

Review of the Tax Office's administration of GST audits for large taxpayers

A report to the Assistant Treasurer

22 January 2008

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22 January 2008

The Hon Chris Bowen MP
Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Assistant Treasurer

I am pleased to present to you my report on findings and recommendations in respect of the review of the Tax Office's administration of Goods and Services Tax (GST) audits for large taxpayers. This report has been prepared under section 10 of the *Inspector-General of Taxation Act 2003* (the Act).

I have provided the Commissioner of Taxation with the opportunity to respond to the report's findings and recommendations. The Tax Office's response, including the relevant covering letter, is in Appendix 2 to the report. In finalising the report, I have fully considered the Tax Office's response.

The Tax Office agrees with 12 out of 14 recommendations. The Tax Office's positive approach and response to this review should result in significant improvements to tax administration. The Tax Office has acknowledged the need for more detailed and transparent reporting of the nature of its GST audit results in the large market. It has also confirmed there is a need to improve its approaches to cases dealing with margin scheme valuation issues and has stated that my review has provided significant assistance on this issue.

The first of the two recommendations that the Tax Office has been unable to agree with relates to my view that the Tax Office should administer the general interest charge (GIC) so that full remission of this charge becomes the norm rather than the exception in cases of one-off revenue-neutral transactions which involve no net loss to the revenue and that any undesirable behaviour on the part of taxpayers in failing to account for GST on such transactions should be addressed via the penalty regime. The Tax Office considers that this course is not open to it under the present law. In view of this response I have made a recommendation to the Government that it should consult with the community on the need for a specific legislative penalty to replace the GIC in GST audit cases which result in adjustments involving no net loss to the revenue.

The other recommendation that the Tax Office has expressed disagreement with relates to my view that it should review all GST audit cases for large taxpayers which have arisen from an unprompted voluntary disclosure where GIC has been charged at the full rate, rather than the lesser rate which appears to represent Tax Office policy.

I offer my thanks for the support and contribution of the Tax Office, other government bodies, professional bodies, business groups and individuals to this review.

Yours sincerely

A handwritten signature in black ink that reads 'David Vos'.

David Vos AM
Inspector-General of Taxation

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CHAPTER 1: INTRODUCTION

1.1 This is the report on the review conducted by the Inspector-General of Taxation (Inspector-General) of the Australian Taxation Office's (Tax Office or ATO) administration of Goods and Services Tax (GST) audits. This report is made under section 10 of the *Inspector-General of Taxation Act 2003* (IGT Act).

1.2 The review was announced on 30 October 2006. Its terms of reference are reproduced in Appendix 1 to this report. Details of how the review was conducted are also given in Appendix 1.

1.3 The decision to undertake the review was prompted by concerns raised with the Inspector-General by industry and tax practitioners.

1.4 Large taxpayers and/or their advisers made the overwhelming majority of oral and written submissions to this review. Relatively few concerns about GST audits were expressed by small businesses and their representatives at meetings which the Inspector-General held around the country during the review. Early in the review, the Inspector-General therefore decided to focus the review on GST audits that are conducted on large taxpayers (that is, those which have an annual turnover of more than \$100 million).

1.5 A number of key and subsidiary recommendations arose from the review. These are listed in Chapter 2 which also contains a summary of the review.

1.6 Although these key and subsidiary recommendations arose from examining GST audits of large taxpayers, a number of these recommendations are also relevant to GST audits of smaller taxpayers. In the light of the results of this review, and subject to his work program, the IGT may therefore conduct in the future a separate review of how the Tax Office administers GST audits for taxpayers with a turnover of less than \$100 million.

1.7 Chapter 3 assesses the results of the Tax Office's GST audits for large taxpayers. Chapter 4 deals with the Tax Office's imposition and remission of penalties and interest as a result of such audits. Chapter 5 deals with other issues raised concerning GST audits of large taxpayers during the course of this review, including the Tax Office's approach to margin scheme cases and to cases involving classification issues, the length of time of GST audits, Tax Office communication processes during GST audits and the training of GST auditors.

1.8 During the course of the Inspector-General's review, the Tax Office made or proposed a number of changes to its processes for dealing with GST audits. Some of those changes directly addressed concerns raised with the Inspector-General. All changes made or proposed by the Tax Office are noted in this report wherever relevant.

1.9 The Commissioner of Taxation's response to the review is in Appendix 2. The Commissioner's detailed comments on each recommendation of the report are set out immediately below each recommendation.

ACKNOWLEDGEMENTS

1.10 Sincere thanks are extended to those businesses, accountants and tax practitioners and the organisations representing them who prepared written submissions for this review.

1.11 The Inspector-General of Taxation acknowledges with sincere thanks the cooperation of the Commissioner of Taxation and his staff.

CHAPTER 2: OVERVIEW

2.1 This chapter firstly summarises the main conclusions of the review. It then sets out the recommendations of the review and the Tax Office's response to these recommendations.

Introduction

2.2 GST audits are activities by the Tax Office which are directed to ensuring compliance with the GST law and which involve direct contact with the taxpayer. These activities play an important role in providing confidence to the community that all businesses liable to pay the GST are paying their fair share. Our tax system involves taxpayers making a self assessment of their GST liability. Without a GST audit program there is a risk that taxpayers may self-assess their GST liability inaccurately, thereby receiving a competitive advantage over those businesses which do self-assess accurately.

2.3 The review was prompted by concerns raised by large taxpayers on the following issues:

- the nature of the GST audit adjustments that have been reported by the Tax Office as being the results of its GST audit activity on large taxpayers;
- the Tax Office's imposition of penalties and interest in large taxpayer GST audits; and
- other issues concerning GST audits, including the Tax Office's approach to margin scheme valuation cases and to cases involving classification issues, the length of time of GST audits, Tax Office communication processes during GST audits, the training of GST auditors and other issues.

2.4 The conclusions of the review on each of these issues were as follows.

Nature of GST audit adjustments being made and reported by the Tax Office

2.5 The review has found that, based on a sampling process, only 32 per cent of the dollar value of all GST audit adjustments made for large taxpayers by the Tax Office appear to involve net contributions to the revenue that were made as a result of a Tax Office initiated compliance activity.

2.6 It also found that 42 per cent of the dollar value of all reported GST audit adjustments for large taxpayers arose as a result of an unprompted voluntary disclosure.

2.7 Neither of these results has been readily apparent from the GST audit results reported by the Tax Office to the community and the States and Territories. These Tax Office reports have therefore not given a clear indication of the results of GST audits in terms of their real contribution to revenue and may give an overly negative picture of compliance levels within the large taxpayer segment.

2.8 This situation appears to be compounded by the Tax Office's use of liabilities raised as a basis for reporting performance, unadjusted by the difference between liabilities and actual collections. Liabilities raised from compliance activities appear to be reduced compared to actual collections, but the reasons and components of this reduction are not fully reported.

2.9 It is also compounded by the Tax Office's internal and external reports not setting out the sources of, or amounts eventually collected in penalties in GST audit cases or the amount, source and eventual collections of the general interest charge (GIC) in such cases.

2.10 Generally, the Inspector-General considers that the Tax Office should, for audit reporting purposes, work towards identifying those GST audit adjustments which have arisen from unprompted voluntary disclosures and those that have not. The Tax Office should then identify how much of the adjustments which have not arisen from unprompted voluntary disclosures involve real contributions to the revenue and how much of these adjustments do not.

2.11 One result of the Tax Office's failure to adequately identify for both internal and external purposes the source and overall revenue outcomes of its GST adjustments is that the Tax Office has not matched its identification of risks for large cases and allocation of resources towards its GST compliance work with true outcomes from its compliance activities.

2.12 This review has also established that there is a low 'strike rate' in GST audits and many unresolved audits are chasing elusive issues with no outright revenue gain. A 'strike rate' is the percentage of audit cases which achieved a result over the number of audit cases completed. The low strike rate in GST audits would be even lower if cases that do not deliver a revenue gain were excluded. Combined with the low level of net revenue gain this suggests a substantial unnecessary cost to business from GST active compliance work on large taxpayers.

2.13 The Inspector-General has made two recommendations aimed at improving the Tax Office's analysis and reporting of its GST audit results for large taxpayers. These recommendations should lead to better outcomes in terms of the Tax Office better targeting its GST audit resources to the areas of greatest actual risk. These recommendations have been agreed to by the Tax Office.

2.14 The Inspector-General has also recommended that the Tax Office introduce a formalised consolidated policy for how it will handle unprompted voluntary disclosures for tax adjustments, including GST. This is because it does not presently have a single policy document which clearly sets out for taxpayers (or for Tax Office staff) the consequences – in terms of the requirement to pay tax, penalties and interest – that will arise from the disclosure of tax errors made for previous tax periods. The Tax Office has also agreed with this recommendation.

The Tax Office's imposition of penalties and interest in large taxpayer GST audits

Penalties

2.15 The review found that the overall level of penalties ultimately applied in large taxpayer GST audits was small in size compared to those applied in GST audits of smaller taxpayers.¹

2.16 However, this review also found that there were systemic issues which adversely affected the Tax Office's imposition of (shortfall) penalties at the initial audit stage in a significant percentage of large taxpayer GST penalty cases examined for the 2006/07 year and earlier years. Examples were found of :

- cases where the Tax Office believed that the taxpayer was 'reckless' despite the matter being arguable in law;
- cases where penalties were applied at full rates despite the taxpayer having previously disclosed the nature of the adjustment to the Tax Office;
- cases where penalties were applied despite the taxpayer having obtained and followed credible legal advice that the position they were adopting was correct;
- cases where different penalty rules were applied to smaller taxpayers as opposed to larger taxpayers (for example, on whether a disclosure of an error had been made before or after an audit had commenced); and
- cases where the rules on the scope of an audit (and hence the level of penalties charged) were being applied inconsistently to large taxpayers.

2.17 Some of these penalties were eventually remitted but only after they had reached an internal appeal stage.

2.18 The review also found that the Tax Office's internal and external reports on penalties are limited in nature. No reports are regularly produced which indicate matters such as:

- the nature of taxpayers who have attracted GST penalties (including matters such as the size of the relevant taxpayer and the industry in which it operates);
- the nature of the issues that attracted penalties; and
- how much of the relevant penalty has actually been collected.

2.19 The review has made a recommendation aimed at improving the Tax Office's administration of penalties in large taxpayer GST audits. The Tax Office has agreed to implement this recommendation.

¹ The Tax Office has advised the Inspector-General that the amount of GST penalties initially imposed on large taxpayers were as follows for the last three years: 2004/05 : \$44 million (this was later reduced to \$2 million as the result of a single case being settled) ; 2005/06: \$1 million; 2006/07: \$6 million. The amount of GST penalties initially imposed on non-large taxpayers in the last two of these years was: 2005/06: \$ 126 million and 2006/07: \$116 million.

General interest charge

GIC in revenue-neutral cases

2.20 Cases examined during the review suggest that the imposition of a general interest charge is inappropriate in relation to certain 'procedural' compliance adjustments which are revenue-neutral and which are made as a result of a GST audit. GST audit cases examined during the review which initially attracted a significant initial GIC charge that was compounded over a number of tax periods included:

- cases where the Tax Office levied GST on a supplier but at the same time (or shortly thereafter) allowed a corresponding input tax credit (ITC) for the GST to the purchaser of the supply. This meant that correction of the error resulted in no net revenue being payable to the Tax Office. These transactions are referred to as 'wash transactions' by the Tax Office;
- situations where a legal technicality was breached by the taxpayer being audited. Examples include input tax credits being claimed on the basis of invalid tax invoices and situations where an input tax credit was not available because of the absence of an agreement between the parties for the purchaser of a supply to create the relevant tax invoice;
- cases where the wrong entity in a group of companies claimed an input tax credit or paid GST but in the correct period; and
- cases where GST was charged by one party to a transaction and fully claimed as a refund by the other party but where no GST was in fact payable or claimable on the relevant transaction.

2.21 Cases in the second to fourth categories above are, like wash transactions, generally corrected in a subsequent tax period with no net gain to the revenue.

2.22 The Inspector-General considers that the imposition of a general interest charge is inappropriate in all the above kinds of cases. An alternative to the GIC regime in these cases could be a penalty set at suitable level which is imposed under either the existing penalty regime or possibly under a new legislative penalty which applies to cases involving no net loss to the revenue. This penalty would be applied only in cases that warrant it (such as cases involving wilful and repeated transgressions of the relevant technicality).

2.23 The Tax Office has maintained, contrary to the view of the Inspector-General, that GIC will continue to be payable in the first of these categories of cases involving procedural adjustments, but at a reduced rate which is seven percentage points lower than the normal GIC rate. It has confirmed that cases in the other three categories will generally not attract GIC, at least where the error is one that the taxpayer has not previously made.

2.24 The Tax Office has indicated it is reluctant to impose a penalty under existing penalty provisions as an alternative to the GIC because this process would imply that the general interest charge is a penalty. This comment ignores the fact that, while the GIC is not a penalty in itself, it can have a penalty effect where, as is currently the case for GST audits, it is imposed for periods where the taxpayer is unaware that the GIC is accruing at a rate

which is well in excess of the usual cost of finance for the taxpayer. This penalty-like effect of the GIC has been noted in other reports prepared by the Inspector-General.²

GIC in cases involving unprompted voluntary disclosures

2.25 The review has also found that the Tax Office has not consistently applied its policy on GIC in cases involving unprompted voluntary disclosures. This policy is that the GIC in such cases will generally be calculated at a rate which is seven percentage points less than the prevailing GIC rate. The Inspector-General has recommended that the Tax Office should review all large taxpayer GST audit adjustment cases where GIC has been charged at a rate which is in excess of the rate set by its policy. The Tax Office has not agreed with this recommendation, but has agreed to review all such cases identified as falling into this category as a result of the fieldwork conducted by staff of the Inspector-General for this review.

Other issues with GIC

2.26 In addition, the review found that the Tax Office does not prepare reports on the amounts of GIC actually imposed, remitted or ultimately collected in GST audit cases. As a result it is not in a position to know the quantum of GIC being generated in GST audit cases, nor the nature of the taxpayers who have become liable for such interest, the issues that generated the interest charge and whether or not this interest was ultimately collected.

2.27 Furthermore, the review found that existing Tax Office internal review processes for GIC decisions may not be fully achieving their quality control aim. When responsibility for GIC remission decisions was transferred from the Operations area of the Tax Office to the GST audit area this process was largely not accompanied by some processes and procedures which exist in the Operations area for ensuring that GIC remission decisions are made correctly.

2.28 The Inspector-General has recommended that steps be taken to improve the Tax Office's quality control of GIC remission decisions for large taxpayer GST audits. The Tax Office has agreed with this recommendation.

Other issues concerning GST audits of large taxpayers

Margin scheme valuation cases

2.29 The review found that the Tax Office has been inappropriately dealing with cases involving margin scheme valuations in a number of instances. Margin scheme valuation cases are those where the GST payable on the sale of real property acquired before 1 July 2000 is calculated on the difference between the consideration received for the property and its value as at 1 July 2000.

2.30 The Tax Office has inappropriately dealt with a number of these cases by failing to supply taxpayers with reasons why their valuations do not meet Tax Office requirements. It has also failed to inform taxpayers of alternative valuation amounts the ATO has obtained

² See, for example, Inspector-General of Taxation, *Review of the remission of the General Interest Charge for groups of taxpayers in dispute with the Tax Office*, 5 August 2004 at paragraphs 2.27 to 2.29.

from the Australian Valuation Office (AVO). Additionally, it has a practice of challenging and invalidating taxpayer valuations using AVO 'critiques' and then using the original purchase price – even from years earlier – as a basis for adjustment, when it could take steps to narrow the dispute to the difference between the value referred to in the AVO critique and the taxpayer's valuation.

2.31 The Inspector-General has recommended that:

- taxpayers are supplied with reasons why their valuations do not meet Tax Office requirements as soon as possible during the course of a GST audit involving a margin scheme valuation issue and that these reasons include the alternative valuation amount the Tax Office has obtained from the Australian Valuation Office, whether that amount is set out in a 'critique' or in a full valuation; and
- disputes on margin scheme valuations are confined to the difference between what the Tax Office considers to be an acceptable valuation amount and what the taxpayer contends is an acceptable amount.

2.32 The Tax Office has agreed to the first part of this recommendation but not to the second.

Audit cases involving classification issues

2.33 The review found that there are also a number of cases where taxpayers are contending that the Tax Office has changed the GST classification of a food item without warning and has sought to apply the new classification retrospectively throughout the supply chain.

2.34 The Inspector-General has recommended that the Tax Office should introduce a system of binding pronouncements for GST. Such pronouncements were used for many years by the Tax Office in administering sales tax. The Tax Office has agreed with this recommendation.

Timeframes for GST audits of large taxpayers

2.35 The review found that the Tax Office does not have GST audit timeframe benchmarks which can be readily compared with those of other countries or with the benchmarks for other types of audits that are conducted on large taxpayers. It is also taking far too long to finalise some audits, particularly specific issue audits. In some cases, the Tax Office has not applied adequate governance to the planning, management and taxpayer interface of its audit activities. Technical decisions are also taking far too long to be made and communicated to taxpayers in some cases. Furthermore, audit letters are not always issued and risk reviews become audits without taxpayers being aware of the transition.

2.36 The Inspector-General has made a recommendation to address each of these issues. This recommendation has been agreed to by the Tax Office.

Communication and other issues concerning GST audits

2.37 Large GST taxpayers do not always receive letters notifying them of the commencement and finalisation of a GST audit.

2.38 There are also some cases where taxpayers and/or advisers in large GST audit cases are being denied access to the relevant Tax Office decision maker on their case.

2.39 The Tax Office has created a perception that it has a view that retrospective ITC claims, particularly for financial services arising from reappraisal of apportionment methodologies, are somehow indicative of non-compliance or bad practice. The law allows up to four years for ITCs to be claimed. It would be inappropriate for the Tax Office to attempt to thwart legitimate claims for retrospective credits or to read them as a sign of compliance risk.

2.40 Auditors do not in some cases understand the business they are auditing. Training needs to be improved for auditors particularly in business process and activity and how to focus on revenue adding issues.

2.41 Feedback is not always provided to individual auditors on the results of the cases they have audited, in terms of the final outcome of cases after they have gone through the appeal process.

2.42 The review has also established that, when conducting GST audits on imported items, the Australian Customs Service (Customs) does not apply materiality guidelines similar to those contained in the Tax Office's GST mistakes fact sheet.

2.43 The Inspector-General has made a number of subsidiary recommendations to address these communication and other issues associated with GST audits. All of these recommendations have been agreed to by the Tax Office.

KEY RECOMMENDATIONS

KEY RECOMMENDATION 3.1

The Tax Office should ensure that there is greater transparency in the presentation of its GST audit results to the community by:

- identifying those GST audit adjustments which have arisen from unprompted voluntary disclosure and those that have not;*
- identifying how much of reported GST audit adjustments which have not arisen from unprompted voluntary disclosures involve a net contribution to the revenue and how much of these adjustments involve revenue-neutral or other kinds of adjustments which do not; and*
- identifying the quantum of credit amendments made by taxpayers to prior year GST returns which the Tax Office has not included as GST audit adjustments.*

Tax Office response

Dot point 1

2.44 The Tax Office agrees with this recommendation and is in the process of implementing it. The *GST Risk and Strategy and Large Active Compliance (RS & LAC) Business Plan for 2007-08* includes a commitment to plan and report separately on active compliance activities and unprompted voluntary disclosures. Work is currently under way by the Tax Office Compliance Support and Capability unit to introduce Tax Office wide reporting procedures to deal with voluntary disclosures.

Dot point 2

2.45 The Tax Office agrees with this recommendation and will work to separately report revenue-neutral adjustments.

Dot point 3

2.46 The Tax Office notes this recommendation and will investigate the extent to which we can report credit amendments associated with audits.

KEY RECOMMENDATION 3.2

The Tax Office should ensure that, for risk management purposes, it fully understands the nature of the GST audit results it is achieving for large taxpayer GST audits with a view to ensuring that the resources it allocates to these audits are being appropriately balanced against the risk management outcomes of these audits.

Tax Office response

2.47 The Tax Office agrees with this recommendation on the basis that we have, as part of major organisational changes made in November 2006, established an area with responsibility for identifying and managing GST risks in the large market to achieve these outcomes. Based on our most recent assessment of the risks in the large market, the Tax Office believes it has appropriately allocated audit resources to this market.

KEY RECOMMENDATION 3.3

The Tax Office should provide the whole community with a consolidated statement or guide on how they can make voluntary disclosures and how they will be treated in terms of tax, penalties and GIC when they do so.

Tax Office response

2.48 The Tax Office agrees with this recommendation.

KEY RECOMMENDATION 4.1

The Tax Office should enhance its processes for the proper application of penalties in GST large taxpayer audits by:

- issuing GST-specific guidance for its staff on the application of penalties which arise as a result of a GST audit;*
- ensuring that this guidance covers what kinds of disclosures will give rise to a reduction in penalties, when a disclosure will be considered to have been voluntary and when any voluntary disclosure will be considered to have been made before or after the start of an audit;*
- continuing to conduct periodic reviews of the extent to which penalties in large taxpayer GST audits are being applied appropriately; and*
- ensuring that, where a penalty is reduced after the issue of an audit report as a result of either an internal or external review process, feedback on the reasons for the reduction is provided to all Tax Office staff who were involved in the initial setting of the penalty.*

Tax Office response

Dot point 1

2.49 The Tax Office agrees with this recommendation. This guidance may be in the form of a single document or a number of documents which together provide the level of detail needed by GST auditors to impose penalties.

Dot point 2

2.50 The Tax Office agrees with this recommendation.

Dot point 3

2.51 The Tax Office agrees with this recommendation and is of the view that continuation of the periodic technical quality reviews of the application of the penalty regime imposed in large taxpayer audits will meet this requirement. During the 2006-07 year the National Technical Quality Review (TQR) results show that penalty decisions met corporate benchmarks.

Dot point 4

2.52 The Tax Office agrees with this recommendation as it has already been implemented as a separate initiative unrelated to this review.

KEY RECOMMENDATION 4.2

The Inspector-General recommends:

- *that the Tax Office's existing policy on wash transactions should be altered so that full remission of GIC on a one-off wash transaction error becomes the norm rather than the exception;*
- *that the Tax Office should issue a specific policy to reflect that it will generally fully remit GIC in cases where a wrong entity has accounted for the GST; and*
- *that the Tax Office addresses any undesirable behaviour on the part of the relevant taxpayer in relation to failing to account for GST on one-off wash transaction errors or other similar transactions which involve no revenue loss through the existing penalty regime rather than the GIC regime.*

Tax Office response

2.53 The Tax Office does not agree with this recommendation.

Dot point 1

2.54 The scheme of the Act does not take into consideration the treatment of another taxpayer when applying GIC to an entity which has made a mistake.

