THE TAXATION APPEALS SYSTEM: AN ADMINISTRATIVE LAW PERSPECTIVE

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ABSTRACT

This paper examines the current review rights provided under the *Income Tax Assessment Act* 1936 to evaluate their fairness and efficiency by reference to the significant developments in administrative law over the last 20 years. It is concluded that the internal review process offered under the Act (ie. the objection procedure) is not operating efficiently and in cases where ATO policy is disputed it is incapable of considering the merits of the dispute. It is also concluded that the external review avenues (ie. by the Administrative Appeals Tribunal and Federal Court) are unfair due to delay and high litigation costs involved together with the Commissioner's power to prejudice the taxpayer's rights through his power to recover the amount in dispute before the appeal is determined.

Keywords: Income tax, Australia, objection, appeal, review, administrative law, reforms

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INTRODUCTION

1.1 STATEMENT OF THE PROBLEM

Administrative law in Australia has undergone great expansion over the last 20 years due mainly to the introduction of a variety of new statutory remedies for citizens who wish to challenge government administrative decisions. During a similar period the *Income Tax Assessment Act* 1936 ("the ITAA") and related legislation (hereinafter referred to collectively as "the Tax Act") has expanded greatly to become one of the most complex and voluminous statutory schemes in Australian law. Developments under the Tax Act have provided the Commissioner of Taxation with broader discretionary powers to assist him in the basic functions of assessment and collection of income tax. These discretionary powers include wide access to a taxpayer's financial records.[1] Where a taxpayer does not keep adequate records the Commissioner may estimate the taxpayer's liability by making a default assessment.[2] In cases involving artificial arrangements the Commissioner has a broad power to "reconstruct" transactions.[3] As protection against possible abuse of these powers the Tax Act provides taxpayers with certain review rights however in stark contrast to the massive developments in the substantive tax provisions those review rights have remained effectively unchanged since 1915, when the Federal income tax was first introduced.

The question arises whether the review procedures provided under the Tax Act can still be considered fair and efficient in view of the recent developments in administrative law. Some of these developments in administrative law do operate to assist taxpayers but many important aspects of have been excluded or modified in their application to taxation decisions. This paper examines the review rights under the Tax Act to evaluate their fairness and efficiency. The approach adopted is to consider the specific elements of those review rights by reference to principles which have emerged from relevant case law and a number of major reports on administrative review. At the outset, a brief outline of the more significant reports and the review procedures under the Tax Act is appropriate.

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[1] ITAA s.263.
[2] ITAA s.167.
[3] ITAA Part IVA: ss.177A to 177G.

1.2 REPORTS ON ADMINISTRATIVE REVIEW

The major developments in administrative law were based on several reports on the review of administrative decisions during the early 1970's. Those reports were directed at the provision of better access to review of administrative decisions "on the merits" by external bodies. There were already a plethora of boards and tribunals carrying out this type of function with great diversity in their powers and procedures. However there were many concerns about the fairness and efficiency of many of those bodies. The reports also considered improvements to the alternative avenue of judicial review by the courts, where the traditional prerogative writ procedures were considered too complex and potentially expensive to provide adequate redress.[4]

The leading reports were the Commonwealth Administrative Review Committee (1971) ("*the Kerr Committee*")[5] and the Committee on Administrative Discretions (1974) ("*the Bland Committee*").[6] The reports by these Committees set out a broad charter for a fair and efficient system for review administrative decisions. In particular they identified the following major principles which lie at the heart of an effective review system:

- independence - the review body should be independent of the primary decision maker
- distinctive review function - the provision for review on the merits should be complementary to judicial review
- fairness - the well established standards of fairness applicable in judicial review should also apply to administrative review
- equity - avenues for review should apply across all areas of decision making
- accessibility - equality of review should be available across all geographic locations
- informed review - there should be effective communication to a review body of the relevant facts and reasons for the primary decision

The major recommendation of the Kerr Committee was establishment of a general administrative tribunal for review of administrative decisions "on the merits" which would

[4] Kerr Committee, paragraph 58.
[5] Parliamentary Papers 1971 No.144.
[6] Parliamentary Papers 1973 No.316.

include specialist members to deal with specific areas of administration. One of the most successful early models for administrative review was the Taxation Board of Review. This board was established in 1922 to enable taxpayers to appeal from decisions of the Commissioner with a minimum of expense and delay with cases being heard by members with relevant commercial experience. The Administrative Appeals Tribunal ("the AAT") was established to fulfil this role across a much broader range of administrative functions under the *Administrative Appeals Tribunal Act* 1975 (the "AAT Act").

The Kerr and Bland Committee reports also initiated several other major enhancements to the administrative review system including establishment of a statutory scheme for judicial review of administrative decisions by the Federal Court under the *Administrative Decisions (Judicial Review) Act* 1977 (the "ADJR Act"), an officer with broad investigatory powers under the *Ombudsman Act* 1976, and new statutory rights to government information under the *Freedom of Information Act* 1982. The AAT Act also established the *Administrative Review Council* ("the ARC") to act as a supervisory body responsible for monitoring and refining the new administrative review system. The ARC has made numerous reports which provide specific guidance on various aspects of administrative review, including one on aspects of the tax appeals system.[7]

1.3 ASSESSMENT AND REVIEW PROCEDURES UNDER THE TAX ACT

The Commissioner has an obligation to make an assessment of the taxable income of a taxpayer and the tax payable thereon from the returns and any other information in his possession.[8] Prior to 1 July 1986 the traditional system of "administrative assessment" obliged the Commissioner to scrutinise every tax return to ascertain the correct tax liability. With the increasing prosperity and complexity of society in the post war years came increasingly complex tax legislation which made the Commissioner's assessment task practically impossible.[9] This problem was addressed by the introduction of a system of "self assessment" whereby the Commissioner can simply accept the tax position stated by a taxpayer in a tax return in making an assessment without any

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[7] Administrative Review Council *Report No.17, Review of Taxation Decisions by Boards of Review* (AGPS, 1983).
[8] ITAA s.166.
[9] Auditor General *Reports of the Auditor General on Efficiency Audits* (AGPS, 1984).

administrative obligation to make further enquiries.[10] Under self assessment the original assessment is usually, in substance, "made" by the taxpayer and the Commissioner's major role is to carry out post assessment checking and auditing of taxpayers. For this purpose he can, subject to certain time limits, exercise the power to amend an assessment under s.170.

