Taxing Times

Is Self Assessment Working?

Michael Inglis

The ATO no longer needs itself to understand and apply the income tax law, so all restraints on lengthy, complex and changeable income tax law have been removed.

To collect income tax, a Government must wage a continual war on its own people. This metaphor bears elaboration in contemporary Australia. By far the bulk of income tax is collected by the Australian Government from occupied territories: the lands of the employers who have been press-ganged into deducting income tax at source from the earnings of millions of Australian employees, and their like. The rest of the income tax is raised from hostile territory, from lands where war is literally waged.

How has the Australian Government waged war on its own people in the field of income tax? The approach of the past 20 years or so has been law, law, law. This has failed consistently and yet the Government and its agencies have not deviated from this approach of ever more income tax law. When challenged to do something new in the face of long, proven failure of familiar methods, a common human response is to continue to adopt those same discredited methods, only harder. Nothing could sum up more aptly the route taken by those responsible for the decline of the Australian income tax system.

A brief history of self assessment for income tax

In a recent article, Michael D'Ascenzo and Tony Poulakis of the Australian Taxation Office (ATO) give a short account of Australia's self assessment system for income tax:[1]

> In 1986-87 a system of income tax self assessment was first introduced. Under this system all taxpayers still lodged returns containing relatively detailed information and their calculation of taxable income. However, the returns were no longer subject to technical scrutiny (ATO assessing). Emphasis shifted to advisory services and post assessment checking primarily through audit activity.
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> The move to a self assessment system came about following an ATO review of the effectiveness of its traditional system of assessment of income tax returns. The ATO review concluded that the assessment system was not cost effective and had little effect on taxpayer compliance with the income tax law.
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> Self assessment has been a staged process moving from partial self assessment for all taxpayers from 1986-87 to full self assessment for companies and superannuation funds since 1989-90. Under the full self assessment system the taxpayer goes one step further than calculating taxable income by also calculating the tax payable and sending that amount to the ATO with a return which contains only limited information.
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> Substantial changes to self assessment were enacted in 1992 following the extensive work and consultation process undertaken by the Self

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Assessment Priority Tasks ('SAPT') project. The changes included the introduction of a formal rulings system, a new penalty regime, extended objection periods, reduced interest charges, and self amendment provisions. Full self assessment was not, however, extended beyond companies and superannuation funds. The JCPA Report of 1993 concluded that the SAPT changes contributed significantly to an improvement in the level of equity and fairness in the taxation system.

Further changes to self assessment have been made since 1992. One of these changes was the introduction of shorter periods of review for individual resident taxpayers with simple tax affairs for the purpose of providing them with greater certainty and to reduce their record keeping obligations.

The ATO has also explored other refining options such as excluding certain taxpayers from lodging returns, but the use of the tax system for social purposes and ambivalence by taxpayer groups as to the desirability of these initiatives have been countervailing influences.

A more complete history of self assessment for income tax

What D'Ascenzo and Poulakis do not mention is that the period 1986-87, when a system of income tax self assessment was first introduced, also marked the introduction of some of the largest and most complex 'reforms' to the Australian income tax system—namely, Capital Gains Tax (CGT), Fringe Benefits Tax (FBT) and imputation.

At the same time as the income tax system—in particular, the income tax legislation—was being expanded and complicated, the ATO was able to move from what had become the uncomfortable position of having itself to understand, and be capable of genuinely applying on a consistent Australia-wide basis, the income tax law, to the more comfortable position of armchair critic. The full burden of getting and staying up to speed on, and contending day by day with, the newly expanded and more complicated income tax laws (not to mention existing ones) was thus taken off the shoulders of the ATO and put onto the shoulders of taxpayers and their advisers.

When the ATO every day issued income tax assessments, consciously and deliberately arrived at by various ATO officers (assessors) on the basis of their own work and their own understanding and application of the income tax law to the various facts and circumstances fully and truly disclosed to the ATO by various taxpayers, it gained ongoing first-hand experience (and thus knowledge and, critically, understanding) of whether the income tax law was workable or not.

