Review Into Objections to Tax Office Decisions

TERMS OF REFERENCE AND CONSULTATION PLAN FOR THE INSPECTOR-GENERAL'S REVIEW INTO THE UNDERLYING CAUSES AND THE MANAGEMENT OF OBJECTIONS TO TAX OFFICE DECISIONS

Background

The tax laws provide a person dissatisfied with a particular taxation decision the right to object against it. Taxation decisions may include those relating to assessments, amended assessments, determinations, notices, penalties, shortfall interest charge, income tax and fringe benefits tax private rulings. After a taxpayer lodges an objection the Tax Office reconsiders its decision and may decide to allow the objection in full, allow it in part or disallow it in full.

The Tax Office receives and finalises approximately 15,000 to 20,000 objections each year. The majority are from individual and micro business taxpayers. The Tax Office has estimated that in 2005/06 it allowed around 4,800 objections in full, with approximately 2,200 objections allowed in part and 6,700 objections disallowed. In addition, more than 3,000 objections were settled, withdrawn or otherwise dealt with.

The Inspector-General's recent review into the Tax Office's management of litigation found that the Tax Office concedes or settles a significant number of disputed assessments in the taxpayer's favour after the objection process but before cases are heard in the Administrative Appeals Tribunal (AAT) or the Courts.

In 2005/06 3,481 matters were lodged by taxpayers for review in the AAT, which included 2,354 applications relating to taxation 'schemes'. For 2005/06 the AAT reported that in the Taxation Division 94 per cent of applications were finalised without a hearing, with nearly 70 per cent of those applications resulting in the Tax Office decision being set aside or varied.[1] The Inspector-General notes that across all jurisdictions in the AAT approximately 81 per cent of applications were finalised without a hearing. The Inspector-General considers that it is appropriate for the Tax Office to settle litigated disputes in suitable cases and at the earliest possible stage.

The Tax Office states that the high settlement rate is largely due to taxpayers receiving better quality advice or providing better factual information when seriously contemplating litigation. The tax profession claims that litigated cases receive the attention of better quality Tax Office decision makers and unnecessary cases are settled.

The Inspector-General believes that a range of other factors including taxpayer and Tax Office behaviours could also be among the underlying causes. It could be due to information relevant to the dispute not being sought by the Tax Office earlier in the dispute resolution process or a taxpayer not providing the Tax Office with requested information until the dispute proceeds to litigation. It could also be due to the wrong technical issues being raised by taxpayers' advisers or the Tax Office.[2] Stakeholders have also raised concerns with the Tax Office's approach that notwithstanding its policy of allowing settlement before amended assessments are issued, once amended assessments have issued following an audit, the Tax Office will generally require a dispute to be on foot, either through the lodgement of an objection or an application to the AAT or Court, before the settlement process may commence.

The Inspector-General notes that aspects of the current dispute resolution framework have been discussed previously as part of other reviews including the Joint Committee of Public Accounts in 1993 and the Ralph Review of Business Taxation. A summary of the considerations, findings and recommendations arising from these reviews is attached as further background.

The Tax Office's performance service standard for finalising objections relating to assessments is 70 per cent within 56 days. In 2005/06 the Tax Office reported that it finalised 64 per cent of such objections within this benchmark. The Tax Office has stated that the main reason for not achieving the annual benchmark was the processing of the backlog of objections associated with aggressive tax planning arrangements before June 2003. The Tax Office believes that given the low number of such cases yet to be finalised, the benchmark for this work should be achieved in 2006/07.

The Inspector-General announced on 28 February 2006 that this review would be placed on his forward work program. The Inspector-General notes that the Tax Office has subsequently advised that an internal review of its objection processes is planned for 2007.

This review has been commenced by the Inspector-General on his own initiative in accordance with subsection 8(1) of the *Inspector-General of Taxation Act 2003*. It forms part of a wider examination by the Inspector-General of the Tax Office approaches to settling and finalising issues with taxpayers – information on other reviews related to this wider examination is included below.

Focus and Terms of Reference

This review will focus on what causes objections to Tax Office decisions and the management of objections. The Inspector-General's staff will work with the Tax Office to gain a sound understanding of the range and categories of objections with a view to determining underlying causes.

The Inspector-General will seek input and submissions from the community to understand the taxpayers' experience and perspective in relation to lodging objections.

The timeliness and quality of Tax Office approaches upstream of objections will be explored including audit, communication, and technical decision-making insofar as they may be contributing to potentially unnecessary disputes and litigation.

The review will also examine objection resolution procedures and the administrative framework, including the laws that govern these areas.

