PS LA 2007/24 - Making default assessments: section 167 of the Income Tax Assessment Act 1936

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Australian Taxation Office

PS LA 2007/24

Making default assessments: section 167 of the *Income Tax Assessment Act 1936*

This Law Administration Practice Statement provides guidelines on making default assessments using the powers under the *Income Tax Assessment Act 1936* (ITAA 1936).

This practice statement is an internal ATO document, and is an instruction to ATO staff.

Taxpayers can rely on this practice statement to provide them with protection from interest and penalties in the following way. If a statement turns out to be incorrect and taxpayers underpay their tax as a result, they will not have to pay a penalty. Nor will they have to pay interest on the underpayment provided they reasonably relied on this practice statement in good faith. However, even if they don't have to pay a penalty or interest, taxpayers will have to pay the correct amount of tax provided the time limits under the law allow it.

1. When may section 167 be used?

Section 167 of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] allows the Commissioner to make an assessment of the amount on which, in his judgment, income tax ought to be levied. That amount becomes the person's taxable income for purpose of section 166 of the ITAA 1936.[2]

It can be used where:

- a person defaults in lodging a return
- if we are not satisfied with the return a person has lodged
- we have reason to believe a person who has not lodged a return has derived taxable income.

Such an assessment is called a 'default assessment'.

Note: the principles relating to section 167 mentioned in this practice statement should also be applied to similar provisions, such as section 73 of the *Fringe Benefits Tax Assessment Act 1986*, where appropriate.

Refer also to Law Administration Practice Statement PS LA 2007/10 *Making default assessments: section 36 of the Superannuation Guarantee (Administration) Act 1992*.

2. Making default assessments – general principles

In making a default assessment, you must ensure that:

- you are authorised to do so
- your decision is fair and made in good faith
- your decision has been made independently, and not at the direction of a third party, such as another government agency (see also section 6)
- the assessment is valid (see section 3)
- your decision is based on reasonable grounds, and is defensible (see section 5)
- there is sufficient information to support your decision
- you have considered all the relevant individual circumstances in accordance with the law
- that you have considered the commitments made in the Taxpayers' Charter and the principles of the compliance model.

3. Making a valid default assessment

A default assessment is subject to the same legal principles as any other assessment in order to be valid, that is:

- the assessment must be the result of an 'act or operation of the Commissioner'[3]
- the assessment must lead to an ascertainment of the taxpayer's taxable income and the tax payable thereon[4]
- you must consider all relevant circumstances including our view
- the assessment must be definitive in character, and not tentative or provisional[5]

[1] All legislative references in this practice statement are to the ITAA 1936, unless otherwise indicated.
[2] Under sections 166, 168 and 170. Amendment of assessments remains subject to the time limits in section 170.
[3] *R v. Deputy Commissioner of Taxation, ex parte Hooper* (1926) 37 CLR 368, at 373 per Isaacs J.
[4] *R v. Deputy Commissioner of Taxation, ex parte Hooper* (1926) 37 CLR 368.
[5] *Federal Commissioner of Taxation v. sec Hoffnung & Co Pty Ltd* (1928) 42 CLR 39, *FJ Bloemen Pty Ltd and Simons v. Federal Commissioner of Taxation* (1981) 147 CLR 360.

- the assessment notice must be served on the taxpayer.

Relevant legal cases with respect to default assessment are provided in the '**More Information'** section of this practice statement.

The combined effect of sections 175 ITAA 1936 and item 2 of subsection 350-10(1) TAA 1953[6] (formerly subsection 177(1) ITAA 1936) means that provided we have made a **genuine attempt** to ascertain the taxpayer's taxable income, the taxpayer cannot challenge the assessment except under a Part IVC TAA 1953 objection.

Errors in calculating a taxpayer's taxable income during the process of making the default assessment do not mean that the assessment is invalid. The Commissioner is not limited to using a particular methodology to calculate an amount on which to tax the taxpayer as long as he has undertaken a logical process by which he has arrived at an amount the assessment is valid.

