Joint Committee of Public Accounts and Audit

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Bi-annual Hearing – 30 April 2008

Question	1
Topic:	Margin Loan Facilities – Opes Prime
Hansard Page:	PA 9-10

Senator WATSON: I will start off with a current issue. I refer to the Opus Prime operation and others which essentially involve margin loan facilities under which money is lent against the value of stock. There are two parts to my question. Often there is a clause in these contracts under which ownership rights are forfeited in the event of a default. When such a situation arises, do not capital gains tax and other taxation issues emerge? You might say that given the collapse of the market there may be losses rather than profits, but, given that generally the stocks that are lent are usually blue chip type stocks and stocks that are traded regularly on the exchange, I can foresee a situation of capital gains. Where does the tax office fit in in relation to that sort of situation? It is obviously going to be a big issue for the tax office, because capital gains would not be just on the margin but on the whole value of the stock, wouldn't they?

Mr D'Ascenzo: I do not know whether Mr Quigley has looked at that issue. I have not looked at that issue.

Mr Quigley—I am sure that we have looked at the issue, but exactly what the technical position is, I am not sure. I would probably need to take that one on notice and get back to you on that. To whom are you suggesting the capital gains accrue?

Senator WATSON: Where a bank takes over the stock and sells it, there is effectively a crystallisation of an event, which gives rise to either a capital gain or a capital loss.

Mr Quigley: I would have thought there would have been a cost base there. I will need to take that on notice.

Senator WATSON: Yes, there has got to be a cost base to determine the quantum of the capital gain or loss.

Ms Granger: Without going into specifics, I think the question of ownership is going to be at issue there—who owns the shares—isn't it? It is a good question; I think we should take it on notice.

Senator WATSON: It is one that, as a committee, we should be across.

Mr D'Ascenzo: And, indeed, if there are many dealings in the stock it will all be on revenue account as well.

Australian Taxation Office response:

Working with partner agencies such as the Australian Securities and Investment Commission and with the administrator, the Tax Office is currently seeking information about Opes Prime's business model. The aim is to identify and understand the tax implications of the different type of arrangements so that the ATO can provide general advice.

If investors in the arrangements wish to gain tax certainty about their individual circumstances they can apply for an individual taxation ruling before or at the time of lodging their tax returns.

In respect of security lending in relation to Opes Prime, the question of whether title transfer has occurred is still before the courts.

However, depending on the circumstances potential tax consequences could arise under:

- Section 26BB or Section 70B of the *Income Tax Assessment Act 1936* (ITAA 1936) (traditional securities)
- Section 26BC of the ITAA 1936 (securities lending arrangements)
- Division 16E of the ITAA 1936 (deferred interest arrangements) or
- Capital gains tax (CGT) (if the dealing relates to a CGT event for the investor).

In respect of post-CGT assets, the cost base of the shares would reflect the cost of the shares when originally acquired and the capital proceeds would reflect the price obtained by the security trustee when it exercised its power to sell less any fees involved.

Generally in margin lending, in the event of default on the loan, the security trustee will sell the shares and - after payment of its own fees and expenses - pay the proceeds of the sale first to the moneylender and the surplus (if any) to the borrower.

There will be different implications for the investor if they are a share dealer or trader.

Certain individuals and parties have been identified as subject to current compliance activities and these processes will continue.

Joint Committee of Public Accounts and Audit

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Bi-annual Hearing – 30 April 2008

Question	2
Topic:	Tabling of Discussion Paper: Outsourcing and Off-shoring (Nov 2007)
Hansard Page:	PA 10-11

Senator WATSON—Yes, that is right. Just to put other members of the committee in the picture, the tax office handles the secretarial work for the Tax Agents Board. Prior to the last election there was a legislative review that got derailed for a number of reasons. I am getting the feedback that there do appear to be elements or problems, in that some agents are finding it difficult to reregister as tax agents. Is this an issue, and how can we overcome it? I will go onto the next thing. An increasing amount of work is being outsourced by tax agents. Some of that is being directed to overseas countries that provide cheap labour and have a well educated workforce. In terms of the tax agents' responsibilities for supervision and control, this is what I am concerned about. This raises these issues. Can the tax office comment, because how can you exercise that close supervision and control when a person may be somewhere in Asia? Does it fit within the concept of what I would call an employer-employee relationship in managing, supervision and control, which I think is required under the act—or certainly under practice? There is also a practice emerging within Australia—and maybe some of this can be overseas—of a service trust, which is actually preparing the tax return. If a service trust exists, is there an employer-employee relationship? You might like to take those issues on notice.

