Review of
Aspects of Income Tax
Self Assessment

Discussion Paper March 2004
I am pleased to present the 'Review of Aspects of Income Tax Self Assessment' discussion paper, as foreshadowed in my press release of 24 November 2003.

The discussion paper outlines a range of issues and approaches for refining the operation of Australia’s income tax self assessment system. In doing this, the paper examines whether the right balance has been struck between protecting the rights of individual taxpayers and protecting the ability of the Australian Taxation Office to collect revenue.

The development of the discussion paper has benefited from consultations with interested parties. At this stage of the review, I would like to take the opportunity to express my gratitude for this valuable assistance.

I encourage all interested parties to take the opportunity to put forward their views on potential refinements to the income tax self assessment system, by making contact with the Review team or providing a written submission. These views will assist the Government in considering all issues, before making decisions on these matters.

The Government has introduced sweeping reforms to modernise the Australian tax system to make it fairer and more sustainable. The Government is also determined to ensure that the income tax self assessment system best serves the needs of the Australian community. This paper represents another example of the Government’s commitment to achieving this goal.

PETER COSTELLO

March 2004
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INTRODUCTION

Scope of the Review

The Treasurer announced the Review of Aspects of Income Tax Self Assessment in November 2003. The Review is exploring ways to refine Australia’s income tax self assessment system to provide taxpayers with greater certainty and lower compliance costs, without jeopardising the capacity of the Australian Taxation Office (the Tax Office) to collect taxes.

The Review is examining, among other things, six aspects of Australia’s current income tax self assessment system:

- the level of reliance that taxpayers can and should be able to place on Tax Office advice
- the proper time frame for amending assessments
- the appropriateness of the length of tax audits
- the circumstances in which the Tax Office should undertake earlier examination of tax returns
- whether taxpayers are adequately protected from unreasonable delays in enforcing the tax law
- aspects of the operation of the General Interest Charge (GIC).

The Review has not been asked to consider fundamental tax policy changes, such as the extent to which tax returns, or categories of tax deduction, could be dispensed with. Nor is the Review looking at tax collection issues or assessment of other taxes.

Review process

This discussion paper, prepared by a team in Treasury, has been based largely on the various opinions and writings on self assessment since its introduction. A full list of references accessed by the Review team is contained in this report. The team has also received a number of phone calls, e-mails and background papers from interested parties, held initial discussions with taxpayers’ representatives and professional bodies and sought out the views of other government agencies with an oversight role in the tax
The Tax Office has assisted the team by providing comprehensive data about the tax system, checking facts and providing a preliminary view on the ease of administering some of the changes discussed herein.

The Government welcomes submissions by 21 May 2004 on the ideas in the paper (or any other matters that may be relevant to the issue of improving self assessment processes). If you do not want your submission to be made publicly available please indicate that clearly. The Review team will convene consultations with groups representing taxpayers and tax practitioners during this formal consultation period.

At the end of each of Chapters 2 to 6, there is a list of questions which you may like to comment on. Submissions need not be constrained to answering these questions, nor should you feel obliged to address them all.

**Submissions**

Submissions may be sent by post to:

**The Review of Self Assessment**
The Treasury
Langton Crescent  ACT  2600

Submissions may be e-mailed to:

selfassessment@treasury.gov.au

Closing date for submissions is Friday 21 May 2004.

Additional information and further contact details are available on the Review Website:

http://selfassessment.treasury.gov.au
CHAPTER 1: BACKGROUND TO SELF ASSESSMENT AND THE FOCUS OF THE REVIEW

This Chapter provides the context and essential background for the Review. It discusses the nature of income tax assessment and compares certain aspects of the current self assessment system with the full assessment system it replaced. The Chapter explains why the change was made, how the self assessment system has evolved and gives an overview of how the Tax Office approaches its compliance work.

As further background, Chapter 1 highlights some similarities and differences between our system and that of four other countries with which Australia commonly compares itself: Canada, New Zealand, the United Kingdom and the United States.

The Chapter also introduces themes that are the focus of the Review, including:

- how the current arrangements affect taxpayer uncertainty and the consequences of that uncertainty
- the need to balance the potentially conflicting objectives of collecting income tax, protecting the rights of taxpayers, and minimising the costs of compliance and administration
- the need to appreciate differences in the behaviour and needs of different categories of taxpayers.

1.1 What is tax assessment?

Tax assessments are fundamental to tax collection. Every country that taxes income has laws to impose the tax and a system to assess and collect it. An assessment is the end result of the process of ascertaining a taxpayer's taxable income and calculating the tax
payable on that income.¹ A notice of assessment becomes final once the statutory period for reviewing it has expired (see Chapter 3).

In Australia, a key part of the assessment process is the completion and lodgement of an income tax return. This requires taxpayers or their agents (and sometimes third parties) to provide information to the Tax Office about their income, deductions, and any tax offsets to which they are entitled. The task of completing income tax returns requires taxpayers (or their agents) to apply the income tax laws properly to their affairs. The length, scope and nature of income tax law, and the style of the administrative systems to support the law, mean that this can be a difficult task for some.

Depending on the type of assessment system, the roles and responsibilities of taxpayers, agents, third parties and the Tax Office can vary. This is illustrated below in the discussion of the former and current Australian assessment systems and overseas experience.

### 1.1.1 The former system of full income tax assessment

Prior to 1986, taxpayers in Australia lodged returns and tax officers, called assessors, formally determined the taxable income and the tax payable (or refundable). A notice of assessment was issued to the taxpayer by the Tax Office. If there was tax to be paid, the amount became a debt. If too much tax had been paid, for example, by excess instalments through the year, tax overpaid would be refunded. If a taxpayer had incurred a loss, the tax payable would be zero and the loss could be carried forward to be considered for set off against income derived in future years.

A taxpayer had the right to object to the assessment, including the assessor's decisions, in which case the Tax Office was required to review the assessment. Appeal rights (to courts or special Taxation Boards of Review) applied if the objection was not successful.

By the early 1980s, the need to process tax refunds quickly had placed considerable strain on the Tax Office’s resources. In 1984, the number of objections against assessments exceeded 236,000.² Furthermore, with over 10 million income tax returns to assess annually, on average, a typical salary and wage tax return only received one minute of scrutiny by assessors. In the case of business returns, an average of four minutes' scrutiny applied.

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A 1984 Efficiency Audit by the Auditor-General laid the groundwork for reconsidering the assessing function, finding the assessing method to be deficient on several counts:

- In a significant proportion of assessments made, the taxpayer’s statement of gross income was accepted with little or no independent check.
- Most returns were considered by assessors not to require adjustment.
- About half of the value of the original revenue gain from Tax Office adjustments during the assessment process was reversed on objection or complaint by taxpayers.
- Other methods of collecting revenue achieved greater returns for a given cost compared with the traditional assessing method.

On this last point, while the 'revenue to cost' ratio for assessing was about 1:1, it was 5:1 for field audit, 6:1 for some internal checking processes and 11:1 for investigations.

### 1.1.2 The introduction of self assessment

From 1986-87 the system was changed with the encouragement and support of the Tax Office. Self assessment relieved the Tax Office of the obligation to examine returns lodged by taxpayers in the process of assessment. The Tax Office continued to issue notices of assessment (to create the formal obligation to pay tax), but returns were generally taken at face value, subject to post-assessment audit and other verification checks. Changes to the law included:

- allowing the Tax Office to amend not only for errors of calculation or mistakes of fact but also for mistakes of law
- providing a mechanism for taxpayers to seek advice, in the form of a ruling, when a return was lodged.

From 1989-90, the returns of companies and superannuation funds became subject to a system of full self assessment. Under full self assessment, the Tax Office no longer issues notices of assessment — the taxpayer calculates and pays their tax liability when lodging their return.

The introduction of the self assessment system changed the way the Tax Office carried out its compliance activities. Under the former system, significant Tax Office resources

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(including about 2,200 staff) were focused on the assessment process. As the emphasis moved from assessment, the Tax Office began to develop more sophisticated models of compliance, based on helping willing taxpayers to comply and identifying (and dealing with) those who do not. Resources from assessing went broadly into taxpayer assistance and compliance improvement, allowing the Tax Office to collect more tax from those who had under-assessed their tax liability.

For many non-business taxpayers, an immediate dividend was shown in the time taken to process tax refunds. With the introduction of the Electronic Lodgement System (ELS), which was largely made possible by the switch to self assessment, refunds came to be processed in a few weeks, rather than taking months. Presently, electronic returns are commonly processed within a fortnight.

1.1.3 Subsequent changes to self assessment

By the early 1990s problems had been identified with the initial self assessment arrangements, particularly in relation to penalties and interest and the need to provide greater taxpayer certainty. The Government of the day responded by announcing a review that had as its objective ‘... to provide a more supportive legislative and administrative environment for existing self assessment arrangements and in so doing make the taxation system fairer and more certain’.

In response to that review’s findings, further changes were made in 1992, the most notable being:

- a new system of binding public rulings
- a new system of binding private rulings
- an extension (to four years) of the period within which a taxpayer could object against an assessment
- a new system of penalties for understatements of income tax liability, based on the requirement that taxpayers exercise reasonable care
- a new interest system for underpayments or late payments of income tax, based on commercial principles and market interest rates.

5. Legislation giving effect to these changes was largely contained in the Taxation Laws Amendment (Self Assessment) Act 1992.
More recently, the Government has implemented a shorter period of review for taxpayers with straightforward tax affairs, introduced binding oral advice and reduced the rate of interest charged on underpayments and late payments.

1.1.4 How do full assessment and self assessment compare?

There are diverse views on the answer to this question. On the one hand, not a great deal of the law was changed, so one might argue that the current system has much in common with the system that preceded it. Both systems require taxpayers to complete and lodge annual returns with the Tax Office and, in preparing those returns, both systems require taxpayers to correctly apply the relevant parts of the income tax law. Under both systems, the Tax Office issues notices of assessment, but can review returns later and impose interest and penalties on any income tax shortfall detected.

Nevertheless, many taxpayers consider that with the move to self assessment there was an important change to the *finality* of the Tax Office’s assessment. This difference has been a matter of great significance for some and it seems that certain aspects of the self assessment system have not been widely understood. The Chapters that follow attempt to determine the real impacts of the changed system.

1.1.5 International comparisons

To help identify ways to improve Australia’s self assessment system, the Review team has examined income tax systems in a number of other countries, especially Canada, New Zealand, the United Kingdom (UK) and the United States (US).

These comparisons reveal many similarities, but it is difficult to draw firm conclusions given the differences in tax policy and other factors.

In each jurisdiction there is an annual reconciliation of a taxpayer’s income tax affairs, through means such as a tax return, an income tax statement generated by the revenue authority or a withholding tax system (in Canada and the US, provincial/state and/or city income taxes may also apply). Revenue authorities provide taxpayers and their agents with a wide range of information and advice to assist them in discharging their obligations. All revenue authorities focus on post-assessment review, and generally have a fixed period of three to six years in which to verify the information supplied by taxpayers and amend assessments if shortfalls are identified. In cases of fraud, the time period is unlimited in each country except the UK, where the time period is 20 years.

One substantial difference between the five countries is the extent to which particular categories of taxpayers are required to lodge annual income tax returns. In Australia, Canada and the US, most income earners are expected to lodge an annual income tax
return containing information on their taxable income and deductions. However, New Zealand and the UK have removed this requirement for large numbers of taxpayers (generally individuals with simpler tax affairs), while those with more complex affairs are still required to lodge annual returns.

- In New Zealand, the revenue authority also generates income tax statements for many taxpayers using information supplied by employers, financial institutions and other government agencies (rather than taxpayers themselves). This has been possible because of New Zealand’s extensive withholding tax system and tax policy changes since the mid 1980s.

- In the UK, the majority of individuals do not fill in tax returns as their tax liabilities are withheld. Tax returns are sent to individuals who need to complete one. In practice this is about 25% of the taxpayer population, being those who are self employed, have complicated tax affairs, or are in the top tax bracket. The UK is presently reviewing its approach, due to concerns about the cost of their withholding arrangements for small employers.

Revenue authorities in all five countries release public rulings. In most cases the revenue authority considers itself bound by the ruling unless there is a change to the law. The UK revenue authority grants extra-statutory concessions, which are relaxations of the strict interpretation of the tax laws allowed for the purposes of making administration of the tax laws easier or providing taxpayers with relief from hardship occasioned by the revenue authority rigidly enforcing every aspect of the law. These concessions are published and can be relied on by taxpayers to bind the revenue authority. They operate much like public rulings in Australia, although over time the UK authority might have adopted pragmatic positions to a greater extent.

Revenue authorities consider themselves to be bound by a private ruling unless the information upon which they based the ruling was incorrect or incomplete. In Australia, Canada, the US and New Zealand, taxpayers can apply for a private binding ruling in advance of entering into an arrangement. Of the four countries, only Australia does not charge a fee for preparing a private ruling. The UK revenue authority will only provide taxpayers with a post-transaction ruling in limited circumstances and does not charge a fee to prepare them.

Where an income tax shortfall is identified, taxpayers in all five countries are potentially liable to pay interest and penalties. Australia generally charges the highest rate of interest on amounts owed, however, the amount of interest paid is tax deductible. None of the other countries examined allow an individual this deduction, although New Zealand, the UK and the US allow a deduction in limited circumstances for interest paid by a company.
Chapter 1: Background to self assessment and the focus of the Review

More information on the income tax assessment systems in Australia, Canada, New Zealand, the UK and the US is contained in Appendix 4.

1.2 Focus for the review

The main objective of Australia’s tax system as a whole is to efficiently raise revenue to be redistributed to the community in accordance with Government priorities. The main aim of the system of administration is to collect that revenue with minimum administration and compliance costs.

The focus for the Review is to consider the appropriateness of the balance between ensuring income tax collection and the impact of self assessment on taxpayers (particularly in terms of certainty and compliance costs). The Review is not considering issues of tax policy, such as tax rates or deductions.

1.2.1 Potential for uncertainty

Under self assessment, taxpayers may be uncertain about how the law applies to their circumstances or they may be unaware of certain entitlements. Uncertainty, especially if significant, has the potential for adverse impacts on taxpayers, the system of administration and the economy as a whole.

Uncertainty may therefore expose taxpayers to costs (such as a requirement to pay additional tax, the General Interest Charge and penalties or the costs of professional advice and litigation) if a shortfall is detected by the Tax Office. Some taxpayers may pay too much income tax because they do not want to expose themselves to uncertainty. Thus they might not claim legitimate deductions simply because they are unsure if they are allowable.

Moreover, uncertainty may have implications for taxpayer perceptions about the fairness of the tax system (and hence affect the level of voluntary compliance by taxpayers).

Finally, uncertainty about the tax implications of a proposed transaction may have adverse economic implications. Taxpayers may be unwilling to enter into economically beneficial transactions if they are not able to obtain assurances about their taxation consequences.

6. The income tax system sometimes also has the subsidiary objective of influencing behaviour by reducing or increasing the economic cost of particular activities that are subject to or exempt from taxation.
Confidence

One way to reduce the uncertainty of self assessment would be through taxpayers being confident that they are assessing their income tax liabilities in line with the Tax Office’s interpretation (such as through rulings). The capacity to enhance taxpayer certainty in this way depends on the quality of Tax Office advice as measured in these terms:

- How easy is it to get and understand advice from the Tax Office?
- Is the advice timely — that is, can you get it when it is needed?
- Is the advice ‘accurate’?
- Is the advice reliable — that is, will the Tax Office stand by it?

These issues are dealt with in detail in Chapter 2.

Finality

Another way to reduce uncertainty is by giving earlier finality to taxpayers who have tried to do the right thing, by shortening the period in which their assessment can be amended to increase their liability. Once the Tax Office can no longer re-open their assessments, taxpayers can stop worrying about whether they ‘got it right’.

Issues affecting the review of assessments and the period for amendment are canvassed in Chapter 3.

Consequences of uncertainty

Penalties and interest charges are potential consequences of uncertainty for taxpayers. Penalties can apply where a taxpayer does not take reasonable care in assessing their tax liability. The General Interest Charge applies a uniform rate of interest to late payments (including under payments) of any type of tax.

Chapters 4 and 5 examine issues surrounding penalties and the General Interest Charge respectively.

Chapter 6 collects a range of other issues associated with the self assessment system.
1.2.2 Revenue collection

Suggestions for improvements to increase certainty and/or reduce compliance costs for taxpayers should bear in mind the need to preserve the capacity of the Tax Office to collect legitimate revenue.

Income tax paid by individuals and business is the largest source of funding for Government spending priorities or the retirement of debt. In 2002-03, $129.6 billion was collected in income tax (excluding petroleum resource rent tax).

1.2.3 Compliance and administration costs

However well a tax system is designed, it involves some administrative and compliance costs. Administrative costs are the costs of administering the tax system borne by the Tax Office, while compliance costs are the costs of complying with the tax system borne by the taxpayer, agents and third parties.

Compliance costs can be financial or non-financial. Compliance costs relevant to self assessment can include:

- direct financial costs (for example, the cost of obtaining professional advice from a tax agent or other tax practitioner)
- opportunity costs (for example, the cost of spending time complying with self assessment obligations at the expense of running a business)
- non-financial compliance costs, such as stress from the uncertainty about whether the right amount of tax has been paid.

Compliance and administration costs can be a product of various factors, but for the purposes of this Review, the structure of the law, the role of the Tax Office and the level of assistance and advice provided to taxpayers are especially important.

1.2.4 Trade-offs between competing objectives

Sometimes improving one aspect of the system might adversely affect another. For example, the Tax Office could increase certainty for some taxpayers by providing them with more binding information. This might optimise revenue if more people comply with the Tax Office position without the need for audit, but it may also increase compliance costs for all those not directly affected (or their representatives) because of the need to be across more information.
Similarly, the shorter the period for review and amendment of assessments, the sooner a taxpayer obtains finality for a particular income year. However, a shortened period of review applied too generally might overstretch the resources of the Tax Office, thereby encouraging non-compliance and prejudicing revenue collection.

So, as a practical matter, there will often need to be trade-offs between improving certainty for taxpayers and ensuring revenue collection at least cost for the benefit of the community.

1.2.5 Commencement dates of potential reforms

It will be important for government to consider the date when any potential reforms should commence. Factors such as the scope of change to legislation or administrative systems will need to be taken into account. These issues are not specifically dealt with in this discussion paper, however, it is likely that many of the approaches canvassed, if adopted, would require significant lead times.

1.2.6 Different types of taxpayers

Groups of taxpayers have different characteristics. These differences have implications for the Review, as different categories of taxpayers are likely to experience different degrees of uncertainty and different levels of compliance costs. In addition, the appropriateness of measures to improve certainty or reduce compliance costs is likely to differ between different groups of taxpayers.

This discussion paper will often canvass options as they are relevant to three distinct groups: individuals (not in business), very small businesses and other businesses (that is, small/medium and large business). While very small businesses are likely to be carried out by individuals, other businesses are usually carried out using entity structures, or a combination of structures.

Individuals who are not in business are likely to have relatively simple tax affairs for most returns they lodge over a lifetime. In most years, these taxpayers are only required to complete parts of the income tax return and have few sources of income, few deductions and offsets and relatively few record keeping obligations. Returns coinciding with special events, such as retirement, or the sale of investment property, will be more complex. These types of taxpayers do not require a detailed understanding of the majority of income tax law in order to work out their tax liabilities.

At the other end of the spectrum, business taxpayers (especially large businesses with international operations) are highly likely to have more complex affairs. They often have multiple sources of income and commercial arrangements that require substantial record
Chapter 1: Background to self assessment and the focus of the Review

keeping. These types of taxpayers require a detailed understanding of the income tax law in order to discharge their responsibilities and frequently obtain professional advice. The complexity and opaqueness of the affairs of these taxpayers mean that it is much more difficult and time consuming for the Tax Office to determine whether or not they have complied with the income tax law. In addition, the large amounts of income tax that may be paid by these taxpayers mean that substantial resources are likely to be devoted by the Tax Office to post-assessment verification.
CHAPTER 2: RULINGS AND OTHER TAX OFFICE ADVICE

This Chapter outlines the main types of advice that the Tax Office provides to assist taxpayers and practitioners, comparing the advice with that provided by the national tax authorities in Canada, New Zealand, the UK and the US.

The Chapter reviews the key issues that have been identified in relation to the quality of Tax Office advice. It identifies several options for enhancing Tax Office advice, the most important being to make more of it legally binding, providing more protection for taxpayers who act in accordance with advice that applies to them.

Tax Office rulings and other advice are important for taxpayer certainty. Taxpayers who self assess in line with the Tax Office's interpretation of the law have confidence that they will not be liable to pay additional primary tax, interest or penalties. Taxpayers who do not follow Tax Office advice, or do not know the Tax Office position, run the risk that the Tax Office will amend their assessments and they will be liable to pay additional amounts.

