



**Australian Government**  
**Inspector-General of Taxation**

# **Review into the Tax Office's Administration of Penalties and Interest Arising from Active Compliance Activities**

**Report to the Minister for Revenue  
and Assistant Treasurer**

**Inspector-General of Taxation**

**18 May 2005**



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Administration of Penalties and Interest  
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**Australian Government**  
**Inspector-General of Taxation**

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17 May 2005

The Hon Mal Brough MP  
Minister for Revenue and Assistant Treasurer  
Parliament House  
CANBERRA ACT 2600

Dear Minister

I am pleased to present to you my report of the Review into the Tax Office's Administration of Penalties and Interest Arising from Active Compliance Activities. The report has been prepared under section 10 of the *Inspector-General of Taxation Act 2003* ('the Act').

In accordance with the requirements of section 25 of the Act, I have provided the Commissioner of Taxation with the opportunity to respond to the report's findings and recommendations. His reply and associated comments on individual recommendations have been incorporated into the report. It will be noted that the Commissioner has agreed with all of my recommendations.

I offer my thanks for the co-operative approach of the Tax Office staff and the support and contribution of many professional bodies, business groups, individuals and government bodies. The willingness of many to provide their time in preparing submissions and discussing issues with me and my staff is greatly appreciated.

Yours sincerely

A handwritten signature in cursive script that reads "David Vos".

David R Vos AM  
Inspector-General of Taxation



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# CHAPTER 1: OVERVIEW

## INITIATING THE REVIEW

1.1 This is the report on the review conducted by the Inspector-General of Taxation (Inspector-General) pursuant to section 10 of the *Inspector-General of Taxation Act 2003* (IGT Act) on the consistency of application of penalties and interest to businesses during active compliance activities by the Australian Taxation Office (Tax Office).

1.2 The review was included in the Inspector-General's 2004-05 work programme on 19 August 2004. On 23 November 2004 the Inspector-General announced terms of reference for the review into aspects of the Tax Office's business active compliance activities with a particular focus on length of time of audits and whether the application of penalties and interest is consistent.<sup>1</sup> The terms of reference for this review are reproduced at Appendix 1 to this report. Details of how the review was conducted are given at Appendix 2.

1.3 The review was conducted pursuant to subsection 8(1) of the IGT Act, being a review conducted on the initiative of the Inspector-General. The decision to undertake the review was prompted by concerns raised with the Inspector-General by industry and tax practitioners.

1.4 During the course of the Inspector-General's review, the Tax Office provided this office with an internal draft report outlining suggested changes to its systems involved with the administration of penalties. The findings and recommendations of the internal review have yet to be approved and implemented by the Tax Office.

1.5 The assistance and cooperation provided by the Commissioner of Taxation and his officers to the Inspector-General and his team during the course of the review are gratefully acknowledged.

## STRUCTURE OF THE REPORT

1.6 Chapter 2 of this report provides a summary of the key findings and recommendations for this review.

1.7 Chapter 3 of this report describes the nature and extent of penalties and interest applied in the active compliance environment. It also briefly discusses previous reviews that have examined the Tax Office's administration of the penalty and/or interest regimes.

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1 The Inspector-General's review into the length of time of audits and other compliance activities is currently in progress.

1.8 Chapter 4 examines the Tax Office's administration of the penalty and interest regimes. It discusses the Tax Office's management of the penalty and interest regimes, its corporate information systems, its communication strategies with taxpayers and their advisers, its quality assurance processes and work practices. It includes and discusses concerns raised in submissions from taxpayers, tax practitioners and tax practitioner associations. It also lists a number of suggested improvements for the Tax Office's consideration as part of its internal review into the penalty regime.

## CHAPTER 2: SUMMARY OF KEY FINDINGS AND RECOMMENDATIONS

### KEY FINDINGS

2.1 The terms of reference for this review have required the Inspector-General to consider whether the Tax Office's application of penalties and interest to businesses during active compliance activities is consistent. In doing so, the Inspector-General has focused on the consistency in the nature and extent of penalties applied and the consistency of the Tax Office's approach in that application.

2.2 The Tax Office administers a number of administrative penalties and charges, the most relevant arising from audit and other active compliance activity being tax shortfall penalties and the general interest charge. The Tax Office states in its annual reports that, during 2002-03, it raised a total of approximately \$6.138 billion as a result of its active compliance programme, composed of \$4.387 billion in tax and \$1.75 billion in penalties and interest. During 2003-04, it raised approximately \$6.368 billion as a result of its active compliance programme, composed of \$4.902 billion in tax and \$1.466 billion in penalties and interest.

2.3 Consistency of application of penalties is implicit in achieving fairness, equity and effectiveness in the administration of the penalty regime.<sup>2</sup> The importance of consistency in the imposition of interest is equally relevant in the administration of the interest regime. Consistency, however, has many facets. It includes consistency between taxpayers in similar circumstances, consistency of approach over time and the consistent consideration of a taxpayer's individual circumstances.

2.4 In the Inspector-General's view the consistent and equitable imposition of penalties and interest arising from active compliance activities is promoted by:

- having a corporate approach to the administration of the penalty and interest regimes, including a uniform set of work practices and support tools for staff
- having in place corporate management information systems
- providing guidance to taxpayers and their advisers on the application and remission of penalties and interest, and
- having in place quality assurance and staff-skilling processes.

2.5 Information provided by the Tax Office shows some variation in the average rate of penalties between business lines, market segments and the different types of tax. However, this is not unexpected and could be due to a number of different factors. These include the

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2 Australian National Audit Office, Report No. 31 of 1999-2000, *Administration of Tax Penalties*, p. 31.

different focus of each business line and market segment, the nature of the tax shortfall, type of taxpayer and level of taxpayer compliance within each business line and market segment.

2.6 It is important, however, that the Tax Office be able to differentiate between variations in the average rate of penalties caused by such factors, and variations caused by the approach adopted by each business line in administering penalties.

2.7 In comparing individual cases, there are difficulties in determining consistency in the application of penalties and interest. This is because the application and remission of penalties and interest involve a consideration of the taxpayer's individual facts and circumstances and an assessment of their culpability. The Tax Office has in place a framework of rulings and practice statements to provide guidance to staff in the application and remission of penalties and interest. A tax officer is required to exercise judgment in how the case law, rulings and practice statements apply in particular circumstances. It is not the role of the Inspector-General to stand in the shoes of the Commissioner of Taxation in exercising these judgments.

2.8 Currently, the Tax Office does not have the corporate management information systems to examine whether there is consistency in the nature and extent of penalties and interest applied at a broader level. One example of this broader level requirement is the application and remission of penalties and interest for similar groups of taxpayers across business lines, for example, those involved in aggressive tax planning. Another example of this broader level requirement is the approach of different business lines in increasing or decreasing the base penalty amount according to whether the taxpayer has prevented or obstructed the Tax Office in investigating the shortfall, has previously been penalised for a shortfall, or has made a voluntary disclosure of the shortfall.

2.9 Improvements in the Tax Office's ability to examine the administration of the penalty and interest regimes at this broader level would provide greater assurances to Tax Office management and the community that the Tax Office's approach in the application of penalties and interest is equitable and consistent.

2.10 In February 2000 the Australian National Audit Office (ANAO) made a number of recommendations to improve the administration of the penalty regime, all of which were agreed to by the Tax Office. Although these recommendations were in relation to the Tax Office's administration of the previous penalty regime, they are equally relevant to the current uniform administrative penalty regime, which came into effect on 1 July 2000.

2.11 The Tax Office indicated in the ANAO report that because of the high demand on system changes during the period of tax reform, it would stagger the implementation of any changes to penalties over a period of up to two years to fit into its systems development schedule.

2.12 To date, the Tax Office has yet to implement fully all of the ANAO recommendations. The Tax Office has stated that it deferred implementing a number of recommendations as there were fewer instances where penalties were imposed given the concessions in relation to the application of penalties as part of the new tax system.<sup>3</sup> The

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3 These penalty concessions are outlined in Practice Statements PS LA 2000/9 and PS LA 2002/8.

Tax Office has advised that with the penalty concessions no longer generally applicable it is now better placed to implement the outstanding ANAO recommendations.<sup>4</sup>

2.13 While some progress has been made by the Tax Office in implementing the ANAO recommendations, such as the establishment of a technical quality review process and a Penalty Policy and Practice Committee, the Inspector-General notes that further work needs to be done in addressing the findings of the ANAO report and improving the Tax Office's penalty administration. This was evidenced during the Inspector-General's review, with a number of key findings identified by the ANAO remaining of concern to taxpayers and their advisers.

2.14 During the course of the Inspector-General's review, the Tax Office informed the Inspector-General that the active compliance area has initiated its own internal review into its administration of the penalties regime. The Tax Office also provided the Inspector-General with the review team's draft report. The Inspector-General commends the Tax Office for its initiative in seeking to improve its administration of the penalty system.

2.15 The internal review is examining the extent to which the Tax Office has a system that enables the equitable application of penalties across all markets and active compliance activities in accordance with Compliance Model and Taxpayers' Charter principles, and adheres to legislation, rulings and practice statements.

2.16 The Tax Office review team's draft report looks at a number of features of the penalty system, including:

- how the Tax Office is influencing taxpayer behaviour through the penalty system
- the level of understanding of the penalty system by taxpayers
- the quality assurance processes undertaken by the Tax Office to examine penalty decisions
- the level of skilling of staff, and
- the systems, support and infrastructure in place to help the Tax Office deliver quality outcomes.

2.17 The Tax Office review team's draft report examines a number of issues raised by the ANAO report, suggesting that further work needs to be done in addressing the ANAO findings and improving the administration of the penalty regime. The draft report also outlines a number of findings and recommendations, however, it has yet to be finalised for consideration by Tax Office senior management.

2.18 The Tax Office's internal review is examining the administration of penalties with a view to addressing issues similar to the key features identified by the Inspector-General as important in promoting the consistent and equitable imposition of penalties and interest. The Inspector-General is of the view that it would be inappropriate to pre-empt the draft report which is yet to be considered by Tax Office senior management.

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<sup>4</sup> Practice Statement PS LA 2004/5 outlines the Tax Office's position on the remission of penalties following the transition period to the new tax system.

2.19 Accordingly, the Inspector-General will defer more substantive consideration of this topic until after the Tax Office's implementation of recommendations from its internal review and this report.

2.20 As such, the Inspector-General has not examined case files to test directly the potential systemic issues expressed in the submissions received in the course of this review. However, these potential systemic issues will be included in any further substantive consideration of this topic. In addition, a number of the suggestions made by stakeholders have been included as suggested improvements for the Tax Office to consider as part of the current internal review.

2.21 The Inspector-General has examined selected case files in the course of examining the Tax Office's policies and procedures in the application and remission of penalties and interest. Cases selected were not examined on the basis of whether the decision was correct or fair but rather from the perspective of procedural conformity and consistency. Given the Tax Office's current internal review, a more substantive examination of case files has not been undertaken at this point in time. Any observations resulting from the limited case file examination undertaken are not necessarily indicative of a systemic problem. However, these observations will be examined in greater detail in any further substantive consideration of this topic following the Tax Office's implementation of the recommendations from its internal review and this report.

2.22 Enquiries and observations by the Inspector-General also reveal a lack of uniform processes and procedures between business lines in the administration of the penalty and interest regimes.

