

## CHAPTER 1: BACKGROUND TO SELF ASSESSMENT AND THE FOCUS OF THE REVIEW

This Chapter provides the context and essential background for the Review. It discusses the nature of income tax assessment and compares certain aspects of the current self assessment system with the full assessment system it replaced. The Chapter explains why the change was made, how the self assessment system has evolved and gives an overview of how the Tax Office approaches its compliance work.

As further background, Chapter 1 highlights some similarities and differences between our system and that of four other countries with which Australia commonly compares itself: Canada, New Zealand, the United Kingdom and the United States.

The Chapter also introduces themes that are the focus of the Review, including:

- how the current arrangements affect taxpayer uncertainty and the consequences of that uncertainty
- the need to balance the potentially conflicting objectives of collecting income tax, protecting the rights of taxpayers, and minimising the costs of compliance and administration
- the need to appreciate differences in the behaviour and needs of different categories of taxpayers.

### 1.1 What is tax assessment?

Tax assessments are fundamental to tax collection. Every country that taxes income has laws to impose the tax and a system to assess and collect it. An *assessment* is the end result of the process of ascertaining a taxpayer's taxable income and calculating the tax

payable on that income.<sup>1</sup> A *notice of assessment* becomes final once the statutory period for reviewing it has expired (see Chapter 3).

In Australia, a key part of the assessment process is the completion and lodgement of an income tax return. This requires taxpayers or their agents (and sometimes third parties) to provide information to the Tax Office about their income, deductions, and any tax offsets to which they are entitled. The task of completing income tax returns requires taxpayers (or their agents) to apply the income tax laws properly to their affairs. The length, scope and nature of income tax law, and the style of the administrative systems to support the law, mean that this can be a difficult task for some.

Depending on the type of assessment system, the roles and responsibilities of taxpayers, agents, third parties and the Tax Office can vary. This is illustrated below in the discussion of the former and current Australian assessment systems and overseas experience.

### 1.1.1 The former system of full income tax assessment

Prior to 1986, taxpayers in Australia lodged returns and tax officers, called assessors, formally determined the taxable income and the tax payable (or refundable). A notice of assessment was issued to the taxpayer by the Tax Office. If there was tax to be paid, the amount became a debt. If too much tax had been paid, for example, by excess instalments through the year, tax overpaid would be refunded. If a taxpayer had incurred a loss, the tax payable would be zero and the loss could be carried forward to be considered for set off against income derived in future years.

A taxpayer had the right to object to the assessment, including the assessor's decisions, in which case the Tax Office was required to review the assessment. Appeal rights (to courts or special Taxation Boards of Review) applied if the objection was not successful.

By the early 1980s, the need to process tax refunds quickly had placed considerable strain on the Tax Office's resources. In 1984, the number of objections against assessments exceeded 236,000.<sup>2</sup> Furthermore, with over 10 million income tax returns to assess annually, on average, a typical salary and wage tax return only received one minute of scrutiny by assessors. In the case of business returns, an average of four minutes' scrutiny applied.

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1. See *Batagol v Federal Commissioner of Taxation* (1963) 109 CLR 243.

2. Commonwealth of Australia Joint Committee of Public Accounts 1993, *An Assessment of Tax, Report 326*, 1993, Commonwealth of Australia, Canberra, p.63 citing Commissioner of Taxation's 1984 Annual Report, at p.8.

A 1984 Efficiency Audit by the Auditor-General<sup>3</sup> laid the groundwork for reconsidering the assessing function, finding the assessing method to be deficient on several counts:

- In a significant proportion of assessments made, the taxpayer's statement of gross income was accepted with little or no independent check.
- Most returns were considered by assessors not to require adjustment.
- About half of the value of the original revenue gain from Tax Office adjustments during the assessment process was reversed on objection or complaint by taxpayers.
- Other methods of collecting revenue achieved greater returns for a given cost compared with the traditional assessing method.

On this last point, while the 'revenue to cost' ratio for assessing was about 1:1, it was 5:1 for field audit, 6:1 for some internal checking processes and 11:1 for investigations.

### 1.1.2 The introduction of self assessment

From 1986-87 the system was changed with the encouragement and support of the Tax Office. Self assessment relieved the Tax Office of the obligation to examine returns lodged by taxpayers in the process of assessment. The Tax Office continued to issue notices of assessment (to create the formal obligation to pay tax), but returns were generally taken at face value, subject to post-assessment audit and other verification checks. Changes to the law included:

- allowing the Tax Office to amend not only for errors of calculation or mistakes of fact but also for mistakes of law
- providing a mechanism for taxpayers to seek advice, in the form of a ruling, when a return was lodged.

