THE COMMISSIONER'S POWERS: DEMOCRACY FRAYING AT THE EDGES?

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This article gives a broad overview of the powers exercised by the Commissioner in administering the Income Tax Assessment Act 1936. It highlights areas where those powers seem excessive and proposes changes which would better safeguard the rights of taxpayers.

> Necessity is the plea for every infringement of human freedom. It is the argument of tyrants; it is the creed of slaves.
> **William Pitt**

> The power of kings and magistrates is nothing else, but what only is derivative, transformed and committed to them in trust from the people to the common good of them all, in whom the power yet remains fundamentally, and cannot be taken from them, without a violation of their natural birthright.
> **John Milton**

Introduction

Whether the administration of any tax system is effective is always an issue of great contention. In recent years, the debate has increased in Australia. This has been assisted by a number of studies showing the high incidence of compliance costs in Australia, especially as compared with other OECD countries.[1] The results of these studies have been hotly disputed by the

1 Eg, see Pope J, Fayle R and Duncanson M, *The Compliance Costs of Personal Income Taxation in Australia, 1986/87* (1990 Australian Tax Research Foundation); Pope J, Fayle R and Chen DL, *The Compliance Costs of Public Companies' Income Taxation in Australia, 1986/87* (1991 Australian Tax Research Foundation); Pope J, Fayle R and

Australian Taxation Office ("ATO"), which has major problems with the methodology used in this research.[2]

Meanwhile the Victorian Law Reform Commission has led the way in criticising the drafting of the Income Tax Assessment Act 1936 ("the Act") by providing a sample simplification of the complex provisions of Division 16E.[3] This has met with studied scepticism from the Legislative Drafting Office, who prefer their own simplified style of drafting, trialled in the new Division 1AA covering social security and similar payments.[4]

Nonetheless, the Government has recognised the need for a review of the Act and has set up a Tax Law Improvement Project.[5] That this is more than a token gesture can be seen from the additional funding of $5.2 million, of an expected total of more than $10 million, provided in the 1994 Budget[6] and the fact that the Project is headed by former Second Commissioner, Brian Nolan. Senior private sector taxation specialists have been recruited to work on the project[7] assisted by an impressive advisory board.[8]

Mr Nolan has stated that his aim is merely to clean up the Act: to make it

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Chen DL, *The Compliance Costs of Employment-Related Taxation* (1993 Australian Tax Research Foundation); Pope J, Fayle R and Chen DL, *The Compliance Costs of the Wholesale Sales Tax* (1993 Australian Tax Research Foundation); and Pope J, Fayle R and Chen DL, *The Compliance Costs of Companies' Income Taxation* (1994 Australian Tax Research Foundation).

2 The ATO position was strongly put by several senior members of the ATO in response to a paper by Pope J, "Policy implications arising from compliance costs of taxation research" presented at the 1993 Australian Taxation Office Research Conference, 2 and 3 December 1993, Canberra.

3 Reported in "Snappy Language: The Dingo Division" (1991) 26 *Taxation in Australia* 246 and discussed by the former Chairman of the Law Reform Commission of Victoria, D St L Kelly in the Guest Editorial, (1993) 3 Revenue L J.

4 Turnbull I, "Dingos Revisited" (1992) 27 *Taxation in Australia* 79, which was answered by Kelly D St L in "Dingos Revitalised" (1992) 27 *Taxation in Australia* 270.

5 Announced by the Treasurer on 17 December 1993.

6 *1994/95 Budget Papers* (1994 AGPS) and "Tax law simplification: Where to start?" (1994) *Butterworths Weekly Tax Bulletin* 509.

7 The private sector members of the Tax Law Improvement Project were announced on 21 April 1994 to be Mr Robert Allerdice of ATAX and Mr Simon Gaylard of Coopers & Lybrand.

8 Announced by Treasurer's Press Release, 21 April 1994. Reported in (1994) *Butterworths Weekly Tax Bulletin* 339.

more presentable; to improve on poor drafting using plainer English; to eliminate double definitions; to create a more coherent structure; and perhaps to simplify the numbering system.[9] This limited approach has been roundly criticised by most private sector taxpayer groups and professional bodies.[10] It remains doubtful whether the much more adventurous approach, advocated in respect of the Corporations Law Simplification Project by the Attorney-General Mr Lavarch,[11] will eventually be emulated by the Treasury in determining how far the Tax Law Improvement Project will go.

A similar doubt remains as to the scope for reform and an easing of the burden of compliance for long-suffering taxpayers in a number of other areas. In the 1994 Budget, the Treasurer announced a review of the FBT compliance burden.[12] The problem here is that the Treasury has said that any changes must be tax neutral.[13] The ATO takes a similar view of changes mooted by taxpayers to ease any aspect of the general tax compliance burden.[14] Whether this is possible without significant reform of the particular areas of tax concerned is questionable. Minor attempts at technical reform in specific areas can rarely achieve their goal and maintain tax neutrality.

However, when looked at on a larger scale, tax neutrality or even increases in revenue are achievable. This was arguably shown on the grand scale by the *Fightback!* package put forward by the Coalition at the 1993 election.[15] It is doubtful whether the Treasury would have sanctioned the Streamlined Sales Tax Law had it not at least maintained revenue neutrality.

Unfortunately, revenue neutrality is but one aspect. Achieving real improvements in complex tax legislation through reform has been shown

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9 Speech to the 6th Annual Australasian Tax Teachers' Conference, 19-21 January 1994, Sydney.

10 See, eg, the discussion under "Current Topic" (1994) 28 *Taxation in Australia* 484 and Mace J, "Looking into the ATO" (1994) 65 (1) *Charter* 14.

11 Second reading speech, Corporations Legislation Amendment Bill 1994 (Cth), 8 June 1994.

12 Above n 6 and Treasurer's press release, 13 May 1994.

13 Minutes of the FBT Subcommittee Meetings of the National Tax Liaison Group held on 24 March 1994 and 17 May 1994 and Treasurer's press release, 13 May 1994.

14 Above n 10.

15 *Fightback! Taxation and Expenditure Reform for Jobs and Growth* 21 November 1991.

in various jurisdictions to be no easy task.[16] For example, leading commentators have strongly criticised the attempt at reform of the Sales Tax system.[17] This experience, together with the wider political implications of the electorate's rejection in 1993 of the Coalition policies, has resulted in a situation where politicians on both sides now seem to prefer tinkering at the edges to attempting real reform of the tax system.

A further area of concern to taxpayers is that in the 1993 and 1994 Budgets it was predicted that over $1 billion in extra revenue could be raised in the 1994/95 financial year from improved revenue collection.[18] The obvious question is why, if there was $1 billion of extra revenue which could be collected, was it not thought of sooner? The next question is where is this revenue expected to come from? The Budget papers are scarcely illuminating and one is left to assume that the improved collection procedures resulting from the huge modernisation program[19] undertaken by the ATO in recent years are bearing significant fruit.

These improved collection procedures, which have developed increasingly in the move to self-assessment,[20] include a greatly improved audit program.[21] The ATO has put significant resources into ensuring that its audit program is as efficient and effective as possible.[22] Australia is now recognised as having one of the most effective tax administrations in the

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16 See further on this point from an international perspective: McCaffery EJ, "The Holy Grail of Tax Simplification" (1990) *Wisconsin Law Review* 1267; *Tax Simplification - Final Report of the Consultative Committee* (1990 NZGP); and Boskin MJ and McLure CE (eds), *World Tax Reform: Case Studies of Developed and Developing Countries* (1990 ICS Press).

17 See, eg, Hill DG, "Sales Tax: The Simplified System Explained" (1993) 28 *Taxation in Australia* 268 and De Liefde R & Sommerville D, "Reform of the Australian Wholesale Sales Tax" (1994) 4 Revenue LJ.

18 *Statement on Tax Policy* (1992 AGPS) and *Budget Papers*, above n 6.

19 This program is well documented, not only in the Commissioner's Annual Reports, but also by commentators such as Wickerson J, in "The Changing Roles of Taxpayer Audit Programs: Some Recent Changes in the Australian Taxation Office" (1994) 4 Revenue LJ.

20 Ibid.

21 Interesting insights into this program are provided by three papers presented at the 1993 Australian Taxation Office Research Conference on 2 and 3 December 1993: Donoghue D and Barry G, "The objectives of the project based audit methodology"; Anderson R, "Taxpayers are people"; and Wirth A, "Changing taxpayer compliance: the impact of business auditors as service providers".

22 ATO, *Risk Management in the ATO* (1992).

audit area and is a world leader in technology and innovation.[23] The counterpoint to this is that taxpayers and their representatives have become alarmed by the aggressive ATO approach to revenue collection and are calling for curbs on the ATO powers.[24]

This was particularly visible during the hearings before the Joint Committee of Public Accounts ("JCPA") and is reflected in their report.[25] Some of their recommendations have been criticised.[26] Nonetheless, calls for the establishment of a tax ombudsman[27] and a Taxpayer's Charter[28] reflect an increasing concern for taxpayers' rights in the face of seeming increases in the Commissioner's exercise of his powers.

