

The rule of law and the model litigant rules

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The quality of the ATO's compliance with the rule of law and model litigant rules determines the public's confidence in it as an institution.



In short, in matters vegetable, animal, and mineral, I am the very model of a modern Major-General.¹

Introduction

The conduct of the Australian Taxation Office (ATO) in administering audits and test cases, purportedly restricting the application of court decisions favourable to the taxpayer and pursuing public identities through Project Wickenby, has resulted in much public criticism.

Current² and former judges³ have debated, the Inspector-General of Taxation (IGOT)⁴ has investigated, and public identities have lamented the scope of, and compliance by the ATO with, the rule of law and the Commonwealth model litigant rules.

The public criticism should not be lightly dismissed because, in a democracy, public order and the rule of law are maintained by “public confidence in the institutions which promulgate and administer it”.⁵

The essential criteria for assessing a taxation system are equity, efficiency and simplicity.⁶ Compliance with the rule of law and the model litigant rules are fundamental to equity, efficiency and simplicity.

This article considers the debate regarding the scope of and compliance by the ATO and the Victorian State Revenue Office (VSRO) with the rule of law and the model litigant rules. This article also provides examples to facilitate discussion.

Legislative references are to the *Income Tax Assessment Act 1936* (ITAA36), the *Tax Administration Act 1953* (TAA53), the *Judiciary Act 1903* (JA03) and the *Administrative Appeals Tribunal Act 1975* (AATA75).

The rule of law

Introduction

The rule of law manifests itself as the doctrine of the separation of powers and the binding force of court precedent.⁷

As an arm of the executive government, the ATO is expected to adhere to the separation of powers inherent in Australia's governmental structure and to act, and be seen to act, in accordance with the rule of law. However, the rule of law is ultimately an abstract political ideal, the scope and content of which is unclear. Similarly, there is much debate regarding the extent to which separation of powers is facilitative of good governance.

Separation of powers

Separation of powers, as an ideal, is the division of the institutions of government into three branches: the legislature, the executive and the judiciary.⁸ In relation to the administration of taxation law, separation of powers requires generally that “the Parliament's role is to enact the tax laws, the courts' role is to interpret these laws and the Tax Office's role is to administer the laws”.⁸

At a Commonwealth level, separation of powers is established by the conferral of governmental power on three separate institutions under the Commonwealth Constitution.⁹

At a state level, the separation of powers can be legislated in a constitution or applied by the Westminster System conventions. In Victoria, the separation of powers is less engrained but does have statutory basis through Pt III of the *Constitution Act 1975* (Vic) and s 6 of the *Interpretation of Legislation Act 1984* (Vic).¹⁰

The rule of law is often equated only with maintaining the separation of powers. Other ideals also commonly considered to be requirements of the rule of law include:¹¹

- the accountability requirement, that is, that government should be held accountable for its decisions and that persons affected by government decisions should have recourse to an independent arbiter to determine the legitimacy of decisions;
- the impartiality requirement, that is, the manner in which the law is administered should not be dictated by personal, moral or political views; and
- the equality requirement, that is, all persons should be treated as equal before the law.

The doctrine of stare decisis

Under the doctrine of stare decisis (to stand by decided matters), the decision of higher courts are binding authority on lower courts within the same legal jurisdiction, the decision of courts of other jurisdictions are persuasive only and depends on the relative level of the foreign court to the court in the jurisdiction. The ratio decidendi (core reasons of deciding) of the case is binding, and obiter dicta (other statements) of the case are persuasive only. The circumstances in which the highest court can overrule itself are limited.¹²

Much debate arises regarding whether a particular statement or principle is binding or persuasive only and the extent to which the ATO is bound by court decisions favourable to the taxpayer.

Conclusion

Resolving the disparity in views cannot occur because there is unlikely to be common agreement as to the scope and obligations of the rule of law.