Circumstances that do not amount to a genuine attempt to assess include simply plucking a figure from the air, or is made upon no intelligible basis. A genuine attempt will arrive at a definitive taxable income for the taxpayer. The fact that an assessment may be amended later (for example, on the provision of further information) or that alternative assessments are issued does not mean that it is not definitive.

An assessment will be invalid if it is motivated by an improper or collateral purpose (for example, if it is issued to cause a taxpayer to talk to us, or is based on facts that are known to be untrue).

4. Gathering the information to make the default assessment

The following sources should, depending on the circumstances, be used to obtain the information required to make the assessment.

The taxpayer

The taxpayer is the best starting point for information because they should possess information about their own taxation affairs.

Note: different procedures may be adopted if the audit is being undertaken without informing the taxpayer, for example due to safety concerns or the audit is being conducted covertly.

Taxpayers who have not kept records cannot use this as the basis of an objection.[7] The Courts have said:

> 'In the absence of some record in the mind or in the books of the taxpayer, it would often be quite impossible to make a correct assessment. The assessment would necessarily be a guess to some extent, and almost certainly inaccurate in fact. There is every reason to assume that the legislature did not intend to confer upon a potential taxpayer the valuable privilege of disqualifying himself in that capacity by the simple and relatively unskilled method of losing either his memory or his books.'[8]

In cases where the taxpayer's records have been lost or destroyed, you should note the policy in Law Administration Practice Statement PS LA 2011/25 *Reconstructing records and making reasonable estimates for taxpayers affected by disaster*.

Third parties

Where complete information may not be available from the taxpayer, you can seek to obtain information from third parties, including but not limited to:

- Australian government agencies, such as other Commonwealth agencies, local Council authorities, Utilities providers, transport departments
- employers, commercial entities, financial institutions
- foreign governments (subject to applicable tax treaties)
- information provided to us by the public.

Formal access powers

The Commissioner's formal access powers may be used in appropriate circumstances to obtain information from the taxpayer or third parties. You should follow the guidelines in *Our approach to information gathering* when seeking to use these powers.

5. Determining reasonable grounds on which to make the assessment

When making a default assessment, you should generally make allowance for usually incurred deductions. However, due to the nature of a default

[6] Section 175 protects the validity of an assessment in the event of non-compliance with provisions of the Act. Section 350-10 of Schedule 1 to the *Taxation Administration Act 1953* (TAA) provides the production of a notice of assessment is conclusive evidence of making that assessment.

[7] *Stone v. Federal Commissioner of Taxation* (1918) 25 CLR 389.

[8] Latham CJ; *Trautwein v Federal Commissioner of Taxation* (1936) 56 CLR 63 at 87.

assessment it is not necessary to calculate assessable income and then applicable deductions; depending on the circumstances it may be entirely appropriate for you to make a direct judgment of taxable income.

Reasonable grounds on which a default assessment may be made include:

- information provided by third parties
- information obtained from data matching
- the application of industry benchmarks
- relevant economic statistics – for example Australian Bureau of Statistics cost-of-living figures[9]
- extrapolation from previous year returns.

Indirect audit methodologies, including 'T' accounts and asset betterment calculations, have been upheld by the courts as proper bases on which an assessment may be raised.

6. Documenting your decision

You must accurately document the basis on which the default assessment is made. The importance for doing so underlies our ability to rebut claims the assessment was not validly made or is excessive.

You must also record all dealings with third parties, including other government agencies. Keeping accurate contemporary records should reflect the fact that the assessment is made solely for income tax law purposes. Failure to do so may give rise to the risk of an allegation that the assessment was made for an improper purpose.

