Review of Tax Office management of Part IVC litigation

A report to the Minister for Revenue and Assistant Treasurer

28 April 2006

ISBN 0 642 74330 4

Review team:

Helen Warner and Tasos Mihail

Telephone: (02) 8239 2111
Facsimile: (02) 8239 2100

Australian Government
Inspector-General of Taxation

Level 19, 50 Bridge Street
Sydney NSW 2000
GPO Box 551
Sydney NSW 2001

18 May, 2006

The Hon Peter Dutton MP
Minister for Revenue and Assistant Treasurer
Parliament House
Canberra ACT 2600

Dear Minister

I am pleased to present to you my report on findings and recommendations in respect of the Review of Tax Office Management of Part IVC Litigation. The report has been prepared under section 10 of the *Inspector-General of Taxation Act 2003* (the Act). The report also includes my evaluation of the test case litigation program in response to a request made by your predecessor. The review was conducted pursuant to section 8 of the Act.

I have provided the Commissioner of Taxation with the opportunity to respond to the report's findings and recommendations. The Commissioner's full response, including his covering letter, is in a set of appendices to the report. In finalising the report, I have fully considered the Commissioner's response.

The Tax Office agrees with most of my recommendations. There are, however, some recommendations where the Tax Office has indicated a less than full endorsement of implementation.

Part of the Tax Office's response in the late stages of the review was to seek and to share with me important advice from the Solicitor-General and Australian Government Solicitor's Chief General Counsel on what constitutes good administrative practice when the Tax Office decides to challenge a finalised court decision. In my view, this advice is in itself a significant contribution by the review process to improved tax administration in the future. With the agreement of the Commissioner, a copy of the advice is included in the report.

I offer my thanks to the support and contribution of many government bodies, professional bodies, business groups and individuals to this review. The willingness of many to provide their time in preparing submissions and discussing issues with myself and my staff is greatly appreciated.

Yours sincerely

David Vos

David Vos AM
Inspector-General of Taxation

TABLE OF CONTENTS

CHAPTER 1: INTRODUCTION

1.1 This is the report on the review conducted by the Inspector-General of Taxation (Inspector-General) of aspects of the management of litigation by the Australian Taxation Office (Tax Office). This report is made under section 10 of the *Inspector-General of Taxation Act 2003* (IGT Act).

1.2 The review was announced on 10 March 2005. Its terms of reference are reproduced at Appendix 1 to this report. Details of how the review was conducted are given at Appendix 2.

1.3 Part of this review involves an evaluation of the test case litigation program. This aspect of the review was conducted in response to a request made by the Minister for Revenue and Assistant Treasurer and is therefore conducted pursuant to section 8(3) of the IGT Act. The remainder of the review was conducted pursuant to section 8(1) being a review conducted on the initiative of the Inspector-General. The decision to undertake the remainder of the review was prompted by concerns raised with the Inspector-General by industry and tax practitioners.

1.4 A number of key findings were identified by the review. Associated key recommendations are listed in Chapter 2. All key findings and key and subsidiary recommendations are discussed in Chapters 3 to 7 under each of the five specific terms of reference.

1.5 During the course of the Inspector-General's review, the Tax Office made or proposed a number of changes to its systems involved with the administration of litigation. Some of those changes directly addressed concerns raised with the Inspector-General. All changes made or proposed by the Tax Office are noted in this report wherever relevant.

1.6 The Commissioner of Taxation's detailed response to the review is in Appendix 3. His detailed comments on key recommendations are set out in Chapter 2. The Commissioner's comments on subsidiary recommendations are set out in the body of the report.

1.7 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.

CHAPTER 2: OVERVIEW, SUMMARY AND KEY RECOMMENDATIONS

OVERVIEW

2.1 From a simplistic, number-driven perspective, tax litigation is only a small part of the overall operation of the tax system, numerically overshadowed by the large volumes of transactions and compliance actions that do not result in litigation. Based on Tax Office figures, over the last two years, fewer than 0.3 per cent of Tax Office compliance adjustments have led to appeals and disputes, a total of some 3,200 cases. Importantly, this review has noted that the majority of these cases are appropriately concluded by the Tax Office.

2.2 However, the importance of tax litigation is greatly leveraged in the overall system for a number of reasons:

- Litigation is part of the operation of the broader system of government at a higher level than the tax system itself. As both the practical and symbolic interface between the administrators of the laws and the judiciary in its role of determining how the laws apply, it brings into sharper focus foundational concepts of the broader system such as the right of those affected by government administrative decisions to have those decisions reviewed by a body which is independent of the original decision maker and other principles of the rule of law.

- As well as resolving particular disputes, litigation contributes directly to the basis of ongoing administration of the laws, and may lead to the shaping (or re-shaping) of the laws in Parliament.

- Litigation often involves the more contentious, higher profile issues and engages significant players in adversarial positions. Some cases may be, or have been perceived as having flow-on financial impact to large numbers of people in the community.

2.3 These factors also leverage the negative impact of the relatively few but significant cases which the community thinks have been inappropriately handled by the Tax Office. They often leverage the influence that perceptions of litigation processes and administrative outcomes may have on the community's broader view of the integrity of tax administration.

2.4 In this context, it is a matter of concern that many submissions to this review, often from significant and representational quarters in the community, have surfaced strong negative perceptions of the Tax Office's management of its litigation program. Most submissions also provided details of the reasons why these perceptions are held.

2.5 A strong focus of this review has therefore been to establish if these perceptions were valid by testing for systemic issues behind them beyond mere 'sour grapes' or assertions of differing legal interpretations in particular cases.

2.6 The review has evidenced and concluded that a composite set of systemic deficiencies in the Tax Office's management of its litigation program is providing fertile ground for these negative perceptions to arise. Uncorrected, these deficiencies will continue to grow perceptions that will further undermine community confidence in the Tax Office as a fair administrator, and in the tax system itself. The review puts forward recommendations which, when implemented, would correct these deficiencies and improve both the actuality and perceptions of administration in this area.

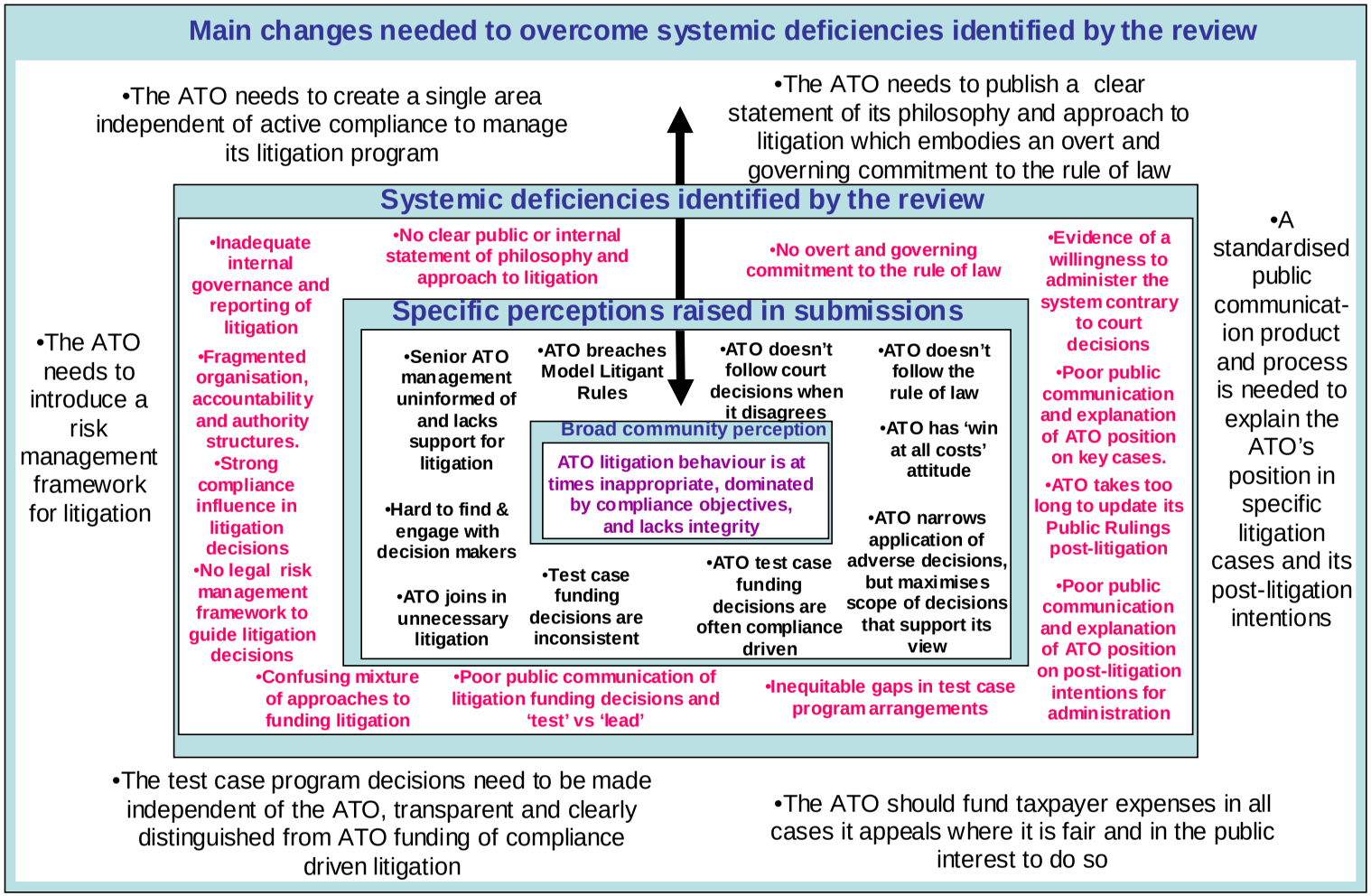
2.7 Diagram 2.1 presents a summary of these major deficiencies, how they lead to specific and broad negative perceptions, and what major changes are necessary to correct them. (Care should be taken, however, to examine the body of this report to obtain a full picture of the review's findings and recommendations that support this summary level diagram.)

2.8 The challenge for the Tax Office is not to defend against perceptions that it disagrees with by arguing specific cases or by dismissing perceptions on the grounds that they are based on unrepresentative exceptions. The Tax Office must acknowledge that these damaging perceptions are a reality evidenced by the many submissions to this review. It should objectively consider the underlying systemic problems which give rise to these perceptions and shift its focus to implementing the recommended changes that will overcome them.

2.9 This review has also raised issues which, subject to community consultation, are likely to be the subject of future Inspector-General reviews and may also be explored further in the course of reviews currently under way. One of these issues is the possibility that inadequate quality of Tax Office processes upstream of litigation, such as audit or resolving objections, may be driving unnecessary litigation and having other negative impacts for taxpayers.

Diagram 2.1: Summary of systemic deficiencies, consequential perceptions and major changes required

This diagram presents a summary of the major deficiencies referred to in this review, how they lead to specific and broad negative perceptions, and what major changes are necessary to correct them. (Care should be taken, however to examine the body of this report to obtain a full picture of the review's findings and recommendations that support this summary level diagram.)



SUMMARY OF REPORT

2.10 Tax litigation is the process which begins when a taxpayer seeks a review of a Tax Office decision on the amount of a tax liability or on the terms of private ruling by appealing the relevant decision to either the Administrative Appeals Tribunal (AAT) or the Federal Court. Tax litigation generally ends when the appeal is withdrawn or settled or when the AAT or Federal Court (or a court of higher appeal status) finally determines the matter or matters in dispute.

2.11 The number of tax cases which have been litigated over the last few years has remained relatively constant. However, in the 2000/01 year the number of litigated tax cases surged, primarily as a result of an influx of cases which related to the Tax Office's crackdown on various mass marketed tax effective investments (MMTEIs) in the late 1990s.

2.12 Only a minority of litigated cases are finalised by a court or AAT decision (12 per cent in respect of cases referred to the AAT). The Tax Office keeps statistics which show that it wins the majority of court or tribunal cases that are finalised by a hearing. These figures represent a positive achievement for the Tax Office, but do not give an accurate picture of the Tax Office's success in all litigated cases.

2.13 AAT statistics indicate that the overwhelming majority of litigated disputes which are referred to the AAT — around 88 per cent (85 per cent once two years affected by mass marketed tax effective investments are excluded) — are resolved without any hearing by the AAT and that, of these cases, 70 per cent are finalised by the Tax Office's decision being set aside or varied. These figures indicate that the majority (61 per cent) of all Tax Office decisions which enter the litigation phase and are referred to the AAT are varied in some way.

2.14 The AAT does not keep statistics to show which of these 70 per cent of Tax Office decisions which are set aside or varied prior to a hearing are resolved wholly or in part in favour of the taxpayer. An examination by staff of the Inspector-General of a sample of these cases that were resolved by way of a settlement between the parties indicated that a significant proportion of these cases were settled wholly in favour of taxpayers by the objection being allowed in full. This indicates that a significant percentage of the tax cases which reach the litigation stage could have been resolved at an earlier stage. In the Inspector-General's view this could be due to a number of reasons. It could be due to information relevant to the dispute not being sought by the Tax Office earlier in the dispute resolution process or a taxpayer not providing the Tax Office with requested information until the dispute proceeds to litigation. It could also be due to the wrong technical issues being raised by taxpayers' advisers or the Tax Office. It suggests that the earlier stages of the tax dispute process may not be wholly effective in the timely resolution of disputes and may warrant further review.

2.15 These figures have led the Inspector-General to recommend that the Tax Office report its litigation performance to the public and the Parliament more fully in the future than it has in the past. As well, the Inspector-General has placed on his forward work program future reviews to consider settlements and finalising disputes by the Tax Office with taxpayers.

2.16 Normally, taxpayers engage in litigation to resolve their particular tax dispute. However, they are generally unwilling to do so because it is a costly and lengthy process whose outcome is uncertain. Also, if tax litigation reaches the stage of a court or tribunal hearing it can result in adverse publicity for a taxpayer. However, sometimes litigation can be deliberately used by a taxpayer to delay the payment of tax that is rightfully due.

2.17 The principles (or philosophy) which guide the Tax Office's involvement in litigation are less clear. These principles are not set out in any single Tax Office document. They need to be gleaned from a number of different Tax Office documents and from the Tax Office's actual conduct in litigation.

2.18 These principles have been created in an environment where the Tax Office acts as a litigant in all tax cases and is not in control of all aspects of tax litigation, and where litigation is an adversarial process.

2.19 Tax Office statements on litigation indicate that it regards litigation as an important part of its overall compliance program. The Tax Office therefore sees litigation as an important means to ensure that taxpayers both individually and collectively act in accordance with the tax law.

2.20 Tax Office statements on litigation also indicate that the Tax Office sees litigation as having a role in clarifying the law. The Tax Office considers that this clarification purpose is to be carried out in accordance with the Tax Office's view of the underlying policy of the law, which may not be the same as the actual terms of the law. The Tax Office states that it supports this law clarification aim for litigation by running a test case program. Under this program the Tax Office will agree to fund a taxpayer's costs in cases which it considers will clarify an area of the law, in the sense of establishing new legal principles.

2.21 The Tax Office's actual conduct in litigation indicates that, in reality, its principal philosophy on litigation is that it is a means of validating the Tax Office view and ensuring that taxpayers comply with its view of the law. This compliance aim for litigation is also, in certain circumstances, overriding its involvement in activities which may lead to law clarification through objectively testing what the legislation means.

2.22 The Inspector-General has observed that the Tax Office's aspiration to be seen as a fair administrator is at risk because its objectivity and fairness in litigation is compromised by a perceived over-emphasis on achieving compliance with its views.

2.23 This over-emphasis is most evident in the Tax Office's behaviour in relation to its administration of the test case litigation program and the application of finalised court decisions.

2.24 The Inspector-General considers that the test case litigation program is important, is generally achieving its purpose and should be continued to provide public funding for litigating major disputes and grey areas of the tax law. An analysis of the cases that have been selected by the Tax Office for funding under the program up to the stage of a final court or tribunal decision showed that most were meeting this objective.

2.25 However, the Tax Office is currently not administering the test case litigation program in a way that ensures that it meets its objective of clarifying the law by establishing new legal principles in all appropriate cases. Test case funds have been $20 million over the ten year life of the program ($2 million per year), but only $5.97 million of these funds has been spent. Of this $5.97 million, a significant percentage (38 per cent) has been used to fund two cases where the primary purpose of funding was to achieve a compliance outcome, that is, to assist the Tax Office to enforce the existing law, rather than to clarify the law by establishing new legal principles.

2.26 The Inspector-General does not question the right or the validity of the Commissioner deciding to fund cases to assist in achieving compliance outcomes.

2.27 However, in addition to using the formal test case program for funding compliance-based cases, the Tax Office has not adequately communicated to the public the overall operations of the program and has not internally managed this program well. Although there have recently been improvements in the Tax Office's internal management of the program, this review finds that new arrangements for the management of the test case program are needed to overcome community confusion about the operations of the program, to improve its administration and overcome perceptions that the program is overly subject to Tax Office influence.

2.28 In some significant cases, such as *Essenbourne*, the Tax Office is also not giving effect to the results of a litigated case to taxpayers other than the particular taxpayer who has initiated the relevant case. These types of cases have not achieved clarification of the law for the benefit of the community as a whole because the Tax Office has refused to follow relevant legal principles which have been established by the case to any other similar case.

2.29 The Inspector-General considers that any Tax Office behaviour of not following the legal principles set by court decisions can be perceived to be in breach of the principles of the rule of law. Under these principles the Parliament's role is to enact the tax laws, the courts' role is to interpret these laws and the Tax Office's role is to administer the tax laws in all cases in accordance with finalised court decisions. Although cases where the Tax Office is not following court decisions are few in number, and the Inspector-General believes that the Tax Office follows rule of law principles in the majority of litigated tax cases, the existence of any such cases causes the community to doubt the Tax Office's commitment to rule of law principles. This is undermining the community's confidence in the tax litigation process and the Tax Office's administration generally.

2.30 There are differing views in the community on the extent to which the Tax Office should follow finalised court decisions in all situations and whether a failure to do so amounts to a breach of the principles of the rule of law.

2.31 Just prior to the finalisation of this review, when giving its response to this report, the Tax Office provided the Inspector-General with an opinion from the Solicitor-General and Australian Government Solicitor's Chief General Counsel on this issue. This opinion is an opinion on what constitutes good administration, rather than a matter of strict law. The opinion refers to the rules of precedent and notes that it would usually be inappropriate and unwise for an administrative decision maker to depart from decisions of single judges or of higher courts. Subject to following the rules

of precedent, the opinion appears to confirm that there is no legal impediment to the Tax Office resisting a finalised court decision in rare and exceptional circumstances.

2.32 The opinion states that, if the Tax Office considers that a finalised court decision is wrong, it may challenge that decision in a subsequent case provided certain conditions are met. These conditions are:

- that the Tax Office has credible and robust legal advice (which will withstand public scrutiny) that the court's interpretation is wrong in law;
- that the challenge is made as soon as possible;
- that those affected by the challenge are advised of the Tax Office's proposed course of action;
- that the Tax Office must take steps to avoid any suggestion that the challenge will unduly burden or prejudice individual taxpayers and must therefore fund or organise suitable assistance to bring a test case on the issue; and
- that the challenge must not be made just because, as matter of policy, the Tax Office considers that the decision in the case is wrong or undesirable.

2.33 The Inspector-General has not sought to resolve the debate on whether the Commissioner, who aspires to be seen as a good administrator, should challenge finalised court decisions and, if he does so, the circumstances in which this can be done. The Inspector-General considers that this matter is worthy of further debate, including in a broader context than the tax system and this review. However, the Inspector-General has found during this review that the Tax Office's conduct in this area has not, in relevant cases, met all the conditions for making such a challenge that have currently been formulated by the Solicitor-General and Chief General Counsel. The Tax Office's conduct in this area has therefore amounted to poor administration and has led to legitimate negative community perceptions of its behaviour.

2.34 The Tax Office also refuses to follow the results of certain finalised court decisions that have altered a previous Tax Office view as set out in a ruling or other statement until that view has been formally changed by the Tax Office. This process can take many months or even years. In addition, the Tax Office also has no process for undertaking an urgent review of any rulings during any earlier stage of the litigation process where doubts arise as to the correctness of a ruling.

2.35 The Tax Office's conduct of litigation has also generated community perceptions that the Tax Office is not managing its litigation in accordance with the rules which have been formulated by the Attorney-General to guide Australian Government departments on how they should act in all litigation matters to which they are a party ('the Model Litigant Rules'). The Tax Office's conduct which has led to these perceptions includes its conduct in certain specific litigated cases, a possible failure to ensure that all cases that should not be litigated are identified and dealt with early in the dispute resolution process, and its refusal to follow aspects of finalised decisions.

2.36 The Inspector-General considers that the Tax Office should issue a formal consolidated public statement to guide its conduct in litigation. This statement should say that the purpose of tax litigation is to resolve a dispute in a fair, timely and cost

effective manner consistent with the rule of law. Principles of ensuring compliance with or clarification of the law should be subject to the overriding purpose of ensuring that a just and fair result is achieved for taxpayers engaged in litigation with the Tax Office.

2.37 The Tax Office's overriding compliance approach to litigation is also evident in the way in which it internally manages tax litigation. The Tax Office's compliance areas — its business lines — have the primary decision making roles in most litigated cases. There is no area of the Tax Office which conducts an internal review of litigated cases which is free of the influence of the Tax Office's compliance areas. Processes for handling high priority cases that involve what the Tax Office terms Priority Technical Issues (PTIs) are more robust, in that decisions are made by senior tax officers from the Tax Counsel Network outside the business lines and external counsel is often involved.

2.38 Unlike the Tax Office's other activities which are wholly or partly directed towards compliance, the Tax Office has not implemented a risk management approach to its internal management of litigation. As a result, the Tax Office does not identify, assess, analyse, prioritise, treat and monitor its risks that are associated with tax litigation.

2.39 The Tax Office's overall compliance approach to litigation when coupled with the absence of risk management approaches to litigation means that community perceptions that at times the Tax Office has a 'win at all costs' approach to litigation are justified.

2.40 Unlike certain other compliance activities, the Tax Office has no formal, structured internal quality control processes for litigation. Other internal management policies and procedures for litigation also require improvement. For example, the Tax Office has inadequate internal reporting of litigation and test case matters to its senior management. There are also no reporting and review systems for evaluating the effectiveness of the Tax Office's in-house legal area and there is a lack of national support structures for staff who work in that area. Some areas of the Tax Office with key roles in the litigation process (including the Aggressive Tax Planning area which has the largest number of litigated cases) have no documented internal policies for their involvement in litigation. Most areas of the Tax Office which are involved in litigation have inadequate processes for the internal review of their litigation decisions.

2.41 The Tax Office does not communicate the status of its litigation program (including the revenue results and/or costs incurred) to the public. As a result the public is unable to assess whether the Tax Office's overall litigation program is being conducted effectively, fairly and with minimum cost.

2.42 The Tax Office has internal policies in place for funding taxpayer's costs in some litigated cases where a taxpayer wins their case but the Tax Office appeals against that decision to a higher court. These cases are not part of the formal test case litigation program. These funding policies are commendable and recognise to some degree that some taxpayers do not have access to the same resources for pursuing a case to finality through the appeal courts that may be available to the Tax Office. They help avoid the possibility that a taxpayer will withdraw because they cannot meet the costs. However, these policies do not cover all cases where the Tax Office has been unsuccessful at any stage of litigation and decides to appeal the relevant decision, and where funding might be in the public interest.

2.43 The Inspector-General makes the following major recommendations which he considers must be implemented to overcome the systemic deficiencies identified in this review. Subsidiary recommendations of this review are set out in the remaining chapters of this report.

KEY RECOMMENDATION 1

The Tax Office should clearly articulate its corporate philosophy and approach to litigation in a formal and consolidated published policy or guidelines on tax litigation, such as a Litigation Charter.

The Inspector-General considers that this document should state that the primary aim of litigation for the Tax Office is to resolve disputes in a fair, timely and cost effective manner, consistent with the rule of law.

There should also be community consultation in the development of a published policy or guidelines on tax litigation.

In this document the Tax Office should also affirm its commitment to administer the tax laws as enacted by Parliament and interpreted by the courts in an impartial and transparent manner. The Tax Office should also affirm that it will follow the results of finalised court decisions in other similar cases.

There should be wide community consultation in the development of any policy by the Tax Office on whether it should challenge finalised court decisions in certain circumstances. If the result of this process is that the Tax Office still considers that it will challenge finalised court decisions in certain circumstances then the Tax Office should clearly and fully articulate those circumstances and its associated processes in its formal published policy or guidelines on litigation.

Pending the development of any such policy regarding challenging finalised court decisions, and its publication in a formal consolidated set of guidelines on litigation, the Tax Office should publicly affirm that it will follow the results of finalised court decisions in accordance with the criteria which have been formulated by the Commonwealth Solicitor-General and Chief General Counsel.

Tax Office response

2.44 We will issue a practice statement on the Tax Office's approach to, and conduct of litigation, ensuring that it is consistent with Attorney-General directions relating to the conduct of litigation by the Commonwealth. We will consult with professional bodies in the development of the practice statement.

2.45 In relation to the question of whether the Commissioner should challenge finalised court decisions in certain circumstances, we have the benefit of the advice of the Solicitor-General and the Attorney-General's Chief General Counsel. That advice

indicated that it may be appropriate in exceptional circumstances for the Tax Office to challenge an earlier decision which it considers to be wrong, where there is credible legal advice (including internal advice) to that effect. The advice also stated that the Tax Office should put those affected on notice of its view and it would normally be appropriate for the Tax Office to fund any further challenge.

2.46 The guidance provided by the advice will be set out in a proposed litigation practice statement.

Inspector-General's comments on Tax Office response

2.47 The Inspector-General considers that the Tax Office should accept and implement Key Recommendation 1 in full.

2.48 While the Tax Office's proposal to develop a practice statement on litigation is a positive step, the Inspector-General's recommendation actually refers to a document being developed which is in a form similar to the existing Taxpayers' Charter. A litigation practice statement of the kind referred to in the Tax Office's response could supplement but should not be a substitute for a Charter-like document.

2.49 The Inspector-General considers that a document of higher status than a practice statement is needed to promote community confidence in the Tax Office's philosophy on litigation. The Inspector-General also believes that this document needs to contain a formal affirmation of the Tax Office's role in relation to litigation as distinct from the roles of Government, Parliament and the Judiciary. Consultation processes for this document (and any accompanying practice statement) also need to embrace the views of the wider community as well as those of the professional bodies.

KEY RECOMMENDATION 2

The Tax Office should establish management arrangements which give a single area of the Tax Office overall responsibility and authority for the management of all aspects of litigated cases.

Tax Office response

2.50 Agreed

2.51 We are reviewing our end-to-end processes for litigation to find efficiency and quality improvements. We will establish arrangements so that all decisions regarding litigated cases will be managed by the Office of the Chief Tax Counsel (OCTC) or the Tax Counsel Network.

2.52 In cases involving a Priority Technical Issue (PTI), the Tax Counsel Network will continue to decide the Tax Office's position.

2.53 In other cases, the Legal Services Branch (LSB) will be responsible for deciding the Tax Office's position. However, we will retain the existing processes through the Law Sub-plan whereby any differences of views on such matters can be quickly resolved through escalation.

2.54 In all cases, the Tax Office business lines will continue to be responsible for the risk ownership and mitigation strategies.

KEY RECOMMENDATION 3

The Tax Office should introduce risk management techniques to its management of tax litigation issues. It should start this process by defining the scope of the Commissioner's and the Tax Office's legal risk in collaboration with the Australian Government Solicitor (AGS) and counsel engaged by the Tax Office.

Tax Office response

2.55 We will review our current practices with this recommendation in mind.

2.56 All litigation cases are risk assessed at the commencement of litigation and risks are reviewed throughout the course of litigation. The Tax Office has a practice statement that outlines the process for risk assessment in litigation — see PSLA 2005/22. Although that practice statement focuses on priority technical issues (PTI) it makes it clear that, whether or not a case is linked to a priority technical issue, business lines must adhere to their own governance practices to ensure decision making is made at the appropriate level. Moreover, the Tax Office's Code of Settlement Practice provides guidance for Tax Office staff considering settlement of disputes, which also encapsulates risk management concepts. Where counsel and the AGS are involved in litigation, they assist in identifying legal risks to the Commissioner throughout the course of litigation.

2.57 Nevertheless we will review our current practices to ensure that the proposed litigation practice statement clearly articulates how we approach litigation in cases which do not involve PTIs, including a better articulation of the factors that underlie our risk management approach.

KEY RECOMMENDATION 4

The formal test case program (defined as the program under which a taxpayer makes a formal application for test case funding in accordance with funding criteria that have been publicised by the Tax Office) which is designed to fund cases which will clarify the law by establishing new legal principles should remain but new arrangements for the management of the test case program are needed. Precedents for an appropriate structure which deliver independence without being overly bureaucratic could be the existing Tax Agents' Boards or the Board of Taxation.

Tax Office response

2.58 The establishment of a panel independent of the Tax Office to decide applications for test case funding is a matter for government.

2.59 The existing Test Case Panel comprises seven members, five of whom are external to the Tax Office, including a former judge of the NSW Court of Appeal, a barrister, a solicitor and two accountants.

Inspector-General's comments on Tax Office response

2.60 The Inspector-General notes that the Tax Office's response does not address the suggestion made in the recommendation that possible precedents for an appropriate structure for the formal test case program which deliver independence without being overly bureaucratic could be the existing Tax Agents' Boards or the Board of Taxation.

2.61 The Inspector-General also believes that the detailed findings contained in this report on the manner in which the Tax Office has managed the program speak for themselves.

KEY RECOMMENDATION 5

The Tax Office should fund taxpayers' expenses in defending the case in all cases where the Tax Office has been unsuccessful at any stage of litigation, a decision is made to appeal the relevant decision and it is fair and in the public interest for the Tax Office to fund the taxpayer's expenses. The Tax Office should develop and publicise appropriate guidelines for the funding of such cases.

Tax Office response

2.62 Agreed in principle where it is fair and in the public interest to do so, and the test case program does this.

2.63 At present, the Tax Office funds the costs of taxpayers in small claims where the Tax Office appeals a decision of the Administrative Appeals Tribunal or Small Taxation Claims Tribunal to protect small taxpayers from the costs of court litigation. Considerations of capacity to pay are relevant to this practice.

2.64 The Tax Office has also established the Test Case Funding Program to fund cases where it is fair and in the public interest to do so. We will review the Test Case funding criteria in consultation with others to determine whether the capacity to pay should remain a factor, and whether the other factors clearly reflect the requirements of fairness and the public interest.

Inspector-General's comments on Tax Office response

2.65 The Inspector-General welcomes the Tax Office's acceptance of this recommendation. However, the Tax Office's response also refers to the test case funding program when this recommendation and the report's findings leading up to this recommendation indicate that the recommendation is dealing with cases funded under the Tax Office's other funding practices.

KEY RECOMMENDATION 6

The Tax Office should introduce a standard communication product to communicate the application of finalised court and tribunal decisions. The content of any Tax Office communication should be consistent with its role of administering the tax laws in a fair and objective manner and could include, for example:

- *the issues to be decided by the tribunal or court;*
- *the implications of the decision on each of those issues;*
- *the implications of the decision on the Tax Office view;*
- *how the Tax Office will apply and follow the finalised decision;*
- *the reasons why the Tax Office will apply and follow the finalised decision in that manner; and*
- *whether the Tax Office will be seeking legislative amendments.*

Tax Office response

2.66 Agreed in principle.

2.67 We will communicate to taxpayers the implications of adverse court and AAT decisions and significant court decisions. This will include impacts on any published views of the Tax Office, except where this is likely to mislead taxpayers.

2.68 While it would generally be inappropriate for the Tax Office to make its advice to Government public, we will further consult with Treasury as to whether it would generally be appropriate to advise that a matter has been referred to Treasury.

Inspector-General's comments

2.69 The Inspector-General notes that where Government is considering legislative amendments the Tax Office should nevertheless communicate to the community that it is seeking legislative change or that the matter is with Government. This is important in promoting transparency in tax administration by providing guidance to taxpayers operating in a self assessing environment on the implications of a finalised court or tribunal decision.

CHAPTER 3: NATURE AND CIRCUMSTANCES OF TAX LITIGATION

3.1 This chapter discusses the scope of this review and the nature and extent of the tax litigation which is covered by this review. It also discusses the effect which various environmental factors have on the management of this type of litigation.

3.2 These various environmental factors include:

- the legislative framework for reviews and appeals of taxation decisions;
- the Tax Office's role in the tax system generally;
- the Tax Office's role in the tax litigation process specifically;
- the rules and guidelines which shape the Tax Office's behaviour as an Australian Government agency;
- the role and approach of the Administrative Appeals Tribunal (AAT), the courts, solicitors and barristers to tax litigation; and
- the overall nature and extent of tax litigation.

SCOPE OF THIS REVIEW

3.3 For the purposes of this review, the Inspector-General has defined 'tax litigation' as the process which commences when a taxpayer seeks a review or appeal of a Tax Office decision to disallow an objection to either an assessment of tax or a Tax Office private ruling by referring the disallowance to either the AAT or Federal Court.

3.4 This review process is set out in Part IVC of the *Taxation Administration Act 1953* (the TAA 1953). The Part IVC review procedures apply to most types of tax which the Tax Office administers, including income tax, fringe benefits tax, goods and services tax (GST), superannuation surcharge (prior to 1 July 2005), superannuation guarantee, franking deficits tax and most types of withholding tax.

3.5 The litigation process is generally the final stage of any dispute between a taxpayer and the Tax Office concerning an assessment of tax or the contents of a private ruling.

LEGISLATIVE FRAMEWORK FOR REVIEWS AND APPEALS

3.6 A significant proportion of tax litigation falls within the review procedures set out in Part IVC. For these procedures to apply, a provision of the relevant taxing Act must specifically provide a person dissatisfied with the relevant assessment, determination, notice or decision with the right to object to it in accordance with Part IVC.

3.7 If the provisions of Part IVC do not apply, the relevant decision may be challengeable under other administrative law appeals avenues, such as those provided in the *Administrative Decisions (Judicial Review) Act 1977* and section 39B of the *Judiciary Act 1903*.

3.8 The choice of whether to have an objection decision referred to the AAT or the Court is one for the taxpayer.

3.9 Relevant factors in this choice include cost, the formality of proceedings, the complexity of the matter, considerations as to evidence, rights of appeal and whether or not the objection decision involves the formation of a judgment or opinion or the exercise of the Commissioner's discretion or the making of a determination by the Commissioner. The last factor can be particularly important as the AAT may exercise all the powers and discretions that are conferred on the Commissioner for the purposes of making the objection decision. This allows the AAT to be the primary finder of fact in review proceedings.

3.10 This review does not examine alternatives to the current legislative framework for reviews and appeals which has changed little since the early days of the federal income tax.[1]

Liability to pay tax

3.11 The liability to pay tax is not suspended during any review by the AAT or appeal to the Federal Court.[2] However, if there is a genuine dispute the Tax Office has a number of policies which it applies to the debt in dispute. These are generally set out in the *ATO Receivables Policy*.

3.12 One such policy is that the Tax Office will generally allow 50 per cent of the tax in dispute to be deferred until the final outcome of the review or appeal. Another policy is that, if the taxpayer's case depends on the outcome of another taxpayer's case and the second taxpayer wins their case but the case is taken on appeal, the Tax Office will not apply the general interest charge (GIC) to the first taxpayer for the period during which the favourable decision in the second taxpayer's case remains on foot.[3]

3.13 If tax which is subject to litigation is paid, in whole or in part, and the taxpayer wins their case they will be entitled to interest on any overpaid tax at the rates set out in the *Taxation (Interest on Overpayments and Early Payments) Act 1983*.

3.14 This report does not generally examine the Tax Office's policies and procedures for recovering tax which is the subject of litigation.

---

1 Other reviews which have considered reforms in this area include the Review of Business Taxation (Ralph Review) in its publication *A Strong Foundation — Discussion Paper 1: Establishing objectives, principles and processes* — see especially paragraphs 8.9 to 8.17. See also the discussion of alternative dispute resolution frameworks for income tax in Chapple, S, *Income Tax Dispute Resolution: Can we learn from other Jurisdictions?* 1999 Australasian Tax Teachers Association Conference.

2 See sections 14ZZM and 14ZZR of the TAA 1953.

3 Taxation Ruling IT 2250.

Burden of proof

3.15 Under the current legislative provisions for the review and appeal of objection decisions, the taxpayer bears the burden of proving, on the balance of probabilities, that the assessment is excessive or that the taxation decision concerned should not have been made or that it should have been made differently.[4]

3.16 In general, the taxpayer must go further than showing the assessment is excessive or wrong and show what the correct assessment should be. It is not necessary for the Commissioner to show that the assessment was made correctly. The effect of the onus provisions is that if the taxpayer fails to lead any evidence on a matter, or the taxpayer's evidence is rejected, the taxpayer fails even if the Commissioner has led no evidence on the issue.

3.17 A taxpayer also bears the burden of proof in the AAT notwithstanding that the Tribunal is undertaking a review of the Commissioner's decision. In this respect, the review of tax decisions is unique from other matters before the Tribunal where neither the applicant nor the respondent agency carries a burden of proof to prove or disprove a fact.

TAX OFFICE'S ROLE IN THE TAX SYSTEM

3.18 The Tax Office's role in the tax system is to administer the tax laws in accordance with the tax legislation and finalised court decisions. The Government's role is to develop policy and propose laws and amendments, the Parliament's role is to consider and enact those proposed laws and the Judiciary's role is to interpret those laws.

3.19 This division of functions that are associated with tax laws is premised on the principles of the rule of law, that is, that all authorities involving in rule making are subject to and constrained by law.[5]

3.20 The basic administration duty of the Commissioner of Taxation is to assess and collect taxes.

3.21 In performing that duty, there is a strong community expectation that the Commissioner of Taxation will be an independent and impartial administrator. There is also a strong community expectation that the Commissioner of Taxation will perform that duty in a manner that acknowledges the role of Government to develop policy and propose laws and amendments, the role of Parliament to consider and enact those proposed laws and the role and independence of the Judiciary to interpret those laws.

3.22 The general rule is that the Commissioner does not forego tax properly payable (including penalty and interest where appropriate) and will, with minimal delay, seek to collect that tax as near as practicable.

---

4 For the AAT, the burden of proof rules are contained in section 14ZZK(b) of the TAA 1953, while for the Federal Court they are contained in section 14ZZO(b) of the same Act. Note that for franking assessments, a taxpayer must only show that an assessment is incorrect.

5 See the definition of the rule of law contained in Gleeson M, *Courts and the Rule of Law*, Melbourne University, 7 November 2001 available at www.hcourt.gov.au.

3.23 Where a taxpayer wishes to contest a liability that the Commissioner, on good grounds, considers to be properly payable, the Commissioner has a duty to defend such a challenge.[6]

TAX OFFICE'S ROLE IN THE LITIGATION PROCESS

3.24 The Tax Office's role in the litigation process is principally that of a litigant, rather than an advocate.

3.25 The Australian Government Solicitor (AGS) and members of the independent bar act as the Tax Office's legal representatives in all taxation appeals that are heard by the Federal or High Court.

3.26 The Tax Office perceives that its role as a litigant and client of the AGS and of external barristers in cases that are heard by a court is unique and different to that of other litigants who appear before a court. This is because the Tax Office has a strong interest in having the law clarified. It states that :

> The relationship between the ATO, AGS and the bar is somewhat unique in litigation. Unlike most barrister-client relationships, the ATO approaches litigation on tax technical matters as a professional client, who has strong interest in having contentious areas of the law clarified in a sensible and coherent way consistent with the underlying policy of the law.[7]

3.27 Where litigation involves the AAT or Small Taxation Claims Tribunal (STCT), the Tax Office will sometimes be represented by its own staff. However, Tax Office staff do not appear before these tribunals in an independent solicitor capacity. They do not require certificates to practice as a solicitor and only recently have been required to have legal qualifications.

3.28 The Tax Office's role as a litigant in proceedings brought before the AAT or STCT is different to where proceedings are brought before the Federal Court. In the AAT or STCT, the Tax Office is required to actively assist the tribunal to reach a fair and just decision, while in a court the Tax Office's role is that of a defendant to the relevant proceedings.

3.29 As discussed by the Australian Law Reform Commission, in review tribunal proceedings both parties have an interest in ensuring that the correct or preferable decision is made in the particular circumstances of the taxpayer.[8] For the Tax Office,

---

6 Equally, paragraph 4.3 of the Legal Services Directions provides that litigation against the Commonwealth or its agency is to be conducted by the agency in accordance with legal principle and practice, taking into account the legal rights of the parties and the financial risk to the Commonwealth (including the agency) of pursuing its rights. One example of conducting litigation in accordance with legal principle and practice is acting in the Commonwealth's financial interest to defend fully and firmly claims brought against the Commonwealth where a defence is properly available, subject to the desirability of settling claims wherever possible and appropriate.

7 D'Ascenzo M and Martin S, *A unique taxation partnership for the benefit of the Australian community,* speech given to ATO/AGS/Counsel Workshop, 3 April 2004 downloaded from www.ato.gov.au.

8 Australian Law Reform Commission, *ALRC Report 89, MANAGING JUSTICE: Review of the Federal Civil Justice System*, p 742.

review tribunal proceedings also provide an opportunity for external review of its decision-making process, which contributes to correct and fair administration.

3.30 In 2003/04 the Tax Office's total expenditure on legal services was $86.2 million, of which approximately $30.17 million[9] was on litigation.[10] From 1 March 2006, the Tax Office, together with all other Australian Government agencies, will be required to make publicly available records of its legal services expenditure for the previous year.[11]

RULES AND GUIDELINES WHICH SHAPE THE TAX OFFICE'S ROLE IN LITIGATION

3.31 Other than the overriding rule of law, the main rules which affect the Tax Office's behaviour as an Australian Government agency litigant are:

- the Legal Services Directions including the obligation to act as a model litigant set out in Appendix B and associated guidance materials;
- guidelines on the procurement of legal services, issued by the Department of Finance and Administration; and
- the Australian Public Service (APS) Values and Code of Conduct guidelines and accompanying Public Service Commissioner's Directions.[12]

3.32 Of these rules, the most important from the viewpoint of taxpayers and other parties involved in a tax dispute are the Legal Services Directions and accompanying model litigant guidelines.

3.33 The Legal Services Directions are directions that have been issued by the Australian Government's Attorney-General with effect from 1 September 1999. From that date, the Australian Government Solicitor ceased to be the sole provider of litigation services to all Australian Government agencies. Two versions of these directions have been issued. The first version was in effect from 1 September 1999 to 28 February 2006. The second version is effective from 1 March 2006 and was released during the final stages of this review.

3.34 From 1999, the aim of the Directions was to ensure that the quality of the Government's legal work was maintained and that the public interest was protected in the new decentralised legal services environment where agencies were free to choose their legal services provider.

3.35 Under clause 4.2 of both versions of the Directions, litigation is to be conducted by agencies in accordance with the *Directions on the Commonwealth's Obligation to Act as a model litigant*, (the model litigant rules) which are set out in

---

9 Auditor-General, *Legal Services Arrangements in the Australian Public Service*, Audit Report No 52, 20 June 2005, p 35.

10 ibid, p 37.

11 Attorney- General, *Legal Services Directions*, issued pursuant to section 55ZF of the *Judiciary Act 1903*, at paragraph 11.1(ba). These directions are effective from 1 March 2006.

12 These are set out in sections 10 and 13 of the *Public Service Act 1999.*

Appendix B to the Directions. Copies of the old and new versions of the model litigant rules are set out in Appendix 5 to this report.

3.36 In summary, under the model litigant rules which apply from 1 March 2006, the Tax Office is obliged to do all of the following:

- It should not cause unnecessary delay in the handling of litigation.
- It should act consistently.
- It should endeavour to avoid, prevent and limit the scope of legal proceedings wherever possible, for example by the use of alternative dispute resolution processes.
- It should keep the costs of any litigation to a minimum.
- It should not take advantage of claimants who lack the resources to litigate a claim.
- It should not rely on technical defences.
- It should not pursue an appeal unless it believes that it has reasonable prospects for success or the appeal is otherwise justified in the public interest.
- It should apologise where it is clear that it has acted wrongfully or improperly.

3.37 The new model litigant rules also note that these rules may in certain circumstances make it appropriate for the Commonwealth to pay a litigant's costs, for example in test cases in the public interest. They also state that the rules apply to merit review proceedings such as those conducted by the AAT.

3.38 The new model litigant rules differ from those in place before 1 March 2006 by containing an obligation to consider the use of alternative dispute resolution, a specific reference to test cases, and new clauses which state that the rules apply to AAT proceedings. All previous obligations have been maintained in the new rules.

3.39 The Office of Legal Services Coordination (OLSC) is a branch of the Attorney-General's Department which is responsible for investigating and monitoring breaches of the Legal Services Directions, including the model litigant guidelines.

3.40 The model litigant obligation in the Legal Service Directions draws on previous guidelines, which in turn drew on relevant case law, which existed in non-legislative form prior to 1999. The Attorney-General or delegate may determine that there has been a breach of the Directions. Further, a court or tribunal that considers that the Commonwealth has not acted as a model litigant may make adverse comment or take this into account, for example in assessing costs in the relevant case.

3.41 Where a breach is identified, OLSC will seek to identify the underlying deficiency that led to the breach, and work with the agency and its legal service provider to overcome that deficiency. For example, if a requirement of the Directions has been misunderstood, in a manner that may recur, guidance material will be promulgated to overcome that misunderstanding. If an agency has placed insufficient value on compliance with the Directions, OLSC will work to ensure the agency recognises and acts in accordance with its obligations. In extreme cases (for example,

deliberate flouting of the Directions) the Attorney-General may issue a specific direction requiring the agency to handle a particular matter or class of matters in a particular manner. There have been three occasions since 1999 when the OLSC has done this, but no case has so far involved the Tax Office.

3.42 The new Legal Services Directions were created as a result of a review process. One issue which was considered during this review was whether the rules should provide more guidance to agencies on the use of the media, particular in relation to describing the nature and conduct of other parties to the litigation. However, the new Legal Services Directions do not contain any additional guidance to agencies on this issue. OLSC provides advice on a case-by-case basis and envisages formulating guidance material as part of its forward work program.

OTHER PARTIES IN TAX LITIGATION

3.43 The Tax Office is not in complete control of tax litigation. Rather, taxpayers, the AAT, the courts and lawyers also exercise a degree of control over when a case is litigated and how litigation proceeds.

3.44 This report will not examine the advantages and disadvantages of the present adversarial system of conducting tax litigation before the courts and tribunals exercising federal jurisdiction. This issue was broadly examined by the Australian Law Reform Commission (ALRC) in its inquiry with its findings and recommendations in its report *ALRC Report 89 MANAGING JUSTICE: Review of the Federal Civil Justice System*.[13] The recommendations from the ALRC report were from a whole-of-government perspective with no specific focus on tax disputes.

ROLE OF TAXPAYERS

3.45 There is a community perception that the Tax Office 'initiates' litigation with taxpayers. Under the current review and appeal procedures only a taxpayer may apply to the AAT for review of the decision or appeal to the Federal Court. Apart from disallowing an objection, the Commissioner has no control over which cases are litigated and whether the objection decision is referred to the AAT or the Federal Court. The Commissioner is ordinarily the respondent or the defendant in tax litigation and is not empowered to refer an objection decision to the AAT or the Federal Court.

3.46 Although the Tax Office does not determine which cases come before the AAT or the courts, it does play a role, through its compliance strategy, regarding which

13 The Australian Law Reform Commission, as part of its inquiry, considered:
- the civil litigation and administrative law procedures in civil code jurisdictions;
- the procedures and case management schemes used by courts and tribunals to control the conduct of proceedings that come before them;
- the relationship between courts and tribunals;
- the mechanisms for identifying the issues in dispute;
- the means of gathering, testing and examining evidence;
- the use of court-based and community alternative dispute resolution schemes;
- the significance of legal education and professional training to the legal process;
- the training, functions, duties and role of judicial officers as managers of the litigation process; and
- the appellate court processes.

issues may be subject to dispute. It also plays a role in the contentions that are argued before the AAT or Court and whether an adverse decision is to be appealed. Furthermore, through its test case litigation program, it can facilitate taxpayers bringing their cases before the AAT or Federal Court by providing funding for the costs taxpayers may incur in pursuing their case.

3.47 There is very little information publicly available on the cost of tax litigation to taxpayers. However, as a part of its research for its review of the federal civil justice system, the ALRC undertook and also commissioned empirical research. In a 1999 research report, it indicated that the mean value of professional fees for applicants in tax matters that came before that Court was $7,962 and for respondents, $54,135.[14] The ALRC also reported that the mean value of disbursements in tax matters in the Federal Court were $9,080 for applicants and $21,369 for respondents.[15]

3.48 Submissions made to this review have estimated that the current minimum costs of running a tax case in the Federal Court are in the order of $100,000 with an additional cost of $50,000 to $75,000 to run any appeal from that decision.

ROLE OF THE COURTS

High Court of Australia

3.49 The High Court is the highest court in the Australian judicial system and was established by section 71 of the Constitution. The functions of the High Court are to interpret and apply the law of Australia, to decide cases of special federal significance including challenges to the constitutional validity of laws and to hear appeals, by special leave, from federal, state and territory courts.[16]

3.50 In taxation matters, the High Court has stated that it considers that the Full Court of the Federal Court is the ultimate court of appeal subject only to the exceptional cases in which the High Court grants special leave to appeal. Such exceptional cases will need to give rise to a question of fundamental principle before the High Court will grant special leave.[17]

Federal Court of Australia

3.51 The Federal Court of Australia was created by the *Federal Court of Australia Act 1976*. The Federal Court's original jurisdiction in tax matters is conferred by the *Taxation Administration Act 1953*.

---

14 T Matruglio Part two: The costs of litigation in the Federal Court of Australia, ALRC Sydney June 1999, p 59. Available at http://www.austlii.edu.au/au/other/alrc/publications/dp/62/report_index.html.

15 ibid, p 60.

16 Information from High Court of Australia website, available at: http://www.hcourt.gov.au/about_01.html.

17 Mason C J, Deane and McHugh J J, Application for special leave to the High Court, *Federal Commissioner of Taxation v Westfield Ltd*, 5 August 1991. In refusing the application for special leave, the High Court held that although the Commissioner contended that the decision of the Full Court of the Federal Court rested on a misinterpretation of the principle enunciated by the High Court in the *Myer Emporium* case, the case turned on its own facts and did not call for the grant of special leave to appeal.

3.52 The Court exercises a first instance jurisdiction to hear objections to decisions made by the Commissioner of Taxation. It also hears appeals from decisions of single judges of the Court and taxation matters on appeal from the Administrative Appeals Tribunal, but only on questions of law.

3.53 The primary objective of the Court is to decide disputes according to the law and to determine the existing rights between the parties to the litigation. The Court is required to interpret the statutory law and develop the general law of the Commonwealth. In doing so, the Court exercises the judicial power of the Commonwealth under the Constitution.

3.54 The Federal Court has only limited power to intervene where there has been an exercise of a discretionary power by the Commissioner. The Court may only examine the exercise of the discretionary power to see whether the Commissioner has acted in accordance with correct legal principles. Unlike the AAT, the Court cannot interfere merely because it would have exercised the discretion in a different way. For this reason, disputes involving the exercise of the Commissioner's discretion, for example the remission of tax shortfall penalties, are often referred to the AAT.

Procedural aspects of an appeal to the Federal Court

3.55 The *Federal Court of Australia Act 1976* and the *Federal Court Rules*, in particular Order 52B, govern tax proceedings before the Federal Court. A taxpayer filing an application in accordance with the Federal Court Rules must commence the appeal. The application for appeal must be lodged within 60 days after being served with the Commissioner's objection decision.[18] The Federal Court has no power to extend the time for lodging an appeal beyond this 60-day period.[19]

3.56 Unless the Court orders otherwise, the appeal is limited to the grounds stated in the objection.

3.57 Within 28 days of being served with a taxpayer's application, the Commissioner is required to file a statement outlining succinctly the Commissioner's contentions and the facts and issues in the appeal as the Commissioner perceives them.[20]

ROLE OF THE ADMINISTRATIVE APPEALS TRIBUNAL

3.58 In the federal jurisdiction, tribunals are part of the executive arm of government and provide administrative, not judicial, decision making and dispute resolution processes.

3.59 Review tribunals are directed to make the correct or preferable decision after considering the whole of the evidence, and to ensure that their decisions are in accordance with relevant legislation. This is referred to as a 'merits' review and requires the AAT to stand in the shoes of the original decision maker, consider all the

18 Section 14ZZN of the TAA 1953.
19 *Bayeh v Federal Commissioner of Taxation* 99 ATC 4895.
20 Order 52B Rule 5 of the *Federal Court Rules*.

evidence anew and substitute its own decision for the decision of the original decision maker.

3.60 The AAT's objective has been made explicitly clear in the *Administrative Appeals Tribunal Act 1977* which provides that, in carrying out its functions, the AAT must pursue the objective of providing a mechanism of review that is fair, just, economical, informal and quick.

3.61 The role of the AAT is ordinarily different from that of the courts within the review and appeal framework. In a recent extrajudicial speech Justice Downes, President of the Administrative Appeals Tribunal, observed that:

> Administrative decision-making, which is an important aspect of Executive Government, is not concerned with dispute resolution as such. There may be a dispute as to the decision which should be made but administrative decision-making must always focus on the making of the correct or preferable decision and not upon the resolution of the dispute relating to that decision. Administrative decisions usually have wider impact than their effect on those in dispute. Litigation concentrates on the resolution of disputes between parties.[21]

3.62 The contrast between merits review of administrative decisions and litigation was further illustrated by his Honour by reference to the adversarial nature of litigation, observing that:

> Litigation is adversarial because it must result from an assertion by one party which is rejected by another party which the first party then seeks to have adjudicated by a court. The assertion and rejection through a court process is the adversarial process.[22]

3.63 However, participants in AAT hearings — particularly where both parties are represented by lawyers and accountants — can perceive that the dispute they are involved in is conducted in much the same manner as court hearings.

3.64 Once a taxpayer seeks review of a decision, the AAT assumes the role of the decision maker rather than that of an adjudicator of a dispute between the taxpayer and the Tax Office. The Australian Law Reform Commission has aptly described the consequences of this:

> Tribunals and other administrative decision making processes are not intended to identify the winner from two competing parties. The public interest 'wins' just as much as the successful applicant because correct or preferable decision making contributes, through its normative effect, to correct and fair administration and to the jurisprudence and policy in the particular area. The values underpinning administrative review are said to encompass the desire for a review system which promotes lawfulness, fairness, openness, participation and rationality.[23]

---

21 His Honourable Justice Garry Downes AM, *Government Agencies as Respondents in the Administrative Appeals Tribunal*, paper delivered to the Australian Government Solicitor Government Law Group, Canberra 16 June 2005, p 2. Available at: http://www.aat.gov.au/CorporatePublications/speeches/downes/GovernmentAgenciesJune2005.htm

22 ibid, p 4.

23 Australian Law Reform Commission, *ALRC Report 89 MANAGING JUSTICE: Review of the Federal Civil Justice System*, p 742.

Procedural aspects of review by the AAT

3.65 The *Administrative Appeals Tribunal Act 1977* and the Practice Directions govern proceedings before the AAT.

3.66 A taxpayer may commence a review of the Commissioner's objection decision by applying directly to the AAT. This application must be lodged within 60 days of the taxpayer being served with the Commissioner's objection decision.[24] The AAT has the power to grant an extension to lodge an application in certain circumstances. Where a taxpayer refers a decision to the AAT, it is the whole decision that is reviewed by the AAT and not merely that part of the decision with which the taxpayer is dissatisfied. As such, the Commissioner, subject to the taxpayer being given reasonable time to respond, may advance other arguments to defend his decision.

3.67 Within 28 days after receiving notice of application for review the Commissioner is required to lodge with the AAT the 'T' documents. These documents include a statement of reasons for the decision and every other document in the possession of or under the control of the Commissioner that the Commissioner believes is necessary to the review of the objection.

3.68 The AAT is also empowered to serve notice on the parties requiring the production of documents within a specified time or requiring the person to produce a listing of all documents in that person's possession or control relevant to the objection decision.

3.69 The AAT may exercise all the powers and discretions of the Commissioner for the purposes of reviewing the Commissioner's objection decision. As such, the AAT may confirm, vary or set aside the Commissioner's decision on an objection. In reaching its decision the AAT is bound to follow precedent set by earlier court decisions. The AAT may refer a question of law arising before it to the Federal Court.

3.70 In the AAT each party bears their own costs. This is unlike the Federal Court, where the unsuccessful party normally bears both parties' costs on a party/party basis. Proceedings in the AAT are also required to be conducted with as little formality and technicality, and with as much expedition, as the requirements of the *Administrative Appeals Act 1977* and a proper consideration of the matters before the AAT permit. Also the AAT is not bound by the rules of evidence but may inform itself on any matter in such manner as it thinks appropriate. However, the AAT is required to comply with the rules of natural justice, which includes procedural fairness.

ROLE OF LAWYERS

3.71 As representatives of the client, lawyers are primarily responsible for the preparation and conduct of the litigation. This includes determining the technical issues that are to be litigated, the documentary and other evidence that is to be led in the course of the litigation and the presentation of the case before the AAT or the Court. In many instances, lawyers only become involved in the tax dispute once litigation is commenced. This may mean that technical issues, evidence and strategies are re-examined as part of the matter now subject to litigation.

---

24 Section 14ZZC of the TAA 1953.

3.72 The role of lawyers in litigation is, in part, guided by the duty of the solicitor or barrister to the court. A lawyer as a member of the community has an obligation to respect the authority of the court. A lawyer has additional obligations to protect the integrity of the judicial process that arises out of the special role the lawyer has in the judicial process. The lawyer's obligation is to do the best the lawyer can for the client. But the lawyer and other participants in the judicial process (including the parties) have a broader concern. That concern is the pursuit of a just result, that is, the fair and proper application of the law to the facts.[25]

3.73 One consequence of the existence of the duty to the court will be that in particular circumstances the lawyer will be required to act in a manner that may appear to be contrary to the interests of the client in the proceedings. One example of the lawyer's duty to the court is the requirement in civil cases to insist upon a client producing a document (subject to any claim of privilege) even though the production of the document may be fatal to the client's case. Other aspects of the lawyer's duty to the court include the duty to conduct proceedings with candour and honesty, the duty not to mislead the court as to the law and duty not to mislead the court as to the facts.

NATURE OF TAX LITIGATION

3.74 An important facet of tax litigation is that the application of fiscal statutes to the affairs of taxpayers will to a large extent depend on the particular factual circumstances of each taxpayer. In refusing special leave to appeal to the High Court in *FCT v Eastern Nitrogen Ltd* B28/2001, McHugh J commented that:

> … most tax cases turn on questions of fact and they are not worthy of re-examination in this Court. We have said that the Full Court of the Federal Court is, in all but a small category of cases, the final court of appeal in tax matters.

3.75 A question of law involves a determination of what the law is and may require the interpretation of a statute or the application of precedent. A question of fact involves a decision by the court or tribunal of what happened in the case. This requires the court or tribunal to consider all the evidence and decide what the facts of the case were.

3.76 The distinction between a question of law and a question of fact is important as only questions of law give rise to an appeal from the AAT to the Federal Court. Where an appeal to the Federal Court against an AAT decision does not turn on a question of law then the appeal will be dismissed as incompetent. In contrast, where litigation is commenced in the Federal Court there is a general right of appeal to the Full Federal Court. Special leave is required for an appeal from the Full Federal Court to the High Court.

3.77 The precedential value and effect of decided cases of any court of record, whether at first instance, by an intermediate court of appeal or by a final court of appeal is the legal principle established by or applied in that case. As one submission to this review stated:

---

25 Bennett P, College of Law, Book 1, *Duty of Solicitors and Barristers*.

> … the identification of that legal principle does not depend upon being able to apply some general abstract label to the particular kind of transaction at issue in the case; and then contending that the outcome arrived at in that case is necessarily to be applied to every other case in which the transaction in issue could be said to bear the same label or description. Closer and more refined analysis is necessary. Most particularly, proper account must be taken of whether it can be said that there were factual differences between any two cases.

3.78 The fact-specific nature of tax litigation also means that neither the Tax Office nor taxpayers are bound to follow the tax treatment given to a particular matter in one year to later years of income for the same taxpayer.[26]

3.79 The significance of the distinct factual circumstances of each taxpayer, and the application of a decision to other cases with similar issues, is an area of some concern, and misunderstanding, amongst a number of taxpayers and their advisers. These issues are considered in further detail in subsequent chapters of this report, in particular Chapter 7 which deals with the role of the Tax Office in providing certainty following a court or tribunal decision.

THE EXTENT OF TAX LITIGATION

KEY FINDING 3.1

Only a small proportion of active compliance activities and objections lead to litigation.

Tax Office response

3.80 Agreed.

3.81 Each year the Tax Office makes a large number of decisions that affect the tax liabilities of persons and entities inside and outside Australia. Administrative decisions may be reviewed internally (by another senior officer within the Tax Office, for example, by way of objection), by review tribunals and by the courts (in particular, the Federal Court and the High Court). As the figures below indicate, taxpayers sought to have the decision reviewed by the AAT or appealed to the Federal Court in a small proportion of total active compliance activities. The Tax Office defines 'active compliance activities' as activities which involve the Tax Office checking whether the tax laws are being complied with. These activities include data-matching, telephone calls, letters, walk-in visits, risk reviews, audits and prosecution investigations.

3.82 In 2003/04 the Tax Office carried out 1,167,786 of these active compliance activities. In 2004/05 the Tax Office carried out 1,197,891 such activities.

3.83 In 2003/04, of the total number of active compliance activities, 558,182 resulted in variations to taxpayer liabilities or claims for rebates or refunds. In 2004/05, a total of 679,938 of the active compliance activities gave rise to a liability impact. This includes cases resulting in reductions of carried forward losses and referrals to external

26 *Caffoor v Commissioner of Income Tax* [1961] AC 584; [1961] 2 All ER 436.

organisations such as the Director of Public Prosecutions. In 2003/04 the Tax Office also received 14,793 applications for private binding rulings.

3.84 In 2003/04 the Tax Office received 16,872 objections to assessments and 155 objections to private binding rulings. During the same period, 1,541 matters were lodged for review by taxpayers in the AAT and the STCT and 322 taxation appeals were filed in the Federal Court. Based on Tax Office figures, the number of appeals generated from compliance adjustments is less than 0.3 per cent. Fewer than 10 per cent of objections resulted in an appeal and approximately 3 per cent of objections in non-mass marketed tax arrangement cases proceeded to appeal.

3.85 Although the total number of litigated cases is small, these cases are important to the effective operation of the current self assessment system of tax administration. This is especially so where the cases result in a published Court or AAT decision. Often these published decisions provide the only material which is available to taxpayers and the community to guide them on how the tax law will be applied or interpreted in a given set of factual circumstances.

3.86 The outcome of cases that proceed to litigation and the manner in which these cases are finalised are discussed below.

Outcomes of applications to the AAT and courts

Administrative Appeals Tribunal

3.87 As shown in the Table 3.1, in 2003/04, the AAT received 7,267 applications for review across all jurisdictions. Of these, 1,354 were lodged in the Taxation Division with 187 applications lodged in the STCT.[27] In the same period, the AAT finalised 2,980 applications for review of tax decisions in the Taxation Division and 163 applications in the STCT.[28]

3.88 In 2004/05, the AAT received 7,679 applications for review across all jurisdictions. Of these, 2,140 were lodged in the Taxation Division with 213 applications lodged in the STCT. In the same period, the AAT finalised 1477 applications for review of tax decisions in the Tax Division and 225 applications in the STCT. The large increase in applications for review to the AAT for 2000/01 may be attributed to mass marketed tax arrangements.

27 For the 2003/04 year, applications lodged in the Taxation Division of the AAT included 625 taxation scheme cases. For the 2004/05 year, applications lodged in the Taxation Division of the AAT included 1160 taxation scheme cases.

28 For the 2003/04 year, applications finalised in the Taxation Division of the AAT included 2,415 taxation scheme cases. For the 2004/05 year, applications finalised in the Taxation Division of the AAT included 662 taxation scheme cases.

Table 3.1: Applications to the Administrative Appeals Tribunal and Small Taxation Claims Tribunal

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Total applications for review for all jurisdictions	7,330	7,538	8,050	12,863	7,767	7,766	7,267	7,679
Applications to the Taxation Division	962	780	1321	6,371	1254	856	1,354	2,140
Applications to the Small Taxation Claims Tribunal	312	359	272	220	215	149	187	213

Source: Administrative Appeals Tribunal annual reports 1997/98 to 2004/05.

3.89 Statistics from the AAT indicate that nearly 85 per cent of applications for review of tax decisions relate to income tax, with the remaining cases predominantly involving goods and services tax and superannuation guarantee issues.

Federal Court of Australia

3.90 In 2003/04, 5,312 cases were commenced in, or transferred to, the Federal Court's original jurisdiction. Of these, 322 were classified as tax appeals. In comparison, the number of matters concerning decisions under the Migration Act filed in, or remitted to, the Court's original jurisdiction was 2,591 and under the Corporations Act, 626.

3.91 As is evident from Table 3.2, apart from 2000/01, the number of tax appeals commenced in the Federal Court and the proportion of tax appeal cases have been fairly constant. The increase in the number of tax appeals in 2000/01 coincides with an increase in the number of applications for review related to mass marketed tax arrangements in the AAT. Likewise the number of appeals to the Full Federal Court has been fairly constant over the previous 15-year period with approximately 5 per cent of all appeals to the Full Federal Court involving tax matters.

3.92 In 2003/04, there were 12 tax appeals to the Federal Court from the AAT. In this same period, the AAT finalised an application for review by way of decision in 201 cases, suggesting that only a small proportion of AAT decisions are appealed to the Federal Court on questions of law.

Table 3.2: Tax appeals to the Federal Court and Full Federal Court

	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
Total appeals to Federal Court (including non-tax matters)	N/A	N/A	N/A	N/A	N/A	N/A	5,482
Tax appeals to Federal Court	167	330	222	167	515	163	159
Tax appeals to Full Federal Court	24	43	36	30	25	24	34
Tax appeals from Tribunal	36	17	25	17	313	37	16

Table 3.2: Tax appeals to the Federal Court and Full Federal Court (continued)

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Total appeals to Federal Court (including non-tax matters)	6,697	7,626	5,869	4,971	3,924	4,218	5,312
Tax appeals to Federal Court	216	288	266	958	167	198	322
Tax appeals to Full Federal Court	30	27	18	11	17	13	30
Tax appeals from Tribunal	12	21	7	18	8	7	12

Source: Annual Reports of the Federal Court of Australia and the Federal Court Registry.

Resolution of review and appeal cases

Administrative Appeals Tribunal

3.93 In 2003/04 the Commissioner reported that in the AAT and STCT the Commissioner's decision was wholly upheld in 69 per cent of cases, while 11 per cent of decisions were in favour of the taxpayer. The remaining 20 per cent were decided partly in favour of each party.[29] Appendix 6 provides greater detail on the information contained in the Tax Office's Annual Report 2003/04.