2.55 Each case for remission of GIC will be considered on its own circumstances and merit. Interest charges are automatically imposed by the law in all relevant shortfall cases. The scheme of the Act is to apply GIC to individual taxpayers whose responsibility it is to correctly report an obligation within the correct time period. The scheme introduced by Parliament clearly intends for GIC to be applied where individual taxpayers failed to report correctly within the nominated time.

Dot point 2

2.56 The Tax Office is currently reviewing its practice statement PSLA 2003/2 in relation to GST 'wash' transactions and these comments will be considered as part of this review.

Dot point 3

2.57 Penalty and GIC are two separate and distinct regimes. The culpability of the taxpayer remains a matter for the administrative penalties regime and not the GIC regime.

Inspector-General's comments on Tax Office response

2.58 In view of the Tax Office's response to this recommendation, the Inspector-General makes the following key recommendation to the Government:

KEY RECOMMENDATION 4.2A

The Inspector-General recommends that the Government consults with the community on the need for legislative changes which have the effect of requiring or allowing the Tax Office to:

- adopt a default position of fully remitting the general interest charge in GST audit cases which result in adjustments that involve no net loss to the revenue such as wash transactions, cases involving documentation issues and cases where GST has been paid by the wrong entity; and*
- where warranted, address any undesirable behaviour on the part of the relevant taxpayer in relation to failing to account for GST on such transactions through a form of penalty.*

KEY RECOMMENDATION 4.3

The Tax Office should review all large taxpayer GST audit adjustment cases which have involved unprompted voluntary disclosures where GIC has been charged at the full rate with a view to re-setting the GIC rate in these cases to the bank bill rate, being the rate which generally represents Tax Office policy.

Tax Office response

2.59 The Tax Office disagrees with Recommendation 4.3.

2.60 The Tax Office policy (*PSLA 2006/8 Remission of shortfall interest charge and general interest charge for shortfall periods of remission of GIC*) provides that a voluntary disclosure itself is not a ground for routine remission to the bank bill rate (base rate). However, the policy does provide that there may be some cases where the circumstances surrounding the voluntary disclosure will make it fair and reasonable to remit interest charges. Any remission of interest charges on the basis of a voluntary disclosure will have regard to the specific circumstances and will consider matters such as:

- how soon the disclosure was made after the error was first detected;
- whether it was made before the notification of the commencement of an audit;
- the size of the shortfall, either in monetary terms or in relation to the totality of the taxpayer's affairs, and
- the taxpayer's compliance history, including the number of times a taxpayer has had to disclose shortfalls following an initial self-assessment of liability.

2.61 As the circumstances of each taxpayer are invariably different it is unlikely that the application of the policy will result in remission of interest to base rate in every case where a voluntary disclosure is made.

2.62 The Tax Office is satisfied, based on its Technical Quality Reviews, that GIC has been appropriately applied in GST audits cases.

Inspector-General's comments on Tax Office response

2.63 The Inspector-General acknowledges the Tax Office's case-by-case approach and the relevance of considering the specific circumstances as outlined in their response. The Inspector-General also agrees that this approach will mean that some voluntary disclosures will not have the GIC reduced to the bank bill rate. However, the Inspector-General is disappointed that the Tax Office has declined to review all voluntary disclosure cases that have full GIC applied because the sample of cases examined as part of the review showed greater variance of treatment than would be expected including a fairly high proportion with full GIC (refer to para 4.118 of the report). The Inspector-General also notes that this issue was raised as a concern in a number of submissions to the review. However, the comments in the report on this issue may raise awareness in the community and lead to affected taxpayers taking the matter up with the Tax Office.

KEY RECOMMENDATION 4.4

The Inspector-General recommends that the Tax Office enhance its processes for ensuring that GIC imposition and/or remission decisions in large taxpayer GST audits are being made appropriately and consistently by:

- *issuing detailed GST-specific guidance for its staff on GIC remissions which arise as a result of a GST audit;*
- *ensuring that large taxpayer GST auditors are appropriately trained on the Tax Office's guidelines for GIC imposition and remission; and*
- *ensuring that GIC remission decisions for large taxpayer GST audits are subject to adequate internal quality controls.*

Tax Office response

Dot point 1

2.64 The Tax Office agrees with this recommendation.

Dot point 2

2.65 The Tax Office agrees with this recommendation on the basis that it is already providing training and support to GST auditors in the correct application of the Tax Office's policies on the application of general interest charge as part of an initiative that had commenced prior to the commencement of this review.

Dot point 3

2.66 The Tax Office agrees and will ensure that GIC remissions are subject to internal quality controls.

KEY RECOMMENDATION 5.1

The Inspector-General recommends that the Tax Office takes steps to:

- *ensure that taxpayers are supplied with reasons why their valuations do not meet Tax Office requirements as soon as possible during the course of a GST audit involving a margin scheme valuation issue and that these reasons include the alternative valuation amount the Tax Office has obtained from the Australian Valuation Office, whether that amount is set out in a 'critique' or in a full valuation; and*
- *ensure that disputes on margin scheme valuations are confined to the difference between what the Tax Office considers to be an acceptable valuation amount and what the taxpayer contends is an acceptable amount.*

Tax Office response

Dot point 1

2.67 The Tax Office agrees although it notes that not all critiques provided by the AVO will include an alternative estimated valuation. However, where an alternative estimated valuation is provided as part of the AVO critique this will be communicated to the taxpayer.

Dot point 2

2.68 The Tax Office notes this recommendation. The Tax Office is currently examining options by which it can, within the law, substitute an alternative valuation rather than use the last sale price in those cases where it believes the taxpayer's original valuation is not an approved valuation. In November 2007, the Tax Office put a proposal along these lines to the GST Sub Committee of the National Taxation Liaison Group for consideration and feedback.

KEY RECOMMENDATION 5.2

Because of competitive winners/losers as a result of different GST classifications in the market place, the Tax Office must review its current approaches to ensure binding GST decisions in relation to new products coming onto the market are made and communicated quickly into the market to ensure that there is improved through-the-chain certainty, better compliance and lower costs.

Tax Office response

2.69 The Tax Office agrees with this recommendation.

KEY RECOMMENDATION 5.3

The Inspector-General recommends that the Tax Office:

- *expeditiously resolves GST large taxpayer audits experiencing significant delays;*
- *clarifies in a public statement its position on when a GST audit has started and the circumstances in which this will occur orally or by letter;*
- *takes steps to ensure that technical decisions which impact audits are made without delay; and*
- *should review, in consultation with taxpayers and their representative associations, the existing benchmark times to complete GST audits and should also work with other countries to develop appropriate approaches to comparing benchmark times to complete a GST/VAT audit.*

Tax Office response

Dot point 1

2.70 The Tax Office agrees with this recommendation and will continue its current focus on resolving GST audits in a timely manner. Where an audit is experiencing delays that are within the Tax Office's control, auditors will keep the taxpayer informed of the reason for the delay and the progress of the case. We will continue to apply the procedures we have in place to ensure the active case management of cases exceeding cycle time.

Dot point 2

2.71 The Tax Office agrees with this recommendation and will take this into account as part of the review of the 2006 Large business and tax compliance booklet.

Dot point 3

2.72 The Tax Office agrees with this recommendation. However, there will at times be delays in the resolution of technical issues that arise in the large market due to their complex nature.

Dot point 4

2.73 The Tax Office agrees with this recommendation.

SUBSIDIARY RECOMMENDATIONS

Subsidiary recommendation 5.1

The Inspector-General recommends that large taxpayer GST auditors should always confirm the date of commencement and finalisation of an audit in writing. If advice of the commencement or finalisation of an audit is given orally this advice should be confirmed in writing within a reasonable time thereafter.

Tax Office response

2.74 The Tax Office agrees with this recommendation

Subsidiary recommendation 5.2

The Tax Office should ensure that GST auditors facilitate access by large taxpayers who are subject to a GST audit to the key technical decision makers involved in their case and also ensure that the large taxpayers are made aware of the senior officer they can escalate issues or concerns to.

Tax Office response

2.75 The Tax Office agrees with this recommendation.

Subsidiary recommendation 5.3

The Inspector-General recommends that the Tax Office takes steps to:

- ensure that auditors better understand the businesses they are auditing by providing more training on business process and activity and on how to focus on issues that involve a real net gain to the revenue;
- ensure that auditors understand that businesses may want to exercise their legal rights to correct their GST liabilities for previous years in cases where they have overpaid and that such claims are not, per se, evidence of an attitude of non-compliance with the GST law; and
- ensure that GST auditors are in all cases provided with individual feedback on the results of the cases they have audited, in terms of the final outcome of cases after they have gone through the appeal process.

Tax Office response

Dot point 1

2.76 The Tax Office agrees that it will continue to provide its auditors with skilling on business process and activities to improve their capability in this area.

Dot point 2

2.77 The Tax Office agrees with this recommendation and understands that business will at times exercise their rights to correct prior year GST liabilities. The ATO has never seen this as evidence of an attitude of non compliance. However, it must be recognised that the Tax Office is under an obligation to ensure that a taxpayer has a legal right to the claim it is making. The Tax Office rejects any implication that there has been any systemic problem in relation to this issue.

Dot point 3

2.78 The Tax Office agrees with this recommendation and this process which it has already implemented as part of a separate initiative unrelated to this review.

Subsidiary recommendation 5.4

The Inspector-General recommends that tolerance or materiality levels are aligned across both Australian Customs Service and Tax Office administration of GST.

Tax Office response

2.79 The Tax Office agrees with the recommendation to the extent that it will work with the Australian Customs Service (ACS) to achieve this outcome. It notes that the ACS is currently planning a review of the materiality thresholds. It is intended that this review will be conducted jointly with the Tax Office and will take into account the compliance cost to industry of amending import declarations. It is intended that the revised approach will be published in a practice statement.

CHAPTER 3: ASSESSMENT OF THE RESULTS OF LARGE TAXPAYER GST AUDITS

INTRODUCTION

3.1 GST audits for the purposes of this review have been defined as activities by the Tax Office which are directed to ensuring compliance with the GST law and which involve direct contact with the taxpayer.

3.2 These activities play an important role in providing confidence to the community that all businesses liable to pay the GST are paying their fair share. Our tax system involves taxpayers making a self assessment of their GST liability. Without a GST audit program there is a risk that taxpayers may self-assess their GST liability inaccurately, thereby receiving a competitive advantage over those businesses which do self-assess accurately.

TAX OFFICE PERFORMANCE INDICATORS FOR GST AUDITS

3.3 There are a number of performance indicators used by the Tax Office to assess the results of its GST audits. These include: the amounts of GST audit adjustments, 'strike rates' (that is, the percentage of audit cases which achieved a result over the number of audit cases completed), the cycle time of audits, technical quality review, Tax Office adherence to practice statements, external surveys and Tax Office adherence to the standards of the Taxpayers' Charter.

3.4 The two main performance standards used by the Tax Office to assess its audits results are the amounts of GST audit adjustments and 'strike rates'. However, fieldwork conducted by the Inspector-General's staff for the purposes of this review has shown that both these indicators are flawed for the reasons set out below.

GST audit adjustments

Permanent and timing tax adjustments

3.5 Tax audits may yield tax adjustments that are either of a permanent or timing nature. Permanent tax adjustments are adjustments where the taxpayer has underpaid their tax or over claimed a refund entitlement and the underpayment or over claim will not be reversed in a subsequent time period. Timing adjustments are tax adjustments where payments or claims have been made in the wrong tax period. They may therefore be made in one period but reversed in a subsequent time period. Both these types of adjustments occur in GST audits.

Revenue-neutral adjustments

3.6 Unlike most other kinds of tax audits, GST audits also yield tax adjustments which do not result in a net amount of additional tax being payable to the revenue. These are called 'revenue-neutral adjustments'. These revenue-neutral adjustments arise because of the nature of a GST.

3.7 A GST is levied at each stage of the supply chain of a good or service. However, if the purchaser of a supply is registered for GST purposes they can usually, with few exceptions, claim the full amount of any GST charged by the supplier as a refund (called an input tax credit or ITC) from the Tax Office. This amount is not fully refundable where the purchaser is a consumer or where the purchaser is a business which is not registered for GST. It is also not fully refundable where a purchaser is registered for GST, but the purchase is of a certain kind (such as a purchase which relates to financial supplies or supplies of residential property).

3.8 This means that, if GST is not charged on a supply made by one business to another, and this underpayment is discovered as a result of a Tax Office audit, the non-payment may not result in the payment of a net amount of additional tax to the revenue. This is because while the Tax Office may collect the underpaid GST from the supplier it may at the same time (or shortly thereafter) be required to credit this amount to the purchaser. The Tax Office calls these types of revenue-neutral adjustments 'wash transactions'.

3.9 Other types of revenue-neutral adjustments which arise from the nature of a GST include:

- where the adjustment arises from a transaction where GST was paid in the correct time period but by the wrong entity in a group (wrong entity cases); and
- where the adjustment arises from a transaction between two GST registered entities where GST was charged by one party and fully claimed as a refund by the other party but where no GST was in fact payable or claimable on the relevant transaction (no GST payable cases).

Examples of permanent and timing GST adjustments

3.10 An example of a GST audit adjustment which is of a permanent nature is where an audit adjustment relates to a supplier's failure to charge GST on a supply made to a purchaser who is a consumer. This type of tax adjustment is known by the Tax Office as a 'sticky tax' adjustment for GST purposes because, unlike the GST revenue-neutral adjustments discussed above, this type of adjustment is not offset by any refund that is payable by the Tax Office to the purchaser. The adjustment therefore 'sticks' to the purchaser and adds in real terms to the revenue's bottom line.

3.11 An example of a GST adjustment which is of a timing nature is where GST is reported and paid in a GST tax return³ period that is later than the period when the GST should have been reported and paid. In this case, as with all GST timing adjustments, the adjustment does not lead to a net increase in the amount of tax payable to the revenue overall, although interest may be charged for the period during which the tax was not paid.

³ GST returns are called Business Activity Statements.

3.12 Another example of a timing adjustment is where a GST credit has been claimed in a tax period but this is earlier than the period when the credit should have been claimed. This situation can arise because a purchaser may not have the correct documentation to support their claim for a GST credit. For a GST credit to be available on a purchase, the purchaser must have a document which is in the form of a tax invoice (including a recipient created tax invoice). Furthermore, if the relevant document is a recipient created tax invoice, that invoice must be supported by a written agreement that has been entered into by the purchaser and supplier under which the supplier agrees that the purchaser may issue these types of invoices. Timing adjustments arising from the absence of full and proper documentation to support a GST refund claim are referred to in this report as adjustments involving documentation issues

GST 'active compliance activities' results

3.13 GST audit adjustments are published in the Tax Office's Annual Report, which is made available to the community. They are also reported in performance reports the Tax Office must provide to the States and Territories to whom GST collections are eventually paid. These reports to the States and Territories are not made public.

3.14 The Tax Office does not use the term 'GST audits' for the purposes of these reports. Instead, in both sets of reports, the Tax Office refers to the results of its GST 'active compliance activities'. The Tax Office defines these activities as those which it conducts which are aimed at deterring, detecting and addressing non-compliance with the GST law.

3.15 The term includes a number of activities that are not commonly thought of as audits. It includes, for example, unprompted voluntary disclosures and amounts shown on returns which are lodged late after the Tax Office has followed up an overdue return.

3.16 During the review the Tax Office advised that in 2006/07 it raised over \$1.436 billion in tax and \$124 million in penalties and interest from all GST active compliance activities.⁴

3.17 These amounts came from the following market segments:

Table 3.1: GST liabilities, penalties and interest raised in 2006/07

Market	Tax liabilities raised (\$m)	Penalties and interest (\$m)
Large	311	7
Small to medium enterprise (SME)	440	46
Micro	617	70
Not for profit organisation (NFP)	50	-
Government	18	1
Total	1436	124

⁴ The ATO's 2006/07 Annual Report, which was published after this report was submitted to the ATO for their response, indicates that in 2006/07 \$1480 million in tax and \$165 million in penalties and interest was raised from GST active compliance activities. The ATO has advised the Inspector-General that all of the \$41 million difference in penalties and interest and \$33 million of the \$44 million difference in liabilities between the Annual Report figures and those provided to the Inspector-General arise from GST active compliance activities undertaken by business lines other than the ATO's GST business line. There is also \$11 million overstatement of liabilities in the Annual Report. The new figures do not materially alter the amounts for the large market for 2006/07 shown in Table 3.1.

3.18 This table shows that \$311 million (or 22 per cent of all GST adjustments) was raised from GST active compliance activities involving large businesses, that is those with a turnover of more than \$100 million.

3.19 Although these active compliance adjustments are one of the performance measures used by the Tax Office to assess the effectiveness of its GST audits for large taxpayers, this review has found that the Tax Office does not analyse these GST active compliance results for the purposes of ascertaining a number of key data items that are relevant to fully assessing the effectiveness of its GST audit activities.

3.20 Firstly, these adjustments only reflect GST liabilities raised in the year. They are not adjusted from year to year to show the amounts of GST liabilities that are actually collected. The Tax Office has provided to the Inspector-General figures which indicate that liabilities raised from GST compliance activities on large taxpayers over the last two financial years have been between 5 and 6 per cent more than actual collections, but the reasons for and components of this difference are not reported in either the Annual Report (or the reports to the States and Territories).

3.21 Secondly, the Tax Office does not analyse the amounts of penalties and/or interest actually levied, remitted or collected in GST audit cases for large taxpayers to determine matters such as the nature of the taxpayer involved, the type of issue involved, the amount of penalty or interest involved and the nature of the penalty.

3.22 Thirdly, until this review commenced, the Tax Office only segmented adjustments according to a description of the underlying issue that was involved and the dollar values raised. It also segmented total audit adjustments according to whether the result involved permanent (sticky) tax or a wash or timing adjustment. It did not analyse them to any further extent.

3.23 Significantly, GST audit adjustments were not analysed according to whether or not the result came from an unprompted voluntary disclosure by the relevant taxpayer.

3.24 This meant that the Tax Office was unable to identify the extent to which any adjustments which arose from Tax Office initiated (that is, non-voluntary) audit activities were :

- adjustments which amounted to a contribution to the revenue (that is, 'sticky' tax adjustments);
- adjustments which arose from a request for lodgement of a late return;
- adjustments which arose from a documentation issue; or
- adjustments which arose from revenue-neutral transactions such as those involving:
 - wash transactions;
 - wrong entity transactions; or
 - a no GST payable transaction.

3.25 During the review the Tax Office started to analyse the extent to which its GST audit adjustments arose from unprompted voluntary disclosures. This analysis indicated that for

the large market for the 2006/07 year around \$130 million of GST audit adjustments (that is, around 42 per cent of its reported adjustments for this market) arose from unprompted voluntary disclosures. The Tax Office also advised during the review that this \$130 million of unprompted voluntary disclosures were attributable to the following types of adjustments:

- sticky tax adjustments: \$75 million;
- wash adjustments: \$37 million;
- timing adjustments: \$18 million.

3.26 The Tax Office was unable during the course of this review to indicate any further break up of the nature of its GST audit results and in particular was unable to advise on what proportion of the \$181 million of Tax Office initiated (that is, non-voluntary) GST audit adjustments were attributable to matters such as sticky tax adjustments, requests for lodgement of a late return, a documentation issue or revenue-neutral transactions.

3.27 The Inspector-General's fieldwork confirmed that there was a significant percentage of unprompted voluntary disclosure adjustments included in the ATO's reported GST audit adjustments figures. This fieldwork also indicated that, in a significant number of cases in prior years, a voluntary disclosure gave rise to an automatic audit of the item that was disclosed.

3.28 However only voluntary disclosures involving amounts of GST payable gave rise to such automatic audits. Cases were also encountered where a number of voluntary disclosures were made by taxpayers involving both debit and credit amounts and only the debit amounts (not refund claims) were audited. This suggests that GST auditors may be selectively choosing to audit only debit voluntary disclosures amounts so as to boost overall reported GST audit results.

3.29 The Tax Office has advised that its current procedures for voluntary disclosures by large taxpayers do not automatically give rise to audit activity. It states that now every voluntary disclosure is reviewed and risk assessed. Where the risk assessment is rated as high, and is in line with the current GST audit program, the voluntary disclosure may give rise to audit activity.

3.30 The Tax Office has also advised that it treats credit amendments referred to in a voluntary disclosure by a taxpayer as being in the nature of self amendments rather than as part of any voluntary disclosure of a tax shortfall. On this basis it contends that it is not conducting any audits of voluntary disclosures in a manner which boosts overall reported GST audit results.

3.31 The Inspector-General considers that if the Tax Office includes for reporting and other purposes the quantum of any debit adjustments arising from unprompted voluntary disclosures in GST audit statistics then it should:

- firstly, separately identify the quantum of any such debit adjustments; and
- secondly, separately identify unprompted credit adjustments to prior year GST returns that are made by taxpayers.

3.32 This would provide a more transparent picture of the nature of GST audit results made from year to year in terms of the extent to which those results arise from Tax Office

initiated audit activity and the extent to which prior year adjustments initiated by taxpayers give rise to an overall contribution to the revenue.

3.33 The Tax Office's definition of what it regards as a voluntary disclosure (that is, that only debit, not credit amounts are included) also affects its rules for the application of penalties in cases involving voluntary disclosures. This penalties impact is discussed in the next chapter of this report.

3.34 Unlike some other jurisdictions (for example, Canada) the Tax Office has no formalised consolidated policy for how it will deal with unprompted voluntary disclosures by taxpayers – either in the GST area specifically or in relation to any other taxes which it administers. In Canada this formal consolidated policy is summarised in an information circular which is titled 'Voluntary Disclosures Program' which is dated October 2007 and is available on its revenue agency's website at www.cra.gc.ca.

3.35 Significant percentages of the GST tax adjustments (in dollar value terms) reviewed by staff of the Inspector-General in Perth and Adelaide involved documentation issues only. These at most would lead to a GST timing adjustment. Audit cases that were handled by the Melbourne, Sydney and Brisbane Tax Offices involved more adjustments for issues not involving documentation and/or for sticky GST. However, in Melbourne and Sydney there were not many examples of GST audits involving sticky GST as opposed to timing or wash transactions in the cases selected by staff of the Inspector-General for review.

3.36 GST tax adjustments are also escalated for review within the Tax Office purely on the basis of the size of the relevant tax adjustment. There is no regard to the nature of the adjustment such as whether it involves no additional net tax because it involves a documentation or wrong entity issue. The resources of senior management are being unnecessarily tied up in the review of such cases.

3.37 The Inspector-General has analysed the sample of GST audit cases it examined during the fieldwork phase for this review to determine the extent to which any adjustment falls into the following categories:

- Unprompted voluntary disclosures;
- Non-voluntary adjustments which involve:
 - sticky tax;
 - a request for lodgement of a late return;
 - a documentation issue;
 - a timing issue;
 - revenue-neutral transactions such as those involving:
 - : wash transactions;
 - : wrong entity transactions; and
 - : a no GST payable transaction.

3.38 The cases examined by the Inspector-General during his fieldwork consisted of cases for each of the 2004/05 and 2005/06 years and for the 10 months ended 30 April 2007.