The removal of this vital feedback element from the Australian income tax system could well be equated with removing all the brakes from a large vehicle which was starting to roll down a long hill towards an abyss. As soon as the ATO engineered the introduction of self-assessment, and adopted the position of armchair critic, free to pick and choose when and where (if at all) it would examine any given taxpayer and their affairs, the income tax system started to roll towards disaster.

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A multitude of little coloured boxes

What experience as a tax practitioner teaches is that real life factual situations do not commonly fit neatly into the one little coloured 'box' constituted by one section (or subsection, or paragraph, or sub-paragraph, or sentence, or group of words, or phrase) of the income tax legislation, nor into the one little coloured 'box' constituted by one (or part of one) ATO Ruling (or Determination, or whatever), nor into the one little coloured 'box' constituted by one (or part of one) income tax case.

What experience as a tax practitioner teaches is that real life factual situations are untidy and diffuse. To resolve the relevant income tax issue or issues in a reliable manner, the tax practitioner needs both to cast around for all relevant facts and circumstances, and for all items of income tax law, that might be relevant for a multitude of little coloured boxes (or parts thereof).

What experience as a tax practitioner teaches is that having cast around and identified all relevant facts and circumstances, as well as the multitude of relevant little coloured boxes of income tax law (or parts thereof), the relevant income tax law must then be applied to the relevant facts and circumstances. This can be likened to seeking to fit all the little coloured boxes of

income tax law (or parts thereof) together so as to construct a reliable answer to the relevant income tax law question.

The more little coloured boxes there are, the more 'parts' each box has, the more complex those boxes are (the more difficult it is to be sure of their precise colour or shape, the more difficult it is to 'fit' them all together), the more often the little coloured boxes are changed (amended), embellished, refurbished and added to, the harder the task of the tax practitioner becomes.

The ATO officers and the Parliamentary counsel who produce the income tax legislation, can be likened to small children sitting in a sunny playroom, playing with little coloured boxes. Their play has little connection with the real world of experience. To them, the little coloured boxes are easy to identify and to play with, but in real life it doesn't work like that.

Hard and challenging though the drafting of good income tax legislation undoubtedly is, the relevant ATO officers and Parliamentary Counsel have inestimable practical advantages over the tax practitioners (let alone the humble taxpayers) who have the full burden, under self assessment, of seeking to understand and apply the income tax legislation in practical situations. The ATO officers and the Parliamentary Counsel who produce the income tax legislation also have time available to devote to their work product, relative to the typical consumer of their work product.

Many provisions in the legislation are not applied for the simple reason that no one is able to comprehend them.

Is self assessment working?

The answer is no. Law without measure turns out to be no law at all. Those responsible for the decline of the Australian income tax system have produced a situation with the following salient features:

- The income tax legislation is far too lengthy: an Ernst & Young survey[2] noted that as recently as 1996, the Income Tax Assessment Act 1936 (Cth) (the ITAA 1936) comprised (no less than) approximately 3,500 pages of legislation. Now, however, in 2002 the legislation is spread over two Acts (really three Acts, that is, the ITAA 1936, the Income Tax Assessment Act 1997 (Cth) (the ITAA 1997) and the Schedules to the Taxation Administration Act 1953 (Cth)), and comprises nearly 8,500 pages. In addition, in the last financial year alone, the ATO made approximately 3,500 general public tax rulings.
- The income tax legislation is so poorly drafted as to be incomprehensible even to tax experts (let alone anyone else): as long ago as 23 September 1987, when the Australian income tax system was functioning far better than today, Graham Hill QC (now Mr Justice Hill, of the Federal Court) said in his Foreword to the First edition of *Australian Taxation Law* that:[3]