Model litigant rules

ATO's obligation

The ATO has an obligation to act as a model litigant in its conduct of litigation because the ATO is an agency of the Commonwealth Government.¹³

The *Legal Services Directions* (directions) set out the conduct required of a model litigant. The directions require the ATO to act honestly and fairly in handling claims and litigation by:¹⁴

- dealing with claims promptly and not causing unnecessary delay;
- assessing the ATO's prospects of success and potential liability at an early stage;
- paying legitimate claims without litigation if it is clear that the ATO's liability is at least as much as the amount to be paid;
- handling claims and litigation consistently;
- endeavouring to avoid, prevent and limit the scope of legal proceedings where possible, including consideration of alternative dispute resolution procedures;
- keeping the costs of litigation to a minimum by not requiring proof of any fact which the ATO knows to be true, not contesting liability if the ATO knows that the dispute is about quantum, and considering resolution of litigation by settlement or alternative dispute resolution where appropriate;
- not taking advantage of a claimant who lacks the resources to pursue a legitimate claim;
- not relying on technical defences unless the ATO's interests would be prejudiced by the technical deficiency;
- not undertaking and pursuing appeals unless the ATO believes that it has reasonable prospects of success or the appeal is justified in the public interest; and
- apologising where the ATO or its lawyers have acted wrongfully or inappropriately.

The directions apply to both tribunal proceedings and litigation, and to both merits review and judicial review.¹⁵ In respect of merits review proceedings, the ATO is obliged to use its best endeavours to assist the tribunal to make a decision.¹⁶

As a legislative instrument, the directions impose legally enforceable obligations on the ATO. However, only the Attorney-

General can bring an action for non-compliance with the directions,¹⁷ and the issue of non-compliance with the Directions cannot be raised in any proceeding, unless raised on behalf of the Commonwealth.¹⁷

The model litigant rules can be used with limited success to negotiate with the ATO regarding non-compliance, but there is no private action for taxpayers to enforce the directions.

VSRO's obligation

Victoria has also adopted model litigant guidelines (guidelines) similar to the directions, which apply to departments and agencies of the state of Victoria and set out similar expectations with respect to the conduct expected of government departments and agencies.¹⁸

The guidelines require the VSRO:

- to act fairly in handling claims and litigation brought by or against the state or an agency;
- to act consistently in the handling of claims and litigation;
- to avoid litigation, wherever possible;
- to pay legitimate claims without litigation, including making partial settlements of claims or interim payments, where it is clear that liability is at least as much as the amount paid;
- where it is not possible to avoid litigation, to keep the costs of litigation to a minimum, including by:
 - not requiring the other party to prove a matter which the state or the agency knows to be true; and
 - not contesting liability of the state or the agency when the dispute is really about quantum;
- to not rely on technical defences unless the state's or the agency's interest would be prejudiced by the failure to comply with a particular requirement;
- to not take advantage of a claimant who lacks the resources to litigate a legitimate claim; and

to not undertake and pursue appeals unless the state or the agency believes that it has reasonable prospects for success or the appeal is otherwise justified in the public interest.

Unlike the directions, the guidelines take the form of a policy document, and do not provide an avenue for any legal enforcement. However, the general principles found in the guidelines are

recognised by the courts and can be used with limited success in negotiations.¹⁹

Examples for discussion

Approach to judicial precedent

The ATO considers that it is not bound by single judge decisions.²⁰ The ATO's view is based on advice received from the Attorney-General's Department that:²¹

"An administrator is not part of the judicial hierarchy, and is not bound by the doctrines of precedent as is a lower court. Accordingly, in appropriate circumstances, it would be legitimate for (the agency) to depart from existing judicial decisions in order to produce a further test case seeking to overturn those decisions and uphold (the agency's) view as to the correct legal position."

