

## SELF-ASSESSMENT LEGISLATION: THE TIP OF THE TAXATION ICEBERG



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*Unlike many other recent tax changes the self-assessment system quietly slipped into the Assessment Act without fuss or fanfare. The relevant legislation is deceptively simple. Notwithstanding its apparent simplicity and inconspicuous entry into the Act, it is considered that the self-assessment system will ultimately be adjudged as the most significant tax legislation introduced during the 1980s. This article seeks to identify the significant ramifications that will arise as a consequence of the new system. What we see is only the tip of the iceberg.*

*...most icebergs have a specific gravity of 0.9, and thus six-sevenths of the mass is below the sea surface.<sup>1</sup>*

### The need for an iceberg

On 1 July 1989 the self-assessment system celebrated its third birthday. This new assessment method was first announced by the Federal Treasurer, Mr Keating, in August 1985 during his 1985/1986 Budget Speech.

The Bill was introduced by the Acting Treasurer, Mr Hurford, on 17 April 1986 and it was explained during the Second Reading speech that the decision to introduce a system of self-assessment was taken by the government following a detailed examination by the Commissioner of Taxation (the Commissioner) of existing income tax assessing methods. During the speech he said:

Under self-assessment the Commissioner's Officers will generally not subject income tax returns to the same degree of technical scrutiny that has existed in the past before a notice of assessment is issued. Self-assessment will mean that, after assessments have been issued, there will be more audits and more checking and verifying of information in returns against data obtained from external sources. Taxpayers who, when their return is processed or later, are

\* The law is stated as at July 1989.

<sup>1</sup> The *New Encyclopaedia Britannica* vol 20, p 812.

found to have made false or misleading statements in their returns will face heavy penalties.<sup>2</sup>

The examination by the Commissioner referred to by the Acting Treasurer had apparently revealed that the majority of taxation returns were not adjusted during the assessment process and that a huge percentage of the extra tax collected as a result of assessing adjustments occurred in a relatively small percentage of the returns that were so adjusted. The Commissioner stated that the more significant findings of the working group were:

- existing assessing methods were not cost-effective for certain categories of taxpayer;
- assessing was perceived to have little deterrent effect in terms of tax avoidance and evasion for many classes of taxpayer;
- present assessing processes could not effectively respond to the increasing trend of taxpayers to claim excessive and questionable deductions;
- the majority of assessing staff got little job satisfaction under the present system;
- there was an overwhelming case on cost-effectiveness grounds to move to a system of taxpayer self-assessment.<sup>3</sup>

## The iceberg created

The decision to introduce the concept of self-assessment required very little by way of legislative amendment and accordingly the Amending Bill was unusually simple. Sub-section 169A (1) of the Income Tax Assessment Act (the Act) states:

Where a return of income of a taxpayer of a year of income is furnished to the Commissioner (whether or not by the taxpayer) the Commissioner may, for the purpose of making an assessment in relation to the taxpayer under this Act, accept, either in whole or in part, a statement in the return of the assessable income derived by the taxpayer and of any allowable deductions or rebates to which it is claimed that the taxpayer is entitled and any other statement in the return relevant to the assessment.

In addition it was necessary to amend s 170 to enable the Commissioner to amend an assessment for any reason including the correction of an error of law. The Commissioner is still not permitted to amend an assessment to correct an error of law in respect of an assessment made prior to 1 July 1986 or an assessment made in respect of a year of income ended 30 June 1985 or prior.

Finally, new provisions<sup>4</sup> were enacted providing for the payment of interest at a prescribed rate to a taxpayer by the Commissioner and vice versa where an over or under payment of tax was ultimately discovered and where the taxpayer had provided a full and true disclosure. The prescribed rate has remained at 14.026% per annum since the

<sup>2</sup> House of Representatives *Weekly Hansard* No 6 (1986) 2555.

<sup>3</sup> Commissioner of Taxation, *Annual Report 1984/85* p 27.