This review will examine the extent and reasons for the Tax Office conceding cases after the objection process, focussing on the quality of decision making and processes employed in determining taxpayers' objections.

In the context of potentially unnecessary litigation, it would determine whether disputes (and their associated costs) could have been prevented and whether the broad system and sequence of amended assessment, objection, and dispute resolution could be improved. The review will also examine whether the current system minimises any disproportionate effects on taxpayers, in particular corporations and encourages alternative dispute resolution processes.

The review focus is not only on the Tax Office conduct and approaches to dispute resolution but also on the administrative systems established by the tax laws for resolving disputes between taxpayers and the Tax Office.

Aims of the review

The review will aim to identify and recommend changes that will assist the Tax Office to improve the efficiency, effectiveness and fairness of the current approaches.

Related Reviews

This review is part of a wider examination by the Inspector-General of the Tax Office's approaches to settling and finalising issues with taxpayers. It is expected that this wider examination will also include the following reviews; formal terms of reference for these reviews have not yet issued, but further details can be found on the Inspector-General's web site under the forward work program:

- The Tax Office's consistency, transparency and conduct regarding settlements with taxpayers, including those negotiations taking place during audits and before amended assessments are issued.
- The application of prosecution policies in the context of settling and finalising issues.

This review also stems in part from the Inspector-General's Review of Tax Office Management of Part IVC litigation which was completed in May 2006. The report arising from the litigation review is available from the Inspector-General's web site.

This review may also draw on findings and submissions in relation to the Inspector-General's Review into the Tax Office's Administration of GST Audits which is currently underway. Terms of reference for the GST audit review are also available from the Inspector-General's web site.

Consultation Processes

The Inspector-General will:

- publish a copy of the terms of reference for this review on his website at www.igt.gov.au;
- take submissions on this review from members of the public generally, or from particular people or organisations, within the time frame set out below; and
- request the Commissioner of Taxation to provide information and/or documents relevant to this review.

Contacting the Inspector-General of Taxation

Submissions should be focussed on the terms of reference for the review and should ideally be received by 5 March 2007. However the Inspector-General will take submissions throughout the review. Submissions may be sent:

- By email:
  objections@igt.gov.au
- By post:

  Consultation on Objections
  Inspector-General of Taxation
  GPO Box 551
  SYDNEY NSW 2001

- By facsimile:

  (02) 8239 2100

Further information may be obtained from Mr Tasos Mihail on (02) 8239 2111.

ATTACHMENT

EARLIER EXTERNAL CONSIDERATIONS OF THE AUDIT AND OBJECTION DISPUTE RESOLUTION PROCESSES

An Assessment of Tax – Joint Committee of Public Accounts 1993, Report 326, 1993, Commonwealth of Australia

