



Australian Government
Inspector-General of Taxation

Review into aspects of the Australian Taxation Office's use of compliance risk assessment tools

A report to the Assistant Treasurer

Inspector-General of Taxation

October 2013

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21 October 2013

Senator the Hon Arthur Sinodinos AO
Assistant Treasurer
Parliament House
Canberra ACT 2600

Dear Minister

Review into Aspects of the Australian Taxation Office's Use of Compliance Risk Assessment Tools

I am pleased to present you with my report of the above review. The ATO's use of risk assessment tools has been a persistent concern across taxpayer segments over a number of reviews.

Stakeholders have generally supported the Australian Taxation Office's (ATO) risk-based approach which informs its compliance activities. However, they believed an unnecessary but significant compliance burden has been imposed on them due to inaccuracies in risk assessments, ineffective communication and disproportionate compliance action to perceived risks.

I have reviewed a range of risk assessment tools and recommended the adoption of a set of guidelines to assist the ATO design more effective risk assessment tools for the future. In addition, I have made recommendations to improve existing risk assessment tools with which taxpayers have raised most concern.

Overall, I have made 16 recommendations to all of which the ATO has agreed. Once implemented appropriately, they should result in extensive and enduring improvements to the ATO's risk assessment processes.

I am grateful for the support and contribution of taxpayers, tax practitioners and their representatives to this review. The willingness of many to provide their time, expertise and experience in preparing submissions and discussing issues with my office is greatly appreciated. I also thank ATO officers involved in this review for their professional cooperation and assistance.

Yours faithfully,

Ali Noroozi
Inspector-General of Taxation

Contents

EXECUTIVE SUMMARY	IX
CHAPTER 1 — OVERVIEW	1
Conduct of the review	1
Summary of stakeholder concerns.....	2
Structure of this report.....	4
CHAPTER 2 — ATO RISK MANAGEMENT	5
The ATO's enterprise risk management framework (ERMF)	6
Types of taxpayer compliance risks	11
ATO risk management approach to taxpayer compliance	15
How the ATO assesses risk	23
Inputs into ATO risk assessment tools	25
Outputs of risk assessment tools	26
Health of the system assessments — HOTSA	27
IGT observations.....	30
CHAPTER 3 — LARGE BUSINESS AND INTERNATIONAL	37
Historical context.....	37
The Risk Differentiation Framework (RDF)	39
ATO governance and moderation panel	50
ATO risk filters, risk managers and risk owners	51
Taxpayer notification of RDF categorisation	54
Additional higher consequence requirements — taxpayer assurance plans (TAPs)	56
ATO review of the risk categorisation template.....	57
Stakeholder concern — transparency of the risk categorisation process.....	58
Stakeholder concern — accuracy and relevance of inputs	60
Stakeholder concern — formal notification of risk categorisation	87
Stakeholder concern — proportionality of ATO compliance approach	92
CHAPTER 4 — SMALL TO MEDIUM ENTERPRISES	103
Background	103
Stakeholder concern — inputs into the risk categorisation process.....	108
Stakeholder concern — communication of the risk categorisation	111
Proportionality of ATO compliance approach.....	117
CHAPTER 5 — MICRO BUSINESSES	119
Background	119
Risk assessment tools used in the micro business segment	120
IGT observations.....	121
CHAPTER 6 — INDIVIDUALS.....	123
Background	123
ATO risk assessment tools used in the individuals segment	124
IGT observations.....	126
CHAPTER 7 — TAX PRACTITIONERS AND ADVISORS	129

Background	129
ATO approaches to tax practitioner risk identification	130
CHAPTER 8 — TEMPLATE FOR FUTURE DESIGN	141
Governance.....	141
Effective use of inputs	142
Transparency and communication	147
Proportionality of ATO compliance approach.....	149
Compliance effectiveness	157
Project management — balancing risk, resources and time	158
Conclusion	161
APPENDIX 1 — TERMS OF REFERENCE	163
APPENDIX 2 — ATO LEVEL 0 ENTERPRISE RISKS	171
APPENDIX 3 — LEVEL 0 AND LEVEL 1 RISK OWNERS AND DESCRIPTIONS	173
APPENDIX 4 — CONFIDENCE LEVELS USED IN RISK ASSESSMENT	181
APPENDIX 5 — PREVIOUS IGT RECOMMENDATIONS RELATED TO COMPLIANCE COSTS.....	183
APPENDIX 6 — OVERVIEW OF ATO RISK ASSESSMENT TOOLS	185
APPENDIX 7 — ATO ENTERPRISE LEVEL RISK MATRIX	187
APPENDIX 8 — RDF CHART FROM LARGE BUSINESS AND TAX COMPLIANCE 2010 BOOKLET	189
APPENDIX 9 — LARGE MARKET INCOME TAX RISK FILTERS.....	191
APPENDIX 10 — SME MARKET RISK FACTORS.....	193
APPENDIX 11 — TAX PRACTITIONER RDF	195
APPENDIX 12 — QUALITY ASSURANCE CHECKLIST FOR COMPLIANCE RISK ASSESSMENT TOOL DESIGN	197
APPENDIX 13 — ATO RESPONSE	200

LIST OF TABLES

Table 1: ATO levels of risk	8
Table 2: ATO operational risk matrix	23
Table 3: The ATO Enterprise level risk likelihood rating table	24
Table 4: 'Confusion matrix'	145
Table 5: Sample of ATO information gathering approaches.....	151
Table 6: Triple constraint applied to ITRIP	160
Table 7: ATO enterprise level risk matrix	187

LIST OF FIGURES

Figure 1: Structure of this report	4
Figure 2: ATO 'Wheel of Risk'	9
Figure 3: ATO Compliance Model	16
Figure 4: Risk bow-tie for large business	18
Figure 5: Differentiation in intensity and visibility of ATO verification activities	21
Figure 6: Element status ratings for HOTSA reporting	29
Figure 7: Data integrity status ratings for HOTSA reporting	29
Figure 8: Risk and information confidence and cost	35
Figure 9: Large business RDF 'quadrants'	40
Figure 10: Sample ATO risk filter description.....	52
Figure 11: Simplified higher consequence taxpayer risk categorisation process	58
Figure 12: Large taxpayers and uncertain positions.....	64
Figure 13: Risk and information confidence and cost	71
Figure 14: Potential integrated PCR process	101
Figure 15: ATO example of a kind of private group	105
Figure 16: RDF for small-to-medium enterprises and wealthy individuals	106
Figure 17: How RAPT fits into the suite of corporate risk tools	108
Figure 18: Risk bow-tie for promoter penalty laws	132
Figure 19: RDF for intermediaries – promoter penalty laws.....	133
Figure 20: ATO RDF for Tax Practitioners.....	136
Figure 21: Risk and information confidence and cost	150
Figure 22: SME business line compliance 'funnel'	156
Figure 23: Indirect taxes business line compliance funnel	156
Figure 24: The triple constraints of project management	159
Figure 25: Applying the triple constraint to risk treatment projects.....	159
Figure 26: Overview of ATO compliance risk assessment tools.....	185
Figure 27: RDF chart from 2010 Large business and tax compliance booklet	189
Figure 28: Tax practitioner risk differentiation framework.....	195

EXECUTIVE SUMMARY

The Inspector-General of Taxation's (IGT) review into aspects of the Australian Taxation Office's (ATO) use of compliance risk assessment tools was prompted by concerns raised about their effectiveness by taxpayers, tax practitioners and their representative bodies. It had also been identified as a review topic during the course of previous reviews.

Stakeholders have acknowledged that it is appropriate for the ATO to adopt a risk-based approach in its compliance strategy. In fact, most comparable revenue authorities take such an approach to make the best use of their resources in protecting government revenue.

There are many risk assessment tools within the ATO's enterprise risk management framework. These tools are used to gauge risks posed by taxpayers in each market segment. The IGT has observed that, ultimately, the effectiveness of these risk assessment tools could only be reliably evaluated if evidence-based metrics, such as random audits, were used. Such metrics could also be used to refine the associated risk assessment tools.

In the absence of evaluation metrics, the IGT has drawn on the examination of the ATO's main risk assessment tools in this review as well as those investigated in previous IGT reviews, to create guidelines for developing effective risk assessment tools. These IGT recommended guidelines address key stakeholder concerns, such as the governance, inputs and transparency of the ATO's risk assessment processes as well as related communication with taxpayers and the proportionality of resulting ATO compliance action to detected risks. Furthermore, these guidelines emphasise the importance of effective project management to minimise adverse impacts on taxpayers whilst making best use of ATO resources.

The appropriate implementation of the IGT recommended guidelines should result in extensive and enduring improvements to the ATO's risk assessment processes. In addition to these guidelines, specific recommendations have also been made to enhance aspects of those risk assessment tools with which taxpayers have raised the most concerns.

In a recent review¹, the IGT examined the ATO's small business benchmarks, one of its main risk assessment tools in the micro and small business market segments, and made recommendations aimed at increasing the robustness and transparency of inputs and methodology used amongst other things.

The IGT has also, more recently, reviewed the key risk assessment tools used by the ATO in the individual market segment.² These tools benefit from large amounts of relatively low-cost third-party information available to the ATO. Indeed, an estimated 1.4 million individuals with simple tax affairs may not need to lodge tax returns in the near future.³ The IGT's recommendations for improvement in this regard will be made available upon the public release of the reports of these reviews.

¹ *Review into the ATO's use of benchmarking to target the cash economy*, publicly released in October 2012.

² *Review into the ATO's compliance approach to individual taxpayers – income tax refund integrity program*; and *Review into the ATO's compliance approach to individual taxpayers – use of data matching*.

³ Neil Olesen, 'Reinventing the ATO – ready, willing and underway', (Speech to CPA Congress, 17 October 2013)

In other market segments, the ATO does not have access to the same level or quality of third-party information. The quality of information at the ATO's disposal and the cost of gathering more information to gain sufficient confidence (information confidence and cost) have a major impact on the way the risk assessment tools are used and the compliance activities that follow.

The ATO's main risk model, which is examined closely in this review, is the risk differentiation framework (RDF). It is used in a number of market segments including small to medium enterprises (SMEs) and large business and international (LB&I) as well as tax practitioners.

The IGT has recommended that the RDF be refined to reflect recent administrative developments and related taxpayer compliance patterns. A number of opportunities have been identified to reduce overall taxpayer compliance costs and improve ATO-taxpayer interactions by distinguishing between those risk factors that can be addressed by taxpayers (behavioural risks), those factors that cannot (inherent risks) and information confidence and cost.

The most mature application of the RDF is in the LB&I market segment. Stakeholders in this segment had raised concerns with the ATO's use of judgement-based inputs, communication of taxpayers' risk categorisations and the costs of resulting compliance activities. In this respect, the IGT has made a number of recommendations including:

- ATO risk assessment processes, related communication and subsequent compliance action should reflect the differing levels and mixes of inherent and behavioural risks as well as information confidence and cost;
- 'willing participation' and 'transparency' should be objectively considered in terms of information confidence and cost alongside, but separate from, the RDF;
- discrete transactions or presence of a number of contestable positions should not of themselves be determinative of a taxpayer's overall risk rating; and
- greater detail should be provided to taxpayers about how particular risks are assessed and there should be an open dialogue between the ATO and taxpayers before risk ratings are finalised.

Stakeholders in the SME market segment expressed uncertainty with the RDF given the infancy of its application to this market segment. Drawing on the issues that have arisen with the RDF's application to the LB&I market segment, the IGT has recommended that the ATO bolster its process of refining the risk inputs used and make more information publicly available about these inputs, amongst other things.

In relation to the application of the RDF to tax practitioners, the IGT had already raised a number of issues in his *Review into Improving the Self Assessment System*. In this review, the IGT has called for the ATO to consult with tax practitioners with a view to developing a guide on the operation of the RDF for them.

Overall, the IGT has made 16 recommendations to the ATO. The ATO has agreed with all of the recommendations.

CHAPTER 1 — OVERVIEW

CONDUCT OF THE REVIEW

1.1 This is the report of the Inspector-General of Taxation's (IGT) review into aspects of the Australian Taxation Office's (ATO) use of compliance risk assessment tools. The report is produced pursuant to section 10 of the *Inspector-General of Taxation Act 2003* (the IGT Act 2003).

1.2 During public consultation for the IGT's 2012-13 work program, submissions were received from a range of taxpayers, tax practitioners and their representative bodies raising concerns about how the ATO selects taxpayers for compliance activities, that is, the ATO's compliance risk assessment tools. The IGT commenced this review in response to those concerns and pursuant to section 8(1) of the IGT Act 2003. The IGT undertook further community consultation to better understand these stakeholders' concerns which are reflected in the terms of reference issued on 31 October 2012 and reproduced in Appendix 1.

1.3 The IGT received a number of submissions in response to the issuance of the terms of reference. The IGT also met with interested taxpayers, their representatives, selected professional bodies and industry associations to understand their experiences and to discuss their submissions.

1.4 To further assist the review, the IGT established a working group comprising key tax practitioners and representatives: Craig Jackson (Ernst & Young), David Drummond (KPMG), Andrew Noolan (The Tax Institute/SBN Lawyers), Michael Fenner (Chevron), John Avery (Australand), Michelle de Neise (Corporate Tax Association), Jeremy Child (Australian Financial Markets Association/Royal Bank of Scotland), Michael Johnson (Consolidated Press Holdings), Steven Green (ANZ Bank), Jane Michie (Macquarie Bank), John Condon (BP Australia) and senior ATO officials.

1.5 The IGT greatly appreciates the generosity of the members of this working group in giving of their time and expertise. Their involvement has significantly enhanced the outcomes of this review.

1.6 The working group met to discuss concerns and to consider potential solutions. It should be noted, however, that the views and recommendations expressed in this report are not necessarily those of individual members of the working group.

1.7 The IGT worked progressively with ATO senior management to identify the areas for improvement and to distil specific action items.

1.8 During the conduct of the IGT's review, the ATO completed an internal audit which covered aspects of the ATO's 'Risk Differentiation Framework' (RDF). The ATO kept the IGT informed of the progress and the findings of the internal audit. Some of these findings are referred to in Chapter 3.

1.9 During the final stages of this review, the ATO's organisational structure also changed with a corresponding name change for some of the business lines. It should be noted that their former names are used below.

1.10 In accordance with section 25 of the IGT Act 2003, the Commissioner of Taxation was provided with an opportunity to make submissions on any implied or actual criticisms contained in this report. The Commissioner's response is included in Appendix 13, whilst the detailed responses are reproduced under each recommendation as they appear in the report.

SUMMARY OF STAKEHOLDER CONCERNS

1.11 Stakeholders from the large business sector focussed on a key ATO risk assessment tool used for this market segment, the RDF. Their concerns with the RDF risk categorisation process included:

- the relevance of inputs;
- the governance and transparency of the process;
- whether taxpayers were afforded due process during various aspects of the process; and
- whether the categorisation resulted in a proportionate compliance response from the ATO.

1.12 Stakeholders from the small to medium enterprises (SME) sector also focussed on the rollout of the RDF to this market, pursuant to the ATO guide *Tax compliance for small to medium enterprises and wealthy individuals*.⁴ Stakeholders held particular concerns about:

- how the ATO would communicate taxpayer risk categorisations; and
- the nature of the opportunities to test the underlying evidence before categorisation is finalised.

1.13 In a previous IGT review,⁵ concerns were also raised with the impact of applying the RDF to tax practitioners. In the first instance, it was questioned whether they would be compromised in their duty to their clients by being subjected to such a risk assessment system. Amongst other issues, transparency, governance and communication were again raised if the RDF were to be applied in this context.

1.14 Stakeholders from the micro businesses sector⁶ expressed concerns regarding the ATO's cash economy risk assessment tool (the small business benchmarks) in another IGT review.⁷ Their concerns included:

⁴ Australian Taxation Office, *Tax compliance for small-to-medium enterprises and wealthy individuals* (26 October 2012) <<http://www.ato.gov.au>>.

⁵ Inspector-General of Taxation, *Review into improving the self assessment system* (2013).

⁶ In this case, small businesses with a turnover below \$15 million.

- the accuracy of the data used as inputs into the benchmarks;
- aspects of how the ATO communicated benchmark comparisons to taxpayers;
- whether the benchmarks were an effective compliance risk identification tool; and
- the proportionality of the ATO compliance approach to taxpayers who were outside the benchmarks.

1.15 In the current work program, the IGT also conducted a review into the Income Tax Refund Integrity Program (ITRIP) and ATO data matching activities, being specific risk assessment tools used in the general individuals area. The stakeholder concerns with respect to the ITRIP include whether the ITRIP:

- uses relevant and accurate information for detecting potentially incorrect or fraudulent claims;
- has adequate resources available to promptly verify and release refunds;
- has a proportionate impact on compliant taxpayers and their representatives; and
- provides adequate explanation to taxpayers and their agents as to why their refund was withheld for checking.

1.16 Stakeholder concerns regarding ATO data matching activities include:

- the quality of the data being used in these activities;
- the low accuracy at predicting non-compliance for certain projects; and
- the inadequate information or opportunity given to taxpayers to address the ATO's concerns before assessments were amended.

1.17 The above concerns of stakeholders across all market segments can be distilled into four broad categories:

- the governance and transparency of the risk assessment process;
- the accuracy or relevance of inputs used in the risk assessment process;
- the resultant risk rating or categorisation, and the quality of communication and due process afforded to taxpayers in relation to it; and
- the proportionality of subsequent ATO compliance activity to the purported or actual risk level.

1.18 Besides the small business benchmarks, ITRIP and data-matching, this current review provides information on other ATO risk assessment tools used in the micro business and individuals market segments. Significant concerns were not raised by

⁷ Inspector-General of Taxation, *Review into the Australian Taxation Office's Use of Benchmarking to Target the Cash Economy* (2012).

stakeholders in relation to these other tools. This may be partly due to a lack of awareness by affected parties. The information provided in this report should place them in a better position to provide feedback in the future at which time consideration could be given to a separate review of these areas.

STRUCTURE OF THIS REPORT

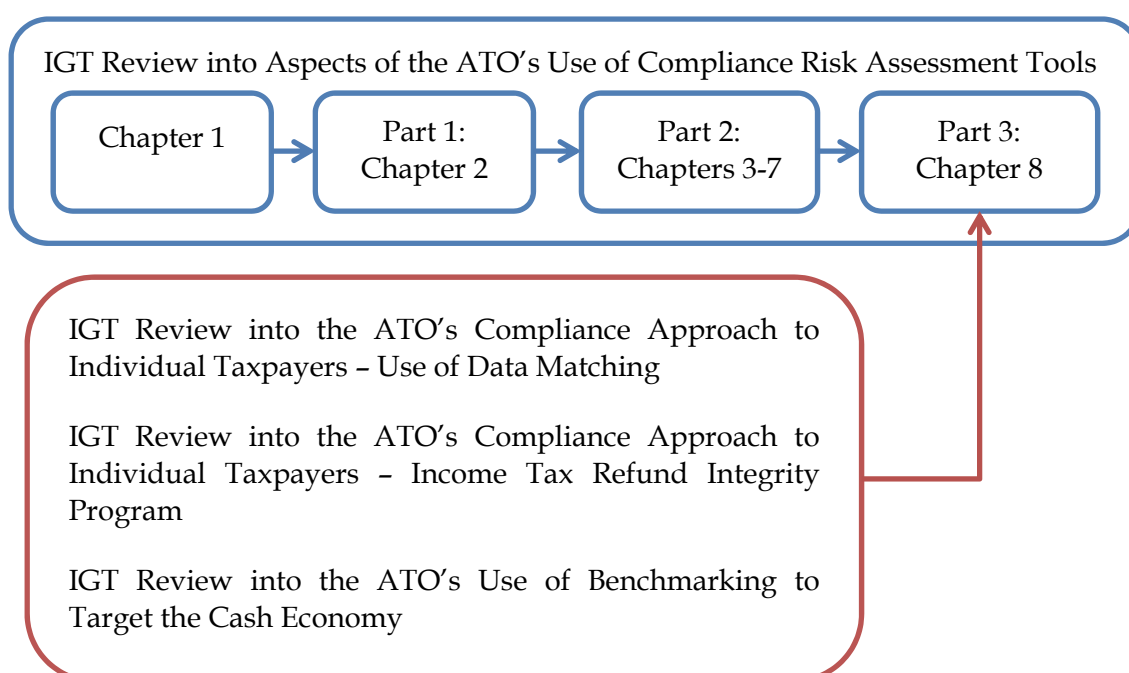
1.19 This report is comprised of three main parts. The first part, Chapter 2, provides background on the ATO's risk management systems and corporate expectations in relation to compliance risk management.

1.20 The second part, Chapters 3 to 7, focuses on each market segment covered by this review and the compliance risk assessment tools the ATO uses within them. The market segments explored are:

- large business and international;
- small to medium enterprises, wealthy Australians and high wealth individuals;
- micro enterprises;
- individuals; and
- tax practitioners.

1.21 As depicted in Figure 1 below, the final part of this review, Chapter 8, draws on the observations made in part 2 of this report as well the observations made in separate IGT reviews for small business benchmarks, ITRIP and data-matching and makes recommendations of broader application to the ATO's use of compliance risk assessment tools.

Figure 1: Structure of this report



CHAPTER 2 — ATO RISK MANAGEMENT

2.1 The activities of any organisation involve some level of risk.⁸ Risk can be defined as the effect of uncertainty on objectives.⁹ All organisations must effectively manage the impacts of this uncertainty to ensure they can deliver on their objectives. Risk management, therefore, is commonly considered to be a key governance and management tool within the private and public sectors.¹⁰

2.2 Internationally, risk management is also recognised as a key part of organisational management. As such, the International Organization for Standardization (ISO) issued International Standard ISO 31000 *Risk management – Principles and guidelines*. In Australia, this standard has been adopted as AS/NZS ISO 31000:2009. The ATO's enterprise risk management framework refers to this standard as one of the reasons for the framework's current form.¹¹

2.3 Risk management has also been the focus of research and public discussion as both a management discipline and as a profession in various industries.¹² For example, other approaches have suggested a greater focus on identifying vulnerabilities beyond those currently identified through intelligence sources.¹³ Other research indicates the need for paradigm shifts in risk prevention strategies as the return on investment of current risk detection methods begins to decline.¹⁴ Such approaches are also applicable to revenue authorities.

2.4 Guidance from the Organisation for Economic Co-operation and Development (OECD) Committee on Fiscal Affairs¹⁵ has also advocated that revenue authorities adopt a risk management approach:

Revenue authorities have turned to risk management in order to allocate better scarce resources to achieve an optimum compliance strategy – one aimed at achieving the best long-term compliance for the resources employed. Without a systematic methodology to do this, resource allocation decisions are open to question and criticism and, for a revenue authority, potential tax revenue may be lost.¹⁶

⁸ International Organization for Standardization, *ISO 31000 Risk management – principles and guidelines* (2009), p v.

⁹ Ibid para [2.1].

¹⁰ Comcover, *Better Practice Guide - Risk Management* (June 2008).

¹¹ Australian Taxation Office, 'Enterprise Risk Management Framework' intranet document.

¹² For example, the Risk Management Association of Australia; Risk Management Institution of Australasia; Australian Risk Policy Institute.

¹³ Australian Risk Policy Institute, *The Risk Policy Model* (2012) p 25.

¹⁴ IGT stakeholder consultation 21 May 2013.

¹⁵ Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development, *General Administrative Principles - GAP003 Risk Management* (2001).

¹⁶ Ibid para [10].

The ATO's organisational objectives

2.5 As risk is defined as the effect of uncertainty on objectives, it is important to articulate the ATO's actual objectives. The ATO's objectives, on one view, may be described in terms of their stated outcomes and vision. Both are articulated in their 2011-12 Annual Report:

2.6 The ATO's vision is:

... that Australians value their tax and superannuation systems as community assets, where willing participation is recognised as good citizenship.¹⁷

2.7 The ATO's outcome is:

Confidence in the administration of aspects of Australia's tax and superannuation systems through helping people understand their rights and obligations, improving ease of compliance and access to benefits, and managing non-compliance with the law.¹⁸

2.8 In order to achieve the above vision and outcome with the resources at their disposal, the ATO adopts a risk-based approach.

2.9 In addition to taxpayer non-compliance risks, the ATO, like any other organisation, faces a variety of risks which can impact on its ability to deliver on its objectives. These may relate to areas such as technology, people or finances. For example, the ATO needs to manage the risk of skilled, knowledgeable or experienced employees leaving the ATO. As a human capital risk adequate succession management plans need to be considered for the management of knowledge transfer.

2.10 Another common organisational risk involves the use of technology. This includes ensuring that ATO systems effectively support the organisation's objectives and that staff are able to adapt to system changes and that the cost of maintaining or acquiring systems is adequately planned for and managed.

2.11 As an Australian Public Service (APS) agency, the ATO is subject to particular legislative requirements.¹⁹ This includes the responsibility for the effective and efficient use of Commonwealth resources. The Department of Finance and Deregulation's *Risk Management (Comcover) Better Practice Guide* provides additional risk management guidance to all APS agencies in this regard.

2.12 All of these risks, including risks associated with taxpayer compliance with the law, are managed under the ATO's Enterprise Risk Management Framework (ERMF) which is described below.

THE ATO'S ENTERPRISE RISK MANAGEMENT FRAMEWORK (ERMF)

2.13 The ATO uses an ERMF to record, categorise and manage all 'enterprise risks'. The ATO Corporate business line has overall responsibility for the ERMF and works

¹⁷ Australian Taxation Office, *Commissioner of Taxation Annual Report 2011-12* (2012) p a.

¹⁸ Ibid.

¹⁹ One of the main sources being the *Financial Management and Accountability Act 1997*.

with all areas of the ATO to implement it.²⁰ The ERMF is outlined in the Corporate Management Practice Statement PS CM 2003/02 *Risk and issues management* which is aimed at ensuring:

A consistent, effective and integrated approach to the overall management of risks and issues at all levels to enable the ATO to achieve its outcome, deliver on government commitments and meet legislative obligations.²¹

2.14 The ATO's risk and issues management policy is to:

... actively manage all risks and issues that may compromise either its outcome or community confidence in the fair and effective administration of Australia's taxation and superannuation systems.²²

2.15 This practice statement also places a positive obligation on all ATO personnel to identify, report and appropriately mitigate risks as part of their normal duties.²³ It establishes three key principles:

- enterprise risk owners will record all enterprise and operational level risks against the relevant risk category in the Enterprise risk register [now renamed Enterprise risk manager];
- [the] risk management process will be applied to all risks in accordance with the corporately endorsed ATO Risk Matrices instructions; and
- identified risks will be categorised using the corporately endorsed ATO Risk Categories.²⁴

2.16 In addition to the practice statement, three other 'Corporate Management Procedures and Instructions' (CMPI) documents provide further details on how the ERMF is to be implemented.

2.17 For example, CMPI 2003/02/01 *Risk management instructions for enterprise risk owners* describes three levels of risks within the ATO:²⁵

²⁰ At the commencement of the review, the Office of the Chief Knowledge Officer (OCKO) business line had overall responsibility for the ERMF. During the review, the OCKO business line was dissolved and its functions and staff were subsumed into the ATO Corporate business line.

²¹ Australian Taxation Office, *Risk and issues management*, PS CM 2003/02, 22 May 2013.

²² Ibid para [7].

²³ Ibid para [14].

²⁴ Ibid para [16].

²⁵ Australian Taxation Office, *Risk management instructions for enterprise risk owners*, CMPI 2003/02/01, 22 May 2013, para [9].

Table 1: ATO levels of risk

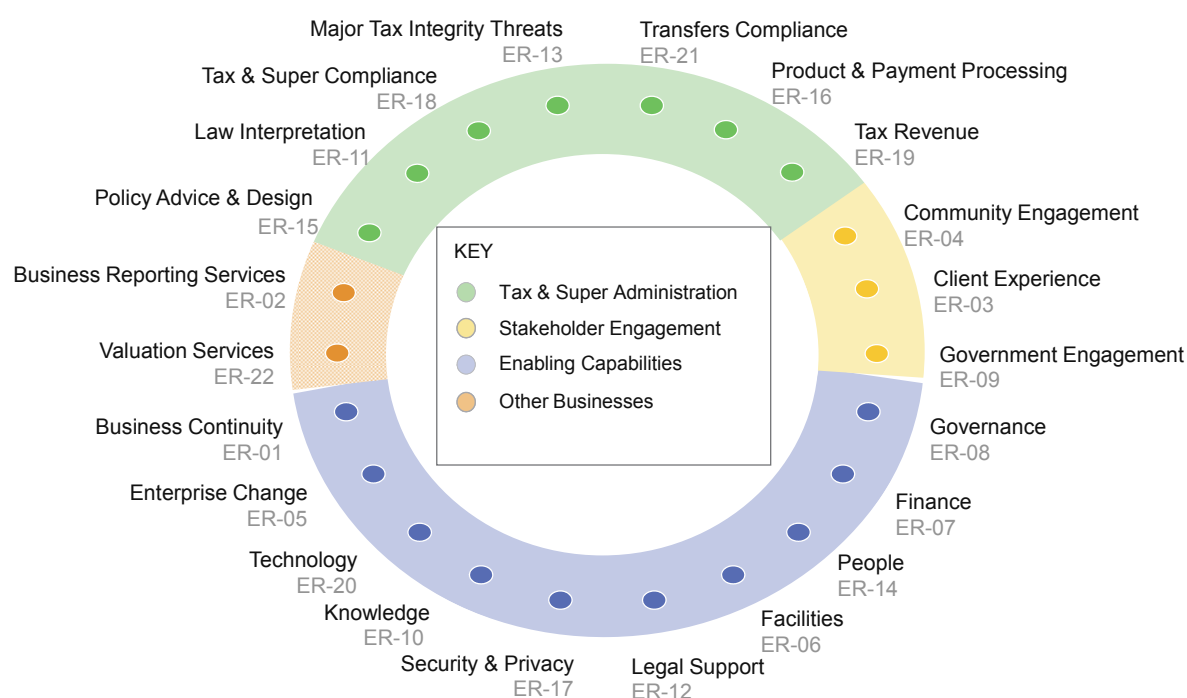
Level	A guide to the characteristics of the risk	Management arrangements
Enterprise	<p>The risk relates to a core or enabling business function or process.</p> <p>The risk usually occurs in all or many parts of the ATO.</p> <p>The risk is described in the enterprise risk categories.</p> <p>The risk is rated high or severe when assessed on a corporate scale.</p> <p>Includes strategic risks.</p>	Risks are normally managed at the sub-plan or ATO Executive level.
Operational	<p>The risk is a component or a part of an enterprise risk.</p> <p>The risk may be limited to one or a small number of Business and Service Lines (BSLs).</p>	Risks at this level are normally managed by BSLs and capability areas.
Tactical	The risk is associated with localised events or activities such as transactions, incidents and cases.	Risks at this level are managed by individuals or teams as part of their day-to-day management.

Source: ATO, Corporate Management Procedures and Instructions CMPI 2003/02/01 *Risk management instructions for enterprise risk owners*.

2.18 At the enterprise level, the ATO has listed 22 enterprise risk categories at the highest level (known as 'Level 0 risks'). These risks include general organisational risks, risks associated with public sector agencies, and risks associated with functions of a revenue authority. These Level 0 risk categories are grouped into four broad categories:

- tax and superannuation administration;
- stakeholder engagement;
- enabling capabilities; and
- other businesses [that is other ATO business operations].

2.19 This grouping is represented in the ATO's 'Wheel of Risk' in Figure 2 below and reproduced as a list in Appendix 2. Each of these 22 Level 0 enterprise risk categories are then broken down into Level 1 risk categories. Currently, there are 79 Level 1 risk categories. These are reproduced in full in Appendix 3.

Figure 2: ATO ‘Wheel of Risk’

Source: ATO.

2.20 The ATO's ERMF intranet page also indicates that each²⁶ of the Level 1 risk categories has an Enterprise Risk Owner who is a senior management officer. CMPI 2003/02/03 *ATO Enterprise risk categories and enterprise risk owners*, lists all the Level 1 enterprise risk categories, each with a risk owner who is a senior executive officer.

2.21 Second Commissioners are responsible for 'portfolios of risk'. These portfolios are all of the 22 Level 0 enterprise risk categories divided into three groups amongst each of the three Second Commissioners.

2.22 Actual risks are mapped to these Level 1 risk categories and have operational risk owners and risk managers. Operational risk owners have accountability and responsibility for managing a discrete area of risk within an enterprise risk category. Risk managers have responsibility for managing risk controls, treatment or mitigation, and aspects of risk assessment and identification as directed by an enterprise risk owner.²⁷ The ATO has detailed internal documentation about these risks and mitigation strategies.

2.23 All operational risk documents, along with the Level 0 and Level 1 enterprise risk categories hierarchy supporting it, are recorded and managed in the Enterprise Risk Manager (ERM).

²⁶ Australian Taxation Office, Enterprise Risk Management Framework intranet page. 'Enterprise Change' does not have an enterprise risk owner.

²⁷ Australian Taxation Office, *Risk and issues management*, PS CM 2003/02, 22 May 2013, see 'Key roles and responsibilities'.

2.24 One of the main documents recorded on the ATO's ERM is the risk assessment. This assessment is prepared by the risk manager, and it includes, amongst other things:

- a risk description;
- the impacted taxpayer market segments, ATO areas and revenue products;
- the initial level of risk;
- the confidence level in the risk rating;
- the residual risk; and
- whether a treatment plan exists.

2.25 The initial level of risk is a combination of the likelihood and the consequence of the risk event occurring. This is discussed further below.

Confidence levels

2.26 The confidence level of the risk rating takes into account the fact that the risk rating may be based on limited information. Instructions in the risk assessment template indicate:

Factors determining confidence in the risk rating include availability, quality, quantity and relevance of available data and information, as well as divergence of opinion among experts and limitations to the analysis, as previously described.²⁸

2.27 The risk manager then selects a rating of Low, Medium or High, depending on the availability of accurate and verifiable data or information to support the risk rating:

- High – Sufficient accurate and verifiable data and information available to support risk rating.
- Medium – Gaps or inconsistencies in available data and information, some not verifiable.
- Low – Limited verifiable data and information available to support the risk rating.²⁹

2.28 Such an approach is consistent with International Standard ISO 31000:2009:

The confidence in determination of the level of risk and its sensitivity to preconditions and assumptions should be considered in the analysis, and communicated effectively to decision makers and, as appropriate, other stakeholders. Factors such as divergence of opinion among experts, uncertainty, availability, quality, quantity and ongoing relevance of information, or limitations on modelling should be stated and can be highlighted.³⁰

²⁸ ATO Risk Assessment Template – March 2013 – from the Enterprise Risk Manager 22 April 2013, page 10.

²⁹ Ibid.

³⁰ International Organization for Standardization, *ISO 31000 Risk management – principles and guidelines* (2009) para [5.4.3]

2.29 Confidence levels can be used in the context of other risks, for example, in public safety. An example of such use is included in Appendix 4.

2.30 The ATO practice statement and associated CMPIs on risk management guidance appear to be silent about the use of confidence levels.

2.31 The disclosure of confidence levels may also be useful to indicate whether further research or testing is needed to increase the level of certainty about the risk rating before committing resources to address the risk.

2.32 This report now considers the types of risks the ATO associates with taxation and superannuation law compliance by taxpayers.

TYPES OF TAXPAYER COMPLIANCE RISKS

2.33 There are generally four main types of taxation obligations with which taxpayers are expected to comply:³¹

- registration — correctly registering in the system where required, such as for tax file numbers (TFNs), Australian Business Numbers (ABNs) or Goods and Services Tax (GST). This also includes not inappropriately registering (for an ABN etc.) where parties are not entitled to do so such as those that are not carrying on an enterprise.
- lodgment — delivery of returns or statements on time, such as income tax returns and activity statements for registered parties.
- payment — discharging taxation liabilities on time.
- reporting — ensuring records, returns and statements are complete and accurate.

2.34 With each obligation there is a risk of non-compliance. Further details about these obligations are described below, along with some basic examples on how the ATO seeks to deter, detect or deal with potential or actual non-compliance.

Registration risk

2.35 Entities not registered in the tax system may potentially avoid a number of taxation obligations. It is important, therefore, that the ATO is able to deter and detect instances where entities attempt to remain unregistered where they are required to do so. Various withholding, reporting and penalty regimes assist to deter or make non-registration unattractive. For example, salary and wage payments are subject to Pay As You Go (PAYG) withholding where employers are required to report these payments to the ATO. Businesses in the building and construction industry are also required to report certain payments made to other contractors for building and construction services.³² This enables the ATO to verify or reconcile this reporting

³¹ Forum on Tax Administration Compliance Sub-group, Organisation for Economic Co-operation and Development, *Guidance Note - Compliance Risk Management - Managing and Improving Compliance* (2004) para [4].

³² Australian Taxation Office, *Taxable payments reporting - building and construction industry* (22 July 2013) <<http://www.ato.gov.au>>.

against non-reporting of other taxpayer information. Gaps in reporting may indicate an unregistered entity risk is present.

2.36 For transactions not subject to comprehensive withholding or third party reporting regimes, the ATO uses data matching and computer modelling to assist in detecting unregistered entities operating in the cash economy.³³

Lodgment risk

2.37 After registration, verifying compliance with lodgment obligations is relatively straightforward. If a taxpayer is obliged to lodge a particular document by a particular time, the ATO will know promptly whether this is the case.

2.38 The timely lodgment of an income tax return is necessary for the ATO to accurately assess income tax liabilities. Accordingly, the ATO has a range of measures to ensure timely lodgment. Nevertheless, as recognised in the IGT's *Review into the Non-lodgement of Individual Income Tax Returns* (Non-lodgment Review), the sheer number of returns and statements that must be potentially lodged means that the ATO must take a risk management approach to enforcing lodgment obligations.³⁴

2.39 It is important to recognise that the non-lodgment of a tax return or activity statement may not only represent a risk to the Commonwealth revenue (that is, underpaid tax), it may also represent a threat to community confidence in the integrity of the tax system.³⁵

2.40 The IGT's Non-lodgment Review recommended several measures to reduce the risk posed by the non-lodgment of income tax returns. These measures include increasing support for the ATO use of third party data to identify non-lodgers and increasing penalties for high-risk taxpayers.

Payment risk

2.41 After a taxpayer has lodged an income tax return or activity statement and been subjected to an assessment process, a taxation liability may be established giving rise to a debt. The ability to collect the monies due on these debts represents the payment risk. There are strategies to reduce this risk. For example, withholding at source regimes, such as that used for salary and wage payments, assist in reducing individual PAYG taxpayer payment risk.

2.42 As with the lodgment obligation, the ATO's systems are designed to determine whether a taxpayer has paid their tax liability on time. The ATO uses analytics and debt models to help determine the strategies to recover tax debts where they become outstanding.³⁶

³³ Australian Taxation Office, *Compliance Program 2012-13* (2012) p 23.

³⁴ Inspector-General of Taxation, *Review into the non-lodgement of individual income tax returns* (2009) para [4.1].

³⁵ Ibid para [4.8].

³⁶ Michael D'Ascenzo, 'The effective use of analytics in public administration: The Australian Taxation Office Experience', (Speech delivered at the Australian Institute of Company Directors, Hobart, 22 June 2012).

Reporting risk

2.43 Verifying compliance with taxpayers' reporting obligations is a more challenging area for many revenue authorities.

2.44 Australia's tax system operates on the basis of self-assessment. In general, this means that while taxpayers must lodge correct returns where required, the ATO initially accepts these claims, usually without adjustment, before issuing an assessment.³⁷ The ATO does not necessarily verify the correctness of each return before processing it.³⁸ For example, businesses may not be required to include financial documents with their tax returns, nor are salary and wage earners required, upfront, to include evidence supporting deductions claimed with their tax returns.

2.45 The self-assessment system reduces the costs otherwise incurred by the ATO in attempting to verify the correctness of every return, including dealing with detailed taxpayer information submitted with tax returns.³⁹ The ATO's decision not to request detailed taxpayer information with every return is a deliberate one, aimed at the efficient use of ATO resources and in minimising taxpayer costs associated with supplying additional information with the return.

2.46 With this approach, the ATO accepts a degree of uncertainty or risk as to whether a particular taxpayer has complied with their obligation to report correctly when accepting their return and issuing the assessment.

2.47 This uncertainty or risk is partially addressed through the use of third party reporting regimes. In particular, employers and financial institutions are all required to report certain payments to the ATO, for example, salary, interest and dividend details. Once taxpayers have lodged their returns, the ATO may use available third party data to verify the data provided in tax returns ('data matching').

2.48 Where the ATO identifies a potential risk that a taxpayer has not correctly completed their tax return, it may seek to understand the taxpayer's situation via an enquiry and if necessary via a formal review or audit. An audit examines the relevant taxpayer's affairs to ensure the ATO is reasonably satisfied that the taxpayer's tax position is correct.⁴⁰ The ATO has extensive access powers to compel taxpayers and third parties to provide information, with limited exceptions.⁴¹ Since the ATO generally seeks limited information up-front in the self-assessment environment, these powers may be called upon to seek information at a later stage.

Different types of reporting risk

2.49 The risk that a taxpayer has not correctly reported required information can manifest itself in several ways, depending on the nature of the taxpayer's

³⁷ Australian Taxation Office, *Self-assessment and the taxpayer* (7 March 2013) <<http://www.ato.gov.au>>.

³⁸ IGT, above n 5, para [3.13]. The IGT noted that increased ATO information gathering activities at or before the time of lodgment represented a pendulum swing back towards full assessment 'without any of the previous benefits available from the former full assessment regime.'

³⁹ Michael D'Ascenzo, 'Self assessment: the ATO perspective', (Speech delivered at the Taxation Institute of Australia, 9 May 2012).

⁴⁰ Australian Taxation Office, *Taxpayers' charter – If you're subject to review or audit* (2010).

⁴¹ For example, *Income Tax Assessment Act 1997* ss 263 and 264.

circumstances and the applicable law. One may consider two main situations where there is a risk that the taxpayer has incorrectly reported their tax information:

- the law is clear about the taxpayer's obligation but the taxpayer does not make full disclosure to the ATO; or
- information is fully disclosed to the ATO but there is uncertainty as to how the law applies and the taxpayer has applied the law in a manner with which the ATO disagrees.

2.50 The first type of risk is illustrated through the following example. The law clearly requires taxpayers to report all cash income received from business activities as assessable income. If a taxpayer inadvertently or consciously omits this from their reported income, it will be inconsistent with the law. In this case, the ATO may take action to determine whether such omitted income was received by the business. If that is found to be the case, the ATO may take corrective action. Taxpayers who consciously take this course are said to be taking a 'detection risk', whereby they rely on the ATO not detecting their omission.

2.51 In the second type of risk, for example, the taxpayer has undertaken a business sale but the taxpayer has applied the capital gains tax and consolidation law in a manner with which the ATO disagrees. Where the area of law is uncertain, the taxpayer and ATO may find themselves seeking the final view of the courts to determine the correct meaning of the law and its application to the facts. These taxpayers are ultimately taking an 'interpretation' risk, whereby they rely on their view of the law prevailing over that of the ATO.

2.52 These two categories are not necessarily mutually exclusive, as a taxpayer may take an interpretation risk by adopting a contestable tax position while also taking a detection risk by not fully disclosing details of the position to the ATO.

2.53 The current taxation environment presents challenges and heightens the interpretation risk for taxpayers and the ATO alike. Taxation law is extensive, regularly changing and increasing in complexity.⁴² Furthermore, announced but unenacted tax law changes are likely to increase uncertainty for taxpayers and the ATO, particularly where such measures are intended to be retrospective.⁴³

2.54 Under self-assessment, taxpayers are required to lodge their tax returns after forming a view about the correct legal treatment of the transaction. To reduce the risk of the ATO challenging the taxpayer's view, taxpayers may seek the advice of the ATO before lodging their return. Nevertheless, taxpayers may be required to take an increased interpretation risk by lodging tax returns without the benefit of ATO advice due to commercial timing considerations and/or delays in obtaining that advice. This risk is also significant in the GST context, where taxpayers often lodge activity statements on a monthly basis, compared with annual income tax returns.

⁴² Joint Committee of Public Accounts and Audit, Parliament of Australia, *Report No 410 – Tax Administration* (2008) paras [3.9] to [3.39]. See also, Inspector-General of Taxation, *Review into improving the self assessment system* (2013) paras [5.3] to [5.6].

⁴³ The Tax Institute, Submission to the Treasury (Cth), *2013-14 Federal Budget* (13 February 2013) p 5.

Interpretation risk

2.55 In relation to interpretation risk, the ATO, as the administrator of the tax law, may provide advice as to its interpretation of the law. This advice is only the ATO's view of the law and not the law itself.⁴⁴ A court may find such interpretation to be incorrect.

2.56 Some aspects of the ATO's advice and guidance framework seek to protect taxpayers from adverse tax outcomes should they rely on certain ATO advice that a court ultimately determines to be incorrect. Such protections only exist for 'binding' ATO advice. Further discussion about the ATO advice and guidance framework can be found in the IGT's *Review into Improving the Self Assessment System* (Self Assessment Review) and *Review of the Tax Office's Administration of Public Binding Advice*.⁴⁵

2.57 There may be a number of factors which increase the interpretation risk for the ATO. For example, an interpretation put forward in court by the ATO may not succeed due to:

- case selection;⁴⁶
- the collection and management of evidence;⁴⁷ and
- how and which arguments are put forth to the court.⁴⁸

2.58 The ATO's management of interpretation risk is undertaken at the enterprise level through 'Enterprise Risk ER-11 — Law interpretation'. Further details about this enterprise risk can be found in Appendix 3.

ATO RISK MANAGEMENT APPROACH TO TAXPAYER COMPLIANCE

2.59 Traditionally, compliance risk management may be understood as a form of risk analysis focussing mainly on better selection for tax audits⁴⁹, with an emphasis on increasing the 'detection' capability of the revenue authority. Audits, however, are comparatively costly activities for both the taxpayer and the ATO.⁵⁰

2.60 There is ongoing recognition that compliance risk management goes beyond making the best audit selection decisions. The goal is ultimately optimising taxpayer compliance.⁵¹ In a self assessment system, this means understanding and influencing

⁴⁴ IGT, above n 5, para [2.20].

⁴⁵ Inspector-General of Taxation, *Review of the Tax Office's Administration of Public Binding Advice*, publicly released 7 August 2009).

⁴⁶ Inspector-General of Taxation, Submission to the Australian Government, *Tax Forum – Next steps for Australia* (September 2011) p 17.

⁴⁷ The Senate, Economics Legislation Committee, Parliament of Australia, *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 [Provisions]*, May 2013, paras [2.10] and [2.14].

⁴⁸ Commonwealth, *Estimates*, Senate Economics Committee (30 May 2012) p 99.

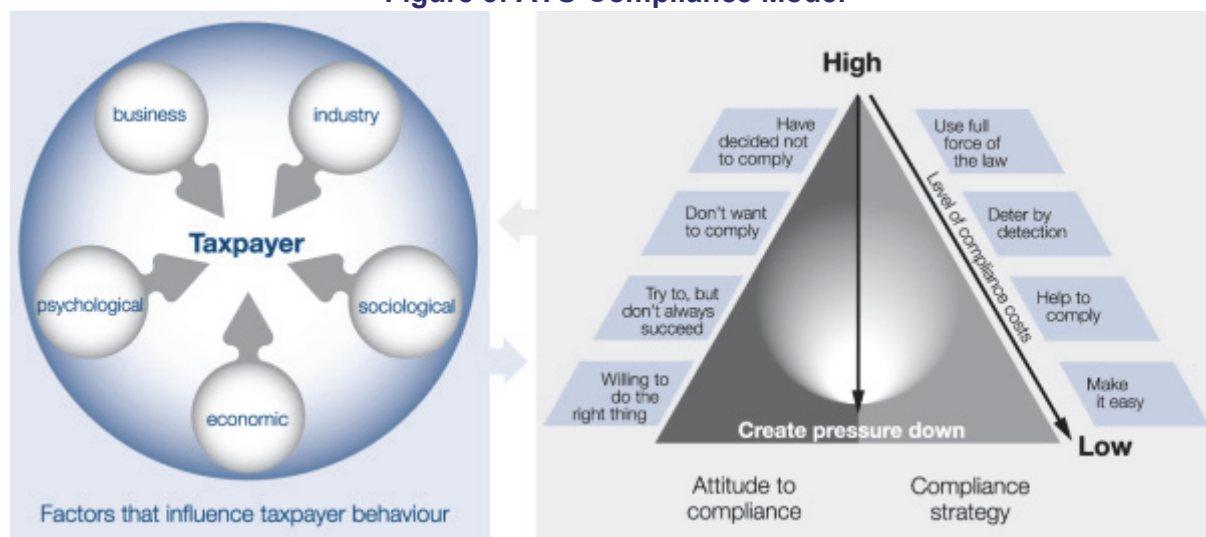
⁴⁹ Fiscalis Risk Management Platform Group, European Union, *Compliance Risk Management Guide for Tax Administrations* (2010) para [1.3]

⁵⁰ Inspector-General of Taxation, *Review into Tax Office Audit Timeframes* (2008) para [3.7].

⁵¹ Michael D'Ascenzo, 'Optimising voluntary compliance', (Speech delivered to the Australian Securities and Investment's Commissioner Summer School, Sydney, Tuesday 14 February 2006). <<http://www.ato.gov.au>>.

taxpayer behaviour. An example is the ATO's research into taxpayer behaviour in the 1990's, culminating in the Cash Economy Taskforce Reports. The *Improving Compliance in the Cash Economy April 1998 Second Report*⁵² (Second Report of the Cash Economy Taskforce) led to the ATO's adoption of the ATO Compliance Model shown in Figure 3 below:

Figure 3: ATO Compliance Model



Source: ATO Compliance Program 2012-13, page 1.

2.61 Importantly, the ATO Compliance Model emphasises the need for the ATO to address the underlying drivers of taxpayer behaviour.⁵³ This is illustrated by the left side of Figure 3 above, known as 'BISEP' which encourages the ATO to understand the Business, Industry, Sociological, Economic and Psychological factors affecting taxpayer behaviour.

2.62 By addressing these behavioural drivers, the ATO may be able to prevent and deter non-compliant behaviour in the first place, rather than solely relying on sophisticated audit selection techniques to detect the risk of non-compliance after it has occurred. The right side of the ATO Compliance Model also describes a series of regulatory responses to non-compliance, ranging from education through to penalties or prosecutions, depending on the taxpayer's attitude to compliance. The BISEP factors assist ATO officers in understanding the taxpayer's attitude to compliance.⁵⁴

2.63 Such models or approaches are applied by other revenue authorities overseas⁵⁵, with publications from the European Union and the OECD providing

⁵² Australian Taxation Office, *Improving Tax Compliance in the Cash Economy* (1998).

⁵³ Ibid p 19.

⁵⁴ Rob Whait, 'Developing risk management strategies in tax administration: the evolution of the Australian Taxation Office's compliance model' (2012) 10(2) *eJournal of Tax Research* 436-464, p 446.

⁵⁵ For example, the UK's HMRC Risk and Intelligence Service drives risk-based compliance activity. See Fiscalis Risk Management Platform Group, European Union, *Compliance Risk Management Guide for Tax Administrations* (2010) p 108.

additional guidance on compliance risk management for tax administration in this regard.⁵⁶

2.64 The ATO Compliance Model as originally conceived and recommended in 1998 in the Second Report of the Cash Economy Taskforce was not strictly a risk management or resource allocation model. It was a model originally designed to support voluntary compliance by, in part, increasing a taxpayer's perceptions of fairness of the system.⁵⁷ Such perceptions of fairness could be enhanced by the ATO not routinely applying penalties when faced with non-compliance, forgiving past poor behaviour, and recognising good behaviour.⁵⁸ The ATO should take into account the taxpayer's different circumstances and respond appropriately.⁵⁹

2.65 Broadly, risk detection assists in helping the ATO prioritise 'who' it should review or audit, and the Compliance Model guides the ATO 'choice of remedy' if a risk of non-compliance is identified.⁶⁰

2.66 The ATO Compliance Model approach of seeking to positively influence taxpayers through differentiated ATO responses, is an indirect form of risk management that recognises the ATO's finite resources:

An approach which relies simply on detecting non-compliance and imposing sanctions on detected non-compliers will tend to be short term in effect and increasingly resource intensive for the ATO. It will also place an unreasonable compliance burden on good compliers.⁶¹

2.67 The ATO employs a range of activities aimed at preventing, deterring, detecting and dealing with the risks of non-compliance. The relationship between these activities can be understood in terms of the 'bow-tie' risk assessment technique. This technique, included in ISO 31010:2009 *Risk Management – Risk Assessment Techniques*⁶², has been implemented by the ATO and is represented in its *Large Business and Tax Compliance* (LBTC) booklet:⁶³

⁵⁶ See for example, Fiscalis Risk Management Platform Group, European Union, *Compliance Risk Management Guide for Tax Administrations* (2010) and OECD, above n 31.

