Australian National Audit Office, Canberra (Audit report No 31) at page 20 – as quoted in ALRC discussion paper

[6] set out in section 8AAD of the TA Act.

[7] Sub- section 8AAD(1) of the T A Act.

[8] CBA - @ 17 February 2003

[9] National Australia Bank –@ 17 February 2003

It is difficult to see how the current method of application of the GIC and the current rate at which it prevails is a commercially realistic one, given the addition of the 7 percentage points. Nor is it possible to see how it could be labelled compensatory in nature. So much was acknowledged by the Commissioner when he stated that eligible investors in mass marketed schemes "will be entitled to an interest reduction from the full general interest charge, currently 11.89 per cent, to a rate reflecting the time value of money."[10]

In the United States, which has a similar interest regime, the interest on underpayments of tax is imposed at the federal short-term rate plus three percentage points.[11] The interest rates, which are adjusted quarterly, are determined during the first month of a calendar quarter and become effective for the following quarter. As in Australia, the interest accrues from the date that the payment was due (determined without regard to any extensions of time) until it is received by the Internal Revenue Service ("IRS"). Interest is compounded daily, except for additions to tax for underpayment of estimated tax by individuals and corporations. The interest rate on underpayments for the first through to fourth quarters of 2002 was 6%. The interest is also tax deductible.

In the United States, interest on large underpayments of tax by corporations is imposed at the federal short-term rate plus five percentage points.[12] A large corporate underpayment is any tax underpayment by a C corporation that exceeds $100,000 for any tax period. For purposes of determining the $100,000 threshold, underpayments of different types of taxes (for example, income and employment taxes) as well as underpayments relating to different tax periods are not added together. The tax period is the tax year in the case of income tax or, in the case of any other tax, the period to which the underpayment relates (see below for comparative table).

Recommendation:

The rate of the GIC should be lowered, to reflect its compensatory nature. The rate should replicate either the rate paid by the ATO for the overpayment of tax (see below), or it should be no more than the market rate charged by financial institutions.

2. Interest Rate on Overpayment of Tax:

Another issue which is related to the excessive rate of the GIC and the need for it to more accurately reflect its compensatory nature, is that it should mirror the amount of interest received by a taxpayer in accordance with the Part III of the *Taxation (Interest on Overpayments and Early Payments) Act* (1983) Cwth (the "Interest Act"). The interest is assessable (section 15-35 of the ITA Act 1997).

From 1 July 1999, the relevant interest rate under all sections of the Interest Act is the annual rate provided for by section 214A of the *Income Tax Assessment Act* (1936) Cwth (the "ITA Act 1936"). That is, the base interest rate as defined in section 8AAD of the TA Act. Examples of rates in the past are 4.89% (July 2001 quarter) and 4.84% (September 02 quarter).

Interest is calculated as simple interest (not compound interest).[13] Any interest payable is set off against any tax debts allocated to the taxpayer's running balance account ("RBA") and the GIC on those debts or alternatively, any non-RBA tax debts.

The amount by which the interest rate and method of calculation differs where the taxpayer is owed money by the ATO as compared to when the taxpayer owes money to the ATO illustrates the inequity and inappropriateness of the rate, and indeed the method of calculation. As outlined above, the GIC has been calculated at the base rate plus the 7 percentage points on a compound basis and is netted off by an amount calculated at the base rate on a simple interest method.

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[10] Commissioner of Taxation Media Release – Nat 01/58; 23 July 2001.

[11] Code Sec. 6621(a)(2)

[12] Code Sec. 6621(c)(1)

[13] Consolidated Fertilizers Limited v DCT (1992) 23 ATR 305

The inappropriateness of the current situation is highlighted in the instance where there may be amounts relating to the same issue but where, on resolution of the outstanding issue and due to timing differences, there is both a payment due to the ATO and a refund (of an equal amount) due to the taxpayer. In this instance, due to the difference in methodology and rate of interest when comparing GIC to overpayment of tax, the amounts will not net to zero. From a logical and equitable standpoint, this situation should not arise.

In some cases the ATO and the taxpayer negotiate penalties and reach settlement without court action or a formal or separate court determination. Resolution of disputes by informal settlement rather than by court process adopts a "bargain" and negotiated model of decision-making. [14] Its critical feature is the achievement of agreement and consensus between disputing parties, ideally given freely and on an informed basis. In defence of these negotiated penalties, the ALRC observed that it is often said that at any time either party can invoke the formal court process in order to determine the matter. However, the ALCR also points out that the regulated person or company may face significant pressure to agree to a settlement with the regulator rather than risk a harsher penalty and significant costs for an uncertain outcome. In such circumstances, it may be difficult to characterize the resulting settlement as one based on consent.

We suggest that the significant penalty rates imposed via the GIC, and the difference in quantum when compared with any interest on overpayment means that a settlement is not necessarily one based on consent. To ensure that the parties are negotiating on a level playing field, we suggest that the rates and calculation method should be the same. The importance of this is further outlined below in the context of appeal of ATO decisions. If there is any argument that the rate should be different in order to reflect a deterrent aspect to the penalty, the rate should certainly not be as divergent.