The capacity of Tax Office advice to enhance taxpayer confidence depends on its quality (defined in Chapter 1 as its accessibility, timeliness, accuracy and reliability).

The quality of Tax Office advice is equally important for taxpayers who complete their own income tax returns and for the 75% of Australian taxpayers whose income tax returns are prepared on their behalf by tax agents. Practitioners play an important role in interpreting Tax Office advice, determining what Tax Office advice is relevant and whether more detailed advice is required. Practitioners need to have a clear understanding of the Tax Office's position on relevant issues in order to advise their clients effectively. Reforms that improve the capacity of practitioners to understand the views of the Tax Office can be expected to boost overall confidence in the system.

2.1 Types of Tax Office advice

The Tax Office provides taxpayers and practitioners with a comprehensive range of advice on how to apply the income tax law, through formal rulings as well as other products.
2.1.1 Formal rulings

There are currently three types of formal income tax rulings: public rulings, private binding rulings (PBRs) and oral rulings. As noted in Chapter 1, public rulings and PBRs were introduced in 1992 in order to provide taxpayers with greater certainty. Oral rulings were introduced in 2000 as part of the New Tax System.

The advice contained in formal rulings is binding by law on the Tax Office. Rulings remain valid until they are either withdrawn or replaced and can only be withdrawn prospectively. This means that a taxpayer covered by a formal ruling is protected from retrospective amendment, even if the Tax Office subsequently changes its interpretation of the relevant provisions of the income tax law. As the law currently stands, rulings may only deal with interpretation of those parts of the income tax laws under which a taxpayer’s liability is worked out.

Public rulings

Public rulings provide general written guidance on matters relevant to a wide range of taxpayers. They state the Tax Office’s view on how the income tax law applies to a particular type or class of arrangements.

Public rulings are provided at the discretion of the Tax Office and there are no statutory or administrative limits on the time taken for them to be issued. The Public Rulings Program is developed in consultation with the National Tax Liaison Group, which is chaired by the Tax Office, and draws its membership from Tax Office staff, practitioners and other external representatives. Rulings are prepared in conjunction with panels that contain representatives from the accounting and legal professions.

Recently, the Tax Office has introduced two sub-categories of public rulings that provide advice to groups of taxpayers.

- Product rulings were introduced in 1998 to rule publicly on the availability of tax benefits from particular investment products.

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1. The legislative frameworks that underpin these three types of formal rulings are contained in Part IVAAA, Part IVAA and Part 5-5 of Schedule 1 of the Taxation Administration Act 1953 (the TAA) respectively. The provisions of Part IVAAA and IVAA of the TAA also apply to the fringe benefits tax and fuel sales grants. A different legislative framework applies to the Goods and Services Tax (GST), the Luxury Car Tax (LCT) and the Wine Equalisation Tax (WET). This framework is contained in section 37 of the TAA.
2. In general, a public ruling or a PBR will continue to apply to a taxpayer in relation to an arrangement that has already commenced, even if it is withdrawn or replaced by the Tax Office. The only exception is when the relevant legislation is amended or repealed. If a ruling applying to an arrangement that has already commenced is replaced with another ruling, the ruling that is most advantageous to a taxpayer will be binding on the Tax Office.
Class rulings are a more recent innovation and are used to rule on the application of tax laws to a large number of persons in relation to a particular arrangement, such as an employee share scheme.

Product and class rulings are intended to eliminate the need for each participating taxpayer to obtain a separate PBR.

**Private binding rulings**

PBRs provide specific written advice to a particular taxpayer on how the Tax Office considers the law applies to that taxpayer. They only apply to a specified arrangement for a specified income year. They are not binding on the Tax Office in relation to other taxpayers.

PBRs are provided in response to requests for advice from taxpayers and practitioners. Most taxpayers may apply for a PBR at any time until four years after the last date for lodging a return for the income year to which the ruling relates. The Tax Office must provide a PBR unless the request falls into one of the exclusions listed in the relevant legislation. In these circumstances, the Tax Office can issue a PBR, but is not obliged to do so. Taxpayers are not charged a fee by the Tax Office for PBRs.

There is no statutory time limit for the Tax Office to make a PBR. The *Taxpayers’ Charter* indicates that the Tax Office aims to provide PBRs within 28 days of receiving all necessary information from the applicant (or a longer period negotiated with the relevant taxpayer).

PBRs are published by the Tax Office on its website, in an edited form to protect the confidentiality of recipients. In practice, some taxpayers and practitioners use these to gain insights into how the Tax Office interprets particular provisions of the law, although the Tax Office would prefer them to use Australian Taxation Office Interpretative Decisions (ATOIDs, see 2.1.2) for this purpose.

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3. Section 14ZAG of the TAA allows practitioners to apply for a PBR on behalf of a taxpayer.
4. Shorter Period of Review (SPOR) taxpayers have only two years to apply for a PBR.
5. Section 14ZAN of the TAA lists the circumstances in which the Tax Office is not required to comply with an application for a PBR. These include: where a tax audit has commenced which will examine the matter covered by the application; where the matter is already subject to an objection against a self-assessment; where the application is considered to be frivolous or vexatious; where the applicant has not provided the Tax Office with sufficient information; or where complying with the application would require an unreasonable amount of Tax Office resources.
6. If no ruling has been issued within three months of the provision of the relevant information, an applicant may request a written notice from the Tax Office setting out the reasons for the delay.
Oral rulings

Oral rulings are used to provide specific advice on a limited range of simple income tax matters to taxpayers with simple tax affairs. In common with PBRs, the Tax Office is required to provide an oral ruling to a taxpayer unless the request falls into one of the specific exclusions contained in the legislation. An important difference between oral rulings and PBRs is that practitioners cannot generally apply for oral rulings on behalf of their clients.

Rulings data

In 2002-03, the Tax Office issued 7,631 PBRs, 46 public rulings (as well as 154 product and class rulings, excluding those dealing with superannuation) and nine oral rulings on income tax matters. Around 60% of PBRs were issued to individual non-business taxpayers and around 30% were issued to micro businesses. Less than 3% were issued to large businesses.

The Tax Office estimates that only about 2% of PBR applications require a precedent to be established. The remainder are dealt with on the basis of existing Tax Office advice that is already available to taxpayers and practitioners. Only 3% of PBR applications are classified by the Tax Office as complex. Many PBR applications involve how the law might apply to particular fact patterns, rather than complex interpretive matters.

2.1.2 Other types of Tax Office advice

Formal rulings are not the only way in which the Tax Office provides advice to taxpayers on the interpretation of the income tax law.

The Tax Office publishes a wide range of general written advice, a considerable amount of which is available on the Tax Office website. Possibly its most important publication for individuals is TaxPack. This is intended to provide taxpayers with the key information required to complete their annual income tax return. The information contained in TaxPack is supplemented by over 70 specialised publications that provide information on particular issues that are not relevant to the majority of taxpayers.

7. These concepts are defined in Part 5-5 of Schedule 1 of the TAA, which lists the matters on which an oral ruling may be sought. These include basic categories of assessable income, deductions and offsets.
8. 4,816 were issued to individual non-business taxpayers; 2,380 to micro businesses; 78 to small and medium businesses; 177 to large businesses and 180 to government and non-profit bodies.
9. The Tax Office estimates that around 30% of all income tax PBR applications relate to the following matters: the status of compensation payments, the undeducted price of superannuation payments, eligible termination payments, primary production status, residency status, and deductibility of expenses. The Tax Office estimates that responding to these requests requires reference to 13 publicly available precedents or interpretative decisions.
Chapter 2: Rulings and other Tax Office advice

Many of the Tax Office’s main general advice products are tailored to particular taxpayer segments with special needs (such as immigrants, investors or indigenous Australians). The Tax Office also publishes a wide range of other advice in the forms of manuals, booklets, schedules, fact sheets, policy statements, press releases, ATOIDs, and taxpayer alerts.

- ATOIDs explain how the Tax Office has applied the law in relation to a particular matter. They are used primarily for internal purposes by Tax Office officials to promote consistency in decision making (including in the provision of advice to taxpayers and practitioners). They have precedential value in that the principles underlying a particular decision will often be followed in subsequent cases. However, these principles are not binding on the Tax Office and it is free to change its interpretation of relevant provisions and amend assessments accordingly. ATOIDs are published on the Tax Office’s website pursuant to the Freedom of Information Act 1982 (which generally requires Commonwealth agencies to publish or make available material relating to their internal decision-making processes).  

- Taxpayer alerts are intended to be an ‘early warning’ of significant new and emerging tax planning issues that the Tax Office has under risk assessment.

The Tax Office also provides a large amount of oral advice in response to enquiries from taxpayers and their advisers in person and by telephone. In 2002-03, the Tax Office received more than 6 million telephone calls, evenly divided between its personal tax information line and business call centres, and over 1 million visits to its assistance centres. About a third of the telephone calls sought advice about the tax law. During the same period, over 3 million calls were made to the Tax Office’s agent telephone inquiry service, and it received more than 600,000 general telephone inquiries.

Status of other Tax Office advice

Advice provided through these other mechanisms is not legally binding on the Tax Office. In theory this means that it could be altered or withdrawn at any time. However, some of this advice is treated as administratively binding. The Tax Office’s policy is to only depart from administratively binding advice where there is a material change to the relevant law, where a court or tribunal adopts a different interpretation to that previously followed by the Tax Office, or where the existing interpretation is no longer

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11. The data refers to all taxpayer inquiries and is not confined to inquiries relating to income tax matters.
considered appropriate (for example, because it has created unforeseen consequences for the revenue). 12

Taxpayers who have relied on non-legally binding advice to complete their returns may be liable to pay additional primary tax and interest (but no shortfall penalties) as a result of a change in the Tax Office's interpretation. 13 Where advice is neither legally nor administratively binding, the Tax Office does not generally provide an assurance that it will 'stand by' it. For example, the Consolidation Reference Manual, an important source of advice for many business taxpayers, is not legally binding and has no formal status. However, advice contained in TaxPack and the publications it refers to are covered by the Commissioner's Guarantee. This states that:

- If a taxpayer relies on advice in TaxPack (or one of the related publications) and makes an honest mistake, the Tax Office will not charge a penalty, but may charge interest.

- If the taxpayer's mistake has been made because the Tax Office advice is misleading, it will not charge either penalties or interest.

In either case, the taxpayer will have to pay any shortfall in their primary tax liability.

2.2 International comparisons

In Canada, New Zealand, the UK and the US, the national tax authorities also provide a wide range of general and specific income tax advice to taxpayers. In particular, each authority provides taxpayers with general advice in the form of public rulings and most also provide specific tax advice to particular taxpayers and practitioners.

Despite these broad similarities, there are some differences.

Australia and New Zealand provide legally binding advice (as well as administratively binding and non-binding advice). By contrast, the Canadian, UK and US tax authorities do not provide legally binding advice. Another difference is the extent to which it is

12. The circumstances in which the Tax Office may depart from administratively binding advice are set out in paragraph 73 of Australian Taxation Office 2001, Practice Statement PS LA 2001/4, Australian Taxation Office, Canberra.
13. Subsection 284-215 (1) of the TAA provides that penalties do not apply where a taxpayer has a shortfall as a result of following Tax Office advice.
14. The Australian Taxation Office 2003, Practice Statement PS LA 2003/3, Australian Taxation Office, Canberra indicates that it will be administratively bound by publicly issued rulings that are not formal public rulings within the meaning of Part IVAAA of the TAA.
possible to appeal against private rulings. This is possible in Australia, but not in either New Zealand or Canada. The UK and the US both allow limited appeals against certain rulings (although it is not possible to appeal against a refusal by the UK Inland Revenue to issue a ruling). Canada, New Zealand and the US all charge fees for private advice. This is provided free of charge in Australia. The UK charges for some types of private advice, but not others.

Australia is the only jurisdiction that imposes a penalty where a taxpayer has an income tax shortfall as a result of a failure to follow a PBR. Furthermore, only Australia has a formal system of binding oral rulings (albeit one that has been little used since its introduction in 2000). Finally, among the five tax authorities, Australia’s Tax Office has arguably the most extensive processes for involving practitioners and other representatives in the selection and preparation of public rulings.

2.3 Previous reviews of the rulings system

Australia’s formal tax ruling system has been subject to a number of reviews since its introduction in 1992. These reviews have examined the policy objectives underlying the system as well as its administration by the Tax Office.

- In 1993, the Joint Committee of Public Accounts reviewed the ruling system as part of a wider inquiry into tax administration.\(^\text{15}\) It also examined some of the Tax Office’s other advice products, most notably TaxPack.

- In 1998, the Government’s plan for the introduction of A New Tax System proposed a number of reforms to the income tax rulings system.\(^\text{16}\)

- In 1999, the Review of Business Taxation (the Ralph Review) considered the ruling system as part of its examination of Australia’s business tax framework.\(^\text{17}\)


Review of Self Assessment

- In 2000, the Tax Office commissioned Mr Tom Sherman AO to review the Tax Office’s systems and procedures for producing PBRs.\textsuperscript{18}

- In 2001, the Australian National Audit Office (ANAO) completed a performance audit on the Tax Office’s administration of taxation rulings.\textsuperscript{19}

While not constituting a formal review, in 2003, the Inspector-General of Taxation reported on practitioners’ concerns with aspects of the Tax Office’s administration of the formal rulings system.\textsuperscript{20}

These reviews all expressed general support for the rulings system, but identified shortcomings with particular aspects of its operation.

There have been few significant amendments to the legislative framework for rulings, but the Tax Office has changed the way it administers the system. These changes have included the introduction of new classes of public rulings, new procedures intended to produce greater consistency in PBRs and publication of PBRs and ATOIDs on the Tax Office’s website.

While there have been reviews of the formal rulings system, other advice products have generally only been subject to internal review by the Tax Office (although many are developed in conjunction with community bodies). The Tax Office’s recent Listening to the Community project has gathered extensive qualitative data concerning the perceptions of a range of taxpayers and tax agents towards Tax Office advice products. It found that taxpayers want quick, accurate and accessible advice that the Tax Office stands behind.\textsuperscript{21}

2.4 Tax Office advice — issues and possible reforms

The Review seeks feedback on how Tax Office advice might be improved in order to enhance taxpayer confidence, while maintaining the overall integrity of the income tax system. To facilitate this feedback, this section lists, without necessarily endorsing, some

\textsuperscript{18}. Sherman, T 2000, Report of an internal review of the systems and procedures relating to private binding rulings and advance opinions in the Australian Taxation Office, Commonwealth of Australia, Canberra.


\textsuperscript{21}. Australian Taxation Office 2003, Making it easier to comply: the easier, cheaper and more personalised program, Australian Taxation Office, Canberra, p.5.
Chapter 2: Rulings and other Tax Office advice

of the main issues relating to Tax Office advice that have been identified by previous reviews and in commentary by academics and practitioners.

2.4.1 Accessibility

Accessibility is an important characteristic of high quality advice. The Tax Office should provide sufficient advice for taxpayers to meet their obligations and this advice ought to be easily obtained and understood by those to whom it is directed.

Several issues have been identified in relation to the accessibility of Tax Office advice.

Taxpayers and practitioners derive considerable benefit from the general advice that is provided by the Tax Office. The existence of a comprehensive range of general advice assists taxpayers and practitioners to apply the law correctly without the need to request specific advice from the Tax Office. However, some practitioners have expressed concerns about their capacity to cope with the volume of general advice that the Tax Office produces and to determine which advice might be relevant in particular circumstances. Some practitioners have expressed concerns about the difficulty of locating ATOIDs and other relevant information on the Tax Office website.

In recognition of the importance of this issue, the Tax Office has recently redeveloped its website to improve its accessibility. It has also introduced improvements such as a mechanism to allow frequent users to suggest further refinements.

Concerns have also been expressed that it can be hard for taxpayers and practitioners to obtain PBRs on particular topics. The Tax Office is said to have adopted informal policies of refusing to provide PBRs in areas which have been designated ‘off-limits’.

A particular concern in this regard relates to PBRs covering the possible application of Part IVA.22 Some practitioners have expressed concern that the Tax Office is reluctant to issue rulings on whether or not Part IVA will apply to a particular arrangement. It has also been argued that the Tax Office has inappropriately sought to invoke Part IVA in relation to arrangements that are covered by a PBR (where the PBR does not deal with

22. Part IVA of the Income Tax Assessment Act 1936 contains what are known as the general anti-avoidance provisions. These provisions enable the Tax Office to disallow taxation benefits obtained from schemes whose dominant purpose is to enable a taxpayer to obtain a tax benefit. The question of whether the dominant purpose of a particular scheme is to confer a tax benefit is determined with regard to the matters listed in paragraph 177D(b) in Part IVA.
the potential application of Part IVA. These concerns were noted by the Inspector-General of Taxation in his recent issues paper on self assessment.\(^{21}\)

Concerns about the willingness of the Tax Office to issue PBRs on certain topics have tended to be raised by large business taxpayers and their representatives (rather than individual or small business taxpayers). It is difficult to empirically assess the validity of these concerns. The Tax Office has stated that there are certain limited circumstances in which it may not be appropriate for it to issue PBRs, although in 2002-03 it only refused to rule in relation to three applications from large business taxpayers. In relation to the possible application of Part IVA, it has stated that it will issue PBRs where it can do so on the basis of the information that has been supplied to it.

Another issue is the capacity of taxpayers and their advisers to understand Tax Office advice. Some concerns have been expressed about the clarity of Tax Office advice (especially for ordinary taxpayers). Taxpayers could benefit if Tax Office advice could be expressed in straightforward language. However, the Tax Office must strike a difficult balance between the need to provide advice that is succinct and the need to ensure that its advice is accurate in all circumstances. Moreover, some taxpayers and practitioners may prefer a lengthier explanation of principles in order to gain a better understanding of how the Tax Office might approach similar cases.

### 2.4.2 Timeliness

To be useful, advice needs to be provided in time to meet the needs of taxpayers. This is most important where a decision to enter into a prospective transaction is dependent on the Tax Office's view of its taxation consequences.

The time required to provide advice often depends on the complexity of the matter in relation to which advice is sought. It is also likely to depend on the time taken for the Tax Office to be provided with the information needed to formulate the advice — an issue that is often beyond the Tax Office's control.

In previous reviews, some large business taxpayers and their advisers have criticised the time taken by the Tax Office to produce PBRs covering prospective transactions. Similar criticisms have been levelled at the time taken to finalise some public rulings (although the time taken also reflects the lengthy consultation processes that currently apply to them). Finally, there appears to be some criticism from some taxpayers and practitioners about the time taken by the Tax Office to respond to telephone and over the counter requests for information about the operation of the income tax law.

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Concerns about the time taken by the Tax Office to finalise public rulings and to respond to requests for legally binding advice were noted in the Inspector-General of Taxation’s recent issues paper on self assessment. That paper also noted that the Tax Office has proposed a package of administrative measures to improve the timeliness of PBRs.

### Table 2.1: Data on timeliness of Tax Office advice — 2002–03

<table>
<thead>
<tr>
<th>Performance benchmark</th>
<th>Performance (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General correspondence</td>
<td>84% completed in 28 days</td>
</tr>
<tr>
<td>General telephone inquiries</td>
<td>80% answered in 2 minutes (peak 5 minutes)</td>
</tr>
<tr>
<td>General visit inquiries</td>
<td>85% attended in 10 minutes (peak 15 minutes)</td>
</tr>
<tr>
<td>PBRs</td>
<td>75% completed in 28 days or a longer period negotiated with the applicant</td>
</tr>
<tr>
<td>Objections against PBRs</td>
<td>85% completed in 28 days</td>
</tr>
<tr>
<td>Public rulings (b)</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Source: Tax Office data. The data covers all taxes (not just advice relating to income tax).

(a) The Tax Office has indicated that 37% of all PBR applications from individuals were finalised within 28 days, but only 8% of PBR applications from large business taxpayers were finalised in that period.

(b) In 2000, the Tax Office finalised 69 Taxation Rulings and Taxation Determinations. 18 of these were finalised in 100 days or less; 8 were finalised in 101 to 200 days; 18 were finalised in 201–300 days; 17 were finalised in 401 to 500 days; and 8 had taken more than 501 days to finalise (cited in ANAO Audit Report No 3, 2001, p.57).

While there is no statutory time limit on the provision of PBRs, taxpayers have a right to obtain reasons for the delay if no PBR has been provided within three months after all necessary information has been provided.

It would be possible to impose a statutory time limit within which certain types of advice must be provided by the Tax Office. However, it would be necessary to consider the following issues:

- How long should the Tax Office be given to respond to complex requests from taxpayers?
- What would happen if no advice has been provided by the end of the period?

One suggestion on this second issue is that the taxpayer should receive a default positive ruling. Alternatively, the taxpayer could receive a default negative ruling (and could then appeal against it). Both these options are problematic. The former may create incentives

for taxpayers to withhold information from the Tax Office (especially if the time period is not reset when new information was requested) or overload the Tax Office with requests for advice. The latter may not assist those taxpayers who prefer to wait longer for a substantive ruling. It may also simply shift any ‘timeliness’ problems from the rulings process to the appeal process.

