

REVIEWING PROCESSES FOR POLICY, LEGISLATION AND ADMINISTRATION

No adequate analysis of the current arrangements for the taxation of business income can ignore the core processes by which the law is developed and administered.

These processes involve the Government and Parliament as well as government agencies such as the Treasury, the Office of Parliamentary Counsel and the Australian Taxation Office. In addition, the courts play a critical role through their interpretation of the law. Private sector involvement is largely *ad hoc*.

The Review sees the current processes as deficient for four major reasons: there is no sound conceptual underpinning, there is no integrated approach to change, there are no specific accountabilities directed at overall performance of the business tax system and there is no adequate arrangement for private sector consultation. Identification of these problems underpins the Review's proposed strategy for process reforms set out in Chapter 7.

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Why review current processes?

Rewriting legislation pointed to deeper problems

4.1 The outcomes of the business tax system, in particular, the anomalies and complexity discussed in Chapters 2 and 3, leave many participants dissatisfied. Initially the finger was pointed at the tax legislation as the culprit. However, as unsatisfactory as the legislation was and is, recent attempts to improve its drafting, without changing policy, have underscored recognition of deeper-seated problems in the overall tax system. A common suggestion is that flawed processes lie at the root of the problems. Accordingly, the Review's terms of reference encompass an investigation of processes as well as substantive tax policy.

4.2 This chapter examines the processes used to formulate business tax policy, to draft the legislation to give effect to that policy and to administer the policy. It identifies a number of problems with the current arrangements, lending support to the analysis of the business tax system in Chapters 2 and 3 and pointing to the need for fundamental reform.

What are the business tax system processes?

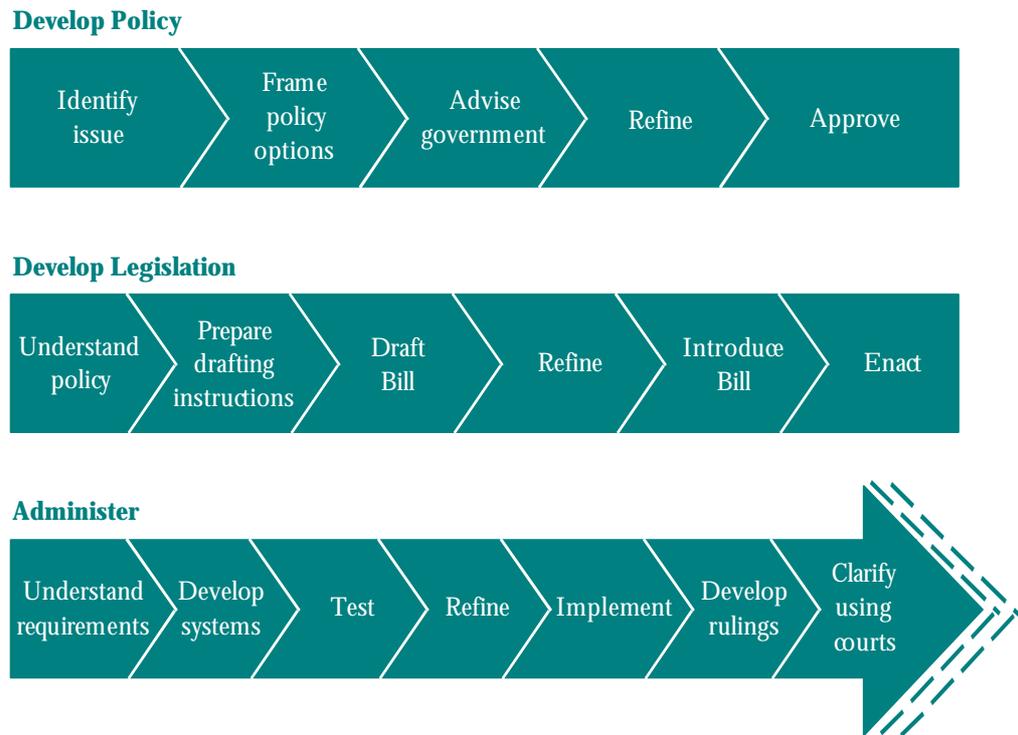
Formulating policy, developing legislation and administering law

4.3 Changes to the business tax system come about through the operation of three core processes which are summarised in Figure 4.1.

