MEDIA RELEASE

Ombudsman supports Tax Commissioner's actions on tax scheme, Budplan

Under embargo until Friday 11 June 1999

A Commonwealth Ombudsman investigation into the ATO's disallowance of Budplan investors' tax deductions has concluded that the ATO acted correctly in disallowing participants' tax deductions.

Commonwealth Ombudsman Ron McLeod said: "Although the ultimate decision as to the legality of the Budplan deductions will probably be made in the courts, our investigation indicates that the Commissioner's decision to disallow the participants' deductions was reasonable. The Commissioner's action to disallow participants' tax instalment variations and to amend their tax returns was appropriate."

The Commonwealth Ombudsman's Office received some 1600 complaints from Budplan investors, many of whom were faced with large tax liabilities as a result of the ATO's actions.

Mr McLeod said: "This is the largest single tax issue investigated by the Ombudsman's Office since the special Tax Team was established in 1995. The investigation put considerable pressure on the team, under the leadership of the new Special Tax Adviser, Catherine McPherson.

The Ombudsman joined the Commissioner for Taxation, Michael Carmody and Chairman of the Australian Securities and Investment Commission, Alan Cameron, who recently warned investors that they should be wary of tax effective investment schemes which offer benefits that seemed "too good to be true".

"Our investigation of this matter has revealed the importance of taxpayers obtaining certainty in taxation matters before they begin investing in, and claiming deductions for, arrangements like Budplan," Mr McLeod said.

"As a result of the issues raised by Budplan, and the proliferation of other so called 'tax effective' investment schemes, the ATO has introduced a product ruling system, designed to provide greater certainty for would be investors.

"Our investigation did find some minor administrative shortcomings, however, these deficiencies did not affect the appropriateness of the Commissioner's decisions.

"The ATO has now sought to rectify these problems by centralising much of its decision making to improve consistency for people seeking rulings and other decisions related to investment schemes of this type, including the processing of tax instalment variations.

"My office will monitor the effectiveness of these initiatives to ensure they provide taxpayers with more timely rulings and greater certainty," Mr McLeod said.

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The ATO and Budplan

Report of the Investigation into the Australian Taxation Office's handling of claims for tax deductions by investors in a tax-effective financing scheme known as Budplan

Report under section 35A of
the *Ombudsman Act 1976*
June 1999

Executive Summary

The Complaint

This is the report of an investigation by the Commonwealth Ombudsman into complaints by investors in a tax-effective financing arrangement known as Budplan.

More than 1600 people complained to the Ombudsman about the way the Australian Taxation Office handled their claims for tax deductions in relation to the Budplan Arrangements.

In the main, the complaints covered:

- the alleged retrospectivity of the application of the Commissioner's interpretation of the law as it applies to the Budplan Arrangements;
- the delays by the Commissioner in forming an opinion of the Arrangements and inaction in providing a response to a private ruling request; and
- the withdrawal of previously approved tax instalment variation applications.

The Investigation

This investigation covers by far the largest number of complaints the Ombudsman has received on a single taxation matter. The investigation, which has taken ten months to complete, has placed the small specialist tax team within the Ombudsman's Office under significant pressure. Aside from the regular ongoing representations by individual complainants and their representatives during this period, the tax team has also met several times with ATO staff and the legal representatives of the Budplan manager, Business and Research Management Pty Ltd (BARM), and reviewed numerous papers and submissions from the parties involved.

Public Report

Given the number of complainants and other interested parties, the nature of the issues raised, and the more general public discussion about the Commissioner of Taxation's stand on tax-effective financing schemes, the Ombudsman has decided that it is in the public interest for this report to be released under section 35A of the *Ombudsman Act 1976*. The ATO and representatives of BARM have had the opportunity to review and comment on the Ombudsman's draft conclusions. Their views have been taken into account in preparing this final report.

Conclusions and Recommendations

It is my opinion that the Commissioner's interpretation of the law as it applies to Budplan is reasonable and that the Commissioner's subsequent actions including amending the assessments of the Participants for the 1996 and 1997 financial years, and identifying the likely application of Part IVA were not retrospective, unjust or oppressive.

I am of the view that the Commissioner's inaction in relation to the private ruling request of a taxpayer and Director of BARM, Mr Stotter, amounted to defective administration but that, under self assessment, this defective administration could not have influenced any individual participant's decision to invest in the Arrangement or to claim any tax benefits.

Consistent with administration under self assessment, the fact that the Commissioner did not provide a public position paper in relation to the Arrangement until 1998 does not, in my view, amount to defective administration. Participants were not entitled to assume that the Commissioner's silence amounted to an implicit approval of the Arrangement.

While there were inconsistencies in the ATO's processing of tax instalment variation applications, which in my view, amount to defective administration, whether or not Participants had an approved Variation had no bearing on the ultimate action in relation to the Participants' assessments. Further, by advice from Senior Counsel retained by BARM, the Commissioner was entitled to withdraw the approved Variations on a prospective basis, and it is my view that this was the right thing for the Commissioner to do.

For whatever reason, it appears that the Participants have not sufficiently accounted for the requirements of self assessment when lodging their tax returns.

The Commissioner has acknowledged the administrative deficiencies highlighted by the complaints and has sought to rectify them by:

- establishing a more coordinated approach to Variation processing;
- centralising administration of audit activities in relation to tax- effective financing schemes; and
- developing a Product Ruling system to provide greater certainty as to the tax benefits of tax-effective schemes.

I have made no recommendations in relation to the administrative deficiencies highlighted by the report, as I believe that these improvements will meet the administrative shortcomings identified in the course of the investigation.

My Office has been instrumental in bringing the parties together, and the Commissioner and BARM are in negotiations regarding suitable test cases. It is in the interests of all concerned that this process is resolved in a timely way. Alternatively, it is open to either party to canvass settlement options.