Administrative system

1. The Committee was particularly concerned at the consequence of assessments being issued which were not fully supported by the Tax Office at the highest level. It noted that assessment is a critical stage in the audit process because it is through the issuing of an assessment that a legal obligation is created. As soon as an assessed amount of taxation becomes due and payable, that amount constitutes a debt due to the Commonwealth. The importance of an adverse audit assessment is highlighted in the case of public companies where the need to provide disclosure to the Australian Stock Exchange can materially affect the value of the company.
2. Evidence was put before the Committee of the potential consequences for a corporate entity against whom an amended assessment was issued which established a debt exceeding the capacity of the corporate entity to fund it from the entity's total asset so that the taxation debt places the corporate entity in a situation of technical insolvency. This situation has ramifications for the company regardless of whether the company challenged the debt or not.
3. The Committee noted that as long as the implication of an amended assessment and tax debt are so potentially significant, then the role of an audit remains crucial. Further, given the power to issue an amended assessment which places a corporation in technical insolvency, or puts it in a position where Australian Stock Exchange notification is required, the Tax Office wields considerable power.
4. The Committee concluded that the difficulty facing corporate taxpayers does not derive from the nature of the debt, but rather from the manner in which the debt is incurred and becomes known to the taxpayer.
5. The Committee then briefly outlined the approach adopted in the United States of America, in particular the operation of a Deficiency Notice System which inserts a review mechanism between the official determination of an audit by the Internal Revenue Service (IRS) and the issuing of an assessment. Where, following the various internal IRS review procedures, the IRS and taxpayer have failed to settle a tax audit dispute, or where the procedures have not been utilised by the taxpayer, the IRS will serve a deficiency notice upon the taxpayer.
6. The notice sets out the details of the adjustments to tax payable and the amount determined by the IRS to be owed by the taxpayer. The taxpayer may then, within a statutory period, seek to have a tax court re-determine the deficiency. In the majority of cases, it is only following the final determination of the full appellate process that the tax may be assessed and collected. The Committee also noted that procedures in this system protect against any possible losses to the revenue. However, the procedures place the position of the revenue above the interests of the taxpayer while at the same time allowing the taxpayer to pursue the issues involved in the amended assessment through the judicial processes.
7. The Committee stated that the Deficiency Notice System operated as an administrative mechanism of review which established a procedure for protecting corporations against debts raised that would place them in technical insolvency. It allowed the corporation to challenge the debt prior to legal ramifications taking effect.
8. The Committee considered the arguments for and against requiring additional review procedures, external to the Tax Office, prior to assessments being issued. On balance, the Committee concluded that, provided changes were made to the method of determining audit based assessments, there was no advantage to be gained from imposing an additional review level on the present structure.
9. However, the Committee concluded that, where amended assessments would make taxpayers technically insolvent, the implications for them, its employees and Australia as an economic entity were so significant that a mechanism was needed to allow the issues creating those implications to be tested and mitigated through an external review process.
10. The Committee also referred to the Tax Office agreeing to implement a review procedure to ensure that positions taken by auditors properly reflected the law. This was in response to representations made to the Tax Office of the need to establish an independent review mechanism for decisions of auditors which would operate prior to the issuing of an amended assessment. Arguments in support of independent review concentrated on the need for a mechanism which was separate from the intensity of an audit. A perceived lack of objectivity was considered unavoidable in relation to the work of auditors. Review, prior to amendment, was considered necessary as a result of the debt consequences of an assessment being issued. The Committee noted that such a procedure was, in part, a response to the Pappas, Carter Report's recommendation for a case coordinator's position.
11. The Committee concluded that a deficiency notice system should be established. Under this system, taxpayers who face insolvency as a result of the issuing of an assessment notice could seek a notice of deficiency from the Commissioner prior to the notice's issuance. Such a notice would have the effect of automatically raising with the Federal Court an issue of dispute. The Court would be required to determine, in the first instance, whether there was a reasonably arguable case. If such a determination were made, the Commissioner would not issue the assessment notice, pending the matter being settled by the Court. In the event that the Court determines that the issue is not arguable, the Commissioner would be entitled to issue the assessment with the taxpayer's full rights of objection and appeal intact.
12. The Committee noted that the deficiency notice would have the effect of suspending the amended assessment and therefore technically no debt would be incurred. As such, issues of penalties and interest would not apply while a notice of deficiency existed. Upon the determination of the issue before the Federal Court, the Commissioner would be able to issue as assessment in accordance with the Court's decision. The Committee also considered that the use of a deficiency notice would be limited and the onus would rest on the taxpayer to demonstrate potential insolvency. However, in the event that such evidence was provided, the Committee anticipated that the Commissioner would automatically issue the notice.

Internal Tax Office organisation

13. The Committee considered whether it was appropriate to have in a professional organisation the same person or group of people who investigate and report on a taxpayer's circumstances also making decisions on assessments. The Committee also debated whether principles of good tax administration required that a decision-maker should be independent of an investigator.
14. The Committee acknowledged that the technically difficult and complicated nature of taxation auditing and regarded the professionalism of auditors generally as demonstrating a clear commitment to the taxation system, but noted the difficultly of maintaining a balanced perspective in the case of audits which spanned long periods of time.
15. The Committee considered that in principle the establishment of a professional investigatory and decision-making process required the separation of the investigation/evaluation stage form the decision-making stage to the greatest extent possible. The Committee concluded that the process of taxation auditing needs to be divided into two clear stages. The function performed in those two stages needs to be seen to be performed by officers from separate professional streams.
16. The Committee anticipated that the separation of the audit investigation and evaluation functions from the decision making stage would allow for the creation of a 'classical' audit function within the Tax Office. Such a stream would be supervised by a professional leader, highly qualified in the skills of auditing and audit approaches. Officers working in the technical audit stream would be required to gather evidence on taxpayer cases and prepare quality reports detailing the relevant facts, legal precedents, rulings, interpretations and other relevant material pertaining to the case. The written audit report would be reviewable by superiors within the audit group. The final audit report produced by this group would then be presented to an independent decision maker outside the audit group.
17. The Committee considered that the responsibility for determining the final assessment and issuing the notice of assessment or recommending a deficiency notice would rest with a separate management group. This group would include technical experts in taxation law, business practices, evidence and accountancy. In the Committee's opinion this group would have the responsibility for assessing all audit reports and determining the Tax Office's position in respect of the actual assessment notices to be issued. Settlement negotiations

would be performed by this group on the basis of the evidence contained in the audit report. The group would also be responsible for assessing the weight of evidence and the appropriate direction in which to advance cases, that is, whether through settlement, litigation or prosecution. The Committee anticipated that this group would balance commercial practicalities and the importance of clarifying the law, with the need to maintain the legal revenue of the Commonwealth.