4.4 First, the need to change a policy or develop a new policy is identified by the Government, the Treasury or the Australian Taxation Office (ATO), sometimes prompted by the private sector. The policy options are framed, consultation sometimes occurs, refinements are made and then approval is sought from the Treasurer and government of the day.

4.5 Policy is converted to legislation through the second process. Drafting instructions are issued, the draft legislation is developed (sometimes with the assistance of consultation), refinements occur and the legislation is introduced into the Parliament and enacted.

Figure 4.1: Core processes for designing business taxation



4.6 The third process is for the new or changed legislation to be administered. It begins with identification of the systems requirements which would usually include, but not be confined to, information technology systems. Then the system is developed, a process involving testing and refinement. Finally, the system is implemented. Once legislation is enacted, its practical effect is developed over time through interpretation. Interpretation and application of the law are assisted through rulings and the courts where necessary.

4.7 Of course, the actual operation of these processes is not this simple in practice. The processes are iterative in nature; they are not carried out in parallel, nor are the activities conducted sequentially. For example, consultation might occur at several points during the development of policy, or it might not occur at all. Nonetheless, understanding these processes provides the basis for understanding where the problems lie.

Who are the key players?

4.8 Ultimately the main players in the business tax system are the Commonwealth Government and Parliament, on the one hand, and the taxpayers, on the other. Within government, specific roles can be identified for the government of the day, and for the Treasurer and Cabinet in

particular. Roles can also be identified for government agencies, principally the Treasury, the ATO and the Office of Parliamentary Counsel (OPC). The courts play a critical role through their interpretation of the legislation over time. On the taxpayer side the most important distinction is between tax professionals and taxpayers, although the groups overlap and both contain people with a diversity of expertise and interests.

Government and the Parliament

4.9 Decision making responsibility for tax policy and legislation rests with the Treasurer, the Cabinet and ultimately the Parliament. The prerogative for the policy and administrative design of the tax system belongs to the government of the day and the Australian Parliament. In particular, any modifications proposed to design processes must not derogate from government's prerogatives in relation to policy.

Government agencies

The Treasury

Policy development role

4.10 The Treasury has the principal role in the first core process – the development of tax policy. Treasury has carriage of major policy initiatives from the conceptual stage until the government, as part of its tax or broader policy agenda, decides its final policy in relation to the proposal. During this phase the ATO is often asked to provide input to Treasury concerning administrative, compliance and technical issues and other implementation matters.

Independence and accountability

4.11 As a Commonwealth department, the Treasury is accountable to the Treasurer in relation to advice provided on portfolio functions. It is also accountable to the Parliament for matters relating to how it performs those advisory and statutory functions, discharging that accountability through its annual report and through appearances before relevant Parliamentary committees. In general, Treasury's accountability to Parliament addresses the provision of factual or technical advice about economic policy announced or implemented by the government of the day. That accountability does not extend to, nor substitute for, Ministerial accountability for determination of economic policy.

4.12 The Review notes that while the Treasury has responsibility for provision of taxation policy advice to the Treasurer, there are no formal or

express accountabilities defined for Treasury in relation to that advice. In part, that lack of express accountability reflects the intended separation of Ministerial and advisory accountabilities —with Ministers deciding policy and public servants advising on, and then implementing, those decisions.

The Australian Taxation Office

Policy implementation role

4.13 Following approval of a policy proposal, the ATO's role is to guide the transition of the policy into legislation. As the legislative drafting is performed separately by the OPC, the ATO prepares detailed written drafting instructions for the drafters and reviews the draft legislation they prepare. In the course of carrying out this function, the ATO is often required to resolve subsidiary policy issues, clarifying with Treasury details of the broad policy established by government.

Independence and accountability

4.14 The Commissioner of Taxation, and the ATO generally, are independent and not subject to ministerial direction in respect of the application of taxation legislation to individual taxpayers.