Introduction

There are two specific Budplan Arrangements: Personal Budplan Arrangement; and the Company Budplan Arrangement. In all but three cases, the complaints to the Ombudsman's Office were in respect of the Personal Budplan Arrangements and I have restricted my investigation to the Personal Budplan Arrangements. In my opinion, information in relation to the Company Arrangements was not relevant to the investigation and has not been considered when forming conclusions to this report.

Budplan activities

The nature of the activities of Budplan are research and development.

The initial Personal Budplan Prospectus issued on 5 December 1995 described an arrangement which planned to commercially market tea tree oil for pharmaceutical and cosmetics use to the major pharmaceutical and cosmetic companies. *Personal Budplan No.2* involves the business of developing the potential manufacture and sale of specified tea tree oil based products. *Personal Budplan No.3* involves a project looking at the use of celery seed for arthritis cures. *Personal Budplan No. 4* is a project dealing with the ageing process, specifically rheumatic pain, arthritic pain and gouty arthritis. *Personal Budplan No.5* relates to wine grape genetics.

The Commissioner has formed an opinion that inter alia, the losses or outgoings incurred from the investment in the Budplan Arrangements do not satisfy the requirements of the general deduction provisions of the tax laws as it is considered the individual Participants are not carrying on a business. Alternatively, if it is ultimately determined that they are carrying on a business, the loss or outgoing is incurred at a point prior to the establishment of the business, and not deductible under the general deduction provisions or alternatively it is capital in nature.

The Commissioner is also of the opinion the investment was entered into for the dominant purpose of obtaining a tax benefit, and the general anti-avoidance provisions of the *Income Tax Assessment Act 1936* (ITAA) are therefore likely to apply. The general anti-avoidance provisions are contained in Part IVA of the ITAA. Part IVA applies where a scheme has been entered into for the dominant purpose of obtaining a tax benefit. Section 177A of the ITAA defines a scheme to include:

> "*...any agreement, arrangement, understanding promise or undertaking... and any scheme, plan, proposal, action, course of action or course of conduct*."

Section 177C of the ITAA defines a tax benefit to include:

> "*...a deduction being allowable to a taxpayer ... where the whole or a part of that deduction would not have been allowable, or might reasonably be expected not to be allowable ... to the taxpayer if the scheme had not been entered into or carried out".*

Where Part IVA applies, the Commissioner is authorised to make a determination including that an amount should be included in the assessable income of the taxpayer or all or part of a deduction should not be allowed to a taxpayer. The rate of penalty tax in respect of a tax avoidance scheme is 50 per cent of the amount of tax sought to be avoided, reduced to 25 per cent where the taxpayer has a reasonably arguable case that the relevant anti-avoidance provisions do not apply.

The ATO issued a position statement to BARM on 29 April 1998 outlining the Commissioner's opinion regarding the Arrangements. Following submissions from

BARM on the position taken, on 30 June 1998, the ATO issued a letter to all taxpayers who had sought to claim deductions in relation to the Budplan Arrangements (the 'Participants'), advising them that it had concluded the expenses in relation to the Arrangements were not allowable under the law, and that it proposed to amend their income tax assessments for the 1996 and 1997 financial years accordingly.

During the period May to September 1998, the Commonwealth Ombudsman received in excess of 1,600 complaints from people who had invested in, and claimed tax deductions for Budplan. We also received a complaint from Business and Research Management Pty Ltd (BARM), the manager of Budplan. The complaints were generated following the release of the ATO's position statement on the proposed tax treatment of investments in Budplan.

As part of the action taken by the ATO, an offer was made to all Participants to voluntarily provide information on their deductions claimed and to request an amendment to their income tax assessment(s). By voluntarily providing information, penalty tax would to be reduced from a potential 50 per cent to five per cent. Participants were advised that interest on the tax shortfall would be payable from the due date of the original assessment to the date of issue of the amended assessment(s). By accepting the offer, the Participants' individual rights of objection were not affected, and in the majority of cases, objections have now been lodged.

Tax instalment deductions

Section 221D of the ITAA allows a taxpayer to vary his or her tax instalment deductions if he or she believes their taxable income will be substantially reduced at the end of the year due to a deduction from inter alia, an investment. The taxpayer obtains the advantage of a tax deduction during the course of the financial year through reduced tax instalments deductions rather than receiving a refund or reduced tax bill when the assessment is issued at the end of the year. From August 1997, the ATO had decided to refuse to allow Variations for tax instalment deductions where the application for a Variation was identified as based on Budplan. Previously approved Variations were also withdrawn on a prospective basis.

From the complaints received by this Office, there was a perception that the Ombudsman could determine the correctness or otherwise of the ATO's stated position on Budplan. This is not correct. At a meeting on 7 August 1998 between representatives of BARM, the ATO and this Office, it was agreed it was not appropriate for the Ombudsman to attempt to determine what were arguable legal

issues. Such matters can only be determined through the review and appeal provisions of the ITAA.

Suggestions of mounting a test case on the Commissioner's interpretation were first raised between the ATO and BARM in June 1998. Detailed negotiations on this matter commenced following the 7 August meeting. I note concerns that settling of a test case program has taken far longer than anticipated, and while it is a matter for BARM and the ATO to resolve, it had been agreed that the Ombudsman would assist in ensuring the matter was expedited, if necessary. Neither party has sought my intervention on this matter.