3.39 The results of the Inspector-General's analysis are as follows.

Table 3.2: Analysis of large taxpayer GST adjustments (excluding penalties) reviewed by Inspector-General for 2004/05 and 2005/06

Nature of adjustment	Amount \$m	Number of cases sampled
Unprompted voluntary disclosures	76 ⁵	22
Sticky tax	114 ⁶	14
Late lodgement cases	44	56
Cases involving potentially invalid tax invoices or RCTIs	34	6
Timing issues	13	5
Revenue-neutral wash transactions	35	9
No GST payable revenue-neutral cases	61	1
Wrong entity revenue-neutral cases	-	-
No tax adjustment cases	-	12
Penalty only review	-	1
Total dollar value of cases in Inspector-General sample	377	126
Total GST adjustments for 2 years	741	

Table 3.3: Analysis of large taxpayer GST adjustments (excluding penalties) reviewed by Inspector-General for 10 months ended 30 April 2007

Nature of adjustment	Amount \$m	Number of cases sampled
Unprompted voluntary disclosures	36	7
Sticky tax	49 ⁷	15
Late lodgement cases	2	8
Cases involving potentially invalid tax invoices or RCTIs	28	2
Timing issues	-	-
Revenue-neutral wash transactions	4 ⁸	1
No GST payable revenue-neutral cases	-	-
Revenue-neutral wrong entity cases	16	2
No tax adjustment or refund cases	-	3
Penalty only review	-	-
Totals	135	38

5 A further \$54 million of GST adjustments for the 2005/06 year are known to involve unprompted voluntary disclosures.

6 Note that one Brisbane case accounts for \$72 million of this amount.

7 One Sydney case accounts for \$9 million of this amount.

8 There is one unfinalised wash case in Sydney which according to the ATO will generate between \$20 and \$30 million of GST.

3.40 Both tables appear to confirm that:

- A significant percentage of GST audit adjustments for large taxpayers involve unprompted voluntary disclosures. These cases accounted for 22 per cent of the dollar value of all cases with an adjustment examined during this review.
- Sticky GST tax adjustments gave rise to 32 per cent of the dollar value of all cases with an adjustment examined during this review.
- Late lodgement cases accounted for 9 per cent of the dollar value of all cases with an adjustment examined during this review.
- Cases involving documentation issues accounted for 12 per cent of the dollar value of all cases with an adjustment examined during this review.
- Revenue-neutral transactions accounted for 23 per cent of the dollar value of all audit cases with an adjustment examined during this review.
- Cases involving timing issues accounted for 2 per cent of the dollar value of all audit cases with an adjustment examined during this review.

3.41 These figures suggest that only 32 per cent of the dollar value of all GST audit adjustment cases for large taxpayers may involve a net contribution to the revenue which may not have been obtained but for the audit activity.

3.42 The Tax Office's reported GST audit results for large taxpayers do not show the above kind of break-up. They are not therefore transparent and give an overly negative view of the nature of the GST compliance in the large taxpayer market.

Tax Office's risk assessment processes for large taxpayer GST audits

3.43 The Tax Office's failure to fully analyse its actual GST audit results negatively affects the processes the Tax Office uses to determine which risks the Tax Office will seek to address through future audit activity.

3.44 This review has confirmed the results of other reviews⁹ which have found that the Tax Office's overall risk assessment processes for GST were under-developed. The Inspector-General found that the Tax Office has yet to develop an overall process for assessing and prioritising all GST risks in the large taxpayer segment. However, it has taken a number of steps in this direction. These steps include the establishment of a GST Risk and Strategy stream, a GST risk management subcommittee and a GST risk register. The Tax Office also acknowledges that its risk management processes are evolving as the GST business line becomes more sophisticated in its dealings with risk.

3.45 Overseas experience indicates that GST is relatively low risk for large taxpayers except for systems breakdowns. This view is supported by a survey that was done by Deloitte Touche Tohmatsu Limited in 2006 of in-house GST advisors at large corporates in

⁹ See: Deloitte, *Final Report: Review of the GST Large Corporate Compliance Program and Appendix prepared for the Australian Taxation Office*, 23 March 2005 (both these documents are available on the Tax Office's website at www.ato.gov.au); and also Australian National Audit Office, *Administration of Goods and Services Tax Compliance in the Large Market Business Segment – Australian Taxation Office*, Audit Report No. 13 2005/06, 18 October 2005.

Australia, which found that 50 per cent of survey respondents agreed that some large businesses had failed to keep up their internal corporate governance processes and systems for GST.¹⁰ From the fieldwork conducted by the Inspector-General for this review it appears that systems breakdowns may represent the most significant category of issues that are the subject of unprompted voluntary disclosures.

3.46 The Tax Office's approach to assessing the risks to be addressed by GST audits may also need to be better integrated with audits involving other tax issues on the same taxpayers so that for any one particular taxpayer the Tax Office's overall audit activity focuses on the tax issues that are of the greatest actual risk.

3.47 The Inspector-General notes that in a number of comparable overseas jurisdictions – notably New Zealand and Canada – there is no separate GST business line in the relevant revenue authority. In these countries, GST and income tax audit risks for any one taxpayer are assessed jointly. From discussions with tax practitioners in these countries it appears that this may have had the effect of lessening the extent of GST-specific audit activity that is conducted on large taxpayers in those countries when compared to what currently occurs in Australia.

Strike rates

3.48 Strike rates for particular GST audit activities are an internal measure used by the Tax Office to assess its audit activities. A strike rate is the percentage of audit cases which achieved a result over the number of audit cases completed.

3.49 The Tax Office has advised that the overall strike rate for large taxpayer GST audits calculated on this basis was 17.4 per cent for the 2006/07 year. There were 2,403 audits which were escalated to an audit as a result of a telephone query on a GST refund. These had a strike rate of 12.5 per cent. There were 496 audits which were initiated as fieldwork audits. These had a strike rate of 41.1 per cent.

3.50 However, these strike rates include cases which yield an overall net positive result to the revenue (that is, sticky tax cases) and those that do not. The rate therefore includes revenue-neutral adjustments where a corresponding credit in the same case is not recorded, adjustments which arise from unprompted voluntary disclosures and adjustments involving documentation issues only. The inclusion of these adjustments in the strike rate figure gives a misleading picture of the results of the Tax Office's GST audit program for large taxpayers.

3.51 During the review the Tax Office advised that if non sticky cases were excluded from the strike calculation the overall strike rate would be reduced. However, the Tax Office considers errors in wash transactions and other non-sticky transactions (for example, where the wrong entity accounts) as important matters requiring audit intervention and amendment for the following reasons:

- The Tax Office is obliged to correct errors in reporting GST payable.
- Its strategy is to maintain the integrity of the tax, introduced by Parliament as a multistage tax rather than a retail tax.

¹⁰ Deloitte Touche Tohmatsu Ltd, *In-house GST advisor: How are you evolving?*, Survey November 2006 at p 4, available at www.deloitte.com.au.

- The Tax Office aims for equity of treatment among all taxpayers through the supply chain including business to business transactions and business to consumer.
- Correcting errors in classification upstream (at the business to business level) helps to ensure that errors are not made downstream (at the business to consumer level).
- Acquirers have a right to ITCs that is not extinguished where the Tax Office does not adjust the supplier.
- Acquirers may have a right to an ITC without having to pay the supplier additional consideration, say where the contract does not make allowance for the imposition of GST.

3.52 The Tax Office also advised that it would continue to look at wash transactions as conformance with the law protects the integrity of the system.

KEY RECOMMENDATIONS

3.53 The Inspector-General considers that Tax Office accounting for GST compliance results does not accurately attribute results by reason for the adjustment, lacks transparency and needs more detail.

3.54 Also, the Tax Office's identification of risks for large cases and allocation of resources towards its GST compliance work have not been appropriately matched with true outcomes from its compliance activities. There is a low strike rate in GST audits. A significant number of audits are chasing issues with no outright revenue gain. The low strike rate in GST audits would be even lower if cases that do not deliver 'sticky tax' were excluded. Combined with the low level of 'sticky tax' this suggests a substantial unnecessary cost to business from GST active compliance work for large taxpayers.

3.55 These conclusions and the other material in this chapter lead to the following key recommendations.

KEY RECOMMENDATION 3.1

The Tax Office should ensure that there is greater transparency in the presentation of its GST audit results to the community by:

- *identifying those GST audit adjustments which have arisen from unprompted voluntary disclosure and those that have not;*
- *identifying how much of reported GST audit adjustments which have not arisen from unprompted voluntary disclosures involve a net contribution to the revenue and how much of these adjustments involve revenue-neutral or other kinds of adjustments which do not; and*
- *identifying the quantum of credit amendments made by taxpayers to prior year GST returns which the Tax Office has not included as GST audit adjustments.*

Tax Office response

Dot point 1

3.56 The Tax Office agrees with this recommendation and is in the process of implementing it. The *GST Risk and Strategy and Large Active Compliance (RS & LAC) Business Plan for 2007-08* includes a commitment to plan and report separately on active compliance activities and unprompted voluntary disclosures. Work is currently under way by the Tax Office Compliance Support and Capability unit to introduce Tax Office wide reporting procedures to deal with voluntary disclosures.

Dot point 2

3.57 The Tax Office agrees with this recommendation and will work to separately report revenue neutral adjustments.

Dot point 3

3.58 The Tax Office notes this recommendation and will investigate the extent to which we can report credit amendments associated with audits.

KEY RECOMMENDATION 3.2

The Tax Office should ensure that, for risk management purposes, it fully understands the nature of the GST audit results it is achieving for large taxpayer GST audits with a view to ensuring that the resources it allocates to these audits are being appropriately balanced against the risk management outcomes of these audits.

Tax Office response

3.59 The Tax Office agrees with this recommendation on the basis that we have, as part of major organisational changes made in November 2006, established an area with responsibility for identifying and managing GST risks in the large market to achieve these outcomes. Based on our most recent assessment of the risks in the large market, the Tax Office believes it has appropriately allocated audit resources to this market.

KEY RECOMMENDATION 3.3

The Tax Office should provide the whole community with a consolidated statement or guide on how they can make voluntary disclosures and how they will be treated in terms of tax, penalties and GIC when they do so.

Tax Office response

3.60 The Tax Office agrees with this recommendation.

CHAPTER 4: THE IMPOSITION AND/OR REMISSION OF PENALTIES AND INTEREST IN LARGE TAXPAYER GST AUDITS

4.1 This chapter sets out the legal and administrative rules for the imposition and remission of penalties and interest in GST audits and the concerns that were raised in submissions to this review about how these rules are currently being applied by the Tax Office to GST audits conducted on large taxpayers. It then sets out the Inspector-General's overall findings in relation the Tax Office's imposition of penalties and interest in large taxpayer GST audits.

PENALTIES

Legislative rules

4.2 Where additional GST is payable as a result of an audit, a tax shortfall arises. In such cases, the Tax Office, in addition to collecting the actual tax shortfall, may also apply an administrative penalty known as a tax shortfall penalty. This penalty arises under Part 4-25 of Schedule 1 to the *Taxation Administration Act 1953*.

4.3 For GST, tax shortfall penalties may arise:

- where the taxpayer has made a false or misleading statement to the Tax Office (for example, by omitting to pay GST on a taxable supply or by over claiming an input tax credit); or
- where the taxpayer has entered into a GST tax avoidance scheme.

4.4 The GST penalty regime is part of the uniform penalty regime that applies to most federal tax obligations with effect from 1 July 2000. This regime was implemented to ensure that a common penalty applies where a taxpayer has failed to satisfy the same type of obligation under different tax laws.

4.5 The GST penalty legislative regime for tax shortfalls sets out a base penalty amount which increases according to the degree of culpability of the taxpayer.

4.6 The base penalty amounts for GST shortfalls arising from false statements are as follows:

- where the taxpayer has failed to take reasonable care: 25 per cent of the tax shortfall;
- where the taxpayer has been reckless: 50 per cent of the tax shortfall;
- where the taxpayer has intentionally disregarded the law: 75 per cent of the tax shortfall.

4.7 The base penalty amounts for GST shortfalls that arise from tax avoidance schemes are as follows:

- where it is reasonably arguable that the anti-avoidance rules do not apply: 25 per cent of the amount of tax benefit obtained from the scheme ;
- in all other cases: 50 per cent of the tax benefit obtained from the scheme.

4.8 These base penalty amounts can then be increased by 20 per cent according to whether the taxpayer:

- has prevented or obstructed the Tax Office's investigation of the tax shortfall; or
- has previously been penalised for a shortfall.

4.9 If a taxpayer has voluntarily disclosed a tax shortfall to the Tax Office before being advised of a tax audit any tax shortfall penalty is reduced by 80 per cent. If the taxpayer voluntarily discloses the shortfall after being advised of a tax audit, any penalty is reduced by 20 per cent.

4.10 No tax shortfall penalty is payable if a taxpayer has relied on Tax Office advice or a general administrative practice.

4.11 The Commissioner has the discretion to remit all or part of an administrative tax shortfall penalty.

4.12 Where the Commissioner decides not to remit a penalty or to remit only part of the penalty he must give written notice of the decision and the reasons for the decision to the taxpayer.¹¹

Administrative rules for penalties

4.13 The Commissioner has issued a number of public rulings, practice statements, fact sheets and other material which set out how he will administer the legislative rules on tax shortfall penalties under the uniform penalties regime. Most of this material is not GST-specific but some of this material contains examples which deal with GST penalties. The Commissioner has also issued other internal guidelines to his staff on how these uniform penalties are to be applied. Some of this internal material is GST-specific.

Published guidelines

4.14 Over the years since the GST was introduced the Commissioner has progressively adopted a harder stance on the application of tax shortfall penalties for post-2000 audit adjustments in his published guidelines.

4.15 For the first year of the GST, penalties were generally only applied if the taxpayer acted with intentional disregard of the law.¹² For GST returns¹³ lodged from 1 August 2001 to 31 March 2004, penalties were only generally applied if the taxpayer acted recklessly or

11 Subsection 298-20(2) of Schedule 1 to the TAA.

12 PS LA 2000/9.

13 These are known as Business Activity Statements.

with intentional disregard of the law.¹⁴ The current administrative rule, which has applied for GST returns lodged after 1 April 2004, is that penalties will be applied fully in accordance with the legislative rules for penalties that is, they will be applied if the taxpayer has acted with a lack of reasonable care, recklessly or with intentional disregard of the law.¹⁵

4.16 Under the current published administrative rules for the application of penalties in GST audits, which are contained in Practice Statement PS LA 2006/2, the Commissioner has indicated that he will generally not levy a tax shortfall penalty in the following circumstances:

- where an isolated bookkeeping or record keeping mistake has been made, the mistake does not relate to an extraordinary transaction, the mistake was honest and unintended and the taxpayer has a good compliance history¹⁶;
- where the taxpayer has, prior to being notified of an audit, made an unprompted voluntary disclosure of a GST adjustment to the Tax Office and the entity has made an honest mistake¹⁷;
- where GST has been paid by (or a credit has been claimed by) the wrong entity in a related group of entities and the entities have not acted recklessly or with intentional disregard of the law¹⁸;
- where a taxpayer does not have a valid tax or recipient created tax invoice but has made an acquisition that otherwise qualifies for an input tax credit¹⁹;
- where the mistake is corrected in a subsequent tax period in accordance with the guidelines contained in the Tax Office's guide on Correcting GST Mistakes-07/2004²⁰; and
- where a penalty would lead to an unjust result.²¹

Internal Tax Office guidelines on penalties

4.17 Tax Office auditors principally rely on the rulings, practice statements, fact sheets and other material which has been made public by the Tax Office when applying penalties. However, they also rely on a number of internal work procedure documents and guidance notes which set out certain procedural steps which they must follow when dealing with tax shortfall penalties.

14 PS LA 2002/8.

15 PS LA 2006/2.

16 PS LA 2006/2 at paragraph 139.

17 PS LA 2006/2 at paragraph 149. Remission in full does not however apply where the Commissioner has exercised his discretion to treat a prompted disclosure as unprompted: See paragraph 150 of PS LA 2006/2.

18 PS LA 2006/2 at paragraphs 151, 152 and 154.

19 PS LA 2004/11 at paragraph 37 and Attachment A paragraphs 7 and 8.

20 PS LA 2006/2 at paragraph 146.

21 PS LA 2006/2 at paragraph 157.

4.18 For GST penalties these internal documents require tax officers dealing with large taxpayer GST audits to provide written notice to taxpayers of matters such as:

- the reasons why a taxpayer was considered liable for a penalty (even in cases where that penalty is remitted to nil);
- the reasons for any remission of penalty; and
- the practice statement or other published material relied on when remitting a penalty.

INTEREST

Legislative rules

4.19 A general interest charge (GIC) is imposed on any tax or penalty that remains unpaid after the date it becomes due and payable. The interest charge is separate to any penalty imposed. It represents compensation to the revenue for the delay in payment of tax, acts as an incentive for payment of tax liabilities by their due date and ensures that taxpayers who fail to fulfil their payment and return or statement obligations do not receive an advantage over those who meet their tax liabilities in full by the due date.

4.20 Where a GST audit leads to a tax adjustment creating a liability to pay additional tax, the interest charge will be imposed from the original date that the tax was due until the date the tax is paid. For large taxpayers who lodge monthly GST returns the original date that the tax was due will be 21 days after the end of the month to which the adjustment relates.²²

4.21 The amount of interest arising from a GST audit adjustment is calculated on a daily compounding basis and is calculated by adding seven percentage points to the 90 day bank bill rate.²³

4.22 The amount of interest charge that arises from a GST audit adjustment differs from that which arises in an income tax audit adjustment.

4.23 For income tax audit adjustments the rate of interest charged is the 90 day bank bill rate plus three percentage points for the period from when the tax was originally due up until the date before the Commissioner issues an amended assessment. No interest is charged for the period between service of the amended assessment and the due date shown on that amended assessment.

4.24 The Commissioner may remit interest arising from GST audit adjustments in the following circumstances:

- the delay in payment was not caused directly or indirectly by an act or omission of the taxpayer and the taxpayer has taken reasonable action to correct the situation;

²² Section 33-3 of the GST Act and section 105-80 of the TAA.

²³ Section 8 AAD(1) of the TAA.

- the delay in payment was caused directly or indirectly by an act or omission of the taxpayer, they have taken reasonable action to correct the situation and it would be fair and reasonable to remit all or part of the charge; and
- there are special circumstances which make it fair and reasonable to remit or it is otherwise appropriate to do so.²⁴

Administrative rules

4.25 The Commissioner has issued a number of practice statements, manuals and other material which set out how he will administer the legislative rules on interest. These are largely not GST specific, although some of this material contains sections which are GST-specific. He has also issued other internal guidelines to his staff on how interest is to be applied.

Published guidelines

4.26 The principal published guidelines for the remission of interest are contained in Practice Statements PS LA 2003/2, PS LA 2004/11 and PS LA 2006/8 and the ATO's Receivables Policy.

4.27 Under these guidelines remission of the GIC will only occur where a taxpayer's individual circumstances warrant this result. Paragraph 93.5.1 of the ATO's Receivables Policy confirms that this is the Tax Office's underlying policy with respect to the remission of GIC. It states:

The law imposes GIC in all cases and the Commissioner will take steps to recover those charges, even after a primary debt is finalised. However, the legislation acknowledges that situations exist where it would be fair and reasonable for the GIC to be remitted. The Commissioner has the discretion to remit the GIC in part or in full depending on the circumstances that led to the late payment.

4.28 Under the Tax Office's guidelines for the remission of GIC, the seven percentage point uplift factor for interest will generally be remitted, and interest charged at the 90 day bank bill rate only in the following three circumstances:

- where there have been delays by the Tax Office and certain reasonable delays by the taxpayer;
- where the taxpayer has made an unprompted voluntary disclosure;
- where the transaction is a 'wash' transaction as defined. These transactions are defined in PS LA 2003/2 as being a transaction which involves GST not being charged on a taxable supply, where the supply is made to a GST registered recipient who would have been entitled to claim a full input tax credit on the supply. The term 'wash' in this context refers to the fact that there is no net tax effect on the revenue from such transactions.

²⁴ Section 8AAG of the TAA.

4.29 Under these practice statements interest arising from a GST audit adjustment will generally be remitted to nil in the following circumstances:

- where there has been no action by the Tax Office on a GST audit for 30 days or more and it was possible for the case to progress during that time;
- where the delay is outside the taxpayer's control due to a disaster or serious illness; or
- where the taxpayer has reasonably relied in good faith on Tax Office advice, a general administrative practice or an ATO Interpretative Decision (ATO ID).²⁵

Internal Tax Office guidelines on GIC

4.30 Tax Office auditors principally rely on the rulings, practice statements, fact sheets and other material which has been made public by the Tax Office when dealing with GIC. However, they also rely on a number of internal work procedure documents and guidance notes which set out certain procedural steps which they must follow when dealing with GIC. However, this internal material is not as detailed as that which has been developed for penalties.

CONCERNS RAISED IN SUBMISSIONS TO THE REVIEW ABOUT THE TAX OFFICE'S APPLICATION OF PENALTIES AND INTEREST IN LARGE TAXPAYER GST AUDITS

4.31 Submissions made to this review in relation to the issue of penalties and interest levied on large taxpayers during GST audits principally focused on the Tax Office's application of interest rather than penalties. This is understandable given that the amount of penalties ultimately levied on large taxpayers as a result of GST audits has, until the 2006/07 year, been quite low.²⁶

4.32 Submissions made to this review in relation to the application of interest made the following assertions:

- the legislative rules for interest in GST audits were inappropriate in a number of key respects;
- the Tax Office's administrative guidelines for the application of interest were in some key respects inappropriate;
- the Tax Office was not following either the legislative or administrative guidelines for interest in a number of cases; and
- the Tax Office took too long to reach a decision on the amount of interest that would be levied in a number of cases.

4.33 Similar concerns were raised in relation to the Tax Office's application of penalties.

²⁵ The Tax Office does not consider that ATO IDs are published as a form of advice : see PS LA 2006/8 at para 108.

²⁶ The Tax Office has advised the Inspector-General that the amount of GST penalties initially imposed on large taxpayers were as follows for the last three years: 2004/05: \$44 million (this was later reduced to \$2 million as the result of a single case being settled); 2005/06: \$1 million; 2006/07: \$6 million. The amount of GST penalties initially imposed on non-large taxpayers in the last two of these years was: 2005/06: \$ 126 million and 2006/07: \$116 million.

4.34 In relation to the legislative guidelines for the application of interest and penalties in GST audits many submissions asserted that a number of the changes to the interest and penalties regime that were made as a result of Treasury's Review of Aspects of Income Tax Self Assessment (RoSA)²⁷ had not been carried through to the GST regime. In particular submissions stated that the reduced rate of interest (known as the shortfall interest charge) where additional tax is payable as a result of an income tax audit should also be implemented for GST.

4.35 The extent to which changes to interest that were made to the income tax regime as a result of the RoSA review should be extended to other taxes such as GST is currently the subject of review by the Board of Taxation. The terms of reference of the Board of Taxation's review do not extend to examining the GST penalty regime and the extent to which it may differ from the income tax penalty regime.