  > If two of the important criteria of a 'good' taxation system are simplicity and certainty . . . the Australian taxation system and particularly the *Income Tax Assessment Act 1936* fail the test miserably. The spate of anti-avoidance legislation, a reaction to the excesses of the tax avoidance era of the seventies, and the more recent taxation reform package have brought about legislation of almost unrivalled complexity.
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  > The legislation is in some cases unintelligible: without a commerce or law degree the ordinary taxpayer stands no chance of finding his way through the morass and even with these qualifications his advisers will of necessity have to struggle to make sense of language that is as convoluted as it is confusing. Nor is the task of the taxation officer any easier. Many provisions in the legislation are not applied for the simple reason that no one is able to comprehend them. The need for a work that will operate as a guide to the traveller through these murky waters is painfully apparent.

- The income tax legislation suffers from a number of unacceptable 'design features' which often make it near impossible for even the specialist tax practitioner (let alone anyone else) to apply the income tax legislation to concrete factual situations. The CGT provisions provide but one example of the most unacceptable of all these 'design features', the mosaic nature of the income tax legislation.

  The core CGT provisions in the ITAA 1997 are themselves 500-odd pages long (having been

but 90 pages in length when first introduced with effect from 20 September 1985). To these core CGT provisions must be added the many definitions and other provisions connected to, or incorporated into, the CGT provisions from other parts of the income tax legislation located hundreds of pages away from the tax question being answered—not to mention all the relevant tax cases, general law cases and statutes, Rulings, Determinations, and so on, that are necessary to be kept ever in mind so as to apply reliably the core CGT provisions to concrete factual situations.

- Another totally unacceptable 'design feature' of the income tax legislation is the use of definitions which virtually constitute a code in themselves (running to a page or more) and contain within their boundaries not only other defined terms, but also deeming provisions, reverse deeming provisions, negatives, double negatives and even triple negatives.
- For example, in s152-20 of the ITAA 1997, the meaning of the 'net value of the CGT assets' of an entity is meant to be laid out. This page-long definitional provision contains (as well as standard defined terms, such as 'entity') eight (special) defined terms—to wit, the (incorporated) defined term 'connected with' is elaborated in s152-30 which comprises, in turn, eight subsections and extends to nearly two pages.
- Yet another unacceptable 'design feature' of the income tax legislation is the obsessive use of deeming provisions which often prove unworkable because they produce a maze from which the reader is unable to extricate himself or herself.
- The income tax legislation is changed far too often, prompting one colleague to say that his life was like living in a revolving door and never coming out.

The legislative explosion

In taking a systemic view of the current Australian income tax system (of which self assessment is but a part), the best possible starting and ending point is the landmark 1988 publication *The Rule of Law: Foundation of Constitutional Democracy* by Geoffrey de Q.Walker.[4] The antecedents of today's farcical Australian income tax system can be found early in Walker's text (p. 48), where he describes the prevalence of 'a view of society as a machine made up of independent parts with which one can tinker without affecting the rest of the mechanism'.

This is highly relevant to the decline of the Australian income tax system. Income tax law lies at the centre of a very busy intersection: the intersection of law, accounting, economics, politics, globalisation and international competitiveness. Given this busy intersection, it's nothing short of fatal to adopt a mechanistic approach to the 'production' of income tax laws, particularly the 'production' of income tax laws without measure.

THE PUNITIVE AUSTRALIAN INCOME TAX SYSTEM

The Australian economy has performed extraordinarily well in the past decade. But one of the biggest impediments to continued global economic success is our tax system. A slate of tax reform is required, but two important issues stand out.

First, to make it globally competitive the top marginal rate of income tax should be substantially cut to 30%, and should cut in at a much higher level than the current $60,000 threshold (with equivalent changes throughout the tax schedule). When the top marginal tax rate was 60%, the reward for evading tax was greater than that from earning more money. Even at 47%, the reward for evasion is almost as great as the return from earning more. Substantially cutting the top marginal tax rate of income tax to 30% would equate the top personal rate with the company tax rate and allow substantial simplification of administrative arrangements. It also would make Australia highly competitive in the race for internationally mobile capital and skilled labour, as a recent IMF assessment of the Australian economy argued.