There is an underlying thread in all these calls for reform. Increasing compliance costs for taxpayers arise as a result of the Commissioner's powers to require the taxpayer to provide detailed supporting information for every transaction. The need for simplification comes not only from the poor drafting of complex legislation. It comes, too, because the Commissioner is increasingly able to interpret the law to his advantage through rulings and the position he takes in disputes. Although it is to their detriment, no challenge comes from taxpayers unable or unwilling to match the ATO resources.

The system of self-assessment and the improved efficiency of the information gathering, audit and collection processes are reflective of the Commissioner's effective exercise of his wide-ranging powers. The

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23 This can be seen from the increased interest taken in the Australian Tax Administration by other countries and was acknowledged, eg, in a speech by Mr Wayne Thomas, Director of the IRS National Office Research Division at the 1993 Australian Taxation Office Research Conference. On a technical level, it can be seen in the participation by the ATO in international advanced pricing agreements in the transfer pricing area (refer draft Taxation Ruling TR 94/D32).

24 See, eg, "Taxpayers' Bill of Rights" (1993) 28 *Taxation in Australia* 50 and the trenchant criticism of the current tax system by the former Chief Justice, Sir Harry Gibbs, "The Tax System: Seriously Wrong in Principle" (1993) 28 *Taxation in Australia* 31.

25 Joint Committee of Public Accounts, Report No 326, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993 AGPS).

26 See, eg, Wickerson J, "The Changing Roles of Taxpayer Audit Programs: Some Recent Changes in the Australian Taxation Office" (1994) 4 Revenue LJ.

27 Recommendation 132.

28 Recommendation 131.

pressure on the Commissioner to use those powers can only increase, as successive budgets require him to produce the ever larger amounts necessary to balance those budgets.

This article examines, in broad overview, some of the powers of the Commissioner in the area of tax administration. It seeks to determine whether these powers are too broad. Where they are felt to be too broad, appropriate measures are suggested to limit their effect.

Powers of the Commissioner under the Act

Section 8 of the Act simply states that "(t)he Commissioner shall have the general administration of this Act". This is repeated in s 3A of the Taxation Administration Act 1953 ("TAA"). The TAA deals extensively with the powers and obligations of the Commissioner, but further powers and obligations appear throughout the Act and related legislation[29] to ensure that his administration is effective.

A necessary first step in the administration process is the delegation by the Commissioner of his powers of administration. This makes possible the administration of the huge and complex tax system. Inevitably, strong arguments are raised before the courts under various sections of the Act as to the proper exercise of the authority to delegate.[30] However, no-one can reasonably object to the principle of delegation. It is seldom the delegation or the process of delegation of powers to tax officers which is the root problem in issue before the courts.[31] Rather it is the manner of the exercise of the powers delegated which gives rise to most contention.[32]

The limit to any of the Commissioner's powers is that they must be exercised "for the purposes of this Act". What this means has seldom been

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29 See, eg, the Fringe Benefits Tax Assessment Act 1986 and the Superannuation Guarantee (Administration) Act 1992.

30 See, eg, *FCT v Citibank Ltd* 89 ATC 4268; *Allen Allen & Hemsley v DFCT* 89 ATC 4294; and *Smorgon v FCT* 76 ATC 4364.

31 Whether the proper procedures have been followed is often queried before the courts in the overall attempt to prevent tax officers from acting in the way they wish to: see *Smorgon v FCT* 76 ATC 4364.

32 See, eg, *FCT v Citibank Ltd* 89 ATC 4268 and *Clyne v DFCT* 85 ATC 4597.

explored before the courts. When it is examined, the judges generally conclude that the exercise of the powers under a particular section has been in accordance with the purposes of the Act without exploring in detail what those purposes are.[33]

However, in *FCT v The ANZ Banking Group Ltd*, Murphy J examined the exercise of the Commissioner's powers under s 263 of the Act. He stated that:[34]

> Like all powers, it must be exercised in good faith, for the purposes for which it was conferred, and having regard to those affected by its exercise... . These implied limitations on the power in sec 263, serve to safeguard the extremely important social value of privacy which must be balanced against the necessities of administration of the revenue laws. They moderate what would otherwise be a power capable of oppressive use. The Commissioner of Taxation is not only expected, but bound, to observe those limitations on the power.

For an act or decision of the Commissioner to be valid, it "must relate to the subject matter, scope and purposes of the Act".[35] Although, generally, the courts may be prepared to read down "seemingly wide powers by reference to implications drawn from the Act as to subject matter, scope and objects",[36] this is unlikely to be the case with the Income Tax Assessment Act, given the judgments handed down by the High Court in *FCT v The ANZ Banking Group Ltd*,[37] which implied that wide powers were a necessary part of revenue legislation.[38] Nonetheless, it is clear from the judgment of Murphy J that the Commissioner must not exercise his powers in bad faith or for an improper purpose.[39]

Bad faith has a heavy burden of proof.[40] The courts have been more

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33 See, eg, *FCT v The ANZ Banking Group Ltd* 79 ATC 4039 at 4053 and *Industrial Equity Ltd v DFCT* 90 ATC 5008 at 5013.

34 *FCT v The ANZ Banking Group Ltd* 79 ATC 4039 at 4057.

35 Aronson M and Franklin N, *Review of Administrative Action* (1987 Law Book Co) 45.

36 Ibid at 44.

37 Above n 34.

38 Ibid and see, especially, the judgment of Murphy J at 4057.

39 Ibid at 4057 and see also *Clyne v DFCT* 85 ATC 4597.

40 Aronson and Franklin, above n 35 at 45.

willing to accept arguments relating to improper purpose.[41] However, here too, Aronson and Franklin warn that "the allegation of an improper purpose frequently fails for want of proof".[42]

Other arguments which could be put forward to limit the exercise of the Commissioner's powers include: illegality;[43] irrelevant considerations;[44] uncertainty;[45] unreasonableness;[46] and procedural error,[47] which includes natural justice and fairness.[48] The effectiveness of any or all of these arguments in limiting the powers of the Commissioner is by no means convincing, given the almost impossible burden of proof placed upon taxpayers. In some sections too, such as s 263 and s 264 of the Act, the wording of those sections is sufficient to preclude the operation of the principles of natural justice.

In fact, the powers are probably necessary to ensure that the revenue collection process is effective against the most recalcitrant taxpayers. The problem is that there is no legislative guidance as to how the powers given to the Commissioner should be exercised in the middle ground, for the majority of the time, in respect of the vast majority of taxpayers who are doing their best to comply with the law. The administrative law reliefs available offer little help. A taxpayer is necessarily left to argue that the only real protection is to be found in a taxpayer's bill of rights, which is considered in detail below.

General administration

A change took place in the way the Commissioner exercised his powers,

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41 *Sydney Municipal Council v Campbell* [1925] AC 338; *Building Owners and Managers Association of Australia Ltd v Sydney City Council* (1984) 53 LGRA 54; and *Lai Corporation Pty Ltd v Sydney City Council* (1984) 53 LGRA 144.

42 Above n 35 at 46.

43 Ibid at 55.

44 Sykes EI, Lanham DJ and Tracey RRS, *General Principles of Administrative Law* (3rd ed 1989 Butterworths) at 105.

45 Ibid at 137.

46 Aronson and Franklin, above n 35 at 68 and see also s 5(2)(g) and s 6(2)(g) of the Administrative Decisions (Judicial Review) Act 1977.

47 Aronson and Franlin, above n 35 at 61.

48 Ibid at 106 and Sykes, Lanham and Tracey, above n 44 at Part Four.

with the introduction of partial self-assessment for the year ended 30 June 1986 and full self-assessment for companies and superannuation funds for the year ended 30 June 1990. The move to self-assessment was accompanied by the introduction of a more rigorous audit and enforcement program, facilitated by the freeing-up of ATO resources.[49] In order to streamline and make the administration of the self-assessment process more effective, major amendments to the legislation were introduced from 1 July 1992.[50] The impact of these changes in a number of areas is discussed below.

Returns

The Commissioner has extensive powers to require the furnishing of returns.[51] Annual returns must be furnished under s 161 as required by notice published in the *Gazette*. Further returns may be required by the Commissioner under s 162, while s 163 covers returns which are not based on income derived by taxpayers themselves, such as when interest is paid to non-residents.

The powers to require the furnishing of further or special returns are seldom exercised. With the introduction of self-assessment, the Commissioner has limited to a great extent the information he requires to be lodged.[52] Almost all of the information required under the old assessment system, where each return was examined individually, can be retained instead by the taxpayer, to be presented at the time of an ATO audit.

Some information is still required by the Commissioner to assist in the audit program. For example, the Form C company tax return includes a page of financial and other information which can be used for statistical purposes to build up a profile of industry groups and sub-groups. The

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49 See further, Wickerson, above n 26.

50 Taxation Laws Amendment (Self Assessment) Act 1992, which received Royal Assent on 30 June 1992.

51 For example, under the Income Tax Assessment Act 1936 as discussed below, together with other sections such as s 160ARE and s 160ARF, which deal with franking returns. Returns are also required under related legislation such as s 68 and s 69 of the Fringe Benefits Tax Assessment Act 1986.