<sup>4</sup> Income Tax Assessment Act, s 170AA.

commencement of the system. In the case of an underpayment of tax where a full and true disclosure was not made by the taxpayer, the normal much harsher additional (penalty) tax provisions will apply instead of the interest provisions. The Acting Treasurer explained that the interest component payable by a taxpayer will compensate the revenue for the full amount of tax not having been paid by the due date. In view of the rate adopted it can be seen that the interest is not in the nature of a penalty.

Although the legislative changes were put into place with effect from 1 July 1986, presumably for practical reasons, the Commissioner decided to introduce self-assessment in two phases.

The Commissioner's *Annual Report* stated:<sup>5</sup>

Phase one commenced on 1 July 1986 with return form types B (business individuals), P (partnerships) and C (companies) being processed under self-assessment. Traditional assessing remained for S (salary and wage), A (investment and property), T (trusts) and F (superannuation fund) return form types during the 1986/87, all form types except superannuation funds are being processed under self-assessment.

Irrespective of this phasing-in process or the method of assessment of a particular return actually adopted by the Commissioner, the law regarding interest and/or the power of the Commissioner to issue amended assessments applies to all assessments that fall within the self-assessment system. It is irrelevant whether or not the Commissioner scrutinised the return prior to the assessment being issued.

## The taxpayer's lighthouse

In contrast to the recent superannuation tax changes, the self-assessment package of legislation slipped through the Parliament with barely a whisper from the professions or the media. However, the legislation did have one common aspect with the superannuation package. It was also successfully targeted by the Australian Democrats for amendment during its passage through the Senate.

In speaking to his amendment, which was accepted by the government, Senator Siddons stated:<sup>6</sup>

As we all know, tax law is extremely complex and it is very difficult for the ordinary taxpayer to be absolutely certain that his or her return, as filled in, complies with the principles of the taxation law. There could easily be all kinds of queries in the taxpayer's mind. The Australian Democrats felt that it was unfair for the Taxation Office to be completely freed of any responsibility to answer genuine questions, at least in principle, that a taxpayer may raise. That is essentially the thrust of our amendment. It requires the Taxation Office to reply to the taxpayer if that taxpayer furnishes a query with the return, indicating that he or she is uncertain about a matter of law, fact or principle. We believe that at least this will go some of the way to placing some responsibility on the Commissioner of Taxation and his office for the smooth introduction of self-assessment. The taxpayer, under this amendment, could reasonably expect to

5 Commissioner of Taxation, *Annual Report 1986/87* p 25.

6 Senate *Weekly Hansard* No 10 (1986) p 3368.

receive in due course an answer to his or her queries and would not have to wait for three years to be certain that the tax return, as filled in, was correct.

The amendment was enacted as ss 169A (2) of the Act which states:

Notwithstanding sub-section (1), where, in a document furnished with a return of income of a taxpayer of a year of income and signed by or on behalf of the taxpayer, a question is raised that is relevant to the liability of the taxpayer to tax in respect of the year of income, the Commissioner shall give attention to that question.

This amendment and the recent superannuation legislation amendments, each of which resulted from intervention by the Democrats, contain a common element. After careful analysis it will be observed that each is immaterial, and, at least in the case of self-assessment, the amendment is somewhat ineffectual. This fact was observed by Senator Messner when speaking for the Federal Opposition against the proposed amendment. He said:<sup>7</sup>

I am afraid that this amendment is totally without merit in that it has absolutely no binding powers upon the Commissioner to provide information and clearly does not in any way assist the situation. Indeed, I go as far as to say that what the Democrats are proposing is nothing more or less than what the Commissioner already does in practice.

A cynic might argue that the Government obviously made a similar observation and for this reason did not oppose the amendment. There are two inherent problems with the lighthouse. First, the taxpayer must be aware that the lighthouse exists, and secondly he must understand how it operates. If the taxpayer does raise the appropriate questions it is to be hoped the Commissioner shall give attention in a proper way to those questions.