A taxpayer who wishes to challenge the correctness of an assessment (or an amended assessment) may lodge an objection under the rules set out in Part IVC of the *Taxation Administration Act 1953* ("the TAA").[11] A similar procedure allows a taxpayer to challenge a private ruling made by the Commissioner in relation to a person's tax liability however the private ruling system is outside the scope of this paper. The Commissioner must either allow (wholly or in part) or disallow the objection.[12] If the taxpayer is dissatisfied with the objection decision there is a choice of forum for review between the Administrative Appeals Tribunal ("the AAT") by way of "review" of the decision and the Federal Court by way of "appeal " against the decision.[13]

This paper will now consider separately the internal and external levels of review.

[10] ITAA s.169A.
[11] ITAA 175A and TAA s.14ZU.
[12] TAA s.14ZY(1).
[13] TAA s.14ZS.

INTERNAL REVIEW OF TAX ASSESSMENTS

A recent ARC report ("ARC Report No.39") has identified a number of general concerns about internal review processes. These include delay, cost, lack of separation between review officers and primary decision makers and poor communication of reasons and other information to applicants.[14] Tax appeals in particular are also subject to several specific problems which affect the effectiveness of the internal review process. These are the burden of proof, reliance upon internal policies, the change to self assessment and the absence of detailed reasons.

2.1 DELAY

ARC Report No.39 recommended that internal review should generally be completed within a 28 day time limit.[15] It is difficult to obtain specific figures on the timeliness of objection decisions as the Commissioner of Taxation's annual reports do not include any measure of performance on this point. No doubt there would be considerable delay in some cases due to the complexity or importance of the issue which may require the reviewing officer to refer to a higher ATO authority or external counsel. However there is widespread concern that even the most routine objection decisions are taking too long.

One of the causes of delay is that taxpayers do not have an effective right to compel the making of an objection decision within a reasonable time. Before 1 March 1992 the Tax Act did not provide any procedure for this purpose and the only remedy was an onerous court application to seek an order of mandamus against the Commissioner. Under this system unreasonable delays in objection decisions were common. Since that date TAA s.14ZYA allows the taxpayer to give the Commissioner a written notice requiring the Commissioner to make the objection decision if he has not done so within 60 days of the objection being lodged. On receipt of such a notice, if the Commissioner does not make the decision within a further 60 days, he is deemed to have disallowed the objection and the taxpayer may proceed to external review. It is submitted that this remedy is only barely adequate as the time limit does not begin to run unless the taxpayer makes a specific request. Even if the request is promptly made the Commissioner

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[14] Administrative Review Council, Report No.39 *Better Decisions: Review of the Commonwealth Merits Review Tribunals* (AGPS 1995) para 6.54.

[15] Id at para 6.57.

has a minimum of a two month period in which to make the decision, and this period can be extended if the Commissioner seeks further information from the taxpayer.

Bearing in mind the broad spectrum of taxation issues which are subject to this procedure, there will generally be a wide range of underlying reasons for delay in objection decisions. No doubt increased complexity of the law and inadequate staff resources would contribute in many cases. However the discussion of other problems below suggests that there are fundamental problems in the tax appeal process which make delay inevitable under the present rules.

2.2 COST

There is no fee for the making of an objection but the complexity of taxation law generally requires a professional adviser to be involved in preparation of the objection and subsequent discussions with the ATO (if any), which tends to make internal review moderately expensive. The more significant problem is that this expenditure is wasted where the internal review process is in effect, little more than a rubber stamp.

2.3 LACK OF SEPARATION

The internal review mechanism requires consideration of an objection by the Commissioner however in practice the objection is considered by staff in the Appeals and Review Group of the ATO. In November 1993 the Joint Committee of Public Accounts completed a report on income taxation administration in Australia ("Report 326").[16] That report considered the independence of the Appeals and Review Group and concluded:

> *It is difficult to characterise the function of the Appeals and Review Group as one of 'independent review'. This is because, to the extent that this group is established within the ATO, it is subject to the same culture, corporate goals and values as all other ATO groups. That culture includes a commitment to the protection of the revenue of the Commonwealth.*
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> *To the extent that a decision has been made within the ATO which advances the collection of revenue and which may be considered likely to be as equally valid as a decision which would reduce revenue*

[16] Joint Committee of Public Accounts *Report 326 An Assessment of Tax* (AGPS Nov 1993).

collection, the Appeals and Review Group can be seen as culturally bound to determine the matter in favour of the ATO.[17]

Report 326 did not make any specific recommendations for reform of the current internal review procedures but simply noted the need for an independent internal review procedure, outside the normal channels of the assessment process.[18] This vague recommendation probably reflects an unrealistic expectation by the Joint Committee that internal review could ever be truly independent. The ARC observed that internal review is normally carried out by another officer within the same agency who is usually more senior than the primary decision maker, and that its main objectives are to quickly and cheaply satisfy the concerns of a significant proportion of applicants, and to improve the quality of agency decision making.[19] It cannot be said that the Tax Act is out of step in this respect, indeed the Appeals and Review Group was quite deliberately established as a physically remote and functionally separate group from the ATO groups which make assessments. Ironically, the latest wave of restructuring of the ATO includes a move away from the present "functional group" structure to a "business lines" structure which requires all major ATO functions in relation to particular taxpayers to be carried out within a close-knit group.[20] This presumably means that the same group will deal with all matters relating to a particular taxpayer including audit, assessment, debt recovery as well as objections and appeals, and thus the important element of independence in internal review may be seriously compromised.

