



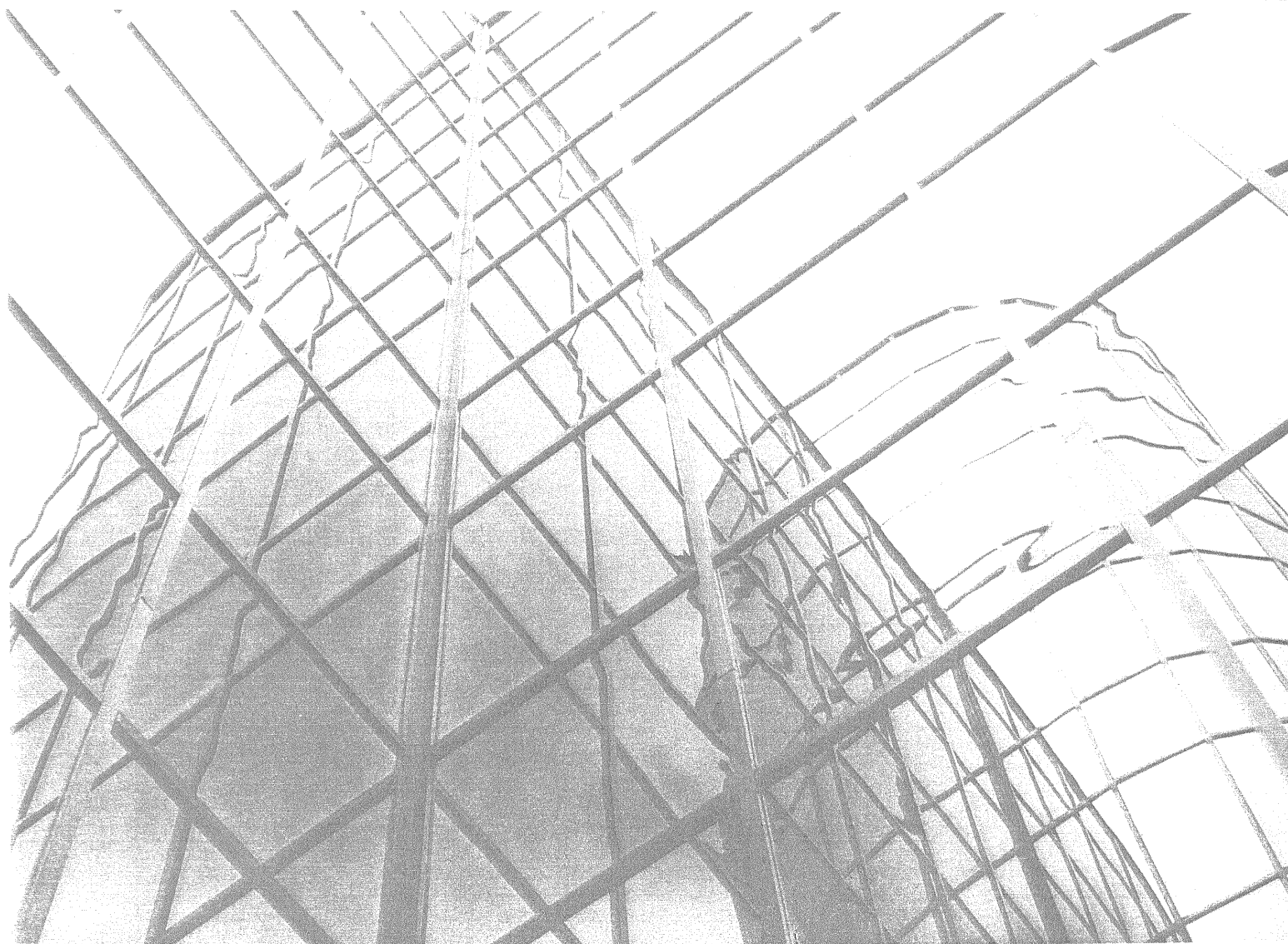
Australian Government
Australian Taxation Office

Senate Standing Committee on Economics
Supplementary Budget Estimates 2006-2007
1-2 November 2006

Tabled Document No 8
By: Michael D'Ascenzo
Date: 2/11/06

2006

Large business and tax compliance



© COMMONWEALTH OF AUSTRALIA 2006

This work is copyright. Apart from any use as permitted under the *Copyright Act 1968*, no part may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to the Commonwealth Copyright Administration, Attorney General's Department, Robert Garran Offices, National Circuit, Barton ACT 2600 or posted at <http://www.ag.gov.au/cca>

PUBLISHED BY

Australian Taxation Office
Canberra August 2006
NAT 8675-08.06
JS 4584

COMMISSIONER'S FOREWORD



The Australian Taxation Office has overall responsibility for the administration of Australia's tax system on behalf of the government and the community. In doing this important work, our business intent is to encourage high levels of voluntary compliance with the tax laws. We also have a responsibility for monitoring whether the system works efficiently and as intended.

This booklet describes how we do this for large businesses. It will help directors, chief executive officers, chief finance officers, tax managers, their staff and, of course, our own Tax Office staff to better understand our processes and how we seek to foster a good working relationship with large businesses.

The contribution of large business to taxation revenue is significant – last year tax paid by large business made up around 36% of the tax we collect. In addition, around one third of the Australian workforce is employed by the large business sector, which accounts for around 35% of all PAYG withholding. Employer

obligations also extend to fringe benefits tax and superannuation payments.

Perceptions about the compliance behaviour of large business also impact on how the wider community views the fairness and integrity of the tax system.

While levels of voluntary compliance with the tax laws by large businesses in Australia are generally high, the dynamic and globalised nature of large business enterprises and the value, volume and complexity of transactions undertaken by them create challenges for their own governance and for the Tax Office.

Given the significance of large businesses to the efficient and effective operation of Australia's tax system, and the inherent uncertainty in the application of the tax law to complex arrangements, it is critical that we develop a close and constructive working relationship with the large business sector, including the efficient and proper resolution of disputes.

We believe that there are opportunities to work together to consult, collaborate and co-design administrative solutions that make it easier for large businesses to comply with the tax law. This helps reduce dead weight compliance costs and increases our competitiveness in the global market. Also contributing to these goals are compliance processes that promote certainty and make our interactions with large businesses efficient and professional.

An environment that values consultation and co-design on the implementation of new measures, and full and frank feedback to us on how the system is working in practice, also encourages voluntary compliance, and provides the opportunity for improvements to the tax system.

I look forward to working with large businesses to build an approach of cooperative compliance that allows them to add value to their shareholders and to the Australian community.

Michael D'Ascenzo
Michael D'Ascenzo
Commissioner of Taxation

CONTENTS

COMMISSIONER'S FOREWORD

1

01

INTRODUCTION

1

Why it is important that we have a good relationship with large business, and our approach to achieving this.

02

MEETING YOUR TAX OBLIGATIONS

9

Suggestions for large businesses in terms of the management of their tax obligations and corporate governance.

03

WHAT ATTRACTS OUR ATTENTION

15

The issues and characteristics that attract our attention and constitute risk.

04

HOW WE HELP YOU COMPLY

32

Details of our key information and support services for large businesses.

05

HOW WE IDENTIFY COMPLIANCE RISKS

39

Our broad approach to identifying compliance risks, including how we select cases for further compliance verification.

06

HOW WE CONDUCT RISK REVIEWS & AUDITS

45

Our typical processes for conducting risk reviews and audits.

07

KEY ASPECTS OF THE LAW AND OF OUR COMPLIANCE PROCESSES

57

Some structural features of the law and some of the key aspects of our compliance processes.

08

MORE INFORMATION

65

Details of other information products and where to find them.

APPENDICES

67

FEEDBACK MECHANISMS

How to provide feedback about our risk management choices, how we operate, and how the tax system is operating in practice.

ADVICE AND ACTIVE COMPLIANCE PRODUCTS

Key advice and active compliance products.

01

INTRODUCTION

This chapter outlines why it is important that we have a good relationship with large business and our approach to this.

PURPOSE OF THE BOOKLET

This publication is designed to provide large businesses (and their advisers) with detailed information on the Tax Office's approach to tax compliance so they can ensure their tax affairs are well managed. In keeping with our commitment to transparency, we have set out:

- our suggestions as to how corporate taxpayers could approach compliance
- what we do to help taxpayers and give them the greatest possible certainty in relation to their tax obligations
- our approach to managing compliance risk and the features that attract our attention (these are also elaborated and updated in our annual *Compliance program*), and
- our compliance processes.

The publication also sets out for Tax Office staff our compliance approach to corporate taxpayers, and provides guidelines for the conduct of their activities.¹

Large business and tax compliance is part of a suite of information products on compliance risk management for large businesses (see 'More information', Chapter 8).

This publication encompasses the principles and philosophy outlined in the *Cooperative compliance model* booklet issued in November 2000.

This version of *Large business and tax compliance* supercedes:

- the previous version issued in 2003, and
- *Complex audits: Guidelines for the conduct of taxpayers and taxation auditors* and the addendum which introduces a review process for auditors' decisions.

LARGE BUSINESS AND TAX

Large businesses have a critical role in the revenue system, paying and withholding taxes, and contributing to and managing superannuation on behalf of employees. They also act as intermediaries in transactions between us and other taxpayers, and providing financial facilities used by other taxpayers.

For the purposes of market segmentation, we classify large businesses as those groups with a turnover of around \$100 million or more.

The segment currently comprises around 1,900 economic groups and single entity taxpayers. Most are corporations. Of these enterprises, around 600 are foreign owned or controlled and 1,300 are Australian owned. The level of international dealings is significant in this segment with 68% of all large businesses lodging a schedule 25A detailing transactions with offshore affiliates.

Major industry sectors include the finance sector which accounts for more than 500 businesses, of which 300 are holding companies or financial asset investors, the retail and wholesale sector with more than 460 businesses, and manufacturing with 380. Around 70 large businesses are involved predominantly in the natural resources sector.

TABLE 1: Key large business obligations

Taxpayer obligations	Employer obligations
Income tax	PAYG withholding
GST	Fringe benefits tax reporting
Excise	Superannuation guarantee
Petroleum resource rent tax	Superannuation reporting
Fringe benefits tax	Superannuation choice
Wine equalisation tax	
Luxury car tax	
Fuel tax credits scheme	
Withholding taxes	

¹ The approaches, processes and policies described in this booklet apply to all tax obligations unless indicated otherwise.

Contribution to revenue

Figures 2 and 3 demonstrate the significance of the revenue contribution in this sector and trends in income tax and GST compared with key economic indicators. The scale of the revenue contribution emphasises the importance of managing compliance in this sector.

Net GST revenue from large businesses has grown from \$17 billion in 2000–01 to \$19 billion in 2004–05, in line with the growth and trends in final household consumption in the same period. The net GST revenue from large businesses represents 59% of total GST revenue.

Company income tax has grown from \$18 billion in 1993–94 to \$40 billion in 2004–05, outstripping the growth in gross domestic product (GDP) and gross operating surplus (GOS).

Large businesses represented 62% (\$25 billion) of income tax collections from companies in 2004–05. In 2005–06, this share grew to around two-thirds of company tax collections. In addition to income tax, in 2004–05 large businesses paid:

- 59% (\$19 billion) of total net GST – see Figure 2 on page 4
- 99% (\$22 billion) of excise revenue
- 100% (\$1.5 billion) of petroleum resource rent tax
- 56% (\$2 billion) of fringe benefits tax, and
- 66% (\$3 billion) of superannuation funds income tax.

As intermediaries, large businesses (excluding government and non-profit organisations):

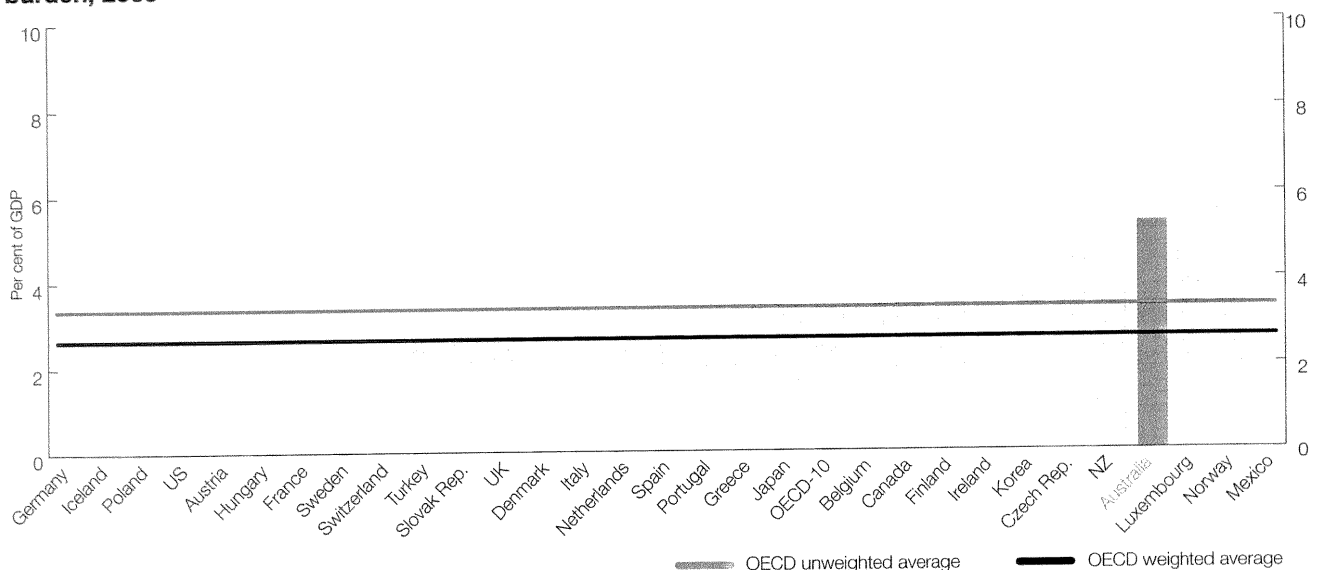
- collected around 35% (\$35 billion) of total pay as you go (PAYG) withholding tax in 2004–05 (on behalf of individuals they employed), and
- play a major role as employers in the superannuation guarantee scheme.

Australia's corporate income tax as a proportion of GDP is above that of the OECD-10 (though classification issues make this comparison difficult). It is worth noting however, that:

- from 2000, the reduction in Australia's corporate tax rate has exceeded the fall in both the OECD-30 and the OECD-10 averages, and
- Australia's 30% statutory corporate tax rate is slightly above the OECD-30 unweighted average of 28.5% and below the weighted average of 35.6%.

As Figure 1 suggests, there are generally high levels of voluntary compliance with the tax laws by large business in Australia. Nevertheless, the dynamic and globalised nature of large business enterprises, and the value, volume and complexity of their transactions, create challenges both for their own governance and the Tax Office.