7. Interaction with prosecution

Non-lodgment of income tax returns is pursued through the reminder correspondence, final notice and prosecution actions.[10]

However, it may be appropriate to issue default assessments instead of enforcing lodgment in the following circumstances:

- where there is a risk that a taxpayer would remove themselves or their assets from Australia (that is, in conjunction with issuing a departure prohibition order or seeking a freezing order/Mareva injunction)
- where there is a risk that money available to satisfy the tax debt would become irrecoverable unless garnishee action was taken
- where it appears that a taxpayer will pay fines resulting from prosecution action, but continues not to lodge outstanding returns
- where non-lodgment is rife in a particular industry or occupation, or as a result of a scheme or arrangement, there may be significant administrative advantages in making default assessments
- where an independent decision based on whole-of-government initiatives indicates issuing a default notice is more appropriate.

Once a default assessment has been made we would not normally continue with prosecution action. However a default assessment can be made after prosecution for non-lodgment if the taxpayer has subsequently failed to comply with the court order to lodge.

Note: you should consult the ATO officer in charge of the prosecution before raising a default assessment.

8. Applying penalties

You need to consider the application of administrative penalties when making a default assessment. Refer to Divisions 284 and 286 of Schedule 1 to the TAA 1953 and Law Administration Practice Statement PSLA 2014/4 *Administration of the penalty imposed under subsection 284-75(3) of Schedule 1 to the Taxation Administration Act 1953*.

9. Notifying the taxpayer

In accordance with usual audit practices you should advise the taxpayer that you intend to raise a default assessment and provide them with the opportunity to comment on that proposed default assessment.

Note: even if you make adjustments based on any information a taxpayer provides it is still a default assessment.

It may not always be appropriate to give a taxpayer advance notice of your intention to issue a default assessment. Such instances include:

- where the taxpayer poses a flight risk
- where there is a risk of the dissipation of assets, such as the transfer or movement of liquid assets/funds, especially out of Australia
- where the default assessment is used in conjunction with another tax remedy, such as a departure prohibition order, or where there is a personal safety risk to an ATO officer, for

[9] See *Favaro v. Federal Commissioner of Taxation* (1996) 34 ATR 1 at 6; *Gamini Bus Co Ltd v. Commr of Income Tax, Colombo* (1952) AC 571; (1952) TR 44 and *Case B1* (1951) 2 TBRD.

[10] See TPLSES – Non-lodgment prosecution guidelines.

example in audits of taxpayers linked to organised crime.

10. Debt collection issues

You should contact the Debt business line to discuss collection and any associated risks as early as possible **before** issuing a default assessment. Debt needs information on any identified assets in order to maximise the likelihood of collection and recovery.

11. Review and objection rights

A taxpayer has the usual internal and external review and objection rights including objecting against a default assessment (per the usual Part IVC TAA 1953 process).

12. Examples

Example 1 – unexplained deposits

A taxpayer who has not lodged any income tax returns has used funds sourced from a series of significant cash bank deposits over several years to pay for living expenses for himself and his family. The taxpayer has provided several unsatisfactory explanations for these deposits. A default assessment under section 167 is made for the amounts of unexplained deposits in each year as taxable income. The assessment does not include any allowable deductions based on the insufficient evidence concerning the source of the funds.

Example 2 – asset betterment / 'T' account

A taxpayer has lodged returns for a number of years disclosing consistent losses from business activities. An audit of the taxpayer's affairs reveals a significant increase in the value of the taxpayer's assets and evidence of a lavish lifestyle inconsistent with the reported ongoing losses. The taxpayer is uncooperative. An indirect financial analysis is conducted ('T' account) which quantifies the shortfall of non-disclosed business income on which to raise a default assessment.

Example 3 – extrapolation from prior year returns and third party information

A taxpayer failed to lodge returns for several years. The last two lodged returns contain stable income details for the taxpayer's business activity. Following a lack of response, the ATO uses third party information to confirm the taxpayer is still conducting the same business. Section 167 default assessments, based on an extrapolation of the previous tax returns (taking into account assessable income and allowable deductions) and increased by the ABS inflation rate for the relevant periods, are raised. The ATO officer also advises the Debt business line of the third parties with whom the taxpayer is apparently trading in order to aid debt collection activity.