2.4 POOR COMMUNICATION

In Report No.39 the ARC noted that it is common for internal review to be conducted without any personal contact with the applicant, which is usually true in taxation matters.[21] The ARC view is that decision making would generally be improved by an increased level of personal contact between review officers and applicants.[22] Justice O'Connor (1993) in examining the effectiveness of two-tier external review systems made some general comments which are

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[17] Id at 325.
[18] Id at 326.
[19] Op cit, Report No.39, para 6.42.
[20] See *Butterworths FBT Bulletin* No.9 (24 July 1995).
[21] Op cit, Report No.39, para 6.64.
[22] Op cit, Report No.39, Recommendation 75 (p.126).

readily applicable to internal review.[23] She observed that review without both parties present is inferior if it is the final step in the review process, on grounds of natural justice. Whilst an objection is not technically the final step in the tax review process, there are often practical constraints faced by taxpayers which make it unlikely they will proceed further even where they have a good case. In particular, the prohibitive cost of second tier review in cases where the amount in dispute is relatively small will produce this result.

A more fundamental factor contributing to a lack of communication at this stage is the absence of detailed reasons for the decision, discussed further below. The result is that the issues in dispute are generally not well defined and therefore communication between the parties is lacking in focus.

2.5 THE BURDEN OF PROOF

In challenging a tax assessment, the taxpayer carries the burden of proving that the assessment is excessive.[24] This rule is based upon the premise that the taxpayer knows all of the facts concerning his or her tax liability and it is intended to compel taxpayers to produce those facts when disputing an assessment. The grounds of objection need not be stated in formal legal language provided they are sufficient to alert the Commissioner to the particular aspects of the assessment which are considered to be erroneous.[25] The objection does not require production of any supporting evidence. Thus in a dispute which is essentially factual, unless the review officer seeks the relevant evidence from the taxpayer before considering the objection, the decision may be inevitable that the taxpayer has not *proved* that the assessment is excessive. Anecdotal sources suggest that such evidence is rarely sought by the ATO in consideration of objections.

Another consequence of the burden of proof is that it allows the Commissioner to make an assessment which may be in the nature of an "ambit claim". For example, a taxpayer who has an amount included in assessable income or a deduction disallowed may be obliged to argue

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[23] DF O'Connor "Effective Administrative Review: An Analysis of Two-tier Review" (1993) 1 *Australian Journal of Administrative Law* 4.
[24] TAA ss.14ZZK and 14ZZO.
[25] *HR Lancey Shipping Co Pty Ltd v FCT* (1951) 9 ATD 267.

against several alternative specific provisions which the Commissioner may have applied as well as the Commissioner's discretionary anti avoidance powers under Part IVA. It follows that the Commissioner may change his initial basis for an assessment during subsequent appeal proceedings.[26] The only restriction procedural fairness, which requires the AAT or Court to allow the taxpayer an appropriate opportunity to make submissions and adduce evidence in relation to the Commissioner's new arguments, particularly where Part IVA is belatedly raised.[27] When viewed in this context a tax assessment can be a very fluid decision, which can gain permanence if the taxpayer does not challenge it or, where it is challenged, if it is approved of by the AAT or Federal Court. Thus the burden of proof in tax appeals seems to greatly limit the role of internal review.

2.6 RELIANCE UPON INTERNAL POLICY

ATO staff are part of a large bureaucracy which rightfully places a very high value on consistency in its decision making role. One consequence is that they are usually constrained in their decision making by an extensive range of policy directives from the upper echelons of the department. The ATO regularly issues public rulings on new or difficult areas of the legislation or as a response to recent Tribunal and court decisions. These rulings invariably take a pro-revenue stance on ambiguous points. A tax assessor will be obliged to follow those rulings whilst on the other side of the assessment a well advised taxpayer is quite likely to contend that an assessment based on such a ruling is wrong. In this context, internal review is likely to be a shallow exercise as the review officer is most unlikely to depart from the internal policy. The review officer's major function will be limited to ensuring that the primary decision maker has applied ATO policy correctly in each case.

2.7 CHANGE TO SELF ASSESSMENT

The internal review system for tax assessments was designed long before self assessment and long before the current complexities in the tax legislation. In the past assessments were usually made by ATO assessors who examined extensive detailed information provided with tax

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[26] *FCT v Wade* (1951) 84 CLR 105, *FCT v ANZ Savings Bank Ltd* 94 ATC 4844.
[27] *Fletcher & Ors v FCT* 88 ATC 4834, *FCT v Jackson* 90 ATC 4990.

returns. The scope for accidental error in such a mass decision making process was high. By contrast, under self assessment, there should be much less scope for error in the making of assessments as most original assessments simply reflect the tax return and most amended assessment are made after a comprehensive investigation by ATO auditors. Such an investigation may include data matching with financial institutions and other government agencies, access to the taxpayer's premises and personal records and statements by the taxpayer. In this context the primary decision maker has ample opportunity to obtain all relevant information and make a well reasoned decision. It would be most unnecessary, and inefficient, for an internal review officer to carry out a second investigation of the same magnitude, particularly when he or she would be subject to the same ATO policy and cultural influences as the primary decision maker. Clearly the nature of internal review should be dramatically changed after self assessment. However there is little evidence from public rulings and other ATO behaviour to suggest that the ATO has recognised this change. It is apparent that ATO review officers still take very long periods to consider objections, particularly where the assessment involves a large amount of money or complex issues.