## **90% of the iceberg is below the water**

Numerous discussions with taxpayers and tax advisers alike since 1 July 1986 have demonstrated a mammoth ignorance by such persons of the effect of the introduction of the self-assessment system. Indeed this has led to the conclusion that the Taxation Laws Amendment Act 1986 gave rise to the creation of a Taxation Iceberg complete with 90% hidden below the surface waiting for unsuspecting taxpayers to be severely holed during the Taxation Office audit process over the next three years and more.

It is to be assumed that the Commissioner has also realised, and, no doubt is concerned at, the level of taxpayer ignorance or indifference to the new assessment process.

In respect of fiscal year 1988, after three years of operation the Tax Office finally included a specific reference to the self-assessment process in its Instruction Booklet. In addition, taxation return forms for 1988 provided a box at the top of page 1 highlighting the existence of a s 169A ruling request. One wonders how many taxpayers will read the Instruction Booklet and thereby discover the existence of the lighthouse.

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<sup>7</sup> Senate *Weekly Hansard* No 10 (1986) p 3369.

Due to the substantial time lag between the date of an objection being lodged and an appeal being heard, there has been no case reported to date involving interest being assessed under s 170AA of the Act. However, *Case V10*<sup>8</sup> released by the Administrative Appeals Tribunal (AAT) on 6 January 1988 provides a good example of things to come. In that case the taxpayer, who was employed as a statistician in the Commonwealth Public Service, claimed deductions for staff gifts and lunches, costs of attending a departmental sports carnival, an airshow, a wine appreciation course and a bricklaying course. After giving his reasons for disallowing the claims, Mr RK Todd, Deputy President, said:<sup>9</sup>

This case illustrates the type of taxpayer who will be exposed to great risk under the new 'self-assessment' provisions. In the past taxpayers have been able to include imaginative if not bizarre claims in their taxation returns (see *Case U154*, 87 ATC 902 also involving the present applicant) knowing that, at worst, the claims could be expected to be rejected at the time of assessment. Pursuant to the self-assessment provisions, however, the assessments that issue will not be final, and in a number of years' time the taxpayer may be subjected to an audit following which, if the claims are disallowed, the taxpayer will be presented with penalties for late payment.

In that particular case the claims related to both years ended 30 June 1985 and 30 June 1986. Obviously, the claims and subsequent objection in relation to the first year drew attention to the claims in the second year. Had that not been the case the claims in the 1986 year (the first year under self-assessment) would almost certainly have been allowed. As a result, provided that the taxpayer could establish that the information contained in his return in relation to the claims represented a full and true disclosure of the material facts, the Commissioner would have been entitled to amend the assessment to disallow the claim within the three year period and to assess interest to the taxpayer. If such a full and true disclosure was not able to be established, the amendment period would be extended to 6 years. Furthermore, if any statement included in the taxpayer's return amounted to a false or misleading statement, the interest component would have been able to be replaced by a much harsher penalty. It is an extremely simple matter for a somewhat zealous taxpayer to provide a false or misleading claim or statement in relation to a claim in his return in an attempt to make the claim appear more palatable should the return actually be scrutinized by an assessor.

The dividing line between an 'imaginative' claim and a false or misleading statement is extremely fine, but the resulting difference between interest and penalty can be enormous. This fine line was demonstrated in another recent decision of the AAT. In that case,<sup>10</sup> a physical education teacher at a secondary school claimed, inter alia, a deduction for travel expenses of \$1989 in respect of the year ended 30 June 1986. In an assessment issued on 24 October 1986 his claim was accepted. However, on 9 December 1986 an amended assessment was issued disallowing \$1537 of the expenses claimed. This assessment also included an amount of \$320 as additional (penalty) tax. The initial assessment was probably issued under the self-assessment process (ie, without scrutiny by an

<sup>8</sup> 88 ATC 154.

<sup>9</sup> 88 ATC 156.