An alternative to the introduction of a statutory time limit may be for the Tax Office to establish more demanding internal performance standards.

The resource implications of any proposals for the Tax Office to provide advice more quickly need to be considered, as well as their possible impact on the accuracy of advice. Reducing the time taken to produce public rulings might impact on the extensive consultation processes in place to facilitate input from practitioner representatives.

### 2.4.3 Accuracy

Taxpayers and practitioners are entitled to expect the advice they receive from the Tax Office to be accurate. However, the meaning of this concept depends on the nature of the issue to which the advice relates.

If the advice relates to a provision of the law that is not contentious, it can simply mean that the advice is the same as would be given to any other person who asked the same question. Concerns have been raised about the consistency of Tax Office advice.26

Where advice relates to a provision that can be interpreted in different ways with different tax consequences, the concept of accuracy is more closely related to objectivity. It has been argued by some taxpayers and practitioners that, rather than being objective, there is a systematic ‘pro-revenue’ bias in Tax Office advice on complex and contentious issues.

It is difficult to establish the validity of the concern relating to objectivity, because of the difficulty in measuring it. The Tax Office has indicated that where there are two viable interpretations of a provision that are consistent with its underlying policy objectives, it will adopt the more practical approach, or the approach that minimises compliance costs. Tax Office statistics suggest that more than two thirds of the PBRs issued are either

wholly or partially favourable to the applicant. However, some practitioners argue that this is to be expected given the penalty for not following a PBR.

One way to address concerns about the objectivity of Tax Office advice might be for a suitable independent body to undertake a systematic evaluation of advice, especially that in PBRs.

### 2.4.4 Reliability

The reliability of Tax Office advice is fundamental to taxpayer confidence. Reliability depends on the extent to which the Tax Office’s advice is binding on it or, if not binding, will be followed nevertheless.

As previously noted, the Tax Office must stand behind advice that is legally binding. Where its advice is not legally binding, the Tax Office is able to withdraw it or adopt a new position. However, in practice the Tax Office will only depart from its advice relatively infrequently and only with what it believes to be good cause.

The reliability of Tax Office advice might be improved by making more advice legally binding. The main benefit of making more advice legally binding is that the Tax Office would only be able to withdraw or amend it prospectively. As a consequence, taxpayers who follow Tax Office advice would be protected from any requirement to pay additional primary tax or interest (rather than just being protected in relation to penalties). Making more general advice legally binding on the Tax Office would also bring this aspect of the income tax rulings system more closely into line with the effect of the ruling system that currently applies to the GST, WET and LCT (and that previously applied to wholesale sales tax). Under these systems, almost all published Tax Office advice is binding for the purposes of determining whether the Tax Office can recover underpaid tax or overpaid refunds.

Adopting this approach could constitute a significant extension of the existing formal income tax rulings system. Under the present system, the Tax Office only provides legally binding income tax advice in the form of public rulings, PBRs and oral rulings. PBRs and

27. In 2002-03, the Tax Office issued 7,631 PBRs. 4,150 were wholly favourable to the applicant, 1,246 were partially favourable and 2,235 were unfavourable. It also finalised 3,674 applications without issuing rulings (usually because the application was withdrawn, deemed invalid or because the Tax Office refused to rule).

28. A taxpayer who disregards a PBR is liable to a penalty if their failure to follow the ruling results in a shortfall. Many practitioners argue that they only request rulings when they are confident that the ruling will be favourable. Penalties are examined in greater detail in Chapter 4.

29. Provided advice was not obtained under false pretences and, where it covers a prospective transaction, the transaction is implemented as foreshadowed at the time the advice was sought.
oral rulings provide specific advice to particular taxpayers in relation to arrangements where the Tax Office has all the material facts. Public rulings relate to defined arrangements and are subject to a lengthy process of refinement and consultation before they are released. These procedures do not currently apply to the same extent to many of the other advice products currently provided by the Tax Office. If more Tax Office advice was binding, it might become more limited, cautious and conditional and therefore more complex and less timely.

Providing more legally binding advice would reduce the capacity of the Tax Office to amend assessments where taxpayers have paid too little tax on the basis of incorrect Tax Office advice. This may have significant revenue consequences, or the tax foregone might effectively be borne by taxpayers as a whole. However, these concerns do not apply if the advice is correct.

For Tax Office advice to be reliable, it is also necessary for taxpayers and practitioners to be confident about when it applies. This is particularly important for advice intended to have potential application to a wide range of taxpayers. If more of the Tax Office's general advice were made legally binding, it would still be necessary for taxpayers and practitioners to determine when it applies. The benefit of making more of its general advice legally binding would depend on the way in which this advice is framed, as well as the skill of taxpayers and practitioners in applying it in particular cases.

A comprehensive binding regime might result in higher dispute levels between taxpayers and the Tax Office over whether particular arrangements are covered by general advice, although this has not been the experience with the indirect tax ruling system.

2.5 Rights of appeal against private binding rulings

In Australia, taxpayers have the right to object against a PBR with which they disagree. In 2002-03, the Tax Office received a total of 156 objections in relation to PBRs. If taxpayers are dissatisfied with the Tax Office's response, they may appeal to either the Administrative Appeals Tribunal (AAT) or the Federal Court.

It is not possible for a taxpayer to directly seek review of any other type of Tax Office advice. However, a taxpayer who is dissatisfied with a public ruling or an oral ruling can

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30. In this sense, taxpayers who are covered by these types of rulings are in a similar position to that which applied before the introduction of self assessment, whereby the Tax Office could not alter an assessment if a 'full and true disclosure' of the facts had been made.

31. This issue is less significant in relation to specific advice (such as that provided to taxpayers in the form of a PBR). Because the Tax Office must have all relevant facts in relation to an arrangement before a PBR can be issued, taxpayers can have a high degree of confidence that the advice will apply to them.
appeal by obtaining a PBR and then objecting to it, or assessing themselves on the basis of the advice and then objecting to the assessment.\textsuperscript{32}

Direct appeal rights for PBRs are linked to the penalty that applies to shortfalls where the taxpayer disregards a PBR. Taxpayers who have shortfalls after failing to follow either public or oral rulings are not liable to penalties merely for that reason.

Previous reviews have identified the inability of the AAT or Federal Court to consider additional facts relating to an arrangement not set out in the relevant ruling. This has meant that matters have had to be referred back to the Tax Office, increasing the duration and cost of the review process for dissatisfied taxpayers.\textsuperscript{33}

\section*{2.6 Funding rulings and other advice}

Tax Office advice is currently funded from consolidated revenue as part of its annual budget allocation. It is provided free of charge to taxpayers and practitioners (although significant costs may be incurred in obtaining certain types of advice, for example, in preparing an application for a PBR on a complex issue).

If it is considered that the Tax Office should provide more advice to taxpayers and practitioners, or that it should provide advice within a shorter time frame, it is necessary to consider how these improvements should be funded.

Another issue is whether there are any mechanisms that could be used by the Tax Office to provide taxpayers and practitioners with specific advice at lower cost than under the current PBR system. One suggestion is to make greater use of legally binding oral advice than is possible under the current system. Another idea that has been raised is for practitioners to be licensed to provide taxpayers with limited types of specific advice on behalf of the Tax Office. This advice could be submitted to the Tax Office at the time that a taxpayer lodges their return and become binding on the Tax Office if it were not explicitly disallowed within a particular period. This would be a major step, requiring lengthy consultation, the establishment of a licensing regime, monitoring procedures, and possibly also penalties.

\textsuperscript{32} Part IVC of the TAA contains standardised objection, review and appeal provisions that apply to a wide range of taxation decisions. These provisions apply to decisions about PBRs as well as decisions relating to assessments.

2.7 Questions for consultation

2.A Is Tax Office advice sufficiently accessible?

2.B Should Tax Office advice indicate whether Part IVA applies to a particular arrangement as a matter of course, or only on request?

2.C Do taxpayers and their advisers currently encounter delays in obtaining Tax Office advice? If so, what strategies might allow the Tax Office to provide advice on a more timely basis?

2.D Are there significant problems with the accuracy of Tax Office advice? If so, how should they be addressed?

2.E Is there evidence of pro-revenue bias in Tax Office advice? What measures would improve confidence in the objectivity of Tax Office advice? Would an independent evaluation assist?

2.F How should Tax Office advice be framed to assist taxpayers — by explaining contending views of the law, or by setting out how the Tax Office intends to apply it? Does this impact on the way that advice is expressed?

2.G How might the Tax Office clarify the circumstances in which general advice can be relied upon?

2.H Is there value in making more Tax Office advice legally binding? What additional safeguards would be required?

2.I Should taxpayers be penalised merely for not following PBRs when self assessing their income tax liabilities?

2.J If no penalty applied, would direct appeals against PBRs still be required?

2.K If appeals are retained, how could the process be improved?

2.L Should the Tax Office be permitted to charge for certain advice?

2.M How could the Tax Office use more cost effective channels for the delivery of binding advice to taxpayers or through practitioners?
This Chapter explains the current rules governing the amendment of assessments and discusses whether they should be changed to give taxpayers earlier certainty as to their income tax liability. The Chapter considers various approaches including shortening amendment periods, early notification of compliance activity and extending pre-assessment agreements.

The rules governing the amendment of income tax assessments attempt to balance two competing objectives, namely that:

- A taxpayer should pay the correct amount of tax according to law.
- Whether or not a taxpayer has paid the correct amount, eventually their tax affairs for a particular year should become final, unless they have deliberately sought to evade their responsibilities.

The law seeks to balance these objectives by allowing the Tax Office to amend assessments to correct errors, but only within time limits set out in the law.

This Review has examined the topic from the perspective that, in order to promote the concept of certainty, the period permitted for amendment should approach the minimum required by the Tax Office (and the taxpayer) to identify incorrect assessments and take action to correct them.

### 3.1 The amendment rules before self assessment

Before self assessment, the Tax Office's ability to amend an assessment depended on whether the taxpayer had made a ‘full and true disclosure’ in their tax return of all the facts necessary for the Tax Office to make an assessment.¹

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¹ Former sub-sections 170(2) and 170(3) *Income Tax Assessment Act 1936.*
Where a taxpayer had done this, the Tax Office could increase the assessment within three years from the date that the tax on the original assessment became due and payable, but only to correct an error in calculation or a mistake of fact. The Tax Office could not amend an assessment to correct a mistake of law. In practice, this meant that if a person told the Tax Office all about a claim they were making in an attachment to their tax return and the assessor allowed it incorrectly, the Tax Office could not usually correct its mistake later. However, if an assessor had simply made a mistake in working out the details of the claim (say by wrongly calculating the proportion of private use of a motor vehicle used partly for work), that mistake could be corrected later, if discovered within the time limit.

Where a taxpayer had not made a full and true disclosure (for example, by not giving the correct details about a deduction claimed), or had been involved in a tax avoidance scheme, the Tax Office could alter the assessment for up to six years. There were special rules allowing amendments in longer time frames in certain cases.

Finally, if the underpayment of tax was due to fraud or evasion, the Tax Office could amend the assessment at any time.

The rules for decreasing assessments did not depend directly on the adequacy of the disclosure by the taxpayer. Once an assessment had been made, the Tax Office could correct calculation errors and factual mistakes (for example, a forgotten claim for a tax deductible gift) within three years of the original assessment, but could only correct an error of law if the taxpayer objected to the assessment within 60 days.

### 3.2 The current amendment rules

The standard period now allowed for the Tax Office to amend an assessment (either to increase or reduce a taxpayer’s liability) is four years. For certain individuals with very

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2. The income tax law defines neither fraud nor evasion. The ordinary legal meaning of fraud is obtaining a material advantage by unfair or wrongful means; it involves obliquity (Osborn, P 2001, Osborn’s concise law dictionary, 9th ed, Sweet & Maxwell, United Kingdom). It involves the making of a false representation knowingly, without belief in its truth, or recklessly. In Denver Chemical Manufacturing Co v Commissioner of Taxation (NSW) (1949) CLR 296 at 313, Dixon J said that evasion requires a blameworthy act or omission by the taxpayer (or those for whom the taxpayer is responsible).

3. For individual taxpayers, the amendment period is calculated from the day on which tax became due and payable under an assessment. For full self assessment taxpayers (primarily companies and superannuation funds), the four year period is calculated from the day on which the assessment is deemed to be made, which is the date the taxpayer lodged its return. Where the Tax Office has begun an audit of a taxpayer’s affairs, but not completed it within the period allowed for amendment, the Tax Office can apply to the Federal Court for an order extending the amendment period, or request the taxpayer to consent to an extension.
simple tax affairs’, the period is two years.

With self assessment, the concept of ‘full and true disclosure’ was removed from the amendment rules because taxpayers were no longer required to disclose the full details of their income and deductions in their returns and assessors no longer scrutinised that information before an assessment was issued. Amendment is now effectively unrestricted within the relevant time limits.

Where the Tax Office considers that there has been fraud or evasion, there continues to be no time limit on the Tax Office amending an assessment.

The law now also allows for ‘self amendment’ of assessments (to increase or decrease liability), meaning that the Tax Office can rely on statements made by a taxpayer in a request for amendment in the same way it can rely on a statement in a return.

### 3.2.1 Special amendment rules

There is a special period for amendment where Part IVA (the general anti-avoidance provision) is invoked. As with the previous system, the Tax Office has up to six years (from the date on which tax became due and payable under an assessment) to amend an assessment to cancel a tax benefit under that Part.

There are also some specific provisions allowing the Tax Office to amend an assessment to deal with special issues, regardless of the normal time limits. These special cases are discussed in more detail below at 3.4.6.

### 3.2.2 International comparisons

The table below summarises the periods of review that apply in Australia, Canada, New Zealand, the United Kingdom and the United States.

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4. To be a Shorter Period of Review (SPOR) taxpayer, the taxpayer must be an individual deriving only salary or wages (or certain other income subject to withholding), interest or public company dividends. The taxpayer must not claim deductions except for gifts, account–keeping fees or government charges on account transactions and expenses of managing tax affairs. There are also disqualifying factors such as having a capital gain or loss. The Tax Office estimates that about 1.5 million taxpayers are SPOR taxpayers.
3.3 How long does the Tax Office need to complete its compliance activities?

In the beginning of this Chapter, the Review proposed that the period permitted for amendment should approach the minimum required by the Tax Office (and the taxpayer) to identify incorrect assessments and take action to correct them.

The Tax Office currently tailors its compliance activities to meet the differing circumstances and characteristics of taxpayers. It does this by adopting a market segment approach that distinguishes between businesses of various sizes, individuals who are not in business and not-for-profit taxpayers (for example, charities and government agencies).

The range of compliance activities that the Tax Office might adopt will vary according to the compliance profile of the taxpayer and the market segment to which they belong. While most returns are subject to office based analysis, such as risk profiling and data matching, relatively few are selected for comprehensive audit. Selection for audit is generally based on a risk assessment, rather than arising merely by chance, or because it is 'your turn'.

The length of time that the Tax Office takes to review returns will therefore vary according to the compliance activities it has chosen.

5. Risk assessment is the process of identifying potential risks to the revenue, quantifying their likelihood of occurrence and assessing their likely impact. Case selection occurs after risk assessment and is part of the risk mitigation process.
For non-business individuals with simple affairs, the compliance activity will often be based primarily on processes such as income matching\(^6\). The Tax Office can generally complete these processes within 12 months of the taxpayer lodging a return. If these activities reveal possible non-compliant behaviour, the Tax Office may take further action. Either way, the Tax Office is generally in a position to know whether an amendment should be made to a non-business individual’s assessment in much less than the four years presently allowed.

At the other extreme, large business taxpayers with complex (sometimes international) affairs and transactions involving substantial amounts of money will often be subject to more comprehensive audits. These require more time to complete, reflecting the complexity of these taxpayers’ affairs and the administrative processes (usually intended to protect taxpayers’ rights) that accompany these audits.\(^7\) Audit actions may be delayed by difficulties with access to the facts or evidence, claims of legal professional privilege\(^8\), administrative law remedies, delays in responding to requests for information or time to comment on Tax Office statements of facts or position papers.

Consequently, large audits often extend for the full time allowed under the Act for amendment, and sometimes go beyond the normal statutory limit, either with the agreement of the taxpayer, or by an order of the Federal Court.\(^9\)

3.4 Issues and possible approaches

As canvassed in Chapter 1, the length of time that elapses before a person’s assessment can no longer be amended represents an aspect of uncertainty for them. If that time can be reduced, the time that people experience the ‘costs’ of uncertainty will also be reduced. This section canvasses whether this might be achieved without a negative impact on compliance behaviour or revenue collection.

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6. Income matching means comparing income returned by a taxpayer with information provided by third parties, for example, electronically comparing the database of information about interest paid by financial institutions and dividends paid by public companies with the information in returns.

7. These processes may involve the Tax Office issuing a statement of facts or a position paper on the legal issues, which a taxpayer can dispute or clarify, and further discussions, negotiations and exchanges of papers. At any stage either or both parties may need time to obtain legal advice, expert advice or valuations, etc. The taxpayer can also request that the Tax Office review its position and has the opportunity to provide a submission on any penalty issues that may arise.

8. Legal professional privilege is a common law ground upon which a party may object to the disclosure or inspection of confidential communications between a legal adviser and their client in relation to litigation taking place or being contemplated by the client.

9. The Federal Court can extend the amendment period where, because of any act or omission of the taxpayer, it was inappropriate or not reasonably practicable for the Tax Office to complete an audit within the normal period, see subsections 170(4)-(4C) of the *Income Tax Assessment Act* 1936.
3.4.1 A shorter amendment period for individuals and very small businesses

Many individuals who are not in business (and some very small businesses) have straightforward tax affairs. The Tax Office generally completes its compliance activity for these taxpayers within two years of the original assessment, although some amendments are completed in the third year.

In the 2002-03 financial year, the Tax Office initiated just over 217,000 amendments to increase the liability of individuals not in business (excluding tax avoidance cases) raising total revenue of about $173 million. Of those, about 175,000 amendments (81%), raising revenue of about $135 million, were completed within two years.

Similarly for very small businesses, the Tax Office usually completes the majority of its audits, accounting for about half of the extra tax, interest and penalties raised from this group, within about two years of the original assessment.

On these raw figures, it seems as if the current period of review for individuals and very small businesses could be reduced somewhat — perhaps to a period of two years, rather than the present four — without greatly prejudicing compliance or increasing risks presented by these groups. If some changes need to be made, the Tax Office (and possibly taxpayers) could reorganise resources and activities to accommodate those changes.

Very small businesses

While there may be no ideal dividing line for defining very small business, the law would be simpler if it used a definition already in existence.

The current eligibility test for a Simplified Tax System (STS) taxpayer may be well suited for this delineation because its purpose is to distinguish businesses with simpler income tax affairs. This test broadly requires that the taxpayer:

- carries on a business in that income year
- has an average annual turnover of less than $1 million (ignoring GST credits)
- has depreciating assets with an end of year value below $3 million.

So, one approach would be to make the two year amendment period available to non-business individuals and those business taxpayers who choose to be STS taxpayers (and thus adopt simpler tax accounting methods). Another approach could limit the two year amendment period to those eligible to be STS taxpayers.
Possible exclusions from a two year period

Other businesses

Most Tax Office audits of other businesses are not completed within two years of the original assessments. Indeed, in the 2002-03 year about 35% of the audit amendments for large businesses, raising 63% of the additional revenue from such audit amendments, were completed in the fourth year after the original assessment, or later (where the taxpayer consented to an extension of the standard four year amendment period). These timeframes reflect the comprehensive investigations that occur with taxpayers with complex affairs.

Given these figures, unless the Tax Office is able to change its approach (with consequent impact on taxpayers) there are sound reasons for the current four year amendment period to continue to apply. Table 3.1 shows that the amendment period for large businesses in Australia is similar to that of Canada, New Zealand, the UK and the US.

To shorten the audit process for larger businesses, the Tax Office may have to truncate either its investigatory processes or the administrative procedures designed to protect taxpayers' rights. This could endanger large amounts of revenue or limit the opportunity for taxpayers to respond to Tax Office positions during the audit.

As larger businesses already commonly agree to an extension of the amendment period, a reduction of the period is likely to result in this happening more often. While this could lessen any undesirable consequences of a reduction, it also raises doubts as to whether any reduction is worthwhile.

Other possible exclusions

The Tax Office would have difficulty completing its compliance activity for some individuals and very small businesses within two years. This would particularly be the case for those with complex affairs and where information from third parties (for example, about capital gains) is not readily available. Consequently, it might be necessary to exclude more complex cases (and some special cases) from the two year period for individuals and small businesses, such as:

- recipients of partnership income or trust distributions where the partnership or trust is excluded from the shorter amendment period
- schemes to produce tax benefits to which Part IVA (the general anti-avoidance provision) applies (or would have applied if the benefit had not been denied by other provisions of the law)
- international transactions
capital gains omitted from tax returns.