2.8 ABSENCE OF REASONS

The ARC has stressed that it is important that the reasons for agency decisions and internal review decisions are clearly explained to applicants.[28] It is a curious anomaly that a taxpayer is not entitled to a statement of reasons in relation to a tax assessment until after an application for external review or appeal is lodged with either the AAT or Federal Court. The ATO has traditionally provided taxpayers with a brief "adjustment sheet" with an assessment which identifies the specific items adjusted but that sheet is merely a numerical statement, it does not explain why the adjustments were made. This situation arises because under the ITAA the Commissioner simply has a duty to makes an assessment and serve notice of the assessment upon the taxpayer,[29] and where an objection is lodged by the taxpayer, to merely consider the objection and either allow or to disallow it wholly or in pre-application" part and to notify the taxpayer in writing.[30]

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[28] Op cit, Report No.39, para 6.65.
[29] ITAA ss.166 and 174.
[30] TAA s.14ZX.

At common law the High Court has held that there is no general duty to give reasons for an administrative decision.[31] It was considered important in the administrative law reforms to provide a statutory right to such reasons and these were introduced in AAT Act s.28 and ADJR Act s.13. However in most taxation matters these rights have been specifically withdrawn.[32]

Once an application is made to the AAT the Commissioner must provide a "section 37" statement including reasons for the decision and copies of all documents considered by the Commissioner to be necessary to the review.[33] A similar requirement applies in appeals to the Federal Court.[34] This creates the patently unfair result that a taxpayer is obliged to pay an application fee of $368 to obtain a statement of reasons. It is a "Catch 22" situation that the reasons upon which an application for external review should be based cannot be obtained until after the making of the application.

The absence of reasons also undermines the effectiveness of the internal review process by making it more difficult for the taxpayer to draw up specific grounds of objection against the assessment. It is also more difficult for the Appeals and Review Group to review an "unexplained" decision. Taxpayers facing this situation are obliged to prepare "omnibus" grounds of objection which put everything in issue. This situation aggravated by the rule in tax appeals that a taxpayer is limited to the grounds stated in the objection, unless the AAT or Federal Court gives leave to amend the grounds.[35] Fortunately the Federal Court has taken a pragmatic approach to the granting of leave to amend under this rule.[36]

It is difficult to see any convincing arguments to sustain this statement of reasons anomaly. The Joint Committee of Public Accounts concluded as follows:[37]

> *In the Committee's view it was preferable that decisions of the ATO were both professionally determined and communicated to taxpayers. In essence this would require the ATO to provide reasons*

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[31] *Public Service Board of NSW v Osmond* (1986) 159 CLR 656.
[32] TAA s.14ZZB and ADJR Act Schedule 1, para (e) and Schedule 2, para (f).
[33] As modified by TAA s.14ZZF.
[34] Federal Court Rules , Order 52B.
[35] TAA ss.14ZZK(a) and 14ZZO(a).
[36] *Lighthouse Philatelics Pty Ltd v FCT* 91 ATC 4942.
[37] Op cit, Report 326 at para 14.13.

> *for final (decisions) on all occasions and be willing to accept, evaluate and critically respond to taxpayer submissions on all aspects of administration and interpretation.*

The only justification advanced by the ATO for not providing detailed reasons is the additional workload which would be imposed upon decision makers. However it was pointed out in ARC Report No.33 that since the introduction of self assessment this argument is no longer valid.[38] Under self assessment the Commissioner is not obliged to satisfy himself of the correct taxable income of a taxpayer in every case, he can simply accept the statements made in the taxpayer's return and make an assessment accordingly. In that report the ARC was ultimately persuaded by the ATO workload argument not to recommend that statements of reasons be provided in relation to assessment decisions. However in relation to objection decisions the ARC recommended that the general rules for provision of reasons under AAT Act s.28 or ADJR Act s.13 should apply. This recommendation remains unimplemented.

Curiously, the ARC stated that assessment decisions should be subject to a request for reasons under ADJR Act s.13 once "full self assessment" is introduced. The ATO has no commitment to introduce full self assessment at this stage, and there is no reason to believe it will ever do so. It is submitted that the ARC reasoning is defective on this point as there is very little difference in substance between the present system of partial self assessment and full self assessment. The only distinction is that under full self assessment (which already applies to companies and superannuation funds, but not individuals) the tax return itself is deemed to be a notice of assessment and no separate notice is issued by the ATO, whereas partial self assessment still requires the ATO to issue an assessment notice. Ironically, it is easier for the Commissioner to provide statements of reasons under partial self assessment than it would be under full self assessment, because he can rely upon ADJR Act s.13(11)(b) which excludes the obligation to provide reasons if the decision itself includes a statement containing the required reasons and other particulars. Thus where an assessment issued based solely upon the tax return, a simple statement to that effect could be appended to the notice of assessment. In any event, taxpayers would not be disadvantaged if statements of reasons were not available in those cases. The real issue is provision of a statement of reasons where the Commissioner has completed an

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[38] Administrative Review Council, Report No.33 *Review of the ADJR Act: Statements of Reasons for Decisions* (AGPS 1991) para 312.

investigation into a taxpayer and issued an assessment based on a deliberate consideration of the taxpayer's circumstances. In these cases the usual statement of reasons should be provided.