52 See, eg, Taxation Ruling TR 93/D13 and Taxation Determination TD 93/128.

information provided in each return can be matched against the industry profile by computer. Companies whose data varies from the expected norm can be identified. This information can be used in mapping company risk profiles to highlight those taxpayers who show a high risk of non-compliance and are consequently, obvious targets for an audit.[53] The ATO computerisation program is still at a relatively early stage[54] and such computer matching programs, although highly successful where in use, have yet to be implemented across the board.[55]

Other information required which is not already used in this way, will certainly be used in the future. This covers such information as that required on Schedule 25A for companies involved in transactions of any kind with associated overseas entities. Transfer pricing audits have become a major focus for the ATO.[56] Basic information provided by all taxpayers possibly involved in any form of transfer pricing arrangement helps in building up a database of information which can be used in making the audits more efficient and effective. Similarly, information from statements of dividend and interest paid, which have recently been required by the Commissioner with annual company tax returns,[57] can be used in computerised matching exercises. This has been found to be an effective and profitable tool to increase revenue collection in other

53 Much as has been done by the ATO using the Key Abnormal Tax Agent Evaluation (KATE) System (refer Sweatman E, "Compliance Improvement: Leverage Initiatives", a paper presented at the 1993 Australian Taxation Office Research Conference, 2 and 3 December 1993, Canberra) and is proposed in ATO, *The ATO's Approach to Taxpayer Compliance Research* (1993) at 12.

54 This is acknowledged by the ATO, who are keen, not only to proceed rapidly with their computerisation agenda, but to do so in conjunction with the tax profession. Their good faith in this regard can be seen in the formation of an ATO Modernisation Sub-committee of the Tax Agent Liaison Group, which held its first meeting in Canberra on 25 May 1994.

55 Sweatman, above n 53.

56 Boucher TP, *Minute Paper to the Treasurer*, 15 September 1992 and the 16 September 1992 Treasurer's *Statement on Tax Policy* (1992 AGPS) 12. This approach is reflected in the Commissioner of Taxation's *Annual Report 1991/92* (1992 AGPS) and for later years. In conjunction with this focus, the ATO has established a Profit Allocation Unit specifically to deal with transfer pricing issues and to issue a series of major rulings on transfer pricing. See also Nolan BM, "The Tax Office of the '90s" (1992) *31st Taxation Institute of Australia Victorian Taxation Convention Papers* 3.

57 See the annual *Gazette* notice, which publishes the Commissioner's requirements for lodgment of income tax and franking returns, in accordance with s 161 of the Act.

jurisdictions, such as the United Kingdom.[58]

The Commissioner's use of his powers to require returns and gather information in this way is essential to the proper administration of the Act. The strict secrecy rules contained in the Act are closely monitored and are seldom obviously breached.[59] The ATO seems well aware of its obligations to taxpayers in this area. Nonetheless, an area which may become of concern to taxpayers is the amount and type of information the Commissioner may require on returns.

Increased computerisation will generate new and sophisticated technology which will be able to use a wide range of data to assess non-compliance among taxpayers.[60] It will place an increased compliance burden on taxpayers asked to provide a range of detailed information not previously required, but which will enable the audit program to be targetted more effectively.[61] It will also become more intrusive as price-sensitive and other secret information is revealed to the ATO to enable it to build up its industry profiles. This is already done during complex tax audits. However, centralised databases of very sensitive information will require a far greater level of security for the protection of taxpayers.[62]

It is an area which requires attention at an early stage in the computerisation process. The Commissioner cannot afford to be caught out with a major security breach involving not just one, but potentially hundreds of taxpayers in an unauthorised dissemination of information possibly critical to the commercial survival of those taxpayers. In such a situation, it would be of little solace to the taxpayers concerned that the Commissioner would be in breach of his obligations under the Act.[63]

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58 In the author's own experience, it is surprising the number of taxpayers who forget the existence of certain interest bearing accounts, despite enquiries by a tax adviser, until reminded of them by the Inland Revenue.

59 For example, s 16 of the Act and s 8XA and s 8XB of the TAA.

60 Above n 53.

61 Practically, this can be seen from the annual development of new tax return forms.

62 Newspaper reports of computer hackers gaining unauthorised access to defence information provide welcome fodder for the sensationalist press. However, they do raise the issue that unauthorised access to restricted information is possible, even in the most sophisticated computer environments.

63 Above n 59.

Taxpayers should be given the assurance that appropriate internal systems and procedures are being implemented to prevent breaches of security. They should be commensurate with the increasing burden of confidentiality placed on a larger number of ATO officers. In addition to annual reviews to take account of improved technology available to those seeking unauthorised access, internal systems and procedures should also be reviewed in conjunction with every increase in information requested.

Audits

Under self-assessment, the audit process has become one of the ATO's most important tools for ensuring taxpayer compliance. The Commissioner has no specific authority in the Act for carrying out tax audits as they are presently conducted.[64]

For most tax audits, the ATO contacts taxpayers by letter or by telephone and asks them to attend an interview with a tax officer. The interview can be at the Tax Office for smaller audits, but is normally held at the taxpayer's premises for larger audits. In a complex audit, the audit team generally asks the taxpayer to provide them with facilities such as desks, photocopying facilities and telephones. This can be a significant burden where the audit continues over a period of months or years. Yet it is a burden the ATO can enforce under s 263.[65]

All audits involve the provision of information. In a complex audit, which can last for over three years,[66] the information required is substantial. Negotiations may take place over the course of the audit or at the end of the audit over the taxpayer's treatment of items in one or more tax returns. The Commissioner then raises an amended assessment for tax under or overpaid.

The Commissioner believes that his power of the general administration of

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64 *Industrial Equity Ltd v DFCT* 90 ATC 5008.

65 *FCT v Citibank* 89 ATC 4268 and see the Explanatory Memorandum to Taxation Laws Amendment Bill (No 2) 1987, enacting s 263(3), which mentions specifically what are reasonable facilities.

66 Bryant B, "Tax Audit Experience - Key Issues"(1992) *31st Taxation Institute of Australia Victoria Taxation Convention Papers* 15 and 1992 *Butterworths Weekly Tax Bulletin* 672-673.

the Act and related legislation is sufficient to cover full implementation of the audit process.[67] It is certainly true that the vast majority of audits take place with the full cooperation of taxpayers.[68] It is only rarely on audit that the ATO uses the specific statutory powers of access and the right to obtain information and evidence.[69] Perhaps because these enforcement sections remain as the ultimate threat in the case of taxpayer obstruction, the Commissioner can rely on taxpayers' cooperation for the smooth operation of the audit program.

The audit process is made up of a flexible set of administrative procedures, not contemplated by the legislation, but implementing the effect of the legislation without resorting to the more draconian measures envisaged by Parliament to enforce its will. This is an important and consistent thread which runs through the procedures and processes governing the practical administration of the Act by the ATO. In fact, it has often happened, and certainly did with some of the self-assessment rules, that administrative rules long practised by the ATO have subsequently been enacted as legislation. The development of the use of rulings is an obvious example.[70]

This has long been the case in tax administrations all over the world. In jurisdictions such as Japan and Singapore, it is not generally seen as necessary to enact the administrative rules as law.[71] The Australian black letter law culture, with its litigious tendencies, probably explains our different approach.

Cooperation by taxpayers during a tax audit is understandable from a purely pragmatic standpoint. It saves not only the high costs of litigation,

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67 Section 8 and Part 1A of the TAA.

68 D'Ascenzo M, "A Tax Office Insight into Business Audits" (1993) *23rd Taxation Institute of Australia Queensland Taxation Convention Papers* 80 and Stolarek TJ, "The Tax Office in the 90's: The Tax Practitioner's Perspective" (1992) *31st Taxation Institute of Australia Victoria Taxation Convention Papers* 8.

69 Sections 263, 264 and 264A.

70 Another example is the new penalty provisions under Part VII of the Act, which reflect the practice of the Commissioner in remitting penalties under the old rules (see, eg, Taxation Ruling IT 2214).

71 Beyer VL, "Tax Administration in Japan" (1994) 4 Revenue LJ and Scully MP, 1993 Coopers & Lybrand taxation notes discussing the taxation administration of Singapore.

but also the extended perusal of the taxpayer's affairs by tax auditors, which can be extremely costly in terms of personnel (particularly senior management).

Nonetheless, it is of some concern that taxpayers should accept without question the rules set down by individual tax auditors.[72] In an often stressful situation, not fully governed by published documented guidelines,[73] it is often difficult for taxpayers to take issue with tax auditors. The concern is that taxpayers often cannot know whether tax auditors are acting within their internal guidelines.

Furthermore, even where there are published guidelines, the bulk of individuals and small businesses are probably not aware that those guidelines exist. This leaves it open for zealous auditors to go beyond the guidelines and what is allowed by the Act. Invasion of privacy would generally result. This scenario is increasingly likely in the context of growing demands on revenue collection and the increasing emphasis on productivity within the ATO, which would include tax auditors.[74]

Although this may be dismissed by the ATO, experience has shown that the authority carried by tax officers can, on occasions, be exploited with little resistance.[75] One solution would be to publish more widely the general internal guidelines which govern the conduct of tax auditors. It would help to give a copy of those guidelines to taxpayers at the commencement of every audit, in addition to the pamphlets describing what an audit is, which are currently given. This would at least provide a benchmark against which even the most ill-informed taxpayers and professional advisers could judge the actions of tax auditors.