Fraud and evasion cases should continue to have an unlimited period for amendment — people who engage in calculated behaviour to evade tax should remain permanently at risk. Deliberate behaviour designed to make it more difficult for the Tax Office to find and remedy any understatement of liability within two years would be likely to amount to fraud or evasion.

In some cases taxpayers omit significant amounts of income from their tax returns, but it is unclear whether there has been fraud or evasion. It may be necessary to define evasion to cover major understatements of taxable income.

3.4.2 A new amendment period for arrangements conferring tax benefits

Currently, there is a six year period for amendments to give effect to a determination under Part IVA, the general anti-avoidance provision. This is effectively a 50% extension on the standard time for taxpayers to be exposed to the uncertainty of a possible increase in their liability.

Originally, the Part IVA amendment period was aligned with the standard period for amendment where a taxpayer failed to make a full and true disclosure. When the standard amendment period became four years, the six year period was not changed.

In an environment where large and complex cases are generally able to be completed within four years, a six year period seems an unnecessarily long time, especially when records are usually only required to be kept for five years. The question therefore arises whether the time allowed for Part IVA amendments could be reduced, perhaps to that for large and complex cases, that is, four years.

A four year amendment period could apply generally to arrangements where someone who entered into or carried out the arrangement had the dominant purpose that they (or someone else) obtain a tax benefit from the arrangement. Under this approach the amendment period would be the same whether the Tax Office was relying on Part IVA, specific anti-avoidance provisions or ordinary provisions.

As shortening the amendment period on tax avoidance cases would require the Tax Office to formally identify risks to revenue earlier, it might need to acquire some

10. This would be similar to the current law for penalties relating to tax avoidance schemes: see section 284-145 of Schedule 1 to the Taxation Administration Act 1953.
information earlier. For example, it may require more information in the tax return about areas with a significant revenue risk. 11

3.4.3 Early notification of intended compliance activity

As noted above, amendments for many taxpayers, even those who are formally audited, are often finalised within two years of the original assessment (in the case of individuals and very small business) or four years (in the case of larger businesses).

However, taxpayers who ‘pass’ the checking activity that goes on behind the scenes do not know the Tax Office is satisfied with their return until the statutory time has passed. Only those ‘caught out’ are aware of Tax Office income matching processes. Statistically, most taxpayers are never subjected to full audits, reflecting the Tax Office’s sophisticated compliance strategies that target taxpayers and transactions where the highest risk of non-compliance is likely.

The current review periods therefore prolong uncertainty for the vast bulk of taxpayers who are considered, but not selected, in a given year, for comprehensive scrutiny. This could be avoided if the Tax Office were required to notify, at an early stage, those taxpayers it selects for further compliance activity. Taxpayers not so notified would know that the Tax Office could not amend their assessments (except in limited cases).

Such a system might work in the following way:

- The Tax Office would have, say, half of the applicable amendment period to notify a taxpayer that they will be subject to further scrutiny. The notice would not need to specify the issues to be reviewed, although the Tax Office could mention issues to assist the taxpayer to prepare for the review.
  - Once the Tax Office has notified a taxpayer within that period, the normal amendment times would apply for all issues in the income year.
  - If, however, a taxpayer was not notified within the period, the Tax Office would be unable to amend (other than to address fraud or evasion).

A statutory notification period of this type might result in some loss of revenue as the Tax Office does not currently identify all understatements of tax or compliance risks within the time that would be allowed for notification. This is especially the case for

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11. In the US, corporate taxpayers that enter into ‘reportable transactions’ must (among other things) disclose details of the transactions to the Internal Revenue Service (IRS) in their annual tax return. Reportable transactions are ones identified by the IRS as tax shelter transactions or that have characteristics typically found in tax shelter transactions.
larger businesses and other complex cases. The early notification approach may therefore need to be accompanied by further declaration requirements.

Furthermore, this approach could reduce the incentive for taxpayers to 'self amend' to increase their liabilities and might encourage more risk taking on the perception that the Tax Office would be less likely to catch transgressors. Currently, substantial numbers of taxpayers self amend to increase their liabilities more than one year after tax became due and payable under their original assessment.\footnote{In 2002-03 about 9,400 very small businesses and 66,000 individuals not in business (excluding tax avoidance cases) requested amendments increasing their liabilities, with about three quarters doing so within one year of their original assessment. The amendments after one year raised revenue of about $53 million.}

An alternative to introducing a statutory notification period might be for the Tax Office to change its procedures administratively. The Tax Office could notify certain taxpayers, particularly those with straightforward affairs, either that there will be no review of an assessment or that it will review a particular risk area. The Tax Office could do this as soon as possible after it issues an assessment (or for a full self assessment taxpayer, as soon as possible after the taxpayer lodges its return). This administrative approach to providing earlier finality on an assessment could be included in the Taxpayers’ Charter.

\subsection*{3.4.4 Extending pre-assessment agreements}

Another way to reduce the period of uncertainty for taxpayers, in this case predominantly larger ones, would be to extend the Tax Office’s existing pre-assessment agreements to cover a wider range of transactions or circumstances. Currently, taxpayers can enter into pre-assessment agreements with the Tax Office to bring early finality (and therefore certainty) to some limited activities covered by the agreement, such as transactions relating to transfer pricing\footnote{Transfer pricing agreements set out the transfer pricing methodology to be used in the future apportionment or allocation of income and deductions for income tax purposes. The benefit of these agreements is that the Tax Office will not make any adjustments to the tax liability established under the agreements provided taxpayer has complied with the terms and conditions of the agreement.} and certain GST activities.\footnote{GST pre-assessment agreements apply where the Tax Office is satisfied that businesses have appropriate internal controls in place to meet their full range of GST responsibilities. By obtaining an agreement with the Tax Office, businesses can reduce the risk of audits and penalties, provided they properly implement and maintain the agreed assurance processes.} One advantage of this approach is cost effectiveness — on average, transfer pricing pre-assessment agreements take nine months to complete, compared with audits on the topic, which can take two to three years.\footnote{Australian Taxation Office 2003, \textit{Large Business and Tax Compliance}, Australian Taxation Office, Canberra, p.5.}
If the pre-assessment agreement approach could be adopted more broadly, it would be equivalent to re-introducing the ‘pre-self assessment’ certainty that practitioners have spoken to the Review team about. However, as the agreements require significant resources from both the taxpayer and the Tax Office, they are likely to be most suitable for large issues that might otherwise require substantial expense to resolve.

Examples of transaction based income tax activities that might lend themselves to pre-assessment agreements include:

- the application of losses
- research and development expenditure.

Examples of appropriate internal controls that might be covered by a pre-assessment agreement include:

- trading stock calculations involving significant volumes
- depreciation calculations.

### 3.4.5 Loss and nil liability returns

Where a taxpayer returns a tax loss in an income year, the Tax Office effectively has an unlimited period to review their affairs. This is because, as explained above, the time limitations only start to run from when tax becomes *due and payable under an assessment* and, for a taxpayer returning a loss, no tax is due and payable. The same issue arises in other nil liability cases, for example, where the taxpayer’s taxable income is below the tax-free threshold, or where the taxpayer’s tax offsets reduce the tax payable on their taxable income to nil.

Taxpayers and practitioners have argued that it is unfair to face an effectively unlimited period of review in these circumstances.

In principle, there are no compelling reasons to distinguish so drastically between taxpayers who, for example, claim large deductions to reduce tax payable to a very small amount and those who do the same to reduce tax to zero.

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16. For full self assessment taxpayers (primarily companies and superannuation funds) the four year period is calculated from the date on which the assessment is deemed to be made. However, the Tax Office considers that there is no deemed assessment when a full self assessment taxpayer lodges a non-taxable return (Australian Taxation Office 2004, *Draft Taxation Determination TD 2004/D2*, Australian Taxation Office, Canberra).
One possible way to remedy the problem would be to apply equivalent rules to limit the period for the Tax Office to review a nil liability as for assessments. However, to minimise the risk to revenue, the deductibility of a tax loss would still be determined in the year that the taxpayer has income against which to offset the loss.

If this change were made, the Tax Office may wish to allocate more resources to reviewing loss returns and other nil liability cases, suggesting some lead time may be necessary.

### 3.4.6 Addressing other unlimited review periods

The law currently sets out a number of special cases where the Tax Office can amend an assessment at any time. Examples include the expenditure recoupment scheme provisions, the car expenses provisions, the farm management deposit provisions and the private health insurance offset provisions.

In some cases there is a logical rationale for the unlimited period, for example, where a taxpayer incurs an expense and claims a deduction, which is subsequently reimbursed.

However, in other cases, an unlimited period may not be justified. The substantiation provisions, for example, have an unlimited amendment period although taxpayers are only required to keep the necessary records for five years.

### 3.4.7 Where the Tax Office fails to amend within a reasonable time of having all the material facts

Some taxpayers and practitioners have criticised the Tax Office's handling of mass marketed investment arrangements because of the apparent delay between the Tax Office becoming aware of the details of the arrangements and taking action to amend assessments to deny deductions.

It has therefore been suggested that taxpayers could be given a remedy where the Tax Office has delayed unreasonably in issuing an amended assessment after it received all the relevant information.

This idea is similar to the doctrine of laches (which is an equitable defence where a claimant unreasonably delays seeking their equitable remedy), applied as a statutory defence to the Tax Office's claims. The defence of laches arises only if a plaintiff delays unreasonably in commencing proceedings and, in view of the nature and consequences of that delay, it would be unjust in all the circumstances to grant the relief sought. The idea would be that, if the Tax Office has all the information necessary to raise an
amendment, but takes an unreasonable time to do anything, there may be circumstances where it would be unjust to allow an amendment, even within the statutory time limit.

In practice this approach might present some practical problems.

First, this approach would not fit comfortably with the rest of the income tax law. The statutory time limits already attempt to balance the merits of finality against the ideal of all taxpayers paying their correct liability. Superimposing a rule that would require the Tax Office to act within reasonable time of having all the material facts would add significant complexity. The principle has long been established that the Act should govern the right to tax collection, rather than the Tax Office’s actions.\textsuperscript{17}

Secondly, as taxpayers assess their own liability when they lodge their return, they do not — and are not required to — disclose all the facts to the Tax Office.

Thirdly, the approach would introduce two fresh sources of uncertainty and potential dispute, namely the time when the Tax Office had all the material facts and the reasonableness of the period after that in which the Tax Office could amend. (Before the introduction of self assessment, there were many disputes about when and if the taxpayer had made a full and true disclosure of all the material facts.)

Currently, the Parliament has addressed the concern that the Tax Office needs to act in a timely way by limiting the time for it to act. A more direct way to improve certainty without the possible practical or evidentiary problems of a ‘laches’ approach may be to reduce these periods of review as canvassed above.

Other consequences of delays in amendments are discussed in Chapter 5 (dealing with the General Interest Charge).

### 3.4.8 Amendments to reduce a liability

Currently, the periods for an amendment reducing a taxpayer’s liability mirror those for amendments increasing a taxpayer’s liability. This approach has been supported in the past on the basis of fairness — if it is fair that the Tax Office is able to increase a taxpayer’s liability for a particular period, it should also be fair that a taxpayer can request it to reduce it in the same period.

If the shorter review period canvassed above was adopted, the question arises whether symmetrical periods should be maintained, so that a two year period applied generally

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17. \textit{Federal Commissioner of Taxation v Wade} (1951) 84 CLR 105 at 117 per Kitto J: ‘No conduct on the part of the commissioner could operate as an estoppel against the operation of the Act ...’.
Review of Self Assessment

for amendments reducing a taxpayer's liability with a four year period applying to the more complex cases.

An alternative approach would be to have a set amendment period (of say four years) for all amendments reducing a taxpayer's liability.
3.5 Questions for consultation

3.A Should the period for an amendment increasing the liability of an individual not in business, and/or a very small business be reduced to, say, two years?

- Should the eligibility of a very small business be based on whether it has chosen to be a Simplified Tax System taxpayer?
- What exclusions from a two year period would be appropriate?

3.B Should the amendment period for medium and large businesses and other complex cases remain as four years?

3.C Should the amendment period for arrangements conferring unintended tax benefits (including arrangements covered by Part IVA) be reduced from six years to, say, four years? Should taxpayers be required to disclose certain tax planning arrangements more fully in returns?

3.D Is there benefit in the idea of the Tax Office providing early notice to those taxpayers that it has decided to audit?

- What would be a suitable notification period?
- What exclusions from the notification regime would be appropriate?
- Would this idea still be beneficial if taxpayers had to disclose more information?

3.E Should pre-assessment agreements be extended to a wider range of cases?

3.F Should a taxpayer who lodges a nil liability return be subject to the same time limits as apply in amending an assessment?

3.G What amendment periods should apply to cases that currently have an unlimited period?

3.H Should taxpayers have a remedy where the Tax Office delays unreasonably in issuing an amended assessment after it has all the relevant information?

3.I Should the period for an amendment reducing a taxpayer’s liability be the same as for increasing liability, or be set at a fixed period?
Review of Self Assessment

3.J Would it be better to implement some of the possible changes raised in this Chapter (for example, early notification of compliance activity) by changing administrative procedures, rather than by changes to the law?
CHAPTER 4: PENALTIES

This Chapter explains the penalties that can apply if a taxpayer understates their tax liability. The Chapter considers whether the standard of care required of taxpayers is sufficiently clear and whether there should be a penalty for failing to follow a Tax Office private ruling. It outlines a ‘safe harbour’ for taxpayers using agents and examines the Tax Office’s power to remit penalties.

4.1 Penalties and self assessment

Penalties exist as incentives for taxpayers to comply with their various tax obligations. The penalties relevant to this Review are those that apply where, in self assessing, a taxpayer understates their liability and therefore pays less tax than they ought to. These are known as tax shortfall penalties.

Tax shortfall penalties may apply, depending on the degree of blameworthiness on the taxpayer’s part, if a taxpayer has a tax shortfall resulting from any of the following:

- making a false or misleading statement. Omitting income, over-claiming deductions or claiming deductions that are not allowable will generally fall into this category
- failing to provide a document that the Tax Office needs to work out liability
- applying an income tax law in a way that is not reasonably arguable (but only if the tax shortfall amount exceeds the greater of $10,000 or 1% of the income tax payable by the taxpayer)
- disregarding a private ruling
- entering into a tax avoidance scheme or having a transfer pricing adjustment.

These culpability penalties are distinct from the General Interest Charge (see Chapter 5).
4.1.1 Scale of penalties

The amount of shortfall penalty for which a taxpayer may be liable depends on the reason for the shortfall, as set out in the following scale.

Table 4.1: Scale of shortfall penalties

<table>
<thead>
<tr>
<th>Cause of shortfall</th>
<th>Base penalty amount (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intentional disregard of a taxation law</td>
<td>75</td>
</tr>
<tr>
<td>Failure to provide a document necessary for the Commissioner to work out the liability</td>
<td>75</td>
</tr>
<tr>
<td>Recklessness</td>
<td>50</td>
</tr>
<tr>
<td>Lack of reasonable care</td>
<td>25</td>
</tr>
<tr>
<td>A position that is not reasonably arguable is taken on a large item</td>
<td>25</td>
</tr>
<tr>
<td>Disregard of a private ruling</td>
<td>25</td>
</tr>
</tbody>
</table>

The starting point for determining the penalty amount is a percentage of the shortfall. This can be varied up or down according to whether the taxpayer has hindered the Tax Office in investigating the shortfall, has previously had a shortfall amount with a similar cause, or has made a voluntary disclosure of the shortfall.

The scale works so that a taxpayer is not penalised if they have taken reasonable care (except in a few special cases dealt with later).

A taxpayer cannot be penalised for a shortfall caused by relying on Tax Office advice, publications, or general administrative practice.¹

4.1.2 Remission of penalties

The Tax Office can reduce penalties partially or in full. This is known formally as the power of remission. The taxpayer can apply for remission of the penalty, or the Tax Office can remit the penalty on its own initiative. The Tax Office must advise the taxpayer in writing if it decides not to remit the penalty, or decides to remit only part of the penalty. The normal objection and review procedures apply to the remission decision if the amount of the penalty not remitted exceeds two penalty units (currently $220).

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¹ Subsection 284–215(1) of Schedule 1 to the Taxation Administration Act 1953.
4.1.3 Criminal offences

The law contains a range of criminal offences that can apply where taxpayers fail to meet their tax obligations. Some of the main offences relate to failing to comply with requirements under a tax law (for example, failing to lodge a tax return), making false or misleading statements and failing to keep adequate records. If a taxpayer is found guilty of an offence, a court can impose a fine or, in very limited circumstances, a prison sentence.

4.2 Issues for the Review

As explained in Chapter 1, penalties are a potential consequence of uncertainty for taxpayers. Practitioners and industry groups in particular have argued that:

- The meaning of key concepts such as ‘reasonable care’ and ‘reasonably arguable position’ are not clear.
- The penalty for failure to follow a private ruling should not apply if the taxpayer has taken reasonable care and, for a large item, has a reasonably arguable position.
- When a tax agent makes a mistake, penalties should not apply to a taxpayer who has taken reasonable care to provide the correct information to the agent.
- The Tax Office ought to be more flexible in remitting penalties.

These issues are considered in more detail below.

4.2.1 Meaning of reasonable care and reasonably arguable position

‘Reasonable care’ is not defined in the tax law and ‘reasonably arguable’ is only defined in general terms. The Explanatory Memorandum to the *A New Tax System (Tax Administration) Act (No. 2) 2000* (the EM) provides some explanation of these concepts and the Tax Office has issued Taxation Rulings to explain their meaning. The courts have

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also provided guidance, for example about the meaning of reasonably arguable in the recent *Walstern* case. Nevertheless, there may be some scope to clarify the terms.

**Lack of reasonable care**

The EM makes the following points about the reasonable care test:

- The test requires a taxpayer to exercise the care that a reasonable person would be likely to have exercised in the circumstances of the taxpayer (including their knowledge, education, experience and skill).

- Taxpayers must take reasonable care not only in the preparation of their tax returns, but throughout the year on matters that may impact on their tax obligations, for example, record keeping.

- The reasonable care test is not intended to be overly onerous for taxpayers completing their own returns. For most taxpayers, an earnest effort to follow *TaxPack* instructions would usually be sufficient to pass the test.

- On questions of interpretation, if the taxpayer is uncertain about the correct treatment of a tax-related matter, reasonable care requires that they make reasonable enquiries to resolve the issue. Reasonable enquiry would include consulting someone or reference to a Tax Office publication to satisfy themselves about the proper tax treatment of the matter.

- Where a tax agent completes a return, the standard of care expected of the agent is much higher than the standard expected of the client.

**Reasonably arguable position**

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


4. The project on the regulation of the tax profession is considering the issue of the appropriate standard of care for taxpayers and tax agents (see below at 4.2.3).

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

6. Section 284–15 of Schedule 1 to the *Taxation Administration Act 1953*. 

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The EM explains this concept further as follows:

‘...the position must be a contentious area of the law, where the relevant law is unsettled or where, although the principles of the law are settled, there is a serious question about the application of those principles to the circumstances of the particular case.

The test does not require the taxpayer's position to be the 'better view'; the standard is 'as likely correct as incorrect', and not 'more likely to be than not'. However, the reasonably arguable position standard would not be satisfied if a taxpayer takes a position which is not defensible, or that is fairly unlikely to prevail in court. On the contrary, the strength of the taxpayer's argument should be sufficient to support a reasonable expectation that the taxpayer could win in court. The taxpayer's argument should be cogent, well-grounded and considerable in its persuasiveness.'

In the *Walstern* case, Justice Hill said (at paragraph 108 of his judgment) that:

‘The case must be one where reasonable minds could differ as to which view, that of the taxpayer or that ultimately adopted by the Commissioner was correct. There must, in other words, be room for a real and rational difference of opinion between the two views such that while the taxpayer's view is ultimately seen to be wrong it is nevertheless “about” as likely to be correct as the correct view.’

### 4.2.2 Penalty for failure to follow a private ruling

Where a person has asked the Tax Office for a private ruling and failed to follow it, resulting in a tax shortfall, a penalty applies. This approach is not followed in Canada, New Zealand, the US or the UK. The rationale for applying this penalty is that, where the Tax Office has issued a private ruling, the taxpayer has sufficient guidance as to the law and, if they disregard it, they can no longer have a reasonably arguable position (or have taken reasonable care). Rather than simply ignoring a private ruling, a taxpayer can challenge it if they disagree — either through the objection and appeal processes or by assessing in accordance with the ruling and then objecting to the assessment.