The ATO workload argument should be evaluated by reference to the fact that other high volume agencies such as Social Security, Veterans Affairs and Immigration are obliged to provide reasons. One guide to the magnitude of the increased burden upon the ATO is the number of amended assessments issued by the ATO each year. Whilst direct figures on this matter are difficult to obtain, they would be related to the number of completed audits disclosed by the Commissioner's Annual Report for 1994/95 as shown in the table below:[39]

TABLE: COMPLETED TAX AUDITS 1994/95

Audit type	Audits completed
Large case and complex audits	91
Special audit	627
Business audits	6,478
Sales tax	1,625
Non-business individuals	172,466
Restricted access	185
Total	181,472

If Business Audits is taken as a guide, there were 4,354 adjustments arising from 6,478 audits, which suggests that about 67% of audits would result in amended assessments. Thus it can be estimated that a detailed statements of reasons might potentially be required for up to 67% the total audits of 181,472 being 121,586 cases per annum. Many of these cases would not be disputed by taxpayers and accordingly no statement of reasons would be requested. For example the above table shows that the vast majority of these cases (around 95%) are non-business individuals. This group would include a great number of routine adjustments for uncomplicated misdemeanours such as omission of bank interest, failure to substantiate deductions and overclaimed dependent rebates. The required statement of reasons in such cases

[39] Commissioner of Taxation *Annual Report* 19994-95 (AGPS 1995).

would generally be quite simple to prepare. Overall, it is most unlikely that this burden is greater than that which is imposed on other major Commonwealth agencies.

Once detailed reasons were provided at the assessment stage the obligation to also provide reasons for objection decisions would not be a significant additional burden because, assuming that most assessments are well founded, the reasons provided for the assessment would be a perfect prototype for reasons on the objection decision. One effect of the introduction of detailed reasons is that the grounds of objection prepared by a taxpayer can be much more focused, which must surely improve the effectiveness of the internal review process.

2.9 FAILURE TO FILTER

Justice O'Connor (1993) suggested that a high settlement rate before the AAT is an indication that the filtering function expected at the first tier of review is not working effectively. In this respect it is significant that the Taxation Division of the AAT has the highest percentage of applications settled without a hearing in 1994/95 (93%).[40] This was well above the Social Security Division (76%) and Compensation Division (67%). Anecdotal evidence suggests that the vast majority of these settlements are made in favour of the Commissioner, which may suggest that taxpayers are either acting irrationally or they are acting without full knowledge of their prospects of success when lodging appeals to the AAT.[41] On the other hand, these figures indicate a very low success rate for internal review under the Tax Act. One obvious explanation is that, due to the various factors mentioned above, it is only when a matter gets to the AAT (or Federal Court) that a full and fair review process takes place.

[40] Administrative Review Council, Annual Report 1994/95, Appendix 7, Table 5.
[41] Figures are not available but the author has been advised by ATO staff on this point.

EXTERNAL REVIEW

3.1 BACKGROUND

As mentioned earlier, a taxpayer dissatisfied with an objection decision may seek either review of that decision by the AAT or an appeal against the decision to the Federal Court.[42] The jurisdiction of the AAT was transferred from the former Taxation Boards of Review from 1 July 1986 following recommendations made by the ARC in a 1983 report ("ARC Report No.17").[43] This report addressed a problem perceived by tax practitioners that the presence of former ATO employees as chairs of the Boards undermined their independence. A related argument was that the relatively small number of Board members (some of whom were also former ATO officers) created a risk that they would become attuned favourably to arguments regularly presented by ATO advocates before the Board. Whilst some former Board members went onto become members of the newly created Taxation Division of the AAT, the transfer of jurisdiction to the AAT in 1986 appears to have satisfied the necessity for independence in external review. The Federal Court jurisdiction on tax appeals was transferred to it from the State Supreme Courts from 1 September 1987. A major reason for this change was a lack of resources in the State Courts to handle a vast backlog of tax appeals which had developed in the early 1980's.

This choice of forum provided in tax appeals is unusual as it offers two alternatives which are quite distinct options. On the one hand the AAT provides a de novo review on the merits whereby the AAT may "exercise all of the powers and discretions that are conferred ... on the person who made the decision" [44]. By contrast, the Federal Court is empowered to make "such order ... as it thinks fit".[45] The Court has inherent jurisdiction to take evidence and make relevant findings of fact but the separation of powers doctrine limits the involvement of Federal Courts in "administrative" functions. Accordingly a recent ARC report noted that the Court may review all issues of fact and law but cannot re-exercise any of the Commissioner's discretions.[46] In this sense the Court's powers are more limited than that of the AAT. It is

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[42] Supra, p.5.
[43] Administrative Review Council *Review of Taxation Decisions by Boards of Review* (AGPS, 1983).
[44] AAT s.43.
[45] TAA s.14ZZP.
[46] Administrative Review Council, Discussion Paper - May 1995 *Appeals from the Administrative Appeals Tribunal to the Federal Court* (AGPS 1995).

interesting to note that the State Supreme Courts which previously exercised this jurisdiction could carry out a de novo review as they are not subject to the same constitutional constraints. In considering the nature of external review it is also important to note that it is the objection decision being reviewed, not the assessment. This means that when the AAT exercises the same powers as the decision maker, which was the internal review officer not the primary decision maker. Accordingly it has been held that the AAT has no power to make a fresh assessment, it can merely remit the matter with directions to the ATO.[47]