2.23 In particular, while the Tax Office has corporate policy documents, each business line has developed line-specific processes, procedures, management information systems and guidance to staff. While it is expected that each business line will tailor its arrangements to match its client group, it is also expected that there will be a uniform set of processes, procedures and guidance to staff. This is particularly important in ensuring that the uniform administrative penalty regime is administered in a manner that ensures that a common penalty is applied where a taxpayer fails to satisfy the same type of obligation irrespective of the internal Tax Office structures.

2.24 In response to the ANAO's recommendation to consider options for providing information in plain English to inform taxpayers better about the penalty regime, the Tax Office states that it has published several practice statements that provide guidance to staff and taxpayers. Submissions to the Inspector-General, however, suggest that there is room for improvement in information provided to taxpayers and their advisers.

2.25 Given that the Tax Office is currently examining its administration of the penalty regime, the Inspector-General makes the following key recommendations:

### **KEY RECOMMENDATIONS**

1. The Tax Office promptly acts to ensure that the agreed ANAO recommendations are fully implemented and addresses the findings identified in the ANAO report.
2. The Tax Office develops a uniform set of processes, procedures, corporate management information systems and guidance to staff for cross-business line application.
3. The Tax Office includes an examination of the administration of the tax shortfall interest regime from the same perspective as its internal review into the penalty regime.
4. The Tax Office considers, as part of its internal review, suggested improvements to the administration of the penalty and interest regimes as set out in Chapter 4.



## CHAPTER 3: PENALTIES, INTEREST AND ACTIVE COMPLIANCE ACTIVITIES — BACKGROUND

### OVERVIEW OF CURRENT ADMINISTRATIVE PENALTY REGIME

3.1 Administrative penalties in Australian Federal law are broadly understood as being sanctions imposed by the regulator, or by the regulator's enforcement of legislation, without intervention by a court or tribunal.<sup>5</sup>

3.2 The current uniform administrative penalty regime commenced on 1 July 2000 to streamline the penalties framework and to support compliance under the new tax system.<sup>6</sup>

3.3 This was in response to a number of problems with the previous penalties framework including the duplication of penalty provisions in the different taxation laws, the disparity between the various penalty provisions and the previous penalties framework not being designed to deal with the obligations introduced by the new tax system.<sup>7</sup>

3.4 The uniform administrative penalty regime was intended to overcome these problems by:

- grouping together existing penalty provisions that had a substantially similar operative effect
- imposing the same administrative penalty for breaches of similar tax obligations, and
- applying the new administrative penalty regime uniformly to all taxation laws, including those recently introduced as part of the new tax system.<sup>8</sup>

3.5 The new administrative penalty regime was also designed to be easily understood by taxpayers and easily administered by the Commissioner.<sup>9</sup> It had the purpose of improving equity by ensuring that a common penalty applies where a taxpayer fails to satisfy the same type of obligation under different tax laws.

### NATURE OF PENALTIES AND INTEREST APPLIED

#### Penalties

3.6 Penalties seek to punish undesirable behaviour and thereby to promote desired behaviour. Penalties represent an escalation in sanction by the Tax Office and are an

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5 Australian Law Reform Commission, ALRC 95, *Principled Regulation: Civil and Administrative Penalties in Australian Federal Regulation*, at paragraph 2.64.

6 Explanatory Memorandum to A New Tax System (Tax Administration) Bill (No. 2) 2000, at paragraph 1.3.

7 *ibid.*, at paragraphs 1.3-1.7.

8 *ibid.*, at paragraph 1.12.

9 *ibid.*, at paragraph 1.4.

indication that less interventionist measures, such as help and education, have failed to produce compliance. The form and level of penalty applied will depend on its purpose as well as the type of wrongdoer and the nature of the wrongdoing.<sup>10</sup>

3.7 The Tax Office has adopted a compliance model which is intended to encourage voluntary compliance by taxpayers through education. Where voluntary compliance is not obtained, there is an escalation of sanctions, including penalties.

3.8 The purpose of penalties in such circumstances is two-fold – firstly, to impose a punishment where there is non-compliance so as to deter the person sanctioned from repeating the contravention, and secondly, as a general deterrent, to deter others from engaging in the prohibited behaviour.

3.9 In the active compliance environment, the most common penalties will be those that apply where a taxpayer understates their liability and therefore pays less tax than they ought. These are known as tax shortfall penalties.<sup>11</sup>

3.10 Tax shortfall penalties may apply if a taxpayer has a tax shortfall arising from any of the following:

- making a false and misleading statement, for example, omitting income or over-claiming deductions
- applying an income tax law in a way that is not reasonably arguable (but only if the tax shortfall amount exceeds the greater of \$10,000 or 1 per cent of the income tax payable by the taxpayer)
- disregarding a private ruling,<sup>12</sup> or
- entering into a tax avoidance scheme or having a transfer pricing adjustment.

3.11 The penalty regime sets out a base penalty amount depending on the culpability of the taxpayer. This is determined by examining the reasons for the tax shortfall and takes into account factors such as whether the taxpayer has intentionally disregarded the law, been reckless, failed to take reasonable care or taken a position that is not reasonably arguable.

3.12 This base penalty amount can then be increased or reduced according to whether the taxpayer has prevented or obstructed the Tax Office in investigating the shortfall, has previously been penalised for a shortfall, or has made a voluntary disclosure of the shortfall.

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

3.14 The Commissioner also has the discretion to remit all or part of an administrative penalty. A taxpayer may apply for remission, or the Tax Office may remit the penalty on its own initiative. The Tax Office must provide a taxpayer with written notice of a decision not to remit the penalty, or to remit only part of a penalty.

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10 Australian Law Reform Commission, *op. cit.*, at paragraph 3.4.

11 Tax shortfall penalties are set out in Part 4-25 of Schedule 1 to the *Taxation Administration Act 1953*.

12 On 17 March 2005, the Tax Laws Amendment (Improvements to Self Assessment) Bill (No. 1) 2005 was introduced into Parliament to amend the administrative penalty regime in the *Taxation Administration Act 1953* to repeal the penalty for failing to follow a private ruling.

3.15 A decision not to remit a penalty, or to remit only part of a penalty, is reviewable in accordance with Part IVC of the *Taxation Administration Act 1953* provided the penalty not remitted exceeds two penalty units.<sup>13</sup>

## Interest

3.16 A general interest charge (GIC) is imposed on any tax or penalty that remains unpaid after the time it becomes due and payable. The interest charge is separate from the penalty imposed, representing compensation to the revenue for the delay in payment of tax.

3.17 Where an active compliance activity leads to a tax adjustment creating a liability to pay, then the interest charge will be imposed from the day on which tax became due and payable under the original assessment.

3.18 The Commissioner of Taxation may remit all or part of the GIC where:

- the delay in payment was not caused directly or indirectly by an act or omission of the person and the person has taken reasonable action to correct the situation
- the delay in payment was caused directly or indirectly by an act or omission of the person, the person has taken reasonable action to correct the situation, and it would be fair and reasonable to remit all or part of the charge, or
- there are special circumstances making it fair and reasonable to remit all or part of the GIC or it is otherwise appropriate to do so.

3.19 The Tax Office's GIC remission guidelines are set out in Chapter 93 of the Tax Office's Receivables Policy. Following the Inspector-General's review into the remission of the GIC for groups of taxpayers in dispute with the Tax Office, the Tax Office announced that it would be publishing clearer guidelines on the remission of GIC, in particular where the GIC relates to the pre-amended assessment period.

## MEANING OF 'ACTIVE COMPLIANCE ACTIVITIES'

3.20 A key component of the Tax Office's corporate capability is active compliance. The Tax Office has developed a broad range of compliance products to be used by active compliance staff. The Tax Office defines a compliance product as a process used to deliver a compliance strategy to a client or group of clients.

3.21 Compliance products are sorted according to different compliance strategies that the Tax Office could adopt as part of its active compliance activities such as Investigate/Prosecute, Audit/Enforcement and Review. Each type of response, or 'product', is targeted for a particular revenue type and population of taxpayer.

3.22 For example, the Tax Office states that audit and enforcement products are primarily used where it is reasonable to believe there is a risk of non-compliance. This risk is addressed by the use of audit products that involve the examination of records to establish the correct liability and enforce compliance. The audit and enforcement product set also

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<sup>13</sup> Section 4AA of the *Crimes Act 1914* sets the current value of a penalty unit at \$110.

includes products, other than audit, to ensure administrative compliance with obligations such as registration, lodgment, payment, regulatory responsibilities and withholding liabilities.

3.23 In contrast, the Tax Office states that review products are designed to maintain the integrity of the tax system by helping taxpayers to comply and ensure that taxpayers remain 'on track' with compliance. These review products seek to encourage voluntary disclosures, and concessional penalty treatment may apply for amended assessments arising from such disclosures.

3.24 Each compliance product set is further sorted into more specific Tax Office active compliance activities, depending on the type of activity. For example, a review product would include desk review activities, computer review activities and field review activities.

3.25 As at September 2004, the Tax Office had 91 review products, 79 audit enforcement products and 10 investigate/prosecute products.

## EXTENT OF PENALTIES AND INTEREST APPLIED

3.26 For the 2002-03 income year the Commissioner of Taxation reported that the Tax Office raised a total of approximately \$6.138 billion as a result of its active compliance programme, composed of \$4.387 billion in tax and \$1.75 billion in penalties and interest.<sup>14</sup>

3.27 For the 2003-04 income year the Commissioner of Taxation reported that the Tax Office raised a total of approximately \$6.368 billion as a result of its active compliance programme, composed of \$4.902 billion in tax and \$1.466 billion in penalties and interest.<sup>15</sup>

3.28 The active compliance results are examined below from various perspectives including market segment, business line and revenue product.

3.29 The penalties information presented below represents all Tax Office penalties imposed and would include tax shortfall penalties along with other general penalties that relate to indirect tax, withholding tax and PAYG and which deal with acts or omissions such as failure to lodge.

### By market segment

3.30 The Tax Office breaks up the taxpaying community into six market segments, which are based upon the nature of the taxpayer and the taxpayer's annual turnover. The market segments are individuals, micro-businesses, small to medium enterprises, large businesses, non-profit organisations and government organisations.<sup>16</sup>

3.31 Table 3.1 shows active compliance results by market segment for the 2002-03 and 2003-04 income years.

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14 Commissioner of Taxation, *Annual Report 2002-03*, at p. 65.

15 Commissioner of Taxation, *Annual Report 2003-04*, at p. 62.

16 The Tax Office classifies micro-businesses as those with an annual turnover of less than \$2 million. Small to medium enterprises are defined as those businesses with an annual turnover of between \$2 million and \$100 million. The large business segment consists of those businesses with a turnover of \$100 million or more. High-wealth individuals are included as part of the large business segment.

**Table 3.1: Penalties and interest applied by market segment**

Market segment	Tax (\$m)		Penalties (\$m) including interest		For 2003-04 income year (\$m)		
	02-03	03-04	02-03	03-04	Penalties	Average rate of penalty (%)	GIC
Individuals	222	285	33	53	46.7	16.39	5.6
Micro-business	1,138	1,589	115	269	214.2	13.48	54.5
Small to medium	785	782	135	120	89.7	11.47	31.4
Large business	2,133	2,134	1,467	1,008	354.9	16.63	653.2
Government and non-profit	110	112	1	16	13.7	12.23	2.0
<b>Total</b>	<b>4,388</b>	<b>4,902</b>	<b>1,751</b>	<b>1,466</b>	<b>719.2</b>	<b>14.67</b>	<b>746.7</b>

Source: Tax Office.