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72 Bryant, above n 66.

73 Although the ATO has issued a series of guidelines covering, eg, access powers (*Butterworths Rulings and Guidelines*, OG 53 and OG 69), negotiated settlements (OG 62) and the conduct of taxpayers and auditors during complex audits (OG 65), the guidelines are often very general, particularly in the area of taxpayer, as opposed to ATO, rights.

74 Commissioner of Taxation, *Annual Report 1991/92* (1992 AGPS), but see also 1993 *Butterworths Weekly Tax Bulletin* 433 and 769.

75 Lehmann G and Coleman C, *Taxation Law in Australia* (1994 Butterworths) 1192-1199 and see the reaction of the Citibank employees in *Citibank Ltd v FCT* 88 ATC 4714.

Asset betterment tests

An example of the Commissioner's use of his powers in the broadest sense is the asset betterment test. Section 167 of the Act gives the Commissioner the power, where no return is made when he believes a return should have been made or he is not satisfied with a return which is made, to "make an assessment of the amount upon which in his judgment income tax ought to be levied". That becomes the taxpayer's taxable income.[76] This is a broad power which, provided it is properly used, is necessary to deal with recalcitrant taxpayers.

There are various specific sections requiring individual taxpayers to maintain records.[77] An even stronger incentive to do so is the fact that, in any review or appeal against an assessment by the Commissioner, it is the taxpayer who bears the burden of proof to show that the assessment is excessive.[78] This is especially so in relation to asset betterment tests.

Asset betterment tests are used where taxpayers, generally individuals or small businesses, are thought to have understated their taxable income. A useful way of verifying a taxpayer's return is to measure the increase or decrease in the taxpayer's net assets over a year of income. Adjustment is then made for non-deductible expenditure, non-taxable income and any deductions, such as depreciation, which do not involve physical expenditure. The result should give a good indication of the taxpayer's true taxable income and this is compared with what is shown on the return.[79]

Asset betterment tests are generally reserved for taxpayers suspected of significant understatement of their taxable income. Nonetheless, mere suspicion on the part of the Tax Office is insufficient to waive taxpayers' rights.

The Commissioner may use guesswork in making a default assessment, but

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76 Section 166.

77 See eg, s 160ZZU under the capital gain or loss provisions and s 82KZA under the substantiation provisions.

78 Sections 14ZZK and 14ZZO TAA.

79 *Case V17* 88 ATC 191.

only in accordance with all the relevant facts.[80] Before an assessment is issued there should be a proper investigation and an assessment should not be raised based on uninformed guesswork.[81] The ATO must make full use of the process of calculating taxable income, as required under the Act.[82]

The courts have developed these principles in cases where Tax Officers have failed to recognise the rights of taxpayers in issuing default assessments. In *Case 8240* a taxpayer proved that she had not derived part of the income assessed.[83] The ATO had assessed the taxpayer because her husband had derived undeclared income from prohibited imports.[84] However, this is not sufficient reason for the ATO to raise an assessment without following proper procedures and on the basis of proper evidence.

Tax officers who have to deal with this type of case deserve some sympathy. It is amazing how many beleagured taxpayers happen to be successful gamblers[85] or receive gifts or legacies.[86] Tax officers could probably be forgiven for taking a cynical view of taxpayers' claims that such windfalls are genuine. Nonetheless, windfalls do happen.[87]

The point is that the Commissioner is given wide powers under s 167. Added to that, the onus is on the taxpayer to prove the Commissioner's assessment is excessive. Many taxpayers, innocent of any fraud on the revenue, may struggle to substantiate all their income and expenses. It is essential that the Commissioner implements detailed procedures for raising default assessments. These procedures should be publicised, followed by tax officers and made available to taxpayers when the ATO raises a default assessment. This will help taxpayers to understand exactly how the taxable income on which they are being assessed was arrived at and reduce the opportunity for ATO officers to misuse their powers.

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80 *Briggs v DFCT (WA): Ex Parte Briggs* 87 ATC 4278; *Dalco v FCT* 88 ATC 4649; and *Galea v FCT* 90 ATC 5060.

81 *Case X65* 90 ATC 492.

82 *Ma v FCT* 92 ATC 4373 and *Martin v FCT* (1994) 27 ATR 282.

83 *Case 8240* (1993) 24 ATR 1047.

84 Ibid at 1050.

85 *Ousley v FCT* 92 ATC 4486 and *Case 8717* (1993) 25 ATR 1159.

86 *Krew v FCT* 71 ATC 4213.

87 See, eg, *Case 8227* (1992) 24 ATR 1001.

The enforcement provisions

The Commissioner has the power under s 263 to authorise in writing:

> full and free access to all buildings, places, books, documents and other papers for any of the purposes of this Act, and for that purpose may make extracts from or copies of any such books, documents or papers.

Under s 264 the Commissioner has the power to require any person:

> (a) to furnish him with such information as he may require; and
>
> (b) to attend and give evidence before him or before any officer
>
> authorised by him in that behalf concerning his or any other person's income or assessment, and may require him to produce all books, documents and other papers whatever in his custody or under his control relating thereto.

Since 1973, the meaning and extent of these sections have been explored in a steady stream of cases.[88] They conclude that the Commissioner is limited in his exercise of these powers only by the requirement that he act within the purposes of the Act.

Fishing expeditions,[89] random audits[90] and dawn raids[91] have been approved by the courts. The enforcement provisions have been held to apply equally to taxpayers and third parties.[92] Banks,[93] lawyers[94] and accountants[95] have all queried the validity of these provisions and have received little comfort from the courts. Contractual liability to the taxpayer is no bar to a third party being forced to hand over to the ATO, documents

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88 *Southwestern Indemnities Limited v Bank of New South Wales* 73 ATC 4171 was the first case to examine the sections.

89 *FCT v Citibank* 89 ATC 4268.

90 *Industrial Equity Ltd v DFCT* 90 ATC 5008.

91 *FCT v Citibank* 89 ATC 4268.

92 Ibid.

93 Ibid.

94 *Allen, Allen & Hemsley v DFCT* 89 ATC 4294.

95 *Sharp v DFCT* 88 ATC 4259.

and papers left with the third party by the taxpayer for safe-keeping.[96]

Legal professional privilege is the main protection against s 263 and s 264. It can be claimed for documents which, either are the subject of litigation before a court, or contain legal advice from lawyers to their clients.[97]

In 1989, legal professional privilege was upheld by the full Federal Court in *Citibank*. In 1993, Ryan J in *Re Steele; ex parte Official Trustee of Bankruptcy* [98] strongly rejected the argument that the decision of the High Court in *Corporate Affairs Commission of NSW v Yuill*[99] diluted or abrogated the right to claim legal professional privilege. He held that the right to make such a claim stands, unless the statute shows a legislative intent to abrogate the right to claim legal professional privilege, either by express words or by necessary implication. He found that the words in s 263 do not show such legislative intent.

There was also concern that the right to claim the common law right of privilege against self-incrimination might not be available to taxpayers as a bar to the exercise of s 263 and s 264 following *Corporate Affairs Commission of NSW v Yuill*. The concern was seen to be well-founded in subsequent cases.[100] In the most recent case of *Donovan v FCT*,[101] Wilcox J found that, while there were no express words abrogating the common law right to privilege against self-incrimination, such an abrogation was implicit in the sections, when looked at in context and in the light of the explanatory memorandum.

Such findings are bizarre, particularly in the light of *Steele's* case. It seems that, in the self-incrimination cases, judges are willing to read into the legislation direct infringements of individual rights, even where an abrogation of common law privileges is by no means clearly intended by the legislature. This seems to go against the clear practice of the legislature when it has abrogated such rights. For example, the Trade Practices Act

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96 *FCT v The ANZ Banking Group Ltd* 79 ATC 4039.

97 Byrne DM and Heydon JD, *Cross on Evidence* (3rd ed 1986 Butterworths) ch 13 and *FCT v Citibank* 89 ATC 4268.

98 *Re Steele; ex parte Official Trustee of Bankruptcy* (1993-4) 119 ALR 716.

99 *Corporate Affairs Commission of NSW v Yuill* (1991) 4 ACSR 624.

100 *Stergis v Boucher* (1989) 20 ATR 591 and *Price v McCabe* (1984) 55 ALR 319.

101 *Donovan v FCT* (1992) 23 ATR 129.

1974 abrogates the right to claim the privilege of self-incrimination, but it also deals expressly with the consequences in s 155, defining the specific uses to which information obtained can be put. There is no such limitation in respect of information obtained under s 263 and s 264.[102]

The importance of this reading down of individual liberty is that under the provisions of the Act, the Commissioner could, following *Donovan*, obtain information which would incriminate a taxpayer. This information could be forwarded to the Director of Public Prosecutions, who could use it in evidence against the taxpayer in a criminal trial. This goes against the normal rules of evidence in a criminal trial, where confessions which are not given voluntarily are excluded.[103]

Courts must interpret the Act and define the powers of the Commissioner with due regard for the consequences of their decisions. Otherwise, in the name of beating tax fraud, they can cause incalculable harm to the maintenance of individual freedoms and civil liberties.