INSPECTOR-GENERAL'S FINDINGS

Internal Tax Office reports on penalties and interest

4.36 The Tax Office produces reports on the amount of penalty that is initially levied in large taxpayer GST audits. These are the amounts of penalties which are reported in the Tax Office's Annual Report for each year. However no reports are regularly produced which indicate matters such as:

- the nature of taxpayers who have attracted GST penalties as a result of an audit (including matters such as the size of the relevant taxpayer and the industry in which it operates);
- the nature of the issues in audits which attracted penalties;
- how much of the relevant penalty imposed during the audit has actually been collected.

4.37 The penalty amounts recorded in the Tax Office's internal reports show that, for the 2006/07 year, \$6 million was levied on large taxpayers. For the 2005/06 year, \$1 million of penalties were levied and, for the 2004/05 year, \$44 million of penalties were levied.

4.38 However the \$44 million penalties actually levied for 2004/05 have been reduced by at least \$42.4 million (that is, to a maximum of \$1.6 million) as a result of a single case being settled. Penalties for the 2005/06 year also appear to have been subsequently reduced significantly in a number of cases examined by the Inspector-General.

4.39 The Tax Office's internal reports on penalties applied in GST audit cases therefore do not provide a basis for assessing the extent to which penalty decisions (including decisions on the remission of penalties) are being applied consistently and in accordance with existing guidelines. They also do not provide an indication of the level of large GST taxpayers' culpability with respect to GST errors that they may have made.

²⁷ The Treasury, *Report on Aspects of Income Tax Self Assessment*, August 2004, Commonwealth of Australia.

4.40 During the review the Tax Office advised that it is currently looking for a corporate reporting solution for the reporting of cases where significant amounts of shortfall penalty have been imposed or remitted, and how this may be reflected in external reports. It is currently exploring with the Change Program how this approach may be supported.

4.41 The Tax Office also does not prepare any report on the amounts of GIC imposed, remitted or collected in large taxpayer GST audit cases. As a result of this reporting defect, the Tax Office does not know the amounts of GIC actually imposed, remitted or ultimately collected in GST audit cases, including large taxpayer cases. As a result it does not know the extent to which GIC decisions (including decisions on the remission of GIC) are being applied consistently and in accordance with existing guidelines.

4.42 During the review the Tax Office advised that it is possible to manually isolate and calculate the GIC arising from GST assessments in individual cases. This is not done as a matter of course. The Tax Office advised that it is currently reviewing this with a view to determining how it can report on GIC.

Inspector-General's review of GST penalty and interest cases for large taxpayers

4.43 For this review, staff of the Inspector-General examined aspects of GST penalty cases that were evident from internal Tax Office material and publicly available material on GST cases that had been subject to the objection and appeal process. IGT staff also examined in detail the case files for 100 randomly selected large taxpayer GST audits that were finalised during the 2004/05 and 2005/06 years and the ten months ended 30 April 2007. Of these cases that were examined, 16 cases involved the imposition of both penalties and interest at the audit stage, 5 involved the imposition of penalties only at the audit stage and 35 involved only the imposition of GIC at the audit stage. There were 44 cases which involved neither the imposition of GIC or any penalty.

Inspector-General's review of penalty cases

Cases involving GST penalties that have been subject to objection and appeal

4.44 An internal Tax Office report which was based on a sample of 100 GST audit cases drawn from the 2004/05 and 2005/06 years indicates that 78 per cent of objections against GST assessments included a penalty issue. 28 per cent of cases involved a penalty only objection.

4.45 For audit-sourced GST objection decisions which involve a penalty only, 58 per cent were allowed either in full or part. In 33 per cent of cases the objection decision was allowed in full.

4.46 Furthermore, although the number of GST audits conducted in 2005/06 and 2004/05 were similar, there was a 36 per cent increase in the number of GST objections received in 2005/06 compared to 2004/05.

4.47 These figures cover GST objections for all GST taxpayers – not just those in the large category. However, they strongly suggest that there may be an issue with the manner in which penalties are being levied in large taxpayer GST audits.

Fieldwork on penalty cases conducted for this review

4.48 Of the 21 penalty cases examined by the Inspector-General, 15 related to the 2006/07 year. Two of these cases were on hand at year end but had penalties applied thereafter. The penalties levied in these 15 cases totalled \$5.5 million. The total number of finalised penalty cases in the large taxpayer market for this year was 26 and the total dollar value of such penalties was \$6.3 million. The cases reviewed by the Inspector-General therefore covered 87 per cent of the dollar value (and 58 per cent of the number) of all 2006/07 large taxpayer GST audit penalty cases.

4.49 Of the 15 penalty cases examined for the 2006/07 year, the Inspector-General considers that there are issues which directly affect the level of penalty imposed in 11 of these cases. In most of these cases, these systemic issues affect whether the penalty has been levied at too high a rate, although there are some cases where the systemic issues indicate that the penalty may have been set too low.

4.50 The systemic issue which affected the largest number of cases examined by the Inspector-General (nine cases) related to the Tax Office's practices for levying penalties in cases where there was an issue as to whether the taxpayer had voluntarily disclosed the matter that was subject to an audit adjustment. The next most significant systemic issue related to the Tax Office's practice for levying penalties in cases where a taxpayer has obtained external advice that the position they are adopting is correct (three cases).²⁸

4.51 The Inspector-General considers that these two issues represent systemic issues given that the 11 penalty cases reviewed represent a very high percentage – 67 per cent of the total dollar value – of penalties imposed in large taxpayer GST audits for the 2006/07 year.

4.52 Two issues affected only one case each. In one case a penalty was levied in a situation where the taxpayer was owed a net refund as a result of the audit. This practice is inconsistent with the policy that is applied for other taxes, such as income tax. In the other case, a penalty was levied in a situation where the taxpayer thought it was protected from any penalty because of a practice which had been confirmed in writing by the Tax Office. Again this result is contrary to stated Tax Office policy.

4.53 The two issues which affected more than one case are examined in further detail below.

Levy of penalties in GST audit cases involving voluntary disclosure

4.54 In the nine penalty cases involving disclosures where inappropriate outcomes penalties may have been achieved, the particular issues that were central to these inappropriate outcomes were as follows:

- Was the taxpayer's action one which met the definition of being a 'voluntary disclosure'?
- Was the disclosure made before or after the taxpayer was notified of an audit?
- Was the disclosure voluntary?

²⁸ Note that in one of the 11 cases both these issues were present.

What amounts to a 'voluntary disclosure'?

4.55 In two of these nine cases, the GST audit was generated after the taxpayer made a self amendment request for an additional refund where they fully disclosed the basis for the additional refund claim. Each of the refund claims was queried by the Tax Office under its usual procedures for checking unusual or high refunds. In each case the additional refund claim was disallowed. In one case a 50 per cent penalty was imposed on the basis that the taxpayer had been reckless in making their claim. In the other case a penalty was imposed on the basis that the taxpayer had failed to take reasonable care. In neither case was the penalty reduced to either 80 per cent of the initial penalty (in accordance with the relevant legislative rules) or to nil (in accordance with the administrative rule contained in PSLA 2006/2) to take into account the taxpayer's initial disclosure of the relevant items.

4.56 The Tax Office auditors in each case asserted that there was an internal Tax Office policy that self amendments resulting in an additional refund claim where there was full disclosure of the basis of the amendments were not treated as voluntary disclosures for the purposes of the application of penalties. The Inspector-General has confirmed with the senior management of the GST business line that such a policy exists. However, this policy is not clearly articulated in any document. Furthermore, tax commentators have noted there is a lack of clear Tax Office guidance generally on how taxpayers can made self amendments to GST returns and the legal basis for doing so.²⁹

4.57 During the review the Tax Office asserted that its policy that self amendments do not amount to voluntary disclosures was articulated at page 58 of its 2006 Large business and tax compliance booklet. The words that the Tax Office relies on in support of this contention are as follows:

... taxpayers may choose to disclose a shortfall (or an overpayment) by making a voluntary disclosure (or a request for a self amendment).

4.58 The Inspector-General does not consider that these words clearly indicate to either taxpayers or to Tax Office staff that self amendments resulting in an additional refund claim will not be regarded as voluntary disclosure for penalty purposes. In fact, these words appear in a paragraph which is headed 'Voluntary Disclosures'. This suggests that self amendments will amount to voluntary disclosures.

4.59 The Inspector-General considers that the Tax Office's policy in this area is not supported by the relevant legislative rules for voluntary disclosures. It also appears to be inconsistent with the ruling which deals with voluntary disclosures of income tax adjustments (TR 94/6). Paragraph 49 of this ruling states that a request for a self amendment which fully sets out the basis for the amendment will usually be a voluntary disclosure.

4.60 The Tax Office has indicated that it disagrees with the view that this policy is inconsistent with TR 94/6. It considers that paragraph 49 of this ruling only applies to situations where a taxpayer has made a self amendment to increase rather than decrease the tax that is payable. However, the term 'self amendment' is not usually defined in this way by the Tax Office and is not expressly limited to debit amendment cases in TR 94/6 itself.

²⁹ See for example, Hill, P R, Carey, A, Davidson, J A, Murray-Jones, I G and Stacey, P A, *Australian GST Handbook 2007-8*, Thomson, 2007 at para 47-105.

4.61 The Inspector-General considers that this systemic issue should be addressed by the Tax Office issuing a statement (either in a practice statement or ruling) which confirms that disclosures made in GST self amendments which involve a full disclosure of the basis of the amendments will amount to voluntary disclosures for the purposes of applying penalties. It should also consider issuing clearer guidance on the general topic of how taxpayers can make self amendments to GST returns and the legal basis for doing so.

Was the disclosure made before or after the taxpayer was notified of an audit?

4.62 In four cases the taxpayer disclosed the matters that were the subject of adjustment a few days after the refund claims involving the items to be adjusted had been stopped for checking by the Tax Office under its usual procedures for querying high or unusual GST refunds. In each case the disclosure was made before the Tax Office issued a formal letter notifying the taxpayer that it was under audit. In one case, the taxpayer's disclosure was treated as arising before an audit and any penalty was reduced to nil. In three cases the taxpayer's disclosure was treated as occurring only after the taxpayer had been notified of an audit and a 20 per cent rather than 80 per cent or 100 per cent reduction in penalty was applied.

4.63 In the case where the penalty was reduced to nil the Tax Office advised that this reduction had occurred because the taxpayer concerned was formerly a small to medium taxpayer. The Tax Office advised that it has an internal policy for small and medium size businesses that it will treat a taxpayer who makes a voluntary disclosure of an error within a few days of receiving a call from the Tax Office querying any refund as having made a disclosure before a formal audit.

4.64 In the other three cases where the disclosure was made shortly after the relevant refund was stopped the relevant taxpayer had always been treated by the Tax Office as a large taxpayer. The Tax Office auditors on these cases advised that for this type of taxpayer a disclosure made after a refund had been stopped for checking but before any formal notification letter was sent was always treated as being a disclosure that was made after an audit had been notified.

4.65 In another case, the taxpayer alleged that it had disclosed the item that was subject to adjustment to the Tax Office some time after the refund containing the relevant item was stopped for checking by the Tax Office. In this case, the Tax Office only ever formally advised the taxpayer that it was conducting a 'review' of the refund – rather than any audit. The taxpayer alleged that a notice of a review did not amount to notification of an audit and that as a result any penalty imposed on the relevant item should be reduced by a factor of 20 per cent. The Tax Office however did not however give any reduction in penalty.

4.66 The Tax Office has no clear publicly available guideline which covers the issue of what it will regard as amounting to the notification of an audit for the purpose of applying penalties. The Tax Office does however have internal reference material for its GST auditors, which is available on its intranet, which deals with this issue. This material specifically states that when a taxpayer, after being advised of a compliance activity makes a voluntary disclosure before the formal date of commencement of the audit the disclosure will be treated as having been made before the taxpayer was informed of an audit. It appears from the fieldwork conducted by the Inspector-General that this internal policy may be being applied only to small to medium size taxpayers rather than to large taxpayers.

4.67 During the review the Tax Office advised that the reasons for the different policy it has in this area for large taxpayers when compared to small to medium size taxpayers is that audits of large taxpayer refund claims are generally conducted after the relevant refund has been paid, while such audits in the SME area occur before the refund is paid. However, this distinction is not referred to in the Tax Office's internal reference material and is not understood by either its staff or by taxpayers and their advisers. Furthermore, the Tax Office does not actually apply this distinction in practice as its guidelines allow refunds for SME taxpayers to be paid before the period of grace for making any disclosure has ended.

4.68 In the Inspector-General's view, the Tax Office should take steps to ensure that any internal policy in this area is applied to all, not just some, GST audits. One way in which this could be done would be by the Tax Office issuing a publicly available practice statement or ruling which clearly outlines its view on whether a taxpayer, who makes a voluntary disclosure after their refund has been stopped for checking but before being formally notified in writing of an audit, will be treated as having made a voluntary disclosure before or after being notified of an audit.

4.69 The Inspector-General notes that members of the National Tax Liaison Group's ATPF subcommittee have been seeking public clarification of when a taxpayer has been notified of the commencement of an audit for the purposes of the application of the penalty rules from as early as 2005. It was also an issue raised in a previous report of the Inspector-General. However, to date no such public clarification has been made.

Was the disclosure 'voluntary'?

4.70 In two cases after the relevant audit had commenced errors were disclosed by the taxpayer as a direct result of Tax Office queries into the relevant subject matter. These errors affected other tax periods. The Tax Office treated the errors for the other periods as voluntary disclosures occurring before an audit had commenced for those periods and no penalties were applied for these periods.

4.71 This process is inconsistent with the administrative rule which applies in income tax cases as stated in paragraph 35 of TR 94/6. For income tax purposes, such disclosures would not be treated as being made voluntarily.

4.72 The Tax Office states that its policy on what constitutes a disclosure that is voluntary for GST audits is also contained in TR 94/6. However, this document pre-dates and does not address any of the GST-specific issues concerning voluntary disclosure that were examined during this review, nor any other issues concerning the application of this ruling to GST.

4.73 The Inspector-General considers that the systemic issue about the lack of definitive guidance on voluntary disclosure issues of this nature should be addressed by the Tax Office issuing a statement (either in a practice statement or ruling) which clearly outlines its view on when a disclosure made during a GST audit will be considered to be voluntary.

Other issues found in the review concerning the application of penalties in voluntary disclosure cases

4.74 During the review the Inspector-General also found that in a number of cases involving unprompted voluntary disclosures where a penalty was not ultimately applied,

auditors led the taxpayer to believe that a penalty would be applied, even though this was generally not at the relevant time Tax Office policy.

4.75 The Inspector-General also found instances where large penalties were applied but were substantially reduced upon further internal review because there was no actual tax shortfall for the relevant period.

4.76 These findings relate to issues that are stated in either the law on penalties or in existing Tax Office policy documents on penalties. They therefore raise an issue concerning the adequacy of the training of large taxpayer GST auditors on the law and current Tax Office policy on penalties.

4.77 The failure of GST auditors to advise taxpayers that current Tax Office policy involves no application of penalties in voluntary disclosure cases also raises the issue as to the nature of communication processes between GST auditors and taxpayers.

4.78 These issues are discussed further later in this report.

Levy of penalties in cases involving external advice

4.79 In three large taxpayer penalty cases penalties were levied in a situation where the taxpayer, prior to submitting the relevant GST return, had obtained external advice from a reputable source which indicated that there was some basis for the position adopted. In each case the Commissioner disagreed with the position adopted in a subsequent audit.

4.80 The imposition of a penalty in these circumstances appears to be contrary to Tax Office policy. For statements made in GST returns lodged after 1 April 2004 this policy is stated in paragraph 35 of PS LA 2006/2. This paragraph confirms that no penalty for failing to take reasonable care will apply in such circumstances. It states that:

Where an entity or their agent adopted a tax treatment that is not consistent with the Commissioner's view, reasonable care will have been exercised where they have made a genuine effort to research the issue and there is some basis for the position adopted.

4.81 The imposition of a penalty in these circumstances is also contrary to the guidance on the meaning of 'reasonable care' contained in the Explanatory Memorandum which introduced the present GST penalty regime in 2000. Paragraphs 1.75 and 1.76 of the Explanatory Memorandum state:

1.75 A taxpayer who prepares his or her own return or BAS would usually be taken to have exercised reasonable care if in doing so the taxpayer relies upon the advice of a registered tax agent, accountant or lawyer or other person whom the taxpayer could reasonably expect to provide competent advice on the relevant matter. On the other hand, where such advice is not followed this would usually mean that the taxpayer did not exercise reasonable care.

1.76 If a taxpayer seeks to rely upon the wrong advice, and the taxpayer's skill and education was such that the taxpayer could reasonably be expected to have known or suspected that the advice was wrong, the taxpayer would risk penalty. A taxpayer would also risk penalty if the taxpayer

was careless in presenting all of the relevant facts to the advisor and this had materially affected the advice on which the taxpayer sought to rely.³⁰

4.82 The Inspector-General notes that the income tax penalties regime has a specific provision which applies to tax adjustments over certain thresholds where a taxpayer has developed a 'reasonably arguable position' based on researching the relevant issue. The effect of this provision is that if a taxpayer has a reasonably arguable position in relation to a disputed income tax item no penalty will be applied.

4.83 The GST penalty regime does not have a similar provision. It appears that, in some GST audit cases, the difference between the income tax and GST penalty regimes on this issue may be causing GST auditors to think, incorrectly, that for GST, a reasonably arguable position does not give rise to a valid defence to the application of a GST penalty.

4.84 The Inspector-General considers that the results of this review indicate that the Tax Office needs to take further steps to ensure that its GST audit staff correctly apply the law on penalties for GST adjustments in cases where a taxpayer has obtained and followed credible external advice and/or has a reasonably arguable position.

Tax Office internal review processes for penalties

4.85 Although the Tax Office has no process for recording and assessing the results of all GST audit cases where a penalty has been levied, it does have a number of internal processes designed to ensure that correct audit and penalty results have been achieved.

4.86 These processes are as follows:

- an internal policy which states that any penalty imposed must be subject to a peer review;
- an internal policy which states that all shortfall penalty cases are to be signed off by a member of the Tax Office's internal Penalty and Interest Network. This network was established in August 2006 and comprises about 100 staff who review penalty decisions for the whole of the GST business line;
- an internal policy that all penalty cases which exceed a certain dollar value must be signed off by a member of the Senior Executive Service;
- periodic Technical Quality Reviews (TQRs) of a sample of penalty cases;
- formal internal reviews of a sample of large taxpayer penalty cases;
- informal internal reviews of specific taxpayer cases;
- a formal internal review process which applies where a taxpayer objects to a GST audit assessment;
- periodic training on the application of penalties.

³⁰ Explanatory Memorandum to A New Tax System (Tax Administration) Bill (No. 2) 2000.

4.87 A Technical Quality Review on GST cases involving penalties conducted in March 2007 indicated that there was a significant increase in the percentages of cases achieving either a pass or 'A' result over the period from September 2004 to January 2007. As at January 2007 the GST business line was meeting corporate quality control benchmarks for these types of cases. In earlier periods it was not meeting these benchmarks.

4.88 During the 2006/07 year the Tax Office conducted a review of the application of penalty policy within the GST's large taxpayer audit area. The review looked at 47 cases in the 2005/06 year although the main focus was on cases completed post February 2006. This review found that 17 of the sampled cases (36 per cent) involved an incorrect penalty decision. The reasons for the incorrect decision were as follows:

- Auditors had a lack of understanding around penalty remission guidelines, especially for unprompted voluntary disclosures.
- Auditors were listing as reasons for remission of penalties the taxpayer's co-operative behaviour during an audit, whereas the law required them to assess the taxpayer's behaviour as at the time the underpayment of tax was made.
- Auditors were finding that a taxpayer had exercised reasonable care simply on the basis that they had used a tax agent or obtained external advice without analysing whether that advice was specific to the taxpayer's circumstances, whether it had been followed and whether the adviser had been provided with all relevant facts.

4.89 Tax officers who conducted this review advised that it was prompted by concerns that the level of penalties charged to large taxpayers was too low and that penalties were being applied inconsistently. Of the 47 cases that were sampled, there were only six where a penalty was ultimately levied, with the remainder of cases being those where no penalty was levied.

4.90 The Tax Office's internal review principally focused on whether internal processes for levying penalties had been correctly carried out, and not on whether the correct penalty outcome was in fact achieved. A penalty decision was therefore classified in this internal review as being incorrect if internal processes had not been followed, not because an incorrect penalty outcome was in fact achieved.

4.91 One of the conclusions the Tax Office made from this internal review was that penalties in large taxpayer GST audit cases were not, in the main, being set too low. Furthermore, as a result of this internal penalty review the Tax Office resolved to:

- provide further training on penalties to large taxpayer GST auditors. A series of facilitated workshops was rolled out from mid 2007 to the end of August 2007 to address this matter;
- restructure its internal penalty network. This has been completed;
- ensure that all penalty cases are referred to a member of its internal penalty network and have its internal Penalties and Interest Practice oversee and review a sample of those cases; and
- ensure that internal penalty authorisation levels are observed. The Tax Office has advised that this has been reinforced with all approving officers.

4.92 While this internal Tax Office review had a different focus to the review of penalty cases that was conducted by the Inspector-General, its results do lend some support to a conclusion that GST auditors may be levying penalties in a significant percentage (36 per cent according to the Tax Office's report) of all penalty cases inappropriately because of a failure to correctly follow internal Tax Office processes for applying penalties.

4.93 During this review the Inspector-General found that, out of the 21 cases he examined which involved the application of penalties at the audit stage, there were five cases which initially involved substantial recklessness penalties. In three of these five cases the penalty was subsequently reduced to nil as a result of an internal review. Two of these internal reviews involved the Tax Office's Tax Counsel Network. Feedback was not provided to the original auditors on the reasons for penalty reductions in all these cases.

4.94 The Tax Office also provided data which indicates that, of the 16 cases involving penalties in large taxpayer GST audits that proceeded to the objection stage during the three years ended 30 June 2007, and involved valid objection requests, six cases resulted in the penalty objections being allowed in full and three cases involved the penalty objections being allowed in part. One case was settled. In the remaining six cases the penalty objection was disallowed.

4.95 The Tax Office asserts that a number of these overturned penalties cases were the result of the taxpayer presenting more evidence and/or information at the objection stage. While this may be a factor in the eventual penalty result, there remains an issue as to why a correct penalty outcome was not achieved at the audit stage of the relevant dispute. These results therefore suggest that at least in some cases GST auditors may have an approach to the application of penalties which does not lead to the correct result being achieved on a timely basis. A lack of feedback on the ultimate penalty results will also mean that the relevant GST auditors are not aware of any mistakes they have made in this regard.

4.96 In the light of the results of his fieldwork for this review, and the Tax Office's own internal review, the Inspector-General has concerns that the Tax Office's quality review processes for penalties are not fully achieving their desired aim of appropriate quality control over GST audit penalty decisions.