3.94 In 2004/05 it was reported that the Commissioner's decision was wholly upheld in 76 per cent of cases, while 7 per cent of decisions were in favour of the taxpayer. The remaining 17 per cent were decided partly in favour of each party.[30]

3.95 However, the Tax Office statistics only represent cases that were finalised by way of decision by the AAT. They do not include cases that were settled between the Tax Office and the taxpayer, cases that were conceded or abandoned by the Tax Office or cases that were withdrawn by the taxpayer prior to hearing.

Subsidiary recommendation 3.1

The Tax Office should publish a more complete picture of the outcomes of litigation to include information on the proportion of applications for review and appeals finalised without a hearing and the outcome.

Tax Office response

3.96 Agreed

3.97 If all finalised AAT tax cases are included, then in 2003/04 approximately 1 per cent of AAT tax cases were finalised by way of the Tax Office decision being affirmed by the AAT following a hearing. Similarly, in 2003/04 less than 1 per cent of AAT tax cases were finalised by way of the Tax Office decision being set aside by the AAT following a hearing. Appendix 6 provides greater detail on the break-up of finalised AAT tax cases.

29 Commissioner of Taxation, *Annual Report 2003/04*, p 220.
30 Commissioner of Taxation, *Annual Report 2004/05*, p 233.

3.98 Table 3.3 shows the percentage of applications for review of tax decisions in the AAT that were finalised without a hearing over the period from 1997/98 to 2004/05.[31] Chart 1 of Appendix 6 indicates that the average percentage of such applications over this eight year period was 88 per cent. The average percentage is influenced by the large number of mass marketed tax arrangement cases finalised in 2002/03 and 2003/04. If these two years are excluded, the average percentage of applications for review of tax decisions finalised without a hearing falls to 85 per cent.

Table 3.3: Percentage of applications finalised in the AAT without a hearing

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
All applications	77	76	77	74	74	74	81	78
Taxation Division	84	85	87	88	81	96	97	83
Small Taxation Claims Tribunal	80	78	66	68	78	73	85	75

Source: Administrative Appeals Tribunal annual reports 1997/98 to 2004/05.

3.99 Table 3.4 indicates for the same eight year period the number of applications that were finalised without a hearing, broken down into whether the Tax Office's decision at objection was set aside, varied, dismissed, withdrawn or remitted.[32] Decisions set aside or varied prior to a hearing would include cases where the substantive adjustment is maintained, but there is a relatively minor concession. Chart 1 of Appendix 6 provides average percentages for each of these results over the last eight years and indicates that approximately 70 per cent of applications that were finalised over these eight years without a hearing resulted in the Tax Office decision at objection being set aside or varied.

3.100 The average percentage is influenced by the large number of mass marketed tax arrangement cases finalised in 2002/03 and 2003/04. If these two years are excluded, the average percentage of applications for review of tax decisions finalised without a hearing resulting in the Tax Office decision at objection being set aside or varied falls from 70 per cent to 63 per cent.

31 'Applications finalised without a hearing' includes all applications that were finalised otherwise than by an AAT decision following a hearing on the merits. For example, applications finalised by consent pursuant to section 42C of the AAT Act or withdrawn by the applicant under section 42A(1A) of the AAT Act are included in this category.

32 The AAT has the power to vary or to set aside a Tax Office objection decision under review. Where the AAT sets aside the Tax Office objection decision it may make a decision in substitution for the decision set aside or it may remit the matter back to the Tax Office for reconsideration in accordance with any directions or recommendations of the AAT.

Table 3.4: Number of applications for review set aside or varied by consent in the Taxation Division

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Affirmed	6	11	5	22	2	11	37	144
Set aside	142	152	168	161	207	2,050	1,705	385
Varied	154	115	366	405	116	1170	848	354
Dismissed/ withdrawn	203	238	149	198	302	245	197	246
Remitted	0	1	1	0	7	0	0	0
Total	505	517	689	786	634	3,476	2,787	1,129
Percentage of applications set aside or varied	58.6	51.6	77.5	72.0	50.9	92.6	91.6	65.5

Source: Administrative Appeals Tribunal annual reports 1997/98 to 2004/05.

3.101 The high proportion of settled cases is also confirmed by information provided by the Tax Office. In the period from 1 June 2003 to 30 June 2005 the Tax Office finalised 3,200 review and appeal cases. Of these, 1,858 were classified as 'settled' by the Tax Office, with 257 withdrawn by the taxpayer and 87 conceded by the Tax Office. Table 3.5 provides a more detailed break-up of the appeal cases finalised by the Tax Office.

Table 3.5: Review and appeal cases finalised in the period 1 July 2003 to 30 June 2005

Outcome	**Category**		**Total**
	Aggressive Tax Planning (ATP)	Non-ATP	
Settled	1,609	249	1,858
Part favourable to the Tax Office	282	44	326
Favourable to the Tax Office	132	184	316
Withdrawn by taxpayer	72	185	257
Conceded by Tax Office	3	84	87
Affirmed on review in favour of the Tax Office	14	55	69
Unfavourable to the Tax Office	8	39	47
Abandoned by the Tax Office	5	37	42
Other	72	126	198
Totals	2,197	1,003	3,200

Source: Australian Taxation Office.

3.102 The Tax Office considers that the AAT figures do not give any reflection of the cases conceded or abandoned outright by the Commissioner during litigation. The Tax Office advises that for the 2003/04 and 2004/05 years the total number of cases conceded or abandoned at appeal amounted to 4 per cent of all appeals. In cases other than mass marketed tax arrangements the Tax Office advises that it conceded or abandoned approximately 12 per cent of cases.

3.103 These Tax Office comments overlook the high percentage of cases that are settled. Fieldwork conducted by the Inspector-General on the outcomes of settled cases is discussed in the next chapter.

KEY FINDING 3.2

A relatively high proportion of appeal cases are settled once a matter proceeds to litigation.

3.104 Information from the Tax Office also suggests that the majority of cases 'settled' by the Tax Office involve a question of fact rather than a question of law. This is consistent with the Tax Office's approach in its Code of Settlement, which provides that settlement may be appropriate where there are complex factual or quantum issues in contention, or evidentiary difficulties sufficient to make the case problematic in outcome or unsuitable for resolution through the AAT or the Federal Court.

3.105 The Tax Office's approach to settlement, and the high number of cases settled without the matter proceeding to hearing, suggest that a matter that proceeds to hearing will generally involve either:

- a question of law where the Tax Office has an established view or is seeking a clarification of the law from the AAT or the Court; or
- a question of fact where a taxpayer has not been able to satisfy the Tax Office, through the production of documents or other evidence, that the assessment is excessive or that the taxation decision concerned should not have been made or that it should have been made differently.

Federal Court of Australia and High Court of Australia

3.106 In 2003/04 the Commissioner reports that in the courts the Commissioner's decision was wholly upheld in 68 per cent of cases, while 23 per cent of decisions were in favour of the taxpayer. The remaining 9 per cent were decided partly in favour of each party. Again, the Tax Office statistics only represent cases that were finalised by way of decision by the court and would not include appeals finalised without a hearing. Table 3.6 provides a more detailed break-up of the resolution of appeal cases.

Table 3.6: Resolution of Federal Court and High Court tax appeal cases in the period 1 July 2003 to 30 June 2004

Court	Favourable to the Tax Office	Adverse to the Tax Office	Partially favourable to the Tax Office	Total
Federal Court	21	6	1	28
Full Federal Court	6	3	3	12
High Court	3	1	0	4
Total	30	10	4	44

Source: Australian Taxation Office.

3.107 Unlike the AAT, the Federal Court and High Court do not publish further data which would allow closer assessment of issues such as the extent to which cases pursued in these jurisdictions are settled before hearing and the percentage of such cases which might be settled partly in favour of the taxpayer.

CHAPTER 4: TAX OFFICE'S PHILOSOPHY ON AND APPROACH TO LITIGATION

4.1 This chapter seeks to identify the Tax Office's corporate philosophy on litigation and examine its approach to litigation.

4.2 This chapter focuses on how the Tax Office's philosophy on and approach to litigation impacts upon taxpayers and other parties to a tax dispute that are external to the Tax Office. The next chapter discusses the Tax Office's internal management and policies and procedures in respect of litigation.

TAX OFFICE PHILOSOPHY ON LITIGATION

Concerns and issues raised in submissions

4.3 In the course of the Inspector-General's scoping study in 2003 and this review, stakeholders raised the following issues and concerns in relation to the Tax Office's philosophy on litigation.

4.4 Firstly, a number of submissions noted that there was no public statement by Tax Office as to its philosophy on litigation.

4.5 Secondly, a number of submissions asserted that the Tax Office appeared to be using litigation to confirm its view of the law, rather than to clarify that law.

4.6 Thirdly, a number of submissions stated that the Tax Office acts, in some cases, as though it makes the law rather than administers the law.

4.7 A number of these submissions asserted that one key example of this behaviour was that the Tax Office was not administering the tax system in line with a number of court decisions. A number of these submissions asserted that, by acting in this way, the Tax Office is not acting in accordance with the principles of the rule of law. Under these principles, the Government's role is to develop policy and propose laws and amendments, the Parliament's role is to consider and enact those proposed laws, the Judiciary's role is to interpret those laws and the Tax Office's role is to administer those laws in accordance with finalised court decisions.

4.8 Fourthly, submissions asserted that the Tax Office was unjustifiably focused on winning its case rather than getting it right. The degree to which this was said to occur varied between submissions.

4.9 For example, one organisation observed that, while, in its view, the Tax Office is to a large extent not focused on winning at all costs, there were three types of cases where this focus was evident:

- cases involving issues of fact (such as cases involving undisclosed income);
- cases involving complex tax avoidance arrangements; and

- cases where a judgement has been given which rejected the Tax Office view and the Tax Office proceeds with an appeal in circumstances where the prospects of success are negligible.

4.10 Other submissions stated this 'win at all costs' focus was evident in most tax litigation cases.

4.11 Fifthly, a number of submissions stated that the Tax Office has a seemingly limitless budget and long timeframes available to ensure that cases, especially those involving large tax claims and/or issues of precedent, are litigated. These submissions note that such resources and timeframes are not available to taxpayers to the same extent.

4.12 Finally a number of submissions asserted that the Tax Office's litigation philosophy fails to take into account the adverse effect which various environmental factors concerning the tax and legal systems currently have on taxpayers. These environmental factors include the cost of litigation to taxpayers and the operation of the self assessment system for tax under which taxpayers bear the initial burden of determining how tax laws apply to their circumstances.

4.13 The Inspector-General's findings in relation to the above six stakeholder concerns, and in relation to other concerns about the Tax Office's philosophy on litigation that have arisen as a result of this review, are set out below.

Absence of comprehensive Tax Office statement on its litigation philosophy

4.14 This review has confirmed that there is no formal, consolidated public statement by the Tax Office on its corporate philosophy towards tax litigation.

4.15 The Tax Office's corporate philosophy on litigation needs to be gleaned, to the extent that it can be, by referring to a number of Tax Office statements. Some of these statements are publicly available and located on the Tax Office's website, while other statements are located in internal Tax Office documents. A number of the internal documents are however, outdated.

4.16 These statements include:

- speeches by Tax Office staff and the Commissioner of Taxation;
- the Model Litigant Guidelines;
- the Commissioner's Annual Report;
- the Legal Services Guidelines;
- various final and draft Practice Statements, including in particular PS LA 2005/22;
- the Taxpayers' Charter;
- the Tax Office's Compliance Model;
- the Tax Office's Code of Settlement Guidelines;

- the Tax Office's Test Case Litigation Program booklet; and
- internal litigation bulletins.

4.17 However, across each of these corporate documents there is no common statement regarding the Tax Office's philosophy towards tax litigation. At times, there are even competing views on the stated philosophy towards litigation in some of these statements. In addition, none of these statements commits the Tax Office to fundamental elements of its role in the tax system. Notably, there is no explicit commitment to the principles of the rule of law.

4.18 The Tax Office directed the Inspector-General to a speech by a Second Commissioner[33] and stated that it was one of the primary documents that articulates the Tax Office's philosophy towards tax litigation. In this speech, the importance of law clarification as an aim of litigation was emphasised:

> … the ATO … has a strong interest in having contentious areas of the law clarified in a sensible and coherent way consistent with the underlying policy of the law.

4.19 The role of tax litigation is also discussed in the Commissioner's 2003/04 and 2004/05 annual reports. In the 2003/04 Annual Report the Tax Office emphasises the compliance aim of litigation:

> … litigation forms an important part of our compliance and dispute resolution program, and clarifying the law helps us administer the revenue.

4.20 In the 2004/05 Annual Report the Tax Office states that:

> Litigation is an essential part of our law clarification and compliance programs.

4.21 The above sources appear to indicate that litigation is regarded by the Tax Office as being both part of its compliance program and also a means to clarify the law in line with its understanding of the underlying policy.

4.22 The above statements, however, do not indicate which of these aims will have priority, for example, in cases where the two aims are in conflict.

Tax Office conduct in litigation

4.23 The Tax Office's conduct in litigation also conveys mixed messages as to its philosophy on, and approach to, litigation.

4.24 As noted above, a number of submissions by stakeholders asserted that the Tax Office's conduct in litigation appears to be driven by the compliance aim of ensuring that its view of the law is applied and that this aim is overshadowing any law clarification aim. Submissions also stated that the Tax Office can, at least at times, have a 'win at all costs' approach to litigation.

---

33 Michael D'Ascenzo and Steve Martin, *A unique taxation partnership for the benefit of the Australian community*, ATO/AGS/Counsel Workshop, 3 April 2004.

4.25 The Tax Office has however denied that it ever has a 'win at all costs' approach to litigation. It has stated that

> … our purpose is never to win at all costs. We strive to make sure that legislation is given its intended effect as best as we can discern it from the law, informed by our knowledge of the underlying policy. There are circumstances where counsel may suggest an entirely different means of arguing a case inconsistent with the way in which we may have publicly expressed our views of the law… Whilst we are grateful for advice which might assist us in the successful outcome of a particular case, we are mindful as to whether the argument will assist us generally in the law clarification that we seek. The consequences for other taxpayers or other provisions in the range of laws administered by the ATO weigh heavily on our deliberations.[34]

4.26 From this entire review, the Inspector-General has concluded that there are a number of aspects of the Tax Office's conduct with respect to litigation which strongly suggest that the Tax Office's principal philosophy on litigation is that it is a means of validating the Tax Office view and ensuring that taxpayers comply with its view of the law. This compliance approach is, in certain circumstances, overriding law clarification aims for litigation. These features of the Tax Office's conduct, when coupled with the absence of cost/benefit approaches by the Tax Office in terms of assessing the benefits of litigation against the total internal and external costs of litigated cases (which is discussed further in the next chapter), mean that community perceptions that at times the Tax Office has a 'win at all costs' approach to litigation are justified.

4.27 The Tax Office's conduct in applying the outcome of finalised decisions and in litigating certain test cases particularly evidences a systemic compliance-driven approach to litigation. The following five examples are drawn from both these areas and are discussed in further detail in subsequent chapters of this report.

4.28 Firstly, the Tax Office has not followed certain principles of law established in finalised court decisions and is administering the law as if the relevant cases had not been decided. For example, it has refused to follow the interpretation of the meaning of a 'fringe benefit' established in the case of *Essenbourne*.[35]

4.29 Secondly, the Tax Office has also not applied the results of certain court decisions that have altered a previous Tax Office view until that view has been formally changed. This process can take many months or even years. It is also continuing to adhere to previous rulings in litigation where the views expressed in the relevant rulings can no longer be defended because of court decisions. Examples of where both these results have occurred are firstly, in respect of the case of *Marana*[36] and secondly, in the application of the *Marana* decision to other AAT cases impacted by *Marana*.

4.30 Thirdly, the Tax Office has not treated a Full Federal Court decision in favour of a taxpayer as having any precedential significance, as in the cases of *Metal*

---

34 Michael D'Ascenzo and Steve Martin, *A unique taxation partnership for the benefit of the Australian community*, ATO/AGS/Counsel Workshop, 3 April 2004.

35 *Essenbourne Pty Limited v Commissioner of Taxation* (2002) FCA 1577 (17 December 2002).

36 *Marana Holdings Pty Ltd v Commissioner of Taxation* (2004) FCAFC 307 (25 November 2004); *Marana Holdings Pty Ltd v Commissioner of Taxation* (2004) FCA 233 (15 March 2004)

Manufactures and *Eastern Nitrogen*[37], for example, by promptly updating rulings to reflect the results of these decisions.

4.31 Fourthly, approximately 38 per cent of the total test case litigation program funds expended over the ten year life of the program have been used to fund two cases where the primary purpose in funding was to achieve a compliance outcome, that is, to assist the Tax Office to enforce the law, rather than to clarify the law. Neither of these cases was approved for funding in accordance with the principles which apply under the formal test case program.

4.32 Finally, the Tax Office has settled a number of 'test cases' once it was advised it was likely to lose them. For example, a number of cases were selected as test cases by the Tax Office to consider the application of the income tax anti-avoidance provision (Part IVA of the ITAA 1936) to the alienation of personal services income. After receiving external advice that the Tax Office was likely to lose the Part IVA argument in these cases, the Tax Office settled or did not proceed with four cases out of the total 12 selected for test case funding. The Tax Office indicated that it did so because it wanted to ensure that no Part IVA case it proceeds with detracts from the result reached in the High Court decision in *Hart*.[38]

4.33 Another indicator of the emphasis given by the Tax Office to the compliance aim of litigation is that, for internal management purposes, tax litigation is currently part of the Tax Office's Compliance sub-plan. However, since this review began, the Tax Office has announced the creation of a Law sub-plan which may include litigation.

4.34 The above comments lead to the following key finding:

KEY FINDING 4.1

The Tax Office's principal philosophy on litigation is that it is a means of validating the Tax Office view and ensuring that taxpayers comply with its view of the law. This compliance aim for litigation is, in certain circumstances, overriding its involvement in activities which may lead to law clarification. These features of the Tax Office's conduct, when coupled with the absence of cost/benefit approaches by the Tax Office in terms of assessing the benefits of litigation against the total internal and external costs of litigated cases, mean that community perceptions that, at times, the Tax Office has a 'win at all costs' approach to litigation are justified.

37 *Commissioner of Taxation v Metal Manufactures Ltd* (2001) FCA 365 (3 April 2001); *Metal Manufactures Ltd v Commissioner of Taxation* (1999) FCA 1712 (8 December 1999) and *Eastern Nitrogen Ltd v Commissioner of Taxation* (2001) FCA 366 (3 April 2001); *Eastern Nitrogen Ltd v Commissioner of Taxation* (1999) FCA 1536 (5 November 1999). A more detailed discussion of the Tax Office's approach in these cases may be found at Chapter 7 of this report.

38 *FCT v Hart* (2004) 55 ATR 712

Tax Office conduct in applying the outcomes of finalised court decisions

4.35 Submissions to this review have expressed concern that the Tax Office, in some significant cases does not administer the tax system in line with court decisions and that in doing so the Tax Office is not acting in accordance with the principles of the rule of law. Under these principles, all authority is subject to, and constrained by, law and both taxpayers and the Commissioner are bound by finalised decisions of the courts.[39]

4.36 The Tax Office, however, has stated in the course of this review that it always has and always will give effect to the statutes and to the decisions of courts and tribunals.

4.37 The Inspector-General has found no evidence to suggest that the Tax Office does not give effect to the results of a litigated case as regards the particular taxpayer who has initiated the case. However there is a concern as to whether the Tax Office is prepared to act, has acted, or has given rise to perceptions that it has acted, in ways which inappropriately (unjustifiably) limit the application of a court decision which has gone against the Tax Office.

4.38 The Tax Office has advised in the course of this review that there are a small number of cases where it '… does not automatically follow the decisions of courts and tribunals'. The Tax Office advises that it would only take this course where it'… feels obliged to do so to protect the intention of the Parliament'.

4.39 The Inspector-General considers that protecting the intention of the Parliament or the Tax Office's own understanding of the policy of the law should not become a law in itself; the Tax Office should be independent and guided by the rule of law principles.

4.40 There are also other public Tax Office statements that refer to '… loopholes created by the courts…', or the courts making 'wrong' decisions, or statements that specific court decisions are not correct.

4.41 For example, in the case of *Essenbourne* the Tax Office has publicly stated the Federal Court's construction of the fringe benefit tax provisions is not correct and is inconsistent with the Tax Office's understanding of the intent of the fringe benefit tax law.

4.42 Submissions to this review have given other examples of cases where there are strong perceptions that the Tax Office has ignored the decisions of courts and tribunals in its administration. These cases are discussed in more detail in Chapter 7.

4.43 The Inspector-General considers that statements and actions of this nature by the Tax Office are sufficient to raise and justify the perceptions raised in submissions to this review.

---

39 Gleeson, M, *Courts and the Rule of Law*, Melbourne University, 7 November, 2001. Available at http://www.hcourt.gov.au/speeches/cj/cj_ruleoflaw.htm.

4.44 In the course of this review the Tax Office has sought to minimise the validity of these conclusions on the basis that they are based on only a handful of examples, a small proportion of the whole.

4.45 The Inspector-General does not doubt that in the vast majority of cases the Tax Office acts consistently with the principles embodied in the rule of law. However, there are a handful of significant cases where the Inspector-General believes that perceptions that the Tax Office has departed from these principles are justified.

4.46 In the continuing absence of a clear public statement about its philosophy on litigation, perceptions that the Tax Office's management of its litigation program is overly susceptible to influence by its compliance culture and by its view of underlying policy will continue to grow. In turn and over time, these perceptions will continue to undermine the integrity of tax administration.

4.47 Also, the principle that taxpayers and the Tax Office are bound by decisions of the courts does not preclude the Tax Office from continuing to test the law, where appropriate, through appeals or providing advice to the Government on law reform. However, the desire to continue to test the law should not mean that the Tax Office administers the tax laws by ignoring decisions it believes are 'incorrect' or 'inconsistent with the Tax Office's understanding of the intent of the law'.

What should the Tax Office's philosophy on litigation be and how should this philosophy be communicated?

4.48 The Inspector-General considers that the Tax Office needs to publicly state its philosophy on litigation. This statement should provide clear guidance on how it serves to advance the Tax Office's role in the tax system as an independent and impartial administrator. Public recognition by the Tax Office of rule of law principles is crucial to community acceptance of the Tax Office as a fair administrator and also to community acceptance of the general role of taxation and of the fairness of the tax system.

4.49 This statement should also cover the Tax Office's approach to litigation. As discussed later in this chapter, this approach is also not evidenced in any public statement.

4.50 A formal, consolidated public statement is needed to reinforce an appropriate culture within the Tax Office and provide guidance and direction to Tax Office staff on what should be the Tax Office's philosophy on litigation. This statement could also act as a yardstick to measure Tax Office performance and set out clear and appropriate expectations for the community on Tax Office litigation.

4.51 The Inspector-General's view is that the Tax Office's formal public statement on litigation should affirm that the primary aim of tax litigation is to resolve a dispute in a fair, timely and cost effective manner. There should also be community consultation in the development of a published policy or guidelines on tax litigation.

4.52 In this document the Tax Office should also affirm its commitment to administer the tax laws, as enacted by Parliament and interpreted by the courts, in an impartial and transparent manner. The Tax Office should also affirm that it will follow the results of finalised court decisions in other similar cases.

4.53 There are differing views in the community on the extent to which the Tax Office should follow finalised court decisions in all situations and whether a failure to follow such decisions in all situations amounts to a breach of the principles of the rule of law.

4.54 These views range from views that a failure to follow finalised court decisions is not justified in any circumstances through to views that failing to follow finalised court decisions is permissible provided certain conditions are met.

4.55 Just prior to the finalisation of this review, when providing its response to this report, the Tax Office provided the Inspector-General with a joint opinion from the Solicitor-General and Australian Government Solicitor's Chief General Counsel on the issue of whether the Tax Office can challenge a previous finalised judicial decision and the circumstances in which it can do so. This joint opinion, together with a further opinion from the Acting Solicitor-General in relation to it, are set out in Appendix 4 of this report.

4.56 The joint Solicitor-General and Chief General Counsel's opinion is an opinion on what constitutes good administration, rather than a matter of strict law. The opinion refers to the rules of precedent[40] and notes that it would usually be inappropriate and unwise for an administrative decision maker to depart from decisions of single judges or of higher courts. Subject to following the rules of precedent, the opinion appears to confirm that there is no legal impediment to the Tax Office resisting a finalised court decision in rare and exceptional circumstances. It states that, if the Tax Office considers that a finalised court decision is wrong, it may challenge that decision in a subsequent case provided certain conditions are met. These conditions are:

- that the Tax Office has credible and robust legal advice (which will withstand public scrutiny) that the court's interpretation is wrong;
- that the challenge is made as soon as possible;
- that those affected by the challenge are advised of the Tax Office's proposed course of action;
- that the Tax Office must take steps to avoid any suggestion that the challenge will unduly burden or prejudice individual taxpayers, and must therefore fund or organise suitable assistance to bring a test case on the issue; and
- that the challenge must not be made just because, as matter of policy, the Tax Office considers that the decision in the case is wrong or undesirable.

---

40 As a matter of precedent:
(a) single judges must follow the principles established by decisions of Full Courts (that is, of courts superior to them in the appellate hierarchy);
(b) single judges should as a matter of comity follow the decisions of other single judges if they are in point, unless they are clearly persuaded that the other decision is wrong (whether the other decision is distinguishable is another matter);
(c) full Federal courts must follow decisions of a full bench of the High Court if in point;
(d) full Federal courts should follow previous full court decisions unless clearly satisfied the earlier decision is plainly wrong; and
(e) the High Court can depart from its own decisions in limited circumstances.

4.57 The Inspector-General has not sought to resolve the debate on whether the Commissioner should challenge finalised court decisions and, if he does so, the circumstances in which this can be done. The Inspector-General considers that this matter is worthy of further debate including in a broader context than the tax system and this review.

4.58 However, the Inspector-General has found during this review that the Tax Office's conduct in this area has not, in relevant cases, met all the strict conditions for making such a challenge that have currently been formulated by the Solicitor-General and Chief General Counsel. Examples include the following:

- The Commissioner has provided no evidence to this review which indicates that he sought to provide test case funding for any of the cases which were litigated subsequent to *Essenbourne* where he sought to re-argue his view contrary to *Essenbourne.*

- The Commissioner's decision to challenge the interpretation in *Essenbourne* in subsequent cases was because the Tax Office believed that there was an alternative view that was more consistent with its understanding of the policy intent of the law.

- The Commissioner did not seek or receive written legal advice as to whether the decision in *Essenbourne* should be challenged generally in other cases.

4.59 The Tax Office's conduct in this area has therefore amounted to poor administration and has led to legitimate negative community perceptions of its behaviour.

4.60 The above comments lead to the following key findings and recommendations:

KEY FINDING 4.2

There is no formal, consolidated public statement by the Tax Office on its corporate philosophy towards tax litigation. In the continuing absence of such a statement, perceptions that the Tax Office's management of its litigation program is overly susceptible to influence by its compliance culture and by its view of underlying policy will continue to grow. Community perceptions have arisen that the Tax Office is using litigation to confirm its view of the law for compliance purposes rather than to clarify the law.

KEY FINDING 4.3

The Inspector-General finds that a formal, consolidated public statement is needed to provide community confidence, and appropriate guidance and direction to Tax Office staff on the Tax Office's philosophy on litigation. This statement should state that the primary aim of litigation is to resolve a dispute in a fair, timely and cost effective manner. The statement should confirm that the Tax Office's philosophy and approach to litigation is consistent with its role in the tax system as an independent and impartial administrator and that it is committed to administering the tax system in line with the rule of law. The statement should also re-affirm the Tax Office's role in relation to and distinct from the roles of Government, Parliament and the Judiciary.

KEY FINDING 4.4

The Tax Office has stated on a number of occasions that it is prepared to not follow decisions of the courts or tribunals in other similar cases where it believes it is obliged to take steps to protect the intention of Parliament. It has also acted on this policy in a number of cases. The Inspector-General believes that these actions and statements by the Tax Office provide a basis for the perception that the Tax Office is prepared to act, and in some cases has acted, outside the rule of law.

KEY FINDING 4.5

There are differing views in the community on the extent to which the Tax Office should follow finalised court decisions in all situations and whether a failure to follow such decisions in all situations amounts to a breach of the principles of the rule of law.

These views range from views that a failure to follow finalised court decisions is not justified in any circumstances through to views that failing to follow finalised court decisions is permissible provided certain conditions are met.

The Inspector-General has not sought to resolve the debate on whether the Commissioner should challenge finalised court decisions and, if he does so, the circumstances in which this can be done. The Inspector-General considers that this matter is worthy of further debate including in a broader context than the tax system and this review.

KEY FINDING 4.6

The Tax Office has received an opinion from the Solicitor-General and from the Australian Government Solicitor's Chief General Counsel which sets out that the following five conditions need to be met before the Tax Office can challenge a finalised court decision which it considers to be wrong:

- that the Tax Office has credible and robust legal advice that the court's interpretation is wrong;
- that the challenge is made as soon as possible;
- that those affected by the challenge are advised of the Tax Office's proposed course of action;
- that the Tax Office must take steps to avoid any suggestion that the challenge will unduly burden or prejudice individual taxpayers and must therefore fund or organise suitable assistance to bring a test case on the issue; and
- that the challenge must not be made just because, as matter of policy, the Tax Office considers that the decision in the case is wrong or undesirable.

The Inspector-General has found during this review that the Tax Office's conduct in challenging finalised court decisions has not, in relevant cases, met all the above conditions.

KEY RECOMMENDATION 1

The Tax Office should clearly articulate its corporate philosophy and approach to litigation in a formal and consolidated published policy or guidelines on tax litigation, such as a Litigation Charter.

The Inspector-General considers that this document should state that the primary aim of litigation for the Tax Office is to resolve disputes in a fair, timely and cost effective manner, consistent with the rule of law.

There should also be community consultation in the development of a published policy or guidelines on tax litigation.

In this document the Tax Office should also affirm its commitment to administer the tax laws, as enacted by Parliament and interpreted by the courts, in an impartial and transparent manner. The Tax Office should also affirm that it will follow the results of finalised court decisions in other similar cases.

There should be wide community consultation in the development of any policy by the Tax Office on whether it should challenge finalised court decisions in certain circumstances. If the result of this process is that the Tax Office still considers that it will challenge finalised court decisions in certain circumstances then the Tax Office should clearly and fully articulate those circumstances and its associated processes in its formal published policy or guidelines on litigation.

Pending the development of any such policy regarding challenging finalised court decisions, and its publication in a formal consolidated set of guidelines on litigation, the Tax Office should publicly affirm that it will follow the results of finalised court decisions in accordance with the criteria which have been formulated by the Commonwealth Solicitor-General and Chief General Counsel.

Tax Office response

4.61 We will issue a practice statement on the Tax Office's approach to, and conduct of litigation, ensuring that it is consistent with Attorney-General directions relating to the conduct of litigation by the Commonwealth. We will consult with professional bodies in the development of the practice statement.

4.62 In relation to the question of whether the Commissioner should challenge finalised court decisions in certain circumstances, we have the benefit of the advice of the Solicitor-General and the Attorney-General's Chief General Counsel. That advice indicated that it may be appropriate in exceptional circumstances for the Tax Office to challenge an earlier decision which it considers to be wrong, where there is credible legal advice (including internal advice) to that effect. The advice also stated that the Tax Office should put those affected on notice of its view and it would normally be appropriate for the Tax Office to fund any further challenge.

4.63 The guidance provided by the advice will be set out in a proposed litigation practice statement.

Inspector-General's comments on Tax Office response

4.64 The Inspector-General considers that the Tax Office should accept and implement Key Recommendation 1 in full.

4.65 While the Tax Office's proposal to develop a practice statement on litigation is a positive step, the Inspector-General's recommendation actually refers to a document being developed which is in a form similar to the existing Taxpayers' Charter. A litigation practice statement of the kind referred to in the Tax Office's response could supplement but should not be a substitute for a Charter-like document.

4.66 The Inspector-General considers that a document of higher status than a practice statement is needed to promote community confidence in the Tax Office's philosophy on litigation. The Inspector-General also believes that this document needs to contain a formal affirmation of the Tax Office's role in relation to litigation as distinct from the roles of Government, Parliament and the Judiciary. Consultation processes for this document (and any accompanying practice statement) also need to embrace the views of the wider community as well as those of the professional bodies.

TAX OFFICE'S APPROACH TO AND HANDLING OF LITIGATION

4.67 The nature of the Tax Office's approach to litigation is shaped by a number of factors. These include:

- the Tax Office's role in the tax system generally and in the tax litigation process specifically;
- the laws which govern tax dispute and litigation processes for tax objections and appeals; and
- the rules and guidelines which shape the Tax Office's behaviour as an Australian Government agency.

These factors have been described in preceding sections of this report.

4.68 Other factors which shape the Tax Office's approach to litigation are:

- its overall management structure for handling tax disputes; and
- the particular structure it has adopted for managing disputes which involve litigation.

4.69 This section firstly describes these two factors and then discusses in further detail the nature of the Tax Office's approach to litigation.

Tax Office's overall management structure for disputes with taxpayers

4.70 For the purposes of managing tax disputes with taxpayers, the Tax Office is organised into a number of separate 'business lines' and other areas which are designated as 'strategic partners' to its business lines. The business lines which are involved in tax disputes (including litigation) and their areas of responsibility are:

- Large Business and International (LBI) which is responsible for tax issues (including disputes) which affect large corporate taxpayers or groups with a turnover of $100 million or more;
- Small Business (SB) which is responsible for tax disputes involving small business taxpayers with a turnover of less than $100 million;
- Personal Tax (PTax) which is responsible for tax disputes affecting individual taxpayers;
- Goods and Services Tax (GST) which handles all disputes involving goods and services tax; and
- Superannuation (Super) which handles tax disputes which affect superannuation funds. This area also handles disputes involving superannuation guarantee charge and superannuation surcharge issues.

4.71 The areas which are designated as 'strategic partners' which are involved in tax disputes (including litigation) are:

- the Tax Counsel Network. Members of this network are the Tax Office's most senior technical staff. However, despite their title, they are not always legally trained nor are they always involved in tax litigation;
- the Serious Non Compliance area, whose role is to investigate tax disputes which give rise to compliance issues which the Tax Office considers to be the most extreme or blatant;
- the Operations area, which is responsible for the management of tax debt in dispute; and
- the Aggressive Tax Planning area, which is responsible for most tax disputes (including litigation) which involve the application of the general anti avoidance provision of the tax laws (Part IVA).

4.72 The Tax Office's in-house legal area, the Legal Services Branch (LSB), is currently located within the Office of the Chief Tax Counsel. The LSB area is not part of the Tax Counsel Network as the Tax Counsel Network reports to a Second Commissioner and not to the Office of the Chief Tax Counsel.

Tax Office's structures for managing litigation

Structures in place prior to 2004

4.73 Up to 1999, the Tax Office had no area within its organisation that acted as a central coordinator of all the litigation to which the Tax Office was a party. In this period, the Tax Office's business lines and/or partner areas were responsible for conducting their own litigation and they created their own separate approaches (including policies and procedures) for this purpose.

4.74 In 1999 a separate internal legal practice was established within the Tax Office, called the Legal Practice.

4.75 The role of the new Legal Practice was to work in partnership with the Tax Office's business lines and strategic partner areas. These lines and areas would retain ownership of litigated cases, responsibility for determining the Tax Office view, legal argument and the gathering of all factual and evidentiary material.

4.76 The Legal Practice was to control the quality of the Tax Office legal position. It was to provide quality feedback to the business lines and other areas on their decision-making processes and assist them in bringing about continuous improvements in their processes, thereby producing cost savings in litigation.

Changes adopted after 2004

4.77 In 2003 the Tax Office conducted an internal review of its management structure for litigation. This review (the Behm report), which is discussed in further detail in the next chapter, concluded that the Tax Office's Legal Practice had not achieved its intended purposes.

4.78 The Behm report canvassed a number of options, including the abolition of a centralised legal area within the Tax Office with all litigation (and debt recovery work) being outsourced to the Australian Government Solicitor. However, this option was considered unworkable, as there was a continuing need for the Commissioner to manage, within his own organisation, the legal risks associated with his role as a collector of revenue.

4.79 The option selected was a new organisational structure under which the Tax Office's Legal Practice would retain its administrative function in relation to litigation, but in a reshaped form.

4.80 Under this new organisational structure, which was implemented in early 2004, the Tax Office's Legal Practice was abolished, and replaced by the Legal Services Branch which is located within the Office of the Chief Tax Counsel.

Present organisational structure for litigation management

4.81 The present roles of each area of the Tax Office which is involved in litigation are now set out in PS LA 2005/22, which was released during the course of this review.

4.82 Under this practice statement, there is no one area of the Tax Office that is responsible for handling all aspects of a litigated case. The division of litigation roles

within the Tax Office depends principally on whether a case involves a priority technical issue.

4.83 Priority technical issue cases are cases that involve a technical issue that has been assessed as having a certain priority status by the relevant Tax Office business line responsible for the case.

4.84 The Tax Office has indicated that the following cases will generally be priority technical issues cases:

- proceedings involving the application of general anti avoidance provisions. This will generally include all cases involving the Aggressive Tax Planning area of the Tax Office;
- cases where test case funding has been granted;
- cases involving $50 million or more of revenue;
- all appeals to the Full Federal Court and all cases that involve or are likely to involve the High Court; and
- cases that:
  - are likely to attract media interest;
  - involve a challenge to a Tax Office view (including cases where it may be perceived that the Tax Office is arguing against its own views);
  - result in the Tax Office receiving external advice that the underlying legislation is defective; or
  - may have serious consequences for tax administration.

4.85 Under PS LA 2005/22, the roles of each of the main areas of the Tax Office which are involved in tax litigation are now as follows:

Business lines and Aggressive Tax Planning area

4.86 These areas are responsible for managing the risks associated with a case and dependent cases. Throughout the litigation process the business lines retain ownership of the case and are ultimately responsible for determining the desired outcome of the litigation. Their role involves:

- at the outset of the litigation, the identification of whether the case involves a priority technical issue;
- development of the Tax Office position on the issues to be litigated and the arguments to be run (both subject to relevant escalation processes within the Tax Office);
- the gathering of evidence;
- the management of the ongoing relationship with the opposing party; and

- the development of a strategy to explain and manage the implications of any resulting court decisions and the associated compliance impact.

Legal Services Branch (LSB)

4.87 The LSB area is responsible for acquiring and/or providing the legal services required by the Tax Office to litigate cases. It is the conduit for the exchange of information between the Tax Office, and AGS and Counsel and also acts as a liaison point for all internal Tax Office areas that are involved in litigation.

Tax Counsel Network

4.88 Members of the Tax Counsel Network are to be involved in all priority technical issues cases. Where they are involved in any case, they are to have the final say on technical arguments run in the case. In effect, this often means that Tax Counsel will have a significant influence over which cases proceed to hearing and which cases are resolved.

Decisions to appeal

4.89 Decisions to appeal a case which is adverse to the Tax Office will be made either by a Deputy Chief Tax Counsel or by the senior executive who is in charge of the Aggressive Tax Planning area.

Stakeholder concerns on the Tax Office's overall approach to litigation

4.90 Stakeholders have raised the following concerns with the Tax Office's approach to and handling of tax litigation.

4.91 Firstly, a number of submissions noted that there was no clear public statement by the Tax Office as to its approach to litigation.

4.92 Secondly, submissions stated that the Tax Office pursues cases that it will not win. Submissions offered differing views on the extent to which this occurred.

4.93 A number of submissions noted that these types of cases occur only relatively rarely. One submission stated that a case of this nature can be appropriate where the aim of the case is to clarify the law or to establish that the law does not operate in the manner assumed by the Tax Office and that a legislative amendment is required. However, this submission noted that these types of cases appeared to be less justified in the following two types of cases:

- where the case is pursued because either an ATO officer or business line has developed an immutable view of the law which it is unwilling to abandon despite external counsel's advice to do so; and

- where the case is pursued because the taxpayer is regarded by the Tax Office or tax officer conducting the case as engaging in undesirable behaviour and the Tax Office considers that the pursuit of the case will impede this behaviour.

4.94 Other submissions suggested that these types of 'hopeless' cases occurred more often.

4.95 Thirdly, a number of submissions, particularly from Bar Associations with members who have acted for the Tax Office, asserted that many disputes are reaching the litigation stage without a proper identification of facts, evidence, issues and application of the law being made earlier in the dispute process. This was a major theme in these submissions.

4.96 Fourthly, submissions have stated that the Tax Office has a fragmented and ad hoc approach to the handling of litigation with no one area responsible for all aspects of objectively resolving the dispute once it proceeds to litigation. Several submissions have raised concerns that the current fragmented approach to litigation means that:

- there is often no one Tax Office person whom the taxpayer or their legal representatives can interface with who is able to make timely and final decisions which may resolve a case; and

- if there is a key Tax Office decision maker on a case, that decision maker is unable to make an independent, objective decision on the case, because of their prior involvement.

4.97 Fifthly, submissions have stated that the Tax Office's litigation approach is compliance driven, that compliance views can dominate litigation decisions and strategy and that there is no independent and objective review of a dispute once a case proceeds to litigation. These submissions state that these features of the Tax Office's approach are leading to unnecessary litigation.

4.98 For example, one submission referred to a protracted court case involving a sales tax matter that was ultimately won by the taxpayer. The submission asserted that this litigation could have been prevented if the factual evidence gathered by the Tax Office for the case and underlying technical arguments had been subject to an 'independent' review prior to the case proceeding.

4.99 Sixth, submissions have raised concerns that the Tax Office's conduct in litigated cases was sometimes (or many times) in breach of the Attorney-General's model litigant guidelines. Submissions noted that there were also no penalties for breaching these guidelines.

4.100 Pursuing a case that cannot be won is an example of conduct that is prohibited by these guidelines. Submissions raised the following other examples of cases where the Tax Office had engaged in this type of prohibited conduct:

- cases involving long delays;

- cases where the Tax Office had not acted consistently;

- cases where the Tax Office had not made any effort to resolve the dispute outside the litigation process, for example through mediation or other alternative dispute resolution mechanisms;

- cases where the Tax Office had mishandled cases leading to unnecessary additional litigation costs for both parties to the litigation;

- cases where the Tax Office had taken advantage of taxpayers who did not have the same resources to pursue litigation;

- cases where the Tax Office had relied on technical defences; and
- cases where the Tax Office had refused to apologise for wrongdoing.

4.101 Appendix 7 provides further details of cases involving possible breaches of the model litigant guidelines that were provided in submissions.

4.102 Several submissions suggested that one reason that the above types of cases have arisen is because Tax Office staff are not trained in the model litigant principles.

4.103 A number of other submissions questioned the existence and/or severity of the alleged breaches of the model litigant guidelines outlined in the preceding paragraphs. One representative body submission noted that, in tax litigation, taxpayers and their representatives are not themselves bound by any model litigant guidelines and that taxpayers who engage in non-model litigant behaviour can be the most vocal complainants about similar Tax Office behaviour.

4.104 The Commonwealth Ombudsman in his submission for this review noted that he had received only a very small number of complaints on the Tax Office's conduct in litigation. However, the Ombudsman also noted that this could be because he is reluctant, because of the statutory provisions that govern his powers, and for public policy considerations, to investigate a complaint concerning Tax Office conduct in litigation if the matter is properly one that should be left to a court or tribunal to determine.

4.105 The seventh broad area of concern raised in submissions was that the Tax Office withholds information from taxpayers involved in a litigated dispute.

4.106 The eighth broad area of concern was on the subject of rulings and other written statements of Tax Office policy. A number of submissions stated that the Tax Office had a tendency to adhere to rulings and practice statements during litigation even where the advice of its external counsel was that those rulings and statements were not correct. Other submissions stated that, at times, the Tax Office departs from its previous rulings and practice statements during litigation.

4.107 The ninth concern was that the Tax Office could conduct 'smear' campaigns against its opponents in litigation. One example provided under this heading is the Tax Office's behaviour with respect to taxpayers involved in certain mass marketed tax effective schemes.

4.108 The topic of smear campaigns being conducted by government bodies against opposing litigants was being investigated during the course of this review by the Attorney-General's Department as part of its review of the Legal Services Directions. This matter has therefore not been examined during the course of this review.

4.109 A number of submissions also raised serious concerns in relation to the Tax Office's practices for the recovery of tax that is the subject of a litigated dispute, including its practices in debt recovery litigation. Submissions asserted that these practices are wasteful and oppressive. They asserted that there was a laxity in the administration of tax collection, inflexibility in dealing with the individual circumstances of different taxpayers, a failure by the Tax Office to appreciate the commercial consequences of its actions and oppressive reliance on certain conclusive proof provisions.

4.110 The Tax Office's approaches in this area are set out in the *ATO Receivables Policy*.

4.111 This review has not examined these last concerns relating to the recovery of tax, except to the extent that they relate to the Tax Office's adherence to the model litigant rules. However, these concerns may be the subject of a future review by the Inspector-General.

4.112 A number of submissions also raised concerns about the Tax Office's practices that relate to the prosecution of taxpayers for matters that are also the subject of Part IVC litigation. These practices are outside the terms of reference of this review, but may be examined by the Inspector-General at a later date.

4.113 The Inspector-General's findings in relation to the eight stakeholder concerns examined for the purposes of this review, and in relation to other concerns about the Tax Office's approach to litigation that have arisen as a result of this review, are set out below.

Absence of comprehensive Tax Office statement on its litigation approach

4.114 The Tax Office's approach to litigation, and the documentation surrounding its approach, are dependent upon whether the litigation involves a priority technical issue (PTI). Although the Tax Office has release a specific practice statement outlining its approach to PTI litigation, this review has confirmed that there is no formal, complete and consolidated statement on the Tax Office's approach to tax litigation.

4.115 Broadly, the Tax Office's approach to litigation is partly contained in the same set of documents listed earlier in this chapter, which set out certain elements of its philosophy on litigation. However, in addition to the documents listed earlier in this chapter, the following documents are relevant for determining the Tax Office's approach to litigation:

- the Tax Office's Access Guidelines;
- a number of specific practice statements (including PS LA 2005/22);
- a draft practice statement on the Tax Office's approach to adverse court and tribunal decisions; and
- service agreements between LSB and the business lines.

4.116 Appendix 8 contains a list of the publicly available practice statements that are relevant to the Tax Office's approach to litigation.

Tax Office approach to priority technical issue cases

4.117 The Tax Office has developed processes and procedures to identify and handle litigation involving priority technical issues, referred to by the Tax Office as PTI litigation. These processes are now embodied in PS LA 2005/22 that was released during the course of this review.

4.118 All PTI litigation cases are subject to the following processes within the Tax Office:

- At the commencement of the litigation process, each business line must assess whether a case gives rise to a priority technical issue and must follow internal Tax Office processes, which are set out in PS LA 2003/10, to have that case classified as a priority technical issue case.
- All PTI litigation cases are subject to internal review in the form of Strategic Litigation Callovers, which are held every six months. All officers involved in the case, including the LSB case officer, Tax Counsel and the business line representative, attend these callovers. The callover panel includes the Senior Tax Counsel (Strategic Litigation) and the Part IVC Litigation Stream Leader.
- The litigation is tracked against the recorded technical issue on an internal PTI register, as the litigation is expected to clarify the law in relation to the issue. This register is reviewed by a Priority Technical Issue Committee, which is chaired by a Second Commissioner.

4.119 In addition, the most strategically important of priority technical issue cases are separately identified and are managed by a strategic litigation team within the Tax Office's Legal Services Branch (LSB). All other priority technical litigation and strategic cases are managed elsewhere in the LSB, but are monitored by the strategic litigation team.

Tax Office approach to cases which do not involve PTI issues

4.120 There is no formal and consolidated Tax Office statement that outlines the processes and procedures that Tax Office staff are to apply to handle litigated cases that do not involve priority technical issues.

4.121 Currently, the Tax Office only has processes and procedures to deal with specific aspects of such cases, such as the handling of finalised decisions.

4.122 Each of the Tax Office's business lines has also adopted a different approach for handling this type of litigation. These approaches are discussed in detail in the next chapter. They vary markedly, particularly in the degree to which they involve a review within each business line by an officer who has not been previously involved in the case.

4.123 The Inspector-General is of the view that there would be benefit to both staff and the community if the Tax Office's approach to cases that do not involve PTI issues were also consolidated in a formal document such as a practice statement.

Improving Tax Office internal processes to ensure cases are resolved prior to litigation

4.124 Submissions from legal practitioners have raised concerns with the Tax Office's conduct of litigation, in particular about how the Tax Office identifies technical issues and how it identifies and collects the relevant facts and evidence. Submissions noted that these processes must begin at the very earliest stage that the Tax Office deals with a taxpayer in relation to the application of the relevant taxation laws.

4.125 The Legal Services Directions impose an obligation on the Commonwealth and its agencies to act honestly and fairly in handling claims and litigation brought by or against the Commonwealth or an agency by endeavouring to avoid litigation, wherever possible. In the Inspector-General's view this obligation, for the purposes of good taxation administration, should be interpreted to broadly apply to the litigation process as well as the internal dispute processes within the Tax Office (the upstream processes) that lead to litigation. The Tax Office, through these upstream processes, should ensure the precise identification of the relevant facts and the legal principles involved and in dispute between the parties at the earliest possible stage.

4.126 As a result of evidence gathered during the course of this review, the Inspector-General considers that the majority of disputes leading to Part IVC litigation are appropriately concluded by the Tax Office. However, the Inspector-General shares the concerns expressed in submissions regarding the timeliness in identifying the technical issues and identifying and collecting the facts and evidence required to resolve the dispute. The nature of this evidence is set out below.

4.127 Information from the AAT indicates that a large proportion of the applications for review of tax decisions in the Tribunal, approximately 88 per cent, are finalised without a hearing. The Inspector-General considers that it is appropriate for the Tax Office to settle litigated disputes in suitable cases, and that the high percentage of settled cases suggests that the majority of Part IVC appeal cases are appropriately concluded by the Tax Office.

4.128 However, of those applications that are finalised without a hearing approximately 70 per cent result in the decision being set aside or varied, with the majority of the remaining applications either being dismissed or withdrawn.[41]

4.129 An examination by staff of the Inspector-General of a small sample of cases that were resolved by way of a settlement between the parties indicated that a significant proportion of these cases were settled wholly in favour of taxpayers by the objection being allowed in full.[42] This suggests that a significant percentage of the tax cases which reach the litigation stage could have been resolved at an earlier stage. In the Inspector-General's view this could be due to a number of reasons. It could be due to information relevant to the dispute not being sought by the Tax Office earlier in the dispute resolution process or a taxpayer not providing the Tax Office with requested information until the dispute proceeds to litigation. It could also be due to the wrong technical issues being raised by taxpayers' advisers or the Tax Office. The Inspector-General has not sought to examine in greater detail these observations. However they suggest that the earlier stages of the tax dispute process may not be wholly effective in the timely resolution of disputes and may warrant further review.

4.130 During this review, the Inspector-General was also provided with a copy of internal feedback made by LSB staff to the Tax Office's business lines. This feedback highlighted problems with the upstream processes. This feedback raised concerns

41 The average percentage is influenced by the large number of mass marketed tax arrangement cases finalised in 2002/03 and 2003/04. If these two years are excluded, the average percentage of applications for review of tax decisions finalised without a hearing resulting in the Tax Office decision at objection being set aside or varied falls from 70 per cent to 63 per cent.

42 The Inspector-General examined a total of 37 cases that were resolved by agreement between the parties in the AAT. Of those 37, the objection was allowed in full in 20 cases with 16 cases where the objection was allowed in part and 1 case where the taxpayer withdrew the application for review.

about the business lines not identifying the relevant facts, not referencing identified facts to the evidence, not gathering the appropriate evidence, making inappropriate assumptions and assertions in audit and objection decisions and not gathering all the relevant facts and information.

4.131 An examination of sampled case files by staff of the Inspector-General also revealed that, in a significant number of cases, LSB officers were often required to seek additional information from taxpayers or their advisers at the litigation stage. This was required to allow the business line officers and Tax Counsel, where necessary, to make an informed decision on how to proceed with the dispute. In the Inspector-General's view this could indicate:

- that information relevant to the dispute has not been sought earlier in the dispute resolution process (at the audit and objection stages) so as to allow the dispute to be properly considered. This could be due to auditors/review officers not asking relevant questions, not using their information-gathering powers or over-reliance on the burden of proof provisions;

- that taxpayers are not providing the Tax Office with relevant information until the dispute proceeds to litigation; or

- that wrong technical issues have been raised by taxpayers' advisers or by the Tax Office.

4.132 The examination of sampled case files also indicated that, where the dispute was settled or conceded by the Tax Office after the commencement of litigation, a significant proportion involved escalation of the technical view or a reconsideration of the application of the law to the facts. This could be due to a number of factors, including those listed above.

4.133 The Tax Office has quality control procedures for objection decisions (called the Technical Quality Review) but these do not adequately test the correctness of the facts relied on for the decision or whether the facts are supported by evidence. The Compliance TQR tests whether the decisions on technical issues were convincing and supported by the facts. The Dispute TQR tests whether the relevant facts were gathered. An examination of sampled case files indicated that for disputes settled at litigation either the facts were not correct or there was inadequate evidence to support the facts as set out in the objection decision.

4.134 The Inspector-General believes that the concerns expressed by submissions and the validation of the concerns through an analysis of information from the AAT and the Inspector-General's own fieldwork suggest that the objection/dispute resolution processes framework and the Tax Office's approach and conduct in relation to objections are areas warranting further review.

Absence of a single Tax Office area with overall responsibility for reviewing and/or resolving a dispute

4.135 As stated elsewhere in this report, submissions have asserted that Tax Office litigation is compliance driven and that compliance views can dominate litigation decisions and strategy. Submissions have also asserted that there is no independent internal review of a dispute once a case proceeds to litigation.

4.136 These perceptions are supported by evidence that has been gathered during the course of this review, including the Tax Office's detailed internal management policies and procedures for litigation that are discussed in detail in the next chapter.

4.137 Key decisions on whether to engage in litigation or on the need for external counsel rest with the Tax Office's business lines, and are open to strong influence by their strong compliance culture. There is also evidence of tension between compliance views and TCN escalating to the point where competing external legal opinions may be sought.

4.138 As previously discussed, the Tax Office's structure for managing litigation involves people from three different areas within the Tax Office, all of whom have varying degrees of involvement in the case. In addition to these three areas, the Operations area of the Tax Office also has a separate responsibility for the management of the tax debt that is subject to litigation. The Tax Office considers that the involvement of TCN, LSB and the business lines ensures that the case is reviewed thoroughly with the appropriate level of technical and litigation expertise.

4.139 However, the division of management responsibilities for litigated disputes between at least three different areas of the Tax Office means that there is no one person or area which has overall responsibility for managing all issues (that is, both technical and procedural) for any one case and no one person on a case team who exercises an independent oversight role.

4.140 The LSB area does not perform either of these roles, even for priority technical issues cases, as confirmed in PS LA 2005/22. The role of LSB is discussed further in the next chapter, but for practical purposes appears largely to be reduced to procedural aspects of the litigation including compiling correct documentation, preparing draft documents for sign-off from business line officers and Tax Counsel, scheduling arrangements and giving effect to business line decisions on, for example, the need for external counsel or to gather additional information or evidence. In addition, where there is a disagreement between the LSB officer, the business line officer and, where relevant, Tax Counsel regarding technical or procedural issues related to the litigation then these must be escalated to the respective managers and stream leaders.

4.141 The Inspector-General believes that the ability for an LSB officer to escalate a concern with the progress of a case or the approach being adopted in litigation does not amount to an internal review function.

4.142 Where a case involves a priority technical issue, then TCN is responsible for the conduct of the litigation including forming the Tax Office view and settling court and tribunal documents including statements of facts, issues and contentions and submissions to be made during the hearing.

4.143 Where the case does not involve a priority technical issue then the business line determines the desired outcome of litigation.

4.144 Consistent with a litigation philosophy of objectively resolving disputes, when cases move into a litigation phase, judgments and decisions need to be made by people who have not previously been deeply involved in the matter. Current Tax Office arrangements for managing litigation do not adequately provide this objectivity.

4.145 The Inspector-General found that Tax Office arrangements do not provide an appropriate internal review mechanism once a case proceeds to litigation. These arrangements do not promote the LSB area having the function of providing an 'independent' review of the dispute once it proceeds to litigation. Nor do these arrangements promote a distinct culture, corporate goal and set of values, separate from those of the compliance areas. This has meant that the approach to litigation has been driven by the compliance area (that is, the business line) where the case originated, rather than by an approach which ensures that in all cases there is a fair, timely and cost effective resolution of the dispute.

4.146 Also, the absence of an internal review mechanism at the litigation stage, and a clear separation between the business lines and the Legal Services Branch, have reinforced the perceptions that Tax Office litigation is compliance driven and that compliance views can dominate litigation decisions and strategy.

4.147 Examination by staff of the Inspector-General of sampled case files also revealed little, if any, evidence on why a case was being litigated, even for some priority technical issues cases. This suggests uncertainty as to why litigation is being continued and uncertainty as to the role and functions of all areas of the Tax Office that are involved in litigation.

4.148 Fieldwork conducted by staff of the Inspector-General for the purposes of this review also indicates that there is little use by the Tax Office of mediation or other alternative dispute resolution processes. Revised model litigant guidelines which operate from 1 March 2006 and which are discussed in the next section of this chapter now specifically require government agencies to consider alternative dispute resolution before initiating legal proceedings and to participate in alternative dispute resolution processes where appropriate. These new guidelines should affect future Tax Office use of these processes.

4.149 The Inspector-General believes that there is a need for a single area within the Tax Office that is able to undertake an internal review of a business line's decision that has led to litigation. The Inspector-General is of the view that such an area is important in promoting community confidence in the appeals and review procedures and, more importantly, in providing an appropriate check on the conduct and approach of the compliance areas and business lines during audit and objection.

4.150 The above comments lead to the following key findings and recommendations:

KEY FINDING 4.7

The Tax Office has developed processes and procedures to identify and handle litigation involving priority technical issues. There is no formal and consolidated Tax Office statement that outlines the processes and procedures that Tax Office staff are to apply to handle litigated cases that do not involve priority technical issues.

KEY FINDING 4.8

The high percentage of settled Part IVC appeal cases suggest that the majority of these cases are appropriately concluded by the Tax Office.

KEY FINDING 4.9

A significant proportion of disputes are proceeding to the litigation stage without the proper identification of the technical issues, facts and evidence, only to be settled once the LSB officer, business line officer and, where necessary, Tax Counsel become involved.

KEY FINDING 4.10

Key decisions on whether to engage in litigation or on the need for external counsel rest with the Tax Office's business lines, and are open to strong influence by their strong compliance culture.

KEY FINDING 4.11

The Tax Office's structure for managing litigation involves people from at least three different areas within the Tax Office, all of whom have varying degrees of involvement in the case. There is no one person or area within the Tax Office which has overall responsibility for managing all issues (that is, both technical and procedural) for any one litigated case and no one person on a case team who exercises an independent oversight role.

KEY FINDING 4.12

The Tax Office has no area that is separate from its business lines that will review a dispute and whether litigation should be continued.

There is a need for an internal review procedure at the litigation stage, with one area responsible for all aspects of resolving a dispute, including technical and procedural issues, once it proceeds to litigation. Such an area should also promote and encourage a distinct culture, corporate goal and set of values, separate from those of the compliance areas.

KEY RECOMMENDATION 2

The Tax Office should establish management arrangements which give a single area of the Tax Office overall responsibility and authority for the management of all aspects of litigated cases.

Tax Office response

4.151 Agreed

4.152 We are reviewing our end-to-end processes for litigation to find efficiency and quality improvements. We will establish arrangements so that all decisions regarding litigated cases will be managed by the Office of the Chief Tax Counsel (OCTC) or the Tax Counsel Network.

4.153 In cases involving a Priority Technical Issue (PTI), the Tax Counsel Network will continue to decide the Tax Office's position.

4.154 In other cases, the Legal Services Branch (LSB) will be responsible for deciding the Tax Office's position. However, we will retain the existing processes through the Law Sub-plan whereby any differences of views on such matters can be quickly resolved through escalation.

4.155 In all cases, the Tax Office business lines will continue to be responsible for the risk ownership and mitigation strategies.

Tax Office adherence to model litigant guidelines

4.156 The Office of Legal Services Coordination (OLSC) has reported to the Inspector-General that the Tax Office is one of the better Australian Government agencies in terms of compliance with the rules and self-reporting any potential breaches.[43]

4.157 Members of the AAT and Federal Court that were interviewed for the purposes of this review also indicated that, from their perspective, the Tax Office generally acts as a model litigant, although there were some exceptions. However, as indicated earlier in this report, cases that are actually heard by the AAT or Federal Court represent only a small minority of all litigated cases.

4.158 The Tax Office has reported that from January 2005 to May 2005 only 24 cases involving litigation were referred to its internal complaints area. All of these complaints related to litigation concerning the Aggressive Tax Planning area. Of these cases 18 involved settlements and 6 involved ongoing disputes. The Ombudsman was involved in 8 of the 18 settlements and 2 of the 6 disputes. Of the 6 cases involving disputes, 4 had been finalised with one case recording a breach of the Taxpayers'

43 The Office of Legal Services Coordination (OLSC) is a branch of the Attorney-General's Department which is responsible for investigating and monitoring breaches of the Legal Services Directions, including the model litigant guidelines.

Charter. Of the 18 settlements, 7 had been finalised, with one case showing a breach of the Taxpayers' Charter.

4.159 Nevertheless, there are strong community perceptions that the Tax Office's approach and conduct is not consistent with the model litigant rules.

4.160 The Inspector-General believes that the existence of these perceptions is of concern and that there are grounds for these perceptions at least in some cases.

4.161 Firstly, there are significant shortcomings in the present system for identifying possible breaches of the model litigant rules by the Tax Office. As a result, it is not possible to make an assessment of the extent to which the Tax Office is complying with these rules.

4.162 Secondly, this review and other inquiries have identified cases of possible breaches of the rules which have not previously been detected.

The present system for identifying breaches of the model litigant rules

4.163 The present system for identifying breaches of the model litigant rules may not identify all potential and actual breaches, for a number of reasons.

4.164 Firstly, the OLSC is not actively reviewing compliance with the model litigant guidelines. This has been confirmed in a recent ANAO report which noted that the OLSC's approach to monitoring the Legal Services Directions (including the model litigant rules) relies heavily on alleged breaches being reported by the relevant Australian Government agency and that the OLSC does not proactively monitor agencies' compliance with the Directions.[44]

4.165 The nature of the OLSC's role in reviewing breaches of the model litigant guidelines reflects Government policy that the chief executive of each Government agency has the principal responsibility for ensuring compliance with the Legal Services Directions and accompanying model litigant guidelines.

4.166 During the course of this review, the Attorney-General has issued revised Legal Services Directions which operate from 1 March 2006. These revised Directions contain a new requirement which is designed to overcome the ANAO's concerns about ensuring that possible breaches of the Legal Service Directions are identified. This new requirement stipulates that each agency chief executive is responsible for giving to the OLSC an annual certification concerning breaches of the Directions.[45]

4.167 Second, there is evidence that taxpayers, their representatives and Tax Office staff are unaware of:

- the role of the OLSC as a independent reviewer of breaches of the model litigant rules;

---

44 Auditor-General, *Legal Services Arrangements in the Australian Public Service*, Audit Report No 52, 20 June 2005, p 35 at paragraphs 5.12-5.13.

45 Attorney- General , Legal Services Directions 2005, issued under section 55ZF of the *Judiciary Act 1903* at paragraph 11.2.

- the public complaints mechanism which the OLSC has established which permits members of the public to lodge complaints about breaches of these rules;
- the nature of matters that can be the subject of a public complaint to the OLSC; and
- the types of behaviour which may constitute a breach of the rules.

4.168 The OSLC considers that, in accordance with the manner in which the OSLC is intended to discharge its role under the Legal Service Directions, measures to address this lack of awareness should be tackled by the Tax Office taking the lead, in consultation with the OLSC.

4.169 The lack of awareness of these matters is evidenced in a number of ways.

Awareness of review role of OLSC

4.170 As late as December 2001, tax professional bodies who are members of the National Tax Liaison group were apparently unaware of the OLSC's role as an independent review mechanism for the model litigant rules. In that month, these bodies raised an agenda item with the National Tax Liaison group calling for such an independent review mechanism to be established. The Tax Office responded to this item by stating that such a mechanism already existed.

Awareness of public complaint mechanism

4.171 During the last two years, the OLSC has investigated only one alleged breach of the model litigant rules in respect of Part IVC litigation in response to a public complaint. However, many more examples of alleged breaches of the model litigant rules have been provided by taxpayers and their representatives to the Inspector-General during the course of this review. While taxpayers may have chosen not to report these breaches, it is also likely, given that there has been only one complaint, that in a number of these cases taxpayers were unaware of the existence of the OLSC's public review mechanism.

Awareness of matters which the OLSC can review

4.172 As noted above, there has been only one public complaint made to the OLSC concerning the Tax Office during the last two years. While the party making this complaint was aware of the OLSC's review role, its submission to the OLSC raised several matters which the OLSC determined it could not review. The OLSC considered that it could not review these matters because they related to the administration of legislation by the Tax Office, for which there were alternative review mechanisms, rather than the Tax Office's conduct of litigation and directly related matters.

4.173 There is no information which expands upon the model litigant guidelines to guide members of the public on what matters are model litigant issues which are reviewable by the OLSC. If such information had been available, the party making the above submission may not have raised with the OLSC matters which it could not review.

Awareness of the rules and their content

4.174 The Australian Law Reform Commission in its 2000 *Managing Justice* report noted that even several judges and barristers had professed not to have heard of the

term 'model litigant' or seen the text of the rules. It recommended that the OLSC should facilitate proper education and training programs to promote awareness of the content and importance of the rules.[46] The ALRC also suggested that the rules should contain more commentary and examples, particularly with respect to behaviour which involved 'unnecessary delay', 'technical defences' and 'taking advantage of a claimant who lacks resources'.[47]

Tax Office staff's awareness of the rules

4.175 The Behm review, which is discussed further in the next chapter, found that there was a lack of awareness in the Tax Office's in-house legal area of the Legal Services Directions, which include the model litigant rules.[48]

4.176 The Inspector-General's review found that no internal practical guidance has been issued to Tax Office staff on the application of the model litigant rules.

Extent to which breaches of the rules may be occurring

4.177 During its review, the ANAO identified a number of possible breaches by Government agencies of the Legal Services Directions that the OLSC was yet to identify and which had not been self-reported by the agencies concerned.[49] The ANAO did not identify whether the Tax Office was involved in these breaches.

4.178 The Behm review found that the ATO's overall compliance with these Directions was uneven.

4.179 The Inspector-General in this review has identified a number of instances of potential breaches of the Legal Services Directions by the Tax Office, in particular of the model litigant rules.