From 1989-90, the returns of companies and superannuation funds became subject to a system of full self assessment. Under full self assessment, the Tax Office no longer issues notices of assessment – the taxpayer calculates and pays their tax liability when lodging their return.

The introduction of the self assessment system changed the way the Tax Office carried out its compliance activities. Under the former system, significant Tax Office resources

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3. Auditor-General (Australian National Audit Office) 1984, *Controls over Processing Income Tax Returns*, in *Reports of the Auditor-General on Efficiency Audits*, Commonwealth of Australia, Canberra.

(including about 2,200 staff) were focused on the assessment process. As the emphasis moved from assessment, the Tax Office began to develop more sophisticated models of compliance, based on helping willing taxpayers to comply and identifying (and dealing with) those who do not. Resources from assessing went broadly into taxpayer assistance and compliance improvement, allowing the Tax Office to collect more tax from those who had under-assessed their tax liability.

For many non-business taxpayers, an immediate dividend was shown in the time taken to process tax refunds. With the introduction of the Electronic Lodgement System (ELS), which was largely made possible by the switch to self assessment, refunds came to be processed in a few weeks, rather than taking months. Presently, electronic returns are commonly processed within a fortnight.

### 1.1.3 Subsequent changes to self assessment

By the early 1990s problems had been identified with the initial self assessment arrangements, particularly in relation to penalties and interest and the need to provide greater taxpayer certainty. The Government of the day responded by announcing a review that had as its objective '... to provide a more supportive legislative and administrative environment for existing self assessment arrangements and in so doing make the taxation system fairer and more certain'.<sup>4</sup>

In response to that review's findings, further changes were made in 1992<sup>5</sup>, the most notable being:

- a new system of binding public rulings
- a new system of binding private rulings
- an extension (to four years) of the period within which a taxpayer could object against an assessment
- a new system of penalties for understatements of income tax liability, based on the requirement that taxpayers exercise reasonable care
- a new interest system for underpayments or late payments of income tax, based on commercial principles and market interest rates.

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4. Commonwealth of Australia 1991, *Improvements to self assessment – priority tasks*, 20 August 1991, Commonwealth of Australia, Canberra, p.2.

5. Legislation giving effect to these changes was largely contained in the *Taxation Laws Amendment (Self Assessment) Act 1992*.

More recently, the Government has implemented a shorter period of review for taxpayers with straightforward tax affairs, introduced binding oral advice and reduced the rate of interest charged on underpayments and late payments.

#### 1.1.4 How do full assessment and self assessment compare?

There are diverse views on the answer to this question. On the one hand, not a great deal of the law was changed, so one might argue that the current system has much in common with the system that preceded it. Both systems require taxpayers to complete and lodge annual returns with the Tax Office and, in preparing those returns, both systems require taxpayers to correctly apply the relevant parts of the income tax law. Under both systems, the Tax Office issues notices of assessment, but can review returns later and impose interest and penalties on any income tax shortfall detected.

Nevertheless, many taxpayers consider that with the move to self assessment there was an important change to the *finality* of the Tax Office's assessment. This difference has been a matter of great significance for some and it seems that certain aspects of the self assessment system have not been widely understood. The Chapters that follow attempt to determine the real impacts of the changed system.

#### 1.1.5 International comparisons

To help identify ways to improve Australia's self assessment system, the Review team has examined income tax systems in a number of other countries, especially Canada, New Zealand, the United Kingdom (UK) and the United States (US).

These comparisons reveal many similarities, but it is difficult to draw firm conclusions given the differences in tax policy and other factors.

In each jurisdiction there is an annual reconciliation of a taxpayer's income tax affairs, through means such as a tax return, an income tax statement generated by the revenue authority or a withholding tax system (in Canada and the US, provincial/state and/or city income taxes may also apply). Revenue authorities provide taxpayers and their agents with a wide range of information and advice to assist them in discharging their obligations. All revenue authorities focus on post-assessment review, and generally have a fixed period of three to six years in which to verify the information supplied by taxpayers and amend assessments if shortfalls are identified. In cases of fraud, the time period is unlimited in each country except the UK, where the time period is 20 years.

One substantial difference between the five countries is the extent to which particular categories of taxpayers are required to lodge annual income tax returns. In Australia, Canada and the US, most income earners are expected to lodge an annual income tax

return containing information on their taxable income and deductions. However, New Zealand and the UK have removed this requirement for large numbers of taxpayers (generally individuals with simpler tax affairs), while those with more complex affairs are still required to lodge annual returns.