The Review of Business Taxation (commonly called the Ralph review) recommended abolishing this penalty.’ The Ralph review considered that ‘the criteria for invoking the penalty should be concerned solely with considerations of whether the taxpayer has taken reasonable care and whether a reasonably arguable position has been adopted.

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Review of Self Assessment

Where this has been adopted, no penalties should apply — though interest should continue to be payable on any tax shortfall.’

The Ralph review reflects a different perspective from that in earlier papers' as to why taxpayers seek private rulings. The earlier papers took the approach that, in requesting a ruling, a taxpayer is seeking clarification of how the law works. In contrast, the Ralph review took the view that the taxpayer probably has a good idea of how the law works (from the taxpayer’s own advisers), but wants to know the Tax Office view.

This issue is intimately linked to the design of the private ruling system. Abolishing the penalty for failing to follow a ruling, without other changes, could bias the system by providing strong incentives to seek private rulings (that is, free private advice potentially conferring a commercial benefit), with little or no cost or disadvantage. This could result in a significant increase in private ruling applications and therefore either increase the Tax Office’s administration costs, to be borne by all taxpayers, or draw resources from other aspects of revenue collection. To overcome those difficulties, the Ralph review also recommended that the Tax Office charge for selected private rulings — making the recipient bear at least some of the costs.

It should be noted that, even if the penalty were abolished, a taxpayer not following a private ruling could still be liable for a penalty for failing to take reasonable care or, for a large item, not having a reasonably arguable position. Further, the Tax Office might need to improve procedures to check whether a taxpayer has followed a ruling, perhaps by requiring a declaration in their tax return.

4.2.3 A ‘safe harbour’ for taxpayers using tax agents

Under the existing law, as before self assessment, taxpayers are responsible for errors in returns made by their tax agents. There are no penalties directly for agents, although the criminal offence provisions can apply to them.

Over ten years ago, the Self Assessment Priority Tasks project flagged a possible ‘safe harbour’ for taxpayers when the agent makes an error, if they have provided their agent with all the details necessary to complete their return. The previous Government decided to consider the issue further as part of a broader review of the role of tax agents.

On 6 April 1998, the then Assistant Treasurer, Senator the Hon Rod Kemp, announced that the Government had approved a new legislative framework for tax agent services. He said that:

8. See footnote 4 of Chapter 1.
Chapter 4: Penalties

'The proposals will give taxpayers who engage a tax agent a 'safe harbour' from penalties, providing they exercise reasonable care in furnishing all the relevant taxation information to their tax agent. Taxpayers will no longer be vicariously liable for penalties imposed under the current law as a result of the actions of their tax agent.

Similarly, there will be no sanctions against tax agents who meet a defined standard of reasonable care in the preparation of tax returns...

Where a taxpayer satisfies these obligations [to take reasonable care], and there is a tax shortfall caused by the tax agent failing to exercise reasonable care, the taxpayer will have a 'safe harbour' and not be penalised. Instead the tax agent may be subject to a disciplinary measure.'

At the request of industry representatives, the Government deferred the implementation of that announcement until after tax reform was bedded down. Since then there have been further consultations between government officials and industry representatives about the announced framework.

The Government intends that the safe harbour issue will be finalised as part of the project on the regulation of the tax profession that is being undertaken concurrently with this Review. The proposed new framework will include a regulatory body for the profession (the National Tax Agents' Board) and effective sanctions for poor performance by agents (for example, repeated failure to take reasonable care).

4.2.4 Administration of the remission power

The Tax Office's power to remit shortfall penalties is theoretically unrestricted. While the law does not set out any conditions or grounds for remission, the Tax Office has published guidelines for its staff.

The current system of imposition matches the penalty to the seriousness of the wrongdoing and fine-tunes that amount for aggravating or mitigating factors. Consequently, remission of penalties should not be the norm, as it was before self-assessment, when there was a statutory 200% penalty for false or misleading statements.

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Practitioners and industry representatives have asserted that the Tax Office automatically applies penalties in a ‘speeding infringement’ fashion, even where it may have contributed to the taxpayer failing to meet their obligations.\textsuperscript{10}

The raw quantitative evidence does not show that the Tax Office applies penalties (or fails to remit them) indiscriminately. In the 2002-03 year, for example, the Tax Office initiated debit amendments for individuals not in business (excluding tax avoidance cases) that raised total primary tax of around $160 million. Although 90\% of these amendments were for omitted income, the total penalty imposed was under $9 million.

4.3 Questions for consultation

4.A What (if any) clarification of the terms 'reasonable care' and 'reasonably arguable position' is needed?

4.B What is the effect of the penalty for failing to follow a Tax Office private ruling? Do taxpayers only request PBRs when they are confident of a favourable ruling?

4.C If the penalty for failing to follow a Tax Office private ruling were to be removed, what other changes would be appropriate?

4.D What further guidance on grounds for remission of penalties is required?
CHAPTER 5: THE GENERAL INTEREST CHARGE

This Chapter outlines the operation of the General Interest Charge (GIC) and explores its implications for self assessment. The GIC applies a uniform rate of interest to late payments of any type of tax, compounding daily from when the tax was originally due. This means that, where a taxpayer under assesses their liability, a substantial amount of GIC may have accumulated before the Tax Office informs the taxpayer of the shortfall. The Chapter discusses whether the way the GIC applies to shortfalls is consistent with a fair balance between the rights of individual taxpayers and protecting the revenue for the benefit of the whole community. Some alternative approaches are canvassed.

The GIC applies a uniform rate of interest to all overdue tax debts, whether or not a taxpayer has acted knowingly to create the debt. The GIC compounds daily from the day the tax was due until all tax and accrued GIC have been paid. The GIC is tax deductible.¹

This Review has not been asked to examine the application of the GIC to tax debts in general. However, the GIC has implications for self assessment where, following an error by the taxpayer, an amended assessment is issued requiring the payment of further tax. As the 'due date' for that additional primary tax will be the same as that for the original assessment, the GIC will apply to that shortfall from the original due date. It is this 'shortfall GIC' — the GIC that accumulates prior to the shortfall being identified — that is the focus of this Chapter.

Views have been expressed in consultations that the GIC payable on shortfalls can be excessive and that the Tax Office is too reluctant to remit GIC. Industry representatives have also expressed the view that requiring taxpayers to apply for remission is unfair and impractical.

5.1 How the GIC works

The GIC was introduced in 1999 to simplify a complex array of penalties and interest charges applying to late payments and tax shortfalls. In most cases, the GIC reforms reduced the rates imposed by between 3% and 23%. However, in the case of shortfalls of income tax, the new charges exceeded the previous interest rates (originally by 4%, now by 3%).

Prior to the introduction of the GIC, income tax shortfalls were subject to a (tax deductible) interest charge equal to the Treasury Note Yield rate plus 4%. The GIC rate was originally set by adding an 8% uplift factor to the Treasury Note Yield base rate. This base rate reflected the simple cost to Government from delayed receipt of revenue, and also served as the interest rate that taxpayers received from the Tax Office on their overpayments. The uplift factor was set to encourage the payment of tax liabilities when due and discourage the ongoing use of tax debts as a source of business or private finance. In part, it recouped the cost of collection and compensated Government for credit risk. The uplift factor was not intended as a culpability penalty.

The structure of the GIC was amended in 2001, as Treasury Notes were no longer being issued on a regular basis. The bank bill rate series published by the Reserve Bank was found to be a suitable proxy, and adopted as the new base rate. At that time the uplift factor was reduced, as the Government considered that a 7% margin over the base rate was ‘sufficient to support the policy objective that taxpayers should pay their tax liabilities on time.’ The 7% uplift factor over the base rate still places the GIC, intentionally, among ‘high’ commercial rates.

The nominal annualised GIC rate is divided by the number of days in the calendar year to obtain the daily interest rate, which is applied on a compounding basis to the balance owed by a taxpayer at the end of each day. The GIC rate is adjusted quarterly to reflect movements in the base rate.

For the quarter January to March 2004, the GIC rate is 12.31% per annum (0.03363388% per day). Allowing for daily compounding, this would be equivalent to a

2. The Small Business Deregulation Task Force reported confusion among small business over how penalties were determined [Commonwealth of Australia 1996, Time for Business: Report of the small business deregulation task force, Commonwealth of Australia, Canberra – the Bell Report pp. 44–45]. In response, the Government considered the complexity of penalty arrangements to be the major factor behind taxpayer confusion and misunderstanding, and asked the Tax Office to develop options for simplification (Commonwealth of Australia statement by the Prime Minister, the Honourable John Howard, MP 1997, More Time for Business, Commonwealth of Australia, Canberra).
3. Taxation Laws Amendment Act (No. 5) 1998, Explanatory Memorandum, paragraphs 1.45–1.47.
4. Culpability penalties are discussed in Chapter 4.
5. Taxation Laws Amendment Act (No. 3) 2001, Supplementary Explanatory Memorandum, paragraph 4.6.
simple interest rate of 13.1% per annum. That is, a $100 underpayment left to compound daily at the GIC rate would grow to $113.10 over a year.

In recent years, the GIC rate has varied between 11% and 14%. For ease of discussion, this Chapter will adopt a 12.5% GIC rate unless stated otherwise.

### 5.1.1 Compounding effect

The amount of the GIC resulting from a shortfall will escalate over time, due to the effects of compound interest. Figure 5.1 presents, as a percentage of the shortfall, the GIC that would accrue at an interest rate of 12.5%, for periods up to six years.

![Figure 5.1: Accumulation of 12.5% GIC as percentage of shortfall](image)

At a GIC rate of 12.5%, interest charges would be approximately 28% of the shortfall after two years and 65% by the end of the normal four year review period. Where the shortfall arises from a tax avoidance scheme, a longer six year review period applies, exposing the taxpayer to GIC up to 112% of the tax shortfall.

In many (but not all) cases, these figures exaggerate the adverse impact that the GIC would have on a taxpayer, as they account for neither the interest that would have been payable to an alternate finance provider, nor the tax deductibility of the GIC.
5.1.2 Remission of the GIC

Broadly speaking, the Tax Office has the power to remit all or part of the GIC in any of the following circumstances:

- The taxpayer did not cause the delay and has taken reasonable mitigating action.
- The taxpayer caused the delay, but has taken mitigating action, and it is fair and reasonable to remit.
- There are special circumstances by reason of which it would be fair and reasonable to remit.
- It is otherwise appropriate to remit.

The Tax Office, in interpreting how this power should be used, places significant emphasis on the presumption under the legislation that the GIC should normally apply. For example, although the last criterion appears very broad, the Tax Office's Receivables Policy states that decisions to use this power 'will not usually be concerned with the circumstances of a particular taxpayer'.

The presumption that the GIC should apply is also reflected in the practice of usually requiring taxpayers to apply for remission, rather than it being initiated by the Tax Office.

If the Tax Office decides not to remit an amount of GIC in full, the taxpayer cannot use the normal objection and review provisions to obtain a review on the merits of the Tax Office's decision. However, the taxpayer can use administrative law actions to challenge whether a decision not to remit was according to law.

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6. The precise wording of these powers is at section 8AAQ of the Taxation Administration Act 1953. Guidance on how the Tax Office interprets the various remission categories can be found in the Receivables Policy, Chapter 93 (see footnote 7 of this Chapter). Under the Commissioner's Guarantee, the GIC will always be remitted where a taxpayer relies on information in TaxPack that is misleading.

5.1.3 International comparisons

Table 5.1 presents key aspects of the interest charges on shortfalls in Australia, Canada, New Zealand, the UK and the US. Each country has a discretionary power to remit interest charges. Further details can be found at Appendix 4.

<table>
<thead>
<tr>
<th>Country</th>
<th>Rate of interest</th>
<th>Interest tax deductible?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Bank Accepted Bill rate plus 7%</td>
<td>Yes</td>
</tr>
<tr>
<td>Canada</td>
<td>Canada 90 day Treasury Bill rate plus 4%</td>
<td>No</td>
</tr>
<tr>
<td>New Zealand</td>
<td>NZ business base lending rate plus 2%</td>
<td>Only for businesses</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>4.75% for corporations which pay their tax in quarterly instalments</td>
<td>Only for corporations</td>
</tr>
<tr>
<td></td>
<td>6.5% for individuals and corporations which pay their tax annually</td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>Federal short term rate plus 3% for individuals</td>
<td>Only for corporations</td>
</tr>
</tbody>
</table>

5.2 Impact of the GIC on shortfalls in different circumstances

This section outlines factors influencing the impact of shortfall GIC on various taxpayers. The range of possible impacts is illustrated through fictional cameos. Although not drawn from actual cases, the cameos demonstrate the different impacts that can arise from the imposition of the GIC on an amended assessment.

The extent to which these impacts are consistent with the policy objectives, including administrative workability, are addressed later. However, it should be noted that, given the size and inherent complexity of the tax administration system, arrangements will inevitably represent a balance of these competing considerations, rather than being fine tuned to the circumstances of each taxpayer.

An important issue in analysing the impact of the GIC on a taxpayer is the taxpayer's alternative borrowing rate. A 12.5% tax deductible GIC rate would be a significant loan benefit for an individual otherwise borrowing at a non-deductible overdraft rate of 15%. So, even when the GIC applies, for some taxpayers the net result is a cheap loan, whereas for others, it is a significant cost. Between these two extremes, the GIC can be seen as neutralising, to various extents, loan benefits received from the shortfall.

Another consideration is how the shortfall funds are applied. If they are invested, the net impact of the GIC will largely depend on the return from the investment, after allowing...
for the cost of liquidating or refinancing the investment. If the shortfall funds are applied to consumption, the shortfall might provide no loan benefit at all for some taxpayers — even before the GIC is considered.

Larger enterprises tend to carry ongoing, tax deductible debt as part of their financing structure. Consequently, a shortfall would be more likely to have displaced normal borrowing, and the GIC would primarily be a cost of finance issue. Representatives of larger businesses have argued that the GIC rate is consistently well above their normal borrowing rate.

**Cameo 1: Large low-risk business**

MegaCorp is a ‘blue chip’ company and borrows at about the bank bill rate. About six years ago, MegaCorp engaged in a complex financing arrangement for a project and claimed substantial deductions. In a subsequent audit, the Tax Office rejected certain deductions, which MegaCorp disputed. Hoping for a favourable outcome, MegaCorp agreed to extend the period of review beyond the statutory four years. About five years after the original ‘due and payable’ date, the Tax Office issued an amended assessment for $100 million plus $85 million in GIC. No penalties were applied, as the Tax Office considered MegaCorp to have taken reasonable care and to have had a reasonably arguable position. Had MegaCorp assessed correctly, it would have borrowed an additional $100 million in the marketplace, at 5.5%, incurring interest costs of around $30 million. Interest costs would be tax deductible in either case.

For healthy small to medium businesses, the GIC premium over their normal borrowing rates would vary.

**Cameo 2: Healthy small business**

XYZ Industries is a large family business with a strong credit rating and asset backing, readily able to borrow at benchmark overdraft rates. The Tax Office issued the firm with a revised assessment around three years after the original ‘due and payable’ date for $100,000 plus $45,000 of GIC. Had XYZ Industries assessed correctly, they would have borrowed an additional $100,000 at 8.5%, incurring interest costs of around $30,000. Interest costs would be tax deductible in either case.
Chapter 5: The General Interest Charge

For individuals with debt, because the interest would not normally be tax deductible, the net impact of the (tax deductible) GIC could be negligible (in the case of home mortgages) or significantly favourable to the taxpayer (in the case of consumer credit).

**Cameo 3: Mortgagee**

Mary earns a good income and lives to a strict budget, with any variations in receipts and expenditures absorbed by her mortgage account, which has an interest rate of 7%. The Tax Office issued Mary with a revised assessment for $10,000 plus $2,060 of GIC around 18 months after the original ‘due and payable’ date. Had Mary assessed correctly, she would have incurred an additional interest cost on her mortgage of around $1,100, which would not have been tax deductible. Mary subsequently received a tax deduction for the GIC, leaving her with a net GIC cost of $1,060. Allowing for the mortgage interest incurred prior to claiming a tax deduction for the GIC in her next return, Mary was financially no worse off, despite the inadvertent error.

**Cameo 4: Consumer credit**

Peter runs a small business. On a recent holiday to Europe, he made a number of brief visits to some potential suppliers he heard about from someone he met on the plane, and subsequently claimed what he thought was a reasonable proportion of his holiday as a business expense on his tax return. He applied the funds from the tax deduction toward his substantial credit card debt, which was incurring interest at 15%. Around 18 months after the original 'due and payable' date, Peter, who was close to paying off his trip, received an amended assessment that disallowed most of his claim for the European visits, creating a tax debt of $10,000 plus $2,060 GIC. Had Peter assessed correctly, he would have incurred an additional interest cost on his credit card account of around $2,500, which would not have been tax deductible. Peter subsequently received a tax deduction for the GIC, leaving him with a net GIC cost of $1,060. Allowing for the credit card interest incurred prior to accessing this tax benefit in his next return, Peter was $1,300 better off financially, despite the inadvertent error.

Where an individual has, in effect, invested the shortfall funds, the net impact of the GIC will depend primarily on the gap between the returns on those investments and the GIC rate. A personal investor is unlikely to receive the GIC rate in ordinary circumstances, given its equivalence to a high commercial rate. Indeed, a personal investor perceiving themselves as saving, rather than borrowing, could face a net impact from shortfall GIC
that was greater than for low risk businesses. Further, they might face difficulty in liquidating financial investments.

**Cameo 5: Conservative personal investor**

Fred invested the net proceeds from share sales in a term deposit at 5%. Due to an error in his capital gains tax calculation, Fred received a revised assessment around a year after the original 'due and payable' date for a further $1,000 plus $133 of (tax deductible) GIC. Over that period, Fred had only earned $50 from having deposited that extra $1,000 (taxable at the top rate).

In other cases, the shortfall funds will have been applied (effectively) to consumption. In these cases, there is a real prospect that the discovery of the shortfall itself will cause significant problems. That is, while the individual might have enjoyed the goods and services purchased with the shortfall, the ultimate cost may prove too high. This would be more likely where the individuals would not otherwise have borrowed to make those purchases. In such cases, the net impact of the GIC could be the full GIC amount.

**Cameo 6: Tax shortfall spent on consumption**

Tom and Ingrid are a middle aged couple. Ingrid inherited a rental property and used savings to finance substantial renovations. Ingrid incorrectly claimed the renovation cost as a deduction, rather than capitalising the improvements, and received a sizeable tax refund. Later that year, they spent what they understood to be their residual savings of $25,000 on an extensive overseas trip. Ingrid returned to an amended assessment for $25,000 plus over $3,000 in accrued GIC, with an adverse impact on the lifestyle they were otherwise expecting. Tom had previously decided against accepting his parent’s offer of an interest free loan for such a trip because they did not think it would be worth the sacrifices needed to pay off the trip in a reasonable time.

Very small businesses can display mixed characteristics, compared with larger businesses and individuals. Like larger businesses, a very small business might always carry ongoing, tax deductible debt as part of its financing structure. However, if the business is operating at its borrowing limit, a shortfall amount is unlikely to displace other borrowing. Rather, there is a significant possibility that the shortfall would have been ploughed back into the business — possibly providing a return lower than the GIC rate.
In other cases, apparently spare funds arising from a shortfall might be withdrawn by the proprietor for consumption spending.

**Cameo 7: Struggling start-up business**

Phil accepted a redundancy package so he could develop and commercialise a software product he had created, but failed to achieve significant sales. He was on the point of returning to salaried employment when the business received a sizeable tax refund, which he went on to use for both business and personal living expenses. Subsequently, the business received a revised assessment for $10,000 plus $640 for six months’ GIC.

### 5.3 Policy goals for the GIC in shortfall cases

The operation of the GIC is indifferent between the taxpayer who assesses correctly and leaves $100 of the assessment unpaid, and the taxpayer who under assessed by $100, but pays the full amount of the original assessment.

This section discusses the appropriateness of this ‘one size fits all’ approach. A key consideration is the extent to which the functions served by the GIC in the normal tax debt case are applicable to the shortfall case. Other important policy issues are tax deductibility and administrative simplicity.

Three conceivable benchmarks for evaluating the GIC in relation to shortfalls are that it should:

- ensure that non-compliant taxpayers do not receive an advantage — in the form of a free loan — over those who meet their tax liabilities by the due date
- provide a positive incentive for taxpayers to take steps to ensure they assess correctly
- compensate Government for the cost of delayed tax payments.

#### 5.3.1 Neutralising the loan advantage

As mentioned in the first dot point above, the GIC serves to ensure that non-compliant taxpayers do not receive an advantage — in the form of a free loan — over those who meet their tax liabilities by the due date. This function of the GIC is relevant both to shortfalls and late payments of assessed tax.
As demonstrated in the cameos presented above, the loan benefit from a shortfall can vary from nil to greater than the GIC. Accordingly, the ‘shortfall interest rate’ required to neutralise any loan benefit from a shortfall could range from zero to the full GIC rate.