4.180 Examples of potential breaches that were identified included:

- A case where the Tax Office briefed counsel in a Small Taxation Claim Tribunal matter involving the interpretation of the new commercial loss provisions where the taxpayer was unrepresented. No offer of test case funding was made despite the reason for briefing counsel being that the matter involved the interpretation of a new area of the law.

- Cases, which are discussed further in a subsequent chapter, where the Tax Office has refused to follow aspects of a finalised decision in similar fact situations and has continued with litigation.

- Cases such as those referred to earlier in this chapter which suggest that unnecessary litigation (which is causing unnecessary costs to taxpayers) may be being generated by poor upstream processes within the Tax Office.

4.181 The above comments lead to the following key findings and recommendations:

---

46 Recommendation 25.
47 Recommendation 23.
48 Behm review p 16.
49 ANAO report paragraph 5.15.

KEY FINDING 4.13

There are strong community perceptions that the Tax Office's approach and conduct is not consistent with the model litigant rules. The Inspector-General believes that there are strong grounds for these perceptions.

Subsidiary recommendation 4.1

The Tax Office should develop practical guidelines for staff on the application of the model litigant guidelines.

Tax Office response

4.182 Agreed

4.183 A proposed practice statement on the conduct of litigation will further guide staff on the Model Litigant Guidelines, in accordance with the Attorney-General's broader policy for Commonwealth departments.

4.184 Since 1999, the Legal Services/ Legal Practice internal website has contained a Legal Practice Note advising staff about the Model Litigant Guidelines.

4.185 All briefs to counsel from the Commissioner in tax litigation contain copies of the guidelines.

Subsidiary recommendation 4.2

The Tax Office, as part of its public statement on its philosophy and approach to tax litigation, should make taxpayers aware of the model litigant guidelines and that the Office of Legal Services Coordination is responsible for administering the model guidelines, including considering any alleged breaches of the model litigant guidelines. This should also include making taxpayers aware of the model litigant guidelines at the outset of litigation.

Tax Office response

4.186 Agreed

Subsidiary recommendation 4.3

The Tax Office should introduce an escalation process whereby senior tax officers or independent counsel, at the request of taxpayers or their representatives, may administratively review alleged breaches of the model litigant guidelines and departures from the Tax Office's stated philosophy and approach to litigation.

Tax Office response

4.187 The Tax Office has a well-established and effective escalation process. Alleged breaches of the Model Litigant Guidelines will continue to be referred to the Office of Legal Services Coordination (OLSC) by the Tax Office General Counsel, who is responsible for the relationship with OLSC.

4.188 Other complaints concerning the conduct of litigation will continue to be reviewed by an independent senior officer.

Inspector-General's comments on Tax Office response

4.189 The Tax Office has not responded to the terms of this recommendation. It confirms that an escalation process for potential breaches of the model litigant rules exists but has not agreed to make this process accessible to taxpayers or their representatives or to extend it to issues concerning the Tax Office's overall conduct in litigation. The Inspector-General believes that the Tax Office should implement this recommendation in full.

Provision of information or documents to opposing litigants

Provision of information and documents by the Tax Office to taxpayers

4.190 A number of submissions asserted that the Tax Office either fails to provide information (including relevant documents) to opposing litigants during litigation or fails to provide information that is adequate. Submissions also asserted that the Tax Office will, at least in certain cases, only provide this information when compelled to do so under various statutory provisions.

4.191 The kinds of information that were referred to in these submissions included the Tax Office's findings on relevant facts, the evidence on which those findings are based, the reasons for the relevant decision and copies of relevant documents held by the Tax Office.

4.192 The Tax Office is only under a duty to provide statements of facts, evidence and reasons to taxpayers once certain statutory conditions have been met. One set of conditions that will activate this requirement is that a dispute has been referred to either the AAT or the Federal Court.

4.193 Any Tax Office failure to meet these obligations, or to meet them adequately, is a matter which can be policed by the relevant tribunal or court. The AAT has advised the Inspector-General that the Tax Office does not fail to provide the

statements required for AAT matters, but can sometimes be late in filing these documents. The AAT has advised that the Tax Office has agreed to address this problem. Members of the Federal Court that were interviewed by the Inspector-General for the purposes of this review did not express any concerns over the nature of equivalent statements filed in that jurisdiction.

4.194 The Tax Office asserts that its policy is to provide taxpayers with the statement of facts, evidence and reasons that is required once a matter has been referred to the Federal Court or AAT earlier in the dispute process, that is, at the time when it issues to the taxpayer its notice of decision on the taxpayer's objection.

4.195 However, the Law Council of Australia noted in its submission that:

> There have been many experiences with notices (and reasons for decisions) which … do not contain full reasons, set out the material facts relied upon or address each of the taxpayer's substantive grounds of objection.

4.196 As the terms of reference for this review relate to Tax Office administrative practices that are generally applied once a matter has been referred to the AAT or Federal Court, this review has not examined the Tax Office's practices with respect to providing adequate statements of facts, evidence and reasons at the stage when the Tax Office has issued a notice of decision on an objection. However, this matter may be the subject of a future review by the Inspector-General.

4.197 The Tax Office has a general obligation to provide copies of documents to taxpayers in accordance with the provisions of the *Freedom of Information Act 1982*. The handling of Freedom of Information (FOI) requests has been the subject of a report by the Commonwealth Ombudsman which was released during the final stages of this review.[50] The Ombudsman's investigation found that there was an uneven culture of support for FOI among Australian Government agencies, with some agencies displaying a clear commitment to FOI while others do not as firmly demonstrate such a commitment. The report contains no specific comments on the approach of particular agencies, such as the Tax Office, to FOI.

4.198 When a matter has been referred to the AAT, there is also an obligation for copies of relevant documents to be provided to the opposing litigant at the same time as the statement of facts, evidence and reasons. For cases involving the Federal Court, the obligation to provide copies of documents arises if the Court orders discovery of those documents. Any Tax Office failure to provide documents in accordance with these statutory obligations is a matter which can be the subject of review by either the relevant tribunal or the Federal Court.

4.199 The Tax Office's overall administrative practices in providing copies of documents to taxpayers apply to a wider category of matters than those which involve Part IVC litigation. For this reason, these practices have not been examined during the course of this review. However, they too may be the subject of a future review by the Inspector-General.

---

50 Commonwealth Ombudsman, *Scrutinising Government – Administration of the Freedom of Information Act 1982 in Australian Government Agencies*, Report No. 02 of 2006.

Provision of documents by taxpayers to the Tax Office

4.200 A number of submissions were also made to this review, particularly by barristers acting for the Tax Office, that the Tax Office fails to exercise its powers to obtain information from taxpayers effectively. These submissions are supported by the fieldwork for this review which indicated that a significant proportion of disputes are reaching the litigation stage without relevant information and documents having been obtained earlier in the dispute process.

4.201 This review has not conducted a detailed examination of the Tax Office's processes for gathering information at either the audit or objection review stages of a dispute. Nor has this review sought to examine the possible reasons for relevant information not being considered or made available until a dispute proceeds to litigation. These matters may be the subject of a later review or reviews. However, the findings of this review raise strong concerns about the possible need for further training and quality control processes to be introduced into these areas of the Tax Office's activities.

Perceived Tax Office failure to adhere to public rulings during litigation

4.202 Submissions stated that, at times, the Tax Office departs from its previous rulings and practice statements during litigation. The Inspector-General found that the Tax Office has a policy of not departing from its rulings and practice statements, although the Tax Office has admitted that this policy was not followed in the recent case of *Queensland Rail*.[51] The Tax Office considers that this departure is a minor transgression from its stated policy.

KEY FINDING 4.14

The Tax Office has a policy of not departing from its published position (as set out in rulings, determinations and similar documents) in the conduct of litigation. It has however not followed this policy in one recent case.

4.203 However, apart from a Second Commissioner's speech[52], there is no public statement from the Commissioner affirming the Tax Office's approach to following rulings, determinations and other interpretative decisions in the course of litigation.

4.204 The Inspector-General considers that the Tax Office should include in any formal, consolidated statement on litigation an affirmation that it will follow rulings, determinations and interpretive decisions in the conduct of litigation.

Tax Office adherence to public rulings during litigation

4.205 A number of stakeholders raised concerns that the Tax Office is reluctant to depart from a view expressed in a ruling during the litigation process.

---

51 *Queensland Rail v F C of T.* First instance appeal before the Federal Court. Decision reserved.

52 Michael D'Ascenzo and Steve Martin, *A unique taxation partnership for the benefit of the Australian community*, ATO/AGS/ Counsel Workshop, 3 April 2004.

4.206 This concern is discussed in more detail in the last chapter of this review. This final chapter examines a number of case studies which, in the Inspector-General's view, confirm that Tax Office staff regard the Tax Office as bound by the language of the rulings.

4.207 Submissions to this review also strongly urged that there should be a process inside the Tax Office which would allow the terms of a ruling to be urgently reviewed either internally within the Tax Office or by outside parties while litigation which relies on the ruling is under way. This review process would be triggered where doubts arise (for example, from barristers who are briefed to act for the Tax Office) on the correctness of the ruling.

4.208 The Inspector-General considers that the conduct of such reviews should be one of the key responsibilities carried out by the proposed new area that is responsible for the management of all aspects of a litigated dispute.

4.209 The above comments lead to the following key finding and recommendation:

KEY FINDING 4.15

There should be a process inside the Tax Office which would allow the terms of a ruling to be urgently reviewed where litigation which relies on the ruling is under way and doubts arise on the correctness of the ruling.

Subsidiary recommendation 4.4

The new area of the Tax Office responsible for the management of all aspects of litigation should establish a formal process under which the terms of existing Tax Office rulings are urgently reviewed either internally by the Tax Office or by outside parties where, during the litigation process, doubts arise as to the correctness of the rulings.

Tax Office response

4.210 Where doubts arise during the litigation process about the correctness of a Tax Office ruling, the issue will continue to be escalated to the Tax Counsel Network for urgent attention.

Inspector-General's comments on Tax Office response

4.211 The Inspector-General believes that the Tax Office should implement this recommendation in full. An escalation of the matter to the Tax Counsel Network will not achieve an urgent review of a ruling that is the subject of pending litigation if any change to the ruling can only be achieved by the Tax Counsel Network using current lengthy rulings program processes.

CHAPTER 5: TAX OFFICE'S INTERNAL POLICIES AND PROCEDURES IN RESPECT OF LITIGATION

5.1 This chapter discusses the Tax Office's policies and procedures for managing Part IVC tax litigation matters. It focuses on the policies and procedures for the management of litigation activities that are generally internal to the Tax Office.

5.2 The preceding chapter focuses on the policies and procedures for the management of activities that involve contact with taxpayers during the course of litigation, that is, on the Tax Office's actual conduct of litigation with taxpayers.

5.3 This chapter discusses a number of concerns about the Tax Office's internal policies and procedures for litigation and sets out a number of recommendations for improvements to these policies and procedures.

STAKEHOLDER CONCERNS

5.4 Submissions raised only a limited number of concerns about the Tax Office's internal policies and procedures for managing Part IVC litigation. This is understandable, given that there is very little material that is publicly available on these policies and procedures. The concerns that were raised were as follows:

- The Tax Office's senior management appears to lack awareness of and support for cases that are being litigated.
- The Tax Office does not perceive litigation risks in the same way as a normal litigant.
- The Tax Office's staff do not understand the materials/commercial transactions they are dealing with during litigation.
- Part IVC litigation appears to be initiated at low levels within the Tax Office.
- There are no processes which allow decisions on litigated cases made by any one area of the Tax Office to be reviewed inside that area by other staff who have not previously been involved in the case.

5.5 These concerns and the Inspector-General's overall findings in relation to the Tax Office's internal policies and procedures for litigation are discussed below.

PREVIOUS REVIEW OF TAX OFFICE'S INTERNAL MANAGEMENT PROCESSES FOR LITIGATION

5.6 In 2003 the Tax Office's Chief Tax Counsel commissioned a major review (the Behm review) of its internal management of legal risk, including its management of the risks associated with its conduct of litigation on Part IVC matters. The review was

conducted by Mr Allan Behm, Director of Knowledge Pond Pty Ltd, with technical assistance provided by The Value Creation Group Pty Ltd. The final report from this review was prepared in September 2003.

5.7 All the findings and recommendations of the Behm review have been accepted by the Tax Office. The Tax Office is working to implement these recommendations over an approximately two year timeframe.

5.8 The Behm review focused on the activities of the Tax Office's in-house legal area. It was based on the premise that the division of litigation activities within the Tax Office between the business lines, partner areas and the in-house legal area was to continue to be as set out in the preceding chapter. Under this division, the business lines have ownership of a litigated case, the Tax Counsel Network is responsible for determining the technical issues to be argued in the case and the in-house legal area is responsible for acquiring or providing the legal services required by the Tax Office to litigate the case.

5.9 As the Behm review was based on this three-way division of the Tax Office's litigation functions remaining in place, it did not examine any of the internal policies and procedures adopted within the Tax Office's business lines and partner areas for litigation.

5.10 The preceding chapter of this review has recommended that the Tax Office re-consider the above three-way division of litigation functions with a view to establishing a single area of the Tax Office with primary responsibility for litigation activities.

5.11 The Behm review findings and recommendations on the internal management activities of the Tax Office's in-house legal area will remain relevant if a new overall structure for litigation management is adopted. This is because the proposed new area will remain responsible for performing all the litigation functions currently carried out by this in-house area. Accordingly, this chapter discusses these findings and the current status of their implementation.

5.12 The proposed new single area for managing litigation would also assume some of the roles currently carried out by the Tax Office's business lines and Tax Counsel Network. Accordingly, this chapter also examines the current internal policies and procedures for litigation carried out by these areas. It makes certain recommendations for improvements to these policies and procedures.

KEY FINDINGS OF BEHM REVIEW ON TAX OFFICE'S INTERNAL MANAGEMENT OF LEGAL ACTIVITIES OVERALL

5.13 The Behm review made a large number of findings on the Tax Office's internal management of its legal activities, as carried out by its in-house legal area during 2003 and previous years. Most of these findings were highly critical. The Behm review findings were, in summary, as follows:

Risk management issues

5.14 The Behm review found that, although the Tax Office did employ reasonably sophisticated risk management techniques across its organisation as a whole, it did not apply risk identification and assessment techniques to its legal risk issues overall (including litigation issues). The Behm review concluded that the absence of this risk management approach to legal risk issues was largely because there was no overall strategic management of the Tax Office's in-house legal practice.

5.15 Legal risk in this context broadly means the risk faced by the Commissioner which arises from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations. These risks include those which arise from the Commissioner being a party to litigation involving tax laws as well as those which arise from him being a party to litigation involving non-tax laws (such as those involving freedom of information, employment law, privacy law, commercial law) in his capacity as the head of a Government agency.

5.16 The review specifically found that:

- the concept of the legal risk faced by the Commissioner was not well understood either in the Tax Office's in-house legal area or the Tax Office at large;
- the Tax Office's in-house legal area did not take available measures to sufficiently mitigate the Commissioner's legal risk; and
- there was little recognition within the in-house legal area or the Tax Office as a whole of the significant value that could be created through the effective management of client/service provider relationships and the effect this could have on minimising the Commissioner's legal risks.[53]

5.17 The Tax Office has an internal practice statement — PS CM 2003/02(G) — which states that risk management is to be applied to all its activities. Under this practice statement, the Tax Office is to identify risks that threaten its objectives and to assess, analyse, prioritise, treat and monitor these risks. This risk management process is to be done in an environment where the Tax Office has scarce resources, cannot do everything, operates in a self assessment environment and has to deal with what is material. The Behm review found that this risk management policy had not been applied to the Tax Office's activities which deal with legal risk.

Quality review and other reporting processes

5.18 The Behm review also found that reporting and reviewing processes within the in-house legal area were deficient. These reports did not, for example, address the following:

- the setting and achievement of targets, including the value for money performance of the area; and
- the identification of the Commissioner's needs and the needs and expectations of other areas of the Tax Office and whether those needs were achieved.

53 pp 16-17.

Overall management structure and management support systems

5.19 The Behm review found that the Tax Office's in-house legal area generally operated as a loose federation of state-based legal services providers who did not offer coordinated national services based on standardised performance criteria.

5.20 Furthermore, the in-house practice did not have the support systems (particularly precedents, forms and opinions data bases) that were the normal trademarks of a functioning legal practice. It also did not have a national standardised practice management system, with matter management standards and practices and data recording practices varying between different ATO offices. This meant that no useful national performance reports could be prepared on the operation of the practice.[54]

Performance of Tax Office's in-house legal staff

5.21 The review found that, while the Tax Office's in–house legal staff impressed as dedicated, hard working and enthusiastic[55], the in-house legal area had not been able to establish its credibility within the Tax Office as a high performing professional group — in contrast to other areas of the Tax Office such as the TCN.

5.22 The review found that, both amongst staff of the Tax Office's in-house legal practice and across the Tax Office overall, there was a lack of understanding of the in-house area's role, purpose, responsibilities, core business processes and the key services provided.

BEHM REVIEW FINDINGS ON TAX OFFICE'S INTERNAL MANAGEMENT OF LITIGATION

5.23 The Behm review made the following specific findings about the in-house legal area's practices with respect to litigation:

- The in-house area's performance in relation to litigation specifically was at best uneven, and at worst poor.
- Some of the litigation work it was carrying out was being duplicated, for example by the AGS.
- The area's relationship with the AGS while adequate in some states, was generally uneven. This reflected a view within the Tax Office that the in-house practice was a competitor with the AGS, rather than working in a collaborative relationship with that agency.
- The quality of briefs prepared by the Tax Office's in-house area for the AGS and adherence to court procedural requirements was uneven.[56]

54 p 13.
55 p 7.
56 Paragraphs 5.15, 5.16 and 5.23.

- There were no clear procedural guidelines for the management of the Tax Office's Part IVC litigation activities.

- Some parts of the in-house practice had an exaggerated appreciation of their skills and capabilities in providing litigation services.

RECOMMENDATIONS OF BEHM REVIEW ON TAX OFFICE'S MANAGEMENT OF ITS LEGAL ACTIVITIES OVERALL

5.24 The Behm review recommended that the in-house legal area of the Tax Office should be abolished and replaced by a group within the Office of the Chief Tax Counsel. The primary role of this new group was:

- to provide or acquire high quality legal services to meet the legal requirements of the Tax Office; and

- to manage the legal risk that attached to the office of the Commissioner.

5.25 To achieve these two goals, the new in-house area was to deliver a range of legal services — some internally and some externally. For services that were to be provided by external legal service providers the new area was to establish and manage legal services provider panels and monitor the performance of those providers in accordance with memoranda of understanding or legal service provision contracts.

5.26 To achieve these goals the Behm review recommended that the Tax Office should undertake the following steps as regards the management of its legal activities overall.

5.27 The first step was that the Tax Office should define the scope of the Commissioner's and the Tax Office's legal risk in collaboration with other areas of the Tax Office, the AGS and counsel engaged by the Tax Office.

5.28 The second step was that a national identity should be forged for the in-house legal area by:

- establishing a nationally based approach to managing legal risk;

- managing the performance agreements of staff employed in the in-house legal area;

- ensuring that the relationships between the in-house legal area and the business lines are effectively managed at a national level, for example by revising the internal service agreements in place between the in-house legal area and the Tax Office's business lines to ensure that each party recognised the need to meet certain performance standards; and

- instituting a nationally focused continuing legal education system for the Tax Office in-house legal area's staff.

5.29 The third step was that the leadership of the Tax Office's in-house legal area, which was then vested in one person, should be replaced with a leadership team consisting of three executives. The first of these executives was to be responsible for the area's Part IVC and certain other litigation activities. The second executive was to be

responsible for the overall management of and delivery of legal services within the Tax Office, including the provision of management reports on these services to the Tax Office's Executive. The third executive was responsible for providing in-house legal advice to the Commissioner on all non-tax technical legal matters.

RECOMMENDATIONS OF BEHM REPORT ON TAX OFFICE'S INTERNAL MANAGEMENT OF LITIGATION

5.30 The Behm review made the following three recommendations in relation to the Tax Office's internal management of litigation, including Part IVC litigation.

5.31 Firstly, the Behm review recommended that a small and strong specialist group should be established within the Tax Office to provide the strategic management and conduct of Part IVC litigation and certain other litigation, led by the senior executive responsible for litigation management.

5.32 This group was to undertake the following specific duties as regards Part IVC litigation:

- to establish and manage a strategic litigation program;
- to establish and maintain efficiency and quality standards in the conduct of such litigation;
- to ensure that the Tax Office's legal position on technical issues is properly presented to relevant courts and tribunals and, where doubts arise about the legitimacy or practicality of that view, to ensure that it is reviewed by appropriate areas of the Tax Office;
- to ensure that the impacts of court or tribunal decisions are communicated to relevant areas of the Tax Office and to guide the implementation of necessary changes;
- to document and establish procedural guidelines for the management of this litigation; and
- to represent the Tax Office before courts and tribunals as appropriate.

5.33 The Tax Office considers that the term 'strategic litigation' as referred to in this recommendation is litigation that leverages compliance with the tax laws through clarification of the law in key high risk areas and litigation where law clarification opportunities are not the primary objective but which requires a strategic corporate Tax Office response because of the risks involved in the litigation.[57] Strategic litigation embraces priority technical issues cases[58], but only those which are considered the most strategically important.

5.34 The second recommendation made by the Behm review for Tax Office litigation was that procedures should be introduced to ensure that more collaborative

57 Practice Statement LA 2005/22 at paragraph 6.
58 These cases have been defined in the previous chapter.

and effective working relationships exist between all those who are managing litigation services within the Tax Office to minimise the Commissioner's legal risk in this area. To this end, the new specialist litigation group was to undertake the following duties:

- to manage and monitor a new comprehensive Tax Office/AGS memorandum of understanding in litigation matters; and
- to manage and monitor a provider panel for litigation services.

5.35 The third recommendation was that the Tax Office should market-test its in-house litigation services against those which could be performed by the AGS with a view to establishing the effectiveness and cost efficiency of keeping those services in-house.[59]

CURRENT STATUS OF BEHM RECOMMENDATIONS

5.36 As at the date of this report, the Tax Office has not implemented a number of the major recommendations of the Behm report. The major recommendations that have not been implemented include the introduction of:

- risk identification and other risk management processes;
- reporting systems and review processes which evaluate client satisfaction, the achievement of targets and the value for money of in-house legal area; and
- national support structures for staff of the in-house legal services area.

5.37 The Tax Office has implemented those recommendations of the Behm report which concern management reorganisation.

5.38 This comment leads to the following key finding:

59 Paragraph 4.2.2 p 17.

KEY FINDING 5.1

The Tax Office has not implemented some of the major recommendations from an internal review relating to the management of its in-house legal services area. The Tax Office has implemented those recommendations of the internal review which concern management reorganisation.

The major recommendations that have not been implemented include the introduction of:

- risk management processes;
- reporting and reviewing systems which evaluate client satisfaction, the achievement of targets and the value for money of the in-house legal area; and
- national support structures for staff of the in–house legal services area.

5.39 The current status of the implementation of the main Behm recommendations is as follows.

Recommendations relating to overall management of legal activities

Management structure

5.40 The Tax Office has made its in-house legal area a branch within the Office of the Chief Tax Counsel. The branch does not form part of the Tax Counsel Network. The Tax Office has also instituted a three-person leadership structure for this branch. Initially this three–person leadership structure differed from the structure recommended in the Behm report in that responsibility for managing litigation activities was split between two of the three executives suggested in the Behm report, rather than vesting in one of these executives alone. However, in the latter half of 2005 the Tax Office adopted a leadership structure for litigation that was more similar to the Behm recommendation, under which leadership responsibility for all litigation vested in a single person. The position title for this litigation role is Senior Tax Counsel (Strategic Litigation).

5.41 The current management structure of the Tax Office's legal services branch (LSB) is shown in Appendix 9.

Risk management

5.42 The Tax Office has not responded to the major Behm recommendation that it develop a process for identifying and assessing legal risk in collaboration with the AGS and its external legal service providers. The Tax Office has advised that the current extent of risk identification and assessment consists of certain reports made to the Tax Office's Executive on current legal activities. The Tax Office has advised that risk

identification processes are currently being considered as part of the implementation of a new law sub plan within the Tax Office.[60]

5.43 One manifestation of the absence of these risk management processes is as follows. There is currently no internal report prepared by the in-house Legal Services Branch (or by any other area of the Tax Office) to the ATO's Executive which details the overall state of the Tax Office's litigation program, including the revenue tied up in this process and the Tax Office costs incurred to date on either all or any individual cases.

5.44 The extent of Tax Office reporting by the LSB area to the ATO's Executive on the status of litigated cases is that the Senior Tax Counsel responsible for strategic litigation provides to the Commissioner and Treasury, on a monthly basis, a strategic litigation report which describes all strategically important litigation and decisions regarded as being the most significant to the Tax Office.

5.45 This report contains very little material to support a proper risk management approach to these cases.

5.46 The report is divided into two parts — one being for mass marketed cases and the other for non-mass marketed cases — and each of these is prepared in a different format. Both parts of the report contain descriptions of litigated cases which the Tax Office considers to be significant. However, each part does not contain any description of the criteria for classifying cases as being significant, does not list the cases discussed in their order of significance and does not provide the amount of tax, penalties and interest in dispute for all cases. Both parts also do not contain any cost/benefit analysis for any of the cases discussed. Both parts are also lengthy and contain no summary of the relevant cases.

5.47 Each part of the report also does not contain any data — including risk management data such as the total quantum of tax in dispute — for litigated cases that are not considered to be significant.

5.48 Other internal reports prepared on litigation activities by the in-house Legal Services Branch but which are not directly provided to the ATO's Executive are as follows:

- Litigated cases which deal with issues that the Tax Office has identified as priority technical issues are included in a report prepared for a cross-business line committee which deals with priority technical issues.

- Monthly call over reports are prepared, which are sent to the LSB area's administrative manager of all non-strategic Part IVC litigation.

5.49 The Tax Office also has no policy for communicating the status of its litigation program (including the revenue results and/or costs incurred) to the public. Its published compliance results for each year have also not included adjustments to prior year results for credit adjustments arising as a result of litigated disputes being resolved wholly or partly in a taxpayer's favour. However, in October 2005 the

60 Attachment to ATO Minute No: IGT 76-2005, p 9.

Commissioner agreed to update these compliance results for each year to reflect these credit amendments, at least in respect of large business taxpayers.[61]

5.50 The lack of separate reporting by the Tax Office on the results of its litigation program means that the community is unable to assess whether the Tax Office's overall litigation program is being conducted effectively, fairly and with minimum cost.

5.51 The results of the Tax Office's litigation program published in its Annual Report only give percentages of cases won, lost and partly won by the Tax Office. The Tax Office does not publish in its annual report or elsewhere the total number and dollar value of all litigated cases won, lost or partly won.

5.52 Furthermore, the Tax Office's Annual Report figures on litigated cases won and lost by the Tax Office do not accurately reflect the results of all litigated cases. The percentages reported are based only on cases won, lost and partly won, where the relevant cases have resulted in a court or tribunal decision. These figures indicate that the Tax Office wins the majority of these cases (in 2004/05 the relevant figures were 76 per cent of cases for the AAT, and 63 per cent for court cases[62]). However, as discussed in preceding chapters, these cases represent only a small proportion of all litigated cases (for example for the eight year period to 2004/05 they were on average only 12 per cent of all AAT tax cases).

5.53 Another manifestation of the absence of risk management in the Tax Office's approaches to litigation is as follows. The Inspector-General found during the course of this review that there were disputed tax cases being litigated by the Tax Office where the result of the case was that the Tax Office was required to make a net payout of tax revenue to the opposing party, even though the case was settled on the basis that the Tax Office won the case.

5.54 In one case, this result came about because of the combined effect of:

- the compensating adjustments made by the Tax Office to other parties related to the taxpayer;
- the Tax Office being required to pay interest on the tax overpaid by some of these parties; and
- the Tax Office being unable to collect the interest on tax underpaid by the other parties in the case.

5.55 If the Tax Office had not challenged the taxpayer's arguments in this type of case, a net revenue payment would not have needed to be made.

5.56 It seems unlikely that, if a risk management approach had been applied to this type of case, the Tax Office would have continued with the case once it became apparent that the case was revenue negative. A formal framework of risk assessment directed at dispute and litigation matters would provide more accountable criteria for making such decisions.

---

61 Commissioner of Taxation, *Large Business and Tax Compliance*, address to the International CFO Forum, Sydney, Australia, 13 October 2005.

62 Commissioner of Taxation, *Annual Report 2004-05* p 233.

Tax Office's approach to assessing litigation risks

5.57 The above type of case is an example of what can occur as a result of the Tax Office not assessing its litigation risk in the same manner as a normal litigant. Normally a litigant would only continue with a disputed tax case where the expected monetary benefit from the case exceeds the sum of both any internal and external costs incurred in litigating the case.

5.58 The Tax Office has confirmed during this review that it considers that cost/benefit processes of this nature are either not relevant or cannot currently be fully carried out for litigated tax cases.

5.59 Where a litigated tax case is considered to be significant the Tax Office considers that such an analysis is irrelevant. This is because it considers that it will generally be appropriate for the Tax Office to meet whatever external and internal litigation costs are necessary to achieve finalisation of the issue at stake.

5.60 For non-significant cases, the Tax Office has advised that this analysis cannot be currently carried out. This because the Tax Office has no internal costing and reporting processes which allow it to assess its total internal costs of running a litigated case.

5.61 The absence of a risk management approach to litigation means that the Tax Office is not applying its internal practice statement PS CM 2003/02(G) which states that risk management is to be applied to all its activities.

5.62 The above comments lead to the following key findings and recommendations:

KEY FINDING 5.2

The Tax Office does not employ risk identification and assessment techniques to its legal risk issues overall, including litigation issues. One result of this is that the Tax Office has no reporting systems which detail the overall state of the Tax Office's litigation program, including the revenue in dispute tied up in this process and the Tax Office costs incurred to date on either all or any individual cases. Another result is that the Tax Office does not employ cost/benefit analyses to its assessment of whether to proceed with litigation.

KEY FINDING 5.3

The Tax Office does not communicate the status of its litigation program (including the revenue results and/or costs incurred) to the public and as a result the public is unable to assess whether the Tax Office's overall litigation program is being conducted effectively, fairly and with minimum cost.

KEY RECOMMENDATION 3

The Tax Office should introduce risk management techniques to its management of tax litigation issues. It should start this process by defining the scope of the Commissioner's and the Tax Office's legal risk in collaboration with the Australian Government Solicitor (AGS) and counsel engaged by the Tax Office.

Tax Office response

5.63 We will review our current practices with this recommendation in mind.

5.64 All litigation cases are risk assessed at the commencement of litigation and risks are reviewed throughout the course of litigation. The Tax Office has a practice statement that outlines the process for risk assessment in litigation– see PSLA 2005/22. Although that practice statement focuses on priority technical issues (PTI) it makes it clear that, whether or not a case is linked to a priority technical issue, business lines must adhere to their own governance practices to ensure decision making is made at the appropriate level. Moreover, the Tax Office's Code of Settlement Practice provides guidance for Tax Office staff considering settlement of disputes, which also encapsulates risk management concepts. Where counsel and the AGS are involved in litigation, they assist in identifying legal risks to the Commissioner throughout the course of litigation.

5.65 Nevertheless we will review our current practices to ensure that the proposed litigation practice statement clearly articulates how we approach litigation in cases which do not involve PTIs, including a better articulation of the factors that underlie our risk management approach.

Subsidiary recommendation 5.1

The Tax Office should introduce reporting systems under which its Executive is aware of the total state of all Tax Office Part IVC litigation, including the extent to which cases being litigated have produced negative revenue results.

Tax Office response

5.66 The Tax Office has in place a monthly report which is sent to the Tax Office Executive to advise them of the most significant cases currently before the courts and Administrative Appeals Tribunal (AAT). The focus of the Executive is on strategic issues such as those that have an impact on the coherent fabric of the law. However, we will improve the level of reporting through the Law Sub-plan.

Subsidiary recommendation 5.2

The Tax Office should be more transparent in communicating the overall results of its litigation program (including the number and dollar value of cases heard by a court or tribunal, the number and dollar value of cases settled or resolved by other means and the total costs incurred by the Tax Office in resolving all these disputes) to enable the public to assess whether the Tax Office's overall litigation program is being conducted effectively, fairly and with minimum cost.

Tax Office response

5.67 We will examine, in the context of the Tax Office's Change Program, ways to improve our reporting of cases which are litigated, as well as cases that are resolved before a decision of a court or tribunal

National support structures

5.68 During the fieldwork stage of this review, the Tax Office advised that it has constructed a national opinions data base for the LSB area and that opinions are progressively being loaded onto this data base. Case management systems are being reviewed as part of the Tax Office's overall change program. A professional development project is under way. Capability profiling has been completed to identify capabilities required for work in the in-house legal area. Individual staff capabilities have been ascertained and gaps identified. Development of a continuing legal education curriculum is well advanced.[63]

5.69 The above comments indicate that at the time of the Inspector-General's fieldwork there was a lack of support tools for Tax Office staff who work in the in-house legal area, including support tools that are necessary for the staff of this area who actually conduct litigation at the Small Taxation Claims Tribunal or Administrative Appeals Tribunal.

5.70 The above comments lead to the following key findings and recommendations:

KEY FINDING 5. 4

There is a lack of support tools for Tax Office staff who work in the in-house legal area, including support tools that are necessary for the staff of this area who actually conduct litigation at the Small Taxation Claims Tribunal or Administrative Appeals Tribunal.

63 Minute 76.

Subsidiary recommendation 5.3

The Tax Office should ensure that adequate support tools (such as a database of precedents, adequate facilities to interview taxpayers and/or their representatives, and adequate continuing legal education) are developed for Tax Office staff that are responsible for the actual conduct of cases.

Tax Office response

5.71 We agree with subsidiary recommendations 5.3 and 5.4, but not with key finding 5.4.

5.72 The Tax Office has a number of support tools, including a litigation manual, litigation flow charts and the Significant Issues Litigation Committee (SILC) process to provide guidance to legal services staff.

5.73 We have recently updated our reference materials, including practice statements, instruction bulletins and reference manuals which apply to litigation. These materials are added to websites and share drives for the convenience of staff.

5.74 A mentoring system is also in place, where a less experienced staff member is paired with a senior staff member who will provide guidance and advice on the conduct of litigation.

5.75 We will review existing support tools to ensure they are adequate.

Inspector-General's Comments

5.76 The review found that at the time fieldwork was conducted there was a lack of support tools for Tax Office staff who work in the in-house legal area. The Inspector-General welcomes the comments that the Tax Office has recently updated its reference materials, has introduced a mentoring system and will review existing support tools to ensure they are adequate.

Status of Behm recommendations relating to litigation activities

Strategic litigation program

5.77 As discussed in the preceding chapter, the Tax Office has established a strategic litigation program to identify and manage strategic litigation cases. This review has not performed a detailed assessment of this program. However, the fieldwork conducted for this review, discussed in the preceding chapter, suggests that this internal management program is producing benefits. These benefits include the establishment of a Tax Office wide internal policy which sets out uniform processes that are to be applied to these cases. There is however, no similar program in place for the management of non-strategic litigation cases.

Establishment and documentation of procedures for litigation

5.78 There is presently only limited written reference material which explains, to LSB staff and others within the Tax Office, the policies and procedures, including case management procedures, which apply to litigated cases. Most of this material is outdated. This material is also spread across a number of different sources. There is currently no single reference document available to any of its staff (including staff in its in-house legal area) which lists all of the sources of both policies and procedures for litigation.[64]

5.79 The available reference material on policies for litigation has been listed in the preceding chapter. The available reference material which describes the procedures for litigation consists of the following:

- ATO legal practice bulletins;
- an ATO Litigation Reference Manual;
- an Appeals Litigation handbook; and
- certain publicly available practice statements.

5.80 The LSB area is currently engaged in a project to update all this material.

5.81 Under this process, and during the course of this review, a practice statement (PS LA 2005/22) has been published which explains the Tax Office's internal processes for handling disputes which involve priority technical issues. There is no similar draft or final practice statement which deals with all aspects of the Tax Office's processes for handling litigation disputes which do not involve priority technical issues. The Tax Office has advised the Inspector-General that it considers its internal litigation reference material, once updated, and governance measures within its business lines will address this issue and that there is no need for a separate practice statement.[65]

5.82 The Tax Office is preparing a draft practice statement which, when finalised, will explain the Tax Office's processes for handling the management of the outcomes of decisions arising from all litigated cases.

5.83 The above comments lead to the following key finding and recommendations:

---

64 The internal bulletin which the Tax Office has issued to staff in its in-house legal area (Bulletin 99/02) does not, for example, list as a source of litigation policy, speeches that have been given by the Commissioner or a Second Commissioner. However, as noted in the previous chapter, during this review senior ATO staff involved in litigation pointed to a particular speech by the Second Commissioner for Taxation as being a particularly important guiding statement as to its philosophy on litigation.

65 ATO Minute No: IGT 87-2005, dated 16 December 2005 p 27.

KEY FINDING 5.5

There is presently only limited written reference material which explains to LSB staff and others within the Tax Office the policies and procedures, including case management procedures, which apply to litigated cases. Most of this material is outdated and is also spread across a number of different sources.

Subsidiary recommendation 5.4

The Inspector-General recommends that a consolidated and up-to-date set of litigation reference material should be developed and made available to all Tax Office staff.

Tax Office response

5.84 We agree with subsidiary recommendation 5.4.

5.85 The Tax Office will develop a single document which will consolidate procedures for handling litigation matters which do not involve a Priority Technical Issue.

Subsidiary recommendation 5.5

The Tax Office should develop a reference document which sets out all of its procedures for handling litigated matters which do not involve priority technical issues.

Tax Office response

5.86 Agreed

Nature of case management procedures within LSB

5.87 Case management procedures within LSB for a case that involves a decision being handed down by a court or a tribunal have been established and documented during the course of this review in a draft practice statement. The LSB area is working on establishing and documenting procedures for other aspects of litigated cases. These procedures are currently embodied in draft flow charts.

5.88 The case management procedures for a decision which has been handed down by a court or tribunal are set out in Appendix 10.

5.89 A principal feature of these procedures is that the LSB officer who has been designated as the relevant case manager for the case must convene a number of strategic internal litigation committee (SILC) meetings with other Tax Office staff within certain time periods after the relevant decision is handed down. These meetings

must, as a minimum, be held with the officer that has been designated by the relevant business line or area as being its case officer for that case. Other attendees will vary according to the nature of the case. For example, they may include a member of the Tax Counsel Network (if they are involved in the case) and members of other business lines. The Tax Office expects these meetings to be documented on the relevant case file and also expects that the LSB file for the case will contain all other key materials associated with the case.

Extent to which case management procedures are presently followed within the LSB area

5.90 Fieldwork by staff of the Inspector-General indicates there is a lack of adherence to case management procedures which deal with proper record-keeping procedures within the LSB area.

5.91 A significant percentage of the LSB files examined by staff of the Inspector-General were of poor quality. Deficiencies in these files included the absence of key internal documents (such as records of SILC meetings), the absence of key external documents (such as briefs to counsel and counsel's subsequent advice) and an absence of any material which indicated how the case was eventually resolved.

5.92 The above comments lead to the following key finding and recommendation:

KEY FINDING 5.6

A significant percentage of the case files in the Tax Office's legal services area examined by staff of the Inspector-General indicated that staff of the Tax Office's in-house legal area are not complying with internal Tax Office case management procedures in relation to the keeping of records in connection with a litigated case. Procedures that are not being followed include those which require staff to record the outcomes of key internal Tax Office meetings in relation to litigation, to keep copies of external key litigation documents (such as briefs to counsel and counsel's subsequent advice) and to record the eventual outcome of the case.

Subsidiary recommendation 5.6

The Tax Office's LSB area should develop appropriate file and record-keeping keeping procedures for litigated cases. Processes should also be established to monitor the application of these procedures, to review their effectiveness and to implement any necessary improvements.

Tax Office response

5.93 There is room for improvement in our file and record-keeping procedures.

5.94 We will review and reissue the File Management Protocol issued in May 2001. We will put in place governance arrangements to ensure compliance with the revised practices in line with recently issued Corporate Management Practice Statement (CMPS) PS CM 2005/27 on record keeping.

Quality standards

5.95 The Tax Office has no set of policies for the quality control of litigation. It considers that the inherent nature of litigation and the manner in which it is managed by the Tax Office ensures that there are a number of checks on the way cases are conducted. These checks include:

- the involvement (via the SILC process) of a number of different business lines and areas in any decisions that are made concerning a particular litigated matter;
- the involvement of a number of external parties in all litigated cases, including the AGS, external barristers and the courts and tribunals which hear the case; and
- the ability of taxpayers to appeal a case to a higher level tribunal or court.

5.96 A number of submissions made to this review suggested that the Attorney-General's model litigant rules were a sufficient set of quality control policies for the Tax Office's conduct of litigation. However, the previous chapter has noted that there is a lack of awareness of these rules amongst taxpayers, advisers and within the Tax Office and that these rules are not actively enforced by the Office of Legal Services Coordination within the Attorney-General's Department.

5.97 The fieldwork by staff of the Inspector-General discussed in this and the preceding chapter indicates there is a need for specific quality control processes to be introduced by the Tax Office into litigated tax cases.

5.98 The fieldwork discussed in the preceding chapter indicates that there is a need for appropriate evidence on litigated tax cases to be obtained earlier in the dispute process, for ensuring that the technical position being relied upon in the case is confirmed by internal or external Tax Office technical staff rather than compliance staff at an early stage and that all Tax Office staff involved in a case understand why a case is being litigated.

5.99 The fieldwork discussed in this chapter indicates that there is presently a lack of quality control to ensure that internal Tax Office procedures (for example in relation to the documentation of SILC meetings and proper file maintenance) are being followed.

5.100 The establishment of a new independent area for the management of litigated disputes recommended in the preceding chapter will of itself introduce a quality control mechanism into current procedures for litigation, but this area needs to develop its own quality control procedures.

5.101 The above comments lead to the following key finding and recommendation:

KEY FINDING 5.7

The Tax Office has no structured internal quality control processes for litigation.

Subsidiary recommendation 5.7

The new independent area of the Tax Office that is primarily responsible for the management of all aspects of litigated cases should be subject to formal quality control processes for work conducted by staff of that area.

Tax Office response

5.102 Agreed in principle.

5.103 We will develop a more structured quality assurance process. As indicated in our response to Key Recommendation 2, all decisions regarding litigated cases will be managed by the Office of the Chief Tax Counsel (OCTC) or the Tax Counsel Network.

Maintenance of Tax Office technical views and guidance on results of court decisions

5.104 The Tax Office's progress on the Behm recommendations for ensuring that Tax Office technical views are maintained or reviewed during litigation and that guidance is provided on the results of court decisions is discussed in detail in the last chapter of this report.

Relationship management

5.105 The Tax Office has engaged an external consultant to review its existing Memorandum of Understanding with the AGS. The new memorandum is to incorporate an evaluation process for both parties to the memorandum.

Market testing

5.106 While the Tax Office has now established panels of external providers for debt litigation work and commercial and general law advice, it has not yet established a similar provider panel for Part IVC litigation services.

TAX OFFICE'S INTERNAL POLICIES AND PROCEDURES FOR MANAGING LITIGATION OUTSIDE THE LEGAL SERVICES BRANCH

5.107 The Tax Office's internal policies for managing litigation do not consist solely of the policies and procedures applied by its in-house legal area. They also consist of policies and procedures that are applied by the other areas of the Tax Office that have a role in litigation — namely the Tax Counsel Network and business lines.

Nature of policies and procedures for litigation applied by the Tax Counsel Network

5.108 The Tax Counsel Network (TCN), which comprises around 76 Tax Office staff, has no uniform policies and procedures for its role in the management of tax litigation.

5.109 The role of this area in respect of litigation is currently described in PS LA 2005/22, but only in very general terms. In accordance with this practice statement, TCN is responsible for forming the Tax Office technical view that is to be applied in all cases involving priority technical issues (PTIs).

5.110 In practice, members of TCN have generally taken this statement of their role to mean that, where they are involved in a PTI case, they are responsible for all key decisions that are required by the Tax Office on the case, including the settling of the wording of court and tribunal documents and the nature of submissions that are to be made during the hearing. The relevant business line is not therefore responsible for these decisions.

5.111 However, the degree of involvement by any TCN member in any case (including a PTI case) is at the sole discretion of that TCN member. This is explicitly permitted by PS LA 2005/22.

5.112 TCN's role in a case can also be affected by the degree to which a Tax Office business line resists the technical views of TCN in relation to the case. If these views differ, the matter can be escalated to higher management levels within the Tax Office for a decision on which view will prevail.

5.113 Under the Tax Office's current management chart for litigation as set out in Appendix 9, two separate senior members of the Tax Counsel Network have ultimate technical responsibility for all cases involving aggressive tax planning and GST issues. However, the nature of the relationship of these positions to the TCN position within the LSB area which is responsible for strategic litigation is not clear, as it is not set out in any formal Tax Office internal policy document.

5.114 The Inspector-General considers that it is undesirable for the role of any tax officer to be either unclear or left to the discretion of that officer. The Inspector-General considers that the Tax Office should establish and enforce a uniform, written and clear set of internal management policies and procedures for the litigation roles which are currently carried out by TCN members.

5.115 The Tax Counsel Network is not required to prepare any management reports to the ATO's Executive for any cases for which it is effectively responsible. The litigation management activities of this network are also not subject to quality control processes.

5.116 The above comments lead to the following key finding:

KEY FINDING 5.8

There is no uniform, written and clear set of internal management policies and procedures for the litigation roles which are currently carried out by members of the Tax Office's Tax Counsel Network. The Tax Counsel Network is also not required to prepare any management reports to the ATO's Executive for any cases for which it is effectively responsible. The litigation management activities of this network are also not subject to adequate quality control processes.

Nature of policies and procedures for litigation within business lines

5.117 For most business lines, the only written statement of their overall policies and/or procedures for litigation is contained in service agreements they have entered into with the Tax Office's in-house legal area. Until recently, the terms of these service agreements have differed between each business line. However, the Tax Office has recently produced a single, standardised service agreement for all business lines.

5.118 Under this generic service agreement the business lines are responsible for the following elements in relation to the management of litigation[66]:

- development of the Tax Office position on the issues to be litigated and the arguments to be run (both subject to relevant escalation processes within the Tax Office);
- the gathering of evidence; and
- the management of the ongoing relationship with the opposing party.

5.119 The draft service agreements contain the following details of the procedures to be followed by each business line in relation to litigation:

- The lines are to provide the LSB area with instructions. These are to include the facts of the case, the Tax Office position on the issues to be litigated, the arguments to be put and all details and documents that establish the relevant facts and arguments.
- The line is to collaborate with the LSB to prepare any necessary court or tribunal documents. For AAT matters, the line is to actually prepare a draft of the relevant tribunal documents and send this to the LSB area. These documents are to be finally approved by the business line before they are filed in the relevant court or tribunal.
- Where AGS and/or external counsel are to be engaged for the case, the LSB area will engage these parties if the matter involves tied work (that is, work which can only be performed by the AGS under the current Commonwealth Legal Services Directions for engaging solicitors). The LSB area will only engage these parties for non-tied work if the business line agrees. In all cases the LSB area will prepare the brief required by these parties.

66 Service agreement at clause 7.4.

- Litigation strategy and non-technical decisions made in the conduct of the case are to follow the agreement on these matters reached between LSB and the business line at relevant SILC meetings.

- Where a decision is handed down, the business line is responsible for all follow-up work in relation to the case (including the issue of assessments and the payment of interest).

5.120 Generally, other than for the GST business line, the only other procedural documents which are available to business lines to guide them on carrying out the above responsibilities are the same procedural documents currently available to LSB officers. As discussed above, these documents are largely unhelpful as they are either incomplete, out of date or spread across a number of different sources. However, the LSB area is engaged in a process to update these documents.

5.121 The GST business line recently developed a manual for staff involved in litigation activities.[67] It is also preparing a draft procedural document on declaratory proceedings. During the course of this review, in September 2005 this business line also developed a document setting out the various governance processes in the GST business line for managing litigation.

5.122 The business lines' role throughout the litigation process, as stated above, is far wider than that of the LSB area. While the LSB area is working towards improving documentation of its role and procedures in the litigation process, apart from in the GST business line, there is only limited work that has been undertaken or is under way within the business lines to prepare policy and/or procedural documentation which would guide their officers on how to carry out all of their significant litigation responsibilities. If the Tax Office creates a single area responsible for all aspects of the management of litigated disputes, the current state of this documentation in relation to these responsibilities will need to be addressed.

Business line governance processes in relation to litigation

5.123 The business lines' responsibilities in relation to litigation also include responsibilities for ensuring that there are appropriate governance processes (including quality control processes and the provision of reports to the ATO's Executive) for the litigation activities for which they are responsible.

5.124 The business lines are also responsible for the payment of all costs incurred by the Tax Office in relation to litigation.

5.125 As noted above, the Inspector-General found during this review that there were no structured quality control processes in relation the Tax Office's litigation activities. This finding also applies to the litigation activities for which the business lines are responsible.

5.126 As also noted above, the Inspector-General found that there is no management report prepared anywhere in the Tax Office for the ATO's Executive which details the overall state of the Tax Office's litigation program, including the revenue tied up in this process and the Tax Office costs incurred to date on either all or any individual cases.

---

67 ATO Minute No: IGT 65-2005, dated 13 October 2005.

5.127 There are also no such reports prepared for the ATO's Executive by any of the business lines in respect of the litigation for which they are responsible. This absence of written reports by the business lines to the ATO's Executive extends to strategically important litigation. This is the case, even though the ATO's Executive regards the business lines as having the primary responsibility to provide timely advice to both it, the Treasury and Treasury Ministers on the progress and implications of at least all strategically important litigation.

5.128 The actual nature of the internal management reports that are prepared by each business line varies considerably between each business line and is discussed further below.

Nature of policies and procedures (including reporting processes) within each business line

Large business and international

5.129 The Tax Office estimates that as at June 2005 there were 128 litigated cases involving the Large Business and International business (LBI) area. The total number of all Tax Office litigated cases at that date was 2,666. During the 2004/05 year, this area finalised 72 cases. The total number of all Tax Office litigated cases finalised during this year was 1,166.

5.130 The LBI area considers that the majority of all its litigated cases involve priority technical issues.

5.131 There is no specific team in this area which handles litigation. Staff teams in this area are organised into teams that focus on particular clients. As a result, a litigated matter is handled by the team responsible for the relevant client who has the case which is being litigated.

5.132 The LBI case officer who handles the original dispute decision is also the staff member who has primary carriage of any subsequent litigation.

5.133 There is no process for an internal review within the business line of any decisions made by this LBI case officer during the litigation process. This same officer has the prime responsibility for developing any strategies that arise as a result of a decision in a litigated case.

5.134 Submissions made to the Inspector-General during the course of this review provided a number of examples of cases where it was asserted that an internal review of decisions made by LBI litigation case officers responsible for the case would have led to the cases being resolved much earlier in the litigation process.

5.135 An LBI National Litigation manager has overall responsibility for litigation within the line. This manager chairs a four–person Litigation Strategy Committee which held its first meeting during the course of this review. This committee meets quarterly to review litigation cases and practices within the line.

5.136 LBI also has a litigation coordination unit which provides statistical data and reports on certain details of litigation cases involving LBI clients and acts as a liaison point between the business line and the LSB area.

5.137 The reports prepared by this unit consist of:

- a litigation cases spreadsheet. This is circulated to the Litigation Strategy Committee and to various segment leaders within the business line, but not to the line's Executive team; and

- narrative comments on certain litigated cases which are included in a monthly report prepared for the business line's Executive team.

5.138 The line prepares no specific reports to the ATO's Executive on litigated cases.

5.139 The line is in the process of developing a website to provide LBI staff with additional support around litigation practices and procedures.

Small business

5.140 The number of cases finalised by the Small Business Line during the 2004/05 year was 174.

5.141 For cases handled by the Small Business (SB) area, a litigation coordinator is assigned to each litigated case. This person is additional to the officer who handled the original dispute which gave rise to the litigation. The litigation coordinator must prepare the draft set of tribunal documents for AAT matters and must attend all SILC meetings held on the case. The original dispute officer usually however maintains an involvement throughout the litigation and may attend SILCs.

5.142 The coordinator plays no role in determining the objection decision or reviewing any other decisions made earlier in the dispute process. Once the objection decision is referred to a court or tribunal, the litigation coordinator can then review the original decision and determine that the case should not proceed. However, the coordinator cannot overturn an objection decision at this stage if they consider that the objection decision is incorrect because it applies a settled Tax Office technical view which the coordinator considers is incorrect. In this case, the coordinator needs to escalate the matter both within their business line and to the Tax Counsel Network for a decision on how to proceed.

5.143 There is no further internal review process for any litigation decisions made by the litigation coordinators.

5.144 Submissions made to the Inspector-General during the course of this review provided a number of examples of cases where it was asserted that an internal review of decisions made by SB litigation coordinators responsible for the case would have led to the cases being resolved much earlier in the litigation process.

5.145 A monthly report is prepared within the business line providing a summary of the majority of cases on hand. This report is available to the business line's executive team. There is an expectation (but no formal requirement) that litigation coordinators will inform the national manager responsible for litigation of all significant litigation cases. Whether a case is significant is determined by the litigation coordinator. On a quarterly basis, the national manager within SB conducts a review (call over) of all SB litigated cases.

5.146 The business line's executive is not currently briefed on the more important litigation matters on hand but it is proposed that such briefings will be conducted on a three monthly basis.

5.147 Follow-up action required as a result of a decided case is carried out by the technical area within the business line responsible for the relevant issue.

5.148 The line prepares no specific reports to the ATO's Executive on litigated cases.

5.149 Part IVC litigation matters which involve the Serious Non-Compliance area of the Tax Office are litigated by the SB area. This arrangement is managed under a draft Memorandum of Understanding between these two areas.

Personal tax

5.150 The total number of cases the Personal Tax (Ptax) area was handling as at June 2005 was 124. During the 2004/05 year, it finalised 91 cases.

5.151 There is a small team of around 6-7 people involved in the supervision of Ptax litigation, headed by a litigation manager. Members of this team are all members of the business line's tax technical team, which is separate from the line's audit area. The team only handles matters that have reached the stage of litigation and play no role in determining original objection decisions. However they do review these objection decisions once they have reached the litigation stage.

5.152 No further internal review process exists for any steps taken in the litigation beyond this stage.

5.153 The Ptax litigation team rates litigation cases into three categories according to risk — with category 1 and 2 cases being the highest risk cases. Decisions to proceed with these two categories of case are made by senior officers of the Tax Technical network who are outside the litigation team. Decisions to proceed with category 3 risk cases (the lowest risk cases) are made by the manager who is in charge of the area's litigation.

5.154 The Ptax area handles a relatively small number of cases but, as a number of these cases can affect a large number of taxpayers, it has detailed processes for preparing communication plans which outline the communication strategies that need to be adopted following the outcome of cases with wide impact.

5.155 The only management report where litigated cases are reported is in a weekly 'Heartbeat' report. This contains short one-paragraph narratives on litigated cases considered to be of interest to the business line's executive.

5.156 The line prepares no specific reports to the ATO's Executive on litigated cases.

GST

5.157 The GST business line had 98 litigated cases it was handling as at June 2005. In the 2004/05 year, the line finalised 70 cases.

5.158 This area has established the most extensive policies and procedures of all business lines for litigation.

5.159 The line has a number of internal committees which consider aspects of litigated cases. For example, it has an internal technical priority issues committee which reviews the priority and status of priority technical issues including those which are or may become the subject of litigation. It also has an issues management committee which monitors priority technical and other critical issues.

5.160 As regards individual cases the following processes apply.

5.161 With the exception of 'penalty only' matters, in almost all GST litigation cases a Tax Counsel Network member is allocated to assist in the carriage of the case, regardless of whether or not the case involves a priority technical issue. This arrangement dates from the beginning of the introduction of GST in mid 2000.

5.162 The GST line's policy is also that, with the possible exception of Small Taxation Claims Tribunal cases, generally at least a junior external counsel and possibly a junior and senior counsel (depending on the issue) may be briefed for a GST case.

5.163 The GST business line has a formal review and litigation team, headed by a Review and Litigation Director and comprised of about 55 staff in seven teams which are located across Australia. These teams review all objection decisions prior to their finalisation. If the case proceeds to litigation, the same review and litigation team officer who made the original objection decision will become the business line's litigation coordinator for the case and will attend all relevant SILC meetings.

5.164 The GST area also assigns a senior executive as 'risk owner' to each litigated case. This senior executive is responsible for assigning an appropriate mentor/subject expert to the case. This expert will attend all SILC meetings not attended by the senior executive risk owner.

5.165 Decisions to proceed with all litigated cases are made by the relevant senior executive risk owner.

5.166 These processes mean that a minimum of three GST business line officers are actively involved in any one GST case. The GST litigation manual states that at least five GST business line members are to be invited to all SILC meetings for GST cases. These numbers greatly exceed the number of business line officers actively involved in litigated cases run by other business lines. These numbers can grow depending, for example, on the significance of the case and can, on occasion, reach levels which are clearly excessive. For example, in one case reviewed by staff of the Inspector-General during this review there were seven GST business line staff involved in a GST litigated case involving disputed tax of only $1818.

5.167 The GST line's practices exhibit more elements of an internal review process for litigation decisions than any other business line. The line's litigation manual states that it has an informal review process which arises from the Taxpayers' Charter. Under this process a taxpayer may seek an informal review of a decision made by one GST business line officer, with this review generally being conducted by an officer who was not previously involved in making the original decision. However, this internal review process is only informal (that is, taxpayers have no formal rights under which they can request this review process).

5.168 However, despite the GST business line's practices, cases are still proceeding to litigation and are subsequently settled as a result of the necessary facts and evidence and/or correct technical views being obtained only at this stage and not earlier in the dispute resolution process.

5.169 As discussed above, the GST line has developed more detailed internal written procedures for its litigation than any other business line. It has a manual for staff involved in litigation and has also developed a draft practice statement on declaratory proceedings involving GST.

5.170 Written reports to the GST Executive team on litigation matters consist of the following:

- A report is prepared by the Issues Management Committee which will touch on litigation where a key event occurs for an issue and this event relates to litigation.
- A fortnightly GST Litigation report is prepared which is reviewed by the GST Executive. This report is comprehensive in many respects and includes details of the tax and penalty involved in each case. Unlike any other business line litigation report or any report prepared by the LSB area, it includes cost/benefit analyses for most cases on hand, although the costs recorded are only those which have been incurred externally by the Tax Office. However, the report does not summarise the total GST that is currently the subject of litigated disputes.
- On a monthly basis, the Review and Litigation Director will forward to the Deputy Commissioner for GST the significant litigation report prepared by the LSB branch with briefing notes on any significant changes for GST cases.

5.171 The line prepares no specific reports to the ATO's Executive on litigated cases.

Superannuation

5.172 The Superannuation business line was handling 37 litigated cases as at June 2005. During the 2004/05 year it finalised 57 cases.

5.173 Management of litigation in the Superannuation business line is undertaken by the Superannuation Centre of Expertise (COE) area which is separate from the business line's audit area. A litigation manager in this area monitors the overall progress of all cases. The Tax Office advised that from early 2006 the management of litigation within this business line was to be moved to a Complex Technical Unit (CTU) area which is currently involved in providing certain reports on litigation. The CTU area is also separate from the business line's audit area. The COE area would continue to be involved in litigation if the matter is precedential or a high risk case.[68]

5.174 Currently, case officers for particular litigated cases are selected by other managers within the COE area and these case officers report directly to the managers who have appointed them. Technical arguments are agreed between the case officer and their respective manager in conjunction with the LSB area. All decisions on cases are made by the case officers in conjunction with their managers.

---

68 ATO Minute No: IGT 86-2005, dated 13 December 2005.

5.175 Where a case involves complex technical issues, views will be sought from the Complex Precedent team within the Centre of Expertise.

5.176 The regular written reports to the Superannuation area's Executive team on litigation matters consist of weekly 'Heartbeat' and monthly 'Line Delivery' reports. These record the number of litigation cases on hand and (in certain cases) the number of cases finalised during the relevant period.

5.177 The line has prepared a one-off superannuation court case analysis covering the period from August 2003 to June 2005. This analysis provides further information on the characteristics of litigated cases during this period, including the number of cases involving particular areas of superannuation law, the issue that was involved, and the average time to complete cases. However, this analysis is not part of its regular reporting processes.

5.178 The line prepares no specific reports to the ATO's Executive on litigated cases.

Aggressive tax planning

5.179 As indicated in an earlier chapter, aggressive tax planning cases account for the majority of all cases litigated by the Tax Office.

5.180 The Tax Office estimates that as at June 2005 there were 1,500 cases in the Aggressive Tax Planning (ATP) area which were at the stage of litigation. The number of cases finalised by the line during the 2004/05 year was 597.

5.181 The ATP area has only a very small number of staff dedicated to working in this area. The remaining staff who work on ATP matters are drawn from the Tax Office's business lines (chiefly the Small Business line). A specific TCN officer is dedicated to coordinating strategic ATP litigation. The area has no procedural documents which set out its processes for managing ATP litigation.

5.182 Management reports for the ATP area (including those prepared for the ATO's Executive) do not separately identify ATP disputes which are at the stage of having been appealed to a court or tribunal from those which have reached the objection stage.

5.183 ATP dispute cases do not have an individual case manager assigned to each case. All ATP cases are managed by the Tax Office on a bulk basis. The Tax Office has an agreement with the AAT that it can initially lodge standardised documents to record the issues in dispute for these types of cases. These standardised documents are later tailored to the individual facts of the case once the matter proceeds to a hearing.

5.184 An ATP litigated case will have a Tax Counsel assigned to the case once it has been identified as having lead case status. A case will have lead case status if it becomes the first case that will be heard by a court or tribunal on a particular aggressive tax planning arrangement.

5.185 There is no general internal review process for matters litigated by the ATP area. However, internal review processes have been established for certain ATP cases that have reached the stage of litigation. Examples include the internal review process established for taxpayers who were involved in pre-1999 mass marketed tax effective schemes and were not eligible for the concessional settlement offer made in 2002 for

those schemes, and the internal review process that has been established for taxpayers involved in employee benefit arrangements.

5.186 Decisions to appeal ATP cases are, unlike all other litigated cases, not made by the Deputy Chief Tax Counsel who is part of the Tax Counsel network. These decisions are made by the business line executive who heads the ATP area.

Adherence by business lines to internal business line procedures for litigated cases

5.187 The scope of this review did not extend to conducting an examination of the extent to which the above policies and procedures for litigation by each business line are followed by relevant Tax Office staff.

5.188 However, the fieldwork conducted by staff of the Inspector-General for this review did indicate possible concerns in this area. For example, although it is the policy of each business line to maintain files for litigated matters that are separate from those maintained by the LSB area, a significant percentage of those files were not able to be located when requested by the Inspector-General. Furthermore, those files that were located and examined by staff of the Inspector-General were generally of extremely poor quality. Key deficiencies in these business line files included the absence of key external and internal documents relevant to the case and an absence of any material indicating how the case was eventually resolved.

5.189 The above comments lead to the following finding.

KEY FINDING 5.9

The internal management policies and procedures for litigation of each of the Tax Office's business lines are not uniform and are of varying quality, with none exhibiting all the hallmarks of best practice. The area with the most extensive and detailed processes for the internal management of its litigation processes is the GST business line. However, this area's processes still require improvement, particular in the area of efficiency. The area with the least extensive and least detailed internal management processes for Part IVC litigation is the Aggressive Tax Planning area, with other lines falling in between.

CONCLUSIONS ON STAKEHOLDER CONCERNS AND ON TAX OFFICE POLICIES AND PROCEDURES FOR LITIGATION

5.190 The material discussed in this chapter confirms that the first of the concerns raised by stakeholders in relation to the Tax Office's internal policies and procedures for litigation — namely, that the Tax Office's senior management appears to lack awareness of and support for cases that are being litigated — is valid.

5.191 The material discussed in this report confirms that the only management report provided to the Tax Office's Executive on litigated cases is the significant

litigation report prepared by the LSB area. This report contains very little material to support a proper risk management approach to these cases — such as that contained in the ATO's internal practice statement on risk management[69]. This report also contains no data — including risk management data such as the total quantum of tax in dispute — for litigated cases that are not considered to be significant. There is also considerable variation in the quality of management reports on litigation being provided to lower levels of management within the Tax Office.

5.192 The second issue raised by stakeholders — that the Tax Office does not perceive litigation risks in the same way as a normal litigant — is also valid.

5.193 The third concern was that the Tax Office's staff do not understand the materials/commercial transactions they are dealing with during litigation. The Inspector-General's review found that there is a lack of educational support given to officers of the LSB area. Therefore, to the extent that this absence of support leads to LSB officers not being fully trained on the materials or transactions they are dealing with, the Inspector-General believes that this concern is valid for these officers. This review did not examine the educational support processes for business line officers who may be involved in litigated cases.

5.194 The Inspector-General considers that the fourth stakeholder concern — that Part IVC litigation appears to be initiated at low levels within the Tax Office — is not valid to the extent that it suggests that litigation is initiated by the Tax Office. As discussed in a previous chapter, litigation with the Tax Office is initiated by taxpayers in all cases, although certain Tax Office decisions can play an important role in the creation and/or continuance of that litigation.

5.195 The Inspector-General also considers that this fourth concern is also not valid to the extent that it suggests that the fact that a litigated case is handled by a relatively junior ATO officer is prima facie evidence of a systemic problem in the Tax Office's management of litigation. While this chapter and other chapters of this report discuss certain systemic problems in the Tax Office's management of litigation, none of these suggest that there is a systemic problem in the manner in which the Tax Office can allocate responsibility for litigated cases to certain relatively junior staff.

5.196 The fifth stakeholder concern was that there are no processes which allow decisions on litigated cases made by any one area of the Tax Office to be reviewed inside that area by other staff who have not previously been involved in the case. This concern differs from the concern of stakeholders about the absence of an internal review process that is discussed in the preceding chapter of this report. In this chapter, the concern is the absence of any internal review process inside any one area of the Tax Office with responsibilities for litigation decisions. In the previous chapter, the concern related to the absence of any process which allowed litigation decisions made by one area of the Tax Office (for example the business lines) to be reviewed by another, separate area of the Tax Office.

5.197 The findings set out in this chapter confirm that this fifth concern of stakeholders is valid for all areas of the Tax Office which play a role in litigation. While some areas do have elements of such an internal review process, other areas (such as the LBI area) have none at all. For those areas which do have certain elements of an

69 ATO Practice Statement PS CM 2003/02(G).

internal review process, this process is not fully effective. For some business lines, such as the Ptax and SB area, this internal review process stops at an early stage in the litigation. For all business lines, a formal internal review process cannot be initiated by a taxpayer.

5.198 The Inspector-General considers that the above comments, together with the other key findings referred to in this chapter, reinforce the recommendations for changes in the Tax Office's approach to litigation made in the preceding chapter. In particular, these comments and findings strongly support the need for the Tax Office to establish a separate single area of the Tax Office which is responsible for all aspects of the management of litigation. The Inspector-General considers that a single area of this nature with a single litigation management focus is more likely to generate better internal management processes for litigation (including appropriate internal review processes) than those which currently exist inside the Tax Office.