FIGURE 1: OECD-30, direct taxation revenue paid by companies as a proportion of GDP, ordered by tax burden, 2003²



2 International comparison of Australia's taxes, 2006, p xxiii

FIGURE 2: Quarterly final household consumption (including dwelling investment) original prices vs large segment net GST

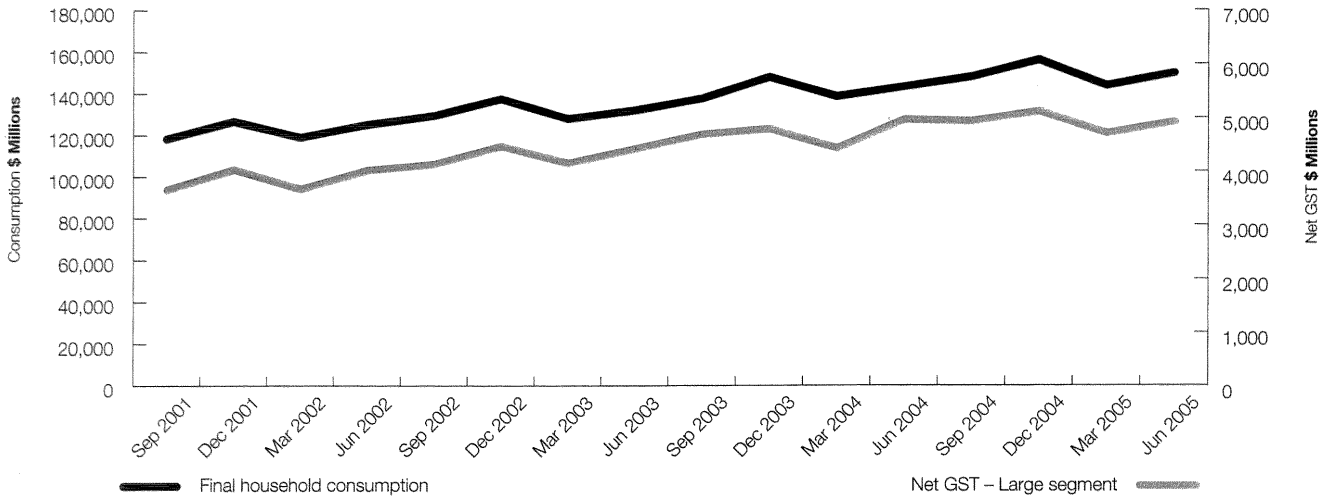
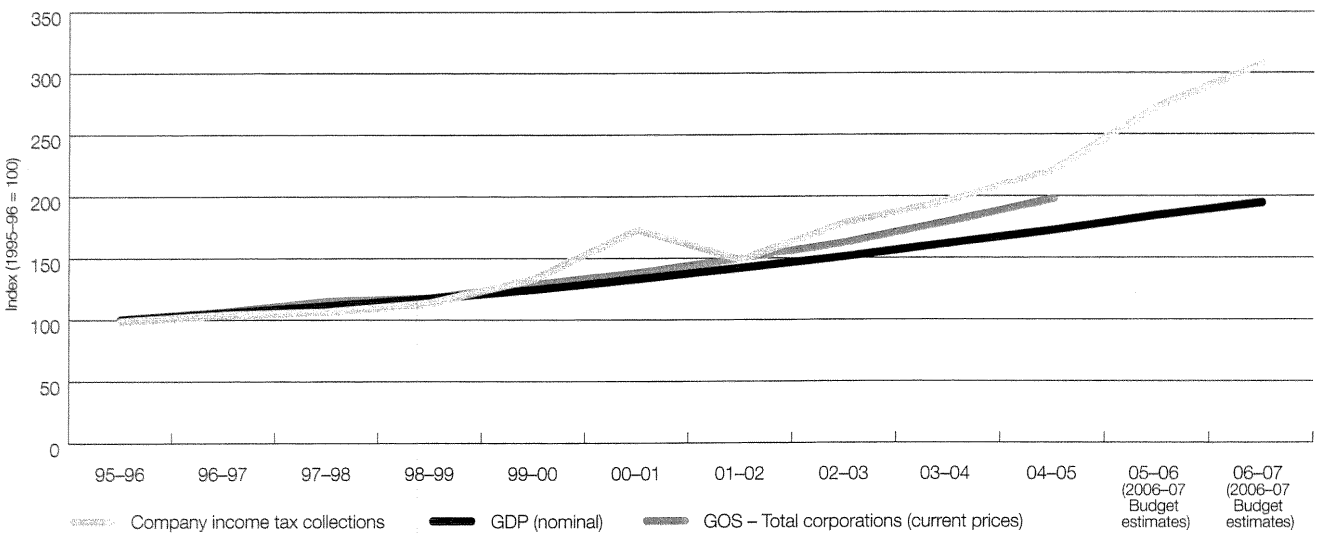


FIGURE 3: Growth trends for GDP, GOS and company income tax



OUR APPROACH TO COMPLIANCE

The Tax Office's aim is to help large businesses self regulate. In this regard we have set out in Chapter 2 key governance questions that will assist directors and senior management in identifying where tax risks may occur in their business so they can be appropriately managed.

The relationship with the large business taxpayer is ongoing, not merely incidental or transactional. Both sides have to try to make the administration of the tax laws work well, to remove unnecessary costs and streamline the resolution of disputes.

The value, volume and complexity of transactions undertaken by large businesses carry inherent risks for tax compliance. While the revenue increases in this sector over the past ten years are consistent with economic parameters, we continue to make large adjustments through our compliance programs, indicating a need for ongoing monitoring of compliance in this sector.

We monitor payments in real time and profile all large business taxpayers using information that is reported by them, provided by third parties, and available in the public domain. For more information, see Chapter 5 'How we identify compliance risks' on page 39.

From their own risk management perspective, large businesses want to know where they stand on the application of the tax laws to complex and novel transactions, which often occur in a global environment. They also want to understand how the Tax Office identifies tax risk and what we will challenge.

Most large businesses have appropriate corporate governance processes in place and ensure appropriate oversight of systems for management and integrity

assurance relative to the importance of the tax issues involved. Our starting assumption is that most large businesses seek to:

- closely manage and scrutinise material issues
- make a reasonable assessment of compliance risks, and
- properly apply the law.

Where large businesses have a history of non-compliance, whether through tax planning to avoid the policy intent of the law or through lack of proper attention or weaknesses in their administrative systems, it is appropriate for us to maintain our risk assessment and relatively intensive audit activity until we can be confident that a more constructive approach has developed.

Our active compliance program for large business – involving risk assessment and audit – is all about encouraging voluntary compliance, identifying areas for law clarification and addressing failure to meet tax obligations. Our focus is on large businesses that appear to present risks to the intended operation of the tax system. Our field work is directed to verifying whether our initial concerns are soundly based and, if so, to taking corrective action where possible. This may include referring matters to the Treasury where the tax law is not consistent with policy, or produces unintended consequences or significant compliance costs. Our approach is even handed and we advise the Treasury where the law's misalignment with policy is detrimental or beneficial to taxpayers.

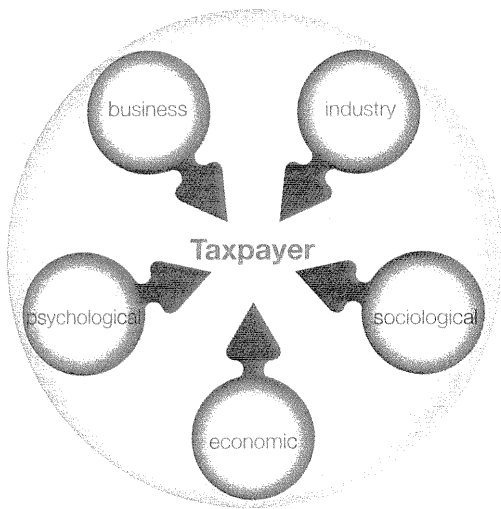
For the large business taxpayer, non-compliance carries risks to their financial position (the costs of dealing with intensive auditing, civil litigation and paying interest and penalties) and to their reputation for competent governance and management.

Compliance model

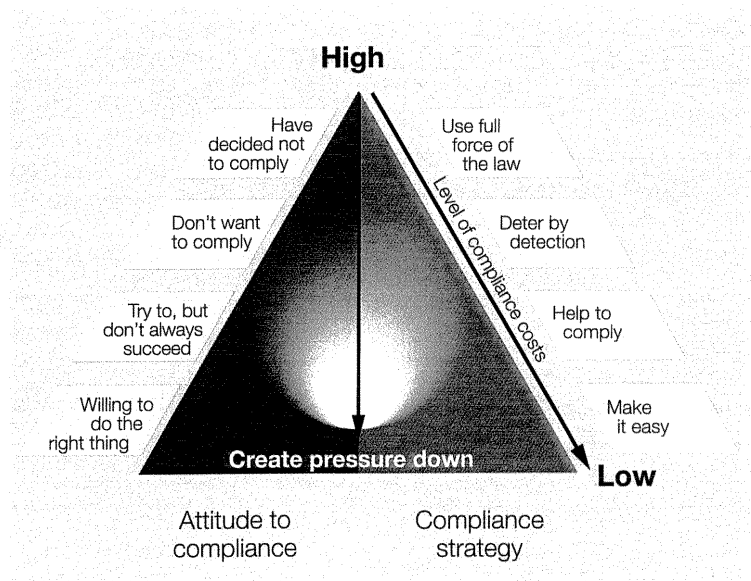
The Tax Office's broad approach to verifying compliance is encapsulated in our compliance model. This is a structured way of understanding compliance behaviour and helps us develop appropriate and proportionate responses according to the nature and level of risk we identify, the causes of non-compliance and the level of cooperation we receive. The compliance pyramid provides the framework against which taxpayer behaviours can be assessed and the appropriate level and nature of the response determined.

The processes in this publication are designed specifically for the large business environment. However, there is no hard and fast threshold and the processes (or variations to them) may also be applied to the top end of the small to medium enterprise segment.

FIGURE 4



Factors that influence taxpayer behaviour



HOW WE WORK WITH LARGE BUSINESS

The guiding principles underpinning our approach to working with large business taxpayers are reflected in the *Taxpayers' Charter* and the compliance model. This involves mutual respect and a professional relationship based on an understanding of the tax law, the causes of non-compliance and the taxpayer's business environment and perspective.

We work at a range of different levels in the large market, through formal consultative forums and representative groups to industry bodies, the major advisers, and at the individual business level.

This collaborative approach includes:

- working together in developing administrative processes for new law measures
- ensuring we address taxpayer concerns about administrative matters or bring them, or unintended outcomes (whether they benefit taxpayers or the revenue), to the attention of the Treasury, and
- providing taxpayers with information to help them identify and manage their tax obligations.

Consulting with large business and industry

The peak body for consultation with the large business sector is the Corporate Consultative Committee (CCC). With representatives from key industry peak bodies, the committee meets twice a year to discuss issues of mutual interest on the management and administration of the tax system. The CCC compliance sub-committee meets up to three times a year to examine practical compliance issues.

Another major consultative forum is the National Tax Liaison Group (NTLG) which deals with broad issues of procedure and policy in tax administration, looking at particular issues in more detail through sub-committees. The group's role is to identify and prioritise significant issues in tax administration, including referring matters to Treasury where necessary.

There are also key industry bodies and professional associations with whom we meet regularly. These meetings help improve the Tax Office's understanding of particular business environments and the various industry perspectives on key tax issues.

Co-designing our administrative processes

A focus of these forums is on partnering and joint development of compliance practices and approaches. This dialogue with taxpayers enables us to help them comply with an evolving legislative environment, and guides our approaches to reduce compliance costs and foster improvements in the system.

INTRODUCTION

02

MEETING YOUR TAX OBLIGATIONS

This chapter sets out our suggestions on corporate governance in relation to meeting tax obligations.

OUR APPROACH TO CERTAINTY

A tax administration that operates in accordance with the rule of law promotes certainty for taxpayers. Our approach to the application of the tax law to the particular facts of a case is to have regard to the words of the Act read in the light of the scheme of the Act and the history and objects of the relevant provisions. In legal terms this is referred to as a 'purposive' approach.

Where the law is clear, we have a duty to apply that law, even if it produces inconvenient outcomes for the revenue or for taxpayers. For example, the law may give rise to unintended consequences, anomalies, or significant compliance costs inconsistent with the policy intent. In such circumstances we see it as our responsibility to advise the Government (usually through Treasury) of the outcome (whether the existing law favours taxpayers or the revenue), giving it the opportunity to consider legislative change.

There are times when, regardless of the quality of the legislative drafting, the words in the Act are ambiguous or open to be interpreted in a number of ways. In these cases, our approach is to adopt the interpretation that best promotes the policy intent. If more than one of the available interpretations promotes the policy intent, we will generally favour the interpretation that reduces taxpayer compliance costs. Of course, these are merely rules of construction and the alternative view is usually reasonably arguable.

In relation to important matters with broad significance, our view of the tax law is communicated to taxpayers and their advisers through public rulings. The types of matters suitable to be covered in our public rulings are identified in consultation with taxpayers through their representative bodies.

To further reduce uncertainty a taxpayer can seek a private and reviewable ruling from us – they can ask to be 'assessed' in relation to an existing or proposed transaction, including where appropriate a ruling on the application of a general anti-avoidance provision.

CORPORATE GOVERNANCE AND TAX RISK MANAGEMENT

There are two levels of issues for large businesses to consider in relation to their tax obligations. The first is ensuring that basic accounting and control mechanisms are operating to handle the day to day obligations, including:

- identifying matters that arise in the ordinary course of their business operations that have a tax impact, and
- ensuring that registration, payment and lodgment obligations are handled in an accurate and timely way.

The second relates to the tax issues associated with major transactions, arrangements and strategies that would themselves be subject to board, or top management, consideration.

In particular, we suggest that directors and senior management may want to:

- have a broad understanding, at least from a financial and business perspective, of the major tax issues that arise in the normal ongoing operations of the business
- make enquiries about or establish reporting procedures to identify material risks so as to provide a level of confidence that corporate processes promote tax compliance
- consider, at least from a financial and business perspective, the tax implications of major transactions, business structures and strategies
- oversee the overall amounts of different taxes paid by the business and be aware of whether these amounts are increasing or reducing and the trends for key indicators such as effective tax rates and the extent to which dividends can or cannot be paid and (if desired) franked, and
- be aware of the kind of relationship the company has with the Tax Office, the level of scrutiny of the business's affairs and the stance the business and its advisers adopt in relation to tax compliance and tax planning.

All of these factors have a bearing on whether the large business has a high, moderate or low tax risk level and the ability of directors and senior management to be in a position to know where the tax risks are and to ensure they are properly managed.

The Tax Office does not expect directors and senior management to be tax experts, though some may have that expertise. In most instances directors and senior management will rely on expert advice from others, whether it is the taxation area at the corporate or business unit level, or external advisers.

It is advisable in those circumstances that directors and senior managers are able to bring a level of independent judgement to proposals suggested to them. Otherwise the business may inadvertently be adopting the attitude of the adviser in relation to tax compliance and the level of risk inherent in the adviser's approach. The prudence or aggressiveness of an adviser's approach may be a factor that the business would consider in engaging external firms and in overseeing its internal taxation function. And this choice itself may purposefully reflect the tax risk appetite of the business.

OPERATIONAL ISSUES

In providing stewardship to a large organisation, most senior managers seek to set up operational processes to:

- ensure that data and information relied on for tax purposes or provided to the Tax Office in activity statements, returns, schedules, reports and for data matching purposes is accurate and reliable
- provide adequate resources to offer reasonable assistance in dealings with the Tax Office
- ensure appropriate changes are made to processes to accommodate changes in tax laws and inform the Tax Office of implementation difficulties
- ensure that record keeping and new systems provide ready access to key information and that there are no gaps in corporate memory, and
- identify systemic errors in financial and tax reporting systems, such as errors in system coding, that magnify the risk if affected transactions occur frequently.

It is desirable to have regular reviews of the currency and on-going suitability for purpose of these operational systems.

KEY GOVERNANCE QUESTIONS – OVERALL TAX PERFORMANCE

The following questions are proposed as a means by which directors and senior management may be able to better understand the nature and extent of the tax risks in relation to the overall tax performance of the group and major transactions and strategies.

As chief executive officer, company director or chief financial officer:

- 1 Are you confident that your records and control systems enable your group to:
 - keep your tax registrations up to date
 - pay the correct amount of tax without overpaying tax or incurring any general interest charge or underpayment penalty
 - meet your obligations to supply accurate returns and information when required, and
 - identify and manage tax risks to your satisfaction?
- 2 Are the amounts of tax you are paying and your pattern of tax payments in line with your current and previous business results? If not, can the inconsistency be explained in terms of business decisions or the ordinary course of your operations? Or is the tax result associated with a major transaction, and if so, is the shape of the transaction explicable on commercial grounds?
- 3 Is there anything to indicate that your group's business results and tax payments are lower than would be suggested by economic conditions and the performance of others in your sector? If so, what are the reasons? For example, are you confident that the processes you have in place to handle transfer pricing are producing a proper allocation of income and expenses in relation to your dealings with offshore associates? Or, if there are other reasons why your group is underperforming, is there a convincing business case?
- 4 If your group is consistently reporting losses, are these real economic losses and can they be satisfactorily explained in terms of the group's overall performance? Is there a material difference between the losses reported for accounting purposes and the losses claimed for tax purposes? If so, can the difference be satisfactorily explained?
- 5 Are you comfortable that your group is making the necessary changes to its processes and giving proper consideration to major transactions and strategies to take account of changes in the tax laws and any tax compliance problem previously identified?
- 6 Are you aware of any material timing or permanent differences in the group's tax effect accounting and, if so, are you comfortable with the reasons for those differences?
- 7 Are there any areas of major disagreement between your group and the Tax Office? If so, are you satisfied with the way they are being handled? Have any additional tax liabilities been adequately provided for?

**KEY GOVERNANCE QUESTIONS –
MAJOR TRANSACTIONS AND STRATEGIES**

In the course of considering a major transaction or strategy in your role as chief executive officer, company director or chief financial officer, ask yourself:

- 1 What commercial objectives are being sought by the proposed strategy or the ownership and financial structure being proposed for a major transaction? Is there a genuine and material financial benefit for your group apart from any effect on the group's tax position? Are the tax results at odds with the commercial results?
- 2 If the structure and financing for your group's business or a major transaction is complicated, is this because the business issues are complex? Is it more complex than necessary to achieve the commercial objectives? Are there additional steps designed primarily to reduce the taxes that would ordinarily be payable? Is the form of the transaction or strategy consistent with the substance of the arrangement?
- 3 What level of confidence do you have in the correctness of your advice? For example, is the advice provided on the basis that it is as likely as not to be correct? Is the person giving the tax advice fully acquainted with your group's business and the purposes of the major transaction or strategy on which the advice was given, or were they asked a more limited set of questions?
- 4 How likely is it that the Tax Office will take a different view of the application of the law and assess the company accordingly?