Mr Quigley: I could make some broad observations—that is, under part VIIA of the *Income Tax Assessment Act 1936*, the responsibility for registration and reregistration is actually vested in the board—the various boards. As such, they are the ones that actually make the decisions about whether or not there is sufficient supervision and control, or indeed whether a person is a fit and proper person to be registered as a tax agent. So it is not a decision of the commissioner. It is one of those strange—

Senator WATSON: It is one of those things that is a hybrid.

Mr Quigley—It is in the assessment act, which is why I spelt that out. But parts of that particular area—part VIIA—are not vested in the Commissioner; they are vested in the board. Certainly, issues have been raised through the National Tax Liaison Group and we are having discussions with the chairs of the various boards as well as the NTLG on those types of issues. But, ultimately, the decision is one for the boards to make.

Mr D'Ascenzo: We have tried to assist the boards and the profession by providing a discussion paper that outlines some of those issues—the very issues you raised, and some others—

CHAIR: **Is that tabled?**

Mr D'Ascenzo: ***Yes, we can do that.*** But basically, as Mr Quigley said, ultimately we provided that paper for discussion between the tax profession and the boards, for resolution by the boards.

Australian Taxation Office response:

As requested, a copy of the Tax Office November 2007 Discussion Paper "Outsourcing and off-shoring" is now provided.

The paper was prepared by the Tax Office to promote and facilitate discussion within the tax and accounting profession on the issue of outsourcing of taxation preparation work, including arrangements involving the undertaking of this work off-shore.

While considering the implications these arrangements have for the administration of the tax system, the intent of the paper was also to allow a common understanding of the terminology, of the market and of the business drivers.

The Discussion Paper was tabled at various Industry consultative forums throughout the November to December 2007 period, including the National Tax Liaison Group [NTLG], the ATO Tax Practitioner Forum [ATPF] and the ATO professional associations' CEO forum. The November NTLG was attended by representatives of the state based Tax Agents' Boards.

At the November NTLG, members were asked to provide feedback and contribute further scenarios to the discussion. That feedback, in particular several written submissions, was received and included in further Tax Office review of the issue. This feedback was acknowledged and discussed at the March 2008 meeting of the NTLG.

The Tax Agents' Boards are independent of the Commissioner, but it is noted that a meeting of the combined chairs of the Boards in March 2008 decided to form a working group to further examine issues associated with the outsourcing of tax agent services. The Tax Office has accepted an invitation to participate in this working group.

In progressing the matter the Tax Office is mindful of the Tax Agent Services Bill, and any new arrangements that the new measures may introduce.

DISCUSSION PAPER	FORUMS	5 NOVEMBER 2007	UNCLASSIFIED
FORMAT	AUDIENCE	DATE	CLASSIFICATION

Australian Government
Australian Taxation Office

FILE REF: [FILE NO.]

Outsourcing and off-shoring

A DISCUSSION PAPER –

Please note that this paper does not represent the formal views of the Tax Office or the Commissioner. It has been created for the purposes of discussion only.

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PURPOSE OF PAPER

There has been a growing focus on the globalisation of various services both within the accounting and tax agent environment.

The purpose of this paper is to promote discussion and allow consistent understanding of terminology, market and business drivers and consequences.

This discussion paper provides an overview of:

- the current landscape of both the global and domestic outsourcing market for finance and accounting;
- potential compliance issues with outsourcing tax compliance services as it relates to Part VIIA (Registration of tax agents) of the *Income Tax Assessment Act 1936* (ITAA36); and
- certain scenarios which may constitute potential risks for taxpayers, the Australian tax profession and the Tax Office.