Also at the meeting of 7 August the representatives of BARM raised concerns about the terms of the ATO's letter of 30 June 1998 to the Participants, in particular, the mention of the raising of amended assessments and the expectation that 50 per cent of the tax in dispute would be payable pending the resolution of the Test Cases. My Annual Report for 1997- 98 also highlighted the recovery of the tax debts generated from the issue of the proposed amended assessments as an issue for the complainants. As the ATO subsequently agreed to allow Participants to elect to have their amended assessments, and the full amount of tax in dispute held in abeyance pending the determination of the Test Cases, (with interest accruing until the debit assessments were paid), there was no need for the Ombudsman to consider this aspect of the complaint further.

My Office was instrumental in bringing together the ATO and the representatives of the complainants to provide some direction in the way the dispute should be resolved. As a result of this meeting, the parties were able to agree to a process for identifying suitable test cases and relevant test case funding matters. Given this the Commissioner agreed, subject to certain conditions about the test case process, to withhold recovery action for those debts arising out of this dispute until a relevant test case decision was handed down.

The complaint issues

Although some of the matters raised related to individual circumstances of certain complainants, generally, the main issues involved:

- assessments for the 1996 and 1997 financial years of income and the proposed application of Part IVA. The Participants and their representatives allege that this is a retrospective application of the ATO's interpretation of the tax law as it applies to this type of Arrangement, and that the Participants were entitled to rely on the interpretation provided by Income Tax Ruling IT 2195 and draft Ruling TR97/D17 to support the tax deductions;

• the ATO's timeliness regarding the issuing of a position statement and acting on a request for a private ruling. The Participants and their representatives allege that the Commissioner had information available to provide a position much earlier than he did provide it; and

• the ATO's approach to the processing of tax instalment variations and its decision to withdraw the prior approvals for tax variations. The Participants and their representatives argue that the Commissioner should not have been entitled to withdraw previously approved applications, and that by allowing the majority of such applications, Participants assumed that the Arrangement had been accepted by the Commissioner. In addition, there appeared to an inconsistent approach to the processing of applications for variations.

Our review has been limited to these administrative matters.

Issue 1: Application of the ATO's Position Statement in relation to Budplan Arrangements for 1996 and 1997 financial years of income

The Complaint

The Budplan Participants have suggested that the ATO should reconsider its position on the ATO's proposed amendment of their 1996 and 1997 income tax assessments.

The Participants claimed they were entitled to rely on Income Tax Ruling IT 2195 and paragraph 39 of Draft Ruling TR 97/D17, to allow them to claim the deductions in the 1996 and 1997 years. They claimed that by not accepting reliance on these Rulings the Commissioner was, in effect, applying a new interpretation of the law retrospectively.

The Participants also argued that Part IVA should not apply.

Matters for consideration

Ultimately, the Commissioner's interpretation of the application of the law to the Budplan Arrangements is a matter for the courts to determine. However, for me to investigate the Participants' complaints, I must first determine whether the ATO's application of IT 2195 to the Budplan Arrangements is reasonable. I must also consider whether the action taken by the Commissioner prior to, or post the release of the Position Statement, is unreasonable, discriminatory, in anyway oppressive, or otherwise unjust.

Application of IT 2195 and TR97/D17

Income Tax Ruling IT 2195 was released on 24 September 1985, following the Full Federal Court decision in *Federal Commissioner of Taxation v Lau 84 ATC 4929* (Lau's case), where tax deductions were sought in relation to an afforestation arrangement. IT 2195 sets out the ATO's policy on the tax treatment of afforestation arrangements.

TR97/D17 is a draft ruling, and as a draft ruling it represents the preliminary but considered views of the ATO. However, as a draft ruling, taxation officers, taxpayers and practitioners cannot rely on its principles in relation to tax deductions. TR97/D17 also applies to afforestation schemes. At paragraph 39 it states that: "It will not apply to an income year before the 1997-98 income year in which a taxpayer, relying on Taxation Rulings IT 360 or IT 2195, would have a lesser liability to income tax than if this Ruling applied." The participants argue that their reliance on IT 2195 is supported by the reference to it in TR97/D17. The real issue is whether IT 2195 should be applied to the Budplan Participants' tax assessments. The application of the draft ruling only becomes an issue if it is accepted that IT2195 applied to the assessments for the years prior to the 1997-98 income year.

At paragraph 12 of IT 2195, the Commissioner in accepting the Full Federal Court decision made the following ruling:

"12. A taxpayer who has entered into agreements on terms consistent with arm's length dealings between independent parties, under which he has sufficient interests, rights and control in or over commercial activities to meet the business tests referred to in para.6 of Taxation Ruling IT 360, may be accepted as having carried on a business even though there is provision in the agreements for non-recourse financing of part of his expenditures and his escape from further liability upon default by the taxpayer or other parties to the agreements."

Paragraph 13 states that:

"13. In cases falling within para. 12, it will be accepted on normal principles that the taxpayer has incurred expenditure in carrying on the business to the extent that the expenditure has been paid out of the taxpayer's resources including funds borrowed in the traditional manner from arm's length sources. Such arm's length sources may include the promoter or its associates. However, deductions for expenditure said to be incurred in round robin arrangements, whether in the actual incurring of the expenditure or in the obtaining of the funds to be expended, will be denied in cases where the taxpayer's claim fails any one or more of the following tests:

(1) on an objective view of the facts, it is apparent that a sham is involved;

(2) non-arms length transactions are involved; ...

(4) the former sec. 260 or Part IVA applies;..."

BARM has argued that IT 2195 covers the participants for the following reasons:

- non-recourse and limited-recourse loans and round robin arrangements are accepted as legally effective;
- management fees prepayment arrangements similar to those in Lau's case are also acceptable;
- the escape from further liability upon default by other parties to the agreement is permissible; and
- the Commissioner's general statements that taxpayers are entitled to rely upon ATO announcements and practices.