CHAPTER 6: THE TEST CASE LITIGATION PROGRAM AND OTHER TAX OFFICE FUNDING ARRANGEMENTS FOR CASES

6.1 This chapter discusses the Tax Office's test case litigation program and other arrangements which the Tax Office has in place to fund the cost of certain cases that are litigated under Part IVC of the TAA 1953 (Part IVC cases).

6.2 The chapter also details community concerns with these arrangements for funding litigated cases and sets out certain recommendations to address these concerns.

INTRODUCTION — TYPES OF CASES WHICH THE TAX OFFICE HAS FUNDED

6.3 There are four categories of Part IVC litigated cases which the Tax Office currently funds. These categories of funded cases are:

- cases funded under the formal test case litigation program. These are cases where the taxpayer makes a formal application for test case funding, in accordance with funding criteria that have been publicised by the Tax Office, and that funding is approved by the Tax Office in accordance with those criteria, in conjunction with external consultation arrangements;
- cases where the Tax Office will fund a taxpayer's appeal costs where the Tax Office has lost a case at the AAT;
- cases where the Tax Office will fund the taxpayer's appeal costs where the Tax Office appeals to the High Court; and
- cases funded by the Commissioner of his own volition. In this report these cases have been described as 'other cases the Tax Office will fund'.

6.4 The Tax Office considers that the first and last categories of funded cases together comprise the formal test case litigation program. Since 2004 the Tax Office also considers that the second and third categories of case form part of this formal program, in the sense that these cases can be funded out of the amount budgeted for the formal test case program.

6.5 However, submissions made to this review indicate overwhelmingly that the community has never perceived that cases which fall into the second, third and fourth categories above form part of the formal test case litigation program. Throughout the life of the test case program, the community's perceptions have been that the formal test case litigation program only covers cases that fall into the first of the above categories of funded cases.

6.6 The Tax Office's definition of cases which fall into the formal test case program effectively means that the program consists of cases which meet the formal criteria for funding which the Tax Office has set for category 1 cases and those which do not meet these criteria. This definition is logically flawed and effectively makes the

formal test case funding criteria meaningless. These criteria therefore do not, in practice, operate as a means of controlling which cases will and will not be funded by the Tax Office.

6.7 This chapter uses the community's concept of the formal test case litigation program as this concept relies on the existence of certain criteria which must be met for funding to be granted. It therefore ensures that appropriate transparency, accountability and consistency mechanisms can be introduced into the Tax Office's funding of certain cases.

6.8 Using this definition, this chapter identifies that there have been types of cases funded by the Tax Office which have fallen outside the Tax Office's formally stated test case litigation program criteria. In this chapter, the Inspector-General is not providing comments on whether or not the Tax Office should have funded *particular* cases (such as *Budplan*[70] and *Stone*[71]) outside these criteria. The Inspector-General acknowledges that the Commissioner is entitled to fund any litigated case, under his general administration powers. However this chapter argues that appropriate transparency, accountability and consistency mechanisms should operate on these other types of funded cases as well as cases funded under the formal test case program.

6.9 This chapter also argues that the formal test case program should be managed in a way that overcomes perceptions that the program is overly subject to influence by the Tax Office. This could include removing the program to a government body other than the Tax Office. If this is done, there will automatically be a separation between cases which are funded under the formal test case program and cases funded by the Commissioner of his own volition. Under a new structure, the problems set out in this chapter which have emerged from the Tax Office's failure to be transparent about its objectives for funding particular litigated test cases should be less likely to arise.

6.10 The above comments lead to the following key findings:

KEY FINDING 6.1

There are four categories of litigated cases which the Tax Office currently funds. These are cases funded under the formal test case program, cases where the Tax Office will fund a taxpayer's appeal costs where the Tax Office has lost a case at the AAT, cases involving the Tax Office appealing to the High Court and other cases it will fund under its general administrative powers.

70 *Howland-Rose & others v Commissioner of Taxation* (the Budplan case) (2002) 49 ATR 206.
71 *Federal Commissioner of Taxation v Stone* (2005) 59 ATR 50.

KEY FINDING 6.2

The Tax Office has defined cases which fall into the formal test case program as cases which consist of those which meet the formal criteria for funding which the Tax Office has formally communicated to the community as well as cases which do not meet these criteria. This definition is logically flawed and means that the formal communicated criteria for funding test cases are meaningless and do not operate as a means of controlling which cases will and will not be funded by the Tax Office. If the test case program were to be managed more independently of the Tax Office, perhaps by moving it to another Government body, there would automatically be a separation between cases which are funded under the formal test case program and cases funded by the Commissioner of his own volition, and the problems which have emerged from the Tax Office's failure to be transparent about its objectives for funding particular litigated test cases should be less likely to arise.

6.11 The Tax Office's definition of cases which fall into the formal test case program has also led the Tax Office to argue that cases which have achieved 'law clarification' in the sense of clarifying how existing law applies to a given set of facts have fulfilled one of the purposes of the program. This argument ignores the definition of 'law clarification' which is set out in the formal test case program and is discussed further later in this chapter. In the formal program, the term 'law clarification' is effectively defined narrowly to mean only those cases which result in new law.

6.12 In this chapter the term 'law clarification' is generally used in this narrow sense of the creation of new law, except where otherwise indicated.

FEATURES OF THE FOUR CATEGORIES OF CASES WHICH THE TAX OFFICE MAY FUND

Internal Tax Office management arrangements for funded cases

6.13 The Tax Office has advised that, up to 2004, there was no one area within the Tax Office which was responsible for managing all the above four categories of funded cases. Decisions to fund cases under the formal test case litigation program were generally made by the officer who was responsible for this program. This officer is presently located in the Strategic Litigation Team of the Tax Office's Legal Services Branch.

6.14 The responsibility for making decisions to fund cases that fall into the other three categories of funded cases generally lay within the business line which owned the relevant case. However, the manager of the formal test case litigation program was generally consulted for their opinion on whether all these types of cases should be funded.

6.15 The Tax Office has advised that since 2004 the decision to fund all four categories of Tax Office funded cases has been within the control of the manager of the formal test case litigation program.

Cases funded under the test case litigation program

6.16 The first category of cases funded by the Tax Office consists of cases that are funded under the formal test case litigation program.

6.17 Under the program, taxpayers can apply to the Tax Office to have their case funded by that Office on the basis that it meets certain specified law clarification criteria. These criteria specify that the case must raise questions relating to an area of the law where there is uncertainty or contention, rather than questions of fact where the law is already settled. These criteria have been communicated to the community via a test case litigation program booklet which is available on the Tax Office's web site.

6.18 The program is not a legal aid program and is open to all taxpayers, regardless of their financial circumstances. The Tax Office has advised that it has been unable to identify any similar programs existing in any revenue authority elsewhere in the world.

6.19 The program was established by the Tax Office in the 1995/96 year in response to a set of recommendations made in a 1993 report by the Commonwealth Parliament's Joint Committee of Public Accounts (JCPA) into the operation of the self assessment system.

6.20 The program implemented by the Tax Office has differed however in a number of major respects from the JCPA's recommendations.

6.21 The JCPA's recommendations envisaged that the Tax Office would fully fund taxpayers' expenses at no cost and with no penalty to the taxpayer.

6.22 At the start of the program, the Tax Office determined that costs funded under the formal test case program were to be limited to those costs which were usually awarded to a successful party in litigation, unless very special circumstances existed. These are generally known as party/party costs. Party/party costs are usually less than the costs which a party actually incurs in connection with a case and do not cover, for example, fees paid to an accountant in connection with the case. This basis of funding was selected because this was the basis used in most legal aid programs. More recently, costs funded under the program have been awarded on a solicitor/client basis. This generally results in a higher amount of costs being paid to the taxpayer than would be the case if party/party costs applied.

6.23 The thrust of the JCPA's recommendations on test case funding also involved transferring some of the litigation power from the Tax Office to taxpayers. Funding decisions were not to be solely in the hands of the Tax Office.[72] However, from its inception funding decisions under the program have been made solely by the Tax Office. External input to funding decisions has consisted of advice received from an advisory panel (the test case panel) which is made up of both Tax Office and non-Tax

72 Joint Committee of Public Accounts, *JCPA: Concerns about Tax Reforms*, media release, 21 November 1995.

Office members. This panel is chaired by a senior tax officer who normally makes the final decisions on funding, although this decision may also be taken by a Deputy Chief Counsel, Second Commissioner or the Commissioner.

6.24 Just prior to finalisation of this review, and after all fieldwork had been completed, the Tax Office advised that there were a total of 61 cases funded under this program, with a further 64 cases being funded in accordance with one of the Tax Office's other three funding practices.

6.25 The formal test case litigation program is the main way in which the Tax Office funds cases and is the principal focus of this chapter. However, Tax Office material on the cases it funds has not clearly distinguished the formal test case program from the other types of litigation cases that it has funded or will fund. To understand the nature of the formal test case program, it is therefore necessary to understand the three types of funded cases which are not part of the formal test case program. These types of cases are discussed in the next three sections of this report.

Cases where the Tax Office funds the costs of appeals it makes against decisions of the AAT

6.26 The second category of Tax Office funded case arises from its longstanding practice of funding a taxpayer's reasonable costs of appeal where the Tax Office appeals against a decision of the AAT or Small Taxation Claims Tribunal. This category of funded case was established in response to a press release issued in June 1967 by the then Treasurer, the Rt Hon William McMahon, under which the Australian Government undertook to pay, irrespective of the outcome, the taxpayer's reasonable costs in such cases.[73] These cases do not form part of the formal test case program. Only 15 cases have been funded under this category of funded cases from 1995/96 to 2004/05.

6.27 Funding is not granted under this category for cases involving alleged tax avoidance. However, where funding is granted it will generally also be extended to any further appeals that arise from the case, whether the further appeals are made by the Commissioner or by the taxpayer.

6.28 Funding under this arrangement is also made on a 'party/party' basis which can often be less than the solicitor/client basis which applies where a case is funded under the formal test case program. Therefore, a taxpayer who qualifies for funding under this other funding practice may also seek test case funding under the formal test case program.

Cases involving High Court appeals

6.29 The third category of funded case is where the Tax Office offers to fund the costs of a taxpayer's appeal where the Commissioner appeals to the High Court. These types of cases do not form part of the formal test case program, although a taxpayer may use the test case program processes to receive the benefit of this form of funding. The Tax Office has no recorded policy for these types of funded cases. Costs are not offered in all cases. Funding is determined on a case-by-case basis, depending on a

73 ATO Minute No: IGT 62-2005, dated 11 October 2005.

range of factors including the advice of counsel, the importance of the case and how the High Court might perceive the ability of the taxpayer to meet their own costs or be inconvenienced by the grant of an appeal.[74] The amount of costs provided under this category are the usual reasonable party/party costs calculated in accordance with the High Court's rules.[75]

6.30 Just prior to finalisation of this review the Tax Office advised that there were nine cases funded under this category in the period from 1995/96 to 2004/05.

Other cases funded by the Tax Office

6.31 At the time the fieldwork was conducted for this review, management practices within the Tax Office did not enable it to readily identify other cases it has funded under the fourth category referred to above. The Tax Office still does not prepare any reports for the Tax Office's Executive which separately identify the number, cost and progress of 'other' types of funded cases. Reports to the Tax Office's Executive on these cases are currently bundled with reports on cases that are funded under the formal test case program.

6.32 The Tax Office has also not been clear in its communications to the community about the existence and nature of these other funded cases. Its only public statement on these types of cases is in the test case litigation booklet. This booklet states that these cases are funded for 'law clarification' and consist of cases where the Tax Office agrees in principle that a 'test' case (involving either a known taxpayer or a taxpayer that is yet to be found) should be developed. The booklet strongly suggests that the only cases which fall into the category of 'other cases' funded by the Tax Office are cases which meet the usual law clarification criteria (in the sense of creating new legal principles) necessary for funding under the formal test case program, but which are at too preliminary a stage to seek test case funding.

6.33 The Tax Office has also not issued any statement to the community which indicates that, in accordance with an opinion which it has received from the Solicitor-General and Chief General Counsel in December 2005, it will fund or organise suitable assistance to bring a test case in circumstances where the Tax Office launches a challenge to an earlier finalised judicial decision.

6.34 Owing to the Tax Office's internal management practices for these cases, during the fieldwork for this review, the Inspector-General's staff were not readily able to identify the cases which fell into this category. Since this fieldwork and just prior to the finalisation of this review, the Tax Office provided the Inspector-General with figures indicating that over the 10-year period from 1995/06 to 2004/05 there were 40 funded cases which fell into this category. Due to the very late provision of this material, the Inspector-General was not able to confirm the correctness of this figure.

6.35 All of the cases identified during the fieldwork for this review as being 'other' types of funded cases have the following common elements:

- The decision to fund the case was made by the Tax Office alone (usually by the relevant business line responsible for the case in conjunction with the manager of

74 ATO Minute No: IGT 72-2005, dated 12 November 2005.
75 Australian Tax Office, *Test Case Litigation Program,* April 2005 at p 8.

the formal test case program). The case was not initially approved for funding by the test case program's test case panel. The case is therefore not part of the formal test case program.

- The case does not fall into any of the other two categories of Tax Office funded cases.

6.36 One high profile case which falls into this category of other funded case is the case of *Howland-Rose & others v Commissioner of Taxation* (the Budplan case)[76], which was handled by the Tax Office's Aggressive Tax Planning area.

6.37 In a response provided just prior to the finalisation of this review the Tax Office has disputed that this case is one which was funded purely on the Commissioner's own volition. The Tax Office asserts that this case was approved for funding by the test case panel.

6.38 However, funding for this case was not initially granted when the case was first considered by the panel. Funding was only granted retrospectively after the Tax Office had already decided to fund the case.

6.39 Furthermore, the minutes of the relevant test case panel meeting indicate that the panel considered that this case still did not meet the general policy of the test case program, but nevertheless should be funded on an exception basis. The panel's reasons for retrospectively approving funding were because of the circumstances in which the case had come to the panel (the case was being reconsidered by the panel because funding was recommended by the Commonwealth Ombudsman), the length of time already involved in obtaining Tax Office approval to fund and the expectations of the relevant taxpayers. The Inspector-General considers that these factors all indicate that this case was funded by the Commissioner of his own volition, and not via normal test case program processes.

6.40 Other cases that were identified during the fieldwork for this review as falling into this category were handled by the following Tax Office business lines: Aggressive Tax Planning, Large Business and International, Small Business and Personal Tax.

6.41 Contrary to the Tax Office's public statement on the nature of these other types of funded cases, the Inspector-General's review team found that a number of the cases which fall into this category were not funded in accordance with the normal funding arrangements that apply to cases funded under the formal test case program.

6.42 In two of the other types of funded cases identified by the Inspector-General's staff, the relevant funding files indicated that funding for the case was provided to the relevant taxpayers on a full indemnity basis. This funding is more generous than the party/party or solicitor/client basis for funding that has been applied to cases funded under the formal test case program.

6.43 The Inspector-General's review team also found that a number of the cases which fall into this category were not funded in accordance with any of the formal test case program criteria.

---

76 (2002) 49 ATR 206.

6.44 For example, in one of the cases examined, which involved the Aggressive Tax Planning area, the basis for the funding decision was evident from email communications on the relevant Tax Office file. These indicated that the basis was that the case would provide 'the necessary precedent' on the relevant scheme. The file did not suggest that the case was being funded to establish any new principle of law, but rather that it was being funded to apply or enforce the relevant law.

6.45 The *Budplan* case is another example of a case that was not funded in accordance with any of the formal test case program criteria. In this case, the reasons for the funding decision were made public in an information sheet issued on 20 April 2001. This sheet makes no reference to the case being funded in accordance with the usual formal test case criteria, such as the need to clarify/establish a principle of law. Instead this information sheet states that the case would be funded 'if funding is a barrier to these progressing in a timely way'. It states that the reason for this decision was that:

> the Tax Office believes that one of the most effective ways to put an end to so called 'tax effective' investment schemes is to secure strong judicial decisions reinforcing the strength of the law including anti–avoidance provisions … We are now prepared to fund cases if this is what it takes to get the matter heard.

6.46 Another group of 'other funded cases' that were identified for the purposes of this review were the cases which the Tax Office has agreed to fund to test certain issues concerning the application of the anti-avoidance provision of the income tax law (Part IVA) to the alienation of personal services income.

6.47 The decision to fund these cases was made public in a speech given by the Commissioner in March 2003. In the press release which accompanied this speech the Commissioner stated that these cases will be funded:

> in order to get further clarification from the courts on how general anti-avoidance rules apply to these arrangements

6.48 However, of the 12 cases chosen for this type of funding under this program, four have been settled or not proceeded with prior to the case proceeding to a court hearing. The reason for settling or not proceeding with these cases was that the Tax Office received external advice that it was likely to lose all these cases.

6.49 These cases illustrate that the Tax Office's primary role as the collector of the revenue (and as a party to most litigated tax cases) will, in certain cases, override its role to help clarify the application of the law (that is, law clarification in a wide sense) for the benefit of the community in cases where the two roles are in conflict. These cases strongly suggest that the Tax Office does not have the required degree of independence and objectivity to properly select all the types of cases which should be funded for the purpose of clarifying the application of the law for the benefit of the community.

6.50 During this review, the Tax Office has responded to this by asserting that the Tax Office's model litigant obligations required it to not proceed with these cases. However, the Tax Office has not in other contexts asserted that the model litigant obligations prevent it from being involved in cases that it will not win.

6.51 The above comments lead to the following conclusions:

6.52 Firstly, the Tax Office does not have adequate governance processes in place to ensure that either the decision to fund these cases or the method of funding these cases is subject to appropriate internal scrutiny.

6.53 Secondly, the Tax Office has not adequately communicated to the community the existence and nature of the fourth category of 'other funded cases'.

6.54 Thirdly, it has also not communicated to the community the criteria that it applies in deciding to fund cases that fall into this category.

6.55 Fourthly, it has failed to ensure that cases funded under this category have been funded on a basis which is consistent with that which it applies to cases funded under the formal test case program.

6.56 Fifthly, the Tax Office's abandonment of cases which it initially funded for law clarification purposes once it became clear it would lose these cases strongly suggests that the Tax Office may be giving preference to funding 'test' cases which result in achieving compliance with its own view of the law. This strongly suggests that the Tax Office does not in all cases objectively determine whether it should be involved in a case which clarifies the application of the law.

6.57 Finally, it should be noted that during this review, a number of submissions stated that the Tax Office's funding of the *Budplan* case and other similar cases were evidence of the Tax Office's mismanagement of the formal test case program. These submissions have pointed to the publicly known features of the *Budplan* case and other cases and have stated that these features do not seem to allow these cases to qualify for funding under the formal test case funding rules. These submissions indicate the confusion that underlies perceptions about the test case program. The Tax Office has failed to address these perceptions by failing to state that *Budplan* and certain other cases were not funded in accordance with the criteria that apply to cases funded under the formal test case program.

6.58 The above comments lead to the following key findings and recommendations:

KEY FINDING 6.3

The Tax Office has failed to adequately communicate to the community the existence of the fourth category of 'other funded cases', and the criteria it will apply to fund such cases. This lack of communication has led taxpayers to believe that taxpayers funded under the fourth 'other' category of funding have been funded under the formal test case program. This has fuelled community perceptions that the Tax Office is not consistently applying its test case program criteria to all cases that are funded under that program.

KEY FINDING 6.4

The Tax Office does not have adequate governance processes in place to ensure that either the decision to fund the 'other' category of cases it will fund or the method of funding these cases is subject to appropriate internal scrutiny.

Subsidiary recommendation 6.1

The Tax Office should establish appropriate governance arrangements to allow appropriate oversight by the Tax Office's Executive of all litigated cases which it funds. These governance arrangements should distinguish between cases where the Tax Office has obtained no external advice on its decision to fund the case and those where it has obtained, and followed, that advice.

Tax Office response

6.59 We currently report this information to the Priority Technical Issues Committee (PTIC) which is chaired by the Second Commissioner Law.

Inspector-General's comments on Tax Office response

6.60 The Inspector-General believes that the Tax Office should implement this recommendation in full. As the report indicates, at the time of the Inspector-General's review, the Tax Office did not prepare internal management reports (which identify details such as the number, cost and progress) either for cases which it funds of its own volition, or for cases which it funds under the formal test case program. The Tax Office's response indicates that the practices observed by the Inspector-General have not changed. The Inspector-General does not believe that the Tax Office can assert that it is appropriately managing its decisions to fund any of these cases when no such internal reports are prepared.

Subsidiary recommendation 6.2

The Tax Office should take steps to clearly notify the community of the existence of funding arrangements for cases which fall outside the formal test case program and the other rules for funding Tax Office appeals against AAT decisions and appeals to the High Court. It should notify the community of the types of cases that it will fund in this way and of the circumstances in which this funding has been and will be used by the Tax Office.

Tax Office response

6.61 Agreed in principle.

6.62 Commentary on the different types of cases funded is now in the booklet 'Test Case Litigation Program', published in April 2005. In developing the booklet, we

consulted externally before finalising its content and mailing it to major stakeholders. It was placed on our external website and a media release announcing its availability was issued.

6.63 The Test Case Funding Program includes cases funded for law clarification purposes that are in the public interest. This includes cases where the Tax Office agrees to fund cases based on an application by a taxpayer, and those cases where the Tax Office funds a case without the taxpayer needing to apply. The booklet identifies when the Tax Office will fund appeals from decisions of the Administrative Appeals Tribunal and Small Taxation Claims Tribunal. It also makes clear that the Tax Office sometimes offers to meet the taxpayer's costs when special leave is being sought to appeal a case to the High Court.

6.64 Ideally we would prefer to make these funding arrangements totally transparent, but we have been advised by the Australian Government Solicitor (AGS) that there may be problems in doing this in some aspects because of the secrecy provisions contained in the tax law. We will continue to consult with AGS to clarify this.

Subsidiary recommendation 6.3

The Tax Office should ensure that where it funds cases under its general administrative powers, the method of funding (such as the basis and timing of funding) provided is consistent with that which is provided under the formal test case program. This would be to ensure that litigants who achieve funding for law clarification purposes are not disadvantaged when compared with litigants who have achieved Tax Office funding of their case for purposes other than law clarification.

Tax Office response

6.65 We have not drawn any distinctions in our funding practices based on whether it was commenced by a taxpayer application or funded by the Commissioner offering funding in important cases. That said, while the intention is to provide consistent approaches to funding cases, there needs to be some flexibility in appropriate cases having regard to individual circumstances so that all cases are appropriately supported under the program.

6.66 All cases funded are for the purposes of law clarification.

Inspector-General's comments on Tax Office response

6.67 The Inspector-General welcomes the Tax Office's intention to provide consistent approaches to funding cases but notes that, as indicated in the report, this intention has not been put into practice by the Tax Office over the life of the test case program.

FORMAL TEST CASE LITIGATION PROGRAM

6.68 To evaluate the Tax Office's formal test case program the Inspector-General and/or his staff met with a number of key stakeholders and received 22 submissions which commented on the operation of the program.

6.69 The Inspector-General and/or his staff also examined 36 test case program files (21 of which were commenced prior to 2004). A member of the review team attended two meetings of the test case panel as an observer. Interviews were conducted with non-Tax Office members of the test case panel. Information was also obtained from various internal and external reports prepared by the Tax Office on the operations of the program.

6.70 The Inspector-General also conducted an analysis of whether the formal test case program was meeting its aims of law clarification for cases that had resulted in a court or tribunal decision.

6.71 The Inspector-General's findings fall into two groups. The first group of findings relate to the overall structure of the program. These structural findings include findings relating to the overall purpose of the program, whether that purpose is desirable and whether the Tax Office's activities have achieved that purpose. The second group of findings deal with the Tax Office's management of the program in relation to all the individual cases which have been subject to the program.

STRUCTURE OF THE TEST CASE PROGRAM

Purpose of the program

6.72 The test case program was established because of a perceived need for there to be a publicly funded program for litigating major points of dispute and grey areas of the tax law in an environment where taxpayers (rather than the Tax Office) are largely responsible for determining what tax laws apply to their financial transactions.

6.73 The Inspector-General considers that this reason for a publicly funded test case program still remains valid.

6.74 The Tax Office has publicly confirmed that it considers that the purpose of the formal test case program is law clarification for the benefit of the community. It has stated that this purpose will be met in cases which meet the following three criteria:

- There is uncertainty or contention about the operation of areas of law.
- The issue is of significance to a substantial segment of the public or has significant commercial implications for an industry segment.
- It is in the public interest for the issue to be litigated.[77]

6.75 The Inspector-General believes that the Tax Office's statement is an appropriate statement of what should be the purpose of the program.

---

77 Australian Taxation Office, *Test Case Litigation Booklet*, April 2005 p 2.

Budget for the program

6.76 The budget for the program is administered by the Tax Office. $2 million has been allocated to the program each year. From 1999/2000, the program has been funded out of the Tax Office's normal operating budget. Prior to that date, it was funded as part of a separate budget appropriation. This amount was fully expended only in the 2001/02 year.[78]

6.77 Under the current funding arrangements for the program the Tax Office has the discretionary power to expand or contract the program without reference to any external party.[79]

Number of cases funded under the program

6.78 Just prior to the finalisation of this review, the Tax Office advised the Inspector-General that the Tax Office has considered 262 cases for funding, either under its formal test case program, its programs for funding adverse AAT appeals and High Court appeals, or its program for funding other cases. At this time it also provided for the first time a break up of these 262 funding applications into cases that were not funded and that were funded either in accordance with a recommendation by the test case panel, or in accordance with the Commissioner's policies for funding adverse AAT appeals and appeals to the High Court. This break up is shown in Appendix 11.

6.79 The 262 cases referred to in Appendix 11 do not reflect figures reported in the Commissioner's annual reports or in other published material for the relevant years, such as reports for these years made to the National Tax Liaison Group.[80] They also include 28 cases that were not identified as cases for which funding was sought at the time of the fieldwork conducted by the Inspector-General for this review. The Inspector-General has therefore not examined any of these 28 additional cases, nor has he examined the extent to which the figures in Appendix 11 accurately represent a break up between the four categories of funded cases identified during this review.

6.80 The material in Appendix 11 indicates that, of the 262 cases where funding was sought, 125 cases (48 per cent) were funded under one of the four Tax Office funding practices and that of these cases 61 were funded under the formal test case program. There were 137 cases (52 per cent) where funding was sought under one of these practices but where funding was denied.

6.81 Other material provided by the Tax Office indicates that there were 110 cases funded by the Tax Office, other than the 15 cases that were funded under adverse AAT decision funding. These 110 cases led to 44 cases which resulted in a final court decision. Of these cases, 21 have been cases ultimately won by the Tax Office, 20 have

78 Just prior to finalisation of this review, the Tax Office has indicated that amounts spent on the program have been as follows: 1995/1996: $10,616; 1996/1997: $228,250; 1997/1998: $316,621; 1998/1999: $421,949; 1999/2000: $528,373; 2000/2001: $466,611; 2001/2002: $2,008,967; 2002/2003: $692,775; 2003/2004: $904,578; 2004/2005: $393,917.

79 ATO Minute No: IGT-18-2005, dated 27 June 2005.

80 The figures do not, for example, reflect the numbers shown in the National Tax Liaison Group Minutes for the meeting of 7 September 2005, available at www.ato.gov.au, which were publicly released on 26 March 2006.

been cases won by the taxpayer and 3 have been cases won partly by the Tax Office and partly by the taxpayer.

Criteria developed by the Tax Office to determine cases to be funded under the program

6.82 The Tax Office has developed nine internal criteria that it will apply to determine which cases may be funded under the formal test case program. These criteria have been communicated to the community in the Test Case Litigation Program booklet which the Tax Office has published on its website.

6.83 The first three criteria are essential criteria, and mirror each of the three elements of the purpose of the test case program. The remaining criteria are additional and are applied flexibly. The nine criteria are:

- that the issue in question relates to an area of the law where there is uncertainty or contention;
- that the issue is of significance to a substantial segment of the public or has sufficient commercial implications for an industry segment;
- that it is in the public interest for the issue to be litigated;
- whether the case has issues involving questions of fact where there are established legal principles (as questions of fact are not normally funded);
- whether the case is to be brought before a court (as preference is given to cases brought before the courts);
- whether the case involves a challenge to an administrative decision under the *Administrative Decisions (Judicial Review) Act 1977* (as preference is given to cases which involve the review of objections or private rulings which are litigated through Part IVC of the TAA 1953);
- the financial capacity of the taxpayer to pursue litigation (although applicants of financial substance would not necessarily be excluded);
- whether the case involves a tax avoidance scheme or an attempt to gain a benefit not intended by the legislation (as tax avoidance cases are not generally funded); and
- whether the taxpayer is prepared to cooperate to achieve an early hearing.

6.84 The above nine criteria have been in place since April 2005. Prior to that date, there were the following additional criteria:

- that the issues in the case were of relative significance to the administration of tax law;
- that the issue had been noted as having high priority for resolution under the Tax Office's rulings program and judicial determination might be preferable; and
- the case involved a challenge to a controversial ruling or issues seen to be contentious in issued or draft rulings.

6.85 The Tax Office has removed these three criteria during the course of this review because of concerns that they suggested that the Tax Office would only fund cases under the program that were of interest to the Tax Office, rather than of interest to taxpayers generally.

6.86 The pre-April 2005 criteria also indicated that administrative law cases would not be funded. As a result of the April 2005 changes these cases now qualify for funding.

6.87 The pre-April 2005 criteria did not make it clear that cases involving avoidance issues would not generally be funded. The present criteria now state that this is the case.

6.88 The Inspector-General believes that the nine present criteria for the formal test case program (as altered by the April 2005 changes) are appropriate, but that an additional criterion should be added which reflects the opinion which the Tax Office received in December 2005 from the Solicitor-General and Chief General Counsel that funding should be made available in cases where the Tax Office challenges an earlier judicial decision.

6.89 A number of submissions asserted that, although these criteria indicate that funding under the program is available to all, in practice it seems to be restricted to small taxpayers. These submissions asserted that the program should be administered so that it provides funding for suitably representative and significant cases, even where the taxpayer has the means to fund the case.

6.90 In this review, the Inspector-General has found that there was one case involving a large taxpayer that has been funded by the Tax Office. However, this funding was not done under the umbrella of the formal test case program.

6.91 As discussed further below, the Inspector-General considers that the Tax Office should use its own internal resources to be more proactive in seeking out all cases that are suitable for test case funding. In the light of the above comments it should, in doing this, take particular steps to ensure that all suitable cases involving large taxpayers are identified and funded, where appropriate.

Is the Tax Office administering the program so that law clarification is being achieved in all appropriate cases?

Amount budgeted for and spent on the program and number of cases funded

6.92 From the program's inception, concerns have been expressed that the budget for the program has been too low overall.[81] Concerns have also been raised that the Tax Office has been unwilling to spend the total funds allocated to the program.

6.93 Submissions made to this review also suggested that the Tax Office does not do enough to ensure that its test case budget is spent. These submissions noted that the Tax Office could, for example, make better use of its own internal resources or of other

81 See for example, comments by the National Tax & Accountants Association made on 13 August 1997, quoted in *Weekly Tax Bulletin*, August 1997.

publicly available material to find taxpayer cases that would be suitable vehicles for the formal test case program.

6.94 The Inspector-General considers that the above concerns are well founded. This review has established that the Tax Office has spent only $5.97 million on its formal test case program over its ten years of operation. However, the total budgeted funds available for this program over these ten years have been $20 million.

6.95 In addition, there have been only 44 cases funded either under the program or in accordance with the Tax Office's practices for funding other cases and High Court appeals which have reached the stage of a hearing.

6.96 Furthermore, a 2000 Tax Office internal review of the program found that the Tax Office's business lines were unwilling to come forward with suitable formal test case program cases.

6.97 The Tax Office has submitted that its formal test case program budget has not been fully expended because there have been insufficient applications which have met the criteria for funding under the program. It has also pointed to recent efforts to locate cases that could be funded to test certain issues arising from the alienation of personal services income. However, as noted earlier in this report, the Tax Office has now settled or decided not to proceed with a significant percentage of these cases and, as a result, these cases will not proceed to a hearing.

Types of cases that have been funded from program monies

6.98 A number of cases (including *Budplan*) that have not met the formal test case program criteria have been funded out of the $5.97 million spent on funded cases. At least two of these cases, both of which were funded for enforcement purposes, together used up 38 per cent ($2.25 million) of this $5.97 million. These two cases exhausted 83 per cent of the $2 million of budgeted test case funds in one year. This meant that few other cases could be funded during that year under the formal test case program.

6.99 This strongly indicates that the Tax Office has given preferential funding to cases that it wants to have heard for enforcement or other purposes, rather than for the purposes of clarifying the law for the benefit of the community.

Basis of funding formal test case program cases versus other cases

6.100 A number of the cases funded for enforcement purposes out of the $2 million annual budget for funded cases have been funded on a full indemnity basis. However, cases funded in accordance with the formal test case program have generally been funded only on a party/party or solicitor/client basis. This again strongly indicates the Tax Office has given preferential funding to cases involving law enforcement purposes.

Role of the test case panel

6.101 Aspects of the operation of the test case panel raise questions as to how effective it has been in independently ensuring that only cases which meet the formal test case program criteria have been funded.

6.102 Firstly, a number of cases have been funded by the Tax Office without reference to this panel.

6.103 Secondly, there have been at least two significant cases which the independent panel recommended be funded at certain stages but which the Tax Office decided not to fund. There has also been at least one case which the panel recommended not be funded but which the Tax Office funded through its processes for funding other cases, then sought retrospective approval from the panel for this action.

6.104 Thirdly, test case panel members have played no role in monitoring the implementation of funding decisions and are not aware when their funding recommendations have been overturned.

6.105 Fourthly, extensive experience in tax is not an essential requirement for panel membership.

6.106 These features of the operation of the test case panel are further evidence that the Tax Office is giving preferential funding treatment to cases which meet its corporate objectives (for example that of law enforcement), rather than cases which may give rise to law clarification (in the wide sense) for the benefit of the community.

Results of funded and decided test cases

6.107 Of the 44 funded cases which have ultimately decided by a court or tribunal, 21 have been won by the Tax Office, 20 by the taxpayer and 3 partly by the Tax Office and partly by the taxpayer. At face value, these figures may suggest that there is an even split between funded cases that have been won by the taxpayer and cases won by the Tax Office, and that the Tax Office may therefore not be giving preferential treatment to test cases that will vindicate its view on an issue.

6.108 However these figures do not include the significant number of funded cases which were settled or not proceeded with after funding was granted. The number of these cases is the difference between the 110 cases which were initially funded by the Tax Office and the 44 cases which have led to a final court or tribunal decision.

6.109 The figures on the results of funded and decided cases therefore do not give any clear indication of bias in the Tax Office's funding of test cases.

Conclusion

6.110 In view of the above findings, the Inspector-General has concluded that the Tax Office could do more to administer the formal test case program to achieve law clarification in more areas of tax law.

Have the decided cases which have been funded under the program met the stated purpose of the program?

6.111 The Inspector-General has conducted an analysis of finalised court or tribunal decisions that have been funded under the program. The purpose of this analysis was to see if, for these cases, the program has met its stated purpose of clarifying the operation of the tax law by establishing new legal principles.

6.112 The cases analysed were drawn from the Tax Office's internal list of test case program funded cases that had been finalised by way of a court hearing. Just prior to the finalisation of this review, the Tax Office advised that there were 44 such cases.

6.113 The Inspector-General's analysis assessed firstly whether the final decision in the case had established a principle of law or had been decided only on its facts.

6.114 The results were that 33 of the 44 cases (that is, 75 per cent of these cases) established a principle of law, although in some cases the importance of this principle was open to question. In the remaining 11 cases (that is, 25 per cent) no principle of law was established, with the case being decided on its facts or on other grounds.

6.115 During this review, the Tax Office rejected this finding and asserted that a higher number of these cases have led to law clarification. However, the definition of 'law clarification' which the Tax Office has used in arriving at its conclusion is that law clarification arises where a case either leads to new legal principles or results in an outcome which shows how settled law applies to a novel set of facts. As indicated earlier in this chapter, this definition of law clarification is not the one which is used in the formal test case program guidelines. The Inspector-General does not dispute that some of these cases might have been worthwhile for other reasons.

6.116 The second part of the Inspector-General's analysis assessed the degree to which any legal principles established by the cases were still of relevance.

6.117 The results here were that of the 33 cases which established a legal principle, in 19 of these cases (or 58 per cent) these principles were still relevant and in 7 cases (or 21 per cent) these principles were no longer relevant (for example, because of changes in legislation). The principles from the remaining 7 cases (or 21 per cent) were possibly still relevant.

6.118 The third aspect of this analysis was to see whether any cases had led to the Commonwealth Parliament changing the law that was considered in the case. The results here were that in only 8 cases (18 per cent) was the law changed after the decision, while in the remaining cases it was not.

6.119 The above findings suggest that the test case litigation program is substantially achieving its aims of law clarification, at least for the cases that have been decided by a court or tribunal under the program. However, even for these cases there is some room for improvement.

6.120 The final part of the Inspector-General's analysis examined whether the Tax Office had taken any action as a result of the case (for example, by issuing a media release or changing a ruling). The findings on this aspect were that in 22 cases (50 per cent) the Tax Office had made no response to the case while in the other 22 cases they had made a response.

6.121 This aspect of the Tax Office's processes concerning the application of the outcomes of test case funded decisions is discussed further in the next chapter.

6.122 A number of submissions to this review raised concerns about the nature of cases funded under the program. These appear to be borne out by the results of the above analysis. These submissions noted the Tax Office has funded a number of cases under the program which have involved issues of fact rather than issues of law. These

submissions note that the funding of these types of cases is contrary to test case guidelines.

6.123 In this regard, the Inspector-General notes that a number of submissions asserted that *Stone's* case[82] was an example of a case which should not have been funded under the program as it was decided on issues of fact and therefore will not directly apply to other similar taxpayers.

6.124 The Inspector-General further notes that, at a test case panel meeting held in June 2005, the Tax Office agreed to seek out test cases involving the issue of the deductibility of expenses paid by athletes. This issue is essentially the opposite side of the income assessability issue that was considered in *Stone's* case. Its resolution is therefore highly likely to turn on questions of fact. Accordingly, the decision to seek possible test case funding on this issue under the formal test case program may need to be re-examined. This observation is aimed at improving perceptions of consistency about formal test case program decisions. It is not a criticism that funding *Stone's* case was not in the public interest per se.

INTERNAL MANAGEMENT OF THE FORMAL TEST CASE PROGRAM

Governance and organisational framework for the program

6.125 From 1 December 2003, the formal test case program has been managed within the Strategic Litigation Team of the Tax Office's Legal Services Branch. This branch is located within the Office of the Chief Tax Counsel. The manager of the test case program is assisted by one to two other Tax Office staff.

6.126 The review notes that the management of the program appears to have recently improved, especially when compared to the observations of poor past administration below.

6.127 The internal reporting arrangements for the program are not clear and reflect the nature of the Tax Office's current governance processes for litigation generally. For administrative and reporting purposes, the manager of the program reports to a Senior Assistant Commissioner who in turn reports to the National Program Manager of the Office of Chief Tax Counsel. However, for technical purposes, the manager of the program works to a Deputy Chief Tax Counsel who in turn reports to a Second Commissioner of Taxation and then the Commissioner.

6.128 No specific internal management reports are prepared for the Tax Office's Executive on the formal test case program. Any internal reporting on the program is combined with internal reporting for the other types of cases which are funded out of the $2 million budget. The extent of internal reporting arrangements for all funded cases that are managed by the manager of the formal test case program is as follows:

- the number of cases funded out of the $2 million budget are identified in monthly reports prepared for lower level management within the Tax Office;

82 *Federal Commissioner of Taxation v Stone* (2005) 59 ATR 50.

- these funded cases are identified in Significant Litigation reports circulated to the Tax Office's Executive and Treasury; and

- these cases are also included in reports prepared for a cross-business line committee which deals with priority technical issues.

6.129 Internal reports on and records for the Tax Office Executive do not record the amount of tax involved in any of the above cases, nor the amount the Tax Office has spent on the case to date, both internally and under the formal budgeted funding arrangements. This practice reflects the Tax Office's current governance processes for litigation generally.

6.130 There is no quality assurance process for the formal test case program.

6.131 The Tax Office was unable to locate any written charter setting out the role and structure of the test case panel. A charter for the panel was, however, in existence during 2000 when the Tax Office conducted an internal review of the test case program.

Record keeping practices and file management for funded cases

6.132 During the fieldwork stage of this review, the Tax Office was unable to provide the review team with a complete listing of cases that have been subject to any form of funding, including cases funded under the formal test case program. This was because the Tax Office did not, at that time, have a detailed register of all cases that had been subject to funding. The Tax Office has since completed a 'best estimate' listing of all cases that have been subject to funding.

6.133 During the fieldwork stage of this review, the Tax Office was also unable to provide the review team with any minutes of the meetings of the test case panel that were held prior to June 1999.

6.134 Furthermore, most files for pre-July 2004 funded cases that were identified during the fieldwork stage of this review were not able to be located by the Tax Office. This was particularly true for files which pre-dated 1999. During the final stages of this review, the Tax Office advised that it has now located all test case files post 1998, but the Inspector-General has not verified this statement.

6.135 As a result of the above, this review has not been able to fully assess the operation of the formal test case program in respect of cases that were subject to the program prior to July 2004.

6.136 An internal Tax Office review of the program was done in 2000. The results of this review offer some insight into the internal administrative processes for the program prior to and, to a certain extent after, 2000.

6.137 This internal review found that there was a lack of proper record keeping for the program. Files were poorly maintained and there was no central register of all applications for funding with the critical information (such as the amount of tax in dispute) well recorded.

Controls over amounts funded under the program

6.138 Until recently, amounts funded under the program have not been sufficiently controlled. As noted above, there have been inconsistent funding practices applied to funded cases, with certain cases funded from the formal test case budget being funded on a full indemnity basis, while other cases have been funded on either a party/party or solicitor/client basis.

6.139 The 2000 internal review into the formal test case program noted that this lack of control over the costing arrangements was due to the Tax Office not having experienced or qualified staff to determine costs to be awarded under the program.

6.140 From 2004, the Tax Office has implemented measures to try to address this issue. From 2004, it has progressively implemented a formal test case funding deed (rather than what was formerly an exchange of letters) to set out the terms of the funding agreement. This deed has been drawn up in consultation with advisers from the Attorney-General's Department who have expertise in costing issues.

Public reporting of identity of cases funded under the program

6.141 The Tax Office has not, during the life of the formal test case program, publicly disclosed the names of all cases that have been funded under the formal test case program. This practice has continued since new management arrangements for the program were introduced in 2004.

6.142 The Tax Office has advised the Inspector-General that the secrecy provisions of the income tax legislation prevent any further public disclosure of the names of cases which have been funded under the test case program.

6.143 A list of cases that have received test case or other funding according to publicly available material (such as the Commissioner's Annual Reports and/or reports to the National Tax Liaison group) is in Appendix 12.

6.144 A number of submissions, particularly from the bodies representing professional associations, have asserted that the Tax Office has not been sufficiently transparent about the current operation of the test case program by publishing only the above details on the program. The Inspector-General agrees with these assertions.

6.145 A number of these submissions also assert that the Tax Office has also not published any financial information on the operation of the program. The Inspector-General also agrees with these assertions.

6.146 As a result of this financial information being unavailable, the community has not been aware of the extent of the total budgeted funds for the program, the extent of money actual spent under the program and the extent of cases funded under the program that have either not been funded for law clarification purposes or have been funded for such purposes but have not in fact achieved the aim of law clarification.

6.147 The Inspector-General notes that the Tax Office has investigated overcoming the lack of publicity on the identity of cases funded under the test case program by seeking the agreement of the Federal Court and/or AAT to insert a reference to the funding arrangements for a case in the relevant court or tribunal's published decision. Another means of addressing this lack of publicity would be for there to be a

requirement of funding that the taxpayer agrees to the Tax Office publishing their name, a brief description of the issue in the case and a description of how that issue was eventually resolved.

6.148 However, the Tax Office has rejected both these possible solutions because it considers that the secrecy provisions of the ITAA 1936 (which impose a statutory obligation on the Commissioner and Tax Office not to disclose matters relating to the tax affairs of a taxpayer) cannot be overridden by having a taxpayer agree to waive their rights to secrecy.

Application processes for the formal test case program

Nature of application processes

6.149 Cases that are administered under the formal test case program must be initiated by the taxpayer or their representative completing a submission for test case funding.

6.150 The submission needs to address the nine criteria that the Tax Office currently applies for test case program approvals.

6.151 The Tax Office's fact sheet on test case litigation indicates that decisions on test case funding will be made within three months of the application being received. Once an application is registered, comments are first sought from the Tax Office business line responsible for the relevant matter. The next step currently involves consultation with the test case litigation panel, although urgent cases may be considered by the chairman of the panel without reference to other panel members.

6.152 If funding is approved the Tax Office will advise taxpayers in writing of the details of the costs that are offered under the test case program. The most common type of test case program funding arrangement agreed to by the Tax Office involves the taxpayer entering into a test case deed under which the Tax Office agrees to pay the reasonable costs incurred at the relevant approved stage of litigation on a solicitor/client basis. Costs are limited to a single stage of proceedings and may not cover all the taxpayer's expense of running the case.

6.153 Taxpayers can seek a review of any decision to decline funding where there have been further developments in the case since the initial application. The review process normally takes about a month and is undertaken by a senior tax officer.

Taxpayer concerns with test case application processes

Attendance by taxpayers at meetings of the test case panel

6.154 A number of submissions raised concerns with the current application processes for test case funding. Several suggested that the taxpayer should be able to personally attend test case panel meetings to make submissions for funding and noted that such appearances were now a feature of the operation of other Tax Office panels, such as the Part IVA panel.

6.155 The Inspector-General sees merit in this suggestion.

Tax Office's treatment of individual test case applicants

6.156 Several submissions also provided examples of where the Tax Office had treated test case applicants less than satisfactorily.

6.157 Examples included letters where the Tax Office had adopted an unnecessarily adversarial tone in responses to letters that were sent to unsuccessful applicants for test case funding. The Inspector-General notes that such correspondence is against the principles set out in the Taxpayers' Charter.

6.158 Several submissions also claimed that a test case could involve adverse publicity being directed to a particular test case taxpayer. One example of this was where the taxpayer had volunteered to create a dispute for the purpose of having a test case heard, but was ultimately found as a result of that process to have engaged in tax avoidance.

6.159 Submissions noted that most taxpayers are usually more willing to settle a dispute rather than litigate it. This is generally because of the possible impost on their time and resources and because court processes may give rise to confidential information being aired about their financial affairs. The failure of the test case process to protect test case taxpayers against possibly adverse personal publicity therefore gives rise to a further negative factor which will weigh against any taxpayer being willing to become involved in the test case program.

6.160 The Inspector-General notes that these concerns could possibly be addressed by having the Tax Office include, in any public material which it issues on a test case, an explanation of the role which the relevant taxpayer has played in achieving clarification of the law for the benefit of the community.

Fieldwork conducted on application processes

6.161 The review team's examination of the applications filed for 36 test case program applications has led to the following findings.

Taxpayer awareness of test case criteria

6.162 In a number of the test case program files examined, applications for funding were poorly drafted and did not address the test case criteria that the Tax Office applied in determining funding decisions. In a number of these cases the applications appear to have been constructed of material that was 'cut and pasted' from documents created for other purposes. The poor form of these applications suggests that the applicants might not have been aware of the relevant Tax Office guidelines that were applied in granting test case funding. However, there are other possible explanations. One such explanation could be that these poorly drafted applications reflected the applicant's belief that the funding application would be denied and that therefore there was no reason to put much effort into the form of the application.

6.163 Prior to April 2005, the test case program application form that was included with the test case litigation booklet did not itself specify that the application needed to address the criteria that the Tax Office applies for granting test case funding. This omission has now been addressed, with the current application form now specifying that any application needs to be accompanied by a comprehensive submission addressing the Tax Office's test case funding criteria.

Conformity with requirements of the Taxpayers' Charter in responding to applications

6.164 The Inspector-General's fieldwork indicated that the test case program appears to be currently meeting Taxpayers' Charter requirements for dealing with individual taxpayers as regards responding to applications for funding. For example, it is currently meeting the Charter requirement to provide, on a timely basis, adequate written reasons to individual taxpayers for decisions made. For all applications made after 2004 that were reviewed where funding was denied, adequate written reasons for this decision were given to the applicant on a timely basis.

6.165 However, this commitment was not uniformly met in the case of the pre-2004 applications that were reviewed. Ten of these pre-2004 applications involved decisions not to fund. In six of these, either no written reasons for the decision were given to the applicant or the reasons given did not appear to address the relevant test case funding criteria that were in place at the time of the application.

Funding processes for test case program cases

Quantum of funding

6.166 A number of submissions have noted that the design of the test case program has never fully implemented the original JCPA recommendation that the Tax Office should fully fund the cost of the test case taxpayer's case at no cost or penalty to the taxpayer.

6.167 Submissions have also suggested that the costs paid by the Tax Office under the program for counsel and solicitors should be aligned to market rates. Currently these costs are pegged to the rates paid by the Commonwealth for its own legal representation.

6.168 Submissions have further stated that the current test case funding arrangements only allow sufficient funding for one legal representative for the taxpayer, while the Tax Office can employ a larger number of legal counsel to represent its case.

6.169 The Tax Office considers that the current solicitor/client basis for funding, which incorporates pegged rates for counsel and solicitors, is appropriate. It argues that, if funding extended to all costs that might be incurred at the sole discretion of the taxpayer, the program would be unduly expensive and no incentive would exist to be economical in the use of public resources, including the time of the courts. The Tax Office also argues that there would be difficulties if the Tax Office were funding a case under the program and paying counsel employed by the Tax Office at one rate and counsel employed by the taxpayer but funded by the Tax Office at a higher rate.

6.170 The Tax Office has further noted that the Tax Office's test case program arrangements are more generous than legal aid type arrangements as most legal aid schemes contribute to the applicant's legal costs; they do not, unlike the test case

program, guarantee the reimbursement of costs should the legal aid applicant be unsuccessful in their litigation and have costs awarded against them.[83]

6.171 The Tax Office also asserts that its current policy for funding the number of legal representatives for a taxpayer is stated in its April 2005 Test Case Litigation Program booklet. This booklet indicates that the Tax Office will fund a taxpayer no more than the same number and seniority of counsel that the Tax Office will itself engage to run the case.

6.172 The Inspector-General has concluded that the current rules which determine the quantum of funding for test case program cases are appropriate.

Delays in receiving funding

6.173 Some submissions also raised concerns that amounts paid to successful applicants under the program have been only paid at six monthly intervals. Other commentators on the test case program have noted that, in some cases, costs have only been paid at the conclusion of the case.[84]

6.174 Some submissions from barristers involved in acting for taxpayers in test cases have noted that payment of their bills has not been delayed and that delays in payment could be due to how quickly and regularly the solicitor acting for the taxpayer in the relevant case prepares relevant accounts.

6.175 The Inspector-General notes that the current test case funding deed states that invoices will generally be paid only after every six months or immediately after each significant court appearance, whichever occurs first, although it does indicate that alternative arrangements may be available.

6.176 The Inspector-General notes that the six monthly terms of payment are not consistent with normal commercial terms for the payment of legal bills.

Extension of funding to objections stage

6.177 Submissions have also asserted that the funding for a test case, once granted, should also cover the objection stage of a dispute. The Inspector-General notes that when the test case program was first established the original rationale for not extending test case funding to the objection stage of a dispute was to achieve parity with the rules for funding that apply in the legal aid area. Legal aid funding only extends to the cost associated with an actual hearing.

6.178 The Inspector-General however notes that in the tax context the form and content of an objection is in effect the originating document for tax litigation. It serves to define the dispute in the same way that pleadings do in a non-tax context.

6.179 The Inspector-General therefore considers that test case funding should generally be extended to the stage of preparing an objection for cases that have been

---

83 Comments prepared in October 2004 by the Tax Office in response to October 2004 paper by the Law Council on test case funding.

84 Gordon, M, *'Tax Litigation – does the Commissioner make a difference?'* paper for the ATO Litigation Workshop, Melbourne Law School, University of Melbourne, 3 April 2004 p 20.

approved for funding. The present test case guidelines indicate that the cost of objections will only be funded in certain cases.

Conclusions on internal management of the test case program

6.180 Based on all the above material, the Inspector-General has concluded that the formal test case program has been poorly managed, at least up until the time when the Inspector-General flagged that this program would be the subject of a review in his 2003 scoping study. There have been improvements in the internal management of the formal test case program since this time (for example in respect of controlling costs funded under the program, in giving reasons to taxpayers if their funding request is denied and in record-keeping). However, a number of key internal management deficiencies remain.

6.181 The principal internal management deficiencies of the program which remain are as follows:

- There is no quality assurance process for the program.
- The Tax Office has not performed and does not perform any analysis of the success of the formal test case program in meeting its aims of clarifying the law.
- The Tax Office does not do enough to ensure that all cases warranting funding are identified and funded to an appropriate extent.
- The Tax Office is not sufficiently proactive in seeking out possible test cases.
- The Tax Office does not make publicly available key aspects of the operation of the program including:
  - details of the budget for the program and the extent to which it has been spent each year;
  - the number of applications made for funding and the number granted, rejected or held over; and
  - the identity of cases funded under the program and the reasons why they have been funded.
- The Tax Office has not during the life of the program maintained a complete and up to date listing of all cases that it has funded under the program.
- There are no specific internal management reports prepared for the Tax Office's Executive on the test case program.
- The Tax Office has failed to protect test case taxpayers against adverse publicity arising from their involvement in the program.
- Taxpayers costs are generally only funded at six monthly intervals.

Overall conclusions on the formal test case program

6.182 The Inspector-General concludes that the test case program is important, is generally achieving its purpose and should be continued to provide public funding for litigating major disputes and grey areas of the law. The existing Tax Office criteria are appropriate criteria for determining what types of cases should be funded for this purpose as part of the formal test case program, but there should be an additional criterion added which reflects the opinion which the Tax Office received from the Solicitor-General and Chief General Counsel that funding should be made available in cases where the Tax Office challenges an earlier judicial decision.

6.183 The Inspector-General notes that a number of submissions made to this review recommended that any such program should not be administered by the Tax Office but should be administered by a body which is entirely independent of the Tax Office. One submission suggested that the Attorney-General's Department should administer the program, while others suggested it should be administered by an independent board.

6.184 Many submissions which called for the program to be administered by an independent body did so because of a perception that the Tax Office has administered the formal program poorly, unfairly and not openly.

6.185 The findings of this review confirm that the formal test case program has not been well managed internally by the Tax Office, although there have been recent improvements.

6.186 These findings also confirm that the program has not been administered fairly, in the sense of achieving its aim of law clarification in all cases that warrant funding determined on an objective basis. The Tax Office appears to have used the program's funds, together with other public funds, to support its organisational objectives of collecting revenue and enforcing the tax laws, rather than using these funds primarily to ensure that certain areas of the tax law are clarified by the courts. A large percentage of the funds employed in the formal test case program have been used by the Tax Office to fund cases for law enforcement purposes, rather than for any purpose of clarifying the law in the sense of creating new legal principles. Certain 'test' cases funded by the Tax Office purportedly for law clarification purposes have been settled or not proceeded with once the Tax Office became aware that it would lose the case.

6.187 The program has not been administered openly in that the Tax Office has not published the names of cases that it has funded under the program and continues to assert that the secrecy provisions prevent it from publishing these names. It has also not published financial data on the operation of the program which would allow the community to properly assess the operations of the program.

6.188 These findings lead to a conclusion that responsibility for the formal test case should be administered by a body which is independent of the Tax Office.

6.189 The above comments lead to the following key findings and key recommendation:

KEY FINDING 6.5

The Inspector-General concludes that the test case litigation program is important, is generally achieving its purposes and should be continued to provide public funding for litigating major disputes and grey areas of the tax law. The existing Tax Office criteria, which have been changed during the course of the Inspector-General's review, are appropriate criteria for determining what types of cases should be funded for this purpose, but an additional criterion should be added which reflects an opinion obtained by the Tax Office from the Solicitor-General and Chief General Counsel that funding should be made available in cases where the Tax Office challenges an earlier judicial decision.

KEY FINDING 6.6

The formal test case program has not been well managed internally by the Tax Office. Although there have been recent improvements, including processes to control costs funded under the program, to ensure that taxpayers are given reasons if their funding request is denied and in respect of record-keeping for the program, key deficiencies in the Tax Office's internal management of the program remain. These include:

- an absence of adequate quality assurance processes for the program;
- a general failure by the Tax Office to ensure that all cases warranting funding are identified and funded to the appropriate extent; and
- a lack of appropriate internal governance arrangements for the program.

KEY FINDING 6.7

The test case program has not been administered fairly by the Tax Office in the sense of achieving its aim of law clarification in all cases that warrant funding determined on an objective basis. The Tax Office appears to have used the program's funds, together with other public funds, to support its organisational objectives of collecting revenue and enforcing the tax laws, rather than using these funds primarily to have certain areas of the tax law clarified by the courts.

KEY FINDING 6.8

The test case program has not been administered openly. For example, the Tax Office has not published the names of cases that it has funded under the program and continues to assert that the secrecy provisions prevent it from publishing these names. It has also not published financial data on the operation of the program which would allow the community to properly assess the operations of the program.

KEY FINDING 6.9

New arrangements for the management of the test case program are needed to overcome community confusion abut the operations of the program, to improve its administration and overcome perceptions that the program is overly subject to Tax Office influence.

KEY RECOMMENDATION 4

The formal test case program (defined as the program under which a taxpayer makes a formal application for test case funding in accordance with funding criteria that have been publicised by the Tax Office) which is designed to fund cases which will clarify the law by establishing new legal principles should remain but new arrangements for the management of the test case program are needed. Precedents for an appropriate structure which deliver independence without being overly bureaucratic could be the existing Tax Agents' Boards or the Board of Taxation.

Tax Office response

6.190 The establishment of a panel independent of the Tax Office to decide applications for test case funding is a matter for government.

6.191 The existing Test Case Panel comprises seven members, five of whom are external to the Tax Office, including a former judge of the NSW Court of Appeal, a barrister, a solicitor and two accountants.

Inspector-General's comments on Tax Office response

6.192 The Inspector-General notes that the Tax Office's response does not address the suggestion made in the recommendation that possible precedents for an appropriate structure for the formal test case program which deliver independence without being overly bureaucratic could be the existing Tax Agents' Boards or the Board of Taxation.

6.193 The Inspector-General also believes that the detailed findings contained in this report on the manner in which the Tax Office has managed the program speak for themselves.

Public accountability mechanisms required if the program is transferred to another body

6.194 This chapter has discussed the lack of public accountability for the operation of the current test case program. Public accountability for the current program has been minimal as the Tax Office has not published the names of all cases funded under the program, the issues involved and the nature of the eventual outcome of these cases.

6.195 The Tax Office has also not published financial information on the operation of the program.

6.196 If administration of the test case program is transferred to a new body these issues of transparency will need to be addressed in the future by that body.

6.197 The Inspector-General therefore makes the following recommendation:

Subsidiary recommendation 6.4

The Inspector-General recommends that any new arrangements for administering the formal test case program should involve making publicly available to taxpayers an annual report on the operations of its processes for funding cases. This report should at a minimum contain the following:

- an annual assessment of the degree to which test cases funded by the relevant body have achieved the aim of law clarification;
- details of the extent to which the budget for test cases has been spent; and
- details of the number of test case applications made, the number granted and the number rejected, with broad details of the reasons for the rejections.

Tax Office response

6.198 Agreed

6.199 We will make publicly available the details of funded cases in our Annual Report, or some other publication.

OTHER TAXPAYER CONCERNS WITH THE TAX OFFICE'S PRACTICES FOR FUNDING CASES

6.200 A number of other concerns have been raised about the present Tax Office funding arrangements for cases. These concerns are discussed below.

Should Tax Office funding be extended to cover all cases where the Tax Office appeals against a court or tribunal decision?

6.201 The 1993 JCPA report which led to the establishment of the formal test case program also contained a recommendation that the Tax Office should fully fund the taxpayer's expenses in all cases where the Tax Office has been unsuccessful at any stage of litigation and decides to appeal the relevant decision. This recommendation was made principally because of the perceived mismatch between the limitless nature of Commonwealth legal resources and those which are available to ordinary taxpayers.

6.202 The Inspector-General considers that it is inappropriate in many cases for the taxpayer to bear any further costs where they have won any stage of a case but the Tax Office then decides to appeal that case.

6.203 The current structure of the Tax Office's arrangements for funding cases means that there is at least one significant group of cases which receive no funding. These are cases which a taxpayer commences and wins in the Federal Court but which the Tax Office then takes on appeal to the Full Federal Court.

6.204 In the Inspector-General's view, cases of this nature should be at least subject to the same types of funding rules as apply to appeals made by the Tax Office from decisions that have been made in the taxpayer's favour at the AAT. This type of funding would be similar, in effect, to the orders that the Full Federal Court made in the time when appeals to that Court could only be made with the leave of that Court.[85]

6.205 The above comments lead to the following key finding and key recommendation:

KEY FINDING 6.10

The Tax Office's funding of cases does not presently extend to all cases where the Tax Office appeals against a court or tribunal decision in relation to Part IVC litigation matters.

KEY RECOMMENDATION 5

The Tax Office should fund taxpayers' expenses in defending the case in all cases where the Tax Office has been unsuccessful at any stage of litigation, a decision is made to appeal the relevant decision and it is fair and in the public interest for the Tax Office to fund the taxpayer's expenses. The Tax Office should develop and publicise appropriate guidelines for the funding of such cases.

85 See for example, the conditions for leave to appeal by the Commissioner that were applied by the Full Federal Court in the case of *Applegate v F C of T*.

Tax Office response

6.206 Agreed in principle where it is fair and in the public interest to do so, and the test case program does this.

6.207 At present, the Tax Office funds the costs of taxpayers in small claims where the Tax Office appeals a decision of the Administrative Appeals Tribunal or Small Taxation Claims Tribunal to protect small taxpayers from the costs of court litigation. Considerations of capacity to pay are relevant to this practice.

6.208 The Tax Office has also established the Test Case Funding Program to fund cases where it is fair and in the public interest to do so. We will review the Test Case funding criteria in consultation with others to determine whether the capacity to pay should remain a factor, and whether the other factors clearly reflect the requirements of fairness and the public interest.

Inspector-General's comments on Tax Office response

6.209 The Inspector-General welcomes the Tax Office's acceptance of this recommendation. However, the Tax Office's response also refers to the test case funding program when this recommendation and the report's finding leading up to this recommendation indicate that the recommendation is dealing with cases funded under the Tax Office's other funding practices.

Should funding for AAT and other appeals be extended to tax avoidance cases?

6.210 Tax avoidance cases are currently expressly excluded from the processes for funding AAT cases which the Tax Office appeals.

6.211 A number of submissions to this review asserted that there should be no express exclusion of tax avoidance cases from the AAT adverse appeals program. These submissions claimed that there was no reason to deny funding in these types of cases. This was because a decision in the taxpayer's favour in this type of case means that an independent body has found that taxpayer's case does not involve tax avoidance.

6.212 On the other hand, some submissions noted that there were arguments against the AAT adverse appeals program being extended to tax avoidance cases. For example the Commonwealth Ombudsman in its submission stated:

> We can also understand the rationale underlying the setting in the ATO guidelines:
>
> - If successful in asserting there was no avoidance, the taxpayer can seek funding in the form of a costs award or possibly by retrospectively applying to the ATO for the grant of test case funding;
>
> - If unsuccessful, it would generally appear contrary to the public interest for the ATO to provide funding to a taxpayer who has been found to have engaged in tax avoidance behaviour.

6.213 The Inspector-General considers that a taxpayer should receive assistance for the cost of any appeal of the Tax Office if an independent tribunal has determined that the case does not amount to tax avoidance.

6.214 The Tax Office's acceptance of key recommendation 5 and subsidiary recommendation 6.5 below would mean that tax avoidance cases like *Sleight*[86] (which was won at the first instance by the taxpayer) would qualify for Tax Office funding during all subsequent appeal stages if it was fair and in the public interest to fund such a case.

6.215 The above comments lead to the following key findings and recommendation:

KEY FINDING 6.11

Taxpayers who are involved in a case involving alleged tax avoidance do not generally receive assistance for the cost of any appeal of the Tax Office if an independent tribunal has determined that their case does not amount to tax avoidance.

Subsidiary recommendation 6.5

The Inspector-General recommends that the current exclusion of tax avoidance cases from the AAT adverse appeal funding arrangements be removed. The Tax Office should develop guidelines which allow funding for the costs of an appeal to be provided to taxpayers in cases involving alleged tax avoidance where the AAT determines that there was no such tax avoidance, the taxpayer wins their case and the Tax Office appeals against that AAT case to the Federal Court.

Tax Office response

6.216 Tax avoidance cases will not be automatically excluded where it is fair and in the public interest to fund an appeal.

TAX OFFICE'S USE OF THE TERM 'TEST CASE'

6.217 During the review, the Inspector-General noted that the Tax Office has used the term 'test case' in a number of different ways in its communications to taxpayers both generally and individually.

6.218 In some public statements, it has used the term to apply to any case which is being litigated in the courts whose outcome may affect more than one taxpayer. In a second set of statements it has used the term to refer to cases that have been funded under the formal test case program. In a third group of statements it has used the term

86 *Federal Commissioner of Taxation v Sleight* (2004) 55 ATR 555.

to refer to cases which have been funded, but not under the test case program. In a fourth group of statements it has used the term to refer to a case which has been funded by a private sector organisation which is acting on behalf of a number of taxpayers.

6.219 These diverse uses of the phrase 'test case' have had a number of adverse consequences.

6.220 Firstly, taxpayers can assume that where the Tax Office has described a case as a 'test case', the Tax Office will apply the result of the case to all cases with similar facts. This misconception can particularly arise where the Tax Office advises individual taxpayers in writing that their current dispute with the Tax Office has been held over because it is dependent on the outcome of a test case.

6.221 One means of overcoming this misconception would be for the Tax Office to refrain from calling any case a 'test case'. This suggestion was made in one submission.

6.222 Another means of addressing this problem is for the Tax Office to refer to any case whose outcome may affect other cases as a 'leading case' or a 'representative case' rather than a 'test case'. The Aggressive Tax Planning area of the Tax Office has adopted these terms in some, but not all, of its correspondence with taxpayers.

6.223 The term 'test case' is however widely used outside a tax context and its use cannot therefore easily be curtailed or substituted. Furthermore, the Tax Office cannot readily abandon this term while it is involved in a program which is called the test case litigation program.

6.224 An alternative suggestion is as follows. The Tax Office could clearly explain to any taxpayer whose case is being held over because of a 'test case' that the result of that other case may not resolve the taxpayer's particular dispute. This is because the other 'test' case may be decided on a technicality or because the court's ultimate decision may depend on the presence of facts in the test case which are not present in the taxpayer's case.