18. The Committee concluded that such a formal separation of functions would provide the Tax Office with the opportunity to develop a professional organisation and establish transparency in the handling of taxpayers' cases.

A Strong Foundation – Discussion Paper 1: Establishing objectives, principles and processes (November 1998)

19. The discussion paper set out a number of issues relating to the audits, assessments, objections and mediation. It noted that reform of the audit adjustment process may lessen disputation. It also discussed the commercial consequences that audit adjustments may have on businesses:

> Most disputes between taxpayers and the Commissioner arise from adjustments following an audit of a taxpayer's affairs. Audits may range from a simple check for omitted income or an overclaimed rebate or deduction in the return of an individual taxpayer, to a full review of a large multi-national company for several years of income.
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> Assessments (or amended assessments) issued to taxpayers to give effect to the ATO's views following an audit can have significant effects on taxpayers. For example, listed companies may be obliged to notify the stock exchange of the issue of the assessment requiring payment of a material amount of tax. This could have an immediate effect on the company's share price. In the case of private companies and individuals engaged in business, the issue of an assessment may cause lenders to the business to call in securities or otherwise seek to recover amounts owing. Satisfactory resolution of the subsequent dispute offers little comfort for taxpayers faced with these potential impacts on issue of the assessment.

20. The discussion paper also indicated that reform of the audit adjustment process may limit recourse to litigation and minimise any disproportionate effects from the issue of assessments. It stated that a revised process may better allow the parties to focus on the issues (and amounts) in dispute before the assessment which gives effect to the adjustment is formally issued — thus triggering the existing dispute resolution mechanism. Such a process would allow for more consideration of the issues, reduce cases of multiple assessments that sometimes occur because of the inflexibility of the amendment provisions and time constraints under the current law, and permit more negotiation before litigation becomes necessary. Some informal processes of this kind currently exist, such as position papers in large audits.
21. The discussion paper also sought to consider how might disputes might be resolved more efficiently. It discussed the need for targeted process reforms, in particular regarding the objection process and mediation.
22. The discussion paper noted that:

> If an assessment issues in accordance with the return of income lodged by the taxpayer, arguably the objection process is now of little value. The position is even more questionable for companies which effectively object against their own self-assessment. The taxpayer may have followed (but may wish to challenge) the Commissioner's view of the law as contained in a public ruling. Upon objection it would be expected that the review officer would follow the ruling; thus the objection process serves to delay the appeal process (and sometimes the collection process). An alternative might be to provide the taxpayer with an immediate remedy of appealing directly to a tribunal or court.
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> If, on the other hand, the ATO has determined its position on a matter after fully considering it either in the course of an audit of the taxpayer's affairs or during preparation of a private binding ruling, it should not need a second chance to get it right. Again the taxpayer should have an immediate remedy.
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> A direct appeal process would not restrict opportunities for negotiation and settlement. Most references to a tribunal and appeals to courts are settled in the early stages of the dispute process. On lodgement of either a reference or an appeal, the process is then under tribunal or court oversight, helping to create a more dynamic process for dispute resolution.

23. In respect to mediation, the discussion paper also noted the Commissioner's then announcement in extending the use of alternative resolution for tax matters, including the proposed establishment of a panel of mediators. The discussion paper indicated that the law relating to the objection and appeal processes reflects and encourages an adversarial mindset and that it may be desirable to provide legislative encouragement for wider use of alternative dispute resolution approaches. Mediation processes might usefully be employed in areas such as private rulings and audit adjustments where there is potential for disputes to arise.
24. In a submission in response to the discussion paper, the Australian Taxpayers' Association stated that the current tax system is an adversarial system with each party's rights and responsibilities enshrined in legislation. The tax system mirrors other aspects of our legal system.
25. They submitted that there is a need to break that adversarial culture in an attempt to gain efficiencies for both the public purse and taxpayers generally. They indicated that they would support a system of compulsory mediation to settle disputes before they proceed to the AAT or Federal Court.

Review of Business Taxation – A Tax System Redesigned (July 1999)

Recommendation 3.7 – Redesigning procedures for determining taxpayer liability

That the assessment, objection and dispute resolution regime under which a taxpayer's liability for taxation is finally determined be redesigned:

(i) on a `whole-of-transaction' basis, embracing the totality of actions from the time a transaction is initiated until a legally enforceable final decision is reached with respect to its taxation consequences, and any consequential liability is discharged;

(ii) in accordance with the integrated taxation design process; and

(iii) in consultation with the Board of Taxation.