KEY TERMINOLOGY

'Outsourcing' and 'off-shoring' are used interchangeably in public discourse, but there are important technical differences.

- **Outsourcing** is the movement of internal business processes to an external entity contracted to carry out the business processes. Outsourcing may or may not involve some degree of 'off-shoring'.

- **Off-shoring** is the transfer of an organizational function to another country, regardless of whether the work is outsourced or stays within the same corporation. Almost always work is moved due to a lower cost of operations in the new location.[1]

> **Examples**
> A company moving an internal business unit from one country to another would be off-shoring, but not outsourcing.
>
> A company subcontracting a business unit to a different company in another country would be both outsourcing and off-shoring.

- **FAO** – Finance & Accounting Outsourcing (i.e. processes in the finance and accounting industry which vary from low-skilled processes such as accounts payable and billing to higher-level analytical and strategic skills such as financial analysis, audit, financial planning, consolidations etc).[2]

BACKGROUND

The Australian tax profession has indicated that it would like the Tax Office view and/or guidelines on a variety of scenarios in relation to outsourcing of accounting and tax compliance services (particularly outsourcing overseas).

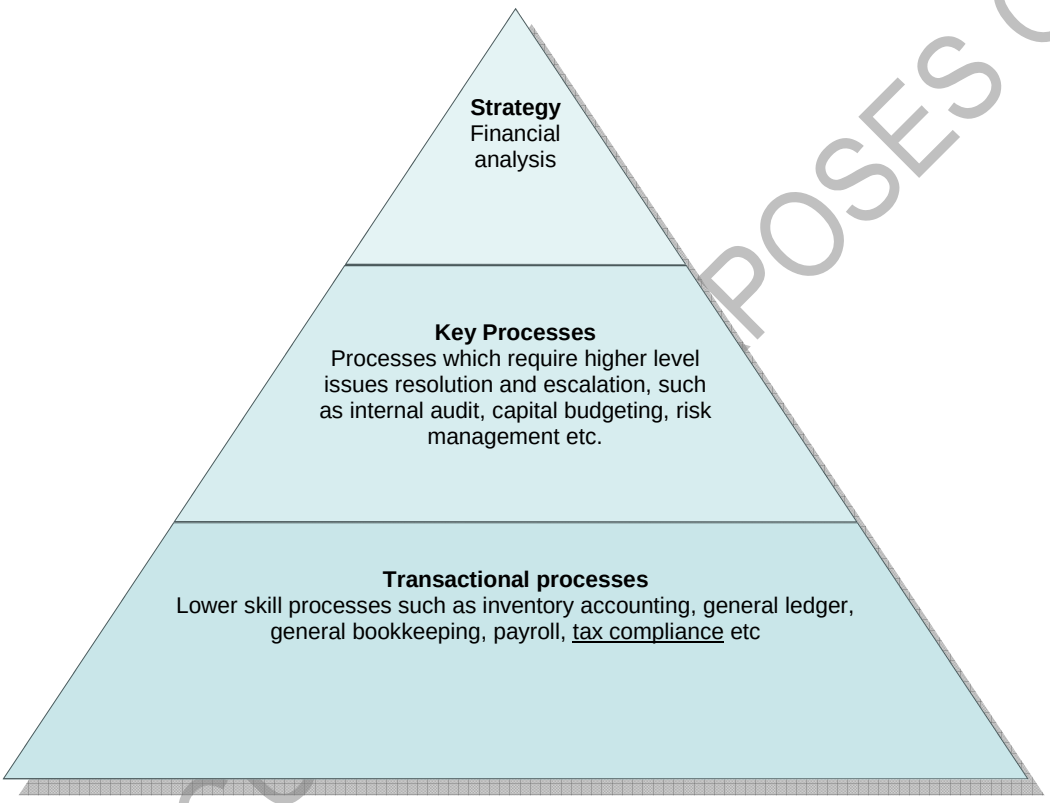
[1] Refer to *Wikipedia* on 'Outsourcing' and 'Offshoring', **http://en.wikipedia.org/wiki/Outsourcing** and **http://en.wikipedia.org/wiki/Offshoring**.
[2] Fahy, Martin and Fuller, Chris, "Wheels of Change", *Excellence in Leadership*, 2007, (full reference unknown, sourced from author).