Example 4 – use of external economic statistics

Australian Transaction Reports and Analysis Centre (AUSTRAC) identifies large sums of money being sent offshore to a tax secrecy jurisdiction. The taxpayer did not offer a credible explanation for the transactions nor provided any details of returns on these funds. After considering the evidence, the taxpayer is assessed on the unexplained funds that were transferred offshore as taxable income. Additionally, ABS data is used on net return on foreign investments to calculate the taxpayer's taxable (not assessable) income and section 167 default assessments are raised.

Example 5 – lost records for individual

A self-employed individual taxpayer's taxation records were destroyed by a fire at the business premises. The taxpayer was unable to easily reconstruct them as they largely related to cash receipts and payments. The taxpayer had a good compliance history and a reasonably stable taxable income over the prior five years. As a result the ATO officer responsible for the taxpayer's lodgment enforcement case decided to issue a section 167 default assessment for the relevant financial year. The ATO officer contacted the taxpayer and discussed an appropriate basis for calculating the taxpayer's taxable income, including the taxpayer's estimates of their assessable income and allowable deductions. The ATO officer raised a default assessment on the basis agreed with the taxpayer (which was the average of the last three years' taxable income).

13. More information

- For judicial interpretation on valid assessments generally and default assessments under section 167, see:
  - *Bailey v. Federal Commissioner of Taxation* (1977) 136 CLR 214
  - *Briggs (No 2)* 87 ATC 4278

- *Case B1* (1951) 2 TBRD
- *Commissioner of Taxation v. Dalco* [1990] HCA 3; (1990) 168 CLR 614; 90 ATC 4088; (1990) 20 ATR 1370
- *Darrell Lea Chocolate Shops Pty Ltd v. FCT* (1996) 72 FCR 175
- *Eldridge v. Federal Commissioner of Taxation* 90 ATC 4907
- *Favaro v. Federal Commissioner of Taxation* (1996) 34 ATR 1
- *Gamini Bus Co Ltd v. Commr of Income Tax, Colombo* (1952) AC 571; (1952) TR 44
- *Gashi v. Commissioner of Taxation* [2013] FCAFC 30
- *George v. Federal Commissioner of Taxation* (1952) 86 CLR 183
- *Madden* 96 ATC 4268
- *Martin v. FCT* 93 ATC 5200, (1993) 27 ATR 282
- *McAndrew v. Federal Commissioner of Taxation* (1956) 98 CLR 263
- *McCleary v. Commissioner of Taxation* 97 ATC 4266
- *Rigoli v. Commissioner of Taxation* [2014] FCAFC 29
- *R v. DCT (WA); Ex Parte Briggs* 87 ATC 4278; (1987)18 ATR 570
- *Stone v. Federal Commissioner of Taxation* (1918) 25 CLR 389
- *Trautwein v. FCT* (1936) 56 CLR 63

- For guidelines on our formal access powers, see Our approach to information gathering
- Relevant policies in relation to administrative penalties, see:
  - PS LA 2012/4 *Administration of penalties for making false or misleading statements that do not result in shortfall amounts*
  - PS LA 2012/5 *Administration of penalties for making false or misleading statements that result in shortfall amounts*
  - PS LA 2011/19 *Administration of the penalty for failure to lodge*
  - TR 94/3 *Income tax: tax shortfall penalties: calculation of a tax shortfall and allocation of additional tax*
  - TR 94/7 *Income tax: tax shortfall penalties: guidelines for the exercise of the Commissioner's discretion to remit penalty otherwise attracted*
- Other
  - Taxpayers' Charter
  - TPLSES – Non-lodgment prosecution guidelines

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