## By business line

3.32 The Tax Office is structured into a number of business areas (known as 'business lines'), which, together with a number of specialist areas, are responsible for the delivery of the Tax Office's compliance programme.

3.33 The delivery lines include Large Business and International (LB&I), Small Business (SB), Personal Tax (PTax), Excise, Goods and Services Tax (GST) and Superannuation (SPR). The specialist areas include Serious Non-Compliance (SNC), Operations and Aggressive Tax Planning (ATP).

3.34 Table 3.2 shows active compliance results, by business line, for the 2003-04 income year.

**Table 3.2: Penalties and interest applied by business line**

Business Line	Tax (\$m)	Proportion of total tax (%)	Penalties (\$m)	Proportion of penalty (%)	Average rate of penalty (%)
Excise Revenue	11.7	0.2	4.7	0.7	40.2
Excise Transfer	330.3	6.7	0.049	0	0.0
GST	1,302.7	26.6	74.8	10.4	5.7
LBI	1,543	31.5	349.3	48.6	22.6
LBI ATP	59.1	1.2	21.1	2.9	35.6
Operations	669.9	13.7	3.1	0.4	0.5
PTax	171.6	3.5	6.4	0.9	3.7
PTax ATP	38.8	0.8	7.5	1.0	19.2
SB	199.1	4.1	24.8	3.5	12.5
SB ATP	274.1	5.6	184.6	25.7	67.3
SNC	90	1.8	30.8	4.3	34.3
SPR Revenue	36.1	0.7	0.53	0.1	1.5
SPR Transfer	176	3.6	11.4	1.6	6.5
<b>Total</b>	<b>4,902.4</b>	<b>100.0</b>	<b>719.2</b>	<b>100.0</b>	<b>14.7</b>

Source: Tax Office.

## By revenue type

3.35 Table 3.3 shows active compliance results, by revenue type, for the 2003-04 income year.

**Table 3.3: Penalties and interest applied by revenue type**

Revenue type	Finalised cases with liability impact	Tax (\$m)	Penalties (\$m)	Average rate of penalty (%)	Interest (\$m)
Excise	9,126	348	4.8	1.38	0
GST	32,023	1,139	64.2	5.64	1.2
Income tax	480,173	2,717	626.4	23.05	709.7
PAYG withholding	27,755	509	11.7	2.3	5.1
Superannuation	1,665	11	0.063	0.57	0.17
Superannuation Guarantee	13,943	176	11.4	6.48	30.7
Luxury car tax/sales tax	68	2	0.58	29	0
<b>Total</b>	<b>564,753</b>	<b>4,902</b>	<b>719.2</b>	<b>14.67</b>	<b>746.7</b>

Source: Tax Office.

## PREVIOUS REVIEWS

3.36 The administration of the penalty and/or interest regimes, and their underlying policy, have previously been examined by the Australian National Audit Office (ANAO) and recently by the Treasury as part of its Review of Aspects of Income Tax Self Assessment (ROSA).

### Australian National Audit Office

3.37 On 16 February 2000 the ANAO tabled its report titled *Administration of Tax Penalties*, Auditor-General Report No. 31, 1999-2000 ('the ANAO report'). This report examined the Tax Office's administration of penalties with a particular emphasis on its corporate governance framework and issues relating to the consistency, effectiveness and accountability in the administration of the then current penalty regime.

3.38 The audit found that there was scope for improvement in the Tax Office's administration of that penalty regime.<sup>17</sup> It concluded that, although penalties are an important enforcement strategy featured in the ATO Compliance Model, the Tax Office lacked appropriate control structures to oversight the accountability, consistency and effectiveness of its penalty administration.

3.39 The ANAO made a number of key findings as part of its review. These key findings are listed in Appendix 4.

3.40 Flowing from those key findings, the ANAO made five recommendations, all of which were agreed to by the Tax Office. The recommendations were as follows:

1. The Tax Office includes penalties administration within its corporate governance framework in order to provide assurance to the Commissioner that it is operating consistently and effectively. This could include
  - (a) establishing organisation-wide quality assurance of the Tax Office penalty administration to assist in promoting better practice and provide assurance that it is operating consistently, and

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<sup>17</sup> Australian National Audit Office, op. cit., at p. 11.

- (b) using statistical and demographic data to monitor the effectiveness of penalties in addressing and improving compliance.
2. The Tax Office technical training material on penalties includes reference to, and discussion of, the impact of the Taxpayer Charter and the Compliance Model. This would include guidance on the application of penalties to the different scenarios outlined in the Compliance Model.
3. The Tax Office investigate the cost effectiveness of providing on-line, decision support tools to staff to assist with consistent and efficient application of penalties.
4. The Tax Office considers options for providing information in plain English to better inform taxpayers about the Tax Office penalties regime.
5. The Tax Office study the relative effectiveness of penalties on taxpayer behaviour to assist in determining whether penalties have been effective. This would assist the Tax Office in improving taxpayer compliance and in refining the Compliance Model.

3.41 The Tax Office indicated in the ANAO report that because of the high demand on system changes during the period of tax reform, it would stagger the implementation of any changes to penalties over a period of up to two years to fit into its systems development schedule.<sup>18</sup>

3.42 While these recommendations are in relation to the Tax Office's administration of the previous penalty regime, they are equally relevant to the current uniform administrative penalty regime, which came into effect on 1 July 2000.

3.43 The Tax Office has indicated that, where possible, it has implemented the ANAO recommendations. This includes:

- the establishment of a technical quality review process that applies to all business lines and measures the quality of penalty decisions
- the establishment of a Penalty Policy and Practice Committee to coordinate the delivery of a sustainable integrated design capability to manage penalties
- the publishing of Taxation Authorisation Guidelines on the assessment of penalty amounts
- the development of a national training package titled 'An Introduction to Penalties', which provides an overview of penalty administration for all staff
- the publishing of several practice statements in relation to penalty administration which are also available to taxpayers through the Tax Office website.

3.44 The Tax Office advises that it is also currently developing a penalty website that will act as a single electronic access point for staff and taxpayers on material relating to penalties

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18 *ibid.*, at p. 28.

such as relevant legislation, explanatory memorandums, rulings, practice statements and policy documents.

3.45 The Tax Office has stated that it deferred implementing recommendations 1(b), 3 and 5 of the ANAO recommendations as there were fewer instances where penalties were imposed given the concessions in relation to the application of penalties as part of the new tax system.<sup>19</sup> The Tax Office has advised that with the penalty concessions no longer generally available it is now better placed to implement the outstanding ANAO recommendations.<sup>20</sup>

3.46 While some progress has been made by the Tax Office in implementing the ANAO recommendations, the Inspector-General notes that further work needs to be done in addressing the findings of the ANAO report and improving the Tax Office's penalty administration. In particular, there is a need to ensure that there is cross-business line consistency in the processes and procedures in respect to the administration of the penalty regime.

3.47 This is further evidenced by the Tax Office's internal review into its approach and administration of the penalty regime, which addresses similar issues to those raised by the ANAO report.

## Review of Aspects of Income Tax Self Assessment

3.48 On 16 December 2004, the Government released the Report on Aspects of Income Tax Self Assessment ('the ROSA report').

3.49 The Review identified a number of changes to the current system that would reduce uncertainty and compliance costs for taxpayers while preserving the Tax Office's capacity to collect legitimate income tax liabilities.<sup>21</sup>

3.50 The Government announced that it would adopt the legislative recommendations made in the report. The Commissioner of Taxation agreed to implement the administrative recommendations outlined as soon as practicable and indicated that substantial progress had already been made on many of them.<sup>22</sup>

## Penalties

3.51 The ROSA report made a number of recommendations to improve the transparency of the process of imposing penalties on taxpayers who underestimate a tax liability, and clarify the standard of care required by taxpayers. Relevant to this review, the ROSA report recommended that:

- the Tax Office revise its rulings on reasonable care and reasonably arguable position, with a view to providing clearer guidance and further examples as to what conduct will, or will not, attract a penalty

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19 These penalty concessions are outlined in Practice Statements PS LA 2000/9 and PS LA 2002/8.

20 Practice Statement PS LA 2004/5 outlines the Tax Office's position on the remission of penalties following the transition period to the new tax system.

21 P Costello, Treasurer, *Outcome of the Review of Aspects Of Income Tax Self Assessment*, Press Release No. 106, Melbourne, 16 December 2004.

22 *ibid.*

- the Tax Office explain more fully, for example in a ruling or Practice Statement, how it exercises the discretion to remit tax shortfall penalties, including Part IVA cases
- where the Tax Office decides that a penalty applies and should not be remitted in full, it provide an explanation of why the penalty has been imposed (for example, why the taxpayer has not taken reasonable care or does not have a reasonably arguable position) and why the penalty should not be remitted in full
- the Tax Office further explain in a ruling or Practice Statement what understatements of liability it regards as immaterial for tax shortfall purposes.

3.52 The Inspector-General is supportive of the recommendations and is of the view that they will also have benefits in improving consistency in the application of penalties.

### **General interest charge**

3.53 The ROSA report also made a number of recommendations for change to the design of the GIC to improve its operation in the context of self assessment. Relevant to this review, the ROSA report recommended that:

- from the 2004-05 income year, the standard interest charge applying to income tax shortfalls (that is, the tax difference between the original and amended assessment) be lower than the GIC rate, reflecting the benchmark cost of finance for business
- the new lower uplift factor be implemented by a separate pre-amendment shortfall interest charge, in lieu of the GIC. GIC will continue to apply to crystallised debts from the new due date
- the Commissioner have a broad discretion to remit the new shortfall interest charge, where he considers it fair and reasonable<sup>23</sup>
- where unremitted shortfall interest exceeds 20 per cent of the tax shortfall, the taxpayer be entitled to object to the decision not to remit. Objection decisions should be subject to review and appeal where the shortfall interest remaining after determination of the objection exceeds 20 per cent of the tax shortfall
- when notifying taxpayers of a shortfall interest liability, the Tax Office advise taxpayers on how to seek remission
- the Tax Office provide reasons for rejecting shortfall interest remission requests.

3.54 The Inspector-General is supportive of the recommendations and is of the view that they will also have benefits in improving consistency in the application and remission of GIC.

3.55 Submissions to the Inspector-General have raised concerns that there will still be outstanding issues with the administration of tax shortfall penalties and interest after the

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23 The Explanatory Memorandum to the Tax Laws Amendment (Improvements to Self Assessment) Bill (No. 1) 2005 states that remission should occur where the circumstances justify the Commonwealth bearing part of the cost of delayed receipt of taxes. Such cases would usually entail delay, contributory cause or fault on the part of the Tax Office or others. Where the Commissioner is aware that these circumstances arise, he should initiate remission.

implementation of the recommendations of the ROSA report. These include the treatment of taxpayers prior to the legislative enactment of the ROSA report recommendations and the application of tax shortfall penalties where the tax shortfall arises due to a timing mismatch with no net detriment to the revenue. The commencement date of the revised tax shortfall interest regime is a matter for Government. On 17 March 2005 the Minister for Revenue and Assistant Treasurer introduced legislation into Parliament to give effect to the penalty and shortfall interest changes recommended by the ROSA report.