<sup>10</sup> *Case V147* 88 ATC 923.

assessor). Presumably the return was later subjected to some form of audit or review process, as a result of which the amended assessment was issued. Although the return was prepared by the taxpayer's accountants, it included a two page handwritten schedule which itemised various expenses said to be incurred in earning his income. Included in the schedule were travelling expenses which were headed 'for school and teaching purposes', although one particular item was described as 'Coaching of 2nd division soccer team—... league—2 nights training and 1 game/week during seasons (from Feb. to Sept.)—games and training held at (c)—claim av. return trip = 20 km/game or 60 km/week x 32 weeks—1920 kms.' This particular claim was disallowed and formed part of the taxpayer's appeal to the Tribunal. Mr Todd said:<sup>11</sup>

The information set out in his return in the schedule referred to in para. 8 of these reasons, however, was misleading and disingenuous. The claims in relation to the coaching are wedged in amongst other claims to deduct expenditure firmly related to teaching activities. More particularly, the impression is then given by the use in the tax return of the words 'For School and Teaching Purposes' that the travel expenses the subject of this application related directly to the coaching of school teams as opposed to outside coaching commitments to teams outside the school. A reasonable person, knowing that the applicant was a school teacher, would be unlikely to think anything else.

Mr Todd held that the 40% flat additional (penalty) tax assessed by the Commissioner was correctly assessed because statements made in the applicant's tax return were misleading in a material way. Had he not so held, the Commissioner would have been entitled to assess interest at the prescribed rate of 14.026% per annum rather than additional (penalty) tax.

The decision in *Case V103*<sup>12</sup> serves as a good illustration of the magnitude of the portion of the iceberg that remains unseen beneath the water. The case involved a claim for travelling expenses in travelling between his home and place of work by a deputy manager of a coal mine. It is well known that travelling between home and place of work is generally not deductible. However, the applicant received an allowance from his employer under an industrial award and it was (and still is) usual for such allowances to be treated as tax free or, at least, that a deduction is allowable up to the amount of the allowance. In giving his reasons for decision, Mr PM Roach, Senior Member, made the following remarks:<sup>13</sup>

In my view, the answer to the claim of the particular applicant is clear and it must fail. It is so clear that a decision in this reference might have been delivered summarily. None the less, I chose to reserve my decision in order that these reasons might be set forth in writing. I did so because I am conscious that the applicant is but one of many clients of the same accountant employed at the same coal mine who are applicants to this Tribunal in relation to similar questions. (I say 'similar' because I have no information before me as to whether any of them might be entitled to deductions. Each taxpayer is entitled to be assessed according to his circumstances. However, the reasons for decision in this case may be of some assistance to them). I have also been aware that,

<sup>11</sup> 88 ATC 928.

<sup>12</sup> 88 ATC 664.

<sup>13</sup> 88 ATC 669.

in at least two States, there have been many applicants to the Tribunal who have been encouraged in the pursuit of such claims by their industrial union. I am also aware that the view seems to be widely held that, provided a sum of money received is described as an 'allowance' in an industrial award or equivalent, the recipient is entitled to a tax deduction equal to the amount of the allowance, at least if the money is 'expended for the purpose for which it is paid' (cf. the claim *Case UI56*, 87 ATC 908).

It is my very firm conviction that literally thousands of such claims would already have been made in returns lodged since 1 July 1986. These claims have not and in the vast majority of cases will not ever be discovered and presently lie on the Commissioner's shelves or in his filing cupboards waiting to run into icebergs or, at least, growlers and therefore be subjected to interest charges at best and in many cases receive the full force of the additional (penalty) tax provisions.

### Charting the taxation waters

Prior to self-assessment all returns were individually assessed. Although it was not made public by the Commissioner, it is widely known that for many years the level of individual scrutiny by an assessor of most salary and wage and certain other types of returns was negligible. Accordingly, where such methods resulted in an assessment being issued that was incorrect in law and the tax assessed less than the correct amount, the taxpayer could take comfort in the knowledge that the Commissioner was not permitted to issue an amended assessment to correct the position. The public servant statistician discussed earlier would appear to be an example of such a taxpayer.