⁵⁷ ATO, above n 52, pp 57 and 59. Other parts include building community partnerships, making it easier to comply, improving detection capability and enforcing record keeping obligations.

⁵⁸ ATO, above n 52, p 41.

⁵⁹ Ibid p 47.

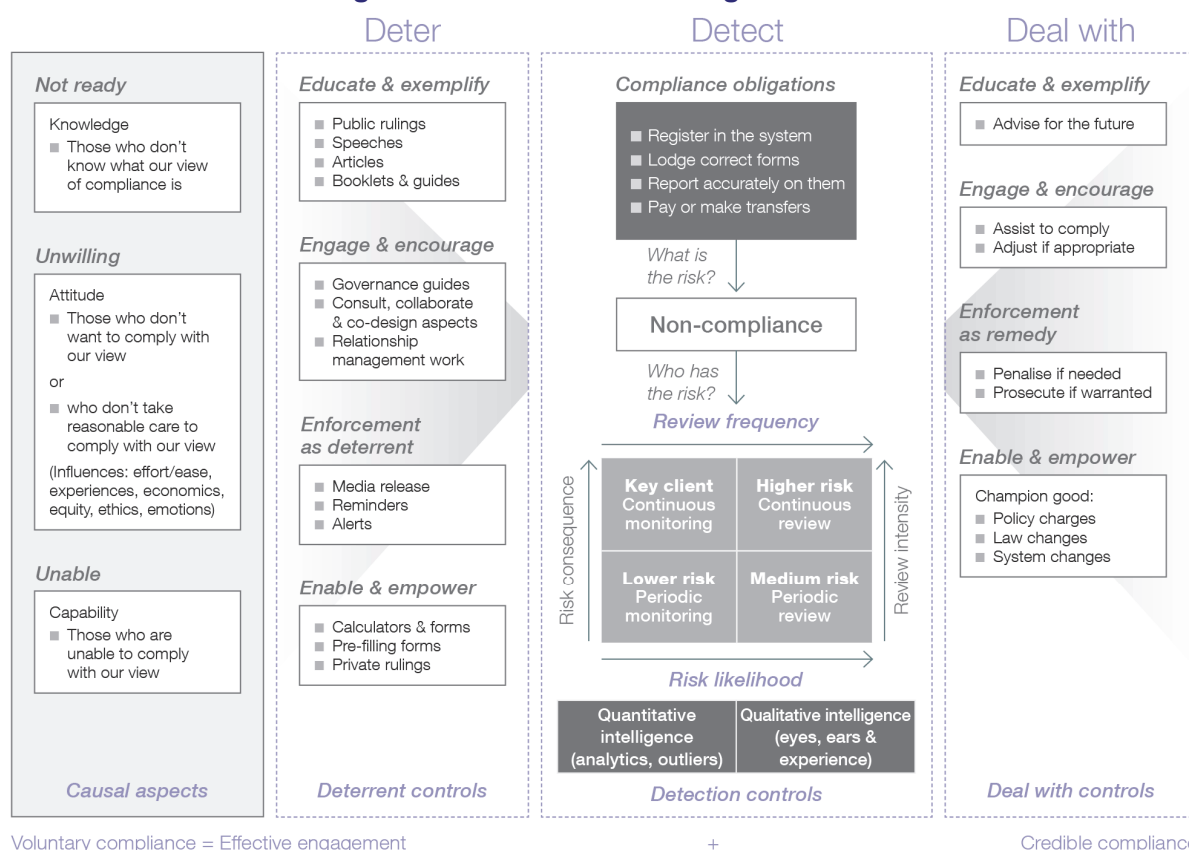
⁶⁰ Stuart Hamilton, 'New dimensions in regulatory compliance – building the bridge to better compliance' (2012) 10(2) *eJournal of Tax Research* 483-531, p 483.

⁶¹ ATO, above n 52, p 19.

⁶² International Organization for Standardization, *ISO 31010 Risk management – risk assessment techniques* (2009) para [B.21].

⁶³ Australian Taxation Office, *Large business and tax compliance publication* (2012) p 24.

Figure 4: Risk bow-tie for large business



Source: ATO, Large business and tax compliance 2012, page 24.

2.68 The 'detect' column in Figure 4 above shows that the risk event is 'non-compliance' with the four main taxation obligations described above as 'compliance obligations'. Recognising that detection is part of a broader picture of compliance risk management, attention is now directed towards how the ATO's uses a risk management approach to detect non-compliance.

ATO detection of taxpayer risk of non-compliance

2.69 The ATO takes a risk management approach to its compliance activities, directing its resources to areas of greatest risk.⁶⁴ The ATO chooses which taxpayers it will audit. The ATO's Strategic Statement 2010-15 says 'we use a risk-based approach to prioritise our work'.⁶⁵ The ATO has also indicated:

Where you have limited resources and the scale of your role covers a broad canvas, it is necessary to adopt a risk management approach.

... Managing risk is about recognising risks, and making the right choices, and opting for the right trade-offs.⁶⁶

⁶⁴ ATO, above n 33, p 2.

⁶⁵ Australian Taxation Office, *Strategic Statement 2010-15* (2010).

⁶⁶ Michael D'Ascenzo, 'Risk: The framework, the vision, the values', (Speech delivered at the CPA Public Sector Finance and Management Conference, Barton, 12 August 2010).

2.70 A risk-based approach to compliance activity is often contrasted with random selection.⁶⁷ While random selection is useful for gathering compliance information, and presents a ‘fair selection strategy’ — in that a given population of taxpayers have the same chance of being selected — it does have a drawback of presenting a high opportunity cost.⁶⁸ The World Bank notes:

Cases selected for audit by methods focused on high-risk taxpayers or even by manual screening are likely to raise higher revenue than cases selected randomly (even with stratification). As a result, random audits have a low impact on direct generation of revenue and, arguably, on deterrence of non-compliance.⁶⁹

2.71 The risk-based approach, therefore, may be viewed as a way of managing the opportunity costs associated with limited resources:

We are in an opportunity cost business. For all practical purposes, the areas and issues we can cover are limited, and every hour we spend with taxpayer A is an hour we cannot spend with taxpayer B. Effective use of our time is vital. If there are areas with high levels of compliance we will get out and look elsewhere.⁷⁰

2.72 It should also be noted that the adoption of a risk-based approach to resource allocation is well founded in the origins of the administrative law notion of the ‘good-management rule’. This rule acknowledges that, whilst the Commissioner must administer the tax law and ensure the correct amount of tax is collected, it has finite resources with which to do this:

Having regard to the competing duties and powers that arise under the taxation laws, the courts have acknowledged that the Commissioner must make administrative decisions as to the allocation of scarce resources to achieve an optimal, though not necessarily the maximum, revenue collection. This ensures that the Commissioner is not obliged, for example, to pursue every last cent of revenue where the cost of doing so is prohibitive.⁷¹

2.73 Section 44 of the *Financial Management and Accountability Act 1997* (FMA Act) also imposes a general obligation on the Commissioner to ‘manage the affairs of the [ATO] in a way that promotes proper use of the Commonwealth resources for which the [Commissioner] is responsible’.⁷² Section 16 of the *Public Governance, Performance and Accountability Act 2013* (which is anticipated to effectively replace the FMA Act from 1 July 2014) imposes a new specific duty for the Commissioner to establish and maintain an appropriate system of risk oversight and management.⁷³

2.74 However, another important reason for the risk-based approach is to seek to reduce the compliance burden on low-risk or compliant taxpayers. The use of random

⁶⁷ World Bank, *Risk-based tax audits: approaches and country experiences* (2011) p 18.

⁶⁸ Ibid p 19.

⁶⁹ Ibid p 20.

⁷⁰ Michael D’Ascenzo, ‘Commissioner’s perspective on audit programs’, (Speech delivered at the Taxation Institute of Australia’s Lecture Series on Tax Audits, Sydney, 10 October 1990).

⁷¹ Bruce Quigley, ‘The Commissioner’s power of general administration: How far can he go?’, (Speech delivered at the Taxation Institute of Australia’s Convention, Sydney, 12 March 2009).

⁷² *Financial Management and Accountability Act 1997* s 44.

⁷³ Australian Government Solicitor, *Bill introduces new governance, performance and accountability framework for Commonwealth bodies* (28 June 2013) <<http://www.ags.gov.au>>.

selection methods inevitably means that some compliant taxpayers will be audited. In responding to the recommendation by the Joint Committee of Public Accounts and Audit (JCPAA) that the ATO report on a mechanism to estimate the GST gap, the ATO said:⁷⁴

Not only would [a random audit program] consume large amounts of Tax Office resources that could otherwise be targeted at substantive compliance risks, it would place a significant additional burden on compliant taxpayers who otherwise would not need to incur audit-related costs.

2.75 A risk-based approach, therefore, is also considered to have a twin virtue of excluding likely compliant taxpayers from unnecessary interactions, while focusing ATO attention and resources on higher-risk taxpayers or populations. As an example, the ATO regards its small business benchmarks as a tool to, not only identify 76,000 small businesses likely to attract ATO attention, but also to exclude 800,000 businesses who it regards as 'likely to be competing on a level playing field with their peers'.⁷⁵

2.76 The risk management approach not only means the ATO is selective as to which taxpayer it audits. It also means that the ATO takes a variety of approaches depending on the taxpayer's situation. The ATO has said:

... if you are in a lower risk category, our help and support services assist you to comply and the lower intensity of our compliance activities reduces compliance costs.⁷⁶

2.77 In its 2008-09 Compliance Program, the ATO highlighted the relationship between the level of risk, the intensity of verification activity and the numbers of taxpayers involved. The ATO states that:

When risks are identified, our contact with people depends on the nature and complexity of the risk. But it typically starts with letters and phone calls seeking more information or clarification, and extends to field visits and audits where required. Risk profiling is as much about identifying individuals or businesses that represent little or no risk to the tax and superannuation systems, as it is about identifying non-compliance.⁷⁷

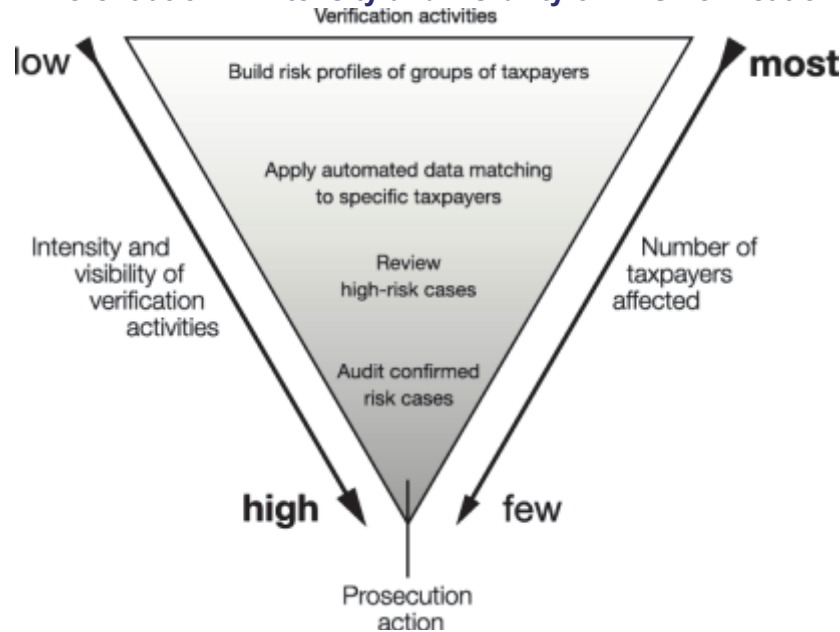
2.78 This risk management differentiation approach ensures the intensity of the compliance activity is commensurate with the risk. The approach also reduces the taxpayer population it seeks to interact with as risk increases. This is shown diagrammatically in Figure 5 below:

⁷⁴ Australian Taxation Office, Response to Joint Committee of Public Accounts and Audit, *Recommendation 5 of Report 398 – Review of Auditor-General's Reports 2002-2003 Fourth Quarter March 2004*(undated) <<http://www.aph.gov.au>>.

⁷⁵ ATO, above n 33, p 28.

⁷⁶ Ibid p 2.

⁷⁷ Australian Taxation Office, *Compliance Program 2008-09* (2008).

Figure 5: Differentiation in intensity and visibility of ATO verification activities

Source: ATO, Compliance Program 2008-09, page 8.

2.79 The IGT made similar observations in his *Review into Tax Office Audit Timeframes*:

... audit activities are directed at areas of greatest risk. The level of taxpayer interaction should be proportionate to the nature of the risk being addressed and such matters as the complexity of the issue and the level of taxpayer assistance. The aim is to minimise the level of taxpayer interaction to that needed for the Tax Office to assure itself of a business's compliance level.⁷⁸

2.80 Therefore, where there is a level of uncertainty as to the correctness of a taxpayer's tax return, the ATO may not necessarily conduct a full audit to verify it. Rather, the ATO may use information gathering approaches which are less formal, intense and costly to ensure returns are correctly lodged. These may include telephone enquiry, letters requesting an explanation or substantiation for a particular item in the tax return, or more comprehensive risk review interactions. In some circumstances, where the level of risk is considered low, the ATO may take no further action despite the existence of such uncertainty. Where ATO perceptions of risk persist, the above figure highlights the ATO's ability to escalate its verification activities.

Risks associated with taxpayer compliance costs

2.81 The ATO's Wheel of Risk in Figure 2 above shows that there are several risk categories that are related to taxpayer compliance with tax laws. In addition to taxpayer compliance risks, the ATO also recognises risks in relation to 'Client Experience', such as compliance costs. These risks include:

- failure to manage and reduce the cost of compliance to taxpayers within agreed tolerances (excluding large business); and

⁷⁸ IGT, above n 50, para [2.5].

- failure to manage the cost of compliance for large business at appropriate levels.⁷⁹

2.82 The importance of minimising the level of costs incurred by taxpayers in complying with the law is vital. These costs include those imposed on intermediaries such as advisors. The cost of compliance can take various forms. For example, it may include time and expense in relation to:

- completing forms such as income tax returns or business activity statements;
- establishing and maintaining record keeping systems;
- dealing with the ATO;
- dealing with advisors;
- tax planning; and
- learning about tax.⁸⁰

2.83 At the time of this report, the ATO was undertaking a review of the 'Cost of Compliance' enterprise risk.⁸¹

2.84 The risks associated with increasing compliance costs are of particular interest to the IGT as a number of recommendations in previous IGT reviews were directed at minimising taxpayer compliance costs. These recommendations are in Appendix 5.

2.85 Figure 5 above highlights the ATO's attempt to minimise taxpayer compliance costs by escalating compliance activities according to their risk.

2.86 In summary, the ATO risk management approach to taxpayer compliance:

- consists of a range of strategies to deter, detect and deal with taxpayer non-compliance;
- seeks to foster voluntary compliance where possible;
- includes the ATO understanding and influencing of taxpayer behaviour, including choosing appropriate sanctions to deal with non-compliance depending on the taxpayer's circumstances;
- with respect to detection, requires the ATO to make choices as to which taxpayers will be the subject of inquiry;
- seeks to minimise taxpayer compliance costs by taking a graduated and differentiated approach to its inquiries and escalating them where risks persist; and
- means undertaking audits for the areas of highest risk.

⁷⁹ The ATO was reviewing this enterprise risk during the IGT review.

⁸⁰ Philip Lignier and Chris Evans, 'The rise and rise of tax compliance costs for the small business sector in Australia' (2012) 27(3) *Australian Tax Forum* 615-672, p 634.

⁸¹ Australian Taxation Office, Strategic Intelligence Product Tasking Plan - Cost of compliance, 10 October 2012.

2.87 This report now describes how the ATO assesses risk.

HOW THE ATO ASSESSES RISK

2.88 The ATO uses a range of methods to apply differentiated compliance risk and verification strategies. This report refers to these strategies as ‘compliance risk assessment tools’. To address the diverse nature of the taxpayer population, the ATO uses specific tools for each taxpayer segment to ensure the most appropriate approach is taken. Appendix 6 illustrates the variety of the tools the ATO uses for various market segments.

2.89 The ATO’s Corporate Management Practice Statement PS CM 2003/02 *Risk and issues management* outlines various roles and responsibilities with respect to risk management. One of them is the requirement to apply the risk management process in accordance with CMPI 2003/02/02 *ATO risk matrices*. This instruction specifically mandates the use of matrices which assess the combination of a risk event’s likelihood and the consequences of the risk event happening. It should be noted that the likelihood/consequence table is a method derived from the International Standard ISO 31010 — *Risk assessment techniques*.⁸² One example of an ATO risk matrix is shown below.⁸³

Table 2: ATO operational risk matrix

ATO - Operational risk matrix				
Consequence	High	Moderate	High	High
	Medium	Low	Moderate	High
	Low	Low	Low	Moderate
		Unlikely	Possible	Likely
Likelihood				

Source: ATO, CMPI 2003/02/02 — ATO risk matrices.

2.90 In making a risk assessment the ATO seeks to establish the two key criteria of likelihood and consequence. Each criterion is addressed in more detail in the next sections.

Likelihood criteria

2.91 The likelihood of a given risk is estimated by the ATO using various techniques. The ATO’s Risk Matrices (CMPI 2003/02/02) offers some guidance on estimating likelihood in a rating-based framework. The table in this document is reproduced in Table 3 below:

⁸² Known as a consequence/probability matrix. See International Organization for Standardization, *ISO 31010 Risk management – risk assessment techniques* (2009) p 82 and para [B.29].

⁸³ It should be noted that this is a simple example for illustrative purposes. Risks registered in the ERM must be assessed using the more sophisticated ‘enterprise level risk matrix’ reproduced in Appendix 7.

Table 3: The ATO Enterprise level risk likelihood rating table

Likelihood rating	Likelihood guide	Risk probability guide	Issue frequency guide*
1	Rare	0-5% chance of occurring	Less than 1% of the risk population involved in non-compliance
2	Unlikely	6-30% chance of occurring	Between 1 and 10% of the risk population involved in non-compliance
3	Even Chance	31-70% chance of occurring	Between 11 and 20% of the risk population involved in non-compliance
4	Likely	71-95% chance of occurring	Between 21 and 25% of the risk population involved in non-compliance
5	Almost Certain	96-100% chance of occurring	Greater than 25% of the risk population involved in non-compliance

*Frequency is a measure of the number of occurrences per unit of time (or some other base unit of measure; for example, distance, population etc.). In a compliance risk context this should be an estimated frequency of occurrence of an issue in the target population.

Example: The fact that we know that work related expenses (WRE) claims are being fraudulently claimed does not mean the likelihood rating for this incorrect reporting is '5 Almost Certain'. If in the population of individual clients only approximately 10 per cent of clients are involved then the likelihood rating should be '2 — Unlikely'.

Source: ATO, including note.

Consequence criteria

2.92 The consequence from a given risk arising is also estimated through various techniques depending on the nature of the risk. For tax compliance, this is often through financial analysis. In the case of a tax deduction under review, this would include the amount actually being claimed by the taxpayer and the reduction in tax payable as a result. If the amount claimed is significant, then the consequence is *prima facie* higher.

2.93 There may be other circumstances where an amount at risk is relatively low, but the consequence may still be considered higher if the taxpayer is considered influential in the market place.⁸⁴ Additionally, a particular taxpayer in a select population may represent a low risk to the revenue (due to the amount of the revenue at risk), but the risk may have high cumulative effects, in that the entire select population represents, in aggregate, a large amount of revenue at risk.⁸⁵ It should be noted, however, that the ATO considers this type of cumulative effect in the likelihood part of the risk assessment, as seen in the 'issue frequency guide' column in Table 3 above.

2.94 This approach, with respect to the cash economy, is supported by the OECD Forum on Tax Administration:

For many participants the amounts of tax involved are relatively small; however, given the large numbers involved, the aggregate tax revenue at stake is sizeable.⁸⁶

⁸⁴ Michael D'Ascenzo, 'Do you see what I see?', (Speech delivered at the 22nd Australasian Tax Teachers Association Conference, Sydney, 22 January 2010)

⁸⁵ International Organization for Standardization, *ISO 31010 Risk management – risk assessment techniques* (2009), p 82 and para [5.3.3].

⁸⁶ Forum on Tax Administration Compliance Sub-group, Organisation for Economic Co-operation and Development, *Information Note - Reducing opportunities for tax non-compliance in the underground economy* (2012) p 2.

2.95 It is one reason why the ATO directs significant compliance resources toward addressing the cash economy. Community confidence is also another reason why addressing the cash economy is so important. The risk posed by the cash economy is described in the Enterprise Risk Framework as:

Failure to identify and respond to major threats posed by the cash economy which have the potential to undermine community confidence in the integrity of the system.⁸⁷

2.96 For the ATO, therefore, consequences may relate to amounts of revenue at risk, community confidence, or other outcomes related to taxpayer compliance.

Operational risk management matrix

2.97 The ATO assesses the likelihood and consequence of risks through a matrix construct, shown in Table 2 above. In the case of small deductions claimed in individual tax returns, the combination of ‘likely’ likelihood and ‘low’ consequence scores may result in a ‘moderate’ risk. In this situation, the ATO may wish to avoid a costly comprehensive audit and instead seek verification of that particular deduction through informal means, such as a letter requesting a copy of a receipt.

2.98 Alternatively, the ATO may face a different scenario with large business taxpayers where deductions are much larger. In this case, the consequence would be regarded as ‘high’. Due to the size of the deduction, even if the likelihood was ‘unlikely’, the risk would still be regarded as ‘moderate’. The ATO may still decide to review the claim even if there is a low likelihood that it is incorrect. The ATO indicates:

As you know, the ATO’s approach to compliance across the taxpayer spectrum is about assuring the community of the integrity of the taxation system. This means that large business is always an area of focus for us; not necessarily because you are less compliant, but because the value and complexity of your transactions are so great that the potential impact of non-compliance on the taxation system could be extreme.⁸⁸

2.99 Therefore, the risk matrix may indicate that different combinations of likelihood and consequence may result in the same nominal level of risk. However, a given ‘moderate’ outcome does not necessarily mean the ATO treatment is the same. The type of taxpayer, the type of risk and the level of risk all influence the ATO approach.

INPUTS INTO ATO RISK ASSESSMENT TOOLS

2.100 There are generally two forms of data used in risk assessment processes, quantitative data and qualitative information.

2.101 In general, ATO compliance risk assessment tools require quantitative data or information to process. The sources for such information include tax returns or activity statements and third party data.

⁸⁷ Australian Taxation Office, Risk Description - Enterprise Risk 13.3: Cash Economy (From the ATO Enterprise Risk Manager).

⁸⁸ Bruce Quigley, ‘We can see clearly now: growing transparency with large businesses’, (Speech delivered at the Corporate Tax Association Convention, Melbourne, 7 June 2011).

2.102 At the other end of the spectrum, the ATO may use qualitative information sourced from the media or other disclosures and ATO officer judgement of a taxpayer's behaviours and attitudes. Use of this type of information is necessary where a smaller or heterogeneous taxpayer population make it difficult for the ATO to develop and rely simply on statistical, analytical and quantitative methods. A case in point is the large business market segment⁸⁹, which encompasses only 1850 economic groups and entities.⁹⁰ With respect to this market, the ATO states:

Our perception of the likelihood of non-compliance is an informed professional judgment based on assessing a range of risk factors for each tax type. We undertake a moderation process to ensure the RDF categorisation is consistent and supported by the evidence.⁹¹

2.103 Depending on the situation, the ATO may use quantitative data, qualitative information or differing combinations of both, as inputs into risk assessment tools.

OUTPUTS OF RISK ASSESSMENT TOOLS

2.104 After a risk has been identified and assessed, some form of output is produced. Depending on the specific compliance risk assessment tool it may be a ranking system, a risk rating number, a risk categorisation, or a 'risk population' after filtering.

2.105 The ATO risk differentiation framework (RDF) is one approach that provides a risk output. The RDF was first introduced in the Large Business and International (LB&I) business line, to allow the ATO to assess the risk of large business taxpayers in relation to each other. The RDF is used to identify the level of risk relative to the rest of the large business population, rather than the absolute level of risk. This relative risk categorisation assists the ATO determine which taxpayers to review, and what compliance product or approach to use in relation to that taxpayer.

2.106 The small business benchmarks are a different type of risk assessment tool. It is used to assess the risk of underreported income by businesses operating in the cash economy. Businesses that report within the benchmarks for certain financial performance ratios (such as cost of sales to turnover) are 'filtered out' from this process. Those that report outside the benchmarks remain inside the risk population for further ATO consideration.⁹² In this sense, there is no particular risk rating created as an output from this process.

2.107 The ATO has indicated in the Compliance Program 2012-13 and various other publications that it is using the RDF for the large business market⁹³, the small-to-medium enterprises market⁹⁴, the mineral resource rent tax and petroleum

⁸⁹ With respect to income tax and indirect taxes.

⁹⁰ ATO, above n 63, p 5.

⁹¹ Ibid p 25.

⁹² IGT, above n 7, para [2.12].

⁹³ ATO, above n 33, p 45.

⁹⁴ Ibid p 32.

resource rent tax⁹⁵, as well as tax practitioner practices⁹⁶ and self-managed superannuation funds.⁹⁷

2.108 The RDF is now a central ATO compliance risk assessment tool. It is considered in detail in Chapter 3 in the context of the large business market where it has had longer application. The RDF is also considered in Chapter 4 and 7 in relation to SME and tax practitioners respectively.

HEALTH OF THE SYSTEM ASSESSMENTS — HOTSA

2.109 The ATO also regularly conducts what are known as ‘Health of the System Assessments’ (HOTSAs). These HOTSA processes have been conducted by the ATO for income tax or GST a number of years prior to the adoption of the current ERMF.⁹⁸

2.110 The ATO advised the IGT in relation to this review:

[the] Health of the System Assessment (HOTSA) is an integral part of the processes adopted by the ITSC [Income Tax Steering Committee] to monitor and evaluate the health of the income tax system. All business lines and sub-revenue products with an income tax focus provide input to the income tax HOTSA on an annual basis.

... The value of the HOTSA is not only in the informative documents generated from the process. The primary value is the opportunity the process provides to discuss the numerous income tax risks in a structured format on an annual basis. It provides a rigorous method by which to examine and analyse the assessment and treatment of income tax risks.⁹⁹

2.111 The ATO also notes:

HOTSAs are recognised as an effective process to assist Enterprise Risk Managers in managing their enterprise risk categories. The HOTSA approach will equip the Enterprise Risk Owners with the best information and intelligence available to produce the best possible assessment of their risk areas.¹⁰⁰

2.112 HOTSAs continue to be prepared for each revenue product, (such as income tax, GST, excise and superannuation) and for each market segment (such as individuals and large business) every year.

2.113 The Income Tax Revenue Product HOTSA is created primarily for the Income Tax Steering Committee (ITSC) which is responsible for contributing to the strategic

⁹⁵ Ibid p 53.

⁹⁶ Ibid p 13.

⁹⁷ Australian Taxation Office, *Superannuation Consultative Committee Minutes September 2012* (12 November 2012) <<http://ato.gov.au/Super/Consultation--Super/In-detail/Super-Consultative-Committee/Minutes/SCC-Minutes,-September-2012/>>.

⁹⁸ A form of HOTSA has been in existence since 2003. The ERMF in its current form was implemented in 2010 after the adoption of ISO31000:2009. See Julian Jenkins, ‘Information Design for Strategic Thinking: Health of the system reports’ (2008) 24(1) *Design Issues*, p 77.

⁹⁹ ATO communication to IGT, 20 March 2013.

¹⁰⁰ Ibid.

direction of income tax administration (which includes PAYG withholding, PAYG instalments, capital gains tax and fringe benefits tax).¹⁰¹ The Chair of the ITSC is also the Enterprise Risk Owner for income tax under the enterprise risk management framework.

2.114 With respect to income tax or GST HOTSAs, the process is designed to ask and answer specific questions focussed on three broad areas, each with a series of 'focusing questions':¹⁰²

- Outcomes
 - Appropriate revenue, transfers and payments?
 - Cost to operate?
 - Community confidence in the system?
- Operating Features
 - Are the right players in the system?
 - Clients understand their obligations?
 - Clients meet obligations?
 - Risks identified and acted upon?
 - Internal capability?
 - Role of intermediaries?
- Administrative design features
 - Effective design?
 - Sustainable design?

2.115 The HOTSA uses a coloured rating system to convey the status of each of the above strategic questions, known as 'element status ratings', as shown in Figure 6 below:

¹⁰¹ Ibid.

¹⁰² Ibid.

Figure 6: Element status ratings for HOTSA reporting**ELEMENT STATUS RATINGS**

The 'dial' ratings system shows at a glance the status (strategic importance, risk or relative priority) of system elements.

The solid arrow indicates the current degree of the rating; the dotted arrow indicates the rating position last year; a coloured arrow (optional) under the dial indicates the likely future direction of the rating.

GREEN	AMBER	RED
A green rating means the health of the system element is basically sound; there are no major barriers to continued operation; no major risks on the horizon; no substantive change to the current management approach is required (although resources being applied may need review as part of regular management).	An amber rating means the element of the system is not fully healthy; caution required; some specific risks that can be dealt with in the normal course of business but may have the potential to escalate; the area requires active monitoring, additional attention and some priority.	A red rating means the system element is in poor health and needs immediate treatment; priority must be assigned to this area; one or more specific issues present a major risk; requires close and active involvement by senior management in planning and monitoring.

Source: ATO communication to IGT, 20 March 2013

2.116 Each of the element status ratings is accompanied by a 'data integrity status rating'. This is a numerical rating used to indicate confidence levels, 1 being the highest and 3 the lowest. An extract of this is provided in Figure 7 below.

Figure 7: Data integrity status ratings for HOTSA reporting**DATA INTEGRITY STATUS RATINGS**

The report shows rating of the level of confidence we have in the integrity, reliability, and/or availability of the data/information used to assess the issues.

① RATING 1	② RATING 2	③ RATING 3
A rating of 1 means we have high levels of confidence that the supporting data/information is complete, accurate and verifiable.	A rating of 2 means that we have moderate confidence in the integrity but there are gaps and some uncertainty associated with the underlying data and information.	A rating of 3 means that the data or information is very limited in quality and/or quantity and heavy reliance has been placed on unsubstantiated anecdotal or other evidence.

Source: ATO response to information request 4, supplied 20 March 2013

2.117 Like the confidence levels used in risk assessment templates on the ERM, the data integrity status ratings recognise that assessments rely on information with varying degrees of completeness, accuracy and verifiability.

2.118 The HOTSA process, therefore, represents one of the key methods in which the ATO identifies and monitors enterprise risks including taxpayer compliance risks.

IGT OBSERVATIONS

Risk ratings and confidence levels

2.119 As indicated above, the ATO assesses enterprise risks with a risk rating based on likelihood and consequence. A separate confidence level is then articulated for that risk rating based on the quality and completeness of the information used to determine that rating. The ATO uses this approach for all of its enterprise risks, such as business continuity and security and not just for compliance risks.

2.120 This distinction between the confidence level and the risk rating assists in determining what further action is required. For example, a high risk rating may require a particular form of risk treatment, whilst a low confidence level may require the ATO to gather more information to increase its confidence level before implementing a risk treatment.¹⁰³

2.121 As outlined above in paragraph 2.105, the ATO uses the RDF as a means of communicating a risk rating to taxpayers. It has been used for large business taxpayers for a number of years with more recent implementation for other market segments. One distinctive feature of the RDF is that, whilst it is an adaptation of the likelihood and consequence risk matrix, a separate confidence level is not a part of the model.

2.122 The ATO may have a low level of confidence about the information it receives from certain taxpayers or a low level of confidence that the taxpayer will proactively provide the necessary information. In these circumstances, rather than communicating a low confidence level separate to the risk rating, the ATO instead increases the risk rating. The reasons for this approach in the large business market and the consequent stakeholder concerns are discussed in Chapter 3.

Information confidence levels and cost

2.123 A low level of confidence may be due to a lack of ATO information or a low level of quality or accuracy of the information it already holds. In these circumstances, the ATO may attempt to obtain more or higher quality information to improve its 'information confidence' level. The extent to which the ATO can reasonably obtain more information is limited by the cost of doing so and the risk level at play.

2.124 It would be difficult for the ATO to justify incurring and imposing significant costs for low level risks. Conversely, the ATO may be able obtain high levels of confidence, even for low levels risks, at relatively low cost where the additional information is easily obtainable.

2.125 For example, the ATO requires a higher level of information confidence for very large business taxpayers, where the risk to the revenue may be substantial, and is prepared to devote significant resources to obtain further information.

2.126 For risks involving lower amounts of revenue, the ATO does not necessarily require a high confidence level but may be able to achieve it cost-effectively anyway.

¹⁰³ United States Department of the Interior, *Reclamation Managing Water In The West – Interim Dam Safety Public Protection Guidelines*, August 2011, page 24.

2.127 For example, whilst not all 12.4 million individuals who lodge tax returns may be seen as a higher risk, the ATO has ‘an almost complete picture of each individual’s financial dealings’.¹⁰⁴ The ATO has acknowledged that, for taxpayers with simple tax returns, it is in a position to exploit the ‘substantial amounts of information’ it routinely receives about those taxpayers to potentially send a completed tax return to taxpayers without the need for those taxpayers to actively lodge a return.¹⁰⁵

2.128 The above demonstrates that the ATO has a high level of confidence in the information at its disposal and no further taxpayer disclosures are required. Accordingly there is no direct cost to individual taxpayers – the costs are borne by third party information providers.¹⁰⁶

Taxpayer ‘transparency’ and ATO information gathering approaches

2.129 In the large business market segment, a relevant consideration relating to information confidence is the taxpayer’s ‘willing participation’¹⁰⁷ or ‘transparency’.¹⁰⁸ The ATO is reliant on direct disclosures from these taxpayers and has an increased focus on real-time engagement with them. For example, the ATO describes the large business taxpayer Annual Compliance Arrangement (ACA) in these ways:

The ACA is an administrative arrangement developed to manage the compliance relationship with you in an open and transparent environment.

... By committing to work in a frank and transparent environment with an assurance based approach we can tailor your compliance relationship and experience, rather than working through traditional compliance approaches such as audits and risk reviews.

... Collaboration, transparency and trust are the key features throughout the ACA process.

... Subject to true and full disclosures, and a commitment to adhering to the corporate governance principles, ACAs provide practical certainty for your tax return, shortly after lodgment.¹⁰⁹

2.130 The IGT notes that large business taxpayers which the ATO considers ‘higher consequence’ and who are not in an ACA are subject to Pre-lodgment Compliance Reviews (PCRs).

2.131 The ATO has also expanded the disclosure requirements associated with income tax returns. For both large and small-to-medium enterprises with international transactions reaching certain thresholds, the ATO requires the lodgment of an International Dealings Schedule (IDS). With respect to higher consequence large

¹⁰⁴ ATO, above n 33, p 19.

¹⁰⁵ Geoff Leeper, Second Commissioner of Taxation, Transforming the taxation experience: insights and opportunities, Speech, To the Trans-Tasman Business Circle Canberra, 13 August 2013.

¹⁰⁶ Australian Taxation Office, *Access and Information Gathering Manual* (1st version, 2010) para [2.4.57].

¹⁰⁷ Quigley, above n 88.

¹⁰⁸ Mark Konza, ‘Our compliance approach and management of risks in the energy and resources sector’, (Speech delivered at the Minerals Council of Australia Biennial Tax Conference, Brisbane, 16 April 2013).

¹⁰⁹ ATO, above n 63, p 22.

business taxpayers, there is also the reportable tax position schedule (RTP schedule) which the ATO describes as supporting:

a more contemporaneous review of, and engagement with these taxpayers, supporting increased taxpayer transparency in a targeted and efficient manner.¹¹⁰

2.132 It should be noted that the IGT has considered products such as ACAs, PCRs as well as IDS and RTP schedule in a previous review.¹¹¹ Furthermore, the IGT has made specific recommendations about the ATO's information gathering approaches to large businesses and SMEs and high wealth individuals in a number of other reviews.

2.133 Whilst the ATO prefers to obtain information by informal means, the ATO has strong access and information gathering powers to obtain the information it needs to increase its information confidence levels.

2.134 The ATO's wide ranging¹¹² access and information gathering powers may be used to improve information confidence with respect to both risk assessment as well as subsequent compliance activities. The ATO has described these powers in the following manner:

Access powers

We have, at all times, free and full access to all buildings, places, books, documents and other papers for the purposes of the Acts we administer. We can also take extracts from or copies of any such books, documents or papers.

Under the indirect tax and excise laws, this also extends to goods and includes the capacity to take samples.

Information gathering powers

Our information gathering powers allow us to require:

- information to be given
- a person to attend an interview with us and to provide information and evidence
- documents to be produced.

In some circumstances we use a combination of these powers.

We can only use our information gathering powers by serving you with a notice.¹¹³

¹¹⁰ Ibid.

¹¹¹ IGT, above n 5, pp 92-100.

¹¹² Australian Taxation Office, *Taxpayers' charter – Fair use of our access and information gathering powers* (2010) p 1.

¹¹³ Ibid p 2.

2.135 Some important exceptions to these access and information gathering powers are discussed in the ATO Access and information gathering manual.¹¹⁴ These limitations are:

- legal professional privilege, which is a taxpayer right conferred by law;
- the Accountants' Concession, which is an administrative concession established by the ATO; and
- the 'corporate board documents' concession, which is also an administrative concession established by the ATO.

2.136 Legal professional privilege is a substantive common law right, and cannot be abrogated by the Commissioner's access and information gathering powers.

2.137 Administrative concessions are self-imposed restrictions on the ATO's access and information gathering powers. The ATO undertakes not to compel the production of information falling within the above two categories 'in all but exceptional circumstances'.¹¹⁵ Where 'exceptional circumstances' exist, the ATO may 'lift' the concession and continue to seek that information.

2.138 Despite the above exceptions, the ongoing disclosure requirement, along with expanded tax return schedules and the ATO's formal access and information gathering powers mean that taxpayers regard themselves as highly transparent to the ATO.

2.139 The ATO's view of transparency, however, is based on whether taxpayers provide such information proactively without being compelled to do so. The ATO uses its RDF-related communication in order to encourage taxpayers to 'adopt a more open stance'.¹¹⁶ The ATO approach to seeking information directly from taxpayers in the large business market is further discussed in Chapter 3 and more generally in Chapter 8.

2.140 Other sources of data for the ATO, as noted above, are third parties such as financial institutions, who may be able to provide the ATO with large amounts of data at a relatively low direct cost to taxpayers.¹¹⁷ These data sources are particularly useful in relation to individual taxpayers and are explored in greater detail in another IGT review which examines the ATO's use of data matching for individual taxpayers.¹¹⁸

2.141 For present purposes, it is sufficient to note that some of the information from third party providers may be available to the ATO under the law ('legislative data') whilst some have to be obtained by the Commissioner under his formal information gathering powers ('special purpose data' or 'non-legislative data').

¹¹⁴ Australian Taxation Office, *Access and information gathering manual*.

¹¹⁵ See Australian Taxation Office, *Access to 'corporate board documents on tax compliance risk'*, PS LA 2004/14, 1 July 2006, para [1] and Australian Taxation Office, *Access and Information Gathering Manual* (1st version, 2010) para [7.1.1].

¹¹⁶ Bruce Quigley, 'The power of transparency - 12 months on', (Speech delivered at the Corporate Tax Association Conference, Canberra, 18 June 2012).

¹¹⁷ Australian Taxation Office, *Data matching* (22 January 2013) <<http://www.ato.gov.au>>.

¹¹⁸ Inspector-General of Taxation, *Review into the ATO's Compliance Approach to Individual Taxpayers - Use of Data Matching*.

2.142 Legislative data is provided by certain third parties under a legislative regime. For example, banks and other financial institutions are required by law to provide the ATO with the details of investors, including their names, interest and dividends paid and tax file numbers.¹¹⁹ Other providers of annual legislative data include Centrelink, the Department of Veterans' Affairs, private health insurers and superannuation funds.¹²⁰

2.143 The ATO has a high level of confidence in the legislative data that it receives, such as salary, interest, dividends and managed funds distribution information. For individual taxpayers who receive income from such sources, the ATO may more readily rely on this data to notify the taxpayer of a discrepancy between the data and the reported income as well as any proposed adjustments if the taxpayer does not respond to ATO enquiries.

2.144 In addition to the data matching approach to individuals described above, the ATO has also highlighted its increasing use of third party data for the small-to-medium enterprises market:

This year, we will continue to expand sources of third party data to further enhance our data mining capability to identify risks relating to related-party transactions, disposals of capital assets and international dealings.

... Our risk models use information in income tax returns and schedules, business activity statements and a range of information we gather from government agencies, financial institutions and other third parties.¹²¹

2.145 For high wealth individuals, it is more difficult for the ATO to obtain low cost third party data about private group structures or business details. As an alternative to compliance activity such as a risk review or audit, which could be costly, taxpayers are required to complete questionnaires or expanded income tax returns in the first instance. Taxpayers may incur significant additional costs in meeting those requirements.

Other drivers of ATO information gathering approaches

2.146 As noted above, the level of confidence sought and the cost of obtaining the necessary information to assess risk as well the level of risk itself both influence the ATO's demand for information and its approach in gathering it. Another reason for the ATO's desire for obtaining more information at an early stage, particularly in the large business market segment or more complex cases, is *Federal Court Practice Note TAX 1*. The discovery limits of this practice note essentially require the ATO to be 'litigation-ready' by the time the matter has reached the objection stage. This requires the ATO to have 'full facts quickly' during compliance activities. The IGT had raised

¹¹⁹ *Income Tax Regulations 1936* reg 54, requires the lodgment of the 'annual investment income reports'.

¹²⁰ Australian Taxation Office, *Small Business Partnership meeting minutes 18 April 2012* (27 June 2012) <<http://www.ato.gov.au>>.

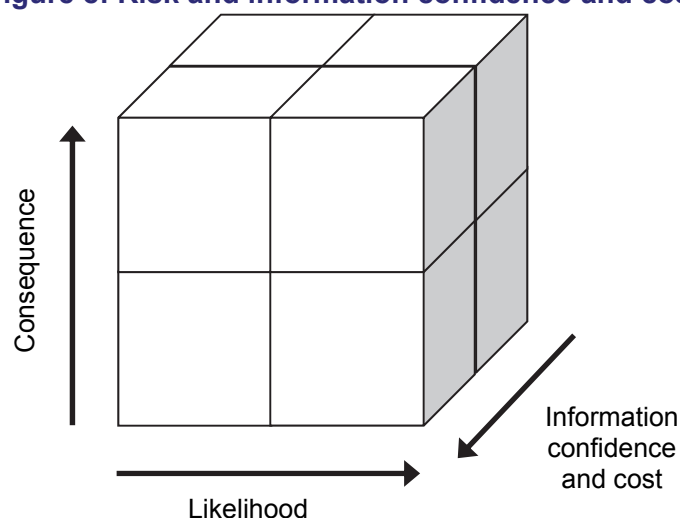
¹²¹ ATO, above n 33, p 31.

this issue in his *Report into the Australian Taxation Office's Large Business Risk Review and Audit Policies, Procedures and Practices*¹²² (LB&I Review) and Self Assessment Review.¹²³

Likelihood, consequence, information confidence and cost

2.147 Figure 8 below summarises the relationship between risk, which is composed of likelihood and consequence, on the one hand, and information confidence and cost on the other. Consistent with the ISO approach and the ATO approaches as set out in its Risk Assessment Template and HOTSA process, information confidence and cost is considered separately to the likelihood and consequence considerations. The required level of information confidence, as well as the ATO action to attain that level of confidence, may vary depending on the context.

Figure 8: Risk and information confidence and cost



Source: IGT

2.148 As noted, the RDF currently does not communicate information confidence and cost separately from the risk rating. The IGT has generally observed that the 'likelihood' axis in the RDF is not readily understood or appreciated. This had led to some taxpayers considering that the system fails to recognise that they are highly compliant.

2.149 The interaction between risk and information confidence and cost is discussed further in Chapter 3 with reference to the use of the RDF in the large business market segment. Whilst the ATO has begun using the RDF for the small to medium enterprise market segment, and earmarked it for other areas, the ATO has been using the RDF in the large business market segment for a number of years. By addressing specific stakeholder concerns with the ATO's use of the RDF in the large business market segment, this report seeks to identify opportunities to improve the use of the RDF more broadly.

¹²² Inspector-General of Taxation, *Report into the Australian Taxation Office's Large Business Risk Review and Audit Policies, Procedures and Practices* (2011) para [3.21].

¹²³ IGT, above n 5, para [3.17].

CHAPTER 3 — LARGE BUSINESS AND INTERNATIONAL

3.1 Stakeholders representing the large business market segment raised concerns regarding aspects of the ATO's risk differentiation framework (RDF) as it applied to them. The RDF provides a means to categorise taxpayers according to the relative risk they pose to the revenue as perceived by the ATO. These risk categorisations influence the ATO's compliance approach toward them and taxpayers are made aware of their categorisation. The concerns raised may be summarised into four broad themes:

- transparency, including individual ATO officers having disproportionate influence on qualitative inputs into the process;
- relevance and accuracy of the inputs into the process;
- lack of differentiation among the categorisations and the manner in which the ATO notifies the taxpayers or their boards; and
- the proportionality of subsequent ATO compliance activity.

3.2 In order to provide context for this chapter, some background about the ATO's Large Business and International (LB&I) governance and the RDF is included here. The stakeholder specific issues and concerns are addressed thereafter.

3.3 The nature of the risk assessment framework in the ATO's large business market segment has been the subject of continuing evolution. It is instructive to consider certain key developments and describe the current processes as in operation more recently to provide a background to the IGT's observations and recommendations in addressing stakeholder concerns.

HISTORICAL CONTEXT

3.4 During the 1980's, the ATO did not have an organisational structure comprised of business and service lines as is currently the case. Concerned about the coverage of the large business market, the ATO initiated the large case program in 1988 which was effectively an audit program of the largest 100 businesses.¹²⁴

3.5 A subsequent ATO review of the program was commissioned. It recommended that the ATO segment the taxpayer population into different markets, to ensure the large business market segment is covered using a variety of ATO compliance products.¹²⁵

¹²⁴ Pappas Carter Evans and Koop, *Review of the Large Case Program: Australian Taxation Office* (Boston Consulting Group, 1992).

¹²⁵ Ibid p 8.

3.6 In 1993, it was foreshadowed for this market segment that:

... as a further illustration of risk management techniques, that the large corporate group, to be expanded in coverage from 100 to 600, itself warrants internal segmentation, leading to the companies being placed across a spectrum of perceived revenue risk. This will lead, at one extreme, to a continuous ATO audit presence for a small number of low complying corporations and at the other to much shorter attention to those where the risk is seen to be lower.¹²⁶

3.7 The ATO moved away from functional departments, such as assessment, collection and appeals. Instead, business lines were created in 1994 to match the taxpayer market segments.¹²⁷ One of these was to become eventually known as LB&I.

3.8 During the 1990's the ATO intensified its scrutiny of large business taxpayers, including increasing use of formal information gathering powers. This also led to increased taxpayer challenges for the ATO to access information, such as that protected by legal professional privilege.

3.9 In 2000, the ATO published 'Cooperative Compliance'¹²⁸, which outlined the relationship the ATO was seeking to establish with large business taxpayers. It indicated that large businesses needed to be involved in the ATO's risk assessment process, to reduce the likelihood of misinterpretations or misunderstandings. The booklet also provided a list of risk categories that the ATO considered relevant, enabling taxpayers to self-assess and self-manage their own risk.¹²⁹

3.10 In 2004, the Commissioner wrote letters to the boards of 1500 publicly listed companies, elevating the importance of tax risk management to the board level.¹³⁰ The letter included some questions the board should consider putting to their tax advisors with a view to identifying and managing tax risks.¹³¹

3.11 In 2006, the ATO issued the first *Large Business and Tax Compliance* (LBTC) booklet. This publication described the ATO's approach to compliance in the large business market, including the relationship it was seeking with this market. The LBTC booklet also highlighted the ATO's expectations with respect to the taxpayer's corporate governance and tax risk management.

3.12 In 2010, the ATO issued a revised edition of the LBTC booklet. This edition introduced the concept of the RDF. The ATO continues to develop and refine their risk assessment approach in response to stakeholder consultation and changing circumstances in the business environment and within the ATO itself.

¹²⁶ Peter Grabosky and John Braithwaite, *Business regulation and Australia's future* (Australian Institute of Criminology, 1993) p 238.

¹²⁷ Leigh Edmonds, *Working for all Australians: A brief history of the Australian Taxation Office 1910 - 2010* (Australian Taxation Office, 1st ed, 2010) pp 199 - 228.

¹²⁸ Australian Taxation Office, *Cooperative Compliance: Working with large business in the new tax system* (2000).

¹²⁹ Ibid p 21.

¹³⁰ Australian Taxation Office, *Commissioner of Taxation Annual Report 2003-04* (2004) p 139.

¹³¹ Glenn Williams and Emily Marsden, 'Tax risk and corporate governance: The ATO's growing interest in taxpayer self risk management' (Paper presented at the Corporate Tax Masterclass (Tax Institute of Australia), Sydney, 30 October 2012).

3.13 Part of the RDF strategy was not only categorising taxpayers according to perceived risk, but also informing taxpayers about their categorisation through notification letters. These letters, for income tax, were sent to key taxpayers and lower risk taxpayers in mid-2010 through to mid-2011. From November 2011 to March 2012 a new ATO campaign saw notification letters issued with a separate risk categorisation for income tax and indirect taxes.

3.14 The most recent ATO letters were sent to taxpayers in November 2012.

3.15 Relevantly, the IGT's LB&I Review was publicly released in 2011. That review covered some aspects of the RDF as it was being deployed within LB&I during the course of that review. The IGT made certain recommendations limited to the communication of the RDF risk categorisation¹³² and the differentiation of compliance approaches according to risk.¹³³ The IGT also foreshadowed the need to conduct a more comprehensive review of the LB&I risk identification process.¹³⁴

3.16 The IGT's Self Assessment Review, publicly released in February 2013, also made some observations and recommendations with respect to the RDF, particularly with respect to the inputs and criteria used by the ATO.¹³⁵ That review also foreshadowed a more fulsome review of the RDF.¹³⁶

3.17 As stated in Chapter 1, the RDF was subject to an internal ATO audit during the course of the review. The final report of that audit was made available to the IGT during the review.

THE RISK DIFFERENTIATION FRAMEWORK (RDF)

3.18 The main ATO publication outlining the use of the RDF in the large business market segment is the LBTC booklet. The most recent edition was published in December 2012. The ATO also published a fact sheet in 2011, *The Risk Differentiation Framework*. During the conduct of the review, the ATO published a new version of the LB&I compliance manual, the *Large business active compliance manual – income tax* (LBAC manual), some of which contains guidance to staff about the application of the RDF. The LBAC manual and its publication also addresses a range of recommendations from the IGT's LB&I Review.¹³⁷

3.19 The intent behind the ATO's RDF is expressed in these terms:

... we use the risk-differentiation framework (RDF) to form a view of your relative tax risk and determine the intensity of our response in a coherent and considered way.

¹³² IGT, above n 122, recommendation 4.1.

¹³³ Ibid recommendation 4.2.

¹³⁴ Ibid para [4.19].

¹³⁵ IGT, above n5, recs 3.5 and 3.6.

¹³⁶ Ibid para [3.84].

¹³⁷ IGT, above n 122, recommendations 4.2, 4.3, 5.1, 6.1, 6.2, 7.3 and 9.1.