3.56 In respect to the concerns regarding the application of tax shortfall penalties arising from a timing mismatch, Practice Statement PS LA 2004/5 discusses the Tax Office's approach to timing adjustments. It addresses situations where taxpayers include an income amount in a period later than the period in which the amount should have been included, or claim a deduction or credit in a period earlier than the period in which the claim should have been made. In such cases, the penalty on the resulting shortfall amount will generally be remitted unless it is clear that the taxpayer was aware of the proper tax treatment of the particular item but sought to gain an advantage by disclosing or claiming in the incorrect period.

## **CHAPTER 4: CONSISTENCY OF THE TAX OFFICE'S APPROACH IN THE APPLICATION OF PENALTIES AND INTEREST**

4.1 Consistency of application of penalties is implicit in achieving fairness, equity and effectiveness in the administration of the penalty regime.<sup>24</sup> The importance of consistency in the imposition of interest is equally relevant in the administration of the interest regime. Consistency, however, has many facets. It includes consistency between taxpayers in similar circumstances, consistency of approach over time and the consistent consideration of a taxpayer's individual circumstances.

4.2 The administration of penalties and interest represents a double-edged sword for both the Tax Office and the community. Taxpayers want greater consistency in the application and remission of penalties and interest while expecting that tax officers exercise appropriate judgment and flexibility to respond to individual facts and circumstances.

4.3 In the Inspector-General's view the consistent and equitable imposition of penalties and interest is promoted by:

- having a corporate approach to the administration of the penalty and interest regimes, including providing a uniform set of work practices and support tools for staff
- having in place corporate management information systems
- providing guidance to taxpayers and their advisers on the application and remission of penalties and interest
- having in place quality assurance and staff-skilling processes.

4.4 This chapter examines each of these key features in the Tax Office's administration of the penalty and interest regimes and discusses concerns raised in submissions from taxpayers, tax practitioners and tax practitioner associations.

### **UNIFORM CORPORATE APPROACH IN ADMINISTRATION OF PENALTY AND INTEREST REGIMES**

#### **Management of penalty and interest regimes**

4.5 The Tax Office has a Penalty, Policy and Practice Committee, which has the role of developing Tax Office-wide penalty policy. The work practices are the responsibility of each business line.

4.6 The Tax Office also has a number of systems and support mechanisms designed to assist in managing the administration of the penalty regime. Some of the systems and support, like guidance to staff in the form of rulings and the Technical Decision Making

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24 Australian National Audit Office, Report No. 31 of 1999/2000, *Administration of Tax Penalties*, p. 31.

System, apply across the Tax Office. Other systems and support, such as the guidance notes to staff and the case management systems designed to record and report penalty and interest information, are developed at a business line level.

4.7 However, there is no overarching management of the systems and support mechanisms for penalties and interest from a Tax Office-wide perspective. While it is expected that each business line will tailor its arrangements to match its client group, it is also expected that there would be a uniform set of processes, procedures, management information systems and guidance to staff.

4.8 The Tax Office review team has identified, as a potential issue, the Tax Office's current approach in administering the penalty regime across business lines and segments.

4.9 The Tax Office advises that currently the Active Compliance Steering Committee and ATOField, a Tax Office website designed to enable Tax Office staff to achieve best practice in their field work, are a means of ensuring consistency amongst business lines. The Active Compliance Steering Committee has the role of reviewing and driving corporate initiatives and capabilities. The Tax Office has also advised that as part of the Change Program work is in progress to develop a single case management system.

4.10 Broad concerns have also been raised by taxpayers and tax practitioner associations about the penalty ramifications from Tax Office compliance activities. A taxpayer may be selected for a number of compliance activities such as a client risk review, specific issues review or audit. Submissions have suggested that different penalty outcomes arise depending on the risk strategy and active compliance activity adopted by the Tax Office. This, they argue, could lead to an inconsistent application of penalties.

4.11 For example, if a taxpayer is selected for a client risk review and makes a voluntary disclosure in the course of that review, the penalty that would otherwise be imposed for a shortfall amount will be reduced by 80 per cent.<sup>25</sup> If the same taxpayer is selected for an audit, then a voluntary disclosure made in the course of that audit will not attract the same penalty concessions. Taxpayers and their advisers have also expressed some uncertainty as to whether a particular compliance activity is an audit or review, and the different expectations and consequences between these two types of compliance activities.

4.12 Submissions to the Inspector-General suggest that the Tax Office should put in place protocols for advising taxpayers about whether a particular compliance activity is an audit, and if so, when the audit commences. Submissions also suggest that irrespective of whether the Tax Office initiates a client risk review or an audit, taxpayers should be provided with a reasonable period to make voluntary disclosures which attract the same penalty concessions. This would prevent the different types of active compliance review activity having different penalty ramifications for taxpayers.

4.13 Given the Tax Office's internal review into its administration of the penalty regime, the Inspector-General has not examined case files to test directly the concerns expressed in the submissions. However, the issues raised in these submissions have also been identified by the Tax Office. In the course of the review the Inspector-General was provided with an internal Tax Office document prepared by the ATPF Working Group on Audit Activities

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25 This applies where the shortfall amount is \$1,000 or more. If the shortfall amount is less than \$1,000, then the penalty will be reduced to nil.

which sought to provide some protocols concerning the Tax Office practices for notifying the commencement of a compliance activity. The paper also stated that this was an important issue for a number of reasons, most obviously the application of the penalty concessions for tax shortfalls relating to voluntary disclosures.

4.14 Practice Statement PS LA 2004/5 does state that the Commissioner has the discretion to treat a disclosure made after an audit commences as having been made before the taxpayer is informed of the commencement of the audit. It states that this discretion will be exercised where a taxpayer, after being advised of a compliance activity, makes a voluntary disclosure before the formal date of commencement of the audit. The effect of this discretion is to reduce the penalty by 80 per cent.

## Work practices

4.15 Broad concerns have been raised with the Inspector-General regarding the Tax Office's procedures in imposing penalties arising from an audit. A number of submissions expressed some uncertainty over when in the audit process the Tax Office considers the application of penalties.

4.16 Specifically, one submission from an accounting firm suggested that the Tax Office's procedures should require case officers to resolve substantive tax issues in negotiations before they commence discussions of penalties. The submission noted that:

Shortfall penalties are generally imposed as a matter of course upon issue of an amended assessment despite the fact that the Commissioner is technically not entitled to shortfall penalties until such time the tax shortfall is determined. A tax shortfall should not be considered as being 'determined' if the taxpayer genuinely disputes it. Indeed, the Commissioner's Settlement Guidelines at paragraph 5.1.1 state that primary tax should be agreed upon prior to discussion of penalties and interest. Therefore, the Commissioner should not be permitted to impose shortfall penalties until such time the substantive issue (that is, the issue concerning the tax shortfall) is resolved.

4.17 In response to this submission, the Tax Office states:

The intention of the Code is to indicate that global settlements are only to be entered into in exceptional cases. That is, if the settlement involves more than one issue, regard must be had to the legal and practical merits of each issue. Negotiations around a single amount in full settlement of the tax, penalties and interest attributable to all unrelated issues under review (sometimes referred to as a 'global' settlement) are only to be entered into in exceptional cases (and must be approved by senior officers).

The Code deals with the process for settling substantive disputes – it does not imply that, whenever an amended assessment is issued, the Commissioner must reach agreement on the primary tax before imposing penalties and interest. Where the Commissioner makes a bona fide assessment of a tax shortfall, he is also entitled to make an assessment of the applicable shortfall penalty, notwithstanding that the taxpayer may have rights of objection. Similarly, tax shortfall interest attaches by law upon the issue of the amended assessment. While the Commissioner may exercise his discretion to remit interest at that time, or at any later time, there is nothing in the scheme of the law that suggests that the imposition of shortfall interest is to be delayed until all of a taxpayer's rights of objection or appeal are exhausted.

4.18 Paragraph 5.1.1 of the Tax Office's *Code of Settlement* states that:

...wherever possible agreement should be reached in respect of the substantive issues before officers consider penalties and interest.

4.19 Paragraph 5.1.5 of the *Code of Settlement* provides that there may be exceptional circumstances, such as global settlements, where penalty and interest could be considered as part of the settlement process.

## **Tax Office audit procedures**

4.20 Business lines within the Tax Office have developed procedures or 'process maps', which provide a broad 'best practice' approach to staff conducting a client risk review or an audit. These set out step by step what case officers should consider as part of a client risk review or an audit. Appendix 6 provides information on the Tax Office process maps relevant to the application of penalties as part of an audit.

4.21 A review of selected audit case files by the Inspector-General did indicate some divergence from the audit procedures. This included some variation in the content and quality of the information contained in the final audit report and penalty submissions regarding the imposition and remission of penalties and interest.

4.22 The Inspector-General also found some variation in the content and detail between the business lines' audit process maps. In particular, much of the detail included in the large business audit process map was absent from the small business audit process maps. The Inspector-General considers that the large business audit process map provides greater guidance to staff for each step of an audit.

4.23 The small business area has a focus on the higher turnover end of the small to medium enterprise market. The Inspector-General is of the view that the Tax Office should examine whether relevant content and detail in the large business audit map could be adopted by the small business area for the higher turnover end of the small to medium enterprise market in its audit process maps, in particular for the audit finalisation steps.

4.24 The Tax Office advises that it has been moving towards this and has brought together a number of people with large case experience to develop an audit process map that takes into account the experience in the large market and is tailored specifically to the top end of the small to medium enterprise market.

## **Consideration of interest remission**

4.25 It is important that all business lines adopt a common approach to whether tax shortfall interest remission is considered where adjustments are made arising from active compliance activities.

4.26 An examination of selected audit case files revealed some variation in the interest remission processes for the pre-amended assessment period. In some instances, case officers considered the remission of interest for Tax Office delay as part of the audit report or penalty submission. In some of the cases where the case officer did consider interest remission this was only after there had been a specific request by the taxpayer.

4.27 In other instances there was no evidence of interest remission for Tax Office delay being considered as part of the audit. This could be despite lengthy delays in finalising the audit, caused partly by the Tax Office in concluding its views as outlined in an audit report

or position paper. In one case reviewed there was no consideration of interest remission after the taxpayer had made a voluntary disclosure of a tax shortfall to the Tax Office during an audit, and the amended assessments were not issued until seven months later.

4.28 The Tax Office advises that following the Inspector-General's review into the remission of the general interest charge for groups of taxpayers in dispute with the Tax Office, the Tax Office is reviewing its guidelines on the remission of the general interest charge, in particular where the general interest charge relates to the pre-amended assessment period.

4.29 The Tax Office advises that these new guidelines will provide more detailed guidance around the issue of delay, covering not just situations where an amended assessment is delayed once the Commissioner has all information necessary to make an amended assessment (a situation already dealt with in Chapter 93 of the *ATO receivables policy*), but also situations where delay arises during the conduct of an audit, or where the complexity of the issues under consideration leads to delay. The Tax Office anticipates that similar considerations will apply to the remission of the shortfall interest charge.

4.30 Part of this problem relates to the inconsistent approach between business lines in considering interest remission arising during the pre-amended assessment period. Some business lines are of the view that the consideration of interest remission for Tax Office delay should be the responsibility of the business line conducting the audit. Other business lines, however, have indicated that interest remission is the responsibility of the Operations line, which is responsible for administering the Tax Office's receivables policy.