5.3.2 Incentive to assess correctly

The uplift factor in the GIC is intended to encourage taxpayers to pay their tax liabilities on time. However, in the inadvertent shortfall case, which is central to the self assessment context, there will be no apparent tax debt until an assessment is amended. This contrasts with the late payment case, where the tax liability will have been crystallised in an assessment, the taxpayer will know that a debt is payable, and can choose the best way to minimise interest charges.

Consequently, in the shortfall context, the ‘incentive to pay on time’ function of the GIC primarily translates to an incentive to assess correctly. That is, the threat of the GIC (being at a high commercial rate) should encourage taxpayers to take steps to ensure they assess correctly and avoid ‘aggressive’ interpretations of the law.

However, the GIC attaching to a shortfall will also depend on the length of time before the shortfall is detected, rather than simply reflecting the shortfall amount or the error that caused it.

5.3.3 Compensating the government for delayed payment

The other function served by the GIC is to compensate government for the impact of late payments. Delays in tax receipts due to late payment or under assessment of tax mean that government borrowing and interest costs are higher than otherwise need be.

The 7% uplift factor means that the GIC would generally more than compensate government for its interest costs, which are in the region of the base rate, allowing some contribution to cover collection costs and default risk. In cases of remission, the Tax Office is often unwilling to go below the base rate, for the reason that this would entail a cost to government.

Given the possibility for inadvertent errors in the tax system, it could be argued that government should sometimes accept delay in revenue collection without full compensation.

8. The full GIC rate should be taken to provide a ceiling for any shortfall interest rate, as this is the most that a taxpayer would be charged for knowingly not paying an assessed tax amount.
Other arguments for a more generous approach include:

- Due to its responsibility for providing information on tax law interpretation, the Tax Office has some influence over the likelihood of taxpayer errors.

- The cost to government from shortfalls will often depend on how long the Tax Office takes to identify and correct those shortfalls.

- Taxpayers can feel that they face a 'lottery' over the timing for the amendment of their shortfall. Where an audit program progressively amends assessments, the total revenue delay cost from those amendments might not depend significantly on the order in which the assessments are reviewed, but the cost to a particular taxpayer could. For those taxpayers who do not receive a loan benefit, being reviewed later rather than earlier is disadvantageous.

### 5.3.4 The impact on the GIC of tax deductibility

The GIC is currently tax deductible, as are the cost of income producing loans and certain other costs related to tax obligations, such as tax agent fees. Therefore, where shortfall GIC is to be remitted, it might be appropriate to have regard to the ultimate after tax impact of the GIC on particular taxpayers.

### 5.3.5 Administrative workability

The preceding sections have explored various impacts that the shortfall element of the GIC might have on taxpayers in a range of circumstances. However, administrative workability must form a key consideration. As noted above, the GIC was a response to pressures for a simple, more transparent regime that applies across all taxes.

An alternative system will not be viewed as fair if, by being tailored to an individual's confidential circumstances, the reasons for differences in the treatment of various taxpayers are not transparent.

### 5.4 Possible alternative approaches

The approaches below seek to address the concern expressed in preliminary consultations that the rate of the GIC is generally too high for shortfall cases, especially where several years elapse between the original assessment and amendment.
Review of Self Assessment

There are two possible mechanisms for implementing the approaches. One would be to alter the formal legal benchmarks for imposing interest charges on shortfalls. Another would be to give effect to those benchmarks by altering the Tax Office's remission powers. For convenience, the latter route is used below in presenting the approaches.

Unless otherwise indicated, all current features of the GIC would remain the same, including tax deductibility.

If any of the following approaches were adopted, it may be necessary to reconsider the appropriateness of the culpability penalty rates (set out in Chapter 4).

5.4.1 Approach A: Remit the GIC down to a cap

Under this approach any shortfall GIC in excess of a cap (say, 25% of the shortfall) would be remitted. Once an amended assessment has been issued, the GIC will apply at the normal (statutory) rate from that date on any amount unpaid.

The principle underlying this approach would be that a shortfall should not be treated more harshly simply because it took longer to be identified, after a reasonable time for identification has elapsed. The cap would address arguments that the Tax Office has an incentive to delay amending assessments.

With a cap, the period over which shortfall GIC would effectively accrue would vary with movements in interest rates. This is consistent with an objective that the GIC should not become disproportionately high compared with the amount of the shortfall. Table 5.2 shows the time it would take the GIC to reach a 25% cap for GIC rates from 10% to 15%. At recent GIC rates, a 25% cap would be consistent with the Tax Office identifying and acting on any shortfalls in about two years.

Table 5.2: Time for the GIC to reach a 25% cap

<table>
<thead>
<tr>
<th>GIC rate (%)</th>
<th>Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.0</td>
<td>27</td>
</tr>
<tr>
<td>12.5</td>
<td>21</td>
</tr>
<tr>
<td>15.0</td>
<td>18</td>
</tr>
</tbody>
</table>

No taxpayer would pay more GIC than under the present arrangements.

As discussed earlier, many (but not all) taxpayers would derive some loan benefit from a shortfall in their assessment, prior to the additional tax being paid. Where assessments are amended beyond the point at which a cap came into effect, those loan benefits would tend to erode or even surpass the impact of the (capped) GIC. To preserve the
incentive effect, an alternative way to implement this approach might be to only partly remit shortfall GIC beyond the cap. That is, full GIC would apply until the cap were reached, after which the GIC would be remitted to a lower rate.

### 5.4.2 Approach B: Remit the GIC beyond a set period

Under this approach, once a set period (say, two years) had passed from the date of the original assessment, any further shortfall GIC would be remitted. Once the amended assessment had been issued, the GIC would then apply from that date on any amount still unpaid.

This approach would also protect taxpayers from the GIC impact of long review periods. However, it would not cap the size of the GIC in proportion to the shortfall as consistently as Approach A. The extent to which the GIC on a given shortfall could accrue in the two year period would depend on the interest rate. Table 5.3 shows the GIC after two years as a proportion of shortfall for GIC rates from 10% to 15%.

<table>
<thead>
<tr>
<th>GIC rate (%)</th>
<th>Percentage of shortfall</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.0</td>
<td>22.1</td>
</tr>
<tr>
<td>12.5</td>
<td>28.4</td>
</tr>
<tr>
<td>15.0</td>
<td>35.0</td>
</tr>
</tbody>
</table>

Adopting this approach would principally reflect a concern with the impact of long review periods, rather than with the direct proportionality of GIC to the size of the shortfall. As with Approach A, an alternative way to implement this proposal would be to only partly remit GIC after the set period, to preserve the impact of the GIC accumulated up to that point.

A more direct means of protecting taxpayers from the GIC impact of long review periods would be to reduce the actual review periods. The potential for reducing review periods is discussed in Chapter 3.

### 5.4.3 Approach C: Remit uplift factor

Under this approach, the uplift factor for shortfall interest would be remitted to some lower standard. As with other approaches, once the amended assessment had been issued, the GIC would apply from that date on any amount unpaid.
As an alternative, remission of all or part of the uplift factor could be confined to GIC charges after a cap or time limit is reached, along the lines discussed in Approaches A and B above.

5.4.4 Tax Office initiated remission

At present, the Tax Office generally only remits following an application by the taxpayer. The act of applying for remission arguably imposes unnecessary compliance costs, especially where there are clear grounds for the power to be exercised in a taxpayer’s favour.

In initial consultations, practitioners have suggested that the present system would be improved if the Tax Office initiated remission of the GIC more frequently. In some instances, this remission could happen as a matter of course. For example, if the ‘capping’ concepts discussed above were adopted, remission to give effect to them would be applied without the need for individual application.

The rationale for this approach would be to streamline the administration of remission and interest compliance costs in an environment where remission became more common. It may also reduce the need for taxpayers to involve tax agents in the process.

5.4.5 Standardisation of tax deductibility

An idea that has been raised to eliminate the current diversity in after tax shortfall GIC outcomes would be to replace tax deductibility with an offset. The offset would apply to the GIC in general, and be set for individuals at around the top tax rate, and for companies at the rate of 30%.

Alternatively, tax deductibility could be abolished entirely on all GIC, with a commensurate reduction in the uplift factor.
5.5 Questions for consultation

5.A Should the GIC be set at a level to provide a positive incentive to encourage taxpayers to take steps to ensure they assess correctly? Or should this be dealt with exclusively under the penalty regime?

5.B Is the rate of the GIC excessive against this principle?

5.C Are the approaches identified in this Chapter suitable to address identified concerns with the GIC? If so, by what mechanism should the approaches be implemented? Are there cases where full GIC should continue to apply to shortfalls?

5.D What priority should be given to simplicity in considering any changes to the current GIC regime? Should different market segments be treated differently for GIC purposes? Is it feasible to move away from a single, comprehensive system?

5.E Should remission of the GIC be initiated by the Tax Office in more circumstances? If so, what criteria should be used?

5.F Should the benefit from tax deductibility of the GIC be standardised, to eliminate the impact of varying tax rates? If so, how should this be achieved?
CHAPTER 6: OTHER ISSUES

Chapters 2-5 have each examined topics that have potentially substantial impacts on taxpayer certainty and/or compliance costs. This Chapter collects some issues identified in discussions with the Review team and from recent publications that do not fall clearly within the main themes of those Chapters. While these issues have not been subject to extensive consideration and some may not affect many taxpayers, the team invites comments by interested parties on these issues.

6.1 Earlier examination of returns

Under self assessment, taxpayers are responsible for correctly assessing their own assessable income, deductions and tax offsets. Under the former system certain issues were finalised with the notice of assessment.

One way to give taxpayers earlier finality would be for the Tax Office to undertake more pre-assessment examinations of returns. Early examination of returns could apply to taxpayers who:

- have straightforward affairs
- have a one-off complex transaction and who place a high premium on certainty
- are covered by complex or new legislative provisions
- are involved in arrangements where there is significant revenue risk
- may be difficult to contact for audit (for example because they have moved overseas).

Pre-assessment examination could be at the request of taxpayers or at the initiative of the Tax Office. The Tax Office would only be able to re-open such assessments in limited circumstances, for example, fraud or evasion.
This approach would have costs and benefits. Taxpayers would achieve earlier closure of their tax returns and the Tax Office would receive earlier intelligence. However, more vetting would be likely to delay some assessments (and therefore refunds or tax payments). It could potentially increase Tax Office costs, as compliance checks would need to be performed in a compressed timeframe. Furthermore, the approach would be of less value if there was a shorter period of review (discussed in Chapter 3). If it applied to a large number of taxpayers, it would, in effect, be a return to the former assessment system and its attendant problems.

6.2 Taxpayer awareness of self assessment obligations

Taxpayers have considerable responsibilities under the self assessment system and are subject to sanctions if they do not meet them. These responsibilities and the self assessment framework do not appear to be well understood by sections of the taxpaying community. This lack of understanding has contributed to resentment by taxpayers who have had assessments amended by the Tax Office.

The operation of the self assessment system is often particularly problematic for taxpayers when they become subject to one of the Tax Office’s post assessment verification processes. It may transpire that the taxpayers find themselves in dispute with the Tax Office, leading to their returns being amended some years after the original assessment, with penalties and/or interest also payable. Some taxpayers (particularly individuals and very small businesses) are unaware of their responsibilities for ensuring their returns are correct and the consequences of getting it wrong.

The 1993 Joint Committee of Public Accounts recommended that ‘the Australian Tax Office develop and make publicly available appropriate information for taxpayers on their obligations under a self assessment system’. Reviews into Mass Marketed Schemes by the Ombudsman and Senate Economics Reference Committee have recommended that

3. Commonwealth of Australia Senate Economics Reference Committee 2001, Inquiry into mass marketed tax effective schemes and investor protection, A Recommended Resolution and Settlement, Second Report, Commonwealth of Australia, Canberra, Recommendation 3.36: ‘The Committee recommends that the ATO, in consultation with Taxation Institute of Australia, the Commonwealth Ombudsman and other relevant bodies, develop measures to educate taxpayers about their obligations and rights in the self assessment environment …’. 

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the Tax Office do more to ensure greater understanding by taxpayers about the self assessment system. In making his recommendations, the Ombudsman noted ‘the promoter and the overwhelming majority of complainants argue that the Commissioner had given these projects the all clear and has now changed his mind and is seeking to amend assessments retrospectively’.

For its part, the Tax Office has recognised the lack of awareness about the self assessment system by some taxpayers and is looking to adopt an approach where self assessment messages are closely aligned to key tax events. Already, additional messages have been included on the notice of assessment, in TaxPack and around the signature block of paper returns. However, it is not clear whether these measures have been sufficient to address the concerns identified.

Tax agents also play an integral role in informing taxpayers of their obligations under the system, especially since virtually all business taxpayers and around 75% of individuals use them.

Through his early consultations, the Inspector-General of Taxation identified ‘a lack of understanding among taxpayers that their “notice of assessment” is not a final account... and that the Commissioner has not given his “tacit” approval to their tax affairs but may, in fact, review their assessment years later’.4

Internal Tax Office research has also found that some small business and individual taxpayers believe that once they receive their notice of assessment that is the end of the matter and their tax affairs for that year are finalised.

Other commentators5 have noted ‘... the word “assessment” has an idea of finality and legally it cannot be conditional. Thus, the issue of a “notice of assessment” sits uncomfortably with the concept of self assessment.’ They go on to suggest that the word assessment should only be used when a taxpayer’s liability has been finalised (such as after an audit) and the current notice of assessment should be renamed to convey the message that the notice is merely a confirmation of information supplied by the taxpayer, not a final statement of liability.

6.3 Balance of power

Another issue is the perception of a power imbalance between the Tax Office and the taxpayer when it comes to formal disputation. From the point of view of many taxpayers, the Tax Office appears to be a powerful adversary with virtually unlimited resources and finances. As a result, there may be many instances where a taxpayer's case has some merit, but is not ultimately heard because of the cost and difficulty of presenting the case. This phenomenon is not simply a tax matter, but can arise whenever an individual disputes issues with government.

In other situations where such an imbalance of resources exists, mechanisms such as alternative dispute resolution (ADR) have proven successful. This non-adversarial approach could improve relations between individual and small business taxpayers and the Tax Office and remove the perception of the Tax Office aligning its resources against a single taxpayer in a court setting. Access to an inexpensive dispute resolution mechanism may also encourage taxpayers to become more aware of their rights and to query an adverse assessment. The Tax Office itself may benefit, in terms of costs, public image and ease of administration. Of course, this approach would not help clarify areas of the law.

The governance system for taxation in Australia already includes roles for an Ombudsman (to consider and investigate complaints from people who believe they have been treated unfairly or unreasonably), an Inspector-General (to review systemic issues of tax administration) and scrutiny by the ANAO. Furthermore, there are processes to streamline litigation, including the Small Taxation Claims Tribunal and the structured mediation of the Administrative Appeals Tribunal. The question arises whether there is a gap to be filled, perhaps by greater use of ADR processes or whether a new element is required in the governance structure, such as a publicly funded taxation advocate similar to that of the United States.⁶

6.4 Review of tax agents' systems by the Tax Office

Tax agents play a particularly important role in the self assessment system by advising clients and preparing income tax returns using information provided by clients. In collecting and collating this information, agents would usually carry out some checks or ask questions to ensure the information is correct and consistent. Accordingly, the Tax Office places heavy emphasis on assisting tax agents and advisers as part of their overall compliance strategy.

⁶. See explanation of the US system in Appendix 4.
Chapter 6: Other issues

The Tax Office has undertaken recent initiatives to improve services to tax agents, for example, through the establishment of the tax agent portal. Nevertheless, tax agents have expressed concerns in submissions to the Inspector-General of Taxation about reviews by the Tax Office of the agents’ systems to verify information provided by clients. These reviews, which are not audits, are time consuming for agents and they assert that their cost is difficult to recoup from clients. Two flow-on issues are that such compliance work is supposedly discouraging new entrants to the profession and displacing time an agent could be spending on providing other services to clients, such as advice about cash flow or general business operation/structure.

As the Tax Office relies on the information provided in tax returns, it is appropriate that it attempts to gauge how much quality assurance of the information the agent has undertaken. While this kind of review is less intrusive than an audit, and will ultimately reduce costs by minimising the need for some audits, nonetheless it imposes up-front compliance costs.

Some options for reducing these initial costs include streamlining the review process, or establishing guidelines on the type of verification activity the Tax Office expects.

6.5 Obligations to provide information

The Tax Office needs to collect certain information to identify revenue risks. Taxpayers primarily provide this information in tax returns. Third parties, including employers, financial institutions, companies and Government agencies such as Centrelink and Veterans’ Affairs, also provide it directly. Practitioners have raised concerns that the Tax Office does not need or use some information provided.

A related issue is the extent to which the Tax Office gives advance notice of the types of information it will potentially require from taxpayers and their advisers. Taxpayer representatives have noted that it is sometimes time consuming or difficult for taxpayers, especially large business, to extract additional information since their systems are designed to produce accounting, rather than taxation, information. They suggest that the Tax Office should flag its information requirements earlier, making it possible to design systems where information is easier to extract.

The Tax Office often publicly states before the end of the financial year the areas of tax returns that it will pay particular attention to, such as work related or rental income expenses. This puts taxpayers on notice that additional information may be required after lodgement. In addition, the Tax Office sometimes writes to individual taxpayers prior to lodgement noting the areas to which it is paying particular attention.
Providing more guidance to taxpayers on areas of interest to the Tax Office and advance notice of the exact information required post lodgement may assist them in gathering information more efficiently. However, the Tax Office needs to be able to respond to issues which emerge from lodged income tax returns.

### 6.6 Obligations to keep records

In addition to providing certain information in a tax return, businesses must maintain proper records and explanations of their business transactions. Individuals are also required to keep records relevant to their tax affairs.

Good records will assist in the accurate and timely completion of a tax return and may lead to better business management.

From a Tax Office audit perspective, good records are needed to determine the appropriate tax position more easily. However, it is also important to allow businesses the scope to keep records in a way that suits their needs. Submissions to the Inspector-General of Taxation have raised concerns that the current record keeping requirements are onerous.

Some of the possible approaches discussed in Chapter 3 regarding the period of time allowed for Tax Office examination of returns would, if adopted, allow for commensurate reductions in the period of time that records would need to be kept.

### 6.7 Lodgement deadlines

Individuals who prepare their own tax returns are generally required to be lodged by 31 October following the year of income. However, agents can lodge returns throughout the year under the Tax Office lodgement program. This program attempts to take into account a tax agent’s overall workloads and their lodgement obligations across different taxes, while facilitating the collection of revenue within the financial year.

While the lodgement program assists tax agents, some say they are overworked in meeting lodgement deadlines and that extensions are not sufficiently readily available. In addition, some agents have raised concerns regarding the application of late lodgement penalties, for example, claiming the Tax Office does not sufficiently consider good lodgement histories.
Any significant changes to the lodgement program or penalties would need to consider the impact on the timing of revenue collection (and associated interest costs) and taxpayer compliance.

### 6.8 Discretions and elections

Most provisions of the law dealing with a taxpayer's liability are self operating, in that they require no decision of the Tax Office to have legal effect. However, the law also includes many provisions that give the Tax Office a power to make a decision (discretions), or allow the taxpayer to make a choice (elections) affecting their liability.

#### 6.8.1 Discretions

Practitioner and industry groups have expressed concern that self assessment cannot work properly where the calculation of a taxpayer's liability depends on a decision or determination by the Tax Office. The reason that discretions are problematic is that taxpayers cannot exercise the powers themselves and, under self assessment, the Tax Office will not normally consider the issue at the assessment stage.

One factor that reduces this impact is that the Tax Office makes public rulings about how it will exercise a discretion and taxpayers can request private rulings on their particular circumstances.\(^7\)

The 1991 paper 'Improvements to self assessment – priority tasks'\(^8\) said that discretions can be grouped under the following three broad categories:

- administrative discretions — which allow the Tax Office to carry out its administrative duties (for example, to issue forms, grant extensions of time, approve schemes and organizations)
- anti-avoidance discretions — which give the Tax Office the power to ensure that the revenue is protected

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discretions used in calculating elements of taxable income — which authorise the Tax Office to make decisions that affect the calculation of taxable income (for example, to determine a reasonable amount).

The paper said that, where possible, discretions in the third category would be removed, but the other two categories would be retained. The paper explained that administrative discretions do not contribute to uncertainty and anti-avoidance discretions are needed to make sure the Tax Office has the power to protect the revenue.

The Tax Law Improvement Project of the mid 1990s, rewrote parts of the *Income Tax Assessment Act 1936*, replacing discretions used in calculating elements of taxable income with objective tests. For example, where the old law required the Tax Office to be satisfied that something had happened, the new law simply required the thing to have happened. In 1998, the Government subsumed that project into the implementation of the Government’s tax reform measures. Legislation implementing recent measures (such as the consolidation reform) has generally avoided discretions in calculating elements of taxable income.