4.97 He also notes that the Tax Office's current policies on the imposition and remission of penalties are contained in a large number of different Tax Office documents, some of which are not GST specific, and that this, of itself, may be causing GST auditors to make errors in penalty decisions.

4.98 The above comments lead to the following key recommendation.

KEY RECOMMENDATION 4.1

The Tax Office should enhance its processes for the proper application of penalties in GST large taxpayer audits by:

- issuing GST-specific guidance for its staff on the application of penalties which arise as a result of a GST audit;*
- ensuring that this guidance covers what kinds of disclosures will give rise to a reduction in penalties, when a disclosure will be considered to have been voluntary and when any voluntary disclosure will be considered to have been made before or after the start of an audit;*
- continuing to conduct periodic reviews of the extent to which penalties in large taxpayer GST audits are being applied appropriately; and*
- ensuring that, where a penalty is reduced after the issue of an audit report as a result of either an internal or external review process, feedback on the reasons for the reduction is provided to all Tax Office staff who were involved in the initial setting of the penalty.*

Tax Office response

Dot point 1

4.99 The Tax Office agrees with this recommendation. This guidance may be in the form of a single document or a number of documents which together provide the level of detail needed by GST auditors to impose penalties.

Dot point 2

4.100 The Tax Office agrees with this recommendation.

Dot point 3

4.101 The Tax Office agrees with this recommendation and is of the view that continuation of the periodic technical quality reviews of the application of the penalty regime imposed in large taxpayer audits will meet this requirement. During the 2006-07 year the National Technical Quality Review (TQR) results show that penalty decisions met corporate benchmarks.

Dot point 4

4.102 The Tax Office agrees with this recommendation as it has already been implemented as a separate initiative unrelated to this review.

Inspector-General review of cases involving GIC

4.103 The work conducted by the Inspector-General for this review on the issue of GIC focused on the following two concerns raised in submissions:

- whether GIC imposition and/or remissions decisions were being made on a timely basis;
- whether these decisions were being made consistently in accordance with existing legislative and/or administrative rules.

Delays in making GIC imposition and/or remission decisions

4.104 Prior to and during the 2006/07 year a number of taxpayers and/or their representatives raised concerns with the Tax Office at the length of time it was taking for GIC remission decisions in connection with GST audit adjustments to be made. During this period GIC remission decisions were the responsibility of an area of the Tax Office (the Operations area) which was separate from the GST audit area. The Inspector-General's fieldwork for this review has confirmed that delays of up to a year in reaching these remission decisions were not uncommon.

4.105 The Tax Office took steps early in the 2006/07 year to address these delays by transferring responsibility for GIC remission decisions in the context of audits to the GST audits area. This change took effect from October 2006. The change was part of a Tax Office-wide process for shifting responsibility for determining GIC remission decisions from the Operations area of the Tax Office to its audit (Compliance) areas.

4.106 From the Inspector-General's fieldwork for this review, it appears that, since this change, delays in making GIC remission decisions have decreased in number and intensity. However, during his fieldwork the Inspector-General found a number of post October 2006 cases where unreasonable delays were still occurring.

4.107 One such group of cases were those which had been finalised prior to October 2006 where responsibility for the GIC remission remained with the Operations area after that date. In a number of these cases, the Tax Office took more than nine months to reach any GIC remission decision.

4.108 Another group of cases in this category were those which were finalised after October 2006 where GST had been paid but by the wrong entity in a group and the only issue in dispute was the GIC. In a number of these cases the GIC remission took more than nine months to make.

4.109 The Inspector-General notes that the Tax Office currently has no published guidelines on the remission of GIC in cases involving the payment of GST by the wrong entity in the group. It does however have a guideline which states that any penalty will generally be fully remitted in this kind of case.

4.110 The Inspector-General considers that the absence of such a guideline has been a significant factor which has led to the remission decision delays which have occurred in these cases. He therefore recommends that a guideline be issued on this topic, in the form of either a Practice Statement or ruling. This guideline should confirm, in line with the policy the Tax Office is in fact applying, that in these kinds of cases GIC will be fully remitted.

Consistency of application of GIC

4.111 Of the 100 large taxpayer GST audit cases reviewed by the Inspector-General, about half (51 cases) involved the imposition of some GIC, while the other half (49 cases) involved no imposition of GIC.

4.112 In 23 cases, GIC was not imposed because there was no shortfall as a result of the audit. In 26 cases GIC was theoretically payable, but was remitted in full.

4.113 Of the 51 cases where some GIC was imposed, GIC was imposed at full rates in 23 cases, was remitted to the base rate in 18 cases and was partially remitted to a rate that was less than the base rate in the remaining 10 cases.

4.114 These numbers at face value appear to indicate that there may be some inconsistency in the way in which the Tax Office is levying GIC in GST audit cases, given that the Tax Office's stated policy on the remission of GIC is that this will occur only where individual circumstances warrant this result.

4.115 The Inspector-General has further analysed the 77 sampled cases where the imposition of GIC was an issue and has concluded that there is a marked lack of consistency in the imposition and/or remission of GIC in the following particular areas:

- cases involving unprompted voluntary disclosures; and
- cases involving wash transactions.

Unprompted voluntary disclosures

4.116 As discussed above, the Tax Office's administrative rules for GIC state that GIC on any adjustments arising from an unprompted voluntary disclosure will generally be remitted to the bank bill rate (called the 'base rate') (that is, the normal GIC rate will be reduced by 7 per cent). This reduced interest rate is subject to the taxpayer meeting a number of conditions such as acting promptly after detecting the error and having a satisfactory compliance history. This current policy is contained in paragraphs 81 to 83 of PS LA 2006/8.

4.117 Given this administrative rule, the Inspector-General expected to find that this base rate GIC would be the GIC levied in almost all of the 35 cases involving unprompted voluntary disclosures that he reviewed for the purposes of this review. However this was not the case.

4.118 Instead, the GIC results for these 35 voluntary disclosure cases that were examined during the review were as follows:

- cases involving full GIC: 9 cases (26 per cent);
- cases involving full GIC remission (that is, no GIC): 9 cases (26 per cent);
- cases involving base rate GIC: 9 cases (26 per cent);
- cases involving GIC, but not at the base or full rate: 1 (3 per cent);

- cases involving no GIC because no GST had in fact been underpaid (for example, because the GST had been paid by another entity in the same group or the taxpayer was owed a refund as a result of the audit): 6 cases (17 per cent).;
- cases where no GIC remission decision had been reached: 1 (2 per cent).

4.119 These results indicate that where a large taxpayer has made an unprompted voluntary disclosure GIC, where properly payable, is just as likely to be either remitted in full or levied at the full rate as it is to be levied at the base rate. The base rate is the rate which is generally set under the Tax Office's current policy provided a number of conditions are met.

4.120 These results indicate that the Tax Office administrative rule for GIC in cases of unprompted voluntary disclosures is not being followed in practice by ATO officers. The Inspector-General considers that the Tax Office should take appropriate corrective action to address this issue.

4.121 In particular, the Inspector-General considers that the Tax Office should review the GIC decisions reached in all cases of unprompted voluntary disclosures where GIC has been charged in full with a view to re-setting the GIC rate in these cases to at least the base rate, being the rate which represents the Tax Office's current policy.

Wash transactions

4.122 As also discussed above, the Tax Office's administrative rules for GIC state that GIC on any adjustments arising from a wash transaction will generally be remitted to the bank bill rate (called the 'base rate') (that is, the normal GIC rate will be reduced by 7 per cent).

4.123 Given this administrative rule, the Inspector-General expected to find that this base rate GIC would be the GIC levied in almost all cases selected for review which involved wash transactions. However this was not the case.

4.124 Of the cases examined there were only eight cases which involved a wash transaction alone and no other factor such as the making of an unprompted voluntary disclosure that might operate to reduce the GIC. The GIC results in these 'wash' cases were as follows:

- cases involving full GIC: 1;
- cases involving full GIC remission (that is, no GIC): 4;
- cases involving base rate GIC: 2;
- cases involving GIC remission, but not at the base or full rate: 1.

4.125 Although the number of these types of cases examined by the Inspector-General during his review is small, they do appear to indicate that in practice GST audit cases involving pure wash transactions are more likely to result in the Tax Office fully remitting the GIC rather than remitting to the base rate only. However, the Tax Office's policy in this area is that GIC will generally not be remitted fully but will only be remitted to the base rate. The Inspector-General's review therefore strongly suggests that the current Tax Office

administrative rule for the application of GIC in wash transactions is at odds with the GIC remission decisions GST auditors are actually making and is therefore flawed.

4.126 The Inspector-General considers that the Tax Office reached a correct remission decision in the four cases where a full GIC remission was granted.

4.127 The Inspector-General considers that full GIC remission in cases of one-off wash transaction errors should be the norm rather than the exception.

4.128 In wash cases the operation of the GIC rules mean that the GIC amount can become very high relative to the tax that is at issue, especially where multiple transactions which have occurred over a number of years are involved. A high GIC amount in these kinds of cases would appear to be unwarranted, given the overall revenue-neutral result of the error the taxpayer has made.

4.129 Any problem arising from the imposition of such an amount is further compounded if, as noted above, the Tax Office takes too long to remit this amount, as appears to be occurring in some cases. Tax Office delays in these circumstances can mean that the affected taxpayer is required to bring any GIC charge to account for statutory reporting purposes, even though the GIC is eventually fully remitted.

4.130 The levy of any GIC in such cases is also at odds with the underlying rationale for the imposition of the GIC. The Explanatory Memorandum which introduced the present GIC charge states that this rationale is that the GIC provides compensation to the revenue for money it should have received earlier. In wash transactions there is generally no overall amount which the revenue should have received earlier.

4.131 Furthermore, the Tax Office is aware that there will be no overall tax amount that arises from these kinds of cases, because at the time the cases are concluded it is required, under its existing policies, to assess whether there is an overall revenue-neutral effect, at least for the purposes of determining GIC.

4.132 The Inspector-General's view is that any undesirable behaviour on the part of the relevant taxpayer in relation to failing to account for GST on such transactions should be addressed by the levy of a penalty rather than any GIC. The Government could explore the establishment of a specific penalty for this purpose. A separate and specific penalty would help to address the administrative problems which the Tax Office is currently experiencing in arriving at consistent decisions on the level of recompense that should be payable to the revenue in these kinds of cases.

4.133 The Inspector-General also considers that the levy of an existing or possibly newly created administrative penalty, rather than any GIC, should also be considered in other GST adjustment situations which involve no overall loss to the revenue such as:

- cases involving invalid tax invoices or recipient created tax invoices where the relevant invoices are invalid only because of a minor technical defect involving the form of the relevant invoice or any related document; and
- cases where GST has been paid at the correct time but by the wrong entity in a group of related entities.

4.134 The Inspector-General notes that in both these other kinds of revenue-neutral transactions, where they are one-off in nature, the Tax Office will, under its existing stated

policies, currently generally remit any GIC in full. For cases involving invalid documentation penalties for failing to keep proper records are also being levied, but in the cases sampled by the Inspector-General this was only occurring in cases which involved repeat offences.

Tax Office response provided during the review

4.135 During the review the Tax Office advised that it was currently considering its policy on GIC in relation to revenue-neutral and documentation issues.

Tax Office internal review of GIC decisions

4.136 Although the Tax Office has no process for recording and assessing the results of all GST audit cases where GIC has been charged and/or remitted it does have a number of internal processes designed to ensure that correct GIC results have been achieved.

4.137 These processes are as follows:

- an internal policy which has applied since October 2006 which states that any GIC remission decision made by a large taxpayer GST auditor must be signed off by a member of the GST business line's internal Penalty and Interest Network;
- periodic technical quality reviews of GIC remission cases. A review of this nature was conducted across all the Tax Office's business lines in respect of audit cases finalised between August and December 2006.

4.138 The Inspector-General has concerns that these processes for GIC may not be fully achieving their quality control aims in the light of the results of his fieldwork on GIC cases for this review.

4.139 In addition, the Inspector-General has the following specific concerns about these internal Tax Office quality control processes for GIC for large taxpayer GST audits.

4.140 Firstly, the internal guidelines on when GIC interest remission decisions for large taxpayers must be referred to the penalties and interest network are poor in detail and are not readily available to GST auditors.

4.141 Secondly, these guidelines are not being followed in a number of cases. During his fieldwork for this review the Inspector-General found instances where GIC remission decisions should have been referred to this network but were not.

4.142 Thirdly, the Tax Office's processes for reviewing GIC remission decisions for large taxpayer audits also do not require either the auditors or any penalty network reviewer to ascertain some relevant important information prior to granting any GIC remission such as, in particular, the actual total amount of GIC that was initially imposed in the relevant case or the amount that would be involved in any remission. This may mean that very sizeable remissions of GIC could be occurring without proper senior management scrutiny.

4.143 These flaws appear to indicate that when responsibility for GIC remission decisions was transferred from the Operations area of the Tax Office to the GST audit area this process was largely not accompanied by some processes and procedures which exist in the Operations area for ensuring that GIC remission decisions are made correctly. The Inspector-General considers that this matter should be addressed as soon as possible.

4.144 During the review the Tax Office advised that a corporate wide capability TQR was conducted in relation to GIC remission decisions on a sample of cases finalised between August and December 2006. The GST result from this TQR was a 83.3 per cent pass rate. The Tax Office noted that this was 11.7 per cent below the corporate benchmark, but it also noted that these cases were finalised within the first months of the release of the practice statement (PS LA 2006/8 Remission of shortfall interest charge and general interest charge for shortfall periods), which was introduced on the first day of the TQR period sampled.

4.145 The Tax Office advised that the results showed that there were very few cases where further remission was warranted, although it was clear that not all officers were applying the guidelines. Another capability wide GIC TQR was undertaken in September 2007. The results from this TQR included specific results for GST.

4.146 The Inspector-General notes that the results of the 2006 TQR review confirm a number of findings of his review. He also notes that the Tax Office's current policies on the imposition and remission of GIC in GST audits are contained in a large number of different Tax Office documents, some of which are not GST specific, and that this, of itself, may be causing GST auditors to make errors in GIC remission decisions.

Conclusions on GIC

4.147 Cases examined during the review suggest that the imposition of a general interest charge is inappropriate in relation to certain 'procedural' compliance adjustments which are revenue-neutral and which are made as a result of a GST audit. GST audit cases examined during the review which initially attracted a significant initial GIC charge that was compounded over a number of tax periods included:

- cases where the Tax Office levied GST on a supplier but at the same time (or shortly thereafter) allowed a corresponding input tax credit (ITC) for the GST to the purchaser of the supply. This meant that correction of the error resulted in no net revenue being payable to the Tax Office. These transactions are referred to as 'wash transactions' by the Tax Office;
- situations where a legal technicality was breached by the taxpayer being audited. Examples include input tax credits being claimed on the basis of invalid tax invoices and situations where an input tax credit was not available because of the absence of an agreement between the parties for the purchaser of a supply to create the relevant tax invoice;
- cases where the wrong entity in a group of companies claimed an input tax credit or paid GST but in the correct period; and
- cases where GST was charged by one party to a transaction and fully claimed as a refund by the other party but where no GST was in fact payable or claimable on the relevant transaction.

4.148 Cases in the second to fourth categories above are, like wash transactions, generally corrected in a subsequent tax period with no net gain to the revenue.

4.149 An alternative to the GIC regime could be penalties imposed under either the existing penalty regime (for example, for failing to keep proper records) or possibly under a new legislative penalty which applies to one-off cases involving no net loss to the revenue.

Any such penalty should be applied only in cases that warrant it (such as cases involving wilful and repeated transgressions of the relevant technicality).

4.150 The Tax Office has indicated it is reluctant to impose a penalty under existing penalty provisions because this process would imply that the general interest charge is a penalty. This comment ignores the fact that, while the GIC is not a penalty in itself, it can have a penalty effect where, as is currently the case for GST, it is imposed for periods where the taxpayer is unaware that the GIC is accruing at a rate which is well in excess of the usual cost of finance for the taxpayer. This penalty-like effect of the GIC has been noted in other reports prepared by the Inspector-General.³¹

4.151 In addition, existing Tax Office internal review processes for GIC decisions may not be fully achieving their quality control aim. When responsibility for GIC remission decisions was transferred from the Operations area of the Tax Office to the GST audit area this process was largely not accompanied by some processes and procedures which exist in the Operations area for ensuring that GIC remission decisions are made correctly.

4.152 These conclusions and the comments earlier in this report lead to the following key recommendations:

KEY RECOMMENDATION 4.2

The Inspector-General recommends:

- *that the Tax Office's existing policy on wash transactions should be altered so that full remission of GIC on a one-off wash transaction error becomes the norm rather than the exception;*
- *that the Tax Office should issue a specific policy to reflect that it will generally fully remit GIC in cases where a wrong entity has accounted for the GST; and*
- *that the Tax Office addresses any undesirable behaviour on the part of the relevant taxpayer in relation to failing to account for GST on one-off wash transaction errors or other similar transactions which involve no revenue loss through the existing penalty regime rather than the GIC regime.*

Tax Office response

4.153 The Tax Office does not agree with this recommendation.

Dot point 1

4.154 The scheme of the Act does not take into consideration the treatment of another taxpayer when applying GIC to an entity which has made a mistake.

³¹ See, for example, Inspector-General of Taxation, *Review of the remission of the General Interest Charge for groups of taxpayers in dispute with the Tax Office*, 5 August 2004 at paras 2.27 to 2.29.

4.155 Each case for remission of GIC will be considered on its own circumstances and merit. Interest charges are automatically imposed by the law in all relevant shortfall cases. The scheme of the Act is to apply GIC to individual taxpayers whose responsibility it is to correctly report an obligation within the correct time period. The scheme introduced by Parliament clearly intends for GIC to be applied where individual taxpayers failed to report correctly within the nominated time.

Dot point 2

4.156 The Tax Office is currently reviewing its practice statement PSLA 2003/2 in relation to GST 'wash' transactions and these comments will be considered as part of this review.

Dot point 3

4.157 Penalty and GIC are two separate and distinct regimes. The culpability of the taxpayer remains a matter for the administrative penalties regime and not the GIC regime.

Inspector-General's comments on Tax Office response

4.158 In view of the Tax Office's response to this recommendation, the Inspector-General makes the following key recommendation to the Government:

KEY RECOMMENDATION 4.2A

The Inspector-General recommends that the Government consults with the community on the need for legislative changes which have the effect of requiring or allowing the Tax Office to:

- *adopt a default position of fully remitting the general interest charge in GST audit cases which result in adjustments that involve no net loss to the revenue such as wash transactions, cases involving documentation issues and cases where GST has been paid by the wrong entity; and*
- *where warranted, address any undesirable behaviour on the part of the relevant taxpayer in relation to failing to account for GST on such transactions through a form of penalty.*

KEY RECOMMENDATION 4.3

The Tax Office should review all large taxpayer GST audit adjustment cases which have involved unprompted voluntary disclosures where GIC has been charged at the full rate with a view to re-setting the GIC rate in these cases to the bank bill rate, being the rate which generally represents Tax Office policy.

Tax Office response

4.159 The Tax Office disagrees with Recommendation 4.3.

4.160 The Tax Office policy (*PSLA 2006/8 Remission of shortfall interest charge and general interest charge for shortfall periods of remission of GIC*) provides that a voluntary disclosure itself is not a ground for routine remission to the bank bill rate (base rate). However, the policy does provide that there may be some cases where the circumstances surrounding the voluntary disclosure will make it fair and reasonable to remit interest charges. Any remission of interest charges on the basis of a voluntary disclosure will have regard to the specific circumstances and will consider matters such as:

- how soon the disclosure was made after the error was first detected;
- whether it was made before the notification of the commencement of an audit;
- the size of the shortfall, either in monetary terms or in relation to the totality of the taxpayer's affairs; and
- the taxpayer's compliance history, including the number of times a taxpayer has had to disclose shortfalls following an initial self assessment of liability.

4.161 As the circumstances of each taxpayer are invariably different it is unlikely that the application of the policy will result in remission of interest to base rate in every case where a voluntary disclosure is made.

4.162 The Tax Office is satisfied, based on its Technical Quality Reviews, that GIC has been appropriately applied in GST audits cases.

Inspector-General's comments on Tax Office response

4.163 The Inspector-General acknowledges the Tax Office's case-by-case approach and the relevance of considering the specific circumstances as outlined in their response. The Inspector-General also agrees that this approach will mean that some voluntary disclosures will not have the GIC reduced to the bank bill rate. However, the Inspector-General is disappointed that the Tax Office has declined to review all voluntary disclosure cases that have full GIC applied because the sample of cases examined as part of the review showed greater variance of treatment than would be expected including a fairly high proportion with full GIC (refer to paragraph 4.118 of the report). The Inspector-General also notes that this issue was raised as a concern in a number of submissions to the review. However, the comments in the report on this issue may raise awareness in the community and lead to affected taxpayers taking the matter up with the Tax Office.

KEY RECOMMENDATION 4.4

The Inspector-General recommends that the Tax Office enhance its processes for ensuring that GIC imposition and/or remission decisions in large taxpayer GST audits are being made appropriately and consistently by:

- *issuing detailed GST-specific guidance for its staff on GIC remissions which arise as a result of a GST audit*
- *ensuring that large taxpayer GST auditors are appropriately trained on the Tax Office's guidelines for GIC imposition and remission*
- *ensuring that GIC remission decisions for large taxpayer GST audits are subject to adequate internal quality controls.*

Tax Office response

Dot point 1

4.164 The Tax Office agrees with this recommendation.

Dot point 2

4.165 The Tax Office agrees with this recommendation on the basis that it is already providing training and support to GST auditors in the correct application of the Tax Office's policies on the application of general interest charge as part of an initiative that had commenced prior to the commencement of this review.

Dot point 3

4.166 The Tax Office agrees and will ensure that GIC remissions are subject to internal quality controls.

CHAPTER 5: OTHER ISSUES

5.1 This chapter deals with other issues concerning GST audits raised in submissions during the course of this review, including the Tax Office's approach to margin scheme cases and to cases involving classification issues, the length of time of GST audits, Tax Office communication processes during GST audits, the training of GST auditors and other issues.

AUDIT CASES INVOLVING MARGIN SCHEME VALUATION ISSUES

5.2 A number of the GST audit cases examined by the Inspector-General during this review involved disputes over the valuation of property as at 1 July 2000 for the purposes of applying the margin scheme. This is a scheme under which GST payable on the sale of real property acquired before 1 July 2000 is calculated on the difference between the consideration received for the property and its value as at 1 July 2000. In these cases taxpayers are contending that the Tax Office has acted unfairly in at least two major ways. Firstly, the Tax Office has failed to adequately inform them of the requirements that such valuations need to meet to be considered acceptable to the Tax Office. Secondly, the Tax Office has applied the margin scheme on the basis that the appropriate July 2000 value is the original price paid on the purchase of the property – even where this occurred up to 50 years ago.