4.31 The internal Tax Office guidance notes and penalty checklists provided to staff are also not clear on whether and when tax shortfall interest remission is to be considered where adjustments are made arising from active compliance activities. Some refer to interest remission as part of the penalty consideration while other guidance notes state that under no circumstances should the case officer undertake to remit interest in part or in full as the Operations line should consider all requests for remission. Other guidance notes make no reference to interest remission.

## Support to staff

### Current support tools

4.32 The development of work procedures and guidance notes is currently the responsibility of each business line. These work procedures and guidance notes are additional to the rulings, practice statements and interpretive decisions made available to the public. The Tax Office advises that currently the Active Compliance Steering Committee and ATOfield, a Tax Office website designed to enable Tax Office staff to achieve best practice in their field work, play a role in ensuring consistency amongst business lines.

4.33 The Tax Office intranet site indicates a number of different business line procedures providing guidance to staff on the application and remission of penalties and interest. These guidance notes include the:

- GST General Compliance procedures for issuing an amended tax assessment and imposing tax shortfall penalties
- GST procedures for imposing administrative penalties for false or misleading statements

- procedures to impose administrative penalties – Small Business
- penalties relating to statements – step-by-step guide

4.34 A number of business lines have also developed their own 'Penalty Checklists' to provide guidance to staff. These include:

- LB&I Penalties Checklist – Shortfall and Scheme Penalties
- SB Field – Penalty Submission Checklist.

4.35 The Tax Office has developed a number of tax and penalty calculators to assist staff to calculate the amount of penalty to be imposed. The Tax Office has also introduced a repository for all its technical decisions – the Technical Decision-Making System (TDMS). Staff may access other penalty decisions on similar issues from TDMS when considering the application and remission of penalties. Case officers, however, do not record interest remission decisions onto TDMS.

4.36 The Tax Office conducts a biannual Technical Quality Review (TQR) process that seeks to assess the Tax Office's performance in providing advice that is accurate, consistent, relevant and clearly explained.<sup>26</sup> Following the TQR process in August 2004, some concerns were expressed regarding the support tools available to staff.<sup>27</sup> The report outlining the results of this TQR process (the TQR report) mentioned a number of reasons for penalty decisions not obtaining a 'Pass' rating. These reasons included:

- Tax Office staff within particular business lines not adequately explaining the reasons for the imposition of the penalty
- inadequate or non-existent documentation of client behaviour
- the lack of penalty consideration despite a tax shortfall
- the failure to consider correctly a voluntary disclosure
- the failure to refer to the relevant Practice Statement when considering a remission
- lack of guidance amongst staff regarding the application of the 'reasonable care' principle
- standard letters not being customised to individual taxpayer circumstances.

4.37 One business line indicated that the lack of consolidated instructions to staff on the application of penalties is a contributing factor to non-conformance and inaccuracy.

4.38 The TQR report suggested that there is a need to ensure that the support tools available to staff, such as checklists, templates and guidance notes, are consistent across business lines to minimise any inconsistent application of penalties.

4.39 The external representative of the TQR panel for Large Business & International identified the consistent application of penalties as a major issue. In order to avoid

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<sup>26</sup> Practice Statement PS LA 2001/11, page 2.

<sup>27</sup> The Technical Quality Review process is the corporate tool used by the Tax Office to measure the quality of technical decisions. Further detail on this process is provided in this chapter.

inconsistent treatment across the different business lines, it was suggested that the Tax Office review its practice statements and produce one consolidated document. The external representative suggested that this document also contain examples to guide case officers.

4.40 The Tax Office states that issues identified in the TQR report and suggested by external representatives should be considered in the context of the overall favourable assessment of the TQR process and the improved quality of penalty decision-making.<sup>28</sup>

4.41 The Tax Office's internal review also suggested that there may be some difficulty in applying the principles expressed across the multitude of Tax Office strategic documents such as the Taxpayers' Charter, Compliance Model, rulings, practice statements and guidance notes on the application and remission of penalties and interest. The internal review suggests that this may lead to different approaches in the application and remission of penalties and interest across the Tax Office.

### **ANAO report**

4.42 The ANAO report identified the need for the Tax Office to develop better decision support tools. The ANAO recommended that the Tax Office investigate the cost effectiveness of providing on-line, decision support tools to staff to assist with consistent and efficient application of penalties. It stated that:

...it considers that better consistency in application of penalties within and between BSLs could be achieved by providing a cost-effective, on-line, rule based information system to support penalty administration. Such a system would respond to information entered, provide options for decisions concerning penalty remission and record statistical information concerning penalty application, including the reasons why remissions are granted. It should be designed to ensure that the ATO maintained the capacity to address exceptional and individual circumstances.

The ANAO considers that a system of this kind could provide multiple benefits for staff administering penalties, particularly Tax Shortfall Penalty. It could assist them to achieve more efficient and consistent decision-making while capturing data for ATO statistical and quality assurance purposes.<sup>29</sup>

4.43 To date, the Tax Office has deferred the implementation of this recommendation. The Tax Office states that this has been due to the penalty concessions granted in Practice Statements PS LA 2000/9 and PS LA 2002/8, resulting in fewer instances of penalty application during the tax reform period.

4.44 The Tax Office advised that it is currently in the planning stages of implementing a penalty website. This site would be a single electronic access point for staff and taxpayers on material such as legislation, explanatory memorandums, rulings, practice statements and other relevant policy documents. The Tax Office also indicated that business lines are currently developing their own support tools.

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28 See paragraph 4.88 of this report for further information regarding the TQR process and results from previous technical quality reviews by the Tax Office.

29 Australian National Audit Office, *op. cit.*, at p. 39.

## **Taxpayer compliance history**

4.45 There is a need for the Tax Office to provide greater guidance and support to staff in ascertaining a taxpayer's circumstances and compliance history.

4.46 Some taxpayers and tax agents believe that the Tax Office imposes penalties without making any allowance for a taxpayer's prior good compliance record.

4.47 The Taxpayers' Charter states that the Tax Office will treat each taxpayer as an individual and recognise and take into account individual circumstances where it is relevant to the decision. Relevant circumstances include a taxpayer's prior compliance history and their level of knowledge and understanding of the tax laws. The Taxpayers' Charter also provides that where a taxpayer makes a mistake in complying with their obligations, they will be given an opportunity to explain their circumstances and that the Tax Office will take any explanation into account. Such considerations are crucial in determining the imposition of penalties arising from active compliance activities.

4.48 Business lines have developed penalty checklists to assist staff in making a decision regarding the imposition or remission of penalties and interest. However, these checklists do not provide adequate guidance to staff on how they are to consider a taxpayer's compliance history in determining remission of penalties.

4.49 For example, the Large Business & International penalties checklist directs the case officer to the Taxpayers' Charter, Compliance Model and numerous practice statements. There is no guidance to staff, once they have referred to those documents, on how they are to determine a taxpayer's overall level of compliance.

4.50 The Small Business Field penalties checklist makes no specific reference to the Taxpayers' Charter, Compliance Model or any practice statements. Nor does it provide more specific guidance on how a case officer should determine a taxpayer's overall level of compliance.

4.51 The Tax Office review team's paper also identified the consistency in the assessment of taxpayer behaviour as an area of concern.

## CORPORATE INFORMATION SYSTEMS

### Reporting and analysis of penalty and interest information

4.52 Currently, the Tax Office does not have the corporate management information systems to examine whether there is consistency in the nature and extent of penalties and interest applied at a broader level. One example of this broader level requirement is the application and remission of penalties and interest for similar groups of taxpayers across business lines, for example, those involved in aggressive tax planning. Another example of this broader level requirement is the approach of different business lines in increasing or decreasing the base penalty amount according to whether the taxpayer has prevented or obstructed the Tax Office in investigating the shortfall, has previously been penalised for a shortfall, or has made a voluntary disclosure of the shortfall.

4.53 Each business line has its own management information system, leading to variations between business lines in the type of penalty and interest information that is captured and recorded. The effect of these variations has been that the current management information systems do not adequately support the analysis of this penalty and interest information.

4.54 This has led to the Tax Office encountering difficulties in analysing penalty and interest information from a Tax Office-wide perspective so as to allow it to examine the application of penalties and interest between business lines, market segments and revenue products. For example, the Tax Office is not able to provide information readily on the remission of tax shortfall penalties and interest across the Tax Office. This is further demonstrated by the fact that the recording of cases within the Tax Office does not allow for the clear identification of voluntary disclosures across all business lines. This has also meant that the Tax Office has not been able to measure how effective its compliance and education strategies have been in encouraging voluntary disclosures and greater cooperation on the part of taxpayers.

4.55 There is a need for the Tax Office to develop corporate management information systems that support the broader examination of the consistency in the nature and extent of penalties applied. The development of such systems would improve the Tax Office's ability to analyse penalty and interest information from a Tax Office-wide perspective. It will also provide another means for the Tax Office to identify and address inconsistent approaches in the application of penalties and interest between business lines. The Tax Office advises that as part of the Change Program work is in progress to develop a single case management system, known as 'Siebel'.

4.56 Improvements in the Tax Office's ability to examine the administration of the penalty and interest regimes at this broader level would also provide greater assurances to Tax Office management and the community that the Tax Office's approach in the application of penalties and interest is equitable and consistent.

4.57 The ability of the current Tax Office systems to support the recording, reporting and analysis of penalty and interest data has also been raised as an issue for consideration in the Tax Office's internal review.

## Taxpayer compliance history

4.58 Submissions to the Inspector-General have expressed some disquiet regarding the Tax Office's ability to consider a taxpayer's circumstances and compliance history properly.

4.59 The ANAO has previously noted that although some Tax Office field team members attempt to ascertain the taxpayer's circumstances and compliance history in applying a tax shortfall penalty, most do not.<sup>30</sup>

4.60 The ANAO concluded that:

...there was a lack of an appropriate level of access to ATO data systems for staff administering penalties to determine a taxpayer's profile, compliance history and level of compliance with the tax law in order to properly implement the principles of the Taxpayers' Charter and the Compliance Model. There is a risk that in the absence of complete information concerning a taxpayer's compliance history, ATO officers will form different opinions about the compliance status of a taxpayer resulting in the ATO applying penalties in an inconsistent manner.<sup>31</sup>

4.61 In response to the ANAO findings the Tax Office recognised that this was a problem area, noting that its systems were designed for a transactional business, not for managing risk and client relationships.<sup>32</sup>

4.62 The Tax Office advises that it has made a number of improvements since the ANAO report. This includes the introduction of CVoC (Compliance View of Client), a computer application that allows a case officer to access data across Tax Office systems, and the current development of a single case management system.

4.63 The Inspector General's review has found that there is still a need for the Tax Office to improve its management information systems so as to better support Tax Office staff in ascertaining a taxpayer's profile and compliance history. This is particularly important in providing greater assurances to the community that the Tax Office's approach in imposing penalties is consistent with the Taxpayers' Charter.

4.64 The Tax Office review team's paper also identified the consistency in the assessment of taxpayer behaviour as an area of concern.