A chart comparing the tax appeal system with external review procedures in other major Federal legislative is set out at Schedule 1 to this paper. In the high volume jurisdictions of Social Security and Veterans Affairs a two tier external review system operates in which the first tier tribunal is intended to act as a filter to ensure only worthy cases get through to "high level" independent review by the AAT at the second tier. In immigration matters a "one tier with referral" system operates whereby important cases of general application may be referred to the AAT.[48] The first tier tribunals are distinguished from the AAT by being constituted by specialist members and they are expected to operate more quickly and flexibly than the AAT. In considering the effectiveness of the two tier review tribunals Justice O'Connor (1993) concluded that "the current system, in spite of its defects ... works well".[49] However, in Report No.39 the ARC recommended that the current first tier tribunals should be united within a new tribunal to be called the "Administrative Review Tribunal".[50] This is in keeping with the Bland Committee which stated:

> *To permit a continuing proliferation of tribunals would be wasteful of resources, inimical to the efficient functioning of government and calculated to cause public dissatisfaction.*[51]

Once a tax appeal reaches the external review stage, some of the problems affecting internal review such as poor communication and absence of reasons are overcome due to the well worn procedural rules in the AAT and Federal Court which require provision of reasons for the decision, exchange of documents and negotiation between the parties through preliminary

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[47] *Stevenson v FCT* 91 ATC 4476.
[48] See the *Migration Reform Act* 1992.
[49] Op cit, DF O'Connor at 12.
[50] Op cit, Report No.39, para 8.22.
[51] Op cit, Bland Committee, para 123.

conferences, directions hearings and in some cases, mediation. However, there are also several problems in external review. One is delay in obtaining a hearing. Another is the high cost of proceedings in both the AAT and Federal Court. A third is the additional complexity imposed by offering a choice of forum. A fourth problem is the absence of power of in both the AAT and Federal Court to stay the operation of the assessment in dispute.

3.2 DELAY

In the current situation external review is the first in-depth examination of a tax dispute. This makes it important for external review to be carried out expeditiously. Unfortunately, once an application for external review is lodged, there is currently a considerable delay in obtaining a hearing, currently about a 9 months in the AAT and about 12 months in the Federal Court. If the decision is reserved, further weeks or months of delay may pass until the decision is delivered. These lengthy periods are in addition to delays in internal review.

A further problem is that under the current system of internal review there is insufficient refining of the issues which makes it difficult for taxpayers to predict what evidence needs to be retained for appeal purposes. The problem confronting taxpayers and the ATO in this context is that the elapse of time often makes the evidence relied upon at external review incomplete or less reliable.

3.3 COST

An application fee of $368 applies in both the AAT and Federal Court with a further fee of $616 in the Federal Court upon setting down for a hearing.[52] The complexity of income tax law generally obliges a taxpayer to use legal representation in such applications, which adds considerably to the cost. These application fees alone make external review of tax assessments prohibitive for small disputes which involve only a few hundred dollars. When account is also taken of the cost of high quality legal advice over many months leading up to a hearing followed

[52] These fees were increased from 1 January 1996. The AAT fee is refundable if the matter terminates favourably for the applicant (AAT regulation 19(7)) and the Federal Court fees may be recoverable with costs if the applicant is successful.

by the cost of representation at a hearing which may last several days, the threshold is raised to tens of thousands of dollars before a tax appeal makes economic sense.

A Small Tax Claims Division of the AAT was proposed by the ARC in Report No.39.[53] Legislation was introduced into Parliament prior to the last election which provided for the establishment of such a Tribunal however that bill has now lapsed and has not yet been re-presented by the new government.[54] The jurisdiction of the new Tribunal will be limited to amounts not greater than $5,000, however the cost factor will still be a concern as legal representation will be permitted and there will still be a right of appeal to the Federal Court.

3.4 COMPLEXITY

There does not appear to be a sound rationale for the choice of forum offered in tax appeals between the AAT and Federal Court. The different procedures and powers applicable in each forum makes the choice difficult and an error in this choice may contribute to failure. For this reason taxpayers are obliged to consider the choice of forum as an additional complex issue in the dispute upon which legal advice will be necessary. Some of the factors which contribute to the strategic importance of this decision in particular cases include:

- the limited power of the Federal Court to review the exercise of a discretionary power;
- the lack of a power to award costs against the Commissioner in the AAT;
- the relaxed application of the rules of evidence in the AAT; and
- differences in the degree of disclosure of documentary evidence between the AAT and Federal Court.

It is difficult to see why an appeal to the Federal Court is necessary in a merits review system. One explanation is that is merely an historical accident. The ITAA originally permitted appeals only to a State court. The Taxation Board of Review were introduced in 1922 to provide a cheap and simple alternative to the Courts constituted by specialist members. At that time it would have been appropriate to retain the option of going to a court due to the non-legal

[53] Op cit, Report No.39, para 8.15.
[54] See Law and Justice Legislation Amendment Bill (No.2) 1995.

background of the Board members. However since the transfer of jurisdiction to the AAT which has a number of judicial members and also has power to refer questions of law to the Federal Court,[55] the rationale for such a choice has disappeared. It is also relevant that judicial review of assessments is available to taxpayers in some circumstances under s.39B of the Judiciary Act.[56]

With regard to higher appeals there has been a recent suggestion that appeals to the Federal Court from the AAT or Federal Court ought to be by way of review on the merits, however this paper will not consider that issue.[57]

3.5 ABSENCE OF A STAY[58]

Income tax is due and payable on a date specified in the notice of assessment.[59] Unpaid tax is a debt due to the Commonwealth recoverable in a court of competent jurisdiction.[60] The fact that a review or appeal is pending in relation to the assessment does not in the meantime interfere with, or affect, the decision and any tax, additional tax or other amount may be recovered as if no review or appeal were pending.[61] The taxpayer cannot obtain a stay of the operation of the assessment in review or appeal proceedings before the AAT or Federal Court.[62]