The Solicitor-General's advice is subject to a number of caveats, including that the ATO should only depart from a decision of a single judge where the ATO had received legal advice that the decision was wrong (which advice may be internal advice).²²

It was stated by the Solicitor-General that the conduct of the ATO in departing from judicial precedent would not be inconsistent with the rule of law as "the rule of law is maintained by the amenability of each administrative decision made to correction by the courts on the grounds of legal error".²³

Justice McHugh, writing extra judicially, also expressed the view that:

"Judicial decisions are not provisional rulings until confirmed by the ultimate appellate court in the system. Until set aside, they represent the law and should be followed. Moreover the Executive can run into serious legal problems where it continues to enforce legislation that a court has ruled invalid [see *Owen v Tuner* (1989) 19 ALD 550]. Even more difficult to justify is the refusal to follow a ruling that is not the subject of appeal merely because the agency regards it as wrong and will test it at the next opportunity. The Attorney-General's Department has said that an agency should act inconsistently with a court ruling only on the advice of the Attorney-General's Department. One hopes that this advice is followed meticulously."²⁴

The fundamental theoretical criticism of the ATO position is that the ATO's disregard for single judge decisions demonstrates disregard for the fundamental principles underlying the rule of law.

Commentators have criticised the ATO position for several reasons.

First, the policy of not following final decisions of a court demonstrates disregard for the separation of powers

doctrine. The ATO's advice is correct in that the ATO is not subject to judicial precedent because of judicial hierarchy; the ATO is not part of the judiciary. However, the ATO is bound by judicial precedent as are all Australians because it is judiciary's function to determine how the laws are to be interpreted and, in relation to the ATO, to ensure that the ATO's powers are only exercised within the limits of the powers conferred on the ATO. Judicial determinations are the only means through which the judiciary is able to fulfil this function; therefore, they must necessarily be binding.

Second, the policy of not following final decisions of a court demonstrates a disregard for the principal that all persons should be treated as equal before the law, being one of the ideals of the rule of law.

Practically, the administration of tax law is brought into disrepute because of the contradiction in the ATO's view that it may act reasonably by relying on internal legal advice, but for a taxpayer: "Using the services of a tax agent or tax adviser does not of itself mean that an entity discharges the obligation to take reasonable care."²⁵

Also, the equity, efficiency and simplicity objectives of the tax law administration are undermined. This approach exposes taxpayers to unnecessary legal proceedings which are costly and time-consuming. Arguably, this issue can be addressed by test case litigation funding (discussed below).

Further, the approach "exposed taxpayers during that period to the risk of wrongful assessments and penalties, and the ATO's approach probably also deterred a number of honest taxpayers and advisors from using what turned out to be a perfectly legitimate tax minimisation technique".²⁶

FCT v Indooroopilly Children's Services (Qld) P/L

The ATO's view arose from its administration of employee benefit trust administration. In a series of judgments, single judges of the Federal Court of Australia had consistently stated that fringe benefits tax did not apply to the arrangement.²⁷

The ATO maintained this position, despite four prior single judge decisions stating that the ATO view was wrong in *FCT v Indooroopilly Children's Services (Qld) P/L*.²⁸ The ATO's submission to the court that the ATO was not bound to follow single judge decisions²⁹ elicited the following response from Justice Allsop:³⁰

"3. I wish, however, to add some comments about the attitude apparently taken by, and some of the submissions of, the appellant. From the material that was put to the Full Court, it was open to conclude that the appellant was administering the relevant revenue statute in a way known to be contrary to how this Court had declared the meaning of that statute. Thus, taxpayers appeared to be in the position of seeing a superior court of record in the exercise of federal jurisdiction declaring the meaning and proper content of a law of the Parliament, but the executive branch of the government, in the form of the Australian Taxation Office, administering the statute in a manner contrary to the meaning and content as declared by the Court; that is, seeing the executive branch of government ignoring the views of the judicial branch of government in the administration of a law of the Parliament by the former. This should not have occurred.

...

6. Considered decisions of a court declaring the meaning of a statute are not to be ignored by the executive as *inter partes* rulings binding only in the earlier *lis*. As Mahoney J (as his Honour then was) said in *P & C Cantarella v Egg Marketing Board* [1973] 2 NSWLR 366 at 383:

'The duty of the executive branch of government is to ascertain the law and obey it. If there is any difficulty in ascertaining what the law is, as applicable to the particular case, it is open to the executive to approach the court, or afford the citizen the opportunity of approaching the court, to clarify the matter. Where the matter is before the court it is the duty of the executive to assist the court to arrive at the proper and just result.'