We note that the interest rates for overpayment and underpayments of tax have been equalized in the United States (sometimes referred to as "global interest netting") for any period of mutual indebtedness between the taxpayer and the IRS. To the extent that the overpayment and underpayment of the same taxpayer are equal in amount, no interest is imposed. The zero interest rate applies regardless of whether the underpayment otherwise would be subject to the higher interest rate imposed on large corporate underpayments.

The interest rates imposed by the IRS in the United States for the quarter beginning January 1, 2003 are as follows:

Federal Short-Term Rate ("FSTR") is 2%	**Non-Corporate**	**Corporate**	Corp. Underpayments >$100,000/ Overpayment>$10,000
Underpayment	5% (FSTR +3%)	5% (FSTR + 2%)	7% (FSTR + 5%)
Overpayment	5% (FSTR +3%)	4% (FSTR + 2%)	2.5% (FSTR +.5%)

Recommendation:

The GIC rate should be equal to the rate received by taxpayers on monies refunded by the ATO where the taxpayer has made an overpayment of tax. The method of calculating the GIC charge should also be calculated in the same manner as any overpayment of tax interest is calculated. As a minimum, there should be netting off during periods of mutual indebtedness between the taxpayer and the ATO.

3. Retrospective application

[14] Australian Law Reform Commission – Review of Civil and Administrative Penalties in Federal Jurisdiction

Due to the nature of the tax law, and its reliance on the interpretation of both statutory provisions and common law, there are frequently instances where taxpayers may interpret the law, and its application to their particular factual circumstances, differently to that of the ATO. The impact of this potential difference in interpretation is further heightened by the self-assessment regime. It is only through the occurrence of a review by the ATO that this difference in interpretation is identified. It then becomes a question of how the issue is resolved. Whilst we recognize that charges and civil penalties imposed for failure to meet obligations[15] take into account such factors as whether a reasonably arguable position has been adopted or whether the taxpayer has made a false or misleading statement, the imposition of GIC in its current form appears to add an extra element of punishment. As stated in the ALCR discussion paper, appeal and review mechanisms are another means of keeping a penalty system accountable and fair by allowing decisions made at one level to be tested at another.[16] Appeal and review can also result in more rigorous and lawful decision making because regulators are aware that their decisions will be subject to scrutiny. Avenues of appeal and review are also a source of legitimacy – regulators can claim that their activities are legitimate and acceptable because they are properly accountable to, and controlled by, other public institutions. Formal avenues of appeal and review also structure a person's participation in the penalty process. They determine when complaints are heard, how they are heard, what evidence they can produce, and how many times they can be heard.

As proposed above, when administrative penalties are imposed by a regulator, external reviews should always be available. These reviews, in a self assessment regime such as that prevalent in the Australian taxation system, are invaluable. However, one of the specific questions raised by the ALRC discussion paper [17] is whether legislation should always provide for the option to seek a suspension of an administrative penalty decision while internal review, external merits review or judicial review is undertaken.

We suggest that where the interpretation of the implementation of the tax law is being challenged, there should always be an option available to the taxpayer to seek to stay the operation of the penalty until the review is concluded, due to the very nature of the law and the prevailing self assessment system.

A clear example of why this stay in penalty should be available is the recent case of Vincent v Commissioner of Taxation[18] concerning mass marketed schemes. This case illustrates the inequity of the taxpayer incurring GIC retrospectively where there is a significant delay between the date of assessment and the resolution of the issue. As stated in the judgment, this was a test case in the sense that there were several hundred people who had become involved with the project. As such, its drawn out resolution should be an instance where the retrospective and penal nature of the GIC should not apply. Indeed, on 26 April 2001, the Commissioner announced that he intended to reduce the interest on tax debts for some mass marketed tax effective scheme debts as "they are facing a very substantial and mounting interest bill." He stated that there were grounds "in a range of cases to appropriately reduce the level of interest payable, for example, to an amount that more closely approximates the time value of money. This would see the current interest rate applied to these people reduced from 13.86% to 5.86%."[19]

It is submitted that such a reduction ought to apply in all test cases.

We note that subdivision 255-B of the TA Act deals directly with the Commissioners power to vary the due date for the payment of tax. Section 255-10 of the TA Act provides that the Commissioner may, having regard to the circumstances of the particular case, defer the time at which an amount of a tax-related liability is, or would become, due and payable (whether or not the liability has already arisen). If the Commissioner does so, that time is varied accordingly. In the notes to the section, it is stated that the GIC or any other relevant penalty, if applicable for any unpaid amount of the liability, will begin to accrue from the new deadline. There is however, no statutory right to challenge a decision by the

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[15] Part 4-25 of Schedule 1 – TA Act

[16] Paragraph 10.13 - Australian Law Reform Commission – Review of Civil and Administrative Penalties in Federal Jurisdiction

[17] Question 10-3 - Australian Law Reform Commission – Review of Civil and Administrative Penalties in Federal Jurisdiction

[18] 2002 Federal Court of Australia – Full Court FCAFC 291 (16 September 2002)

[19] Commissioner of Taxation - Media Release Nat 01/30 26 April 2001.