## The processing and issuing of amended assessments, penalty and GIC notices

4.65 A submission from a tax practitioner association representing the views of a broad range of tax advisers expressed some concern with the delays in issuing amended assessments arising from an audit and in processing GIC amounts. The submission cited two representative examples where the Tax Office has contributed to a delay in finalising a review. These examples involved Tax Office delay in reaching a concluded view on an issue and Tax Office delay in making a decision on whether to remit GIC.

4.66 The submission also stated that the association commonly hears of significant delays in issuing amended assessments arising from audits, resulting in significant GIC

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30 Australian National Audit Office, op. cit., at p. 40.

31 *ibid.*, at p. 41.

32 *ibid.*, at p. 40.

accumulating in addition to the primary tax. The submission expressed the view that case officers do not consistently remit GIC where there has been Tax Office delay.

4.67 The submission put forward two recommendations on how the Tax Office could improve its administration of the penalty and GIC regimes. It recommended that:

...the ATO implement appropriate procedures to overcome delays in the processing of GIC and penalty notices after an audit. The ATO should issue GIC and penalty amounts within a reasonable time and include adequate explanations of how the amounts were calculated. At the very least, the ATO should issue a letter to the relevant taxpayer to advise of any delays and the reasons for the delay.

4.68 The submission further recommends that:

...the ATO implement appropriate arrangements to overcome delays in issuing amended assessments. Amended assessments should be issued within a reasonable time frame. Where 'significant delays' have been caused by the ATO the Commissioner should exercise his discretion to remit some of the penalty.

4.69 In a similar vein, another submission from an accounting firm expressed some concern with the lack of an incentive for the Tax Office to complete audits and process amended assessments in a timely manner given that GIC continues to accrue on a daily basis.

4.70 The submission suggested if the Tax Office identifies a matter that is subject to potential adjustment, GIC should be calculated to the earlier of, six months after the commencement of the examination of an issue, and three months after the taxpayer and the Tax Office agree an adjustment is warranted or an amended assessment is issued. The submission noted that:

...often an audit is being conducted before the taxpayer is notified. Consequently, GIC is potentially accruing without the taxpayer's knowledge, leaving the taxpayer with no opportunity to mitigate this imposition. In cases where audits are not finalised and amended assessments are not issued until the 'last minute' (that is, until immediately prior to the expiration of the limitation period) GIC can accrue for four years (six in the case of Part IVA). Further, as GIC is imposed from the date on which the relevant amount would have been due and payable, GIC can accrue despite ATO inefficiencies. We have had experience whereby GIC has continued to accrue despite a particular request being passed between four different decision makers within the ATO. We are sure you will agree that taxpayers should not be liable for inaction or inefficiency on the part of the ATO.

4.71 Given the Tax Office's internal review into its administration of the penalties regime, the Inspector-General has not examined case files to test directly the concerns expressed in the submissions. However, these concerns will be included in any further substantive consideration of this topic following the Tax Office's implementation of recommendations from its internal review and this report. In addition, a number of the suggestions made by stakeholders have been included as suggested improvements for the Tax Office to consider as part of the current internal review.

## COMMUNICATION WITH TAXPAYERS AND THEIR ADVISERS

### Level of understanding of the penalty and interest regimes by taxpayers

4.72 Information on how the Tax Office will administer the penalty and interest regimes is made available to the public through a multitude of rulings, practice statements and administrative policies, a list of which is at Appendix 5.

4.73 A number of taxation rulings dealing with the administration of the penalty regime were released in January 1994, prior to the commencement of the current penalty regime on 1 July 2000.<sup>33</sup>

4.74 Since the release of those taxation rulings the Tax Office has also issued a number of other corporate documents, such as the Taxpayers' Charter, the Compliance Model and practice statements, to provide guidance to staff and taxpayers on the Tax Office's approach to penalties. The multitude of guidance documents has meant that taxpayers and their advisers have found it difficult to determine the relevancy of the taxation rulings and practice statements and how all the guidance documents interact and apply in individual circumstances.

4.75 The Inspector-General believes that with the introduction of the new administrative penalties regime and the Taxpayers' Charter, Compliance Model and practice statements, there is a need for the Tax Office to review the status of taxation rulings currently dealing with the penalty regime.

4.76 The importance of providing clear information about penalties and the consequences for failing to comply with the tax laws were discussed in the ANAO report. If taxpayers are not appropriately informed on how the penalty regime operates and what factors the Tax Office will consider in determining the application and remission of penalties and interest, then taxpayers may view the type and extent of penalty imposition as unfair or unjustified.

4.77 The ANAO recommended that the Tax Office consider options for providing information on its penalty regime in plain English and disseminate this through all current information channels. The Inspector-General supports the ANAO's recommendation to provide taxpayers and their advisers with information on the Tax Office's approach to penalties in plain English, and is encouraged that the Tax Office is considering this issue as part of its internal review.

4.78 While the Tax Office has released a number of practice statements on its approach to penalties, a broad message in submissions has been that there is a need to improve the communication between the Tax Office, taxpayers and their advisers on the Tax Office's approach to penalties and interest. The need to provide greater guidance to taxpayers and their advisers is reinforced by the recommendations of the Review of Aspects of Income Tax Self Assessment, which recommended changes to improve the transparency and fairness of penalty and interest charges.

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33 *Taxation Rulings* TR 94/2, TR 94/3, TR 94/4, TR 94/5, TR 94/6 and TR 94/7.

## Penalties relating to schemes

4.79 Submissions to the Inspector-General have noted concern with the Tax Office's approach in the application of penalties where an audit involves a group of taxpayers. It has been asserted that the Tax Office has taken a blanket approach with the application of penalties and does not provide taxpayers with an opportunity to make submissions prior to the Tax Office determining penalties.

4.80 Broadly, it has also been asserted that in dealing with such groups of taxpayers the Tax Office has failed to take into consideration their individual circumstances and compliance history when determining the application and remission of penalties.

4.81 A number of the submissions received from taxpayers regarding this concern involve the application of the penalties relating to schemes.<sup>34</sup> These penalties arise where an anti-avoidance provision, such as Part IVA of the *Income Tax Assessment Act 1936*, is applied to cancel a benefit which a taxpayer has obtained as a result of participating in a scheme.

4.82 Unlike the application of penalties relating to false and misleading statements, an assessment of taxpayer culpability is not required to trigger the penalty provisions applicable to schemes.<sup>35</sup> For most schemes, the base penalty amount is 50 per cent of the scheme shortfall amount or 25 per cent of the scheme shortfall amount if it is reasonably arguable that the adjustment provision does not apply. This base penalty amount may be increased or reduced according to whether the taxpayer has prevented or obstructed the Tax Office in investigating the shortfall, has previously been penalised for a shortfall, or has made a voluntary disclosure of the shortfall.

4.83 The current Tax Office rulings and practice statements do not provide guidance to taxpayers and their advisers on the operation of the penalties relating to schemes. There is currently no information available on how these provisions operate and the circumstances that lead to an increase or decrease in the base penalty amount.

## How the Tax Office is influencing taxpayer behaviour through the penalty system

4.84 The need for the Tax Office to study the relative effectiveness of penalties on taxpayer behaviour was previously recommended in the ANAO report in 2000. The ANAO indicated that such a study could assist the Tax Office in improving taxpayer compliance and in refining the Compliance Model.

4.85 The Tax Office has advised that with the introduction of the new penalty regime on 1 July 2000, it has not been appropriate to attempt to measure the effectiveness of the new penalty regime given that very few penalties were imposed during the transition period. This, according to the Tax Office, has been due to the phased introduction of the new penalty regime and the concessionary approach during this transition period in the application of penalties.

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34 Prior to 1 July 2000, sections 224, 225 and 226 of the *Income Tax Assessment Act 1936*. From 1 July 2000 onwards, Subdivision 284-C of Schedule 1 of the *Taxation Administration Act 1953*.

35 To trigger the penalty provisions relating to schemes, section 284-145 requires that an entity obtains a scheme benefit from a scheme and, having regard to any relevant matters, it is reasonable to conclude that an entity entered into or carried out the scheme, or part of it, with the sole or dominant purpose of obtaining a scheme benefit from the scheme.

4.86 The Tax Office has stated that penalties that were imposed during the transition period related to taxpayers who had a previous history of non-compliance. As such, it was considered that these taxpayers were not the ideal group from which to draw any definitive conclusions about the effectiveness of penalties on compliance behaviour. The Tax Office also consulted with the Australian National University Centre for Tax System Integrity about including this topic in their research programme. However, it was decided due to the low number of penalties being imposed that this research be deferred.

4.87 The Tax Office agrees that it should measure the effectiveness of the penalty framework and it will be conducting research once the effect of Practice Statement PS LA 2004/5 is more evident. The need to undertake some analysis of the effectiveness of penalty administration was also raised in the Tax Office's internal review.

## QUALITY ASSURANCE PROCESSES AND STAFF SKILLING

### Technical Quality Review

4.88 The Technical Quality Review (TQR) process is the corporate tool used by the Tax Office to measure the quality of technical decisions, including penalty decisions. It involves an examination of a random sample of completed cases to assess the quality of decisions communicated in writing to taxpayers on the interpretation and application of the laws administered by the Commissioner.

4.89 Each Tax Office business line is required to report on the quality of its written interpretive decision-making. Included on each business line TQR panel is one private sector/academic representative and a representative from the Office of the Chief Tax Counsel<sup>36</sup>, to assist in maintaining a consistent application of the TQR processes. Each case is awarded an A, B, C, D or E rating in accordance with the Judgment Model.<sup>37</sup>

4.90 The Tax Office states that the aim of the TQR process is to examine whether the advice it provides is accurate, consistent, relevant and clearly explained.<sup>38</sup> The Tax Office further states that the quality of its decisions, measured by considering a number of aspects of a good-quality decision, is also a broad indicator of its IT systems, business line work practices and skilling of Tax Office staff.<sup>39</sup>

4.91 The Tax Office states that there are other quality assurance processes in place apart from the TQR process. For example, a penalty decision arising from an audit requires approval by the case officer's team leader or higher, depending on the level of authorisation. Penalty decisions are deemed interpretive decisions and are recorded on the Tax Office's Technical Decision-Making System (TDMS).

4.92 The Tax Office is of the view that having a representative from the Office of the Chief Tax Counsel as part of the TQR process ensures that there is a consistent approach in the application and remission of penalties. The Inspector-General believes that the TQR process is only one part of the Tax Office's corporate governance approach to ensuring that

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36 The Office of the Chief Tax Counsel is a specialist area within the Tax Office.

37 The Tax Office advises that the current rating scale has replaced the 'D' and 'E' ratings with 'Fail'.

38 Practice Statement PS LA 2001/11, at p. 2.

39 *ibid.*

the application of penalties is equitable and consistent. Equally important are the key features identified by the Inspector-General at paragraph 2.4 of this report.

4.93 The results in the August 2004 TQR report, as presented below in Table 4.1, show that most business lines are achieving 'A' and 'Pass' benchmarks.<sup>40</sup>

**Table 4.1: TQR Penalty Case Ratings**

Business line	Mar 02-Aug 02		Sept 02-Feb 03		Mar 03-Aug 03		Sept 03-Feb 04		Mar 04-Aug 04	
	A %	Pass %	A %	Pass %	A %	Pass %	A %	Pass %	A %	Pass %
<b>Excise</b>	51	99	73	96	60	95	88	93	86	100
<b>GST</b>	26	53	30	85	39	83	45	89	50	78
<b>LB&amp;I</b>	85	100	80	100	74	88	63	86	95	100
<b>OPS</b>	N/A	N/A	80	93	80	94	87	94	85	93
<b>PTax</b>	77	95	86	93	80	92	84	95	81	93
<b>SB</b>	87	91	81	92	86	92	85	91	86	96
<b>SPR</b>	97	100	96	99	98	98	98	98	100	100
<b>SNC</b>	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	92	98

Source: Tax Office.