This obligation to pay the tax "up front" may jeopardise a taxpayer's financial capacity to conduct the external review proceedings. The Commissioner has a discretion to refrain from commencing recovery proceedings however his stated policy is that the collection of outstanding taxes has priority over determination of the taxpayer's appeal.[63] On this basis the Commissioner' will only totally refrain from recovery proceedings in cases of severe financial hardship. He will partially refrain in cases where he considers there is a "genuine dispute" by requiring the taxpayer to pay a 50% of the tax (and penalties) in dispute.[64]

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[55] AAT Act s.45.
[56] See *Richard Walter v DFCT* 95 ATC 4440.
[57] Op cit, ARC Discussion Paper - May 1995.
[58] The author recently presented a paper to a conference on tax administration at the University of NSW which was jointly authored by K.Wyatt titled "Are the Commissioner's Debt Recovery Powers Excessive?". The discussion on this point is derived from that paper.
[59] ITAA s.204.
[60] ITAA s.209.
[61] TAA ss.14ZZM and 14ZZR.
[62] TAA ss.14ZZB and 17A.
[63] Income Tax Ruling IT 2569, at para 30.
[64] Ibid.

Given the situation that the ultimate correctness of an assessment may not be decided until the completion of appeal proceedings, the Commissioner's power to take prior recovery proceedings seems quite unfair. This rule has been in the ITAA since the first Commonwealth income tax was introduced in 1915 (during World War 1). Thus the rule was presumably derived from administration of a prior tax system based on customs and excise duties, which were no doubt much more simple in their application than the modern income tax. Being indirect taxes they were also generally passed on to consumers in the price of goods and thus, where the tax was disputed, "payment under protest" was a much less onerous obligation.

It is readily apparent that the review of assessments of modern income tax is far more complex task and it should be undertaken without the interference of debt recovery proceedings by the Commissioner. The Commissioner cannot argue that the revenue will suffer by delay in payment as substantial interest and penalties are applicable to taxpayers for late payment if they should fail on the appeal.[65] The only solid argument for prior recovery of the tax in dispute is that unscrupulous taxpayers may bring frivolous appeal proceedings to gain time to conceal or dissipate their assets so that debt recovery proceedings by the Commissioner after the appeal will be fruitless. In those cases the Commissioner has other remedies including mareva injunctions and actions for the setting aside of dispositions of property carried out with the intention of defrauding a creditor.[66] If these remedies are inadequate then it may be appropriate to permit the Commissioner to show cause to the AAT or Federal Court why prior recovery proceedings ought to be taken. This would recognise that prior recovery should take place only in exceptional cases, not as a matter of course.

[65] There is a late payment penalty of 8% per annum under s.207A (which is not deductible) and an additional interest penalty under s.170AA (currently 11.5% pa, and deductible). If a taxpayer has paid the amount of tax assessed and later succeeds on the appeal, interest is payable upon the overpayment under the *Taxation (Interest on Overpayments and Early Payments) Act* (currently the rate is 7.5% and assessable).

[66] See s.172 *Property Law Act* (Vic.) and ss.115,116 and 121 *Bankruptcy Act* 1966.

CONCLUSIONS

The foregoing discussion has revealed that taxpayers are provided with a relatively cheap but ineffective internal review mechanism (the objection) followed by a choice of two comprehensive but rather costly external review options (the AAT or Federal Court).

4.1 INTERNAL REVIEW

This paper has considered a number of factors affecting taxation decisions which appear to undermine the potential for effective internal review. In particular these include the absence of detailed reasons for the decision, the burden of proof, adherence to internal policies and the change to self assessment. The ARC is of the view that comprehensive and lengthy internal review is not the most desirable mode of review. It has stated that where independent external review is provided, internal review is a helpful adjunct but not a substitute for external review, and accordingly, a major focus of internal review policies should be to ensure that an applicant's access to external merits tribunals is not prejudiced.[67]

Accordingly it is concluded here that the ATO approach to internal review should be changed to a more limited supervisory function, whereby a more experienced staff member will quickly examine the assessment to ensure that a basic minimum of fairness and correctness has been applied, followed by a process which accommodates the taxpayer's right to have a full and proper review on the merits by an external tribunal at the earliest possible opportunity.

It is also concluded that there is no justification for the continued lack of an enforceable obligation upon the Commissioner to provide detailed reasons for both assessment decisions and objection decisions. Provision of a statement of reasons is a basic minimum standard of practice under modern administrative law. This paper also challenges the view that provision of reasons would impose an undue administrative burden upon the ATO. This obligation would not be onerous compared to the same obligation imposed on other Federal government agencies and it should not be viewed as a burden at all, but rather as an opportunity for improved management which will greatly enhance the decision making processes in the ATO and save

[67] Op cit, Report No.39, para 6.67.

substantial resources which are presently devoted to unnecessary review procedures. The provision of detailed reasons would allow taxpayers to give more specific and more relevant grounds of objection which in turn would encourage improved communication and more meaningful settlement negotiation at the internal review level.

The ATO should also reconsider the nature of the role of internal review under self assessment, where original assessments are rarely in dispute and amended assessments are expected to be very well considered decisions, often determined by specific internal policies. These circumstances leave little scope for reconsideration of the merits in internal review as the dispute may, in essence, be a challenge to the internal policy. In such cases internal review should be performed quickly to expedite access to external review.

The burden of proof in tax appeals also tends to undermine the effectiveness of internal review. However this should not be used as an excuse by ATO staff for a failure to provide specific reasons for decisions, and where factual matters are in dispute, the taxpayer ought to be given the opportunity to discharge that burden without being forced to undertake costly external review.

4.2 EXTERNAL REVIEW

The shortcomings in internal review of taxation decisions mentioned above place additional importance upon the external review process. Unfortunately there are also several problems at this level which tend to deny applicants their right to the correct and preferable decision.