4.15 The Commissioner of Taxation is directly accountable to Parliament, via an annual report, and also through Parliamentary committees —such as the Joint Committee of Public Accounts and Audit, the Senate Economic and Legislation Committee and from time to time other Parliamentary committees, such as the Senate Economics Reference Committee. The Commissioner is also subject to scrutiny on an ongoing basis by statutory review organisations —such as the Australian National Audit Office, the Ombudsman (who has a special taxation adviser), and the Privacy Commissioner —as well as being subject to the requirements of administrative law.

4.16 The Commissioner is also directly accountable to the community through the Taxpayers' Charter and its associated complaints mechanism, and through the levels of service the ATO publicly aims to achieve.

4.17 As part of the Government's regulation review and reform policy, the ATO prepares a *Regulation Impact Statement* to help ensure compliance and other costs are fully considered in the implementation of tax policy.

The Office of Parliamentary Counsel

Development of legislation

4.18 As indicated, the OPC, in accordance with instructions issued by the ATO, drafts legislation to give effect to the policy decisions of government. This process can itself identify further legislative or policy issues that need to be addressed.

Independence and accountability

4.19 The OPC is accountable for drafting bills (and Parliamentary amendments to bills) to deliver the government's legislative program. In particular, it is accountable for ensuring, subject to the government's directions:

- that bills are drafted for consideration by the Parliament in accordance with the government's legislative priorities;
- that bills are drafted to a high standard, that they are legally effective and clearly expressed, and that they contribute to maintaining a coherent statute book; and
- that bills are in accordance with the Cabinet or other policy authority under which they are drafted.

4.20 The OPC is accountable directly to the government, rather than to the Parliament (apart from the statutory requirement for OPC's annual report to be tabled). The Office's responsibility includes providing to the government independent advice on matters affecting the drafting and introduction of bills, especially on whether bills are in accordance with policy authority.

Courts and appeal bodies

4.21 A taxpayer dissatisfied with an assessment or other taxation decision by the Commissioner of Taxation may challenge that decision in the Administrative Appeals Tribunal or the Federal Court. Ultimately taxation disagreements of significance may come before the High Court.

4.22 The judicial system therefore has an important role in the interpretation, development and application of the taxation law. Judges do not merely interpret the tax law. They are seen to create the working law, case by case. Accordingly, judges have a critical influence in the system of working tax rules and the construction of many detailed provisions. Their constructions are important to the integrity of the tax system and its base and to the development of key tax concepts.

4.23 The business tax system operates in a continually changing business environment. In such an environment, it is not possible to draft detailed rules applying to every situation that has arisen and may arise; indeed, detailed complex rules can often frustrate the lawmakers' intention to deal effectively and fairly with business transactions generally. The preferable course is for the legislation to establish clear principles of parliamentary intent and for the courts to explain how the rules apply to particular instances.

4.24 As the law has increased in complexity, there has been criticism from some quarters that the courts have allowed aggressive tax planners to escape obligations by resorting to arrangements which exploit rigidities in a system of rules. It is a long-standing judicial principle that courts interpret legislation to give effect to the purpose of the law and this principle is now codified in interpretation of legislation.

4.25 Courts can only give effect to the purpose of legislation, however, if that purpose can be discerned either from the legislation itself or from other appropriate sources. If the law comprises a large number of *ad hoc* rules that prescribe apparently arbitrary results for different types of transactions, the courts are left with no principled signposts to guide them in applying the law to transactions that on their face fall between the detailed rules. There is no alternative open to the courts but to decide whether taxpayers' arrangements fall inside or outside the narrow rules that tax authorities seek to apply in particular instances.

The private sector

4.26 At present, opportunities for taxpayers, tax advisors and other interested groups to contribute to the formulation of tax policy and legislation are limited. Opportunity is however available to contribute to the tax administrative process through ATO consultative arrangements, as indicated in Appendix D. Traditionally, taxpayers, tax advisors and other interested groups have been able to provide comment on proposed legislation only after the legislation has been introduced into the Parliament. In the past few years some effort has been made to provide greater opportunity for comment by means of 'exposure' drafts of legislation, particularly with respect to the 'plain English' redraft of the 1936 income tax legislation.