5.3 During this review the Inspector-General has validated these two major concerns of taxpayers.

5.4 In a number of cases examined by staff of the Inspector-General for the purposes of this review the Tax Office failed to inform taxpayers of what was wrong with their valuations of pre-July 2000 property even though those taxpayers had attempted to provide valuations which met Tax Office requirements.

5.5 Furthermore, the Inspector-General found that the Tax Office has a policy that, where it rejects a valuation obtained by a taxpayer from an independent valuer for a pre-2000 property it does so generally on the basis of a lower valuation amount set out in a 'critique' obtained from the Australian Valuation Office (AVO). These critiques are not full valuations. The Tax Office obtains full valuations from the AVO only once it is clear that the matter will be seriously disputed. This is because full valuations are much more costly than critiques.

5.6 The Tax Office has a policy of not communicating to taxpayers the valuation amounts referred to in AVO critiques. However the Tax Office will disclose an AVO valuation amount to the taxpayer where the AVO has carried out a full valuation and a copy of that valuation is provided to the taxpayer.

5.7 The Tax Office also does not actually use the value set out in any AVO critique when levying an assessment for additional GST in these kinds of cases. Instead, the Tax Office adopts the original price the vendor paid as the relevant value for the property. This is generally much lower than the AVO's amount as it is a price that was paid some time (often years) prior to 1 July 2000. This lower valuation leads to a higher GST assessment, as the

figure for the value of the property as at 1 July 2000 is subtracted in the formula which determines the GST payable in this kind of case.

5.8 The Tax Office contends that it is required to set the value of the property in this type of case at the original purchase price, rather than any higher value indicated by the AVO because of the operation of subsection 75-10(2) of the GST Act. However, this approach ignores the existence of the Commissioner's general administrative power and its specific power to determine what valuations are acceptable. These powers would allow him to apply the law so as to narrow the dispute to the difference between what he contends is a reasonable valuation, based on the AVO's view and what the taxpayer believes to be reasonable.

5.9 In the Inspector-General's view, the Tax Office's current approach in this area is unfair as it involves the Commissioner withholding essential information from taxpayers (that is, the valuation amounts which are referred to in AVO critiques) and raising assessments and demands for payment based on valuations he knows to be too low, either because he has obtained his own higher valuation (from the AVO) or because of the known age of the property. The approach essentially amounts to a demand that taxpayers pay an amount of tax which is in excess of what the Commissioner regards as reasonable in the circumstances.

5.10 The Inspector-General also found that a number of GST disputes involving pre-July 2000 property were being settled once they were referred to the Tax Office's litigation area. These settlements were achieved because misunderstandings that had developed between the parties during the audit stage of the dispute were resolved once more senior Tax Office personnel from the Tax Office's Tax Counsel Network became involved in the case. However, this eventual resolution still involved prolonged periods of angst and financial costs to the taxpayers involved.

5.11 These comments lead to the following key recommendation:

KEY RECOMMENDATION 5.1

The Inspector-General recommends that the Tax Office takes steps to:

- *ensure that taxpayers are supplied with reasons why their valuations do not meet Tax Office requirements as soon as possible during the course of a GST audit involving a margin scheme valuation issue and that these reasons include the alternative valuation amount the Tax Office has obtained from the Australian Valuation Office, whether that amount is set out in a 'critique' or in a full valuation; and*
- *ensure that disputes on margin scheme valuations are confined to the difference between what the Tax Office considers to be an acceptable valuation amount and what the taxpayer contends is an acceptable amount.*

Tax Office response

Dot point 1

5.12 The Tax Office agrees although it notes that not all critiques provided by the AVO will include an alternative estimated valuation. However, where an alternative estimated valuation is provided as part of the AVO critique this will be communicated to the taxpayer.

Dot point 2

5.13 The Tax Office notes this recommendation. The Tax Office is currently examining options by which it can, within the law, substitute an alternative valuation rather than use the last sale price in those cases where it believes the taxpayer's original valuation is not an approved valuation. In November 2007, the Tax Office put a proposal along these lines to the GST Sub Committee of the National Taxation Liaison Group for consideration and feedback.

AUDIT CASES INVOLVING CLASSIFICATION ISSUES

5.14 A number of the GST audits on hand examined by the Inspector-General involved cases where taxpayers are contending that the Tax Office has changed the GST classification of a food item without warning and has sought to apply the new classification retrospectively throughout the supply chain. The Inspector-General considers that the Tax Office needs to improve its system of making pronouncements on the classification of items for GST purposes so that perceptions that it is applying an agreed GST classification retrospectively do not arise.

5.15 The Inspector-General suggests that a product similar to ATO Interpretative Decisions (ATO IDs) – but binding on the Commissioner in respect of tax, penalties and interest – could be used in the GST context as a basis for issuing classification rulings. This would result in through-the-chain certainty, better compliance and lower costs.

5.16 For many years the Tax Office issued public and/or private rulings on classification issues in administering sales tax. Public rulings included Commissioner's press releases or advertisements by the Tax Office in newspapers or magazines, general information booklets published by the Tax Office, formal sales tax rulings (which included determinations) and sales tax bulletins. Also, under the sales tax regime, if a manufacturer or importer of goods was given a private ruling on the classification of goods they manufactured or imported, any wholesaler of those products was able to rely on that classification of those products unless and until that private ruling was altered by a subsequent public or private ruling. This system eliminated the need for businesses in direct dealings with the same goods to request duplicate private rulings on identical issues.³²

5.17 These comments lead to the following key recommendation.

32 SST Ruling No 1 at paragraphs 4.4 to 4.5

KEY RECOMMENDATION 5.2

Because of competitive winners/losers as a result of different GST classifications in the market place, the Tax Office must review its current approaches to ensure binding GST decisions in relation to new products coming onto the market are made and communicated quickly into the market to ensure that there is improved through-the-chain certainty, better compliance and lower costs.

Tax Office response

5.18 The Tax Office agrees with this recommendation.

TIMELINESS OF AUDITS

5.19 The Tax Office has a number of benchmark times for completion of large taxpayer GST audits. These benchmark times differ according to the type of audit product that is employed – for example whether it involves a simple check of a GST refund or an activity which is more substantial, such as a GST form audit or a GST specific issues audit.

5.20 The two main types of GST audits conducted on large taxpayers which involve fieldwork are GST form audits and GST specific issues audits. The Tax Office conducts a GST form audit when reviewing a GST return with more than two identified risks. It conducts specific issue audits in cases where one or two risks have been identified.

5.21 The Tax Office has advised that the present benchmark time to complete a GST form audit is 230 calendar days, while the benchmark time to complete a specific issue audit is 220 calendar days. Until 1 July 2006 the benchmark time to complete a form audit was 260 calendar days. Where audits go over these benchmark times the Tax Office considers that the case is an ‘aged case’.

5.22 There is an initial issue as to whether these benchmark times are appropriate. Anecdotal material obtained from discussions with tax practitioners in other countries indicates that the average time to complete a GST audit in Australia may be significantly higher than for other comparable countries such as Canada, New Zealand and the United Kingdom. A number of submissions to this review also asserted that the Tax Office’s benchmark time to complete at least a specific issue audit should be at most 60 days.

5.23 GST audit benchmark times are also set according to the number of calendar days which have elapsed during the audit. They therefore do not exclude delays in the audit that may be due to the taxpayer, for example delays that arise from the time taxpayers take to respond to information requests from the Tax Office.

5.24 The Inspector-General considers that the Tax Office should work towards developing appropriate and meaningful benchmark times to complete an audit. Furthermore, these benchmarks should be developed on a basis which allows them to be compared with GST audit timeframes of other countries and with the timeframes of audits conducted on large taxpayers which involve other taxes.

5.25 The Tax Office also has guidelines for large taxpayer GST audits which require that:

- an audit plan be prepared, approved and provided to the taxpayer at the preliminary audit interview; and
- a written audit notification letter be provided to taxpayers to advise them that an audit has commenced.

5.26 These guidelines have been published in the Tax Office's Large business and tax compliance booklet 2006.

5.27 In submissions made to this review large taxpayers asserted that in some cases there was no evidence of an audit plan. In several cases sampled by staff of the Inspector-General during fieldwork for this review audit plans were either non-existent or were very sketchy.

5.28 Large taxpayers also asserted that in some cases no audit notification letter is provided. In several cases sampled by staff of the Inspector-General during the fieldwork for this review, no audit notification letters were provided. In other cases a letter was provided but it stated that a 'review' rather than an 'audit' was underway.

5.29 Large taxpayers also asserted that major technical issues which affect a taxpayer's industry as a whole can take too long to resolve and can result in unnecessarily protracted audits.

5.30 The Inspector-General's fieldwork for this review found that some cases which were dependent on an industry technical issue were being finalised but then immediately re-opened. This process allowed the relevant audit to escape internal Tax Office scrutiny as an 'aged' case.

5.31 The Inspector-General's fieldwork found that some cases dependent on the resolution of an industry technical issue were resolved in a relatively expeditious manner during an audit by the use of declaratory proceedings.

5.32 The Inspector-General's fieldwork also found that several cases arising from an unprompted voluntary disclosure took a long time (a year or more) to resolve.

5.33 The Tax Office has a case leadership area within its GST business line whose primary purpose is to monitor the length of time of audits. This area was established in September 2005.

5.34 Since this area was established this area has had success in expediting the timely completion of audits.

5.35 The success of the case leadership area in this regard can be gauged from figures which the Tax Office provided to the Inspector-General during this review which showed there had been a significant reduction in the number of aged large branch GST audits over the last three financial years. These figures were as follows:

Year of income	Number of cases completed	Number of aged cases on hand at year end
2004/05	3997	603
2005/06	4665	119
2006/07	2899	147

5.36 However, this area has a facilitation function only and cannot itself make decisions relating to the conduct of an audit. During his fieldwork for this review the Inspector-General encountered a number of unresolved audits, some of which involve revenue-neutral transactions, which were several years old where the case leadership area appears to have failed to carry out its primary role effectively.

Conclusion

5.37 The Tax Office does not have GST audit timeframe benchmarks which can be readily compared with those of other countries or with the benchmarks for other types of audits that are conducted on large taxpayers. It is also taking far too long to finalise some audits, particularly specific issue audits. In some cases, the Tax Office has not applied adequate governance to the planning, management and taxpayer interface of its audit activities. Technical decisions are also taking far too long to be made and communicated to taxpayers in some cases. Furthermore, audit letters are not always issued and risk reviews become audits without taxpayers being aware of the transition.

5.38 These comments lead to the following key recommendation:

KEY RECOMMENDATION 5.3

The Inspector-General recommends that the Tax Office:

- *expeditiously resolves GST large taxpayer audits experiencing significant delays;*
- *clarifies in a public statement its position on when a GST audit has started and the circumstances in which this will occur orally or by letter;*
- *takes steps to ensure that technical decisions which impact audits are made without delay; and*
- *should review, in consultation with taxpayers and their representative associations, the existing benchmark times to complete GST audits and should also work with other countries to develop appropriate approaches to comparing benchmark times to complete a GST/VAT audit.*

Tax Office response

Dot point 1

5.39 The Tax Office agrees with this recommendation and will continue its current focus on resolving GST audits in a timely manner. Where an audit is experiencing delays that are within the Tax Office's control, auditors will keep the taxpayer informed of the reason for the delay and the progress of the case. We will continue to apply the procedures we have in place to ensure the active case management of cases exceeding cycle time.

Dot point 2

5.40 The Tax Office agrees with this recommendation and will take this into account as part of the review of the 2006 Large business and tax compliance booklet.

Dot point 3

5.41 The Tax Office agrees with this recommendation. However, there will at time be delays in the resolution of technical issues that arise in the large market due to their complex nature.

Dot point 4

5.42 The Tax Office agrees with this recommendation.

TAX OFFICE COMMUNICATION ISSUES

Notification of the start and end of an audit

5.43 As indicated earlier in this chapter, Tax Office policy is to provide a written audit notification letter to taxpayers to advise them that an audit has commenced. However, in a significant number of large cases sampled by the Inspector-General no such letter was provided. In other cases a letter was provided but it stated that a 'review' rather than an 'audit' was underway.

5.44 Tax Office policy is also to provide taxpayers with an audit finalisation letter, and/or a compliance activity report (CAR) to advise them that the audit has ended and of any proposed tax adjustments. This policy is also referred to in the Tax Office's Large business and tax compliance booklet 2006.

5.45 However, in a number of cases sampled by staff of the Inspector-General no finalisation letters and/or CARs were on the relevant audit file.

5.46 The case leadership area does not examine the extent to which auditors comply with internal guidelines on notifying taxpayers about the start and end of an audit and the documentation of the results of an audit. However, a case will fail the Tax Office's internal Technical Quality Review process if an audit finalisation letter or compliance activity report has not issued.

5.47 The comments in this section lead to the following subsidiary recommendation:

Subsidiary recommendation 5.1

The Inspector-General recommends that large taxpayer GST auditors should always confirm the date of commencement and finalisation of an audit in writing. If advice of the commencement or finalisation of an audit is given orally this advice should be confirmed in writing within a reasonable time thereafter.

Tax Office response

5.48 The Tax Office agrees with this recommendation.

Taxpayer access to technical decision-makers during an audit

5.49 Taxpayers asserted that they either were unable to access the Tax Office's technical decision maker on an audit case or were only able to do so after a lengthy delay or after a complaint was made which resulted in such access being made available. In at least one case examined by staff of the Inspector-General the taxpayer was told it could not speak to the relevant technical decision-maker.

5.50 This comment leads to the following subsidiary recommendation.

Subsidiary recommendation 5.2

The Tax Office should ensure that GST auditors facilitate access by large taxpayers who are subject to a GST audit to the key technical decision makers involved in their case and also ensure that the large taxpayers are made aware of the senior officer they can escalate issues or concerns to.

Tax Office response

5.51 The Tax Office agrees with this recommendation.

TRAINING OF TAX OFFICE AUDITORS

5.52 Large taxpayers and/or their advisers in the finance sector asserted that GST auditors for their industry:

- do not understand their industry and/or the transactions being undertaken in that industry;
- do not understand the GST rules applicable to that industry; and
- were being prevented from properly understanding the industry and the GST rules applicable to that industry because of an in-built bias against companies in the industry.

5.53 Large taxpayers in the property and construction industry and/or their advisers commented that the GST auditors of their industry generally had a good understanding of their industry and of the GST rules applicable to that industry but had adopted unfair stances in relation to particular transactions in the industry. An example of one such set of transactions was margin scheme sales of pre 2000 property where a valuation as at 1 July 2000 was required for the relevant property.

5.54 The Inspector-General has also found that GST auditors appear not to be adequately trained on how to identify and audit GST cases which involve a net amount of GST being payable to the Tax Office (that is, sticky tax cases). GST auditors in Perth and Adelaide in

particular appear to be inadequately trained on how to conduct GST audits involving sticky tax issues. This finding is supported by a survey conducted in 2006 of in-house GST advisors at large corporates in Australia by Deloitte Touche Tohmatsu which found that 50 per cent of survey respondents were of the view that the Tax Office rarely or never focused on the right areas of the business with regards to GST compliance.³³

5.55 The Inspector-General also found that GST auditors who conduct audits in the finance industry are not adequately trained on the nature of that industry and of the GST rules that apply to that industry.

Perception that retrospective ITC claims are indicative of non-compliance or bad practice

5.56 During the review the Inspector-General found that the Tax Office has created a perception that it has a view that retrospective ITC claims, particularly for financial services arising from reappraisal of apportionment methodologies, are somehow indicative of non-compliance or bad practice. The law allows up to four years for ITCs to be claimed. It would be inappropriate for the Tax Office to attempt to thwart legitimate claims for retrospective credits or to read them as a sign of compliance risk.

5.57 During the review the Tax Office advised that prima facie, it does not consider that any retrospective ITC claim is indicative of non-compliance or bad practice. It asserts that at no time has it attempted in any way to thwart a taxpayer from claiming any credit to which they are entitled.

5.58 In relation to the reappraisal of methodologies for apportionment, the Tax Office advised that it undertook a review of the law in relation to this issue as the practical application of the law was unclear.

5.59 The Tax Office advised that, after due consideration to both the legislation and overseas precedent, it agreed that on the proper construction of the law where it is fair and reasonable a new apportionment methodology may be retrospectively applied.

5.60 The Tax Office also advised that it will, where necessary, undertake a review of any claim made by a taxpayer where it considers the law to be unclear in relation to the claim. Such a review is not and should not be seen as thwarting a taxpayer's claim but rather as a process of clarifying the law associated with the claim.

Auditors do not in some cases understand the businesses they are auditing

5.61 The Inspector-General has also concluded that Tax Office auditors do not in some cases understand the business they are auditing. Training needs to be improved for auditors particularly in business process and activity and how to focus on 'sticky tax' issues.

5.62 During the review the Tax Office advised that it agrees that there is always room for improvement in the auditors' understanding of the business and industries they are involved with. To this end, the Tax Office is in the process of finalising panels of internal and external experts to assist with the progression of technical issues.

³³ Deloitte Touche Tohmatsu Ltd, *In-house GST advisor: How are you evolving?*, survey November 2006 at p 4 available at www.deloitte.com.au.

5.63 It also advised that in the last 18 months the GST business line has trained 320 auditors in Financial Supplies (FS) in the SME and Large markets.

Feedback issues

5.64 During the review the Inspector-General found that feedback is not always provided to individual auditors on the results of the cases they have audited, in terms of the final outcome of cases after they have gone through the appeal process.

5.65 During the review the Tax Office advised that the GST business line has changed its procedures to ensure that auditors are informed of the outcome of review, objection and litigation cases where they were the case officer. The GST Review & Litigation Manual sets out the policy and procedures regarding communicating outcomes to auditors. An Office Minute was issued on 26 September 2006 to reiterate the consultation process between GST Review & Litigation (R&L) staff and Active Compliance staff.

5.66 The Tax Office states that along with specifically advising the original audit officer, all GST officers are advised of court and tribunal decisions via a technical bulletin which is circulated each week, and all decisions are reported on ATO Law, an internal database available to all tax officers. Decision Impact Statements are published in relation to adverse decisions and decisions in strategic litigation cases.

5.67 The above comments lead to the following subsidiary recommendation.

Subsidiary recommendation 5.3

The Inspector-General recommends that the Tax Office takes steps to:

- ensure that auditors better understand the businesses they are auditing by providing more training on business process and activity and on how to focus on issues that involve a real net gain to the revenue;
- ensure that auditors understand that businesses may want to exercise their legal rights to correct their GST liabilities for previous years in cases where they have overpaid and that such claims are not, per se, evidence of an attitude of non-compliance with the GST law; and
- ensure that GST auditors are in all cases provided with individual feedback on the results of the cases they have audited, in terms of the final outcome of cases after they have gone through the appeal process.

Tax Office response

Dot point 1

5.68 The Tax Office agrees that it will continue to provide its auditors with skilling on business process and activities to improve their capability in this area.

Dot point 2

5.69 The Tax Office agrees with this recommendation and understands that business will at times exercise their rights to correct prior year GST liabilities. The ATO has never seen this as evidence of an attitude of non compliance. However, it must be recognised that the Tax Office is under an obligation to ensure that a taxpayer has a legal right to the claim it is making. The Tax Office rejects any implication that there has been any systemic problem in relation to this issue.

Dot point 3

5.70 The Tax Office agrees with this recommendation and this process which it has already implemented as part of a separate initiative unrelated to this review.

OTHER ISSUES

GST audits conducted by Customs

5.71 Submissions made to this review asserted that, when conducting GST audits on imported items, the Australian Customs Service does not apply materiality guidelines similar to those contained in the Tax Office's GST mistakes fact sheet.

5.72 The Inspector-General has confirmed that the Australian Customs Service has been obtaining adjustments of often insignificant amounts on values of imported goods which will be fully credited by the importer or are subject to the deferment scheme and that it is not using the same materiality guidelines as the Tax Office in this area.

5.73 These comments lead to the following subsidiary recommendation:

Subsidiary recommendation 5.4

The Inspector-General recommends that tolerance or materiality levels are aligned across both the Australian Customs Service and Tax Office administration of GST.

Tax Office response

5.74 The Tax Office agrees with the recommendation to the extent that it will work with the Australian Customs Service (ACS) to achieve this outcome. It notes that the ACS is currently planning a review of the materiality thresholds. It is intended that this review will be conducted jointly with the Tax Office and will take into account the compliance cost to industry of amending import declarations. It is intended that the revised approach will be published in a practice statement.

APPENDIX 1: TERMS OF REFERENCE AND CONDUCT OF THE REVIEW

TERMS OF REFERENCE

A.1.1 On 30 October 2006 the Inspector-General announced the terms of reference for his review of the Tax Office's administration of GST audits. The terms of reference for this review were as follows:

This review will investigate the ATO's administration of audits relating to the GST across all sectors. It will include reviewing the processes used by the Tax Office to identify, assess, analyse, prioritise and treat matters that arise during a GST audit and the processes employed by the ATO to evaluate the results of its GST audit activities. The review will focus particularly upon the following matters:

- the adequacy and effectiveness of ATO policies and procedures relating to how taxpayers and /or issues are identified for GST audit activity, including the extent to which the issues identified involve amounts which involve no net gain to the revenue or which are of a timing nature only;
- the processes and procedures employed by the Tax Office to conduct GST audits, including:
 - whether GST audits are conducted by officers who are appropriately trained on the nature of the industry in which the relevant audited taxpayer operates and on the GST rules for that industry;
 - the manner in which penalties and interest arising from GST audits are levied;
 - the time frames of GST audits;
 - whether Tax Office processes and procedures for GST audits achieve an appropriate balance between minimising any adverse impacts on businesses and other enterprises and ensuring that they are meeting their GST obligations; and
- the adequacy and effectiveness of the processes used by the Tax Office to evaluate the results of its GST audit program, including the processes used to compare amounts collected from GST audits with liabilities that are raised.

CONDUCT OF REVIEW

A.1.2 The Inspector-General advertised the review on his website, www.igt.gov.au, from 30 October 2006. The review was also reported in the press and in specialist accounting and legal publications.

A.1.3 Written submissions to the review were taken from members of the public and a number of organisations.

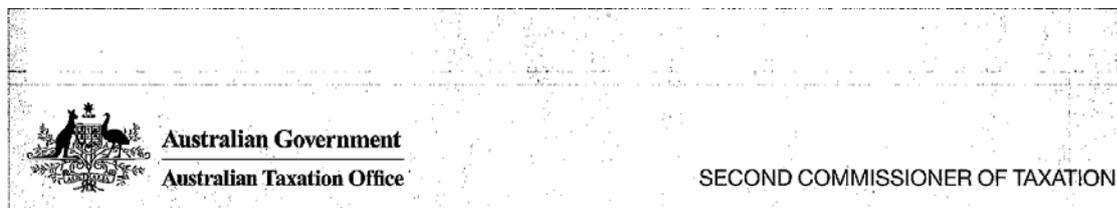
A.1.4 Members of the review team also met with taxpayers, members of the accounting and legal professions, and representatives of various professional bodies representing lawyers and accountants.