It is reasonable to expect that senior decision makers are aware of Tax Office advice that is out in the marketplace through for example public rulings, taxpayer alerts, and compliance programs, even if a different view is adopted. If the contentious issue has wider impact in the market, has it been discussed at consultative forums with the Tax Office? Should the issue be prioritised by these representative bodies as sufficiently important to require a public ruling from the Tax Office?

- 5 If the Tax Office takes a different view and the matter proceeds to litigation, what is the risk of the Federal Court or the High Court deciding the matter in favour of the Tax Office?

The reality is that not all judges will necessarily come to the same conclusion on a disputed issue. Neither the Tax Office nor taxpayers have a 100% track record in the courts. Matters of evidence may also be critical.

- 6 What is the potential downside if the company is unsuccessful in litigation with the Tax Office?

Any response to this question would have to take into account interest charges, possible culpability penalties (which will depend generally on whether there is a reasonably arguable case) and the potential application of the anti-avoidance provisions of the tax law (breaches of which generally attract a minimum culpability penalty of 25% of the primary tax and 50% if the group does not have a reasonably arguable case). Clearly, also, unsuccessful litigation almost invariably involves substantial litigation costs and senior management attention.

- 7 If there is a dispute with the Tax Office, what is the likelihood of the Tax Office being prepared to settle the dispute and, if so, on what terms?

The Tax Office has published guidelines on settlements. If the disputed issue involves a matter of principle which could be of precedent value, we could be expected to take the matter through the courts rather than entering into a settlement.

- 8 How likely is it that the Tax Office will identify the tax issues arising from the proposed course of action? Allied with that, to what extent will embarking on the proposed course of action increase the tax risk profile of the company and the possibility of audit scrutiny?

Nowadays, in the case of major corporates it is unlikely that many material issues go undetected. This publication details the comprehensive approach the Tax Office has to analysing tax risk profiles and to identifying cases for possible audit.

- 9 Depending on the potential risk, and your need for certainty, would it be desirable to approach the Tax Office for guidance in the form of a private binding ruling?

How likely is it that a positive private binding ruling could be secured? If it is unlikely, why? If there are time pressures is it possible to arrange with the Tax Office for a ruling to issue within the applicable time constraint? The Tax Office can provide advice on major transactions within tight deadlines. We have publicly stated that we will work with taxpayers to meet commercial deadlines where they are prepared to work cooperatively with us and involve us at the earliest practical time.

On the other hand, you may be comfortable with the level of risk, particularly where you have good grounds to believe that there will not be a tax problem. In these situations, even if you prove to be mistaken, you will generally not be subject to penalties if you have a reasonably arguable position. In addition the new shortfall and general interest charge remission policy reduces the interest that is applicable to your shortfall.

- 10 Where a position has been taken on a tax issue, would it be desirable to be upfront with the Tax Office in identifying the issues before or when lodging the tax return or business activity statement and endeavouring to constructively handle any disagreements that may ensue?

The advantage of this approach is that the culpability penalty and interest charge may be avoided if the Tax Office view prevails.

- 11 Is the advice based on the actual transaction or on an expectation of how the transaction will be implemented?

Tax liabilities will arise from the actual transaction implemented and not any proposed or intended transaction on which taxation advice may have been sought at an earlier point. In such cases consideration will need to be given to the implications of any material changes that occur, or have occurred, in implementing the transaction.

- 12 Are you satisfied that the factual basis for the tax advice has been properly checked?

The factual basis of a transaction or strategy critically influences the tax consequence. Senior decision makers may feel it prudent in assessing the tax risk to seek assurances on the accuracy of the facts. For example, were they independently verified or were statements of intention or other people's understanding of the relevant facts relied on? Does the factual basis stated for the transaction or strategy accord with your understanding of the matter? If the advice is based on any assumptions, are they reasonable, and what would happen if they did not eventuate?

03

WHAT ATTRACTS OUR ATTENTION

This chapter outlines the issues and characteristics that attract our attention and constitute a risk.

We acknowledge that it is appropriate for business to reduce costs within the parameters of the law so as to make themselves more competitive and to increase shareholder value. However, underpayment of tax provides a business with an unfair competitive advantage over other businesses. The Tax Office's role is to promote a level playing field that fosters competition based on comparative advantage rather than unfair practices, and in this way to encourage high levels of voluntary compliance.

The balance between legitimately minimising costs (and the associated tax planning) and pushing the interpretative envelope beyond its proper limit is often a fine one to judge. There is often a natural tension. It is not surprising therefore that sometimes the Tax Office takes a different view from the business on the proper application of the law to the facts.

Given the financial impacts of material adjustments, the Tax Office has a duty to ensure that it has a sound position for taking a different view. In this regard, we have developed a corporate approach to ensure our interpretative and analytical skills are fully applied to such decisions, including the use of external experts in some cases. This approach is complemented by pre-adjustment discussions with the taxpayer, including a full and frank disclosure of our position, and informal and formal processes of dispute resolution.

CHARACTERISTICS OF RISK

Characteristics of low risk groups include:

- effective tax rates reasonably in line with statutory rates and tax concessions
- minimal differences between accounting profit outcomes and taxable income
- a history of substantial income tax and GST payments
- appropriate capital gains tax outcomes on major transactions, and
- income tax and GST payments that reflect industry and business performance.

Conversely, high risk groups typically exhibit the opposite characteristics.

A QUESTION OF LAW

While features of the kind outlined in this chapter will attract our attention, a business's tax position must be determined on the basis of the proper application of the tax law to the facts of the case. In this regard, we understand that Australian tax law does not recognise the concept of economic equivalence for tax purposes.

A positive feature of the tax laws is the availability of recourse to the Administrative Appeals Tribunal or the courts in the case of dispute. The observations made in this publication (and in our rulings) reflect the Tax Office's view of the law, which ultimately may need to be reviewed by those bodies.

Your checklist for what will attract our attention

1

Financial or tax performance that varies substantially from industry patterns

2

Significant variations in the amounts or patterns of tax payments compared to past performance and relevant economic indicators and industry trends – for example, where major transactions have a significant tax impact

3

Unexplained variation between economic performance, productivity and tax performance

4

Unexplained losses, low effective tax rates, and cases where a business or entity consistently pays relatively little or no tax

5

A history of aggressive tax planning by the corporation, group, board members, key executives or advisers

6

Weaknesses in the compliance structures, processes and approaches

7

Tax structures that are inconsistent with the policy intent of the tax law

1

Financial or tax performance that varies substantially from industry patterns

In systematically risk-profiling the entire large business population (see page 40), we start by applying standard financial ratios at the group and entity level to compare tax performance with business performance and establish the trend in effective tax rates. For transfer pricing, GST and excise, this also involves an economic analysis of the various stages of production and distribution.

Where tax performance appears to be inconsistent with business results, or the effective tax rate is inexplicably low or below industry averages, we may investigate further. We focus on both the integrity of the accounting results reported and the translation of the accounting results to taxable income, or the relevant base for excise.

Secondly, taking an investor perspective, we analyse rates of return on investments compared with broad benchmarks in the economy, such as long-term bond rates and business overdraft rates. More specifically, we benchmark performance against the taxpayer's industry peers. If rates of return are below what is typical in the industry, or low relative to the level of investment and business risk, we try to understand why and will seek explanations from the business. This analysis includes the use of the Berry ratio (gross profit to operating expenses) to identify cases where rates of return are low relative to the level of operating expenses, or are significantly below the norm for that particular industry.

This is not an exercise in taxation by reference to industry averages and is not a substitute for properly applying the law. We approach our risk-profiling of large businesses openly and objectively. Where we see a lack of correlation between economic and tax performances, we will discuss this with the taxpayer. It may be that such outcomes can be explained. However, the analysis and judgments outlined above form the basis for identifying cases for our large business fieldwork programs.

EXAMPLE

Benchmarking against industry patterns identified that, over an extended period, some large manufacturing groups paid a very low level of tax relative to the industry.

Audits have resulted in adjustments to taxable income of over \$150 million, with further adjustments of around the same amount expected. Audit coverage based on industry comparisons has also resulted in some large businesses entering into advance pricing arrangements with the Tax Office, locking in an appropriate level of tax payments for a number of years.

2

Significant variations in the amounts or patterns of tax payments compared to past performance and relevant economic indicators and industry trends

In the care and management of the tax system, the Tax Office seeks assurance that the amounts being collected are explicable by the interaction of the tax law and the underlying economic and industry performance, and with the payment patterns that could reasonably be expected.

This is important in terms of revenue forecasting. Where tax payments are less than expected after taking into account trends in business performance and economic and industry conditions, we make enquiries to see whether tax payments are low because of changes in the business itself or because of tax planning. Many large businesses have already been subject to this type of contact.

If our enquiries alert us to material tax risks in respect of any type of tax, or a large business brings them to our attention before the payment date, we can address these issues with the business at that time and seek to resolve them before tax returns are lodged. If we can resolve the issues, the business gets certainty on the issues, and penalties and interest charges do not apply.

We supplement detailed systematic analysis with our knowledge of the industry and the economic conditions at the time, our understanding of tax laws and their underlying policy intent, and what we know about the strategies being pursued by the business in question – how it has organised itself and operated from time to time, and why. Major events such as mergers and acquisitions, demergers, asset sales, capital restructuring and changes in products, services, operating levels as well as market strategies are considered. We also pay close attention to a business's compliance history.

We also follow the pattern of tax payments as legislative changes, such as tax consolidation, are implemented to ensure that any variations are consistent with the policy reflected in the law.

EXAMPLE

Income tax

Having observed that a taxpayer's payments had decreased substantially and suddenly, we promptly contacted the taxpayer who confirmed that some value-added functions and assets had been transferred from Australia to a low tax country and a new international related party royalty was being paid. The taxpayer is now being reviewed for capital gains tax and transfer pricing risks given its new low tax profile. Of course, this does not mean that the taxpayer has not fully complied with their Australian tax obligations.

EXAMPLE

GST

In analysing overall GST payments by the large business segment as a whole, including a comparison of GST payable and input tax credits with both historical data and forecasts, we identified unexpected variations, indicating potential revenue leakage. We found that the variation was a direct result of increasing refunds within a particular industry sector. On further investigation it was discovered that the industry was incurring greater input costs as a result of increasing export sales. Given that export sales do not attract GST but input tax credits arise on the increased costs, the increase in refunds was understandable and the variation explained.

3

Unexplained variation between economic performance, productivity and tax performance

The Tax Office looks to a corporate group's business results as an indicator of the tax to which it may be liable. Where the tax paid is less than the results suggest, we may look at the adjustments the business has made to accounting profit in calculating its taxable income and tax payable, and examine the basis for those adjustments. We would also examine:

- the business's internal structures and dealings, such as its financial structure and any loans between related companies that gave rise to deductions for interest and bad debts
- whether the business has properly classified income and expenses for tax purposes
- whether the business has properly calculated deductible items such as capital allowances (taking into account any tax write-off rates that have been calculated on a self-assessment basis rather than on the basis of indicative rates published by the Tax Office), and
- whether the business has adopted consistent accounting practices in treating flows of income and expenses within the group, and in recognising profits and losses in respect of any related party dealings.

If costs are abnormally high relative to sales figures, we may check (among other things) that:

- the transfer pricing is at arm's length
- GST input tax credits have been properly calculated
- all sales, including barter and other non-monetary transactions, have been properly accounted for (for income tax, GST and excise), and
- costs have not been artificially increased through a tax avoidance arrangement.

EXAMPLE

Benchmarking against industry patterns identified that a distributor for an overseas company had recorded losses or small profits over several years. The distributor performed a number of value-adding functions in Australia although ownership or control of trademarks and patents remained with its parent company offshore.

An audit was commenced and the distributor's performance compared with that of independent companies having similar functions, assets, operations and risks. The distributor's profit level was found to be substantially lower than comparable independent companies in the industry. An adjustment was made for several years, increasing the distributor's taxable income to reflect arm's length pricing taking into account its business circumstances.

4

Unexplained losses, low effective tax rates, and cases where a business or entity consistently pays relatively little or no tax

The Tax Office recognises that large businesses sometimes incur substantial real losses. However, we would regard it as unusual for a business manager to allow large amounts of investment to consistently produce little or no net return, or to continue to diminish in value through losses over the longer term. This is especially so given the keen interest in financial performance taken by shareholders, rating agencies, financial houses and regulators.

For a number of years we have focused on specific cases where large businesses have been consistently reporting losses or paying little tax. Various arrangements have been detected where deductions have been created in cases where no real loss has been incurred, or the real loss is much less than the deduction claimed. For example, in our experience some of these cases present a significant transfer pricing risk, where there are significant fee payments or purchases of manufacturing inputs that result in profits for related offshore parties.

Over the last three financial years we have disallowed over \$7.5 billion in losses, although much of this is subject to dispute. Nevertheless, by any measure this is a significant issue requiring ongoing scrutiny, including attention to large businesses that are marginally tax positive and where the tax paid is very low compared to the profits made.

EXAMPLE

A number of large businesses that had major import–export flows with related parties offshore were found to have a consistently low taxable income relative to the size of their businesses. Audits resulted in an increase in net tax liabilities from \$80 million to more than \$300 million over six years (albeit that some of this remains in dispute).

Many of these taxpayers subsequently entered the Advance Pricing Arrangement Program to agree with the Tax Office and their home tax administration on the methodologies for allocating income and expenses between the countries in which they operate. As a consequence, over 80% of the turnover in this industry is now covered by advance pricing arrangements.

5

A history of aggressive tax planning by the corporation, group, board members, key executives or advisers

A few participants in the large business segment consistently operate on the basis that they can plan for any tax outcome they want, regardless of the policy reflected in the law and the operation of the anti-avoidance provisions. Some of these have minimal (if any) records on major tax issues, challenge our access to information that is essential to a proper examination of the matter, or seek to put that information beyond our reach. They make extensive use of administrative law review processes to challenge every step we take.

We do not shy away from these hard cases and will use the full extent of our information gathering powers in respect of onshore and offshore information, including the ability to obtain sworn statements from directors and advisers.

Where a particular tax adviser or promoter of a tax avoidance arrangement is taking a lead role in aggressive tax planning, we will investigate their clients to determine whether they have participated in the same or other aggressive arrangements. We will also investigate the adviser or promoter to ensure compliance by the person or entity in respect of their own affairs. Our experience is that the more aggressive advisers and promoters are high risk taxpayers.

Taxpayers are entitled to have our administrative decisions reviewed under the Administrative Decisions Judicial Review Act and our adjustments reviewed by the Administrative Appeals Tribunal or the courts – and it is quite proper for taxpayers to exercise their rights, provided their claims are not frivolous or vexatious.

EXAMPLE

Income tax

A tax planning arrangement which operated to convert capital losses into revenue losses was discovered during the course of a client risk review. During the review, the taxpayer advised the Tax Office that an accounting firm had approached them with the arrangement. Given this information, and the artificial nature of the arrangement, the adviser was issued with a notice requiring them to provide details of other taxpayers to whom they had given advice on the same arrangement. The other taxpayers identified are now subject to review.

EXAMPLE

Income tax

A venture capital consortium incorporated a two tier company structure in a tax haven for the purposes of acquiring an Australian business. The consortium improved the value of the business they purchased by initiating an internal reorganisation of the Australian business and entering into a comprehensive marketing program. The Australian business was then floated and the companies in the tax haven jurisdiction dissolved. A significant gain was generated from these transactions and the Tax Office is seeking to ensure that an appropriate amount is taxed in Australia in accordance with our tax law.

EXAMPLE

GST

Where a resident business has restructured its business activities or transactions to remove the apparent connection with Australia so as to avoid GST obligations, the Tax Office is seeking to ensure an appropriate amount is taxed in Australia in accordance with our tax law.

6

Weaknesses in the compliance structures, processes and approaches

The Tax Office understands that large businesses need to keep their compliance costs to a minimum. We take a practical approach to the streamlined processes sometimes adopted by large businesses, provided these processes allow a reasonable assessment of compliance, have a degree of rigour that reflects the relative importance of the tax issues in the context of the particular business, and enables the business to reasonably calculate and pay the tax properly payable.

Where we see a large business not lodging returns or paying on time, we contact them to find out whether they are having any difficulties. This early contact may help them reduce or avoid the general interest charge and penalties. Similarly, where information is not lodged by the due date, we follow up as soon as practicable after the due date, either by phone or a formal demand, depending on the circumstances.

There are some other major tax issues that most large businesses have to manage, including GST, transfer pricing, capital gains tax and the uniform capital allowances provisions. We are seeing cases where large businesses do not have processes or records to justify their transfer pricing, particularly in relation to subsidiaries or affiliates of foreign corporations.

Most large businesses have sound processes to manage significant line items in the balance sheet and profit and loss statement, as well as those elements showing rapid change. Nevertheless, these items naturally become a focus of any risk assessment and audit activity.