26. The report stated that a piecemeal approach has applied historically to each process-that is, each ruling, objection, appeal and judicial review. Each of these have been largely discrete exercises based on the separation of responsibilities and 'independent' review processes associated with the assessment system that existed prior to the commencement of self-assessment in 1986. The report noted that the issues, and the processes, need to be considered on an integrated - that is, a 'whole-of-transaction' - basis, in order that the best possible administrative regime can be designed and implemented. This administrative regime will be one that is seamless and keeps disputes-and their associated costs and delays-to a minimum.
27. The report also noted that concerns had been expressed with the current system and had been addressed in Chapter 8 of 'A Strong Foundation'. The report stated that these concerns are critical to taxpayer perceptions of fairness and hence impact on levels of voluntary compliance and that a redesign of the administrative regime would assist in addressing these perceptions.
28. The report concluded that the objective of such redesign was to:

    – improve the quality and timeliness of interactions between taxpayers and the taxation administration and reduce the likelihood of, and grounds for, dispute; and

    – significantly simplify post-return processes and provide incentives to all parties to resolve disputes quickly.

29. The report stated that Recommendation 3.7 is intended to provide improved, streamlined and less costly interaction between business and the Tax Office and to assist in building trust between the business community and the taxation administration. It should provide a platform for ongoing improvements to tax administration and ongoing increases in the levels of voluntary compliance.
30. The report also stated that it is important that the redesign of administrative procedures be undertaken on a consultative basis, in accordance with the integrated taxation design process and that the Board of Taxation should be brought into this consultative process at an early stage, as it would be well placed to assist with and advise on the features of the new arrangements.

Recommendation 3.8 – Improved dispute resolution

31. That improved mechanisms to resolve disputes – incorporating provision for negotiation, mediation/arbitration and new or improved litigation and court processes – be features of the redesigned administrative regime.
32. The report noted that the existing arrangements for resolving disputes between taxpayers and the Commissioner regarding tax liability were established well before the introduction of self-assessment and have long passed their use-by date. It concluded that they are needlessly tortuous, often unacceptably slow and costly, and intrinsically overly adversarial. They do not encourage open and direct communication between the parties, or the timely exchange of relevant information. They can cause taxpayers, especially business taxpayers, and the Tax Office frustration, not to mention avoidable expense.
33. The report further noted that the deficiencies in the dispute resolution arrangements were discussed in detail in A Strong Foundation (Chapter 8), and had since been a focus in submissions and comments made at the Review's public forums. It stated that it was essential they be addressed effectively in the proposed redesign of administrative arrangements.
34. The report concluded that a key aspect of the redesign should be a shift in emphasis from adversarial structures (based for example on objections and appeals) to arrangements that employ concepts of dialogue, mediation/arbitration and expanded small claims procedures, with consideration to be given to more specialist tax litigation arrangements and court processes.
35. The report stated that the streamlining of dispute arrangements should ensure that disputes are identified at the earliest possible stage and dealt with on a timely basis. When it was clear a matter will not be able to be resolved by dialogue or mediation, provision should exist for the matter to move quickly to resolution through an appropriately skilled and informed independent tribunal or court.
36. The Review noted in A Strong Foundation that disputation in the tax area generates hundreds of pages of tribunal and court decisions each year, contributing to delays and uncertainty. Therefore, the prompt referral of a dispute to a tribunal or court is not in itself a solution. Therefore, given this, the tribunal and court arrangements applying to tax disputes need themselves to be reviewed and all options for improvement considered.
37. The report concluded that consideration should be given to reforms in this area, including for example:

    – the establishment of a specialist taxation tribunal to facilitate effective tax dispute resolution, possibly as a division of the proposed Administrative Review Tribunal or Federal Magistrates Court; or

    – the creation of a dedicated Tax Court, possibly as part of the Federal Court, presided over by judges with specialist tax knowledge.

38. The report also stated that new arrangements should include provision in certain circumstances (for example, where all parties agree an issue will not be resolved through dialogue or mediation) for taxpayers to by-pass administrative processes and refer a dispute directly to the appropriate independent tribunal or court.

[1] Information sourced from the Administrative Appeal Tribunal's Annual Report 2005/06, at Appendix 3.

[2] A more detailed discussion of these issues may be found at pages 57-59 of the Inspector-General's report from the Review of the Tax Office management of Part IVC litigation, released by the Government on 7 August 2006.