... The RDF provides a strategic approach for directing our resources more efficiently and effectively. It provides for greater differentiation of our risk management approaches based on our considered view of taxpayers' compliance history and status.¹³⁸

3.20 According to the ATO's LBTC booklet, the RDF:

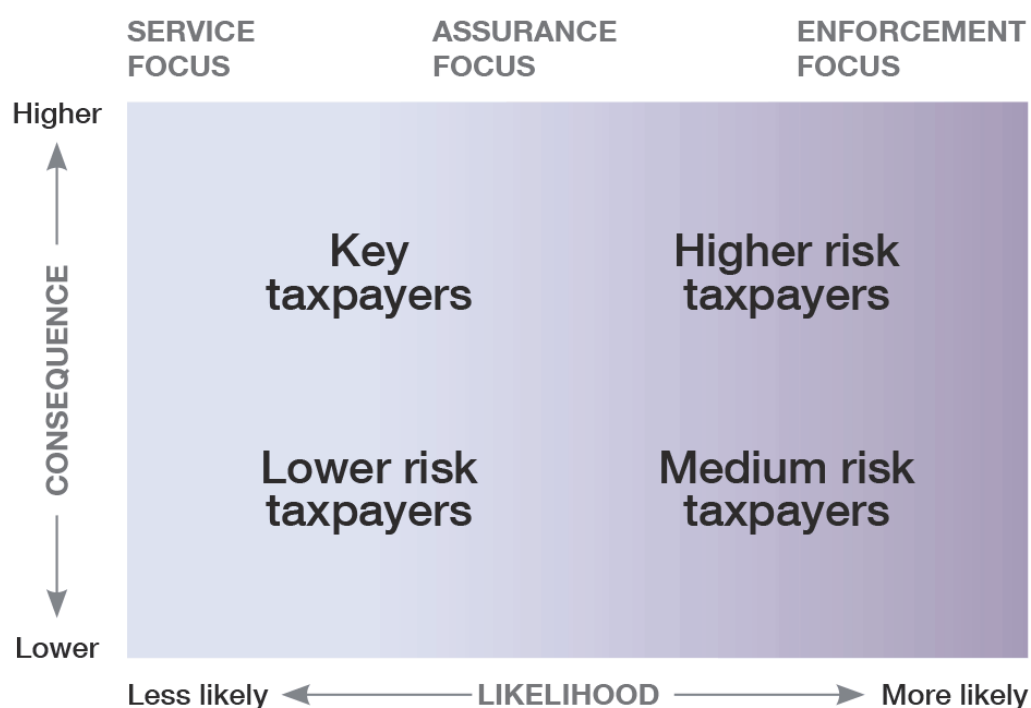
...is based on the premise that our risk management approach to tax compliance should take account of our perception of both the:

* estimated likelihood of you having a tax position that we disagree with or having through error or omission misreported your tax obligations (as evidenced by your behaviour, approach to business activities, governance, and compliance with tax laws)

* consequences (dollars, relative influence, impact on community confidence) of that potential non-compliance.¹³⁹

3.21 The ATO's large business RDF is shown diagrammatically in Figure 9, as extracted from the LBTC booklet:

Figure 9: Large business RDF 'quadrants'



Source: ATO, Large business and tax compliance 2012, page 25.

3.22 As a result of considering the taxpayer's perceived likelihood of non-compliance and the consequence of such non-compliance, the taxpayer is categorised by the ATO into one of four categories or 'quadrants'. These are listed below (refer also to Appendix 8 – RDF chart from Large business and Tax Compliance

¹³⁸ ATO, above n 63, p 25.

¹³⁹ Ibid.

2010 booklet) with both the quadrant identifiers and the numbers of taxpayers in each category for 2013:¹⁴⁰

- higher risk taxpayers (Q1) — 6;
- key taxpayers (Q2) — 86;
- medium risk taxpayers (Q3) — about 300; and
- lower risk taxpayer (Q4) — about 750.

3.23 The RDF is also a relative risk rating system. The ATO uses the tool to assist in understanding a taxpayer's perceived risk relative to others in the population. A taxpayer is unlikely to have the same knowledge as the ATO about other taxpayers' perceived risk. Therefore:

... you may have a different perception of your tax risk. It is likely that there will always be some large businesses that we perceive have a relatively higher risk compared to other large businesses, and understandably these will face more intense scrutiny by us.¹⁴¹

Consequence factors in the LBTC booklet

3.24 The ATO's perception of taxpayer 'consequence' of non-compliance under the RDF is generally determined by the taxpayer's turnover. It is not the only factor considered. The ATO also examines other aspects such as the taxpayer's:

- market share;
- ability to affect the tax compliance of competitors in the industry;
- annual turnover;
- taxes paid;
- assets;
- amounts reported on activity statements; and
- amounts reported for excise obligations including wine equalisation tax and fuel tax credits.¹⁴²

3.25 As a result, a taxpayer is broad banded into a higher consequence or a lower consequence classification. A higher consequence taxpayer can either be a key taxpayer (Q2) or a higher risk taxpayer (Q1), depending on their likelihood of non-compliance. A lower consequence taxpayer can either be a lower risk taxpayer (Q4) or a medium risk taxpayer (Q3), depending on their likelihood of non-compliance. These broad banded consequence categories can be extrapolated from Figure 9 above.

¹⁴⁰ Mark Konza, 'Our compliance approach in the large market', (Speech delivered at the Tax Institute's 28th Annual Convention, Perth, 13 March 2013).

¹⁴¹ ATO, above n 63, p 25.

¹⁴² Ibid p 26.

3.26 The taxpayer's position on the RDF in relation to consequence does not influence the ATO perception of taxpayer compliance behaviours, with key taxpayers and lower risk taxpayers being equally regarded by the ATO as being 'relatively more likely to fulfil their responsibilities and likely to have a positive attitude to compliance'.¹⁴³

Likelihood factors in the LBTC booklet

3.27 The ATO relies on certain evidence to help determine the 'likelihood of non-compliance'. These are reproduced below from the LBTC booklet:¹⁴⁴

- your compliance history, including:
 - the level of disclosure and engagement around significant transactions you undertake;
 - the history of adjustments from previous compliance activity;
 - the fullness of disclosure and cooperation demonstrated in response to any enquiries; and
 - your lodgment and debt history;
- the level of transparency demonstrated by you in keeping us informed about proposed significant transactions or potentially contentious issues;
- whether or not you may have adopted a potentially contentious tax position;
- your effective tax rate;
- an organisational structure that facilitates transactions through secrecy and low-tax jurisdictions, with no commercial basis other than to reduce tax paid in Australia;
- the quality of your tax risk management and governance processes;
- the capability of your staff, systems and processes that produce your tax records;
- information collected from industry associations, domestic and foreign regulatory bodies, and our own internal intelligence areas;
- your business performance over time compared to your tax outcomes and that of your industry peers; and
- the output of various risk filters, generally for risks identified in the compliance program.

3.28 Some of the above indicators, such as effective tax rates, are factual in nature whilst a number of the others seem to require the ATO to form an opinion on the taxpayer's level of transparency, disclosure and engagement.

¹⁴³ Ibid p 26.

¹⁴⁴ Ibid pp 25-26.

3.29 The ATO makes references to ‘engagement’¹⁴⁵ and ‘transparency’¹⁴⁶ in several public speeches. The ATO describes taxpayer ‘engagement’ as the extent to which the taxpayer is willing to disclose information about their tax risks. This disclosure may be initiated by the taxpayer or in response to an ATO information request. Transparency is linked directly to notification of ‘significant transactions’ or ‘potentially contentious issues’. The Deputy Commissioner of the LB&I business line made the following observation in relation to transparency:

The RDF rating is primarily [sic] indicates transparency — how open is the company in revealing its tax risks to the Commissioner for review?¹⁴⁷

3.30 The ATO’s perception of a taxpayer’s likelihood of non-compliance is described as one of ‘informed professional judgment’ based on assessing all of the above factors. The ATO also undertakes a moderation process ‘to ensure the RDF categorisation process is consistent and supported by the evidence’.¹⁴⁸

Likelihood factors in the risk categorisation template

3.31 The main input into the risk categorisation process for higher consequence taxpayers is the ‘higher consequence taxpayer risk categorisation template’ (‘the template’). The template is completed by ATO compliance teams and sent to a moderation panel for consideration. The template considers both likelihood and consequence factors. Stakeholders’ concerns were largely focused on the likelihood factors and not the consequence factors. This is not surprising as the consequence factors (set out in paragraph 3.24 above) are objectively verifiable with one exception. As a result this report does not focus on the consequence factors.

3.32 Whilst not mentioned in the LBTC booklet, this moderation process applies only to higher consequence taxpayers. Lower consequence taxpayers are subject to a different process and not the moderation panel, both of which are considered later in the report.

3.33 With respect to the likelihood factors, the template has several sections. These factors at a high level relate to:

- tax performance, comprising effective tax rate and comparisons with industry;
- organisational structure;
- specific tax risks;
- tax risk management and governance, comprising strategic and operational aspects as well as the taxpayer’s adherence to its processes;
- compliance history, comprising voluntary compliance and willing participation; and

¹⁴⁵ Michael D’Ascenzo, ‘Colours to the mast’, (Speech delivered at the Corporate Tax Association Convention, Sydney, 15 June 2010).

¹⁴⁶ Mark Konza, ‘A world without audits’, (Speech delivered at the Thompson Reuters Annual User Conference Sheraton on the Park, Sydney, 17 October 2011).

¹⁴⁷ Konza, above n 108.

¹⁴⁸ ATO, above n 63, p 25.

- real-time compliance, comprising voluntary compliance and willing participation.

3.34 For each of these areas, LB&I compliance teams are asked to comment on the perceived risks and to refer to evidence (such as reports or minutes) to support it. They are also asked to analyse what contribution that particular risk area makes to the overall risk assessment.

3.35 The final section of the template is for the compliance team to recommend that the taxpayer be rated as either a higher risk taxpayer, key taxpayer or medium risk taxpayer. The recommendation is made to the moderation panel, which may accept or vary the risk categorisation.

3.36 The template is accompanied by guidance material, which includes example text to assist compliance teams in completing each section. The guidance material asks the compliance team to consider a series of questions pertinent to the risk.

3.37 The following section of the report considers each of the 'likelihood' factors as listed above and considered in the template in turn.

Tax performance and effective tax rate

3.38 The template asks the compliance team to consider a variety of financial ratios relating to the effective tax rate of the taxpayer. An examination of a sample of completed templates indicates that compliance teams consider:

- whether the ATO understands the reason for the difference between the ATO measured effective tax rate and the statutory rate where the former is less than the latter;
- whether a reconciliation item warrants investigation or verification where the difference is due to items in reconciliation (such as receiving non-assessable non-exempt income); and
- whether the industry allows for a meaningful comparison as amongst competitors within that industry, as they may have a very different mix of business models, activities and assets.

3.39 This section of the template considers other financial ratios beyond that of tax payable to operating profit. For example, the section also considers tax payable to gross income ratios.

Organisational structure

3.40 In the organisational structure section of the template, compliance teams are advised to:

Comment on the size and complexity of business structures and operations. As these are inherent risks usually associated with higher consequence taxpayers, these risks may be

mitigated to a lower risk level if the taxpayer provides explanation to the satisfaction of the ATO.¹⁴⁹

3.41 Compliance teams are also asked to consider whether they believe any complexity or interposition of entities can be justified.

Tax risks

3.42 This section of the template considers specific tax risk areas, as listed below:

- capital gains tax (CGT) and losses;
- withholding tax;
- taxation of financial arrangements;
- consolidation;
- private equity;
- transfer pricing;
- research and development concessions;
- thin capitalisation;
- tax havens; and
- other issues.

3.43 For each tax risk area, compliance teams are provided with potential risk hypotheses about possible non-compliance that may lead to incorrect reporting in the income tax return. Additional guidance comes in the form of questions for the team to consider, which point to possible facts indicating the presence of a risk of non-compliance.

3.44 For example, for the Consolidation tax risk section:

Has there been a change in the consolidated group?

Taxpayers may obtain inappropriate deductions and/or CGT outcomes where they have used incorrect amounts in the Consolidation entry and exit calculations. The application of the complex consolidation cost-setting rules upon entry and exit can result in incorrect or unintended uplifts in the tax cost of assets. This may occur due to taxpayer error or contrivance.¹⁵⁰

¹⁴⁹ Australian Taxation Office, Higher Consequence Taxpayer Risk Categorisation Template instructions, page 12.

¹⁵⁰ Ibid page 15.

3.45 It should be noted, however, that not all tax risks are accompanied by both risk hypothesis statements and information gathering questions.¹⁵¹

Tax risk management and governance

3.46 The template requires compliance teams to consider the taxpayer's tax risk management and governance in a separate section. This includes the ability and propensity to manage tax risks at both the strategic level (such as the company board) and operational level (such as staff and the in-house tax functions). Compliance teams must consider whether the organisational structure supports the board being made aware of tax risks, including ATO compliance activities. At the operational level, compliance teams are to consider the level of resourcing of the tax function, how staff are remunerated, and the adequacy of record keeping and control systems.

3.47 Tax risk management and governance is also discussed in the LBTC booklet, with a chapter focussing on the ATO's expectations with respect to sound tax risk management and governance arrangements.¹⁵² The ATO's access to documents relating to tax risk management is discussed in a specific section later in this chapter.

Compliance history

3.48 The compliance history section of the template has two parts, 'voluntary compliance' and 'willing participation'.

3.49 The voluntary compliance part has compliance teams considering the taxpayer's historical compliance with their registration, reporting, lodgment and payment obligations. It also considers the outcomes of any previous compliance activities, such as client risk reviews and audits and whether adjustments were sustained in either. The part also considers the taxpayer's use of external advisors:

- How much does the taxpayer rely on external advisors?
- What kind of issues do they seek advice on and how risky are they?
- Does the use of external advice go towards the taxpayers risk appetite?¹⁵³

3.50 The role of taxation advisors is discussed in a specific section later in this chapter.

3.51 The 'willing participation' part of this section, has itself several sub-sections to consider, being:

- objection and litigation history;
- rulings history;

¹⁵¹ CGT and Losses does not have a risk hypothesis;; TOFA has only a basic risk hypothesis; Private equity has no risk hypothesis; Transfer pricing does not have evidence gathering questions; R&D Concessions do have not evidence gathering questions; Tax havens has limited guidance.

¹⁵² ATO, above n 63, p 11.

¹⁵³ ATO, above n 149, page 23.

- previous interaction with the ATO;
- interactions and relationships with other BSLs; and
- utilisation of ATO services.

3.52 Included in the Rulings History sub-section is the question: 'Does the taxpayer apply for rulings on contentious tax issues?'

3.53 Included in the 'Previous interaction with the ATO' sub-section is the question: 'Does the taxpayer make self-disclosures?'

Real time compliance

3.54 The LBTC booklet describes the ATO's transition to a 'real-time' compliance approach towards certain large business taxpayers and its emphasis on ACAs and PCRs for higher consequence taxpayers. A separate fact sheet published after the booklet, *Real-time compliance engagement approach for higher consequence taxpayers in the large market*, indicates that all higher consequence taxpayers who do not have an ACA will be the subject of a PCR.

3.55 The real time compliance section of the template begins with this guidance:

With the move to real-time compliance and PCR's, there is an increasing focus on voluntary compliance and willing participation. This section is for the compliance teams to discuss how willing the taxpayer is to moving towards a real-time compliance approach.¹⁵⁴

3.56 The 'voluntary compliance' section then asks compliance teams to consider the taxpayer's responsiveness to ATO information requests, and whether their behaviour is in line with the Taxpayer Assurance Plan (TAP). The TAP is discussed in a separate section later in this chapter.

3.57 The 'willing participation' section then considers the taxpayers' proactive disclosures and explanations, such as applying for tax rulings for material issues, or disclosing major transactions or potentially controversial tax positions. Some of the important questions posed in this section include:

Requests for material rulings

- Does the taxpayer apply for material rulings with the ATO?
- Do they follow the advice provided in the ruling?

Communication and disclosure of transactions (please note: ATO expect a higher degree of communication and disclosure from ACA vs. PCR taxpayers, and this should be reflected in your evaluation/analysis).

¹⁵⁴ Ibid page 26.

- Does the taxpayer provide regular communication/disclosure of major issues and transactions?
- Do they provide a business approach and an explanation as to why the transaction happened?
- What has the taxpayer done to mitigate tax risks?
- Does the taxpayer possess and provide the team with documentation on transactions?
- Does the taxpayer engage with the team in real-time?
- Does the taxpayer show a willingness to raise potential controversial tax positions with the ATO and work with the ATO to resolve them?
- Does the taxpayer seek clarification with regard to the application of new legislation and measures?¹⁵⁵

3.58 It should be noted that both the 'compliance history' and 'real time compliance' sections have identically titled sub-sections called 'voluntary compliance' and 'willing participation'. An ATO internal audit of the RDF made similar observations and concluded that such an overlap be resolved to minimise the potential for facts or evidence to be given undue weight in the risk categorisation process.¹⁵⁶

Tax risk management and governance — ATO access to board documents

3.59 In 2004, the Commissioner sent letters to the boards of 1500 large business taxpayers, drawing their attention to the increased importance the ATO was placing on companies having adequate tax risk management and corporate governance. The letters included 10 questions that boards should ask of their tax management team.

3.60 Stemming from the likely activity this would generate, the ATO issued Practice Statement PS LA 2004/14 *Access to 'corporate board documents on tax compliance risk'*, to recognise in part:

... that those responsible for managing a company's tax compliance risks need to be able to undertake broad ranging and candid communications. Those persons would include the company's employees, its external advisors and its directors undertaking governance of tax compliance issues.¹⁵⁷

3.61 As a result, the ATO made an undertaking in this practice statement that:

Access to corporate board documents on tax compliance risk will not be sought by the Tax Office during a compliance risk review or an audit of a corporate taxpayer except in exceptional circumstances and the access will need to be approved by an appropriate

¹⁵⁵ Ibid.

¹⁵⁶ Australian Taxation Office, Internal Audit Communications Update 14 May 2013, page 5.

¹⁵⁷ Australian Taxation Office, *Access to 'corporate board documents on tax compliance risk'*, PS LA 2004/14, 1 July 2006, para [11].

Senior Executive Service officer, as described in the Tax Office's *Guidelines to Accessing Professional Accounting Advisors' Papers* (the *Accountants' Guidelines*).¹⁵⁸

... During a compliance risk review or audit the Tax Office will, in the first instance, ordinarily seek information from documents prepared in connection with the conception, implementation and formal recording of a transaction or arrangement, and which explain the setting, context and purpose of the transaction or arrangement.¹⁵⁹

3.62 It should be noted, however, that the class of documents described in this practice statement as falling under this administrative concession are only those documents that are:

- created by advisors (being suitably qualified in-house or independent advisors);
- created for the sole purpose of providing advice or opinion to the board of directors (including properly constituted sub-committees) on tax compliance risks and their likelihood and impact; and
- that address tax risks associated with major transactions and arrangements and/or tax risks arising from corporate systems and processes.¹⁶⁰

3.63 In the LBTC booklet, the ATO's expectations about tax risk management and corporate governance go beyond the creation of documentation as described above. The ATO is also concerned about the policies and structures that support robust internal reporting and decision-making. The practice statement notes that ATO officers will at first instance seek documentation with respect to transactions. Nevertheless, it is open for the ATO to seek documents related to the policies and structures in place that support the taxpayer's tax risk management and governance, in contrast to the corporate board documents on tax compliance risk, which is the product of these policies and structures.

3.64 The practice statement also mentions:

This Practice Statement does not restrict access to corporate board documents on tax risk to the extent that a taxpayer decides to make these documents available to the Tax Office. It is recognised that some corporate taxpayers are willing to make such documents available to assist in prompt and effective assessments of tax compliance risk by the Tax Office when risk reviews or audits are being undertaken. However, no adverse inference is to be drawn merely because a taxpayer does not make such documents available in accordance with this practice statement.¹⁶¹

¹⁵⁸ Ibid para [3].

¹⁵⁹ Ibid para [14].

¹⁶⁰ Ibid para [2].

¹⁶¹ Ibid para [19].

ATO GOVERNANCE AND MODERATION PANEL

3.65 In LB&I, the main group responsible for risk management is the LB&I Risk and Intelligence Committee (RIC). The RIC is accountable to the LB&I Executive and reports its outcomes to it.¹⁶²

3.66 Accountable to the RIC is the Case Selection Sub-Committee (CSSC). The CSSC:

... reviews the risk recommendations to support risk review compliance activity of LB&I lower consequence taxpayers. The casework that is identified will relate to the operational risks that have been already been identified and assured by the Risk and Intelligence Committee.

3.67 The CSSC is also responsible for the RDF categorisations of lower consequence taxpayers. The CSSC uses the concerns raised in the case selection process to assist in determining whether a lower consequence taxpayer is a lower risk taxpayer or a medium risk taxpayer.¹⁶³

3.68 The RDF categorisation process for higher consequence taxpayers is performed by the Large Market Income Tax RDF Moderation Panel ('moderation panel'). The moderation panel reports to the LB&I Operations Committee, the LB&I Executive, and the Large Market Committee. The moderation panel is chaired by the Assistant Commissioner, LB&I Risk Intelligence & Systems Support.¹⁶⁴

3.69 The moderation panel's purpose is to:

... manage the arrangements for categorising large businesses (economic groups and single entities) in the large market, for income tax purposes.

... (the Panel) provides a level of independence and assurance that we have consistency in risk categorisations across large businesses, and that categorisations are supported by appropriate evidence.¹⁶⁵

3.70 For lower consequence taxpayers, the panel reviews and endorses the process by which lower consequence taxpayers are categorised as either lower risk or medium risk taxpayers, but does not undertake the categorisations itself.¹⁶⁶ As indicated above, this is done through the CSSC.

3.71 For higher consequence taxpayers, the moderation panel is responsible for settling on risk categorisation recommendations via two-thirds agreement, before referring them to the LB&I Executive for final approval.¹⁶⁷ The main input into this process is the higher consequence taxpayer risk categorisation template (the template discussed above). The template requires an overall recommendation by the team to

¹⁶² Australian Taxation Office, LB&I Risk and Intelligence Committee Charter, January 2012.

¹⁶³ Australian Taxation Office, LB&I Case Selection Process August 2012.

¹⁶⁴ Australian Taxation Office, Large Market Income Tax RDF Moderation Panel Charter October 2012.

¹⁶⁵ Ibid.

¹⁶⁶ Ibid.

¹⁶⁷ Ibid.

categorise the higher consequence taxpayer as either a key taxpayer or a higher risk taxpayer.

3.72 The moderation panel is convened annually, with sessions lasting approximately one day (but may be spread out over several days) during the June/July period.¹⁶⁸

3.73 The moderation panel's charter makes reference to a broader range of higher consequence taxpayer categories, being higher risk taxpayers, key taxpayers with significant concerns, key taxpayers with little concerns, and key taxpayers with no concerns. The ATO notes that:

For large businesses considered to be of perceived higher risk or key taxpayers with concerns, the moderation panel will examine the data and analysis to ensure consistency, objectivity and transparency. Panel discussions for these businesses, and others where warranted, will generally involve compliance teams or other relevant stakeholders.

Where the moderation is of Key Taxpayers with little, or no concerns, the Panel may endorse the categorisation without further input from compliance teams or other stakeholders.¹⁶⁹

3.74 Whilst not explicit in the moderation panel's charter, the panel is also responsible for making recommendations about the content and tone of the notification letter that is eventually sent to the taxpayer's Chief Executive Officer (CEO).¹⁷⁰ The drafting of this notification letter is described in greater detail in a later section.

ATO RISK FILTERS, RISK MANAGERS AND RISK OWNERS

3.75 The ATO uses a range of 'risk filters' to identify or exclude potential risks. The ATO large business market segment is no exception. All LB&I taxpayer returns and related data are passed through these risk filters to detect patterns or anomalies which may indicate a risk of non-compliance. The approach in the large business market segment uses a range of quantitative data to do so.

3.76 Risk filter information may assist in directing the ATO's enquiries of the taxpayer in various ways. For higher consequence taxpayers, the main risk input is the template, which largely considers qualitative factors described above.

3.77 For lower consequence taxpayers, risk managers make recommendations for case selection. These recommendations are based on risk filter output and other intelligence or research. The section below considers risk filters and the section thereafter the risk manager and risk owner roles.

¹⁶⁸ Ibid.

¹⁶⁹ Ibid.

¹⁷⁰ Australian Taxation Office, RDF Moderation Panel Minutes – 14 June 2012.

Risk filters

3.78 The ATO uses 'risk filters' to scan income tax return and related schedule information for all 1400 economic groups and entities in the income tax large business market. The filters are used to:

... detect financial patterns that may indicate potential non-compliant positions, for example, abnormally low tax payments compared to industry peers or high-risk transactions or arrangements that have not been disclosed.¹⁷¹

3.79 The risk filters are quantitative computer based assessments, and is the 'first cut' of the risk assessment process on data drawn from large business income tax returns. A description of such a filter is shown in Figure 10 below. Each risk filter contains the risk area, the risk description (being a basic form of risk hypothesis), and the risk filter description – which describes the tax return or other data that the filter is relying upon.

Figure 10: Sample ATO risk filter description

Risk area	Inappropriate outcomes involving consolidation
Risk description	<p>An incorrect or contrived application of the complex consolidation cost-setting rules when an entity joins or leaves a group can result in incorrect or unintended uplifts in the tax cost of assets, resulting in:</p> <p style="padding-left: 40px;">elimination of or significant reduction in capital gains or increased capital losses increased or refreshed deductions including capital allowances lower assessable income.</p> <p>This risk is magnified due to complex interactions with other tax laws. Another risk in focus is where foreign partnerships are being included in consolidated groups for the apparent purpose of creating interest deductions in two countries (double dipping).</p>
Risk filter description	<p>We monitor changes to consolidated groups based on:</p> <p style="padding-left: 40px;">significant transactions occurring that are expected to result in a change to one or more consolidated group structures the reported volume and/or pattern of entries and exits from groups information indicating that groups have interposed entities in existing structures entities exiting a consolidated group that do not re-enter the system as an active taxpayer (that is, lodging returns, paying instalments) comparison of economic group with number of taxpayer entities (including consolidated groups) in the structure level and patterns of loss utilisation in consolidated groups use of foreign partnerships.</p>

Source: ato.gov.au¹⁷²

3.80 These 'Large market income tax risk filters' have been published on the internet in implementing Recommendation 3.5 of the IGT's Self Assessment Review.¹⁷³ A list of the published ATO risk filters has been included in Appendix 9. Importantly, the ATO website from which Figure 10 is drawn also notes:

¹⁷¹ ATO, above n 63, p 5.

¹⁷² Australian Taxation Office, *Large market income tax risk filters*, (16 August 2012) <<http://www.ato.gov.au>>.

¹⁷³ Ibid.

We use a number of qualitative and quantitative risk filters to detect areas where there may be differences in views between us and the taxpayer, for example:

- differences in treatment of capital gains and profit shifting
- where the law is new and we want to ensure that it is being complied with, such as taxation of financial arrangements (TOFA).¹⁷⁴

3.81 The risk filters may be used to detect specific instances of potential non-compliance, which may indicate a need for verification activities. Alternatively, it may be used to select taxpayers who may be affected by a new law, so as to assist the ATO to understand how the law is being applied in that industry for assurance purposes.

3.82 The ATO has also advised the IGT during the review that in relation to risk filters:

We are now ensuring that we record more details about the purpose of reviews which are undertaken so that we can better measure our results. For example some reviews are undertaken to provide assurance around the implementation of legislative change. In these instances we may not expect to proceed to audit but that does not mean the filters were ineffective. By understanding our reasons for identifying a group using particular filters we will be better able to measure the effectiveness of these.¹⁷⁵

Risk managers and risk owners

3.83 The actual risk areas of the ATO's LB&I business line are designated to 'risk owners' (being senior executive officers) and 'risk managers' (operational officers). Risk managers develop and implement strategies to mitigate their risks. The strategies outline how the risk will be deterred, and how it will be dealt with at an operational and tactical level.¹⁷⁶

3.84 Risk managers consult with technical experts and officers from the ATO's Risk Intelligence and Systems Support (RI&SS) team to develop risk filters to assist in detecting risks.¹⁷⁷

3.85 Whilst any officer in LB&I can recommend a taxpayer to be subjected to a risk review, risk managers are responsible for considering the risk filter output and regularly making recommendations for case selection.

3.86 Where a taxpayer has not been brought to the attention of the risk manager (or anyone else in LB&I) via the risk filters, the taxpayer may nevertheless be the subject of a risk recommendation due to qualitative information, such as media coverage of a large transaction or intelligence from other sources.¹⁷⁸ All recommendations are

¹⁷⁴ Ibid.

¹⁷⁵ ATO communication to IGT, 23 November 2012.

¹⁷⁶ ATO, above n 163.

¹⁷⁷ ATO, above n 175.

¹⁷⁸ ATO, above n 163.

considered by the CSSC, and must be signed-off by the LB&I Executive before commencement of a risk review.¹⁷⁹

3.87 In the absence of qualitative information and risk filter output, it is possible for a segment of the lower consequence taxpayer population to have little contact with the ATO. Minutes from the December 2012 CSSC workshop indicate that possibly 500 lower risk taxpayers had not had any ATO contact for three years. As a result, it was indicated that the ATO (the Compliance Assurance & Governance and RI&SS teams) were examining a more robust profiling and risk assessment process for lower consequence taxpayers.¹⁸⁰ The minutes also indicate that:

The statistics above show a funnelling effect where initially a large number of risk recommendations were not considered due to low materiality or low risk rating in the output. The numbers that are then considered are whittled down via analysis and cross-referencing to previous cases until only a small number of the original population is left for new recommendations.

It appears that the risk filters, and/or the process, is only identifying a small number of new taxpayers for potential risk reviews.¹⁸¹

3.88 As a result, the ATO's CSSC has identified a number of opportunities for improvement to the risk filter process.

3.89 The minutes also indicate that risk managers expressed a desire to work more closely with the LB&I Operations teams (compliance teams that undertake risk reviews etc) to assist them in identifying risks in taxpayer information and 'asking the right questions' of the taxpayer. By working more closely with them, risk managers may assist in improving the capability of the compliance teams.¹⁸²

TAXPAYER NOTIFICATION OF RDF CATEGORISATION

3.90 Once a taxpayer's risk categorisation has been determined by the moderation panel, the ATO begins a process to author and issue the RDF notification letter. The letter advises taxpayers of their categorisation:

In 2011-12, for the first time we informed most large business in a single letter about our view of their relative risk of non-compliance for GST, income tax and excise.¹⁸³

3.91 For higher risk and key taxpayers, the letters are sent to the CEO, while letters for lower risk and medium risk taxpayers are sent to the public officer.¹⁸⁴ Senior executive ATO officers also meet with their tax managers to explain the ATO's views and discuss any concerns.¹⁸⁵

¹⁷⁹ Ibid.

¹⁸⁰ Australian Taxation Office, Case Selection Sub-Committee Workshop Documents December 2012, page 7.

¹⁸¹ Ibid page 25.

¹⁸² Ibid pp 8-9 .

¹⁸³ ATO, above n 63, p 5.

¹⁸⁴ Konza, above n 146.

¹⁸⁵ Ibid.

3.92 Senior ATO management advised during this review that it expects compliance teams and officers to discuss the potential contents of the letter with the tax manager during the letter development process so that tax managers should not be surprised by the contents of the letter when it is issued.¹⁸⁶

3.93 The RDF notification letters are the subject of a forty-step production process with several ATO staff involved.¹⁸⁷ The process seeks to ensure adequate review of the compliance teams and moderation panel output and relevant Second Commissioner oversight and approval is obtained. This improved process was in response to Recommendation 4.1 of the IGT's LB&I Review.

3.94 The ATO's moderation panel documents indicate that the key taxpayer segment is further subdivided into: 'key with no concerns, key with some concerns, key with significant concerns'.¹⁸⁸ This subdivision is not apparent in the LBTC booklet discussion about the RDF quadrants, nor in the RDF fact sheet.¹⁸⁹ However, the recent ATO publication *Real-time compliance engagement approach for higher consequence taxpayers in the large market* shows key taxpayers and higher risk taxpayers displayed as a spectrum, rather than two halves.¹⁹⁰

3.95 This is consistent with the Second Commissioner's speech in 2011 regarding the categorisations and letters:

An important thing to keep in mind is that while in the large market we have kept it pretty simple with just four risk categorisations, what plays out in reality is a spectrum of behaviours and concerns. We use the RDF to gives [sic] us a consistent suggested initial stance — an initial set of guidelines — but it is not a set of tramlines.¹⁹¹

3.96 For higher consequence taxpayers, the RDF notification letters only describe whether a taxpayer has been categorised as a key taxpayer or a higher risk taxpayer. The letter does not use sub-categories. Rather, moderation panel documents suggest that sub-categories are used to assist in developing the tone and content of the RDF notification letter. For example, where the ATO has some concerns about a key taxpayer, it will outline those concerns in the letter.

3.97 The ATO has advised that all higher consequence RDF notification letters should contain the details of a senior executive contact officer who is available to discuss the categorisation with the taxpayer.

¹⁸⁶ ATO communication to IGT, 15 February 2013.

¹⁸⁷ Australian Taxation Office, RDF Notification Letter Process.

¹⁸⁸ Australian Taxation Office, RDF Moderation Panel Minutes 14 June 2012.

¹⁸⁹ Australian Taxation Office, *Risk differentiation framework fact sheet* (28 March 2012). <<http://www.ato.gov.au>>.

¹⁹⁰ Australian Taxation Office, *Real-time compliance engagement approach for higher consequence taxpayers in the large market fact sheet* (15 February 2013), <<http://www.ato.gov.au>>.

¹⁹¹ Quigley, above n 88.

ADDITIONAL HIGHER CONSEQUENCE REQUIREMENTS — TAXPAYER ASSURANCE PLANS (TAPs)

3.98 Compliance teams dealing with higher consequence taxpayers are expected to develop taxpayer assurance plans (TAPs). These plans are:

the cornerstone of how we deal with our higher consequence large business taxpayers. Taxpayer assurance plans are forward looking, map out the means to achieve longer-term goals and provide options for dealing with unforeseen challenges and opportunities.

Teams are required to have a three year taxpayer assurance plan for each higher consequence taxpayer using a whole of ATO/whole of taxpayer approach. Each plan should be endorsed by the relevant SES leader and periodically updated.¹⁹²

3.99 The TAP is intended to document an understanding of the current state of the relationship between the taxpayer and the ATO, including the taxpayer's compliance, their attitude towards compliance, the intended goal of the plan, the resources to achieve that goal and the approaches required to 'turn the vision into reality'.¹⁹³

3.100 As the TAP only caters for higher consequence taxpayers, it provides examples of intended outcomes for higher risk taxpayers and key taxpayers only. The examples generally focus on increasing or maintaining the taxpayer's commitment to real time disclosure of tax risks to the ATO.

3.101 The ATO's compliance teams document their understanding of the taxpayer's business using an adaptation of the ATO BISEP model explained in Chapter 2. This is essentially a taxpayer profile that documents the taxpayer's past compliance behaviour, including past interactions with the ATO. This profile section also contains a section for the 'rationale for the risk category rating'. This ensures that compliance teams outline the reasons why the taxpayer received the RDF categorisation that it did.

3.102 The profile section of the TAP also contains a section to record the compliance team's observations about the taxpayer's risk management and governance function. This is considered important because:

Reviewing a taxpayer's risk management and governance function is critical to understanding its business and behaviours. Aside from its importance in assisting teams to better understand the business, taxpayers must be able to demonstrate sound tax risk management processes and a willingness to work with us in order to be considered for an ACA (providing the taxpayer meet our other ACA criteria).¹⁹⁴

3.103 The TAP also expects compliance teams to establish protocols with taxpayers to facilitate relationship management at both the strategic and operational levels. The protocols are designed to assist where differences of opinion or disputes arise.

¹⁹² Australian Taxation Office, Taxpayer assurance planning guide for higher consequence taxpayers July 2011.

¹⁹³ Ibid page 5.

¹⁹⁴ Ibid page 14.

3.104 The TAP also anticipates that compliance teams will develop a framework that facilitates:

... both the raising of tax risks and the development of joint assessments of risk in real time in an environment of mutual trust and respect ... The framework should provide for the ATO to respond promptly to taxpayer requests for rulings, APAs and position papers on significant issues.¹⁹⁵

3.105 The TAP is to include the manner in which the ATO-taxpayer relationship is to be managed and resourced within the ATO, with compliance teams documenting the internal resourcing and governance arrangements to implement the strategy.

3.106 The section of the TAP entitled 'what needs to be done?' provides guidance to compliance teams about their approach to information gathering and risk assessment in light of what the ATO knows about the taxpayer (captured earlier in the TAP) and their RDF risk categorisation. For example, it provides examples of kinds of 'monitoring' and information gathering approaches that do not involve taxpayer contact as well as approaches that do.¹⁹⁶

ATO REVIEW OF THE RISK CATEGORISATION TEMPLATE

3.107 In October 2012, the ATO completed a review of the template, with a business analyst seeking feedback from the main users of the template, the LB&I compliance teams. The review noted that there was a degree of overlap between the information entered in the template and that already documented in the TAP.¹⁹⁷

3.108 Feedback also indicated that compliance teams would like to receive feedback from the RDF moderation panel about the compliance teams' work, as well as information about how the moderation panel uses the information in the template.¹⁹⁸

3.109 The review also noted an opportunity to streamline the notification letter process by using technology to reduce the amount of manual re-working of content from the template through to the eventual letter issuance.¹⁹⁹

3.110 The ATO advised the IGT during this review that it was undertaking a review to better integrate the TAP, the template, and PCR related documentation and to reduce overlap and manual data entry.²⁰⁰

3.111 A summary of the process for higher consequence taxpayers can be shown diagrammatically in Figure 11: Simplified higher consequence taxpayer risk categorisation process below:

¹⁹⁵ Ibid page 16.

¹⁹⁶ Ibid page 27.

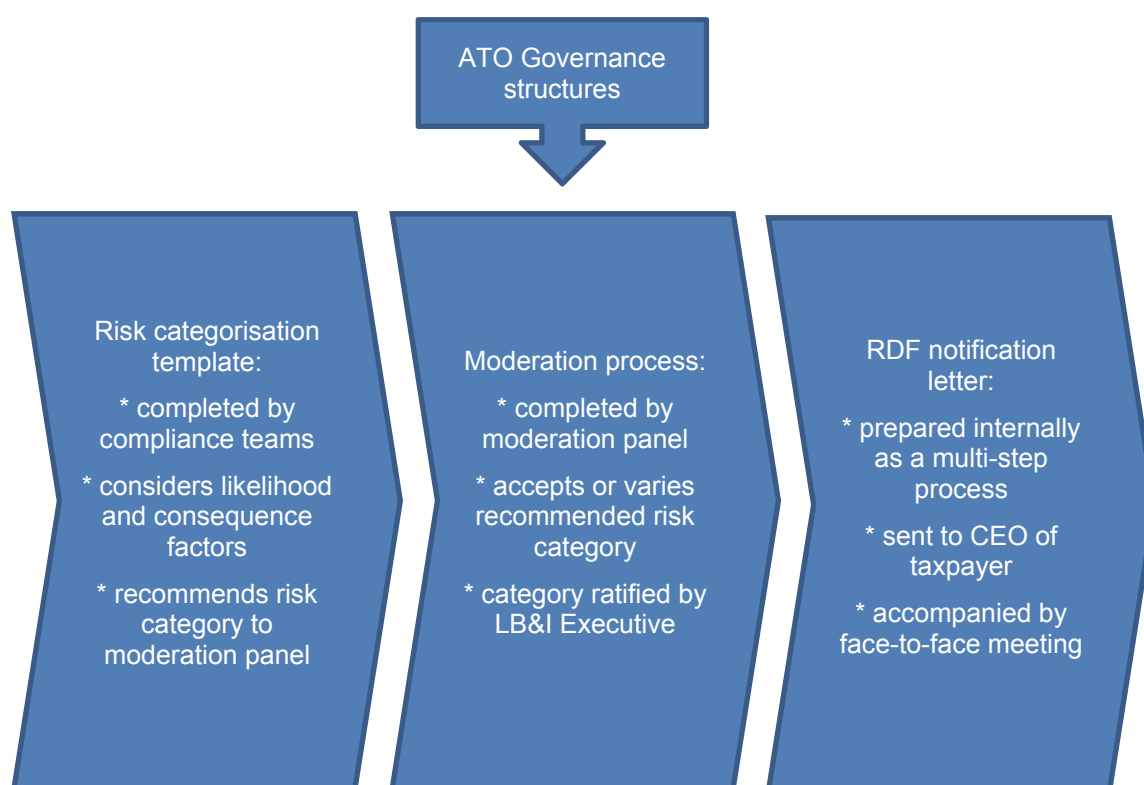
¹⁹⁷ Australian Taxation Office, Higher Consequence Taxpayer Risk Categorisation Revision: Revision of the 2012 Higher Consequence Taxpayer Risk categorisation template and related processes with the purpose of improving annual taxpayer categorisation. Revised 2/10/2012.

¹⁹⁸ Ibid Requirement R14 and R4.

¹⁹⁹ Ibid Requirement R11.

²⁰⁰ ATO communication to IGT, 19 April 2013.

Figure 11: Simplified higher consequence taxpayer risk categorisation process



Source: IGT

3.112 This report now considers the specific concerns stakeholders raised in submissions. The IGT will discuss these and related materials, making observations and, where appropriate, recommendations.

STAKEHOLDER CONCERN — TRANSPARENCY OF THE RISK CATEGORISATION PROCESS

3.113 Stakeholders raised concerns about certain aspects of the ATO's RDF as used by LB&I. Of particular concern was the underlying process that the ATO used to categorise taxpayers. The LBTC booklet notes the use of a moderation process, but no further detail is given about it.²⁰¹

3.114 Stakeholders generally supported the appropriate use of qualitative inputs for the RDF process, recognising that a purely quantitative approach in this market segment will often be impractical. They were concerned, however, to ensure that there was adequate oversight of any process requiring professional judgement or use of subjective measures by ATO officers. The underlying concern was that ATO LB&I audit staff involved in risk rating taxpayers would be heavily influenced by their perceptions of interactions and their own organisational or personal behavioural biases.

²⁰¹ ATO, above n 63, p 25.

3.115 Stakeholder concerns were also directed at the ATO categorisation process for higher consequence taxpayers regarding the key taxpayer or higher risk taxpayer delineation.

3.116 The process for deciding a higher consequence taxpayer's risk categorisation is based on the template as noted. This contains the compliance team's consideration of both the consequence and likelihood factors, concluding with their risk categorisation recommendation.

3.117 The ATO considers the template as:

- a preliminary judgment by the compliance team;
- providing a starting point for the moderation panel to assess the appropriateness of the recommendation; and
- setting out how that taxpayer sits in the RDF relative to other taxpayers.²⁰²

3.118 The template and recommendation are then considered by the ATO's moderation panel. The moderation panel considers all the higher consequence taxpayer templates to assist in determining relativity. The moderation panel documents their decisions, which may be a confirmation or variation of the categorisation proposed by the compliance team. This decision is then escalated to the LB&I Executive whereby the categorisation is ratified.

3.119 The ATO's Internal Audit examined a sample of completed templates and found that 'comparable evaluation and evidencing methods were used for all sampled taxpayers despite different business contexts'.²⁰³

IGT observations

3.120 The moderation panel is an important control measure implemented by the ATO to ensure that risk categorisations of higher consequence taxpayers are not adopted or changed by the action of a single ATO officer or compliance team. As noted in paragraph 3.67 above, similar control measures are in place for lower consequence taxpayers, whose risk categorisations must be approved by the CSSC.

3.121 The IGT also acknowledges that the use of the template is an important measure to facilitate:

- adequate record keeping regarding the evidence presented by the compliance teams to the moderation panel; and
- consistent presentation of considerations and evidence as amongst other taxpayers, assisting the moderation panel to make recommendations with respect to relative risk.

²⁰² Australian Taxation Office, Higher Consequence Taxpayer Risk Categorisation 2012, PowerPoint File provided to Internal Audit under Test 1.3.

²⁰³ Australian Taxation Office, Final Report - Compliance Intelligence & Risk Management Internal Audit, 13 August 2013, p 15.

STAKEHOLDER CONCERN — ACCURACY AND RELEVANCE OF INPUTS

3.122 As noted, stakeholders generally recognise that a purely quantitative approach to assess risk in the large business market segment is impractical and accept that qualitative factors have a role to play.

3.123 Stakeholders did, however, express a number of concerns about the ATO's use of these qualitative inputs. For example, stakeholders submitted that the ATO's use of these inputs would have potential shortcomings in the following areas:

- Taxpayer risk rating disproportionately influenced by one transaction — concern that the ATO may perceive the taxpayer to be risky on the basis of one transaction.
- Non-compliance and contestable tax positions — concerns that the ATO may incorrectly infer taxpayer non-compliance in the presence of a contestable tax position.
- Taxpayer engagement, transparency and access to information — concerns with ATO emphasis on concepts such as 'taxpayer engagement' with potential negative inferences drawn from taxpayer behaviours such as:
 - redacting responses to ATO information requests on the basis of commercial confidentiality;
 - not applying for private rulings;
 - claiming legal professional privilege (LPP); and
 - taxpayers making Freedom of Information (FOI) requests.
- Effective tax rates — concern that the ATO sees low effective tax rates as a higher risk even though they may be explicable.
- Risk ratings based on past behaviour — concern that ATO perceptions of riskiness may be too reliant on past taxpayer behaviour without due acknowledgement of changes or improvements.
- The role of taxation advisors — concern that engaging a tax advisor that the ATO perceives to have a higher risk profile increases ATO perceptions of taxpayer riskiness.
- ATO considerations of taxpayer governance — concern that the ATO does not have the adequate capability to make judgements about a taxpayer's tax risk management system.

3.124 These stakeholder concerns are each addressed in turn below.

Taxpayer risk rating disproportionately influenced by one transaction

3.125 Stakeholders were concerned whether the ATO's focus on a small part of a taxpayer's business or a particular transaction may effectively drive up the risk rating

of an otherwise low risk taxpayer. The result would be unnecessary increases in the compliance costs for the taxpayer by exposing them to enquiries broader than the transaction of concern.

3.126 The ATO's template allows compliance teams to make observations about a particular area of tax law where the taxpayer may have interpreted or applied it incorrectly. For this section of the template, the compliance team is asked:

What impact does the taxpayer risks analysis above have in giving the taxpayer a higher risk category rating?

Negligible, Moderate, Significant, High, Severe²⁰⁴

3.127 Compliance teams have an opportunity to qualify the extent to which a transaction or issue of concern should impact the taxpayer's risk categorisation.

IGT observations

3.128 The IGT is of the view that where the ATO has a concern about a particular taxpayer transaction or interpretation issue, ATO enquiries should be focused on that concern. Such a focus also assists in narrowing the scope for information requests and in minimising compliance costs for both the ATO and the taxpayer. Internal guidance such as TAPs should ensure that the ATO's enquiries of taxpayers are targeted accordingly.

3.129 If the above approach is not adopted, there is potential for an otherwise model taxpayer to have their risk categorisation disproportionately influenced by one particular concern. This is particularly so since the RDF as currently framed is a risk categorisation of the taxpayer itself, rather than a risk categorisation of individual transactions or positions.

3.130 Classifying an otherwise compliant taxpayer as having a higher likelihood of non-compliance because of a limited number of concerns can have significant ramifications for the ATO/taxpayer relationship. It may be interpreted as the ATO not giving due weight to the taxpayer's levels of compliance in the rest of its affairs.

3.131 There may be exceptions to the above approach such as where the ATO has concerns about a single taxpayer transaction or position and the latter is substantial compared to that taxpayer's tax base. In these circumstances, the influence of such transaction or position on the taxpayer's risk rating may be justified. Other exceptions may include situations where the ATO suspects fraud, or where the particular transaction is indicative of poor internal governance whereby the taxpayer is unable to detect or manage non-compliance.

²⁰⁴ ATO, above n 149, page 18.

RECOMMENDATION 3.1

The IGT recommends that discrete transactions or business activities of a taxpayer that cause concern for the ATO should not be determinative of the taxpayer's overall risk rating unless they are substantial compared to the taxpayer's tax base or are indicative of poor internal governance or fraud.

ATO response

Agree.

Non-compliance and contestable tax positions

3.132 Examples of the above concern include the ATO not acknowledging that its view is not always correct, especially in relation to adverse court decisions. Put another way, stakeholders perceive that the ATO does not distinguish between taxpayers who take a detection risk as opposed to an interpretation risk.

3.133 Taxpayers who take a detection risk have not complied with the law, and ultimately rely on the ATO not discovering any tax shortfall. These taxpayers may be less than forthcoming with information as part of their strategy. Importantly, this is not considered to be a significant risk by the ATO in this market segment.²⁰⁵

3.134 Taxpayers who take an interpretation risk on the other hand and rely on the merits of the interpretation of the law adopted are entitled to do so under the legal system. Provided that the taxpayer meets all of the legal obligations, this is a choice that is open to them. It has been acknowledged in various quarters that the tax laws are becoming even more complex and as a consequence there is significant room for uncertainty in application.²⁰⁶

3.135 Stakeholders have highlighted that by not adequately distinguishing between these types of taxpayer behaviours, and describing both as having a higher likelihood of 'non-compliance', the ATO may be undermining efforts to improve taxpayer engagement with the system or driving inappropriate ATO officer behaviours.

The ATO does make reference to 'a tax position that we disagree with' regarding non-compliance in their LBTC booklet in the following terms:

'likelihood of you **having a tax position that we disagree with** or having through error or omission misreported your tax obligations ...'²⁰⁷ [emphasis added]

²⁰⁵ ATO, above n 63, p 28.

²⁰⁶ Australia's Future Tax System (Ken Henry, chairperson), The Treasury (Cth), *Final Report 2(2)* (AGPS, 2009) pp 651–652 and Margaret McKerchar, 'Tax Complexity and its Impact on the Tax Compliance and Administration' (Paper presented at the IRS Research Conference, Washington, 13–14 June, 2007) pp 190–191.

²⁰⁷ ATO, above n 63, p 25.

3.136 The LBTC booklet also makes reference to the ATO's concerns in this way:

The majority of large businesses are compliant, however, we still have concerns about opportunistic tax planning in a relatively small group of large businesses and we will have an intense focus on these businesses.²⁰⁸

3.137 In the main, however, the LBTC booklet refers to 'non-compliance' as the risk event of concern to the ATO, rather than the taxpayer taking a contestable position. For example:

Our perception of the likelihood of non-compliance is an informed professional judgment based on assessing a range of risk factors for each tax type.²⁰⁹

3.138 In a range of other ATO materials, including the LBTC booklet, taxpayer positions are referenced to variously as 'controversial' or 'contentious'.²¹⁰

IGT observations

3.139 The IGT is of the view that, in the large business market segment, the key risks are generally associated with taxpayers adopting a contestable tax position. The outcome may be non-compliance where the taxpayer is incorrect. Conversely, where the ATO is incorrect, the taxpayer is compliant with the law.

3.140 As already mentioned, the taxpayer accepts some interpretation risk even if it accepts the ATO view. The reason being that such a view, if challenged by another taxpayer in court, may prove to be incorrect. Taxpayers are shielded from this interpretation risk to a certain extent. Legally binding ATO advice allows the taxpayer to receive the most advantageous treatment where such advice is ultimately found to be incorrect. The ability to receive such treatment, however, is subject to statutory time limits that is where the taxpayer is found to have overpaid, they are limited by the amendment period.²¹¹

3.141 Contestable areas are often where there may be a high degree of uncertainty about the interpretation or application of law in a particular area, or where opposing taxpayer and ATO views are yet to be tested in relation to specific or unusual facts.

3.142 The ATO has drawn upon certain academic research in support of its original Compliance Model as shown above in Figure 3 in Chapter 2. This includes the BISEP factors and the 'pyramidal' relationship between taxpayer attitudes to compliance and the ATO's methods of dealing with non-compliance.²¹²

3.143 It has also been suggested that such a pyramidal representation may not be reflective of the large business market in light of the uncertainties of the tax law which affect them, or 'grey areas'. Taxpayers may be thought to 'play for the grey' in areas of

²⁰⁸ Ibid p 5.

²⁰⁹ Ibid p 25.