6.225 The second misconception that can arise from the use of the term 'test case' arises where the Tax Office refers to a 'test case' and also states that the case has been 'funded'. Taxpayers can assume that this means that the Tax Office has funded the case when another third party has actually provided the funding. This can lead to perceptions that the Tax Office is funding more test cases than it is actually funding.

6.226 This misconception may be overcome by the Tax Office refraining from referring to any test case as a funded case unless it has been responsible for funding the particular stage of the case which is being referred to. This suggestion is also consistent with the Tax Office's obligation not to disclose directly or indirectly any aspect of the private affairs of taxpayers.

6.227 Thirdly, taxpayers can assume that, where the Tax Office has referred to a test case which has been funded, not only has the Tax Office funded that case but it has done so in accordance with its formal test case program.

6.228 Once taxpayers have made this assumption, they may then assert that the Tax Office is not consistently applying the criteria it has developed for its test case

program. This situation will arise where certain features of this funded 'test case' seem to disqualify it from funding under the formal test case program.

6.229 The *Budplan* case, which involved a mass marketed tax effective investment, and was not funded under the formal test case program, is one case where taxpayers have made these types of assertions. Claims have been made that this case should not have been funded for at least one of two reasons. Firstly, the scheme should not have been funded because it involved tax avoidance and tax avoidance cases are not generally funded under the program. Secondly, it is asserted that the case should not have been funded because it was not sufficiently representative. This was because the Budplan scheme involved research and development expenditure while the majority of MMTEI schemes involved agricultural or franchise projects.

6.230 The above findings lead to the following key finding and recommendation:

KEY FINDING 6.12

The Tax Office has used the term 'test case' in a number of different ways in its communications to taxpayers both generally and individually. This has led to taxpayers in a number of cases making the following incorrect assumptions:

- that the Tax Office will apply the result of the case to their case and all cases with similar facts;
- that the case has been funded by the Tax Office; and
- that the Tax Office's funding of the case has been in accordance with the formal test case program.

The last of these assumptions has added to taxpayers' concerns that the test case program is not being applied consistently.

Subsidiary recommendation 6.6

The Tax Office, when describing a case as a test case or leading case in any communication whether to taxpayers individually or to the public at large, should clearly indicate:

- whether it has funded the case and if so, its reasons for funding the case;
- whether or not the case is expected to determine the tax disputes of taxpayers in similar circumstances;
- if the case is expected to determine other disputes, the nature of the other disputes that will be determined by the case and the nature of disputes that the case is not expected to determine; and
- that the above are subject to the actual findings of the relevant tribunal or court.

Tax Office response

6.231 Agreed in principle.

6.232 However, we will need to clarify our position with the Solicitor-General on possible issues around the secrecy provisions of the various tax laws.

CHAPTER 7: TAX OFFICE'S APPLICATION OF THE OUTCOME OF FINALISED DECISIONS

7.1 This Chapter examines the Tax Office's application of the outcomes of finalised court and tribunal decisions and recommends changes to the Tax Office's current approach to provide greater assistance and certainty to taxpayers.

BACKGROUND

7.2 An important aspect of the Tax Office's stated approach to litigation is to clarify the law. Law clarification provides greater certainty to the community in the administration of the tax laws and assists taxpayers to meet their tax obligations.

7.3 The Tax Office's approach to the application of outcomes may be found in a speech by then Second Commissioner Michael D'Ascenzo, where he states that:

> … where our understanding of the law is shown to be wrong in a court decision, the Commissioner will either accept the outcome and reconsider the position taken in rulings; or in rare circumstances have the underlying technical issue tested in a different factual matrix; or in some cases will refer the matter to Treasury and Government for a possible change of the law.

7.4 The importance of providing certainty to taxpayers is reinforced in the Tax Office's draft internal legal service agreement, which provides that the Tax Office needs to ensure that:

- its cases are well prepared, and its arguments align with relevant precedential decisions and conform with Tax Office and Australian Government policies; and
- it is consistent in its approach to litigation and, where possible, that the outcomes from its litigation assist the community to comply with the law.

7.5 Submissions to the Inspector-General raised a number of concerns with how the Tax Office applies the outcomes of finalised court and tribunal decisions.[87] These include that :

- the Tax Office makes selective use of precedent; and
- the Tax Office does not clearly communicate to taxpayers how it will apply a finalised court or tribunal decision.

87 A finalised court or tribunal decision is defined as a decision where the appeal period has elapsed and is not subject to appeal.

STAKEHOLDER ISSUES AND CONCERNS

7.6 There is a strong perception in the community that the Tax Office will often confine a case where the Commissioner has been unsuccessful to the facts of that case while attempting to broadly apply cases where the Commissioner has been successful. Taxpayers and their advisers refer to the cases of *Budplan*[88], *Vincent*[89], *Essenbourne*[90] and *Cooke and Jamieson*[91] as evidence of where the Tax Office has applied the outcomes of finalised court or tribunal decisions differently depending on if the Tax Office agrees or disagrees with the decision. Submissions noted that:

> … there is a perception that where the Tax Office disagrees with a decision of the court, the Tax Office distinguishes the decision on its facts and where they agree with the decision, they try to apply the decision as widely as possible. The reason for this perception is that the Tax Office is very willing to make media statements where they get a favourable decision and provide a wide interpretation of the consequences of such a favourable decision, meanwhile the Tax Office appear silent on decisions that are unfavourable to it and if pressed, state that the decision turns on its facts and by inference does not have a wide application.

7.7 Submissions suggest that the Tax Office should be more objective in how it handles favourable and unfavourable court decisions.

7.8 It has been further suggested that the Tax Office is reluctant to depart from a view expressed in a ruling notwithstanding case law contrary to that position. There is a perception amongst many tax professionals involved in litigation with the Commissioner (based upon observation) that there are marked inconsistencies in relation to various matters concerning tax litigation and the settlement of such matters.

7.9 Legal practitioners have also expressed concerns that public rulings are attributed a higher authority than warranted with an undue adherence by the Tax Office to rulings, even where it is inappropriate.

7.10 A submission from legal practitioners notes that it has been the experience of legal practitioners that, not infrequently, Tax Office staff regard the Tax Office as bound by the language of the rulings and will not countenance any argument that the ruling is inconsistent with the statute, or with prior authority, or that it has been overtaken by subsequent decisions or legislative amendments. The submission suggests that there is:

> … a tendency in litigation to adhere to the views expressed in rulings even where such views cannot respectably be defended: either because they are logically deficient in a manner revealed by the issues in the litigation, or because they have been shown to be wrong by subsequent decisions of the courts or tribunals. There is a tendency to cleave to the language of the ruling regardless, until it is withdrawn or replaced by another ruling.

---

88 *Howland-Rose v Commissioner of Taxation* (2002) FCA 246 (18 March 2002) (the Budplan case).

89 *Vincent v Commissioner of Taxation* (2002) FCAFC 291 (16 September 2002), *Vincent v Commissioner of Taxation* (2002) FCA 656 (24 May 2002).

90 *Essenbourne Pty Limited v Commissioner of Taxation* (2002) FCA 1577 (17 December 2002).

91 *Commissioner of Taxation v Cooke* (2004) FCAFC 75 (26 March 2004); *Cooke v Commissioner of Taxation* (2001) FCA 1654 (20 November 2001).

7.11 The Taxation Institute of Australia also raised as a concern the Tax Office's reluctance to follow case law precedents in circumstances where the precedent has been established against an argument put forward by the Tax Office. It submits that whilst each case turns on its own merits, there is reluctance on the part of the Tax Office to apply precedents in a fair and consistent manner.

7.12 As an example, the Taxation Institute refers to the Tax Office's response following the High Court's refusal to grant the Commissioner of Taxation special leave to appeal the Part IVA issue arising from the Full Federal Court decisions in *FCT v Metal Manufactures Ltd*[92] and *Eastern Nitrogen Ltd v FCT.*[93] It is submitted that notwithstanding these precedential decisions, the Tax Office continued to contest similar sale and leaseback arrangements long after the High Court's refusal to grant special leave.

7.13 The Ombudsman considers that stakeholder concerns with the Tax Office's use of judicial proceedings and finalised tribunal decisions are issues capable of being addressed — at least in part — by the terms of Legal Services Directions and the model litigant principles, as well as the tribunal or judicial processes.

7.14 The Ombudsman is of the view that Tax Office personnel will feel compelled to defer to counsel, to some degree, in relation to decisions to frame argument and cite precedent. The Ombudsman considers that, given the ability of the tribunals and courts to draw their own conclusions about the efficacy and utility of the use of precedent, they are well positioned to sanction egregious or blatant attempts at their misuse. The Ombudsman stated that he is not aware of any such instances in tax litigation in recent years.

TAX OFFICE PROCEDURES TO CONSIDER IMPLICATIONS OF TRIBUNAL AND COURT DECISIONS

KEY FINDING 7.1

Overall, the review found that the Tax Office, through the use of strategic internal litigation committees and the preparation of case summaries and adverse decision reports, has in place procedures to consider the implications of tribunal and court decisions on the Tax Office view.

7.15 Immediately following a decision being handed down in a litigation matter, the Tax Office procedures require that a number of Strategic Internal Litigation Committees (SILCs) be convened including a decision SILC, a post-decision SILC and,

92 *Commissioner of Taxation v Metal Manufactures Ltd* (2001) FCA 365 (3 April 2001); *Metal Manufactures Ltd v Commissioner of Taxation* (1999) FCA 1712 (8 December 1999).

93 *Eastern Nitrogen Ltd v Commissioner of Taxation* (2001) FCA 366 (3 April 2001); *Eastern Nitrogen Ltd v Commissioner of Taxation* (1999) FCA 1536 (5 November 1999).

if relevant, an appeal SILC.[94] There is evidence of these procedures being followed in the examination of case files.

7.16 There is no current corporate document outlining the Tax Office's procedures for managing finalised court and tribunal decisions. However, the Tax Office is in the process of preparing draft Practice Statement PS LA 2005/D111 on this topic. The Tax Office has yet to finalise this Practice Statement for use by staff or public release but similar procedures are already in place. These procedures are contained in previous litigation manuals, instruction sheets and service agreements and continue to be followed by staff conducting litigation.

7.17 This draft practice statement sets out requirements for managing finalised court and tribunal decisions and outlines the purpose of each stage of the Tax Office's procedures. It also provides that any necessary action requiring consideration of the implications of the decision must be identified and responsibility allocated for each necessary action. The identified risks and the person responsible for managing each of those risks are required to be set out in the Adverse Decision Report. The person responsible for managing the risk is required to maintain the responsibility after the litigation is finalised, unless and until any formal escalation process alters the responsibility.

7.18 The finalised Adverse Decision Report is the corporate record of the decision making process and will include the decision on whether an appeal is to be lodged. All finalised Adverse Decision Reports are maintained on the Tax Office's intranet and made available to other staff involved in litigation.

FINDING A BALANCE BETWEEN COMPETING OBJECTIVES

7.19 In examining the concerns raised by stakeholders it is important to recognise that taxpayers are operating in a self assessment environment.

7.20 Self assessment requires taxpayers to perform certain functions and exercise certain responsibilities in complying with their taxation obligations. As such, Australia's system of self assessment for income tax relies on the principle of voluntary compliance and taxpayers (or their advisers) having a good understanding of the taxation laws in order to meet their obligations. This has placed more responsibility on taxpayers and their advisers to correctly interpret the law.

7.21 This has also meant that taxpayers are more reliant upon the Tax Office to provide summarised, understandable statements that taxpayers may rely upon.

7.22 The Tax Office accepts the importance of this advising role and acknowledges that, as the administrator of tax laws, it must operate as a trusted authority on the law

94 Appendix 10 provides further detail of these procedures. Strategic Internal Litigation Committees, or SILCs, are part of the Tax Office's litigation process and involve key internal stakeholders including the Legal Services Branch officer, the business line officer and, if necessary, the Tax Counsel Network. SILCs are convened at critical stages during the course of the litigation as a means to manage the litigation and ensure that legal risks for the Tax Office arising out of litigation are minimised.

and a professional adviser and educator, ensuring that people have the information and support needed to meet their obligations.[95]

7.23 It is important to appreciate that the Inspector-General is not able to stand in the shoes of the Commissioner of Taxation and determine how the Tax Office should respond to particular court and tribunal decisions. This means that it is not possible for the Inspector-General to comment on how the Tax Office should have applied the outcome of a particular court or tribunal decision. However, in the Inspector-General's view the Tax Office's current approach in the application of finalised court and tribunal decisions has not supported its aspiration to be seen by the community as the 'trusted authority on the law'. It is clear from submissions and through the Inspector-General's own examination of case files, that there is a need to improve both the timeliness and objectivity of the Tax Office's approach following a court or tribunal decision.

7.24 In the Inspector-General's view the Tax Office's current approach following litigation has been primarily focused on managing the consequences of the decision on the perceived compliance risks and its impact on the Tax Office's view. The Inspector-General believes that the Tax Office's approach must better balance the need of the community to be provided with objective and timely guidance on the operation of the tax laws in a self assessing environment and the need of the Tax Office to manage compliance risks resulting from an unfavourable decision. It has been the absence of such a balance in the Tax Office's approach that has contributed to the perception amongst taxpayers, tax practitioners and legal practitioners that the Tax Office is selective in its use of precedent.

KEY FINDING 7.2

There is no clear statement on the Tax Office's philosophy and approach in applying and communicating to taxpayers and the community the outcome of finalised decisions.

Subsidiary recommendation 7.1

The Tax Office should include, in its comprehensive published policy or guidelines on tax litigation, its philosophy and approach in applying and communicating to taxpayers and the community the outcome of finalised decisions.

Tax Office response

7.25 Agreed.

95 The Treasury, *Report on Aspects of Income Tax Self Assessment*, August 2004, Commonwealth of Australia, Canberra, p 7.

Subsidiary recommendation 7.2

The Tax Office's philosophy and approach in applying and communicating to taxpayers and the community the outcome of finalised decisions should be consistent with its role of administering the tax laws in a fair, timely and cost effective manner, consistent with the rule of law.

Tax Office response

7.26 Agreed

COMMUNICATION OF FINALISED COURT AND TRIBUNAL DECISIONS TO TAXPAYERS AND THEIR ADVISERS

KEY FINDING 7.3

The Tax Office internally considers the implications of a finalised court or tribunal decision. However, it does not provide taxpayers with timely guidance on how it will apply all finalised court and tribunal decisions to assist taxpayers operating in a self assessment environment.

7.27 The Tax Office has stated that an important aspect of its litigation strategy is to clarify the law and provide guidance to taxpayers and their advisers so as to assist them to voluntarily comply with the taxation laws.

7.28 Currently, the method and manner of communication of the Tax Office's view on finalised court and tribunal decisions is ad hoc and not uniform. In many cases, including those heard by the Federal Court, Full Federal Court and High Court, which involve a question of law, there is no statement by the Tax Office on the implications of the decision on the Tax Office view. Where there is a statement there is no uniform approach; for example, it could be by way of a brief media release, by an announced review of a ruling, by a subsequent change in a ruling (but this may occur one year after the adverse decision, for example as in *Ryan*[96]), by a communication directed at a specific industry or forum or by a comment on the Tax Office's website, such as in the case of *McNeil*.[97]

7.29 At times the Tax Office will issue a media release to inform the community at large of the Tax Office's response to a court decision, as was done in the cases of *Essenbourne*, *Metal Manufactures* and *Eastern Nitrogen*. Tax and legal practitioners have strongly submitted that media releases alone, which are often focused on producing a compliance response, are inappropriate to convey to taxpayers and their advisers the implications of a court or tribunal decision on the Tax Office view.

---

96 *Ryan v Commissioner of Taxation* (2004) AATA 753 (19 July 2004).

97 *Commissioner of Taxation v McNeil* (2005) FCAFC 147 (8 August 2005); *McNeil v Commissioner of Taxation* (2004) FCA 420 (14 April 2004).

7.30 However, this review has found that on most occasions there is little or no response by the Tax Office on the impact that a finalised court or tribunal decision will have on the Tax Office view.

7.31 The Inspector-General finds that this is an unsatisfactory situation for taxpayers and their advisers, especially given that the Tax Office is aware of the impact that a finalised decision may have on the Tax Office view. For example, prior to a case proceeding to hearing, the Tax Office, through the SILC process, will consider why the case should be litigated and the possible impact the case may have on the Tax Office view. Where a case may have an impact on the Tax Office view, because the case is considered to be significant and involves a priority technical issue, then the Tax Counsel Network will also be involved in the course of the litigation. The Tax Counsel Network is the sole arbiter of the Tax Office view on technical issues arising in litigation and also ensures that cases are prepared and presented in a way that best enables the Tax Office view to be presented to the court or tribunal.

7.32 The implications of a court or tribunal decision are also considered following a decision being handed down. This would occur at the Decision SILC, the Post Decision SILC and, if relevant, at the Appeal SILC. Furthermore, as part of the Case Summary and Adverse Decision Report process (as outlined in Appendix 10), consideration must be given to the policy implications or wider risks flowing from the decision and the potential significance of the case. The Adverse Decision Report must also set out the recommendations from the Tax Counsel Network, external counsel and the Legal Services Branch officer on whether the decision should be appealed. These recommendations will often set out the impact of the decision on the Tax Office view and the consequences if the decision is not appealed, for example, that a Taxation Ruling or Determination will need to be reviewed or withdrawn.

7.33 Where litigation is commenced in the AAT then only questions of law give rise to an appeal to the Federal Court. Where litigation is commenced in the Federal Court there is a general right of appeal to the Full Federal Court. Special leave is required for an appeal from the Full Federal Court to the High Court. This means that by their very nature appeal cases may involve important questions of law of significance to taxpayers and tax practitioners. However, even for such cases there is often no publicly available response on why the Tax Office proceeded with the appeal, the outcome of the appeal, the implications of the decision on the Tax Office view and how the Tax Office will apply the decision.

7.34 Notwithstanding the multi-stage consideration within the Tax Office of the impact that a court or tribunal decision may have on the Tax Office's view, there is no publicly available Tax Office response to assist the community in complying with its taxation obligations.

7.35 In light of the above comments, the Inspector-General makes the following recommendations:

Subsidiary recommendation 7.3

The Tax Office should communicate, in a summarised form, its view of the application of all finalised court and tribunal decisions that involve a question of law within eight weeks of the date of the decision. By implication, this will include all finalised decisions considered by the Full Federal Court, the High Court and by the Federal Court on appeal from the Administrative Appeals Tribunal.

Tax Office response

7.36 Agreed in principle. However it may not be logistically possible to do so within eight weeks in all cases. For example, some may require longer consideration (and consultation) where the possible application to other cases is unclear.

Subsidiary recommendation 7.4

The Tax Office should also communicate, in a summarised form, its views of the application of all other decisions within similar timeframes, where it involves a priority technical issue or there is significant community interest in the outcome of the court or tribunal decision.

Tax Office response

7.37 See response to subsidiary recommendation 7.3.

OBJECTIVITY OF COMMUNICATION OF FINALISED COURT AND TRIBUNAL DECISIONS

7.38 Taxpayers and their advisers have identified a number of finalised cases where, in their opinion, the manner in which the outcome was communicated suggests an absence of objectivity by the Tax Office. They point to the Tax Office's approach of releasing a public statement, where there is a decision adverse to the Tax Office view, stating that the decision is confined to the particular facts of the case and will therefore not be widely applied. They also point to other cases, where the Tax Office has been successful, where the Tax Office has sought to broadly apply the decision with no comment that each tax case is to be decided on its facts. These finalised cases include *Budplan (Howland-Rose & Ors)*, *Vincent*, *Essenbourne* and *Cooke and Jamieson*. The Inspector-General's examination of these cases and the Tax Office's handling of them validate community perceptions.

7.39 The Tax Office states that:

> … the decision in a case sometimes depends on the facts of that case rather than a particular interpretation of the law. Where this is the case the application of the decision is, of course, limited to similar fact situations. This does not involve a failure to apply a decision but, rather, a recognition that the decision is of limited application.

7.40 Following the Federal Court decision in the *Budplan* case, the Tax Office stated that:

> … today's decision confirms arrangements typically employed in mass marketed tax schemes in an attempt to artificially create tax deductions do not succeed.
>
> This is a great result for the Australian community because it protects our revenue system from the serious threat posed by mass marketed schemes.
>
> Following today's decision, we will be shortly writing to all mass marketed scheme investors with full details of the settlement offer announced on 14 February 2002.
>
> This offer gives investors caught up in these arrangements, often as a result of unscrupulous practices by promoters, the opportunity to put this matter behind them in a fair way.[98]

7.41 In a similar vein, in *Vincent* the Tax Office publicly stated that:

> … in a strong decision, *Vincent v. Commissioner of Taxation*, the Federal Court has again confirmed that arrangements typically employed in these schemes, in an attempt to artificially create tax deductions, do not succeed.
>
> Once again, this is a positive result for the Australian community.[99]

7.42 In both these instances the Tax Office has made broad statements regarding the application of these decisions with no publicly available information on how these decisions have widespread implications for other schemes given the factual nature of tax cases.

7.43 In respect of *Vincent*, the Tax Office in its media release did not also inform taxpayers and their advisers that the Full Federal Court did allow the taxpayer's appeal in respect of the 1994/1995 year as the Tax Office was outside the four year period allowed under the general amendment provisions and could not rely upon Part IVA. This aspect of the *Vincent* decision had potential widespread implications to not only other taxpayers who had participated in arrangements similar to *Vincent* but also other arrangements where the Tax Office was outside the four year amendment period and was relying upon Part IVA to deny deductions.

7.44 The Tax Office did subsequently mention that the Court in *Vincent* allowed the appeal in the 1994/1995 year on its website in a summary of court decisions in mass marketed scheme cases.

7.45 However, it did not provide any further details of the potential implications of the *Vincent* decision to other taxpayers. This is despite the Tax Office having considered the implications of the *Vincent* decision as part of determining its response in the case and also having sought legislative amendments as a result of the Full Federal Court's decision in *Vincent*.

---

98 Australian Taxation Office, *Federal Court backs Tax Office on Mass Marketed Schemes*, Media Release — Nat 02/18, 18 March 2002.

99 Australian Taxation Office, *Another Federal Court Win on Mass Marketed Schemes*, Media Release — Nat 02/33, 24 May 2002.

7.46 In *Cooke and Jamieson*, a case where the Tax Office appealed and was unsuccessful in the Full Federal Court, the Tax Office publicly stated that:

> … the Tax Office sought special leave for matters requiring further legal guidance or where decisions had significant impact. Our view is that this decision does not have widespread implications for other schemes.[100]

7.47 Quite clearly, this is a decision that the Tax Office has confined to the particular circumstances of the case. The Inspector-General notes that by their very nature appeal cases may involve important questions of law of significance to taxpayers and tax practitioners. There is no publicly available information on what questions of law the Tax Office sought to test when appealing the decision at first instance, the outcome for each of those questions of law that formed the grounds of appeal and why the Tax Office was of the view that this decision did not have widespread implications.

7.48 In correspondence to this review the Tax Office has advised that it does not believe that these examples evidence systemic conduct on the part of the Commissioner to apply the outcomes of cases differently depending on whether he agrees or disagrees with the decision. However, the Tax Office has advised that it recognises that it can always improve in the area of communication.

KEY FINDING 7.4

There are community perceptions that the Tax Office's communication of the implications of finalised decisions indicates an absence of objectivity in the Tax Office's approach in applying finalised court and tribunal decisions. Stakeholders suggest that the Tax Office has applied the outcomes of finalised court or tribunal decisions differently depending on if the Tax Office agrees or disagrees with the decision. The Inspector-General believes that these perceptions are justified.

7.49 In relation to *Budplan* (or *Howland Rose & Ors)*), the Tax Office has advised that this case was run not only as the lead case in the *Budplan* scheme, but as a test case to seek guidance on the application of the general anti-avoidance provision to round-robin financing involved in the *Budplan* scheme. The Tax Office has also noted in its response that this case illustrated, save for exceptional circumstances, the likely outcome for other participants and gave an indication of how the courts might treat other schemes with similar financing arrangements. The Tax Office has also advised that:

> The taxpayers in *Howland-Rose and Ors* did not pursue appeals from the decision at first instance. No other participant subsequently ran another case on the same scheme to overturn the decision. No other case since has said that the Part IVA reasoning in *Howland-Rose* was wrongly decided. At no stage has the Commissioner said that *Howland-Rose* created precedent binding on other participants or other scheme participants.

---

100 Australian Taxation Office, *Tax Office not seeking special leave*, Media Release — Nat 04/26, 22 April 2004.

7.50 In response to *Vincent*, the Tax Office notes that the Commissioner was successful in showing that the deductions were not available to the participants under the general deduction provision. The Tax Office also notes that the decision found that the six-year period for amending assessments under Part IVA cannot be relied upon where the claimed tax benefit is cancelled under the general provisions of the income tax law. The Tax Office advises that both the Commissioner and the taxpayer accepted the outcome and that the Commissioner accepted that part of the decision in *Vincent* that was adverse to him, and has at no stage sought to confine that aspect to its facts. The Tax Office has stated that where the claimed tax benefit is ultimately found to be 'cancelled' under the general provisions of the income tax law, Part IVA has no application because there was no tax benefit within the meaning of section 177C.

7.51 The Tax Office has also agreed that it could have been more specific in the March 2002 and May 2002 media releases referred to by the Inspector General, and has indicated that it will ensure in future that it articulates more clearly the reasons behind its decisions about how to apply the results of cases.

7.52 In response to *Cooke and Jamieson*, the Tax Office notes that the Full Federal Court upheld the original decision that expenses claimed by the taxpayers in relation to their investment in the Australian Horticultural Project (No. 1) were deductible under the general deduction provisions of the income tax law. Further, the Court held that the anti-avoidance provisions did not apply to disallow the deductions.

7.53 The Tax Office notes that this was the only investment scheme case where the Commissioner was wholly unsuccessful and that the Commissioner accepted this decision and applied it to all other affected participants in the scheme who had outstanding disputes before the Administrative Appeals Tribunal (AAT).

7.54 In its response to the remark that the Tax Office has sought to confine this case to its particular circumstances the Tax Office refers to the comments of Hill J, in considering the application of the decision in *Cooke and Jamieson* to the facts in *Sleight*, that 'decisions on Part IVA will, inevitably, turn upon the particular facts of the case'.

Improving confidence in the objectivity of the Tax Office's application of finalised decisions

7.55 In the course of this review submissions stated that, at times, the Tax Office does not apply the benefit of a decision as regards the particular taxpayer who has initiated the case where it believes that the decision is incorrect. The Inspector-General has found no evidence for these community perceptions.

KEY FINDING 7.5

The Inspector-General found no evidence that the Tax Office does not give effect to the results of a litigated case as regards the particular taxpayer who has initiated the relevant case.

7.56 Stakeholders have also identified a number of finalised cases where, in their opinion, the Tax Office's approach suggests an absence of timeliness and objectivity leading to uncertainty amongst taxpayers and their advisers. Stakeholders have

suggested that in these cases the Tax Office continues to administer the law as if the cases had not been decided. These finalised cases include *Marana Holdings*[101], *Metal Manufactures*, *Eastern Nitrogen* and *Essenbourne*. Each of these is considered below by way of a case study examining the importance of the litigation for the Tax Office and its response following the court's decision. These case studies also consider how, in the Inspector-General's view, the Tax Office in responding to a court or tribunal decision could have achieved a more balanced approach and response.

7.57 Examination of these case files has confirmed stakeholder perceptions that the Tax Office's approach does not adequately balance the need of the community to be provided with objective and timely guidance on the operation of the tax laws in a self assessing environment and the need of the Tax Office to manage compliance risks resulting from decisions.

7.58 The Tax Office has previously stated that it has an ongoing commitment to the clarification of the law in a manner beneficial to the community. However, in the Inspector-General's view the Tax Office is not handling the application of finalised court and tribunal decisions in an objective and timely manner, as evidenced by its approach in these cases. More importantly, such an approach does not assist taxpayers nor provide them with greater certainty in the operation of the tax laws, particularly in a self assessing regime.

7.59 The Tax Office's approach in the handling of the application of the finalised decisions is contributing to the perceptions that the Tax Office is selective in its use of precedent. There is also a perception that the Tax Office is operating behind a veil of secrecy as to implications of finalised court and tribunal decisions. These perceptions are being further fuelled by the Tax Office's approach in issuing media releases and not fully explaining the impact of the decisions on Tax Office policy. This is despite the Tax Office having in place internal procedures to consider and discuss such implications.

7.60 In the Inspector-General's view a key contributor to these concerns and perceptions is the manner in which the Tax Office responds to court and tribunal decisions, in particular those adverse decisions that may impact on a public ruling or public determination, and its approach to communicating the outcome of court and tribunal decisions.

7.61 In the course of this review the Tax Office has also advised that the level of detail included in such a communication product will depend upon a number of factors. These include being able to discern the wider ramifications of a particular case, and a particular issue being referred to the Treasury for consideration of the policy implications of a finalised court or tribunal decision.

7.62 An examination of *Marana Holdings, Metal Manufactures, Eastern Nitrogen* and *Essenbourne* has also confirmed the concerns of stakeholders with the timeliness of the Tax Office's response where a finalised decision impacts a view expressed in a ruling, determination or interpretative decision.

---

101 *Marana Holdings Pty Ltd v Commissioner of Taxation* (2004) FCAFC 307 (25 November 2004); *Marana Holdings Pty Ltd v Commissioner of Taxation* (2004) FCA 233 (15 March 2004).

KEY FINDING 7.6

The Tax Office does not provide taxpayers with adequate and objective guidance on the application of all finalised court and tribunal decisions to assist taxpayers operating in a self assessment environment and, in some cases, continues to administer the law as if the decision did not apply.

KEY RECOMMENDATION 6

The Tax Office should introduce a standard communication product to communicate the application of finalised court and tribunal decisions. The content of any Tax Office communication should be consistent with its role of administering the tax laws in a fair and objective manner and could include for example:

- *the issues to be decided by the tribunal or court;*
- *the implications of the decision on each of those issues;*
- *the implications of the decision on the Tax Office view;*
- *how the Tax Office will apply and follow the finalised decision;*
- *the reasons why the Tax Office will apply and follow the finalised decision in that manner; and*
- *whether the Tax Office will be seeking legislative amendments.*

Tax Office response

7.63 Agreed in principle.

7.64 We will communicate to taxpayers the implications of adverse court and AAT decisions and significant court decisions. This will include impacts on any published views of the Tax Office, except where this is likely to mislead taxpayers.

7.65 While it would generally be inappropriate for the Tax Office to make its advice to Government public, we will further consult with Treasury as to whether it would generally be appropriate to advise that a matter has been referred to Treasury.

Inspector-General's comments on Tax Office response

7.66 The Inspector-General notes that where Government is considering legislative amendments the Tax Office should nevertheless communicate to the community that it is seeking legislative change or that the matter is with Government. This is important in promoting transparency in tax administration by providing guidance to taxpayers operating in a self assessing environment on the implications of a finalised court or tribunal decision.

KEY FINDING 7.7

The Tax Office does not have appropriate processes and procedures in place to ensure that taxpayers are made aware that the Tax Office's view expressed in a public ruling, determination and interpretative decision may be impacted by a court or tribunal decision and that it is under review.

Subsidiary recommendation 7.5

Following a court or tribunal decision, the Tax Office should promptly make taxpayers aware that the Tax Office's view expressed in a public ruling, determination or interpretative decision may be impacted and that it is under review. It should include identifying the paragraphs that are potentially affected and providing guidance to taxpayers on how they should apply the law until the public ruling, determination or interpretative decision is formally amended or withdrawn.

Tax Office response

7.67 Agreed in principle.

7.68 However this could potentially mislead taxpayers in cases where the Government is considering legislative amendments. In these special cases, administrative common sense should prevail.

Case studies

Marana Holdings

7.69 The Full Federal Court handed down its judgment in *Marana Holdings Pty Ltd v Commissioner of Taxation* on 25 November 2004 in favour of the Tax Office.

7.70 The Full Federal Court confirmed the first instance decision of Beaumont J and the general principles adopted by his Honour in concluding that the sale of a unit, which was previously a room in a motel, was 'new residential premises' and therefore subject to goods and services tax.

7.71 In considering the meaning of the terms 'reside' and 'residence', the Court held that both connoted a permanent or at least long-term commitment to dwelling in a particular place. The Court also considered the meaning of the term 'residential' implied long-term accommodation.

7.72 The Decision SILC considered the implications for the Tax Office view following the Full Federal Court's decision. It was noted at the Decision SILC that the decision, particularly the Court's discussion on the meaning of 'residency', would appear to be inconsistent with the position adopted by the Tax Office in GSTR 2000/20.

7.73 The Adverse Decision Report also noted that the *Marana* decision might have an impact on the treatment for GST of some units contained in hotel or motel premises where they are supplied by way of lease to an operator providing commercial accommodation. It went on to note that:

> … in the past input tax credits have been denied to some purchasers of such units because the premises were considered to be residential premises when leased to the operator. Applications for input tax credits in such cases are expected.

7.74 Concurrent with the *Marana* litigation in the Full Federal Court, the Tax Office also received a number of objections and applications for review in the Administration Appeals Tribunal on similar issues to those decided in *Marana*. This included applications for input tax credits by taxpayers in similar circumstances to those described in the Adverse Decision Report.

7.75 In each of the applications for review in the Administrative Appeals Tribunal the Tax Office maintained its position as set out in GSTR 2000/20, namely that the premises were 'residential premises' and no input tax credits were claimable. Following the *Marana* decision the Tax Office conceded the applications for review in the Administrative Appeals Tribunal, allowing the claim for the input tax credit in full. However, tax officers were instructed not to provide reasons to the taxpayers regarding the grounds that the Tax Office was conceding these cases.

7.76 In relation to conceding these cases, the Tax Office advises these cases were conceded prior to the February 2005 Rulings Panel. The principles relied on to concede those cases were not agreed to by the February Panel. It was subsequently decided that the decision to concede those cases was consistent with the current rewrite of the ruling. This meant that the decision to concede those cases was maintained, however on a different, and still non-communicated, basis.

7.77 External stakeholders at a number of National Tax Liaison Group (NTLG)-GST Subcommittee meetings, have also raised concerns with the Tax Office's handling of the *Marana* decision. A key issue of concern has been the impact of the *Marana* decision on the Tax Office's view expressed in GSTR 2000/20.

7.78 At the NTLG-GST Subcommittee meeting held on 1 June 2005, members noted that the Tax Office had not added information to the external website or within GSTR 2000/20 that the ruling was under review. This related to an earlier request by members of the NTLG that the Tax Office advise taxpayers that GSTR 2000/20 was currently under review. The Tax Office advised that it would update its external website and GSTR 2000/20 as a matter of priority. At the time of this report, the Tax Office had yet to provide such an update.

7.79 The Tax Office advises that the rewrite of GSTR 2000/20 has been to the Rulings Panel in December 2004, February 2005 and June 2005 and out of session following the June meeting. The Tax Office also advises that an update on the rewrite of GSTR 2000/20 has been a standing item of the NTLG-GST Subcommittee.

7.80 The Tax Office also notes that there have been assertions that it is not applying the law in accordance with the decision in *Marana*. In answer to this it states that:

> ... it should be remembered that *Marana Holdings* dealt with a particular factual situation and the time taken to rewrite the Ruling has taken into account the application of a

> principle to a particular set of facts by way of analogy to different sets of facts. The effect of the Decision is wide ranging and its application had to be considered in relation to hotel rooms, serviced apartments, display homes, holiday homes, retirement villages and nursing homes. Certain issues in relation to retirement villages and nursing homes have been long running and there have been a number of dialogues with the Assistant Treasurer.

7.81 The Tax Office has also advised that it has sent to Treasury a copy of the draft rewrite and an explanation of the approach to be taken. This summarises the advantages and disadvantages of the proposed approach in relation to embedded tax, physical characteristics, participation in the GST system, increased compliance, possible structuring of arrangements, agency arrangements and interaction with specific issues relating to retirement villages and nursing homes.

7.82 On 27 February 2006 the Minister for Revenue and Assistant Treasurer announced that the Government will amend the GST law to remove uncertainty in relation to the GST treatment of some types of real property. In a press release announcing the change, the Minister said that:

> The decision of the Full Federal Court in the *Marana Holdings Pty Ltd v Commissioner of Taxation* [2004] FCAFC 307 case has resulted in a blurring of the lines between properties that are subject to GST and those qualifying for input taxed treatment.
>
> The Government will amend the GST law to continue the tax treatment of property that existed prior to the Court's decision.
>
> It is appropriate that supplies involving properties such as serviced apartments and strata units leased to hotel operators remain input taxed. This is consistent with the Government's policy intent and will avoid the need for many small investors to register for the GST.
>
> The amendments will apply from 1 July 2000. As this measure affects the GST revenue base, it will be subject to the unanimous approval of the States and Territories, which receive the GST revenue.

7.83 On 28 February 2006 Justice White of the NSW Supreme Court in the case of *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* (2006) NSW SC 83 (*Toyama*) applied the *Marana* decision to determine whether a supply of land was a taxable supply or input taxed residential premises.

7.84 The Inspector-General notes that his Honour in *Toyama* rejected the Tax Office's approach in paragraph 19 of the GSTR 2000/20 regarding the extent to which the intended use of premises by a purchaser is relevant to determining whether the sale of those premises is subject to GST.[102] To date, there has been no public response by the Tax Office on the implications of this court decision on its view on this issue and how it will administer the tax system going forward, including whether it will be seeking to test this issue in another case. In this case the Tax Office was not a party to the proceedings. The Solicitor-General's opinion contained in Appendix 4 indicates that it would be open for an agency, where they were not a party to the proceedings

---

102 GSTR 2000/20 at paragraph 19 states that it is only the physical characteristics of a property which marks it out as being 'for residential accommodation' and therefore not subject to GST.

before a lower court, to depart from existing judicial decisions to produce a further test case seeking to overturn those decisions and uphold the agency's view as to the correct legal position.[103]

Tax Office's approach post-*Marana* decision

7.85 In the Inspector-General's view the Tax Office's approach in handling the application of the *Marana* decision was unsatisfactory on a number of grounds.

7.86 Firstly, notwithstanding numerous requests by external stakeholders of the NTLG-GST Subcommittee to advise taxpayers, by way of information on its external website or within GSTR 2000/20 that the ruling was under review, there is no evidence that this occurred.

7.87 Secondly, there was no information provided by the Tax Office on the potential implications of the *Marana* decision on the Tax Office view. Such information was available within the Tax Office as the review of GSTR 2000/20 was under way prior to the first instance hearing of *Marana,* and the broad implications of the *Marana* decision were considered during the Decision SILC and in the Adverse Decision Report.

7.88 Thirdly, the Tax Office has advised that until GSTR 2000/20 is reviewed and replaced a tax officer must follow the view espoused in the current ruling without considering the implications of the *Marana* decision. This has meant that taxpayers that have lodged objections where the application of the *Marana* decision would provide them with a favourable outcome have been requested to consent to their objection being held in abeyance pending the broader review by the Tax Office.

7.89 The Tax Office has advised that where a public ruling is shown to be wrong by a court case or the Tax Office believes the public ruling to be incorrect or inconsistent with the law, then there is a strict internal process that needs to be followed to have the public ruling amended or withdrawn. The Tax Office agrees that when it needs to review and restate its views following decisions of courts and tribunals, it is desirable that this be done in a timely way. However, the Tax Office states that:

> …given the importance of the reformulated views that are to be relied upon by the community, it is important that the Commissioner follow a robust process in reviewing his precedential decisions. This can sometimes take time. Dealing with issues promptly is an ideal which the Commissioner seeks to aspire to. There are times when it takes some time for the implications of decisions to be properly considered, analysed and applied. It is therefore preferable for taxpayers to wait until we have come to a final view about the law.

7.90 The Tax Office has also advised that if it was required to decide these objections prior to GSTR 2000/20 being replaced, then the objections would be disallowed regardless of the fact that applying the court decision in *Marana* would mean that the taxpayers would be entitled to the input tax credits. This is despite a number of objections being received from a class of taxpayers in similar circumstances

---

103 Solicitor-General opinion, 'Application of Precedent to Tax Cases', Appendix 4, at p 4.

to those that the Tax Office conceded in the course of litigation in the Administrative Appeals Tribunal.

7.91 The Tax Office advises that in such circumstances, taxpayers are asked to sit back and wait until it can properly reformulate its view of the law and/or the matter is considered by Treasury and/or the Government. The Tax Office also states that those taxpayers are also given assurance that they will be compensated in the event of a favourable decision by the payment of interest on tax that is overpaid.

7.92 In the Inspector-General's view this is an unsatisfactory outcome for taxpayers and the community. The Inspector-General acknowledges that a court or tribunal decision may have broader implications on the Tax Office view than merely the issue considered in the particular decision. This is the case with *Marana* with the Full Federal Court's decision potentially having an impact on the Tax Office's view with respect to a variety of other issues such as the possible structuring of arrangements, agency arrangements and the interaction with specific issues relating to retirement villages and nursing homes. The Inspector-General also acknowledges, and considers it appropriate, that the reformulation of a public ruling will be subject to internal review processes and also subject to advice being sought from Government, counsel and the community.

7.93 However, where the Tax Office can readily identify how a decision, as in *Marana*, will impact a particular class of taxpayers then taxpayers should not be expected to hold their dispute in abeyance indefinitely while the Tax Office determines the broader implications of a court or tribunal decision on the Tax Office view espoused in a ruling.

7.94 This approach does not take into account the uncertainty created within the community and potential additional compliance and economic costs where a taxpayer follows the current, though incorrect, Tax Office view that is then later revised.

7.95 In the Inspector-General's view there is a need for an urgent escalation process that will allow such disputes to be handled in a timely case-by-case basis where the decision is made in accordance with the law rather than with the ruling that may have been overtaken by subsequent decisions. This should operate concurrently with the Tax Office continuing to review and revise the broader implications of a finalised decision on the Tax Office view expressed in public rulings, determinations and interpretative decisions.

KEY FINDING 7.8

The Tax Office does not have processes to ensure that objections or disputes on hand involving a public ruling, determination or interpretative decision under review as a result of a court or tribunal decision are handled and resolved in a timely manner, in particular where the decision provides a favourable outcome for taxpayers.

Subsidiary recommendation 7.6

Where the Tax Office can readily identify how a finalised court or tribunal decision will impact a particular class of taxpayers then taxpayers should not be expected to hold their objections or disputes in abeyance indefinitely pending lengthy Tax Office internal processes for amending or withdrawing public rulings, determinations or interpretative decisions.

Tax Office response

7.96 Agreed in principle but subject to the qualification referred to in the response to Subsidiary Recommendation 7.5 above.

Subsidiary recommendation 7.7

The Tax Office should implement processes to ensure that objections and disputes on hand involving a public ruling, determination or interpretative decision under review as a result of a court or tribunal decision are handled and resolved in a timely manner. This could require the resolution process being led by senior tax officers who are able to make a decision based on the current law (the law as interpreted by the courts) rather than the existing Tax Office view.

Tax Office response

7.97 Agreed in principle, subject to the qualification referred to in response to Subsidiary Recommendation 7.5.

7.98 We will review our processes to ensure a timely response to decisions, as appropriate.

Essenbourne

7.99 In Taxation Ruling TR 99/5 the Tax Office expressed the view that contributions to an employee incentive trust would be subject to fringe benefits tax ('FBT') as a property or residual fringe benefit under the *Fringe Benefits Tax Assessment Act 1986*.

7.100 In *Essenbourne*, which involved an employee incentive trust, the Commissioner assessed Essenbourne on its payment of $252,000 as a property benefit or alternatively as a residual benefit. The Commissioner argued that the benefit arose from the provision of those monies to the trustee as an associate of the employees. The Commissioner submitted that it could not have been intended that a particular benefit provided to one employee could be taxable, but if it were provided to a number of employees it could not be. The taxpayer submitted that the definition of 'fringe benefit' required reference to a particular employee in connection with the benefit said to have been provided.

7.101 In her decision Kiefel J noted that:

> The difficulty in the Commissioner's approach is that it does not identify a benefit to a particular employee. The statute may deem a benefit to be provided to an employee where it is provided to the employee's trustee, but this would not obviate the apparent necessity to identify the employee in question. The definition of 'fringe benefit' would appear to require the identification of the employee to whom the benefit is provided...

7.102 The Court held that FBT did not apply to this arrangement, as payment by Essenbourne to the trustee of the employee benefit trust did not qualify as a fringe benefit as defined by the *Fringe Benefits Tax Assessment Act 1986*.

7.103 Following the decision the Commissioner commented that:

> In the *Essenbourne* case the Court held that an income tax deduction was not allowable for an amount contributed by a company to an employee incentive trust because the payment was simply a distribution of the company's profits to the three principals of the company.
>
> In other words, the Court confirmed that the scheme was not tax effective.
>
> The Court also held that Fringe Benefits Tax did not apply and that Part IVA would not have applied in the particular facts of this case.
>
> Given the scheme was rendered ineffective by denying deductions claimed for the contributions, we saw no point in an appeal to the Full Federal Court.
>
> However we do not accept that the Court's comments in *Essenbourne* on both Part IVA and the Fringe Benefits Tax were correct. We will be testing the application of those provisions in future cases.[104]

7.104 In a fact sheet released with the Commissioner's speech, and referred to in the NTLG minutes of 26 March 2003, the Tax Office stated that:

> In relation to FBT, the Tax Office is of the view that the Court's construction of the FBT provisions is not correct and inconsistent with the Tax Office's understanding of the intent of the FBT law. However, the Tax Office considered that the *Essenbourne* case was inappropriate for clarifying the FBT law on an appeal to the Full Federal Court given the Court's finding that the contribution to the employee incentive trust was a profit sharing exercise of the three principals of the company.
>
> As the Court's views about FBT in *Essenbourne* are not limited in their application to employee benefit trust schemes, it is the Tax Office's intention to seek clarification of the FBT law through litigation of other cases.[105]

7.105 A number of submissions have raised concerns with the Tax Office's refusal to follow aspects of finalised court decisions and contend that this is evidenced by the Tax Office's approach and response in *Essenbourne*. They contend that in this case the

---

104 Carmody M (Commissioner of Taxation), *Tensions in Tax Administration*, ICAA NAB Gala Luncheon Address, Melbourne, 14 March 2003. Available at: < http://www.ato.gov.au/corporate/content.asp?doc=/content/sp200301.htm>.

105 National Tax Liaison Group Minutes, 26 March 2003.

Federal Court has interpreted a taxation law in favour of the taxpayer, and the decision has not been appealed, yet the Commissioner administers the relevant taxation laws in a manner contrary to the Court's decision, expressly stating that he does not believe the Court decision was correct.

7.106 They contend that this case also demonstrates the Tax Office's selective use of precedent and, more importantly, the absence of a clear commitment by the Tax Office to the rule of law and a misunderstanding by the Commissioner of his role in the tax system, namely being charged with administering the tax laws as set out in various Acts.

7.107 Submissions by various stakeholders have expressed the view that unless and until the judicial interpretation is overridden by a superior court, or the factual situation can be distinguished, the judicial decision is the authoritative statement of 'the law' as it applies in that situation.

7.108 The Tax Office has also been questioned over its approach in *Essenbourne* at a number of NTLG meetings.

7.109 At the NTLG-FBT Subcommittee on 20 February 2003 the professional bodies requested the Tax Office to provide its view on Taxation Ruling TR 99/5 in light of the *Essenbourne* decision and the future of the ruling given that the Court rejected the interpretation applied by the Tax Office in Taxation Ruling TR 99/5.[106]

7.110 Members also expressed concern that the Tax Office's approach, namely to seek further litigation to clarify the FBT law following the *Essenbourne* decision, would take an unacceptably long time.

7.111 In response the Tax Office advised that it was of the view that the Court's construction of the FBT provisions was not correct and was inconsistent with the Tax Office's understanding of the intent of the FBT law.[107] The Tax Office also advised that it would not be withdrawing Taxation Ruling TR 99/5 and that its views and opinions in that ruling would continue to be applied, notwithstanding the judgement of Kiefel J in *Essenbourne*.

7.112 At the NTLG meeting on 2 September 2003 the Tax Office was again requested to explain the legal basis on which it can administer interpretations of taxation laws that are contrary to 'the law' as stated by the courts. It was also put to the Tax Office that tax practitioners are struggling to understand how the Commissioner, who is charged with administering 'the law', can adopt and apply an interpretation that expressly conflicts with the law as stated by the courts. It was suggested that it was inappropriate that taxpayers were being issued with amended assessments, and charged GIC and penalties, when they have adopted an interpretation of tax laws upheld by the Federal Court and which one would think is therefore 'the law'.[108]

106 National Tax Liaison Group FBT Sub-committee Minutes, 20 February 2003.
107 ibid.
108 National Tax Liaison Group Minutes, 2 September 2003.

7.113 The Tax Office responded to the NTLG concerns.[109] However, the Inspector-General has a number of concerns with this response and the assumed role of the Tax Office in how it applies the outcome of court and tribunal decisions.

7.114 Firstly, the Tax Office maintained that:

> … a decision at first instance may not be appealed for reasons particular to the case (for example, the state of the evidence) or because the particular case is not thought to be an appropriate vehicle to test the issue. In these cases, the Commissioner will usually continue to adhere to his position until the matter is finally resolved in a more appropriate case.

7.115 The Inspector-General is of the view that this is an unsatisfactory outcome for taxpayers. It should be remembered that in tax litigation the taxpayer bears the onus of proving that the assessment was excessive. In a situation where the outcome of the case is adverse to the Tax Office, it would mean that the taxpayer has satisfied that onus. It is the Tax Office's responsibility to ensure that the state of the evidence would support an appeal. It would be inappropriate for the Tax Office not to apply and follow a finalised court or tribunal decision that is contrary to its stated view because of shortcomings in its evidence gathering during audit and objection.

7.116 The Tax Office response also did not provide any indication of what it would consider to be an 'appropriate vehicle to test the issue'. Some stakeholders have suggested that this may mean a case where the Tax Office is more certain that it will win. The Inspector-General is of the view that such an approach inappropriately places a greater emphasis on litigation achieving a compliance outcome for the Tax Office rather than clarifying the law. This seems to be confirmed by the Tax Office's response as to why it did not seek to appeal the decision, with appropriate test case funding to the taxpayer:

> In *Essenbourne* the court held that the taxpayer was not entitled to a deduction for its contribution to an employee incentive trust. In essence, the court held that the payment was simply a means by which the three principals of the company could share profits of the business and at the same time claim tax advantages. Given the court's finding, the Tax Office therefore saw no point in appealing the court's decision that FBT was not payable particularly as the scheme was rendered ineffective by the disallowance of the deduction.

7.117 It would appear that having achieved its compliance outcome, namely to deny the taxpayer's claim for a deduction, the Tax Office did not wish to appeal the fringe benefit tax issue even though it did not agree with the Federal Court decision. The Tax Office also maintains that the particular case was not the appropriate vehicle to test the issue. In the Inspector-General's view this is again an unsatisfactory outcome for taxpayers.

7.118 Secondly, the Tax Office response stated that:

> ... where the Commissioner has an expressed position that is contested he may seek clarification of the law through the courts, sometimes in more than one test case. The Commissioner administers a test case funding program under which taxpayers are

109 ibid.

provided funding to assist them in the litigation of cases with precedential value. In such cases, as a general principle, the Commissioner applies the resulting interpretation of the law regardless of whether it is favourable to the Commissioner.

7.119 A submission for an association representing legal practitioners has noted that:

> … while it is appropriate for the Commissioner, in Mr D'Ascenzo's words, to 'have the underlying technical issue tested in a different factual matrix' where the 'factual matrix' is properly distinguishable from that of the test case, it is not appropriate for the Commissioner, having abandoned or lost an appeal against an adverse decision, to recontest the same issue in a 'factual matrix' which is not properly distinguishable.

7.120 The Inspector-General notes that in *Walstern Pty Ltd v FCT*[110], the Commissioner submitted that Kiefel J in *Essenbourne v FCT* wrongly held that the definition of 'fringe benefit' required that a particular employee be identified in connection with the benefit provided in order for such a benefit to be one that was provided by the employer to the employee or an associate of the employee in respect of the employment of the employee.

7.121 In response to the Commissioner's submissions Hill J stated:

> As I have already noted, I would, as a matter of comity, follow the decision of Kiefel J in *Essenbourne* unless the case was either distinguishable or I was of the view that the decision was clearly wrong. On this point the case is not distinguishable. Further, far from being of the view that her Honour was clearly wrong, I am of the view that her Honour was clearly right.

7.122 In analysing the operation of the fringe benefit tax provisions, his Honour went on to observe that:

> The definition of 'fringe benefit' in s 136(1) of the FBTAA makes clear the importance of identification of the employee. The benefit itself is one which is said to be 'in relation to an employee'. The benefit is required to have been provided to the employee (or associate of the employee) and is required to be in respect of the employment of the employee. The definition of 'property fringe benefit', (if that is the kind of benefit relied upon) requires relevantly provision of property to a particular person there referred to as 'the recipient'. The valuation formula relevantly here requires that there be a benefit provided 'to a person' in respect of the employment of an employee.

7.123 Following *Walstern* there have been further decisions where the Tax Office's view as expressed in Taxation Ruling TR 99/5 has been held to be incorrect. In *Spotlight Stores Pty Ltd & Anor v FC of T*[111], Merkel J concluded that the taxpayer was entitled to succeed in its fringe benefit tax objection. In setting out his reasons for his conclusion, his Honour stated that:

> In *Essenbourne* (at ATR 643 [54]; ATC 5214) Kiefel J concluded that the definition requires that for the benefit to be provided in respect of the employment of 'the employee', a 'particular employee' must be able to be identified in connection with the benefit. In

110 *Walstern v Commissioner of Taxation* (2003) FCA 1428 (8 December 2003).
111 *Spotlight Stores Pty Ltd v Commissioner of Taxation* (2004) FCA 650 (25 May 2004).

> *Walstern* (at ATR 440-441 [87]-[88]; ATC 5091-5092) Hill J agreed with Kiefel J's view. In the present case, it is clear that when the benefit (that is, the $15 million contribution) was provided it was not provided, whether to 'the employee' or to Spotlight Incentive as an 'associate' of 'the employee', in respect of the employment of any particular employee because the employees of Spotlight were not beneficiaries of the Incentive Trust at that time. The Commissioner contended that I should not follow *Essenbourne* or *Walstern* but I am not satisfied those decisions are clearly wrong and, accordingly, propose to follow them. It must follow that Spotlight is entitled to succeed in its appeal in relation to its FBT objection.

7.124 The Inspector-General notes that in *Caelli Constructions (Vic) Pty Ltd v Commissioner of Taxation*[112] the Federal Court again followed *Essenbourne* to dismiss a taxpayer's appeal.[113]

7.125 The Inspector-General observes that there are now four decisions of the Federal Court where it has been concluded that the definition of 'fringe benefit' in paragraphs 43 to 49 of Taxation Ruling TR 99/5 is incorrect. However, Taxation Ruling TR 99/5 has yet to be amended or withdrawn. Nor has the Tax Office made any public comment retracting its earlier held view that the decision of Kiefel J in *Essenbourne* is incorrect. As was noted in one taxpayer submission:

> … tax officers are required to apply the Tax Office view contained in taxation rulings and other documents to any private ruling requests that come before them. Tax officers are required to apply the view espoused in paragraphs 45 to 49 of TR 1999/5 to private ruling requests and ignore the decisions of the Federal Court which are favourable to taxpayers.

7.126 On 28 February 2006 the Tax Office also announced that it would be writing to certain employee benefit trust participants advising them that it will be amending to nil the FBT liability in relation to their employee benefit trust arrangements.

7.127 The cases where the Tax Office will be amending the FBT liability are those where there is a high degree of judicial support for assessment of income tax, that is, for cases with facts similar to those considered by the courts in any of the *Essenbourne*, *Kajewski*[114] or *Spotlight/Pridecraft P/L* cases. The Tax Office has stated that the courts in each of these cases have found income tax to be properly payable and hence there is minimal risk to the revenue from the Tax Office amending the alternative FBT assessments. The Tax Office has advised that up to 400 multiple assessment cases will be affected and its analysis to date indicates that there are about 200 certain cases with a further 200 potential cases where additional information will be sought prior to any amendment of the FBT liability.

7.128 While the Inspector-General welcomes the Tax Office's change in approach, he notes that this is only confined to instances where a taxpayer has not entered into a settlement with the Tax Office with respect to their arrangement and does not have any outstanding objections or appeals regarding the income tax adjustments. It does not

---

112 *Caelli Constructions (Vic) Pty Ltd v Commissioner of Taxation* (2005) FCA 1467 (17 October 2005).

113 In *Caelli* the Commissioner contended that *Essenbourne* was distinguishable from the present case. Alternatively, the Commissioner submitted that *Essenbourne* was wrongly decided to the extent that it required the identification of a particular employee in relation to a fringe benefit.

114 *Kajewski v Commissioner of Taxation* (2003) FCA 258 (26 March 2003).

represent a change in the Tax Office view regarding the *Essenbourne* decision and is intended to finalise outstanding FBT assessments where the Tax Office believes there is a low risk to the revenue.

7.129 In correspondence to this review the Tax Office referred to the findings of Kiefel J in *Essenbourne* that 'the payment in question is of the surplus profits out of the company' and that '[t]he payment is not referrable to the conduct of its income-producing business', meaning that income tax deductions were not available.

7.130 The Tax Office has also advised that it has not sought to confine this case to its facts. Rather, the Tax Office believes that there is an alternative view that is more consistent with its understanding of the policy intent of the law. The Tax Office has advised that in order to clarify the law on fringe benefits tax it will need to have the matter considered by a higher court in another case.

7.131 The Tax Office also stated that it necessarily followed from the findings in relation to income tax (that is, that the payment was not in respect of employment) that it would have been inappropriate to appeal to the Full Federal Court in this case. If the payment was a distribution of 'surplus profits' to the owners of the company in their capacities as owners, the payment could not also be a payment to the owners in their capacities as employees. The Tax Office states that, in short, it won the case, so in order to clarify the law on FBT it needed to have the matter considered by a higher court in another case.

7.132 The Tax Office goes on to state that even if it adopted the approach of Kiefel J in requiring a link to particular individuals at the time the employer makes a contribution to a related trust, it is likely that in some employee benefit arrangement cases that such a link could be discerned. For example in *Walstern*, while Kiefel J's view was followed, the result was different, because it was found that the payments could be attributed to individual employees. The Tax Office concluded in its correspondence that it was not appropriate to ignore the legitimacy of seeking judicial clarification of decisions which are arguably not correct. While such action is and should be rare, the decisions in *John's*[115] case (overturning a previous High Court decision in *Curran's*[116] case) and *Gregrhon Investments*[117] (which distinguished *Slutzkins*[118] case) show that such action can be in support of the rule of law.

7.133 Referring to the comments about *Essenbourne* and *Spotlight Stores Pty Ltd & Anor v FC of T*, the Tax Office advises that it did not appeal those cases or withdraw Taxation Ruling TR 99/5 as it has stated publicly that it will only seek to collect one tax on each transaction — that is, either income tax or fringe benefits tax. As a consequence, the Tax Office advises that it did not appeal the part of the decision that related to the fringe benefit assessment as it had already won the case. The Tax Office also advises that its position in not seeking to recover both income tax and fringe benefits tax in employee benefit arrangements precluded it from appealing the fringe benefit decision in *Essenbourne*.

---

115 *John v Federal Commissioner of Taxation* (1989) 166 CLR 417 (8 February 1989).
116 *Curran v Federal Commissioner of Taxation* (1974) HCA 46; (1974) 131 CLR 409 (4 November 1974).
117 *Federal Commissioner of Taxation v Gregrhon Investments Pty. Limited & Ors* (1987) 87 ATC 4988 (26 November 1987).
118 *Slutzkin v Federal Commissioner of Taxation* (1977) 77 ATC 4076 (25 February 1977).

7.134 The Inspector-General refers to an extrajudicial speech by the Honourable Justice McHugh examining the tensions between the Executive and the Judiciary. His Honour commented that:

> Professor Pearce said that he has encountered circumstances where Federal agencies were not prepared to follow judicial or quasi-judicial rulings and were prepared to ignore them when they were inconvenient to them. Taxation Ruling IT2612 provided a clear example. There, the Commissioner of Taxation said that he did not accept the decision in Administrative Appeals Tribunal case V135 and ruled 'that where similar facts exist that decision is not to be followed'. No doubt an Executive agency is entitled to disregard a decision where it is truly in conflict with another decision that it thinks is correct. It may sometimes also be justifiable to refuse to follow a decision that is the subject of appeal. But that has problems. Judicial decisions are not provisional rulings until confirmed by the ultimate appellate court in the system. Until set aside, they represent the law and should be followed. Moreover, the Executive can run into serious legal problems where it continues to enforce legislation that a court has ruled invalid. Even more difficult to justify is the refusal to follow a ruling that is not the subject of appeal merely because the agency regards it as wrong and will test it at the next opportunity. The Attorney-General's Department has said that an agency should act inconsistently with a court ruling only on the advice of the Attorney-General's Department. One hopes that this advice is followed meticulously.[119]

7.135 The observations of Justice McHugh are pertinent to the discussion of the Tax Office's handling of the finalised decision in *Essenbourne*, in particular his Honour's comments regarding an Executive agency refusing to follow a ruling that is not the subject of appeal merely because the agency regards it as wrong and will test it at the next opportunity. Importantly, his Honour's speech also emphasises the distinct roles of the Executive and Judiciary, noting that a principal aim of the Executive is to administer laws through the creation of consistent, efficient and economical policy. His Honour goes on to say that:

> Judicial decisions, however, are not constructed in order to promote either efficiency, support for broad-based policies or budgetary restraint. Judges must give effect to the will of the legislature even when it conflicts with the policies of the Executive Government. The perspective of courts is 'necessarily different' from that of the Executive Government.[120]

7.136 While the Inspector-General acknowledges the public statements made by the Tax Office regarding its position not to recover both income tax and fringe benefits tax in employee benefit arrangements, it notes that stakeholder concerns were directed at the Tax Office's refusal to accept a clear pronouncement of the law following a number of Federal Court decisions.

7.137 The Inspector-General notes that it is clear from the Solicitor-General's opinion that there is no legal impediment to the Tax Office resisting a finalised court decision in rare and exceptional circumstances. The opinion states that, if the Tax Office considers that a finalised court decision is wrong, it may challenge that decision

---

119 Hon Justice McHugh AC, *Tensions Between The Executive And The Judiciary*, Australian Bar Association Conference, 10 July 2002. Available at http://www.hcourt.gov.au/speeches/mchughj/mchughj_paris.htm.

120 ibid.

in a subsequent case provided certain conditions are met. These conditions have been discussed in Chapter 4 of the report.

Metal Manufactures and *Eastern Nitrogen*

7.138 The Full Federal Court handed down its decision in *Federal Commissioner of Taxation v Metal Manufactures* and *Eastern Nitrogen Ltd v Federal Commissioner of Taxation* on 3 April 2001. The Full Federal Court held that the arrangements were effective to confer upon the financier an equitable ownership of the property. The Court decided that this was sufficient to support a lease and that the rental payments were made entirely on revenue account and were deductible. The Court also dismissed the Commissioner's argument that the taxpayer sought, through the rental payments, a collateral advantage by entering into the lease, namely the re-acquisition of the property at the termination of the lease for the residual value. Finally, the Court concluded that Part IVA did not apply to the arrangements.[121]

7.139 Following the Full Federal Court decision being handed down there was internal consideration of the implications of the decision including the effect of the decision on Tax Office policy. The Tax Office noted that:

> … this decision is in conflict with the Commissioner's long standing position as expressed in Taxation Ruling TR 95/30. For instance in paragraph 16 of that ruling, it is clearly stated that a lessor could not make a fixture the subject of a lease. Similar problems are encountered when looking at the sale value of the assets, given that in this case, the valuation was made on an on-going basis. If this decision is not appealed, it is considered that Taxation Ruling TR 95/30 would need to be rewritten.

7.140 The Tax Office further noted that:

> … the Commissioner will have great difficulty confining this decision to cases with similar or identical facts, especially as a similar decision was reached in *Eastern Nitrogen.*

7.141 The High Court refused special leave to appeal the decision relating to the characterisation and deductibility of the rental payments and the application of Part IVA. However, the High Court granted special leave to appeal the decision relating to the deductibility of fees incurred for entering into the sale and leaseback transaction. On 20 June 2002 the parties in the matter consented to the appeal being allowed.

7.142 Following the High Court's refusal to grant special leave to appeal, the Tax Office issued Media Release Nat 02/16. In that media release the Tax Office indicated that it would continue to challenge sale and leaseback arrangements that were primarily designed as tax avoidance measures. It noted that the Tax Office accepted that sale and leaseback transactions are generally acceptable forms of financing for businesses, except where they contain objectionable features such as inflated prices and artificially low residual values. However, the Tax Office stated that:

---

121 It is also important to note that in *Eastern Nitrogen* at first instance in the Federal Court the Commissioner also contended that the sale and leaseback transaction was a sham. It contended that the rentals were not paid for the use of the plant because the documents executed by Eastern Nitrogen and the financiers to give effect to that transaction cloaked the true position in that the parties were 'ambivalent' about whether title to the plant would ever pass from Eastern Nitrogen or, if they intended title to pass, they also intended that Eastern Nitrogen would reacquire title at the end of the lease. The Commissioner in the appeal to the Full Federal Court did not maintain the 'sham' argument.

> … the High Court made it clear when refusing Special Leave that these test cases were held to turn on their own facts. In view of this, the Tax Office will continue to challenge the validity of sale and leaseback schemes that are blatant, artificial and contrived.

7.143 The Tax Office also noted that its stated position on sale and leasebacks was set out in Taxation Ruling TR 95/30.

7.144 Despite the Tax Office's view when seeking special leave to appeal to the High Court, as indicated in the Adverse Decision Report, that the decisions in *Metal Manufactures* and *Eastern Nitrogen* were in conflict with Taxation Ruling TR 95/30, the Tax Office took approximately five years to release Draft Taxation Ruling TR2006/D5, which is intended to revise and update Taxation Ruling TR 95/30. The Tax Office advises that Taxation Ruling TR 95/30 will be withdrawn from the date of issue of the Final Ruling related to Draft Taxation Ruling TR2006/D5.

7.145 Despite litigating these cases to the Full Federal Court and seeking special leave to appeal to the High Court, the Tax Office, prior to TR 2006/D5, only released a media release outlining its view on sale and leasebacks after these decisions. The Tax Office also did not provide any greater detail on what is meant by the term 'blatant, artificial and contrived' in the circumstances of a sale and leaseback transaction, especially given that the Federal Court dismissed the Commissioner's 'sham' argument in *Eastern Nitrogen* and the Commissioner in the Full Federal Court did not maintain this argument.

7.146 The Tax Office has also acknowledged that there were two outstanding cases that it considered after the High Court refused special leave to appeal in *Eastern Nitrogen* and *Metal Manufactures*. The Tax Office had advised that one case was ultimately conceded and the other was settled. This was after consideration was given to the factual similarities and differences of these cases with *Eastern Nitrogen* and *Metal Manufactures*, as well as seeking counsel advice.