A.1.5 The Commissioner of Taxation was asked to provide information and documents relevant to the review. Visits were made to a number of branches of the Tax Office and to the Tax Office's National Office in Canberra to examine relevant files and interview relevant Tax Office staff.

A.1.6 The review also took into account a number of other inquiries relevant to this review.

APPENDIX 2: TAX OFFICE RESPONSE TO THE REVIEW

A.2.1 The Tax Office's response to the review is set out below.



Mr David Vos
Inspector-General of Taxation
Level 19, 50 Bridge St
Sydney NSW 2001

Dear David

Review of Tax Office's Administration of GST Audits for large taxpayers

Thank you for your letter of 29 November 2007 providing your final report on the above review. This report provides a useful review of our GST audit operations in the large market and has identified a number of opportunities for improvement. In fact, we have agreed to 12 of the 14 recommendations.

In particular, the Tax Office acknowledges that this review by the Inspector-General has identified two major areas of improvement for the Tax Office. The first is in relation to the need for more detailed and transparent reporting of the nature of our audit results in the large market. The second is in relation to our treatment of taxpayers involved in valuation disputes concerning the margin scheme. There are also a number of other less significant areas of improvement identified in the report.

However the Tax Office disagrees with the Inspector General's observations in relation to the application of penalties and general interest charge by the Tax Office in large market GST audits. We also consider that some comments do not sufficiently acknowledge the ongoing efforts made by the Tax Office to improve our audit operations in relation to those issues.

In the attachment to this letter, the Tax Office has provided a detailed response to your report and recommendations. Set out below is a broad summary of our response to key areas of the report:

Nature of GST audit adjustments being made and reported by the Tax Office.

The Tax Office acknowledges that it can improve the level of detail in its reporting of audit adjustments in the large market. We have agreed we should separately report voluntary disclosures and break up other audit results into likely revenue neutral adjustments and other adjustments.

We also note that while we do not currently adjust liabilities reported for actual collections, in the case of the large market the gap between liabilities raised and actual collections is quite small and would therefore make minimal difference to the figures currently reported.

We do not agree that only audits which result in net contributions to revenue are indicators of the effectiveness of our active compliance program. The Tax Office view is that we have an obligation to ensure that businesses are correctly complying with the requirements of the GST law even where there may be no apparent immediate net revenue loss.

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The Tax Office's imposition of penalties and interest in large taxpayer GST audits.

Penalties

The Tax Office disagrees that this review has identified any significant systemic issues in relation to the imposition of penalties in GST large market audits.

Our agreement with the recommendation in relation to penalties is based on the fact that it reflects our current procedures, or involves a sensible improvement to our ongoing efforts to ensure our staff are properly applying penalties.

Our response to the Inspector-General on this issue is based on the fact that:

- the number of penalties imposed on GST large market audit adjustment cases was very small, approximately 4% of large market audit cases had penalties imposed,
- the Tax Office quality assurance process, which involves a level of external oversight, does not show any major issues with the imposition of penalties in GST audit cases, and
- the Tax Office has invested, and continues to invest, considerable effort in ensuring the proper application of penalties by GST audit staff.

Three experienced senior officers reviewed the same audit cases where the Inspector-General identified issues with the imposition of penalty. These officers came to the view that except in one case the penalty decisions correctly applied the law and the current Tax Office practice statement on the application of the law.

General Interest Charge

The Tax Office disagrees that the imposition and remission of General Interest Charge (GIC) is a systemic problem in relation to large market audits.

The GIC is a uniform rate of interest applied to known overdue tax debts whether or not the taxpayer has acted knowingly to create the debt.

The Tax Office is currently considering its policy and practices in relation to circumstances where remission of GIC might be appropriate in GST audit cases involving revenue neutral adjustments and has now issued a draft practice statement for community consultation.

We disagree with the commentary in the report which indicates that the Tax Office has not consistently applied its policy on GIC to unprompted voluntary disclosure cases.

Other issues concerning GST audits of large taxpayers

Margin scheme valuation cases

The Tax Office acknowledges that our application of the law in these cases has caused considerable concern amongst taxpayers and, as a result of the issues raised by the Inspector-General, we are examining options within the current law that may enable the substitution of an alternative valuation to the last sale price of the property. Feedback on these options has been sought from the GST sub-committee of the National Taxation Liaison Group.

We also agree that in some cases we have not provided taxpayers with full details of the reasons why their valuation does not meet the Tax Office requirements, including providing details of any alternative indicative valuation amounts that have been obtained.

The Tax Office acknowledges that in this area the work of the Inspector-General has been of significant assistance in improving our approaches to an important and contentious issue for some taxpayers.

Audit cases involving classification issues

The Tax Office agrees that there is a need to better communicate decisions in relation to GST classifications, principally in relation to food items, and is currently working with this industry to develop appropriate strategies to do this.

Time frames for GST audits of large taxpayers

The Tax Office continues to work at improving the timeliness of its audits and has processes in place to achieve this. This has resulted in a significant reduction in aged cases over the last few years.

Communication and other issues concerning GST audits

The Tax Office agrees with the recommendations in relation to these issues. However, we do not consider that the representations made to the Inspector-General are significant in number or constitute evidence of systemic issues in relation to the GST audit programme in the large market.

Training of Tax Office Auditors

The Tax Office continues to seek to improve the technical skills and business knowledge of its auditors. It has undertaken a range of activities to continually improve both the general skills and knowledge of auditors in relation to large business as well as specific specialist areas such as property and construction and the finance industry.

Within this context, we agree with the recommendations of the Inspector-General to continue work already underway.

Other Issues

The Tax Office has indicated it will work with the Australian Customs Service (ACS) in its review of the materiality thresholds of GST audit adjustments made by ACS.

Thank you for the opportunity to comment on your final draft report

Yours sincerely



Barrie Russell
Acting Second Commissioner Compliance
10 January 2008

REVIEW OF TAX OFFICE'S ADMINISTRATION OF GST AUDITS FOR LARGE TAXPAYERS

TAX OFFICE DETAILED RESPONSE TO INSPECTOR-GENERAL REPORT

Chapter 2

Paragraph 2.5

The Tax Office notes the Inspector-General, based on his sample of audit adjustments, claims that only 32 per cent of them involve a net contribution to revenue. While it is clear that the adjustments identified by the Inspector-General will always involve a net contribution to revenue some other areas noted by the Inspector-General may also involve a net contribution to revenue including both lodgement work and some of the so called revenue neutral adjustments.

Paragraph 2.6

The Tax Office seeks to maximise the voluntary compliance of taxpayers with their tax obligations. The GST large market strategy involves a combination of audit activity and client relationship management to seek to maximise voluntary compliance. Results from voluntary disclosures when made directly to audit staff in the GST Large Active Compliance area are treated as outcomes of our overall GST active compliance activities in the large market.

Paragraph 2.7

While the Tax Office accepts that it would be better to provide a more detailed picture of its active compliance results, it doesn't agree that current reporting gives an overly negative picture of large market compliance. The Tax Office view is that the failure of large market businesses to comply with their obligations under GST law to properly account for and report their GST obligations in the correct period represents non compliance with the law even if the actual adjustments might eventually turn out to be revenue neutral.

Paragraph 2.8

The difference between liabilities and collections is not significant in the large market. The 2005-06 GST collection rate for the large market was 95 per cent, the figure for 2006-07 was 94 per cent. The collection rate for liabilities raised in a year also continues to improve over time with continuing collection activity over time bringing it closer to 97 per cent of liabilities collected.

Paragraph 2.11

The Tax Office disagrees with this paragraph. The 2007-08 planning process for the GST Business Line (BSL) ensured that resources were allocated based on the risks to the GST system. The GST planning process involves a balancing of resources across the risks that are rated significant and above.

Active compliance activity is selected not only according to the risk to immediate revenue, but also risks to the integrity of the system, and community confidence. The number and value of risks that are identified will vary across sites as the population and incidence of the risks vary.

GST has recently realigned its structure resulting in a separation of the risk and strategy function from the active compliance function. GST has identified risks specific to the large market and documented these in the Large and International Market Diagnostic and in the GST Risk Register.

Paragraph 2.12

The Tax Office does not consider that there is a low strike rate in GST audits nor that there are many unresolved audits chasing elusive issues. The strike rate of 17.4 per cent includes a major component of office based compliance activity in relation to GST refunds. We expect a relatively low strike rate from this but undertake these activities to protect the integrity of the GST refunds that issue. The strike rate for field audit work of 41 per cent is the more relevant figure and is a reasonable strike rate for this more resource intensive work.

The Tax Office does not consider that strike rates are the only measure of success in our compliance program. The *Tax Office's Strategic Statement 2006-10* outlines our goal to optimise voluntary compliance through our activities.

The Tax Office considers errors in wash transactions and other non-sticky transactions (for example, where the wrong entity accounts) are important matters requiring audit intervention and amendment for the reasons set out in paragraph 3.51.

Paragraph 2.16

The Tax Office disagrees with the view that there is any systemic problem concerning the imposition of penalties in relation to large market audits when in fact both the number of penalties imposed compared to the total number of audits with adjustments and the amount of penalties imposed compared to the total shortfall is extremely small. Refer to our comments at paragraph 4.43.

Paragraph 2.17

The Tax Office notes the fact that in some cases penalty decisions were reviewed and revised at the objection stage indicates that the current checks and balances in the system are working effectively. It would be unrealistic to believe that every decision by an auditor in relation to penalties will be correct. The objection process provides taxpayers with a low cost option to have concerns with the audit decision reviewed by the Tax Office.

Paragraph 2.18

The Tax Office has indicated to the Inspector-General that there are systems issues that limit its current ability to report on penalties to the extent sought by the Inspector-General. Whilst the Tax Office notes that more detailed reporting indicated by the Inspector-General would be useful, we do not believe that our current inability to obtain these reports is a critical problem in managing the imposition of penalties in large market audit cases.

Paragraph 2.20

The Tax Office does not agree with the findings of the Inspector-General that the imposition of the General Interest Charge (GIC) is inappropriate in relation to certain *'procedural compliance adjustments which are revenue neutral and made as a result of a GST audit'*.

The scheme of the Act does not take into consideration the treatment of another taxpayer when applying GIC to an entity which made a mistake.

Each case for remission of GIC will be considered on its own circumstances and merit. Interest charges are automatically imposed by the law in all relevant shortfall cases. The scheme of the Act is to apply GIC to individual taxpayers whose responsibility it is to correctly report an obligation within the correct time period. The scheme introduced by Parliament clearly intends for GIC to be applied where individual taxpayers failed to report correctly within the nominated time.

The Tax Office is currently reviewing its practice statement PSLA 2003/2 in relation to GST 'wash' transactions and the Inspector-General's comments and recommendations will be considered as part of this review.

Paragraph 2.25

The Tax Office disagrees that we have not consistently applied our policy in relation to voluntary disclosures. The Inspector-General statement that the Tax Office policy is 'that GIC in such cases will generally be calculated at a rate which is seven percentage points less than the prevailing GIC rate' is incorrect. The Tax Office practice statement indicates that GIC should not be automatically remitted to the base rate in cases of voluntary disclosure but indicates that this should only occur where certain factors are present.

Paragraph 2.26

The Tax Office agrees that it does not know the total amount of GIC imposed in relation to GST audit cases. This is a direct result of the legislative requirements in relation to the establishment of a Running Balance Account (RBA), whereby audit assessments are added to the taxpayer's RBA, upon which GIC is automatically calculated and updated by reference to all debts on the RBA. This therefore makes it impossible to track the specific element of the GIC which relates to individual audit cases.

Paragraph 2.27

The Tax Office considers that the current processes are adequate and notes that GIC decisions made within GST are subject to a high level of internal review. It is mandatory that all GIC decisions are technically cleared by a member of the GST Penalty and Interest Network. This

additional review step seeks to ensure the correct application of the guidelines and that remission has been considered in all relevant circumstances.

The Tax Office has developed a number of products and tools to assist staff when making GIC decisions and is currently undertaking a process to embed these into the case management system.

The Tax Office notes that, like all changes, the requirement for GST auditors to consider GIC remissions as part of their audit case finalisation took some time to be fully implemented by all audit staff. However, the Tax Office has an ongoing commitment to developing staff capability and will be providing further training to ensure the correct application of GIC remission policy. TQR results indicate a continuing improvement in the application of GIC remission policies by GST auditors.

Paragraph 2.28

The Tax Office believes that it already has in place adequate quality control processes to monitor the imposition and remission of GIC but has agreed to continue to review and monitor the effectiveness of these processes to see if there are further opportunities for improvement.

Paragraph 2.30

The Tax Office has in most cases provided taxpayers with details of why their valuations failed to be assessed by the Australian Valuation Office (AVO) as being a complying valuation. The Tax Office agrees that in a small number of cases, taxpayers were not provided with sufficient details of the reasons for the AVO finding that they were non-compliant. In addition, in a number of cases, the AVO as part of their critique of the valuation provided an indicative estimate of the valuation of the property. In these situations, because of concerns that these estimates did not represent a true professional valuation by the AVO, the Tax Office did not provide this information to taxpayers.

The use by the Tax Office of the original purchase price in those situations where the taxpayer did not provide what the Tax Office considered to be a complying valuation is based on our view of the law as it currently stands.

Paragraph 2.32

The Tax Office acknowledges that the application of the law in disputes over margin scheme valuations has caused considerable concern to some taxpayers and the Tax Office is currently examining if there are options by which the Tax Office can substitute an alternative valuation where it believes the taxpayer's valuation is non-complying.

Paragraph 2.35

The Tax Office does not agree with this conclusion. GST has audit cycle timeframes for audit products. We have not been able to establish the basis on which other tax authorities establish their audit cycle times, if indeed they have established them, although we would be interested in exploring this issue with them. The comments about planning and governance relate largely to the past rather than the present and were addressed by the Tax Office prior

to this review. The Tax Office continues to focus on ensuring cases are finalised within appropriate timeframes and has established a 'case leadership area' with a key role in relation to this issue.

The Tax Office agrees that in prior years some audits may have lacked an audit plan. However, with the introduction of the *2006 Large business and tax compliance* booklet new processes and procedures have been put in place to ensure that audit plans are drafted and discussed with the taxpayer at the initial audit interview. These issues are reviewed by the GST Case Leadership area in their call overs of audit cases in LAC.

Paragraph 2.37

For some office based audits limited to confirming the validity of a refund claim the taxpayer will be verbally advised by phone of the commencement of the audit rather than by way of a formal audit letter. The objective is to speed up the audit process to enable refunds to be released. The Tax Office has now agreed to confirm this verbal advice in writing.

Paragraph 2.38

The Tax Office has a policy that taxpayers should have access to the relevant technical decision maker and arrangements which ensure that senior technical experts will be brought into the audit process early have been put in place.

Where a taxpayer fails to gain access to a technical decision maker they are encouraged to escalate this issue to senior officers for resolution. This process is documented in the *2006 Large business and tax compliance* booklet. The booklet states that the Tax Office may meet the taxpayer to discuss their response to the Tax Office position, and where appropriate, the meeting may include technical specialists or industry or topic experts.

GST has put in place procedures to ensure taxpayers have access to technical decision makers to discuss the merits of the decisions made.

Paragraph 2.39

The Tax Office does not consider that a retrospective claim is indicative of non-compliance or bad practice.

The Tax Office initially queried the appropriateness of retrospective changes to apportionment methodologies when first raised by taxpayers. The Tax Office undertook a thorough technical review taking into account taxpayer contentions and formally concluded that a revised apportionment method may be retrospectively applied subject to the normal 4 year limitation on amendment of returns.

Requests for amendments have been received and have either been processed or are being processed.

The Tax Office will, where appropriate, review any claim arising from a retrospective change in methodology. Again, this does not imply that making a retrospective claim is indicative of non-compliance or bad practice.

Paragraph 2.40

The large market covers a wide range of industries and businesses. The Tax Office seeks to ensure that its staff are appropriately trained in technical knowledge of the law and in their understanding of business operations. For a number of key industries including financial services, property and energy it seeks to provide auditors with specialist industry knowledge. This is an ongoing task and the Tax Office agrees to continue with the further development of our staff.

Paragraph 2.41

The Tax Office had already implemented, as a separate initiative unrelated to this review, a process to provide individual auditors with feedback on the results of objections to cases they have audited.

Chapter 3

Paragraph 3.19

The Tax Office believes that it analyses its active compliance results to the extent that it requires to undertake its business in an efficient manner. It has provided the Inspector-General during the review with the analysis it does of audit cases completed in its Large Active Compliance (LAC) branch. This branch accounts for the overwhelming majority of audit work in the large market. LAC analyses audit outcomes by nature of the risk and by the nature of the eventual adjustment ie sticky, timing, wash, or unprompted voluntary disclosures. While these figures are not able to be directly reconciled with the large market results for GST they are sufficiently indicative for the purposes of risk management and planning and for assessing the effectiveness of our audit activities in the large market.

Paragraph 3.20

The Tax Office's Annual Report for each year covers the activities undertaken by it for the relevant financial year. The covering letter to the Assistant Treasurer indicates the financial year that the report relates to. The function of the report is to inform both Parliament and the community of the activities and revenue collected during that financial year. It is not a document that seeks to reconcile adjustments made to liabilities raised in a previous financial year. Collections are net collections which may include liabilities or refunds from a previous year.

The report meets all legislative requirements that the Commissioner of Taxation is obliged to report on.

The *Compliance Program Booklet* also provides preliminary results on a financial year basis.

Paragraph 3.34

The Tax Office disagrees with this paragraph. The Tax Office does have a consolidated statement of its policy on what constitutes a voluntary disclosure and how it deals with them and this is contained at page 58 of the *2006 Large business and tax compliance* booklet. The Tax

Office has agreed to work towards the development of a consolidated statement or guide for the community on the making of voluntary disclosures.

Paragraph 3.42

While the Tax Office acknowledges that the reporting of active compliance results for the large market could provide a more detailed break up of those results it rejects the view stated in this paragraph that these reported results '*give an overly negative view*'.

Paragraph 3.44

The Tax Office does not agree that it does not have in place a process for assessing and prioritising all GST risks in the large market. While the Tax Office acknowledges that its risk processing is still developing and is continuing to improve, it has set up a separate unit responsible for assessing the risks in the large market. This unit has completed a thorough risk assessment of the large market. Identified risks have been reviewed and endorsed by the GST Risk Management Sub-Committee as part of its overall review of GST risks. Resources are allocated to deal with these risks depending on the nature of each risk.

Paragraph 3.49

The strike rate of 17.4 per cent includes compliance activity on which we expect a relatively low strike rate but we undertake these activities to protect the integrity of the GST refunds that issue, in line with recommendations made by the Australian National Audit Office. The strike rate for field audit work of 41 per cent is the more relevant figure and provides a reasonable strike rate in our view.

Paragraph 3.54

The Tax Office disagrees with this paragraph. The 2007-08 planning process for the GST Business Line (BSL) ensures that resources are allocated based on the risks to the GST system. The GST planning process involves a balancing of resources across the risks that are rated significant and above.

Active compliance activity is selected not only according to the risk to immediate revenue, but also risks to the integrity of the system, and community confidence. The number and value of risks that are identified will vary across sites as the population and incidence of the risks vary.

GST has recently realigned its structure resulting in a separation of the risk and strategy function from the active compliance function. GST has identified risks specific to the large market and documented these through the Large and International Market Diagnostic and through the GST Risk Register.

The Tax Office does not consider that strike rates are the only measure of success in our compliance program. The *Tax Office's Strategic Statement 2006-10* outlines our goal to optimise voluntary compliance through our activities.

The Tax Office considers errors in wash transactions and other non-sticky transactions (for example, where the wrong entity accounts) as important matters requiring audit intervention and amendment for the reasons set out in paragraph 3.51 of the report.

Chapter 4

Paragraph 4.19

There is one additional stated policy reason for the imposition of taxation interest charges and that is 'to compensate the community for the impact of late payments'. The Tax Office would also indicate that many of the comments made on revenue neutral transactions in this report seem to miss the point above about ensuring that taxpayers who fail to meet their statement or payment obligations do not receive an unfair advantage over those who meet their liabilities in full by the due date, which is critical for remission consideration by auditors.

Paragraph 4.30

The Tax Office has developed a number of products and tools to assist staff when making GIC decisions and is currently undertaking a process to embed these into the case management system. These are contained within an interest charge index which provides links to all of the relevant legislation, policy, remission support tools and answers to frequently asked questions.

Paragraph 4.36

The Tax Office believes that its reporting on penalties imposed by audits, together with our quality reviews, provides sufficient information to enable it to monitor the effectiveness of the penalty regime. Due to privacy issues the Tax Office does not report externally at the taxpayer level, or at the industry level in the large market.

Paragraph 4.39

It is not the function of the Tax Office reports on the amount of penalties imposed to ensure that technical decisions are being applied consistently and in accordance with existing guidelines.

The Tax Office specifically seeks to assess the extent to which penalty decisions, including the decisions on the remissions of penalties, are being applied consistently and in accordance with existing guidelines through the regular Technical Quality Review (TQR) process. The TQR process includes a specific separate sample of penalty cases. The outcomes of the report prepared on this process provide the Tax Office with an indication of how effective, or not, its penalty decision making has been.

Paragraph 4.41

The Tax Office agrees that it does not know the total amount of GIC imposed in relation to GST audit cases. This is a direct result of the legislative requirements in relation to the establishment of a Running Balance Account (RBA) whereby audit assessments are added to the taxpayer's RBA upon which GIC is automatically calculated and updated by reference to all debts on the RBA. It is not possible under this system to isolate GIC arising solely from GST assessments from GIC arising from other debts. It is possible to manually isolate and calculate an approximation of what the GIC may be arising from GST adjustments. This is

not done as a matter of course because of the work which would be involved and the limited value which this process would provide.

Paragraph 4.43

The Tax Office believes that this section of the report creates an impression of a significant problem in relation to the imposition of penalties in relation to large market audits when in fact both the number of penalties imposed compared to the total number of audits with adjustments and the amount of penalties imposed compared to the total shortfall is extremely small.

The following table shows that the number of objections received in the GST large market is decreasing, not increasing and that compared to the total number of audits with adjustments the actual number of audits where penalties are imposed is not significant.

	No. of audits with adjustments	Total liabilities raised	No. of penalty audit cases finalised	Total penalties imposed	No. of penalty objections lodged	Penalty in dispute	Penalty allowed
2004-05	750	\$407,342,519	18	\$44,114,192	9	\$2,289,223	\$904,922
2005-06	630	\$365,540,959	35	\$1,253,296	*8	*\$42,686,454	*\$42,000,321
2006-07	505	\$204,540,379	27	\$7,736,777	5	\$639,420	\$218,419
Total	1885	\$977,423,857	80	\$53,104,265	22	\$45,615,096	\$43,123,662

*The 2005-06 year includes one case with penalties in dispute of \$42 million.