EXAMPLE

Income tax

A company undertook a new project with a level of funding approved by its parent. The company claimed capital allowances on an asset base that was \$500 million higher than the funds available to it. The Tax Office is following up the asset management processes used by the group to verify the claim.

EXAMPLE

Income tax

Through analysis of AUSTRAC data, we identified very large royalty flows out of Australia. Where there was no evidence of non-resident withholding tax being paid, we contacted the taxpayers. In a number of cases we found that the appropriate forms had not been lodged and remittances not made. These errors were due to poor compliance processes.

EXAMPLE

GST

A taxpayer was known to be involved in an industry that makes both GST-free and taxable supplies. Our review of the taxpayer's process for classifying its products for GST revealed that it had relied on the suppliers' classifications and did not review these to determine their accuracy. We discovered that a number of these classifications were in fact incorrect and the taxpayer had treated these as GST-free supplies when they were in fact taxable. As a result, they had understated GST payable (and possibly under-priced the products, directly disadvantaging competitors).

EXAMPLE

GST

A primary compliance management process for GST is reconciling the net amount of GST on the activity statement with the financial or general ledgers. During an audit we discovered that this reconciliation had not been performed and the GST control accounts contained significantly larger amounts than had been reported, resulting in a significant underpayment of GST. In this case the reconciliation was not carried out because the person responsible was absent, there were no documented procedures to be followed and no effective succession planning.

In other cases we have found the procedures were not incorporated in the activity statement preparation processes, were ineffective or discrepancies were ignored. Failure to carry out the reconciliation has resulted in both underpayments and overpayments of GST.

7

Tax outcomes that are inconsistent with the policy intent of the tax law

Where there are significant changes to Australia's tax system, the Tax Office works closely with large business to facilitate their implementation and ensure compliance.

We are paying particular attention to the following major legislative measures:

- consolidation (including demergers and value shifting)
- uniform capital allowances
- thin capitalisation
- the debt and equity rules
- changes to the rules on losses, and
- changes to the international tax rules.

Our approach includes close consultation with large business and their advisers often through sub-committees of the National Tax Liaison Group (which includes the Corporate Tax Association).

Through this and other forums we consult on developing administrative systems that minimise red tape and compliance costs for business. We provide assistance and guidance through educational and guidance material on the operation of the new provisions. Where necessary we provide further certainty through public rulings which explain our view of the law.³ We also report to government on issues that arise with the implementation of the new provisions – such as where the law gives rise to unexpected compliance costs or difficulties, or produces unintended consequences. We also make public what we are seeing as compliance risks.

In relation to consolidation, our concern is with structuring that is intended to confer unintended benefits. In the first instance, we follow the pattern of quarterly tax payments in the transition from entity to consolidated group taxation, and as significant group changes occur, to identify any significant variations and the reasons. This includes a trend analysis of credits, rebates and refunds. We are also interested in the basis for calculating the PAYG rate and any variations.

³ These rulings bind the Commissioner but not the taxpayer.

We are looking at how all types of tangible and intangible assets are managed to see that values are not skewed. We will review cases where there is a big uplift in asset values that gives rise to capital allowances. Similarly, we are focusing on intragroup expense trends, given that these should disappear from tax accounting under consolidation.

Any changes in structure, ownership, funding arrangements, functionality and location in the context of the whole group may be reviewed, not just the wholly-owned onshore part of the group. We need assurance that these changes do not involve tax planning beyond the intent of the law and are consistent with the consolidation rules, including the membership rules.

We are also following the stocks and flows in respect of losses.

Analysing patterns of registrations, cancellations and payments, including variations, helps us to identify cases for follow-up action.

EXAMPLE

Income tax

A consolidation risk review revealed that a taxpayer had allocated value in the cost setting process to certain claimed intangible assets, including those described as copyright, that had no previous cost base for tax purposes. We are disputing whether these assets are in fact assets for consolidation purposes, and the values attributed to the intangible assets. In this case, our analysis indicates that for tax purposes the new asset cost bases and deductions, such as capital allowance deductions, need adjustment to correctly treat the assets as goodwill.

EXAMPLE

GST

Changes in circumstances meant that a taxpayer was required to remove an entity from its GST group. However, there had been a failure to recognise the need to change the system tax codes for transactions between GST group members and the entity that had left the group. As a consequence, the GST group failed to include GST payable in its activity statements in relation to taxable supplies it made to the entity that had left the GST group.

Your checklist for what may constitute a risk

A

Related party cross-border and tax haven dealings where tax profit returned in Australia does not reflect the economic contribution made here or the taxable nature of imports

B

Complex structures and intragroup transactions associated with generating tax benefits unrelated to the economic substance of the commercial activity

C

Tax benefits from financial and other arrangements that are disproportionately high compared to the limited financial exposure, or there is a divergence between the real and claimed economic substance of the activity

D

Arrangements or products that transfer or create tax benefits in circumstances not contemplated by the law

E

Characterisation of transactions for tax purposes that is at odds with their economic substance

F

Distortions and inconsistencies in market valuations

A

Related party cross-border and tax haven dealings where tax profit returned in Australia does not reflect the economic contribution made here or the taxable nature of imports

The integration of the Australian and global economies translates to more international dealings by large businesses. For example, related party cross-border dealings have increased markedly over the past decade. The return data for 2003–04 shows that cross-border dealings with related parties amounted to \$368.5 billion, excluding loans. It is therefore important to ensure that the Australian profit reported, and the Australian taxes paid, on these transactions reflect the functions performed here, the Australian assets used in deriving the global profit, and the risks assumed on the Australian side of the operations.

We use the internationally accepted principle that the tax outcomes should reflect the business results that would have been achieved if the cross-border dealings and financial relationships were structured and conducted on terms that independent parties dealing wholly independently with each other would have adopted. Where the tax should have been paid in Australia, it is not an answer to say that the profit has been fully taxed somewhere else.

Transfer pricing audits over the last five years have resulted in further assessments (tax, penalties and interest) of \$1.33 billion and disallowed losses of \$1.25 billion, although some of these amounts are still in dispute.

While many transfer pricing audits will continue to cover the full extent of the operations of a large business, the patterns and trends currently causing us concern are:

- attempts to shift profits to low-tax jurisdictions through the use of service arrangements and fees or commissions paid to related party intermediaries
- arrangements that are claimed to shift risks out of Australian operations to justify low rates of return in Australia
- an increase in interest-free loans to offshore associates
- Australian intangibles not being recognised and properly rewarded, and little justification for royalties being paid overseas

- withholding tax compliance on interest paid or credited on loans from related parties offshore
- transactions and arrangements involving tax havens and other low-tax jurisdictions
- the allocation of exchange rate risk to Australia without adequate reward
- high levels of debt that siphon income out of Australia by the payment of interest and guarantee fees, and
- skewed asset valuations at the time of their transfer to foreign jurisdictions including tax havens.

EXAMPLE

A major corporate group was carrying on business in Australia as an importer, manufacturer and distributor (including as an exporter). Its tax performance was low relative to its economic and business performance.

An extensive transfer pricing audit showed that the Australian business was paying more than an arm's length price for goods and services imported from offshore associates. This had the effect of significantly reducing its profits in Australia, effectively shifting some of the profits from the Australian business to an offshore associate.

The proposed adjustment to taxable income over a number of years is very significant, and the additional tax and penalties and interest are expected to amount to several hundreds of millions of dollars. Of course, the usual consultation and review processes will be followed to safeguard the taxpayer's rights.

EXAMPLE

A large business had a capital structure with such high levels of debt that it was unable to borrow without a parent guarantee. The balance sheet of the large business showed many billions of dollars in assets, over 99% of which were funded by debt. The large business claims it is entitled to a tax deduction for guarantee fees payable to its overseas parent. The Tax Office is examining the matter to ensure that interest expense and guarantee fees are properly deductible.

B

Complex structures and intragroup transactions associated with tax benefits unrelated to the economic substance of the commercial activity

Some taxpayers show a history of tax planning that involves the introduction of complex structures and intragroup transactions in an attempt to reverse tax liabilities naturally arising from a commercial transaction. Some of this proves to be tax effective, some does not – being successfully challenged by the Tax Office or disallowed by the courts.

Most recently, these techniques have been used in an attempt to shield capital gains from tax. In the more extreme examples, a commercial gain is claimed to be transformed to a loss for tax purposes. These arrangements arise from corporate disposals or restructures that realise economic gains on which capital gains tax or income tax would normally have been payable, in the absence of often complex tax structuring.

Apart from the risks that complex restructuring, acquisitions and divestments can pose in relation to capital gains and corporate financing, they often pose GST risks in relation to financial supplies, intragroup dealings and general compliance issues during the transition.

EXAMPLE

A number of Australian corporate groups have sold offshore operations, or parts of their onshore operations, to unrelated parties. Each of these groups stood to make profits on these sales.

Before the sales, these groups undertook various forms of internal restructuring, financial arrangements or dividend distributions that shifted the value out of the assets or companies being sold and sought to produce tax shields of various kinds.

In economic terms, these arrangements result in the artificial situation that Australian tax is not paid on substantial real profits.

These arrangements can include share buy-backs, payment of dividends that are claimed to be exempt or fully rebatable, reinvestment of dividends to inflate the cost base, share or asset revaluations, or the taking over of some of the seller's liabilities so as to arguably reduce the amount of consideration received. In all cases, the seller is receiving the full economic profit from the sale but is avoiding paying tax on it. We give close consideration to these arrangements to determine whether the law allows the claimed outcomes.

C

Tax benefits from financial and other arrangements that are disproportionately high compared to the limited financial exposure, or there is a divergence between the real and claimed economic substance of the activity

A tax benefit that far exceeds the real expenditure, or is associated with minimal or no risk exposure usually warrants further consideration.

EXAMPLE

A large corporate group conducting a number of businesses was financing a sub-group through an in-house finance company. When the sub-group business became commercially unviable it was faced with funding constraints and was refinanced through a series of group companies that each provided a tranche of debt funding.

The group incurred real world losses of over \$1 billion, but the deductions claimed by the various companies funding and operating the sub-group business were substantially more than \$3 billion. The Tax Office is challenging the deductibility under the tax law of much of this claim.

D

Arrangements or products that transfer or create tax benefits in circumstances not contemplated by the law

The government has provided a range of tax concessions and benefits to encourage particular activities or to provide relief or compensation to business. Large businesses that either facilitate or seek to take advantage themselves of such measures beyond the legislative intent will attract our attention.

In particular, we have observed:

- large businesses acting as intermediaries or conduits for other taxpayers to obtain tax benefits not contemplated by the law, and
- incorrect classification of activities that result in concessional tax treatment being provided in circumstances where it should not.

We focus on significant or unusual claims in relation to tax concessions such as capital allowance deductions, research and development concessions, GST-free or input taxed supplies and the GST margin scheme.

EXAMPLE

A large business wanted to raise funding that the market and regulators would regard as equivalent to equity, while getting a tax deduction for amounts paid to investors on the securities. The tax law specifically prohibited such a deduction. The group interposed an offshore structure between itself and the offshore investors who bought the securities. The funding raised by the interposed structure was loaned back to Australia and tax deductions were claimed for interest paid. The Tax Office is challenging the deductibility of the interest deductions.

EXAMPLE

A taxpayer consistently claimed high amounts for research and development tax concessions. Our review revealed that the taxpayer could not demonstrate the connection between the expenditures and the activities that were registered as qualifying for the concession. Accordingly, the Tax Office is challenging the availability of the concession on these facts.

E

Characterisation of transactions for tax purposes that is at odds with their economic substance

There is usually a sound underlying business and commercial rationale for arrangements entered into by large businesses.

Nevertheless, in the course of our audit activity, we have uncovered a range of situations where the shape of major transactions cannot be explained by reference to business and commercial principles, are inconsistent with the policy intent reflected in the tax laws, and produce significant tax advantages.

EXAMPLE

GST

A financial supply provider that is generally subject to GST on inputs characterised their GST acquisitions in a way that entitled them to a partial input tax credit. This resulted in an increase in and generation of input tax credit claims which would not otherwise exist. We are of the view that this is not allowed under the GST law.

EXAMPLE

A group had been hedging its production, with an accrued profit of well over half a billion dollars on the hedges. The group reached an agreement with its counterparty banks to pay out the hedges and reset them at current market rates, thereby releasing the profits for use by the group.

Instead of a straight close-out, the group arranged to assign the hedges to a two dollar offshore company associated with the advisers that were facilitating the arrangement. The group then stripped the hedging companies of all their assets except the hedge books, and sold the hedging companies to the offshore company. The banks paid the profits into an account in the name of the offshore company but the proceeds were mortgaged and could be accessed only by the large companies who had to deliver into the reset hedges.

In the course of selling the hedging companies, the group restructured its shareholdings in the hedging companies, creating a loan in favour of one of the vendor shareholders. The group claimed that the proceeds that were in substance the realisation of the hedge books were received in part as repayment of the loan and in part as capital consideration for the sale of the shares in the hedging companies. Losses were used to offset the capital gain. No tax was paid.

The offshore company was left holding both sides of the hedges that had been assigned, so it had minimal if any financial exposure. Having previously engaged in a series of arranged trades that involved quickly turning over financial instruments, the offshore company claimed the receipt of the payment from the banks was not taxable in Australia under our tax treaties because it was business profits and the company was not carrying on business through a branch in Australia.

Subsequently the offshore company migrated to Australia and sought to use the consolidation rules to group the profits and losses on the two sides of the hedging transactions it was holding so the group had no profit for tax purposes.

The Tax Office is challenging this arrangement on the basis that Australian income tax should have been paid on the hedging profits.

F

Distortions and inconsistencies in market valuations

Market valuations have a bearing on a wide range of tax issues, including:

- values for depreciable assets
- the allocation of asset values (including goodwill) when consolidating
- the calculation of GST in certain circumstances, particularly where values are loaded to the pre-GST period of ownership when applying the margin scheme to real property transactions
- royalty rates for intellectual property
- working out capital gains and losses, including where there are taxable and non-taxable components
- the examination of transfer pricing cases
- financial arrangements, such as non-recourse financing and sale and lease-backs
- accounting for trading stock (including warehousing or holding charges), and
- core technology values for the purposes of the R&D concession.

Where market valuations have significant tax impacts and are materially different from the values used for the purposes of the business generally, we may check that:

- the relevant assumptions have been identified and properly taken into account
- accepted principles have been applied in the valuation
- the valuation method is appropriate to the case and has been properly applied
- the results are realistic in the business context, and
- the full range of probabilities is properly taken into account, so that valuations are based on what is more likely to occur (where, for example, the asset is unique or there are no recent sales to benchmark against).

EXAMPLE

Income tax

A company disposed of business assets, resulting in a very large net capital loss. The assets sold included land, plant and equipment and goodwill. The Tax Office challenged the market valuation of the goodwill. The matter was ultimately resolved and the valuation of the goodwill was substantially increased. This resulted in a substantial reduction of capital losses claimed.

EXAMPLE

GST

A company acquired some real property in late 1999. The company had the property valued as at 1 July 2000 for an amount that was over four times what was paid for it. An independent valuation commissioned by the Tax Office to assess whether the company's valuation complied with the requirements of the GST margin scheme revealed that the original valuation was too high and a valuation conforming to the standards of the professional association had not been obtained. This resulted in GST being underpaid. The Tax Office is challenging the company's claim.

04

HOW WE HELP YOU COMPLY

This chapter sets out our key information and support services to help large businesses comply with their tax obligations.

SERVICES FOR LARGE BUSINESSES

We offer a range of services that help large business taxpayers understand and manage their tax rights and obligations. These include:

- key client arrangements for the top 150 groups
- a premium telephone service
- the Tax Office Business Portal
- a tailored Large corporates and multinationals web page, and
- the *Large business online bulletin*.

Client relationship arrangements

We are enhancing our existing client relationship arrangements. Senior tax officers have embarked on a program to meet with representatives from the top 100 groups on a biannual basis to discuss significant events that may have tax implications, revenue performance and the progress and conduct of any compliance activity.

We also continue to offer individual client managers and contact points for the top 150 corporate taxpayers.

Premium phone service

We offer a premium phone service (1300 137 286) which provides large business taxpayers with direct access to staff experienced in dealing with large business accounts and lodgment processing. This covers both income tax and GST.

Business Portal and electronic commerce

The Business Portal is an Internet-based facility that allows businesses to:

- view running account balances, activity statement records and registration details
- conduct certain transactions online, such as account transfers and refunds
- update registration details, and
- lodge and amend business activity statements.

The secure messaging function enables taxpayers to lodge objections and request private binding rulings.

Our electronic commerce interface enables taxpayers to lodge employee TFN declarations, PAYG withholding payment summary reports and multiple business activity statements.

For further information, go to www.ato.gov.au

In the longer term we are encouraging greater take up of electronic lodgment options for tax returns, schedules, and other interactions with us.