Despite these actions, the law still includes some discretions in calculating taxable income. The replacement of all these, some of which are rarely used, would require substantial legislative resources. An alternative would be to identify discretions that are causing the greatest practical difficulties and address those.

### 6.8.2 Elections

Before the introduction of self assessment, taxpayers were required to make various elections and lodge written notifications with the Tax Office with their returns. However, under self assessment, the Tax Office normally did not look at elections at the time of assessment. Consequently, there was no practical point in taxpayers lodging most elections with the Tax Office and they are now held by taxpayers. In 1992, the law relating to elections was amended to reflect this position.

To make most elections now, the taxpayer simply decides which provision of the income tax law is to apply in calculating a component of taxable income and keeps a record that verifies the calculation. Whether the taxpayer has made the election is evident from the taxpayer’s records and in the calculation of taxable income as disclosed in the tax return.

Taxpayers are still required to make elections by a particular date, usually on or before the due date of lodgement of a return. The Tax Office can extend the date for lodgement of the return and the time for making some elections.

Occasionally there is controversy about aspects of a particular election, such as the implications of making it, the time allowed for it, and whether the Tax Office has a
power to extend that time. For example, tax practitioners have argued for changes to the rules about family trust elections.

A small number of elections, because of their nature, must be in writing and/or lodged with the Tax Office. For example, a primary producer who elects to opt out of the averaging system must advise the Tax Office in writing so that the Tax Office, in issuing an assessment, can calculate the taxpayer's liability correctly. If an election affects the tax treatment of two or more taxpayers, usually those taxpayers must make the election jointly in writing. This prevents difficulties that might arise if taxpayers making joint elections claim to have made different elections.
6.9 Questions for consultation

6.A Should the Tax Office undertake earlier examination of any categories of return (or specific items)? If so, what taxpayers or specific items and why?

6.B What further steps would promote taxpayer awareness of their obligations under self assessment? Could, for example, notices of assessment be better labelled?

6.C In what circumstances is there a need for a Public Tax Advocate or greater use of alternative dispute resolution?

6.D What is the impact of the Tax Office reviewing tax agent systems? Could these reviews be improved, and if so, how?

6.E What particular information could the Tax Office collect more efficiently? What is the optimal balance between the Tax Office giving early warning of information requirements and the need to be able to respond to issues emerging from tax returns?

6.F What particular record keeping requirements are regarded as onerous?

6.G What specific income tax lodgement deadlines are difficult to meet? Are there other circumstances in which penalties should be remitted for late lodgement?

6.H What are the most important discretions as to liability that should be removed/re-written?

6.I Are there any general problems that are affecting the operation of elections under the self assessment system?
APPENDIX 1: PRESS RELEASE

No. 098

EMBARGO 24 November 2003

REVIEW OF ASPECTS OF INCOME TAX SELF-ASSESSMENT

Today I am announcing the Government’s decision to review aspects of the income tax self-assessment system.

The review of the self-assessment system will examine whether the right balance has been struck between protecting the rights of individual taxpayers and protecting the revenue for the benefit of the whole Australian community.

The review will seek to identify whether there are refinements to the present arrangements that would reduce the level of uncertainty for taxpayers, reduce compliance costs and enhance the timeliness of ATO audits and amendments, while preserving the capacity of the ATO to collect legitimate income tax liabilities. The review will consider the self-assessment of income tax returns, especially:

- protection for taxpayers from unreasonable delays in enforcing the tax law;
- the statutory timeframes for amending assessments;
- the length of tax audits;
- aspects of the operation of the general interest charge;
- the level of reliance taxpayers can and should be able to place on taxation rulings and other forms of ATO advice; and
- the circumstances in which the ATO should undertake earlier examination of tax returns.
Review of Self Assessment

The review, to be conducted by the Department of the Treasury, will involve extensive public consultation with stakeholders and interested parties. An initial round of consultation will aid the Treasury in developing a discussion paper, which will contain a range of issues and options for public comment early next year. Following this broad consultation, Treasury will report to Government in mid-2004, including an assessment of the benefits of any proposed improvements against their implications for tax administration and revenue.

CANBERRA
24 November 2003
APPENDIX 2: SUMMARY OF KEY QUESTIONS

CHAPTER 2: RULINGS AND OTHER TAX OFFICE ADVICE

2.A Is Tax Office advice sufficiently accessible?

2.B Should Tax Office advice indicate whether Part IVA applies to a particular arrangement as a matter of course, or only on request?

2.C Do taxpayers and their advisers currently encounter delays in obtaining Tax Office advice? If so, what strategies might allow the Tax Office to provide advice on a more timely basis?

2.D Are there significant problems with the accuracy of Tax Office advice? If so, how should they be addressed?

2.E Is there evidence of pro-revenue bias in Tax Office advice? What measures would improve confidence in the objectivity of Tax Office advice? Would an independent evaluation assist?

2.F How should Tax Office advice be framed to assist taxpayers — by explaining contending views of the law, or by setting out how the Tax Office intends to apply it? Does this impact on the way that advice is expressed?

2.G How might the Tax Office clarify the circumstances in which general advice can be relied upon?

2.H Is there value in making more Tax Office advice legally binding? What additional safeguards would be required?

2.I Should taxpayers be penalised merely for not following PBRs when self assessing their income tax liabilities?

2.J If no penalty applied, would direct appeals against PBRs still be required?

2.K If appeals are retained, how could the process be improved?

2.L Should the Tax Office be permitted to charge for certain advice?

2.M How could the Tax Office use more cost effective channels for the delivery of binding advice to taxpayers or through practitioners?
CHAPTER 3: REVIEW AND AMENDMENT OF ASSESSMENTS

3.A Should the period for an amendment increasing the liability of an individual not in business, and/or a very small business be reduced to, say, two years?
   - Should the eligibility of a very small business be based on whether it has chosen to be a Simplified Tax System taxpayer?
   - What exclusions from a two year period would be appropriate?

3.B Should the amendment period for medium and large businesses and other complex cases remain as four years?

3.C Should the amendment period for arrangements conferring unintended tax benefits (including arrangements covered by Part IVA) be reduced from six years to, say, four years? Should taxpayers be required to disclose certain tax planning arrangements more fully in returns?

3.D Is there benefit in the idea of the Tax Office providing early notice to those taxpayers that it has decided to audit?
   - What would be a suitable notification period?
   - What exclusions from the notification regime would be appropriate?
   - Would this idea still be beneficial if taxpayers had to disclose more information?

3.E Should pre-assessment agreements be extended to a wider range of cases?

3.F Should a taxpayer who lodges a nil liability return be subject to the same time limits as apply in amending an assessment?

3.G What amendment periods should apply to cases that currently have an unlimited period?

3.H Should taxpayers have a remedy where the Tax Office delays unreasonably in issuing an amended assessment after it has all the relevant information?

3.I Should the period for an amendment reducing a taxpayer’s liability be the same as for increasing liability, or be set at a fixed period?

3.J Would it be better to implement some of the possible changes raised in this Chapter (for example, early notification of compliance activity) by changing administrative procedures, rather than by changes to the law?
CHAPTER 4: PENALTIES

4.A What (if any) clarification of the terms 'reasonable care' and 'reasonably arguable position' is needed?

4.B What is the effect of the penalty for failing to follow a Tax Office private ruling? Do taxpayers only request PBRs when they are confident of a favourable ruling?

4.C If the penalty for failing to follow a Tax Office private ruling were to be removed, what other changes would be appropriate?

4.D What further guidance on grounds for remission of penalties is required?

CHAPTER 5: THE GENERAL INTEREST CHARGE

5.A Should the GIC be set at a level to provide a positive incentive to encourage taxpayers to take steps to ensure they assess correctly? Or should this be dealt with exclusively under the penalty regime?

5.B Is the rate of the GIC excessive against this principle?

5.C Are the approaches identified in this Chapter suitable to address identified concerns with the GIC? If so, by what mechanism should the approaches be implemented? Are there cases where full GIC should continue to apply to shortfalls?

5.D What priority should be given to simplicity in considering any changes to the current GIC regime? Should different market segments be treated differently for GIC purposes? Is it feasible to move away from a single, comprehensive system?

5.E Should remission of the GIC be initiated by the Tax Office in more circumstances? If so, what criteria should be used?

5.F Should the benefit from tax deductibility of the GIC be standardised, to eliminate the impact of varying tax rates? If so, how should this be achieved?
CHAPTER 6: OTHER ISSUES

6.A Should the Tax Office undertake earlier examination of any categories of return (or specific items)? If so, what taxpayers or specific items and why?

6.B What further steps would promote taxpayer awareness of their obligations under self assessment? Could, for example, notices of assessment be better labelled?

6.C In what circumstances is there a need for a Public Tax Advocate or greater use of alternative dispute resolution?

6.D What is the impact of the Tax Office reviewing tax agent systems? Could these reviews be improved, and if so, how?

6.E What particular information could the Tax Office collect more efficiently? What is the optimal balance between the Tax Office giving early warning of information requirements and the need to be able to respond to issues emerging from tax returns?

6.F What particular record keeping requirements are regarded as onerous?

6.G What specific income tax lodgement deadlines are difficult to meet? Are there other circumstances in which penalties should be remitted for late lodgement?

6.H What are the most important discretions as to liability that should be removed/re-written?

6.I Are there any general problems that are affecting the operation of elections under the self assessment system?
APPENDIX 3: UNCERTAINTY AND TAX LAW DESIGN – THE WIDER CONTEXT

It has been argued that the current scope of tax policy, the length and complexity of the tax laws and the inherent uncertainties of the self assessment system combine to prevent some taxpayers from determining their tax liability with sufficient certainty at reasonable cost. This Appendix discusses how these elements impact on taxpayers’ self assessment obligations and identifies some steps that have already been taken to improve law design.

Tax policy

Tax policy has a major impact on the structure of the tax law, its administration and costs for taxpayers. As noted in Chapter 1, tax policy balances potentially conflicting objectives including revenue collection, economic efficiency, equity and other social goals, while attempting to minimise administration and compliance costs.

In general, a smaller set of tax policies with broad application will involve fewer concepts, less law and be easier to comply with than a larger set of policies, each with narrower application. However, the latter approach allows distinctions between taxpayers and/or activities to be recognised through different tax treatments, which may be important for equity or other reasons. For example, providing a tax concession for research and development requires taxpayers to determine if their transactions are eligible for the concession (and thus incur compliance costs), but the promotion of research and development can generate higher economic growth, far outweighing the increased compliance costs.

Both individual and business taxpayers will generally have higher compliance costs the more complex areas of the law they need to consider in managing their tax affairs. Individuals, unlike businesses, may not need to keep many financial records, except for tax purposes. Policies that have the effect of requiring taxpayers to create and keep records they otherwise would not need to (particularly where those records cannot be easily obtained after the event) can impose significant compliance costs. One example often cited of this kind is donations to tax deductible entities. Again, while these policy decisions may involve some compliance cost, they may also provide significant equity and other benefits.

Policy is rarely more complex than it needs to be to achieve its objectives — the difficult question is the degree to which exceptions should be accommodated and measures should be targeted. As a practical matter, simplifying policy to reduce the costs of
self assessment would often mean either the removal of established concessions, or altering their limitations (such as means tests).

**Tax law design**

Tax law design is the process of turning tax policy into legislation that can be passed by the Parliament, administered by the Tax Office and complied with by taxpayers. A key design choice relevant to self assessment is the amount of detail set out in the law.

Over the last 20 years or so, the tax legislation has set out in increasing detail how the law will apply in a variety of fact situations. This is often seen as desirable because taxpayers naturally want a high level of certainty as to whether and how the law will apply in their particular circumstances. While this approach does provide certainty where a taxpayer's circumstances are specifically addressed by a rule, laws designed in this way can never anticipate all the relevant circumstances for every taxpayer.

As factual circumstances vary greatly, covering a wide range of circumstances in detail is likely to result in law that is long and complicated. Complex circumstances are not easily clarified through elaboration in the law, at least without generating legislation of inordinate length. Indeed, by introducing more boundaries between the legal concepts, potentially there is increased scope for ambiguity and uncertainty. Long and detailed law can also make it harder to find the underlying policy intent and thus increase the risk that the courts will interpret the legislation in a way unintended by Parliament. When law is cast in a very specific way, new circumstances can generate loopholes or inequities, requiring further specific legislation and so on.

For these reasons, there has been increasing recognition in Australia and overseas of the benefits of using high level principles, rather than black-letter approaches, to draft the tax law. These principles synthesise the detail that would otherwise be set out in black-letter rules, to achieve the substantive effect of the measure.

Where necessary, additional detail can be provided in the law or in subordinate legislation. Elaboration of the practical effects can occur through rulings.

Another significant advantage in using high level principles is that the volume of the law is likely to be reduced as additional detail is used only where the high level principles by themselves are insufficient. Law based on principles is less likely to need to be altered in

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the face of market innovations (for example, the development of new financial products) or to repair structural or technical defects. These effects may reduce the amount of time Parliament needs to devote to tax legislation.

With the transfer of responsibility for legislation from the Tax Office to Treasury in mid 2002, the Government signalled its determination to address issues with tax legislation.

In Press Release No 22 of 2002, the Treasurer noted:

‘The transfer will bring the accountability for tax policy and legislative design more directly under Ministerial control. The change in responsibility will also reinforce the need for whole-of-Government perspectives to be taken into account in tax law design processes.

The new arrangements will see policy and legislative development brought together within the Department of the Treasury, providing maximum opportunity for legislation to be developed in a manner consistent with the policy intent set by Government. Working arrangements between the ATO and the Treasury will ensure that the administrative, compliance and interpretive experience of the ATO fully contributes to policy and legislation processes.’

The principle-based approach will be adopted for new tax law measures, except where it would require extensive rewriting of existing law.

Alignment of tax, law design and administration

It is important for tax law and administration to work together to meet the needs of taxpayers and ensure that Government policy objectives are met. The Ralph Review spoke of the need to integrate the development of policy, legislation and systems of administration in developing new policy initiatives.

Treasury is responsible for advising Government on the design of tax policy and tax law, while the Tax Office is responsible for tax administration. In practice, Treasury works closely with the Tax Office designing tax laws to ensure that the administrative, compliance and interpretative experience of the Tax Office contributes to the tax design process.
Consultation

Consultation is a cornerstone of the Government’s approach. During the development of tax measures the Government works from an in-principle position of:

- consulting on substantive tax legislation initiatives, and announcing the consultation process to be used
- seeking input from external stakeholders in the development of policy and legislation
- road testing draft legislation and related products
- ensuring policy intent for each new measure is described by public announcement
- releasing an indicative forward program of tax legislation
- providing feedback to external participants in consultation processes.

Treasury consults as a matter of course with a wide range of taxpayers and their representatives, on tax law design to ensure all their different perspectives are brought to bear in advising Government. Treasury provides the Board of Taxation with regular updates on the progress of its consultation processes.
APPENDIX 4: INTERNATIONAL COMPARISONS

The Review has examined the income tax assessment systems in Canada, New Zealand (NZ), the United Kingdom (UK) and the United States (US). This Appendix provides an overview of the key features of each system and the Australian system.

The Canadian system of income tax assessment

Canada’s income tax self assessment system commenced in 1917. All Canadian taxpayers must complete an annual tax return and calculate their income tax liability. The income year for individual taxpayers is 1 January to 31 December, with returns due by 30 April the following year. Returns must be sent to the Canada Revenue Agency (CRA) along with payment for any outstanding income tax liabilities. If too much tax has been withheld from a taxpayer during the income year, the CRA will refund the excess amount within two to six weeks. Taxpayers can lodge returns over the internet, through a tax agent, by telephone or by ordinary mail. To receive social security benefits, individuals may need to lodge a return even if they have no taxable income.

In addition to administering the Canadian federal income tax, the CRA collects income tax for Canada’s provinces. As a consequence, individuals and most corporate taxpayers only need to complete a single annual income tax return (although Alberta, Ontario and Quebec levy their own corporate income taxes).

Rulings and other advice

Interpretation bulletins and information circulars (such as newsletters and technical publications) are available electronically and provide taxpayers with a reasonable expectation of how the CRA will treat a transaction. Technical interpretations of specific provisions and written opinions on completed transactions are also provided to taxpayers on request. The CRA provides a wide range of advice to Canadian taxpayers by phone, internet and in fact sheets and other publications. However, none of this advice is binding on the CRA.

Individual taxpayers may apply for an advance income tax ruling on a proposed transaction. These rulings are provided on a user pays basis at a rate of CAN$100 (plus GST) for each of the first ten hours (or part thereof) and CAN$155 (plus GST) for each subsequent hour (or part thereof). These advance rulings are generally administratively binding on the CRA. In common with Australian PBRs, they are only valid for the taxpayer to whom they are issued.
Advance income tax rulings are made publicly available on the CRA website (once they have been edited to remove information that may identify the relevant taxpayer).

**Period of review**

The CRA provides each Canadian taxpayer with a Notice of Review. This is an assessment of each taxpayer’s income tax liability, based on the information supplied in their return.

The CRA may review the information supplied in a taxpayer’s return before it issues a Notice of Review. However, it more commonly undertakes post-assessment verification activities. This may involve matching third party information to identify under-reported income and over/under claimed credits and deductions.

Returns are chosen for post-assessment checking either randomly or based on risk profiling. The CRA identifies possible fraud and evasion through a variety of means, including post-lodgement audits, audits of refund claims, profiling high-risk taxpayers, informant leads and partnerships with other law enforcement agencies. The CRA devotes about 25% of its resources to enforcement — most of these resources are devoted to auditing taxpayers’ returns. Audits focus on detecting and correcting non-compliance among high wealth individuals, corporations and taxpayers with significant opportunities for avoidance.

Individual taxpayers must retain their records for six years. If filing a paper return, all receipts substantiating claims for deductions must be provided to the CRA. However, taxpayers who file electronically need only store the records themselves.

Taxpayers may amend a return as far back as 1985, as long as they can provide sufficient evidence to substantiate the change. The CRA has three years after it issues a Notice of Review to amend the assessments of individual and certain small company taxpayer. It has four years to amend the assessments of large corporations. There is no statutory time limit in cases of fraud.

**Penalties**

Penalties can be applied from the final date for lodging annual returns.

The late filing penalty is 5% of the balance owing for that year, plus 1% of the balance owing for each full month that the return is late, for a maximum of 12 months. The penalty may be higher if a similar penalty was charged on a return for any of the three previous years. Penalties increase to 10% and 2% respectively (for a period not exceeding 20 months) for repeated failures. The penalty can be avoided by filing the return on time, even if the amount owed is not paid (voluntary disclosure provisions).
Appendix 4: International comparisons

The penalty for false statements or omissions is the greater of $100 or 50% of the amount of tax avoided because of the false statement.

**Interest**

Compounding interest is charged on unpaid tax debts. The rate of interest on unpaid tax debts is set at the Canada Treasury Bill rate with an additional uplift factor of 4%. This interest is not tax deductible.

The CRA pays compound daily interest on amounts owing to taxpayers after June 15 each year. Refund interest is paid at the Canada Treasury Bill rate plus an uplift factor of 2%.

**The New Zealand system of income tax assessment**

Since the mid 1980s, New Zealand’s tax policy and administrative arrangements including assessments, rulings, dispute resolution and penalties, have changed significantly. These changes often followed extensive public consultation.

Throughout the 1980s, New Zealand reformed its tax policy by broadening its tax base with a GST and a fringe benefits tax and lowering company and individual tax rates. It also abolished deductions for work related expenses, superannuation and various business concessions, including accelerated depreciation and most individual tax rebates.

Unlike Australia, New Zealand operates a full self assessment system for income tax. Taxpayers assess their own liabilities, then claim a refund or pay the amount owing. The Inland Revenue Department (IRD) does not issue assessment notices as a matter of course, however, it does issue Personal Tax Summaries or Statements of Earnings when requested by a taxpayer.

In practice, around 75% of New Zealand wage and salary earners do not lodge income tax returns. Instead, to pay the correct amount of tax during the year they rely on the extensive tax withholding system for wages, salary, interest and dividends. In addition, taxpayers do not need to contact the IRD if they have less than NZ$200 of under or over-taxed income.

Significant numbers of other individual taxpayers must confirm the details of an IRD generated Personal Tax Summary including wage, salary and interest details; they do this instead of lodging a return. Once taxpayers confirm these details, they receive a refund or pay the amount outstanding.
Review of Self Assessment

Businesses, and individual taxpayers with income outside the withholding tax system (such as from rent), must lodge returns.

Rulings and other advice

The IRD issues non-binding information to taxpayers and tax agents through its monthly Tax Information Bulletin, a telephone service, fact/information sheets and a tax return guide (like Australia’s TaxPack).

The IRD also issues four types of legally binding rulings: public, private, product, and status. Taxpayers do not have to follow a ruling nor can they appeal or dispute a ruling, however they must disclose in their tax return if they follow a ruling.