The Commissioner's arguments for not applying IT 2195 to the Budplan Arrangements include, among other things, that:

- the Budplan activities appear more in the nature of research and development ("R&D") than afforestation which is the subject of IT 2195;
- Budplan Participants are not carrying on a business according to the business tests referenced at paragraph 12 of IT 2195 and outlined in IT 360;
- even if it is ultimately determined that the Budplan Participants are carrying on a business,
  - the business is not one of research, the expenditure has been incurred at a point too soon, or the expenditure is one of a capital nature, and
  - tests (1), (2) and (4) of paragraph 13 of IT 2195 would apply to deny the deductions. In addition to any view the Commissioner has, it was the opinion of the ATO Part IVA Panel (which includes members from the legal and accounting professions) that Part IVA would apply to this Arrangement. This was on the basis that the dominant purpose of the Arrangement was to obtain a tax benefit for the Participants.

The Ombudsman's view

I have considered the arguments put forward by both the Commissioner and the representatives of BARM and in my opinion, there is a sufficient degree of difference between the Budplan Arrangements and the facts presented in Lau's Case to allow the Commissioner to conclude that IT 2195 has no application.

Budplan Arrangements are involved in research and development type activities and not afforestation or arguably, what was envisaged in IT 2195 following the decision in Lau's Case. IT 2195 specifically issued as a result of the decision in Lau's Case and can only be held as precedent for similar afforestation arrangements. The Commissioner has also presented arguments which raise doubts as to whether the business tests referred to in IT 360 have been met.

In addition, the Commissioner has, in Taxation Ruling IT 2500, set out the ATO's policy on Taxation Rulings made before 1 July 1992. IT 2500 states that although the Rulings are not legally binding, they will be followed by the ATO and departed from *"only where there are good and substantial reasons"*. IT 2500 sets out the circumstances in which the ATO will depart from a ruling, including where the approach adopted in a Taxation Ruling is no longer considered appropriate. One of the examples is where an administrative practice in a Taxation Ruling is being exploited by taxpayers as a means of tax avoidance. IT 2195, also states that a deduction for expenditure incurred in round robin arrangements, whether in the actual incurring of the expenditure or in the obtaining of the funds to be expended, will be denied if the taxpayer's claim fails inter alia, the Part IVA test. The Commissioner, through the advice of his Part IVA Panel believes that Part IVA does apply. This gives the ATO a further argument for not accepting the application of IT 2195.

This view is supported by comments in a recent decision of the Federal Court in examining the application of public rulings. In *Bellinz Pty Limited & Ors V Federal Commissioner of Taxation* 98 ATC4634, in his reference to a Public Ruling, his Honour Mr Justice Merkel, at page 4414 - 4413, stated that:

> *"Relevantly, a public ruling will only be binding in the sense that the Commissioner cannot depart from it in making an assessment where the ruling relates to an arrangement and the tax law relates to that arrangement in a different way. The ruling is binding as to the way in which a tax law applies to a person or class of persons in relation to an arrangement or a class of arrangements. It is not binding in relation to the principles or the reasoning stated in it. ...unless the particular arrangement is the same as the arrangement in respect in which the ruling was made, the Commissioner is not bound to assess the taxpayer in the same way."*

In Justice Merkel's view, taxpayers cannot rely on a ruling unless the ruling itself as a whole is binding on the Commissioner. Thus, the arrangement in the public ruling must be exactly the same as that entered into by the taxpayer. The Full Federal Court went on to say that the Commissioner was bound to follow the rulings referred to in that case, only in relation to the types of arrangements set out in those rulings, and not to follow the

underlying philosophy of the rulings. The reference was to public binding rulings issued after 1 July 1992, but I believe it could apply in principle to rulings issued prior to that date.

In short, the Commissioner has made a judgement against the background of the law and the relevant previously published Rulings, that the Budplan Arrangements are not of such a character as to warrant the tax treatment claimed by the Participants. My view is that the Commissioner's judgment is sound in terms of the law and consistent with his previous Public Rulings. On this basis, I see no reason to query the Commissioner's actions.

In the circumstances, it is appropriate that the Commissioner amended the Participants' returns for the years ended 30 June 1996 and 1997 to disallow the deductions claimed against Budplan. It is my opinion that this is not a retrospective application of the law, and the Commissioner has the power to amend the Participants' assessments under section 170 of the ITAA. The fact that the Commissioner did not provide an interpretation on the Arrangement until after the year ended 30 June 1997 gives no comfort, because under the self assessment system the onus is on taxpayers to get certainty about their tax affairs before, or at the very least, at the time they lodge their tax returns.

At the 7 August 1998 meeting between representatives of BARM, the ATO and the Ombudsman's Office, BARM submitted that the ATO should not have made reference to Part IVA penalty considerations in its 30 June 1998 letter to Participants.

BARM also suggested that the ATO should not have mentioned the level of Part IVA penalties until it was established that Part IVA was an issue in the case.

No Part IVA determinations have yet been made by the Commissioner. Part IVA determinations will be made if and when amended assessments are issued. However, in my opinion, the Commissioner was entitled to seek advice from the Part IVA Panel, and form an opinion based on that advice.

Furthermore, it is appropriate for the Commissioner to inform the Participants of all potential exposure including Part IVA implications, that could flow from the ATO's Position Statement. In my opinion, the ATO was correct in bringing this matter to the attention of the Participants. It was in their own interests that they all received the earliest advice of the Commissioner's view of the arrangement that they had invested in, unpalatable though that advice may have been.

The Commissioner has been willing to delay the recovery of the tax debts raised by the amended assessments pending the settling of a test case program and the determination

of the test cases in the Federal Court. He has also agreed to reduce penalties from a possible 50 per cent to five per cent in the interests of coming to an early agreement with participants, a concession which I regard as substantial. In my opinion, the Commissioner has adopted a fair and conciliatory approach in seeking to resolve the matter. Any suggestion that his actions are oppressive or unjust is not justified.