The Tax Office recognises that the imposition of penalties can be a contentious matter with taxpayers and requires a level of subjective judgment on the part of auditors about taxpayer behaviours. It therefore continues to put considerable effort into ensuring shortfall penalties are imposed correctly including:

- providing ongoing auditor training and feedback;
- establishing a penalty and interest network to support and review penalty decisions;
- requiring that penalty decisions are appropriately reviewed;
- conducting a review of penalty only cases as part of the regular TQR;
- conducting regular internal business line reviews of the imposition of penalties;
- providing feedback to auditors where objections to penalties were disallowed in full or part.

Paragraphs 4.44 to 4.46

The Tax Office is of the opinion that the remission of penalties, in part or in full, at the appeal stage is not indicative that the original imposition was inappropriate. While we acknowledge that from time to time there will be instances where the Tax Office has got the decision wrong we do not see this as a 'systemic issue'.

The Tax Office agrees that penalties may be further remitted through the objection and appeal process. There may be a number of reasons for this, including where the taxpayer

presents more evidence and/or information in relation to the application of the shortfall penalties. The fact that the objection and appeals process reverses some of the penalties imposed indicates the system of checks and balances is working effectively.

We would further observe that the statistics referred to in these paragraphs do not indicate the reasons why objection decisions were being allowed, either in full or in part, and there is no clear link made to the impact of the penalty decision.

Paragraph 4.47

Based on the statistics and other information provided in our response to paragraph 4.43 the Tax Office does not see how the Inspector-General can draw the inference from the total GST objection figures that *'they strongly suggest that there may be an issue with the manner in which penalties are being levied in large taxpayer GST audits'*.

Paragraph 4.49

The Tax Office has in the light of the Inspector-General's feedback had three senior staff with extensive penalty experience review the fifteen 2006-07 penalty cases referred to in paragraph 4.48 and has come to a view that except in one case the penalty decisions correctly applied the law and current Tax Office practice statements on the application of the law. We disagree with the Inspector-General's findings.

Paragraph 4.50

In regard to the 'systemic' issue concerning taxpayers who have obtained external advice, it is the Tax Office's opinion that obtaining external advice is not of itself evidence that a taxpayer has taken reasonable care. Consideration must be given to whether the external advice provided was based on all relevant facts (as sometimes taxpayers do not provide all facts material to obtaining the correct decision), whether the external advice that was being relied upon was specific to the taxpayer's particular circumstances i.e. not generic in nature or not in line with their specific circumstances and in particular, did the taxpayer act in accordance with the advice. This view is supported by case law (please refer to *Leary v FCT* (80 ATC 4438) and *McCutcheon & Anor v FC of T* (2006 ATC 2280). In addition, the concept of a reasonably arguable position under Division 284B of Schedule 1 to the TAA only applies to income tax shortfalls. It does not apply to indirect taxes, such as GST.

In consideration of whether an entity has exercised reasonable care, generally no one factor, taken in isolation, will be sufficient to determine reasonable care or the lack thereof, but rather all circumstances need to be considered and it is a question of degree as to the relevance of a particular factor (paragraph 49 of PSLA 2006/2).

In determining whether or not an entity has exercised reasonable care, it is not relevant whether the person intended or tried to exercise reasonable care, but rather whether they have in fact done so. It is generally the case though, that where a person makes a genuine effort to ensure that statements made to the Commissioner are correct, it is likely that the facts will show that reasonable care was taken (paragraph 47 of PSLA 2006/2).

Paragraph 4.51

The Tax Office strongly disagrees that the two issues found represent systemic issues.

Paragraph 4.52

The Tax Office believes it is difficult to draw an inference from a single case that the issues identified in that case represent a systemic problem. In relation to the cases where there were debit and credit adjustments in different periods leading to an overall credit adjustment, the Tax Office notes that for all taxes, where a shortfall occurs for a nominated statutory period a shortfall penalty may apply, notwithstanding that the overall outcome over a number of statutory periods of the audit is a refund.

Paragraph 4.55

In the examples quoted in this paragraph, the Tax Office view is that the taxpayers did not make a voluntary disclosure.

What the taxpayers did was the very reverse, in that they sought through lodging a self amendment to their previous activity statements to claim an increase in their refunds. In doing so it is claimed they 'fully disclosed the basis for the additional refund claim' which appears to be the basis for the Inspector-General claiming that they made a 'voluntary disclosure'.

However, the Tax Office on reviewing their refund claims, found that the bases for the increase in refunds claimed were incorrect and therefore disallowed the claims and on the basis that they had made false and misleading statements, after considering the behaviour that led to them making such statements, imposed appropriate penalties.

A voluntary disclosure, in the Tax Office view, is when a taxpayer makes a statement to the Tax Office that they are required to pay more tax or receive a smaller refund than they have previously disclosed in their activity statement, prior to the discovery of this fact by the Tax Office.

Paragraph 4.57

The quote used by Inspector-General in regard to voluntary disclosures needs to be read in context of the whole section on voluntary disclosures outlined in page 58 of the *2006 Large business and tax compliance* booklet. The Tax Office considers that read in context its policy in relation to voluntary disclosures is clearly articulated.

Paragraph 4.58

The Tax Office policy on voluntary disclosures is set out in our response to paragraph 3.24. This response clearly states that refund claims are not considered to be voluntary disclosures but rather are requests for credit amendment.

The Tax Office's policy on what constitutes a voluntary disclosure is clearly articulated at page 58 of the *2006 Large business and tax compliance* booklet.

Paragraph 4.60

The Tax Office disagrees that TR94/6 does not make clear that 'self amendment' in this context is limited to debit amendments. The following is from paragraph 49 from *TR 94/6 Income tax: tax shortfall penalties: voluntary disclosures*:

... Accordingly, where the Commissioner, following a request from a taxpayer, amends an assessment to increase the tax payable by the taxpayer, ...

Paragraph 4.61

The Tax Office does not agree that there are systemic issues in relation to its policy on voluntary disclosures. Self amendments that relate to the full disclosure of a shortfall, and are not the subject of a current audit, will be treated as a voluntary disclosure in accordance with the policy and procedures set out in the *2006 Large Business and tax compliance* booklet.

Paragraph 4.66

The Tax Office view is that this statement is factually incorrect. Paragraph 120 of the *Practice Statement Law Administration (PSLA) 2006/2 Administration of shortfall penalty for false or misleading statement* states:

120. The penalty on a shortfall amount for an accounting period will be reduced by at least 80 per cent under subsection 284-225(2) where an entity voluntarily tells the Commissioner about a shortfall amount before the earlier of:

- *the day the Commissioner tells the entity that a tax audit of their financial affairs for that accounting period is to be conducted, or*
- *the day by which the Commissioner has publicly requested voluntary disclosure from entities about a transaction that applies to the financial affairs of that entity.*

Paragraph 22 of TR94/6 outlines what constitutes the notification of an audit and also indicates that the use of the word 'audit' is not essential.

Information provided at page 52 of the *2006 Large Business and tax compliance* booklet sets out when and how the large market taxpayers are to be notified of an audit. The *Taxpayers' Charter* booklet, *If you're subject to enquiry or audit* also has information about notification of an audit.

Paragraph 4.71

The two cases mentioned in paragraph 4.70 involved situations where the other tax periods' errors were not within the scope of the audit. The scope of the audit identifies the risk and the period under audit. Therefore, the other tax periods' disclosures have been correctly treated as voluntary.

Paragraph 4.73

The Tax Office disagrees that there are systemic issues in relation to its written policy on what constitutes a disclosure that is voluntary for GST audits.

The Tax Office view is that although TR 94/6 is an income tax ruling prepared prior to GST the original technical positions taken in the TR 94 series remain appropriate. The Tax Office also acknowledges that the sections dealing with disclosure within PS LA 2006/2 could be expanded upon.

Paragraph 4.74

In observance of the Taxpayers' Charter an auditor has the responsibility to inform the taxpayer that a penalty *may* apply.

It should be noted that a voluntary disclosure does not automatically mean that shortfall penalties will not apply. Paragraph 122 of the *Practice Statement Law Administration (PSLA) 2006/2 Administration of shortfall penalty for false or misleading statement* states:

122. Where voluntary disclosure is made before the earlier of the days described above, the base penalty amount in respect of the tax shortfall amount is

- *reduced by 80 per cent if the shortfall amount is \$1,000 or more, or*
- *reduced to nil where the shortfall amount is less than \$1,000.*

Therefore, until the correct shortfall amount has been determined shortfall penalties may apply.

Paragraph 4.75

The Tax Office is only aware of one occasion where this situation occurred.

The Tax Office considers that this one instance is not representative of the quality of the penalty process and the decisions made.

Paragraph 4.76

The Tax Office conducted an internal review of the shortfall penalty cases reviewed by IGOT and concluded that in all but one of the 27 cases reviewed the penalty imposed was in keeping with the law and existing Tax Office policy. In this one case, the review team concluded the behaviour was reasonable care rather than the lack of reasonable care concluded by the auditor.

During the 2006-07 year the National Technical Quality Review (TQR) results show that penalty decisions met corporate benchmarks. This is also supported by the results of the September 2007 TQR results.

The Tax Office rejects the Inspector-General view that the findings raise issues concerning the adequacy of training of large taxpayer GST auditors on the law and current Tax Office policy on penalties. Also as noted by the Inspector-General at paragraphs 4.85, 4.86 and 4.87 the Tax Office continues to put considerable effort into ensuring penalties are imposed correctly.

Paragraph 4.81

The Tax Office needs to consider all circumstances which led to a shortfall occurring and no one factor is sufficient to determine reasonable care, or lack thereof. Reliance on an external advice is not the sole determinant of the shortfall penalty base amount. All relevant factors must be considered in our penalty decision making process.

Paragraph 4.88

The Tax Office agrees that these figures are correct, but considers they are being quoted out of context. Although the decisions were found to be lacking in their reasoning (a capability issue that has been addressed) the outcome of the review was that in a number of cases a higher level of penalty would have been supported by the law, rather than finding that the penalties imposed were too high, which is the main thrust of the Inspector-General's findings in this section of his report.

Paragraph 4.89

Contrary to the comment attributed to tax officers in paragraph 4.89 that the internal review *'was prompted by concerns that the level of penalties charged to large taxpayers was too low'* the review was conducted for the following reasons:

The recent SI&LAC prudential review and the Case Leadership call over process have highlighted that there may be some inconsistent approaches being taken in making decisions regarding penalty imposition and remission, application of law and interpretation of practice statements to the facts of the case and assessing behaviour. There is also some concern that there may be a community perception around the equitable application of penalties within segments and across markets. ('Analysis of a review of the application of penalty policy within GST LAC' report March 2007)

The Tax Office continually seeks to improve the taxpayer experience and reduce the cost of compliance and our action in initiating this internal review without prompting is a consequence of this commitment to continual improvement.

Paragraph 4.95

The Tax Office disagrees with this paragraph. If a taxpayer fails to produce relevant evidence at the audit stage and then provides it at the review stage the results of the audit and the review may well be different. This does not mean that the audit result based on the evidence on hand was incorrect.

The Tax Office has put in place procedures to ensure auditors are informed of any review outcome.

Paragraph 4.109

GIC is imposed at law on a shortfall amount. The scheme of the Act clearly intends for GIC to apply where individual taxpayers fail to report and pay correctly and on time. The Act does not take into consideration the treatment of another taxpayer when applying the GIC on the entity which made the mistake.

Paragraph 4.115

These figures only indicate the number of cases reviewed where GIC was remitted or partially remitted. The fact that there were different outcomes indicates that, consistent with our policy, the individual circumstances of taxpayers were considered.

Paragraph 4.121

The Tax Office disagrees with the view that Tax Office officers are not following the Tax Office administrative rule for remission of GIC in voluntary disclosure cases. The Inspector-General uses the fact that there have been a range of different outcomes in cases where it is claimed there was a voluntary disclosure. The Tax Office practice statement on remission of GIC envisages this on the basis that Tax Office officers should apply the policy taking into account the differing circumstances of each case. There is no intention that remission of GIC to the base rate be semi automatic.

Paragraph 4.122

The Tax Office disagrees that there is a need to review all voluntary disclosure cases where GIC has been charged at the full rate.

Paragraph 4.126

When making GIC remission decisions, auditors must take into account all relevant facts, a wash transaction being just one of the grounds which may apply. The circumstances of individual taxpayers vary greatly and as such it is not unusual that different reductions in GIC may occur.

Paragraph 4.132

Generally, the tax deductible GIC is remitted to base rate where the recipient was registered for GST and would have been entitled to claim a full ITC. Further, the Commissioner will consider remitting GIC in full where it is fair and reasonable or otherwise appropriate to do so. Given the form of the legislation enacted by Parliament and the obligations it imposes on suppliers, it requires the Commissioner to consider issues of integrity and equity, which will differ based on the facts and circumstances of each 'wash' transaction.

Paragraph 4.141

The Tax Office considers that its referral guidelines are detailed. However, the Tax Office does acknowledge that they are not readily available from the case management system and is currently undertaking a process to remedy this. Tax Office auditors have received training in GIC interest remission and have access to the referral guidelines.

The fact that these guidelines are currently not available in the case management system does not mean that they are not readily available to Tax Office auditors.

Paragraph 4.143

It is agreed that there is no requirement to calculate the GIC amount. However, it needs to be noted that the calculation of GIC is quite complicated and is also based on other debts which may be on the RBA, therefore the amount derived through the calculator is an estimate only.

Paragraph 4.144

The Tax Office considers that the current processes are adequate and notes that GIC decisions made within GST are subject to a high level of internal review. It is mandatory, within GST, that all GIC decisions are technically cleared by a member of the Penalty and Interest Network. This additional review step ensures the correct application of the guidelines and that remission has been considered in all relevant circumstances.

The Tax Office has developed a number of products and tools to assist staff when making GIC decisions and is currently undertaking a process to embed these into the case management system.

The Tax Office notes that like most changes, the requirement for GST auditors to consider GIC remissions as part of their audit case finalisation took some time to be fully implemented. However, the Tax Office is committed to the ongoing development of staff capability in this regard and will be providing further training to ensure the correct application of GIC remission policy by our auditors. TQR results indicate a continuing improvement in the application of GIC remission policies by GST auditors.

Paragraph 4.148 and 4.149

The General Interest Charge (GIC) is a uniform rate of interest applied to known overdue tax debts, whether or not a taxpayer has acted knowingly to create the debt. GIC is imposed at law on a shortfall amount, regardless of whether a shortfall penalty is imposed.

The scheme of the Act is to apply GIC to individual taxpayers whose responsibility it is to correctly raise and to correctly claim ITCs when they are legally allowed to. The scheme clearly intends for GIC to be applied where individual taxpayers failed to correctly apply the law. The scheme of the Act does not take into consideration the treatment of another taxpayer when applying the GIC on the entity which made the mistake.

The Commissioner is currently considering his policy and practices in relation to revenue neutral and documentation issues and has released a draft practice statement for consultation.

Paragraph 4.152

The Tax Office's Quality Assurance processes have demonstrated that we are applying the guidelines. The most recent corporate wide capability TQR was conducted on a sample of cases finalised between February and July 2007. GST specific results from this TQR showed an 88 per cent pass rate.

Results showed that there were very few cases where further remission was warranted, although it was clear that not all officers were applying the guidelines (12 per cent Fail rating [3 cases]). Of the cases which failed, all had not been technically cleared as mandated by the

procedures. The requirement for technical clearance has been re-emphasised with staff and approving officers.

Chapter 5

Paragraph 5.4

In the majority of cases, the Tax Office has provided details to the taxpayer of why their valuation was not considered to be compliant. In a small number of cases, the Tax Office agrees it could have provided more detail to the taxpayer of the basis that their valuation was found to be non compliant.

Paragraph 5.6

In most valuation cases where an AVO critique was obtained by the Tax Office it did not include an estimated valuation or valuation range because the purpose of the critique was to determine whether the methodology used in establishing the taxpayer's valuation was an appropriate one and not to come up with an alternative valuation using some other valuation method. In those cases where an estimated valuation or valuation range was included it was not communicated to the taxpayer because of concerns that such an estimate was not a proper valuation based on the use of a professional valuation method. As indicated by the Inspector-General where a full valuation was obtained from the Tax Office it was provided to the taxpayer. The Tax Office acknowledges that it could have been more transparent in these situations and provided the valuation estimates although indicating that they were not based on a detailed valuation.

Paragraph 5.8

The Tax Office view is that in these situations it is inappropriate to use the Commissioner's general administrative powers. However the use of his specific power to determine what valuations are acceptable may be capable of wider application than used to date. The Tax Office is currently examining options by which it can, within the law, substitute an alternative valuation rather than use the last sale price in those cases where it believes the taxpayer's original valuation is not an approved valuation. In November 2007, the Tax Office put a proposal along these lines to the GST Sub Committee of the National Taxation Liaison Group for consideration and feedback.

Paragraph 5.10

The issue of establishing complying valuations for use in the margin scheme has involved technical issues which have been difficult to resolve between the parties. It is therefore not unusual that some of these cases will be taken to the litigation stage by the taxpayer. In these circumstances the Tax Office still strives to reduce the cost of compliance to the taxpayer and this may involve agreeing to a settlement. This is part of the overall objection and litigation process and not a deliberate strategy to force taxpayers into litigation to achieve a resolution of the issue.

Paragraph 5.18

Both public rulings and Tax Office IDs are documents which are identified as sources of the Tax Office view and facilitate consistent decision making by the Tax Office. The Tax Office considers that while Tax Office IDs are quicker and simpler to produce than public rulings, the Tax Office ID process is not a substitute for the more rigorous and consultative process of producing public rulings through the public rulings program. The Tax Office recognises that it needs to review how it communicates its decisions to taxpayers to achieve *'through-the-chain certainty, better compliance and lower costs'* the Inspector-General suggests.

Paragraph 5.24

The Tax Office developed its current audit cycle time benchmarks based on the best information it had at the time. Its new case management system will now provide consistent GST measurement of the cycle time of all audit cases to enable us to continually review and revise our cycle time benchmarks for the different audits we undertake. The Tax Office has been unable to establish if other tax jurisdictions use similar cycle time benchmarks to the Tax Office to enable any meaningful comparison to be made. The Tax Office will work with taxpayers and their representatives to review and if appropriate revise its audit cycle times.

Paragraph 5.26

As outlined in our response to paragraph 5.24 the Tax Office does have benchmarks for all GST audit products and considers that these benchmarks are both appropriate and meaningful. To date we have not been able to identify the benchmarks used by similar tax revenue authorities but will follow this up.

Paragraph 5.29

The Tax Office agrees that in prior years some audits may have lacked an audit plan. However, with the introduction of the *2006 Large Business and tax compliance* booklet, new processes and procedures have been put in place to ensure that audit plans are drafted and discussed with the taxpayer at the initial audit interview. These issues are reviewed by the GST Case Leadership area in their call overs of audit cases in LAC.

Paragraph 5.38

The Tax Office considers that the Case Leadership team within GST has provided guidance on the management of audit cases and as a direct result the number of aged cases on hand has reduced significantly. It is acknowledged that a number of aged cases remain on hand primarily in relation to complex technical issues. This does not indicate that the Case Leadership team have been ineffective in reducing aged cases.

Paragraph 5.39

For the reasons already discussed the Tax Office does not agree with this conclusion. We have not been able to establish the basis on which other tax authorities establish their audit cycle times, if indeed they have established them, although we would be interested in exploring this issue with them. The comments about planning and governance relate largely to the past rather than the present and were addressed by the Tax Office prior to this review.

The Tax Office continues to focus on ensuring cases are finalised within appropriate timeframes and has established the Case Leadership team with a key role in this area.

Paragraph 5.55

Refer to our response at Paragraph 5.58.

Paragraph 5.56

The Tax Office disagrees that applying the law as set out in the GST legislation in relation to margin schemes is taking an 'unfair stance'.

Paragraph 5.58

Whilst it is accepted that the finance industry is complex in nature and in the vast variety of transactions that may be encountered, the Tax Office disagrees that auditors in financial supplies teams do not have an understanding of their industry. For a number of years the Tax Office has utilised the relevant technical experts when auditing particular issues and most financial industry audits to date have been on technical issues as opposed to system type audits.

The Tax Office is in the process of finalising panels of internal and external experts to assist with the progression of technical issues.

In the last 18 months GST has trained 320 auditors in Financial Supplies (FS) in the SME and Large markets. The FS training covers:

What are financial supplies; What are not financial supplies; Financial Supply Providers/Facilitators; The financial acquisitions threshold; Financial acquisitions; Reduced Input Tax Credits; Div 84 – Reverse Charging; Apportionment which also covers various methodologies and fair and reasonable; Div 132 – Supplies of things acquired etc. without full ITCs; Div129 – Change in extent of creditable purpose; Securitisation; Factoring; Initial Public Offerings (IPOs); Using Computer Assisted Verification (CAV) techniques in a FS audit; and an extensive case study that brings it all together.

Paragraph 5.59

The Tax Office does not consider that a retrospective claim is indicative of non-compliance or bad practice.

The Tax Office initially queried the appropriateness of retrospective changes to apportionment methodologies when first raised by taxpayers. The Tax Office undertook a thorough technical review, taking into account taxpayer contentions and formally concluded that a revised apportionment method may be retrospectively applied, subject to the normal 4 year limitation on amendment of returns.

Requests for amendments have been received and have either been processed or are being processed.

The Tax Office will, where appropriate, review any claim arising from a retrospective change in methodology. Again, the Tax Office does not imply that making a retrospective claim is indicative of non-compliance or bad practice.

Paragraph 5.64

GST auditors are trained to identify risks that impact on revenue, integrity of the system and community confidence. The relative importance of each of these factors will vary depending on the circumstances of each client. The decision to audit a particular client before others will depend on the overall risk assessment for each client. For example, a significant RCTI failure at a large client which transacts with many suppliers may outweigh the risk posed by a potential small sticky tax error of another client.

The training and processes required to conduct an audit are the same for both sticky and non sticky issues. For example, the technical acumen required to determine the character of a supply is the same for a supply that is sticky (such as a retail supply) as it is for non sticky (such as business to business supply).

APPENDIX 3: ABBREVIATIONS

ANAO	Australian National Audit Office
ATO	Australian Taxation Office
ATO ID	ATO Interpretative decision
ATPF	ATO – Tax Practitioner Forum
AVO	Australian Valuation Office
CAR	Compliance Activity Report
Commissioner	Commissioner of Taxation
FCT	Federal Commissioner of Taxation
GIC	General Interest Charge
GST	Goods and Services Tax
IGT Act	<i>Inspector-General of Taxation Act 2003</i>
Inspector-General	Inspector-General of Taxation
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
NFP	Not for profit organisation
NTLG	National Tax Liaison Group
PS	Practice Statement
PS LA	Practice Statement Law Administration
RoSA	Review of Aspects of Self Assessment
RCTI	Recipient-created tax invoice
SME	Small to Medium Enterprise
TAA 1953	<i>Taxation Administration Act 1953</i>
TCN	Tax Counsel Network
TD	Taxation Determination
TLAB	Tax Law Amendment Bill
Tax Office	Australian Taxation Office
TQR	Technical Quality Review
TR	Taxation Ruling
VAT	Value Added Tax