Website

The Large corporates and multinationals web page (www.ato.gov.au/large) provides a range of up to date information on new law, announced changes to the law and administrative changes, tailored for large businesses. It also provides access to our legal database. Users can subscribe to this page for regular email updates.

Detailed information on international tax issues affecting large businesses can be found under 'International tax' on the Large corporates and multinationals web page. This contains details of new measures impacting on business such as the review of international tax arrangements, tax treaties and tax treatment of foreign income.

Large business online bulletin

The *Large business online bulletin* is available as a subscription email or via the above web page. The bulletin contains up to date information on income tax, GST and superannuation matters and links to recent rulings, speeches and media releases.

In relation to all of our activities, we welcome your feedback (see Appendix A and our website).

PROVIDING CLARITY

To help large businesses understand their rights, entitlements and obligations, we aim to give timely information and advice that provides greater clarity on the application of the tax law and on our strategies and approaches.

We also keep large businesses informed of our areas of interest, through:

- the annual compliance program
- large business online bulletin
- the *Large business and tax compliance* booklet and Large corporates and multinationals web page
- industry groups and consultative bodies such as the Corporate Consultative Committee, Corporate Tax Association and the National Tax Liaison Group and its associated sub-committees, and
- one-on-one discussions with large businesses, including the recently introduced twice yearly visits with the top 100 corporate groups.

New legislation

The Tax Office is committed to facilitating the efficient and effective implementation of new law through strong partnerships with professional, representative and industry bodies.

In relation to new tax law, we work with our stakeholders including large corporates, to develop administrative systems and information products to ensure the delivery of legislative intent and to minimise compliance costs.

The Tax Office believes that a heavy reliance on Tax Office public interpretative products (for example, public rulings and determinations) rather than on the law itself can introduce an inherent lag between the introduction of the legislation and the certainty desired by the community. Moreover, rulings cannot be used to address gaps or amend deficiencies in the legislation.

The role for public rulings is to explain how we think the tax law applies to new or unexpected and problematic circumstances not envisaged in the drafting phase of the legislation, or which have arisen as the commercial environment has evolved.⁴ Potential issues will be prioritised (usually through the National Tax Liaison Group) and any work will be balanced against other risks and priorities.

We do not, as a general rule, issue interpretative products where similar examples or guidance is provided in explanatory memoranda, second reading speeches and Government press releases, or in the legislation itself. However, we generally provide easy access to them through our website or guides.

Technical Issues Management Sub-committee

Sometimes the application of the tax law can lead to disproportionate compliance costs, for example where detailed evidentiary requirements for compliance are out of step with what is reasonably practical for business.

The Technical Issues Management Sub-committee is a partnership between the tax profession, the Tax Office and Treasury and currently operates under the leadership of the National Tax Liaison Group. The sub-committee's role is to identify and progress those issues where we could possibly take a more practical approach to the application of the law.

The sub-committee looks for situations where there could be practical and material compliance with the law with reduced compliance costs, or where there are problems, inconsistencies or anomalies in the way the law operates. In these situations there might be practical solutions, or alternatively the matter could be considered by Treasury for possible advice to Government for legislation change.

Detailed information on improvements achieved by the sub-committee and its forward work program is included in the Tax Office booklet *Making it easier to comply*.

⁴ Public rulings provide certainty for taxpayers if they follow them, but taxpayers can choose not to follow them if they take a different view of the law.

Provision of written advice

The provision of written advice is a structural feature of Australia's self-assessment system of taxation that makes it more certain for taxpayers. The main forms of advice provided by the Tax Office are:

- public rulings
- class rulings
- product rulings
- private binding and reviewable rulings.

We recognise that the advice we provide must be technically correct and timely, and we continually monitor our performance against both criteria. For private rulings, we undertake a quality assurance review twice yearly, involving external representatives. It looks at how well we have:

- understood the question, including identifying all the issues
- applied the relevant provisions of the law
- reasoned the decision, and
- explained the decision to the taxpayer.

The Review of Self Assessment

Legislation passed in December 2005 to give effect to recommendations from the Review of Self Assessment impacts on the way we provide income tax advice. Some of the key changes include:

- expanding the rulings regime so that the Commissioner can now make rulings on administrative matters and ultimate conclusions of fact. This means that the Commissioner may make a private ruling on market valuation issues
- removing of a specific penalty for obtaining a private binding ruling and then choosing not to follow it, and
- extending the taxpayer's review rights where there has been a delay in the provision of a private ruling.

Priority rulings process

In 2005, we introduced a process to assist corporate boards and others in managing the tax risks associated with significant transactions.

Priority rulings are those associated with a transaction that:

- is time sensitive
- is prospective
- is of major commercial significance and requires consideration at corporate board level
- has a tax outcome that is a critical element of the transaction, and
- requires complex law and facts to be analysed.

This new process relies on taxpayers cooperating with us by:

- notifying us as soon as the transaction is first contemplated
- outlining the details of the transaction and associated tax issues at a pre-ruling conference, and
- providing a comprehensive application.

As well as the emphasis on cooperation, the priority ruling process has the following features that improve our capacity to provide advice in timeframes consistent with taxpayers' business needs:

- a centralised point of reference (process owner) responsible for marshalling resources and taking remedial action to ensure cases are not delayed
- the front-end engagement of all expertise to avoid sequential processing, and
- active case management including a commitment to keeping taxpayers informed of progress.

The priority rulings process is outlined in *Law Administration Practice Statement PS LA 2005/10 Priority private binding rulings*. To date, some 36 matters have been finalised under this program, with average turnaround times of about six weeks from the date of application to the issue of the ruling.

Tips

Three things to remember that will help us provide advice in timeframes that meet your business needs:

1 Early notification

Telling us about transactions as soon as possible helps us meet reasonable requests to rule by a particular time. Even if there is not enough information available to proceed with a pre-ruling conference, early notification helps us to plan ahead so we can have the right people available once you are ready to proceed. We also have the opportunity to understand the commercial context of your business and of the proposed arrangements.

2 Information (pre-ruling)

Be ready to explain the transaction and the technical issues that concern you at a pre-ruling meeting. We will help you determine what should be included in your application, including information we will need and issues you should address.

3 Application and information – timeframes

Provide your comprehensive application and the information we require by the agreed times. We understand that tax is not your only concern when a major transaction is being developed and it is a busy time for you. We do try to accommodate slippage in receiving your information, but delays could jeopardise our ability to give you a ruling by the desired date.

Advance pricing arrangements (APAs)

Taxpayers have the opportunity to reach an agreement with us on the future application of the arm's length principle in their dealings with international related parties, through an advance pricing arrangement. APAs may be unilateral (involving the Tax Office and a taxpayer), or bilateral or multilateral (involving the agreement of two or more tax administrations and their respective taxpayers).

An APA establishes the transfer pricing methodology for determining arm's length prices or results for future transactions, agreements or arrangements covered by the APA. The arrangement generally covers a period of

three to five years and may be reviewed if the trading circumstances of the taxpayer materially change. APAs are also subject to an annual reporting requirement which enables us to monitor the arrangement.

APAs are normally initiated after pre-lodgment meetings and the lodgment of a formal application. Bilateral APAs are concluded under the mutual agreement procedure article of the relevant double tax agreement, while unilateral APAs are concluded under the Commissioner's power of general administration of the income tax legislation.

APAs can provide certainty for both the community and taxpayers, with the benefit of:

- ensuring the fair application of the arm's length principle in related party international dealings
- eliminating or reducing the risk of double taxation on related party international dealings, and
- eliminating the risk of a transfer pricing audit.

Before committing to an APA, both parties need to examine the proposal to ensure the cost and effort of obtaining an APA is proportionate to the benefits obtained. An APA application needs to contain a properly developed and documented solution. Our role involves critical analysis rather than undertaking original work to establish the arm's length outcome. The pre-lodgment process does however provide an opportunity for issues to be identified up front with the aim of facilitating successful applications.

Mutual agreement procedure

At times, international transactions can leave taxpayers potentially exposed to double taxation on the same income. For example, a transfer pricing adjustment in one country can result in the same income being taxable in two jurisdictions.

Taxpayers who believe they may be subject to double taxation can apply for relief to the tax administration(s) of the relevant jurisdictions. If the application is accepted the administrations will discuss the case and attempt to resolve it in accordance with the relevant double tax agreement. This process is known as a mutual agreement procedure (MAP).

In the last five years we have finalised more than 50 MAP cases with various treaty partners.

Forward compliance arrangements

The forward compliance arrangement (FCA) is a new approach to managing compliance for all tax obligations, and provides a viable alternative to traditional compliance approaches. It is a voluntary arrangement between a large business and the Tax Office which sets up an agreed way of working together in the future. We expect that a commitment to the principles of an FCA, such as transparency and real time collaboration, will lead to:

- an environment less likely to produce surprises
- a reduced likelihood of audit, and
- concessions in relation to administrative penalties and interest that apply in the event of tax shortfalls.

Entry into such an arrangement will enable a corporate taxpayer to manage compliance and plan from a position of greater certainty in a real time environment. It is important to recognise that entry will require the taxpayer to make a significant investment in their tax risk management processes (including their systems) together with a demonstrated commitment to continuous disclosure. It may therefore not suit everyone.

A key element of the entry process is a due diligence verification of the taxpayer, including a review across all financial management and tax obligations to examine the adequacy of their systems, governance framework and controls to effectively manage tax risk. The FCA will consist of an overarching arrangement that outlines the agreed responsibilities of the parties with set processes for GST, excise and income tax. Alternatively, an arrangement may only cover a single tax type. The processes for each specific tax type can evolve over time and be added to the original arrangement at the time they are agreed to and entered into.

We are in discussions in relation to three FCAs as part of our pilot program: one in the finance sector, one in the energy sector and one in the manufacturing sector. At a practical level we have developed a joint project management approach which includes joint steering committee arrangements comprising senior officers of the business and the Tax Office. As the pilot program matures we expect to be able to apply our learnings to assist large business.

05

HOW WE IDENTIFY COMPLIANCE RISKS

This chapter sets out our broad approach to identifying compliance risks in the large business segment and explains how we select cases for further compliance verification work, including audits.

Our risk processes involve two phases – risk identification, including the profiling of large businesses; and treatment, including products tailored to the causes of non-compliance.

As the Tax Office is not resourced to do everything, we make intelligent choices about where we can best apply our resources across the large business and other segments. As a general rule we focus our compliance work on the highest risk areas identified through analysis techniques such as taxpayer risk profiling.

Consistent with general expectations in the large business sector, our risk identification processes are increasingly undertaken in real time or near real time, reflecting both the risks in this segment and the increasing sophistication of our intelligence and analysis tools. For example, we make real-time enquiries about the nature and tax outcome of major new transactions and disclosures to the market. Another aspect of real time compliance management involves analysing current and structural impacts of past year tax issues and following through so compliance is brought up to date.

We also track taxation payments in real time to follow up missed registration, lodgment and payment deadlines. Payments are monitored against expected economic outcomes on a sector-by-sector basis – so we also contact large business taxpayers where it appears they may have paid excessive amounts of tax.

Understanding payments and refunds allows us to monitor commercial, economic and taxation revenue trends. For example, when there is a significant boom in commodity exports or capital acquisitions, we examine tax payments and refunds at various levels to check the alignment between trade and investment trends and the tax outcomes for the economy as a whole, specific industries and the large business taxpayer.

We compare tax payments by and refunds to corporate groups against previous or expected amounts, following it up with the taxpayer where there are significant unexplained variances.

RISK PROFILING

Tax risk identification in the large business segment is based on taxpayer profiling. Using a range of both financial and tax-specific indicators (see Table 2 on page 42) and our knowledge of a taxpayer's activities and their business context, we profile all large businesses, comparing their business performance with their tax outcomes.

Quantitative indicators for each group are compared with those of their market peers, along with issues identified by our specialist areas and intelligence gathering generally.

This analysis identifies both:

- across-the-board patterns, trends and risks, and
- specific cases in which tax outcomes seem inconsistent with business performance – which are then flagged as potential compliance risks for case selection purposes (see 'How we respond to potential risk' on the next page).

Profiling includes the use of risk engine⁵ analysis that examines taxpayer-reported information, data from ASIC, our own intelligence and publicly available information, including data on changes to consolidated groups and GST groups. We test this analysis with risk filters (see Table 3 on page 43) to identify potential compliance risks. The process uses established economic and financial analysis tools to understand the taxpayer's business and commercial drivers and to identify income tax and GST outcomes that are outside the expectations for the business and its industry peers.

The risk engine analysis is used to determine and assess risk. This is fine tuned by taking into account:

- intelligence from our industry segments on
 - the latest industry tax risks, and
 - the compliance and tax risk management behaviour of the particular taxpayer
- risks arising out of the implementation of new tax law, and
- other relevant intelligence.

5 The risk engine is a profiling capability/process that examines activity statements, tax return and schedule data and other, publicly available, data to evaluate potential tax compliance risks.

In the case of the more complex economic groups with multiple entities, we map the group structure to better compare profit outcomes with income tax outcomes, analyse GST outcomes for the group and identify potential significant tax structuring designed to minimise tax outcomes across the entire economic group.

A separate analysis is undertaken to examine trends in excise payments relative to industry performance.

We also gather intelligence on tax planning arrangements to better identify high risk cases. At times, we formally approach large business advisers to request details of their clients and the arrangements marketed to them. As a result, we have been successful in identifying tax-driven arrangements aimed at gaining tax benefits beyond the intent of the law, including cases where the tax benefits have been found to be artificial and contrived.

Given the reduced periods of review following the 2005 legislative amendments, we are updating our profiles more frequently so we can more quickly identify and respond to emerging risks.

The risk filters are also periodically reviewed for their effectiveness and changed as necessary to reflect learnings from our intelligence and compliance activities.

We also undertake special research programs where we seek to further enhance our understanding of issues impacting on compliance in the large business segment and better identify high risk cases. For example, we are currently examining economic, trade and profit trends to see if they are playing out as expected in the tax system. In particular, we are looking at whether the profits from the energy and resources boom are translating into an appropriate level of income tax and GST. Our research also looks at whether the increase in banking profits and the increased trade with countries such as China are translating into appropriate tax outcomes.

HOW WE RESPOND TO POTENTIAL RISK

We respond to risks identified through taxpayer profiling and intelligence analysis at both a macro and taxpayer level.

At the macro level our responses may include:

- taxpayer education and guides
- tax rulings and determinations
- bringing areas where the tax system may not be functioning as intended to the attention of the Government (usually through Treasury), and
- targeted and proportionate compliance activities, as guided by our compliance model.

At the taxpayer level, our segment leaders and topic specialists review the risk engine output and determine cases warranting compliance activity. As well as the risk engine output, we take into account our understanding of the taxation implications of significant events or issues affecting a taxpayer's business.

The final decisions on which cases are selected for compliance activity are made by senior executive officers in risk management committees.