Why aren't the processes working?

4.27 There is widespread dissatisfaction and frustration with the current business tax system. This extends not only to taxpayers and private sector

tax professionals but to virtually all other parties involved, including the bureaucracy, the Government and the Parliament.

4.28 In the opinion of the Review there are four fundamental reasons for this:

- the lack of a coherent framework of objectives and principles to guide the operation of the business tax system;
- the largely ‘fragmented’ approach which is usually taken to make changes;
- the lack of accountability for, and review of, the results the system produces; and
- ineffective consultation with the ultimate users of the business tax system, the private sector, when changes are being developed.

4.29 In addition to these fundamental causes of problems with the system, there are specific problems with the way in which the system has been operated and updated. Some areas of concern are outlined in Chapter 8.

No guiding framework

4.30 As Chapter 2 illustrated, without an explicit design framework of objectives and principles for the business tax system to guide the changes that are made, such changes are likely to be improperly designed and implemented. Most participants in the tax system would have their own implicit set of principles, but without a commonly understood framework, or an ability to be explicit about the inevitable trade-offs, changes will produce *ad hoc* outcomes.

4.31 The accumulation of *ad hoc* changes over the years has produced a system which lacks internal consistency. This has a number of consequences.

- Amending the system to reflect new policy positions is an unnecessarily complex exercise. This significantly increases the likelihood that the legislation implementing the new policy may not be fully effective in achieving its objectives, may have unintended consequences, or may open up avoidance opportunities.
- Taxpayer understanding of the system is significantly constrained. This increases compliance costs and reduces respect for the tax system thus diminishing the incentive to comply. Increasing taxpayer alienation and non-compliance may lead to revenue reductions. It also means that, regardless of institutional arrangements, the scope for consultation is, effectively, limited to

a relatively small number of experts in the public and private sectors.

- Taxpayers involved in even quite minor transactions often feel they require tax advice. Increasingly, this involves requesting binding private rulings from the ATO so as to ensure a level of certainty with the application of the law.
- The need for recourse to appeal mechanisms or the courts is greatly increased by the complexity and *ad hoc* nature of the system.
- Anomalies and inconsistencies are an inevitable consequence of complexity. They encourage aggressive tax engineering by the private sector. In turn, this engenders legislative responses from government which, because they are typically directed at specific practices, tend to add to complexity.

4.32 In many ways both taxpayers and government are victims of a system which is in need of radical reform.

Fragmented approach to changes

4.33 The development of tax policy and legislation occurs through the operation of the three processes set out in Figure 4.1: formulating policy, developing legislation and administering the law. While each of these processes requires a separate set of skills, it is apparent that the processes are very closely interrelated.

4.34 The Review sees the development of tax policy and legislation in Australia over recent years as generally being a step-by-step process, with each step performed as a separate and distinct function by one of three different government agencies, lacking both specific accountabilities and sufficient integration.

4.35 Treasury, the ATO and the OPC are all involved in the tax policy and legislation process. Past experience has been that, even with the generally close liaison that occurs between these three agencies of government, tax policy and legislation are often developed in discrete sequences that largely do not overlap. A different agency controls each stage of the policy and legislation process, often with little or no input from the others:

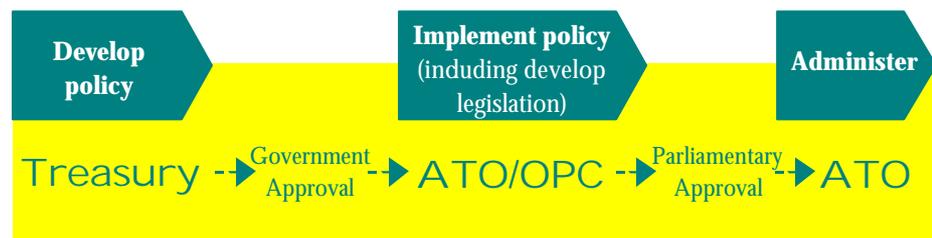
- Treasury is responsible for developing the basic policy to the stage where it can be approved by the government of the day;
- the ATO is responsible for the detailed implementation of policy and legislation, with the significant task of drafting the legislation,

on the basis of ATO advice, being the responsibility of the OPC;
and

- the ATO is also responsible for designing and implementing the systems for administering business tax changes.