7. There was some inferential suggestion in argument that the appellant was somehow bound by legislation (not specifically identified) to conduct his administration of the relevant statute by reference to his own view of the law and the meaning of statutory provisions, rather than by following what the courts have declared. It only need be said that any such provision would require close scrutiny, in particular by reference to issues raised by s 15A of the *Acts Interpretation Act 1901* (Cth)."

The ATO's disregard for single judge decisions has also been the subject of criticism from the IGOT, who reported that: "Any Tax Office behaviour of not following the legal principles set by court decisions can be perceived to be in breach of the principles of the rule of law."³¹

The ATO's approach is also inappropriate in light of the obligation on the ATO to act as a model litigant³² because the ATO is obliged under the model litigant guidelines

not to undertake and pursue appeals unless the ATO believes it has reasonable prospects of success. Arguably, there was little prospect of success since the weight of judicial precedent was clearly against the ATO.

CSR (Vic) v Landrow Properties P/L

A similar criticism can be extended to the VSRO approach in respect of land rich stamp duty. The VSRO lost the decision in *CSR (Vic) v Landrow Properties P/L*³³ and did not appeal the case. The VSRO issued a bulletin³⁴ stating that it did not agree with the decision and, based on counsel's advice, the VSRO would not appeal that decision because it was not a suitable case and would instead select another matter to retest the same issues.

The bulletin stated:

"The Commissioner respectfully agrees with their honours that the taxpayer's interpretation of the legislation subverts its purpose, but respectively disagrees that that interpretation is nevertheless correct ...

The Commissioner did not apply to the High Court for special leave to appeal the decision. He was advised that it was an inappropriate vehicle for special leave, due to the factual matter identified by the Court of Appeal at paragraph 70 of its judgment (that in any event Heeni arguably did not 'obtain' anything by virtue of the particular transaction).

The Commissioner will take immediate steps to bring forward an appropriate vehicle to have the issue reviewed."

Interestingly, the VSRO does not have a test case litigation funding program to defray the costs to the taxpayer of this approach. In a subsequent matter,³⁵ the VSRO refused to defray the costs to the taxpayer of the litigation. The tribunal held:³⁶

"103 The Commissioner relies upon the provisions in the Schedule to the VCAT Act as relieving him from any obligation to pay or offer to pay the Applicants' costs. Furthermore the Commissioner states that he has no general or civic obligation to pay the Applicants' costs where there are grounds in the objection, other than the *Landrow* ground of objection.

104 Counsel for the Applicants submitted that, in light of the foregone conclusion represented by this proceeding, it is most unsatisfactory that the Commissioner has refused to meet the Applicants' costs of the proceeding. The fact that the Applicants must succeed because of the *Landrow* case is a sufficient, and a compelling,

reason for the Commissioner to pay the costs of the Applicants. Counsel further submitted that in any other costs-awarding jurisdiction a party who pursued an indefensible position would be at risk of a costs award on an indemnity basis.

105 Although there is no authority in the Tribunal to award costs in this kind of case, I endorse the submissions made on behalf of the Applicants. The Commissioner has disallowed the Applicants Notice of Objection with the ulterior motive of setting up this proceeding for a test case. While there are important legal issues to explore at the appellate level and the financial ramifications for the Commissioner and the revenue base are potentially very significant, there is no justification for the Applicants being obliged to meet their own costs. The fact that there were alternative grounds also argued by the Applicants does not undermine their position in relation to costs. In view of the Commissioner's foreshadowed appeal, the Applicants were obliged to raise alternative grounds as insurance against the possibility that the principle in the Landrow case is ultimately overturned."

Accordingly, an appropriate costs order may mitigate at least the expense criticism of this approach to the rule of law.

Test case litigation program

The ATO has a test case litigation program under which the ATO will "provide financial assistance to taxpayers whose litigation is likely to be important to the administration of Australia's revenue and superannuation systems".³⁷ The aim of the program is to develop legal precedent to clarify the operation of laws where there is uncertainty or contention.³⁷ Unfortunately, the program does not effectively mitigate the costs of the ATO's approach to the rule of law.