- In New Zealand, the revenue authority also generates income tax statements for many taxpayers using information supplied by employers, financial institutions and other government agencies (rather than taxpayers themselves). This has been possible because of New Zealand's extensive withholding tax system and tax policy changes since the mid 1980s.
- In the UK, the majority of individuals do not fill in tax returns as their tax liabilities are withheld. Tax returns are sent to individuals who need to complete one. In practice this is about 25% of the taxpayer population, being those who are self employed, have complicated tax affairs, or are in the top tax bracket. The UK is presently reviewing its approach, due to concerns about the cost of their withholding arrangements for small employers.

Revenue authorities in all five countries release public rulings. In most cases the revenue authority considers itself bound by the ruling unless there is a change to the law. The UK revenue authority grants extra-statutory concessions, which are relaxations of the strict interpretation of the tax laws allowed for the purposes of making administration of the tax laws easier or providing taxpayers with relief from hardship occasioned by the revenue authority rigidly enforcing every aspect of the law. These concessions are published and can be relied on by taxpayers to bind the revenue authority. They operate much like public rulings in Australia, although over time the UK authority might have adopted pragmatic positions to a greater extent.

Revenue authorities consider themselves to be bound by a private ruling unless the information upon which they based the ruling was incorrect or incomplete. In Australia, Canada, the US and New Zealand, taxpayers can apply for a private binding ruling in advance of entering into an arrangement. Of the four countries, only Australia does not charge a fee for preparing a private ruling. The UK revenue authority will only provide taxpayers with a post-transaction ruling in limited circumstances and does not charge a fee to prepare them.

Where an income tax shortfall is identified, taxpayers in all five countries are potentially liable to pay interest and penalties. Australia generally charges the highest rate of interest on amounts owed, however, the amount of interest paid is tax deductible. None of the other countries examined allow an individual this deduction, although New Zealand, the UK and the US allow a deduction in limited circumstances for interest paid by a company.

More information on the income tax assessment systems in Australia, Canada, New Zealand, the UK and the US is contained in Appendix 4.

## 1.2 Focus for the review

The main objective of Australia's tax system as a whole is to efficiently raise revenue to be redistributed to the community in accordance with Government priorities.<sup>6</sup> The main aim of the system of administration is to collect that revenue with minimum administration and compliance costs.

The focus for the Review is to consider the appropriateness of the balance between ensuring income tax collection and the impact of self assessment on taxpayers (particularly in terms of certainty and compliance costs). The Review is not considering issues of tax policy, such as tax rates or deductions.

### 1.2.1 Potential for uncertainty

Under self assessment, taxpayers may be uncertain about how the law applies to their circumstances or they may be unaware of certain entitlements. Uncertainty, especially if significant, has the potential for adverse impacts on taxpayers, the system of administration and the economy as a whole.

Uncertainty may therefore expose taxpayers to costs (such as a requirement to pay additional tax, the General Interest Charge and penalties or the costs of professional advice and litigation) if a shortfall is detected by the Tax Office. Some taxpayers may pay too much income tax because they do not want to expose themselves to uncertainty. Thus they might not claim legitimate deductions simply because they are unsure if they are allowable.

Moreover, uncertainty may have implications for taxpayer perceptions about the fairness of the tax system (and hence affect the level of voluntary compliance by taxpayers).

Finally, uncertainty about the tax implications of a proposed transaction may have adverse economic implications. Taxpayers may be unwilling to enter into economically beneficial transactions if they are not able to obtain assurances about their taxation consequences.

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6. The income tax system sometimes also has the subsidiary objective of influencing behaviour by reducing or increasing the economic cost of particular activities that are subject to or exempt from taxation.

## Confidence

One way to reduce the uncertainty of self assessment would be through taxpayers being confident that they are assessing their income tax liabilities in line with the Tax Office's interpretation (such as through rulings). The capacity to enhance taxpayer certainty in this way depends on the quality of Tax Office advice as measured in these terms:

- How easy is it to get and understand advice from the Tax Office?
- Is the advice timely – that is, can you get it when it is needed?
- Is the advice 'accurate'?
- Is the advice reliable – that is, will the Tax Office stand by it?

These issues are dealt with in detail in Chapter 2.

## Finality

Another way to reduce uncertainty is by giving earlier finality to taxpayers who have tried to do the right thing, by shortening the period in which their assessment can be amended to increase their liability. Once the Tax Office can no longer re-open their assessments, taxpayers can stop worrying about whether they 'got it right'.