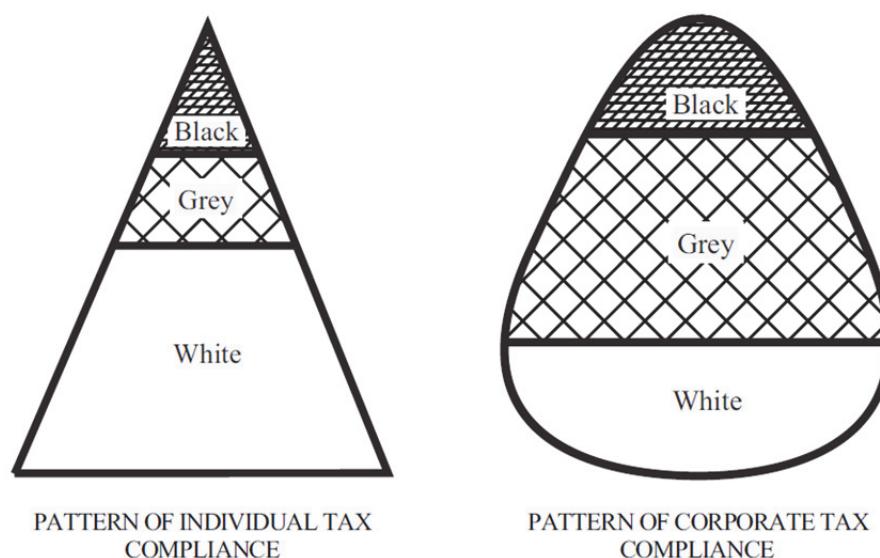
²¹⁰ ATO, above n 189; D'Ascenzo, above n 145; ATO, above n 63, p 25.

²¹¹ Australian Taxation Office, *Taxpayers' charter – helping you to get things right* (2010).

²¹² The ATO's adoption of the Compliance Model is reflected in Australian Taxation Office, *Improving Tax Compliance in the Cash Economy* (1998).

uncertainty.²¹³ This results in a suggested egg-shaped compliance model, rather than a pyramidal one as seen below:

Figure 12: Large taxpayers and uncertain positions



Source: Taxing democracy, Braithwaite, page 180.

3.144 As noted above, the ATO regards the majority of large businesses as compliant, with its concerns focussed on ‘opportunistic tax planning’ and ‘contestable positions’ (the grey area in Figure 12 above). Furthermore, the ATO notes:

Most, but not all, clients generally will comply with the ATO view of the law if it is known to them, or will have a reasonably arguable position that they would dispute with the ATO in an open fashion (going to the umpire) should they disagree.²¹⁴

3.145 The IGT observes that it is important for the ATO to acknowledge that a contestable tax position does not necessarily result in non-compliance. This can be frequently attributed to the complexity of the applicable legislation and the associated uncertainty that can arise from its application to arrangements in this market segment.

3.146 As mentioned in Chapter 2, taxpayers as well as the ATO bear risks. The ATO or the taxpayer may be proven compliant or non-compliant as the case may be when matters are litigated. Often these matters are finely balanced and turn on specific facts.

3.147 Furthermore, higher consequence taxpayers that are public companies have legal corporate governance requirements, directors’ duties and obligations to

²¹³ John Braithwaite, ‘Large Business and the Compliance Model’. In Valerie Braithwaite (ed), *Taxing Democracy: Understanding Tax Avoidance and Evasion* (Ashgate Publishing Ltd, 2003) 177-202, p 179.

²¹⁴ Australian Taxation Office, *Large Business Advisory Group minutes 4 March 2010* (9 July 2010) <<http://ato.gov.au/Business/Consultation: Business/In detail/Large Business Advisory Group/Minutes/Large Business Advisory Group minutes - 4 March 2010/>>; For the avoidance of doubt, the reference to ‘going to the umpire’ should be taken as referring to going to the courts as the umpire for independent judicial interpretation of the law.

shareholders. These obligations and the accompanying civil penalties mean that taxpayers already have a strong incentive to avoid unreasonable tax positions.²¹⁵

3.148 It would be helpful if both ATO internal staff guidance and public guidance acknowledged the complexity and the regulatory landscape to discourage ATO officers from approaching taxpayers with a broader notion of non-compliance when contestable positions are encountered. Such an approach would foster better relationship with taxpayers.

3.149 Currently, the use of the generic term ‘likelihood’ which is applied as ‘likelihood of non-compliance’ in documents such as the LBTC booklet obscures the specific nature of the ATO’s concerns and its ability to effectively communicate them to taxpayers.

3.150 In addition, the references to ‘controversial’ or ‘contentious’ should be replaced with ‘contestable’ which is a more appropriate reflection of the actual risk in the large business market segment context. These former terms may also be considered unhelpful or even pejorative.

RECOMMENDATION 3.2

The IGT recommends that the ATO revise its internal and public documentation to:

- (a) acknowledge that, for the purpose of the RDF, the presence of a number of contestable tax positions does not of itself render a taxpayer as non-compliant; and*
- (b) replace references to ‘controversial’ or ‘contentious’ tax positions with ‘contestable’ tax positions.*

ATO response

Agree and point (b) will be adopted over time as documents are recast.

Taxpayer engagement, transparency and access to information

3.151 Concerns were raised as to what the ATO considered to be ‘engagement’ by taxpayers, and whether perceptions of engagement were influenced by the personal judgements of ATO officers.

3.152 Furthermore, it was contended that a lack of engagement does not necessarily translate into an increased likelihood of non-compliance, and the ATO should not draw that inference.

3.153 Stakeholders raised two main types of concerns relating to the ATO’s perception of taxpayer behaviour:

- those relating to a taxpayer’s level of ‘proactive disclosure’ to the ATO; and

²¹⁵ Hamish Wallace, *Australia*, in *Global Legal Insights Corporate Tax*, First Edition, Global Legal Group, London 2013, page 18 <<http://www.minterellison.com>>.

- the taxpayer's responsiveness to ATO information requests.

Proactive disclosure to the ATO

3.154 In the large business context, stakeholders believed the ATO inappropriately uses factors such as whether the taxpayer asked for private rulings, and the personal auditors views of the taxpayer's 'transparency' in assessing the taxpayer's likelihood of non-compliance.

3.155 Some stakeholders highlighted that a taxpayer may decide not to apply for a private ruling for a variety of reasons and not necessarily be wanting to avoid detection. For example, with respect to time sensitive transactions, a taxpayer may not be able to seek a private ruling because it can be a lengthy process. In this respect, stakeholders may decide to rely on external advice rather than seeking the ATO's view of the issue.

3.156 Alternatively, a taxpayer may not apply for a ruling if they are of the view that the matter is not contestable.

3.157 It was also suggested that simply relying on the number of rulings sought is misleading or is open to manipulation (for example, a taxpayer seeking a large number of fairly straight forward rulings to create an impression of engagement, transparency and compliance).

3.158 In response, senior ATO management have advised that the ATO does not consider mere numbers of private ruling applications as indicative of taxpayer 'transparency'. The ATO considers that the key issue is whether the taxpayer proactively informs them of its significant transactions or perceived contestable positions.

3.159 The template used by compliance teams for risk categorisation considers aspects of proactive taxpayer disclosures in both the 'Compliance history' and 'Real-time compliance' sections of the template. Each of these sections contains a part called 'willing participation' and considers issues such as whether the taxpayer makes private ruling applications for contentious or material issues, and whether the taxpayer provides information outside of the ruling process. The specific questions addressing these factors are described in paragraphs 3.48 to 3.57 above.

Taxpayer responsiveness to ATO information requests

3.160 Stakeholders have also raised specific concerns in relation to the unwillingness of the ATO to exercise its formal information gathering powers (for example those under section 264 of the *Income Tax Assessment Act 1936*) or that the ATO draws negative inferences about the taxpayer where the taxpayer is unable to informally disclose certain information due to contractual, privacy or confidential obligations.

3.161 Other stakeholders raised concerns that the ATO may also draw negative inferences when taxpayers assert their right to LPP. They strongly disagreed 'with the exercise of a fundamental legal right being used as a factor in the risk assessment process.' Similar issues have also been raised with respect to use of the Accountants' Concession and FOI requests.

3.162 The ATO's TAPs for higher consequence taxpayers, though not a direct part of the risk categorisation process, considers past taxpayer behaviour including 'the nature and extent of the taxpayer's use of LPP/accountants' concession claims and the extent we have lifted/challenged the claims' is listed. This item contains the footnote:

The use of LPP or accountants' concession are legitimate avenues available to taxpayers. Concerns only arise where it appears that these processes are being used outside their intent – for example, in an attempt to frustrate our active compliance activities.²¹⁶

3.163 The LBTC booklet also makes reference to the ATO's approach to taxpayer claims of LPP. Broadly, the ATO will recognise a taxpayer's right to claim LPP and expects taxpayers to provide sufficient information to enable the ATO 'properly assess the veracity of their claims'.²¹⁷

Transparency as a risk factor

3.164 The ATO currently considers 'transparency' as a significant likelihood risk factor in the LBTC booklet. It is the main consideration in determining whether a taxpayer is a key taxpayer (Q2) or higher risk taxpayer (Q1) that is a 'lack of transparency' will see an otherwise key taxpayer categorised as higher risk instead.²¹⁸ Furthermore, the following speech highlights the ATO's concerns with taxpayers who it considers are not being transparent and how this would result in increasing costs for both parties:

Unfortunately, it has appeared to us that some taxpayers have been engaged in 'game playing' when responding to information requests. I hasten to add that I've discussed this with many large business taxpayers and their advisors, and also with many of my compliance teams and we are talking about the approach of a minority. However, it has been our observation that game playing during our information requests has dragged out a number of reviews and audits and it must be discouraged.

Of course we prefer to work with you informally when it comes to information gathering, and it is **most efficient** when there is dialogue and a mutual understanding of what information is required to complete the audit in the cheapest way possible. However, we have observed that despite extensive dialogue and cooperation prior to the information request we sometimes have received information marked 'draft', or 'subject to confirmation', or culled due to the auditee's view of its relevance, or claims are made for privilege with no information given as to the basis of the claim.

In such cases we have had to explain that informal approaches are being used in the place of formal powers **for efficiency reasons** and it is not acceptable that the Commissioner be provided with a lesser standard of information than he would be entitled to under formal approaches [emphasis added].²¹⁹

3.165 The ATO acknowledges that where a taxpayer does not proactively provide information (such as in private ruling requests or otherwise) or is generally

²¹⁶ ATO, above n 192, page 10.

²¹⁷ ATO, above n 63, pp 8 and 32.

²¹⁸ Konza, above n 108.

²¹⁹ Konza, above n 140.

unresponsive to ATO information requests, it does not necessarily follow that the taxpayer is likely to be non-compliant.

3.166 However, the ATO is concerned that, where the taxpayer does not proactively make full disclosures and promptly respond to ATO information requests, it would be unable to quickly gather all the facts to form a view as to whether the tax position accords with the ATO view.²²⁰ The LBTC booklet contains a relatively limited articulation of this important transparency issue. It briefly refers to information provision and transparency as factors in assessing likelihood. These factors are described as:

The level of engagement and disclosure around significant transactions you undertake.

The fullness of disclosure and cooperation demonstrated in response to any enquiries.

The level of transparency demonstrated by you in keeping us informed about proposed significant transactions or potentially contentious issues.²²¹

3.167 There is some additional discussion in speeches by ATO officials about the importance of these factors for higher consequence taxpayers but these are relatively limited.

3.168 During this review, the ATO also indicated that, for a given large business taxpayer population, the ATO is initially uncertain as to which taxpayers are adopting contestable tax positions which may need to be scrutinised and challenged. Real-time engagement by the ATO and information disclosure by taxpayers is the primary means by which the ATO is able to assess the presence of these risks.

3.169 For those taxpayers that are 'transparent', the ATO states that it can be more confident that these taxpayers do not have contestable tax positions. For taxpayers that are not as transparent, the uncertainty remains. As the uncertainty about contestable tax positions now applies to a much smaller population, the ATO regards that the likelihood of non-compliance is now higher for these taxpayers (a statistical principle known as 'Bayes' Theorem'). The ATO dedicates resources to reduce this uncertainty with respect to those taxpayers. In summary, the ATO regards the use of transparency as a likelihood factor.²²²

3.170 Whether taxpayers' willingness to proactively make full disclosure or be 'transparent' continues to be a helpful risk factor needs to be examined in the light of the relatively recent use of the reportable tax positions (RTP) schedule which effectively compels higher consequence taxpayers to be transparent. The RTP schedule is explored further in the next section.

²²⁰ Australian Taxation Office, *Large business active compliance manual – income tax* (9 July 2013) <<http://www.ato.gov.au>>.

²²¹ ATO, above n 63, p 25.

²²² ATO communication with IGT, 28 and 29 August 2013.

Reportable tax positions

3.171 For higher consequence taxpayers, the ATO has also mandated a particular information gathering approach called the RTP schedule.

3.172 The ATO has piloted the RTP schedule for some higher consequence taxpayers for the 2011-12 income year.²²³ The schedule requires the taxpayer to disclose three types of reportable tax positions:

- Category A: a position that is about as likely to be correct as incorrect or less likely to be correct than incorrect.
- Category B: a position in respect of which uncertainty about taxes payable or recoverable is recognised and/or disclosed in the taxpayer's financial statements or a related party's financial statements.
- Category C: a reportable transaction or event.²²⁴

3.173 The RTP schedule 'requires large businesses to disclose their most contestable and material tax positions'.²²⁵ Taxpayers do not need to disclose positions outlined in private ruling applications, a company tax return, an RTP early disclosure form, or is subject to an advance pricing arrangement. The ATO will then use the disclosures in the RTP schedule to:

- better understand tax risk for taxpayers, industries and the large market
- further refine our risk differentiation framework categories to enhance the risk-based choices we make to prioritise our work
- improve our dialogue with large businesses about their risk ratings and corporate governance
- help us focus our compliance activities
- identify areas of uncertainty in the tax law that may need:
 - law clarification or legislative improvements
 - further advice and guidance by us.²²⁶

3.174 For the 2012-13 income year, all higher consequence taxpayers will be required to complete an RTP schedule. Taxpayers who have an ACA with the ATO for that year will not be required to complete the schedule.²²⁷

²²³ Australian Taxation Office, *Reportable tax position schedule* (30 August 2012) <<http://www.ato.gov.au>>.

²²⁴ Australian Taxation Office, *Guide to reportable tax positions 2012* (15 June 2012) <<http://www.ato.gov.au>>.

²²⁵ ATO, above n 223.

²²⁶ ATO, above n 223.

²²⁷ Ibid.

IGT observations

Information confidence and cost

3.175 The IGT acknowledges that a taxpayer's approach toward information provision may directly affect the ATO's ability to gather facts and develop a fully informed view on a timely basis. The IGT believes, however, that invoking the 'likelihood of non-compliance' paradigm to frame these information confidence concerns can unnecessarily raise negative or even pejorative connotations. Such connotations may impede the ability for the ATO and taxpayer to cooperatively identify the contestable positions and how they can be addressed.

3.176 The IGT considers that a more refined use of the RDF would assist the ATO to identify and communicate the specific factors causing ATO concerns and select the most appropriate treatment activity. Such treatment activities would primarily consist of:

- reviewing those specific issues causing concern with an intensity commensurate with the level of ATO confidence in the information; and
- differentiating ATO activities based on the following taxpayer behavioural risk factors:
 - a reduced taxpayer ability to identify contestable positions indicating a need to focus ATO activities on improving taxpayer's tax risk management and governance;
 - good tax risk management governance systems but a high number of contestable positions, indicating a need to focus ATO activities on earlier engagement to quickly obtain necessary information to narrow the issues and fast-track resolution processes; or
 - a low level of ATO confidence that the taxpayer provides all information needed in a form that the ATO officers understand, indicating a need to focus ATO activities at improving the quality of the communication channel.

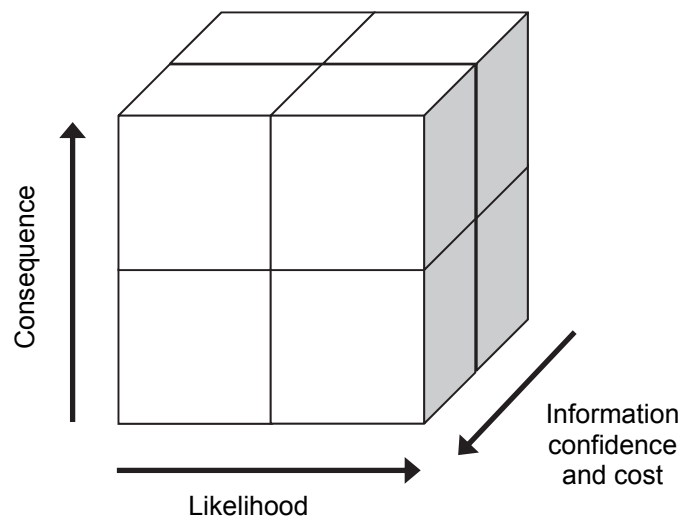
3.177 The IGT acknowledges that, when deciding upon its compliance approach to a taxpayer, the ATO should consider both risk and information confidence and cost. Although useful as a high level pictorial representation, the two dimensional nature of the RDF (likelihood and consequence of non-compliance) means that factors such as information confidence and cost are bundled into the likelihood consideration. Other speeches from the ATO highlight this entanglement.²²⁸

3.178 The IGT believes that, although the ATO seeks to apply Bayes' Theorem to use transparency or information confidence and cost issues as a likelihood factor, it should consider them separately from likelihood risk factors listed in the LBTC booklet and risk template. This would be consistent with ATO's enterprise approach to risk and the ISO approach as set out in Chapter 2.

²²⁸ Konza, above n 108.

3.179 The disentangling of information confidence and cost from risk considerations is depicted in Figure 8 in Chapter 2 and is reproduced below for convenience:

Figure 13: Risk and information confidence and cost



Source: IGT.

3.180 Both the LBTC booklet and risk template should be updated to reflect that information confidence and cost, whilst legitimate considerations in determining the ATO compliance approach, do not necessarily indicate a higher likelihood of non-compliance or contestable tax positions.

3.181 The IGT acknowledges that at this time information confidence and costs concerns can only be effectively articulated for higher consequence taxpayers, since these taxpayers have an ongoing relationship with dedicated ATO compliance teams. However, as stated earlier, whether information confidence and cost remain a legitimate factor in determining the compliance approach for these taxpayers is in doubt given the use of the RTP schedule.

RTP Schedule

3.182 The ATO requirement that all relevant higher consequence taxpayers disclose their 'most contestable and material tax positions' through this schedule appears to run counter to the intent of the RDF to foster taxpayers proactively making disclosures through their day-to-day relationship with the ATO.

3.183 Whilst the ATO has emphasised taxpayer transparency as a key determinant for a taxpayer's RDF categorisation, the schedule represents a movement towards more formal information gathering methods. With the shift to real-time compliance reviews for higher consequence taxpayers (in the PCR²²⁹) and to mandated disclosure of contestable and material tax positions (in the RTP schedule), the relevance of taxpayer 'transparency' or 'information confidence and cost' in terms of the RDF categorisations needs to be reconsidered once the ATO has gained more experience with the use of the RTP schedule.

²²⁹ A more detailed discussion of PCRs is contained later in this chapter.

Willing participation as a risk theme

3.184 The ATO's use of 'willing participation' as a criterion is problematic. While the ATO may use the concept of 'willing participation' in its vision statement and other corporate materials, the IGT questions its use as a theme in an evidence-based template. The reason is that such a term would lead the ATO officer to make a judgement or form an opinion in relation to the taxpayer whereas the template is intended to be a record of facts, evidence and behaviours.

3.185 Furthermore, the use of a subjective and imprecise concept such as 'willing participation' obscures the analysis in relation to information confidence and cost which may adversely impact the ATO/taxpayer relationship. The ATO may be far more effective in influencing taxpayers' approaches to proactive disclosures and/or response to information requests if it simply communicated facts to the taxpayer relating to their action or inaction in the provision of information and how these may result in increased compliance costs on both sides. The use of Figure 13 above is intended to provide an enhanced framework for this communication.

Taxpayer requests for formal exercise of ATO powers

3.186 While the ATO has stated in the LBTC booklet that taxpayers may request the ATO to exercise its formal powers in certain circumstances, some factors support stakeholder concerns that the ATO may be unwilling to exercise its formal powers and perceives taxpayer requests for such exercise as being uncooperative. These include the lack of internal ATO guidance on this matter, especially in the template and TAP. Furthermore, a recent ATO speech appears to set the expectation that taxpayer disclosures during informal approaches should be of the same standard as that the ATO would be entitled to under formal approaches.²³⁰

3.187 Clearly there are exceptions to the expected standard as articulated in the LBTC booklet. Where the ATO insists on using an informal approach, despite taxpayer requests for the formal exercise of powers, then it should accept that taxpayers would redact information subject to contractual or confidentiality obligations as a likely result. Where this occurs, the ATO should not make negative inferences about the taxpayer's 'lack of engagement or transparency'.

3.188 The IGT is of the view that the ATO should better support its stated position in the LBTC booklet by reinforcing these types of exceptions in its internal guidance to ensure ATO officers deal appropriately with taxpayer requests for the exercise of the Commissioner's formal information gathering powers.

Taxpayer exercise of legal rights such as LPP and FOI or use of the Accountants' Concession

3.189 The IGT acknowledges that the ATO must take what formal action it sees fit under the law to consider significant transactions or potentially contestable positions. In such cases, the ATO should seek the necessary information directly from the taxpayer where it is not provided voluntarily. However, the exercise by taxpayers of their legal rights such as LPP or FOI applications, should not, of themselves, lead to perceptions of non-compliance or even a 'lack of transparency or engagement'.

²³⁰ Konza, above n 140.

3.190 The ATO has set an administrative precedent with PS LA 2004/14 which ensures that in certain circumstances where the taxpayer does not provide corporate board documents on tax compliance risk, the ATO will not make an adverse inference about that non-disclosure.²³¹ This is a useful illustration that it is open to taxpayers in the self assessment environment to determine the nature of their relationship with the ATO, including how information is provided, without necessarily invoking the risk paradigm.

3.191 Whilst such acknowledgements of taxpayer 'rights' to maintain the confidentiality of certain board documents are important, it is even more important for the ATO to make at least the same acknowledgement for legal rights such as LPP claims and FOI applications.

3.192 The LBTC booklet does makes some references to how the ATO handles taxpayer claims for LPP and the Accountants' Concession as well as tax risk board documents concession. These references, however, are in the context of compliance activities, rather than how the ATO considers past claims when considering likelihood risk factors for the purpose of the RDF.²³²

3.193 The IGT is of the view that the ATO should clearly articulate when the ATO will or will not consider the taxpayer exercise of legal rights and administrative concessions when assessing the taxpayer's risk categorisation.

²³¹ Australian Taxation Office, *Access to 'corporate board documents on tax compliance risk'*, PS LA 2004/14, 1 July 2006, para [19].

²³² ATO, above n 63, pp 8, 30, 32.

RECOMMENDATION 3.3

The IGT recommends that the ATO:

(a) Consider 'willing participation' or 'transparency' in terms of information confidence and cost and use them alongside, but separate from, the RDF in determining the ATO compliance approach to taxpayers;

(b) The tool for assessing information confidence and cost should consist of objective and specific criteria such as:

(i) Does the taxpayer voluntarily disclose information to the ATO?

(ii) Does the taxpayer respond to informal ATO information requests?

(iii) If no, what were the reasons for this?

(iv) Have you used formal information gathering powers with respect to this taxpayer?

(v) If so, what were the reasons for this? Did the taxpayer outline a specific concern that gave rise to a need for you to exercise such powers?

(vi) How did the taxpayer respond to our formal information gathering requests?

(vii) Did the taxpayer exercise their right to legal professional privilege correctly?

(viii) If not, what was the issue of concern? How was it resolved?

(ix) Did the taxpayer avail themselves of the accountants' or board papers concessions correctly?

(x) If not, what was the issue of concern? How was it resolved?

(c) Update its internal guidance to ATO officers to reflect its stated position in the LBTC booklet in relation to taxpayer requests for exercise of the Commissioner's formal information gathering powers; and

(d) State, in an appropriate publicly available document such as the LBTC booklet, its position with respect to the exercise of such taxpayer legal rights as LPP and FOI as well as use of Accountants' Concession when determining the taxpayer's risk categorisation.

ATO response

Agree

The ATO considers willing participation and transparency pivotal in forming a view as to the likelihood of a risk. We agree to separately consider "information confidence and cost" for higher consequence taxpayers, those where we would be able to form an informed professional judgement on these aspects. We note that for lower consequence taxpayers we would not normally have the information necessary to answer the suggested questions due to the infrequency of interactions.

Effective tax rates

3.194 As noted in paragraph 3.38, the ATO does consider the taxpayer's effective tax rate, or 'tax performance' in the template. However, it is unclear to stakeholders what the basis is for calculating effective tax rates and the weight the ATO attributes to these rates when determining the risk categorisation.

Tax performance focuses on how well the economic performance of the taxpayer translates into tax performance.²³³

3.195 Tax performance is essentially indicated by tax payable, whilst indicators of economic performance are variously indicated by taxable income, net income and gross income. Where the rate is below the statutory rate, there is an emphasis on the ATO understanding the reasons for this.

IGT observations

3.196 A difference in the tax performance and the economic performance of a taxpayer does not automatically point to an inherent risk. The difference between the effective tax rate and the statutory rate may be due to policy design (for example, accelerated depreciation) rather than being attributable to tax planning.²³⁴

3.197 The IGT considers that effective tax rate analysis, whilst not definitive, serves as a useful signpost for ATO enquiries which may assist in identifying specific tax risks. The ATO template does not provide a particular risk hypothesis for this section but asks compliance teams to consider whether they understand the reason for any 'divergence'.

3.198 During discussions with the IGT, stakeholders expressed a desire to better understand how the ATO made its calculations and comparisons.²³⁵ The ATO acknowledged the benefit of making such additional information available to taxpayers. This could include comparisons with others in the industry and a greater degree of granularity about the types of risks that concern the ATO. This information, however, would be limited to ensure the protection of other taxpayers' privacy, and in order not to reveal any risk thresholds (to prevent manipulation).

3.199 The ATO has also undertaken some internal review work on the notification letters. For example, it was observed by some ATO staff that there would be benefit in separating the communication to the board (CEO, CFO) which should focus on relationship management, and the communication to the tax manager, which should focus on greater detail of the risks.²³⁶

²³³ ATO, above n 149, page 10.

²³⁴ Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (OECD Publishing, 2013) p 19.

²³⁵ Australian Taxation Office, Large Business RDF – Report to Large Market Committee 16 February 2012, page 1.

²³⁶ Australian Taxation Office, '2012 – bright ideas for innovation and 'aha' moments' 'Lightbulb moments for RDF'.

RECOMMENDATION 3.4

The IGT recommends that the ATO share with taxpayers greater detail about how the ATO assesses particular risks, including details about how the effective tax rate is calculated.

ATO response

Agree.

Risk ratings based on past behaviour

3.200 Stakeholders have noted that if the ATO always took into account past compliance history, then it may negate more recent positive behaviours of taxpayers. The result may be that, despite the taxpayer significantly improving their tax risk management and governance processes, the ATO may still regard them as higher risk due to past non-compliance. Such delays in changing ATO behaviours may adversely impact on continued taxpayer improvements.

3.201 In this respect, the ATO's template has sections on both 'compliance history' and 'real time compliance'. The compliance history section gives the following guidance:

The compliance history of the taxpayer is an indicator of future compliance performance.

It is also a good indicator of how well the taxpayer engages with ATO systems and services and their approach to compliance. It may also help teams to identify gaps in ATO communication or taxpayer understanding, which then can be actively managed to improve the taxpayer/ATO relationship.

(In some cases, there may have been a change in CEO or tax manager and the taxpayer's current behaviour may not be consistent with their past behaviour. If this is the case, compliance teams can provide this input here.)²³⁷

3.202 The real time compliance section gives the following guidance:

With the move to real-time compliance and PCR's, there is an increasing focus on voluntary compliance and willing participation. This section is for the compliance teams to discuss how willing the taxpayer is to moving towards a real-time compliance approach.²³⁸

IGT observations

3.203 The IGT is of the view that the compliance history of a taxpayer may be relevant in assessing the likelihood of the taxpayer being non-compliant. These considerations largely focus on the taxpayer's compliance with their obligations to correctly register, report, lodge and pay. For example, where the taxpayer is regularly lodging late returns and statements, incorrectly reporting information in these returns

²³⁷ ATO, above n 149, page 23.

²³⁸ Ibid page 26.

and paying debt late, it may be indicative of poor internal controls or an under-resourced tax function that is likely to see such non-compliance continue.

3.204 This criterion is subject to a number of considerations in the large business market. For example, aspects of compliance history may be immaterial or the underlying cause of non-compliance may have been addressed. Such factors have the potential to make analyses of past compliance behaviour an unreliable indicator of future compliance particularly where taxpayers have resolved legacy issues, improved their tax governance and are seeking a better relationship with the ATO.

The role of taxation advisors

3.205 The ATO has previously indicated that it may consider the taxpayer's association with a particular intermediary when determining the taxpayer's risk categorisation. For example, at the National Tax Liaison Group (NTLG), the ATO has noted:

The ATO has signalled on a number of occasions that the use of advisors who have a history of association with controversial or contestable tax planning arrangements will be a consideration in determining the overall risk rating of taxpayers.²³⁹

3.206 Furthermore, the LBTC booklet, under the heading 'Checklist of what will attract our attention' contains the following:

History of aggressive tax planning by the corporation, group, board members, key executives or advisers.²⁴⁰

3.207 During the IGT's Self Assessment Review, stakeholders raised particular concerns in relation to the ATO's risk approaches to tax advisors:

Many submissions from tax professionals expressed concern with the ATO's recent approach to assessing tax advisors' risk of non-compliance and their competence. Unlike an adverse risk rating given to a taxpayer (which may result in an increased likelihood of administrative scrutiny), an adverse risk rating for advisors may result in that advisor becoming unemployable.

It seems that, in certain circumstances, the 'aggressiveness' of an advisor is considered significant in determining the taxpayer's risk rating. In this respect, the ATO considers that if tax advisors are supportive of the system and engaged with the ATO, all things being equal, this would lower the ATO's perception of the underlying risk that their clients (taxpayers) pose to the system.

... Stakeholders, however, have outlined situations where ATO views on advisors were not necessarily based on objective evidence. In addition, they note that where the perception is incorrect, there is no recourse but to contest this. Moreover, where the

²³⁹ Australian Taxation Office, *NTLG minutes September 2011* (9 December 2011) <<http://www.ato.gov.au>>.

²⁴⁰ ATO, above n 63, p 9.

ATO's perception is communicated to taxpayers there is a negative impact on the business of the advisor or their employability.²⁴¹

3.208 Stakeholders have argued that the ATO should be more concerned with the merits and correctness of the position being adopted. These tax positions, although potentially contestable, may ultimately prove to be correct.

3.209 It has also been suggested that any concerns about specific advisors are already dealt with in various statutory or professional standards governed by regulatory or professional boards. Further, advisors may be sued by their own clients for not fearlessly and frankly advising their clients of the optimal position to adopt under the tax laws.

3.210 The ATO's template considers certain questions in relation to the taxpayer's use of external advisors. These are described above in paragraph 3.48. However, there is little additional guidance provided as to how this information should be considered in formulating the risk categorisation.

3.211 Despite the questions in the template, during the course of this review, the ATO has advised the IGT that, with respect to higher consequence taxpayers, the ATO does not consider the taxpayer's engagement of particular tax advisors as determinative of the taxpayer's risk categorisation. Rather, it is focused on the actual transactions that the taxpayer undertakes as a result of that engagement.²⁴²

3.212 Further, if the taxpayer adopts a contestable tax position as a result of that engagement, the ATO would still rate them as a key taxpayer (rather than a higher risk taxpayer) where the taxpayer was forthcoming with material information about the transaction. The ATO's concerns about the transaction (rather than the advisor) would be reflected in the RDF letter to the taxpayer.²⁴³

3.213 The ATO has also indicated that difficulties in the relationship with the taxpayer cannot necessarily be attributed to any particular personnel within the organisation. The ATO would only include in the RDF letter examples of taxpayer behaviour that were causing concern. For example, the ATO would state the time taken for the taxpayer to respond to information requests, rather than naming any particular person or imputing any motive for the delay.²⁴⁴ The ATO considers that since personnel themselves are not risk factors, the ATO focuses on the taxpayer's governance and tax risk management structures.

3.214 Beyond the template and the above advice provided by the ATO, there is minimal public guidance available indicating the ATO's approach in this area.

3.215 The ATO has also advised that where it is apparent that a taxpayer had undertaken a particular contestable position as a result of a tax advisor promoting the scheme, it may investigate other clients of the tax advisor, with a view to administering

²⁴¹ IGT, above n 5, paras [3.94] – [3.95] and [3.97].

²⁴² ATO meeting with IGT, 17 April 2013.

²⁴³ Ibid.

²⁴⁴ Ibid.

the promoter penalty legislation.²⁴⁵ Such administration, however, is within the purview of the ATO's Aggressive Tax Planning business line rather than LB&I.

IGT observations

3.216 The IGT has already explored the arguments for and against applying the RDF to tax advisors or practitioners in his Self Assessment Review.

3.217 Unlike assessing tax liability, ATO risk assessments of advisors and the like are not generally considered to be 'reviewable' through any forum such as the Administrative Appeals Tribunal. As such, in the review mentioned above, the IGT asserted that if the ATO were to persist in applying the RDF to tax advisors, the latter must have a right of review.

3.218 In response to recommendations in that review, the ATO has stated that it does not disclose the tax advisor's risk categorisation to their clients. Therefore taxpayers are unaware of the risk rating of advisors and it follows their choice of advisor may therefore not reflect the taxpayers' risk appetite.

3.219 The IGT is of the view that the ATO should not use the choice of tax advisor as a factor in determining the taxpayer's risk rating. The focus should be on objective criteria to determine actual tax risks rather than using an unreliable shortcut of identifying individual advisors. This is especially so since taxpayers may use a range of different advisors for different tax matters.²⁴⁶

3.220 Although the ATO approach as described in paragraphs 3.211 to 3.215 above accords with this IGT view, such an approach is not reflected in current ATO guidance material.

3.221 The IGT is of the view that the ATO may reduce concerns by ensuring ATO expectations are made clear in staff guidance, such as in the template as well as public guidance, such as in the LBTC booklet regarding the role of tax advisors in the taxpayer risk assessment process. Including examples of the ATO's approach in this area will provide further clarity on the matter.

RECOMMENDATION 3.5

The IGT recommends that the ATO update its internal and public documentation to make it clear that use of particular tax advisors is not a factor in determining a taxpayer's risk categorisation.

ATO response

Agree.

We will improve existing documentation for both staff and the public about when we will follow up on tax arrangements that we view as contentious and associated with certain Advisors.

²⁴⁵ See Chapter 7 for more information about the promoter penalty legislation.

²⁴⁶ ATO, above n 239.

3.222 Further consideration of the ATO's risk assessment approaches in relation to tax practitioners is discussed in Chapter 7.

ATO considerations of taxpayer governance

3.223 Stakeholders have generally supported the increased ATO focus on taxpayer governance processes, acknowledging that it enhances the ATO's risk-based approach. Some concerns have been expressed, however, about the capability of ATO officers to make judgements about the adequacy of the taxpayer's tax risk management and governance processes. For example, one submission indicated that the ATO was unsure if the taxpayer had an audit committee, despite the fact that the taxpayer was a publicly listed company with pertinent information being available in its annual report and accessible via the internet.

3.224 Furthermore, stakeholders have raised concerns that how a tax manager deals with his or her own personal tax obligations has a bearing on the risk rating of the taxpayer for whom they work. The following difficulties with the current ATO approach have been highlighted:

- employees should not be compelled to disclose their personal tax affairs to their employer;
- the ATO itself is better placed to know and deal with the personal tax obligations of tax management staff; and
- the personal tax performance of tax staff has limited correlation to their ability to carry out the corporate tax function.

3.225 As noted above, the ATO's template specifically considers the 'taxpayer's tax risk management and governance process'. Furthermore, the LBTC booklet contains specific expectations regarding a taxpayer's tax risk management arrangements at both the strategic and operational levels. Under the operational level checklist, the ATO asks taxpayers to ensure:

- you obtain appropriate assurances that personal tax obligations are up-to-date for individuals in key tax management roles.²⁴⁷

3.226 Such a requirement, however, is not included in the ATO's template.

3.227 Senior ATO management have indicated that the ATO's interest in a taxpayer's tax risk management and governance stems from two risk hypotheses:

- a taxpayer may have inadequate tax risk management and governance and may be inadvertently adopting potentially contentious tax positions, or even obviously non-compliant ones, without being aware of it and therefore exposing themselves to possible compliance action due to poor tax risk management control systems; or

²⁴⁷ ATO, above n 63, p 13.

- a taxpayer may have good tax risk management and governance, but the taxpayer has knowingly adopted a contestable tax position as a result of management's willingness to accept higher levels of tax risk.²⁴⁸

IGT observations

3.228 The IGT believes that it is appropriate for the ATO to consider the tax risk management and corporate governance arrangements of the taxpayer. It is important to adopt methods which seek to minimise the overall costs of taxpayer compliance and administrator costs by focusing more on the systems and structures that govern the decision-making and operations.

3.229 The ATO has elevated the importance of a taxpayer's corporate governance in many publications, such as the LBTC booklet. Furthermore, the ATO has made 'sound tax risk-management processes' as a one of the pre-requisites for entering into an ACA.²⁴⁹

3.230 Large businesses are generally aware of and compliant with their regulatory responsibilities and obligations including taxation. Accordingly, they appreciate that they have to bear a baseline level of compliance costs. Unnecessary compliance costs, however, are a burden that imposes a dead weight cost on them and the economy.²⁵⁰ This market, along with other commercial markets, understandably seeks to minimise such costs.

3.231 Therefore, the ATO should ensure that its expectations of corporate governance and tax risk management are as closely aligned as practicable with the general corporate governance standards which are expected of corporate taxpayers. Any prescription or divergence over and above general corporate governance standards has the potential to reduce flexibility of the system²⁵¹ and unduly increase compliance costs.

3.232 Furthermore, the examination of tax risk management and corporate governance requires specific skills and experience. It is important, therefore, that ATO compliance staff tasked with the examination and assessment of a taxpayer's corporate governance are adequately skilled to undertake such a task and that such an assessment is subjected to an appropriate internal assurance process.

3.233 The IGT is also of the view that it is not appropriate for the ATO to effectively impose an obligation on taxpayers to monitor their employees' personal tax affairs. Taxpayers have little control over how their employees manage their own tax affairs and the ATO is in better position to know if particular taxpayers are complying with their personal tax obligations.

²⁴⁸ ATO email to IGT 4 June 2013.

²⁴⁹ Australian Taxation Office, *Annual compliance arrangements – what you need to know* (7 June 2013) <<http://www.ato.gov.au>>.

²⁵⁰ IGT, above n 122, para [3.17].

²⁵¹ KPMG, *Tax in the boardroom* (2005).

RECOMMENDATION 3.6

The IGT recommends the ATO:

- (a) ensure that its LB&I compliance staff are appropriately skilled to examine and assess the adequacy of a taxpayer's corporate governance and tax risk management arrangements and that such assessments are the subject of an appropriate internal assurance process; and*
- (b) remove tax manager personal tax obligations as a consideration when assessing the taxpayer's tax risk management and corporate governance.*

ATO response

Agree.

In relation to (a), capability building is an ongoing aspect of maintaining and developing a professional workforce and we invest significantly in our learning and development programs. Our acquisition and or use of external experts also contribute to these developmental programs. Through implementation the ATO will consult with the IGT and others in relation to the specific elements of assessing tax corporate governance and tax risk management which require greater focus.

General IGT observations about inputs

3.234 Further to concerns raised by submissions in relation to the adequacy and relevance of inputs, some general observations can be made on the ATO's use of these inputs, the risk filters, risk managers and risk owners. These are each discussed in turn below.

Distinguishing between different ATO risk factors

3.235 The ATO uses a variety of risk factors in its risk categorisation process. Each of these risk factors may be indicative of specific concerns. The way in which the ATO resolves these concerns will depend on the nature of these risk factors. Better distinguishing between these factors may ensure that the ATO adopts the most suitable approach.

3.236 The IGT considers that the 'likelihood factors' in the ATO template cover three main areas:

- inherent risk factors;
- behavioural risk factors; and
- information confidence and cost.

3.237 Inherent risk factors are those economic or business factors or transactions which, by their very nature, increase the likelihood of a taxpayer adopting a position with which the ATO may disagree (a contestable position). Taxpayers are essentially unable to eliminate these risks since they are a feature of the business they are in. For

example, a taxpayer may technically be able to minimise the risks associated with cross-border transactions by ceasing them altogether, but this is unrealistic.

3.238 Behavioural risk factors are those aspects of a taxpayer's behaviour, such as a taxpayer's tax risk management and governance and appetite for risk, which either serve to mitigate or exacerbate a taxpayer's inherent risk. Taxpayers are more likely to have greater discretion over these risk factors and may minimise behavioural risk factors by adopting certain behaviours or approaches. This may include actions such as increasing resourcing to its tax management function, improving tax information systems or ensuring tax risk management policies are board-approved.

3.239 Information confidence and cost factors have already been addressed in the preceding sections.

Inherent and behavioural risks

3.240 The distinction between inherent risk factors and behavioural risk factors is usefully described in Her Majesty's Revenue and Customs' (HMRC) Tax Compliance Risk Management Manual. The manual firstly considers seven factors:

Complexity — The potential risk in the size, scope and depth of business or tax interests.

Boundary — The level of complexity of international structures, financing and connected party issues.

Change — The degree and pace of change with tax implications affecting the business.

Governance — The customer's openness and co-operation with HMRC and the management accountabilities for managing tax risk.

Delivery — The customer's ability to deliver the right tax through systems, processes and skills.

Tax Strategy — the customer's involvement in tax planning which does not support genuine commercial activity.

Contribution — whether the amount of tax declared/claimed looks reasonable in the light of what we know about the customer and/or sector.²⁵²

3.241 The manual then describes the relationship between these factors:

The first three factors (Complexity, Boundary and Change) are 'inherent' factors i.e. in themselves they create risks while the second three factors (Governance, Tax Strategy and Delivery) are the behaviours through which these inherent risks might be managed. A customer may have inherent factors that potentially create major tax compliance risk, but they can still be Low Risk if they effectively manage these inherent risks through their behaviours. This is not purely theoretical. There are already a number of highly complex Large Business customers who we have identified as Low Risk.

²⁵² HM Revenue & Customs, TCRM3310 - *The Business Risk Review (BRR): Business Risk Review indicators: General* (undated) <<http://www.hmrc.gov.uk>>.

The 'contribution' factor is a reality check before agreeing the overall risk status. In other words, if all other indicators suggest a customer is Low Risk but the customer's tax/duty contribution is lower than expected, we would want to know the reason for this before agreeing Low Risk status overall.²⁵³

3.242 The ATO's template considers similar, but not identical, risk factors to those in the HMRC manual. For example, the ATO template considers the taxpayer's organisational structure which is analogous to the 'complexity' factor in the HMRC manual. Similarly, the ATO's consideration of tax risk management and governance corresponds to some aspects of the 'governance' factor in the HMRC manual.

3.243 Unlike the HMRC manual, however, the ATO template does not explicitly make a distinction between risk factors that are 'inherent' and those that are 'behavioural'. This demonstrates that risk-based approaches can differ as between revenue authorities. As highlighted in Chapter 2, risk management continues to be an evolving discipline in this area.

3.244 The IGT believes that consideration of specific 'tax risks' and 'organisational structure' are largely 'inherent risk factors'. The IGT notes that not all inherent risk factors in the template have a risk hypothesis associated with them. It is the IGT's view that all inherent risk factors should indicate the risk hypothesis that it is purported to test. Such hypotheses may assist in guiding further specific ATO inquiries.

3.245 Identifying inherent risk factors and addressing them through risk hypotheses should assist in framing the ATO's concerns to the taxpayer. For example, where the ATO has concerns regarding inherent risk factors, such as the taxpayer undertaking transactions in a complex area of law, the nature of the dialogue between the ATO and taxpayer can focus on the technical merits of the taxpayer position and the relative 'interpretation risk' associated with each parties' positions.

3.246 'Behavioural risk factors', on the other hand are covered more by the tax risk management and governance section of the template. Where the taxpayer has good tax risk management and governance in place, there may be minimal behavioural risks but there may be inherent risks at play, for example specific transaction(s) of the taxpayer that cause concern for the ATO.

3.247 By specifically addressing the two different types of risk factors noted above, the ATO is better able to present those behavioural risks that taxpayers can address directly such as improving tax risk management and governance and the inherent risk factors which the taxpayer has little ability to change but may be able to monitor or mitigate.

3.248 Accordingly, the ATO should make a clearer distinction between inherent risk factors and behavioural risk factors in the template and other ATO guidance material. This distinction should flow through to subsequent communication to the taxpayer, thereby enabling the ATO to clearly articulate the prima facie risks and to identify potential risk mitigation strategies or information that may assist in reducing those risks.

²⁵³ Ibid.

3.249 The IGT also notes that a similar distinction is also adopted by other regulators, with the Australian Prudential Regulation Authority separately considering ‘inherent risk’ and ‘management and control’ when calculating ‘net risk’.²⁵⁴

RECOMMENDATION 3.7

The IGT recommends that the ATO update its LB&I RDF categorisation template along with internal and external communications to be consistent with the following principles:

- (a) higher consequence taxpayers will always be subject to a form of direct ATO engagement regardless of likelihood factors and the nature, extent and timing of this engagement is influenced by likelihood factors;*
- (b) likelihood factors consist of inherent and behavioural factors and should be addressed separately;*
- (c) inherent factors require the testing of particular hypotheses;*
- (d) behavioural factors require the testing of the taxpayer's tax risk management and governance processes; and*
- (e) the intensity and formality of the review depends on the taxpayer approach to provision of information as well as inherent and behavioural factors.*

ATO response

Agree

The ATO agrees with the proposed recommendation for the management of higher consequence taxpayers, where the behavioural and inherent factors noted by the IGT should be known to the ATO due to the nature of the relationship model we have with higher consequence taxpayers. For lower consequence taxpayers the information needed to form an informed professional judgement on many of the behavioural factors will generally not be known at the time of case selection due to the infrequency of interaction.

Risk filters, risk managers and risk owners

3.250 Whilst risk filters are applied to all large business taxpayer returns, higher consequence taxpayers also use qualitative input from the risk categorisation template. Risk assessment for lower consequence taxpayers are mainly reliant on the risk-filtering system to generate avenues of enquiry or concern which may eventuate into risk reviews for taxpayers.

3.251 In relatively recent ATO documentation considered by the IGT, it appears that the risk filters or the related processes are acknowledged to be less effective at identifying case work:

²⁵⁴ Australian Prudential Regulation Authority, *Probability and Impact Rating System* (June 2012) <<http://www.apra.gov.au>>.

It appears that the risk filters, and/or the process, is only identifying a small number of new taxpayers for potential risk reviews.²⁵⁵

3.252 The ATO documents also highlight the significant effort risk managers are expending to filter out potential cases for risk review. The risk filters are producing considerable numbers of 'false positives', which require further risk manager intervention to reassess cases either on the basis of materiality, data mismatches, or risk hypotheses which have already been addressed by previous compliance activity for that taxpayer.²⁵⁶

3.253 The ATO documents also noted that the ability to detect some risks was limited due to the nature of the income tax return labels. It envisages improved risk detection with the introduction of the new international dealings schedule (IDS).²⁵⁷

3.254 Furthermore, ATO documents indicate the need for better interaction between the risk managers (who identify the risk and recommend the cases) and the compliance teams (who conduct risk reviews to confirm the existence of the risk). For example:

- compliance teams need to consult risk managers when closing a case as an early exit (that is, the compliance teams consider no risk exists before the case commences);²⁵⁸ and
- risk managers could better collaborate with compliance teams in the conduct of cases by helping them to 'ask the right question' of the taxpayer but are subject to resource constraints.²⁵⁹

3.255 The IGT considers that the false positives generated by the risk filters could be attributed to a number of factors:

- risk filters themselves do not accurately discriminate between 'compliant' and 'non-compliant' taxpayers;
- taxpayers in this market segment have increased their general level of compliance, such that any chance of selecting a 'non-compliant' taxpayer has diminished significantly; and
- taxpayers are aware of how risk filters work and ensure they correctly report in those areas subject to the risk filters.

3.256 Considering the importance of the risk filters in identifying potential risks for lower consequence taxpayers and the opportunity costs associated with risk managers regularly reassessing the output of risk filters, the ATO should consider improvements to the risk identification and management systems including the role of risk managers and their relationship with compliance teams.

²⁵⁵ ATO, above n 180, p 25.

²⁵⁶ Ibid.

²⁵⁷ Australian Taxation Office, Case Selection Sub-Committee Workshop Minutes, June 2012, p 4.

²⁵⁸ Australian Taxation Office, Case Selection Sub-Committee Workshop Documents, 15 June 2012, p 12.

²⁵⁹ ATO, above n 180, p 8.

3.257 Furthermore, since risk managers are responsible for developing risk filters, risk hypotheses and risk recommendations, they are an important source of information in better designing compliance activity in the lower consequence market. The ATO should ensure these risk managers are adequately skilled and supported to carry out their role. There should also be, on an ongoing basis, a mutual obligation of risk officers to engage with the compliance teams to better identify potential risks or required information access improvements.

3.258 During the course of the IGT review, the ATO commenced an ‘LB&I improvement program’, which amongst other things, seeks to address the above concerns to some extent. For example, efforts are being made to ensure that:

- risk managers are given meaningful feedback from the compliance teams to refine their risk identification process; and
- compliance teams ‘understand the genesis of their work and apply the correct risk lens when undertaking their work’.²⁶⁰

RECOMMENDATION 3.8

The IGT recommends that the ATO continue to improve the LB&I risk identification process including:

- (a) better identifying potential risk hypotheses through closer working relationships between risk managers and operations teams on an ongoing basis;*
- (b) capture better input data through the income tax return and its associated schedules; and*
- (c) refine or remove inappropriate risk filters.*

ATO response

Agree.

STAKEHOLDER CONCERN — FORMAL NOTIFICATION OF RISK CATEGORISATION

RDF notification letter

3.259 A significant concern arising from the large business market segment were the RDF notification letters sent by the ATO to the CEOs of higher consequence taxpayers and the due process underpinning them. It is important to note the dynamic in relation to large business taxpayers. These taxpayers often have appointed tax managers, some who work solely on tax, or as part of a broader suite of responsibilities.

3.260 Despite the ATO’s stated intention that the RDF notification letter is not a ‘report card on performance’²⁶¹, tax managers representing higher consequence taxpayers have indicated that the letter, including the tone of the letter and the manner

²⁶⁰ Australian Taxation Office, LB&I Business Improvement Program, 19 June 2013, internal document.

²⁶¹ ATO, above n 63, p 25.

in which it is sent, may give the appearance of a de-facto ATO report on their view of the tax manager's performance to the CEO.

3.261 Of particular concern is the fact that tax managers feel they have little involvement in checking the accuracy of the ATO's notification letter. The letter has implications for the tax managers personally as well as the taxpayer organisation as it is sent directly to the CEO. However, tax managers feel it was incumbent on the ATO to ensure that they are adequately consulted about the contents of the letter. They believe that errors and inaccuracies served to undermine the credibility of the ATO as well when the letters are poorly considered. Once the letter goes to the board, tax managers have little right of redress, despite their willingness to provide information to address concerns raised in the letters.

3.262 Furthermore, it was observed by stakeholders that although the risk rating process took into account both quantitative and qualitative information, it appears that more weight was given to, and subsequent discussions centred upon, the qualitative aspects. It was perceived that much of this qualitative information was created by the audit teams directly. The implication being that a taxpayer's attempt to challenge the qualitative information is effectively challenging the audit team. This may create conflict where either the qualitative information is not independently reviewed or is selectively ignored by audit staff.

3.263 Stakeholders also highlighted the need for the ATO to provide more information, in addition to the letter, about the reasons for specific risks or concerns. The benefits of taking such an approach are that the taxpayer may better understand the nature of the concerns in addressing these.