7.147 In the course of this review the Tax Office stated that in relation to sale and leaseback cases, it has not disputed that 'normal' commercial sale and leasebacks are an acceptable form of financing. The Tax Office stated that its policy in this regard has been consistent for many years, and is reflected in Taxation Ruling TR 95/30, noting that the ruling says in conclusion:

> [As] a rule of thumb, most sale and leasebacks will have their usual tax effect, and Part IVA will not apply, where appropriate values are used (in respect of the sale price of the asset, the lease payments, the residual value of the asset and the balancing charge), where there is no question as to the arrangements having a different tax effect (cf fixtures, arrangements akin to hire purchase or where there may be a capital component), and where there is no dominant purpose of obtaining a tax benefit.

7.148 The Tax Office also commented that in broad terms, in *Eastern Nitrogen* and *Metal Manufactures*, Part IVA was held not to apply because the prevailing or most influential purpose of each taxpayer was to obtain a large financial facility on the best terms reasonably available. The taxpayers concerned enjoy the benefit of these decisions.

7.149 In correspondence to this review the Tax Office also provided some further elaboration on how the term 'abusive' should be defined in the context of sale and leasebacks. The Tax Office commented that:

> Abusive to my mind is a situation where someone pays grossly excessive amounts facilitating large lease payments, and refreshing depreciation deductions, in circumstances where there is a clear understanding that the plant would be transferred back to the original owner for a residual cost. It has always been our intention to tidy up Taxation Ruling TR 95/30, but other priorities have delayed this task.

Other cases

7.150 An examination of other public rulings and determinations indicates further instances where the Tax Office has refused to follow the reasoning of a court or tribunal decision, although the Tax Office has accepted the order in relation to the particular taxpayer. In each of these cases the Tax Office has provided an explanation as to why it believes that the court or tribunal has erred and why it will not follow the court or tribunal decision. However, the Inspector-General notes that where the Tax Office has disagreed with the court or tribunal decision it has not sought to appeal the issue to a superior court for possible clarification. These cases include:

- In response to the case of *Norris v Federal Commissioner of Taxation*[122], the Tax Office stated in its draft Taxation Ruling TR 2005/D9 that it did not agree with the Tribunal's conclusion in that case.[123] The Tax Office indicated in the draft ruling that in interpreting the parameters of income from eligible employment for the purposes of the 10 per cent rule, the Commissioner considered that the Tribunal's earlier decision in *Re Edmonds-Wilson v Commissioner of Taxation (Cth)*[124]provided the most appropriate interpretation of the wording of the provisions. The Commissioner's view in the draft ruling is also contained in the final version of this ruling (TR 2005/24).

- In the case of *Gillespie v Federal Commissioner of Taxation*[125] the Tribunal held that a lump sum workers' compensation payment was made in consequence of the termination of employment because the termination of employment of the taxpayer was antecedent to the payment of the lump sum. In Taxation Ruling TR 2003/13 the Tax Office stated that:

  > The Commissioner is of the view that the Tribunal erred in finding that the commuted lump sum payment was made in consequence of the termination of employment. Although the termination of employment of the taxpayer was antecedent to the payment of the lump sum, the termination had no causal connection with the payment. The payment was a consequence of the injury and not the termination of employment. It could not be said in that case that but for the termination of employment the payment would not have been made. This is to be contrasted with the facts in *Seabright* where the injury at work caused the termination which in turn entitled the taxpayer to an invalidity pension. There is a clear causal nexus in the latter case between the termination and the payment which arguably does not exist in *Gillespie*.

---

122 *Norris v Federal Commissioner of Taxation* 2002 ATC 2091 (2 September 2002).

123 It is of the view that the ordinary meaning conveyed by the text of subsection 82AAS(3) of the *Income Tax Assessment Act 1936,* taking into account its context in the Act and the purpose or object underlying the Act, does not lead to a result that is manifestly absurd or unreasonable.

124 (1998) 98 ATC 2276; (1998) 40 ATR 1071.

125 *Gillespie v Federal Commissioner of Taxation* 2002 ATC 2006 (11 December 2001).

- In response to the Federal Court decision in *Trustees of the Indigenous Barristers' Trust v Federal Commissioner of Taxation*[126] the Tax Office issued an Addendum to Taxation Ruling TR 2000/9. In that Addendum the Tax Office stated that:

> In so far as comments by the Federal Court could be taken to imply that needs — such as suffering, helplessness, misfortune or disability — constitute necessitous circumstances independently of financial necessity, they are considered to be inconsistent with the approach of the High Court in *Ballarat Trustees*. *Ballarat Trustees* will therefore continue to be followed in the administration of the law.

7.151 In other instances, such as with Taxation Ruling IT 2547 the Tax Office did not update its expressed view for a very lengthy time despite its appeal to the Full Federal Court in *Federal Commissioner of Taxation v Jackson*[127] being dismissed. IT 2547 was only withdrawn during the closing stages of this review.

Improving the Tax Office framework for handling finalised outcomes

KEY FINDING 7.9

There are no uniform governance processes to deal with the identification, consideration and feeding back to all appropriate areas of the Tax Office of any non-technical issues arising from the conduct of litigation.

7.152 The Tax Office has in place a framework, through the SILC process, to ensure that the appropriate stakeholders consider the implications of tribunal and court decisions.

7.153 Draft Practice Statement PS LA 2005/D111 acknowledges the importance of considering and analysing the outcomes and handling of litigation. For example, it provides that in order for the implications of the decision to be properly considered an Adverse Decision Report should include:

- whether any actions need to be taken to draw legislative deficiencies to the attention of Treasury and/or Government, to vary Tax Office compliance approaches or to remedy any deficiencies in the conduct of litigation;
- whether the decision is inconsistent with or has identified any significant flaws in the published Tax Office view of the law; and
- appropriate commentary on the conduct of the litigation that led to the adverse decision, such as any difficulties with evidence, witnesses, the litigation team or any interlocutory decisions of the court that may have adversely influenced the outcome.

7.154 The draft Practice Statement also provides that a finalised decision could have an impact on the Tax Office's technical view as expressed in a ruling, determination, interpretative decision or other publicly available statement. It states that:

---

126 *Trustees of the Indigenous Barristers' Trust v Federal Commissioner of Taxation* 2002 ATC 5055.
127 *Federal Commissioner of Taxation v Jackson* 90 ATC 4990 (31 October 1990).

> … currently, it is the responsibility of the Tax Counsel Network to handle the review of the impact on any published Tax Office view. Alternatively, a finalised decision could also identify deficiencies in the Tax Office's compliance approaches and upstream processes including the audit and objection stages. In such instances it is the responsibility of the business and service lines to handle and address any such identified difficulties or deficiencies.

7.155 However, there is currently no uniform framework in place for identifying, considering and dealing with non-technical issues that arise in the course of litigation, irrespective of whether the decision was finalised by way of hearing or settlement with the aim of improving the quality and efficiency of litigation through better upstream processes. Such procedures would also serve to improve capabilities within other compliance areas and minimise the recurrence of shortcomings in the upstream processes that have a significant impact of the conduct and handling of litigation.

7.156 An examination of the business lines' governance process indicates an absence of uniform quality control mechanisms providing feedback to compliance areas and objection areas on how they handled a dispute that proceeded to litigation.

7.157 Currently, the feedback mechanisms vary between the business lines, are on a case-by-case basis and normally directed to the original case officer rather than more broadly to others undertaking similar work. There do not appear to be any formal procedures in place setting out the circumstances when feedback is required nor any means to determine whether a non-technical issue arising in the course of litigation is a random event, an emerging trend or a systemic problem.

7.158 An examination of case files also indicated that in a number of settled cases litigation was acting as a de facto quality review of the Tax Office's objection/dispute resolution processes due to shortcomings in the upstream processes. This included disputes proceeding to litigation without the proper identification of facts, evidence, issues and application of the law. In a number of sampled cases litigation was the first instance that the facts, evidence and the application of the law to those facts and evidence were first properly considered.

7.159 Internal feedback by the Legal Services Branch to business lines also highlighted problems with the upstream processes including not identifying the relevant facts, not referencing identified facts to the evidence, not gathering the appropriate evidence, inappropriate assumptions and assertions in audit and objection decisions and not gathering all the relevant facts and information.

7.160 A number of submissions from legal practitioners, tax practitioners and tax practitioner associations have also raised concerns with these aspects of the upstream processes, which have been examined by this review. As a result of this examination, the Inspector-General considers that there is a need for a review of aspects of the Tax Office's dispute resolution processes prior to a dispute proceeding to litigation.

Subsidiary recommendation 7.8

The Tax Office should develop uniform corporate governance processes to deal with the identification, consideration and feeding back to all appropriate areas of the Tax Office of any non-technical issues arising from the conduct of litigation with the aim of improving the quality and efficiency of litigation through better upstream processes.

Tax Office response

7.161 Agreed

APPENDIX 1: TERMS OF REFERENCE OF REVIEW

A.1.1 On 10 March 2005 the Inspector-General announced the terms of reference for this review. These terms of reference were as follows:

> The Inspector-General will investigate the administration of tax litigation arising from the appeal procedures of Part IVC of the *Taxation Administration Act 1953*. The Commissioner of Taxation has at his disposal resources not available to the average taxpayer, and is bound to a requirement to be a model litigant under directions issued by the Attorney-General's department. Issues of adherence to, and the adequacy and transparency of, Tax Office policies and procedures, and taxpayer communication processes, will be evaluated. Particular attention will be given to issues with broad application. The review will consider:
>
> - The nature and circumstances of tax litigation;
> - The Tax Office philosophy and approach to litigation;
> - Tax Office policies and procedures in respect of litigation, including taxpayers communication processes and Tax Office litigation governance processes;
> - The Tax Office Test Case Program; and
> - The Tax Office's application of the outcomes of finalised court and tribunal decisions.

APPENDIX 2: CONDUCT OF REVIEW

A.2.1 Paragraphs 75-84 of the Inspector-General's 2003 *Issues Paper No 4: ATO Enforcement and Governance* identified taxpayers' and tax practitioners' concerns over the Tax Office's tax litigation practices, particularly in relation to test litigation.

A.2.2 On Tax Office litigation practices generally, paragraphs 75 to 78 stated:

- The ATO has published its official policies in relation to prosecutions and settlements. The ATO, as an agency of the Commonwealth, is also bound by the Attorney-General's Model Litigant directions.

- There is concern amongst taxpayers and tax practitioners that these policies are not effectively implemented because responsibility for instituting litigation is devolved to relatively low levels within business lines and regional offices.

- A review into this issue could examine whether the ATO's litigation policies are providing effective and transparent guidance to tax officials and to taxpayers on the cases that should be taken to Court. Such a review could also examine the governance arrangements in place to ensure that litigation is only commenced in accordance with these policies.

- It would be possible for the Inspector-General of Taxation to examine the mechanisms available within the ATO for taxpayers against whom proceedings are instituted to seek further consideration of their circumstances.

A.2.3 On test case litigation, paragraphs 79-84 stated:

- Access to test litigation funding to challenge an ATO position is critical for individuals and small businesses that could not be expected otherwise to afford the high costs associated with Court proceedings. This is especially so where the ATO position has broad impact.

- The ATO has published its policy on test litigation. This policy is administered through the Litigation Panel in the ATO which includes prominent lawyers and tax advisers who are independent of the ATO.

- Submissions were received from investors in Mass Marketed Tax Effective Investments (MMTEIs) alleging they were not treated fairly in terms of access to test litigation funding. There is particular concern that the ATO has only tested its position on MMTEIs to an extremely limited extent in the Courts and that the significant case law on MMTEIs has been established by privately funded actions.

- The Inspector-General of Taxation would not review particular decisions of the Litigation Panel, but could consult with members of the Litigation Panel to determine the systems through which the ATO adopts advice and recommendations from the Panel.

- Any review into this issue could examine how the ATO's test litigation policy applies to aggressive tax planning arrangements.

- The Inspector-General could also review the procedures the Litigation Panel has in place to fulfil its Charter role 'to provide a contact point for public feedback about Tax Office involvement in litigation and dispute resolution'.

A.2.4 During January 2005, the Inspector-General met with representatives from industry, business and tax practitioner organisations. Stakeholders at these discussions supported the Inspector-General conducting a broad review of the Tax Office's litigation management systems covering issues such as the consistency of Tax Office views argued in litigation and senior Tax Office management's awareness of and support for cases litigated.

A.2.5 On 10 March 2005 the Inspector-General announced that he would review the Tax Office's administration of litigation amongst other issues, as a matter of priority.

A.2.6 The Inspector-General advertised the review on its website www.igt.gov.au from 10 March 2005. The review was also reported in the press and in specialist accounting and legal publications.

A.2.7 Written submissions to the review were taken from members of the public and a number of organisations.

A.2.8 Members of the review team also met with taxpayers, members of the legal profession, members of the Judiciary, staff and members of the AAT, staff of the Office of Legal Services Coordination and staff of the Commonwealth Ombudsman to discuss the review.

A.2.9 The Commissioner of Taxation was asked to provide information and documents relevant to the review. Visits were made to a number of branches of the Tax Office and to the Tax Office's National Office in Canberra to examine relevant files and interview relevant Tax Office staff.

A.2.10 The review also took into account a number of other inquiries relevant to this review.

APPENDIX 3: COMMISSIONER'S RESPONSE TO REVIEW

A.3.1 The Commissioner of Taxation's letter in response to the review is reproduced below. The detailed responses referred to in the Commissioner's letter are set out after the Commissioner's letter, with the Inspector-General's comments on those responses set out in coloured ink.

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

Dear Mr Vos

Thank you for your report. The report acknowledges that "from a quantitative perspective the bulk of the Tax Office's litigation work is soundly conducted."

We appreciate this finding and also the acknowledgement of the "assistance and co-operation provided by" the Tax Office during the course of the review.

The Tax Office agrees with most of your recommendations and will expeditiously seek to implement them.

We have some difficulty in understanding or agreeing with some of the findings. A detailed reply to these matters is attached, and we leave to those interested in reading that response to draw their own conclusions.

What is agreed is that there are adverse perceptions held by some that should be addressed. Your recommendations that support better communication by the Tax Office in relation to our litigation decisions are a sensible response to such perceptions.

Yours sincerely

Michael D'Ascenzo
Commissioner of Taxation

28 March 2006

PO BOX 900 CIVIC SQUARE ACT 2608 AUSTRALIA
ADDRESS

+61 (0)2 6216 1111
TELEPHONE

+61 (0)2 6216 2743
FACSIMILE

APPENDIX 3A: TAX OFFICE'S DETAILED REPLY TO CHAPTER 2

A.3a.1 This appendix sets out the Tax Office's detailed responses to Chapter 2 of the review, with the Inspector-General's comments.

TAX OFFICE DETAILED REPLY TO CHAPTER 2

Tax Office response

A.3a.2 This chapter provides an overview, summary and outline of the key recommendations of the report. Our response to this chapter deals with the matters the Inspector-General claims have been identified by the review (see diagram 2.1 in his report) and the Key Recommendations made in the report.

A.3a.3 More detailed discussion can be found in our response to the other chapters of the report.

Outcome of disputes

A.3a.4 The report relies on Administrative Appeals Tribunal (AAT) figures which indicate that the majority of Tax Office decisions which enter the litigation phase and are referred to the AAT are varied in some way. From this, the Inspector-General draws the conclusion that a significant percentage of the tax cases which reach the litigation stage are reaching that stage unnecessarily, and that the earlier stages of the tax dispute process are not wholly effective and warrant further review. However, the opposite conclusion could also be drawn.

A.3a.5 The scope of litigation needs to be put into context. The report at the commencement of Chapter 2 highlights the information we provided, that only 0.3 per cent of compliance adjustments lead to litigation. This suggests that the Tax Office gets the bulk of its decisions right up-front.

A.3a.6 When cases do get to litigation we again continually review our cases and strive to resolve those cases that can still be resolved without the need for expensive litigation. Nevertheless taxpayers have the right to have their matters reviewed by the AAT or the courts. An analysis of the figures extracted from Table 3.5 (in Chapter 3 of the report) indicates that for the two year period from 1 July 2003 to 30 June 2005, only 25 per cent[128] of non aggressive tax planning appeals are settled. The large volume of aggressive tax planning appeals which are settled (73 per cent) reflects the Commissioner's attempt to respond to the recommendations of the Ombudsman and the Senate Economic Reference Committee regarding mass marketed investment schemes, and employee benefits schemes appeals by offering concessions such as reductions in penalties and interest.

128 This figure may well be overstated, due to apparent errors in that some cases that were wholly conceded were recorded as settlements (see footnote 129 below).

More revealing is the fact that only 4 per cent of the appeals are wholly conceded or withdrawn by the Tax Office.[129]

A.3a.7 While this data indicates that the Tax Office has taken the right approach at the objection stage in most instances, we are reviewing our end-to-end process for objections and appeals to see whether further improvements can be made.

Inspector-General's comments on Tax Office response

A.3a.8 The Inspector-General's figures for cases that do not proceed to a hearing (88 per cent of cases) and which are varied (70 per cent of these 88 per cent of cases) are drawn from published third party AAT data. The Tax Office's analyses are based on its internal records which have internal data quality issues.

A.3a.9 The Tax Office's reference to its internal data which shows that only 4 per cent of cases are wholly conceded or withdrawn by the Tax Office overlooks those cases which the Tax Office's internal records show are settled. Fieldwork conducted by staff of the Inspector-General for this review indicated that a significant percentage of cases that are recorded as settled by the Tax Office in its internal records are settled wholly in favour of the taxpayer. As discussed in the report this may be due to a number of reasons including the possibility that information relevant to the dispute has not been sought earlier in the dispute resolution process (at the audit and objection stages) so as to allow the dispute to be properly considered, that taxpayers are not providing the Tax Office with relevant information until the dispute proceeds to litigation or that the wrong technical issues have been raised by taxpayers' advisers or by the Tax Office.

A.3a.10 The Inspector-General welcomes the Tax Office's comment that it is now reviewing its end-to-end process for objections and appeals to see whether further improvements can be made.

Tax Office litigation philosophy

A.3a.11 The Inspector General's references to the Tax Office having an 'overriding compliance approach to litigation' is difficult to understand.

A.3a.12 Generally, litigation arises because taxpayers disagree with our assessments or decisions and are exercising their rights to challenge them. We respect those rights and, if we believe that our assessment of tax (or decision as the case may be) is correct, we defend our objection decisions to ensure that taxpayers are treated equally.

A.3a.13 Sometimes a taxpayer's challenge to our position provides law clarification from the courts and Tribunal, which helps the Tax Office and the community better understand the law. Whether the Commissioner wins or loses, there may be affirmation of our existing views of the law or a need to alter our position as previously expressed in a precedential view. In such cases, either way the result is greater law clarification and certainty for the community.

---

129 Tax Office figures on cases conceded are indicative only. The Inspector-General has correctly identified that there are some cases which have been recorded as settled on the Tax Office database which should more correctly be categorised as conceded. Without a complete analysis of the error in recording it is difficult to be precise. However, to the extent that cases conceded are higher the rate of settlements will be lower.

A.3a.14 The report also states that 'principles of ensuring compliance with or clarification of the law should be subject to the overriding purpose of ensuring that a just and fair result is achieved for taxpayers engaged in litigation with the Tax Office'. We agree with that.

A.3a.15 Our practices clearly show that we attempt to come to the correct view about the law which we believe the courts will ultimately agree with. Often our views have been formed with extensive external involvement and advice, through Rulings Panels, consultation with professional associations and industry body liaison groups and, in the case of Public Rulings, wider community consultation.

Inspector-General's comments on Tax Office response

A.3a.16 The Tax Office's response states that it finds it difficult to understand the Inspector-General's comment that it has a compliance approach to litigation.

A.3a.17 This response contradicts other public statements the Tax Office has made (for example, in its annual reports) which are referred to in the report. In these public statements the Tax Office has stated that litigation is an essential part of its compliance program.

A.3a.18 The Tax Office's response also does not take into account the litigated cases which are referred to in the report where the Tax Office's conduct appears to have been driven by compliance objectives.

Win at all costs approach

A.3a.19 We disagree that the Tax Office has a 'win at all costs' approach to litigation. The Tax Office's approach to litigation has always been to conduct itself as a model litigant. This means that it is not the Tax Office policy to engage in unfair tactics or practices to win a case, and the evidence shows that this is not the case in practice.

A.3a.20 Taxpayers and their advisers are able to refer (either directly or through the Tax Office) any concerns in this regard to the Office of Legal Services Co-ordination in the Attorney General's Department. The Attorney General's Department has reported that the Tax Office is one of the better Commonwealth Government agencies in terms of compliance with the rules and in self-reporting any potential breaches. This view is also supported by the Ombudsman.

A.3a.21 The Inspector General's assertion seems to be based on a view that the Tax Office does not undertake a cost-benefit analysis in litigation. The reality is that all litigation by the Tax Office is based on an overall appreciation of the risks associated with a case. We agree that this could be better articulated.

Inspector-General's comments on Tax Office response

A.3a.22 Contrary to the Tax Office's response, the report does not assert that the Commissioner has a win at all costs approach to litigation. It states that there are features of the Tax Office's conduct which justify community perceptions that, at times, the Tax Office has such an approach.

A.3a.23 The review found that the Tax Office has no overall risk management framework for Part IVC litigation. Cost-benefit analysis is just one facet of an overall risk management framework. In any event, the review found that a very limited form of formal cost–benefit analysis for litigation existed within only one business line of the Tax Office.

Formal Test Case Litigation Program

A.3a.24 We welcome the comments that the 'Test Case Litigation Program is generally achieving its purpose' and that the analysis undertaken by the Inspector-General showed that most of the cases that reached a hearing were generally meeting the test case litigation objectives.

A.3a.25 We have difficulty in understanding the comment that we fund cases for compliance purposes, 'to assist the Tax Office to enforce the existing law, rather than to clarify the law by establishing new legal principles'. The Inspector-General premises these comments later in Chapter 6 by an overly narrow interpretation of law clarification.

A.3a.26 The administration of the Tax Office's Test Case Program is described in the Test Case Booklet. It describes the purpose as being to clarify the operation of the laws administered by the Commissioner of Taxation where:

- there is uncertainty or contention about the operation of areas of law;
- the issue is of significance to a substantial segment of the public or has significant commercial implications for an industry segment; and
- it is in the public interest for the issue to be litigated.

A.3a.27 Although we do not generally fund cases where there are well established legal principles, there will be occasions when court considerations of different factual cases will describe the scope of the law and resolve uncertainty for large segments of the community.

A.3a.28 The Inspector-General places great store in the funding of two cases which he regards as being for compliance purposes. Only one of those cases went to hearing. The taxpayer in the other, which related to a film scheme, accepted the Tax Office's general settlement offer. The decision in *Howland-Rose*, which related to the Budplan mass marketed investment scheme, plainly resolved significant uncertainty for very large numbers of taxpayers and provided guidance on how the courts would apply the law in similar cases. It was treated as a test case by the court. There was a strong public interest served by funding these cases, as is evidenced by the views of the Ombudsman and the Senate Economics Reference Committee.

Inspector-General's comments on Tax Office response

A.3a.29 The Inspector-General's definition of 'law clarification' for the purposes of the test case program is not 'overly narrow'. It is the definition that was in place at the time when the decisions to fund *Budplan (*also known as *Howland-Rose)* and the other cases referred to in the report were made and is the definition which is still in the Tax Office's current test case litigation booklet.

A.3a.30 The Tax Office has confirmed in its response to Chapter 6 that the Commissioner's decision to fund *Budplan* was not made in accordance with relevant applicable test case program criteria, nor was it funded in accordance with normal test case program procedures.

Following court decisions and the rule of law

A.3a.31 The Inspector-General has questioned our behaviour in not following a small number of finalised court decisions and concluded that our conduct has amounted to poor administration. We reject this conclusion. Advice received from the Solicitor-General and the

Attorney-General's Chief General Counsel has confirmed that we have acted properly in accordance with the rule of law.

Inspector-General's comments on Tax Office response

A.3a.32 The advice received from the Solicitor–General and Chief General Tax Counsel makes no comment on whether the Tax Office has acted properly in respect of the particular cases referred to in the report.

A.3a.33 The opinion sets out a number of conditions for good administration in this area.

A.3a.34 In the Inspector-General's view, the Tax Office has not met these conditions in all cases to which they apply (such as that of *Essenbourne)*. For example, the Tax Office has not (as contemplated in the opinion) provided test case funding for any of the cases which were litigated subsequent to *Essenbourne* where it sought to re-argue its view contrary to *Essenbourne*. Also, the Tax Office's decision to challenge *Essenbourne* in subsequent cases was because it believed that there was an alternative view that was more consistent with its understanding of the policy intent of the law. This is also contrary to the opinion. Furthermore, the Tax Office did not (as contemplated in the opinion) seek or receive written legal advice as to whether the decision in *Essenbourne* should be challenged generally in other cases.

Risk management

A.3a.35 The Tax Office does apply a risk management approach to its internal management of litigation.

A.3a.36 There is a sound and extensive process for risk assessment and management within the Tax Office, but it is agreed that this process could be better documented.

Inspector-General's comments on Tax Office response

A.3a.37 The report finds that the Tax Office does not employ risk management and assessment techniques to its legal risk issues overall, including litigation issues. It notes that a previous internal review (the Behm review) also made this finding and associated recommendations which have not yet been implemented.

Communication to the public

A.3a.38 We agree that there should be more public communication on the status of the Tax Office's litigation program. We will do so in our Annual Report or other publications.

A.3a.39 In addition the Tax Office will issue a formal consolidated practice statement to guide its conduct in litigation.

Inspector-General's comments on Tax Office response

A.3a.40 The Inspector-General welcomes the Tax Office's intention to develop a formal statement to guide its conduct in litigation but believes that a document similar to the Taxpayers' Charter is needed to provide community confidence on the Tax Office's philosophy on litigation. A practice statement could supplement this higher status document. The Charter-like document needs to contain a formal affirmation of the Tax Office's role in relation to litigation as distinct from the roles of Government, Parliament and the Judiciary.

APPENDIX 3B: TAX OFFICE'S DETAILED REPLY TO CHAPTER 3

A.3b.1 This appendix sets out the Tax Office's detailed responses to Chapter 3 of the review and contains the Inspector-General's comments on the Tax Office responses.

TAX OFFICE DETAILED REPLY TO CHAPTER 3

KEY FINDING 3.1

Only a small proportion of active compliance activities and objections lead to litigation.

Tax Office response

A.3b.2 Agreed

A.3b.3 It is important to put into perspective the number of cases that result in appeals.

A.3b.4 The table below provides an overview of compliance activities through to litigation:

Work Type	Financial Year ended 30 June 2004	Financial Year ended 30 June 2005	Total over two years
Compliance activities	1,167,786	1,197,891	2,365,677
Liability adjustments	558,182	679,938	1,238,120
Objections	16,872	15,884	32,756
Private Rulings objections	155	218	373
Appeals and disputes	2,034	1166	3,200
Aggressive tax planning	1551	646	2,197
Non aggressive tax planning	483	520	1003
Total	2,034	1166	3,200

A.3b.5 Based on Tax Office figures, the number of appeals generated from compliance adjustments is less than 0.3 per cent. Fewer than 10 per cent of objections result in an appeal; 3 per cent of objection decisions in non aggressive tax planning cases proceed to appeal.

Cases resolved prior to hearing

A.3b.6 These figures suggest that we mainly get our position right before litigation commences. The small number of cases that get to litigation however are reviewed through the litigation process and in many cases, the dispute can be resolved by the taxpayer conceding, the Commissioner conceding or both sides finding room to negotiate an agreed settlement. The Inspector-General takes the view that 'it is appropriate for the Tax Office to settle litigated disputes, in suitable cases and that the high percentage of settled cases suggests that the majority of Part IVC appeal cases are appropriately concluded by the Tax Office.'

A.3b.7 The report nonetheless suggests that a significant percentage of the tax cases which reach the litigation stage could have been resolved at an earlier stage. The Inspector-General has illustrated that a large number of tax matters are resolved prior to hearing in the Administrative Appeals Tribunal.

Inspector-General's comments on Tax Office response

A.3b.8 After commenting that a significant percentage of the tax cases which reach the litigation stage could have been resolved at an earlier stage the Inspector-General noted that this could be due to number of reasons. It could be due to information relevant to the dispute not being sought by the Tax Office earlier in the dispute resolution process (at the audit and objection stages) so as to allow the dispute to be properly considered, or a taxpayer not providing the Tax Office with requested information until the dispute proceeds to litigation. It could also be due to the wrong technical issues being raised by taxpayers' advisers or the Tax Office. The Inspector-General has not sought to examine in greater detail these observations. However they suggest that the earlier stages of the tax dispute process may not be wholly effective in the timely resolution of disputes and warrant further review.

Tax Office response

A.3b.9 Table 3.3 of the report is replicated with an average column included.

Jurisdiction	97/98	98/99	99/00	00/01	01/02	02/03	03/04	04/05	Average
	per cent	per cent	per cent	per cent	per cent	per cent	per cent	per cent	per cent
All applications	77	76	77	74	74	74	81	78	76.4
Taxation Division	84	85	87	88	81	96	97	83	87.6
Small Taxation Claims Tribunal	80	78	66	68	78	73	85	75	75.4

A.3b.10 The rounded-up figure of 88 per cent used by the Inspector-General to illustrate AAT cases finalised without a hearing, includes the massive volume of mass marketed schemes and employee benefit arrangements. It also includes cases where the taxpayer has withdrawn. The table also provides eight years of percentages of cases in the STCT, averaging 75 per cent of cases which did not proceed to hearing. As the STCT only deals with small amounts, its figures are less affected by scheme cases than the cases in the AAT.

Inspector-General's comments on Tax Office response

A.3b.11 The Inspector-General examined the average percentage of applications for review of tax decisions in the AAT that were finalised without a hearing over an eight year period, from 1997/98 to 2004/05. This helped ensure a more accurate picture of the resolution of taxation review cases rather than just over a two year period. The Inspector-General has acknowledged that the average percentage is influenced by the large number of mass marketed tax arrangement cases finalised in 2002/03 and 2003/04. If these two years are excluded, the average percentage of applications for review of tax decisions finalised without a hearing falls to 85 per cent.

Tax Office response

A.3b.12 The following table reflects information provided to the Inspector-General on the outcome of all appeals (court and tribunal), including those conceded and settled over the

two years from 1 July 2003 to 30 June 2005. This table is reflected in the Inspector- General's report at Table 3.5. Percentages are added below for emphasis:

Outcome	Category				Total	
	Aggressive Tax Planning (ATP)	per cent	Non-ATP	per cent		per cent
Settled	1,609	73.2	249	24.8	1,858	**58.1**
Partly Favourable to the Tax Office	282	12.8	44	4.3	326	10.2
Favourable to the Tax Office	132	6	184	18.3	316	10
Abandoned by Taxpayer	72	3.3	185	18.4	257	8
Conceded by Tax Office	3	0.1	84	8.3	87	**2.7**
Affirmed on review in favour of the Tax Office	14	0.6	55	5.5	69	2.1
Unfavourable to the Tax Office	8	0.3	39	3.9	47	1.5
Abandoned by the Tax Office	5	0.2	37	3.7	42	**1.3**
Other	72	3.2	126	12.6	198	6.1
Totals	**2,197**		**1,003**		**3,200**	

A.3b.13 In the absence of publicly available figures, we also examined our database of Federal Court cases finalised in the 2004/05 year. Even though the total numbers are much smaller, the number of cases settled was consistent with the above figures — about 25 per cent of all finalised cases, with another 2 per cent conceded.

Cases conceded[130]

A.3b.14 The Inspector-General's report suggests that the Tax Office's performance in settling and conceding in the AAT is high, resulting in the view that unnecessary appeals are created. In fact, the total number of cases conceded at appeal amounts to 4 per cent of all appeals, based on Tax Office records. In cases other than aggressive tax planning cases, we conceded or abandoned about 12 per cent.

A.3b.15 As the report illustrates elsewhere, there are a number of cases where taxpayers do not give us all of the information until the case is in litigation. There is a risk-management decision needed in a small number of cases. We need to assess whether it is appropriate to:

- devote resources to issuing formal demands for information and then follow up with prosecution action where taxpayers resist giving the information asked for; or
- suggest the taxpayer needs to prove his or her case and if they resist providing information, the objection should be disallowed and can be dealt with at litigation.

A.3b.16 In some cases, taxpayers do not appeal such decisions, thus bringing the dispute to an end. As shown above 90 per cent of objection decisions are accepted by the taxpayer. In non aggressive tax planning cases 97 per cent of decisions are accepted by the taxpayer. Of those that do go to litigation, the required information is sometimes forthcoming and we

130 Tax Office figures on cases conceded are indicative only. The Inspector-General has correctly identified that there are some cases which have been recorded as settled on the Tax Office database which should more correctly be categorised as conceded. Without a complete analysis of the error in recording it is difficult to be precise. However to the extent that cases conceded are higher the rate of settlements will be lower.

concede. In other cases, the information is never brought forward and the AAT deals with the evidence it has.

A.3b.17 As can be seen, the number of cases where the Tax Office makes the wrong decision at the objections stage is very small.

Inspector-General's comments on Tax Office response

A.3b.18 The Tax Office's reference to its internal data which shows that only 4 per cent of cases are wholly conceded or withdrawn by the Tax Office overlooks those cases which the Tax Office's internal records show are settled. A more complete picture of the Tax Office's resolution of cases requires that settled cases be also considered together with the cases classified by the Tax Office as conceded or abandoned. Fieldwork conducted by staff of the Inspector-General for this review indicated that a significant percentage of cases that are recorded as settled by the Tax Office in its internal records are settled wholly in favour of the taxpayer. As discussed in the report this may be due to a number of reasons, some of which have already been listed above.

A.3b.19 The Tax Office internal data does not distinguish those cases that were finalised by consent and those that were finalised by way of hearing. Also, approximately 12.6 per cent of non-aggressive tax planning cases have been classified with an 'other' outcome. Given the broad range of outcome types already used by the Tax Office it does bring into question the accuracy of the internal Tax Office data. The Inspector-General reiterates his suggestion that the Tax Office move to a more objective classification of outcomes similar to that used by the AAT to ensure greater consistency and accuracy in its recording of the finalisation of cases.

A.3b.20 The Inspector-General has made no finding to the effect that the performance of the Tax Office in settling and conceding in the AAT is high, resulting in the view that unnecessary appeals are created. No negative inference is drawn by the Inspector-General with respect to the Tax Office's management of litigation from the AAT data, which indicates that a large proportion of applications for review are finalised without a hearing. Rather, the question that is being asked is whether this high resolution rate is an indicator that upstream processes, involving both the Tax Office and the taxpayer, are not adequately leading to the timely resolution of disputes prior to the matter going to litigation. This could be the subject of any future review by the Inspector-General into the settlement and objection processes.

A.3b.21 In fact, as noted by the Tax Office as part of its response to this chapter, the Inspector-General takes the view that 'it is appropriate for the Tax Office to settle litigated disputes, in suitable cases, and that the high percentage of settled cases suggests that the majority of Part IVC appeal cases are appropriately concluded by the Tax Office.' The Inspector-General is of the view that the ability of taxpayers and the Tax Office to resolve tax disputes in a timely and cost-effective manner without the need to proceed to litigation is of utmost importance to the proper administration of the tax system.

Cases settled

A.3b.22 We do not dispute the fact that there has been a high level of settlement of Tax Office disputes at the litigation stage in the AAT. Rather than being a negative reflection of our performance, the high number of settlements reflects the successful approach the AAT and the Tax Office has in managing and clearing the large workload of tax schemes.

A.3b.23 The Tax Office does not believe the report adequately highlights that the high percentages reflect the high level of settlements of schemes in the AAT. In these cases,

litigants have accepted our offers of settlements following our success in the courts on some key cases. For the most part, in these settlements taxpayers accept the substantive adjustments, with concessions on penalties or deductions allowed for actual funds outlaid by the taxpayer.

A.3b.24 The AAT's annual reports give some indication of the large effect that mass marketed schemes have had on case figures. In 2002/3 and 2003/04, a large number of applications relating to taxation schemes that had been lodged prior to 1 July 2003 were settled.

A.3b.25 In 2002/03, 84 per cent of all finalisations related to taxation scheme cases; in 2003-04 it was 82 per cent.

A.3b.26 From the Tax Office figures above it can be seen that:

- cases that are settled amount to about 58 per cent of all appeals;
- about 73 per cent of aggressive tax planning appeals are settled; and
- about 25 per cent[131] of all non-aggressive tax planning cases are settled.

A.3b.27 These figures are illustrative of the large numbers of mass marketed schemes and employee benefits trust cases that have been settled based on offers by the Commissioner of reductions in penalties and interest.

Inspector-General's comments on Tax Office response

A.3b.28 Again, no negative inference is drawn by the Inspector-General with respect to the Tax Office's management of litigation from the AAT data, which indicates that a large proportion of applications for review are finalised without a hearing.

A.3b.29 Adequate recognition has been made of the effects of the mass marketed tax arrangement cases. In fact, the potential skewing of AAT data by the mass marketed tax arrangement cases and employee benefit arrangement cases was one reason why AAT data over an eight year period was examined rather than over a two year period.

Cases set aside and varied

A.3b.30 The Inspector-General's report provides a range of facts and tables that have been extracted from the AAT's annual reports.

A.3b.31 Chart 1 of Appendix 6 provides average percentages for each of these results over the last eight years and indicates that approximately 70 per cent of applications that were finalised over these eight years without a hearing resulted in the Tax Office decision at objection being set aside or varied.

A.3b.32 Tax Office records show these cases slightly differently. According to our figures, as the above table indicates, the Commissioner concedes, abandons or settles 62 per cent of cases at the litigation stage.

131 This figure may well be overstated, due to apparent errors in that some cases that were wholly conceded were recorded as settlements.

A.3b.33 Again however, the number of cases resolved is distorted somewhat by the high numbers of settlements of scheme cases. Excluding these cases, the Tax Office figures suggest that the Commissioner settles, concedes, or abandons 37 per cent of non aggressive tax planning cases that get to litigation. Tax Office figures suggest that the 37 per cent is broken down to 12 per cent of cases conceded and 25 per cent settled.[132]

A.3b.34 In non tax jurisdictions, about 76 per cent of cases do not make it to hearing. If aggressive tax planning cases are ignored, 622 cases out of 1003 did not make it to hearing, that is about 62 per cent of non aggressive tax planning cases were resolved prior to hearing.

A.3b.35 These figures suggest that our performance in getting to the correct outcome prior to litigation is quite good. That is not to say that we can't do better and we expect that our end to end review of litigation may well lead to reduced duplication and increased efficiencies.

Inspector-General's comments on Tax Office response

A.3b.36 The Inspector-General notes that the Tax Office is relying upon internal data over a two year period rather than external data over an eight year period. The Inspector-General has acknowledged the impact that mass marketed tax arrangement and employee benefit arrangement cases have had on the overall resolution of applications for review in the AAT throughout Chapter 3. For example, in examining the number of applications for review set aside or varied by consent in the AAT, the Inspector-General noted that the average percentage is influenced by the large number of mass marketed tax arrangement cases in 2002/03 and 2003/04. The report went on to observe that if these two years are excluded, then the average percentage of applications for review of tax decisions finalised without a hearing resulting in the Tax Office decision at objection being set aside or varied falls from 70 per cent to 63 per cent. Again, no negative inference is drawn by the Inspector-General in respect of the Tax Office's management of litigation from the AAT data, which indicates that a large proportion of applications for review are finalised without a hearing. Rather, as noted by the Tax Office in its response to this chapter, the Inspector-General takes the view that 'it is appropriate for the Tax Office to settle litigated disputes, in suitable cases, and that the high percentage of settled cases suggests that the majority of Part IVC appeal cases are appropriately concluded by the Tax Office.'

A.3b.37 Further, it should be noted that the AAT data for 'all applications' in Table 3.3 of the report would include tax applications and mass marketed tax arrangement cases. Therefore a direct comparison between that data and the Tax Office's own internal data for non aggressive tax planning cases could result in incorrect conclusions on the finalisation of tax decisions in the AAT as compared to other jurisdictions.

A.3b.38 The Inspector-General welcomes the Tax Office's comment that it is now reviewing its end-to-end process for objections and appeals to see whether further improvements can be made.

132 As mentioned earlier it is accepted that there may be compensating errors between those two figures due to some conceded cases being incorrectly recorded as settlements.

Cases at hearing

A.3b.39 Of the cases that went to hearing in the Administrative Appeals Tribunal (AAT) or the Small Taxation Claims Tribunal (STCT), the Commissioner won 69 per cent of cases in 2003/04 and 76 per cent of cases in 2004/05 (where there was a substantive tax decision).[133]

A.3b.40 In the Federal Court, of the cases that went to hearing, the Commissioner won 68 per cent of cases in 2003/04 and 63 per cent in 2004/05 in substantive decisions.[134]

Conclusions

A.3b.41 We review our cases as they progress through the litigation stages and seek opportunities to avoid further costs to both sides, where resolution can be found. This is consistent with the Tax Office being a model litigant. We note that in cases where resolution has not been possible, the Tax Office has been successful in the majority of cases heard by the courts and Tribunal.

A.3b.42 It is suggested elsewhere in the report that inadequate quality of Tax Office processes upstream of litigation, such as audit or resolving objections, may be driving unnecessary litigation. While we accept that more can be done to improve our processes, the results suggest our processes work well:

- Of the 1.2 million compliance activities that produced a liability adjustment in the two years to 30 June 2005, there were in the same period about 758 cases where the dispute was unable to be resolved and reached a hearing;
- Of the approximately 32,000 objections that were lodged in that same time, taxpayers accepted our decision in 90 per cent of the cases.
- As the Inspector-General says in Key Finding 3.1 'Only a small proportion of active compliance activities and objections lead to litigation.' In those small number of cases the Commissioner:
  - conceded a small percentage;
  - settled large numbers of scheme cases;
  - settled about a quarter of non scheme cases; and
  - won the greater majority of cases that got to hearing and received a decision.

A.3b.43 The low rate of dispute and the high success rate at hearing, combined with the relatively low rate of settlement compared to other jurisdictions, suggest that the Commissioner has managed litigation well.

Inspector-General's comments on Tax Office response

A.3b.44 As noted, the AAT data for 'all applications' in Table 3.3 of the report would include tax applications and mass marketed tax arrangement cases. Therefore a direct comparison between that data and the Tax Office's own internal data for non aggressive tax

133 Source: Annual Reports.
134 Source: Annual Reports.

planning cases could result in incorrect conclusions on the finalisation of tax decisions in the AAT as compared to other jurisdictions.

A.3b.45 Furthermore, while the Inspector-General has suggested that the possibility that inadequate quality of Tax Office processes upstream of litigation, such as audit or resolving objections, may be driving unnecessary litigation, there is no specific finding in this report to that effect. Rather, the report indicates that this may be due to a number of reasons, some of which have already been listed above. The Inspector-General has highlighted this topic as one likely to be the subject of a future review examining whether the earlier stages of the tax dispute process is wholly effective in the timely resolution of disputes.

SUBSIDIARY RECOMMENDATION 3.1

The Tax Office should publish a more complete picture of the outcomes of litigation to include information on the proportion of applications for review and appeals finalised without a hearing and the outcome.

Tax Office response

A.3b.46 Agreed

APPENDIX 3C: TAX OFFICE'S DETAILED REPLY TO CHAPTER 4

A.3c.1 This appendix sets out the Tax Office's detailed responses to Chapter 4 of the review and contains the Inspector-General's comments on the Tax Office's responses.

TAX OFFICE DETAILED REPLY TO CHAPTER 4

KEY FINDING 4.1 (PARAGRAPH 4.34)

The Tax Office's principal philosophy on litigation is that it is a means of validating the Tax Office view and ensuring that taxpayers comply with its view of the law.

This compliance aim for litigation is, in certain circumstances, overriding its involvement in activities which may lead to law clarification. These features of the Tax Office's conduct, when coupled with the absence of cost/benefit approaches by the Tax Office in terms of assessing the benefits of litigation against the total internal and external costs of litigated cases means that community perceptions that, at times, the Tax Office has a 'win at all costs' approach to litigation are justified.

Tax Office response

Litigation can provide law clarification for the community

A.3c.2 We agree law clarification is an essential tool for achieving, facilitating or promoting voluntary compliance with the law.

A.3c.3 Litigation is primarily based on bringing disputes with taxpayers to a conclusion, and reflects a taxpayer's right to contest our application of the law.

A.3c.4 Strategic litigation, law clarification and advice are central to our administration of the tax laws. The Tax Office aims to minimise litigation and disputes with taxpayers by coming to correct positions early in our compliance activities and then ensuring that taxpayers understand our position. However, it is up to taxpayers whether they exercise their rights of objection and appeal.

A.3c.5 There are law clarification opportunities that sometimes emerge from a disputed case. Law clarification promotes compliance because it provides certainty about the law for the Tax Office and the community.

The Tax Office does not have a 'win at all costs' approach

A.3c.6 'Win at all costs' is not a term that can be accurately applied to the behaviour of the Tax Office.

A.3c.7 As a Commonwealth litigant, the Tax Office follows the Model Litigant Guidelines. This means that the Tax Office will not engage in unfair tactics or practices.

A.3c.8 The Tax Office is regarded as a model litigant by the Office of Legal Services Coordination, the Federal Court and Administrative Appeals Tribunal . As such, we do not accept the Inspector-General's view that the Commissioner has a win-at-all-costs approach to litigation.

A.3c.9 This assertion seems to be based on a view that the Tax Office does not undertake a cost-benefit analysis in litigation. The reality is that all litigation by the Tax Office is based on an overall appreciation of the risks associated with a case. Revenue implications will be one of the risks considered.

Cost-benefit analysis

A.3c.10 It appears that the report's concern about the 'compliance culture' and 'compliance aims', and absence of a 'cost-benefit' analysis, reflects a view of the Inspector-General that the proposed independent area of litigation should have the flexibility to not follow its Public Rulings if it appears the Tax Office will spend more to defend the case than if the principle is simply given away. If that is the view of the Inspector-General, then we do not agree with it. A decision not to defend a case in such circumstances would mean that a taxpayer in that situation would be treated differently to other taxpayers who haven't appealed.

A.3c.11 Cost-benefit analysis is relevant at the lower levels of day to day management in each case. When a settlement is contemplated, our settlement policy guides officers to consider the cost of litigating, including internal Tax Office costs, and whether it is out of proportion to the possible benefits.

A.3c.12 This process has regard to the prospects of success, including collection of the tax, and likely award of costs. These issues are assessed as objectively as possible. The Tax Office Code of Settlement states that it would be generally inappropriate to concede or settle in the absence of special circumstances where the matter is clear cut, or there is a clearly established and articulated Tax Office view on the issue. It is important to maintain consistency of treatment for taxpayers in comparable circumstances.

A.3c.13 Even where there might be scope for settlement, there will also be cases where it is in the public interest to have judicial clarification of an issue. There will also be cases where the pursuit of the matter through the courts could have a significant flow-on effect in terms of law clarification.

Inspector-General's comments on Tax Office response

A.3c.14 Contrary to the Tax Office's response, the report does not assert that the Commissioner has a win at all costs approach to litigation. It states that there are features of the Tax Office's conduct which justify community perceptions that, *at times*, the Tax Office has such an approach.

A.3c.15 The report nowhere asserts that the Tax Office should have the flexibility to not follow Public Rulings if it appears that the Tax Office will spend more to defend the case than if the principle is simply given away. The Inspector-General has always accepted that cost-benefit analysis in respect of litigation involves different considerations when conducted by a government department than when conducted by a private litigant.

A.3c.16 The review did find that the Tax Office has no overall risk management framework for Part IVC litigation and that this includes having no overall framework for assessing the costs and benefits of Part IVC litigation at any level of management within the Tax Office. A very limited form of formal cost–benefit analysis for litigation was found to exist within only one business line of the Tax Office.

KEY FINDING 4.2

There is no formal, consolidated public statement by the Tax Office on its corporate philosophy towards tax litigation. In the continuing absence of such a statement, perceptions that the Tax Office's management of its litigation program is overly susceptible to influence by its compliance culture and by its view of underlying policy will continue to grow. Community perceptions have arisen that the Tax Office is using litigation to confirm its view of the law for compliance purposes rather than to clarify the law.

Tax Office response

A.3c.17 We accept that there is no single public statement. However, there are many publicly available documents that set out our approach to litigation. We will consolidate these public statements into one overarching statement of our corporate philosophy to litigation.

KEY FINDING 4.3

The Inspector-General finds that a formal, consolidated public statement is needed to provide community confidence, and appropriate guidance and direction to Tax Office staff on the Tax Office's philosophy on litigation. This statement should state that the primary aim of litigation is to resolve a dispute in a fair, timely and cost effective manner. The statement should confirm that the Tax Office's philosophy and approach to litigation is consistent with its role in the tax system as an independent and impartial administrator and that it is committed to administering the tax system in line with the rule of law. The statement should also re-affirm the Tax Office's role in relation to and distinct from the roles of Government, Parliament and the Judiciary.

Tax Office response

A.3c.18 Primarily, the Tax Office's litigation philosophy is to act as a model litigant in accordance with the guidelines attached to the Attorney-General's legal services directions. We believe the guidelines provide appropriate guidance and direction to Tax Office staff.

A.3c.19 However, we will provide a statement on our approach to the conduct of litigation, in a proposed Practice Statement on the matter.

A.3c.20 The Tax Office recognises that litigation achieves law clarification benefits for Government and the community, and also ensures that disputes between the Commissioner and taxpayers are brought to finality in a fair and consistent way.

A.3c.21 The role of the Tax Office is defined by statute and is distinct from the roles of Government, Parliament and the Judiciary.

Inspector-General's comments on Tax Office response

A.3c.22 The Inspector-General welcomes the Tax Office's intention to develop a formal statement to guide its conduct in litigation but believes that a document similar to the Taxpayers' Charter is needed to provide community confidence in the Tax Office's philosophy on litigation. A practice statement could supplement this higher status document. The Charter-like document needs to contain a formal affirmation of the Tax Office's role in relation to litigation as distinct from the roles of Government, Parliament and the Judiciary.

KEY FINDING 4.4

The Tax Office has stated on a number of occasions that it is prepared to not follow decisions of the courts or tribunals in other similar cases where it believes it is obliged to take steps to protect the intention of Parliament. It has also acted on this policy in a number of cases. The Inspector-General believes that these actions and statements by the Tax Office provide a basis for the perception that the Tax Office is prepared to act, and in some cases has acted, outside the rule of law.

Tax Office response

A.3c.23 The Tax Office takes great care to ensure all actions and decisions are taken in accordance with the law.

A.3c.24 A decision to go back to the courts to revisit the correctness of a previous decision is not only an extremely rare event, but it is done with great care and respect for the judicial system. The review confirms these are rare events. This supports a conclusion that the Tax Office acts very much within the rule of law.

A.3c.25 The Inspector-General has questioned our behaviour in not following a small number of finalised court decisions and concluded that our conduct has amounted to poor administration. We reject this conclusion. Advice received from the Solicitor-General and the Attorney-General's Chief General Counsel has confirmed in our view that we have acted properly in respect of the cases referred to in the report.

Inspector-General's comments on Tax Office response

A.3c.26 The advice received from the Solicitor–General and Chief General Tax Counsel makes no comment on whether the Tax Office has acted properly in respect of the particular cases referred to in the report. It sets out a number of conditions for good administration in this area. The Inspector-General believes that the Tax Office has not met these conditions in all cases to which they apply (such as that of *Essenbourne).*

KEY FINDING 4.5

There are differing views in the community on the extent to which the Tax Office should follow finalised court decisions in all situations and whether a failure to follow such decisions in all situations amounts to a breach of the principles of the rule of law.

These views range from the view that a failure to follow finalised court decisions are not justified in any circumstances through to views that failing to follow finalised court decisions are permissible provided certain conditions are met.

The Inspector-General has not sought to resolve the debate on whether the Commissioner should challenge finalised court decisions and, if he does so, the circumstances in which this can be done. The Inspector-General considers that this matter is worthy of further debate including in a broader context than the tax system and this review.

KEY FINDING 4.6

The Tax Office has received an opinion from the Solicitor-General and from the Australian Government Solicitor's Chief General Counsel which sets out that the following five conditions need to be met before the Tax Office can challenge a finalised court decision which it considers to be wrong:

- *that the Tax Office has credible and robust legal advice that the court's interpretation is wrong;*
- *that the challenge is made as soon as possible;*
- *that those affected by the challenge are advised of the Tax Office's proposed course of action;*
- *that the Tax Office must take steps to avoid any suggestion that the challenge will unduly burden or prejudice individual taxpayers and must therefore fund or organise suitable assistance to bring a test case on the issue; and*
- *that the challenge must not be made just because, as matter of policy, the Tax Office considers that the decision in the case is wrong or undesirable.*

The Inspector-General has found during this review that Tax Office's conduct in challenging finalised court decisions has not, in relevant cases, met all the above conditions.

Tax Office response

A.3c.27 We take the suggestion that we may have acted outside the rule of law very seriously. As a result, we sought the advice of the Solicitor-General and the Attorney-General's Chief General Counsel. In its simplest terms, the advice confirms that there will be times when it is appropriate to challenge previous decisions.

A.3c.28 The advice provided some broad principles which can be used to guide conduct in this area. It should be noted that the advice also states that 'the circumstances of each case may vary and we do not consider that absolute rules are generally appropriate'.[135]

A.3c.29 While it is true in relation to the FBT point in *Essenbourne* that the Tax Office is 'of the view that there is an alternative view that was more consistent with the Tax Office's understanding of the policy intent of the law' this view was supported by advice from external counsel that the decision was incorrect.

A.3c.30 In *Essenbourne*, the Commissioner sought legal advice as to whether the court's decision in respect to the FBT law was in error. Shortly after the decision we were advised that a Full Federal Court would, more likely than not, come to a different view. In March 2004, Senior Counsel provided oral advice in relation to the application of Fringe Benefits Tax to employee benefit arrangements, that both Keifel J and Hill J were wrong in their rejection in the *Essenbourne* and *Walstern* cases of the ATO's construction of the FBT law as stated in TR 1999/5. This satisfies the 'legal advice' requirements of the Solicitor General advice.

A.3c.31 We accept that we have not offered test case funding in any case argued on similar issues since *Essenbourne*. However, this is because there has not been a case where we have not succeeded in relation to the non-deductibility of the claimed deductions for income tax

135 Paragraph 5 of the opinion 'Application of Precedent to Tax Cases' by David Bennett QC and Henry Burmester QC.

purposes. This is in the context of the Tax Office having made the public statement that we would not collect FBT as well as income tax.

Inspector-General's comments on Tax Office response

A.3c.32 The Tax Office's response refers to a comment in the Solicitor-General's opinion that each case must be considered individually and that absolute rules are not generally appropriate.

A.3c.33 This feature of the Tax Office's response could be perceived as raising an issue of whether the Tax Office will follow the Solicitor-General's opinion in all cases. An agreement by the Tax Office to implement Key Recommendation 1 of the Inspector-General's report would help to mitigate this adverse perception.

A.3c.34 The response also asserts that certain oral advice provided in March 2004 by a Senior Counsel satisfies the 'legal advice' requirement of the Solicitor-General's advice. The Inspector-General considers that the Solicitor-General's opinion's reference to robust and credible legal advice which will withstand public scrutiny does not appear to contemplate oral advice.

KEY FINDING 4.7

The Tax Office has developed processes and procedures to identify and handle litigation involving priority technical issues. There is no formal and consolidated Tax Office statement that outlines the processes and procedures that Tax Office staff are to apply to handle litigated cases that do not involve priority technical issues.

Tax Office response

A.3c.35 We accept the finding that there is no formal statement dealing with non-priority technical issues. However, we do have in place numerous documents including documentation from each of the business lines, the Legal Services Branch litigation manual, litigation flow charts, service agreements and guidance by the Strategic Internal Litigation Committee. These documents and processes are currently being consolidated into the one handbook.

KEY FINDING 4.8

The high percentage of settled Part IVC appeal cases suggest that the majority of these cases are appropriately concluded by the Tax Office.

Tax Office response

A.3c.36 We accept this finding.

KEY FINDING 4.9

A significant proportion of disputes are proceeding to the litigation stage without the proper identification of the technical issues, facts and evidence only to be settled once the LSB officer, business line officer and, where necessary, Tax Counsel become involved.

Tax Office Response

A.3c.37 It is assumed that in this context the reference to 'disputes' is a reference to taxpayer objections.

A.3c.38 Each time the Tax Office disallows a taxpayer objection, a report is also compiled which explains to the taxpayer the reason for our decision. This report includes findings of facts and issues. Only 3 per cent of objections in non-aggressive tax planning cases go on to appeal.

A.3c.39 The litigation process can crystallise issues for both parties and generate evidence not provided earlier by the taxpayer. Litigation can clarify whether the objection officer got it wrong, and in some cases the emergence of new evidence can affect our views.

A.3c.40 As the report indicates, it is often the case that prior to litigation documents are not provided by the taxpayer, or the cooperation of taxpayers is not entirely forthcoming.

KEY FINDING 4.10

Key decisions on whether to engage in litigation or on the need for external counsel rest with the Tax Office's business lines, and are open to strong influence by their strong compliance culture.

Tax Office response

A.3c.41 See our response to Key Recommendation 2.

KEY FINDING 4.11

The Tax Office's structure for managing litigation involves people from at least three different areas within the Tax Office, all of whom have varying degrees of involvement in the case. There is no one person or area within the Tax Office which has overall responsibility for managing all issues (that is, both technical and procedural) for any one litigated case and no one person on a case team who exercises an independent oversight role.

KEY FINDING 4.12

The Tax Office has no area that is separate from its business lines that will review a dispute and whether litigation should be continued. There is a need for an internal review procedure at the litigation stage, with one area responsible for all aspects of resolving a dispute, including technical and procedural issues, once it proceeds to litigation. Such an area should also promote and encourage a distinct culture, corporate goal and set of values, separate from those of the compliance areas.

TAX OFFICE RESPONSE

A.3c.42 We are reviewing the end-to-end process of litigation to find efficiency and quality improvements. The corporate values that apply to all officers of the Tax Office is to act fairly in accordance with the law.

A.3c.43 See also Tax Office Response to Key Recommendation 2

KEY FINDING 4.13

There are strong community perceptions that the Tax Office's approach and conduct is not consistent with the model litigant rules. The Inspector-General believes that there are strong grounds for these perceptions.

Tax Office Response

Model litigant guidelines

A.3c.44 The report includes numerous assertions that the Commissioner has failed to act as a model litigant. The Commissioner regards this as a particularly serious matter and rejects the conclusion that there are 'grounds for the perceptions'.

A.3c.45 The extremely robust governance measures in place for ensuring conformance with the litigation guidelines have been provided to the Inspector-General and have not been referred to in the report.

The Commissioner of Taxation as a model litigant

A.3c.46 Every new brief that is given to counsel for the Commissioner contains instructions that we are to comply with the Model Litigant Guidelines.

A.3c.47 The Inspector-General's findings are contrary to the independent views provided by the Office of the Legal Services Co-ordination (OLSC)[136], and judges and members of the Administrative Appeals Tribunal (AAT).

A.3c.48 It is noted that the Inspector-General's review team interviewed OLSC in the course of the review. The report states that:

> The Office of Legal Services Co-ordination (OLSC) has reported to the Inspector-General that the Tax Office is one of the better Commonwealth Government agencies in terms of compliance with the rules and in self-reporting any potential breaches.

A.3c.49 The report also stated that:

> Members of the AAT and Federal Court that were interviewed for the purposes of this review also indicated that, from their perspective, the Tax Office generally acts as a model litigant, although there were some exceptions.

A.3c.50 Unfortunately, we were not advised what those exceptions were. It may be that in some cases the Tax Office has sought more time from the courts to lodge documents.

A.3c.51 The report mentions that during the last two years, OLSC, the body responsible for monitoring breaches of the rules, received only one public complaint about an alleged breach of the model litigant rules. However, the report does not mention that OLSC did not accept the complaint in that instance.

136 OLSC is responsible for investigating and monitoring breaches of Legal Services Directions, including Model Litigant Guidelines.

A.3c.52 The courts expect, and have confidence, that the Commissioner will act as a model litigant.[137] Extra-judicial observations of Beaumont J in Anatomy of a Federal Court tax case (2000) stated:

> the Crown is expected to act, and does act, as a 'model' litigant, so that it may be anticipated that the Commissioner's response to the taxpayer's statement of facts will not seek to put in issue facts which the Commissioner ought not to place seriously in question (emphasis added)

Taking advantage of unrepresented litigants

A.3c.53 The Inspector-General referred to the case of an unrepresented litigant to suggest the Commissioner may potentially have not followed the Model Litigant Guidelines.

A.3c.54 The taxpayer did litigate his issue, in a forum specifically designed for disputing claims at low cost. It is not a breach of the rule for the Commissioner to brief counsel in such litigation.

Failure to follow previous decisions of the court

A.3c.55 The appropriate standards of conduct are set out by the Solicitor-General in his joint advice with the Attorney-General's Chief General Counsel and our response to this issue is detailed in our response to Key Finding 4.6 and also in our response to Chapter 7.

Poor upstream processes

A.3c.56 The Commissioner is able to resolve a high number of disputes prior to hearing. The Tax Office does endeavour to avoid litigation wherever possible.

A.3c.57 We are always looking to improve our feedback and training to original decision makers and officers deciding objections. Experts and senior officers are involved as early as possible in technical and complex cases. Decision makers have the benefit of the Tax Office law precedent database, which facilitates consistency in decision making. If decision makers have concerns about any of the precedents, they are obliged to escalate matters for review. Objection decisions are also subject to a technical quality review (TQR) process.

A.3c.58 However, we do not accept that when we concede cases at the litigation stage after reviewing the evidence and argument by the taxpayer that this amounts to a breach of the guidelines.

Other comments under the model litigant discussion

The Behm report

A.3c.59 The report says:

> The Behm review found that the Tax Office's overall compliance with these directions was uneven.

---

137 See *Melbourne Steamship Limited v Moorhead* (1912) 15 CLR 133, 342; *Kenny v South Australia* (1987) 46 SASR 273. More recently in a tax context see *Queensland Trading and Holding Co Ltd and Another v Federal Commissioner of Taxation* [2004] FCA 1036 at paragraph 49.

A.3c.60 The Tax Office agrees the Behm report makes that comment.[138] However, the discussion before the comment was focused entirely on procurement of legal services. After referring to some other government guidelines at the start of the chapter, the focus of concern was made clear by the statement:

> Seen as a whole, these guidance documents provide clear direction on the procurement of services, and on the delivery of 'in house' services in a competitive market.

A.3c.61 In fact, the term 'model litigant' appears only once in the Behm report at Chapter 5 where he raises a perceived concern, not evidence of a breach.

Litigation complaints in the Tax Office

A.3c.62 The report makes reference to a number of cases (24) in the period January 2005 to May 2005. Not one of these cases related to complaints about our conduct as a litigant.

Model litigant governance process

A.3c.63 The Legal Services Branch Executive, Second Commissioner, and Commissioner are kept informed about how our litigation conforms with the Attorney-General's legal services directions. This includes any remedial action that is in place where we have not met our obligations in any area.

Inspector-General's comments on Tax Office response

A.3c.64 Contrary to the opening paragraph of the Tax Office response to this finding, the report only contains assertions from stakeholders that the Tax Office has failed to act as a model litigant and examples of conduct found by staff of the Inspector-General during the fieldwork for this review which the Inspector-General noted may be examples of failure to follow these rules. The Inspector-General has not sought to determine whether any of these examples reported to him or highlighted during his fieldwork amount to such breaches as he considers that this is a matter which needs to be determined by the Office of Legal Services Coordination.

A.3c.65 The report states that there are strong community perceptions that the Tax Office's approach to litigation is not in accordance with the model litigant rules. The Tax Office's response states that the Tax Office 'rejects' the conclusion that there are grounds for these perceptions. However the report sets out in some detail the bases for these perceptions which include various flaws in the measures which are currently in place for detecting potential and actual possible breaches of the model litigant rules.

A.3c.66 The report states that these measures are in need of improvement. A need for these measures to be improved is not compatible with the Tax Office's assertion that these measures are 'extremely robust'. The report notes that other reviews have raised similar issues. The report makes recommendations for improving these measures. The Tax Office has agreed elsewhere in this report to implement a number of these recommendations.

---

138 Principal Findings 4.1.1: 'The Government's policies with respect to the provision of legal services are set out in the Attorney-General's Directions. Those policies are not well understood in the Tax Office LP, and the Tax Office LP's compliance with those policies is uneven.'

SUBSIDIARY RECOMMENDATION 4.1

The Tax Office should develop practical guidelines for staff on the application of the model litigant guidelines.

Tax Office response

A.3c.67 Agreed

A.3c.68 A proposed practice statement on the conduct of litigation will further guide staff on the Model Litigant Guidelines, in accordance with the Attorney-General's broader policy for Commonwealth departments.

A.3c.69 Since 1999, the Legal Services/ Legal Practice internal website has contained a Legal Practice Note advising staff about the Model Litigant Guidelines.

A.3c.70 All briefs to counsel from the Commissioner in tax litigation contain copies of the guidelines.

SUBSIDIARY RECOMMENDATION 4.2

The Tax Office, as part of its public statement on its philosophy and approach to tax litigation, should make taxpayers aware of the model litigant guidelines and that the Office of Legal Services Co-ordination is responsible for administering the model guidelines, including considering any alleged breaches of the model litigant guidelines. This should also include making taxpayers aware of the model litigant guidelines at the outset of litigation.

Tax Office response

A.3c.71 Agreed

SUBSIDIARY RECOMMENDATION 4.3

The Tax Office should introduce an escalation process whereby senior tax officers or independent counsel, at the request of taxpayers or their representatives, may administratively review alleged breaches of the model litigant guidelines and departures from the Tax Office's stated philosophy and approach to litigation.

Tax Office response

A.3c.72 The Tax Office has a well-established and effective escalation process. Alleged breaches of the Model Litigant Guidelines will continue to be referred to the Office of Legal Services Co-ordination (OLSC) by the Tax Office General Counsel, who is responsible for the relationship with OLSC.

A.3c.73 Other complaints concerning the conduct of litigation will continue to be reviewed by an independent senior officer.

Inspector-General's comments on Tax Office response

A.3c.74 The Tax Office has not responded to the terms of this recommendation. It confirms that an escalation process for potential breaches of the model litigant rules exists but has not agreed to make this process accessible to taxpayers or their representatives or to extend it to

issues concerning the Tax Office's overall conduct in litigation. The Inspector-General believes that the Tax Office should implement this recommendation in full.

KEY FINDING 4.14

The Inspector-General found no recent evidence that the Tax Office is not following public rulings and determinations in the conduct of litigation.