4.94 For the penalty TQR process in August 2004, the Tax Office adopted the same benchmark as the existing corporate benchmark for technical advice, namely 83 per cent for 'A' and 93 per cent for 'Pass'. The Tax Office proposes to set specific corporate benchmarks for penalty decisions for the later review periods.

4.95 Overall, the TQR results indicate an improvement in penalty decisions from the previous periods. In particular, within the Large Business and International (LB&I) business line there was a significant improvement in the number of 'A' ratings (from 63 per cent to 95 per cent). This was attributed to the promotion and usage of the LB&I Penalties Checklist as well as better documentation of decisions.

4.96 The Tax Office advises that the external representatives on the TQR panels hold positive views regarding the TQR process and that there is overwhelming support for the process given its transparency and integrity.

4.97 A review of selected audit case files did reveal some cases showing variation both within and between business lines in the quality of penalty and GIC decisions. In some case files, there were no penalty submissions on the file. The Tax Office audit process maps require that a team leader sign off on a penalty submission before the issuing of penalty notices arising from an audit. In other case files, the penalty submission did not adequately set out facts relevant to the taxpayer nor consider the taxpayer's compliance history. Also, in some cases there were only references to the Tax Office's rulings and practice statements, with little evidence of consideration of the application of the Tax Office view to the taxpayer's circumstances.

## Ensuring quality GIC remission decisions

4.98 The Inspector-General has previously reported a number of findings regarding the remission of GIC for groups of taxpayers.<sup>41</sup> Also, the Treasury, as part of the Review of

<sup>40</sup> A pass rating includes all cases awarded an 'A', 'B' or 'C' rating in accordance with the Judgment Model.

<sup>41</sup> Inspector-General of Taxation, *Review of the Remission of the General Interest Charge for Groups of Taxpayers in Dispute with the Tax Office*, 5 August 2004.

Aspects of Income Tax Self Assessment, made a number of recommendations regarding the operation of the GIC regime.

4.99 Decisions in respect to GIC remission are currently not subject to specific review as part of the TQR process. In addition, GIC remission decisions are not currently recorded on TDMS. The Tax Office advises that a GIC remission decision can be reviewed where it is part of a penalty decision that has been selected for review. However, as has been previously discussed, there is an inconsistent approach between business lines in considering interest remission arising during the pre-amended period.<sup>42</sup> This means that the GIC remission decision will not always form part of the penalty decision that may be selected for technical review.

4.100 A review of selected audit case files by the Inspector-General did indicate some variation between business lines in the GIC remission processes arising from an audit. In some cases, the case officer has not considered GIC remission despite lengthy Tax Office delays. Where GIC remission is considered, the facts behind the delay are often not clearly set out in the decision. On other occasions there is only a reference to the Tax Office delay with little consideration of the *ATO receivables policy* and its application to the taxpayer's circumstances.

4.101 A submission from an accounting firm also suggested that:

Taxpayers may request that GIC be remitted, however the Commissioner generally remains the final arbiter in administrative matters (such as remission of GIC). Consequently, the entity that determines a GIC remission request is not independent from the entity that imposed GIC in the first instance. That is, it is the Commissioner's office that imposed the GIC, and it is the Commissioner's office that determines whether the GIC should be remitted.

4.102 The Inspector-General is of the view that the improved review and appeal rights arising from the ROSA report will introduce a greater level of transparency and independence in the administration of the GIC regime. It will mean that the Tax Office's interpretation and application of its remission powers for shortfall interest may be subject to external review.

## Skilling of staff

4.103 The Tax Office provides training for staff administering penalties via training modules, such as 'Introduction to Penalties', which are available on the Tax Office intranet.

4.104 Various business lines have also implemented a number of strategies to maintain and improve the level of skilling amongst staff. This has included the establishment of dedicated penalty teams within business lines, the review of penalty decisions as part of business line quality assurance processes and the use of technical officers to assist in the penalty decision-making processes. Business lines have also developed penalty training packages as detailed in Table 4.2.

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<sup>42</sup> See paragraph 4.30 of this report.

**Table 4.2: Penalties skilling across business lines**

Business line	Training package	Number of staff participating
Excise	Administrative penalties (Excise)	120
Small Business	Introduction to administrative penalties, amendments and GIC	432
GST General Compliance	Introduction to penalties	2,772
GST ILEC	Penalties	200
GST GCS	Penalties	50
LB&I	Penalties and interest	Not available
<b>Total</b>		<b>3,574</b>

Source: Tax Office.

4.105 The Tax Office states that the 3,574 staff that have attended penalties training modules represent approximately 72 per cent of all active compliance staff. The Tax Office indicates that staff feedback suggests that the training packages have helped to improve staff capabilities.

4.106 A submission representing the views of a broad range of tax practitioners expressed some concerns regarding the awareness amongst staff of the Taxpayers' Charter when dealing with penalties. The submission suggested that additional penalties were being levied because taxpayers sought legal or other advice during an audit. The submission claimed that the rationale of the Tax Office was that seeking advice was a demonstration of a lack of cooperation and a delay tactic warranting additional penalty.

4.107 The submission goes on to note that this practice appears to be contrary to the Taxpayers' Charter, which specifically provides for a taxpayer being able to have a representative act on their behalf. The submission states that if a taxpayer does not unreasonably delay seeking advice and the tax practitioner does not unreasonably delay providing that advice, then it is difficult to understand why this would warrant an increase in the level of tax shortfall penalty.

4.108 To address this concern the submission considers that:

...the ATO needs to implement internal training to create greater awareness and to reinforce the Taxpayers' Charter amongst ATO officers in relation to penalties. This would greatly assist in minimising instances where penalties have been levied as a result of taxpayers seeking legal or other advice in relation to an audit.

4.109 A limited review of selected case files by the Inspector-General did not reveal any evidence to support this concern. However, it has not been possible to identify cases where the Tax Office has imposed additional penalties for preventing or obstructing the Commissioner because a taxpayer sought advice during an audit. This is primarily due to the different systems and work practices used by the business lines to record penalty information. The Tax Office also advises that it currently provides internal training to staff on the Taxpayers' Charter in relation to penalties.

4.110 The Inspector-General has already noted the need for the Tax Office to provide greater guidance to taxpayers on the circumstances it considers in determining the statutory increase, reduction and remission of penalties and GIC. This includes reviewing the currency of a number of taxation rulings released by the Tax Office prior to the introduction of the Taxpayers' Charter, the Compliance Model and the new administrative penalties regime.

## SUGGESTED IMPROVEMENTS FOR TAX OFFICE CONSIDERATION

4.111 Submissions from professional organisations representing accountants and tax practitioners, business and the general public, and enquiries and investigations by the Inspector-General identified a number of improvements that could be made by the Tax Office in its administration of the penalties and interest regimes. These include:

- providing staff with general guidance on determining a taxpayer's overall level of compliance
- providing clearer guidance on when an audit has commenced and providing taxpayers with an opportunity to make voluntary disclosures prior to an audit formally commencing
- providing greater guidance to taxpayers and their advisers on the operation of the penalty concessions for voluntary disclosures
- consolidating the Tax Office view on voluntary disclosures into one corporate document
- introducing service standards for the finalisation of an audit where the taxpayer makes a voluntary disclosure
- introducing service standards for issuing amended assessments once the final audit report is approved and sent to the taxpayer
- clarifying the responsibility of case officers to consider tax shortfall interest remission as part of the audit process under the Tax Office's receivables policy
- providing greater guidance to taxpayers and their advisers on the factors that staff would consider in determining the statutory increase, decrease and remission of penalties
- reviewing the currency of a number of taxation rulings released by the Tax Office prior to the introduction of the new administrative penalties regime
- providing greater guidance to taxpayers and their advisers on the application of penalties relating to schemes pursuant to Subdivision 284-C of the *Taxation Administration Act 1953*, including how the provisions operate and the circumstances that lead to an increase in the base penalty amount
- providing more targeted information to taxpayers in different markets and tailoring its education strategy to deal with differences in understanding and focus in different markets
- providing further training and guidance to staff to improve file management and the quality of written penalty decisions
- establishing organisation-wide quality assurance processes for tax shortfall interest remission decisions
- developing a skilling package in relation to the tax shortfall interest regime

- developing a template for penalty and interest decisions to provide greater guidance to staff on the key issues that should be addressed when considering the application of penalties and interest
- including, as part of its audit quality assurance process, consideration of the extent that case officers follow the audit procedures regarding the imposition and remission of administrative penalties and interest.



## APPENDIX 1: TERMS OF REFERENCE OF REVIEW

A1.1 On 23 November 2004, the Inspector-General of Taxation announced terms of reference for his review into aspects of the Tax Office's business active compliance activities. These were as follows.

The Inspector-General will review whether the length of time taken to complete Tax Office active compliance activities directed at businesses is reasonable in particular circumstances. It will focus on:

- the relevant governance processes and benchmarks;
- the nature and cause of that length of time;
- the extent and impact of that length of time;
- the identified risks to business, the Revenue and other areas of the community; and
- practices which may reasonably minimise the adverse impacts that the length of time may have on businesses while providing reasonable assurance that the risk to the Revenue is minimised.

The Inspector-General will review whether the application of penalties and interest to businesses during active compliance activities is consistent. It will focus on:

- the nature and extent of penalties and interest applied; and
- the consistency of the Tax Office's approach to that application.



## APPENDIX 2: CONDUCT OF REVIEW

A2.1 On 7 December 2003, the Inspector-General of Taxation released five issues papers that outlined about 60 systemic tax administration issues of concern which were raised by taxpayers and their representatives during the course of his scoping review. Paragraphs 34 to 37 of Issues Paper 4 outlined the issues of concern about the Tax Office imposing penalties equitably:

34. The penalty regime that applies to all tax laws administered by the Commissioner of Taxation is defined in Schedule 1 of the TAA 1953. The penalty regime consists of three distinctive components: penalties relating to statements and schemes, penalties for failure to lodge returns and other documents on time, and penalties for failing to meet other taxation obligations.

35. Tax practitioners and industry representatives have expressed concern at the ATO's attitude to the administration of some of these penalty arrangements, in that the ATO automatically applies penalties in a 'speeding infringement' or 'bulk' fashion without asking questions, including where the ATO may have contributed to the taxpayer's failure to meet his or her obligations.

36. The ATO's approach to the administration of penalties is highlighted in the ATO Receivables Policy and ATO Compliance Model, which states that:

The individual circumstances of a taxpayer contribute to his or her underlying attitudes to compliance and to the subsequent behaviour. Accordingly, the Tax Office's strategies, including its approach to the imposition of penalties, are designed to improve that behaviour and in the long term, the underlying attitude to compliance.

37. Any review into this issue could examine the ATO's administrative systems for the application of penalties, including reviewing the ATO Receivables Policy and ATO Compliance Model.