3.264 Certain stakeholders have also raised delays in issuing these letters, with some taxpayers indicating that they have not received them at all despite ATO senior management's intentions.

3.265 An ATO internal audit also analysed a sample of RDF notification letters to determine the average duration between the moderation panel process and the issuance of the RDF letters. The sample identified an average of 188 days, indicating that delays in issuing the letters would reduce their impact as a taxpayer engagement tool. The internal audit anticipated that such delays would improve as a result of shifting the letter notification process from a project to a business-as-usual process. It also recommended reviewing the internal letter approval process to remove non-essential steps and aligning it with 'other natural events during client engagement'.²⁶²

IGT observations

3.266 As a consequence of the IGT's LB&I Review²⁶³, there have been some improvements to the structure, content and manner of the delivery of the notification letter. There is, however, further room for improvement given the level of stakeholder concern raised in this current review.

²⁶² ATO Internal Audit Communications Update 14/05/2013 page 7.

²⁶³ IGT, above n 122, paras [4.35]-[4.36].

3.267 The ATO's position is that the RDF notification letter provides an 'initial stance', or opinion of the taxpayer.²⁶⁴ A senior executive contact officer is available to discuss the categorisation. Furthermore, the ATO has advised that compliance officers should be discussing the risk factors with tax managers before the notification letter is sent to the taxpayer such that there should be 'no surprises' in the letter.²⁶⁵

3.268 Notwithstanding this ATO 'initial stance' approach, the IGT considers that there are a number of factors that undermine this characterisation, giving the RDF letters a sense of finality.

3.269 First, the risk categorisation process, which includes the moderation panel, indicates that significant ATO resources are used to determine the risk categorisation as well as aspects of the notification letter's potential tone and content.

3.270 Second, the ATO undertakes an internal forty-step process in drafting the RDF notification letter, indicating significant ATO resources are used to produce the letter itself. However, concerns were expressed that taxpayers are not consulted during either of these two stages of deliberation.

3.271 Third, the ATO's expectation that compliance officers discuss with tax managers the impending notification letter appears to be a general one. Accordingly, it is understandable that taxpayers and tax managers may feel surprised by its content.

3.272 Fourth, sending the letter to the board members (such as the CEO) of higher consequence taxpayers elevates the importance of the letter well beyond that of 'initial stance' and this is essentially by design:

Our advice has focused the attention of senior executives and Boards on tax matters and has heightened interest in the ATO's view of their relative tax risk. Taxpayers identified as 'higher risk' are talking to us about things they can do differently and 'key' taxpayers want to know how they can maintain their ratings.²⁶⁶

3.273 Fifth, tax managers have indicated that they had little opportunity to have the letter or categorisation revisited before they are sent to the CEO or the board. Some reported that the notification letter was sent to the tax manager as a courtesy, shortly before being sent to the board, and that the tax managers had insufficient opportunity to address their concerns or correct factual errors in the letter.

3.274 The IGT considers that the current features of the notification process suggest that the letter is effectively a form of administrator's opinion of the taxpayer which goes beyond an 'initial stance'.

3.275 In the IGT's view, some changes to the ATO approach would engender greater mutual transparency and assist taxpayers to better understand the reasons for the ATO's concerns. A more effective consultation process would provide a better basis to identify risks and develop appropriate compliance action. Affording due process to

²⁶⁴ Quigley, above n 88.

²⁶⁵ ATO, above n 186.

²⁶⁶ Quigley, above n 88.

tax managers may be better achieved by greater consultation before the issuance of the RDF notification letter, rather than after it.

3.276 Firstly, the IGT believes that the completion of the template should be a point at which the ATO compliance team develops and sends a risk report to the taxpayer. Such a risk report would be the template itself or one that effectively mirrors the contents of the template. The risk report should share the ATO concerns with respect to inherent risks, behavioural risks and information confidence and cost. The report would include the evidentiary basis for these risks including relevant risk filter output.

3.277 Second, the tax manager should be given an opportunity to correct any factual errors within the report and to discuss the ATO's concerns. During this dialogue, the ATO should explain how the risks relate to any potential ATO compliance activity. Even where there is disagreement about a particular risk issue, there should be sufficient engagement to enable the taxpayer to fully understand the ATO's opinion and the reasons and evidence for it.

3.278 Third, once the ATO and tax manager have reached a shared understanding of the evidentiary basis for the risk assessment and its implications, the risk categorisation is subject to the moderation panel process.

3.279 Fourth, the ATO may undertake an internal development process to author and send the RDF notification letter to the CEO. Such a letter would be the product of thorough taxpayer consultation, rather than a purported initial stance.

3.280 This proposed process offers the following advantages:

- tax managers are given adequate notice about the ATO's concerns and provides an opportunity to address them in real-time;
- the ATO can take into account tax managers' concerns before finalising and communicating the risk categorisation;
- it removes potential errors from the template;
- it provides early agreement on facts and narrows the scope of potential disagreement;
- improved relationships through open dialogue;
- distinguishing between ATO perceptions of inherent risk factors and behavioural risk factors of the taxpayer avoiding unnecessary perceptions of a lack of professionalism or competence of the tax manager or indeed of the ATO itself;
- it builds on the ATO's expectation that compliance teams communicate with tax managers in the lead up to the RDF categorisation process to ensure 'no surprises'; and
- it addresses timeliness concerns, since the ATO has engaged the taxpayer throughout the process, before the letter has been issued.

3.281 This consultative approach could also take into account the various communications and activities that the ATO already undertakes. For example, the letter could:

- align the ATO's specific taxpayer compliance concerns with those expressed in the ATO's *Compliance in focus 2013-14* publication;
- reflect any recent activity from current or concluded PCRs or ACAs; and
- align with any protocols, frameworks or communication that were generated as part of implementing the TAP.

3.282 A transparent risk assessment system would enable the ATO to communicate its concern at an early stage and allow the taxpayer to understand the risk hypotheses more readily. Unnecessary or unduly onerous escalation by the ATO to CEOs or boards may be seen as an inefficient use of resources.

3.283 If the taxpayer and ATO together are able to address concerns collaboratively, then the IGT considers this to be a desirable outcome of the process.

3.284 The increased level of interaction between higher consequence taxpayer and the ATO is conducive to the above approach. In relation to lower consequence taxpayers, it may not be possible to strictly follow such an approach because of the less intensive level of ATO/taxpayer engagement. However, the underlying principles remain the same in both scenarios and should be observed.

RECOMMENDATION 3.9

The IGT recommends that the ATO improve the RDF notification letter process for higher consequence taxpayers by:

- (1) providing tax managers with a draft risk report;*
- (2) having a dialogue with tax managers to address any factual errors and discuss the ATO's concerns;*
- (3) having the risk report subject to a moderation process after this dialogue;*
- (4) preparing the RDF notification letter by:*
 - (a) taking into account previous dialogue with the tax manager;*
 - (b) reflecting any recent ATO compliance activity, such as current or concluded PCRs or ACAs;*
 - (c) aligning it with any protocols or frameworks generated as part of implementing the TAP; and*
 - (d) including a roadmap for expected or likely ATO compliance requirements regarding specific concerns; and*
- (5) upon finalising, sending the RDF notification letter to the CEO.*

ATO response

Agree.

The ATO's large business RDF approach continues to evolve and we continue to consult with business each year with a view to enhancing the RDF process.

STAKEHOLDER CONCERN — PROPORTIONALITY OF ATO COMPLIANCE APPROACH

Stakeholder concerns

3.285 Stakeholders have raised concerns that, despite their lower risk categorisation, they have experienced ATO compliance activities whose intensity and frequency were more commensurate with higher risk taxpayers. Several stakeholders observed that, although they were categorised as a key taxpayer (Q2), they appeared to be treated as if they were a higher risk taxpayer (Q1).

3.286 A similar sentiment was expressed in relation to a taxpayer who had been given a medium risk (Q3) rating. Another view expressed by a professional advisor was that Q1 taxpayers appeared to receive consistent treatment, but Q2 clients appeared to receive inconsistent treatment as between themselves.

3.287 Certain professional advisors observed that, in their opinion, the ATO did indeed treat Q1 and Q2 taxpayers differently in an overall sense. However, there were situations where the level of compliance intensity appeared to be inconsistent with that suggested by the original framework. There seemed to be changes in the ATO's approach from the original model that were not communicated. Some argued that the ATO needs to explicitly sub-divide the key taxpayer quadrant (Q2) to allow for a meaningful differentiation in that segment and communicate this properly to reflect what the ATO actually do in practice.

3.288 Additional concerns include that the ATO has been moving some taxpayers from higher risk (Q1) to key taxpayer (Q2) as a means of allaying those taxpayers' concerns, but are in fact still treating some of these taxpayers as higher risk taxpayers.

3.289 The overarching concern for stakeholders appears to be that, if the taxpayer did not perceive that a lower risk rating would result in a less intense ATO activity (and hence lower overall taxpayer compliance costs), the purported incentives that the ATO were offering in relation to the taxpayer were at best illusory and at worst misleading.

3.290 The extent to which the taxpayer's risk categorisation is seen to follow the ATO's stated intentions regarding a specific compliance approach is vital in creating incentives for taxpayers and for them to make informed choices.

3.291 Stakeholders have also observed that risk reviews and audits are two distinctly different compliance activities, requiring different skill sets from ATO officers. Concerns were expressed that compliance staff often took an 'audit approach' when undertaking risk reviews. By way of example they would seek to vouch for transactions or facts, rather than taking a risk-based approach and asking the right questions. The result being that risk reviews continued longer than required and with an intensity that went beyond that of a risk-based approach, which was more akin to an audit.

3.292 Stakeholders have also perceived that the ATO does not use a 'funnelling' approach to information gathering, but rather adopts a 'gather all evidence' approach early in the risk review process, driving up compliance costs. The suggestion is that the gathering of all evidence upfront is inconsistent with a risk-based approach and is not a proportionate compliance approach.

3.293 It is useful to consider the relevant ATO material against the above stakeholder concerns.

3.294 The ATO has indicated that the LBTC booklet and the LBAC manual are the main guidance materials when determining what compliance approach to take. In particular, the LBTC booklet states:

For income tax, we support the real-time compliance approach applied to higher consequence taxpayers through the use of a pre-lodgment compliance review.²⁶⁷

²⁶⁷ ATO, above n 63, p 29.

3.295 With respect to higher consequence taxpayers, the LBAC manual states:

Because of their importance in the system the ATO manages tax risks for higher consequence taxpayers (those we have categorised as key taxpayer or higher risk) using real-time tailored approaches. We encourage key taxpayers to enter into an ACA as a way of providing real-time, practical certainty and of reducing disputes and compliance costs.

For those higher consequence taxpayers not in an ACA, the ATO uses PCRs [pre-lodgement compliance reviews] and risk filtering to detect what risks may exist and if any of these require further treatment such as encouraging a ruling or progressing to an audit.

For higher risk taxpayers, the PCR is in the form of a continuous review. We are more likely to be involved in a comprehensive audit of past years and have other intensive risk analysis approaches underway.²⁶⁸

3.296 With respect to lower consequence taxpayers, the LBAC manual states:

For most lower consequence taxpayers (those categorised as lower or medium risk), the ATO undertakes internal review processes, monitoring, questionnaire, risk reviews or where we are more certain a risk exists, audit activity. For taxpayers categorised as medium risk we generally undertake targeted activities to confirm (detect) and deal with identified tax compliance concerns. These activities are more likely to be reviews and audits than questionnaires.

For lower risk taxpayers we may seek to clarify any concerns that arise out of our internal review processes or monitoring through activities such as requesting targeted information about specific issues (such as via a questionnaire) and visiting the taxpayer.²⁶⁹

3.297 Additionally, the ATO has published a fact sheet called *Real-time compliance engagement approach for higher consequence taxpayers in the large market*.²⁷⁰ This publication and the LBAC manual indicate that all higher consequence taxpayers should expect a PCR if they are not in an ACA. This is regardless of their ATO assessed likelihood rating, that is, whether they are key taxpayers or higher risk taxpayers.

3.298 For higher consequence taxpayers, therefore, the ATO takes a compliance approach which is consistent with the taxpayer's risk profile, resulting in the 'tailoring' of the PCR product. The LBAC manual states:

a level of intensity aligned with the taxpayer's positioning within the RDF – this requires flexibility in the application of the review.

And:

²⁶⁸ ATO, above n 220.

²⁶⁹ Ibid.

²⁷⁰ ATO, above n 190.

Taking a flexible or tailored approach

The PCR, because of its nature and timing, will be heavily influenced by factors not normally encountered in other risk or audit products. While the PCR framework will be in a standard format, the product is flexible and needs to be tailored for each taxpayer. This provides the case officer and the team with the ability to consider different approaches to how the PCR will be undertaken.

It is the case officer, together with their team leader or technical leader, who will be most involved in gaining an understanding of their taxpayer and their transactions. The case officer should be proactive in ensuring that the PCR product works as efficiently as possible for both the ATO and the taxpayer.²⁷¹

3.299 Furthermore, the ATO has additional internal guidance material for ATO officers when conducting PCRs, the *Pre-lodgment compliance review framework guide for higher consequence taxpayers*.²⁷²

3.300 This guidance indicates that the PCR is to be implemented with a level of engagement and intensity commensurate with the taxpayer's level of relative risk.²⁷³

3.301 The guide's framework for intensity makes a distinction between four types of taxpayers:

- key taxpayers with an ACA (2);
- key taxpayers without an ACA and with no concerns (51);
- key taxpayers without an ACA and with concerns or with significant concerns (30); and
- higher risk taxpayers (7).²⁷⁴

3.302 The guide makes the following observations about these groups of taxpayers:

Higher consequence taxpayers that fall into the first two categories will generally find similarities in terms of our approach to engagement and intensity. Higher consequence taxpayers that fall into the last two categories will generally find similarities in terms of our approach to engagement and intensity.

If the compliance team's intended approach and level of intensity changes materially during the life of the PCR, the PCR framework will need to be revised and re-issued to the taxpayer.²⁷⁵

²⁷¹ ATO, above n 268.

²⁷² Australian Taxation Office, *Pre-lodgment compliance review framework guide for higher consequence taxpayers*, 13 December 2012.

²⁷³ *Ibid* page 4.

²⁷⁴ Numbers are from IGT analysis of ATO Moderation Outcomes for 2012-13. Numbers of ACA taxpayers are noted where ACAs for income are mentioned in the Moderation Panel Outcomes field.

²⁷⁵ ATO, above n 272, page 7.

3.303 The guide's appendix sets out how these four groups would be approached by the ATO in terms of:

- The level of information required from the taxpayer to give assurance to the ATO about a particular risk.
- The frequency with which information is requested of the taxpayer.
- The likelihood the ATO will use its formal information gathering powers.
- The likelihood the ATO will seek details of decisions made by key decision makers or committees.

3.304 Lower consequence taxpayers are not subject to real-time, continuous monitoring. Rather, the ATO usually conducts compliance activities as and when risks emerge through the ATO's internal processes. This is usually the result of the taxpayer triggering the risk filters and subsequently being the subject of a recommendation by a risk manager for review in relation to that specific risk.

3.305 Once a risk recommendation is made the taxpayer's case is workshopped by the CSSC who decide on the pool of cases for compliance activity. These compliance activities are typically risk reviews. The process for conducting the risk review is set out in the ATO's LBAC manual.

IGT observations

3.306 As already mentioned, the IGT supports best practice risk management principles as a general proposition. The application of ATO resources should be proportionate to the relative risk. This is generally adopted as an enterprise wide concept in commerce as well as many public organisations.

3.307 The IGT considers that it may be difficult for taxpayers to understand whether or not particular ATO compliance action is appropriately differentiated.

3.308 The explicit use of the RDF to categorise taxpayers may have caused taxpayers, who previously had modest ATO contact, to now receive considerably more contact. The IGT is of the view that such a change of itself does not necessarily indicate that the ATO compliance approach is disproportionate to their relative risk level where those ratings opinions have been reasonably expressed and communicated to taxpayers. Indeed, it has also been suggested that it may be better to know what the ATO perceptions are so that one has the opportunity to address them.

3.309 The IGT is of the view that one of the main sources of contention in this area is the ATO's ability to reasonably and transparently determine and communicate their opinion of the taxpayer's relative risk. As described in the background, the RDF only makes a distinction between key taxpayer and higher risk taxpayers for higher consequence taxpayers. Furthermore, the RDF notification letter only provides those categorisations.

3.310 Nevertheless, as indicated in the moderation panel documents, and the PCR framework guidance documents, the ATO now sub-divides the key taxpayer quadrant into three different sections:

- no concerns;
- some concerns; and
- significant concerns.

3.311 Whilst the ATO compliance approach may on one view be proportionate to the perceived risk level, the risk levels that the ATO are relying upon to develop these approaches are not explicitly communicated to the taxpayer.

3.312 For example, some previously higher risk taxpayers that are now key taxpayers may in fact be 'key taxpayers with concerns/significant concerns'. However, the taxpayer is unaware of this more recent sub-categorisation and may explain why they may be receiving a level of scrutiny beyond their expectations.

3.313 The IGT is of the view that the ATO's use of the RDF framework should be properly reflected in their various publications and communications to taxpayers. The notification letter, by way of example, should explicitly contain the key taxpayer sub-categorisation, in addition to any content addressing particular concerns. By making the sub-categorisation explicit, taxpayers will have a better understanding of the ATO's opinion of level of relative risk and expected compliance approach.

3.314 As discussed in paragraph 3.276, there is scope to provide taxpayers with more specific information about particular risks and the relative risk as compared to other taxpayers. Such information will also assist ATO compliance teams to better understand the risk hypotheses used as a starting point for subsequent ATO compliance actions.

3.315 In this respect, the LBAC manual highlights the importance of the risk hypothesis:

By using a risk-hypothesis-based approach, the ATO can:

- focus resources where they are most needed,
- adjust for or adapt to new information received and or new risks identified, and
- decide whether there are any tax risks requiring further investigation and determine an appropriate response.

A clear risk hypothesis is very important when involving others in the compliance activity. The taxpayer and ATO experts can contribute more efficiently through an early engagement strategy where the risk hypothesis is clearly stated.

For this reason it is essential that taxpayers are informed of the risk hypothesis at the start of the case and at each point it materially evolves or is refined.²⁷⁶

3.316 The IGT is of the view that targeted information requests during risk reviews are one way that the ATO can tailor their compliance response to the risks posed by the

²⁷⁶ ATO, above n 268.

taxpayer. By ensuring that information requests are targeted only to those risk hypotheses that have been raised during the internal risk processes, taxpayer as well as ATO compliance costs can be minimised.

3.317 This is consistent with the observations made in the IGT's LB&I Review, including Recommendation 8.2 of that review.²⁷⁷

3.318 The IGT understands that another source of concern arises from the fact that some key taxpayers have been the subject of audits. The ATO advises that these audits are in relation to prior year (or 'legacy') issues and that the RDF categorisation is relevant for the ATO's current view of the taxpayer's risk in real-time. Whilst the LBTC booklet highlights post-lodgment reviews for higher consequence taxpayers may take place to 'manage a post-lodgment legacy year as part of a transition strategy into real time'²⁷⁸, it does not make the same statement in relation to audits. For completeness, the ATO should update the LBTC booklet to reflect this approach.

Pre-lodgment Compliance Reviews (PCR)

3.319 In terms of higher consequence taxpayers, the ATO has indicated in their *Real-time compliance engagement approach for higher consequence taxpayers in the large market* fact sheet that such taxpayers will all be subject to a PCR if they do not have an ACA.

3.320 As previously mentioned, it is important for taxpayers to perceive benefits in a lower risk categorisation, such as lower compliance costs, to provide an incentive to adopt behaviours desired by the ATO. The broad application of the PCR, to all higher consequence taxpayers without an ACA, seems to taxpayers to undermine such a proportionate approach. However, the ATO intends to achieve a proportionate approach through the 'tailoring' of the PCR product in accordance with the LBAC manual (publicly available), and the PCR framework guide (ATO internal document).

3.321 Whilst the PCR framework guide is indicative of the spectrum of risk, including the concept of key taxpayers with 'no concerns, some concerns and significant concerns', the framework itself appears to place key taxpayers with some concerns and key taxpayers with significant concerns in one category. This may reduce the effectiveness of the guide in facilitating tailored PCR approaches for key taxpayers.²⁷⁹

3.322 Previously in relation to PCRs, in the IGT's Self Assessment Review, the ATO agreed to:

... develop and implement procedures to periodically consult with relevant consultative forums and the community to review the information required on company and individual income tax returns and associated schedules as well as the information

²⁷⁷ ATO, above n 122, pp 87-112.

²⁷⁸ ATO, above n 63, p 43.

²⁷⁹ Australian Taxation Office, Appendix 1 to Pre-lodgment compliance review framework guide for higher consequence taxpayers, 13 December 2012, see also page 8.

requested as part of pre-lodgment compliance reviews and annual compliance arrangements.²⁸⁰

3.323 The ATO also agreed, as part of the above review, to publish more information about the conduct of PCRs through additional information in an updated LBTC booklet.²⁸¹ The 2012 version of the LBTC booklet contains a ‘what we will do and what we expect from you’ section in relation to PCRs. Furthermore, additional information about the conduct of the PCR is available in the publicly available LBAC manual.

3.324 With respect to proportionality, the LBAC manual states:

Level of intensity

The level of intensity is not a static concept and can change depending on key aspects. It is relative to the taxpayer’s:

- RDF categorisation
- level of sustained cooperation
- level of transparency and willing participation.²⁸²

3.325 The IGT is of the view, however, that taxpayers may gain greater confidence in the proportionality of the tailored PCR, if the ATO, among other things, made the PCR framework guide publicly available as part of the LBAC manual or LBTC booklet as appropriate.

3.326 Furthermore, the PCR if conducted appropriately represents an opportunity for the ATO to have ongoing dialogue with higher consequence taxpayers in a manner which affords natural justice, assists taxpayers to make informed choices about their risks and ensures the ATO approach is proportionate to those choices. Such benefits may only be realised if the PCR is conducted as a consultative activity and not merely as another information gathering activity.

3.327 To illustrate this view, consider the following example. As discussed above and consistent with Recommendation 3.9 above, rather than the RDF notification letter going directly to the CEO of the taxpayer, the letter can serve as an opportunity for the ATO to share its risk perspectives with the tax manager. These include an explanation of the ATO’s opinion on the taxpayer’s inherent risks, behavioural risks and information confidence and cost levels and the evidentiary basis for such an opinion. This may include information about particular taxpayer risks, how they compare with others in the market and/or information from the risk filters. It may also include

²⁸⁰ IGT, above n 5, p 66.

²⁸¹ Ibid p 102. It should also be noted that there was a PCR related Recommendation (4.7) about capping penalties and interest for taxpayers subject to these processes. The matter was noted by the Government. ‘The Government needs to better understand how the ATO uses these tools to address risk and how they are used to enhance compliance levels and the effect on compliance more generally’. David Bradbury, Assistant Treasurer, ‘Inspector-General of Taxation review into improving the self assessment system’ (Media Release, 13 February 2013).

²⁸² ATO, above n 268.

information sourced from the RTP schedule and IDS and the ATO's views on those disclosures.

3.328 In the above example, the tax manager can test the evidence and better understand the ATO's proposed approaches in light of those risks. Where the ATO's primary concern is about information confidence and cost, the ATO's subsequent PCR approach may focus on formal information gathering, unless the taxpayer opted for more real-time disclosure.

3.329 Alternatively, where the ATO is primarily concerned about the inherent risks, the ATO's subsequent PCR would focus on ensuring the taxpayer has adequate tax risk management arrangements in place to mitigate those inherent risks.

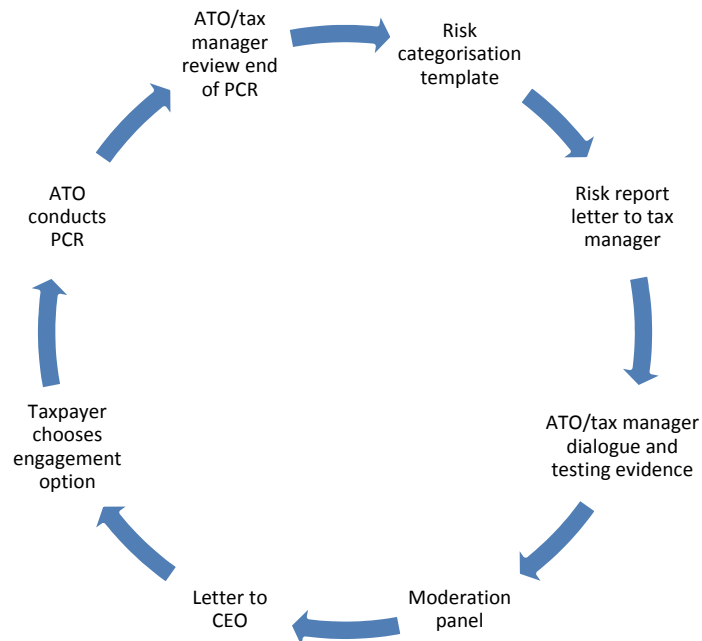
3.330 A letter may then be sent to the CEO setting out these approaches. The taxpayer is then in a position to make an informed choice as to how they will engage with the ATO over the coming year and select the most appropriate engagement option.

3.331 The PCR may then commence on a basis of consultation and differentiation. At the end of the PCR process, the ATO may review the year with the tax manager. Such a consultation may form the basis of the next risk template. Figure 14: Potential integrated PCR process below outlines this approach and incorporates the approach described in Recommendation 3.9.

3.332 The IGT also notes that the PCR elements suffer the same difficulties in application that the RDF does regarding notions of sustained cooperation, level of transparency and willing participation as noted earlier in the chapter.

3.333 The ATO's internal audit team found that there were opportunities for the template, TAP and PCR plans to be streamlined and to make the relationship between these documents clearer.²⁸³

²⁸³ Australian Taxation Office, Internal Audit Communications Update 14 May 2013, page 6.

Figure 14: Potential integrated PCR process

Source: IGT

RECOMMENDATION 3.10

The IGT recommends that the ATO:

- (a) make the pre-lodgment compliance review (PCR) framework guide publicly available as a part of either the large business compliance manual or large business and tax compliance (LBTC) booklet;*
- (b) disclose the risk categories more fully, including any sub-categorisations of the key taxpayer segment, in RDF notification letters and in the LBTC booklet;*
- (c) ensure that the compliance burden of PCRs are graduated according to differing levels and mixes of inherent risk, behavioural risk and information confidence and cost factors; and*
- (d) update the LBTC booklet to indicate that audits may still be applicable to manage legacy issues even where the taxpayer is a key taxpayer.*

ATO response

Agree.

CHAPTER 4 — SMALL TO MEDIUM ENTERPRISES

4.1 Stakeholders from the small to medium enterprises (SME) market segment were largely concerned with the ATO's application of the risk differentiation framework (RDF). As the RDF is yet to be fully deployed in the SME market segment, there was concern and uncertainty about how the ATO will apply it.

4.2 It should be noted that many of the discussions in the previous chapter may become relevant in this context depending on how the application of the RDF to this market segment evolves.

4.3 Particular concerns that have been raised with the IGT thus far include:

- inputs into the risk categorisation process — uncertainty was expressed as to how the ATO uses quantitative and qualitative data; and
- communication of the risk categorisation — whether and how the ATO will communicate to the taxpayer their opinion of the taxpayer's risk and whether the taxpayers would be afforded due process.

4.4 This chapter provides some background to this market segment and the ATO's SME business line before addressing the above stakeholder concerns.

BACKGROUND

4.5 The ATO's SME business line administers SME taxpayers as well as those classified by the ATO as 'highly wealthy individuals' and 'wealthy Australians'.

4.6 SME taxpayers are those entities with an annual turnover between \$2 million and \$250 million. This particular market segment comprises a diverse group of businesses such as closely held private groups, foreign owned multinational corporations, charities, sole traders and partnerships.

4.7 Highly wealthy individuals (HWIs) are those Australian resident individuals who, together with their associates, effectively control \$30 million or more in net wealth.

4.8 Wealthy Australians are those Australian resident individuals who, together with their associates, effectively control net wealth of between \$5 million and \$30 million.²⁸⁴

4.9 As at March 2013, the ATO had identified:

- 183,000 SME economic groups representing 220,000 entities;

²⁸⁴ ATO, above n 4.

- 2,600 HWIs representing 36,000 entities; and
- 70,000 wealthy Australians representing 450,000 entities.²⁸⁵

4.10 There is less publicly available taxpayer information for this market segment as compared to the large business segment. There are various reasons for this, a key one being that entities in these market segments typically do not have the same level of mandatory financial disclosure requirements as public companies listed on the stock exchange.

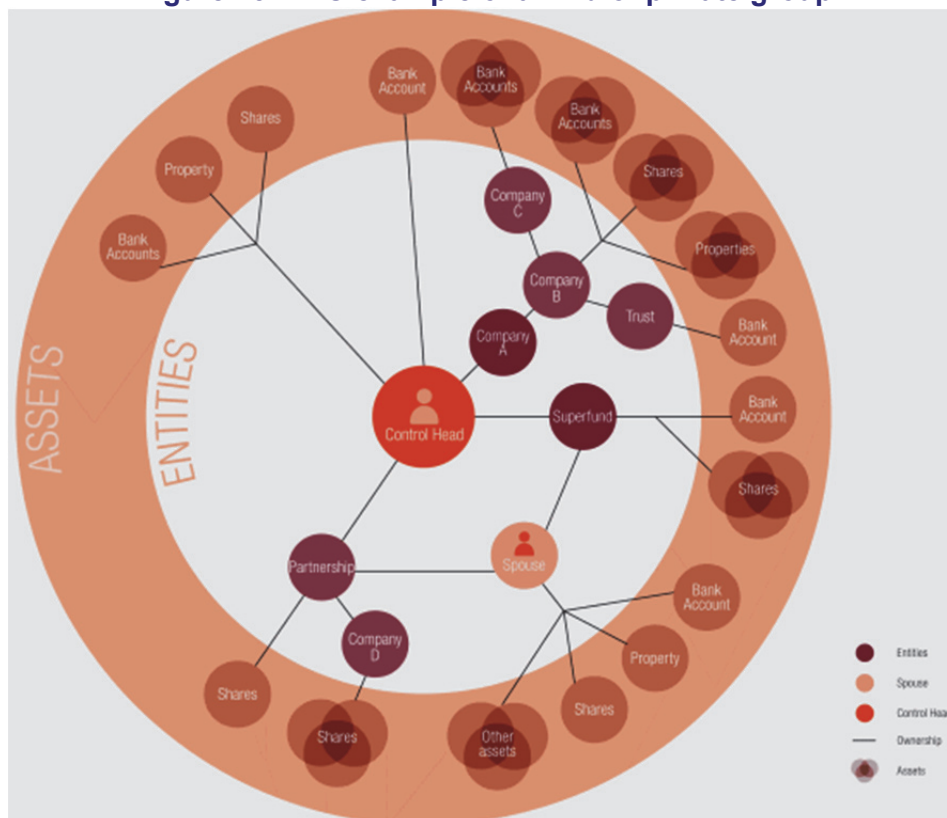
4.11 In relation to risk specifically, another reason why more information is available in the large business segment is that it consists only of approximately 1,850 economic groups and entities encompassing over 32,000 businesses. Whilst all these groups are risk assessed using quantitative 'risk filters', the ATO incorporates additional detailed qualitative information into the risk assessment of a subset of approximately 100 taxpayers. Further information about this process is presented in Chapter 3 in connection with the large business segment.

4.12 For the SME market segment, the ATO has a greater reliance on third party data sources for risk assessment processes. These data sources may be from other government departments, financial institutions or other third parties.²⁸⁶ The ATO approaches to this market segment are outlined in their publication, *Tax compliance for small-to-medium enterprises and wealthy Australians* (Tax Compliance) which was produced following recommendations contained in the IGT's *Review into the ATO's Compliance Approaches to Small and Medium Enterprises with Annual Turnovers Between \$100 million and \$250 million and High Wealth Individuals* (SME Review).

4.13 One of the ATO's approaches to the SME market segment is the 'private-group approach', whereby the ATO recognises that some individuals may be the controlling minds or key decision-makers behind businesses that encompass multiple entities. This approach allows the ATO to assess risk at a holistic group level rather than at the entity level. This also allows ATO officers to approach the group through a single contact point for income tax matters, subject to privacy restrictions. An ATO example of a kind of private group is illustrated below:

²⁸⁵ ATO, above n 4; see also Australian Taxation Office, ATPF SME Working Group, 14 March 2013, handout.

²⁸⁶ ATO, above n 33, p 31.

Figure 15: ATO example of a kind of private group

Source: ATO, Tax compliance for small-to-medium enterprises and wealthy individuals.

4.14 In its Tax Compliance publication, the ATO indicates that it takes a risk-management approach to compliance by categorising SME market sub-segments according to other risks they pose relative to each other:

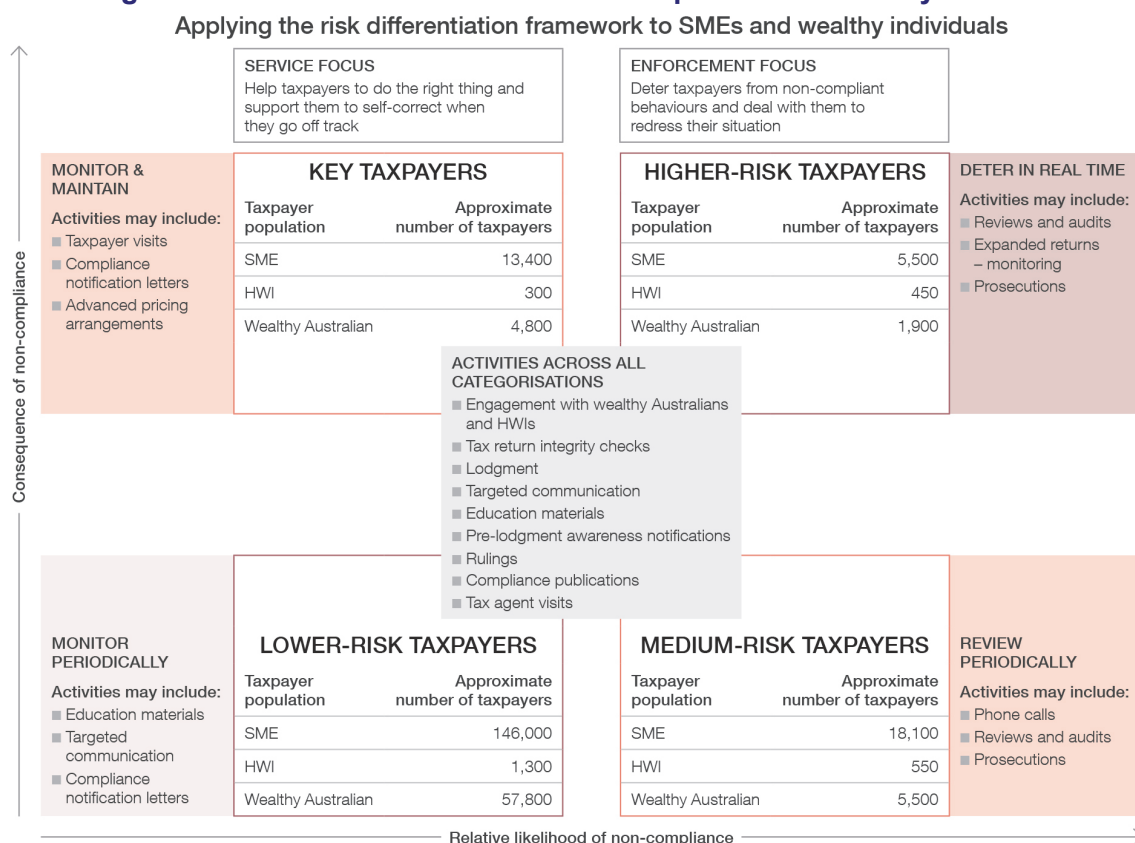
We support this approach with sophisticated data-matching techniques that access external and internal information. This process of filtering and prioritising serves two purposes:

- it reduces the costs of compliance for low-risk taxpayers by minimising the possible intrusiveness of our compliance activities
- it ensures we invest our resources in the areas of greatest risk.

We use our risk differentiation framework to view risk, categorise the SME market from an income tax perspective, formulate strategies and apply treatments. We are committed to using the framework and will continue to improve its application to ensure our interactions with you achieve the best possible compliance outcomes.²⁸⁷

4.15 As with the large business and international (LB&I) RDF, the framework seeks to categorise taxpayers using likelihood and consequence of non-compliance factors. Similar to the LB&I market segment, taxpayers are categorised as higher risk taxpayers, key taxpayers, medium risk taxpayers or lower risk taxpayers. These categorisations are shown in Figure 16 below.

²⁸⁷ ATO, above n 4.

Figure 16: RDF for small-to-medium enterprises and wealthy individuals

Source: ATO, Tax compliance for small-to-medium enterprises and wealthy individuals.

4.16 In addition to outlining the application of the RDF to the above three market segments, the Tax Compliance publication also describes how it determines risk:

We identify compliance risks by matching and analysing data and information.

Our initial risk-identification systems apply complex algorithms and risk rules. Our skilled analysts and compliance officers complement this work by applying their knowledge and experience at the risk-identification stage of a case.

In addition, our compliance program sets out the specific compliance risks we focus on each year. These risks will change in response to economic conditions, new legislation and changes to your business environment. We may also identify new risks through our intelligence and risk-monitoring processes.²⁸⁸

4.17 In earlier years, compliance work in relation to wealthy Australians was supported by the ATO's Strategic Compliance Initiative. This initiative was part of \$302 million Federal Budget funding over four years to address compliance risks associated with Australia's economic recovery. The SME business line was allocated \$68.9 million of this funding to identify and profile wealthy Australians.²⁸⁹

²⁸⁸ ATO, above n4.

²⁸⁹ Inspector-General of Taxation, *Review into the ATO's compliance approaches to small and medium enterprises with annual turnovers between \$100 million and \$250 million and high wealth individuals* (2012) para [1.54].

4.18 Through this initiative, the ATO has developed a repository of intelligence in relation to wealthy Australian group structures. Future compliance activity in this market segment builds on this foundation of intelligence.

4.19 In addition to approaching taxpayers on a private group basis, the ATO undertakes project-based work:

We may undertake reviews and compliance-verification activities on medium-risk taxpayers. These activities may be part of a compliance project involving other businesses with similar issues. This approach allows us to address systemic tax issues on a consistent basis across the SME market, thereby reducing compliance costs to all taxpayers.²⁹⁰

Previous audits and reviews

4.20 Some aspects of the SME business line operations were the subject of a 2011 Australian National Audit Office (ANAO) performance audit.²⁹¹ The audit made findings with respect to:

- the governance arrangements supporting compliance in the SME market;
- how the SME business line assesses compliance risks;
- the ATO's compliance strategies for the SME market segment; and
- how the ATO measures the effectiveness of its compliance strategies.

4.21 The ANAO audit also made two recommendations in relation to aspects of the then SME 'risk engine'. The ATO agreed to both recommendations.

4.22 In 2011, the IGT SME Review covered issues such as:

- technical capability and support;
- compliance decision-making;
- project management;
- audit conduct, communication and taxpayer engagement; and
- information gathering.

4.23 The review made 41 recommendations, 38 of which the ATO agreed in full, two in part and disagreed with one.

²⁹⁰ ATO, above n 4.

²⁹¹ Australian National Audit Office, *The Management of Compliance in the Small to Medium Enterprises Market* (2011).

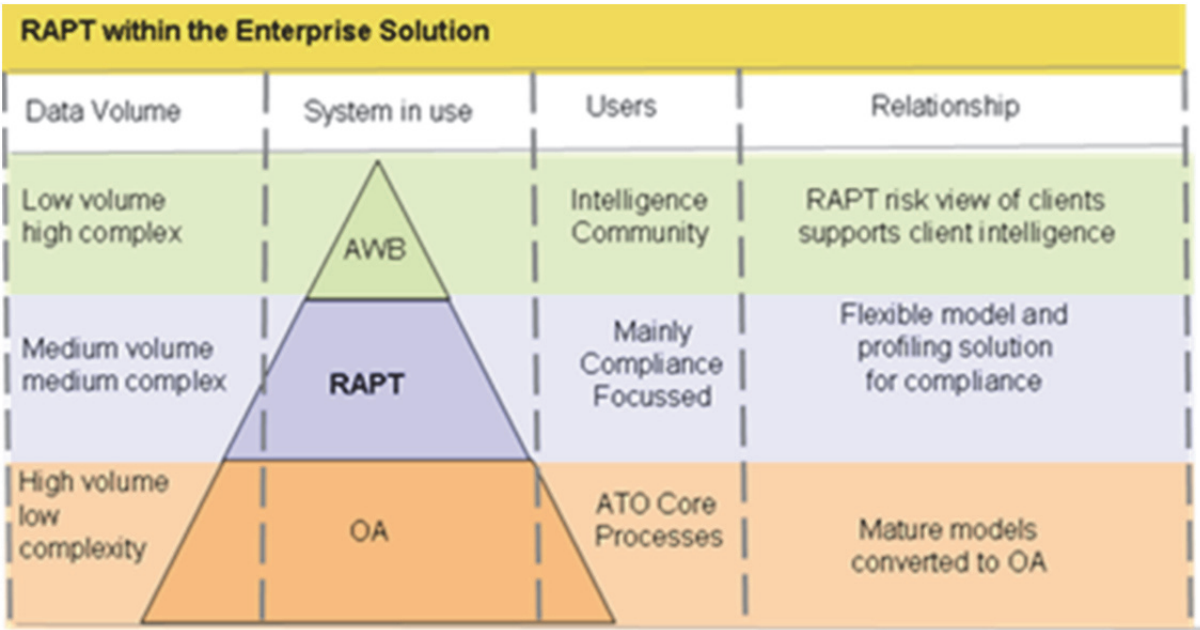
STAKEHOLDER CONCERN — INPUTS INTO THE RISK CATEGORISATION PROCESS

4.24 Stakeholders expressed a sense of uncertainty about the type of information the ATO uses when risk rating the SME population. For example, they were unsure as to how the ATO used quantitative versus qualitative information.

4.25 In 2011, the ATO replaced the former ‘risk engine’ with a new corporate risk assessment tool, being the Risk Assessment and Profiling Tool (RAPT). Whilst the RAPT is used across the ATO, the manner and extent to which it is used can vary by business line. It should be noted that this system is different to the ‘risk filters’ used by the LB&I business line where the RAPT is not a major part of the risk categorisation process.

4.26 The RAPT is one of a suite of corporate risk assessment tools. Among others are the Operational Analytics (OA) and the Analyst Workbench (AWB) tools. The ATO uses OA for mainly high volume low complexity work, while the AWB is used mainly for low volume high complexity work. As seen in Figure 17 below, the RAPT fits in between these tools for medium volume medium complexity compliance work.

Figure 17: How RAPT fits into the suite of corporate risk tools



Source: ATO²⁹²

²⁹² Australian Taxation Office, Risk assessment and profiling tool (RAPT) Overview.

4.27 The SME business line uses the RAPT to drive a largely quantitative-based process using risk flags and risk signposts. All of these risk flags and risk signposts are brought together into what is known as the Integrated Scoring Model (ISM). The ATO has indicated:

The Integrated Scoring Model (ISM) is the process of risk assessing and prioritising the S&ME market (both private wealth groups and SME economic groups) based on likelihood and consequence of known compliance risks. Currently, there are approx 120 risk rules that form part of the likelihood score, these comprise of two types of risk rules:

A risk flag highlights the likelihood of a compliance risk based on a combination of variables from different data sources. A risk flag will affect the group's risk score.

A signpost identifies an event; further verification work may be required to determine if a compliance risk has occurred. A signpost in itself is not a risk; however, a combination of signposts may indicate a potential compliance risk.²⁹³

4.28 A risk flag or combination of flags usually seeks to assess the likelihood that a taxpayer has incorrectly reported against a particular type of tax risk. For example, there are risk flags that assess risks against:

- capital gains tax;
- consolidation;
- various international taxation obligations;
- demergers;
- franking credits;
- fringe benefits tax;
- losses;
- non-lodgement;
- phoenix activity;
- research and development;
- self-managed superannuation funds;
- professional firms;
- trusts; and
- tax and economic performance.²⁹⁴

²⁹³ ATO communication to IGT, 23 November 2012.

4.29 The risk rules usually test a compliance risk hypothesis using the data from income tax return labels.²⁹⁵ In all, there are 84 risk flags and 35 risk signposts covering the above risks. This chapter uses the term 'risk rules' to refer to both risk flags and risk signposts unless a specific reference indicates otherwise.

4.30 In contrast to the LB&I higher consequence segment, where a moderation process considers qualitative information for some 140 large business taxpayers, the SME business line seeks to risk assess 700,000 entities by using quantitative data.

4.31 Nevertheless, the SME business line seeks to take into account some qualitative aspects in its risk assessment. These have been described as 'contextual attributes' and are used to incorporate information about the taxpayer from outside the tax return itself. The contextual attributes are used to increase or decrease the initial likelihood score depending on the attribute.²⁹⁶ The three contextual attributes are 'start-up businesses', 'phoenix activity', and 'advance pricing arrangement'.

4.32 The rules then produce likelihood and consequence scores which are used to place taxpayers relative to each other within the RDF. The ATO emphasises that the 'RDF is an initial risk assessment tool and that it does not indicate non-compliance'.²⁹⁷

4.33 The risk rules are developed by risk managers within the SME business line. As part of developing risk rules, risk managers are also required to develop risk guides,²⁹⁸ which explain to compliance staff why their case was selected (that is how the taxpayer triggered the risk rule) and what the compliance officer should consider during the case. These risk guides are considered later below.

4.34 Risk managers in the SME business line are required to review their risk rules twice a year.²⁹⁹ The purpose of the review is to ensure that the latest information is used when the SME business line runs the RDF in February and August of each year. The risk manager is to convene a workshop to conduct the review. The workshop should have the following participants:

- the risk manager (and appropriate members of their team);
- the senior technical leader(s);
- experienced active compliance officers;
- a population strategy – national case selection panel representative; and
- appropriate guests from other business lines.

²⁹⁴ Australian Taxation Office, Integrated Scoring Model S&ME Pipeline Governance Committee Report, May 2012, page 16.

²⁹⁵ Ibid.

²⁹⁶ Ibid page 33.

²⁹⁷ Australian Taxation Office, Draft SME minutes, March 2013, Agenda item 3, <<http://www.ato.gov.au>>.

²⁹⁸ Australian Taxation Office, SME Detailed Risk Guide Extract – Available fraction flag – provided to IGT 3 April 2013.

²⁹⁹ Australian Taxation Office, RAD13_Review of risk rules in S&ME – (undated), last modified 7/01/2013. Provided to IGT 3 April 2013.

4.35 However, in some workshops, participation may be limited. For example, in a 2011 workshop, representatives from all the above areas attended³⁰⁰ whilst in a 2012 workshop, only the risk manager and two representatives from the SME Risk and Detection area were in attendance.³⁰¹

4.36 The workshop considers the current risk rule and its application, associated documents (such as the risk guides), and considers any new rules or gaps in the current rule. A risk manager may have responsibility for a 'suite' of risk rules related to a particular risk area. In this case, the panel would consider all the rules within the suite.

IGT observations

4.37 The SME market consists of a high number of taxpayers, so the ATO is highly reliant on quantitative methods to filter for risks against the selected population at first instance. The use of 'contextual attributes' is a useful addition to the risk assessment process, adding some qualitative considerations to the process.

4.38 The IGT notes that most of the risk rules are associated with specific taxation risks which is helpful for ensuring that the ATO is testing for specific types of potential non-compliance.

4.39 The IGT supports the ATO's regular review of the risk rules. By necessity, at the outset, risk managers develop risk rules based on estimates which can then be refined and become more accurate by feedback loops that is input from completed cases such as risk reviews and audits. It is important, therefore, for the risk rule review process to incorporate compliance officers' experience from actual case work. Whilst this may be the expectation, it does not always happen in practice.

RECOMMENDATION 4.1

The IGT recommends that the ATO incorporate compliance officer experiences and case work results into the risk rule review processes.

ATO response

Agree.

STAKEHOLDER CONCERN — COMMUNICATION OF THE RISK CATEGORISATION

4.40 As described above, since September 2012, the ATO has publicly shared its RDF process for SME taxpayers through its online Tax Compliance guide. This, however, was a general description, and in contrast with the LB&I notification process, did not specifically inform particular taxpayers about how the ATO considered specific risks.

³⁰⁰ Australian Taxation Office, FBT Review workshop minutes 29 November 2011.

³⁰¹ Australian Taxation Office, Consolidation risk rule workshop meeting minutes 30 July 2012.

4.41 Stakeholders expressed concerns as to whether the ATO would communicate the risk categorisation to them and, if so, how. Furthermore, where the ATO sought to notify the taxpayer of their risk categorisation, there were also concerns as to whether the taxpayer would have an adequate opportunity to have such a categorisation reviewed.

4.42 Some stakeholders indicated that communicating the ATO's specific risk concerns would assist taxpayers and their advisors in self-managing their own compliance risks and may assist in promoting voluntary compliance. Other stakeholders appreciated that such an approach may be impractical for the entire SME market segment, but highlighted that such an approach may be justifiable for the largest taxpayers in this segment. The ATO often refers to this collective segment as 'S4', being businesses with a turnover of between \$100 million to \$250 million.

4.43 As shown in Figure 16 above, the ATO has identified 5500 SMEs, 450 HWIs and 1900 wealthy Australians as higher risk taxpayers. The ATO has indicated that not all taxpayers would receive a notification of their risk categorisation due to the numbers in this market segment. Furthermore, the ATO has indicated that it would only provide a risk categorisation to taxpayers if new compliance activity was underway.³⁰²

4.44 The ATO's Compliance Program 2012-13 indicates that it plans to complete around:

- 200 reviews and 50 audits of HWIs; and
- 120 reviews and 50 audits of wealthy Australians.³⁰³

4.45 The ATO has previously conducted trials and pilots in sharing risk information with some SME taxpayers and their advisors. Between February 2009 and April 2012, the ATO ran the Risk Assessment Information Sharing (RAIS) project. Part of the RAIS project was jointly run with KPMG.³⁰⁴

4.46 The intent of the project was to:

- reduce the uncertainty being experienced by taxpayers and their advisors around the ATO Risk Engine and its results by effectively engaging these taxpayers and making known to them our view of their level of 'riskiness';
- prompt some of them to consider if and how they want to reduce their level of riskiness in our eyes, leading to more voluntary compliance in our market overall; and

³⁰² ATO, above n 297.

³⁰³ ATO, above n 33, p 33.

³⁰⁴ Australian Taxation Office, Tier 3 Project Final Report for KPMG Risk Assessment Information Sharing Project (RAIS) April 2011.

- demonstrate our compliance activity is credible because it is based on a systematic and deliberate risk assessment and case selection method that we are capable of explaining.³⁰⁵

4.47 One of the results of the RAIS project was the ATO's development of two risk communication products for taxpayers in the SME market, namely:

- the Compliance Notification letter; and
- a pilot of the Risk Report.³⁰⁶

4.48 The intent of the Compliance Notification letter was 'to provide earlier certainty to businesses about the conclusion of their tax affairs for that year, improving their experience with the tax system'.³⁰⁷

4.49 The objective of the risk report was for the ATO to influence taxpayer behaviour and 'demonstrate their openness and transparency' about their view of tax risk.³⁰⁸

4.50 Further information about these products was provided to the ATO Tax Practitioner Forum (ATPF) SME sub-group in March 2013 of which IGT officers attended as observers.³⁰⁹ Some practitioners raised potential issues with the intent and delivery of the Compliance Notification letters, citing potential unintended increases in uncertainty and compliance costs from undertaking a further pilot.

4.51 Since then, the ATO has informed the IGT that due to feedback from various sources, the ATO would not proceed with issuing Compliance Notification letters to lower-risk taxpayers. The main reasons for not proceeding were that:

- the initiative would require a high level of ATO resources;
- the letters may not achieve the intent of providing certainty to taxpayers;
- the letters may actually increase compliance costs or cause them concerns; and
- lower-risk taxpayers did not desire contact from the ATO for this purpose.³¹⁰

4.52 For the risk reports, the ATO is continuing to develop further trials, with 500 risk reports sent in March 2013. The ATO intends to only send risk reports to higher consequence taxpayers that are the subject of new ATO compliance activity, citing resource demands given the large numbers of taxpayers in this market segment.³¹¹

³⁰⁵ Ibid page 4.