Again, I note Justice Merkel's comments on the question of procedural fairness in the Bellinz Case at page 4418, where he stated that:

> *"The applicants may have had a justifiable expectation that the Commissioner was likely to apply the principles he relied upon in his rulings and practice .... It was for the Commissioner to determine how the tax law would apply to the tax arrangement and whether it was distinguishable from the arrangement the subject of his rulings and practice. If he erred in doing so, the applicants were entitled to have the matter reviewed by the AAT or the Court. They did so. There was no substantive or procedural unfairness in that process."*

In summary, it is my opinion that there is nothing in the Commissioner's application of IT2195 or subsequent actions in relation to the Participants' assessments which 'appears to have been contrary to the law' or which could be viewed as 'unreasonable, unjust, oppressive or improperly discriminatory' (see paragraphs 15(1)(a) and(b) of the *Ombudsman's Act 1976*).

Issue 2: The ATO's timeliness in issuing a position paper and in acting on requests for private rulings.

The Complaint

BARM claims that the ATO was aware of the Budplan Arrangements from late in 1995, and that the ATO took excessive time to come to a position on the Arrangements or to process ruling requests.

BARM claims:

- In late 1995, the ATO was consulted about the proposed structure of Budplan, and it provided recommendations to BARM which were included in the final version of the Arrangement which was released to the public in early 1996.
- In early 1996, the ATO was again consulted on the structure of Budplan, and once again the ATO's recommendations were incorporated before a release of the Arrangement to the public.
- In the second half of 1996, Mr Stotter sought a private binding ruling ("private ruling"), on his participation in Budplan.

• In December 1996, the ATO suspended processing of section 221D variations based on Budplan expenses, while it sought information from BARM about the projects. Following a detailed submission to the Newcastle ATO, the suspension was lifted and the processing of section 221D applications recommenced. (This issue is covered under Issue 3.)

Matters for consideration

The distinction between the Company Budplan and Personal Budplan Arrangements

There are two specific Budplan Arrangements: Personal Budplan Arrangements; and the Company Budplan Arrangements. I have investigated the ATO's action in respect of the Personal Budplan Arrangements only. The Company Budplan Arrangements are not the subject of this investigation and information in relation to the Company Arrangement is not relevant to the findings of this investigation.

Chronology

The investigation established the following chronology of events.

05.12.95 BARM issued its prospectus for the first Personal Budplan Arrangement.

10.01.96 The ATO was asked to comment on the proposed Company Budplan Arrangement. There is no available evidence of any ATO contact in relation to Personal Budplan Arrangements at this stage.

30.01.96 The ATO was asked to consider a request for a Private Ruling in relation to the Company Budplan Arrangement. The request was lodged with the Adelaide Branch of the ATO. There was no reference to the Personal Budplan Arrangements.

08.05.96 BARM issued a prospectus for first Company Budplan Arrangement.

21.05.96 Evidence suggested that the ATO received a copy of a Personal Budplan Prospectus. The circumstances in which the ATO obtained the Prospectus are unclear. There is no record of any request for a ruling or any consideration of the Personal Budplan Arrangement at that time in the ATO or BARM records.

03.06.96 BARM issued a prospectus for Personal Budplan Syndicate No.2.

17.07.96 Communications between BARM and the ATO confirmed earlier discussions and suggested that the request for a Private Ruling from the Company Budplan Syndicate was to be formally withdrawn because the original prospectus was replaced by a later version. The ATO advised that notwithstanding the withdrawal of the

request, it would decline to give a Private Ruling because of the number of assumptions required.

17.09.96 BARM's original request for a Private Ruling, in relation to the Company Budplan Syndicate, made in January 1996, was formally withdrawn. There were no subsequent requests for a Private Ruling in relation to the Company Budplan Syndicate.

28.10.96 The ATO received a request for a Private Ruling in respect of a Personal Budplan Arrangement on behalf of Mr Stotter at the Chatswood branch of the ATO. From the evidence available, this appears to be the first request for the ATO to rule on the Personal Budplan Syndicate.

22.11.96 Facsimile from the Chatswood Branch of the ATO to Adelaide confirming earlier communication.

29.11.96 The ATO acknowledged receipt of Mr Stotter's request for a Private Ruling.

Nov. 96 The ATO officer dealing with Mr Stotter's request for the Private Ruling, discussed the matter with the R&D Unit of the Large Business and International Group (LB&I) in Adelaide. This unit was previously responsible for handling the request for a Ruling on a Company Budplan Syndicate. The officer was advised not to take action on Mr Stotter's request until the Arrangements were fully investigated.

29.11.96 Information on concerns about the Budplan Arrangements placed on the ATO's 'significant issues' database.

24.12.96 An internal ATO memo on Budplan was distributed to staff advising them of the existence of the Arrangements and that no decisions were to be made until they were thoroughly investigated.

14.05.97 The ATO distributed an internal memo presenting the issues under consideration in relation to the Budplan Arrangements.

June/July 97 ATO's review of Tax Minimisations Schemes commenced.

August 97 Review of Budplan Arrangements commenced as part of the Tax Minimisation Schemes project.

22.09.97 BARM advised of review of Budplan Arrangements. ATO requests initial information.

09.10.97 BARM replied to ATO letter of 22 09.97.

21.11.97 The ATO sent a letter to Mr Stotter advising him that his request for a Private Ruling cannot be determined until further information about the Budplan Arrangements is obtained and considered by the ATO.