In order to obtain funding through the test case litigation program, a taxpayer is required to apply for funding and have the application approved by the ATO's test case litigation panel.³⁸ The ATO's criteria for determining whether a case is eligible for test case funding are:

- the nature of the issue – the issue is one about which there is uncertainty or contention about the law;
- the importance of the issue – the issue is of significance to a substantial section of the public or has significant commercial implications for an industry;
- the consequence of the issue – if it is in the public interest for the issue to be litigated;

- the forum for the dispute – the ATO's preference being for Federal Court litigation;
- the applicant's financial capacity to pursue litigation; and
- whether there is any tax avoidance scheme involved (tax avoidance matters generally being considered unsuitable).

“... the ATO's disregard for single judge decisions demonstrates disregard for the fundamental principles underlying the rule of law.”

While the test case litigation program may mitigate at least the expense, inequity and accountability criticisms of the ATO's approach to the rule of law, test case litigation funding has its limitations. The test case litigation program is only effective to mitigate the ATO's approach to the rule of law if implemented by the ATO in a liberal and impartial manner.

The eligibility criteria for test case funding limit its liberal use as a means to mitigate the costs of the ATO's approach to the rule of law. Further, the ATO has been criticised as using litigation as a means of validating its interpretation of legislation and ensuring that taxpayers comply with its view of the law, rather than as a means of clarifying the meaning of the law so that community perceptions that, at times, the ATO has a "win at all costs" approach to litigation is justified.³⁹

In PS LA 2009/9, the ATO also states that "the Tax Office will have regard to its strategic focus, the desire to obtain law clarification in a timely, cost effective manner which provides greater certainty for the community"⁴⁰ when choosing the matters which are to be test case funded. That the ATO sees its own strategic focus as a central determiner of eligibility is concerning because it means that funding decisions are made on political rather than legal or meritorious grounds, which is inconsistent with the impartiality requirement of the rule of law.

The selection procedures are not the only problem with the current implementation of the test case funding program. As a condition of funding, the ATO limits the

grounds which the taxpayer is able to argue. The perceived or actual threat of losing funding may impede the proper representation and ventilation of all the issues.

Often a condition of funding is that the taxpayer must abandon its rights to anonymity in the Administrative Appeals Tribunal.⁴¹ Again, this is an impediment to

general proper ventilation of the issues or it may deter the pursuit of legitimate claims.

Arguably, this requirement is inconsistent with both the ATO's obligation as a model litigant not to take advantage of a claimant who lacks the resources to pursue a legitimate claim and its obligations under the rule of law because it restricts the arguments a taxpayer can put in their defence. Arguably, the ATO is limiting the taxpayer's prospects of success and the extent to which the courts can consider the legitimacy of the ATO's decision.

Access and information-gathering powers⁴²

The Rule of Law Institute of Australia has criticised the ATO's use of its access and information-gathering powers as a breach of the rule of law and natural justice.⁴³

The ATO has very broad powers to investigate compliance with tax legislation. The ATO's powers include coercive powers to access information and documents for tax purposes, such as by:

- entering premises;⁴⁴
- demanding the provision of information in writing or by interview;⁴⁵
- demanding the provision of documents;⁴⁶ and
- issuing an offshore information exchange demand for documents which affects the admissibility of documents not produced in response to the notice.⁴⁷

The ATO's use of its access powers was the subject of a Commonwealth Ombudsman's inquiry in 2010 which found that: "There is scope for the ATO to improve in the areas of transparency and

public accountability”.⁴⁸ As a result, the ATO agreed to report on its use of access without notice powers only, reporting that, in the 2009-10 financial year, the ATO access without notice power was exercised 10 times.⁴⁹

The ATO’s access powers do not override a taxpayer’s rights to legal privilege, or public interest immunity, but do override the privilege against self-incrimination and spousal privilege.⁵⁰ The ATO has published guidelines regarding how it will administer its access and information-gathering powers. The guidelines include a section on maintaining privilege, and give a limited administrative concession for accountant’s privilege.⁵¹