³⁰⁶ Ibid.

³⁰⁷ Australian Taxation Office, ATPF SME sub-group June 2012 minutes, <<http://www.ato.gov.au>>.

³⁰⁸ Australian Taxation Office, Communication Strategy Risk Report February 2013.

³⁰⁹ Australian Taxation Office, ATO S&ME RDF handout for ATPF SME sub-group, 14 March 2013. Representatives of the IGT were present as observers.

³¹⁰ ATO communication to IGT, 27 March 2013.

³¹¹ ATO, above n 297.

IGT observations

4.53 The IGT recognises the usefulness of the SME business line approach in communicating the risk assessment process to the general SME population through the Tax Compliance guide as well as aspiring to make more personalised communication with taxpayers about their particular risk profile, such as through the risk report pilot.

4.54 In this respect, the Tax Compliance guide reflects the same consideration of transparency to that described in the *Large business and tax compliance* (LBTC) booklet targeted at the large business market:

We believe that being transparent, accountable and willing to engage constructively with us reflects good corporate citizenship and a positive attitude to compliance with tax law. By taking this approach, you are likely to lower your tax-risk profile and enjoy the benefits of good reputation that follow.³¹²

4.55 However, due to the large numbers of taxpayers in this market segment, a different approach to that taken with large business taxpayers is required. This will require a different balance to be struck between providing due process for taxpayer risk categorisation notifications and the ATO's use of resources for such a large number of taxpayers.

4.56 Where the ATO is intending to conduct compliance activity, such as a risk review or an audit, it is vital the ATO and the taxpayer have an opportunity to discuss the taxpayer's risk categorisation. This may address certain taxpayer concerns about receiving due process as part of the risk categorisation process.

4.57 It is apparent, however, that the ATO currently categorises more taxpayers as higher risk than it plans to risk review or audit. Presumably that means those selected for further compliance activity pose an even higher risk and should perhaps be placed in a different risk category. Whilst adding a further category to the RDF may not necessarily change taxpayers' relative risk positions in terms of the ATO's perceptions of likelihood and consequence, it better identifies the highest risk taxpayers and better supports the ATO's actual resource allocation choices and initial taxpayer engagement stance.³¹³

4.58 With respect to the risk reports, the IGT observes that it is desirable for taxpayers to have a better understanding of what the ATO considers to be risk factors and to have the opportunity to change their behaviour if they so desire.

4.59 The SME business line has also indicated that its risk reports are 'indicative and not definitive'.³¹⁴ This is due to the reliance on quantitative data and the lack of a qualitative moderation process as per the LB&I process. Therefore, the risk report arguably represents a lower 'reputational risk' to the taxpayer and perhaps a lower reputational risk for the tax manager of the taxpayer.

³¹² ATO, above n 4; ATO, above n 33, p 37; ATO, above n 63.

³¹³ Hamilton, above n 60, pp 483-531, p 515.

³¹⁴ ATO, above n 309, slide 5.

4.60 In this context, the IGT is concerned that it may be difficult for large numbers of taxpayers to have a one-on-one meeting with ATO staff to discuss the issued risk reports. Accordingly, great care needs to be taken to ensure the process is reliable and robust in this market segment. If not, costs and related consequences may blow out for both taxpayers and the ATO.

4.61 The IGT notes the importance of stakeholder consultation as seen in the case of the now discontinued Compliance Notification letters. Consultation through the ATPF surfaced important feedback about the potential unintended consequences of the proposed letters. Such consultation ensured that the ATO did not undertake a potentially resource intensive project that may have resulted in more uncertainty and higher compliance costs for taxpayers.

4.62 The IGT also sees an opportunity for the ATO to provide greater certainty through publishing more information about the risk flags. As noted in the previous section, risk managers are responsible for developing risk guides for each risk rule. The guides should contain information for compliance officers to consider when undertaking reviews, namely :

- an explanation of the risk hypothesis — what the taxpayer might be doing incorrectly;
- explanations of false positives — a set of facts which would indicate that the taxpayer is indeed compliant, notwithstanding the fact that they triggered the risk rules; and
- information request — the main evidence that the compliance officer would need to request, in order to test whether the taxpayer was correctly or incorrectly applying the law.³¹⁵

4.63 It is the IGT's view that all risk guides should contain at least the above three elements. The risk hypothesis will assist compliance officers in their information gathering activities. Furthermore, when the risk hypothesis is communicated to the taxpayer, the taxpayer will understand why the ATO officer is asking for related information.

4.64 Currently, all risk areas published in the Tax Compliance guide are listed by name only. These are reproduced in Appendix 10. The IGT believes that these risk areas should be accompanied by risk hypotheses and factual situations which should attract the attention of the taxpayer and the ATO. Such approach can be seen in the LB&I income tax risk filter depicted in Figure 10 in Chapter 3.

4.65 Providing the risk hypothesis, along with the relevant risk factor assists taxpayers in understanding the nature of the ATO's concerns. For example, one of the characteristics on the 'What attracts our attention' list is a specific reference to 'accessing business assets for tax-free private use'. For this risk factor, it may be useful for taxpayers themselves to understand that the tax-free private use of business assets has certain tax implications. The risk hypotheses in this instance may be:

³¹⁵ Australian Taxation Office, Risk Guide for FBT and Available Fraction.

- Taxpayer may not have correctly reduced their deduction for decline in value for depreciating assets, due to the private use increasing the non-taxable use percentage (s40-25 *Income Tax Assessment Act 1997* [ITAA 1997]).
- Taxpayer may not have correctly calculated the capital gain or balancing adjustment amount from a balancing adjustment event happening to a depreciating asset that has been used for a non-taxable purpose (s40-250 and s104-235 ITAA 1997).
- Taxpayer may not have correctly applied the partly creditable rules for GST input tax credit purposes (s11-30 *A New Tax System (Goods and Services Tax Act) 1999*).
- Individual taxpayer has accessed benefits of an associated company, but may not have correctly calculated or applied fringe benefits tax (*Fringe Benefits Tax Assessment Act 1986*).

4.66 Expressing the risk hypotheses with the risk factor in the manner outlined above assists taxpayers and their tax advisors to better understand their own risk, by checking to see if those risk factors match their circumstances.

4.67 It should be noted that the IGT uses the term 'risk hypothesis' in the same way it is used in his LB&I Review³¹⁶ and in the large business active compliance manual. The large market income tax risk filters³¹⁷ and other ATO documents refer to the risk hypothesis as the 'risk description'.

³¹⁶ IGT, above n 122, Chapter 5.

³¹⁷ See Figure 10 above on page 54 for a sample large market income tax risk filter description.

RECOMMENDATION 4.2

The IGT recommends that the ATO:

(1) ensure all ATO risk guides contain:

(a) an explanation of the ATO's risk hypothesis;

(b) explanations of any applicable false positives; and

(c) an indication of the types information that the compliance officer should be seeking from the taxpayer to determine the presence of a risk.

(2) publish additional information on the risk factors currently listed in the publication Tax compliance for small-to-medium enterprises and wealthy individuals such as the risk hypothesis and the indicators used to determine the presence of risk.

ATO response

Agree.

The ATO supports greater transparency in respect of what attracts our attention and will also look at other publications to provide this information, for example, placing links in the online *Compliance in Focus* publication.

PROPORTIONALITY OF ATO COMPLIANCE APPROACH

4.68 Stakeholder representations from this market segment were largely focused on the inputs that the ATO uses to arrive at risk categorisation and the manner in which the ATO would communicate such a categorisation. Whilst the ATO's compliance approach is generally articulated in their Tax Compliance publication, taxpayers are yet to experience the full effect of the RDF since its use in this market segment is at an earlier stage than in the large business market.³¹⁸

4.69 The IGT also observes that there are significant differences between the large business market and the SME market and as such this will require different ATO approaches.

4.70 Nevertheless, the IGT's observations in Chapter 3 highlight the importance of ensuring that the ATO's compliance approach is proportionate to the perceived or actual risk. This includes not only the level of risk, but the type of risks which concern the ATO. These include inherent risk factors, behavioural risk factors and information confidence concerns. Clearly articulating these concerns separately ensures that ATO officers make targeted inquiries and use approaches that are proportionate to the differing mixes of these risks and concerns. Furthermore, such an articulation ensures that taxpayers better understand the ATO's concerns and the specific means by which to address those concerns.

³¹⁸ ATO, above n 297.

4.71 The IGT acknowledges, however, that unlike the higher consequence taxpayer segment in the large business market, the ATO cannot make the same in-depth qualitative assessment of the taxpayers' behavioural risks for SMEs. For example, since many SMEs are privately-held, there would be less publicly available information on the taxpayer's tax risk management and corporate governance systems.

4.72 As noted above, the ATO currently takes into account three 'contextual attributes' when using the risk rules. The contextual attributes can be considered as types of behavioural factors. Other behavioural factors may need to be inferred from the taxpayer's compliance history, such as timely lodgment of returns and making of payments.

RECOMMENDATION 4.3

The IGT recommends that the ATO, in consultation with stakeholders, test the distinction between inherent factors, behavioural factors and information confidence and cost for this market segment.

ATO response

Agree.

4.73 The IGT makes more general recommendations regarding proportionality in Chapter 8 of this report.

CHAPTER 5 — MICRO BUSINESSES

5.1 The vast majority of stakeholder concerns that the IGT has received in the past with respect to the ATO's risk assessment tools from this market segment relate to the ATO's use of benchmarks to risk assess business operating in the cash economy. The IGT has already conducted a specific review³¹⁹ into this area, the findings and recommendations of which were well-supported by affected stakeholders and from which conclusions will be drawn in the final chapter of this review.

5.2 The ATO does use other risk assessment tools in this market segment; however, the IGT has received limited feedback from stakeholders on these tools. This may be due to a number of reasons including that there may be a lack of awareness, limited resources of stakeholders in this segment to engage with the IGT and/or the low level of adverse impact caused by the use of these tools.

5.3 Accordingly, this chapter primarily describes these other risk assessment tools in order to raise awareness of them amongst the affected stakeholders and to invite further feedback. In the event that there is significant adverse feedback, the IGT may consider conducting more specific reviews in this area in the future.

5.4 It should also be noted that the Productivity Commission has released its research report *Regulator engagement with small business* in October 2013. In particular, this report makes a number of observations relevant for micro businesses. Although the ATO is one of many regulators impacting micro businesses, several observations in the Productivity Commission's report are consistent with observations in previous and current IGT reports.

BACKGROUND

5.5 The ATO defines micro businesses as those businesses with an annual turnover below \$2 million. They employ one in five Australian workers and account for more than a quarter of tax revenue collected, including approximately \$14 billion in PAYG withholding tax for their employees.³²⁰

5.6 There are approximately 2.8 million micro businesses in this market segment.³²¹ The ATO's Micro Enterprises and Individuals (ME&I) business line has primary responsibility for this market segment. Other ATO business lines also assist in managing various tax risks in the micro businesses market segment. For example, the Tax Practitioner and Lodgment Strategy (TPALS) and Superannuation business lines also administer this market segment in relation to the cash economy and superannuation risks respectively. Whilst the management of taxpayer risks may belong to several business lines, the ME&I business line combines some of these risks when conducting certain compliance activities. For example, the ME&I 'employer

³¹⁹ IGT, above n 7.

³²⁰ ATO, above n 33, p 23.

³²¹ Ibid p 75.

obligations' stream verifies a business's compliance with Pay As You Go withholding, superannuation guarantee and fringe benefits tax obligations.³²²

5.7 The ME&I 'micro active compliance' group is principally involved in monitoring and managing tax compliance risks for this segment.

RISK ASSESSMENT TOOLS USED IN THE MICRO BUSINESS SEGMENT

5.8 The ATO has identified 'expert business rules' as the primary risk assessment tool used in the ME&I business line. These rules essentially query tax return and schedule information and certain third party data to identify potential risks. There is a wide variety of risks that the ATO must manage for this market segment. For example, with respect to Capital Gains Tax (CGT), taxpayers may not correctly report capital gains from various events such as the sale of shares or property. In such cases, certain expert business rules would operate to determine whether there is a risk that the taxpayer may not have disclosed a disposal of shares or property.

5.9 By way of example, taxpayers may claim CGT concessions for small businesses to which they may not be entitled. Expert business rules would query information from income tax returns and CGT schedules in risk assessing the taxpayer's eligibility for such concessions.

5.10 The ME&I business line groups these risks into common themes or issues, CGT being an example of one such theme. Each of these themes has a number of specific risks falling under it along with expert business rules to address them.

5.11 A taxpayer may trigger several risks under a variety of expert business rules. The ATO has advised that it does not aggregate these risks for a given taxpayer for analysis. Therefore, taxpayers are selected for audit only on the basis of individual risks in isolation. Where a taxpayer is selected for an audit, it would initially examine the specific risk which triggered the audit. The scope of the audit may be increased to take into account risks identified during the audit process.³²³

5.12 Additionally, the ATO also uses the Risk Assessment and Profiling Tool (RAPT), a database that contains taxpayer information and allows ATO officers to query and inspect different sets of information. The RAPT also has internal rules to detect risks within the database.

5.13 In addition to the ME&I methods outlined above, the Cash Economy segment of TPALS uses the following tools:

- small business benchmarks — a given business's reported financial performance ratios significantly differ from the norms of their industry (as already mentioned, this area was the subject of a specific IGT review in 2012³²⁴);

³²² Australian Taxation Office, 'An overview of employer obligations', intranet page.

³²³ ATO communication to IGT, email 21/06/2013.

³²⁴ IGT, above n 7.

- cash economy model — a risk model which analyses reported taxpayer income against other data sets to determine if a taxpayer is ‘living beyond’ their reported means; and
- data-matching — the ATO may be able to match the records of third parties (such as suppliers or customers of the taxpayer) against reported taxpayer income to determine possible underreporting (aspects of the use of data-matching for individuals are the subject of a separate current IGT review³²⁵).

5.14 In addition to the ME&I and TPALS cash economy risk tools outlined above, the ATO may also conduct compliance activities in this market segment due to:

- risk pilot programs: hypotheses are developed and tested to determine the level of any risk;
- small scale strategies: includes following up previously audited taxpayers to ensure change in non-compliant behaviour of the taxpayer; and
- referrals: referrals from government agencies or community members.

IGT OBSERVATIONS

5.15 The ATO currently does not have a process for the analysis of risks in a collective or aggregate manner that may be identified in the micro business segment. The IGT is of the view that such holistic analysis may result in an improved examination of taxpayer behaviour and more accurately measures the risks posed by a particular taxpayer.

5.16 Several risks viewed in isolation with respect to a single taxpayer may be low. However, when these risks are viewed as a whole, the result may be that the relevant taxpayer does present a high level of risk. The ATO should conduct research into how it can gain an aggregated view of taxpayers’ risks to better understand the total risk posed by the taxpayer and differentiate and prioritise its treatment accordingly.

RECOMMENDATION 5.1

The IGT recommends that the ATO research and develop strategies to improve aggregated taxpayer risk analysis in the ATO micro business segment.

ATO response

Agree.

5.17 Chapter 8 draws on information from the IGT’s *Review into the Australian Taxation Office’s Use of Benchmarking to Target the Cash Economy* to make additional IGT observations relevant to the micro business market segment.

³²⁵ IGT, above n 118.

CHAPTER 6 — INDIVIDUALS

6.1 As part of his work program consultations, the IGT received significant feedback from individual stakeholders or their representatives in relation to the ATO's risk assessment tools applied to this market segment. The main concerns related to the following areas:

- delayed refunds arising from the ATO's Income Tax Refund Integrity Program (ITRIP); and
- use of third party data in ATO compliance activities.

6.2 The above concerns are the subject of a current specific IGT review.³²⁶ Chapter 8 draws on this later review to make additional observations.

6.3 Although the ATO uses other risk assessment tools in this market segment, stakeholder concerns were largely limited to the above two topics. This may be due to a number of reasons including that there may be a lack of awareness, limited resources of stakeholders in this segment to engage with the IGT and/or the low level of adverse impact caused by the use of these tools.

6.4 This chapter seeks to provide additional information on other risk assessment tools used in the individuals market. This may promote greater awareness and facilitate further stakeholder concerns which, if sufficiently significant, may form the basis of a future specific IGT review.

6.5 In other jurisdictions, some revenue authorities have published details and results from the use of their risk assessment tools. For example, HMRC in the United Kingdom have published details about how they use their system, called 'Connect', to gather and make connections between large data holdings.³²⁷

BACKGROUND

6.6 The individual market segment includes 12.4 million individuals who lodge income tax returns. For many individual taxpayers, the lodgment of their income tax return is their only interaction with the ATO.³²⁸

6.7 Within the ATO, the Micro Enterprises and Individuals (ME&I) business line has main responsibility for administering the individual market segment. Other business lines may be involved in different parts of this market segment, depending on the circumstances. For example, high wealth individuals are administered by the Small and Medium Enterprises (SME) business line.

³²⁶ Ibid. See also Inspector-General of Taxation, *Review into the Australian Taxation Office's Compliance Approach to Individual Taxpayers – Income Tax Refund Integrity Program*.

³²⁷ HM Revenue & Custom, *Closing in on tax evasion – HMRC's approach* (December 2012) <<http://www.hmrc.gov.uk>>.

³²⁸ ATO, above n 33, p 18.

6.8 Within ME&I, the Individuals Compliance and Data Management (ICDM) stream is responsible for managing the compliance risks of individuals for this market segment.

ATO RISK ASSESSMENT TOOLS USED IN THE INDIVIDUALS SEGMENT

6.9 The ATO income tax risk assessment tools used by various areas affecting the individuals market segment are listed in the following table:

ME&I	Serious Non-compliance
Agent rating tool	Identity Crime Model
Data matching with third party data	
Expert business rules	
Pattern detection	
Risk assessment and profiling tool	

6.10 The ATO has through the course of this review supplied the descriptions for each of the above tools. These are outlined below.

Agent Rating Tool (ART)

6.11 The Agent Rating Tool compares returns prepared by a tax agent against those of a pre-determined peer (reference) group. The manner in which the peer groups are established has been validated on two occasions by representatives from Monash University.

6.12 A range of measures are determined for each agent and then compared against their reference group. For example, the Tax Agent Measure may be the median specified work related expenses (WRE) value for their client base. These include median client amounts in relation to motor vehicles expenses or other travel amounts.

6.13 The Reference Group Measure is the median Tax Agent Measure for the specified WRE label for the reference group. The median is used in preference to the average to avoid the influence of extreme scores and outliers.

6.14 For each agent performance measure, the difference between the agent's value and the Reference Group value is indicated by the Deviation Score. The Deviation Score indicates how much an agent differs from the reference group median for that performance measure.

6.15 For each agent, deviation scores are added together to give a Total Deviation Score for each set of performance measures (for example WRE, Rental, CGT and Offsets). Based on these assessments, a risk score is generated to identify which tax agents within a particular population are significantly different to their Reference Group. The product developed to support the presentation of this analysis is called the Agent Rating Tool.

6.16 A key element of the ART is the ability to produce a consolidated one page profile which serves as a tool for the ATO officer to conduct a conversation with a tax agent regarding the return preparation processes and standards.³²⁹

Data matching with third party data

6.17 The ATO receives data in respect of property transactions from state and territory title and revenue offices and continues to expand the use of data matching to identify the omission of capital gains. The ATO use standard data matching rules based on its understanding of the risk to identify individuals who make a gain from disposing property where the property is not covered by main residence exemption.

6.18 The ATO also performs calculations to estimate the capital gains and make allowance for holding costs, such as stamp duty. The ATO compares this information to what has been declared in the return and contacts relevant taxpayers (after the notice of assessment has issued) where it identifies a capital gain has been potentially omitted or calculated incorrectly.³³⁰

Expert Business Rules

6.19 The Expert Business Rules use rules or parameters of known identified 'at risk taxpayer' behaviour across income tax return labels. These rules may use a range of ATO data holdings including corporate data holdings, compliance history information, Payment Summary Annual Reports, Annual Investment Income Reports and Department of Immigration Temporary Visa Holder data. Where these rules are triggered, a decision is taken to either monitor the behaviour or the individual income tax return is taken offline for review prior to issuing the assessment.³³¹

Pattern Detection Model

6.20 The Pattern Detection Model is designed to detect patterns or commonality within individual income tax return data to detect 'high risk' behaviour. The model considers common variables amongst returns and determines whether a pattern exists. This nature of exploration and discovery distinguishes data mining approaches such as the pattern detection model from traditional risk identification models such as the expert business rules.³³²

Identity crime and network detection model

6.21 This model is also used in the individuals market segment but is owned and maintained by the Serious non-compliance (SNC) business line instead of ME&I. The identity crime and network detection model uses known attributes of identity fraud to detect high risk returns using pre-set thresholds. Networks linked to this high risk population are subsequently identified and their size, value and growth assessed. These models run across all lodgment channels.³³³

³²⁹ ATO communication to IGT, 3 June 2013.

³³⁰ ATO communication to IGT, 4 June 2013.

³³¹ ATO, above n 329.

³³² Ibid.

³³³ Australian Taxation Office, Risk Treatment Plan – Income Tax Refund Integrity, p. 8. (from Enterprise Risk Manager).

6.22 The expert business rules, the pattern detection model and the identity crime and network detection model are used in the ITRIP. The use of these rules and models is described in the IGT's, *Review into the Australian Taxation Office's Compliance Approach to Individual Taxpayers – Income Tax Refund Integrity Program* (ITRIP Review).³³⁴

Risk Assessment and Profiling Tool (RAPT)

6.23 The ATO's ME&I business line has commenced developing profiles and rules within RAPT for a number of key populations and risk areas including Pay As You Go Instalments (PAYGI) and the 'High Income Individuals' population. The ME&I business line currently use other risk models outside the RAPT. The intent, however, is for these models to be migrated in the RAPT over time.³³⁵

IGT OBSERVATIONS

6.24 Although the IGT is conducting an in-depth review into the ATO's ITRIP and data-matching in separate reviews, it is useful to draw certain high level observations here about the ITRIP and data-matching from a risk management perspective.

Inputs and accuracy

6.25 Stakeholders had raised concerns that the risk models used in the ITRIP were not accurately detecting cases of incorrect or fraudulent returns. As part of his IGT ITRIP Review, the IGT has analysed the strike rates to determine the rate at which returns stopped and held for investigation were the subject of adjustments.

6.26 Furthermore, the IGT has also examined the average adjustment amounts to assist in determining the actual risk posed by returns stopped via the ITRIP models. However, the use of strike rates and average adjustments as a means to assess the accuracy of risk tools used in ITRIP is limited if there are no benchmarks against which the results can be judged.

6.27 For example, a random sampling of the risk population may indicate a certain strike rate if the returns were stopped at random. Ideally, risk assessment tools would yield strike rates above this benchmark. Chapter 8 further discusses the use of strike rates and random sampling.

6.28 Any changes in the strike rate and average adjustments may be attributable to changes in other variables, such as general community compliance levels and the behaviour of the risk population, rather than directly being attributable to the risk models themselves.

6.29 With respect to data-matching, the ATO receives data from a variety of sources. Each data-set has a different level of quality and usefulness. For example, legislative data, such as interest payment information received from financial institutions, is generally of a high quality since the type of information and its format is mandated by law. For example, the type and format of information is designed to

³³⁴ Inspector-General of Taxation, *Review into the Australian Taxation Office's Compliance Approach to Individual Taxpayers – Income Tax Refund Integrity Program*.

³³⁵ ATO, above n 329.

allow the ATO to readily match the identity of the account holder with the identity of the taxpayer.

6.30 Other data sources, known as non-legislative data, may have a low quality and may not be a reliable source of information for the ATO. For example, some state-based property disposal data does not have sufficient identifiers to enable the ATO to match the vendor's identity with that of the taxpayer. This is because state-based property disposal data is mostly focussed on the identity of the purchaser, as they are usually the party liable for stamp duty.

6.31 When data cannot be relied upon with a high level of confidence, the ATO needs to take care in any subsequent compliance activity which is based on that information. The ATO notes that for pre-filling electronic tax returns, the ATO will only use information that has a high confidence level. Medium and low level confidence level data is disregarded.

6.32 The IGT also notes that the government has included additional funding in the 2013-14 Budget to enhance the quality of data provided to the ATO. This includes data in relation to real property. Such measures should increase the quality of data, and the level of confidence with which the ATO can rely on it.

Proportionality

6.33 In relation to data matching, concerns regarding proportionality differ according to the specific data matching program. For example, adjustments of low amounts of income may be reasonable for one taxpayer in their circumstances but for other taxpayers with lower incomes, such amounts and associated compliance costs may represent a much higher proportion of their income. Therefore, the actual adjustment amounts, the associated compliance costs as well as the circumstances of the target population, are important factors in understanding proportionality.

6.34 In relation to ITRIP, stakeholders have raised concerns that the ATO compliance approach with respect to refunds was not proportionate to the risk posed. An important element of risk is the distinction between fraudulent claims (fraud) and incorrect claims resulting from errors and mistakes (over-claiming).

6.35 The ATO regards fraud as a higher risk compared to over-claiming. This distinction is consistent with the ATO's Compliance Model in Figure 3 in Chapter 2. It is important, therefore, that the ATO's compliance approach is sufficiently differentiated so that those taxpayers who over-claim due to mistakes are not subjected to ATO activity more appropriate for fraud cases.

6.36 In the IGT's ITRIP Review³³⁶, it has been observed that the ATO often bundled fraud and over-claiming concerns in the same communication. For example, reason codes given to tax agents to explain why their clients' tax returns were being held included 'Reason code 1: Potentially fraudulent and/or overstated claims'.

³³⁶ IGT, above n 334, para [5.30].

6.37 Furthermore, since the ITRIP stopped refunds as part of *pre-issue* compliance activity, stakeholders raised the question of whether cases of potentially limited over-claiming that are not fraud are more appropriately addressed as a *post-issue* activity, that is, after the refund is issued, to reflect the lower level of risk.

6.38 Lack of differentiation of different risk such as the one in the ITRIP example above, may increase taxpayer and tax agent perceptions of unfairness in the way the ATO is treating taxpayers and may negatively affect levels of voluntary compliance.

6.39 As indicated in the ATO Compliance Model, the ATO attempts to distinguish between taxpayer attitudes to compliance, ranging from 'willing to do the right thing' through to those who have decided not to comply. The model also indicates, that in light of different taxpayer attitudes, the ATO should also respond in such a way as to positively influence taxpayer behaviour.³³⁷ This distinction is reinforced elsewhere in ATO publications. For example, in the ATO's Second Report of the Cash Economy Taskforce, it is asserted:

The community expects fairness and individual treatment. The ATO needs to recognise and differentiate between those trying to do the right thing and those who intentionally disregard their taxation obligations. This will require the ATO to be firm, but also fair, in bringing to account those who are not meeting their obligations.

... Importantly, the ATO needs to be sure that those already in the system have full knowledge of their obligations and have been given every opportunity to comply. The ATO must be sure that previous good behaviour, or a history of poor behaviour, is acknowledged and taken into consideration in current dealings. The use of stronger enforcement measures on an industry or individual taxpayer will be supported by evidence that lesser measures have proved unsuccessful.³³⁸

6.40 The extract above highlights the importance of taxpayer perceptions of fairness. In the context of the ITRIP, this means the ATO action should also be proportionate to the risk posed by the taxpayer. The ATO Compliance Model needs to be viewed in its historical context. It was originally a model for guiding ATO decision making in relation to sanctions for confirmed non-compliance. The approach in more recent times requires a more holistic consideration of the taxpayer experience and relationship.

³³⁷ Australian Taxation Office, *Introduction to the Compliance Model* (25 March 2009) <<http://www.ato.gov.au>>.

³³⁸ ATO, above n 52, p 58.

CHAPTER 7 — TAX PRACTITIONERS AND ADVISORS

BACKGROUND

7.1 As discussed in the IGT's Self Assessment Review, tax practitioners have an important and significant role to play in Australia's self assessment system.³³⁹ Tax practitioners assist taxpayers in managing their tax affairs and have a role in 'ensuring that their clients understand their rights and obligations'.³⁴⁰

7.2 According to the OECD's 2008 *Study into the role of tax intermediaries*, there is a tripartite relationship between taxpayers, advisors and revenue authorities.³⁴¹ By engaging advisors and involving them in the compliance process, taxpayer compliance will be enhanced, potentially at a lower cost to the ATO. Each party has a unique set of experiences and a different perspective on issues:

A strategy of positive engagement with tax advisors offers potentially significant benefits to all parties in the tax system. In particular, it can add to revenue bodies' understanding of tax advisors and the role they play in the tax system, as well as improved risk and compliance strategies and better-focussed information requests and dialogue with taxpayers, resulting in reduced compliance costs for all.³⁴²

7.3 The ATO has acknowledged the crucial role that tax practitioners play, expressing it in the following manner:

... tax agents (and other intermediaries) are a critical and crucial leverage point as a key intermediary in the tax and superannuation system. There are around 53,000 registered tax practitioners (of which around 23,000 are observed to act on behalf of taxpayers with income tax lodgment obligations) representing over 15 million taxpayers. In a given year, tax agents are responsible for the lodgment of over 90 per cent of business tax returns and over 70 per cent of individual income tax returns.³⁴³

7.4 Considering tax practitioners' important role in optimising voluntary compliance of taxpayers, the ATO seeks to encourage desired behaviours and support of the profession. Such support is largely reflected in the ATO's *Tax Practitioner Action Plan 2011-15*.³⁴⁴ Therefore, the ATO's monitoring of tax practitioners is important in promoting compliance.

7.5 Tax practitioners are also taxpayers themselves. They may be sole traders or part of a small, medium or large business. As taxpayers, they continue to have their own obligations to correctly register, lodge, correctly report their relevant tax information and pay tax liabilities on time. However, unlike other taxpayers, breaches

³³⁹ IGT, above n 5, pp 75-77.

³⁴⁰ ATO, above n 33, p 12.

³⁴¹ Organisation for Economic Co-operation and Development, *Study into the Role of Tax Intermediaries* (2008) p 54.

³⁴² Ibid p 44.

³⁴³ ATO communication to IGT, 25 February 2013.

³⁴⁴ Australian Taxation Office, *Tax Practitioner Action Plan 2011-15* (7 February 2012) <<http://www.ato.gov.au>>.

of these obligations may affect their eligibility to practice. Principle 2 of the Code of Professional Conduct requires that tax practitioners 'must comply with the taxation laws in the conduct of your personal affairs'.³⁴⁵ This Code is contained in the *Tax Agent Services Act 2009* (TASA).

7.6 Whilst the ATO does not administer the TASA, where ATO compliance activities indicate that persons may be breaching the TASA, (for example, by providing unregistered tax agent services), the matter may be referred to the Tax Practitioners Board (TPB) for action.³⁴⁶

7.7 The TPB is the independent regulator of the TASA including the Code. Whilst independent of the ATO in its decision making and administration of the TASA, the TPB is supported by the ATO and constitutes an ATO program of work under the Government's Portfolio Budget Statements framework.³⁴⁷

7.8 Tax practitioners may also be members of professional associations. These associations have their own standards and requirements for membership. These typically include being a 'fit and proper person', having relevant qualifications, experience and mandating continuing professional development. Any breaches may be subject to disciplinary action or even expulsion.

ATO APPROACHES TO TAX PRACTITIONER RISK IDENTIFICATION

7.9 During the IGT's Self Assessment Review, the ATO advised that there were three broad approaches to risk identification relating to tax practitioners:

Firstly, there is the question of management of risk, using a Risk Differentiation Framework ('RDF') which considers a variety of factors, including association with particular intermediaries like tax practitioners and/or advisors.

Secondly, there is the assessment of risks for tax intermediaries who may be subject to the promoter penalty laws, where we need to identify whom we focus our intention [sic] upon and how we engage with them in order to manage risks of contravention of the promoter penalty laws. We have consulted extensively with industry and the professions on these issues ...

Thirdly, there is the assessment of risks for tax practitioners who serve as an interface with their clients and the ATO, where we need to identify whom we focus our intention [sic] upon and how we engage with them in order to manage risks relating to taxpayer compliance with the four pillars of compliance obligations, being registration, lodgment, correct returns and debt.³⁴⁸

7.10 The first approach mentioned above is considered in Chapter 3 of this report whilst the other two approaches are dealt with below.

³⁴⁵ *Tax Agent Services Act 2009* s30-10(2).

³⁴⁶ ATO, above n 33, p 15.

³⁴⁷ The Tax Practitioners Board, *Annual Report 2011-12* (2012) p 30.

³⁴⁸ ATO communication to IGT, 7 June 2012.

Promoter penalty regime

7.11 The ATO has advised that, where the ATO has concerns that a particular tax advisor is promoting contestable schemes, the matter would be referred to the ATO's Aggressive Tax Planning (ATP) business line for further action under the promoter penalty regime.

7.12 The promoter penalty regime took effect from 6 April 2006 when Division 290 was inserted into Schedule 1 of the *Taxation Administration Act 1953*. The regime seeks to deter:

- the promotion of tax avoidance and evasion schemes ('tax exploitation schemes'); and
- the implementation of schemes that have been promoted on the basis of conformity with a product ruling, in a way that is materially different to that described in the product ruling.³⁴⁹

7.13 The Explanatory Memorandum to the Bill which enacted the regime outlines the reasons for the penalties:

3.3 Currently, there are no civil or administrative penalties for the promotion of these schemes, with the result that promoters can obtain substantial profits while investors may be subject to penalties under the TAA 1953. This represents a significant asymmetry in risk exposure.

3.4 Furthermore, the Commissioner of Taxation (Commissioner) cannot currently take legal action to stop the promotion of tax schemes. It is possible to warn investors about the risk that tax benefits will not be available, but educational initiatives have limited 'real time' impact. In contrast, the 'real time' remedies of injunctions and voluntary undertakings in this Bill can stop the promotion of schemes before investors participate.³⁵⁰

7.14 In relation to the alleged promoter, the regime allows the Commissioner, to:

- ask the Federal Court to apply civil penalties;
- ask the Federal Court to issue an injunction preventing promotion of the scheme;
- accept voluntary undertakings; and
- where the Commissioner considers that the terms of the voluntary undertaking have been breached, to ask the Federal Court to make orders directing compliance with the undertaking or other appropriate orders.

7.15 The ATO has issued public guidance on how it manages the risk of non-compliance with the promoter penalty regime in April 2008 through the

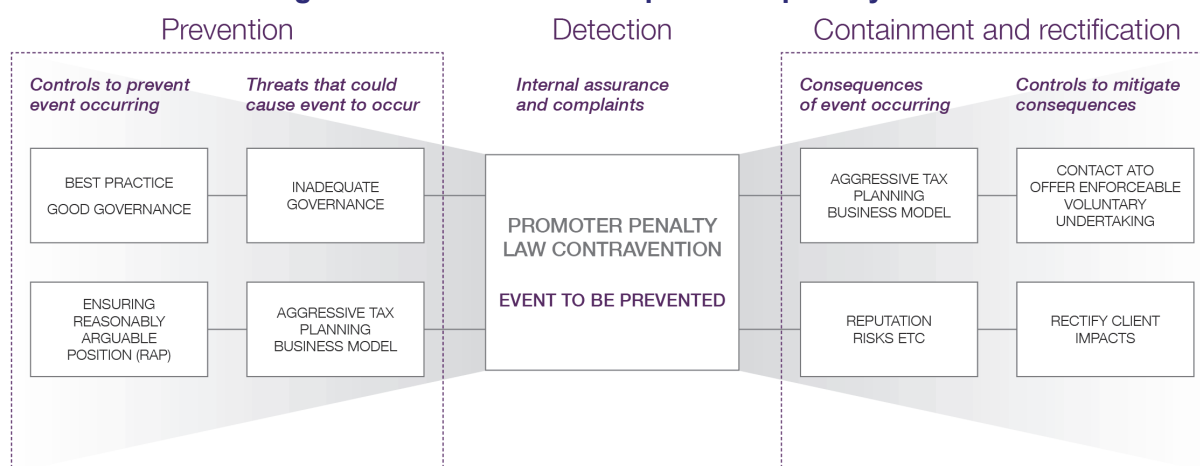
³⁴⁹ Explanatory Memorandum, House of Representatives, Tax Laws Amendment (2006 Measures No.1) Bill 2006, para [3.1].

³⁵⁰ Ibid para [3.3] and [3.4].

publication of PS LA 2008/8 *Application of the promoter penalty laws (Division 290 of Schedule 1 to the Taxation Administration Act 1953) to schemes involving product rulings*.

7.16 Furthermore, the publication *Good governance and the promoter penalty laws* (Good Governance), first published April 2011, outlines the areas that currently concern the ATO and highlights the importance of a taxpayer exercising good governance to reduce the risk of non-compliance. A second edition was published in December 2012. This publication also uses a form of 'risk bow-tie':

Figure 18: Risk bow-tie for promoter penalty laws



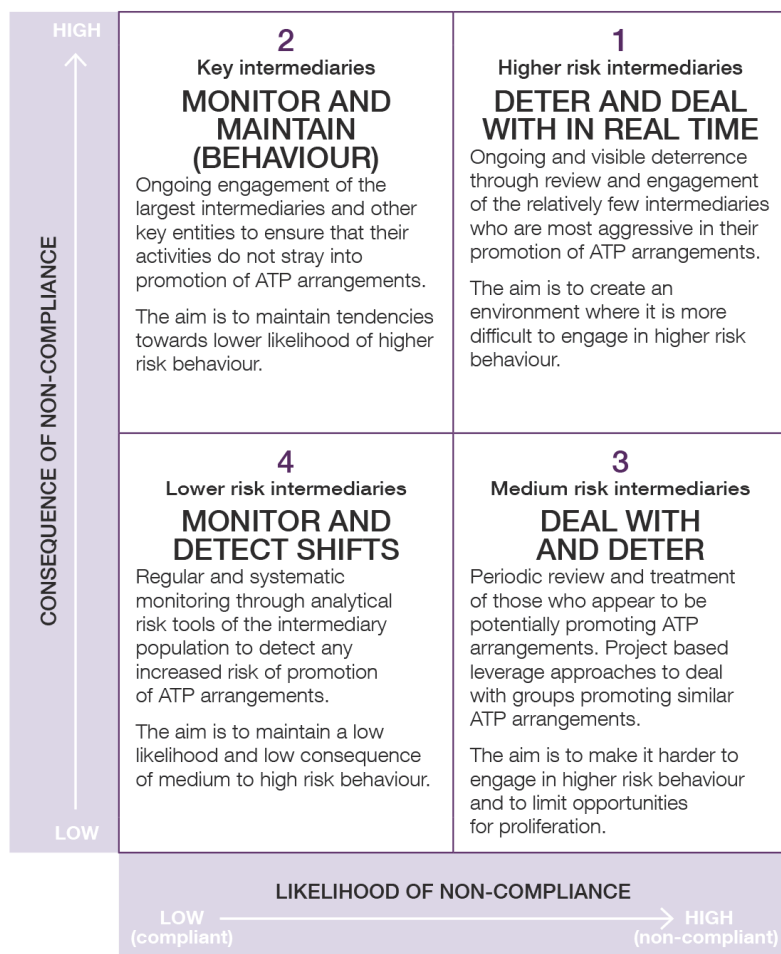
Source: ATO, *Good governance and promoter penalty laws* 2012, page 15.

7.17 The risk bow-tie highlights that the risk event to be prevented is the contravention of the promoter penalty laws. This can be contrasted with the usual application of the risk bow-tie to the tax laws, where the risk events relate to registration, lodgment, reporting and payment.

7.18 Importantly, the definition of the risk event focuses the ATO's attention on the risk hypothesis that it is seeking to test when undertaking compliance activity under the promoter penalty regime.

7.19 The ATO has also indicated that it uses a risk differentiation framework with respect to managing the risk of non-compliance with the promoter penalty laws:

Figure 19: RDF for intermediaries — promoter penalty laws



Source: ATO, Good governance and the promoter penalty laws 2012, page 4.

7.20 According to the Good Governance publication, the ATO takes the following approach with respect to advising intermediaries of their risk rating:

- Higher risk intermediaries:

We notify such entities of their preliminary risk rating when we start a review or investigation of their conduct and their final risk rating at the completion of their case.³⁵¹

- Key intermediaries:

We notify such entities that they are key intermediaries as part of our regular engagement processes, unless our interactions indicate that they have moved to another category.³⁵²

- Medium risk intermediaries:

We notify such entities of their preliminary risk rating when we start a review or investigation of their conduct and their final risk rating at the completion of their case.³⁵³

³⁵¹ Australian Taxation Office, *Good governance and promoter penalty laws* (2012) p 6.

352 Ibid.

353 Ibid p 7.

- Lower risk intermediaries:

This category contains the vast majority of tax intermediaries so we do not ordinarily advise such entities of their risk rating, unless our monitoring indicates that they have moved to another category.³⁵⁴

7.21 The ATO also provides some detail of its compliance activities in this area in its Annual Report:

We reviewed the conduct of 529 entities that were potentially involved in arrangements contravening the promoter penalty legislation, resulting in liabilities of \$29.3 million being raised.

In relation to those entities which had a higher likelihood of contravening the promoter penalty laws, we undertook a mixture of promoter penalty action and audits of their personal tax affairs. We also initiated six proceedings in the Federal Court involving potential contraventions and executed a number of voluntary undertakings where less significant risks were demonstrated.

We engaged with industry, advisory firms and financial institutions about their involvement in financial products and contentious tax planning arrangements. We also undertook governance visits with 27 key intermediaries to examine how they manage their promoter penalty risks. These engagement activities resulted in:

- improvements in their governance processes
- an increase in the numbers of applications for product rulings
- immediate changes to features in products
- withdrawal of some products from the market and some entities ceasing trading entirely
- negotiation with product issuers to pay tax-related liabilities of affected investors by way of third-party settlement deeds.³⁵⁵

IGT observations

7.22 The IGT has received limited stakeholder representation with respect to the administration of the promoter penalty regime. This may be due in part to a much reduced level of scheme activity or ATO activity.

7.23 The ATO's RDF approach for tax intermediaries in relation to the promoter penalty laws has been public since 2009.³⁵⁶ The ATO's action in this area has been cautious with only one court case initially decided against the ATO but subsequently

³⁵⁴ Ibid.

³⁵⁵ ATO, above n 17, p 82.

³⁵⁶ Bruce Collins, 'The promoter penalty regime - How the ATO is applying it in practice', (Paper presented at the Tax Institute of Australia's Annual Tax Forum, Sydney, 17 May 2012).

decided in favour of the ATO upon appeal.³⁵⁷ The ATO also notes that several voluntary undertakings have been provided.³⁵⁸

7.24 The ATO takes a differentiated approach to communicating risk categorisations to tax advisors depending on their categorisation. As such, those advisors categorised as lower-risk or medium-risk would not necessarily receive a risk categorisation on a regular basis.

7.25 The IGT understands that this approach may generate a degree of uncertainty for these intermediaries. Such uncertainty about the ATO's view of their risk level is partly ameliorated by the publication of the risk factors in the Good Governance publication. This allows the intermediary to self-assess their risk to a certain degree. Importantly, this is a specific legislative regime where the ATO is empowered to take action that has a high bar and is publicly transparent.

Tax Practitioner RDF

7.26 In its Compliance Program 2012–13, the ATO has indicated that it is using 'a differentiated approach':

Our focus is on enhancing the ability of tax practitioners to promote proper participation in the tax and superannuation systems, and to create a level playing field for tax practitioners by dealing with those who don't meet the high standards of the profession.

We recognise that the great majority of tax practitioners do a good job of ensuring that their clients properly participate in the tax and superannuation systems.

At the same time, a small minority of tax practitioners struggle, lacking the expertise or resources to meet the business needs of their client base. Others lack the commitment to ensure the full participation and compliance of their clients in the tax and superannuation systems.

Our risk profiling indicates that across a range of different risks, around 90 per cent of tax practitioners have a high proportion of clients that are mostly compliant. Through our initial consultative processes with key tax practitioners we have seen best practices that support clients in getting it 'right from the start'. On the other hand, 8–10 per cent of tax practitioners have higher proportions of clients who are struggling to meet their obligations, and a further 1 per cent have a significant proportion of clients that are at risk of non-compliance across multiple areas of their tax and superannuation obligations.³⁵⁹

7.27 The ATO is seeking to differentiate their approach to tax practitioners, according to the perceived 'riskiness' of their clients. The ATO is of the view that it can influence a larger number of higher risk taxpayers by interacting with a smaller number of tax agents. For example, in 2011–12, the ATO visited about 800 tax practitioners whose clients 'had a high risk of under reporting cash income'.³⁶⁰

³⁵⁷ *Commissioner of Taxation v Ludekens* [2013] FCA 142; *Commissioner of Taxation v Ludekens* [2013] FCAFC 100.

³⁵⁸ ATO, above n 17, p 82.

³⁵⁹ ATO, above n 33, p 12.

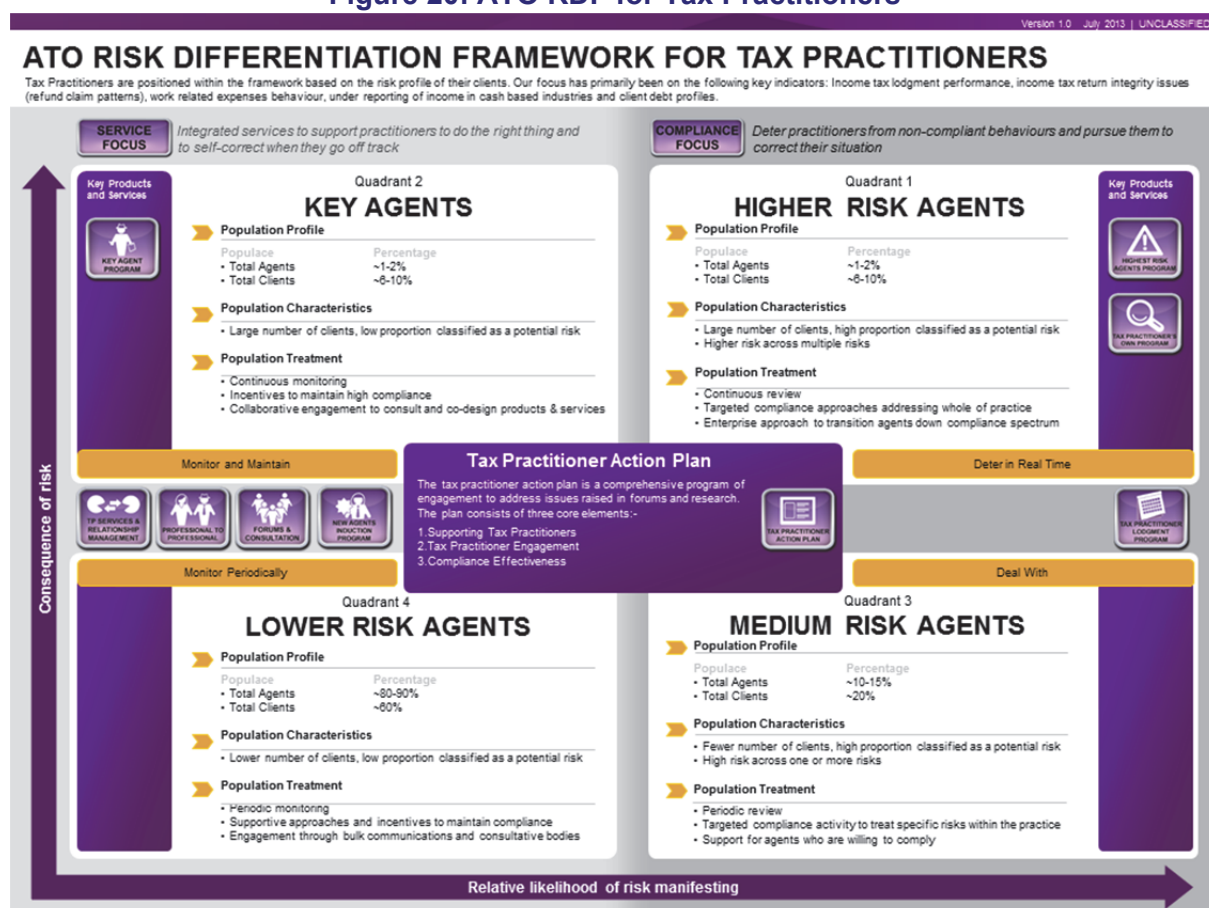
³⁶⁰ Ibid p 14.

7.28 The ATO has also framed this approach as an adoption of the RDF. This approach currently considers the risk of specific types of taxpayer non-compliance. These areas are:

- income tax lodgment performance (non-lodgment and late-lodgment);
- income tax return integrity issues;
- work-related expenses behaviour;
- under reporting of income in cash-based industries; and
- client debt profiles.

7.29 After the above analysis, the ATO has identified 1-2 per cent of tax agents as being higher risk tax agents. These agents account for 6-10 per cent of represented taxpayers. The figure below highlights this division (a larger version is reproduced in Appendix 11). The ATO's *Compliance in focus 2013-14* document states that it plans to engage with 100 tax practices in 2013-14 using the risk differentiation approach.³⁶¹

Figure 20: ATO RDF for Tax Practitioners



Source: ATO, supplied to IGT October 2013.

³⁶¹ Australian Taxation Office, *Compliance in focus 2013-14* (2013) p 24.

7.30 The ATO has also communicated aspects of the tax practitioner RDF at various tax agent consultative forums in 2012.³⁶² The tax practitioner RDF is also briefly mentioned in the September 2012 issue of the ATO's *TAXAGENT* magazine.³⁶³

IGT observations

7.31 The ATO's approach to risk differentiation for tax practitioners is relatively new and their compliance approaches are currently developing. In his Self Assessment Review, the IGT expressed some reservations about the application of an RDF to tax practitioners and proceeded to recommend that:

The ATO should continue consultation with the tax profession to identify strategies to achieve a more constructive relationship. Such consultation should include discussions on whether the use of a risk differentiation system is appropriate and if so how it should be implemented.³⁶⁴

7.32 Once the ATO's Tax Practitioner Action Plan 2011-15 has been further bedded down, the above fundamental issue, of whether an RDF should be applied to tax practitioners, may be further explored in a potential review on the current IGT work program, namely: *the Review of the ATO's Services and Support for Tax Practitioners*.

7.33 The discussion that follows, therefore, focuses on improvements that can be made to the tax practitioner's RDF as it currently stands. Once fully developed, further improvements to it may be considered in the above potential review.

7.34 The IGT notes that the ATO has communicated generally among tax practitioners about the use of the RDF. The minutes to the NSW Regional Tax Practitioners Working Group (RTPWG) April forum indicate that the ATO:

... is introducing a risk differentiation framework for registered agents to assess the perceived risk posed by registered tax and business activity statement (BAS) agents. As part of this framework, the ATO will design a corporate engagement strategy, aligning resources to the perceived risk of the registered agent.

... The ATO will be developing and utilising two frameworks this year:

- the perceived risk of the registered agent as a taxpayer
- the perceived risk of the registered agent's practice.³⁶⁵

7.35 The IGT observes, that where the ATO is assessing the risk of the registered agent as a taxpayer, the risk hypothesis it is seeking to test should be clear and related to effective:

- registration;

³⁶² Australian Taxation Office, *Nth QLD RTPWG minutes, April 2012* (26 September 2012) <<http://www.ato.gov.au>>.

³⁶³ Australian Taxation Office, *The TAXAGENT magazine* (56th issue, 2012).

³⁶⁴ IGT, above n 5, rec 3.6.

³⁶⁵ ATO, above n 362.

- lodgment;
- reporting; and
- payment.

7.36 Where the ATO is assessing the risk of the registered practitioner's practice, the ATO also needs to clearly articulate the risk hypothesis. By way of example, the risk bow-tie used in the promoter penalty regime describes the risk event in the centre of the bow tie, along with measures to deter and deal with potential non-compliance.

7.37 As noted in other contexts, it may be helpful for tax practitioners, as well as ATO staff, to ensure the risk event under the tax practitioner RDF is clearly articulated, so as to focus the nature of the ATO's enquiries.

7.38 The tax practitioner RDF primarily differentiates their approach to tax practitioners based on the risk profile of their clients. This seems to be the reverse of the perception that the risk rating of taxpayers (particularly those in the large business segment) is partly influenced by the advisors they choose as explained in Chapter 3. This does seem to be circular and supports Recommendation 3.6 of this report, that is the choice of advisor should not impact on a taxpayer's risk rating.