22.12.97 ATO advised BARM that the section 221D applications for Budplan would be refused.

19.01.98 Mr Stotter requested reasons for the delay in dealing with his Private Ruling request pursuant to Section 14 ZAO of the *Taxation Administration Act, 1953.*

13.02.98 The ATO requested further information from BARM.

13.03.98 Partial response from BARM to ATO letter of 13.02.98.

23.03.98 The ATO responded to Mr Stotter's letter of 19.01.98 and advised him that his request for Private Ruling was delayed because it was being considered as part of the overall review of Budplan.

07.04.98 Partial response from BARM to ATO letter of 13.02.98.

29.04.98 ATO issued a Position Statement on Personal Budplan Arrangements .

19.06.98 BARM provided the balance of information sought in ATO letter of 13.02.98.

The Ombudsman's view

There was considerable delay by the ATO in dealing with Mr Stotter's Private Ruling request. There was no communication direct to Mr Stotter in relation to his Private Ruling request for 12 months after the acknowledgment letter.

This is clearly an unacceptable length of time for the ATO to have not made a decision on Mr Stotter's request for a Private Ruling or alternatively, to have not negotiated an extension of time to seek further information from him or BARM in relation to the Personal Budplan Arrangement.

Given the large number of individual Participants in this Arrangement (understood to number approximately 10,000), the absence of Private Ruling requests from other Participants is perplexing. While there is no evidence to suggest that other Participants were aware of Mr Stotter's Private Ruling request, the Ombudsman would be concerned if other Participants had not sought clarification of their own position because of the perceived delays by the ATO. Further, I have no evidence to suggest that any general criticism of delays in the processing of Private Ruling requests is warranted. The Commissioner's 1997-98 Annual Report provides statistics about the Taxpayers' Charter performance standards for the Charter's first year of operation. In the case of private rulings, 79.2 per cent were dealt with in the expected 28 days turn-around time

frame. Figures were not available to confirm what additional numbers were subject to a negotiated extended time frame. Other than in relation to the one Budplan private ruling request, my Office received no complaints regarding the timeliness of private rulings during the 1997-98 financial year.

Irrespective of the reasons why Participants did not seek Private Rulings for these Arrangements, in a self assessment environment, the onus is on the Participants to satisfy themselves about the Commissioner's view of the tax consequences of any Arrangement they were proposing to enter. The fact that the Commissioner had not given a position on the Personal Budplan Arrangement was not sufficient reason for Participants to assume the Arrangements would be acceptable to the Commissioner.

The representatives of the Participants have argued that the Commissioner should have provided a position on the Arrangement earlier. It is easy in hindsight to be critical of the Commissioner for not considering the Personal Budplan Arrangements in detail when they were first brought to the ATO's attention. However, I note that the Commissioner has advised that it was not until the seriousness of the risk to revenue was identified that action was taken to develop and communicate an ATO position.

It is also my opinion that, while the ATO was aware of the Arrangement through the private ruling request and through applications for tax instalment deductions, there was insufficient information at that stage for the Commissioner to identify a risk to revenue that warranted attention. It was not until the ATO undertook a national review of tax minimisation schemes which commenced in the 1997-98 financial year, that the risk was identified and the appropriate level of consideration was then given to the Arrangements. Once having identified this, I am of the view that the ATO, in working through the complexities of the Arrangements, took swift and thorough action to provide a position statement.

I reiterate that the onus is on the taxpayers concerned to seek some surety for their tax position, and that only one taxpayer appears to have sought that certainty from the Commissioner by way of a private ruling request. The Participants had entered into the scheme and sought deductions in relation to their investments in their tax returns for the years ended 30 June 1996 and 1997, without bringing the matter to the attention of the Commissioner either in their returns, or by way of Private Ruling requests. The Commissioner is authorised to make assessments on the basis of the unverified information contained in taxpayers' returns, and has the power to amend those assessments by making such alterations and additions as he considers necessary, within certain time limits according to the circumstances requiring the amendment.

While of no value to the Participants of Budplan, future investors in tax-effective schemes will benefit from the convenience of the greater certainty provided under that the Commissioner's new Product Ruling system. Under the system, the promoters of investment schemes can apply to the ATO for an advance opinion before the product is released to the public. I can only suggest that it is in all parties' interests if promoters of these types of arrangements seek a Product Ruling before they offer these schemes to the public.

In the future, taxpayers who wish to invest in these arrangements should confirm that the particular arrangement has a Product Ruling from the ATO. Where a scheme promoter has not sought a Product Ruling, or the ATO has refused to provide a Product Ruling, investors would need to think carefully about the consequences of their investment. While one of the options would still be to apply for a Private Ruling, it is unlikely that the individual investor will have sufficient details about the arrangement for the Commissioner to be able to rule. In which case, the Commissioner would still need to go back to the relevant promoter for information.

Issue 3: Decisions in relation to the processing of the tax instalment variation applications including the withdrawal of prior approvals.

The Complaint

The Personal Budplan Arrangements came to my attention in May 1998 when Participants first raised concerns about the ATO's decision to withdraw previously approved tax instalment variations.

Under section 221D of the ITAA, the Commissioner may vary the amount of tax to be deducted from the salary and wages of an employee in special circumstances where a significant over-deduction of instalments is likely to occur. Budplan Participants sought section 221D tax instalment variations ('Variations') on the basis of tax deductions to be claimed against their Budplan investment.

The Budplan Participants complained that the ATO was not entitled to reverse its earlier Variation approvals. They also believed that by initially approving the Variations, the ATO had considered and accepted the legality of their Budplan investments.

The original applications were approved by regional branches on the basis of information provided in the applications. As is normal practice in a self assessment system, the ATO did not undertake inquiries to establish whether tax deductions were

allowable on receipt of the application. Applicants were, however, generally informed that the approval was subject to the qualifications listed below.