It was a major purpose of the self-assessment process to release assessing staff for more detailed audit programmes and the Commissioner's *Annual Report* for 1986/1987 stated:<sup>14</sup>

In addition, and dwarfing other changes, successful implementation of self-assessment has in under two years seen more than 1200 staff shifted into activities of higher value with important gains in effectiveness and efficiency—this massive improvement effort has resulted in faster revenue collections, and has freed up many hundreds of staff for successful implementation of the first stages of the plan approved by Cabinet for major audit expansion.

The Commissioner has hailed the introduction of the system as a success. The *Annual Report* for 1986/1987 stated:<sup>15</sup>

The results achieved in the first phase have vindicated the decision to introduce self-assessment. There was a significant improvement in the issue of debit assessment which resulted in large amounts of tax becoming due at an earlier date. It has been estimated that the earlier due dates are effectively worth \$20 million to the Government in interest savings... The second phase of self-assessment has resulted in a further reduction in assessing staff, with the savings being directed mainly toward audit work and the clerical examination of returns.

The Commissioner is, of course, entitled to that opinion and the \$20 million estimated interest savings is really only a part of the tip of the

<sup>14</sup> Commissioner of Taxation, *Annual Report 1986/87* p 5.

<sup>15</sup> *Ibid* at 25.

iceberg. The major part of the iceberg is hidden below the surface. During 1987-1988, income tax audits yielded \$775.5 million<sup>16</sup> and obviously some portion of this amount would have been a direct result of the re-deployment of former assessing staff into the audit area.

Whilst the concept of self-assessment is new in the income tax arena, it is not new in the Australian tax scene. Sales tax has been (successfully) collected by a self-assessment process for decades. However, there are three major differences between income tax and sales tax. First, sales tax is payable exclusively by persons carrying on business. Secondly, sales tax is payable by a relatively small number of taxpayers when compared with income tax. Thirdly, the laws relating to sales tax are substantially less complex than the laws relating to income tax.

Despite the enormous increase in income taxation audit staff over the past two years together with anticipated increases for the next three years, less than 2% of non salary and wage earners will be subject to audit by 1992.<sup>17</sup> It is assumed that a negligible percentage of salary and wage earners will be subject to audit. On the other side of the ledger, the Commissioner has aroused much media comment on the Large Case Program<sup>18</sup> in relation to which he announced that by July 1991 the Taxation Office expects to have started audits of the income tax affairs of 100 of the very largest corporate groups in Australia.

As a result of the complexity of income tax law (particularly in relation to the new capital gains tax provisions) and the infinitely small percentage of taxation returns that will be subject to any form of audit within the three year period, three clearly distinctive taxpayer groups will emerge.

There will be an enormous group of taxpayers who will, by a combination of clever disclosure and the law of averages, successfully chart the waters and thus avoid contact with the lurking growlers. Members of this group will pay less than the proper amount of tax.

There will be a second relatively small group of less fortunate taxpayers who will, by a combination of ignorance and odds-defying bad luck, be holed or even sunk by the near submerged iceberg. Members of this group will therefore be required to pay interest (compensation) to the Commissioner or additional (penalty) tax if they are adjudged to have made a false or misleading statement in their income tax returns.

There will be a third undoubtedly extremely small and elite group of well informed taxpayers who will, by virtue of the s 169A(2) lighthouse, properly avoid the iceberg. Members of this group will therefore pay the correct amount of tax.

In the case of a large company, having regard to the volume and complexity of modern business operations and of the present tax laws, the mind boggles at the enormity of the task of avoiding the iceberg with or without the use of the lighthouse. One can visualise a document the

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16 Ibid at 67.

17 Ibid at 47.

18 Ibid at 59.



size of a volume of *Encyclopaedia Britannica* being necessary to set out the questions to which the Commissioner would be required to give attention.

In short, the present complexity of the tax laws in Australia is totally incompatible with the system of self-assessment.