Furthermore, concerns were raised by the Australian National Audit Office (including warnings from the Auditor-General) of possible risks to the integrity of the Tax Office systems in the context of tax agent services performed abroad.

Finance and accounting outsourcing (particularly off-shore outsourcing) is a fully fledged billion dollar global industry. A number of both the global market leaders and emerging contenders have noted that their services include *tax management*, or *tax compliance services*. There is an apparent level of secrecy around global finance and accounting outsourcing deals, thought mainly to be due to concerns for community confidence/acceptance of off-shore outsourcing as well the desire to try and maintain a competitive advantage.[3]

WHAT TYPES OF PROCESSES ARE BEING OUTSOURCED GLOBALLY?

Essentially, the three categories of finance and accounting processes have been characterised as follows:[4]



Currently, over 85% of the global finance and accounting off-shore outsourcing workforce is distributed across labour-intensive transactional processes. However, outsourcing in the finance and accounting industry has evolved from outsourcing *basic tasks* to *key processes* integral to a company's business, and is now currently progressing towards both *end-to-end processes* and *knowledge-intensive key processes*.[5]

[3] At page 16, FAO Today Staff, "The Lucky 13", *FAO Today*, May/June 2007.
[4] At page 4, "*Finance & Accounting Outsourcing (FAO) – Annual Report*", Everest Research Institute, December 2006.
[5] Fahy, Martin and Fuller, Chris, "Wheels of Change", *Excellence in Leadership*, 2007, (full reference unknown, sourced from author).

KEY DRIVERS FOR OFF-SHORE OUTSOURCING OF FINANCE AND ACCOUNTING SERVICES

- Reported shortage of accountants and decreasing numbers of students entering into accountancy-based education courses;
- High domestic salary expectations/rates;
- Operational cost savings;
- Avoidance of capital expenditure on process-based improvements and technology upgrades;
- Access to service provider's intellectual property capital, best practices etc;
- Measurement of performance management and services;
- Increased controls and accountability (due to processes being core expertise of FAO organisation with centralised management);
- Enables tax professionals to focus on growth, front end support to clients and higher end work (i.e. financial planning);
- Potential to expand business without increasing staff / space / infrastructure investment;
- No human resources issues like recruitment / health insurance / staff discipline / attendance / overtime etc.;
- Timely delivery of services; and
- In many cases, services are provided around the clock (24 hours), significantly improving turnaround times and management of workload peaks.

OFF-SHORE OUTSOURCING HUBS

Countries with large accounting graduate pools, lower salary expectations, English language skills and satisfactory infrastructure are the destinations of choice for finance and accounting off-shore outsourcing. Currently, the main off-shore outsourcing hubs are:

- India
- Mexico
- Vietnam
- Eastern Europe
- China
- Africa

THE LANDSCAPE OF OFF-SHORE OUTSOURCING OF AUSTRALIAN TAX AGENT SERVICES

Outsourcing of income tax return preparation and BAS services is not a new phenomenon in Australia. The beginnings of outsourcing started in the 1990s with some tax agents contracting external Australian companies to 'key-in' their clients' tax returns.

The tax profession then began to witness the rise of BAS service providers, an industry change brought about by increasing workloads with registered tax agents for heavy transaction-based work.

As a consequence of the new tax system section 251LA of the ITAA36 was enacted to define 'recognised professional associations' (RPAs) for the purposes of section 251L(6), which allows either members of an RPA or bookkeepers working under the direction of registered tax agents to provide BAS services on behalf of taxpayers.[6]

[6] Clauses 2.3 and 2.4 of Chapter 2, Explanatory Memoranda to *A New Tax System (Tax Administration) Act (No. 2) 2000*.