However, how the ATO assesses its compliance with these obligations and compliance with the rule of law is unclear, given the admission that: “We cannot provide statistics on how often our section 264 powers have been used over the past five years. This is because our use of the subsection 264(1) power, requiring the furnishing of information, is mostly used routinely.”⁵² There has been continuing uncertainty regarding the scope of these access powers.⁵³

Taxpayers who are the subject of the ATO’s use of its access and information-gathering powers, and who feel that their rights to privilege or confidentiality have been infringed, should consider their judicial review rights based on the obiter dicta statements in *Stewart v DCT*.⁵⁴

Stewart v DCT concerned the much-publicised exercise of the ATO access powers in the Paul Hogan investigation. Paul Hogan and his advisers argued that the ATO had exercised its statutory powers to access accounting advice in a manner which was not procedurally fair. In that case, Perram J commented that, had the ATO’s *Guidelines to Accessing Professional Accounting Advisors’ Papers* (accounting guidelines) applied to documents obtained from third parties or had the documents been obtained directly from Paul Hogan, the ATO’s exercise of its access powers would have been invalid because the ATO’s conduct was procedurally unfair.⁵⁵

Stewart v DCT indicates that remedies may be available to a taxpayer if the ATO has breached the taxpayer’s right to procedural fairness.⁵⁵ The basis for procedural fairness in *Stewart* was that the exercise of the access power “threatens to degrade the confidentiality of a subject’s private affairs” in circumstances where “the decision

maker has indicated that the confidentiality will be kept intact unless a particular procedure is followed”.⁵⁶

The decision in *Stewart* also provides guidance on how taxpayers should interact with the ATO, if the subject of the ATO’s access powers, in order to preserve any judicial review rights.

First, *Stewart* indicates that a taxpayer’s rights to make a claim based on procedural fairness are, based on the ATO’s current accounting guidelines, greater where the documents are provided to the ATO directly by the taxpayer. Therefore, taxpayers should avoid referring the ATO to third parties to obtain documents.⁵⁵

Second, *Stewart* states that, where a taxpayer is offered the right to make submissions on whether the ATO’s use of its access powers is legitimate, the taxpayer must respond to that request in order to retain any argument that their rights to procedural fairness have been infringed.⁵⁷

The extent of the profession’s concern with the manner in which the ATO is using its powers and not following administrative procedures and court guidance has resulted in IGOT’s *Review into the ATO’s large business audit and risk review policies, procedures and practices*⁵⁸ and the *Review into the ATO’s small and medium enterprise audit and risk review policies, procedures and practices*.⁵⁹

The government is reviewing the accountant’s rights to claim privilege in order to provide better protection to accountants.⁶⁰

The regular and routine use of these coercive powers increases the exposure of taxpayers to breaches of the rule of law. Hopefully, the government’s review of the accountant’s guidelines will address the ATO’s approach to the rule of law.

Conclusion

The ATO’s approach to administering the rule of law and the model litigant rules has been extensively criticised, justified and defended. Compliance with the rule of law and the model litigant rules are fundamental to equity, efficiency and simplicity.

While the model litigant rules can be used with limited success to negotiate with the ATO and the VSRO regarding non-compliance, there is no private action for taxpayers to enforce the model litigant rules.

The importance of the ATO compliance with the rule of law and the model litigant rules to taxpayers and tax advisers is clear

from the number of government agency investigations and reports conducted or being conducted on the issues.

Hopefully, the public discussion of these issues will assist in defining and refining the principles surrounding the ATO’s approach to the rule of law and the model litigation rules which would provide better equity, efficiency and simplicity in the administration of taxation laws.

The ATO’s publication of binding accounting guidelines and test case litigation program could be used as tools to facilitate the ATO’s fulfilment of its obligations under the rule of law and as a model litigant and improve the public perception of the ATO.

The question which needs to be asked in light of the above analysis is how the ATO can better utilise the tools available to it to comply with its obligations under the rule of law and as a model litigant to improve public perceptions of the ATO while still pursuing its obligations as the collector of revenue.

Whatever the answer to that question, it is essential that the ATO identifies a means to balance these obligations in a manner which elicits public confidence in the ATO.

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