TABLE 2: Ratios used in profiling

Ratio	Used to measure
Operating ratios	
Gross profit margin (gross profit to total income)	Operational analysis of the business
Net return on income (net profit on total income)	Pre-tax profitability of the business
Net return on assets (net profit on total assets)	Pre-tax return on assets employed
EBIT margin (EBIT to total income)	Pre-interest and tax profitability
Salary and wage intensity (S&W to total income)	Level of wages in generating income
Financing/investment ratios	
Net return on equity (after tax profit on shareholders equity)	Return on owner's investment
Gearing (total debt to total assets)	Financial leverage/solvency
Interest coverage (EBIT on total interest expenses)	Ability to service debt
Asset turnover ratio (total assets/total income)	Asset commitment for each unit of sales
Implied interest rate (interest costs on total debt)	Cost of debt financing
Income tax specific ratios	
Effective tax rate 1 (net tax payable to accounting profit)	Utilisation of tax reconciliation to reduce income tax
Effective tax rate 2 (net tax payable to taxable profit)	Use of tax rebates/offsets and credits
Effective tax rate 3 (net tax payable to total income)	Amount of tax collected from each dollar of sales
Effective tax rate 4 (net tax payable to total assets)	Amount of tax collected from each dollar of assets
Tax credit % (net tax on gross tax)	Use of tax credits
Loss intensity (tax losses carry forward on total income)	Magnitude of tax losses carry forward that remain unused in the business
GST specific ratios	
Notional GST payable (1/11th of total sales)	Extent of income not subject to GST
Notional input tax credits (1/11th of acquisitions)	Extent of input tax credits as a percentage of costs and potential incorrect claims
GST tax ratio (GST payable/input tax credits)	Performance of GST over a period of time
Export ratios (value of exports/total sales)	Trends in export sales
GST-free ratio (GST-free sales/total sales)	Trends in GST-free revenue
Notional profit ratio (total sales/total purchases)	Trends in margins
Sales median ratio (total sales/average sales)	Differentials from the average
Purchases median ratio (total purchases/average purchases)	Differentials from the average

TABLE 3: Risk filters used in case selection

Risk filter	Information source
Low effective tax rates	Tax return
History of low income tax and GST payments relative to business outcomes	Tax return and business activity statements
Significant differences between total profit and taxable income	Tax return
Significant increases in other deductible expenses disclosed in tax returns	Tax return
Continuous reporting of tax losses or GST refunds	Tax return and business activity statements
New tax losses being brought to account in a period when a significant accounting gain has been realised	Tax return and schedules
Significant refunds of GST being claimed which are inconsistent with industry or business trends	Business activity statements
Significant divestments or acquisitions	Consolidation notifications, ASIC, GST grouping changes
Sales of intellectual property to offshore entities	Commercial corporate databases
Significant internal restructuring	Consolidation notifications, tax return and schedules, GST registration and grouping changes, media
Significant changes to the capital management profile of the group	ASIC data
Issuers of hybrid instruments	ASIC data
Significant changes in the level of interest deductions	Tax return and schedules
Different tax or GST outcomes following takeover or merger activity	Tax return and schedules, business activity statements, ASIC annual reports, GST registration and grouping changes
Foreign-owned businesses with a history of low or no dividend payments	Tax return and schedules
Foreign-owned businesses with a history of low or no tax outcomes	Tax return and schedules
Significant transactions involving tax haven entities including fees paid, sales of assets, restructuring involving tax haven entities	AUSTRAC information and schedule 25A
Increased claims for tax concessions such as those relevant to the energy and resource sector and more generally research and development concessions, innovation and the mining industry	Tax return and schedules, AusIndustry information
Significant new deductions flowing from the recognition of new tax assets including intellectual property	Tax return and schedules
The movement of non-resident entities onshore	Consolidation notifications, GST registration or grouping changes
Significant increases in deductions for the decline in value of depreciating assets	Tax return and schedules
Distributors paying significant fees to related parties offshore with the result being low or no tax outcomes over time	Tax return and schedules
Large movements in tax return disclosures more generally	Tax return and schedules
Significant taxpayer changes to PAYG instalment rates	Business activity statements

HOW WE IDENTIFY COMPLIANCE RISKS

06

HOW WE CONDUCT RISK REVIEWS AND AUDITS

This chapter describes our typical processes for conducting risk reviews and audits. It sets out the points of interaction and what large business taxpayers can expect.

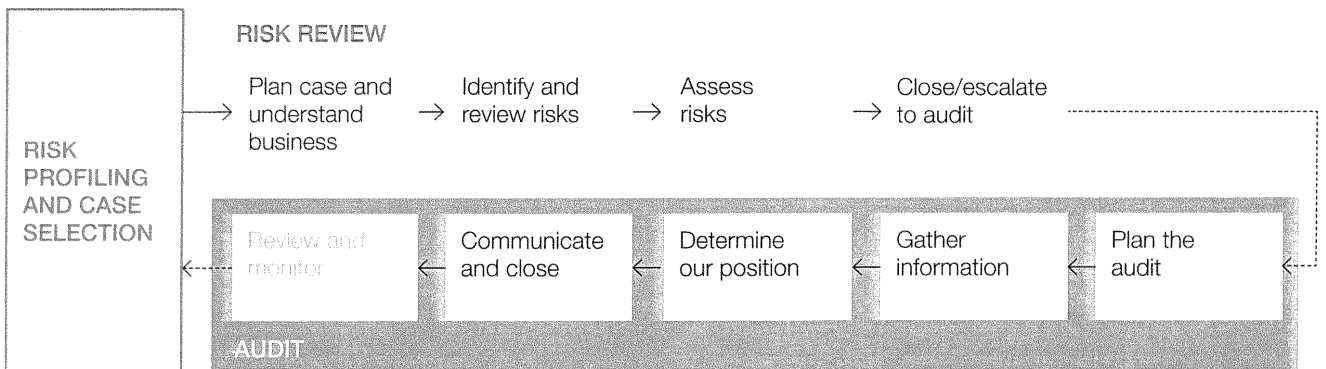
Our compliance activities include a mix of service, help, and active compliance, tailored to the causes of compliance risk.

For example, if non-compliance is the result of uncertainty, we will seek to reduce that uncertainty by explaining our view of the law. If non-compliance arises from administrative issues we will seek to make compliance easier for taxpayers; and we promote a level playing field for large business by deterring, detecting and dealing with those that are ultimately found not to have complied.

Active compliance strategies include risk reviews, audits and prosecution action. This chapter describes our two key active compliance activities, risk reviews and audits, particularly the points of interaction with taxpayers. While verification in the large business segment is necessarily intensive, our aim is to minimise the inconvenience and disruption of these activities on taxpayers, and of our demands for information, particularly in lower risk areas.

Figure 5 shows the Tax Office's generic processes for carrying out more detailed income tax risk reviews and audits of large businesses. Although the figure reflects the usual progress of these processes, we may not necessarily follow every step depending on the circumstances.⁶ For example, an audit may iterate between some of the steps to take into account new information or a better understanding of the matter. Where this occurs we will discuss the changes with you.

FIGURE 5: Our active compliance processes



⁶ Where audit activity is underway in respect of prior years or periods and material risks have been identified in later years or periods, parallel audit processes may be implemented to deal with the legacy issues and bring the case up to date as quickly as practicable.

RISK REVIEWS

Risk reviews are an income tax specific product. They are typically the first step following case selection and are designed to assess whether there may be tax risks arising from a taxpayer's self assessment. For GST purposes, given the transactional nature of GST, the frequency of reporting required, and our GST pre-audit processes for large business, which include risk analysis and assessment, we proceed directly to audit.

From the risk profiling and case selection processes described in Chapter 5, we will form an initial view of risk (or hypothesis) based on risk indicators. Risk reviews help us to test and refine this initial hypothesis and determine whether there are any compliance issues that require a more in-depth investigation and response.

A range of risk review products is used including the Client Risk Review, Specific Review and Compliance Assurance Review. These are described in detail in Appendix B. The type of review will depend on the initial risk hypothesis. In some instances our review process will be conducted without the need to contact you for additional information. The risk hypothesis will determine whether we need to focus on one or more specific risks or review your entire business operations and whether we need to develop an in-depth understanding or conduct a high level analysis. Once we have determined our risk hypothesis and reasoning we share it with the business.

In some instances, the nature of transactions and our knowledge of the compliance risks will be such that it is apparent that the case will have to proceed directly to audit. These include rollover audits, time sensitive cases, transfer pricing cases where major companies have made little or no profit for several years, collection risk cases and cases where risks have already been established from independent sources.

The risk review process provides taxpayers with an opportunity to address our concerns about the compliance issues we have identified. Our experience is that in some cases this can obviate the need for an audit.

Outcomes

At the end of the risk review we will discuss the outcomes with the business, advising them if we are satisfied with their compliance or consider further action is warranted.

Where it is likely we will commence an audit, we will discuss how we can keep the taxpayer informed about our plans through regular dialogue. Depending on the nature of the risks, the discussions may also cover possible mitigation strategies which the taxpayer might choose to implement to reduce the likelihood of an audit, or to mitigate any potentially adverse effects of that activity.

AUDITS

Our audit program complements the comprehensive risk profiling of large business taxpayers and provides for intensive examination of cases where there is a risk of a material underpayment of taxation or excise.

Audits provide a means to:

- verify whether the proper tax has been paid in cases we thought were risky
- understand the causes of any non-compliance and address them for the past and the future
- gain insights that will improve our ability to detect risks, and
- identify areas where the law may need clarification or where audit processes can be improved.

For income tax purposes, an audit typically follows a risk review and tests the review's conclusions. Where we identify additional risks during this process, we may broaden the scope of the audit.

Typically an audit involves more extensive information collection and analysis. During this phase auditors will have more contact with the business and may spend a substantial amount of time at their premises examining documents and processes and discussing issues with key business people and tax managers.

Descriptions of our different audit products are provided in Appendix B.

Two year time frame for large business audits

Our expectation is that a large business audit will be concluded within two years of the notification of its commencement. Implicit in the two year benchmark is an assumption of cooperation. It also requires purposeful management by the case officer and may, in appropriate circumstances, involve the use of our formal powers where there is a genuine lack of cooperation.

For audits commencing after 1 July 2005, we will remit interest charges to the base rate for the period the audit extends beyond two years. Only in exceptional cases involving blatant obstruction will this remission not apply. For audits commencing before 1 July 2005, we will continue to consider remissions on a case by case basis.

UNDERSTANDING YOUR BUSINESS

In conducting any risk review or audit, the Tax Office needs to understand your business context and environment. Where appropriate we will engage experts on particular industries or specific issues (such as financial analysts and market valuers).

In developing this understanding we use a structured system, focusing on the six key factors described in Table 4. These are drawn from the audit accounting standard (AUS 402) *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatements*.

TABLE 4: Business context

Factor	Examples	Factor	Examples			
Business	The extent and nature of the group's business activities and transactions	Economy	Domestic, international environment and trade conditions			
	Location and size of industry		Key overseas developments			
	Business plans and strategies		Government policies – interest rates, inflation, tax system and economic reforms			
	Entity and group structure		Psychology	Management objectives and philosophy		
	Capital structure, financial performance and ratios			Views and reactions of management to wider community		
	Effectiveness of controls within business systems and processes			Approach to managing risk and drivers of the risk strategies		
	Industry			Conditions affecting the industry – region, size and participants	Attitude to and relationship with the Tax Office	
				Industry associations	Systems of compliance	Decision making systems, processes and organisational structure
				Industry profit margins and cost structures		Quality assurances standards and records
				Nature of the competition		The support and authority the corporate taxpayer's compliance team receives from management
Industry skill levels		The degree of ease in accessing information				
Impact of technological and business change		Nature and purpose of transactions, that is value, type, conduct, methods, timing, costs and benefits				
Financial performance		Compliance history				
Industry norms and regulatory environment		Tax analysis of issues and expected range of tax results				
Sociology		Knowledge and norms of the professional/business group, for example, standard of record keeping and lodgment timeliness				
		Culture of the organisation and management				
	Business, professional networks and reputation					
	Approach to community and corporate citizenship					
	How the group deals with finances and paying tax					
	Linkages to control points, decision makers and advisers					

In considering taxpayer attitudes to the tax system and relationships with the Tax Office, we acknowledge that the interaction of the law, environment and the size and nature of transactions in large business gives rise to complexity and, consequently, to differences of view from time to time. This of itself does not indicate uncooperative or non-compliant behaviour. It is also acknowledged that taxpayers who legitimately exercise their legal rights (including legal professional privilege) are not by so doing being uncooperative or non-compliant.

Risk review process

PLAN CASE AND UNDERSTAND BUSINESS

IDENTIFY AND REVIEW RISKS

WHAT THE TAX OFFICE WILL DO

The risk hypothesis

A risk hypothesis is developed for all cases selected for risk review. The hypothesis is determined through our risk management processes, with input from the case officer and, where appropriate, relevant experts.

Plan case

Case officers will:

- identify any other Tax Office interactions with you and coordinate where possible
- collate the information we have on your business
- develop a plan for the review for discussion with you
- ensure the appropriate resources are available to execute the plan
- call to advise you of the risk review, request necessary information and discuss possible interview dates, and
- confirm in writing any initial information request.

Gather information and build understanding of your business

Case officers, their senior officer(s), and, where necessary, technical, topic or industry experts will review the available information to:

- determine any additional information we require
- develop an understanding of your business activities – this may involve discussions with key people within your business, and
- plan for an internal briefing or workshop.

Hold internal briefing or workshop

The case officer will organise an internal workshop which may include technical, topic and industry experts to refine the risk hypothesis by:

- analysing available information
- analysing the industry and business in which you operate
- comparing your economic and tax performance, and
- understanding the impact of events.

Send interview notification letter

The case officer will write to you confirming any interview date and advising of any information required before or during the interview.

Prepare for interview

The case officer will prepare an interview questionnaire with assistance from senior officers, outlining key issues and identifying the information we require.

Hold interview

When we hold an interview we will:

- arrange for the appropriate tax officers to be present to address issues you may raise
- ask whether you have identified any potential risks
- provide you with an opportunity to explain how you may have mitigated any potential risks
- explain our initial view on any risks
- seek your assistance in further developing our understanding of your business, and
- give you the contact details of a senior officer in case you wish to raise any concerns during the review.

WHAT THE TAX OFFICE EXPECTS FROM YOU

Your assistance to help us meet the planned timeframes for the review by:

- cooperating to set dates for interviews
- preparing for interviews, and
- providing information in the agreed timeframe.

To provide information in a timely way and ensure appropriate staff are available for the interview.

To advise us of any potential risks you have identified and how you may have mitigated them.

To provide us in a timely way with any information sought and access to relevant documents and staff.

ASSESS RISKS

Refine risk hypothesis

We will assess the risks we have identified and determine which ones may require further compliance treatment.

Where there are risks that are likely to require further treatment, the case officer may conduct additional internal workshops with technical, topic and industry experts to analyse any new information and refine the risk hypothesis.

Develop recommendations

The case officer makes recommendations on the risk rating and possible future action including whether we should proceed to audit.

The senior officer considers the recommendations. If the recommendation is to proceed to audit a further approval is required from a risk committee that includes other senior tax officers.

Issue a draft finalisation letter

If we have identified risks that require further compliance treatment the case officer will send you a draft finalisation letter advising of the outcomes of our work. If we have not identified risks that require further treatment we will send you a finalisation letter.

We may also offer you an interview to discuss the implications of our findings and our possible next steps.

CLOSE/ESCALATE TO AUDIT

Hold a final interview

Where you have chosen to have a final interview the case officer will organise this with you and arrange for relevant Tax Office staff to attend where material risk(s) exist.

The case officer, senior officer(s) and, where appropriate, technical specialists will attend the interview and discuss the implications of our findings with you.

This discussion will cover our possible next steps and how we will keep you informed of our plans. We will also discuss possible mitigation strategies you might choose to implement such as making a voluntary disclosure.

Send finalisation letter

After the interview the case officer will write to you outlining the final outcomes from the review.

Issue taxpayer feedback questionnaire

Once the case has been finalised we will send you a questionnaire seeking your feedback on the conduct of the review and any suggestions for improvements.

Review

In some cases we will undertake an internal debriefing once the review is finalised to identify learnings and improvements.

Ongoing dialogue

Where we have advised you that your case is likely to proceed to audit we will contact you regularly to inform you of developments.

Where risks are assessed or an interview occurs, to provide us with your input in relation to our findings.

To ensure the necessary staff are available to attend the final interview.

To consider the risks identified and to implement mitigation strategies where possible.

To provide us with feedback on the conduct of the review, including any suggestions for improvement.

Audit process

PLAN THE AUDIT



GATHER INFORMATION



WHAT THE TAX OFFICE WILL DO

Case preparation

The audit case officer undertakes preliminary checks including:

- updating your profile with information available internally or publicly
- reviewing outcomes from recent risk reviews to ensure previously identified risks remain relevant, and
- checking for other Tax Office activity and coordinating where possible.

Prepare audit plan

The case officer prepares an audit plan with the help of their senior officer(s) and other relevant compliance and technical staff. This may involve a planning workshop.

Planning for an audit includes ensuring the appropriate resources are available for its implementation.

The audit plan will be regularly reviewed and updated throughout the course of the audit and you will be informed of progress. We will also explore with you ways in which we might be able to speed up completion.

Notify taxpayer of audit

As we prepare our audit case and the plan, the case officer will generally call to notify you of our intention to audit and determine availability for interview(s). You will be advised of the names of the officers undertaking the audit and the process and contact arrangements for managing the audit. This will be followed by a confirmation letter which will also outline any initial information requirements.

Hold a preliminary audit interview

At the interview we will:

- provide you with a copy of the audit plan for discussion
- discuss the audit scope, the periods under audit and the expected completion date
- discuss the information gathering processes
- discuss any Tax Office guidelines relevant to the issues and years to be audited, including procedures in relation to voluntary disclosures
- outline facilities and assistance we may require, and
- give you the contact details of a senior officer in case you wish to raise any concerns during the audit.

Gather information

At this point we will seek information from you using a range of methods including questionnaires and interviews with your key staff.

This is a key phase where a cooperative approach and regular dialogue can help in managing the audit timeframe.

We will work with you to determine our information needs, establish a dialogue process, and discuss our reasons for requiring information.

In the first instance we will generally request information on an informal basis; however, in some circumstances:

- it may be necessary for us to use our formal access powers, in which case we would normally advise you beforehand and outline the process, and
- information you provide will need to be confirmed for evidentiary purposes.

We will try to coordinate our demands to accommodate your business cycle and any important demands on your key people.

Review information and refine audit scope

At this point the case officer will examine the information we have collected and identify the key issues, refine our risk hypothesis and develop our position.

The case officer will make any necessary adjustments to the scope of the audit and advise you of any changes.