4.36 This fragmented approach to the policy formulation and legislative drafting process is broadly as shown in Figure 4.2.

Figure 4.2: Fragmented approach to policy development



4.37 The disadvantages of the sequential approach include the following:

- The separation of roles and responsibilities between three government agencies opens the potential for policy to be developed without a full appreciation of all its implications and its interaction with the wider tax law and tax system. Conversely, practical solutions to technical issues might often compromise policy intentions.
- Without the involvement of all agencies from the outset of development, the various agencies are often required to clarify progressively their understanding of the proposal and its intended effect and application. The separation of agency roles and responsibilities may not create adequate incentives to ensure that such clarification occurs. Where there is inadequate consultation with other stakeholders, this problem will be aggravated.
- The OPC drafters usually enter the process at a late stage, very often after announcement of a policy change.

Inadequate accountability for system performance and review

4.38 Under current arrangements, there is neither a single point of accountability for maintaining the integrity of the business tax system, nor distributed accountabilities for doing so effectively.

4.39 As explained, there are several key players, including the government of the day and the Treasury, the ATO and the OPC. Neither

the Treasury, the ATO nor OPC —acting alone —can ensure, or be held accountable for ensuring, that the original intent of policy is translated into legislation and administered in line with a commonly agreed set of objectives and design principles.

4.40 Each agency acts in accordance with its functions, but the organisational separation of their duties means it is altogether too easy for one of the following three types of undesirable outcomes to occur:

- the original policy intent is preserved but the legislation and administrative systems which support it are complex and unwieldy. A better outcome may have been achieved if all three agencies were involved to a greater degree across all elements of the process;
- the legislation and systems which are developed to support a policy change are misaligned and cannot easily be made to support the original policy intent. Once again this could be the result of inadequate involvement of all three agencies across all elements of the process; or
- poor policies are put into practice as a result of the failure of any agency to take an integrated view of what is intended to be achieved.

Ineffective consultation with the private sector

4.41 There is widespread dissatisfaction with the extent and effectiveness of public consultation in the development of tax policy. The chart at Appendix D shows the numerous bodies with which the ATO consults. These liaison arrangements provide for over 350 representative positions for community consultation. However, these arrangements are largely in relation to administrative matters. While these bodies may raise policy issues they are rarely able to progress them.

4.42 Consideration of the scope for taxpayers to participate in the development of tax policy raises a number of issues. Taxpayers are subject to the direct impact of the policy and their understanding and acceptance of the reasons for that policy would assist with compliance and administration. Further, it is important that the business tax system, in terms of both its policy intent and administrative requirements, is as compatible with commercial practices as possible. Finally, taxpayers can provide crucial information on the likely effect of particular tax measures on their activities.

4.43 For some tax measures, an announcement of intent to change the tax law would allow taxpayers to frustrate the policy intent of the proposed change at significant cost to the revenue. In some cases the timetable or other policy sensitivities constrain the scope for consultation. It is in these

circumstances that the practice of 'legislation by press release' is most likely to occur. While this can be effective in addressing the issues identified above, it gives rise to other problems:

- on most occasions some time will elapse between the announcement of the policy and the release of the legislative details, resulting in a period of uncertainty for taxpayers; and
- where a proposal has not been subject to effective consultation the possibility of unanticipated amendments by Parliament, and consequent uncertainty for taxpayers, are significantly increased.

4.44 The Review recognises that the present opportunities for private sector involvement in the policy development of the business tax system are inadequate. A major challenge therefore is to provide an opportunity for the private sector to participate effectively and constructively in the development of the business tax system.

Other operational concerns

4.45 The Review has found a number of other more operational concerns with the business tax system. Most of these have been compounded by the fundamental problems described above and need to be addressed specifically. Some areas of concern identified by the Review are outlined in Chapter 8.