Generally, the ATO's letter approving the Variations, contained the following qualifications:

- the authority would remain in force until the end of the then current financial year;
- the approval did not mean the ATO had accepted the tax treatment of the income and deductions shown in the application;
- the tax liability would be determined following the lodgment of an income tax return;
- the ATO reserved its right to review the taxpayers' taxation affairs either before or after the issue of an assessment;
- the approval to vary did not relieve the taxpayer of the need to substantiate expenditure where the ITAA 1936 required the taxpayer to do so;
- if the taxpayer's financial circumstances changed, the taxpayer should immediately apply to the ATO for a review of the variation; and
- an application for variation was required to be lodged at the beginning of each subsequent financial year.

In addition to the Participants' complaints, BARM has alleged that in December 1996, the ATO suspended processing of the section 221D variations while it sought information about the projects from BARM. BARM alleges that after it provided a detailed submission to the Newcastle Branch Office of the ATO, the suspension was lifted and the processing of 221D applications recommenced. Based on this, BARM questioned the ATO's later apparent change of mind and the subsequent withdrawal of the variations.

Matters for consideration

The only indication that an arrangement may have existed with the Newcastle Branch of the ATO is two handwritten file notes produced by BARM. Both indicate discussions with tax officers resulting in agreements to process or to continue to process applications for tax instalment variations for Budplan Participants.

BARM has not been able to provide this Office with a copy of their submission to the Newcastle Branch Office to support their claim. The ATO has not been able to locate any records in relation to such an arrangement. An ATO officier is named in BARM's

handwritten file notes. He was dealing with Budplan related applications, but denies knowledge of any of the agreements referred to.

The two handwritten notes and the ATO officer's denial provide little for me to go on and I have decided not to investigate this specific matter further. Nevertheless, it does appear that there were inconsistencies in the way tax instalment variation applications were processed across the ATO and it may well be that an arrangement was entered into at the local branch level which may not have coincided with any national policy or direction.

From the evidence available, the first request for the ATO to review the Personal Budplan Arrangements was the lodgment of Mr Stotter's Private Ruling application on 28 October 1996. However, as previously noted, the ATO did not consider the Personal Budplan Arrangements in any detail until it undertook a review of tax minimisation schemes which commenced in June-July 1997. It appears the impetus for this review came from the extensive number of tax instalment variation applications made in 1996-1997.

By August 1997, the ATO had received over 6,000 variation applications in relation to tax minimisation schemes. From August 1997, the ATO asked applicants to provide further information where the application for a tax instalment deduction variation appeared to be related to tax minimisation schemes. From then on, Variations requested for Budplan Arrangements were disallowed. Some 3,000 previously approved Budplan related Variations were also withdrawn on a prospective basis.

The Ombudsman's view

It appears the ATO's tax instalment variation policy had developed on a regional basis and as a result there was some inconsistency in the way the applications were processed. This may have led to some branch offices allowing Variations and others not. In addition, Variation approval letters were not consistent in stating the qualifications of the approval. While all appear to have stated that the Variation would only remain in force until the end of the financial year, with a new application required for the subsequent year, it is unfortunate that some did not carry the qualification that the approval did not mean the ATO had accepted the tax treatment of the income and deductions shown in the application. This omission may have contributed, in some cases, to a wrongly held expectation of approval of the tax deductions.

Nevertheless, in the context of the administrative review of the processing of tax instalment variations and changes subsequently made on a national basis during the 97-98 financial year, (discussed below) any agreement which may have been made in a

previous year at a local level would be of little consequence. My investigation has, therefore, focussed on these later events.

The Commissioner has the ability to withdraw the previously approved section 221D Variations on a prospective basis. This has been confirmed with BARM through an opinion provided to them by Senior Counsel, Mr Anthony Slater.

In addition to having the power to withdraw the previously approved Variations, in my opinion, the ATO acted reasonably in withdrawing them following its overall review of the Budplan Arrangements.

If the ATO had allowed the individual Variations to continue, it would have exposed the Budplan Participants to greater tax liabilities. Given that the Position Statement represents an informed opinion of the Commissioner, the ATO has a responsibility to act in good faith and in my opinion this includes ensuring individual Participants are protected from further exposure to tax liabilities.

I note that the ATO has now established a national 221D policy cell. This should provide a more consistent approach to administration of Variation applications in future. As with the Product Ruling System, we will monitor the effectiveness of the new arrangements.

Conclusions

The Commissioner's interpretation of the law

It is my opinion that the Commissioner is able to argue his interpretation of the law as it applies to the Personal Budplan Arrangement. I am also of the opinion that the Arrangement is not on all fours with IT 2195 and that his decisions not to apply that Ruling, or TR97/D17 to the Arrangement are reasonable. Ultimately, however, the Commissioner's interpretation is a matter for the courts to determine.

Retrospective application of the law

Because the Commissioner's interpretation of the law is considered reasonable, I am of the view that the Commissioner's action in amending the Participants' returns for the years ended 30 June 1996 and 1997 to disallow the deductions claimed against Budplan is not a retrospective application of the law under self assessment.

Application of Part IVA

Having decided that the Commissioner's interpretation of the law is arguable, it is also my opinion that it is open for the Commissioner to consider the application of Part IVA and to advise the Participants accordingly. To have not done so would have exposed the Commissioner to criticism for not sufficiently apprising the Participants of the full potential for penalties if the Commissioner's interpretation of the law was found to be correct.

The Commissioner's timeliness in ruling on the Arrangement

However, I am of the view that some criticism of the ATO's action is warranted. The ATO's delay in actioning Mr Stotter's Private Ruling request was unacceptable. The Commissioner is required to make a Ruling, seek further information or negotiate a further period, within 60 days of a receipt of the Ruling request. This was clearly not done.