The extent of the enforcement provisions

As outlined above, the courts have sanctioned random audits and fishing expeditions. The Commissioner may also use s 263 and s 264 to require third parties to provide information they have about any taxpayer. The only constraint on the Commissioner is that these powers must be exercised "for the purposes of the Act".[104]

The courts may well soon have to explore that phrase.[105] As audit techniques are becoming increasingly refined to identify more precisely "risks to revenue",[106] the information required of tax agents to assist in industry prioritisation at the early stage of a Project Based Audit must

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102 For a fuller discussion of these issues, see Williams D, "*Donovan's* case and the further abrogation of the rights of the individual" 1992 *Butterworths Weekly Tax Bulletin* 182.

103 Byrne and Heydon, above n 97 at ch 17.

104 *Southwestern Indemnities Ltd v Bank of New South Wales* 73 ATC 4171 at 4174-4175.

105 See the discussion above under the heading "Powers of the Commissioner under the Act" and the dissenting judgment of Murphy J in *FCT v The ANZ Banking Group Ltd* 79 ATC 4039 at 4057.

106 Above n 21.

necessarily become more detailed and wide-ranging.[107] So, too, must the information required from third parties such as banks and financial advisers, professional advisers such as auditors, accountants and lawyers and other such groups which hold large amounts of potentially useful information. It would be surprising if the ATO failed to use what would be, for them, such efficient sources of information. What remains to be seen is whether the courts will continue to make poorly thought out inroads into individual liberties as in *Donovan*, or whether the protection of such liberties, as in *Steele*, will prevail.

As discussed above, the Commissioner limits his use of the enforcement provisions to situations where he feels their use is necessary in the face of taxpayer obstruction. The ATO is well aware of its obligation to protect individual liberty as far as possible and has made significant concessions to obtain the cooperation of tax advisers. Guidelines to tax officers exercising s 263 access powers were published to show good faith following the *Citibank* case in 1988.[108] These were followed by similar guidelines in respect of access to professional accounting advisors' papers and access to lawyers' premises.[109]

These administrative guidelines often make major concessions. The most obvious is the granting to taxpayers of the right to claim privilege in respect of documents containing taxation advice given by professional accounting advisors. This goes beyond the current legal position.[110] The Law Council of Australia strongly opposes any form of classification which recognises advice given by anyone except a lawyer as "legal advice".[111]

Nonetheless, taxpayers and professional advisers can rely on these administrative guidelines, even though they are not backed up by the law. The Commissioner considers himself bound by them.[112] The problem with the guidelines is that they are produced by the Commissioner. This

107 Donoghue and Barry, above n 21.

108 Guidelines to officers exercising the Access Powers provided under s 263 and equivalent provisions (*Butterworths Rulings and Guidelines*, OG 53).

109 *Butterworths Rulings and Guidelines*, OG 58, updated by OG 69, and OG 66.

110 Byrne and Heydon, above n 97 at ch 13.

111 Joint Submission to the Committee for the National Review of Standards For The Tax Profession, by the Law Council of Australia, Taxation Institute of Australia and the National Institute of Accountants.

112 *Butterworths Rulings and Guidelines*, OG 69.

makes them flexible, but that too is an inherent weakness. It means that they can be changed at the wish of the ATO and this has already happened in the guidelines on access to professional accounting advisors' papers.[113] As soon as the weight of expediency grows too heavy on the ATO, guidelines will be changed in the name of "progress towards a more efficient and effective tax administration system".

This does nothing for the protection of individual liberties and nor should the instrument of tax collection have to be looked to as their protector. This is the job of the legislature, the courts and perhaps the independent ombudsman proposed under the recommendations of the Joint Committee of Public Accounts.[114]

Litigation

Early in 1993, the ATO's Chief Tax Counsel outlined the ATO's litigation policy.[115] The time and costs involved in extensive litigation mean that the ATO has had to develop a policy of "strategic litigation".

Strategic litigation means that the ATO will identify those cases which involve significant contentious issues, which are unlikely to be resolved by the issue of a ruling, or where the law is unclear and clarification is sought from the courts. An encouraging aspect of the policy is that cases chosen are those most likely to result in clarification of the law, and such cases are not necessarily those most likely to achieve a favourable result for the Commissioner. Cases with peculiar facts or which are likely to be of little value as precedents are unlikely to be chosen.

Significant issues are those which, in the eyes of the ATO, could involve significant possible revenue loss, or will result in a clarification of the law in one or more areas. Clarification of the law is seen as necessary where there are large numbers of taxpayers affected by the uncertainty. Clarification may also be needed where there is arguably a loophole in the

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113 Note the differences between the original version of the guidelines, *Butterworths Rulings and Guidelines* OG 58 and the amended version OG 69.

114 JCPA, above n 25, recommendation 132.

115 "1994 - The Tax Year Ahead", a paper given at the 6th Annual Australasian Tax Teachers' Conference, Sydney, 19-21 January 1994. A summary of the main points made in this paper is available in 1994 *Butterworths Weekly Tax Bulletin* 101.

law, which seems to go against the general legislative intention. A decision as to the existence of such a loophole would highlight the need for amendment to the legislation.

Once a case has been chosen as suitable for litigation, every effort is made to move through the judicial hierarchy as quickly as possible to minimise costs for both parties. This is always dependent on the approach taken by the taxpayer in each case and also by the courts themselves, who may not always grant requests for leave to appeal. It is the practice of the Commonwealth to bear the costs of appeal by the Commissioner to the Federal Court and subsequently to the High Court, even if the taxpayer loses.[116]

Often it is the taxpayer who is initiating litigation. In such cases, if the ATO does not feel that a significant issue is involved, it is ATO policy to try and resolve the dispute through negotiation and by providing further information and explanation.[117]

The "fast tracking" of litigation involving public policy issues or matters involving urgent resolution of a dispute may be helped by changes to the Federal Court Rules. They allow a full Federal Court to hear, more quickly, matters arising from private rulings.

CTC Resources v FCT[118] showed that "fast tracking" is crucial to the success of an appeal. That case held that a court's competence to hear an appeal from an unfavourable private ruling is dependent on the transaction being able to affect the tax liability of the taxpayer in that year of income. So, if the taxpayer asks for a private ruling before entering into a transaction and the ultimate appeal from a subsequent unfavourable private ruling takes place after the end of the year of income to which the private ruling request relates, the Federal Court is not competent to hear such an appeal.[119]

This casts doubt on the validity of the appeal process for taxpayers. If they do not intend to enter into a transaction until it has approval by the

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116 Ibid.

117 Ibid.

118 *CTC Resources v FCT* (1994) 27 ATR 403.

119 Ibid. Special leave to appeal to the High Court was refused in this case.

Commissioner, and the Commissioner subsequently gives an unfavourable private ruling in respect of the transaction, the taxpayer's options are limited. Unless the ruling request takes place very early in the income year, there is effectively no appeal from that ruling, as the court will not hear the appeal, in the normal course of events, before the end of the year in which the transaction is proposed to be entered into.

The Treasurer has stated in response to questions raised in Federal Parliament that the Government sees no need to amend the law, as the decision in *CTC Resources v FCT* did not amount to a denial of taxpayer's rights in the resolution of disputes.[120] Some sop is given to taxpayers in that the ATO's administrative arrangements are being reviewed in the light of *CTC Resources v FCT* to ensure that administrative delays:

> do not inhibit the ability of taxpayers to seek a review of a ruling on a proposed arrangement. The ATO understands that the Federal Court is developing special rules for the "fast tracking" of similar appeals.[121]

It seems bizarre that taxpayers' rights of appeal from unfavourable private rulings are limited to certain times of year. The legislation was certainly not introduced with the intention that limits be effectively placed on the rights of appeal. It is the practical effect of the Federal Court's jurisdictional rules which produces this anomaly.

Amendment of the Federal Court Rules can only reduce the period during which such an appeal is ineffective. The principle remains that practical jurisdictional considerations should not prevent taxpayer's having rights of appeal intended by the legislation. How late in an income year it is now worthwhile requesting a private ruling, if it is intended that an appeal will be made against an unfavourable response, is entirely dependent on how quickly the ruling request, the subsequent objection decision and the appeal hearings are processed by the relevant officials. The Federal Government's unwillingness to introduce amending legislation results in a denial of the very taxpayers' rights that the legislation giving the right of appeal in the first place was intended to uphold.

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120 Treasurer's response to questions raised by Senator Watson, *Hansard* 22 and 24 March 1994.

121 Ibid.

Prosecution

There are numerous taxation offence provisions littered throughout the Act and related legislation.[122] It is the final stick which the Commissioner can wield in his efforts to punish non-compliance with the tax law. The Commissioner chooses to use it sparingly and to maximum effect.