Inspector-General's comments on Tax Office response

A.3c.75 The Tax Office provided no response to this key finding. The terms of this finding have now changed since the date of provision of the draft report for comment to the Tax Office. This was because, after this date, the Tax Office published material[139] which confirmed that in the recent case of *Queensland Rail*[140] it did not follow the terms of one of its published excise bulletins regarding the diesel fuel rebate. The finding now reads:

'The Tax Office has a policy of not departing from its published position (as set out in rulings, determinations and similar documents) in the conduct of litigation. It has however not followed this policy in one recent case.'

KEY FINDING 4.15

There should be a process inside the Tax Office which would allow the terms of a ruling to be urgently reviewed where litigation which relies on the ruling is underway and doubts arise on the correctness of the ruling.

Tax Office response

A.3c.76 Such a process is already well established.

Inspector-General's comments on Tax Office response

A.3c.77 The Tax Office has indicated to the Inspector-General that it considers that the existing public rulings program process is the appropriate mechanism for reviewing the terms of any ruling. However, this process does not involve the kind of quick and prioritised review that is contemplated in this key finding for cases which are already subject to the litigation process. These kinds of cases require quick clarification in order that the relevant dispute may be resolved in a fair, timely and cost-effective manner.

SUBSIDIARY RECOMMENDATION 4.4

The new area of the Tax Office responsible for the management of all aspects of litigation should establish a formal process under which the terms of existing Tax Office rulings are urgently reviewed, either internally by the Tax Office or by outside parties where during the litigation process doubts arise as to the correctness of the rulings.

---

139 See Agenda Item 8 and Attachment 3 of the NTLG Minutes for meeting of 7 September 2005, publicly released on the ATO's website at www.ato.gov.au on 24 March 2006.

140 *Queensland Rail v F C of T.* First instance appeal before the Federal Court- decision reserved.

Tax Office response

A.3c.78 Where doubts arise during the litigation process about the correctness of a Tax Office ruling, the issue will continue to be escalated to the Tax Counsel Network for urgent attention.

Inspector-General's comments on Tax Office response

A.3c.79 The Inspector-General believes that the Tax Office should implement this recommendation in full. An escalation of the matter to the Tax Counsel Network will not achieve an urgent review of a ruling that is the subject of pending litigation if any change to the ruling can only be achieved by the Tax Counsel Network using current lengthy rulings program processes.

APPENDIX 3D: TAX OFFICE'S DETAILED REPLY TO CHAPTER 5

A.3d.1 This appendix sets out the Tax Office's detailed responses to Chapter 5 of the review and contains the Inspector-General's comments on the Tax Office's responses.

TAX OFFICE DETAILED REPLY TO CHAPTER 5

KEY FINDING 5.1

The Tax Office has not implemented all the major recommendations from an internal review relating to the management of its in-house legal services area.

The Tax Office has implemented those recommendations of the internal review which concern management reorganisation. The major recommendations that have not been implemented include the introduction of:

- *risk management processes;*
- *reporting and reviewing systems which evaluate client satisfaction, the achievement of targets and the value for money of the in-house legal area; and*
- *national support structures for staff of the in-house legal services area.*

Tax Office response

A.3d.2 The Tax Office commissioned the review to examine the overall performance of our legal practice and recommend ways in which performance could be improved. There were 44 recommendations made in the report which were broadly endorsed by the Tax Office Executive.

A.3d.3 The majority of the recommendations have been implemented. The Tax Office has made substantial progress in improving the capacity to manage legal risk.

A.3d.4 The recent establishment of the Tax Office Law Sub Plan indicates a clear corporate commitment to providing an effective framework and hierarchy for identification and escalation of legal risk.

A.3d.5 Work has been completed to identify capabilities required for legal services work and gaps in individual staff capabilities. Development of a nationally focussed curriculum is well advanced to support continuing legal education. Options are also being explored as to the extent to which financial support is able to be provided corporately to assist staff in privately improving their legal skills.

Inspector-General's comments on Tax Office response

A.3d.6 The Tax Office has misquoted this key finding. The opening words of this finding are as follows:

> The Tax Office has not implemented some of the major recommendations of …

KEY FINDING 5.2

The Tax Office does not employ risk identification and assessment techniques to its legal risk issues overall, including litigation issues. One result of this is that the Tax Office has no reporting systems which detail the overall state of the Tax Office's litigation program, including the revenue in dispute tied up in this process and the Tax Office costs incurred to date on either all or any individual cases. Another result is that the Tax Office does not employ cost/benefit analyses to its assessment of whether to proceed with litigation.

Tax Office response

Risk management

A.3d.7 It appears that 'proper' risk management of litigation requires, in the Inspector-General's view, a cost-benefit analysis to be provided to the Executive.

A.3d.8 At the executive level, the interest in litigation is more specifically based on exception reporting, and that is why most reports deal with issues such as risks to the fabric of the law, decision management, progress and issues about significant cases, and cases that might attract community interest. These significant risks are not measured by reference to the individual costs of all cases, nor is it appropriate to do so.

A.3d.9 Cost-benefit analysis is, however, very relevant at the lower levels of day-to-day management in each case. The taxpayer initiates litigation. When a taxpayer wants to enter into a settlement, cost-benefit analysis would then become relevant. When a settlement is contemplated, particularly in smaller factual or quantum type cases, our settlement policy guides officers to consider the cost of litigating (including internal Tax Office costs) and whether it is out of proportion to the possible benefits, having regard to the prospects for success, including collection of the tax and likely award of costs, assessed as objectively as possible.

A.3d.10 Even where there might be scope for settlement, there will also be cases where it is in the public interest to have judicial clarification of an issue and the case is suitable for this purpose.

Risk assessment in tax litigation

A.3d.11 In the Tax Office we risk manage our litigation in line with the Tax Office Risk Management Policy and with corporate strategies and processes to address risks.

A.3d.12 Due to the inherent legal risks arising from litigation, all litigation arising in the Administrative Appeals Tribunal (AAT), the Federal Court, High Court and State and Territory Supreme Court and Courts of Appeal are risk assessed to determine whether or not the litigation gives rise to a Priority Technical Issue (PTI).

A.3d.13 Unexpected challenges can also arise in the course of litigation to well-established Tax Office positions as well as core tax principles not previously identified under the present PTI process. In these circumstances, escalation as a potential PTI is required to ensure that Tax Counsel Network and/or Centre of Expertise resources are added to the litigation team.

A.3d.14 All new appeals (including both PTI and non PTI cases) are considered within the Legal Services Branch (LSB) callover process.

Inspector-General's comments on Tax Office response

A.3d.15 Contrary to the Tax Office's response, the report does not prescribe in detail the kinds of information that should be provided to the Tax Office's Executive to support a proper risk management approach to litigation.

A.3d.16 The report finds that the Tax Office does not employ risk management and assessment techniques to its legal risk issues overall, including litigation issues. Cost-benefit analysis is just one facet of risk management techniques.

A.3d.17 The review notes that a previous internal review (the Behm review) also made the finding that the Tax Office does not employ risk management and assessment techniques to its legal risk issues, including litigation issues.

A.3d.18 The report notes that the Behm recommendations in this area have not been implemented. The Tax Office's response to Key Finding 5.1 confirms that they have not been implemented by its reference to the progress which the Tax Office considers that it has made in this area.

A.3d.19 The measures referred to by the Tax Office as being 'in line with' Tax Office Risk Management Policy involve only the identification of litigation which involves 'priority technical issues'. The identification of such cases is only one facet of a risk management approach to litigation and will not, for example, enable the identification of legal risk issues that may exist in litigation which does not involve priority technical issues.

A.3d.20 The Tax Office's response confirms that it considers that cost-benefit analyses are relevant to the lower levels of day to day management in litigated cases. Although the Tax Office's response recognises the importance of such analyses, the review found that a very limited form of formal cost–benefit analysis for litigation existed within only one business line of the Tax Office.

KEY FINDING 5.3

The Tax Office does not communicate the status of its litigation program (including the revenue results and/or costs incurred) to the public and as a result the public is unable to assess whether the Tax Office's overall litigation program is being conducted effectively, fairly and with minimum cost.

Tax Office response

A.3d.21 The Tax Office provides in the Annual Report each year an overview of the conduct of litigation and test case funding for that year. As a result of recent initiatives of the Attorney-General's Department, we will also be moving to report legal costs in future Annual Reports.

SUBSIDIARY RECOMMENDATION 5.1

The Tax Office should introduce reporting systems under which its Executive is aware of the total state of all Tax Office Part IVC litigation, including the extent to which cases being litigated have produced negative revenue results.

Tax Office response

A.3d.22 The Tax Office has in place a monthly report which is sent to the Tax Office Executive to advise them of the most significant cases currently before the courts and Administrative Appeals Tribunal (AAT). The focus of the Executive is on strategic issues such as those that have an impact on the coherent fabric of the law. However, we will improve the level of reporting through the Law Sub-plan.

SUBSIDIARY RECOMMENDATION 5.2

The Tax Office should be more transparent in communicating the overall results of its litigation program (including the number and dollar value of cases heard by a court or tribunal, the number and dollar value of cases settled or resolved by other means and the total costs incurred by the Tax Office in resolving all these disputes) to enable the public to assess whether the Tax Office's overall litigation program is being conducted effectively, fairly and with minimum cost.

Tax Office response

A.3d.23 We will examine, in the context of the Tax Office's Change Program, ways to improve our reporting of cases which are litigated, as well as cases that are resolved before a decision of a court or tribunal.

KEY FINDING 5.4

There is a lack of support tools for Tax Office staff who work in the in-house legal area, including support tools that are necessary for the staff of this area who actually conduct litigation at the Small Taxation Claims Tribunal or Administrative Appeals Tribunal.

SUBSIDIARY RECOMMENDATION 5.3

The Tax Office should ensure that adequate support tools (such as a database of precedents, adequate facilities to interview taxpayers and/or their representatives, and adequate continuing legal education) are developed for Tax Office staff who are responsible for the actual conduct of cases.

SUBSIDIARY RECOMMENDATION 5.4

The Inspector-General recommends that a consolidated and up-to-date set of litigation reference material should be developed and made available to all Tax Office staff.

Tax Office response

A.3d.24 We agree with subsidiary recommendations 5.3 and 5.4, but not with Key Finding 5.4.

A.3d.25 The Tax Office has a number of support tools, including a litigation manual, litigation flow charts and the Significant Issues Litigation Committee (SILC) process to provide guidance to legal services staff.

A.3d.26 We have recently updated our reference materials, including practice statements, instruction bulletins and reference manuals which apply to litigation. These materials are added to websites and share drives for the convenience of staff.

A.3d.27 A mentoring system is also in place, where a less experienced staff member is paired with a senior staff member who will provide guidance and advice on the conduct of litigation.

A.3d.28 We will review existing support tools to ensure they are adequate.

Inspector-General's comments on Tax Office response

A.3d.29 The review found that at the time fieldwork was conducted there was a lack of support tools for Tax Office staff who work in the in-house legal area. The Inspector-General welcomes the comments that the Tax Office has recently updated its reference materials, has introduced a mentoring system and will review existing support tools to ensure they are adequate.

KEY FINDING 5.5

There is presently only limited written reference material which explains to LSB staff and others within the Tax Office the policies and procedures, including case management procedures, which apply to litigated cases. Most of this material is outdated and is also spread across a number of different sources.

Tax Office response

A.3d.30 We have recently updated our reference materials, including practice statements, instruction bulletins and reference manuals which apply to litigation. These are being consolidated into one large handbook for the use of all staff and will be posted on our internal website.

SUBSIDIARY RECOMMENDATION 5.5

The Tax Office should develop a reference document which sets out all of its procedures for handling litigated matters which do not involve PTI's.

Tax Office response

A.3d.31 Agreed

A.3d.32 The Tax Office will develop a single document which will consolidate procedures for handling litigation matters which do not involve a Priority Technical Issue.

KEY FINDING 5.6

Case files in the Tax Office's legal services area indicate that, in a significant percentage of cases, staff of the Tax Office's in-house legal area are not complying with internal Tax Office case management procedures in relation to the keeping of records in connection with a litigated case. Procedures that are not being followed include those which require staff to record the outcomes of key internal Tax Office meetings in relation to litigation, to keep copies of external key litigation documents (such as briefs to counsel and counsel's subsequent advice) and to record the eventual outcome of the case.

SUBSIDIARY RECOMMENDATION 5.6

The Tax Office's LSB area should develop appropriate file and record-keeping procedures for litigated cases. Processes should also be established to monitor the application of these procedures, to review their effectiveness and to implement any necessary improvements.

Tax Office response

A.3d.33 There is room for improvement in our file and record-keeping procedures.

A.3d.34 We will review and reissue the File Management Protocol issued in May 2001. We will put in place governance arrangements to ensure compliance with the revised practices in line with recently issued Corporate Management Practice Statement (CMPS) PS CM 2005/27 on record keeping.

Inspector-General's comments on Tax Office response

A.3d.35 The Tax Office's response does not accurately state key finding 5.6. The opening words of this key finding actually state that: 'A significant percentage of the case files in the Tax Office's legal services area examined by staff of the Inspector- General indicated …'

A.3d.36 The Inspector-General welcomes the Tax Office's response that it will improve its file and record-keeping procedures.

KEY FINDING 5.7

The Tax Office has no structured internal quality control processes for litigation.

Tax Office response

A.3d.37 We have a number of internal quality control processes in place for litigation, including the SILC process; monthly meetings with the Assistant Commissioner for litigation; regular callovers; as well as bi-annual meetings with the Senior Tax Counsel Strategic Litigation and other stakeholders.

SUBSIDIARY RECOMMENDATION 5.7

The new independent area of the Tax Office that is primarily responsible for the management of all aspects of litigated cases should be subject to formal quality control processes for work conducted by staff of that area.

Tax Office response

A.3d.38 Agreed in principle.

A.3d.39 We will develop a more structured quality assurance process. As indicated in our response to Key Recommendation 2, all decisions regarding litigated cases will be managed by the Office of the Chief Tax Counsel (OCTC) or the Tax Counsel Network.

Inspector-General's comments on Tax Office response

A.3d.40 The Inspector-General welcomes the Tax Office's comments that it will develop a more structured quality assurance process for litigation.

KEY FINDING 5.8

There is no uniform, written and clear set of internal management policies and procedures for the litigation roles which are currently carried out by members of the Tax Office's Tax Counsel Network. The Tax Counsel Network is also not required to prepare any management reports to the Tax Office's Executive for any cases for which they are effectively responsible. The litigation management activities of this network are also not subject to adequate quality control processes.

Tax Office response

The role of Tax Counsel

A.3d.41 Key Finding 5.8 and the paragraphs that precede it deal with the policy and procedures around the involvement of Tax Counsel in litigation. The Tax Counsel Network works within a broad governance framework provided by a wide range of practice statements and reporting mechanisms. The Priority Technical Issues System, for example, provides a robust means of monitoring the Tax Counsel involvement as the PTI owner of many high-level risks to the Tax Office. Tax Counsel ensures that PTIs are progressed in a timely way, and this is monitored by the Priority Technical Issues Committee.

A.3d.42 In terms of litigation, the Tax Counsel's role is well established through practice statement PSLA 2005/22. The actual conduct of litigation is ordinarily well managed by competent staff in both the Legal Services Branch (LSB) and the Business Lines. In significant litigation Tax Counsel will approve documents and submissions to the court or tribunal. While responsibility rests with Tax Counsel, it is a collaborative effort involving business line and LSB staff, as well as our solicitors and external counsel.

A.3d.43 The business model intends that the Tax Counsel generally limit their involvement in the day to day conduct of litigation.

Inspector-General's comments on Tax Office response

A.3d.44 The Tax Office's comments confirm Key Finding 5.8.

KEY FINDING 5.9

The internal management policies and procedures for litigation of each of the Tax Office's business lines are not uniform and are of varying quality, with none exhibiting all the hallmarks of best practice. The area with the most extensive and detailed processes for the internal management of its litigation processes is the GST business line. However, this area's processes still require improvement, particular in the area of efficiency. The area with the least extensive and least detailed internal management processes for Part IVC litigation is the aggressive tax planning area, with other lines falling in between.

Tax Office response

A.3d.45 We will continue to further develop consistent corporate policy and practices for review and litigation in particular for quality assurance, reporting and analysis. An environment of sharing best practice will be further supported through, for example, regular internal workshops of the type that have been conducted in recent years and have systematically improved our governance processes.

A.3d.46 Of the 77 cases reviewed, the Inspector-General commented against three of the cases that the business line files were not provided despite a request being made. As advised, there was only one case where the files could not be located. The Inspector-General was advised that in the remaining two cases, files were available for inspection. For the Inspector-General to make the comment that a 'significant percentage' of files were not able to be located when requested by the Inspector-General is simply inaccurate.

A.3d.47 It is difficult to understand the Inspector-General's comments with respect to the Aggressive Tax Planning (ATP) area. While ATP is not a separate business line, ATP litigation cases involving mass marketed and employee benefit schemes have been closely managed in recent years. A dedicated senior tax counsel reported to the First Assistant Commissioner (ATP) on all litigation cases.

A.3d.48 It is suggested that there is no process for internal review of decisions made by the Large Business and International business line during the litigation phase.

A.3d.49 The LB&I structure and procedures are such that many quality assurance checks and reviews are built into the front end of the process.

A.3d.50 Amended assessments are raised after position papers are provided to the taxpayer, who is given an opportunity to respond. That material is considered before an assessment is raised; this is the first review. In many cases, Tax Counsel and Centres of Expertise are involved in the technical decision and external counsel's opinion is sought before the case is both peer reviewed and signed off by a senior officer.

A.3d.51 When reviewing objections, LB&I officers are instructed to follow Taxpayers' Charter requirements for an independent review. The review officer is not the officer who approved the assessment.

A.3d.52 At the appeal stage, Legal Services Branch is involved for the first time and the Large Business cases are more often than not supported by Tax Counsel and independent counsel and solicitors.

Inspector-General's comments on Tax Office response

A.3d.53 Staff of the Inspector-General were not provided with a significant percentage of the files requested for examination during the fieldwork stage of this review. This was despite a generous notice period being provided for the production of these files. The Inspector-General's comment that a 'significant percentage' of files were not able to be located when requested by the Inspector-General is therefore entirely accurate. The Inspector-General considers that an inordinate time to locate files concerning litigation is not consistent with good litigation management practice. The Tax Office's comments which imply that most of these files have now been located are noted.

A.3d.54 The Tax Office's comment that 77 cases were reviewed by the Inspector-General is not accurate.

A.3d.55 The Inspector-General also notes the Tax Office comments concerning the absence of an internal review mechanism in the LBI area. The Inspector-General does not consider that any of the internal processes referred to in the Tax Office's response (such as the taxpayer's ability to respond to a position paper or to an amended assessment and the approval of objection decisions by officer not previously involved in the dispute) amount to an internal review mechanism that can be availed of by taxpayers. Furthermore, most of the

processes referred to by the Tax Office occur prior to the stage when the dispute has been referred to the AAT or a court. This review has not examined Tax Office processes that are applied to litigated disputes before they reach the litigation stage.

APPENDIX 3E: TAX OFFICE'S DETAILED REPLY TO CHAPTER 6

A.3e.1 This appendix sets out the Tax Office's detailed responses to Chapter 6 of the review and contains the Inspector-General's comments on the Tax Office's response.

TAX OFFICE DETAILED REPLY TO CHAPTER 6

GENERAL COMMENTS

A.3e.2 Under the Test Case Litigation Program, the Tax Office provides financial assistance to taxpayers involved in litigation matters that are regarded as important to the administration of the revenue system.

A.3e.3 While the Commissioner is the ultimate decision maker on test case applications, there is an advisory panel consisting of members external to the Tax Office. The current panel includes two senior tax officers, a former NSW Court of Appeal judge, a tax barrister, a tax lawyer, a tax accountant and a former taxation director of the Institute of Chartered Accountants. The external panel members bring a range of skills and backgrounds to assist in deliberations.

A.3e.4 The Inspector-General's report advocates that the Test Case Litigation Program would benefit from greater independence from the Tax Office with a suggestion that the program could be administered by a different government agency. The view of the Tax Office is that any decision to remove the program from the Tax Office is one for government.

A.3e.5 The findings and our responses are set out below:

KEY FINDING 6.1

There are four categories of litigated cases which the Tax Office currently funds. These are cases funded under the formal test case program, cases where the Tax Office will fund a taxpayer's appeal costs where the Tax Office has lost a case at the AAT, cases involving a taxpayer appealing to the High Court and other cases it will fund under its general administrative powers.

Tax Office response

A.3e.6 The present booklet[141] developed in consultation with the representative bodies describes all of the types of cases where funding will be provided. Broadly speaking, there are three main categories of test case litigation funding:

- the formal Test Case Litigation Program;
- funding for appeals by the Tax Office from decisions of the Administrative Appeals Tribunal (AAT); and

141 Test Case Litigation Program April 2005 http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/57395.htm.

- funding for some appeals by the Tax Office to the High Court.

A.3e.7 The Inspector-General distinguishes cases funded through the panel, which includes external members, and cases where the Commissioner offers funding of his own volition. Cases not funded under the panel process (i.e. where the Commissioner decided to fund a case of his own volition) are not considered by the Inspector-General as part of the 'formal test case program'.

A.3e.8 We feel it is important to point out the Inspector-General has defined the formal test case program differently to the way the Tax Office has administered it over the last decade.

A.3e.9 We accept the Inspector-General's statement that this may not be well understood by the community, but our publications and our public statements have been consistent in our explanation of the program. We will consider ways to improve understanding of the test case program.

Inspector-General's comments on Tax Office response

A.3e.10 The Inspector-General welcomes the Tax Office's comment that it will consider ways to improve the understanding of the test case program.

KEY FINDING 6.2

The Tax Office has defined cases which fall into the formal test case program as cases which consist of those which meet the formal criteria for funding which the Tax Office has formally communicated to the community as well as cases which do not meet these criteria. This definition is logically flawed and means that the formal communicated criteria for funding test cases are meaningless and do not operate as a means of controlling which cases will and will not be funded by the Tax Office. If the test case program were to be managed more independently of the Tax Office, perhaps by removing it to another government body there will automatically be a separation between cases which are funded under the formal test case program and cases funded by the Commissioner of his own volition and the problems which have emerged from the Tax Office's failure to be transparent about its objectives for funding particular litigated test cases should be less likely to arise.

Tax Office response

A.3e.11 The Tax Office has published a booklet about the Test Case Litigation Program. It invites taxpayers to apply for funding with applications that address certain criteria. It also makes clear that the Commissioner may also offer test case funding in cases where an application has not been specifically made, but which are considered fair and in the public interest to do so, and that these cases are regarded as an important part of the program.

Cases funded for law clarification

A.3e.12 The Inspector-General adopts an overly narrow definition of law clarification in his report. The Tax Office's Test Case Booklet provides that the purpose of the Test Case Litigation Program is to clarify the operation of the laws administered by the Commissioner of Taxation where:

- there is uncertainty or contention about the operation of areas of law;
- the issue is of significance to a substantial segment of the public or has significant commercial implications for an industry segment; and

- it is in the public interest for the issue to be litigated.

A.3e.13 The booklet explains that cases with issues involving questions of fact where there are established legal principles will not generally be funded. The word 'generally' was intentional. There will be cases where uncertainty and contention in the law can be resolved for a substantial section of the community by cases that will further test the scope and application of existing legal principles. The litigation panel has also on occasion agreed to the funding of cases where taxpayers have wanted to challenge long-standing existing principles, where it is considered that a court or tribunal may now take a different view given the passage of time. If the underlying reasons for doing so will remove genuine uncertainty for the community and clarify what the law means, we take the view that favourable consideration should be given to funding.

A.3e.14 We will consult with representative bodies to determine whether a further revision of the booklet is necessary.

Budplan and another unidentified case

A.3e.15 *Budplan* is identified in the report as a case which was funded under the Inspector-General's fourth category. The fourth category refers to cases that the Commissioner decides to fund outside the external advisory panel process. This process is set out on page two of the Test Case Litigation Program booklet.

A.3e.16 When the application came before the Test Case Litigation Panel in 1998, funding was refused because the case involved tax avoidance, which at that stage was prohibited under the guidelines.

A.3e.17 The *Budplan* investment scheme involved 9,842 investors and claimed deductions of $372.5 million.[142]

A.3e.18 By the time it came back to the panel in February 2000, the case had attracted significant community interest and an extensive investigation by the Commonwealth Ombudsman.[143]

A.3e.19 A senior officer of the Ombudsman's office made representations to the panel in February 2000. The Tax Office issued several letters to individual taxpayers involved in the *Budplan* scheme to invite them to apply for test case funding.

A.3e.20 While the Commissioner said at the time that he was looking for effective ways to put an end to schemes of this type by securing strong judicial decisions reinforcing the strength of the law, he was also concerned about the taxpayers who were resisting moves to resolve these disputes and, in doing so, were potentially putting themselves in a worse financial position. The Commissioner's aim was largely to bring an understanding of their legal position to those taxpayers, that is to have the law clarified for them.

---

142 Commissioner of Taxation, Annual Report, 1998-99, p 20.

143 Commonwealth Ombudsman, The ATO and Budplan–Report of the Investigation into the Australian Taxation Office's handling of claims for tax deductions by investors in a tax-effective financing scheme known as *Budplan*. Report under section 35A of the Ombudsman Act 1976, June 1999. The report considered 1600 complaints and concluded in part '… it is my opinion that the Commissioner's actions are fair and could not be regarded in any way as being unjust, oppressive or improperly discriminatory.'

A.3e.21 While the Tax Office does not generally support funding litigation in schemes cases, the decision by the Commissioner to fund these cases, following the panel meeting in February 2000, recognised the public interest in doing so. Up until then there had been long delays in getting lead cases before the courts.

A.3e.22 It is incorrect to say that *Budplan* was not also directed to law clarification. The scheme had a round-robin non-recourse financing arrangement that was typical of mass marketed agricultural schemes and it was hoped that the court's views about the application of Part IVA to that arrangement would be helpful in other, similar cases. It was seen as a test case for all involved and our whole strategy was to test these matters in the court.

A.3e.23 The Commissioner also said that '[we] will consider funding test cases for other schemes if they raise materially different principles.' This was a major factor in the decision to revise the test case booklet, to accommodate this change in policy.

A.3e.24 The Senate Economics Reference Committee[144] 'welcomed' the decision to fund representative cases. It highlighted the uncertainty and ambiguity around the application of Part IVA to round-robin non-recourse financing.[145]

A.3e.25 In our view, these applications fell within the criteria for funding. Page three of the former booklet[146] said 'two aspects of the criteria of funding are:

- whether or not the issue will clarify taxation law in a manner beneficial to the community; and
- whether the issue is in the public interest'.

A.3e.26 The *Budplan* case was a factually complex case and as a result it came at a very high cost to the test case program. Given the massive number of cases waiting in the AAT and at the objection stage, it was important that the case be run well on both sides so that there was no doubt about the correctness of the outcome. His Honour Conti J said:

> The assistance which I received from all legal representatives involved, both in address and in written submissions, was substantial and of a high order professionally. The work of counsel and solicitors engaged in this litigation was competently and thoroughly prepared and presented.[147]

A.3e.27 The court found for the Commissioner on the primary deduction provisions. It was therefore strictly unnecessary for the court to deal with the application of Part IVA. However, this was an area of great public interest. His Honour Conti J said

> The issue arises as to the application of Pt IVA ….. Given the 'test case' character of the present proceedings, it is appropriate that I resolve that issue in any event.[148]

---

144 Senate Economics References Committee, Inquiry Into Mass Marketed Tax Effective Schemes And Investor Protection 2002, Interim Report paragraph 6.26.
145 Ibid. Chapter 4 generally, but paragraph 4.35 particularly.
146 'Test Case Litigation Program Application & Guidelines'.
147 [2002] FCA 246 at paragraph 3.
148 [2002] FCA 246 at paragraph 132.

A.3e.28 The Commissioner won the case. The taxpayers did not appeal the decision. No other case was brought forward by another *Budplan* participant to seek to obtain a different outcome. No subsequent decision of a court has suggested that the *Budplan* decision was incorrectly decided. Clearly this was law clarification.

A.3e.29 Even though the Inspector-General takes the view that this case provided no new principle of law, considering the massive number of mass marketed scheme participants who were waiting for the outcome, the number of cases in the AAT and the amount of revenue involved, this case was plainly a case in the public interest. As required under the previous criteria, the 'issues in the case [were] of relative significance to the administration of the tax law'.[149]

A.3e.30 The Inspector-General points to community perceptions that avoidance cases should not be funded (which stand in contrast to his recommendation 6.5). We agree with community views that avoidance cases should generally not be funded, except where there is a strong public interest served, as in the *Budplan* case.

A.3e.31 Although the Senate Economics Reference Committee welcomed the funding of representative *Budplan* cases[150], it recognised not all lead scheme cases should be test case funded.[151]

Cases funded on a full indemnity basis

A.3e.32 It was said that we funded two cases on a full indemnity basis, and that this 'strongly indicates the Tax Office has given preferential funding to cases involving law enforcement purposes'. The funding was agreed on a solicitor and client basis in these cases, as with all cases under the Test Case Litigation Program[152] (under both the cases dealt with by the panel as well as those funded with the agreement of the Commissioner).

A.3e.33 At the time of the relevant funding, our offers of funding for counsel were consistently based on rates capped for counsel at Commonwealth rates, as they are now. However, in these two cases we agreed to fund counsel at higher rates, due to exceptional circumstances.[153] Approval was obtained from the Attorney-General to fund counsel at these higher rates.

A.3e.34 In both cases, various costs incurred by the taxpayer in the preparation of the cases were denied by the Tax Office in line with the solicitor-client offer of funding.

---

149 From the criteria contained in the Test Case litigation Program booklet that existed at the time of the decision.

150 Senate Economics References Committee, Inquiry Into Mass Marketed Tax Effective Schemes And Investor Protection 2002, Interim Report paragraph 6.26.

151 Senate Economics References Committee, Inquiry into Mass Marketed Tax Effective Schemes and Investor Protection Final Report 11 February 2002 paragraph 3.45.

152 Solicitor/client costs are the costs which a solicitor charges the client for legal services. They relate to costs payable as between a solicitor and a barrister and their respective clients. Party/party costs are costs which the court usually orders another party to pay. Solicitor/client costs are almost always higher than party/party costs because party/party costs only cover costs that are necessary to the court proceedings and do not include other expenses, such as the costs of taking instructions and giving advice to the client.

153 The taxpayers had briefed counsel at an agreed commercial rate. By the time funding was agreed, counsel had already provided substantial work on the cases and it was important to the timely and efficient resolution of these factually complex cases that the counsel arrangements were not disturbed late in the day.

Alienation of personal services income cases

A.3e.35 The Inspector-General highlighted the fact that the Tax Office settled some of the cases chosen for funding because the Commissioner was advised by counsel that he would lose. The relevant cases are those involving alienation of personal services income.

A.3e.36 These cases were not settled, but rather conceded by the Commissioner. However, the Tax Office otherwise agrees with this statement. The Commissioner altered his view and publicly announced his change in policy in December 2005. These actions are consistent with the Tax Office being a model litigant.

Inspector-General's comments on Tax Office response

Cases funded for law clarification

A.3e.37 The Inspector-General's definition of 'law clarification' for the purposes of the test case program is not 'overly narrow'. It is the definition that was in place at the time when the decisions to fund *Budplan* and the other cases referred to in the report were made. Prior to April 2005, the test case litigation program booklet stated, in an unqualified way, that:

> the aim of the program is to develop legal precedent, that is, a legal decision which will serve as a rule for future similar cases

A.3e.38 The law clarification aim for the program was reworded in the April 2005 test case program booklet and now includes a statement that:

> cases with issues involving questions of fact where there are established legal principles will not generally be funded

A.3e.39 The Inspector-General considers that, despite the use of the word 'generally' in the new April 2005 test case program booklet, the essential aim of the test case program remains the same as it was prior to April 2005 i.e. the aim of the program is to fund cases which create new legal principles.

A.3e.40 In any event, it is not appropriate for the Tax Office in responding to this finding to refer to a definition of the aim of the program which was not in place when the decisions to fund the cases referred to in this finding were made.

Budplan and another unidentified case

A.3e.41 The Tax Office response confirms that the Commissioner's decision to fund *Budplan* was not made in accordance with relevant applicable test case program criteria, nor was it funded in accordance with normal test case program procedures.

A.3e.42 The Inspector-General does not dispute that the case may have achieved law clarification in the sense of clarifying how existing law applies to a given set of facts. However, this is not the sense in which the term 'law clarification' is used in the current test case program guidelines, nor the guidelines that were in place at the time of the decision to fund *Budplan*.

A.3e.43 The Inspector-General considers that the Tax Office's approach, combined with poor communication, led the community to believe it was a formal test case chosen by the Tax Office contrary to its stance of not funding avoidance cases. The denial of formal test case funding for other earlier and subsequent avoidance cases was then seen as inconsistent.

KEY FINDING 6.3

The Tax Office has failed to adequately communicate to the community the existence of the fourth category of 'other funded cases', and the criteria it will apply to fund such cases. This lack of communication has led taxpayers to believe that taxpayers funded under the fourth 'other category' of funding have been funded under the formal test case program. This has fuelled community perceptions that the Tax Office is not consistently applying its test case program criteria to all cases that are funded under that program.

Tax Office response

A.3e.44 The so-called 'fourth category' of other funded cases referred to by the Inspector-General is set out on page two of the Test Case Litigation Program booklet.

Inspector-General's comments on Tax Office response

A.3e.45 While this category of funded cases is referred to on page two of the booklet, the subsequent commentary in the booklet fails to clearly set out the nature of these other funded cases and the criteria that will be used to grant funding for these cases.

KEY FINDING 6.4

The Tax Office does not have adequate governance processes in place to ensure that either the decision to fund the 'other category' of cases it will fund or the method of funding these cases is subject to appropriate internal scrutiny.

Tax Office response

A.3e.46 The Tax Office believes there are adequate governance processes in place.

A.3e.47 All test case funding comes under the control of a First Assistant Commissioner within the Office of the Chief Tax Counsel (OCTC). Reports are provided to the Priority Technical Issue Committee (PTIC), including a summary of the cases which have been funded. All decisions have the involvement of senior officers.

Inspector-General's comments on Tax Office response

A.3e.48 The Inspector-General does not believe that the Tax Office can assert that it is appropriately managing its decisions to fund test cases when no internal reports containing details such as the quantum of funding agreed for a case, the progress of that funding and/or the progress of the case itself are prepared and no internal reviews are conducted on whether the test case program is meeting its purpose.

SUBSIDIARY RECOMMENDATION 6.1

The Tax Office should establish appropriate governance arrangements to allow appropriate oversight by the Tax Office's Executive of all litigated cases which it funds. These governance arrangements should distinguish between cases where the Tax Office has obtained no external advice on its decision to fund the case and those where it has obtained, and followed, that advice.

Tax Office response

A.3e.49 We currently report this information to the Priority Technical Issues Committee (PTIC) which is chaired by the Second Commissioner Law.

Inspector-General's comments on Tax Office response

A.3e.50 The Inspector-General believes that the Tax Office should implement this recommendation in full. As the report indicates, at the time of the Inspector-General's review, the Tax Office did not prepare internal management reports (which identify details such as the number, cost and progress) either for cases which it funds of its own volition, or for cases which it has funded under the formal test case program. The Tax Office's response indicates that the practices observed by the Inspector-General have not changed. The Inspector-General does not believe that the Tax Office can assert that it is appropriately managing its decisions to fund any of these cases when no such internal reports are prepared.

SUBSIDIARY RECOMMENDATION 6.2

The Tax Office should take steps to clearly notify the community of the existence of funding arrangements for cases which fall outside the formal test case program and the other rules for funding Tax Office appeals against AAT decisions and appeals to the High Court. It should notify the community of the types of cases that it will fund in this way and of the circumstances in which this funding has been and will be used by the Tax Office.

Tax Office response

A.3e.51 Agreed in principle.

A.3e.52 Commentary on the different types of cases funded is now in the booklet 'Test Case Litigation Program', published in April 2005. In developing the booklet, we consulted externally before finalising its content and mailing it to major stakeholders. It was placed on our external website and a media release announcing its availability was issued.

A.3e.53 The Test Case Funding Program includes cases funded for law clarification purposes that are in the public interest. This includes cases where the Tax Office agrees to fund cases based on an application by a taxpayer, and those cases where the Tax Office funds a case without the taxpayer needing to apply. The booklet identifies when the Tax Office will fund appeals from decisions of the Administrative Appeals Tribunal and Small Taxation Claims Tribunal. It also makes clear that the Tax Office sometimes offers to meet the taxpayer's costs when special leave is being sought to appeal a case to the High Court.

A.3e.54 Ideally we would prefer to make these funding arrangements totally transparent, but we have been advised by the Australian Government Solicitor (AGS) that there may be problems in doing this in some aspects because of the secrecy provisions contained in the tax law. We will continue to consult with AGS to clarify this.

SUBSIDIARY RECOMMENDATION 6.3

The Tax Office should ensure that where it funds cases under its general administrative powers the method of funding (such as the basis and timing of funding) provided is consistent with that which is provided under the formal test case program. This would be to ensure that litigants who achieve funding for law clarification purposes are not disadvantaged when compared with litigants who have achieved Tax Office funding of their case for purposes other than law clarification.

Tax Office response

A.3e.55 We have not drawn any distinctions in our funding practices based on whether it was commenced by a taxpayer application or funded by the Commissioner offering funding in important cases. That said, while the intention is to provide consistent approaches to funding cases, there needs to be some flexibility in appropriate cases having regard to individual circumstances so that all cases are appropriately supported under the program.

A.3e.56 All cases funded are for the purposes of law clarification.

Inspector-General's comments on Tax Office response

A.3e.57 The Inspector-General welcomes the Tax Office's intention to provide consistent approaches to funding cases but notes that, as indicated in the report, this intention has not been put into practice by the Tax Office over the life of the test case program.

KEY FINDING 6.6

The formal test case program has not been well managed internally by the Tax Office. Although there have been recent improvements, including processes to control costs funded under the program, to ensure that taxpayers are given reasons if their funding request is denied and in respect of record-keeping for the program, key deficiencies in the Tax Office's internal management of the program remain. These include:

- *An absence of an adequate quality assurance processes for the program;*
- *A general failure by the Tax Office to ensure that all cases warranting funding are identified and funded to the appropriate extent; and*
- *A lack of appropriate internal governance arrangements for the program.*

Tax Office response

A.3e.58 The placement of the Test Case Litigation Program within the Strategic Litigation team better enables issues of importance to be identified. The connections that exist with the Priority Technical Issue Committee, in particular, enable issues of importance to be identified for a strategic litigation response.

Quality processes

A.3e.59 All decisions are currently made by the First Assistant Commissioner, Office of the Chief Tax Counsel. All letters and communications of substance are signed off by the Senior Tax Counsel, Strategic Litigation.

A.3e.60 There is a corporate file for the application, and a process for collecting comments and feedback from the Tax Office business line and senior officers involved in the case. Decisions are made after careful consideration by a panel consisting of a number of external members. There is a process for internal review where an applicant is aggrieved.

A.3e.61 Concerns about costs, legal issues and the test case deeds are reviewed by the Australian Government Solicitor.

Internal governance arrangements

A.3e.62 Although we believe that we have appropriate internal governance arrangements in place, we will review the Test Case Litigation Program's internal review, analysis, evaluation and quality processes.

A.3e.63 The chair and deputy chair of the Test Case Litigation Panel report directly to the PTIC meeting on the operation of the Test Case Litigation Program.

A.3e.64 The test case reports are also provided to the national tax liaison group, which includes legal and tax professional representative bodies.

Inspector-General's comments on Tax Office response

A.3e.65 The Inspector-General has made no comment on Key Finding 6.5. As regards Key Finding 6.6, the Inspector-General welcomes the Tax Office's commitment to review the test case litigation program's internal review, analysis, evaluation and quality processes.

KEY FINDING 6.7

The test case program has not been administered fairly by the Tax Office. The Tax Office appears to have used the program's funds, together with other public funds, to support its organisational objectives of collecting revenue and enforcing the tax laws, rather than using these funds primarily to have certain areas of the tax law clarified by the courts.

Tax Office response

A.3e.66 We consider that there is absolutely no substance to this finding, nor any explanation in the report of how the Tax Office might have achieved this result before independent courts and tribunals. Moreover, it is not clear how an enforcement objective is achieved by funding taxpayers to be legally represented against us.

A.3e.67 Of the 44 cases funded under the program which resulted in a final decision by a court or tribunal, the Commissioner won 21, the taxpayer won in 20 and there were three cases partly in favour of both. This even split should be compared to the Commissioner's general success rate in the courts and tribunals. For example, in 2004-5 the Commissioner won 76 per cent of cases in the Tribunal and 63 per cent of court cases.

A.3e.68 Despite the finding, the Inspector-General concludes that the 'figures on the results of funded and decided cases therefore do not give any clear indication of bias in the Tax Office's funding of test cases.'

A.3e.69 We would suggest that the figures show positively that there is no bias in the Tax Office's funding of test cases. Our commitment to law clarification is apparent by the existence of the program. Fairness is apparent from the existence of the external panel members, whose advice has generally been followed.

Amount budgeted for and spent on the program

A.3e.70 The Commissioner has an interest in providing funding that will provide law clarification benefits for the broader community, where the matters are in the public interest to be resolved.

A.3e.71 Although the Inspector-General agrees with the assertion put to him that the Commissioner has failed to do enough to ensure the test case budget is spent, the Tax Office has elsewhere in the report been criticised for having voluntarily funded cases.

A.3e.72 There has only been one case where a decision was made contrary to a Test Case Litigation Panel recommendation, other than in those cases where the decision to fund was decided by the Commissioner. In that case, a recommendation was not accepted in relation to the first application of the taxpayer. In subsequent appeal proceedings, the panel's recommendations were accepted by the chair. That case went to the High Court and the taxpayer received costs for all stages of the proceedings.

Inspector-General's comments on Tax Office response

A.3e.73 The Tax Office has not correctly quoted this key finding and its comments in this response are therefore unsound. The key finding's opening sentence actually reads as follows:

> The test case program has not been administered fairly by the Tax Office in the sense of achieving its aim of law clarification in all cases that warrant funding determined on an objective basis.

A.3e.74 The 44 cases referred to in the Commissioner's response which are alleged to show no bias in the Tax Office's funding of cases do not include the significant number of funded test cases that did not result in a finalised court decision. The number of these cases is the difference between the 110 cases that were initially funded by the Tax Office and the 44 cases which have led to a final court or tribunal decision. The percentages quoted for the number of cases won by the Tax Office also only cover cases that were finalised by a court decision and do not cover the significant number of cases that were finalised without a court hearing (for example by being settled).

Amounts budgeted for and spent on the program

A.3e.75 The Tax Office's response suggests that the report is inconsistent by stating, on the one hand, that the Tax Office could do more to ensure that the test case budget is spent and on the other hand, that the Tax Office is to be criticised for having voluntarily funded cases. The report is not inconsistent in this area. The criticisms made in the report in respect of certain cases which the Tax Office has voluntarily funded do not go towards whether or not these cases should have been funded but deal with the manner in which those cases were funded (eg whether they were funded in accordance with stated Tax Office guidelines).

A.3e.76 The Tax Office response also asserts that there has been only one decision to not fund a case where that decision was made contrary to a test case panel funding recommendation. The Tax Office has dismissed the second example of such a case referred to in the report. It has done so on the basis that the test case panel consist of two tax officers as well as a number of parties who are external to the Tax Office and that when the views of these tax officers are counted the decision not to fund the case was made in accordance with an overall recommendation of the panel.

A.3e.77 The Inspector-General's report clearly states (and the Tax Office has confirmed) that a majority of the members of the panel that were external to the Tax Office wanted to fund this case but this was not the decision that was followed by the Tax Office.

A.3e.78 The Inspector-General believes that the Tax Office should not count the views of its own officers in any case where it is making assertions about the extent to which its decision was made in accordance with a recommendation of a consultative panel. To do so devalues the effectiveness of Tax Office consultation panels in the community's eyes because it leads to a community perception that the Tax Office is capable of manipulating the decisions of such panels. This manipulation could occur through the Tax Office appointing enough members of its own staff to such panels to ensure that its own staff's views will override the views of external members of the relevant panel.

A.3e.79 The Tax Office's response emphasises the need for new management arrangements to be implemented for the formal test case program as referred to in Key Recommendation 4.

KEY FINDING 6.8

The test case program has not been administered openly. For example, the Tax Office has not published the names of cases that it has funded under the program and continues to assert that the secrecy provisions prevent it from publishing these names. It has also not published financial data on the operation of the program which would allow the community to properly assess the operations of the program.

Tax Office response

A.3e.80 We have been advised by the Australian Government Solicitor that we are precluded from publishing the names of cases that have been funded under the program, other than in the Annual Report. At present a selection of test case decisions are reported in the Annual Report; in future all cases will be published in the report.

A.3e.81 We also have arrangements in place with the Federal Court where an award of costs will be made in accordance with a Test Case Funding Deed. If the court facilitates that request, this will provide a means by which the test case funding decision is placed on the public record in the body of the court decision.

Inspector-General's comments on Tax Office response

A.3e.82 The Inspector-General welcomes the Tax Office's decision to publish test case decisions in its Annual Report. The Inspector-General also notes that in its response to Subsidiary Recommendation 6.4 it may also make publicly available the details of test cases in 'some other publication'.

KEY FINDING 6.9

The Tax Office's funding of cases does not presently extend to all cases where the Tax Office appeals against a court or tribunal decision in relation to Part IVC litigation matters.

Tax Office response

A.3e.83 The Tax Office accepts this finding. We refer to our comments in relation to recommendation 5.

Inspector-General's comments on Tax Office response

A.3e.84 The key finding quoted by the Tax Office is actually Key Finding 6.10, not Key Finding 6.9 in the report. The Tax Office has made no response to Key Finding 6.9 of the

report which refers to new arrangements for the management of the test case program being needed.

SUBSIDIARY RECOMMENDATION 6.4

The Inspector-General recommends that any new arrangements for administering the formal test case program should make publicly available to taxpayers an annual report on the operations of its processes for funding cases. This report should at a minimum contain the following:

- *an annual assessment of the degree to which test cases funded by the relevant body have achieved the aim of law clarification;*
- *details of the extent to which the budget for test cases has been spent; and*
- *details of the number of test case applications made, the number granted and the number rejected, with broad details of the reasons for the rejections.*

Tax Office response

A.3e.85 Agreed

A.3e.86 We will make publicly available the details of funded cases in our Annual Report, or some other publication.

KEY FINDING 6.10

Taxpayers who are involved in a case involving alleged tax avoidance do not generally receive assistance for the cost of any appeal of the Tax Office if an independent tribunal has determined that their case does not amount to tax avoidance.

Tax Office response

A.3e.87 We agree with this finding, but see comments at recommendation 6.5. It should be remembered that if the taxpayer ultimately succeeds, the taxpayer will usually be awarded costs by the court.

Inspector-General's comments on Tax Office response

A.3e.88 The Key Finding quoted as Key Finding 6.10 by the Tax Office is actually Key Finding 6.11 of the report.

KEY FINDING 6.11

The Tax Office has used the term 'test case' in a number of different ways in its communications to taxpayers both generally and individually. This has led to taxpayers in a number of cases making the following incorrect assumptions:

- *that the Tax Office will apply the result of the case to their case and all cases with similar facts;*
- *that the case has been funded by the Tax Office; and*
- *that the Tax Office's funding of the case has been in accordance with the formal test case program.*

The last of these assumptions has added to taxpayers' concerns that the test case program is not being applied consistently.

Tax Office response

A.3e.89 The use of the term 'test case' traditionally means a case that will test the law and provide a precedent. The Tax Office generally uses the term 'lead case' to refer to cases which are representative of other factual cases.

A.3e.90 We accept that 'test case' has been used in a number of ways and may have led to some confusion in the community. We will attempt to have more uniformity in the manner in which the term 'test case' is used when communicating with taxpayers.

Inspector-General's comments on Tax Office response

A.3e.91 The Key Finding quoted as Key Finding 6.11 by the Tax Office is actually Key Finding 6.12 of the report.

SUBSIDIARY RECOMMENDATION 6.5

The Inspector-General recommends that the current exclusion of tax avoidance cases from the AAT adverse appeal funding arrangements be removed. The Tax Office should develop guidelines which allow funding for the costs of an appeal to be provided to taxpayers in cases involving alleged tax avoidance, where the AAT determines that there was no such tax avoidance, the taxpayer wins their case and the Tax Office appeals against that AAT case to the Federal Court.

Tax Office response

A.3e.92 Tax avoidance cases will not be automatically excluded where it is fair and in the public interest to fund an appeal.

SUBSIDIARY RECOMMENDATION 6.6

The Tax Office, when describing a case as a test case or leading case in any communication, whether to taxpayers individually or to the public at large, should clearly indicate:

- *whether it has funded the case, and if so its reasons for funding the case;*
- *whether or not the case is expected to determine the tax disputes of taxpayers in similar circumstances; and*
- *if the case is expected to determine other disputes, the nature of the other disputes that will be determined by the case and the nature of disputes that the case is not expected to determine.*

Tax Office response

A.3e.93 Agreed in principle.

A.3e.94 However, we will need to clarify our position with the Solicitor-General on possible issues around the secrecy provisions of the various tax laws.

Inspector-General's comments on Tax Office response

A.3e.95 The Tax Office has omitted to quote the last dot point of Subsidiary Recommendation 6.6 which reads:

that the above is subject to the actual findings of the relevant tribunal or court.

OTHER COMMENTS ON CHAPTER 6

Role of the Test Case Panel

A.3e.96 The Inspector-General makes a number of findings in paragraphs 6.102 to 6.105, which he concludes are 'further evidence that the Tax Office is giving preferential funding treatment to cases which meets its corporate objectives (for example that of law enforcement), rather than cases which may give rise to law clarification (in the wide sense) for the benefit of the community'.

A.3e.97 The fact that the Commissioner has funded some cases of his own volition in the interests of the administration of the tax system indicates that the Commissioner is prepared to fund cases in addition to those that have gone through a Test Case Panel process.

Have the decided cases which have been funded under the program met the stated purpose of the program?

A.3e.98 The Inspector-General finds that in 25 per cent of cases that were finalised by way of a court hearing no principle of law was established, with the case being decided on its facts or on other grounds. The relative value of cases can be a subjective analysis.

A.3e.99 The nature of tax cases is such that they can often tend to turn on their facts, and despite the arguments advanced it is a matter for the courts to determine how they will decide cases and how they will apply, distinguish, extend or create legal principle.

A.3e.100 We note that in any event the Inspector-General concludes that 'the test case program has been worthwhile'.

Stone's case

A.3e.101 The Inspector-General noted that a number of submissions asserted that *Stone*'s case was an example of a case which should not have been funded under the program as it was decided on issues of fact and, therefore, will not directly apply to other similar taxpayers

A.3e.102 The High Court does not grant special leave in cases that it expects will simply turn on their facts — *AGC (Investments) Ltd* (1993). Secondly, in granting special leave to the Commissioner, the court accepted that the case involved important matters of principle. The report itself recognises that only exceptional cases are granted special leave to appeal, and these cases need to give rise to a question of fundamental principle before the High Court will grant special leave.

Record keeping

A.3e.103 The Inspector-General's review, rather than reviewing existing systems, somehow became a review of the Test Case Litigation Program over its 10-year life. Most of the test case records had long since been archived. We did have some initial difficulty in finding records of some of the meetings held prior to 1999. However, we did provide minutes from panel meetings in May 1997[154], October 1998 and December 1998[155], as well as the yearly

154 Minute 26 of 2005.
155 Minute 39 of 2005.

spreadsheets of cases considered under the program[156], NTLG records[157] and annual report records[158]. To further assist the Inspector-General's review we undertook an extensive call back of files in June 2005.

A.3e.104 All cases under the program are given a corporate file. All electronic records are now kept on a Tax Office share drive for future reference. Whatever might be said about record management in the early years of the program, we believe we have had very good record keeping in recent years.

Taxpayer awareness of test case criteria

A.3e.105 The Inspector-General makes the finding that applications by taxpayers were poorly drafted and did not address the test case criteria. The Inspector-General somehow finds that the Tax Office is responsible for this. It is suggested that applicants might not have been aware of the relevant guidelines that were applied. The former test case booklet provided guidelines for applicants to prepare their submission for funding. Page 14 of the booklet states:

> A submission must be prepared in order to apply for test case funding.
>
> The submission needs to show how the issue in question relates to an area of the tax law that needs clarification and how it affects a significant number of other taxpayer.
>
> In addition to explaining how your submission meets the objectives of the Test Case Litigation Program, you can support your argument by addressing any of the additional criteria listed below.

A.3e.106 It is difficult to understand the Inspector-General's alternative suggestion that poorly drafted applications reflect the applicant's belief that the funding application would be denied and that therefore there was no reason to put much effort into the form of the application.

Funding processes

A.3e.107 The Inspector-General notes that the six-monthly terms of payment are not consistent with normal commercial terms for the payment of legal bills. In cases that are not test case funded, if the taxpayer succeeds and has costs in their favour they do not get their costs until the proceedings have concluded. That may well be after all appeal processes are concluded.

A.3e.108 The payment of taxpayer's costs at six-monthly intervals in test case proceedings is not unreasonable. Further, the current arrangements make it clear that alternative arrangements may be negotiated.

---

156 Minute 16 of 2005.
157 Minutes 22, 60 of 2005.
158 Minute 26.

Inspector-General's comments on Tax Office response

Stone's case

A.3e.109 The submissions referred to in the report state that the *outcome* of the High Court's decision in *Stone*'s case was that it was a case decided on its facts. The issue of whether the High Court considered, at the time of granting leave to appeal in the case, that the case gave rise to questions of principle is not relevant to the point being made in these submissions. A determination by the High Court, prior to the case being heard, that the case involves questions of principle provides no guidance on the actual outcome of the case. The outcome of any case is affected by developments which cannot be known at the time when leave to appeal is granted.

Record-Keeping

A.3e.110 The Inspector-General flagged that the test case program may be the subject of review in late 2003. Since early 2004, record-keeping for the program has improved.

Taxpayer awareness of test case criteria

A.3e.111 The report nowhere makes an assertion that the Tax Office is responsible for taxpayers not addressing test case criteria in their applications. The report merely notes that some test case applications were poorly drafted and offers some possible reasons for this.

Funding processes

A.3e.112 The Tax Office confirms that six monthly terms of payment for test case funding is the norm but also notes that alternative arrangements can be negotiated. However, no details have been publicly provided of the circumstances which will lead to such a re-negotiation.

A.3e.113 The Tax Office's assertion that its payment terms are not unreasonable does not address the report's statement that these terms are not consistent with normal commercial terms for the payment of legal bills.

APPENDIX 3F: TAX OFFICE'S DETAILED REPLY TO CHAPTER 7

A.3f.1 This appendix sets out the Tax Office's detailed responses to Chapter 7 of the review and contains the Inspector-General's comments on the Tax Office responses.

TAX OFFICE DETAILED REPLY TO CHAPTER 7

SUBSIDIARY RECOMMENDATION 7.1

The Tax Office should include, in its comprehensive published policy or guidelines on tax litigation, its philosophy and approach in applying and communicating to taxpayers and the community the outcome of finalised decisions.

Tax Office Response

A.3f.2 Agreed

SUBSIDIARY RECOMMENDATION 7.2

The Tax Office's philosophy and approach in applying and communicating to taxpayers and the community the outcome of finalised decisions should be consistent with its role of administering the tax laws in a fair, timely and cost effective manner, consistent with the rule of law.

Tax Office response

A.3f.3 Agreed

SUBSIDIARY RECOMMENDATION 7.3

The Tax Office should communicate, in a summarised form, its view of the application of all finalised court and tribunal decisions that involve a question of law within eight weeks of the date of the decision. By implication, this will include all finalised decisions considered by the Full Federal Court, the High Court and by the Federal Court on appeal from the Administrative Appeals Tribunal.

Tax Office response

A.3f.4 Agreed in principle. However it may not be logistically possible to do so within eight weeks in all cases. For example, some may require longer consideration (and consultation) where the possible application to other cases is unclear.

SUBSIDIARY RECOMMENDATION 7.4

The Tax Office should also communicate, in a summarised form, its views of the application of all other decisions within similar timeframes, where it involves a priority technical issue or there is significant community interest in the outcome of the court or tribunal decision.

Tax Office response

A.3f.5 See response to subsidiary recommendation 7.3.

KEY FINDING 7.4

There are community perceptions that the Tax Office's communication of the implications of finalised decisions indicates an absence of objectivity in the Tax Office's approach in applying finalised court and tribunal decisions.

Stakeholders suggest that the Tax Office has applied the outcomes of finalised court or tribunal decisions differently depending on if the Tax Office agrees or disagrees with the decision. The Inspector-General believes that these perceptions are valid.

Tax Office response

A.3f.6 The Tax Office recognises we can always improve in the area of communication and agrees in principle with key recommendation 6. However, the Tax Office disagrees with the perception that it applies the outcomes of finalised cases differently.

A.3f.7 In all cases decided by the courts and tribunals, successful litigants are given the full benefit of decisions finally decided in their favour. Decisions of the courts are also applied broadly where they establish principles of general application. However, even here taxpayers can exercise their rights to appeal. On rare occasions there have been decisions where we disagree with the outcome and we have advised the community that we will either seek to challenge earlier decisions, or test other factual scenarios more broadly. This is in accordance with the advice of the Solicitor-General and the Attorney-General's Chief General Counsel.

A.3f.8 The cases said to justify the finding are mass marketed scheme cases and an employee benefits trust case. In most cases, the underlying relevant facts are common between participants in the same scheme. Therefore, with the exception of individual circumstances, a lead case would tend to be illustrative of the outcome of other similar cases.

A.3f.9 The following comments can be made about three of the four cases referred to[159]:

Howland-Rose & Ors

A.3f.10 These cases were run not only as the lead cases, but as test cases to seek guidance on the application of the general anti-avoidance provision to round-robin non-recourse financing involved in the *Budplan* and similar schemes.

A.3f.11 Apart from some exceptional circumstances, the cases illustrated the likely outcome for other *Budplan* participants. It gave an indication of how the courts might treat other schemes with similar financing arrangements. The taxpayers in *Howland-Rose and Ors* did not pursue appeals from the decision at first instance. No other participant subsequently ran another case on the same scheme to overturn the decision. No other case since has suggested the Part IVA reasoning in *Howland-Rose* was wrongly decided.

Vincent

A.3f.12 In this case the Commissioner was successful in showing that deductions were not available to the participants under the general deduction provision. The decision also found that the six-year period for amending assessments under Part IVA cannot be relied upon where the claimed tax benefit is cancelled under the general provisions of the income tax

159 Essenbourne is discussed later.

law.[160] Both the Commissioner and the taxpayer accepted the outcome. The Commissioner accepted the part of the decision in *Vincent* that was adverse to him, and has at no stage sought to confine that aspect to its facts. Where the claimed tax benefit is ultimately found to be 'cancelled' under the general provisions of the income tax law, it is accepted that Part IVA has no application because there was no tax benefit within the meaning of section 177C.[161]

Cooke and Jamieson

A.3f.13 In this case the Full Federal Court upheld the original decision that expenses claimed by the taxpayers in relation to their investment in the Australian Horticultural Project (No 1) were deductible under the general deduction provisions of the income tax law. Further, the court held that the anti-avoidance provisions did not apply to disallow the deductions.

A.3f.14 This was the only investment scheme case where the Commissioner was wholly unsuccessful. The Commissioner accepted this decision and applied it to all other affected participants in the scheme who had outstanding disputes before the Administrative Appeals Tribunal (AAT).

A.3f.15 *Cooke and Jamieson* is referred to as a case 'the Tax Office has confined to the particular circumstances of the case.' As stated by Hill J in considering the application of the decision in *Cooke* to the facts in *Sleight*: '… decisions on Part IVA will, inevitably, turn upon the particular facts of the case'.[162]

Inspector-General's comments on Tax Office response

A.3f.16 Although the Tax Office may disagree with the perception that it applies the outcomes of finalised cases differently, the Inspector-General is of the view that there have been valid grounds for such perceptions arising. These grounds have been set out in Chapter 7 of the report. It is agreed that many of these perceptions arise from the Tax Office's approach and handling of mass marketed tax arrangement cases and an employee benefits trust case. Nevertheless, these adverse perceptions have the potential to undermine the Tax Office's overall management of litigation, especially without clear statements by the Tax Office regarding its philosophy and approach in applying and communicating to taxpayers and the community the outcome of finalised decisions.

A.3f.17 As acknowledged by the Commissioner of Taxation in his letter of reply what is important is that these adverse perceptions held by some should be addressed. The Inspector-General welcomes the Tax Office's support of the recommendations intended to improve the Tax Office's communication of finalised court and tribunal decisions as a means of addressing such perceptions.

KEY FINDING 7.6

The Tax Office does not provide taxpayers with objective guidance on the application of all finalised court and tribunal decisions to assist taxpayers operating in a self-assessment environment and, in some cases, continues to administer the law as if the decision did not apply.

160 [2002] FCAFC 291; 2002 ATC 4742; 51 ATR 18 at [88] to [94].
161 PSLA 2005/24.
162 [2004] FCAFC 94 at paragraph 111.

Tax Office response

A.3f.18 Of the case studies referred to in the report (*Metal Manufactures*, *Eastern Nitrogen*, and *Essenbourne*) the Commissioner has provided his views in press statements and speeches.[163]

A.3f.19 In relation to *Marana Holdings*, the Commissioner won the case. The Public Rulings Program showed that the re-write of one aspect of GSTR 2000/20 (the availability of input tax credits for units in serviced apartments) was delayed 'pending further consultation with Treasury'.

Inspector-General's comments on Tax Office response

A.3f.20 The Inspector-General does not believe that press statements and speeches represent adequate and objective guidance on the application of all finalised court and tribunal decisions to assist taxpayers operating in a self-assessment environment. Such statements tend to be both very brief (especially in the case of speeches) and difficult to locate by taxpayers and their advisers. Also, such statements, in particular press statements, do not serve to properly inform taxpayers and their advisers of the implications of the finalised decision and, at times, are more concerned with minimising perceived compliance risks. The Inspector-General welcomes the Tax Office's support of Key Recommendation 6 where it has agreed to communicate to taxpayers the implications of adverse and significant court decisions.

KEY FINDING 7.7

The Tax Office does not have appropriate processes and procedures in place to ensure that taxpayers are made aware that the Tax Office's view expressed in a public ruling, determination and interpretative decision may be impacted by a court or tribunal decision and that it is under review.

Tax Office response

A.3f.21 See Key Recommendation 6 where we have agreed to communicate to taxpayers the implications of adverse and significant court decisions and the Tax Office's view wherever practicable.

SUBSIDIARY RECOMMENDATION 7.5

Following a court or tribunal decision, the Tax Office should promptly make taxpayers aware that the Tax Office's view expressed in a public ruling, determination or interpretative decision may be impacted and that it is under review. It should include identifying the paragraphs that are potentially affected and provide guidance to taxpayers on how they should apply the law until the public ruling, determination or interpretative decision is formally amended or withdrawn.

Tax Office response

A.3f.22 Agreed in principle.

---

163 See for example Media Release — Nat 02/16 'Acting Commissioner reaffirms stand on abusive sale and leaseback transactions'; 'Part IVA and the Common Sense of a Reasonable Person' 2002 Queensland Taxation Institute Convention, Michael D'Ascenzo. 17 May 2002; Media Release — Nat 03/30 'Employee benefit arrangements'; http://www.ato.gov.au/atp/pathway.asp?pc=001/008/003.

A.3f.23 However this could potentially mislead taxpayers in cases where the Government is considering legislative amendments. In these special cases, administrative common sense should prevail.

Inspector-General's comments on Tax Office response

A.3f.24 The Inspector-General notes that where Government is considering legislative amendments the Tax Office should nevertheless communicate to the community that it is seeking legislative change or that the matter is with Government. This is important in promoting transparency in tax administration by providing guidance to taxpayers operating in a self-assessing environment of the implications of a finalised court or tribunal decision.

SUBSIDIARY RECOMMENDATION 7.6

Where the Tax Office can readily identify how a finalised court or tribunal decision will impact a particular class of taxpayers then taxpayers should not be expected to hold their objections or disputes in abeyance indefinitely pending lengthy Tax Office internal processes for amending or withdrawing public rulings, determinations or interpretative decisions.

Tax Office response

A.3f.25 Agreed in principle but subject to the qualification referred to in the response to 7.5 above.

SUBSIDIARY RECOMMENDATION 7.7

The Tax Office should implement processes to ensure that objections and disputes on hand involving a public ruling, determination or interpretative decision under review as a result of a court or tribunal decision are handled and resolved in a timely manner. This could require the resolution process being led by senior tax officers who are able to make a decision based on the current law (the law as interpreted by the Courts) rather than the existing Tax Office view.

Tax Office response

A.3f.26 Agreed in principle, subject to the qualification referred to in response to 7.5.

A.3f.27 We will review our processes to ensure a timely response to decisions, as appropriate.

SUBSIDIARY RECOMMENDATION 7.8

A.3f.28 The Tax Office should develop uniform corporate governance processes to deal with the identification, consideration and feeding back to all appropriate areas of the Tax Office of any non-technical issues arising from the conduct of litigation with the aim of improving the quality and efficiency of litigation through better upstream processes.

Tax Office response

A.3f.29 Agreed

OTHER TAX OFFICE COMMENTS

Rule of law

A.3f.30 The joint advice of the Solicitor-General and the Attorney-General's Chief General Counsel confirms that there is no legal impediment to the Commissioner challenging a previous judicial decision in future litigation provided the Commissioner is open about his intentions. If advice has been obtained that suggests an earlier tribunal or single judge decision is wrong, that provides a basis on which to challenge that decision.

A.3f.31 We have reconsidered the cases where the Inspector-General has stated the Commissioner has acted inconsistently with the rule of law.

A.3f.32 Further comment on those cases appears below.

Essenbourne

A.3f.33 Following the decision of the Federal Court in *Essenbourne*, the Tax Office set out its position in an information sheet issued on 14 March 2003. The case related to employee benefit trust (EBT) arrangements.

A.3f.34 The decision of the Federal Court in *Essenbourne* held that the deductions claimed by participants were not allowable. The court also held that fringe benefits tax (FBT) was not payable in respect of the contribution to the trust.

A.3f.35 The court found that the contribution to the trust was simply a means for three principals of the company to share business profits. Therefore, deductions were not allowable, thereby rendering the scheme ineffective.

A.3f.36 We made it clear in our information sheet that we would look to clarify the application of the FBT law through litigation of representative cases. Through this information sheet, we advised those affected of our view.

A.3f.37 The Inspector-General has concluded that 'there have been a number of short-comings in the Tax Office meeting the standards set out in the Solicitor-General's opinion following *Essenbourne*.' He places heavy emphasis on the fact the Tax Office commented that it believed '… that there is an alternative view that is more consistent with our understanding of the policy intent of the law'.

A.3f.38 Although the Tax Office is of the opinion that the decision relating to FBT is not consistent with its understanding of the policy intent of the law, the decision to challenge the finding in later cases was not made on that basis alone. Shortly after the decision we sought and received advice from senior counsel that the decision was questionable and that a Full Federal Court, would, more likely than not, come to a different view. This advice was provided to the Inspector-General.