Second, serious simplification of the rest of the tax system is required. How can a taxpayer under a system of self-assessment be held liable for mistakes when ATO officials often cannot quickly and accurately answer questions? Australians are sick and tired of the current highly complex tax system, the uncompromising attitude of the ATO and the manifest lack of sympathy from politicians who earn good PAYE salaries (implying a relatively simple annual tax return) and receive very good superannuation to boot.

From Peter Jonson, www.henrythorton.com

No-one with any real experience of the Australian income tax system in operation would have assented to, let alone encouraged and championed, the ever-expanding morass of income tax laws over the past 20 years or so. Why? Because they would have known, from experience, that those burgeoning, bloated income tax laws were not working in real life. Walker (p. 238) notes the self-defeating nature of excessive legislation—perhaps the key to the whole Australian income tax debacle of the last 20 years or so—and the similarities between legislative mania and drug abuse:

> Chief Justice Dixon once remarked, after spending a day listening to proposals for law reform, that all the provisions identified as crying out for reform were themselves originally reforms. The more legislation parliaments produce, the more they will need to produce in the future. Legislative mania is like drug abuse in this respect. The addict takes one drug to overcome the side-effects of another and needs ever-increasing quantities just to stave off collapse.

Over 200 years ago Alexander Hamilton and James Madison warned of the dangers legislative inflation posed to the law's function as a guide to human action in the *Federalist* essays, as Walker notes (p.242):

> It will be of little avail to the people, that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man, who knows what the law is today, can guess what it will be tomorrow. Law is defined to be a rule of action; but how can that be a rule, which is little known, and less fixed?

The destruction of comprehensibility

No one openly disputes that the income tax law 'should be readily ascertainable and reasonably clear'.

As is so succinctly stated in the Australian National Audit Office's massive performance audit undertaken in the ATO's Administration of Taxation Rulings:[5]

> The provision of taxation advice [by the ATO] is particularly important given Australia's self-assessment taxation system, which relies heavily upon taxpayers having a good understanding of the taxation law in order to fulfil their taxation obligations . . . Taxpayers require a good understanding of the taxation law to fulfil their taxation obligations if the self-assessment system is to deliver the required efficiency benefits for taxpayers and the ATO.

TAX LESSONS FROM RUSSIA

There's a saying about new technology: that it is overestimated in the short run, but underestimated in the long run. The same may be true of countries like Russia.

The red flag went down over the Kremlin on Christmas Day 1991, and by the end of that month, the USSR had vanished. There were high hopes in the West, but lawlessness, moral decay, and economic collapse followed. In 1998, Russia defaulted on its debt, creating an international financial crisis. Since then, most of the world has paid little attention to Russia, figuring that it would remain an economic backwater.

Instead, Russia is reviving . . . President Vladimir Putin has realised that Russia has to create a friendly environment for business. He's made changes to the legal system to make it more reliable and fair, and he has emerged as the world's leading advocate of lower taxes, putting even George W. Bush to shame.

At the beginning of last year, Russia adopted a 13% flat tax on personal income. There's no capital gains tax on stocks, bonds or home sales. Interest on government bonds is exempt from taxes, and corporate dividends are taxed only once. The lower rate, limited deductions and simpler system have produced higher tax revenues (as supply siders predict). Vastly higher. Preliminary data show that 2001's lower flat tax rate raised 28% more revenue—after adjusting for inflation—than the higher graduated rates raised the year before. Russia now has a budget surplus. Starting in 2002, Russia also cut corporate tax from 35% to 24%, and Putin has proposed small businesses a choice of either paying an 8% flat tax on their revenues or a 20% flat tax on their profits. The Russians now have the best tax system in Europe, and are showing us all the path to a better way of raising revenues.