In *Smiles v FCT*[123] it was argued that the prosecution against a member of the New South Wales' Parliament was politically motivated. Mr Smiles sought to show that the prosecutions against him had been brought to achieve an improper purpose: to obtain the publicity associated with the prosecution of a person in his position. Davies J found that this was indeed one of the criteria for deciding whether the ATO would request the Director of Public Prosecutions ("DPP") to bring a prosecution. However, he was not of the opinion that the selection of high profile taxpayers for prosecution was wrong.[124] He said:

> The prosecution of taxpayers for all offences would not be in the public interest. In very many cases, the administrative penalties available by way of additional tax available under the Income Tax Assessment Act provide a suitable penalty as the Income Tax Assessment Act itself contemplates. It is not wrong to take account of the publicity likely to arise from and the deterrent effect of a prosecution when considering whether or not a prosecution for a taxation offence should be instituted. I see no element of abuse of power in that consideration, rather good administration.
>
> Publicity which makes known to the community that an offender has been convicted and a penalty imposed is not in itself in conflict with the criminal justice system. General deterrence is one of the aims of punishment.[125]

Guidelines to the ATO prosecution policy were published as early as 1986 in Income Tax Ruling IT 2246. These Guidelines are used in determining

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[122] The main offences are found in Part III of the TAA. Prosecution can also take place under the Crimes Act 1914 (Cth).

[123] *Smiles v FCT* (1992) 23 ATR 216 at first instance before Davies J. The full Federal Court (1992) 23 ATR 605 did not consider the merits of this argument.

[124] Ibid, Davies J at 229.

[125] Ibid.

which taxpayers will be selected for prosecution. Although, as pointed out by the DPP in Smiles, it is the DPP who takes the decision to prosecute in all criminal prosecutions and in all cases except those concerning minor offences.[126]

The "Prosecution Policy of the Commonwealth" does not refer to publicity, but concentrates instead on public interest.[127] The liaison guidelines for investigation and prosecution used by the DPP and the ATO state that the main purposes for prosecution are for the deterrent effect and to achieve conviction in cases of serious misconduct such that prosecution is the only appropriate response.[128] Criminal prosecutions are reserved for cases where there is serious fraud against the revenue and cases in which there is a circumstance of aggravation, such as the bribery of an ATO officer or corruption on the part of an ATO officer.[129]

In *Smiles*, Davies J said of the ATO Guidelines that, "the fact that the prosecution policy of the Commonwealth does not refer to the question of publicity would not make the Guidelines irrelevant".[130] This means that the prosecution policies of both the ATO and the DPP are relevant in determining when a taxpayer will be prosecuted.

The ATO Guidelines set out in IT 2246 are fairly broad and recognise the limited resources of the ATO.[131] The key criteria governing prosecution include:[132]

- achievement of an administrative objective
- the deterrent effect (which includes associated publicity)
- the administrative workload
- the time required to achieve the objective
- the seriousness of the offence and the degree of culpability of the person
- the degree of co-operation of the person

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126 Ibid at 223 and *Smiles v FCT* (1992) 23 ATR 605 at 613.

127 *Smiles v FCT* (1992) 23 ATR 216 at 224.

128 *Smiles v FCT* (1992) 23 ATR 605 at 612.

129 *Smiles v FCT* (1992) 23 ATR 216 at 223-224.

130 Ibid at 224.

131 Paragraph 1.4.

132 Paragraph 1.5.

- whether a repeated offence
- other public interest factors.

Although the *Smiles'* case did not show an abuse of power, Davies J said that:

> some of the statements in the "Audit Prosecution Publicity Guidelines" to which I have already referred seem to me to go too far and to have the potential, if implemented, to bring about an abuse of process.[133]

Unfortunately, his Honour did not identify exactly which guidelines he meant, so that the ATO and DPP could revise them.

Following *Smiles*, it will be very difficult to show improper purpose in the conduct of a prosecution unless such improper purpose is clearly documented. This is highly unlikely.

More important, the tax legislation is so complex that it is increasingly easy for even the most diligent of tax advisers unwittingly to commit an offence. It seems harsh that a tax adviser making such an error should be ruined by an ATO prosecution carried out purely for its publicity value.

Prosecutions for publicity are even more likely, considering that in *Smiles* there was no review of the decision to refer the matter to the DPP by the Deputy Commissioner at the relevant Tax Office. Senior ATO officers should review such referrals. This would give some comfort to taxpayers as to the fairness of the prosecution policy.

Tax avoidance, tax evasion, fraud and criminal offences committed recklessly or with intent should be punished. However, equity is a key element in any enforcement process. Although the DPP cannot prosecute all offences, those singled out for prosecution should merit it and not be used purely for publicity purposes (unlike in the example given above).

Interest

Under self-assessment, interest on underpayments and overpayments of tax

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[133] Above n 129 at 230.

now serves its proper purpose.[134] It compensates the Tax Office or the taxpayer at rates linked to current commercial rates. Interest paid to the taxpayer was always assessable,[135] but now interest paid to the ATO is deductible.[136] This followed fierce lobbying by taxpayer groups and professional bodies to try and introduce symmetry, and thereby equity, into the interest regime.

The Commissioner retains the discretion to remit such interest. Remission would be exercised in the same way as remission of penalties and the Commissioner has been quick to issue further guidelines as to how he will exercise his powers to remit both interest and penalties under the new system.[137]

Penalties

Amendments to the self-assessment system have seen the Commissioner's very broad discretion to impose penalties of up to 200% made far more specific. The broad parameters within which the Commissioner could operate the old penalty system led to his developing various guidelines published as Income Tax Rulings.[138] To a certain extent the new legislative rules formalise and expand the Commissioner's administrative guidelines. The rules now have an element of sophistication, made necessary by the move to full self-assessment.

The penalty provisions are rightly based on the category of the taxpayer's offence. The main offences can be divided into three categories. The first is late payment of tax. The second covers late lodgment of returns and other particular offences. The third is where tax is underpaid. In this category, whether there is a penalty is then determined according to whether the taxpayer has taken reasonable care or a reasonably arguable position.

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134 Taxation Laws Amendment (Self-Assessment) Act 1992, which applied generally from 1 July 1992.

135 Section 26(jb).

136 Section 51(5).

137 Taxation Ruling TR 93/D36.

138 The main penalty remission guidelines applicable for offences up until 30 June 1992 are found in Income Tax Ruling IT 2517.

Late payments and lodgments

A penalty of 8% is imposed under s 207 where there is late payment of tax. Section 207 has its own rules as to how the Commissioner should exercise his discretion to remit penalty tax. Broadly, the decision to remit may be exercised if it was not the taxpayer's act or omission which resulted in the late payment of the tax. There is also scope for remission in special circumstances where it would be fair and reasonable. However, the Commissioner's guidelines on remission, mentioned above, go further in providing specific examples of when he will exercise his power to remit penalties and interest.[139]

Special rules still apply to impose penalties in particular circumstances. The most obvious example is the penalty of 200% of the tax payable, imposed where a taxpayer fails to furnish a return.[140] The Commissioner has the power to remit such penalties in whole or part.

Reasonable care

However, the general scheme of penalties applies whenever there is a tax shortfall.[141] If there is a tax shortfall, a series of legislative discretions must be exercised by the Commissioner.

The Commissioner must first determine whether the taxpayer took reasonable care.[142] If so, provided the tax shortfall is less than the greater of, $10,000 or 1% of the taxpayer's return tax for that year, there is no penalty. Reasonable care is not defined, but is deemed not to be present if a taxpayer is involved in what the explanatory memorandum describes as culpable behaviour.[143] This means, any of:

- deliberate evasion (75% primary penalty)
- recklessness (50% primary penalty)

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139 Ibid.

140 Section 222, or where a company which is a "relevant entity" under s 221AK fails to keep certain records.

141 Section 222A.

142 Section 226G and s 160ARZA.

143 Explanatory Memorandum to the Taxation Laws Amendment (Self-Assessment) Bill 1992, ch 4.

- tax avoidance (50% primary penalty)
- profit shifting with no dominant avoidance purpose (25% primary penalty)
- disregard of a private ruling (25% primary penalty).

For each of these, special rates apply to increase the primary penalty in the event of any hindrance to the Commissioner, or to reduce the primary penalty in the event of disclosure of the shortfall during an audit or before an audit. The Act leaves most of the terms it uses undefined. The Commissioner has acted swiftly to issue rulings on several areas of uncertainty, such as what constitutes "voluntary disclosure"[144] and how to calculate a "tax shortfall".[145]

These rulings continue to show the pragmatic and flexible approach taken by the Commissioner under the previous, less legislated regime. For example, the Commissioner says he may, in certain circumstances, exercise his discretion to treat taxpayers who make a disclosure **after** being informed of a tax audit as having made the disclosure **before** being informed of the tax audit.[146] The result is a significant reduction in penalties for the taxpayer. The Commissioner takes this approach, not out of goodwill, but because it has been shown to improve taxpayer compliance.[147] Paragraph 47 of TR 94/6 states that:

> the purpose of the discretion is to ensure that a taxpayer is not improperly denied the benefit of the 80% reduction in penalty rates because of a literal application of the law.