The largest accounting and consulting firms in Australia pioneered 'off-shore' outsourcing of tax preparation and other accounting services. The tendency has been for large companies to make use of low cost processing centres based in Singapore, Malaysia and Macau for finance and administrative processes, particularly payroll tax. These centres hold and manage the companies' data banks of payroll tax information (which includes the Australian employees' tax file numbers and personal information).[7]

It has become evident that in the last five years, many smaller firms within Australia have followed suit with a number of Australian tax agents seeking to gain a competitive advantage from off-shore outsourcing.

A SAMPLE OF REAL SCENARIOS IDENTIFIED TO DATE

The Tax Office is aware of numerous off-shore outsourcing arrangements being entered into by Australian tax agents.

To date, examples of the types of outsourcing scenarios occurring are as follows.

Scenario 1

Arrangement
A tax agent establishes an Australian company which engages a 'partner' company based and incorporated in India which is staffed by local accountants. Some of the local accountants have Australian accountancy qualifications; some have qualifications from other jurisdictions. The partnership is NOT a registered tax agent.

The tax agent promotes the provision of tax outsourcing services (including preparation of returns) to other Australian tax agents and chartered accountants the basis of paying a regular fixed fee for a fixed number of 'consultation hours'.

Process
The Indian accountants access a secure server maintained by the Australian company in order to access client information which the client tax agent has previously uploaded and prepare returns.

The various Australian tax agents' clients are not made aware that their personal tax information is being accessed and prepared by overseas accountants.

Once the returns are completed, the Indian accountants upload the returns onto the secure server. The completed returns are then reviewed by tax agents within the Australian company and lodged through ELS.

Scenario 2

Arrangement
An Australian company employs individual Australian-qualified accountants in various off-shore hubs including India, Malaysia, and Singapore. The Australian company promotes its outsourcing services to Australian tax agents on the basis that 45% of the Australian tax agent's fee for tax services obtained from the client be paid to the outsourcing entity. The Australian company is NOT a registered tax agent.

[7] Hidalgo, Steve; Mason, Stef and van Beesten, Marijke, "The Global Market for Tax Outsourcing", *International Tax Review*, (date unknown).

Process
The Australian tax agent downloads and completes a client checklist and instructions for every job sent. The tax agent then scans in any documentation required for completing the tax services and uploads the files to a secure server. The overseas-based accountants log onto the server to access the information and prepare the returns.

Once the job has been completed, the overseas-based accountant sends an email to the Australian tax agent notifying them that their job has been completed and is ready for uploading into the tax agent's practice software before lodging through ELS.

Scenario 3

Arrangement
A number of Indian-based and incorporated companies are attempting to solicit partnership arrangements or mergers with Australian registered tax agents.

Below is an example of a solicitation letter forwarded to various tax agents.

To,
The Director
XXX Accountants
Australia

Dear Sir,

Sub: A Win-Win Business Proposal

We refer to our proposal for collaboration in the area of business accounting to provide back office support (please refer below). We hope you are reviewing the same. In this connection, we would like to highlight some of the benefits which can help you to take decisions faster.

1) With Smart outsourcing, you will make more money and expand your business without increasing staff / space / infrastructure investment.
2) Reduce operation cost, which in turn will improve margins.
3) No HR issues like recruitment / health insurance / staff discipline / attendance / overtime, etc.
4) Delivery in time with quality resulting in better customer satisfaction.

Further to this, we also have one more interesting business opportunity if you are looking for growth and expansion of your business.

We can join you as a partner or we can have merger to expand our business. You can concentrate on growth and front end support to the customers. We will handle back office activities which will be out sourced to India. We understand that your serious concern would be of security of data and quality of work. You can count on us as we are already providing back office support to 200 CPAs in UK and they are highly satisfied with our quality of work and security of data.

This will be a win-win situation for both of our organization in terms of growth and rewards.
We look forward to have your positive reply to take our business relationship further

Best Regards

XXX

(Business Executive)

Process
Not yet determined.

Scenario 4

Arrangement
A number of Indian-based and incorporated companies are attempting to solicit contracts with Australian tax agents for outsourcing of tax services, including tax return preparation.