In selected cases, relevant officers will hold internal workshops with technical specialists or industry and topic experts to develop our technical position and identify any additional information requirements.

WHAT THE TAX OFFICE EXPECTS FROM YOU

To cooperate in setting a time for the preliminary interview and ensuring your key staff are available.

To provide any requested information before or at the interview.

To discuss the proposed plan with us with the aim of reaching agreement on timeframes and milestones.

To provide the requested information in a timely way.

When an interview is necessary, to cooperate in setting interview times and to ensure your key staff are available.

To provide us with reasonable access to the facilities and resources we require.

**DETERMINE
OUR POSITION**



**COMMUNICATE
AND CLOSE**



Research technical issues

The case officer and compliance team will review and analyse information, consult with relevant technical experts and formulate our position.

We will follow relevant practice statements and, where applicable, refer matters to Tax Office panels such as the General Anti-Avoidance Rules Panel.

Communicate our position in writing

The case officer will write to you outlining our position and inviting your response.

Consider your response

We will consider your response to our position and any additional information you have provided.

We may also meet with you to further discuss our position and any additional information you have provided. Where appropriate this may involve our technical specialists, industry or topic experts.

Advise you of our final position

We will normally respond in writing to any questions you have raised and advise you of our final position.

Where we intend to issue amended assessments we will advise you beforehand.

**Consider any submissions you make
about penalties or interest charges**

If you make submissions for reduction or remission of penalties or interest charges the case officer and their senior officer(s) will consider them.

Communicate audit outcomes in writing

The case officer will send you a letter outlining the audit outcome, the final Tax Office position and any proposed adjustments including penalties and administrative charges.

If you make an offer to settle, the case officer and their senior officer will consider and discuss it with you, applying the Code of Settlement Practice.

If you disagree with our position the case officer will advise you of your dispute rights and possible next steps.

We may make suggestions on how your tax risk management process could be improved to minimise the risk of any further non-compliance and seek your commitment to any improvements.

Offer final interview

The case officer will offer you a final interview, to discuss any penalties or administrative charges and to explain our next steps.

In selected cases, senior officers and technical specialists may attend the final interview.

Finalise the audit

The case officer will obtain approval from their senior officer(s) and will finalise the audit.

We will send you a finalisation letter within seven days of that approval.

Issue taxpayer feedback questionnaire

Once the case has been finalised we will send you a questionnaire seeking your feedback on the conduct of the audit and any suggestions for improvement.

Where you choose to respond to our position, to do so in a timely way and provide information that is relevant.

Where you choose to have a face-to-face discussion with us about our position, to ensure your key staff are available.

Where you choose to have an interview, to ensure your key staff are available.

Where you intend to make submissions about the remission of penalties or interest charges, to do so in a timely way.

To provide feedback on the conduct of the audit, including any suggestions for improvement.

EXPECTATIONS

What you can expect from us:

Tax Office auditors are expected to:

- complete a case in the shortest time practicable and with minimum inconvenience and disruption to taxpayers
- act in a professional, courteous and respectful manner and demonstrate integrity, fairness and impartiality in the conduct of their duties
- maintain open and frank dialogue, including informing you regularly of the progress of the compliance activity
- ensure information requests are clear and unambiguous
- recognise your right to have advisers present during discussions and meetings and to allow you to confer with them as necessary
- recognise your right to claim legal professional privilege and confidentiality in certain circumstances
- notify you where an error is detected that has resulted in you paying too much tax
- follow Tax Office precedents, or escalate them internally if they are concerned about their accuracy, and
- follow Tax Office practice statements.

What we would like to see from you:

The efficient and timely progress of our compliance activities also depends on you. You can assist by:

- engaging with us in developing realistic plans, milestones and timeframes
- advising us at the earliest opportunity of any issues that may result in timeframes or milestones being delayed, including problems with access to personnel or information
- providing us with access to the key personnel in your organisation who can readily provide the financial and business information we require
- engaging in open and frank dialogue on the taxation issues raised by the audit
- taking all reasonable steps to comply with our requests for information and ensure all relevant recording systems (for example, email, business reporting, directors minutes and board papers) are searched and disclosed where appropriate

- explaining the basis of any claim you make for legal professional privilege or confidentiality
- advising us at the earliest opportunity if you consider the compliance activity is not tracking to plan
- ensuring your public officer and tax function are adequately supported and resourced to manage the audit and provide information and responses to us in a timely manner
- ensuring documentation is readily accessible whether maintained as a physical document or stored electronically
- providing information to help us understand the business context as this is central to identifying and evaluating tax risks, and
- escalating any concerns you have about the audit or the conduct of our officers to senior tax officers.

Where you do not provide information – or are uncooperative in providing it – we may:

- seek to escalate the matter in your organisation
- use our formal access powers
- issue assessments where the basis for our increased tax liability has not been refuted, and
- consider increased penalties.

EXAMPLE

An audit was becoming protracted with the taxpayer being unable to provide information within reasonable timeframes. Discussions with senior executives of the company resulted in us prioritising our information requests and the taxpayer allocating further resources to meet the agreed timeframes.

All information was then provided within the new timeframes, and other information, which we were not previously aware of and which had not been shared with us, was accepted as meeting our request. We did not need to use formal access powers and the audit was completed within the renegotiated timeframe.

CASE LEADERSHIP PROCESS

The complex, novel and sensitive nature of some of the issues that arise in this segment has led us to put in place special arrangements in relation to major cases. This includes the appointment of specialist case advisers to assist in identifying and resolving such issues.

WHAT TO DO IF YOU ARE DISSATISFIED WITH THE PROCESS

This publication sets out the standards we expect our officers to maintain in dealing with taxpayers and in implementing processes that are designed to minimise our demands on taxpayers while carrying out our duties.

Where you have concerns about the progress of a compliance activity, or you think that the Tax Office may not be delivering on our undertakings set out above, we encourage you to discuss these issues with the case officer in the first instance.

If this does not resolve the issue, you may escalate it to the senior officer advised to you at the start of the compliance activity. The senior officer will undertake a review of the issue (including the relevance and scope of information requests) and may need to discuss it with you and the case officer. The senior officer will work out with you a process for addressing legitimate concerns.

07

KEY ASPECTS OF THE PROCESSES

This chapter discusses some structural features of the law and the key aspects of our compliance processes.

VOLUNTARY DISCLOSURES

We accept that errors can and do occur and that changing circumstances or reflection or review may prompt taxpayers to change their view on how a particular transaction should be treated. When this occurs, taxpayers may choose to disclose a shortfall (or an overpayment) by making a voluntary disclosure (or a request for a self amendment). The fair and efficient operation of the tax system is enhanced by these practices.

We encourage taxpayers to continue to advise us of any changes in their position or of any errors in their tax affairs as and when they are detected. If they notify us of the resultant tax shortfall before we notify them of an audit, the level of penalty that may otherwise apply is reduced by 80%.

A disclosure made after notification of an audit will still attract a 20% reduction in any applicable penalty, and if it relates to an issue outside the scope of the audit a reduction of 80% will generally apply.

As it is a transaction tax, voluntary disclosures for GST are generally more frequent than for income tax and are often made before we commence any compliance activity.

Our policy on the treatment of voluntary disclosures is set out in *Law Administration Practice Statement PS LA 2006/2 Administration of shortfall penalty for false or misleading statement*.

The remission of interest on tax shortfalls in respect to voluntary disclosures is addressed in *Law Administration Practice Statement PS LA 2006/8 Remission of shortfall interest charge and general interest charge for shortfall periods*.

INFORMATION GATHERING

The examination of complex matters often requires the gathering of substantial amounts of information and evidence. The timely provision of this information is a key component of the efficient conduct of our active compliance activities and their resolution.

In our experience, delay in this phase is one of the main reasons for lengthy cycle times for many compliance activities.

Although the Commissioner has formal access and information gathering powers, generally our approach is to seek information from you on an informal basis. This recognises the cooperative approach we are seeking in our overall approach to compliance.

This phase can be assisted by early and ongoing discussion with taxpayers about our information needs.

Generally, we will:

- make a preliminary assessment of our information needs when planning the compliance activity
- discuss the risk/issue and the information we propose to seek, including reasons. The aim of the discussion is to refine the information request to ensure adequate information is obtained in a reduced time frame. We will seek the taxpayer's views as to any concerns, ambiguities, issues of relevance and the identification of other information that would assist in the timely completion of the enquiry
- discuss with the taxpayer the information gathering protocols and expectations at the commencement of the activity, including the timelines for the provision of information and appropriate levels of resourcing,
- identify, with the taxpayer's assistance, key personnel who may need to provide information and make arrangements to interview them, and
- take into account the particular circumstances of the taxpayer to minimise the inconvenience and cost to them of our enquiries.

If we require additional information, we will follow these same principles.

During the course of gathering information we will:

- have regard to your other statutory obligations and any special circumstances, including business priorities
- properly consider any claims that documents are covered by legal professional privilege, our administrative concessions for access to professional accounting advisers' papers or our practice statement *Law Administration Practice Statement PS LA 2004/14 Access to corporate board documents on tax compliance risk*.
- treat any information in accordance with the secrecy and, where relevant, privacy requirements of the law
- normally inform the taxpayer beforehand where we seek information from third parties. However, there may be circumstances where this is not appropriate. For example, we may verify the respective treatment of a transaction for GST purposes, or to make a preliminary assessment of a risk or to verify information provided.

While we normally request information informally, in certain circumstances we will use our formal access powers. The appropriate use of our formal powers is to ensure that we have adequate information to assess and address a risk in a timely manner. Any use of our formal powers does not necessarily reflect on how we regard the taxpayer's compliance behaviour, nor will it of itself indicate a lack of cooperation or breakdown in working relations between the taxpayer and the Tax Office.

We also recognise that some companies and their staff prefer that we use our formal access powers to provide a legal support for disclosing the information.

For example, we may conduct formal interviews of key personnel to fully understand the business drivers of a transaction. Other circumstances where the formal powers may be used include when:

- the taxpayer has requested formal access to ensure they are complying with the terms of a contractual arrangement
- formal notices are requested by the taxpayer to allay concerns around the confidentiality and privacy of third party information, and
- the taxpayer has not provided adequate information within agreed timeframes and not provided a reasonable explanation for this.

Where information has not been provided within agreed timeframes we may escalate the matter within your organisation and/or issue formal notices.

Our officers will raise matters such as this in their regular discussions with you.

The statutory access and information gathering powers that can be exercised by authorised tax officers comprise the right of full and free access to buildings, places and documents and the right to take copies of, or make extracts from, documents. The law requires that reasonable facilities and assistance be given to tax officers when exercising this power. The Commissioner can also, by notice in writing, require any person to provide information, produce documents and/or attend and give evidence concerning their income or assessment or that of any other taxpayer.

If information is held offshore, a notice can still be effective if a domestic company has 'control' over this information. Alternatively, we may issue a specific notice seeking information held offshore. Failure to comply with this notice may mean the evidence may not be used in proceedings disputing an assessment. We may also obtain information from overseas tax authorities under relevant international agreements.

- For more information see *Fair use of our access and information gathering powers* (NAT 2559), and the *Access and information gathering manual*.

EXAMPLE

During a client risk review, Company X sought an extension of time to provide information but failed to meet the extended deadlines.

Following the risk review, it was decided to proceed to audit. At the initial meeting, the case manager referred to the difficulties in obtaining information during the risk review. Company X's tax manager advised that staffing difficulties during the risk review had now been resolved and they would have no difficulty in meeting future requests in reasonable timeframes. The case manager agreed that the Tax Office would continue to use informal approaches to information gathering but we made it clear that formal powers would be used if delays were encountered.

The likely information needed was discussed and it was agreed that 28 days would normally be a reasonable period to allow the company to provide it. At the end of the 28 day period, Company X's tax manager contacted the case manager and requested a two-week extension. The case manager unsuccessfully sought an assurance that the information would definitely be provided within that extended period, and no reasonable grounds were given for the refusal to provide the information within that timeframe.

In these circumstances it would be reasonable for the case manager to use formal information gathering powers to request the information.

RECORD KEEPING

The tax law requires the keeping of records that extend beyond traditional accounting records and can include documents evidencing an intention, election, choice, estimate, determination or calculation. For these purposes 'documents' include both paper and electronic communications including emails.

These records help to substantiate the taxpayer's liabilities and claims.

DETERMINING OUR POSITION

Having completed information gathering, our next step is to determine our position. Our officers will research the law having regard to any settled Tax Office position on the matter. Where the issue meets certain criteria including any concerns about the accuracy of the existing Tax Office position, it will be escalated to our Tax Counsel Network or a centre of expertise to review or arrive at a view on the matter.

To help determine our position, we sometimes engage external experts such as industry specialists, valuers, economists and legal counsel. Some matters must be referred to a panel before a decision is made. For example, if our officers consider that the general anti-avoidance provisions (such as Part IVA) apply they must refer the case to the General Anti-Avoidance Rules Panel for advice. When the Tax Office view on the application of the general anti-avoidance rule is being finalised through the panel, the taxpayer has the right to attend and argue their case.

At the conclusion of our deliberations we will usually provide you with a position paper setting out our view on the issues. You will have the opportunity to respond to this and we will consider your response and advise you of our decision.

INTEREST CHARGES

In situations where there is a tax shortfall, interest is generally imposed by law for the period of the shortfall. For income tax this is imposed from the 2005 year as shortfall interest charge (SIC) and as general interest charge (GIC) for earlier years. SIC is imposed at a rate 4% lower than GIC. For other taxes GIC is applied to tax shortfalls.

Interest charges for the shortfall period are imposed:

- to ensure that taxpayers who for whatever reason have underpaid their tax during this period do not receive an advantage over those who have not, and
- to compensate government for the impact of not having the funds.

To achieve this the taxation laws generally impose interest charges from the date a taxation liability should have been originally paid. The law also provides the Commissioner with a discretionary power to remit interest charges in certain circumstances. Often this will be where there has been a delay in completing an audit due to circumstances outside your control. In this respect, the Commissioner has set a benchmark of two years for the conduct of a large corporate audit, and interest charges for the period after this will be remitted back to the base rate.

If interest applies we will give you a written statement of the reasons for a decision not to remit all or part of it, including findings on material questions of fact. This will refer to evidence on which these findings were based.

- The Commissioner's remission policy on interest charges for the pre-amendment period (or tax shortfall period) is set out in *Law Administration Practice Statement PS LA 2006/8 Remission of shortfall interest charge and general interest charge for shortfall periods*.

For debts that are unpaid after the due date, GIC applies. The policy for the application of GIC is set out in the *ATO receivables policy*.

ADMINISTRATIVE PENALTIES

The law imposes penalties based on levels of culpability. The facts and circumstance of a case ultimately dictate which category of penalty applies, if any.

Where we have concluded that penalties should apply, we will communicate our reasons and give taxpayers a further opportunity to present their views and any mitigating factors. If following this we still consider that penalties apply, we will give the taxpayer a written statement of the reasons for the decision not to remit all or part of the penalty, including findings on material questions of fact. This will refer to the evidence on which these findings were based.

In many instances large businesses have a reasonably arguable position (RAP) in relation to contentious issues. Our position on RAPs is explained in *Taxation Ruling 94/5 Income tax: tax shortfall penalties: reasonably arguable*.

Large businesses are generally well advised, and some take positions that are about as likely as not to be correct – usually acknowledging that a contrary view exists that could be argued on rational grounds. In such cases, if there is a dispute, the taxpayer has exercised reasonable care and has a RAP such that no culpability penalties apply. An important exception to this is where special provisions in the law apply, such as Part IVA or Division 13 of the *Income Tax Assessment Act (1936)*. If these special provisions apply in such a case, the statutory base penalty is 25% or 10% respectively.

There are also cases where the adviser or the business may lose some objectivity about the extent of structuring that is allowable under the law in achieving an overall commercial end. There are also some cases where positions are taken by the business on the understanding that they are at the margin of what under the law might be acceptable tax planning even though they risk the existence of a different view.

Where we are proposing to adjust a business's tax liability and it has exercised reasonable care but does not have a RAP, a base penalty amount of 25% of the tax shortfall generally applies, depending on the level of culpability. A penalty rate of 50% can apply in tax avoidance cases.

We will give taxpayers the opportunity to discuss the merits of their case before any decision is made. The risk of a penalty applying in these and other circumstances can be mitigated through unprompted voluntary disclosures, early disclosure (such as seeking a private binding ruling) or disclosure of the position taken during the risk review stage of any compliance activity (or afterwards).

PROSECUTIONS

Where circumstances warrant, the law provides for prosecutions to be undertaken in relation to a range of offences against the tax laws. These include:

- making a false or misleading statement (which can include the withholding of information material to a tax matter)
- keeping incorrect or false records
- refusing or failing to furnish a return or information or to produce records or documents
- refusing or failing to attend before a tax officer or answer questions as and when required, and
- hindering or obstructing a tax officer who is exercising the access powers.