In his ruling defining "reasonable care",[148] the Commissioner has followed the tenor of the explanatory memorandum, which states that:

> the test looks to whether an ordinary person, in all the circumstances of the taxpayer, would have foreseen as a reasonable probability or likelihood the prospect that the act or failure to act would result in a shortfall. It is not a question of whether the taxpayer actually foresaw the probable impact of the

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144 Taxation Ruling TR 94/6.
145 Taxation Ruling TR 94/3.
146 Paras 46-47 of Taxation Ruling TR 94/6.
147 Above n 21.
148 Taxation Ruling TR 94/4.

> act or failure to act, but whether an ordinary person in all the circumstances would have foreseen it. The test does not depend on the actual intentions of the taxpayer.[149]

The reasonableness test is an objective test and is, of course, the standard test for negligence. It is likely that the courts will apply the normal rules of negligence, which should apply to the taxpayer in all aspects of record keeping and reporting; in discovering, researching and making judgments on issues of law relating to the return; or in the actual completion of the return. Use of "an ordinary person in the circumstances of the taxpayer" test, does put a greater burden on the sophisticated taxpayer.

Nonetheless, the Commissioner continues to require his officers to take a pragmatic approach to the interpretation of "reasonable care". Taxation Ruling TR 94/4 reflects this, with such statements as:

> The changes to the penalty system represent a proper balance between the need for returns to be correct and the difficulties that taxpayers face in ensuring they are correct. Officers involved in the imposition of penalties under the new system should bear in mind that, under self-assessment, taxpayers are required to resolve issues that may sometimes be quite complex. Provided that a taxpayer may be judged to have tried his or her best to lodge a correct return, having regard to the taxpayer's experience, education, skill and other circumstances, the taxpayer should not be subject to a penalty.[150]

A reasonably arguable position

A similar approach has been taken in the ruling defining a reasonably arguable position.[151] If the taxpayer takes reasonable care, but the tax shortfall exceeds $10,000, or 1% of the taxpayer's return tax for that year, then to avoid a penalty, the taxpayer must show a reasonably arguable position.[152]

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149 Above n 143.

150 Para 14.

151 Taxation Ruling TR 94/5.

152 Section 226K.

Section 222C defines "reasonably arguable" to mean as likely as not correct. In other words, according to the explanatory memorandum, the law is not settled. The taxpayer must have a reasonable expectation of being correct and have a cogent, well-grounded position, which is considerable in its persuasiveness. The language sounds faintly Victorian.

Taxation Ruling TR 94/5 is less expansive in defining a reasonably arguable position, than is Taxation Ruling TR 94/4 in defining reasonable care. However, where s 222C states that a public ruling is authority for a reasonably arguable position, the Commissioner makes it clear that, "the mere fact that a Public Ruling has issued does not necessarily mean that alternative treatments to that suggested by the Public Ruling cannot be reasonably arguable".[153]

A further example of the healthy approach taken by the ATO when acting under these administrative provisions is the willingness of tax auditors to negotiate on penalties.[154] The final element of a tax audit usually takes place within a fairly co-operative framework. The negotiation is generally interest-based rather than using positional bargaining. This produces outcomes most likely to satisfy both parties.[155]

The penalty provisions provide an example of where the exercise of a discretion works best within the broad outlines set out in the legislation. Administrative guidelines and their interpretation are pragmatic and flexible, taking into account, in most cases, the particular circumstances of the individual taxpayer. What is given away by the ATO by taking a more flexible approach, is more than made up for in generating goodwill. The ATO recognises the importance of goodwill and respect in increasing taxpayer compliance.[156] It is an approach increasingly used by the ATO to improve compliance, as a result of detailed research in the area.[157] The same cannot be said of the ATO's approach to the interpretive provisions, discussed below.

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153 Para 9 of Taxation Ruling TR 94/5.

154 Cullen D, "Managing and Controlling a Tax Audit: The External Contribution to the Tax Audit" 1992 conference paper.

155 Ibid. See also Fisher R and Ury W, *Getting to Yes* (1990 Arrow) ch 3.

156 Wirth, above n 21.

157 Above n 21.

The ruling system

Rulings play a pivotal role in the structure of the self-assessment system. There were two major elements introduced by the Taxation Laws Amendment (Self-assessment) Act 1992. Firstly, there were the administrative elements introduced to streamline the administration of the Act, including the new penalty, interest and assessment and determination provisions. Secondly, there were the ruling provisions introduced to improve the interpretation of, and compliance with, the Act.

The explanatory memorandum states that:

> The objective of the amendments affecting rulings is to ensure that rulings made by the Commissioner about the application of tax laws to arrangements are to be binding and that Private Rulings are to be reviewable in the same way as assessments are reviewable under Part IVC of the Administration Act.[158]

Public rulings operate to interpret the application of the tax laws, whether generally or to specific classes of people and/or arrangements.[159] They often explain the way in which a discretion of the Commisioner under the tax law would be exercised.[160]

Public rulings come in a wide range of shapes and forms, the only proviso being that they must state that they are public rulings and be published.[161] The Commissioner has used a range of mediums to convey public rulings, including Taxation Rulings, Taxation Determinations, ATO publications, press statements and speeches. These are now binding on the Commissioner in that where such a ruling is favourable to a taxpayer the Commissioner is compelled by the law to act in accordance with the favourable ruling.[162]

Private rulings are given to individual taxpayers about their own particular tax affairs.[163] They are reviewable by the Administrative Appeals

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158 Chapter 1.

159 Part IVAAA of the TAA.

160 Section 14ZAAD of the TAA.

161 Section 14ZAAI of the TAA.

162 See s 170BA to s 170BE.

163 Part IVAA of the TAA.

Tribunal or the courts in the same way as assessments are reviewable.[164] Where a taxpayer acts under a favourable private ruling it is generally binding on the Commissioner in the same way as a public ruling.[165]

One of the major aspects of the ruling system is that the discretions given to the Commissioner in interpreting the provisions of the tax law and their application are extraordinarily broad. This can give rise to major problems.

Taxation rulings are the showpiece of the ATO's interpretations of the tax laws. Senior officials, backed up by adequate resources, put significant effort into producing a balanced and authoritative interpretation of the law. Taxation rulings are generally preceded by draft taxation rulings. Draft rulings are the subject of extensive liaison with taxpayer groups and professional bodies and public comment is actively sought.[166] It is only once the ATO is completely satisfied with its interpretation in the light of public comment that it publishes a final ruling. This process is commendable, but certainly not foolproof.

Determinations in particular, but also sometimes other publications which state that they are public rulings, are less well thought out before publication. There is a system of draft determinations, but the period for public comment is only a month. This leaves little time for a considered and authoritative response. The strength of determinations is supposed to be that they can provide a swift response by ATO experts on a range of specific interpretations of the tax laws. This is also their weakness. Not only are they made too quickly, but no reasoning is given. The authority and experience of those preparing the determinations is sometimes questionable, as evidenced by the subsequent withdrawal of a number of determinations.

The real concern is that to ignore a ruling under self-assessment is to invite a 25% penalty on any tax shortfall. There is always the opportunity to self assess and then to object against that assessment as a way of obtaining review of the legal position.[167] Review of an unfavourable private ruling

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164 Part IVC of the TAA.

165 See s 170BA to s 170BE.

166 This can be seen in the minutes of the various tax liaison group and subcommittee meetings.

167 Part IVC of the TAA.

is also available, subject to the flaws in the system outlined above.[168] However, this avenue is only of practical use for matters involving significant dollar amounts for the taxpayer. Furthermore, the prohibitive costs involved in the review process limits the number of taxpayers willing to seek a review by the courts. The problem is exacerbated by the knowledge that any significant issue of interpretation will probably have to go at least to the Full Federal Court.

So, effectively, for the majority of taxpayers in respect of the majority of transactions, the rulings issued by the ATO represent the authoritative interpretation of the law. There is to all intents and purposes no real avenue of appeal. Yet, whatever the qualifications of ATO officers involved in the issue of rulings, it is inevitable that as employees of the ATO they certainly cannot be perceived to be completely impartial in their interpretation of the law. Neither are they likely to be completely impartial, working as they do within the ATO, and being imbued with its culture.

Crucial elements of an equitable legal system are the independence and impartiality of the judiciary. This is inherent in the doctrine of the separation of powers.[169] Placing the ATO in the position of initial interpreter of the tax laws may be administratively convenient, but it jeopardises the right of access by taxpayers to an independent judiciary. This may be a problem to be faced in the administration of the legal system as a whole. Nonetheless, it is constitutionally an unsatisfactory position in which to place taxpayers as citizens of this country.

The recommendations of the JCPA included the establishment of a taxpayers' charter of rights, the formation of a Small Taxation Claims Tribunal and the appointment of a taxation ombudsman.[170] These are worthy recommendations. Even more useful would be the removal of the interpretive function from the ATO and the setting up of an independent body to interpret the tax laws and issue tax rulings.

The major advantages of having such a body would be its independence and impartiality. The success of any tax system is founded in its equity.

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168 Part IVAA of the TAA.

169 Hanks PJ, *Constitutional Law in Australia* (1991 Butterworths) ch 12.

170 Above n 25.

This body would be seen to be fair. It would give certainty to the tax law in a way the Commissioner cannot. His interpretation will always be perceived as biased.