Commissioner not to grant an extension of time. However, a taxpayer may apply for judicial review of such a decision under the Administrative Decisions (Judicial Review) Act 1977.

The ATO Receivables Policy, published in December 2000, sets out the policy in relation to the deferment of time for payment. The Commissioner will only defer the time for payment where debtors can demonstrate that:

1. payment cannot be, or has not been, made by the original time for payment because of circumstances beyond their control, and the debtor has taken reasonable steps to mitigate the effects of those circumstances; and
2. payment in full can be made at a later time (when the circumstances that led to non payment have been alleviated).

The types of reasons for deferment that appear to be contemplated by this discretion include such occurrences as natural disasters or serious illness of the debtor. They do not seem to be broad enough to incorporate the more practically relevant circumstance that arises where a taxpayer has a tax position that is in dispute with the ATO and is under review. We note the difficulties experienced by the taxpayer in Asiamet (No 1) Resources Pty Ltd v Federal Commissioner of Taxation[20] where the Commissioner ultimately denied the request for deferral.

In the United States, the IRS has the authority to abate interest in cases where the additional interest was caused by IRS errors or delays.[21] However, the IRS may act only if there was an error or delay in performing either a ministerial act or a managerial act (including loss of records by the IRS, transfers of IRS personnel, extended illness, extended personnel training or extended leave).

The taxpayer may stop the running of interest on tax and on any accrued interest (during a deficiency proceeding or litigation in the Tax Court) by making remittance in an amount sufficient to cover the entire deficiency plus any accrued interest.

Recommendation:

The taxpayer should be able to request a stay in the imposition of the GIC so that it is not effectively retrospective in instances where there is a review process being undertaken, the necessity for which has arisen due to the complexity of the tax law. It should also be available where the ATO has contributed to any delay in the resolution of the issue. In the instances where the issue is being run as a test case by the ATO, there should be an automatic stay.

As an alternative, the taxpayer should be able to request a deferral of the due time, which would effectively result in a deferment of the start time of the imposition of the GIC, until a tax matter, that is under review, is resolved.

4. Consolidation regime

The exposure to GIC under the new consolidations legislation for the transitional year regarding PAYG instalment variations is greater than what it is under the current legislation.

Under the current legislation, if an entity varies its instalment rate (such as to take account of tax loss transfers), that entity may be liable to pay GIC if the varied instalment rate is less than 85 per cent of the instalment rate which would have covered their actual liability for the income year. The ATO will work out that instalment rate based on the entity's instalment income and the tax attributable to their business and investment income (excluding capital gains) for the year.

Under the consolidations regime, Consolidations Bill No 1 contains new (complex) rules governing the imposition of GIC where PAYG instalments are varied in certain circumstances (i.e. to reflect the current year tax losses of various subsidiaries in the transitional year). The ATO Consolidation Reference Manual (updated @ 28 June 02) states at B3-2 page :

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[20] (2003) FCA 35 (31 January 2003)

[21] Code Sec. 6404(e)

"Entities retain their existing right to vary their instalments. The head company of the group may be penalised in relation to the instalments payable by the group's members for a particular instalment quarter if the group's instalments for that quarter are less than 85% of one quarter of the head company's benchmark tax. (Generally, the head company's benchmark tax will be its assessed tax....)." (underlining added).

Under the consolidations legislation for the transitional year, if a single member of a consolidated group varies its instalment rate, the head company will be liable for GIC on any shortfall in quarterly instalment. The shortfall arises if the sum of instalments payable by the group for the respective quarter is less than 85% of one-quarter of the head company's benchmark tax for that consolidation transitional year. Where this is the case, GIC is imposed on the lesser of the total PAYG instalment that would have been payable had no member varied and the amount the head company would have paid if it was required to pay one quarter of its benchmark tax (tax liability for the year).

Therefore, the consolidations legislation uses a formula based on the consolidated group's tax liability (divided by 4) which is compared to the actual PAYG instalments remitted during the year by individual entities when PAYG instalments were calculated on a per entity basis. If the existing legislation were applied to the same single member of the consolidated group which varied it's instalment rate, no GIC would apply as the 85% requirement would have been met by that entity alone.

An administrative solution is required to replace the 25% allocation of the group's actual tax liability, as this is inconsistent with PAYG principles. One possible solution is to use the PAYG tax payable without variation, as a ratio for allocating tax losses (in place of the 25% calculation). Example: PAYG instalments ignoring variation Qtr (1) $100, (2) $300 (3) $300 (4) $300 with tax effect of losses refunded on return lodgment of $400. Should be able to vary down Qtr 1 to 85% of 60 (i.e. allocate 10% of the tax loss to Qtr 1 = $100 – (10% x $400)). 85% being the standard permitted variation.

Recommendation:

The PAYG tax payable should be used without variation, as a ratio for allocating tax losses (in place of the 25% calculation.