The decision whether to prosecute or not is the responsibility of the Tax Office for routine cases and the Commonwealth Director of Public Prosecutions in other cases.

➔ Our approach to prosecutions is outlined in the *Tax Office prosecution policy*.

ASSESSMENTS

Income tax

The standard period in which the Commissioner can amend an assessment is four years for large business taxpayers. There are provisions for extending the time for amendments, and if their use is considered necessary we will contact taxpayers and give them the opportunity to consent to the extension. If they do not give consent, the matter can be escalated to the courts for arbitration.

Different rules relating to the period of amendment can apply to some cases including transfer pricing, research and development, and capital gains tax. Revised processes and our new case management system will help us become more timely in our audit activity, but the level of cooperation we receive from taxpayers, and effective lines of communication, will influence the progress of the audit.

Except in cases of extreme urgency, taxpayers will be given every reasonable opportunity to present their case before an amended assessment issues. We are conscious of possible financial and reputational risks associated with a debt adjustment, and we take due care to ensure that they are based on reasonable grounds.

GST

Where an adjustment needs to be made to a taxpayer's activity statement (whether to increase or decrease their liability) we will normally do this by issuing an assessment. The standard period in which the Commissioner can make an assessment is four years for large business taxpayers. However, by giving notice to the taxpayer that payment is required the Commissioner is able to extend time limits for a net amount or an amount of indirect tax (including GST) which has not been paid within four years of the due date.

Except in cases of extreme urgency, our processes require that the details and reasons for any assessment be advised to the taxpayer before any such assessment is issued and that the taxpayer is given the opportunity to raise any concerns before the assessment issues. Reasonable care is taken to ensure that any amendments are based on reasonable grounds.

Excise

The standard period in which the Commissioner will seek recovery of unpaid excise is four years for large business taxpayers. This four year period is an administrative arrangement rather than a legislative provision.

Where fraud or evasion is suspected the Commissioner would seek to extend his enquiries and possible adjustments beyond the four year period. Should the Tax Office choose to extend the period of enquiry or adjustment you will be contacted and given an opportunity to discuss the arrangements.

You will be given every reasonable opportunity to raise your concerns before a demand for payment issues. However, if you choose not to avail yourself of this opportunity, a demand can still be issued.

GENERAL ANTI-AVOIDANCE RULES PANEL

The purpose of the panel is to help the Tax Office in its administration of Part IVA and other general anti-avoidance provisions in order to ensure that decisions on the application of these provisions are objectively based and well considered. The panel's role is advisory, but the Tax Office decision maker must take the panel's advice into account.

Matters are generally referred to the panel after the Tax Office has issued a position paper and considered the taxpayer's response to this.

To assist the panel in providing advice to the Tax Office, the taxpayer will usually be invited to attend and address the panel meeting. Before attending a panel meeting, they will be asked to provide a written submission to the panel.

➤ For more information see *Law Administration Practice Statement PS LA 2005/24 Application of general anti-avoidance rules*.

COLLECTION OF TAX

The law requires taxpayers to pay their taxation liabilities by the due date for payment. If there is a dispute with us regarding their obligations, we will usually enter into a '50/50 arrangement' under which the taxpayer pays all undisputed debts and at least 50% of the disputed tax (see the *ATO receivables policy*, chapter 28).

Where tax is owed by non-residents, the Tax Office may issue a notice under section 255 of the *Income Tax Assessment Act 1936*, requiring a person who has money belonging to a non-resident to pay any tax due by that non-resident.

OBJECTIONS

Taxpayers have the right to object to a range of decisions that we make about their tax affairs including those relating to assessments, penalties and some private rulings. Although they can't legally object to a GST private ruling, we would take their views into account in reviewing it.

When a written objection is received, a review officer, independent of the original decision maker, is appointed. The process typically involves:

- gathering all relevant information relating to the original decision (for example audit files)
- examining the grounds for objection and considering the scope of the review
- researching the issues, consulting with technical experts and any other party as necessary, taking account of any new information, and determining a response, and
- advising the taxpayer in writing of the decision reached and outlining any further rights of review or appeal.

The review officer will contact the taxpayer within 14 days of receipt of their objection if we need further information.

We aim to deal with objections in line with Taxpayers' Charter service standards. However, if the case is particularly complex we will negotiate a longer period.

Taxpayers can help the process by providing with their objection all the information that they think would be required to deal with it and responding in a timely manner when any additional information is sought.

LITIGATION

If a taxpayer is dissatisfied with the objection decision, they generally have the right to either have the decision reviewed by the Administrative Appeals Tribunal (AAT) or appeal the decision to the Federal Court. Details of the review and appeal procedures are provided to taxpayers with their notice of Decision on Objection.

If taxpayers decide to seek review or to appeal, the application must be lodged directly with the AAT or Federal Court respectively.

We aim to act honestly and fairly at all times during litigation, consistent with our Commonwealth Model Litigant obligation. Model Litigant Guidelines form part of the Legal Services Directions 2005 issued by the Attorney-General. The Legal Service Directions provide the rules under which the Australian Government is required to conduct litigation and outsource legal services. The directions and related guidelines can be viewed on the Attorney-General's Department website (www.ag.gov.au).

If you feel our conduct has fallen short of the standards set by the Attorney-General, the complaint can be referred in writing to the Tax Office General Counsel at 2 Constitution Avenue, Canberra, ACT, 2600.

SETTLEMENTS

The *Code of settlement practice* provides guidance on the settlement of taxation disputes. The Commissioner may settle taxation disputes where it is considered to be consistent with good management of the tax system. The code outlines those circumstances under which it is generally appropriate, or inappropriate, to settle.

While the Commissioner has a responsibility to collect the tax properly payable, he also has an obligation to balance this responsibility with the need for sensible administration. The Commissioner may apply the 'good management rule' and settle the tax liability having regard to relevant factors. Although the power to settle taxation liabilities in accordance with the code has been delegated to a strictly limited range of senior officers, any offer a taxpayer makes to settle a dispute should be directed through the case officer. In significant cases, current settlement practices involve collaboration between senior Tax Office people from the business line, Tax Counsel Network, centres of expertise and Legal Services Branch. In addition, external counsel, where engaged, may give advice to the settlement decision maker.

A revised code will be available at www.ato.gov.au in late 2006.

08

MORE
INFORMATION

A wide range of information
specifically designed for large
businesses is available at our website
www.ato.gov.au/large

Information products of specific relevance to our processes and tax risk management include:

- *Compliance program* (NAT 7769 – published annually)
- *Taxpayers' charter* and associated booklets, in particular *Fair use of our access and information gathering powers* (NAT 2559)
- *A better practice guide for the management of GST administration (BPG)*, designed to help organisations establish appropriate internal control frameworks for the effective management of GST administration. Originally aimed principally at government agencies, the guide and its accompanying workbook are considered relevant to any large public or private organisation
- *Part IVA: the general anti-avoidance rule for income tax* (NAT 14331)
- *Tax havens and tax administration* (NAT 10567)
- *ATO receivables policy*
- *Code of settlement practice*
- *Access and information gathering manual*, and
- *Tax Office prosecution policy*.

Further details of our approach to large business compliance can be found in speeches by the Commissioner and other senior officers, available on our website.

Another source of useful information is the published minutes of key consultative forums such as the Corporate Consultative Committee and the National Tax Liaison Group and its sub-committees, available on our website.

Tax Office law administration practice statements can be found on the legal database of our website.

Some of the key practice statements referred to in this booklet include:

- 2004/14 *Access to corporate board documents on tax compliance risk*
- 2005/10 *Priority private binding rulings*
- 2005/24 *Application of general anti-avoidance rules*
- 2005/25 *Aggressive tax planning end-to-end process*
- 2006/2 *Administration of shortfall penalty for false or misleading statement*
- 2006/8 *Remission of shortfall interest charge and general interest charge for shortfall periods*

Appendices

APPENDIX A

FEEDBACK MECHANISMS

We are committed to consistently providing the highest standard of service to taxpayers. We also believe that good relationships with large business taxpayers could lead to more streamlined processes and better outcomes for both them and the community.

We have therefore put in place a range of avenues that enable us to have an open dialogue with large business about their experiences in working with us.

We also recognise that there may be times when not everything goes to plan in our work. If taxpayers have concerns about the conduct or progress of any compliance activity including the provision of advice, we encourage them to discuss these with the case officer in the first instance. We also encourage them to escalate the matter if they think it appropriate.

It is important that taxpayers do not feel intimidated or fearful in providing feedback. Taxpayers have the Commissioner's guarantee that they will not be jeopardised if they raise reasonable concerns. To the extent practicable, we want to nurture a relationship and environment that welcomes full and frank dialogue.

COMPLAINTS HOTLINE

We also have a formal complaints hotline (**13 28 70**).

See also our section dealing with 'What to do if you are dissatisfied with our processes' on page 55.

TAXPAYER FEEDBACK QUESTIONNAIRES

A short questionnaire is sent to taxpayers following the provision of written advice and after every risk review or audit. Responses are analysed as we seek to improve our processes where necessary, or confirm good practice.

PROFESSIONALISM SURVEY

An annual survey of all large businesses on the professionalism of our officers is conducted to measure our performance against international benchmarks.

CLIENT CONTACT VISITS

The top 100 businesses may also use the client contact visits which are offered on a biannual basis to raise issues of concern or to confirm good practice in relation to our activities.

APPENDIX B

ADVICE AND ACTIVE COMPLIANCE PRODUCTS

This section outlines the main advice and active compliance products used by the Tax Office's large business income tax and GST areas.

ADVICE PRODUCTS

There are two broad categories of advice – rulings and general advice. In very limited circumstances we also provide administratively binding advice.

Rulings

There are two main categories of ruling for large businesses – public and private.

Public rulings

A public ruling is a published statement that contains advice on the way the law applies in defined circumstances that are common to many taxpayers. A taxpayer can rely on a public ruling if it coincides with their particular circumstances. Product rulings and class rulings are types of public rulings that apply to a number of taxpayers who participate in a particular scheme in essentially the same way. Taxpayers are not obliged to follow our advice, but know the position we take in relation to a matter.

Private rulings

A private ruling (or a specific private indirect tax ruling) is provided in writing and applies to a particular taxpayer in relation to their specific circumstances. It is based on the facts relevant to the scheme or transaction defined in the taxpayer's ruling application, and on any assumptions that are made. Applicants for private rulings may be asked to provide additional information or to comment on proposed assumptions or information obtained from another source. Written general advice on an indirect tax matter, which simply restates part of a public indirect tax ruling or law without applying the ruling or law to the taxpayer's circumstances, also constitutes a private indirect tax ruling. A private ruling must state that it is a ruling, the protection it provides and an authorisation number. A taxpayer can choose not to rely on the ruling, and in relation to private rulings on income tax matters has rights of objection and review as if the private ruling were an assessment.

Administratively binding advice

Some of the laws administered by the Commissioner do not currently enable advice to be provided in a legally binding form. In the interests of sensible administration, the Commissioner will, in very limited circumstances, continue to provide administratively binding advice in relation to these laws. This means that if you rely on such advice and it is later found to be wrong you will not ordinarily have to pay any additional tax that would otherwise be due.

For further information see our forthcoming law administration practice statement on administratively binding advice.

General advice and Tax Office publications

General publications and advice have the status of rulings in relation to GST, but not in relation to income tax. For GST, this means that taxpayers who rely on such advice that applies to their own circumstances and which is later found to be wrong will ordinarily not have to pay any additional tax that would otherwise be due.

For income tax, the taxpayer is only protected in relation to penalties and interest.

ACTIVE COMPLIANCE PRODUCTS

Risk products

These are not used for GST.

Client risk review

This is a comprehensive review product used to develop an in depth understanding of the taxpayer's business operations. A client risk review typically involves:

- collecting and analysing information to help us understand a taxpayer's business
- identifying potential material tax risks
- reviewing the identified risks by asking the taxpayer to explain the circumstances and provide information about any mitigation strategies they have implemented
- assessing and evaluating identified risks, and
- making recommendations for future compliance activity and discussing these with the taxpayer.

The aim of a client risk review is to:

- assess identified potential taxation risks (current and emerging)
- get a better understanding of the taxpayer's business through the integration of business and tax analysis
- build a year-by-year picture of the taxpayer's business, and
- build and maintain a relationship with the taxpayer through regular interaction.

Specific review

This is used to examine one or more specific risks that we have identified. A specific review typically involves:

- collecting and analysing information to help us understand the taxpayer's business in relation to the potential risks we have identified
- asking the taxpayer to explain the circumstances and provide information about any mitigation strategies they have implemented
- assessing and evaluating the identified risks, and
- discussing those recommendations with the taxpayer.

The aim of a specific review is to:

- assess identified potential taxation risks (current and emerging)
- gain a better understanding of the taxpayer's business through the integration of business and tax analysis, and
- build and maintain a relationship with the taxpayer through regular interaction.

Compliance assurance review

This is designed to provide us with a high level understanding of the taxpayer's business operations and identify any changes to their level of compliance and their risk profile. The compliance assurance review is a real time review that occurs over a period of approximately one year. It is designed to avoid disruptions to the taxpayer's business activities where there are no changes indicating an increase in risk.

A compliance assurance review typically involves:

- collecting and analysing information as it becomes available
- monitoring revenue
- discussing any risks we identify with the taxpayer, and
- making recommendations for future compliance activity and discussing these with the taxpayer.

The aim of a compliance assurance review is to:

- develop a high level understanding of the taxpayer's current business activities, and
- monitor the taxpayer's level of compliance and risk profile.

See also TR 98/11 *Transfer pricing record reviews*.

Audit products

Specific audit

Where our preliminary risk activities have identified a small number of risk areas that require further investigation (usually one or two) we will undertake a specific issue audit. This is designed to determine the business's level of compliance with respect to the identified risks. The extent of activities conducted will vary on a case by case basis and is influenced by the risk(s).

A specific audit typically involves the following steps:

- determining the scope of the audit, planning the audit and discussing the plan with the taxpayer
- gathering information to ascertain whether a compliance issue exists
- determining our position on identified issues, advising the taxpayer of that position and considering any response from them
- quantifying the impact of any identified issues on the taxpayer's tax liabilities, and
- communicating the audit outcomes to the taxpayer by letter and in person.

The aim of a specific issue audit is to:

- assess the taxpayer's understanding of the tax implications in relation to the risk area(s)
- determine the functionality of the taxpayer's accounting and reporting systems in relation to the risk(s)
- address the identified risks and take appropriate action
- help the taxpayer to comply with their tax obligations, and
- encourage voluntary compliance.

Form audit (GST)

The form audit uses a range of audit tests to verify that the business activity statement (BAS) accurately reflects the business's tax obligations. It is typically limited to one tax period.

A form audit involves testing the:

- systems and accounting processes used to generate the tax information
- form preparation process to ensure the correct financial information is recorded on the BAS, and
- transactions to ensure they are correctly disclosed on the BAS.

The aim of the form audit is to:

- assess the business's understanding of its tax obligations
- determine the ability of the business's accounting systems and processes to generate a correct reporting document
- address the identified risks and take appropriate action
- determine whether the business is achieving an acceptable level of compliance
- educate the business to help it comply with its tax obligations, and
- encourage voluntary compliance.

Comprehensive audit (income tax and GST)

Where our risk assessment activities identify multiple issues that require further investigation we will undertake a comprehensive audit. This is designed to assess the business's overall compliance with its tax obligations over more than one tax period. The scope of the audit will vary on a case by case basis, depending on risk assessment, structure and nature of the taxpayer's operations.

Comprehensive audits are generally issues based, i.e. the focus of an audit will be on specific issues. Examining those issues may involve making enquiries of a number of taxpayers who fall within a corporate group. Enquiries may also be made of third parties.

The nature of the audit activities is driven by the need to determine the business's overall level of compliance and may involve any number of risks being examined.

A comprehensive audit typically involves the following steps:

- determining the scope of the audit, planning the audit and discussing the plan with the taxpayer
- gathering information to ascertain whether a compliance issue exists
- determining our position on identified issues, advising the taxpayer of that position and considering any response from the taxpayer or their advisers
- quantifying the impact of any identified issues on the taxpayer's tax liabilities, and
- communicating the audit outcomes to the taxpayer by letter and in person.

During a comprehensive audit we may examine some or all of the following:

- the taxpayer's systems, controls and accounting practices
- GST classification of supplies and acquisitions
- the BAS and income tax return preparation process
- related party transactions
- contractual obligations
- financing activities and arrangements, and
- international transactions and arrangements.

The aim of a comprehensive audit is to:

- assess the taxpayer's understanding of their tax obligations
- determine the ability of the business's accounting systems and processes to generate a correct reporting document
- address the identified risks and take appropriate action
- determine whether the taxpayer is achieving an acceptable level of compliance
- help the taxpayer to comply with their tax obligations, and
- encourage voluntary compliance.