This body would interpet the law as it is and not as the ATO wants it to be. It could take over all interpretive functions of the ATO, including the issuing of rulings and the development and reform of the tax law. The ATO could request rulings on the interpretation of the law for assessment, audit and enforcement purposes. The objection and appeal procedures, except for the amendments outlined above, could apply equally to the new body and would extend to rulings given to the ATO.

An independent body, closely involved in the application of the law, would provide an invaluable resource in developing policy and new law. It would provide an independent perspective on ATO law-making which is not currently available. Unbiased input into the development of the law could only lead to better laws.

Most of the staff of this body would initially come from the ATO. External experts from the judiciary, tax professions, academia and business would have to be involved from the start to ensure the body's independence. Certainly, over time the ATO culture would be replaced with one reflective of the body's quasi-judicial function.

Such a body, which should be established by statute with its own charter, could administer a Small Claims Tribunal and include the office of the taxation ombudsman. Its creation would simply recognise the quasi-judicial function already being carried out quite inappropriately by the ATO, integrated into its revenue collection and administration function.

The major disadvantage of such a body is that it would be costly to establish. There would have to be some overlap with the ATO. However, the ATO would only require a small staff of tax counsel to represent their preferred interpretation of the law to the new body. In addition, modern communication cuts down the need for offices in each city. Currently there is huge overlap, with advising sections in most Tax Offices. This should give significant savings.

The ATO will also argue that there are stringent safeguards to prevent any bias in the current system. Whatever the merits of this argument and the current system, bias is inevitable. The ATO has signficant input into the

formulation of the law, controls its administration and except in the tiny minority of cases going to the courts, governs its interpretation.

Taxpayers' charter

In the potpourri of the Commissioner's administrative powers, there is significant room for infringement of taxpayers' rights. The problem is that such infringements do not extend far enough to constitute abuses of power, bad faith, illegal actions or decisions, procedural irregularities or breaches of the rules of natural justice. The infringements are sanctioned by the law in the name of protection of the Revenue.

A solution proposed to ensure the protection of taxpayers' rights in the context of the extensive powers available to the Commissioner, is a taxpayers' bill of rights.[171] This issue was recognised in the report by the JCPA, which suggested the establishment of a Taxpayers' Charter[172] and the creation of a Taxation Ombudsman.[173]

A major hurdle to the acceptance of a taxpayers' bill of rights is the differing answers which are given to the obvious questions of:

- what level of enforcement should such a bill have?
- who should decide which rights are to be included?
- which rights should be protected?

The first question is very pertinent, particularly in the light of the bill of rights proposed by the influential Taxation Institute of Australia ("TIA"), as its Jubilee Project.[174] The TIA also propose:

> that the Taxpayers' Bill of Rights should have the force of law and that existing legislation should be read as subject to it; so that, where an inconsistency occurs, the Taxpayers' Bill of Rights

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171 "Taxpayers' Bill of Rights" (1993) 28 *Taxation in Australia* 50 and Sandford C and Wallschutzky I, "Taxpayers' Rights: A Model Magna Carta?"(1994) 28 *Taxation in Australia* 610.

172 Recommendation 131.

173 Recommendation 132.

174 Above n 171.

> will take precedence.[175]

This is semi-entrenchment, as used in Hong Kong's 1990 Bill of Rights.[176] The United States uses full entrenchment and can strike down conflicting legislation. A third method is that used by New Zealand. There the courts are required to interpret Acts of Parliament as though they are consistent with the Bill of Rights. However, they may not refuse to apply a provision in any Act "by reason only that the provision is inconsistent with any provision of this Bill of Rights".[177]

Even if a legislated bill of taxpayers' rights were accepted, it would almost inevitably follow the New Zealand model. This surely is the minimum if the concept is to be taken seriously. Unfortunately, it is more likely that the ATO would at best argue for the introduction of a taxpayers' charter based on the United Kingdom model. There the Inland Revenue has published a Taxpayers' Charter setting out the treatment:

> that a taxpayer is entitled to expect from the Revenue Departments and indicates how dissatisfied taxpayers can complain. It states also that, in return, taxpayers should be honest, provide accurate information and pay on time.[178]

The Taxpayers' Charter is backed up by a series of Codes of Practice which set out how the Inland Revenue will conduct itself in specific areas of its work.[179]

The ATO issues guidelines from time to time, covering the way they will act in specific areas. The most well known examples are the guidelines issued which govern the conduct of tax officers in respect of tax audits, discussed above. It would not be too difficult to extend this further and follow the lead of the United Kingdom. This would be particularly so if it took place in conjunction with the appointment of a Taxation Ombudsman.

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175 Ibid.

176 Article 4(1).

177 Bill of Rights 1990 (No 2) Article 4. For a fuller discussion of the issue of entrenchment, see Klug F and Wadham J, "The 'democratic' entrenchment of a Bill of Rights: Liberty's proposals" 1993 Public Law 579.

178 Sandford and Wallschutzky, above n 171.

179 Ibid.

The concern is that, by making this sort of compromise, the key issues are not addressed effectively. All the real power for the protection of taxpayers' rights remains in the hands of the ATO. Nor does the appointment of a Taxation Ombudsman by itself necessarily solve much. The UK Revenue Adjudicator, although independent, has limited jurisdiction and powers.[180] By its very nature, such a position is concerned more with administrative process than with substantive rights of taxpayers.

An ombudsman should be appointed to provide adjudication of the administrative process. The appointment should be in conjunction with a bill of rights. As is stated by the Taxation Institute, any bill of rights should have the force of law, so that it is taken out of the administrative process and becomes an element of the judicial decision-making process. In this way, the principles will be seen to be interpreted and applied impartially and equitably.

The questions as to what rights should be included and who should choose them are best answered by the approach taken in respect of the National Review of Standards for the Taxation Profession. Rights agreed on, through a co-operative process, by the leading professional bodies and taxpayer groups in conjunction with the ATO, must have the best chance of gaining support. Certainly the Taxpayers' Bill of Rights put forward by the Taxation Institute would form a good starting point for discussion.

Conclusion

The Commissioner's powers and discretions can be separated into those relating to his administration and collection functions and those relating to his function as interpreter of the tax legislation. Administration and collection is operating effectively and efficiently with few provisos. However, the interpretation function should be removed from the Commissioner. This would improve the interpretation of the tax legislation. It would also ensure that taxpayers are provided with the basic rights guaranteed to them under the constitutional doctrine of the separation of powers. Currently, the ATO, as an arm of the executive, is usurping the judiciary in the tax law area.

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[180] Oliver D, "The Revenue Adjudicator: A new breed of Ombudsperson?" 1993 *Public Law* 407.

The tax law should be interpreted by an impartial and independent statutory body. This would benefit all stakeholders in the tax system. Taxpayers would see the law as independent and unbiased. The Tax Office would receive the benefit of truly independent advice as to what the law is. This would lead to less contention and improved compliance. The government would have at its disposal much wider expertise to better develop the tax law. Australia would provide a model other tax administrations would want to follow.

In the administrative area, the attention paid to building up relationships between the ATO and taxpayers can only lead to improvements in voluntary taxpayer compliance. Nonetheless, as illustrated above in the context of audits and asset betterment tests, the ATO must go to greater lengths to publish exactly how its officers operate. Taxpayers under scrutiny must be provided with a published ATO benchmark against which to judge the activities of the officers with whom they have to deal.

This same openness should be extended to an acknowledgement of the difficulties in maintaining the confidentiality of huge databases of secret and sensitive information. The general procedures for assuring confidentiality should be published and reviewed annually, in consultation with the professional bodies and taxpayer groups.

Overall, however, the ATO's administrative function is remarkably successful. The effect of drafting general legislation, which gives wide powers to the Commissioner, means that the ATO has to develop guidelines as to how it will interpret and implement the legislation. Through the ATO's own experience and through representations made by taxpayers and taxpayer groups, the guidelines are usually developed and refined into rules which are acceptable to both the ATO and taxpayers. Anomalies are ironed out and loopholes closed. Subsequent legislation of the guidelines together with further improvements is usually fairly painless.

This can be seen in the easy transition from the old to the new interest and penalties regime, complete with similar administrative rules governing the ATO interpretation of the legislation. This compares favourably to the unfortunate transition to the brand new legislative rules applicable to objection and appeal proceedings in respect of binding private rulings. As the scope for administrative interpretation of the latter arrangements is negligible, change is much slower and more inclined to be held up by

blinkered approaches. This was shown in the Treasurer's response to the question of taxpayer rights once the *CTC Resources* case revealed that the legislation had failed to achieve its purpose.

Provided the parameters are clearly set out in the legislation and there is a clear recognition on all sides of the need to protect taxpayer rights, administrative rules have been shown to be more effective in governing the administrative arrangements of revenue collection than has legislation.

The proviso which should be placed on the pursuit of a more informal set of rules governing tax administration, is that the general governing legislation should be subject to a taxpayers' charter of rights. This will ensure that the rights of the individual are maintained, even in the face of technological advances with the associated increased intrusion into individual privacy.