7.39 Whilst the risk inputs, being the risk profile of the clients of the tax practitioners, may be a useful method of initial identification of higher risk practitioners, the IGT believes that care needs to be taken to ensure risk modelling is appropriately augmented by follow-up and qualitative analysis. This is because the risk assessment of clients themselves may have a degree of inaccuracy. For example, in the ATO's Compliance Program 2011-12, the ATO said:

Most businesses are within benchmark and most registered agents have clients operating within benchmark. We have identified that about 50 per cent of those businesses falling outside benchmark are represented by about 1,900 registered tax agents.

We will contact registered tax agents with a high number of clients whose results fall outside benchmarks to gain an understanding of why this is the case.³⁶⁶

7.40 As part of his *Review into the Australian Taxation Office's Use of Benchmarking to Target the Cash Economy*, the IGT made the following observation:

As correspondence audits have a strike rate of 24 per cent this may suggest that a higher variance from the benchmark does not necessarily, of itself, indicate likely underreporting of income. This is not to say that the variance from the benchmark is ineffective at targeting a proportion of underreported income. As a starting point for risk hypothesis testing, benchmarks have identified non-compliant taxpayers.

However, it is equally true that correspondence audits may be better targeted by not commencing them solely based on benchmarks.³⁶⁷

³⁶⁶ ATO, above n 33, p 37.

³⁶⁷ IGT, above n 7, para [4.32].

7.41 Unless the risk hypothesis has been adequately tested, either via a campaign of compliance activity such as the small business benchmark audits or through a form of pilot or sampling, the actual level of risk is untested. In the above example, the risk hypothesis was that significant variance from the benchmark is positively correlated with a higher probability of underreporting cash income. The IGT's analysis of the results indicated that the level of risk (both in terms of probability and consequence) was lower than that originally expected by the ATO.³⁶⁸

7.42 To base a risk rating of an agent upon the purported, rather than confirmed, risk level of their clients increases the chances that the risk rating of the agent is also inaccurate. It is important, therefore, that the ATO, in determining the level of risk presented by a tax agent, take into account additional qualitative analysis to better understand the preliminary position. The use of confidence levels, as described in Chapter 2, may also be helpful in this regard.

7.43 In addition to improving the inputs and the risk modelling, there is a need for more transparency and communication in relation to the tax practitioner's RDF. The IGT believes that public information should be available about how the Tax Practitioner RDF operates. Such information or guidance would be in addition to the information in the Compliance Program and *TAXAGENT* magazine. A starting point may be the depiction of the RDF in Figure 20 above and tax practitioners should be consulted on the further development of these guidance materials.

7.44 Tax practitioners should also be consulted in relation to the entire RDF process as applied to them and, in particular, how the ATO should proceed once higher risk agents have been identified and whom the ATO intends to investigate further. One important consideration is that the tax practitioners should have a right of review and be afforded due process before the ATO risk rating is finalised.

7.45 It is important that the ATO does not approach the tax practitioners on the assumption that they are doing something wrong with respect to their clients who are perceived to be higher risk taxpayers. For example, there are various reasons why a practitioner may appear to have a large proportion of clients who are outside the small business benchmarks.

7.46 The ATO has advised that it does not disclose the risk rating of agents to their clients. This is crucial to the continued survival of the tax agent business and processes should be in place so that such confidentiality is always honoured. Where a taxpayer's tax liabilities have been adjusted as a result of the tax practitioner not taking reasonable care, the ATO should refer the matter to the TPB.

³⁶⁸ Ibid pp 31 and 33. See table 7 (actual vs planned strike rate) and table 8 (actual vs planned average adjustment).

RECOMMENDATION 7.1

The IGT recommends that, in consultation with tax practitioners, the ATO develop and publish a complete guide on the operation of RDF for tax practitioners. Matters to be covered by the guide include:

- (a) the risk hypothesis being tested;*
- (b) the inputs used;*
- (c) tax practitioners opportunity for review to initial risk rating (consistent with the principles of natural justice);*
- (d) communications between the ATO and practitioners;*
- (e) confidentiality of the risk rating as between the ATO and the practitioner;*
- (f) referral to the ATO's Aggressive Tax Planning Unit where the promoter penalty regime may apply; and*
- (g) referral to the Tax Practitioners Board where the Code of Professional Conduct contained in the Tax Agent Services Act 2009 may have been breached.*

ATO response

Agree.

CHAPTER 8 — TEMPLATE FOR FUTURE DESIGN

8.1 Thus far, this report has covered specific issues in relation to the ATO's risk assessment approaches for particular market segments. This chapter draws together key themes in the earlier chapters. The reason for doing so is to draw out general design elements that assist with future risk assessment architecture in the tax administration environment.

8.2 The key themes adopted based on stakeholder feedback and reflected in the earlier chapters were:

- governance;
- effective use of inputs;
- transparency and communication; and
- proportionality of the compliance approach.

GOVERNANCE

8.3 Good governance is a cornerstone of effective tax administration. The revenue authority must have confidence that its risk assessment approaches are being carried out as intended.

8.4 All risk assessment approaches should ensure that stakeholders and officers are aware of their roles and responsibilities. This may come in the form of job descriptions or duty statements. Key committees or decision-making bodies should have their authority and remit clearly articulated. Internal reporting structures need to be in place to ensure problems and issues are escalated to the appropriate committee or decision-maker for timely action. This may come in the form of charter documents.

8.5 Decision-making bodies need to ensure that they are following agreed, articulated processes and that decisions are made on a timely basis. Decisions should be appropriately documented with supporting evidence and reasoning.

8.6 Risk assessment approaches should also have a clear line of sight from the highest level, that is the Enterprise Risk Management Framework. The ATO has, at the strategic level, identified 22 key enterprise risk areas. Any risk assessment approach, or risk management campaign, should be able to indicate to which key enterprise risk area it relates. This may be evidenced by risk assessment and risk treatment documents on the Enterprise Risk Manager.

8.7 Documentation at the business line level may be required to indicate how the enterprise risk will be addressed at the strategic or tactical level.

8.8 Furthermore, risk assessment and risk treatment measures should have an evaluation strategy, which indicates how the ATO will measure the effectiveness of,

and improve, the risk assessment or risk treatment method. A continuous improvement outlook should also be a hallmark of the entire process.

EFFECTIVE USE OF INPUTS

8.9 A system is only as good as the inputs that go into it. Relevant and effective inputs are vital for risk identification and capture. It facilitates the direction of limited resources to areas that most warrant it.

8.10 It is important to clearly articulate the risk hypothesis to ensure risk inputs are relevant to the risk being identified. In the LBTC booklet, the risk event, for example, is the taxpayer having a tax position with which the ATO disagrees or the taxpayer through error or omission has misreported their obligations.³⁶⁹

8.11 In this case, there are two types of risk events and it is important to ensure that the ATO does not attribute one risk factor against the wrong risk event. For example, a taxpayer may undertake transactions in an uncertain area of the law. To infer that this indicates a higher likelihood of 'non-compliance' (that is error or omission) is not appropriate. It is important that risks be more specifically identified and the expected remediation or action required more carefully targeted.

8.12 This report recognises that the ATO uses a combination of quantitative and qualitative inputs. Quantitative data has the benefit of being perceived as objective fact. Furthermore, quantitative data lends itself well to analysis by computerised methods rather than manual analysis. This means a great deal of analysis can be performed at a high volume at relatively low cost to the ATO.

8.13 The application of quantitative approaches in certain situations need little qualitative inputs where there is objective, verifiable and direct evidence of non-compliance, such as those used in data-matching of interest income disclosures in income tax assessments.

8.14 In the absence of quantitative inputs, the IGT recognises the need to employ qualitative inputs. The small business benchmarks provide a good example of where both these types of input need to be used to arrive at an appropriate outcome.

8.15 The benchmarks are derived from taxpayer income tax returns and activity statements from statistically valid populations of similar businesses. Whether a particular taxpayer's cost of sales to turnover ratio is different to the benchmark range is also objectively verifiable. However, a departure from the benchmark hypothesises an increased risk of underreported income. Therefore, as set out in the IGT's *Review into the ATO's Use of Benchmarking to Target the Cash Economy* (Benchmarking Review), ATO officers also need to examine qualitative inputs, including a better understanding of the taxpayer's business and the consideration of other qualitative risk factors, such as the nature of the business, cash controls and its business mix and record keeping management.

³⁶⁹ ATO, above n 63, p 25.

8.16 The ATO should ensure that qualitative information is considered in an objective and non-arbitrary manner. Adopting appropriate governance arrangements should assist in this regard. In the Large Business and International (LB&I) business line, the adoption of the risk template, which lists specific risk factors to consider, and the moderation panel, which subjects the risk factors to peer review and collective decision making, are helpful measures in ensuring the integrity of the use of qualitative inputs. The LB&I approach is designed to ensure that evidence is tested consistently across the risk population.

8.17 The ATO should also ensure that there are processes in place to refine the accuracy of their risk inputs. In the IGT's Benchmarking Review, the ATO agreed to examine the results of the completed audits to identify any other risk factors which may assist in better targeting likely non-compliant taxpayers.

8.18 In the SME business line, risk managers have responsibility for the regular review of the risk rules under their ownership. This business line has also agreed to previous ANAO recommendations to review their risk rules.

8.19 In LB&I, it is noted that the risk filters are currently generating many false positives that are subsequently filtered out by risk managers. This represents an opportunity to review the risk filters with a view to ensuring they are generating more useful output and reducing the need for risk managers to do this filtering.

8.20 Risk managers play an important role in all business lines. They identify potential risks, develop rules to detect those risks, and develop risk treatment strategies. The ATO should ensure that risk managers have an adequate understanding of the business and economic environment pertaining to the risk over which they have responsibility. This ensures that risk managers can identify potential risks in a timely manner.

8.21 The ATO should also ensure that risk managers are adequately supported in their role. This includes ensuring they have the adequate skills to identify and analyse risk as well as develop guidance for active compliance officers on the indicators and evidence of non-compliance to test the risk hypothesis.

8.22 Risk managers should also be able to articulate what evidence active compliance officers can rely upon to confirm compliance and close the review or audit as soon as practicable. Risk managers should also have regular contact with compliance officers as an additional source of risk intelligence.

8.23 The ATO's Compliance Effectiveness Methodology provides guidance to ATO officers who are developing risk treatment strategies. One aspect of this guidance is that processes should be in place to gather evidence to indicate whether the ATO's intervention was effective in changing compliance behaviour.

8.24 From a risk assessment perspective, the IGT is of the view that the ATO should also consider how to measure the effectiveness of their risk assessment approaches in detecting non-compliance and not just the effectiveness of the compliance activities themselves.

8.25 One such way of evaluating the accuracy of risk assessment methods is through the examination of strike rates and audit yields. Both of these measures provide useful information in more accurately determining the probability and consequence aspects of a risk rating for a population.

Strike rates and audit yields

8.26 Strike rates are essentially the ratio of cases where there is a positive adjustment in tax payable (that is a 'strike') as a proportion of all cases conducted. The remainder of cases are often referred to as 'nil outcome' cases.

8.27 For a given audit selection method, a pool of 'positive' cases is generated. Where the subsequent compliance activity results in a strike, the case is considered a 'true positive' if the result is not reversed on objection, review or appeal. The taxpayer is non-compliant in this case and the risk method accurately detected it.

8.28 As mentioned earlier, where the audit case results in a nil outcome, the case can be said to be a 'false positive'. The taxpayer is actually compliant, but the risk method inaccurately has detected the taxpayer as being non-compliant.

8.29 In limited situations, a nil outcome may be underlying non-compliance due to certain factors.³⁷⁰ Importantly, the tax administration is not assessing risk of over-compliance, being situations where taxpayers have under claimed deductions or not availed themselves of full entitlements.

8.30 It is also important that likely compliant or lower risk taxpayers are spared from unnecessary compliance costs. As such, risk assessment methods should also be accurately identifying likely compliant taxpayers. For example, in the Compliance Program 2012-13, the ATO said of their small business benchmark approach:

We have developed benchmarks for over 900,000 small businesses in over 100 industries. The program was promoted by extensive communication and consultation with tax practitioners, industry associations and taxpayers in those industries.

Approximately 90 per cent of businesses in benchmarked industries fall within a benchmark range. This means around 800,000 businesses are likely to be competing on a level playing field with their peers.³⁷¹

8.31 The above highlights that the benchmarks are used as much as a tool to identify likely compliance as it is to identify potential non-compliance. However, such likely compliance is an assumption, as the ATO cannot be certain that those businesses within the benchmarks are actually compliant unless they are audited.

8.32 In the case above, the benchmark approach has identified a pool of 800,000 cases as 'negatives'. Whether these cases are truly compliant ('true negatives') or truly non-compliant ('false negatives') would require some degree of verification. That is, the ATO may need to audit some of these taxpayers to verify if they are indeed 'likely to be competing on a level playing field with their peers'.

³⁷⁰ Australian Taxation Office, Strike rate – An analysis of Indirect Tax audits, April 2012, slide 19.

³⁷¹ ATO, above n 33, p 28.

8.33 The evaluation of the accuracy of risk assessment tools can be better understood by adding the potential true negatives and false negatives:

Table 4: ‘Confusion matrix’

Actual	Predicted	
	Compliant	Non-compliant
Compliant	True negative (TN)	False positive (FP)
Non-compliant	False negative (FN)	True positive (TP)

Source: Adapted from Gupta and Nagadevara 2007 — Audit Selection Strategy for Improving Tax Compliance — Application of Data Mining Techniques.³⁷²

8.34 It may be apparent from the above table, that the ability for a risk assessment tool to accurately detect non-compliance is reliant on the underlying level of compliance or non-compliance in the risk population. That is, the combination of false negatives and true positives (FN + TP) represents all the non-compliant taxpayers for a given risk population.

8.35 If the population has a low proportion of non-compliance, it is inevitable that any risk assessment tool will have a low strike rate. Therefore, when assessing the accuracy of a risk assessment tool based on strike rate alone, one needs to be aware that a reduced strike rate may be due to a combination of either:

- overall reductions in the level of non-compliance in the risk population (that is reductions in FN and TP); or
- the risk assessment tool is becoming less accurate at detecting non-compliance (that is reductions in TP only, but not FN).

8.36 Strike rate analysis is limited in that it only considers selected cases (the ‘positives’) and which of these were ‘true positives’ (strike rate = $TP/[TP+FP]$). It does not consider false negatives (FN).

8.37 Determining the true cause of low strike rates, therefore, relies on an understanding of the underlying level of non-compliance in a given population. One method for determining this is the use of random audits.

Random audits

8.38 According to the ATO’s research in compliance effectiveness, randomised controlled trials are one of the most accurate ways of determining whether a particular compliance intervention was the cause of changes in taxpayer behaviour.

8.39 Similarly, auditing a random sample of taxpayers in a given population, such as a representative sample of the 900,000 benchmarked small businesses, may indicate the underlying level of non-compliance. If the underlying level of non-compliance is

³⁷² Manish Gupta and Vishnuprasad Nagadevara, ‘Audit selection strategy for improving tax compliance – application of data mining techniques’ in Ashok Agarwal and Venkata Ramana (eds), *Foundations of E-government* (2007) p. 378.

under say, 24 per cent, then it can be said that using the benchmarks alone to select taxpayers for audits is 'better than random'.³⁷³

8.40 Until such sampling is undertaken, however, it cannot be said with certainty that the use of benchmarks alone is indeed better than random selection. Furthermore, random sampling may indicate a higher level of underlying non-compliance. For example, if a random representative sample of the benchmarked population revealed a non-compliance rate of over 24 per cent, it could be said that the benchmarking method was ineffective at targeting likely non-compliant taxpayers. In such a case, the sampling may reveal other correlations or relationships that can be used as a risk inputs besides benchmarks.

8.41 One of the main reasons why the ATO does not conduct random audits is the cost they impose on compliant taxpayers and the opportunity cost to the ATO in conducting a random audit instead of a risk-based audit which is likely to yield more tax revenue.

8.42 Compliance costs imposed on compliant taxpayers through random audits may be mitigated by the ATO reimbursing taxpayers for the additional compliance costs incurred if any. In the case of random audits, the taxpayer is not being audited because they represent a direct risk necessarily, but they are rather contributing to make the ATO's risk assessment method more effective. That is, when they are compliant they are bearing some cost for the benefit of the greater taxpayer population in better identifying non-compliance more broadly.

8.43 Such an approach is not without precedent in Australia. The ATO's test case litigation program is an example of the ATO protecting individual taxpayers from the cost of litigation which is likely to benefit a broader range of other taxpayers through achieving greater certainty of the law:

Under the test case litigation program, the ATO provides financial assistance to taxpayers whose litigation is likely to be important to the administration of Australia's revenue and superannuation systems. The aim of the program is to develop legal precedent – that is, legal decisions that provide guiding principles on how specific provisions we administer should be applied more broadly.³⁷⁴

8.44 The IGT's *Review into the ATO's Use of Early and Alternative Dispute Resolution* also considers the concept of 'public benefit' in greater detail.³⁷⁵

8.45 Whilst reimbursing compliant taxpayers for the additional costs associated with random audits would increase costs for the ATO, it would enhance the system leading to greater overall public benefit. Consistent with the above test case litigation sentiment, the aim of a random audit program is not to raise revenue, but to provide information and intelligence to optimise the ATO's risk assessment outcomes and increase integrity.

³⁷³ IGT, above n 7, para [4.33].

³⁷⁴ Australian Taxation Office, *Test case litigation program* (10 May 2013) <<http://www.ato.gov.au>>.

³⁷⁵ Inspector-General of Taxation, *Review into the Australian Taxation Office's Use of Early and Alternative Dispute Resolution* (2012) rec 4.2.

8.46 Random audits are also known to have other benefits, such as assisting in the calculation of the so-called ‘tax-gap’, and also potentially as a deterrent effect for certain taxpayers. Several OECD countries have conducted random audits, often with the objective of validating risk assessment models, and measuring compliance levels.³⁷⁶

8.47 With respect to the opportunity costs represented by the ATO expending resources on random audits instead of risk-based audits, one should bear in mind the opportunity cost the ATO currently incurs in audits which result in ‘no further action’ under its current risk-based approach, without the insight provided by random audit data.

TRANSPARENCY AND COMMUNICATION

Transparency

8.48 The IGT is of the view that key reasons for transparency or providing information about the risk assessment process are to engender community confidence and improve taxpayer behaviour and practices.

8.49 Transparency of the ATO’s risk assessment framework enhances community confidence that the ATO chooses taxpayers for audits on an objective and coherent basis. A lack of transparency may increase taxpayer perceptions that audit selection decisions are arbitrary or subject to individual officer discretion.

8.50 The publication of details such as risk factors or risk filters facilitates objective verification of the basis for decisions. The publication of the small business benchmarks is a good example of this transparency, where benchmark ranges are published on the ATO’s website. Where taxpayers are selected for compliance activity due to variances from the benchmarks, the taxpayer can refer to the website to verify this basis.

8.51 Other examples of transparent approaches include the publication of the *Large Business and Tax Compliance* (LBTC) booklet and *Tax compliance for small-to-medium enterprises and wealthy individuals* (Tax Compliance) booklet. Although the ATO does not give the same specific detail as in the case of the small business benchmarks, the publications do show, to some extent, how the ATO applies their risk differentiation framework, as well as what taxpayers can expect from the ATO by way of compliance activities and ATO officer conduct.

8.52 In considering what level of transparency to afford a certain risk assessment process, the ATO needs to balance the need for community confidence in a robust risk-based system and the risk of taxpayer manipulation.

Communication

8.53 The IGT acknowledges that the ATO communicates through tailored communication as well as general communication. Examples of general communications include the annual Compliance Program (now *Compliance in focus*) as

³⁷⁶ Organisation for Economic Co-operation and Development, *Forum on Tax Administration, Compliance Risk Management: Use of random audit programs* (2004) para [15].

well as those mentioned above, that is the small business benchmarks and LBTC and Tax Compliance booklets.

8.54 Examples of tailored communications, on the other hand, are the RDF notification letter for taxpayers in the large business market segment and small business benchmark letters for those operating in the cash economy.

8.55 How the ATO communicates risk related information with taxpayers depends on the number involved and the resources required. To facilitate positive change in taxpayer behaviour, taxpayers must be provided with adequate information to understand:

- the ATO's concerns including the risk hypothesis that generated the enquiry;
- the action that the ATO expects them to take (for example review your records, improve your governance arrangements);
- whether a response is required; and
- the action the ATO will take as a consequence of the taxpayer's response or non-response.

8.56 It should also be noted that the ATO must recognise the potential for unintended outcomes resulting from inadequately designed and tested communications. For example, in the case of the small business benchmarks, the ATO sent letters to taxpayers where it did not expect a response from a large proportion. Despite this, many taxpayers responded where this was not required. This caused considerable concern and uncertainty as the ATO initially did not acknowledge these letters.

8.57 Before embarking on large scale communication campaigns, the ATO should ensure that it has accounted for potentially unintended behavioural responses. This may take the form of community consultation, letter testing, or using a limited pilot.

8.58 By way of example, the ATO had intended to issue letters to large numbers of lower risk SME taxpayers, advising them of their lower risk categorisation. Importantly, the letter was intended to be advisory and no action was required from the taxpayer. Consultation with tax practitioners through the ATO Tax Practitioner Forum (ATPF) revealed that such a letter was likely to increase compliance costs, with taxpayers inclined to contact their agent to discuss the letter. As such, the ATO discontinued this initiative.

8.59 The IGT has also noted in his, *Review into the ATO's Compliance Approach to Individual Taxpayers – Income Tax Refund Integrity Program* (ITRIP Review), the potential benefits in having regard to research from the Behavioural Insights Team within the UK Cabinet Office. A key to this approach is the use of randomised controlled trials to assist in developing communication approaches that best achieves the desired behavioural outcome. The ATO currently undertakes a range of testing, such as 'user-testing' and 'simulation centre' projects as prototypes to determine the likely response of taxpayers to ATO communication approaches. Randomised

controlled trials, however, are often considered to be the ‘gold standard’ in generating that evidence.³⁷⁷

8.60 The IGT also notes that the ATO recognises the value of randomised controlled trials as ‘the ideal evaluation methodology to infer program effectiveness’ including with respect to compliance activities.³⁷⁸ However, the application is not widely adopted as a standard across the ATO.

Communicating outcomes and due process

8.61 Pursuant to the legal principles of natural justice, affected taxpayers or tax practitioners must be afforded a right of review of their initial risk rating particularly where they are categorised at the higher levels which may potentially result in further compliance activity.

8.62 How such a right of review should operate and be communicated to the taxpayer with respect to the large business market is detailed in the IGT’s LB&I Review³⁷⁹ and is augmented in Chapter 3 of this report. In this market segment, the ATO has developed a tailored letter, regarding the taxpayer’s risk rating, which is addressed to the board or CEO rather than the tax manager. In these circumstances where the ATO is effectively issuing a regulator’s opinion, it is particularly important that the ATO ensure it has the most accurate and up-to-date information by giving the taxpayer an adequate opportunity to comment on such information before issuing the letter. Without such due diligence, this type of ATO action may impede behavioural change because of a lack of confidence in the ATO’s analysis.

8.63 It should be noted that such rights of review are also considered in Chapters 4 and 7 of this report with respect to SME taxpayers and tax practitioners.

PROPORTIONALITY OF ATO COMPLIANCE APPROACH

8.64 The IGT’s view is that the ATO’s compliance approach, and potential imposition of compliance costs, should be proportionate to the level and type of risk presented by the taxpayer as well the information confidence and cost levels. Where taxpayers pose a lower risk, less intense enquiries should be made of them. It is important, therefore, that the ATO has processes in place to measure the actual risk, as opposed to the perceived or anticipated risk, posed by the taxpayer or taxpayer population.

Inherent and behavioural risk factors

8.65 The ATO needs to also distinguish between different risk factors, such as inherent risk factors and behavioural risk factors. Such differences are explained in greater detail in Chapter 3. By distinguishing between these risk factors, the ATO is able to ensure that their compliance approach addresses the particular risk and minimises the generation of mistrust between administrator and taxpayer.

³⁷⁷ Cabinet Office Behavioural Insights Team, *Applying behavioural insights to reduce fraud, error and debt* (2012), p 21.

³⁷⁸ Australian Taxation Office, *Literature review - Measuring compliance effectiveness* (2007) p 51.

³⁷⁹ IGT, above n 122, pp 53-54.

8.66 For example, where a large consolidated taxpayer has undergone a large corporate restructure, it would be appropriate for the ATO to focus its enquiries in relation to the inherent risk factors associated with consolidation and capital gains tax.

8.67 On the other hand, where the taxpayer has poor governance controls or record keeping practices, then it is appropriate for the ATO to focus their attention on improvements in those areas. Naturally, if inherent risk factors were also a concern, then these should be addressed specifically. As mentioned in Chapter 3, the separate consideration of inherent risk factors and behavioural risk factors is consistent with the practices of both the HMRC in the UK and by APRA in Australia.

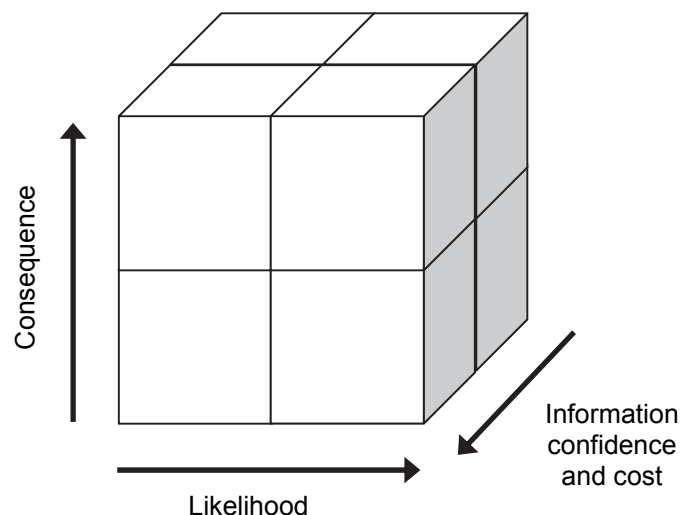
Information confidence and cost

8.68 The ATO requires a certain level of taxpayer information to make informed decisions about the taxpayer's level of risk. Where the taxpayer chooses a relationship approach that may delay this process and increase information costs, the ATO should respond in a manner that it is appropriately more formal.

8.69 Nevertheless, it is important to specifically address the issue of information confidence and cost levels separately from that of likelihood of non-compliance. This allows the ATO to directly address the specific concerns with the taxpayer. The taxpayer is in a position to determine what behaviour it wishes to adopt in full knowledge of the ATO's corresponding response.

8.70 Furthermore, dealing directly and separately with information confidence considerations should reduce the level of concern relating to perceptions that the ATO is drawing subjective or inappropriate conclusions about taxpayer behaviours or actions. This separation is illustrated in Figure 21 below which is reproduced from Chapters 2 and 3 for convenience.

Figure 21: Risk and information confidence and cost



Source: IGT

8.71 It is apparent that the method by which the ATO gathers information is influenced by a variety of factors besides risk and information confidence and cost. For example, in the large business market, 'higher consequence taxpayers' represent such a large compliance risk to the ATO in terms of consequence that likelihood as a risk

factor has little role to play in influencing the decision to engage the taxpayer. This higher consequence means that the ATO seeks a high level of confidence in the information in order to make judgements about the taxpayer's compliance level. The information that the ATO seeks is only partly accessible through third parties. Most of the information has to be provided by the taxpayer on a regular basis as reflected in the real-time compliance approach and the PCR. These taxpayers are, therefore, frequently dealing with information requests.

8.72 Currently, the ATO divides this group of higher consequence taxpayers between key taxpayers and higher risk taxpayers. The RDF puts these taxpayers on a 'likelihood of non-compliance' continuum. In reality, however, the IGT considers that the underlying factor is really whether the taxpayer's approach to the provision of information will allow the ATO to quickly develop an informed view about the taxpayer's risks. An inability to do so is likely to increase the ATO's costs in obtaining information. If the taxpayer chooses a relationship option whereby it will only provide information to the ATO on the basis of the ATO's formal access and information gathering powers, the ATO will continue to gather that information at increased cost since the consequence of not doing so would be considered too high. The PCR is the default means of obtaining this information.

8.73 Where taxpayers have 'sound tax risk-management processes' and indicated a 'commitment to ongoing disclosure of tax risks³⁸⁰', they may be eligible to enter into an annual compliance arrangement (ACA) with the ATO. By providing a degree of certainty to the taxpayer, ACAs provide an incentive for taxpayers to adopt a relationship option that favours real-time informal information disclosure. Such arrangements, however, entail significant obligations and costs for the taxpayer. Relatively few taxpayers have entered into ACAs to date largely for these reasons. These issues are explored in the IGT's Self Assessment Review where there are also recommendations for improvement.³⁸¹

8.74 The following table illustrates a sample of ATO information gathering approaches and indicates that several factors besides risk, information cost and confidence levels influence the resulting ATO approach.

Table 5: Sample of ATO information gathering approaches

	Taxpayer group or 'risk population'			
	LB&I higher consequence taxpayers	LB&I lower consequence taxpayers	Individual taxpayers in receipt of interest income	Individuals subject to ITRIP
Risk event	Taxpayer being non-compliant or having a contestable tax position.	Taxpayer being non-compliant or having a contestable tax position.	Taxpayers not correctly reporting interest income.	Individual income tax return is fraudulent.
Information confidence level sought	High: A high consequence requires a high level of confidence.	Medium: Although not the largest taxpayers, these taxpayers are large nonetheless.	High: Although it is relatively easy to establish if interest has been derived.	High: The possibility of fraud risk means the ATO needs to be sure the refund is legitimate.

³⁸⁰ Australian Taxation Office, *Annual compliance arrangements – what you need to know* (7 June 2013) <<http://www.ato.gov.au>>.

³⁸¹ IGT, above n 5, pp 92-100.

	Taxpayer group or 'risk population'			
	LB&I higher consequence taxpayers	LB&I lower consequence taxpayers	Individual taxpayers in receipt of interest income	Individuals subject to ITRIP
Continuous or periodic	Continuous: A high consequence means the ATO should review these taxpayers every year.	Periodic: A lower consequence means the ATO is willing to not review them every year unless there is a reason for doing so.	Continuous: The risk is endemic and can occur every year.	Continuous: The risk is endemic and can occur every year.
Real-time or post-lodgment	Real-time: A high consequence means it is important to detect risks early.	Post-lodgment: A lower consequence means the ATO is willing to address risks after lodgment.	Both: pre-filing can remind taxpayers about interest income. Where discrepancies persist, post-lodgment verification is available.	Real-time: The risk of fraud or identity theft means such refunds should be withheld lest they be irrecoverable.
Taxpayer or third party information	Taxpayer: the information sought is unlikely to be with a third party.	Taxpayer: risk filters are based on returns and schedules lodged by taxpayers.	Third-party: Financial institutions must provide third party data to the ATO in a suitable format. This is legislative data.	Both: some information can be sourced from employers. Other information may require direct verification or substantiation from the taxpayer.
Cost of obtaining information	Seek to keep both ATO and taxpayer costs low. However, a high consequence means the ATO is prepared to incur significant ATO and taxpayer costs to obtain the information it needs.	Seek to keep both ATO and taxpayer costs low. Only initiate taxpayer contact where a risk recommendation has been made (usually by the risk manager) based on evidence (usually risk filter output).	Seek to keep both ATO and taxpayers costs low by using third party information as a preference. Seek taxpayer information where necessary.	Seek to keep both ATO and taxpayers costs low by using third party information as a preference. Seek taxpayer information where necessary.
Litigation ready?	Contestability brings interpretation risk. The ATO should seek the full facts as early as possible.	Contestability brings interpretation risk. The ATO should seek the full facts as early as possible.	n/a	n/a
Resulting approach	An ACA for taxpayers with sound tax risk-management process and willing to disclose tax risk information on an ongoing and informal basis. A PCR for the remaining taxpayers.	Client Risk Reviews for taxpayers as and when specific risk concerns arise. The conduct of such reviews, however, is comprehensive in nature.	Data matching approach using legislative third party data.	Stop refunds in real time and verify compliance before issuing the refund (pre-issue checks).

Source: IGT

8.75 A balance needs to be struck between the requirement for information and the compliance costs that such information gathering would impose on both the ATO and taxpayers. This balance is highlighted by the Productivity Commission:

Much of the information collection for a risk based approach occurs early in implementation. Correctly identifying and measuring risks may require regulators to

invest in additional training and guidance material to overcome knowledge gaps and other limitations, and undertake extensive consultation and analysis.

...Regulated businesses may also incur costs when regulators seek to measure risk. For instance, one dilemma a regulator can face is that good information is integral to accurately assessing the cost and benefits of alternative regulatory approaches. However, if collected from business this data requirement imposes a burden on these businesses. The regulator must ensure this burden is not excessive, and endeavour to make more effective use of existing and other sources of information wherever possible.³⁸²

8.76 The Productivity Commission also highlights the need to view risk management from a 'net benefit' perspective, taking into account the costs of risk management, both for the regulator and the regulated:

A well designed risk based approach should be used within an explicit net benefit framework. When applied in this way, a risk based approach is not just a simple guide to deployment of regulatory resources, but rather determines the optimal regulatory strategy that maximises net benefits to the community. Such an approach seeks to align the allocation of regulatory resources and the consequent compliance costs for businesses to the risks presented by the actions of businesses and the benefits of reducing these risks (box D.4). Regulatory activities involve an 'opportunity cost', so economic efficiency requires that resources be allocated to alleviating risks where there is the greatest net benefit to society.

For instance, while reducing a risk may yield large *gross* benefits, the costs of intervention may also be large – including the cost and resources involved in identifying and measuring risks and classifying businesses, whether borne by the regulator or the businesses they administer.³⁸³

... Using a net benefits framework should mitigate the potential tendency of regulators – caused, in large part, by their traditional role as purely enforcers of legal compliance – to adopt an overly 'safe' approach and attempt to reduce a particular risk beyond the point where the benefits of doing so outweigh the costs.³⁸⁴

8.77 As noted earlier in this report, taking into account 'risk premium compliance costs' may assist in understanding the community costs associated with a regulator's risk management.

'Funnelling' and case refinement products

8.78 Case refinement products are a class of ATO activities that are undertaken often after a large case pool has been determined by a quantitative method. Importantly, these activities are performed by ATO officers, who must undertake a degree of qualitative research and analysis and come to a judgement about whether there is sufficient risk to proceed to a more intense or formal product, such as an audit.

³⁸² Productivity Commission, *Regulator Engagement with Small Business – Productivity Commission Research Report* (2013) p 275.

³⁸³ Ibid p 279.

³⁸⁴ Ibid p 281.

8.79 The use of case refinement products, with limited taxpayer contact, can minimise compliance costs and is a useful way of treating compliance risks where:

- the level of risk is relatively low (that is historically low strike rates); or
- the actual level of risk is unknown, or there is low confidence in the actual level of risk.

8.80 In the micro enterprises context for example, prior to the IGT's Benchmarking Review, the ATO conducted correspondence audits directly from cases where taxpayers were outside the benchmarks by a pre-set threshold. As a result of the IGT's review, those 'significantly outside the benchmark' cases are now subject to an 'office review product':

A new product, the Office Review product has been introduced as a precursor to all correspondence audits. It allows case officers to determine, based on limited contact with a taxpayer, if there is sufficient risk to progress to a more intensive correspondence audit. This product includes:

- A new profiling document [that] has been introduced to allow staff to early exit case prior to client contact is now in use. The document is supported by a tips sheet that helps our staff get the most out of their profiling and in identifying risk.
- Case guides that step auditors through the case process and provide guidance and links to assist during the progress of the case. The case guides also provide points at which a case can be exited early if insufficient risk exists and guidance as to what records should be sort if verification is warranted. Case guides have also been introduced for other products.³⁸⁵

8.81 As a result, the ATO's strike rate for correspondence audits increased from 24 per cent to over 50 per cent.³⁸⁶

8.82 Case refinement in LB&I is essentially conducted by risk managers who examine the output of the risk filters and remove those cases which are understood to be false positives. There is generally no taxpayer contact for this activity. If a case is ultimately recommended for compliance activity, such as a risk review, the recommendation must be approved by the Case selection sub-committee. This committee, however, has in the past given some consideration to the use of a formal case refinement product.³⁸⁷

8.83 In the SME business line, ATO officers may undertake 'preliminary risk reviews' (PRR) before going on to conduct a comprehensive risk review (CRR). Due to the comprehensive nature of CRRs, they can involve substantial time and cost, both for the ATO and the taxpayer. The PRR gives the ATO an opportunity to determine if sufficient risk exists to justify escalating to a CRR. Importantly, as in the case of the

³⁸⁵ ATO communication to IGT, 25 February 2013.

³⁸⁶ Australian Taxation Office, Senate Estimate Briefing October 2012, page 1. Disclosed under FOI reference number 59632 on ATO FOI disclosure log.

³⁸⁷ Australian Taxation Office, Case Selection Sub-Committee Minutes 7 December 2011, page 9.

cash economy Office Review and large business Case selection process above, the SME product allows lower risk taxpayers to be identified and removed from the process.

8.84 In the Indirect Taxes (ITX) business line (responsible for GST and excise), the ATO undertakes ‘refinement’ and ‘review’ activities:

Case refinements are internal review products, used across markets, to conduct in-house analysis and assessment of client risk. Cases are selected to determine whether further compliance action is required or if the indicative risks can be explained at the case refinement stage. No contact is made with the taxpayer at this stage.

Case reviews are used to determine the existence of a specified risk or the existence of risks generally in respect of that particular entity. Reviews are also used to collect information about specified risks across particular industries and activities to determine the existence and level of risks and the effectiveness of mitigation strategies.

Depending on the nature of the entity and the risk under review, the review process may be conducted by letter, phone or at the entity’s business premises. A review is usually less intrusive than an audit and is designed to encourage voluntary disclosure. It is designed to obtain sufficient information to demonstrate that a specified risk does not exist or has been mitigated substantially by the entity’s business processes.³⁸⁸

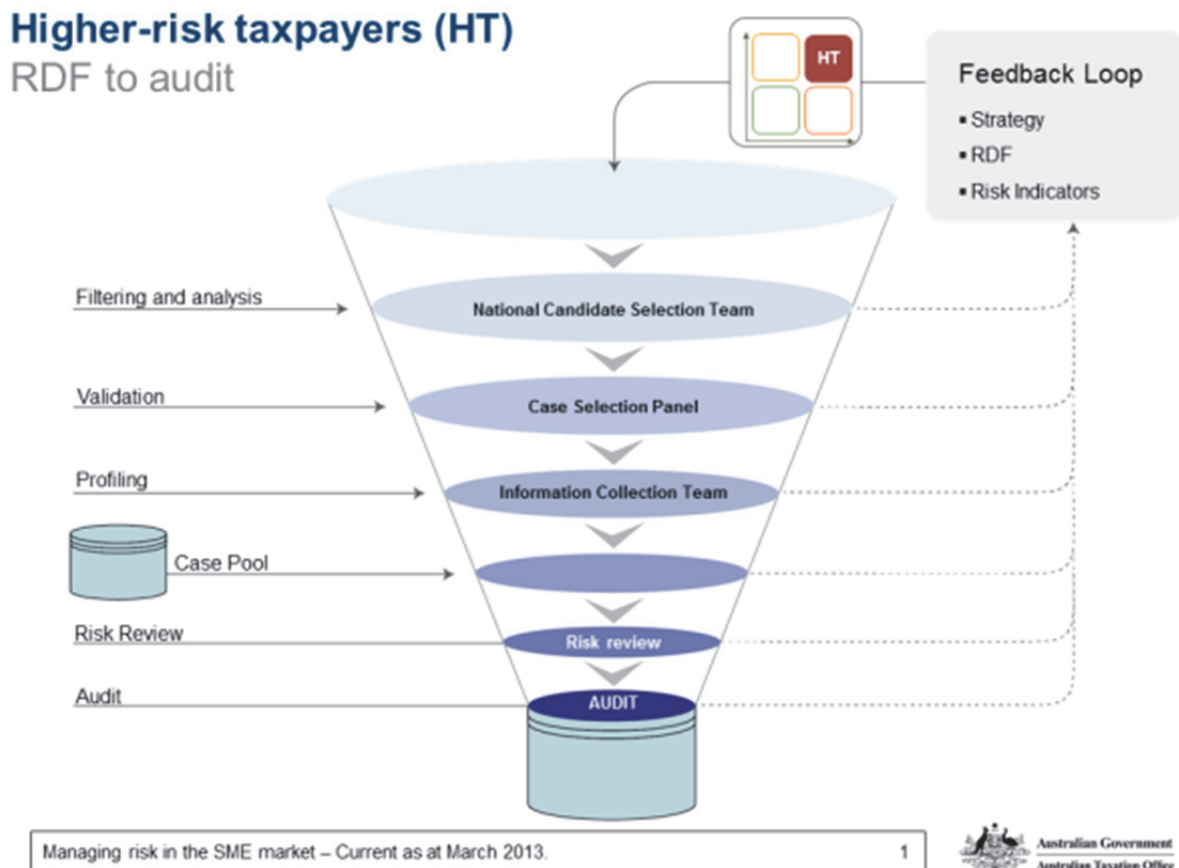
8.85 Support for the use of case refinement activities can also be found overseas.³⁸⁹ This approach recognises that there are limitations on relying on mathematical methods to select audit cases. There are expectations that the tax administrator undertake such additional work beyond risk models to filter out lower risk taxpayers.

8.86 The use of increasingly intense activities is often regarded as a type of ‘funnel’ as shown in the figures below relating to the SME and ITX business lines respectively.

³⁸⁸ Australian Taxation Office, Indirect tax case selection framework , page 10.

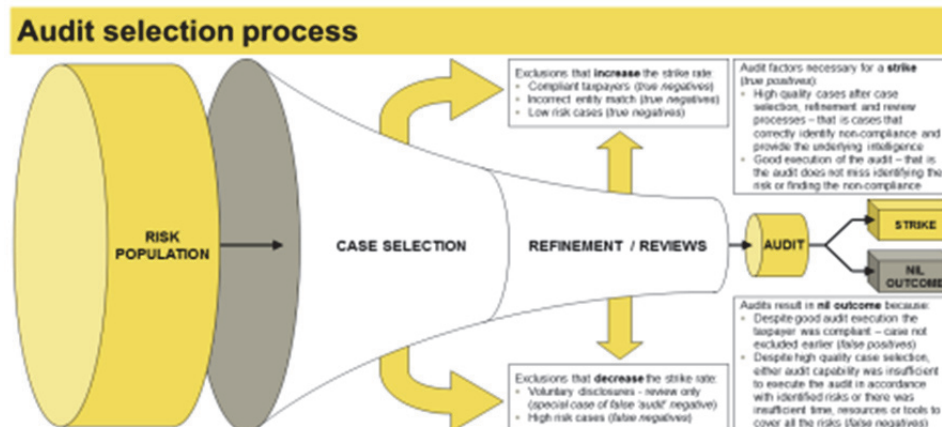
³⁸⁹ United States Treasury Inspector General for Tax Administration (TIGTA) Report 2012-30-062, *The Recommended Adjustments From S Corporation Audits Are Substantial, but the Number of No-Change Audits Is a Concern*, 21 June 2012, page 10.

Figure 22: SME business line compliance 'funnel'



Source: ATO handout to ATPF SME RDF workshop, 14 March 2013.

Figure 23: Indirect taxes business line compliance funnel



Source: ATO, ITX Strike Rate analysis.

8.87 It should be noted that client risk reviews and comprehensive risk reviews often occur before an audit to give the ATO an opportunity to assess the risk with a high level of taxpayer interaction in order to come to a judgement about whether to proceed to an audit. However, due to their intensity, resources and length of time required as well as the extent of taxpayer contact, these are often regarded as 'compliance products', which may carry significant associated compliance costs and are not considered to be 'case refinement products'.

COMPLIANCE EFFECTIVENESS

Measuring compliance effectiveness and compliance costs

8.88 As highlighted in Chapter 5, the ATO has reported on behavioural changes in the micro business market segment in relation to the small business benchmarks. The Compliance Program 2012–13 tracked the financial performance of a set of taxpayers in certain cash economy industries. It reported ‘significant increases in the number of businesses that now report income in the same range as their industry peers when they had previously reported income tax that was well below that of other similar businesses’.³⁹⁰

8.89 Chapter 5 also observed that such convergence may be the result of:

- previously non-compliant taxpayers becoming compliant (positive change in taxpayer behaviour);
- non-compliant taxpayers reporting within the benchmark, but still underreporting their actual income (strategic taxpayer behaviour); and
- compliant taxpayers now over-reporting their income to stay in the benchmarks to reduce audit risk (taxpayer over-compliance).

8.90 Compliant taxpayers may decide to deliberately over pay their tax so as to reduce the chance of an audit.³⁹¹ This ‘over-compliance’ may be regarded as one indicator of taxpayer perceptions of costs associated with ATO compliance activity. The existence of an audit insurance industry is also indicative of the perceived costs of ATO audits.³⁹² Taxpayers may decide to pay such insurance premiums to limit the risks of excessive audit costs.

8.91 Should the ATO be unable to persuade the community that their compliance interactions are low cost, there is a risk that compliance costs for taxpayers may be increased even without any ATO compliance activity through the cost of audit insurance premiums or overpayment of tax. These costs are separate to ‘baseline compliance costs’ such as those associated with record keeping and correct reporting which all taxpayers must bear. Acknowledgment of these risk premium compliance costs is useful to the revenue authority in terms of appreciating the overall compliance cost burden imposed on taxpayers. The ATO has already commenced some work in this area with its TPALS ‘environmental scan’. The IGT is of the view that awareness of these types of risk premium compliance costs should be enterprise-wide and could be included in the compliance cost considerations in the current enterprise risk framework.

8.92 The IGT observed in his Benchmarking Review that taxpayers can be expected to incur a ‘baseline’ level of compliance costs in administering their tax affairs, such as

³⁹⁰ ATO, above n 33, p 29.

³⁹¹ H&R Block Tax Accountants, ‘ATO Scrutiny must not stop Labourers from claiming their entitlements’ (Media release, 26 July 2013).

³⁹² Australian Taxation Office, TPALS draft July-October 2012 environmental scan.

adequate record keeping.³⁹³ These are the costs associated in complying with tax law requirements. The taxpayer may be subject to additional compliance costs as a result of interactions with the ATO. The IGT is focussed on ensuring that these additional compliance costs are minimised through more targeted compliance interactions and the manner in which they are carried out.

PROJECT MANAGEMENT — BALANCING RISK, RESOURCES AND TIME

8.93 The IGT's ITRIP Review has shown that the number of refunds stopped during the 2011-12 year exceeded the expected case load. As such, the ATO did not have adequate staffing resources to action all the stopped returns within the original expected timeframe.

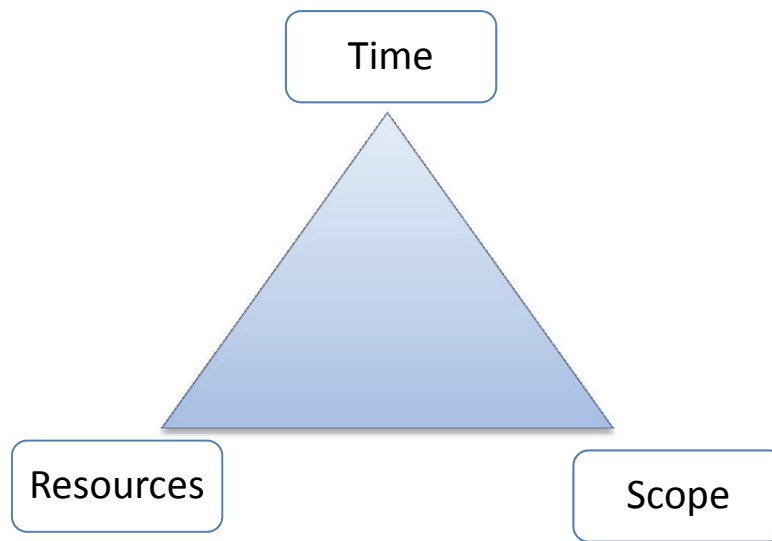
8.94 The ATO applied extra resources by bringing on additional staff and using overtime to assist in clearing the cases. The escalation of such resources, however, was not substantially implemented until six months after the ATO was aware of the increased workload.

8.95 In addition to applying additional resources, the ATO sought to manage the increased workload by contacting taxpayers and tax agents to alert them of longer delays, seeking efficiencies in case work and releasing 'lower-risk' refund cases that were stopped by the ITRIP.

8.96 From a project management perspective, the above scenario highlights the 'triple constraint'³⁹⁴ or 'project management triangle', in which there is a tension between the scope of, the time taken to complete, and the resources required to execute the project. For example, in the event that a project's timeline has been shortened, the project would normally require additional resources or a consideration to reduce the scope of work or a combination of both to successfully complete the project within the reduced timeframe.

³⁹³ IGT, above n 7, para [5.58].

³⁹⁴ Jack T. Marchewka, *Information Technology Project Management, providing measurable organizational value* (John Wiley and Sons, 2009) p 15.

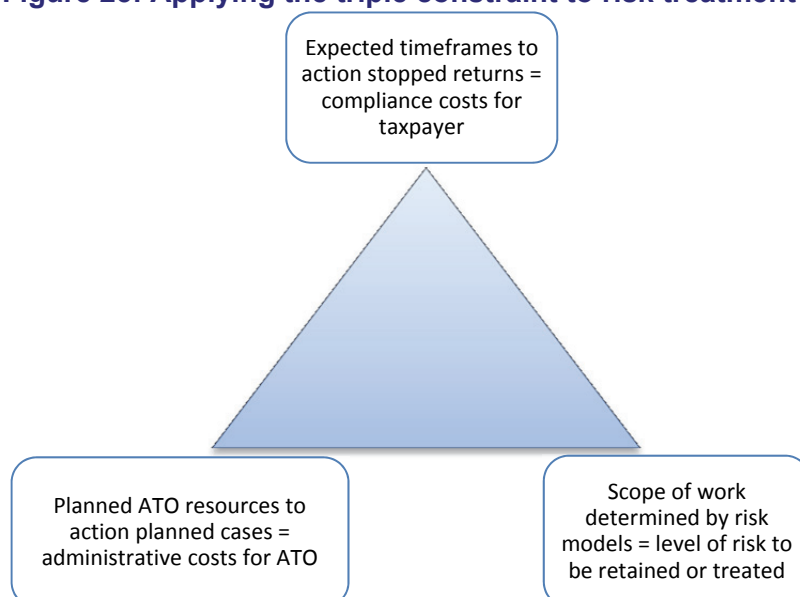
Figure 24: The triple constraints of project management

Source: Adapted from Marchewka 2009.

8.97 Applying this model to the ITRIP, the increased case load can be regarded as an increase to the scope of work requiring the ATO to take some or all of the following remedial actions:

- reducing the scope of the increased workload, by re-configuring the risk models to release previously stopped lower risk refunds;
- increasing the resources available to action the stopped refunds, by using overtime, or bringing in additional staff from other areas; and
- accepting the scope of work and resetting expectations of the completion timeframes.

8.98 As set out in the figure below, each option carries an impact.

Figure 25: Applying the triple constraint to risk treatment projects

Source: IGT

8.99 One of the objectives of risk management is to effectively allocate resources and one of the enterprise risks is 'client experience'.³⁹⁵ Therefore, if workload or scope increases unexpectedly, the ATO must decide how much additional risk of non-compliance it can accept (that is, 'letting through' potential non-compliance cases) due to the risk models. This may be done by either:

- raising the threshold of what it would regard as a significant enough risk to stop the refund for pre-issue verification activity; or
- differentiating its case actioning so that the refunds with most risk were stopped pre-issue, with the remainder released but subject to verification activity post-issue as resources allowed.