A.3f.39 In March 2004, Senior Counsel provided oral advice in relation to the application of fringe benefits tax to employee benefit arrangements, to the effect that both Keifel J and Hill J were wrong in their rejection in the *Essenbourne* and *Walstern* cases of the Tax Office's construction of the FBT law as stated in TR 1999/5. The Inspector-General has been advised of this advice.

A.3f.40 We accept that we have not offered test case funding in any case argued on similar issues since *Essenbourne*, however this is because there has not been a case where we have

not succeeded in relation to the non-deductibility of the claimed deductions for income tax purposes.

Inspector-General's comments on Tax Office response

A.3f.41 The Inspector-General is of the view that, notwithstanding the Tax Office publicly stating the it did not accept that the Court's comments in *Essenbourne* on fringe benefits tax as correct, there have been a number of short-comings in the Tax Office meeting the standards set out in the Solicitor-General's opinion following *Essenbourne*. These have been set out in greater detail in Chapter 4 of the report.

Eastern Nitrogen and Metal Manufactures

A.3f.42 In *Metal Manufactures* and *Eastern Nitrogen*, the High Court refused the Tax Office special leave to appeal the decisions of the Full Federal Court because the decisions were essentially ones of fact. After careful consideration, the Commissioner issued a press release stating that we would not alter our stance in relation to abusive sale and leaseback transactions. This is not a case of not following precedent.

A.3f.43 We took this approach for a number of reasons. Firstly, because the High Court stated that other courts will not be bound by these decisions because they are decisions of fact. Secondly, and importantly, we believed that the Full Federal Court gave undue weight to the commercial reasons for the transaction and insufficient weight to the 'elements of artificiality' inherent in the transactions. If the Full Federal Court's approach had been allowed to stand uncorrected, continuing the approach taken in other Part IVA cases would have undermined the principle established by the High Court in *F C of T v Spotless Services Ltd* (1996) 186 CLR 404 at p 415. That is, that the pursuit of a commercial advantage is not necessarily inconsistent with the existence of a dominant purpose of obtaining a tax benefit. The position was later clarified by the High Court decision in *Hart v FC of T* [2004] HCA 26. The decision in *Hart*, we believe, put into question the approach taken by the Court in *Metal Manufactures* and *Eastern Nitrogen*, and re-affirmed the position taken by the High Court in *Spotless*.

A.3f.44 After the High Court refused leave in the sale and leaseback cases, senior counsel for the Commissioner advised in a note to our solicitor that with the issues now substantially refined, it might be possible to run another case as '… in the view of the High Court, each of these matters depended on its particular facts.'

A.3f.45 Although we believe that the sale and leaseback cases were cases which turned on their facts, in line with the Solicitor-General's advice, we 'as soon as possible put those affected on notice of [our] view'. This was done by reference to the media release issued shortly after the refusal of the High Court to grant special leave.

A.3f.46 We note that in paragraphs 7.138 and 7.139, the Inspector-General has quoted from comments made by Tax Office staff in the process of formative views expressed before a final decision had been taken about the cases. The Tax Office encourages staff to express their honest views about cases so that decision makers are fully informed. However, the final Tax Office view was expressed by those authorised to make such decisions. The earlier formative views of junior staff did not have the benefit of subsequent counsel advice.

A.3f.47 The Public Ruling on sale and leasebacks, TR 95/30, is presently under review.

Inspector-General's comments on Tax Office response

A.3f.48 The Inspector-General acknowledges that ultimately the application of precedent will be dependent on the particular facts of the taxpayer. It should also be stressed that this chapter is not examining the technical basis for the Tax Office view but rather the objectiveness and timeliness in its response to how a finalised decision impacts the Tax Office view.

A.3f.49 In its public response to *Eastern Nitrogen* and *Metal Manufactures* the Tax Office stated its position on sale and leasebacks continued to be set out in *Taxation Ruling* TR 95/30. However, the Full Federal Court in *Eastern Nitrogen* and *Metal Manufactures* did consider important aspects of the law that, following these decisions, were in apparent conflict with *Taxation Ruling* TR 95/30. This includes the Tax Office view that a fixture is not an asset that could be the subject of a lease and that it would not accept a going concern basis for valuation.

A.3f.50 In the Inspector-General's view it has been public statements that *Taxation Ruling* TR 95/30 continued to set out the Tax Office's view on sale and leasebacks when clearly that view was impacted by the Full Federal Court decisions that have fuelled perceptions that the Tax Office is not following precedent. In the Inspector-General's view, the public statements by the Tax Office did not provide sufficient guidance to taxpayers on how the Tax Office view was impacted. This, together with the delay in revising *Taxation Ruling* TR 95/30, has contributed to those perceptions arising from the Tax Office's handling of the application of the *Eastern Nitrogen* and *Metal Manufactures* decisions. There is clearly a need for a more articulated response, especially given the market segment impacted by these decisions.

A.3f.51 The Inspector-General notes that the Tax Office has released Draft Taxation Ruling TR2006/D5, approximately 5 years after the Full Federal Court decisions in *Eastern Nitrogen* and *Metal Manufactures*, which is intended to revise and update *Taxation Ruling* TR 95/30. The Tax Office advises that *Taxation Ruling* TR 95/30 will be withdrawn from the date of issue of the Final Ruling related to Draft Taxation Ruling TR2006/D5.

Other cases

A.3f.52 The report identifies other cases where the Commissioner has either indicated that he does not accept prior decisions of the Tribunal or has clarified how the case has been understood in the context of higher authority. In all of these cases, the Commissioner has made his position clear. The perceptions that may be held by some seem to be assertions of differing legal interpretations in particular cases.

APPENDIX 4: OPINIONS FROM SOLICITOR-GENERAL AND AUSTRALIAN GOVERNMENT SOLICITOR'S CHIEF GENERAL COUNSEL ON THE APPLICATION OF PRECEDENT TO TAX CASES

A.4.1 This appendix contains copies of two opinions received by the Tax Office from the Solicitor-General and/or the Australian Government Solicitor's Chief General Counsel on the application of precedent to tax cases.

A.4.2 The opinions are set out below:

OPINION

APPLICATION OF PRECEDENT TO TAX CASES

15 December 2005

To:
Mr Stephen Martin
Senior Tax Counsel
Legal Services Branch
Australian Taxation Office
Level 6
100 Market Street
SYDNEY NSW 2000

File reference: 05212293

ADVICE

APPLICATION OF PRECEDENT TO TAX CASES

1. We are asked to advise the Australian Tax Office on issues concerned with the rule of law and application of precedent in relation to the handling of tax cases.

2. The Inspector General of Taxation is currently reviewing the Tax Office's management of litigation. It is anticipated that the Inspector General's report will place heavy emphasis on views expressed by Justice McHugh in his speech at the Australian Bar Association Conference, '*Tensions between the Executive and the Judiciary*', in July 2002. In his speech, McHugh J referred to the tension between the executive and the judiciary. He referred to an earlier paper by Professor Pearce that gave examples of Departments refusing to follow judicial or tribunal decisions. The judge said:

> No doubt an Executive agency is entitled to disregard a decision where it is truly in conflict with another decision that it thinks is correct. It may sometimes also be justifiable to refuse to follow a decision that is the subject of appeal. But that has problems. Judicial decisions are not provisional rulings until confirmed by the ultimate appellate court in the system. Until set aside, they represent the law and should be followed. Moreover, the Executive can run into serious legal problems where it continues to enforce legislation that a court has ruled invalid. Even more difficult to justify is the refusal to follow a ruling that is not the subject of appeal merely because the agency regards it as wrong and will test it at the next opportunity.

3. We are instructed that the Inspector General is likely to recommend in his report that the Commissioner should administer tax laws consistently with court decisions in relation to all similar taxpayer cases until and unless the law is changed by Parliament. The view seems to be that this applies equally to "quasi judicial" decisions of the Administrative Appeals Tribunal.

4. We are asked whether we agree with the strict views of McHugh J, and for guidance on how to resolve tensions in this area between administration of the tax law and respect for the rule of law.

Consideration

5. The issues raised involve principally questions of appropriate behaviour, rather than strict law. They arise across government, and are not confined to the area of tax law. The circumstances of each case may vary and we do not consider that absolute rules are generally appropriate. At best, we consider that some broad principles can be identified that can be used to guide conduct in this area.

6. The position of government bodies is different from private parties, in the sense that they are responsible for administration of a law across the board. This means that issues of consistency arise. However, we do not consider that this prevents an agency like the ATO from challenging earlier judicial decisions. Issues of consistency and fair administration can be addressed in ways other than a rigid adherence to previous judicial decisions.

7. The first point we make is that the law is not authoritatively settled in any particular case until final orders are made. Nevertheless, where the law is generally settled as a result of a prior decision of an appellate court, it will not usually be appropriate to resist dealing with another matter covered by the decision on the basis of that authority. This, however is a matter of good administration rather than strict law, and there may be circumstances where a challenge to a decision is appropriate. Where there is not an appellate court decision, there is greater opportunity to challenge a decision although, in extreme cases, even an earlier High Court decision can be the subject of challenge in the High Court..

8. A decision by the High Court or a Full Court is authoritative, in the sense that it will be followed by other judges unless it is overturned. Single judges or tribunals are not free to depart from such decisions and hence it would usually be inappropriate and unwise for an administrative decision-maker to adopt a contrary interpretation. If an appeal is still on foot, such as an outstanding High Court appeal, the most appropriate approach may be to delay finalising a matter until the High Court or Full Court decision is available. It is recognised that this will not always be possible.

9. In the case of single judge decisions, the position is a little different. While a single judge is not obliged by the doctrine of precedent to follow the decision of another single judge, he or she will usually do so unless he or she considers it to be 'clearly wrong'. This is done as a matter of judicial comity.

10. However, an administrative tribunal will normally be expected to follow a single judge decision that has interpreted a statutory provision (*FCT v Salenger* (1988) 19 FCR 378, 387-8). It follows that an administrative decision-maker who did not follow a single judge decision would be likely to find his or her decision overturned on merits review by the administrative tribunal. There is, therefore, clearly a risk in deciding not to follow even a single judge decision, unless that decision is the subject of an appeal. However, if advice has been obtained that suggests that an earlier tribunal or single judge decision is wrong, that in our view provides a basis on which to challenge that decision. The real issue in that situation is how to deal with cases affected by that view pending an opportunity to test the issue in court.

11. We consider there is clearly a difference in this regard between a settled interpretation not subject to appeal and a recent interpretation that is subject to appeal or where there is a clearly announced intention to seek a suitable vehicle to test the issue further.

12. In a previous advice the Solicitor-General has expressed the following views which we reproduce here (amended not to refer to the specific matter under consideration):

> In the present case, however, there is some justification for declining to follow the Full Court's approach to the construction of the definition. The decision was not one of the ultimate appellate court. An appeal to the High Court having been precluded solely on the ground that the matter was not a suitable vehicle to consider the construction issue, it should be open to seek to bring before that Court another case which does not have such problems. If (the agency) were to regard itself as obliged to follow the decision, its ability to generate such a test case would be severely restricted.
>
> (The agency) is obliged to comply with the law (this obligation can generally be enforced through judicial review mechanisms, and is reflected in cl.4 of the APS Code of Conduct, set out in reg.7 of the Public Service Regulations made under the *Public Service Act 1922*). The Act also provides that one of its functions is "to make determinations accurately and quickly in relation to claims and requests" made to it under the Act. More generally, neither the Commonwealth nor (the agency) should exploit their position by simply refusing to follow judicial authorities so as to force claimants through multiple levels of review and appeal in order to maintain their entitlements under the Act. A comparison may be drawn with the model litigant principles applicable to the conduct of litigation by the Commonwealth, which require the• Commonwealth to avoid unnecessary delay and to pay legitimate claims without litigation, and prevent the Commonwealth from taking advantage of claimants who lack the resources to litigate a legitimate claim.
>
> However, such obligations do not necessarily mandate adherence in all circumstances to any decision of an intermediate appellate court. If this were the case, a Department administering a particular statute could be bound for all time (subject only to clarification by legislative amendment) by a decision of a lower court as to the construction of that statute, because an appeal was not or could not be pursued (for example, where the relevant Department was not a party to the proceedings before the lower court). An administrator is not part of the judicial hierarchy, and is not bound by the doctrines of precedent as is a lower court. Accordingly, in appropriate circumstances, it would be legitimate for (the agency) to depart from existing judicial decisions in order to produce a further test case seeking to overturn those decisions and uphold (the agency's) view as to the correct legal position.
>
> …
>
> In the present case, it is important that the High Court has not yet considered the relevant construction issue on its merits, nor has it indicated that the issue is not of sufficient general importance to attract a grant of special leave to appeal in a suitable case…. **Acting on the basis of legal advice that the reasoning of the Full Court is incorrect, we consider that (the agency) is justified in regarding the legal position as unsettled until such time as it has been considered by the High Court**.
>
> If it does adopt such a position, however, it should do so openly, by disclosing to the relevant claimant that its decision may be contrary to (the case in issue), that it has taken the view (on the basis of legal advice) that the approach adopted in that case is incorrect, and indicating that it is prepared to contest the matter on appeal by challenging the correctness of it. If this is the only basis on which (the agency) proposes

> to resist payment of a claim, it would be practically essential, in our view, for the claimant to be given some form of indemnity covering his or her costs of taking or defending any appeals (this could be done either by agreeing to a costs order against it in any event, or through an applicable legal aid scheme). (The agency) must avoid any suggestion that its position will result in an undue burden or prejudice to individual claimants in particular cases who are forced into the courts in order to maintain their entitlement under the Act.
>
> (The agency) should also be aware that it if adopts such an approach, placing express reliance on counsel's opinion as to the correctness of the decision in issue, it may not be entitled to rely on any privilege (including legal professional privilege) to resist the disclosure of the opinion in subsequent merits review or judicial review proceedings. For example, the opinion might be regarded as "relevant to the review of the decision" for the purposes of s 37 of the *Administrative Appeals Tribunal Act 197*5 (note that s 37(3) expressly overrides any privilege in such circumstances).
>
> Provided that the above circumstances are present, we do not consider that such a course of action by (the agency) would expose it to any liability in tort, such as for misfeasance in public office (see *Northern Territory v Mengel* (1996)185 CLR 307), even if it were ultimately established that the decision made was contrary to the Act.
>
> Such an approach would not set (the agency) above the law. The rule of law is maintained by the amenability of each administrative decision made to correction by the courts on the grounds of legal error. Although there is a strong likelihood that the Administrative Appeals Tribunal, the Federal Court at first instance and even the Full Court of the Federal Court will overturn decisions which are not in accordance with the construction adopted in the decision in issue, it is open to argue for the alternative construction throughout the appeals process so as to preserve its rights to argue the construction issue if and when the matter reaches the High Court. (our emphasis)

13. We consider that, in order to resist accusations that the ATO is disregarding judicial decisions contrary to the rule of law, it is important that, if the ATO considers that a decision is wrong, it should as soon as possible put those affected on notice of this view. It should only seek to challenge an earlier decision where it has legal advice to the effect that the decision is wrong. To avoid criticism it will also normally be appropriate, if the ATO launches a challenge to the earlier decision, to fund or organise suitable assistance to bring a test case. Pending the outcome of such a decision, other taxpayers affected should be informed of the proposed course of action.

14. We note that ATO Rulings, and Parliamentary Inquiries into Tax Rulings (see especially the 1987 Senate Report on Income Tax Rulings, pp. no.217/1987) recognised that the Commissioner may wish to argue in future litigation that an

interpretation in a ruling is correct despite an earlier judicial decision. We see no problem with this provided that the Commissioner is open about his intentions.

15. The position is, however, quite different where the law has been administered for a period of time on the basis of a judicial interpretation and the Commissioner subsequently decides that that interpretation is wrong or that it is prejudicial to the revenue. In that situation it is far more difficult to justify seeking to overturn the established interpretation on which the law has been administered and a taxpayer's liability determined. See recent remarks by the Victorian Court of Appeal in *Smith v Transport Accident Commission* [2005] VSCA 251, esp [18],[41],[45].To act in this way can be seen as disadvantaging one group of taxpayers over another. It, therefore, seems important, in our opinion, that a challenge to a decision considered wrong as a matter of law should occur as soon as possible after the particular decision, and that the Commissioner publicly indicate that he considers that the decision is wrong as a matter of law and that he will be seeking an opportunity to have the matter reviewed. He should normally take steps to generate and fund a test case on the point. In this way the model litigant obligations are met.

David Bennett QC
Solicitor-General
T 02 6250 6020 F 02 6250 5950

david.bennett@ag.gov.au

Henry Burmester QC
Chief General Counsel
T 02 6253 7016 F 02 6253 7317
M 0417 403 363
henry.burmester@ags.gov.au

OPINION

APPLICATION OF PRECEDENT TO TAX CASES - FURTHER OPINION

16 January 2006

To:
Mr Stephen Martin
Senior Tax Counsel
Legal Services Branch
Australian Taxation Office
Level 6, 100 Market Street
SYDNEY NSW 2000

Henry Burmester QC
Acting Solicitor-General

T 02 6253 7016 F 02 6253 7317
M 0417 403 363
henry.burmester@ags.gov.au

File reference: 05212293

OPINION

APPLICATION OF PRECEDENT TO TAX CASES - FURTHER OPINION

FURTHER QUESTION

1. On 15 December 2005, the Solicitor-General and I provided an opinion on the extent to which the Australian Taxation Office (ATO) was obliged to follow tribunal or court decisions in subsequent tax matters raising similar issues. I am now asked to provide a further opinion in relation to the statement in paragraph 13 of the earlier advice that 'if the ATO considers that a decision is wrong, it should as soon as possible put those affected on notice of this view. It should only seek to challenge an earlier decision where it has legal advice to the effect that the decision is wrong.' I am asked whether the reference to legal advice can be read to include legal advice from within the ATO.

CONSIDERATION

2. The requirement to have legal advice that a decision is wrong before a decision is challenged was principally intended to ensure that any such decision would be defensible from the perspective of good public administration. Clearly, it is not appropriate for the ATO to seek to challenge a particular interpretation of the tax laws adopted by a court or tribunal just because, as a matter of policy, it considers it wrong or undesirable. If that is the basis for concern then the appropriate approach is to change the tax law. However, if the basis of the ATO's attack on an earlier decision is that as a matter of law it is wrong, then our earlier advice indicated that it was proper for the ATO to seek an appropriate vehicle in which to test that issue. However, it should, among other things, before making a decision to do that have legal advice that supports the argument that the decision is legally wrong.

3. The nature of the legal advice that is required will obviously differ depending on the nature of the tribunal or court whose decision is to be attacked. The level or extent

of legal advice required to challenge a tribunal decision is likely to be quite different from that appropriate where a challenge is made to an appellate court's decision. Where external counsel have been involved in a case on behalf of the Commissioner, it may often be appropriate to have advice from the same counsel or similar level of counsel. In certain cases it may be appropriate to seek the views of more than one legal adviser.

4. In suggesting that legal advice should be obtained we did not, however, intend to prescribe any particular form of legal advice. There is, therefore, no inherent reason why internal ATO legal advice may not suffice depending on the circumstances of the case and the source of the legal advice from within the ATO. From my perspective, what matters is that the legal advice is credible and can withstand public scrutiny. Thus, it is probably undesirable that the legal advice come from lawyers located within the operational area directly concerned with the tax policy, as opposed to advice from the Office of the Chief Tax Counsel or some other source of independent internal advice such as a consultant retained by the Tax Commissioner. There is no hard and fast rule that needs to be adopted in this regard. The question that principally should be asked is whether the advice is credible and whether the decision to challenge the decision has been based on that legal advice. It should not be open to the charge, for instance, that it is a petulant determination of a particular area within the ATO to pursue what is considered to be the correct or preferable interpretation, regardless of whether or not that interpretation can be said to be reasonably based as a matter of law.

5. It is important in this regard to distinguish between the policy decision to pursue a challenge to a legal decision and the provision of legal advice to support that decision. Normally, a policy decision will need to be made at an appropriately high level within the organisation reflecting the nature of the decision, the likely impact

that the challenge to an earlier decision may have on other tax payers and broader tax policy. In making the policy decision, legal advice supporting a challenge is an important element but not the only element to be considered. The legal advice is concerned only with whether there are reasonable legal arguments for a particular interpretation which justify an attack on a previous decision that, for probably good reasons, was not appealed from at the time. The policy decision needs to consider broader issues. For this reason, it will usually be undesirable for the legal advice to be given by the person making the policy decision.

6. In many ways the decision to challenge an earlier decision is not that dissimilar to the decision that might have been taken when the original decision was handed down as to whether an appeal should be pursued. The Legal Services Directions require that an appeal not be pursued unless an agency believes that it has reasonable prospects for success or that the appeal is otherwise justified in the public interest. For that purpose legal advice is obtained. It may be that at the time of the original decision the factual or other circumstances did not make an appeal appropriate. It seems to me, however, that the same burden needs to be met where an earlier decision is to be challenged in another case. The legal advice obtained for this purpose needs to be sufficiently robust and credible to ensure the decision can be seen as consistent with the same principles as determine whether an appeal is justified. Beyond that it does not seem to me necessary or appropriate to try and be prescriptive as to the precise form that any legal advice to support an attack on an earlier decision should take.

Henry Burmester QC
Ag Solicitor-General
T 02 6253 7016 F 02 6253 7317
M 0417 403 363
henry.burmester@ags.gov.au

APPENDIX 5: COMMONWEALTH'S OBLIGATION TO ACT AS A MODEL LITIGANT — OLD AND NEW VERSIONS

A.5.1 This appendix contains copies of the old and new versions of the model litigant rules.

A.5.2 The old (pre 1 March 2006) version of these rules is as follows:

DIRECTIONS ON THE COMMONWEALTH'S OBLIGATION TO ACT AS A MODEL LITIGANT — PRE 1 MARCH 2006 VERSION[164]

1. Consistently with the Attorney-General's responsibility for the maintenance of proper standards in litigation, the Commonwealth and its agencies must behave as a model litigant in the conduct of litigation.

Nature of the obligation

2. The obligation requires that the Commonwealth and its agencies act honestly and fairly in handling claims and litigation brought by or against the Commonwealth or an agency by:

(a) dealing with claims promptly and not causing unnecessary delay in the handling of claims and litigation,

(b) paying legitimate claims without litigation, including making partial settlements of claims or interim payments, where it is clear that liability is at least as much as the amount to be paid,

(c) acting consistently in the handling of claims and litigation,

(d) endeavouring to avoid litigation, wherever possible,

(e) where it is not possible to avoid litigation, keeping the costs of litigation to a minimum, including by:

(i) not requiring the other party to prove a matter which the Commonwealth or the agency knows to be true, and

(ii) not contesting liability if the Commonwealth or the agency knows that the dispute is really about quantum,

(f) not taking advantage of a claimant who lacks the resources to litigate a legitimate claim,

---

164 Attorney-General, Legal Services Directions, Appendix B, issued pursuant to section 55ZF of the Judiciary Act 1903, with effect from 1 September 1999. The directions are available on the Attorney-General's web site at www.ag.gov.au.

(g) not relying on technical defences unless the Commonwealth's or the agency's interests would be prejudiced by the failure to comply with a particular requirement,

(h) not undertaking and pursuing appeals unless the Commonwealth or the agency believes that it has reasonable prospects for success or the appeal is otherwise justified in the public interest, and

(i) apologising where the Commonwealth or the agency is aware that it or its lawyers have acted wrongfully or improperly.

Notes:

1. The obligation applies to litigation (including before courts, tribunals, inquiries, and in arbitration and other alternative dispute resolution processes) involving Commonwealth Departments and agencies, as well as Ministers and officers where the Commonwealth provides a full indemnity in respect of an action for damages brought against them personally. Ensuring compliance with the obligation is primarily the responsibility of the agency which has responsibility for the litigation. In addition, lawyers engaged in such litigation, whether Australian Government Solicitor, in-house or private, will need to act in accordance with the obligation and to assist their client agency to do so.

2. In essence, being a model litigant requires that the Commonwealth and its agencies, as parties to litigation, act with complete propriety, fairly and in accordance with the highest professional standards. The expectation that the Commonwealth and its agencies will act as a model litigant has been recognised by the Courts. See, for example, *Melbourne Steamship Limited v Moorhead (1912)* 15 CLR 133 at 342; *Kenny v State of South Australia (1987)* 46 SASR 268 at 273; *Yong Jun Qin v The Minister for Immigration and Ethnic Affairs* (1997) 75 FCR 155.

3. The obligation to act as a model litigant may require more than merely acting honestly and in accordance with the law and court rules. It also goes beyond the requirement for lawyers to act in accordance with their ethical obligations.

4. The obligation does not prevent the Commonwealth and its agencies from acting firmly and properly to protect their interests. It does not therefore preclude all legitimate steps being taken to pursue claims by the Commonwealth and its agencies and testing or defending claims against them. The commencement of an appeal may be justified in the public interest where it is necessary to avoid prejudice to the interests of the Commonwealth or an agency pending the receipt or proper consideration of legal advice, provided that a decision whether to continue the appeal is made as soon as practicable.

5. The obligation does not prevent the Commonwealth from enforcing costs orders or seeking to recover its costs.

A.5.3 The new post 1 March 2006 version of the model litigant rules is as follows.

DIRECTIONS ON THE COMMONWEALTH'S OBLIGATION TO ACT AS A MODEL LITIGANT — POST 1 MARCH 2006 VERSION[165]

The obligation

1. Consistently with the Attorney-General's responsibility for the maintenance of proper standards in litigation, the Commonwealth and its agencies are to behave as model litigants in the conduct of litigation.

Nature of the obligation

2. The obligation to act as a model litigant requires that the Commonwealth and its agencies act honestly and fairly in handling claims and litigation brought by or against the Commonwealth or an agency by:

(a) dealing with claims promptly and not causing unnecessary delay in the handling of claims and litigation

(b) paying legitimate claims without litigation, including making partial settlements of claims or interim payments, where it is clear that liability is at least as much as the amount to be paid

(c) acting consistently in the handling of claims and litigation

(d) endeavouring to avoid, prevent and limit the scope of legal proceedings wherever possible, including by giving consideration in all cases to alternative dispute resolution before initiating legal proceedings and by participating in alternative dispute resolution processes where appropriate

(e) where it is not possible to avoid litigation, keeping the costs of litigation to a minimum, including by:

  (i) not requiring the other party to prove a matter which the Commonwealth or the agency knows to be true, and

  (ii) not contesting liability if the Commonwealth or the agency knows that the dispute is really about quantum

(f) not taking advantage of a claimant who lacks the resources to litigate a legitimate claim

(g) not relying on technical defences unless the Commonwealth's or the agency's interests would be prejudiced by the failure to comply with a particular requirement

---

165 Attorney-General, *Legal Services Directions*, Appendix B, issued pursuant to section 55ZF of the *Judiciary Act 1903*, with effect from 1 March 2006.

(h) not undertaking and pursuing appeals unless the Commonwealth or the agency believes that it has reasonable prospects for success or the appeal is otherwise justified in the public interest, and

(i) apologising where the Commonwealth or the agency is aware that it or its lawyers have acted wrongfully or improperly.

NOTE 1. The obligation applies to litigation (including before courts, tribunals, inquiries, and in arbitration and other alternative dispute resolution processes) involving Commonwealth Departments and agencies, as well as Ministers and officers where the Commonwealth provides a full indemnity in respect of an action for damages brought against them personally. Ensuring compliance with the obligation is primarily the responsibility of the agency which has responsibility for the litigation. In addition, lawyers engaged in such litigation, whether Australian Government Solicitor, in-house or private, will need to act in accordance with the obligation and to assist their client agency to do so.

NOTE 2. In essence, being a model litigant requires that the Commonwealth and its agencies, as parties to litigation, act with complete propriety, fairly and in accordance with the highest professional standards. The expectation that the Commonwealth and its agencies will act as a model litigant has been recognised by the Courts. See, for example, *Melbourne Steamship Limited v Moorhead* (1912) 15 CLR 133 at 342; *Kenny v State of South Australia* (1987) 46 SASR 268 at 273; *Yong Jun Qin v The Minister for Immigration and Ethnic Affairs* (1997) 75 FCR 155.

NOTE 3. The obligation to act as a model litigant may require more than merely acting honestly and in accordance with the law and court rules. It also goes beyond the requirement for lawyers to act in accordance with their ethical obligations.

NOTE 4. The obligation does not prevent the Commonwealth and its agencies from acting firmly and properly to protect their interests. It does not therefore preclude all legitimate steps being taken to pursue claims by the Commonwealth and its agencies and testing or defending claims against them. It does not preclude pursuing litigation in order to clarify a significant point of law even if the other party wishes to settle the dispute. The commencement of an appeal may be justified in the public interest where it is necessary to avoid prejudice to the interests of the Commonwealth or an agency pending the receipt or proper consideration of legal advice, provided that a decision whether to continue the appeal is made as soon as practicable. In certain circumstances, it will be appropriate for the Commonwealth to pay costs (for example, for a test case in the public interest.)

NOTE 5. The obligation does not prevent the Commonwealth from enforcing costs orders or seeking to recover its costs.

Merits review proceedings

3. The obligation to act as a model litigant extends to agencies involved in merits review proceedings.

4. An agency should use its best endeavours to assist the tribunal to make its decision.

NOTE. The term 'litigation' is defined in paragraph 15 of these Directions in terms that encompass merits review before tribunals. There are particular obligations in relation to assisting a tribunal engaged in merits review to arrive at a decision. Agencies should pay close attention to the legislation under which a tribunal is established, and any practice directions issued by the tribunal. In the case of the Administrative Appeals Tribunal see in particular subsection 33(1AA) of the *Administrative Appeals Tribunal Act 1975* and the explanatory memorandum to the Administrative Appeals Tribunal Amendment Bill 2005.

Alternative dispute resolution

5. When participating in alternative dispute resolution, the Commonwealth and its agencies are to:

(a) participate fully and effectively, and

(b) wherever practicable, ensure that their representatives have authority to settle the matter, or at least clear instructions on the possible terms of settlement that would be acceptable to the Commonwealth, so as to facilitate appropriate and timely resolution of a dispute.

NOTE 1. When participating in alternative dispute resolution processes, regard is still to be had to the requirements for settling major claims under paragraph 4.4 and Appendix C. In practical terms, this may mean that a representative attending an alternative dispute resolution process may not be able to be given authority to settle a matter to finality. This is to be made clear to the other party when discussing the use of this process.

NOTE 2. Agencies are encouraged to develop dispute management plans addressing the place of litigation and alternative strategies in addressing disputes.

APPENDIX 6: FURTHER INFORMATION REGARDING THE EXTENT OF TAX LITIGATION

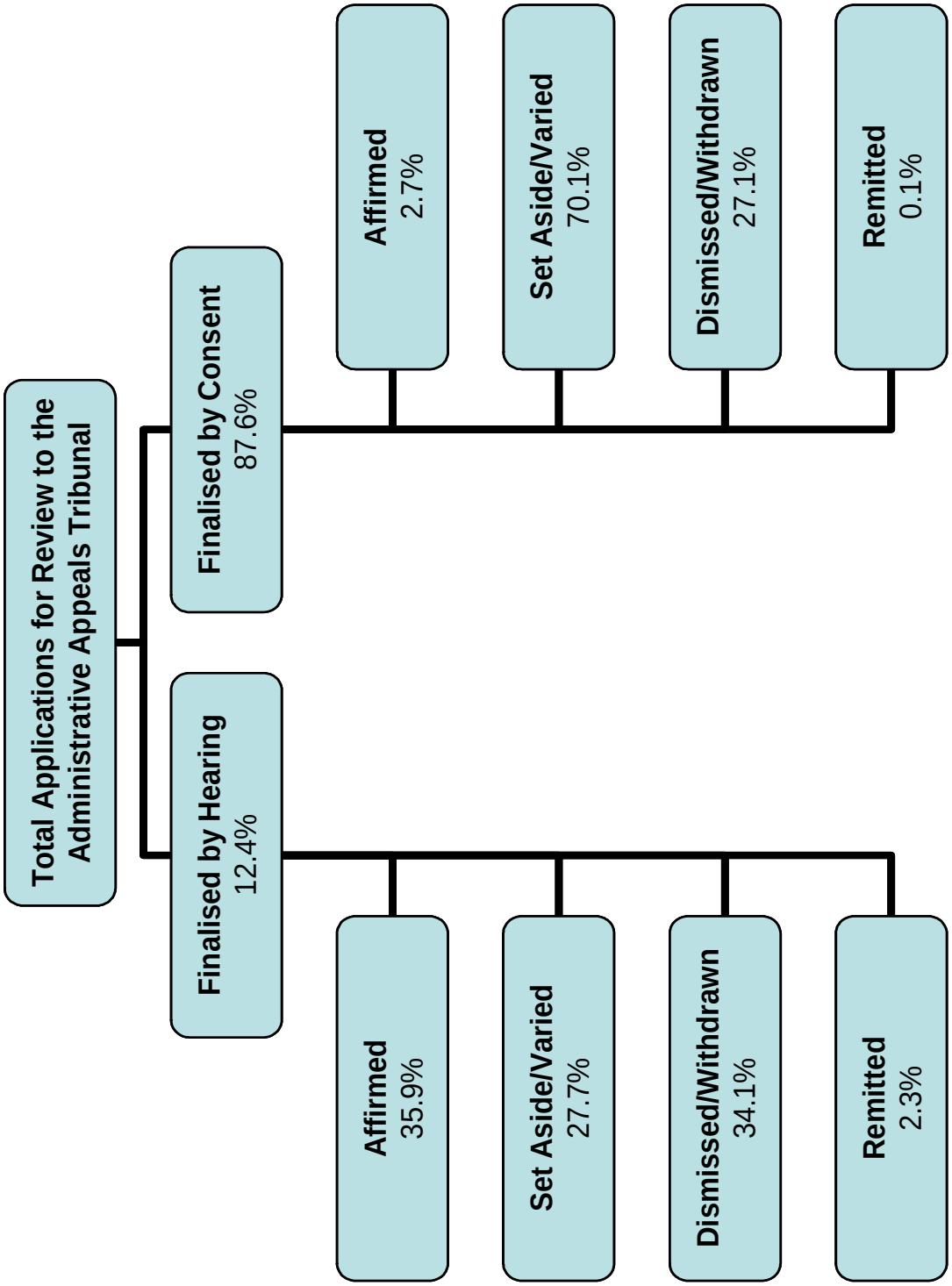
A.6.1 This appendix first provides a summary of the finalisation of applications for review of Tax Office decisions in the Taxation Division of the Administrative Appeals Tribunal over an eight year period. The appendix also provides a comparison between the General and Veterans Division and Taxation Division within the Administrative Appeals Tribunal with respect to the finalisation of applications for review by way of consent and hearing.

A.6.2 In this appendix, the terms used are defined as follows:

- 'Affirmed' indicates that the Tribunal has affirmed a decision under review. This means that the original Tax Office decision still stands.
- 'Dismissed/Withdrawn' indicates that an application by a taxpayer has been dismissed by the Tribunal without proceeding to review the decision. An application may be dismissed, for example, by consent, or if the applicant fails to appear, or if the Tribunal is satisfied that the application is frivolous or vexatious.
- 'Remitted' indicates that the Tribunal has set aside the Tax Office decision and sent it back (remitted it) to the original decision maker to be reconsidered in accordance with any directions or recommendations of the Tribunal.
- 'Set Aside' indicates that the Tribunal has set aside a decision under review. The effect is that the Tribunal disagrees with the original Tax Office decision and makes a new decision.
- 'Varied' indicates that the Tribunal has varied a decision under review. This means that the Tribunal changes or alters the original Tax Office decision.

A.6.3 Chart 1 outlines the resolution of application of review cases by way of resolution type. Percentages are based on eight year averages obtained from Administrative Appeal Tribunal Annual Reports.

Chart 1: Total applications for review of a Tax Office decision to the Taxation Division of the Administrative Appeals Tribunal



A.6.4 The following four tables provide a comparison between the General and Veterans Division and Taxation Division within the Administrative Appeals Tribunal with respect to the finalisation of applications for review by way of consent and hearing.

BY CONSENT

General and Veterans Division

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	Mean	Median
Affirmed (%)	3	3	4	5	5	7	7	8	5.25	5
Dismissed/ Withdrawn(1)	35	31	31	27	30	30	33	34	31.375	31
Set Aside	26	28	26	25	27	25	26	27	26.25	26
Varied	7	9	10	10	10	7	6	5	8	8

Taxation Division

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	Mean	Median
Affirmed (%)	1	2	1	2	<1	<1	1	10	2.125	1
Dismissed/ Withdrawn	29	34	17	20	37	7	7	16	20.875	18.5
Set Aside	20	22	19	16	25	56	57	25	30	23.5
Varied	22	16	42	40	14	32	28	23	27.125	25.5

BY HEARING

General and Veterans Division

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	Mean	Median
Affirmed (%)	12	13	13	15	11	14	16	14	13.5	13.5
Dismissed	3	3	3	4	2	3	2	2	2.75	3
No jurisdiction	1	1	1	<1	1	1	<1	<1	0.625	1
Set Aside	8	8	8	8	9	9	7	6	7.875	8
Varied	1	1	1	2	1	1	<1	1	1	1

(1) Includes matters dismissed under subsections 42A(1) and (1B) of the AAT Act and otherwise by operation of law.
(2) Includes matters dismissed under subsections 42A(2) (non appearance), 42A(4) (failure to show reviewable decision), 42A(5) (failure to comply with a direction of the Tribunal) and 42B(1) (frivolous or vexatious) of the AAT Act.

Taxation Division

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	Mean	Median
Affirmed (%)	11	6	4	7	3	2	1	10	5.5	5
Dismissed	6	4	1	8	7	0	2	4	4	4
No jurisdiction	1	2	3	<1	1	<1	1	<1	1	1
Set Aside	3	4	3	2	2	<1	<1	5	2.375	2.5
Varied	<1	2	1	2	4	<1	<1	2	1.375	1.5

A.6.5 The following table provides information obtained from Administrative Appeal Tribunal Annual Reports regarding the number of applications for review finalised by hearing in the Taxation Division.

Number of applications for review finalised by hearing in the Taxation Division

	1997/ 98	1998/ 99	1999/ 00	2000/01	2001/02	2002/03	2003/04	2004/05	Average percentage of applications finalised by resolution type
Affirmed	79	42	37	70	28	66	40	144	35.9
Set Aside	18	30	28	22	16	34	25	79	18.1
Varied	1	15	5	18	34	19	10	28	9.6
Remitted	7	3	7	1	0	5	0	4	2.3
Dismissed/ Withdrawn	40	26	11	76	58	15	62	66	25.4
No jurisdiction	4	13	22	2	10	9	34	10	8.7
Totals	149	129	110	189	146	148	171	331	

A.6.6 The following four tables provide information obtained from the Tax Office regarding the finalisation of tax litigation in 2003/04.

Non-ATP Part IVC Litigation

Jurisdiction	Favourable to the Tax Office	Adverse to the Tax Office	Partially Favourable	Total
Small Taxation Claims Tribunal	15	0	3	18
Administrative Appeals Tribunal	36	7	12	55
Federal Court	17	5	1	23
Full Federal Court	4	3	3	10
High Court	3	1	0	4
Total	**133**	**32**	**20**	**185**

ATP Part IVC Litigation

Jurisdiction	Favourable to the Tax Office	Adverse to the Tax Office	Partially Favourable	Total
Small Taxation Claims Tribunal	0	0	0	0
Administrative Appeals Tribunal	0	1	0	1
Federal Court	4	1	0	5
Full Federal Court	2	0	0	2
High Court	0	0	0	0
Total	**6**	**2**	**0**	**8**

Part IVC Litigation — Courts

Jurisdiction	Favourable to the Tax Office	Adverse to the Tax Office	Partially Favourable	Total
Federal Court	21	6	1	28
Full Federal Court	6	3	3	12
High Court	3	1	0	4
Total	**30**	**10**	**4**	**44**

Part IVC Litigation — Tribunals

Jurisdiction	Favourable to the Tax Office	Adverse to the Tax Office	Partially Favourable	Total
Small Taxation Claims Tribunal	15	0	3	18
Administrative Appeals Tribunal	36	8	12	56
Total	**51**	**8**	**15**	**74**

APPENDIX 7: EXAMPLES OF POSSIBLE BREACHES OF THE MODEL LITIGANT GUIDELINES RAISED IN SUBMISSIONS

A.7.1 Submissions provided the following examples of cases where the Tax Office had apparently engaged in behaviour that was prohibited by the model litigant guidelines.

Cases involving long delays

A.7.2 Examples of cases involving long delays included:

- cases involving research and development syndicates (such as the case of *Zoffanies*[166]; and
- cases where the Tax Office has failed to meet deadlines set by courts or tribunals.

Cases where the Tax Office had not acted consistently

A.7.3 Examples of cases where the Tax Office had not acted consistently included:

- cases where the Tax Office was not applying agreed settlement terms to other similar cases;
- cases where the Tax Office was not following the Taxpayer's Charter; and
- cases where the Tax Office was relying on legal professional privilege principles but resisting the use of these principles by taxpayers.

Cases where the Tax Office had mishandled cases

A.7.4 Examples of cases which submissions stated had been mishandled by the Tax Office and which had led to unnecessary additional litigation costs for both parties to the litigation included:

- cases where the Tax Office realised late in the litigation process that certain Tax Office documents that were an integral feature of the litigation had either not been prepared at all or had been prepared, but were defective for procedural reasons;
- cases where the Tax Office changed the arguments it was relying on in the case during the hearing; and
- cases where the Tax Office was reluctant to agree certain facts with taxpayers.

166 *F C of T Zoffanies* (2003) 54 ATR 280.

Cases where the Tax Office had taken advantage of taxpayers

A.7.5 Submissions stated that examples of cases where the Tax Office had taken advantage of taxpayers who did not have the same resources to pursue litigation included:

- cases where the Tax Office had deprived taxpayers of the financial resources needed to pursue litigation by, for example, unreasonably pursuing debt recovery action against the taxpayer;
- cases where the Tax Office had used a number of barristers and solicitors and the taxpayer is unrepresented;
- cases where the Tax Office had made unreasonable charges for documents provided under the Freedom of Information Act; and
- cases where the Tax Office had re-classified a case as involving fraud without any proper basis for doing so. Submissions asserted that this reclassification occurred just before the end of the four or six year time period for amendment that would normally have applied to these cases and was done so that the Tax Office could take advantage of the unlimited time period for amendment that applies in fraud cases.

Cases where the Tax Office pursued an appeal where it did not believe that it had reasonable prospects for success

A.7.6 Examples of cases provided in submissions where the Tax Office was said to have pursued an appeal where it did not believe that it had reasonable prospects for success included:

- cases where the case was pursued because either an ATO officer or business line has developed an immutable view of the law which it was unwilling to abandon despite external counsel's advice to do so; and
- cases where the case was pursued because the taxpayer was regarded by the Tax Office or tax officer conducting the case as engaging in undesirable behaviour and the Tax Office considered that the pursuit of the case would impede this behaviour.

Other examples

A.7.7 Submissions also raised the following other examples of possible breaches of the model litigant guidelines:

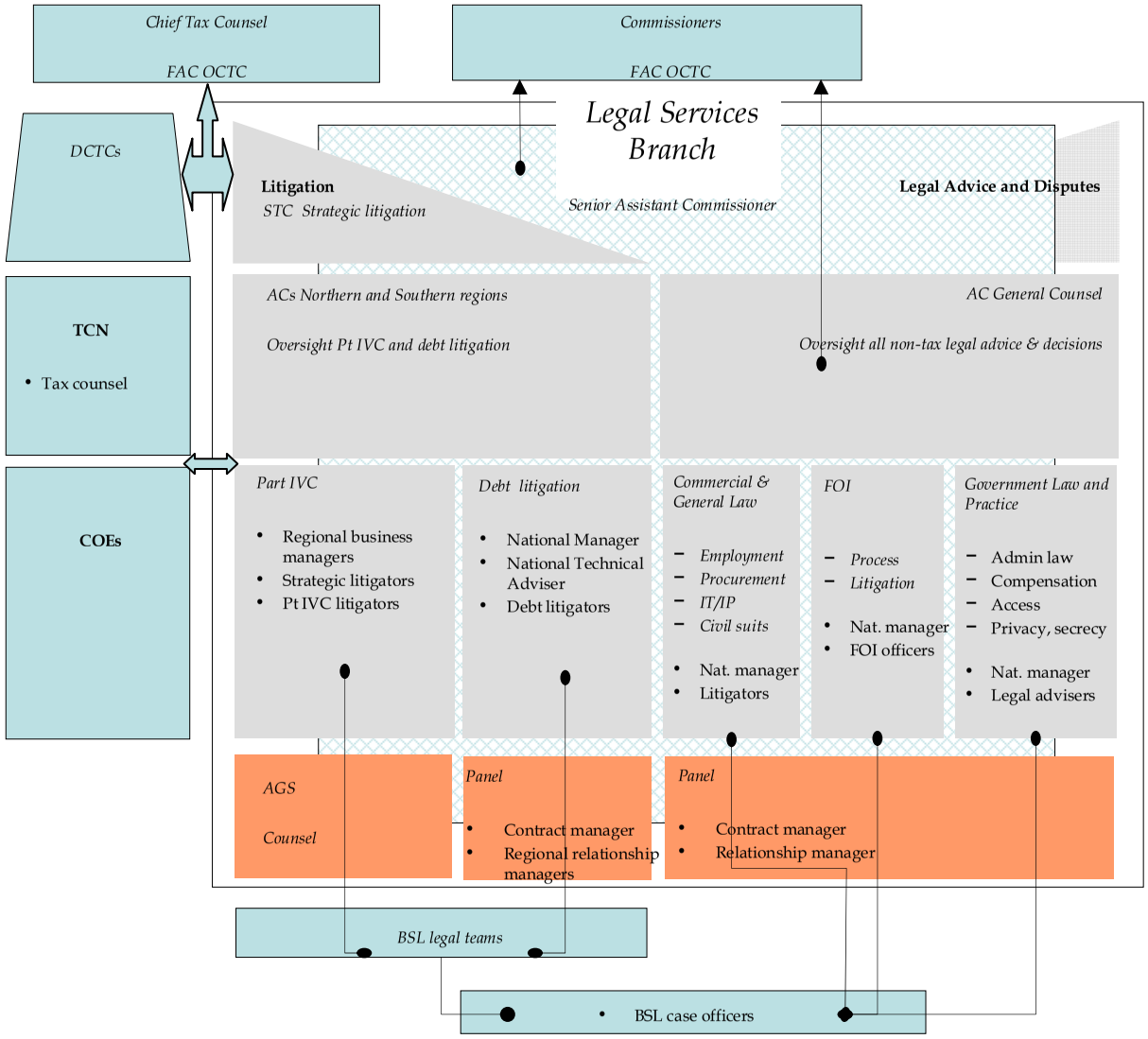
- cases where the Tax Office had not made any effort to resolve the dispute outside the litigation process for example though mediation or other alternative dispute resolution mechanisms;
- cases where the Tax Office had relied on technical defences for example to interlocutary questions;
- cases where the Tax Office has demonstrated a reluctance to make any decision and this refusal has led to the taxpayer being obliged to refer the matter to either the AAT or Federal Court; and
- cases where the Tax Office has refused to apologise for wrongdoing.

APPENDIX 8: PRACTICE STATEMENTS

A.8.1 The following is a list of publicly available practice statements which provide guidance to taxpayers and their advisers on how the Tax Office administers aspects of its Part IVC tax litigation:

- PS LA 1998/3 Significant Litigation Matters
- PS LA 2000/10 Application of Part IVA
- PS LA 2000/3 Signing non-electronic applications for amendment and objections
- PS LA 2002/2 Costs awarded by the courts
- PS LA 2002/3 Engaging external legal providers
- PS LA 2002/4 Service of documents
- PS LA 2002/5 Counsel travel costs
- PS LA 2002/9 Mediation of disputes to which the ATO is a party
- PS LA 2002/10 Signing and executing documents in the ATO
- PS LA 2002/18 MOUs and other non-legally binding arrangements to which the ATO is a party
- PS LA 2003/10 The Management of 'Priority Technical Issues'
- PS 2003/7 Taxation objections — late lodgement
- PS LA 2004/4 Referral of issues to Centres of Expertise for the creation of precedential ATO view
- PS LA 2005/22 Litigation and priority technical issues

APPENDIX 9: CURRENT MANAGEMENT STRUCTURE FOR TAX OFFICE'S IN-HOUSE LEGAL AREA



APPENDIX 10: CASE MANAGEMENT PROCEDURES WHERE A COURT OR TRIBUNAL DECISION IS HANDED DOWN

A.10.1 The case management procedures where a court or tribunal decision is handed down are as follows:

- Step 1: The LSB area receives notification from a court or tribunal that a decision is about to be handed down.
- Step 2: If time permits, the LSB case manager convenes a pre decision Strategic Internal Litigation Committee (SILC) meeting with various internal Tax Office stakeholders.
- Step 3: Once a decision is handed down:
  - The LSB case manager arranges for a copy of the relevant decision to be circulated to relevant Tax Office internal stakeholders on the day of receipt;
  - The LSB case manager convenes a decision SILC within 24 hours. This SILC is to:
    - : implement a mitigation strategy for the case;
    - : approve media briefs for the decision;
    - : review implications of the decision for the Tax Office; and
    - : where appropriate, consider adverse decision processes.
- Step 4: The LSB case manager prepares a case summary of the decision within two working days for strategically important litigation and within seven days for other decisions.
- Step 5: The LSB case manager prepares an adverse decision report within seven days of the decision being handed down, if the decision is wholly or partly favourable
- Step 6: The LSB case manager convenes a post decision SILC within one of the following time frames:
  - Within five days of the decision (for an adverse or partially adverse decision);
  - Within five days of any appeal lodged by the taxpayers against the decision; and
  - Within 28 days for all other cases.

- Step 7: The post decision SILC considers whether there are any flow-on effects from the decision, including risks that arise and whether any changes need to be made to relevant legislation or rulings. Responsibilities for addressing each of these effects are to be assigned at this SILC.

- Step 8: If the case is an adverse decision, the decision to appeal must be made by either a Deputy Chief Tax Counsel who has responsibility for the particular tax area involved in the appeal or by the First Assistant Commissioner (Aggressive Tax Planning) (in cases involving tax avoidance).

- Step 9: Where the case is appealed an appeal SILC is convened no later than a week before the appeal period or cross period expires. This SILC will consider matters such as the basis for the appeal , whether further evidence should be lodged and what actions the Tax Office may need to do pending the appeal (for example, as regards issuing of assessments while the appeal is outstanding).

APPENDIX 11: NUMBERS OF CASES FUNDED UNDER THE TEST CASE LITIGATION PROGRAM OR ON ANOTHER BASIS

Financial Year	Type of funding	Total
95/96	Adverse Decision	6
	Funded at the Commissioner's prerogative	9
	High Court	1
	Not Funded	7
95/96 Total		**23**
96/97	Funded at the Commissioner's prerogative	6
	Funding approved via Panel	1
	High Court	1
	Not Funded	12
96/97 Total		**20**
97/98	Funded at the Commissioner's prerogative	5
	Funding approved via Panel	5
	Not Funded	26
97/98 Total		**36**
98/99	Adverse Decision	1
	Funded at the Commissioner's prerogative	2
	Funding approved via Panel	14
	High Court	4
	Not Funded	11
98/99 Total		**32**
99/00	Adverse Decision	3
	Funding approved via Panel	5
	High Court	1
	Not Funded	3
99/00 Total		**12**
00/01	Adverse Decision	1
	Funded at the Commissioner's prerogative	2
	Funding approved via Panel	7
	Not Funded	16
00/01 Total		**26**

Financial Year	Type of funding	Total
01/02	Funded at the Commissioner's prerogative	1
	Funding approved via Panel	6
	Not Funded	15
01/02 Total		**22**
02/03	Adverse Decision	1
	Funded at the Commissioner's prerogative	1
	Funding approved via Panel	8
	Not Funded	14
02/03 Total		**24**
03/04	Adverse Decision	3
	Funded at the Commissioner's prerogative	4
	Funding approved via Panel	5
	High Court	2
	Not Funded	16
03/04 Total		**30**
04/05	Funded at the Commissioner's prerogative	10
	Funding approved via Panel	10
	Not Funded	17
04/05 Total		**37**
Grand Total		**262**

APPENDIX 12: CASES IDENTIFIED AS TEST CASES OR AS TAX OFFICE FUNDED CASES IN MATERIAL PUBLISHED BY THE TAX OFFICE[(a)]

Year of material/ or date of funding	Name of Case	Date of decision	Source — Annual Report (AR) or NTLG minutes (NTLG)?	Identified as Test case (TC) or funded case (FC)?	Tribunal/ Court	Issues	Successful party
1995/96	Commissioner of Taxation v Polla-Mounter	30/11/95	NTLG	FC	Federal Court (This case was later appealed to the Full Federal Court where the taxpayer succeeded)	Whether a scholarship payment to a footballer was assessable or exempt income	ATO
	D F C of T v Kavich and Official Trustee in Bankruptcy	8/9/96	NTLG	FC	Full Federal Court	Section 207 penalty and bankruptcy	Taxpayer
1996/97	Commissioner of Taxation v Murry	16/06/98	AR	TC	High Court	Ascertaining the goodwill component of a capital gain	ATO
	Whitaker v Federal Commissioner of Taxation	26/03/98	AR	TC	Full Federal Court (This case was later appealed to the High Court)	Whether pre and post judgement interest is assessable income	Taxpayer (in part)
	Commissioner of Taxation v Australian Airlines Ltd	26/11/96	NTLG	FC	Full Federal Court	Sales tax – meaning of exemption for schools	Taxpayer
	F C of T v Rowe	29/4/97	AR and NTLG	TC	High Court	Whether a reimbursement is assessable income	Taxpayer

(a) This table lists a total of 34 finalised cases that reached the stage of a court decision. Some cases appear more than once in this table because they were appealed to the Full Federal Court and/or to the High Court. The Tax Office has advised that during the period from 1995/96 to 2004/05 there were 44 finalised cases that received test case funding or another form of funding (other than funding that is granted where the ATO appeals against a decision of the AAT). Therefore this table (which is compiled from material that the Tax Office has made publicly available) does not list 10 finalised cases that the Tax Office has stated were funded during this period. The Tax Office has stated that secrecy provisions of the income tax legislation prevent the names of these further finalised cases being published.

This table was also prepared prior to the Tax Office's publication on 26 March 2006 of additional information concerning funded cases (in Attachments 2 and 3 to the minutes for the National Tax Liaison Group meeting of 7 September 2005). However, these attachments do not record the names of relevant funded cases.

Year of material/ or date of funding	Name of Case	Date of decision	Source — Annual Report (AR) or NTLG minutes (NTLG)?	Identified as Test case (TC) or funded case (FC)?	Tribunal/ Court	Issues	Successful party
1997/98	No test cases are identified in annual report. However the following case are referred to in NTLG reports:						
	De Luxe and Yellow Cabs Co-operative (Trading) Society Ltd & Ors v Commissioner of Taxation	28/08/97 & 15/4/98	NTLG	TC	Federal Court and Full Federal Court	Whether taxi drivers were employees of the taxi operator	Taxpayer
	National Speakers Association of Australia Inc v F C of T	25/11/97	NTLG	TC	Federal Court	Whether National Speakers Association is exempt from income tax. This issue was not considered by the court as the ATO had not made a valid private ruling	Taxpayer
	National Bus Co Pty Ltd v Commissioner of Taxation	3/03/98	NTLG	FC	Federal Court	Refunds of sales tax on goods subsequently applied for own use in repair and maintenance of buses	ATO
	Deputy Commissioner of Taxation v Gruber	24/03/98	NTLG	FC	NSW Court of Appeal	What particulars need to be on director penalty notices	Taxpayer
	Commissioner of Taxation v Ryan	2/04/98	NLTG	FC	Full Federal Court	Whether a nil assessment is an assessment	Taxpayer
	Brown v Commissioner of Taxation	30/06/98	NLTG	TC	Federal Court	Deductibility of interest on business loan after the business had ceased	Taxpayer
1998/99	Scully v F C of T	10/02/00	NTLG	TC	High Court	Whether an invalidity payment was an eligible termination payment	ATO
	Commissioner of Taxation v Kurts Development Ltd	28/08/98	NTLG	TC	Full Federal Court	How pre-development costs are treated under the trading stock provisions	ATO
	Steele v Deputy Commissioner of Taxation	4/03/99	NTLG	FC	High Court	Deductibility of interest, where property is purchased with the dual purpose of establishing a business on the property and making use of the property (currently) to derive income	Taxpayer
	Commissioner of Taxation v Brown	3/06/99	NTLG	TC	Full Federal Court	Deductibility of interest on a business loan after the business had ceased	Taxpayer

Year of material/ or date of funding	Name of Case	Date of decision	Source — Annual Report (AR) or NTLG minutes (NTLG)?	Identified as Test case (TC) or funded case (FC)?	Tribunal/ Court	Issues	Successful party
1999/00	No test cases are identified in the ATO's annual report. However, the following cases are referred to in NTLG reports:						
	Commissioner of Taxation v Ryan	3/02/00	NTLG	FC	High Court	Whether a nil assessment is an assessment	ATO
	Deputy Commissioner of Taxation v Woodhams	2/03/00	NTLG	FC	High Court	Whether due dates need to be specified in director penalty notices	ATO
	Service v Commissioner of Taxation	27/03/00	NTLG	FC	Full Federal Court	Whether directorship fees are assessable to taxpayer personally or whether taxpayer was entitled to a deduction for payments made to family company	Taxpayer
	Chong v Commissioner of Taxation	16/05/00	NTLG	FC	Federal Court	Whether Malaysian civil service pensions are assessable in Australia	ATO
2000/01	Commissioner of Taxation v Commercial Nominees of Australia Ltd	31/05/01	AR	TC	High Court	Whether prior year losses by superannuation fund are deductible	Taxpayer
	Commissioner of Taxation v Anovoy	23/04/01	AR	TC	Full Federal Court	Whether interest on funds borrowed to renovate a heritage house are deductible	ATO
	Commissioner of Taxation v Andrew Payne	8/02/01	AR	TC	High Court	Whether costs of travel between two unrelated places of work and business are deductible	ATO

Year of material/ or date of funding	Name of Case	Date of decision	Source — Annual Report (AR) or NTLG minutes (NTLG)?	Identified as Test case (TC) or funded case (FC)?	Tribunal/ Court	Issues	Successful party
2001/02	Morris v Commissioner of Taxation	14/05/02	AR	TC	Federal Court	Whether sun protection products are deductible	Taxpayer
	Hart v Commissioner of Taxation	2/11/01	AR	TC	Federal Court	Whether interest payments on a split loan are deductible	ATO
	Howland-Rose & Others v Commissioner of Taxation (the 'Budplan' case)	18/03/02	AR	TC	Federal Court	Whether expenses of participation in the Budplan mass marketed tax effective investment scheme were deductible	ATO
2002/03	Commissioner of Taxation v Hart	26/7/02	AR	FC	Full Federal Court[(b)]	Whether interest payments on a split loan are deductible	Taxpayer
	Stone v Federal Commissioner of Taxation ("Stone's Case")	29/11/02 (Federal Court)	AR	FC	Federal Court (This case was also considered by the Full Federal Court but the Tax Office has confirmed that it did not fund this stage of the case)[(c)]	Whether prize and grant money is assessable to a sportsperson	Taxpayer in part (in Federal Court)
	Deputy Commissioner of Taxation v Dexcam Australia Pty Ltd (in liquidation)	30/6/03	AR	FC	Full Federal Court	Application of credits for tax and priority of ATO in insolvent administrations.	ATO
2003/04	Commissioner of Taxation v Hart	27/05/04	AR	TC	High Court	Split loans – whether Part IVA applied	ATO

(b) The Tax Office has confirmed at a Law Council Workshop held on 15-17 October 2004 that this stage of the case was not funded by the Tax Office although an earlier stage of the case was funded.

(c) See Commissioner of Taxation, Annual Report 2004/05 at p 234.

Year of material/ or date of funding	Name of Case	Date of decision	Source — Annual Report (AR) or NTLG minutes (NTLG)?	Identified as Test case (TC) or funded case (FC)?	Tribunal/ Court	Issues	Successful party
2004/05	Federal Commissioner of Taxation v Joanna Stone	26/04/05	AR	FC	High Court	Whether prize and grant money is assessable to a sportsperson	ATO
	Recoveries Trust v Federal Commissioner of Taxation	15/10/04 & 8/7/05	AR	TC	AAT and Full Federal Court	Entitlement to full input tax credits for services to collect debts and for advice on whether to acquire debts	ATO
	Federal Commissioner of Taxation v BCD Technologies Pty Ltd	2/06/05	AR	FC	Federal Court	Whether nil income tax company return under the self-assessment regime was a deemed assessment	ATO
	DP Excavation & Haulage & Ors v Federal Commissioner of Taxation	3/06/05	AR	FC	Supreme Court of NSW	Conflicting priorities in the winding up of companies	ATO

APPENDIX 13: BIBLIOGRAPHY

TAX OFFICE PUBLICATIONS

- Australian Tax Office, *Test Case Litigation Program,* April 2005 downloaded from the ATO's website at www.ato.gov.au.

- Commissioner of Taxation, *Large Business and Tax Compliance*, Address to the International CFO Forum, Sydney, Australia, 13 October 2005.

- Carmody, M (Commissioner of Taxation), *Tensions in Tax Administration*, ICAA NAB Gala Luncheon Address, Melbourne, 14 March 2003. Available at http://www.ato.gov.au/corporate/content.asp?doc=/content/sp200301.htm>.

- Commissioner of Taxation, *Annual Reports* 1995/96 to 2004/05.

- D'Ascenzo, M and Martin, S *A unique taxation partnership for the benefit of the Australian community*, Speech given to ATO/ AGS/ Counsel Workshop, 3 April 2004 downloaded from www.ato.gov.au.

OFFICIAL PAPERS

- Attorney-General, *Legal Services Directions, Appendix B, (the model litigant rules)* issued pursuant to section 55ZF of the *Judiciary Act 1903*, with effect from 1 September 1999 and 1 March 2006. The directions are available on the Attorney-General's web site at www.ag.gov.au.

- Auditor-General, *Legal Services Arrangements in the Australian Public Service*, Audit Report no 52, 20 June 2005, p 35.

- Australian Law Reform Commission, *Managing Justice: A review of the federal civil justice system,* ALRC 89, 2000.

- T Matruglio, *Part two: The costs of litigation in the Federal Court of Australia*, ALRC Sydney, June 1999, p 59. Available at http://www.austlii.edu.au/au/other/alrc/publications/dp/62/report_index.html.

- Review of Business Taxation (Ralph Review), *A Strong Foundation – Discussion Paper 1: Establishing objectives, principles and processes,* November 1998, Commonwealth of Australia.

- The Treasury, *Report on Aspects of Income Tax Self-Assessment*, August 2004, Commonwealth of Australia.

PARLIAMENTARY PAPERS

- The Parliament of the Commonwealth of Australia, Joint Committee of Public Accounts, *Report No. 326 – An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office*, 1993, Commonwealth of Australia.

OTHER PUBLICATIONS

- Bennett, P College of Law, Book 1, *Duty of Solicitors and Barristers.*
- Bersten, M *The Rule of Law and the Need for a Charter for ATO Litigation Charter,* Paper for the Law Council Taxation Workshop, Victoria, 24-26 October 2003.
- Bersten, M *Independence and the Accountability of the Commissioner of Taxation*, Paper for the Law Council Taxation Workshop, Coolum, Queensland, 9 November 2002.
- Chapple, S *Income Tax Dispute Resolution: Can we learn from other Jurisdictions*? 1999 Australasian Tax Teachers Association Conference.
- His Honourable Justice Garry Downes AM, *Government Agencies as Respondents in the Administrative Appeals Tribunal*, Paper delivered to the Australian Government Solicitor Government Law Group, Canberra 16 June 2005. Available at http://www.aat.gov.au/CorporatePublications/speeches/downes/GovernmentAgenciesJune2005.htm.
- Gleeson, M *Courts and the Rule of Law*, Melbourne University, 7 November, 2001. Available at http://www.hcourt.gov.au/speeches/cj/cj_ruleoflaw.htm.
- Gordon, M *Tax Litigation- does the Commissioner make a difference?* Paper for the ATO Litigation Workshop, Melbourne Law School, University of Melbourne, 3 April 2004.
- Law Council of Australia, *Discussion Paper regarding Test Case Litigation Program*, Law Council of Australia Business Law Section Taxation Workshop, 15-17 October 2004.
- Hon Justice McHugh AC, *Tensions Between The Executive And The Judiciary*, Australian Bar Association Conference, 10 July 2002. Available at http://www.hcourt.gov.au/speeches/mchughj/mchughj_paris.htm.
- Mavrakis, N and Davy, T *Discussion Paper regarding Taxation Litigation*, Law Council of Australia Business Law Section Taxation Workshop, 15-17 October 2004.
- Murphy, Terry S C *Litigation – Riding the Beast*, Taxation in Australia, Issue 39, no 7, February 2005.
- Richards, R *Confronting the Tax System*, Parts 1 ,2 and 3, Taxation in Australia, vol 31 no. 2, 3, and 4 August, September and October 1996.

APPENDIX 14: ABBREVIATIONS

AAT	Administrative Appeals Tribunal
AGS	Australian Government Solicitor
ALRC	Australian Law Reform Commission
ANAO	Australian National Audit Office
APS	Australian Public Service
AR	Annual Report
ATO	Australian Taxation Office
ATP	Aggressive Tax Planning
COE	Centre of Excellence
Commissioner	Commissioner of Taxation
CTU	Complex Technical Unit
FBT	Fringe Benefits Tax
FBTAA	*Fringe Benefits Tax Assessment Act 1986*
FC	Funded Case
FCT	Federal Commissioner of Taxation
GIC	General Interest Charge
GST	Goods and Services Tax
GSTR	Goods and Services Tax Ruling
IGT	Inspector-General of Taxation
IGT Act	*Inspector-General of Taxation Act 2003*
Inspector-General	Inspector-General of Taxation
ITAA 1936	*Income Tax Assessment Act 1936*
JCPA	Joint Committee of Public Accounts
LBI	Large Business and International
LSB	Legal Services Branch

MMTEI	Mass Marketed Tax Effective Investment
MOU	Memorandum of Understanding
NTLG	National Tax Liaison Group
OLSC	Office of Legal Services Co-ordination
Ptax	Personal Tax
PS	Practice Statement
PS CM	Practice Statement Corporate Management
PS LA	Practice Statement Law Administration
PTI	Priority Technical Issue
SB	Small Business
SILC	Strategic Internal Litigation Committee
SNC	Serious Non Compliance (area of the Tax Office)
Super	Superannuation
STCT	Small Taxation Claims Tribunal
TAA 1953	*Taxation Administration Act 1953*
Tax Office	Australian Taxation Office
TC	Test Case
TCN	Tax Counsel Network
TQR	Technical Quality Review
TR	Taxation Ruling