The current delays in obtaining a hearing in both the AAT and Federal Court are substantial, which causes considerable hardship for both parties in the presentation of reliable evidence and for taxpayers by the loss of the use of funds caused by the obligation to pay the amount in dispute up-front. Preliminary procedures and hearings in tax matters could no doubt be shorter if the issues were more clearly defined at the internal review level, particularly by earlier provision of detailed reasons. There may also be a case for greater resources to be devoted to the AAT and Federal Court to expedite the hearing of tax matters.

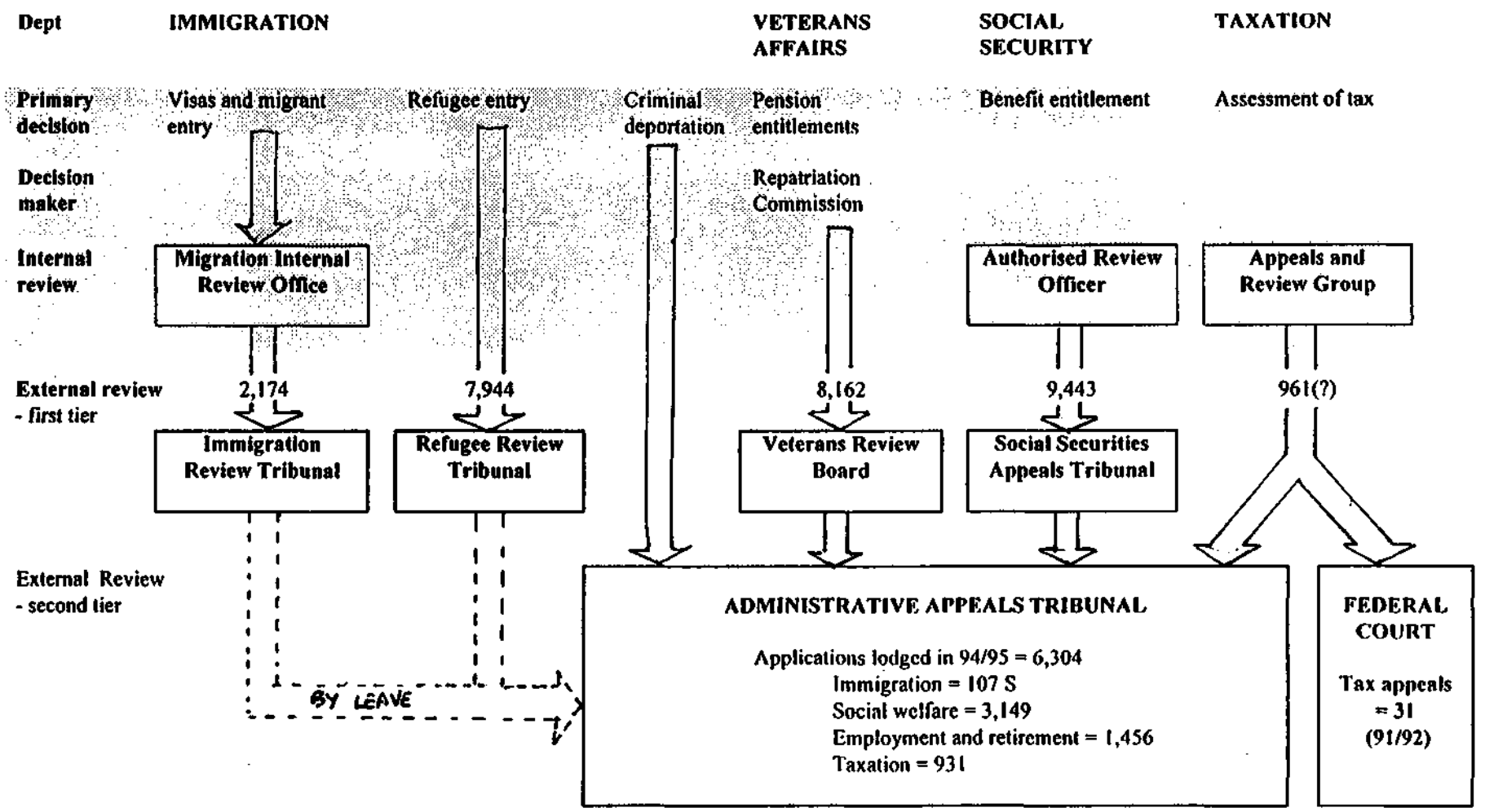
The cost of external review is currently a major barrier to large numbers of taxpayers who have a legitimate dispute. The proposed Small Tax Claims Tribunal will be a welcome development on this point, however the need for legal representation may still make this option too expensive for most small claims.

The Commissioner's power to recover the tax in dispute prior to the resolution of appeals against the assessment is considered contrary to a fair and efficient tax appeal process. This power should be restricted to exceptional cases where the Commissioner can show that there is a risk to the revenue.

It is also concluded that the option of an appeal to the Federal Court from an objection decision is not justifiable. This option causes unnecessary complexity which adds considerably to the cost of tax appeals. It would be more efficient for all objection decisions to be treated uniformly, by way of review on the merits by the AAT. Where the dispute involves purely a question of law, the AAT can choose to refer it directly to the Federal Court. Appeals would continue to lie to the Federal Court from the AAT on a question of law and the Federal Court would also retain it's function as a forum for judicial review of tax decisions under s.39B of the Judiciary Act.

A COMPARISON OF COMMONWEALTH REVIEW PROCEDURES IN HIGH VOLUME AGENCIES

(including number of applications lodged in 1994/95 - Source: ARC Annual Report 1994/95)



SCHEDULE 1

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