While this inaction amounts to defective administration, I can find no evidence to suggest that the Commissioner's silence on the matter contributed to a perception by Mr Stotter that the Arrangement was acceptable to the Commissioner. Nor do I have any evidence to suggest that other Participants were dissuaded from seeking their own Private Rulings because of a perception that they would not be responded to in a timely manner.

Silence on the Arrangements may have incorrectly led Participants to the view that the Commissioner had implicitly approved the Arrangements. Given this, and with the benefit of hindsight, one might criticise the Commissioner for not providing an earlier public position. On the evidence available,
it is my view, that the Commissioner did not have sufficient information to address the Arrangement. This information only became available when the Commissioner sought more information from BARM when the revenue risks associated with this Arrangement were identified as part of an ATO activated review of tax minimisation schemes during the later half of 1997.

The processing of tax instalment deduction variations

In my view the ATO was inconsistent in the way that it processed tax instalment variations. There appeared to be no national policy in relation to decision making processes or advice to taxpayers with qualifications on approvals. These processing inconsistencies do, in my view, point to a deficiency in administration. While the process may have been deficient, I have no evidence to suggest that the approval or otherwise of the Variations affected the investment decisions of the Participants. I note

that, in the vast majority of cases viewed by this Office, Participants were advised, among other things, that approval of the Variation did not mean that the Commissioner had accepted the tax treatment of the income or deductions shown in the Participants' instalment variation applications.

Further, in my opinion, the Commissioner was entitled to withdraw previously approved instalment variations, so long as these withdrawals were made on a prospective basis. It is my understanding that all withdrawals were made on a prospective basis. I have received no complaints to the contrary. Indeed, as with my views regarding Part IVA, if the Commissioner had not taken action to withdraw previously approved Variations, he may have been open to more serious and justified criticism for not taking sufficient action to protect these Participants from accruing further tax debts.

Self Assessment

The complaints from Budplan Participants relate to the operation of the tax selfassessment system. The self assessment system has been operating since 1987, with further amendments to the rulings and penalties arrangements applying from 1992. Under this system, taxpayers assess their own tax liability when they complete their return for the relevant year.

The ATO relies on taxpayers to correctly self-assess their liability. The law allows the ATO to amend assessments generally within four years of service of the notice of assessment, where the ATO considers that tax has been underpaid. The ATO can amend earlier assessments if it considers that fraud or evasion is involved.

Subject to obtaining a Private Binding Ruling on a specific item of income or deduction claimed, the information in a return is therefore never really tested by the ATO until a decision is made to audit a taxpayer, or to examine particular arrangements.

To support self assessment, a system of binding and reviewable public and private rulings was established to promote certainty for taxpayers and to reduce the risks of penalties where disputes may arise with the Commissioner.

To complement the rulings system, a new penalties regime was also introduced. A 'reasonable care' test was introduced which places taxpayers under an obligation to make a reasonable attempt to comply with their tax obligations commensurate with their circumstances, including their knowledge, education and skills. A more rigorous standard, the 'reasonably arguable position' standard applies to items at issue where the tax in question is generally more than $10,000. Where a taxpayer is uncertain as to whether he or she has a reasonably arguable position, having considered the relevant

authorities, including the tax law, Court or AAT decisions or relevant public rulings, the taxpayer has the opportunity to seek a private ruling on the matter.

Failure of a taxpayer to be able to demonstrate that they had a reasonably arguable basis for making a claim can attract a penalty of 25 per cent of the tax shortfall. Where the Commissioner concludes that the taxpayer entered the arrangement for the sole or dominant purpose of avoiding tax, a penalty of 50 per cent of the tax shortfall may apply. During the course of our investigation, the Commissioner of Taxation introduced the Product Ruling System. Promoters of arrangements will be able to obtain such a public ruling by seeking an advance opinion from the ATO before the prospectus is released to the public. The Product Ruling system will provide investors and advisers with greater certainty in the self assessment environment by providing them with an additional means of obtaining the ATO's opinion and the taxation status of prospective tax effective schemes before they are marketed or promoted.

The Commissioner is required to ensure the principles of self-assessment are applied. Given the number and type of complaints to the Ombudsman's Office, it appears that taxpayer obligations under self assessment may not be well understood by Participants. This lack of understanding of self assessment may suggest a wider problem. There would be value in the ATO including information in the TaxPack and other public information initiatives to reinforce the essential characteristics of self assessment.

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Recommendations

My investigation has identified some areas of past defective administration. However, it is my opinion that these administrative deficiencies should have had no bearing on the Participants' decisions to enter the Arrangement and to claim deductions for it. Furthermore, the Commissioner has acknowledged the deficiencies in earlier operations and has sought to rectify them by;

- establishing a more coordinated approach to Variation processing;
- centralising administration of audit activities in relation to tax-effective schemes; and

- developing a Product Ruling system to provide greater certainty as to the tax benefits of tax-effective schemes.

In my opinion, the Commissioner's view of the Arrangement, as stated in his position paper dated 29 April 1998, and his administrative actions have been neither contrary to the law, or unreasonable. It is also my opinion that the Commissioner's decisions to refrain from recovering the outstanding taxes while a test case program is established, despite the length of time this has taken, and to offer a blanket reduction in penalties from 50 per cent to five per cent for the Participants, demonstrates a willingness to resolve the matter in a fair and conciliatory manner.

Accordingly, it is my opinion that the Commissioner's actions are fair and could not in any way be regarded as unjust, oppressive or improperly discriminatory. As a result I make no recommendations. I do however suggest that it is in the interests of all parties concerned to have the matters resolved in a timely way. I therefore urge the parties to come to a resolution on the Test Cases as soon as possible. Of course, it is open to the respective parties to canvass settlement options at any time.