From James Glassman, 'A Russia To Love', *American Enterprise* 13:5 (July-August 2002), 15.

Perhaps a future performance (or other) audit will be directed to ascertaining, in a thorough manner, the implications of the fact that Australian taxpayers do not currently have even a basic (let alone a 'good') understanding of the taxation law and the professional advisers of Australian taxpayers (with few exceptions) do not currently have even a basic (let alone a 'good') understanding of the taxation law either.

It was stated as long ago as 1987 by Graham Hill QC (now Mr Justice Hill, of the Federal Court) that many provisions in the income tax legislation were not, even at that time, applied 'for the simple reason that no one is able to comprehend them', and that the morass of income tax legislation embodied 'language that is as convoluted as it is confusing'.

The stage has now been reached when it can be said that because of its oppressive bulk, its ever-changing nature, its many poorly drafted provisions, and its inherent and ever-deepening complexity, those responsible have destroyed the comprehensibility of the income tax legislation. The consequences of this could not be more serious. Walker notes (p. 237) that during a Lords debate in December 1982:

> Lord Denning and Sir John Donaldson M.R. pointed to the complexity of modern legislation, which was such that even specialist lawyers had difficulty in understanding it: 'If our Acts of Parliament cannot be understood even by clever experts it not only brings the law into contempt, it brings Parliament into contempt. It is a disservice to democracy; it weakens the right of the individual; it eases the way for wrong-doers and it places honest, humble people at the mercy of the State.'

The destruction of certainty

As long ago as 5 May 1993, Sir Harry Gibbs, formerly Chief Justice of the High Court of Australia and currently Chairman of the Australian Tax Research Foundation, publicly, and authoritatively, specified the troubles with the Australian income tax system and also enunciated a number of clear, practical means that could have been adopted to alleviate those troubles:[6]

> Everyone recognises that one essential of a satisfactory system of tax administration is that the law should be clear. The individual should know, without difficulty, when tax will be payable and when it will not. Another essential is that the system should be stable and not subject to constant change. Also, of course, it should be efficient. Efficiency, in relation to the tax system means that the cost and inconvenience to the taxpayer of complying with the law should be kept to a minimum.
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> It also means that the tax should not obstruct the ordinary conduct of business and industry; it should not discourage productive activities or lead taxpayers to engage in activities that are inefficient or harmful to the economy simply for the purpose of gaining a tax benefit and it should not reduce the ability of taxpayers to compete in business with the rest of the world.

A highlight of Sir Harry's paper is the forthright and sensible manner in which he dealt with the need—pressing in 1993, but critical in 2002—to frame a 'new' income tax law:[7]

> I do not suggest that the preparation of an entirely new income tax statute would be an easy task. One suggestion that has been made is that the tax law should not be complicated by the provisions for the concessions, benefits and incentives for which the Act now provides and that they should be provided by means of other legislation. However, tax legislation is commonly used to promote economic and social objectives and it is unlikely that Parliament would forego these objectives altogether in framing a new tax law, even if that were desirable.
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> Another suggestion is that the central policies of the law should be expressed in clear general terms and that there should be delegated to the Tax Office or the Courts power to apply the general rules in particular circumstances. Not everyone would be happy with the suggestion that the discretions of the Tax Office should be enlarged, but the suggestion that the law should be expressed in broader principles, the details of which might be worked out by the Courts, has something to commend it.
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> It is not my aim to attempt to suggest the form that a new law might take—such an attempt would be futile—but the main object of any such exercise should be to enact a law that is accessible and clear, and easier to apply and less burdensome to comply with than the present law. An important part of any reform would be to modify the objectionable provisions which are directed at tax

avoidance, and in particular those that give the Commissioner a discretionary power to override other provisions of the Act. Provisions such as those of Part IVA themselves amount to an abandonment of the rule of law, and the fact that so important a system of legislation is enforced in this way tends to undermine respect for the law generally. The framers of any new law should try to avoid the detail that has resulted from the present obsession with avoidance and should recognise that simpler, clearer rules would themselves help to secure compliance with the law. And in balancing the desire to ensure that the last cent of tax is paid against the cost and burden of compliance, the scales should not always dip in favour of the Commissioner.