8.100 There is a direct relationship between the level of risk the ATO is willing to retain and/or treat and the scope of work planned for a project such as the ITRIP. The nature of the trade-offs is further illustrated in the table below:

Table 6: Triple constraint applied to ITRIP

Selected priority	Time	Resources	Scope
Time: Minimising taxpayer compliance costs is priority by adhering to original timeframes.		Determine the additional cost you are willing to incur.	Determine the level of risk you are willing to retain by reducing the cases you are going to action or action at a later time.
Resources: Containing ATO costs is priority by not adding staff or using overtime.	Determine the extent you are willing to extend timeframes, and manage taxpayer expectations accordingly.		Determine the level of risk you are willing to retain by reducing the cases you are going to action or action at a later time.
Scope: Treating the risks is priority by ensuring all cases are actioned.	Determine the extent you are willing to extend timeframes, and manage taxpayer expectations accordingly.	Determine the additional cost you are willing to incur.	

Source: IGT

8.101 In planning to address a particular risk through a strategy such as the ITRIP, the level and type of risk is known. However, due to a degree of uncertainty, the actual work generated by this approach is not known until the income tax returns are lodged. It should be noted that 'stress-testing' or 'scenario-testing' is one method the ATO can use to predict the workloads generated by new risk models.

8.102 As part of the ITRIP, the ATO did use some scenario testing for the 2011-12 financial year by applying the new risk rules to the tax returns lodged in 2010-11 to predict the workload for the 2011-12 year. Limitations with the testing, however, meant that the actual workload was far in excess of that anticipated.

8.103 In planning future risk treatment initiatives, the ATO would benefit from considering, in advance of implementation, the triple constraint trade-offs it is willing to make. For example, where it is important for the ATO to audit every case generated by a risk model and where it is also important for the ATO to ensure case timeframes

³⁹⁵ This is currently under review by the ATO. Australian Taxation Office, Cost of Compliance Tasking Plan, ATO response to Information Request 4.

are met as planned, then a plan needs to be developed to ensure the ATO can call on additional appropriate resources at relatively short notice to complete the additional work.

8.104 A failure to adequately consider the implications of changes to the triple constraints may result in:

- unexpected increases in taxpayer compliance costs;
- unexpected increases in ATO administrative costs; and
- the ATO unexpectedly raising its risk thresholds or differentiating its risk treatments.

8.105 This requirement is consistent with observations made by the ANAO in its Better Practice Guide *Administering regulation*:

In circumstances where compliance risks increase suddenly and significantly, insufficient resources may be available to a regulator to conduct the necessary monitoring activities. For example, if an unexpected event affects the risk profiles of a substantial number of regulated entities, the regulator may have insufficient resources to conduct not only the compliance assessments that are scheduled, but also the additional high-priority assessments that are required to address the increased regulatory risks.

When this occurs, a special interim monitoring strategy needs to be designed and implemented. The interim strategy operates until either the regulatory environment returns to normal or a new monitoring strategy is implemented because the nature and extent of regulatory risks have fundamentally changed.

At a minimum, the interim strategy should:

- fully document the non-compliance risks that cannot be monitored in accordance with the established monitoring strategy
- identify the types and frequency of activity that will provide a level of assurance (albeit a lower level) that regulatory requirements are being met.³⁹⁶

CONCLUSION

8.106 The above factors, which should be considered in developing compliance risk assessment tools, have been summarised into a checklist in Appendix 12 of this report. The IGT believes that the ATO may improve the quality of its compliance risk assessment tools by incorporating this checklist in the design of those tools. The checklist is not prescriptive, but requires those responsible for designing and implementing compliance risk assessment tools to turn their mind to key issues and, in particular, to any problems that may arise and how to mitigate them.

³⁹⁶ Australian National Audit Office, *Better Practice Guide, Administering Regulation* (2007) p 58.

RECOMMENDATION 8.1

The IGT recommends that:

- (a) the checklist in Appendix 12 of this report should be incorporated into the ATO's compliance risk assessment tool design processes; and*
- (b) the ATO's Enterprise Risk Management Framework consider risk premium compliance costs as a type of taxpayer compliance cost.*

ATO response

Agree.

The ATO currently considers taxpayer cost of compliance as a fundamental component of its operations and actions. While the associated Enterprise Risks are currently under review, the ATO agrees where appropriate and feasible, to give consideration to risk premiums in relation to taxpayer compliance costs.

APPENDIX 1 — TERMS OF REFERENCE

BACKGROUND

Risk management is a well-known concept in the commercial environment. Many revenue authorities have also adopted risk management approaches in the allocation of resources, particularly in an audit and compliance context.¹

The Australian Taxation Office (ATO) has summarised its approach in the following terms:²

We need to use our scarce resources in a way that optimises voluntary compliance. We do so by using a risk management approach, guided very much by our compliance model.

The compliance model is a structured way for the ATO to select the most appropriate activity to optimise taxpayer compliance based on an understanding of the factors that influence taxpayer behaviours and attitudes towards compliance.³

The ATO uses a range of risk assessment tools to identify potential non-compliance as well as selecting which compliance activities should be conducted. A range of quantitative techniques may be used, including specialised software or models using various data sets. They may also incorporate qualitative input based on a given ATO officer's experience, judgement or expertise.

One of the more important ATO risk assessment tools is the Risk Differentiation Framework (RDF). Broadly, the RDF assesses taxpayer's actions or anticipated behaviours and provides a framework for determining the nature of the ATO's engagement with the taxpayer. The ATO's risk assessment concerns may also originate directly from a specific transaction type where significant tax implications are anticipated. Currently, the RDF approach is used in relation to large businesses⁴, small to medium enterprises and wealthy Australians⁵ as well as tax practitioners⁶ and other intermediaries.⁷

Other important risk assessment tools that the ATO uses include: the small business benchmarks targeting the cash economy, the income tax refund integrity program (which may withhold individual taxpayer refunds pending further inquiry, if certain

¹ Forum on Tax Administration, Compliance Sub-group, Organisation for Economic Co-operation and Development, *Information Note: Managing and Improving Compliance: Recent Developments in Compliance Risk Treatments* (2009) para 14.

² Michael D'Ascenzo, 'Good Governance and Tax Risk Management' (Speech delivered at the Australian Risk Policy Institute, University of Canberra, 10 July 2008).

³ Ibid.

⁴ Australian Taxation Office, *Large business and tax compliance publication* (2012), p 23.

⁵ Australian Taxation Office, *Tax compliance for small-to-medium enterprises and wealthy individuals* (26 October 2012) <<http://www.ato.gov.au>>..

⁶ Australian Taxation Office, *Compliance Program 2012-13* (2012), pp 12-13.

⁷ ATO, *Guide for Tax Intermediaries – Good Governance and Tax Promoter Laws* (2011).

risk flags are triggered) and data matching activities such as with AUSTRAC on foreign sourced funds transfers.

During the consultation on the Inspector-General of Taxation's (IGT) work program, a range of concerns were raised by taxpayers, tax practitioners and representative bodies with the ATO's approach to compliance risk management. These concerns may be summarised as follows:

- **The ATO's overall approach to risk management** – The design and adequacy of the ATO's risk management framework not resulting in effective and accurate predictions of non-compliance or exclusions of compliant taxpayers.
- **The inputs into the ATO's risk assessment processes** – The accuracy, relevance, reliability and appropriateness of the inputs used in risk assessment processes.
- **The relationship between the ATO's risk assessment processes and its compliance approaches** – The frequency, intensity and formality of compliance activities not being commensurate with the comparative level of taxpayer risk and perceptions of undue influence of risk assessment processes on tax officer conduct during compliance activities – that is, presumptions of taxpayer wrongdoing.
- **Taxpayer opportunities to reduce or mitigate risk** – Limited opportunities for taxpayers to reduce their risk due to the lack of transparency of risk assessment processes and barriers to entry into cooperative arrangements, such as Annual Compliance Arrangements (ACAs).

Through this review, the IGT seeks to establish the underlying reasons or causes for these concerns, their systemic impacts and opportunities for improvements.

The IGT has also announced a separate review in which two specific types of risk assessment tools (the income tax refund integrity program and the use of third party data) will be reviewed in relation to the ATO's compliance approaches to individuals. Terms of reference for that review will be released in the near future. The IGT has also recently completed a review of another risk assessment tool, the ATO's small business benchmarks, in his *Review into the ATO's use of benchmarking to target the cash economy*.

It is expected that the findings in both of those reviews would inform the work in this review.

TERMS OF REFERENCE

In accordance with subsection 8(1) of the Inspector-General of Taxation Act 2003 (IGT Act), the IGT will review aspects of the ATO's compliance risk management with a focus on:

The ATO's approach to risk management

1. *The suitability of the ATO's risk and compliance management approach and methodology for detecting non-compliance, including the accuracy of the risk assessment processes as predictors of non-compliance.*
2. *The ATO's approach to refining the accuracy of the risk assessment processes in light of the results produced in compliance activities.*

The relationship between the ATO's risk assessment processes and compliance activities

3. *The proportionality of compliance activities with the level of risk determined by the risk assessment processes.*
4. *The influence of risk ratings on the conduct of the ATO during compliance activities.*
5. *The availability of the ATO's risk mitigation products, such as annual compliance arrangements, to taxpayers.*

Inputs into the risk assessment processes

6. *The accuracy, reliability, relevance and appropriateness of the inputs into the ATO's risk assessment processes, including:*
 - a. *validation of inputs before using them for risk assessment purposes or subsequent compliance activity decisions;*
 - b. *the basis for choosing such inputs as a taxpayers' size, industry and turnover; and*
 - c. *those that should or should not be derived from certain taxpayers' conduct.*

Communication

7. *The transparency of the ATO risk assessment processes including the inputs used to develop risk ratings.*
8. *The ATO's communication of the result of its risk assessment processes to affected taxpayers including:*
 - a. *opportunities for taxpayers to comment on risk assessments and test the underlying information on which they are based; and*
 - b. *the ATO's responsiveness to taxpayers' request for reconsideration of their risk rating.*

Impacts

9. *The impacts that risk assessment processes and ratings may have had on taxpayers and their advisors.*

SUBMISSION GUIDELINES

8.107 The IGT envisages that your submission will be set out in two parts:

- views on the ATO's current use of compliance risk assessment tools; and
- suggestions for improvements.

Your views on the ATO's current use of compliance risk assessment tools

8.108 It is important to provide a detailed account of specific ATO practices and behaviours that, in your view, impact upon the appropriateness of the risk assessment and conduct of any subsequent compliance activity.

8.109 We are also seeking examples of ATO practices and behaviours that contributed to a positive taxpayer experience.

8.110 The following questions are designed to assist you in your response.

The ATO's approach to risk management

Q1. What are your views on the ATO's current risk management approach to compliance?

Q2. Which risk assessment process or tool was used by the ATO in relation to you? For example, large businesses may be subject to the LB&I Risk Differentiation Framework. Alternatively, individuals and micro businesses may have been subjected to particular data matching or industry projects.

The relationship between the ATO's risk assessment processes and compliance activities

Q3. With respect to the frequency, formality and intensity of the ATO compliance activity:

(a) for taxpayers: did you believe the compliance activity was appropriate or commensurate with the risk level as communicated to you by the ATO?

(b) for tax practitioners: did clients with similar risk ratings receive similar treatment? Did clients with different risk ratings receive differing treatment from one another? Were higher risk rated clients treated with greater intensity? Do you consider that the taxpayers posing similar levels of risk were rated accordingly?

Q4. Was there a clear distinction between the ATO's risk assessment process and any subsequent compliance activity? If not, please explain why.

Inputs into the risk assessment process

Q5. Are you aware of what inputs the ATO uses in your risk assessment process?

Q6. What are your views on the accuracy, reliability, relevance and appropriateness of the inputs currently used in the ATO's risk assessment processes? What are your

views on inputs such as a taxpayer's size, industry, turnover, effective tax rate and frequency with which private rulings are sought?

Q7. Are you aware of any instances where the ATO has used inaccurate information about you in assessing your risk? How was this information corrected?

Communication

Q8. How well do you understand the ATO's risk assessment processes? Do you believe these processes are sufficiently transparent that is adequate information available in this area?

Q9. How did the ATO communicate with you on its risk assessment processes? Did this communication include:

- (a) the identification of the risk assessment, rating or hypothesis the ATO used;*
- (b) the information the ATO relied upon to come to that conclusion with a degree of detail that would enable you to check the accuracy of that information;*
- (c) the process by which the ATO arrived at that conclusion;*
- (d) what action you could take to reduce your ATO risk rating; and*
- (e) in the context of proposed or commenced ATO compliance activities, whether the ATO adequately explained the reason why you were selected for the activity?*

Q10. Did the ATO:

- (a) provide you with an opportunity to query the ATO's risk assessment, rating or hypothesis and provide further information; and*
- (b) reconsider your rating in light of further information provided?*

Impacts

Q11. Specify any impacts of the ATO's risk assessment process on you, such as:

- (a) compliance costs (including opportunity costs) associated with the process, including those associated with meeting ATO information requests – quantify costs where possible;*
- (b) effect of the risk rating on the ATO's communication and ATO officer conduct;*
- (c) influence of the risk rating on the application of any relevant penalties or interest;*
- (d) reputational damage resulting from the risk rating;*
- (e) access to refunds during the risk assessment process; and*
- (f) your review, objection or escalation options.*

Q12. Have any of your decisions been influenced by the ATO's use of certain inputs?

For example, did you:

- (a) not claim deductions, concessions, etc to which you believed you were entitled;*
- (b) not lodge an objection that you may have otherwise lodged;*
- (c) not claim legal professional privilege or the accountant's concession that you would have otherwise claimed; or*
- (d) seek a private ruling when you might not have otherwise done so?*

Your suggestions for improvements

8.111 We are seeking your views on improvements that may be made to the ATO's risk management and related compliance processes in your submission.

8.112 The following questions are designed to assist you in your response.

The ATO's approach to risk management

Q13. Are there other approaches that the ATO should use to manage compliance in the tax system? Please explain your view.

Q14. Should the ATO modify its current approach? If so, how?

Q15. How should the ATO measure the effectiveness or accuracy of its risk assessment processes?

Q16. Should the ATO conduct random audits of a sample population as a means to establish an evaluation benchmark and assist in refining its risk assessment tools? This would involve some compliant taxpayers being audited. The ATO does not currently conduct random audits but other countries such as USA, Canada and the UK do.

The relationship between the ATO's risk assessment processes and compliance activities

Q17. What relationship should there be between the ATO's risk assessment processes and its compliance activities?

Q18. Should there be a clear distinction between the ATO's risk assessment processes and its compliance activities? Please explain your views.

Q19. What influence, if any, should the risk assessment process have on the application of any penalties or interest?

Inputs into the risk assessment processes

Q20. Are there particular inputs you believe the ATO should consider which may be a useful predictor of non-compliance? Are there particular inputs you believe the ATO should not use? Please explain your views.

Q21. *In what circumstances should the ATO only use objectively verifiable evidence?*

Q22. *What role should ATO officer qualitative or judgement based inputs play in these assessments? Please explain your views.*

Q23. *How should the different types of information be applied? Should the ATO use only objectively verifiable information first, filtering out certain taxpayers before applying qualitative or judgment based inputs? Should the ATO place different weight on different types of information?*

Communication

Q24. *How can the transparency of the ATO's risk assessment processes be improved without reducing their effectiveness as a means of capturing non-compliance?*

Q25. *In what circumstances and how should the ATO communicate the result of the risk assessment to the affected taxpayer? In which cases should it not? Please explain your view.*

Q26. *Where the ATO communicates the result of the risk assessment process, how frequently should it do so?*

Q27. *What opportunities should be afforded to taxpayers to comment on, or review, ATO risk assessments?*

Q28. *In what circumstances should the ATO advise the taxpayer of any changes in behaviour that may lead to a changed risk rating?*

Impacts

Q29. *With a view to minimising any adverse impacts, how should the ATO approach information gathering and risk assessment? Should it seek to make:*

- (a) the most accurate risk assessment at first instance, with a commensurate requirement imposed on taxpayers to provide a greater amount of information at an earlier point in time; or*
- (b) the best risk assessment with the information it currently has available, and only request further information in a staged manner?*

Q30. *When obtaining information pertaining to risk assessment processes:*

- (a) how often should the ATO request information to ensure information is up to date;*
- (b) when should the ATO seek the information from taxpayers directly or from third parties; and*
- (c) how can the ATO balance the need for information with the compliance costs incurred by taxpayers or third parties in satisfying ATO information requests?*

LODGMET

8.113 The closing date for submissions is 30 November 2012. Submissions can be sent by:

Post to: Inspector-General of Taxation
GPO Box 551
SYDNEY NSW 2001

Email to: riskassessment@igt.gov.au

CONFIDENTIALITY

8.114 Submissions provided to the IGT are in strict confidence (unless you specify otherwise). This means that the identity of the taxpayer, the identity of the advisor and any information contained in such submissions will not be made available to any other person, including the ATO. Sections 23, 26 and 37 of the IGT Act 2003 safeguard the confidentiality and secrecy of such information provided to the IGT — for example, the IGT cannot disclose the information as a result of an FOI request, or as a result of a court order generally. Furthermore, if such information is the subject of client legal privilege (or legal professional privilege), disclosing that information to the IGT will **not** result in a waiver of that privilege.

APPENDIX 2 — ATO LEVEL 0 ENTERPRISE RISKS

A2.1 This is a list of the ATO's Level 0 enterprise risks as reflected in Figure 2 in Chapter 2. The list is not in any order of priority or importance, but is listed alphabetically, and reflects the ATO's numbering of these risks. It is reproduced here to assist users of screen reading software.

- 1 Business continuity
- 2 Business reporting services
- 3 Client experience
- 4 Community engagement
- 5 Enterprise change
- 6 Facilities
- 7 Finance
- 8 Governance
- 9 Government engagement
- 10 Knowledge
- 11 Law interpretation
- 12 Legal support
- 13 Major tax integrity threats
- 14 People
- 15 Policy advice & design
- 16 Product & payment processing
- 17 Security & privacy
- 18 Tax & superannuation compliance
- 19 Tax revenue
- 20 Technology
- 21 Transfers compliance
- 22 Valuation services

APPENDIX 3 — LEVEL 0 AND LEVEL 1 RISK OWNERS AND DESCRIPTIONS

A3.1 This table has been reproduced from ATO Enterprise risk categories and enterprise risk owners CMPI 2003/02/03.

	Level 0	Level 1	Enterprise risk owner	Risk description guide
1	Business Continuity	1) Business Continuity	Chief Operating Officer	Failure to develop and maintain business continuity plans and the capability to respond to adverse contingencies.
2	Business Reporting Services			Failure to maintain authoritative information to support business and government interactions, including streamlined registration, secure online authentication and effective reporting services.
		1) Australian Business Register	DC Business Reporting & Registration	Failure to maintain a comprehensive, updated and accessible business register for use across the government and business community.
		2) Standard Business Reporting	DC Business Reporting & Registration	Failure to maintain and update SBR infrastructure and services to an agreed performance level and standard.
		3) AUSkey	DC Business Reporting & Registration	Failure to provide an authentication service that enables government and the business community to reliably and securely fulfil information and reporting obligations.
3	Client Experience			Failure to provide a client centred, user friendly experience to the taxpayer (and intermediaries) which encourages willing participation.
		1) Client Service	Chief Operating Officer	Failure to provide and maintain client service which meets our minimum service standards and broader service promise, including complaints management.
		2) Channel Management	Chief Operating Officer	Failure to provide and maintain appropriate channels to deliver our services and engage with clients.
		3) Cost of compliance (Exc Large Business)	Chief Operating Officer	Failure to manage and reduce the cost of compliance to taxpayers within agreed tolerances.
		4) Cost of Compliance Large Business	DC, Large Business & International	Failure to manage the cost of compliance for Large Business at appropriate levels.

	Level 0	Level 1	Enterprise risk owner	Risk description guide
4	Community ¹ Engagement			Failure to drive appropriate engagement and participation by market segment in the Tax and Super systems through co-design and differentiated treatment and services.
		1) Large	DC, Large Business & International	Failure to drive appropriate engagement and participation by Large business in the Tax and Super systems through co-design and differentiated treatment and services.
		2) Small — Medium Enterprises	DC, Small & Medium Enterprises	Failure to drive appropriate engagement and participation by Small — Medium Enterprises in the Tax and Super systems through co-design and differentiated treatment and services.
		3) Micro-enterprises	DC, Micro Enterprises and Individuals	Failure to drive appropriate engagement and participation by Micro-enterprises in the Tax and Super systems through co-design and differentiated treatment and services.
		4) Individuals	DC, Micro Enterprises and Individuals	Failure to drive appropriate engagement and participation by Individuals in the Tax and Super systems through co-design and differentiated treatment and services.
		5) Government/Not For Profit	DC, Small & Medium Enterprises	Failure to drive appropriate engagement and participation by Govt and Not For Profit sector in the Tax and Super systems through co-design and differentiated treatment and services.
		6) Tax and BAS Agent Engagement	DC, Tax Practitioner and Lodgment Strategy ²	Failure to engage effectively with tax and BAS agents and develop effective relationships with their representative bodies.
5	Enterprise Change			Failure to deliver major enterprise change projects on budget, on time and with specified functionality and benefits.
		1) Other Projects ³	[TBD]	Failure to deliver [major enterprise change initiative] on budget, on time and with specified functionality and benefits.
6	Facilities			Failure to maintain key facilities, services to facilities and access to facilities at specified levels of service, cost and performance.
		1) Accommodation	Chief Finance Officer	Failure to maintain appropriate accommodation.
		2) Maintenance	Chief Finance Officer	Failure to maintain facilities and assets.

	Level 0	Level 1	Enterprise risk owner	Risk description guide
		3) Environmental Management	Chief Finance Officer	Failure to maintain our impact in the environment within specified levels.
7	Finance			Failure to manage, control and account for ATO finances, resources and assets.
		1) Budget	Chief Finance Officer	Failure to manage the agency budget for overspend and underspend within agreed tolerance.
		2) Account	Chief Finance Officer	Failure to maintain appropriate processes and systems for determining the ATO's financial position.
		3) Transact	Chief Finance Officer	Failure to maintain appropriate processes and controls for managing financial transactions.
		4) Procure	Chief Finance Officer	Failure to maintain appropriate procurement practices in accordance with Government legislation and policy (including the Commonwealth Procurement Rules) and ATO policies.
		5) Contract and Outsourced Service Management	Chief Finance Officer	Failure to maintain appropriate processes and systems for developing, negotiating and maintaining contractual arrangements with suppliers.
8	Governance			Failure to effectively manage the governance and direction of the ATO.
		1) Corporate Policy and Planning	FAC, Corporate Relations	Failure to adequately plan, identify appropriate priorities and allocate commensurate resources.
		2) Oversight	FAC, Corporate Relations	Failure to establish and maintain adequate accountability and oversight arrangements including governance, approval and review processes.
		3) Reputation Management	FAC, Corporate Relations	Failure to maintain and protect the integrity of our reputation from high impact risk events, including issues escalation.
		4) Risk Management	Chief Knowledge Officer	Failure to maintain adequate standards and processes for risk management.
		5) Regulatory Compliance	FAC, Law & Practice	Failure of the ATO to comply with all the legislation and regulations under which it has obligations.
		6) Assurance	FAC, Corporate Relations	Failure to provide and maintain ongoing assurance processes.
		7) Internal Fraud	FAC Corporate Relations	Failure to minimise internal fraud and corruption through timely and effective detection, prevention and investigative activities

	Level 0	Level 1	Enterprise risk owner	Risk description guide
9	Government Engagement			Failure to engage effectively with government stakeholders, in Australia and internationally on matters of shared policy interest and delivery against government objectives and priorities.
		1) Ministers & Parliament	FAC, Corporate Relations	Failure to engage effectively with the Treasurer, Assistant Treasurer and other Ministers assisting with ATO responsibilities, and Parliamentary committees.
		2) Treasury	FAC, Corporate Relations	Failure to engage effectively with the Treasury.
		3) States	DC, Indirect Tax	Failure to engage effectively with State Governments/Treasuries.
		4) External Scrutineers	FAC, Corporate Relations	Failure to engage effectively with the External Scrutineers.
		5) Other Australian Agencies	FAC, Corporate Relations	Failure to engage effectively with other Australian agencies.
		6) International	DC, Large Business & International	Failure to engage effectively with key tax authorities internationally on matters requiring cross-jurisdictional collaboration and intelligence gathering.
10	Knowledge			Failure to manage knowledge and information capability at agreed standards.
		1) Information Management	Chief Knowledge Officer	Failure to manage information through the information lifecycle to agreed standards ⁴ .
		2) Knowledge Sharing	Chief Knowledge Officer	Failure to track and make sense of changes in the external environment, learn from experience and share knowledge appropriately between staff, partners and taxpayers.
11	Law Interpretation			Failure to provide reasonable certainty to the community (assist taxpayers understand their obligations) in the operation of laws administered by the Commissioner.
		1) Certainty through Advice	Chief Tax Counsel	Failure to provide reasonable certainty, through rulings and advice to the community, in the operation of the laws administered by the Commissioner.
		2) Certainty through Litigation	Chief Tax Counsel	Failure to manage law interpretation issues in the litigation process and consequential issues arising from court/tribunal decisions.

	Level 0	Level 1	Enterprise risk owner	Risk description guide
12	Legal Support			Failure to provide appropriate legal advice and litigation support to support administration of the tax law and the ATO as an agency (excludes test cases and major precedential cases which form part of the 'Law Interpretation' risk).
		1) Advise	FAC, Law & Practice	Failure to provide appropriate legal advice.
		2) Defend	FAC, Law & Practice	Failure to prepare appropriate defence of a matter.
		3) Litigate	FAC Law & Practice	Failure to litigate a matter to an appropriate resolution point.
13	Major Tax Integrity Threats			Failure to identify and respond effectively to major complex threats to the integrity of Australia's Tax and Superannuation systems.
		1) Tax crime	DC, Serious Non-Compliance	Failure to adequately identify and respond to major criminal threats to Australia's tax and superannuation systems which have the potential to undermine community confidence in the integrity of the system.
		2) Aggressive Tax Planning	DC, Aggressive Tax Planning	Failure to identify and respond in a timely manner to the promotion of, and participation in, tax avoidance arrangements of a nature and at levels which may undermine community confidence in the integrity of the tax and superannuation system.
		3) Cash Economy	DC, Tax Practitioner and Lodgment Strategy ⁵	Failure to identify and respond to major threats posed by the cash economy which have the potential to undermine community confidence in the integrity of the system.
14	People			Failure to manage people capability to meet projected business needs.
		1) Retain	FAC, ATO People	Failure to recruit and retain staff to meet projected capability need in defined work streams.
		2) Develop	FAC, ATO People	Failure to train and develop staff to meet defined competency levels within projected capability requirements.
		3) Engage	FAC, ATO People	Failure to improve and maintain engagement and capability of staff to achieve increased productivity.
		4) Working Environment	FAC, ATO People	Failure to maintain a safe, healthy and harmonious workplace that considers the environment.

	Level 0	Level 1	Enterprise risk owner	Risk description guide
		5) Ethics/Values	FAC, ATO People	Failure to maintain a high standard of conduct and values amongst staff.
15	Policy Advice & Design			Failure to effectively shape tax and related law changes and the design and implementation of new or changed products/services.
		1) Assist Law Development	FAC, Corporate Relations	Failure to assist development and design of law changes consistent with government policy objectives and the role of the ATO.
		2) Admin Design & Implementation	FAC, Corporate Relations	Failure to effectively co-design new or changed ATO products and services and implement those changes with clients and stakeholders in line with the Government's policy intent.
16	Product & Payment Processing			Failure to manage workloads for product and payment processing and client register to specified levels of performance and integrity.
		1) Work Allocation	DC Client Account Services	Failure to triage, manage and allocate work flows efficiently into relevant work areas.
		2) Account and product administration	DC, Client Account Services	Failure to receive and remit payments (including refunds), maintain client accounts, manage account updates and administer products to agreed levels of performance and integrity.
		3) Debt Management	DC, Debt	Failure to manage debt collection processes to agreed levels of performance and integrity.
		4) Call Centres	DC, Customer Service & Solutions	Failure to manage call centres to agreed levels of performance and integrity.
		5) Client Registrations	DC, Client Account Services	Failure to manage Commissioner of Taxation registrations and maintain client registers to specified levels of performance and integrity.
17	Security & Privacy			Failure to effectively maintain the security of ATO assets and the privacy of personal information.
		1) People	FAC, ATO People	Failure to protect ATO staff from physical threats or harm including unauthorised access.
		2) Physical	Chief Finance Officer	Failure to protect ATO assets from physical threats or harm including unauthorised access.
		3) Technology	Chief Information Officer	Failure to protect technology from unauthorised access, damage or loss.
		4) Information	Chief Knowledge	Failure to protect official and

	Level 0	Level 1	Enterprise risk owner	Risk description guide
			Officer	classified information from damage, disclosure or loss.
		5) Privacy	FAC, Law & Practice	Failure to maintain the privacy of taxpayers.
18	Tax & Super Compliance			Failure of the ATO to ensure taxpayers and other clients can understand and meet their tax, super and related obligations and receive appropriate concessions associated with these obligations.
		1) Income Tax	DC, Large Business & International	Failure to ensure taxpayers understand and meet their obligations under the Income Tax product and receive appropriate entitlements.
		2) GST	DC, Indirect Tax	Failure to ensure taxpayers understand and meet their obligations under the GST product and receive appropriate entitlements.
		3) Superannuation	DC, Superannuation	Failure to ensure taxpayers understand and meet their obligations under the Superannuation product and receive appropriate entitlements.
		4) Excise	DC, Indirect Tax	Failure to ensure clients understand and meet their obligations under the Excise product and receive appropriate entitlements.
19	Tax Revenue			Failure of the ATO to maintain appropriate levels of tax revenue and collections, supported by appropriate forecasting and monitoring advice.
		1) Revenue Tracking	FAC, Corporate Relations	Failure to provide appropriate advice, guidance and monitoring with respect to current budget year forecasts.
		2) Liabilities Raised	DC, Compliance Support and Capability (coordination)	Failure to meet budgeted tax revenue targets through liabilities raised.
		3) Payment Compliance	DC, Debt	Failure to maintain payment compliance at acceptable tolerance levels.
20	Technology			Failure to change or sustain key IT systems to meet business requirements.
		1) Invest	Chief Information Officer	Failure to shape and direct a balanced comprehensive investment portfolio for IT systems.
		2) Change	Chief Information Officer	Failure to deliver replacement and enhancement projects on time, on budget and with the specified functionality and benefits.

	Level 0	Level 1	Enterprise risk owner	Risk description guide
		3) Sustain	Chief Information Officer	Failure to maintain existing systems to the level of availability and performance to meet business needs.
21	Transfers Compliance			Failure of the ATO to ensure citizens understand their entitlements and receive appropriate grants, benefits and related payments under the law.
		1) Grants	DC, Micro Enterprises & Individuals	Failure of the ATO to ensure eligible citizens understand their grant entitlements and receive appropriate grants under the law.
		2) Benefits	DC, Micro Enterprises & Individuals	Failure of the ATO to ensure eligible citizens understand their benefit entitlements and receive appropriate benefit payments under the law.
		3) Offsets	DC, Micro Enterprises & Individuals	Failure of the ATO to ensure eligible citizens understand their offsets entitlements and receive appropriate consideration under the law.
22	Valuation Services	1) Valuation Services	General Manager, (Australian Valuation Office)	The failure to maintain the sustainability of the AVO as a viable and successful business operation.

APPENDIX 4 — CONFIDENCE LEVELS USED IN RISK ASSESSMENT

A4.1 The following illustrates how confidence levels are used in different contexts in qualifying a risk rating. Public Safety Canada has issued the 'All Hazards Risk Assessment Methodology Guidelines 2012-13'. As part of the risk assessment process, risk assessors must also indicate their level of confidence:¹

Confidence Level and Justification for Likelihood Analysis and Impact/Consequence Analysis

For each impact category, assessors must indicate their level of confidence in the estimates they have provided with respect to harm caused by the defined Risk Event Scenario. A confidence level from A to E is used to describe the confidence of assessors in the value they have defined or selected. The degree of confidence in the ratings produced will vary, depending on the availability of data, relevant experience and existing body of knowledge. Capturing the confidence level associated with each rating produced provides a crucial piece of information that helps complete the risk assessment picture. Confidence levels will be presented, along with final results, to indicate to decision makers where some low or very low confidence assessments may necessitate caution in interpretation. On the other hand, assessments accompanied with high or very high confidence levels will inspire trust in immediate actions required to treat pressing risks.

The following table presents definitions for confidence levels that must be used for each rating:

Confidence Level	Quantification
A	Very High confidence in the judgement based on a thorough knowledge of the issue, the very large quantity and quality of the relevant data and totally consistent relevant assessments.
B	High confidence in the judgement based on a very large body of knowledge on the issue, the large quantity and quality of the relevant data and very consistent relevant assessments.
C	Moderate confidence in the judgement based on a considerable body of knowledge on the issue, the considerable quantity and quality of relevant data and consistent relevant assessments.
D	Low confidence in the judgement based on a relatively small body of knowledge on the issue, the relatively small quantity and quality of relevant data and somewhat consistent relevant assessments.
E	Very Low confidence in the judgement based on small to insignificant body of knowledge on the issue, quantity and quality of relevant data and/or inconsistent relevant assessments

In addition, any justifications, assumptions and/or references for the various inputs defined by assessors during Risk Analysis should be recorded, along with the rating of each impact category.

¹ Public Safety Canada has issued the 'All Hazards Risk Assessment Methodology Guidelines 2012-13', page 24.

APPENDIX 5 — PREVIOUS IGT RECOMMENDATIONS RELATED TO COMPLIANCE COSTS

A5.1 The following list provides an indication of the recommendations made by the IGT during recent reviews that related to minimising compliance costs:

A5.2 Review into improving the self assessment system — publicly released 13 February 2013:

- Recommendation 2.1
- Recommendation 3.3
- Recommendation 3.4
- Recommendation 3.12
- Recommendation 4.3

A5.3 Review into the Australian Taxation Office's use of benchmarking to target the cash economy — publicly released 4 October 2012:

- Recommendation 3.4
- Recommendation 4.1
- Recommendation 6.3

A5.4 Review into the Australian Taxation Office's use of early and Alternative Dispute Resolution — publicly released 31 July 2012:

- Recommendation 3.2
- Recommendation 4.3
- Recommendation 4.4
- Recommendation 4.5

A5.5 Review into the ATO's compliance approaches to small and medium enterprises with annual turnovers between \$100 million and \$250 million and high wealth individuals — publicly released 24 April 2012:

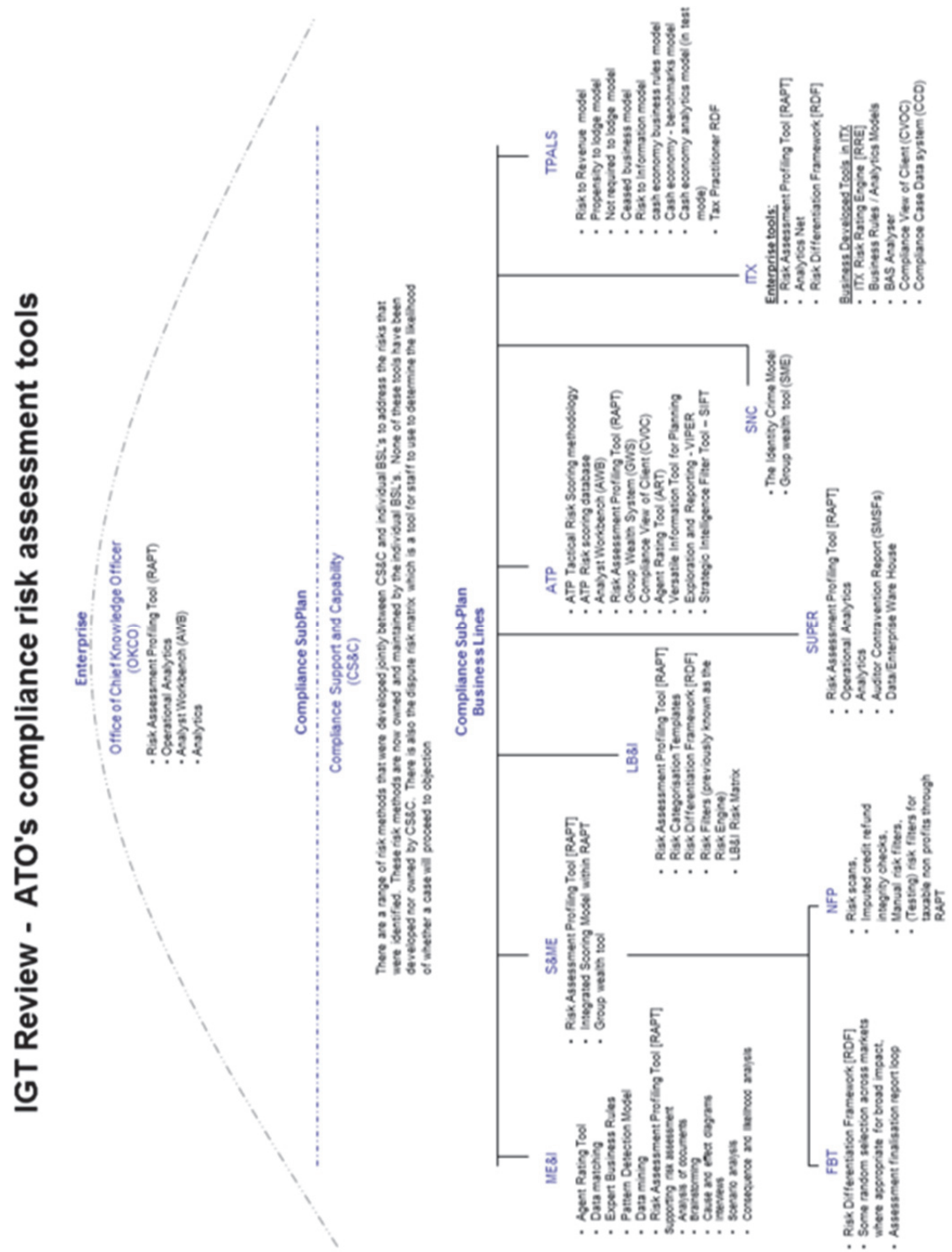
- Recommendation 3.1
- Recommendation 4.4

A5.6 Report into the Australian Taxation Office's large business risk review and audit policies, procedures and practices — released 7 September 2011:

- Recommendation 8.5

APPENDIX 6 — OVERVIEW OF ATO RISK ASSESSMENT TOOLS

Figure 26: Overview of ATO compliance risk assessment tools



Source: ATO supplied to IGT as part of review, December 2012.

APPENDIX 7 — ATO ENTERPRISE LEVEL RISK MATRIX

A7.1 Risks registered on the ATO's Enterprise Risk Manager must be assessed using the Enterprise level risk matrix below:

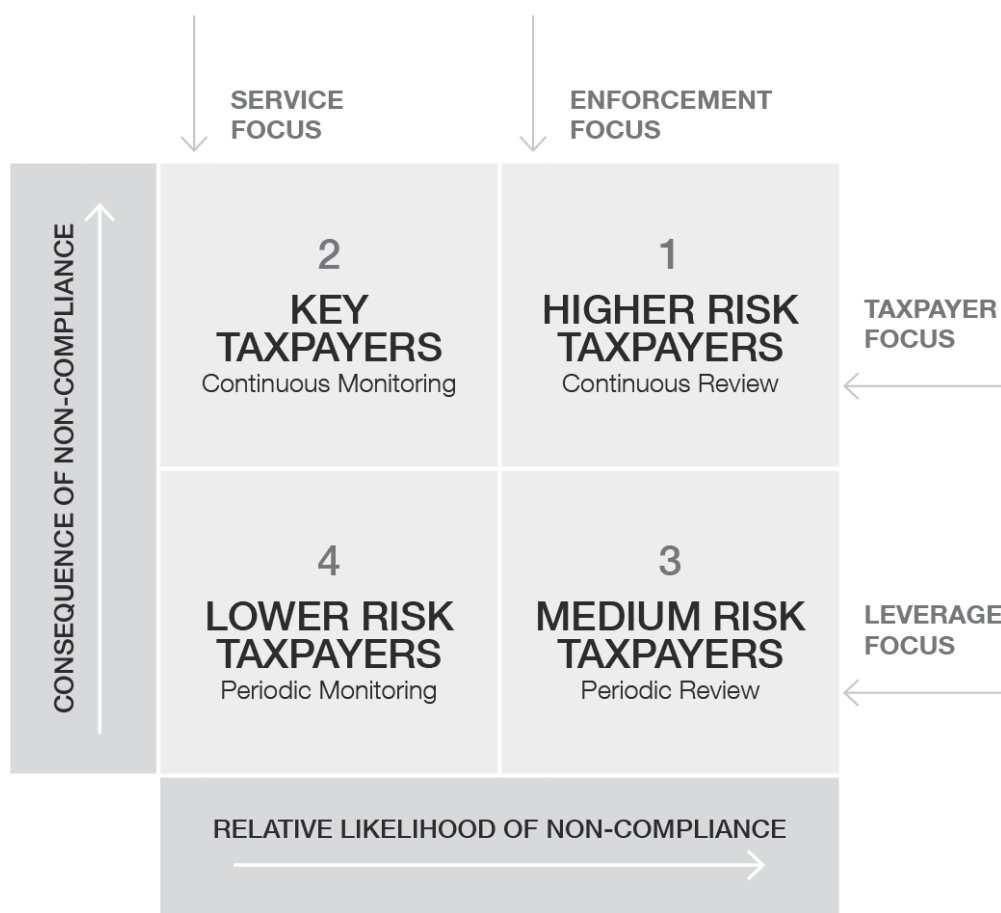
Table 7: ATO enterprise level risk matrix

ATO — Enterprise level risk matrix						
Consequence	Extreme	High	High	Severe	Catastrophic	Catastrophic
	Very High	Significant	Significant	High	Severe	Severe
	High	Moderate	Significant	Significant	High	High
	Medium	Low	Moderate	Significant	Significant	Significant
	Low	Low	Low	Moderate	Moderate	Moderate
		Rare	Unlikely	Even Chance	Likely	Almost Certain
Likelihood						

Source: ATO, ATO risk matrices CMPI 2003/02/02.

APPENDIX 8 — RDF CHART FROM LARGE BUSINESS AND TAX COMPLIANCE 2010 BOOKLET

Figure 27: RDF chart from 2010 Large business and tax compliance booklet



Source: ATO, Large business and tax compliance 2010, page 23.

APPENDIX 9 — LARGE MARKET INCOME TAX RISK FILTERS

A9.1 The following is the list of income tax risk filters used in the large market. For full risk filter descriptions, visit ato.gov.au.

Key compliance program 2012-13 risks:

- Taxation of financial arrangements
- Profit shifting
- Corporate restructure
- Consolidation
- Research and development.

Other compliance program 2012-13 issues:

- Small business and general business tax break
- Private equity exiting Australia
- Immediate deduction for mining, quarrying or prospecting rights
- Financial arrangements
- Revenue and capital losses
- Non-resident withholding tax
- Managed investment trusts
- Financial arrangements undertaken by stapled groups.

Other risk areas we are monitoring:

- Black-hole expenditure
- Offshore banking units
- Structured lease and leaseback
- Superannuation fund related risk
- Tax havens
- Low tax performance.

APPENDIX 10 — SME MARKET RISK FACTORS

A10.1 The following is extracted from the *Tax compliance for small-to-medium enterprises and wealthy individuals* guide available on ato.gov.au.

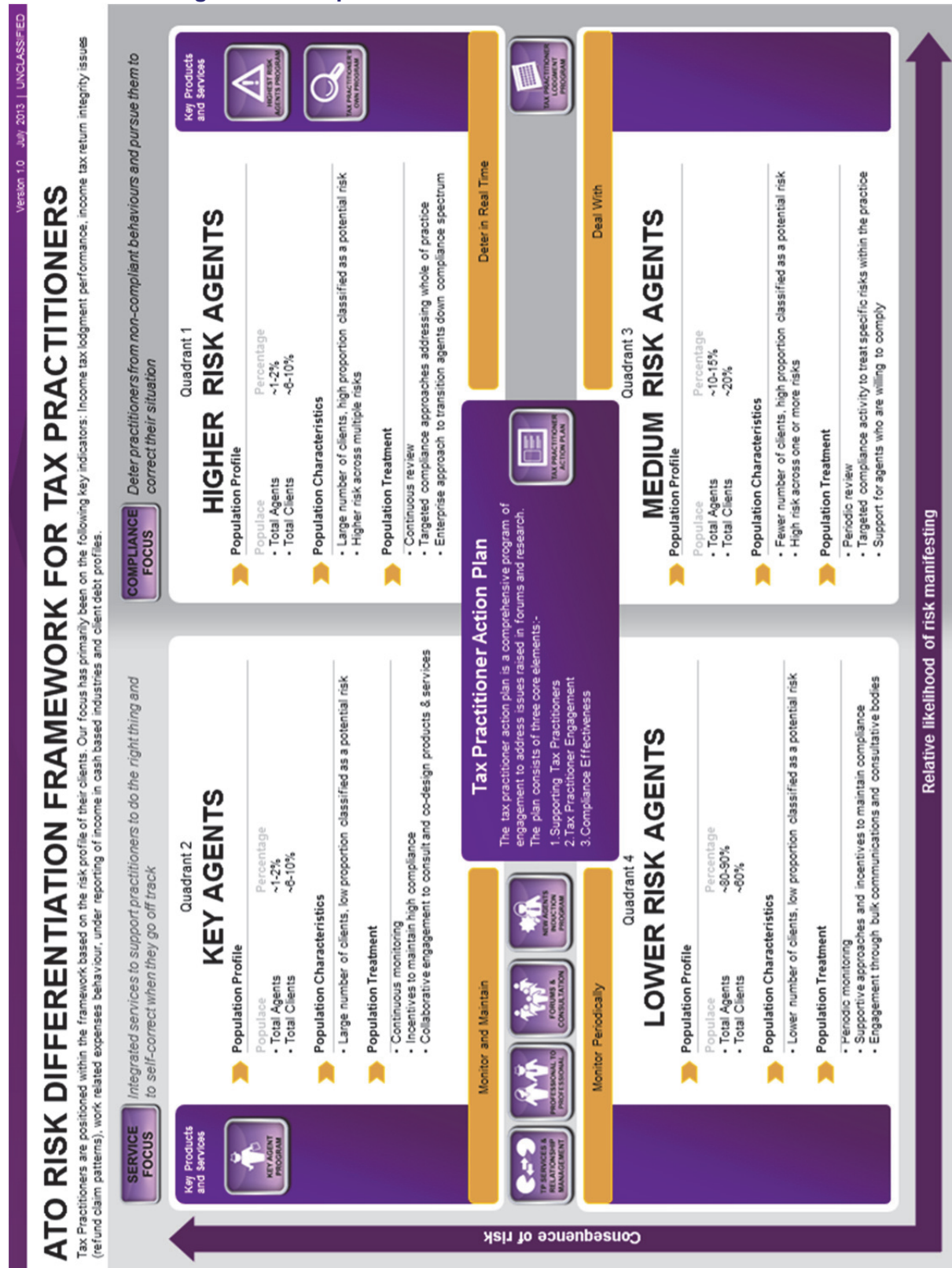
Several characteristics may attract our attention, including:

- tax performance varying substantially from business performance
- inconsistencies in activity statements or spikes in refund claims
- large, one-off or unusual transactions
- tax and economic performance varying significantly from similar businesses in the same industry
- unexplained losses
- a history of aggressive tax planning by individuals or their advisors
- weaknesses in compliance structures, processes and approaches
- tax outcomes inconsistent with the intent of tax law
- lifestyle not supported by after-tax income
- treating private assets as business assets
- accessing business assets for tax-free private use
- not disclosing offshore dealings with overseas entities, especially low-tax jurisdictions and tax havens that allow banking secrecy
- using complex structures and intra-group transactions to minimise tax
- transactions where the tax and economic outcomes are inconsistent
- poor governance and risk-management systems
- distortions and inconsistencies in market valuations and apportionments
- business performance falling outside small business benchmarks (for businesses with turnover of up to \$15 million).

We take these characteristics into account when developing our view of potential risks and determining our compliance approach.

APPENDIX 11 — TAX PRACTITIONER RDF

Figure 28: Tax practitioner risk differentiation framework



Source: ATO supplied to IGT as part of review, October 2013.

APPENDIX 12 — QUALITY ASSURANCE CHECKLIST FOR COMPLIANCE RISK ASSESSMENT TOOL DESIGN

A12.1 The following checklist should be used in the design and implementation of the ATO's compliance risk assessment tools.

1. What is the risk event you are seeking to manage? This may be framed in terms of the 4 pillars of compliance or with reference to an existing enterprise risk.

GOVERNANCE

2. What governance arrangements do you have in place?
3. What documentation and record controls do you have in place?

INPUTS

4. What inputs are you using to detect the risk event?
5. What evidence do you have to support your inputs?
6. What is the expected strike rate and average adjustment?
7. What evidence do you have to support expected strike rates and adjustments?
8. Have you undertaken any testing or trials to test the accuracy of your inputs?
9. Do you have processes in place to ensure your inputs are regularly reviewed in light of compliance activities?
10. Which compliance effectiveness methodology will you be using to evaluate the effectiveness of your risk treatment?
11. If you are not using one, explain why not.

TRANSPARENCY AND COMMUNICATION

12. What general information will you provide publically about your approach?
13. Is there any information that you should provide to a group of taxpayers?
14. At what point will you communicate with a particular taxpayer?

15. What will you tell them?
16. How will you tell them?
17. Will you provide with them a right of review?
18. What behavioural responses are you expecting from taxpayers or their representatives?
19. What evidence do you have to support the expected behavioural responses? For example: pilots, user testing, randomised controlled trials.
20. What opportunities will you give to taxpayers to respond to you or address your concerns?
21. Is it clear to taxpayers why the ATO is contacting them?
22. Have you communicated the risk hypothesis to the taxpayer?
23. Are your expectations of the taxpayer clear in your communication?
24. Are your anticipated ATO responses (for example escalation) clear to the taxpayer?
25. What impact on the taxpayer's compliance costs are you anticipating?
26. What evidence do you have to support this figure?

PROPORTIONALITY

27. How will you distinguish between different levels of risk?
28. How will you distinguish between different types of risk or concerns, for example inherent, behavioural or information confidence and cost?
29. Do you have a range of risk treatment options to match different levels or types of risk?
30. Are you able to use 'case refinement' products to reduce the numbers of taxpayers subject to higher intensity compliance activity?
31. Do you have a strategy in place to escalate lower risk cases to higher intensity compliance activities where higher risks are confirmed?

PROJECT MANAGEMENT

32. What are the planned resources for your risk treatment plan?

33. What timelines are you expecting for your risk treatment plan?
34. How many cases are you anticipating will be created as a result of your risk detection methods?
35. If there are any unexpected changes to any of the above parameters, what are your priorities?
36. To what extent are you willing or able to extend the time taken to action the cases?
37. How will you manage timeline changes in terms of managing ATO staff and taxpayer expectations?
38. To what extent are you willing or able to reduce the cases you action or change the way you action them?
39. Have you identified what level of risk you are willing to retain by not actioning certain cases?
40. Do you have alternative risk treatment strategies for some cases? For example, a lower intensity compliance activity?
41. To what extent are you willing or able to call on additional resources?
42. Have relevant stakeholders agreed to make those resources available to you?

APPENDIX 13 — ATO RESPONSE



Australian Government
Australian Taxation Office

COMMISSIONER OF TAXATION

Mr Ali Noroozi
Inspector-General of Taxation
GPO Box 551
SYDNEY NSW 2001

Dear Ali

Review into aspects of the ATO's use of compliance risk assessment tools

Thank you for the opportunity to comment on your final draft of your report on the review into aspects of the ATO's use of compliance risk assessment tools. I would like to acknowledge the efforts of all involved in undertaking this review.

I welcome your observation that broadly the ATO has good risk management practices and that we have continued to deliver improvements, including those identified by scrutineer reviews of the ATO's administration.

Your draft report's constructive feedback and specific recommendations will assist us to continue the improvement of our compliance approaches.

I am pleased to note that we are agreeing with all of the recommendations made in your report, and we have already commenced implementation of a number of these.

Our detailed response to your recommendations is attached at Annexure 1.

If you require further information on our response, please contact Stuart Hamilton, Assistant Deputy Commissioner.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Bruce Quigley'.

Bruce Quigley
Acting Commissioner of Taxation

14 October 2013

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