Issues affecting the review of assessments and the period for amendment are canvassed in Chapter 3.

## Consequences of uncertainty

Penalties and interest charges are potential consequences of uncertainty for taxpayers. Penalties can apply where a taxpayer does not take reasonable care in assessing their tax liability. The General Interest Charge applies a uniform rate of interest to late payments (including under payments) of any type of tax.

Chapters 4 and 5 examine issues surrounding penalties and the General Interest Charge respectively.

Chapter 6 collects a range of other issues associated with the self assessment system.

## 1.2.2 Revenue collection

Suggestions for improvements to increase certainty and/or reduce compliance costs for taxpayers should bear in mind the need to preserve the capacity of the Tax Office to collect legitimate revenue.

Income tax paid by individuals and business is the largest source of funding for Government spending priorities or the retirement of debt. In 2002-03, \$129.6 billion was collected in income tax (excluding petroleum resource rent tax).

## 1.2.3 Compliance and administration costs

However well a tax system is designed, it involves some administrative and compliance costs. Administrative costs are the costs of administering the tax system borne by the Tax Office, while compliance costs are the costs of complying with the tax system borne by the taxpayer, agents and third parties.

Compliance costs can be financial or non-financial. Compliance costs relevant to self assessment can include:

- direct financial costs (for example, the cost of obtaining professional advice from a tax agent or other tax practitioner)
- opportunity costs (for example, the cost of spending time complying with self assessment obligations at the expense of running a business)
- non-financial compliance costs, such as stress from the uncertainty about whether the right amount of tax has been paid.

Compliance and administration costs can be a product of various factors, but for the purposes of this Review, the structure of the law, the role of the Tax Office and the level of assistance and advice provided to taxpayers are especially important.

## 1.2.4 Trade-offs between competing objectives

Sometimes improving one aspect of the system might adversely affect another. For example, the Tax Office could increase certainty for some taxpayers by providing them with more binding information. This might optimise revenue if more people comply with the Tax Office position without the need for audit, but it may also increase compliance costs for all those not directly affected (or their representatives) because of the need to be across more information.

Similarly, the shorter the period for review and amendment of assessments, the sooner a taxpayer obtains finality for a particular income year. However, a shortened period of review applied too generally might overstretch the resources of the Tax Office, thereby encouraging non-compliance and prejudicing revenue collection.

So, as a practical matter, there will often need to be trade-offs between improving certainty for taxpayers and ensuring revenue collection at least cost for the benefit of the community.

### **1.2.5 Commencement dates of potential reforms**

It will be important for government to consider the date when any potential reforms should commence. Factors such as the scope of change to legislation or administrative systems will need to be taken into account. These issues are not specifically dealt with in this discussion paper, however, it is likely that many of the approaches canvassed, if adopted, would require significant lead times.

### **1.2.6 Different types of taxpayers**

Groups of taxpayers have different characteristics. These differences have implications for the Review, as different categories of taxpayers are likely to experience different degrees of uncertainty and different levels of compliance costs. In addition, the appropriateness of measures to improve certainty or reduce compliance costs is likely to differ between different groups of taxpayers.

This discussion paper will often canvass options as they are relevant to three distinct groups: individuals (not in business), very small businesses and other businesses (that is, small/medium and large business). While very small businesses are likely to be carried out by individuals, other businesses are usually carried out using entity structures, or a combination of structures.

Individuals who are not in business are likely to have relatively simple tax affairs for most returns they lodge over a lifetime. In most years, these taxpayers are only required to complete parts of the income tax return and have few sources of income, few deductions and offsets and relatively few record keeping obligations. Returns coinciding with special events, such as retirement, or the sale of investment property, will be more complex. These types of taxpayers do not require a detailed understanding of the majority of income tax law in order to work out their tax liabilities.

At the other end of the spectrum, business taxpayers (especially large businesses with international operations) are highly likely to have more complex affairs. They often have multiple sources of income and commercial arrangements that require substantial record

keeping. These types of taxpayers require a detailed understanding of the income tax law in order to discharge their responsibilities and frequently obtain professional advice. The complexity and opaqueness of the affairs of these taxpayers mean that it is much more difficult and time consuming for the Tax Office to determine whether or not they have complied with the income tax law. In addition, the large amounts of income tax that may be paid by these taxpayers mean that substantial resources are likely to be devoted by the Tax Office to post-assessment verification.