If a new law is to be framed, its preparation should not be an in-house exercise—that is, the task should not be left to officials alone. To say that is not to question either the ability or the goodwill of the Taxation Office. However, a new approach is needed, and practitioners who are experienced in the operation of the law from the taxpayers' point of view might assist in providing it. No doubt the Taxation Institute and the Tax Research Foundation would both be able to help if such a project were commenced.

A highly dysfunctional system

Large numbers of taxpayers are now playing the odds, and the numbers are growing very significantly every year. Correspondingly, each year, there are fewer and fewer taxpayers who are honest and (rich enough to be) well advised on income tax as well. Why is this not being discussed publicly?

One reason is that so many of the players have a vested interest in maintaining the myth of their own competence in the income tax and the myth of taxpayers' general compliance with the income tax: the ATO, tax agents (and their representatives), accountants in general (and their professional associations), lawyers in general (and their professional associations), large corporations (and their lobby groups), small businesses (and their lobby groups), and so on, and so on. The only competent people these days in income tax are the specialists in superannuation, CGT, or whatever. Many of the well-informed players are also major beneficiaries, in one way or another, of the present gross dysfunctionality of the income tax system.

Another reason is to be found in various stock 'cards' that are played to such telling effect, time and time again, to confuse the issues and divert attention from the real vices within the system. Such a card is the 'blame it on the Barwick pro-tax avoidance court' card. No better illustration could possibly be given of the potency of a falsehood, oft repeated, with confidence. Another such card is the one that reads: 'it's all so complex, and it keeps changing all the time' ('it' being the income tax law, of course) 'because modern commercial activities are all so complex, and commerce keeps changing all the time'. If the ATO devoted—to effective enforcement of the existing income tax laws—one tenth of the time and energy it devotes to living out that fantasy, the need to keep endlessly changing, and endlessly 'explaining', the income tax law would disappear.

> Many well-informed players are major beneficiaries of the present gross dysfunctionality of the income tax system.

There have been many learned studies of the costs of compliance with Australia's income tax laws. Who complies? Putting aside cases where income tax is withheld or deducted at source, very few taxpayers in the whole country comply, in the sense of the phrase once put about by the ATO, of 'paying no less and no more income tax than the law requires'. What about some studies of the real question: What are the costs—to the community (in terms of revenue lost) and to taxpayers (in all relevant ways) of the general non-compliance with the income tax laws? ■

Endnotes

1 Michael D'Ascenzo and Tony Poulakis, 'Self Assessment: Quo Vadis?', *Taxation in Australia* No. 36 (March 2002), 412.

2 'Maximising Value in the Australian Corporate Tax Function', *ATP Weekly Tax Bulletin* No. 6 (2002), para 164, discusses the Ernst & Young survey.

3 D.G. Hill in Robin Woellner et al., *Australian Taxation Law*, 1st ed. (Sydney: CCH Australia, 1987), Foreword.

4 G. de Q. Walker, *The Rule of Law: Foundation of Constitutional Democracy* (Melbourne: Melbourne University Press, 1988).

5 Australian National Audit Office, *The Australian Taxation Office's Administration of Taxation Rulings* (Canberra: AGPS, 2001), paras 2-9 respectively.

6 Sir Harry Gibbs, 'The Need for Taxation Reform', Paper delivered at the 11th National Convention of the Taxation Institute of Australia (5 May 1993), 13-14.

7 H. Gibbs, 'The Need for Taxation Reform', 18-20.