A2.2 On 27 July 2004, the Inspector-General consulted representatives from selected industry, business, accounting, legal practitioner and tax organisations about the prioritisation of his work programme for the next six months. Key issues discussed during this consultation were tax audits and penalties, compliance costs, tax agent support and litigation management. However, the most significant theme emerging related to the Tax Office's conduct in dealing with taxpayers subject to a tax audit and the consequences arising from those audits.

A2.3 Following this meeting the Inspector-General placed the issue of the Tax Office's approach to imposition of penalties and interest resulting from audit activity on his forward work programme for 2004-05.

A2.4 The Inspector-General announced the review into the consistency of the Tax Office's application of penalties and interest to businesses during active compliance activities on his website, [www.igt.gov.au](http://www.igt.gov.au), on 23 November 2004. The review was also reported in the press and in specialist accounting and taxation law publications.

A2.5 Written submissions to the review were taken from professional organisations representing accountants and tax practitioners, business and the general public.

A2.6 The Commissioner of Taxation was asked to provide information and documents relevant to the review. Visits were made to the Tax Office's National, Sydney, Hurstville, Casselden Place and Moonee Ponds offices to examine relevant files and interview relevant Tax Office staff.

## APPENDIX 3: LETTER FROM COMMISSIONER OF TAXATION



**Australian Government**

**Australian Taxation Office**

**COMMISSIONER OF TAXATION**

Mr David Vos AM  
Inspector-General of Taxation  
GPO Box 551  
SYDNEY NSW 2001

Dear David

### **DRAFT REPORT: ADMINISTRATION OF PENALTIES AND INTEREST ARISING FROM ACTIVE COMPLIANCE ACTIVITIES**

Thank you for the opportunity to comment on your draft report to the government on the above subject.

We appreciate the recognition given in the report of the internal review that the Tax Office had already initiated to identify improvements to our administration in this area. We agree that it is appropriate that you defer more substantive consideration of this topic until after the Tax Office has considered the findings of its internal review and implemented any identified improvements. We note that, for this reason, a number of the submissions reproduced in the report are, at this stage, largely untested and unconfirmed by your office.

In respect to the four key recommendations in the report, our response is as follows:

**The Tax Office promptly acts to ensure that the agreed ANAO recommendations are fully implemented and addresses the findings identified in the ANAO report.**

We agree with this recommendation. The Tax Office has progressively implemented the ANAO's recommendations in this report. Implementation of a small number of the recommendations was deferred during the implementation of the new tax system due to the application of transitional penalty concessions.

**The Tax Office develops a uniform set of processes, procedures, corporate management information systems and guidance to staff for cross-business line application.**

We agree with this recommendation. While we have developed comprehensive policy and procedural guidelines for our staff, it is recognised that much of this material is at a specific

business line level which, in part, reflects the different characteristics of the markets in which we operate. We agree that more can be done to draw together the common elements to ensure a greater level of consistency of approach across business lines. Our internal review is focusing on this issue and one of the deliverables under our Change Program is improved management information systems.

**The Tax Office includes an examination of the tax shortfall interest regime from the same perspective as its internal review into the penalty regime.**

We agree with this recommendation. This issue has been canvassed in detail as part of the recent review of certain aspects of the income tax self assessment system (ROSA). Our internal review will take into account the findings of that review.

**The Tax Office considers, as part of its internal review, further improvements to the administration of the penalties and interest regimes as set out in Chapter 4.**

We agree with this recommendation.

Yours sincerely

A handwritten signature in black ink that reads "Michael Carmody". The signature is written in a cursive style with a horizontal line underneath the name.

Michael Carmody  
COMMISSIONER OF TAXATION

11 May 2005

## APPENDIX 4: ANAO FINDINGS

A4.1 On 16 February 2000 the ANAO tabled its report titled *Administration of Tax Penalties*, Auditor-General Report No. 31, 1999-2000. This report examined the Tax Office's administration of penalties with a particular emphasis on its corporate governance framework and issues relating to the consistency, effectiveness and accountability in the administration of the previous penalty regime.

A4.2 The audit found that there was scope for improvement in the Tax Office's administration of the previous penalty regime. It concluded that, although penalties are an important enforcement strategy featured in the ATO Compliance Model, the Tax Office lacked appropriate control structures to oversight the accountability, consistency and effectiveness of its penalty administration.

A4.3 The ANAO made a number of key findings as part of its review dealing with Tax Office management in relation to penalties and its administration of the penalties regime. These were as follows:

### Key Findings

#### ATO management in relation to penalties (Chapter 2)

##### Corporate governance

19. The audit found that the Commissioner does not receive assurance through the ATO's corporate governance framework that the penalty regime is operating effectively or consistently.

##### Quality assurance

20. The ANAO considers there would be benefit to the ATO in taking a more systematic approach to the quality assurance of penalties and analysing and reporting penalty information as a part of its governance reporting process.

##### Staff training

21. ATO staff training in relation to penalties could be enhanced by including the linkages between the Taxpayers' Charter, the Compliance Model and the imposition and remission of penalties. Also, training materials could be improved by providing analyses of the different gradations of non-compliant behaviour and the appropriate enforcement strategies to be applied. The ATO has advised of its intention to develop its training accordingly.

#### ATO administration of penalties (Chapter 3)

##### Aligning administration of penalties with the ATO Charter and Compliance Model

22. The ANAO found the ATO could better align its penalty administration with the principles and undertakings of the Taxpayers' Charter and the Compliance Model by developing a

cost-effective, on-line rule-based decision support system and access to taxpayer history and profiles.

#### Improving public information about penalties

23. The ANAO considers that informing taxpayers of their tax obligations is central to the issue of fairness. In a self-assessment environment, taxpayers need to know of their obligations and responsibilities under the law. The audit identified the provision of information for taxpayers about penalties as an area that could be readily improved.

#### Detection of liability for Tax Shortfall Penalty

24. We found that the ATO does not leverage off its fieldwork where tax shortfalls have been identified, by following-up in future years the effectiveness of penalties on taxpayer behaviour. Such follow-up would enable the ATO to build profiles of non-compliance and to develop indicators of penalty effectiveness.

25. The audit identified areas where detection of liability for Tax Shortfall Penalty could be improved including streamlining claims to legal professional privilege and to concessions under ATO Guidelines for Access to Professional Accounting Advisers Papers.

#### Addressing current gaps in administration of specific penalty types

26. The audit found other potential areas for improvement relating to the ATO's administration of particular penalties including:

- giving priority to outstanding systems changes to implement accurate calculation of the GIC on a compounding basis as required by legislation;
- eliminating anomalies that exist between administrative penalties and penalties imposed through prosecution. This could reduce the incidence of taxpayers preferring prosecution to administrative penalties;
- implementing system changes to avoid incorrectly applying Late Lodgement Penalty to 'nil trading' companies; and
- improving tax agent lodgement programs to reduce the need to apply Late Lodgement Penalty.

## APPENDIX 5: LIST OF TAX OFFICE RULINGS, PRACTICE STATEMENTS AND ADMINISTRATIVE POLICIES

A5.1 The following is a list of publicly available Tax Office rulings, practice statements and administrative policies providing guidance to taxpayers and their advisers on how the Tax Office is to administer the penalty and interest regimes.

- Taxpayers' Charter
- Compliance Model
- Compliance Program 2004-05
- *Taxation Ruling* TR 94/2 Transitional arrangements for 1992-93 substituted accounting periods
- *Taxation Ruling* TR 94/3 Calculation of tax shortfall and allocation of additional tax
- *Taxation Ruling* TR 94/4 Reasonable care, recklessness and intentional disregard
- *Taxation Ruling* TR 94/5 Reasonably arguable
- *Taxation Ruling* TR 94/6 Voluntary disclosures
- *Taxation Ruling* TR 94/7 Income tax: tax shortfall penalties: guidelines for the exercise of the Commissioner's discretion to remit penalty otherwise attracted
- Practice Statement PS LA 2000/9 – sets out guidelines for the remission of administrative penalties during the first year of the new tax system
- Practice Statement PS LA 2002/8 – sets out guidelines for the remission of administrative penalties during the second year of the new tax system
- Practice Statement PS LA 2003/9 – sets out guidelines for the remission of penalty for failure to withhold as required by Division 12 in Schedule 1 to the *Taxation Administration Act 1953*
- Practice Statement PS LA 2004/5 – outlines the Tax Office's position on the remission of penalties following the transition to the new tax system.
- Chapter 91 of the Receivables Policy – Introduction to Part F – Penalties relating to Receivables Activities
- Chapter 93 of the Receivables Policy – General Interest Charge
- Chapter 94 of the Receivables Policy – Over-claimed Credit Penalty. However, this chapter has been withdrawn, as a taxation ruling is to issue. To date, no Taxation Ruling or Practice Statement has issued
- Chapter 98 of the Receivables Policy – Lodgement Penalties.



## APPENDIX 6: INFORMATION FROM TAX OFFICE AUDIT PROCEDURES

A6.1 This appendix provides an outline of the Tax Office audit procedures relevant to the application of penalties and interest. These procedures are set out in audit process maps which are specific for each business line.

A6.2 The audit process map states that a Tax Office view must be established and communicated to the taxpayer before the case officer considers the application of penalties.

A6.3 For example, the large business audit process map recommends that the case officer issue a position paper, which sets out the Tax Office view on the issues, to the taxpayer prior to preparing the final audit report. The case officer's team leader must approve the conclusions and recommendations reached in the audit report.

A6.4 The audit process map then provides that once the case officer has determined the final Tax Office view, the case officer is required to issue a letter to the taxpayer which outlines:

- the outcome of the audit and the Tax Office view
- the details of any proposed income tax adjustments
- the details of any administrative penalties to be imposed
- the details of the general interest charge.

A6.5 The audit process map states that this letter should also provide an opportunity for the taxpayer to present information or evidence that may mitigate the rate of any administrative penalty or GIC to be imposed.

A6.6 The audit process map also requires that the case officer conducts a final interview with the taxpayer. At this final interview the case officer is required to explain to the taxpayer the Tax Office's view on the imposition and remission of administrative penalties and GIC. Where the taxpayer has not already provided mitigation arguments, the audit process map states that the case officer should take on notice any submissions made by the taxpayer on the imposition or remission of administrative penalties and GIC. The audit process map also provides case officers with a list of all the relevant Tax Office corporate documents dealing with imposition and remission of penalties.

A6.7 Following the final interview, the audit process map states that the case officer should finalise the audit report. The final audit report must provide information regarding the imposition of administrative penalties and charges and must include a summary of the circumstances that led to the tax shortfall, including:

- the audit results and adjustments
- the material facts and the evidence relied upon relevant to the decision on administrative penalties and charges

- the taxpayers contentions and mitigation arguments
- the research and interpretation of legislation/cases and legal principles relevant to the facts
- the decision and reasons for the decision.

A6.8 The audit process map also states that the report must contain enough information to justify a recommendation as to whether or not reasonable care was taken, and if not, whether the taxpayer displayed intentional disregard of the law, recklessness or a failure to take reasonable care. The final audit report must also detail whether there were any mitigating or aggravating factors and whether there were any circumstances warranting a remission of the penalty.

A6.9 The audit process map requires that the final audit report show the team leader has authorised the raising of an assessment or amended assessment and the administrative penalties and GIC to be imposed and remitted.

A6.10 Once the final audit report has been completed and approved by the team leader, the case officer is required to send the taxpayer a finalisation letter within seven days of the approval.