The IRD publishes public rulings, giving its interpretation of how certain tax laws apply in a given situation.

Private rulings indicate how the law applies to a particular taxpayer and other taxpayers cannot rely on them. The IRD does not publish private rulings. Taxpayers pay application fees and preparation fees for them.

Product rulings state how the law applies to a particular transaction, rather than to a particular taxpayer. The IRD publishes product rulings in the Tax Information Bulletin and taxpayers seeking them pay fees on the same basis as for private rulings.

Status rulings clarify if changes in the law affect a private or product ruling a taxpayer has received previously.

Period of review

Taxpayers have two months to amend their own tax assessments, although the IRD is canvassing an extension to four months.

The IRD has four years (from the end of the income year in which a return is lodged) to amend taxpayer assessments. When it considers a tax return is fraudulent, wilfully misleading or omits income, the period to amend the assessment is unlimited.

The IRD also has four years to amend the assessments of taxpayers who do not lodge returns.

The IRD conducts audits of selected taxpayers. Audits can range from an examination of one particular issue to a full examination of business records. The IRD selects audit cases in a variety of ways, including analysis of business records or tax returns, matching with
other information sources, taxpayer compliance or payment histories or random selection.

**Penalties**

Penalties can apply for late lodgement of returns. These are flat dollar amounts and depend on the taxpayer's net income. Penalties also apply for late payment of tax, generally an automatic 5% initially, then 1% per month.

In some circumstances taxpayers can request the IRD to remit late lodgement and late payment penalties. For example, taxpayers must demonstrate reasonable justification, genuine oversight, a one-off situation or incorrect IRD advice. Late payment penalties do not apply when the total tax outstanding is under NZ$100.

Penalties can apply where taxpayers have a tax shortfall and depend on taxpayer culpability. Tax shortfall penalties range from 20% for lack of reasonable care or unreasonable interpretation to 40% for gross carelessness, to 100% for abusive tax positions and 150% for evasion. They may be lower if taxpayers voluntarily disclose shortfall details.

If the IRD successfully prosecutes or penalises taxpayers for an abusive tax position or evasion, it can publish taxpayer details in the New Zealand Gazette.

**Interest payments and charges**

When taxpayers have NZ$100 or more in unpaid tax, the IRD charges ‘use of money’ interest at the Reserve Bank of New Zealand business base lending rate plus 200 basis points. When taxpayers have NZ$100 or more in overpaid tax, the IRD pays taxpayers interest at the Reserve Bank of New Zealand 90 day bank bill rate less 100 basis points.

The IRD can remit interest if taxpayers substantiate that payments were late due to incorrect IRD advice and that they corrected the failure to comply as soon as practicable.

‘Use of money’ interest does not compound. It is taxable when paid by the IRD and tax deductable under New Zealand’s deductibility provisions (that is, if a taxpayer deriving income in carrying on a business, or a company, incurred the interest charge).

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1. This is the base interest rate offered to new business borrowers, weighted by each surveyed institution’s total NZ dollar borrowings.
The United Kingdom's system of income tax assessment

The United Kingdom taxes a variety of individual and corporate incomes including employment income, dividends, capital gains, benefits provided in kind, royalties and property income. The components of each variety of income, and all deductions against income, are outlined in schedules in the tax laws. These schedules effectively quarantine deductions, as they can only be offset against income in the same schedule.

For corporations, a full self assessment system has operated in the United Kingdom since 1999 and under this system, all corporations effectively have to complete tax returns.

For individuals, a partial self assessment system was introduced in 1996. Under this system, most individuals do not have to lodge tax returns as their tax liabilities are withheld at source. In practice, the Inland Revenue sends tax returns to those who must lodge a return, which are only those with complicated tax affairs, those in the top income tax bracket and the self-employed. Where individuals are not sent a tax return, they are still required to declare taxable income not subject to withholding to the Inland Revenue. Where an individual is sent a tax return, they have the option to calculate their tax liability themselves or have Inland Revenue calculate it for them.

Rulings and other advice

‘Statements of Practice’ explain the Inland Revenue’s interpretation of the revenue legislation and how it applies the law in practice. While these statements are not legally binding, the Inland Revenue considers that taxpayers who correctly apply such Statements to their circumstances binds the Inland Revenue as a matter of administrative practice.

In general, the Inland Revenue does not provide advance rulings on the tax effect of proposed transactions. The Inland Revenue does provide taxpayers with post-transaction rulings on income and capital gains taxes in certain circumstances. The Inland Revenue will usually consider itself bound by post-transaction rulings, unless information provided to obtain the ruling was incorrect or incomplete. Taxpayers seeking post-transaction rulings are not charged for them.

The Inland Revenue also produces extra-statutory concessions (ESCs), which are relaxations of the strict interpretation of the UK’s tax laws for the purposes of making administration of the tax laws easier or to provide taxpayers with relief from hardship at

2. The UK Inland Revenue has announced it will publish new criteria for who has to complete a self assessment tax return, in April 2004. Under these new criteria, the Inland Revenue has stated the number of people needing to fill in tax returns, will be reduced.
the margins of the tax law. For example, where a new tax law produces unintended consequences which could be resolved with a lengthy statutory remedy, the Inland Revenue can instead grant an ESC which produced the same administrative effect, whilst avoiding the time delays and cost associated with a statutory change. These concessions are published by the Inland Revenue and can be relied on by taxpayers to bind the Inland Revenue, provided they are not used for tax avoidance.

The Inland Revenue also issues non-legally binding information to taxpayers and tax agents through its telephone services, fact and information sheets, and tax return guides.

**Period of review**

The Inland Revenue must inform taxpayers within 12 months of the statutory filing date that it will begin auditing them. Where a tax return is lodged late, the period of review is extended.

In certain circumstances, the Inland Revenue can also open investigations into taxpayers’ returns after the normal period of review. Where taxpayers have made incomplete disclosures in their tax returns without fraudulent or negligent conduct, the Inland Revenue has five years after the statutory filing date. In cases involving fraudulent or negligent conduct, Inland Revenue has 20 years after the statutory filing date to open a review of the return.

**Penalties**

A number of late lodgement penalties apply to individuals. These penalties include an automatic late lodgement penalty of £100 where an individual fails to lodge their tax return by the due date of 31 January, a further £100 penalty if the tax return is six months late, a penalty not exceeding the tax liability owing for that year if the return is 12 months late, and daily penalties of up to £60 per day. Daily penalties may be imposed at any time after the return is due and are not subject to capping.

Debts under £2,000 are recoverable under the pay as you earn system. Otherwise, individual taxpayers usually have to repay their tax debt by 31 January each year. Individuals are liable for a late payment penalty, called a surcharge, if payment is not made on time. If any tax is still unpaid 28 days after that date, a late payment surcharge of 5% of the amount of tax outstanding is charged. Where tax remains unpaid six months after its due date, a further 5% surcharge is also chargeable.

A number of late tax return lodgement penalties can apply to corporations. These include an automatic £100 penalty if a corporation files its return up to three months late, a £1,000 penalty if a corporation lodges its tax return more than three months late.
three times in a row, and tax-related penalties of 10% and 20% of the unpaid tax, where a corporation has not filed a return within 18 months or two years after the end of its accounting period. There are no daily penalties, surcharges nor capping of automatic penalties for corporations who file late.

Both individuals and corporations who fraudulently or negligently file an incorrect return, or fail to remedy an error in the return in a reasonable time, are liable to a penalty of up to the amount of the understated tax. These taxpayers can have their returns audited up to 20 years after the lodgement date.

All penalties for individuals and corporations can be remitted or reduced at the discretion of the Inland Revenue, though it only does so in limited circumstances which include where paying the penalty would produce hardship for the taxpayer or the taxpayer relied on Inland Revenue advice. If dissatisfied with the response of the Inland Revenue, taxpayers may also appeal to an independent Tax Appeals Commissioner to have their penalty, including any late payment penalties, reviewed. Lodgement and payment penalties can also be reduced to nil by the Inland Revenue where the taxpayer has a ‘reasonable excuse’ for incurring the penalty. ‘Reasonable excuse’ includes circumstances such as being too seriously ill to complete a tax return, but does not include the inability to pay the tax due.

**Interest payments and charges**

Individuals with outstanding tax balances and unpaid surcharges are charged interest at 6.5%. The late payment interest incurred by individuals is not tax deductible.

Corporations which pay quarterly company tax instalments are charged an interest rate of 4.75% on unpaid tax balances. Other corporations are charged 6.5%. The interest rate charged on outstanding tax balances is linked to the average of bank base lending rates. Late payment interest is tax deductible.

The Inland Revenue has no specific power to remit late payment interest but can do so under its general discretionary power in limited circumstances. Usually this is where an error or delay by the Inland Revenue has led to tax being unpaid by the due date.
Appendix 4: International comparisons

The United States' system of income tax assessment

Federal income tax was imposed in the United States (US) after the 16th amendment to the US constitution in 1913. Income tax was imposed on a full self assessment basis, that is, taxpayers assess their own liability then pay the amount outstanding or receive a refund. The system is termed 'voluntary compliance'.

Many, but not all, states in the US still impose income taxes. In addition, some cities/municipalities in the US also impose income tax.

The US federal income tax is administered by the Internal Revenue Service (IRS) as a progressive tax with the rates (and a number of other features) determined by the taxpayer's 'filing status'. If a taxpayer satisfies more than one filing status, they may choose which one they will use. There are five different filing statuses:

- single
- married filing joint return
- married filing a separate return
- head of household
- qualifying widow(er) with dependent child.

Federal income taxes are collected by the IRS through a system where tax is withheld by employers. Self employed individuals and businesses must pay their taxes in regular instalments, known as estimated tax payments. At the end of the tax year, the individual must fill out certain forms (determined by their filing status, their taxable income, and all other tax affairs). The taxpayers must also calculate their tax payable, using either tax tables or a tax rate schedule.

Most US taxpayers may either claim a standard deduction or itemise their deductions. The option a taxpayer chooses will typically depend on which will result in the higher deduction. The amount of standard deduction available to a taxpayer is determined by the taxpayer's filing status, however, the option is not available to all taxpayers.

Another characteristic of the US tax system is that the taxpayer must declare any involvement in tax shelters. A series of tax laws have been implemented in the US to

3. Before this time, the constitution only allowed for the imposition of direct federal taxes if they were levied in proportion to each state's population. The constitutional amendment allowed for the federal government to impose tax on income.
limit the use of potentially abusive tax shelters. These laws require organisers of tax shelters to register the shelter, advisors to maintain a list of investors and investors to report the tax shelter registration number and disclose the tax shelter on their tax return. This disclosure is required for a reportable tax shelter transaction that is a 'listed transaction' as identified in a notice, regulation, or other published guidance by the IRS.

**Rulings and other advice**

The IRS provides taxpayers with a number of advice products to guide them in interpreting and applying the tax law. The IRS mails forms to taxpayers along with relevant advice products (similar to TaxPack). The IRS establishes which forms and publications to send based on the taxpayer's previous tax return. The taxpayer needs to contact the IRS if any other forms or publications are required.

Other mechanisms through which the IRS gives advice and guidance are regulations, rulings (including private letter rulings that are administratively binding between the individual taxpayer and the IRS), internal revenue bulletins, the Taxpayer Advocate Service and other forms of free (but not binding) advice (including telephone, fax, walk-ins, email etc).

**Periods of review**

In the US, the various periods for amending returns are as follows:

- For assessing the tax a taxpayer owes and for filing a credit or refund, generally three years from the filing date.
- Where the taxpayer did not report income of more than 25% of the income shown on the return, six years after the taxpayer filed.
- For false or fraudulent returns with an intent to evade tax, there is no limitation period.
- If no return is filed, there is no limitation period.

A related element of the US system is the burden of proof when the IRS is involved in a court proceeding. Prior to the Internal Revenue Service Restructuring and Reform Act of 1998, the burden of proof in a court proceeding was on the taxpayer. The shift of burden

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4. The Taxpayer Advocate Service is an independent organisation within the IRS that helps taxpayers resolve problems with the IRS and recommends changes that will help prevent the problems. It does this through advocating on behalf of both individual aggrieved taxpayers and taxpayers generally (regarding systematic flaws in the administration of the tax system).
to the IRS to prove an item on the taxpayer’s tax return is incorrect occurs only in a court proceeding if the following criteria are satisfied: the taxpayer must comply with all substantiation requirements of the tax law; maintain all the records required by the tax law; cooperate with the IRS’s reasonable requests for information; and, if the taxpayer is a corporation, partnership or trust, meet certain net worth qualifications.

**Penalties**

A wide variety of penalties potentially apply to the US taxpayer. Penalties may be waived if the taxpayer can show they acted reasonably and in good faith, or relied on the incorrect advice of an IRS employee.

- There are three penalties for unpaid taxes (called delinquency penalties): failure to file, failure to pay, and failure to make timely deposits of tax. These penalties vary in amount from 0.5% per month of the unpaid amount to 25% of the amount unpaid.

- Accuracy related penalties apply where a return has been filed and are imposed for negligence, a substantial understatement of income tax, a substantial valuation overstatement, a substantial overstatement of pension liabilities, a substantial estate or gift tax valuation understatement, and gross valuation mis-statements. These penalties vary in amount from 20% of the portion of any under payment to 40% of the under payment. (The penalty is increased to 75% if any under payment is attributable to fraud.)

- Other administrative penalties include information reporting penalties (the amount of which varies depending on the length of time within which the taxpayer corrects the failure), failure to file correct information returns, failure to furnish correct payee statements, and failure to comply with other information reporting requirements.

- Preparer, promoter and protestor penalties include return preparer penalties, penalties for promoting abusive tax shelters, penalties for aiding and abetting the understatement of tax liability and frivolous income tax return penalties. There is no taxpayer immunity from penalties when using an agent, therefore if an agent is penalised it will usually be in addition to the taxpayer concerned.

Criminal penalties also exist for a number of offences including fraud, evasion and wilful failure to file a return, supply information or pay tax due.
**Interest payments and charges**

Interest is levied on amounts owing to the IRS. The IRS will also pay taxpayers interest where they have overpaid their tax and the processing grace period of 45 days from the receipt of the return is exceeded. The interest rate is adjusted quarterly and compounds daily. The interest rate for each quarter is calculated on the following basis:

<table>
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<tr>
<th>Taxpayer</th>
<th>Interest: federal short-term rate plus:</th>
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<tr>
<td></td>
<td>Underpayment</td>
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<tr>
<td>Anyone other than companies</td>
<td>3%</td>
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<tr>
<td></td>
<td>Overpayment</td>
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<tr>
<td>Companies</td>
<td>3%</td>
</tr>
<tr>
<td></td>
<td>Underpayment</td>
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<td></td>
<td>2%</td>
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<td></td>
<td>Underpayment &gt; US$100,000</td>
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<td></td>
<td>5%</td>
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<td>Overpayment &gt; US$10,000</td>
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<td>0.5%</td>
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All or part of any interest charged can be forgiven if the interest is due to an unreasonable error or delay by the IRS in performing ministerial or managerial acts. In addition, the Secretary of the Treasury may abate the interest if the administration and collection costs involved do not warrant collection of the amount due.

In contrast to Australia, the interest paid by an individual is not deductible.

**The Australian system of income tax assessment**

Australia has a partial self assessment system for individual taxpayers, and a full self assessment system for other taxpayers.

Individuals in Australia must lodge a tax return to report their assessable income and claim deductions. This return also collects information relating to various social security payments and offsets and the Higher Education Contributions Scheme. Once a return is lodged, the taxpayer's liability is calculated by the Tax Office and they receive a notice of assessment along with either a refund or a tax bill. Because a broad range of tax deductions and other benefits are allowed in Australia, a significant proportion of taxpayers receive a refund.

Company taxpayers complete a tax return, but take an additional step of actually calculating their liability and, if they owe money, paying this to the Tax Office when they submit their return.

Australia has a pay as you go (PAYG) withholding system for salary and wage earners. Employers withhold tax from their employees and remit this to the Tax Office on at least
a quarterly basis. Financial institutions and companies do not generally withhold tax from interest and shares.

**Rulings and other advice**

The Tax Office provides taxpayers and practitioners with a range of advice on how to apply the income tax law, from general advice that applies to a large number of taxpayers to specific advice about how the law applies to an arrangement being contemplated or undertaken by a particular taxpayer. All rulings and other advice are provided free of charge.

There are three types of formal income tax rulings: public rulings, private binding rulings (PBRs) and oral rulings. The advice contained in these formal rulings is legally binding on the Tax Office; the Tax Office cannot apply the income tax law in a way that is less favourable than that contained in the ruling. A taxpayer covered by a formal ruling is protected even if the Tax Office subsequently changes its interpretation of the relevant provisions of the income tax law in relation to other taxpayers. PBRs are used by the Tax Office to provide specific written advice to a particular taxpayer on how the law applies to that taxpayer. They only apply to a specified arrangement for a specified income year. They are not legally binding on the Tax Office in relation to other taxpayers.

Public rulings provide general written guidance on matters relevant to a wide range of taxpayers.

Oral rulings are used to provide specific advice on a limited range of income tax matters to taxpayers with simple tax affairs.

The Tax Office also publishes interpretative decisions (known as ATOIDs) on its website to allow taxpayers and practitioners to gain insights into how the Tax Office may interpret particular provisions of the law (although this material is not legally binding on the Tax Office).

The Tax Office also publishes a wide range of non-legally binding advice. *TaxPack* is the most important source of advice for individual taxpayers. It is intended to provide these taxpayers with the information needed to complete their annual returns. The Tax Office also publishes a wide range of manuals, booklets, schedules, fact sheets, policy statements, press releases, ATOIDs, and taxpayer alerts.

**Period of review**

The standard period for the Tax Office to amend an assessment, either to increase or reduce a taxpayer's liability, is four years. For taxpayers with simple affairs the period is
two years. For individual taxpayers, the amendment period is calculated from the day on which tax became due and payable under an assessment.

There is an extended period for amendment where Part IVA (the general anti-avoidance provision) is invoked. The Tax Office has up to six years (from the date on which tax became due and payable under an assessment) to amend an assessment to cancel a tax benefit under Part IVA.

There is no time limit in cases of fraud or evasion.

Penalties
A 'tax shortfall' penalty may apply, depending on the degree of blameworthiness on the taxpayer's part, if a taxpayer has a tax shortfall resulting from any of the following:

- making a false or misleading statement
- failing to provide a document that the Tax Office needs to work out their liability
- applying an income tax law in a way that is not reasonably arguable (but only if the tax shortfall amount exceeds the greater of $10,000 or 1% of the income tax payable by the taxpayer)
- disregarding a PBR
- entering into a tax avoidance scheme or having a transfer pricing adjustment.

The term ‘false and misleading statement’ will generally cover omitting income, overclaiming deductions or claiming deductions or benefits that are not allowable.

The Commissioner can remit the whole or part of the penalty. The objection and review procedures can apply to the remission decision if the amount of the penalty not remitted exceeds two penalty units (currently $220).

Interest payments and charges
Interest at a uniform rate is applied to late payments of any type of tax — this is known as the General Interest Charge (GIC). The GIC is calculated by adding 7% to the Reserve Bank’s bank bill rate series. The interest applies whenever a tax debt is overdue, whether or not a taxpayer has acted knowingly to create a debt.

Any GIC incurred by a taxpayer is tax deductible.
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# Abbreviations

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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>AAT</td>
<td>Administrative Appeals Tribunal</td>
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<td>Alternative Dispute Resolution</td>
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<td>AGPS</td>
<td>Australian Government Publishing Service</td>
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<td>ANAO</td>
<td>Australian National Audit Office</td>
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<td>ATD</td>
<td>Australian Taxation Decision</td>
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<td>ATOID</td>
<td>Australian Taxation Office Interpretative Decision</td>
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<td>Commonwealth Law Reports</td>
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<td>Commissioner of Taxation</td>
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<td>CRA</td>
<td>Canada Revenue Authority</td>
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<td>ELS</td>
<td>Electronic Lodgement System</td>
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<td>EM</td>
<td>Explanatory Memorandum</td>
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<td>ESC</td>
<td>Extra-Statutory Concession</td>
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<td>FOI Act</td>
<td>Freedom of Information Act 1982</td>
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<td>GIC</td>
<td>General Interest Charge</td>
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<td>Goods and Services Tax</td>
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<td>Higher Education Contribution Scheme</td>
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<td>Harmonised Sales Tax</td>
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<td>Inland Revenue Department (NZ)</td>
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<td>Internal Revenue Service (US)</td>
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<td>WET</td>
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Review of Self Assessment

Legislation

*Freedom of Information Act 1982*

*Income Tax Assessment Act 1936*

*Income Tax Assessment Act 1997*

*Tax Laws Amendment (Self Assessment) Act 1992*

*Taxation Administration Act 1953*