Below is an example of a solicitation letter forwarded to various Australian tax agents.

Dear Sir

Our Proposal:

Our client - XXX is one of the leading BPO Chartered Accountancy Firm in India having Corporate headquarters in UK. XXX is currently providing back office accounting & taxation services to over 200 Chartered Accountancy Firms in UK & have been preparing Accounts & Audits for Top 20 Firms in Africa. They now have the infrastructure to provide their services globally

XXX has a staff of 300 accountants with 35 Chartered Accountants. XXX works on their client's account files based on the specified accounting standards, using internationally acclaimed softwares like IRIS, SAGE, CCH, VT, Digita, Viztopia, MYOB, TAS, Quickbooks, etc.and are also capable to work on any business accounting software.

XXX has 3350 square metres fully equipped office. They can work directly on client CPA/CA's server and also through Virtual Private Network.

XXX is providing following Sub-contract / Outsourcing services:

1. Year End Accounts
2. Management Accounts
3. Book-keeping
4. Taxation:
5. VAT
6. Payroll

Unique capabilities of XXX:

- High Quality, error free and consistent work
- Timely delivery schedules
- Understanding client's local accounting standards, procedures and requirements
- High work quality / cost ratio

We look forward to a long term collaboration with high growth potential and ambitious company like yours. We envisage A WIN WIN PROPOSAL of working together as business partners.

A FREE trial of 2 sets of Accounts / 2 tax returns / 2 payroll can be done for you, with no obligation thereafter. This will serve as our proof of capabilities and create confidence in outsourcing your

confidential work to us. We can also help you in marketing your services, if desired once we decide to collaborate with each other.

We can provide further information based on your interest. Please feel free to ask questions.

It is our strong desire to collaborate with a fine company like yours. Looking forward.....

Process
The process for provision of outsourced services as offered above, usually involves one the following three systems:

- email-based system – data is transferred through encrypted email;
- Secure server-based system – uploading and downloading of data on the outsourcing provider's server using SSL; or
- Remote access based system – software installed on the client tax agent's system that allows remote access to the outsourcing provider's internal system. The tax agent logs onto the outsourcing provider's system and transfer files directly.

Some Australian tax agents advised that they 'white/blank out' identifying details of clients (e.g. names and addresses) so as to facilitate secure transmission of client data and ensure confidentiality.

Scenario 5

Arrangement

There are a couple of known cases in which unregistered tax agents based in other countries, provide tax agent services to foreign entities with interests in Australia as well as Australian expatriates. The clients engage these providers within their country to prepare and lodge income tax returns and related business on their behalf.

It may be that some of these tax agents wish to be registered tax agents and would be otherwise qualified and entitled to be registered but for the fact that they do meet the requirement of having an Australian-based place of business.

Scenario considerations

These various outsourcing scenarios illustrate that off-shore outsourcing of Australian tax services may be structured/implemented in a variety of ways. Consequently, the question is raised as to whether any such arrangements are consistent with the requirements of Part VIIA (Registration of tax agents) of the ITAA36.

Where off-shore outsourcing providers are engaged for the provision of most transactional accounting services (such as inventory accounting, general ledger, bookkeeping and payroll), there is a low risk of any inconsistency with the provisions of Part VIIA of the ITAA36. For example, under these provisions, to provide BAS services a person need only be either a member of a recognised professional association or 'work under the direction' (which is broadly construed) of a registered tax agent.

However, when off-shore outsourcing providers are engaged for preparation of returns (and other income taxation business) there are strict regulations in force with respect to who may perform such tax agent services.

Many arrangements which may not be compliant could be brought into line in this respect by either ensuring the relevant off-shore outsourcing provider is registered as a tax agent, or that the overseas

individuals providing the services are directly employed by a registered tax agent. However, the main sticking point for most off-shore outsourcing providers is ensuring appropriate '*supervision and control'* over those providing tax agent services.

Of the off-shore outsourcing arrangements which the Tax Office is aware of to date, intelligence suggests that none of the off-shore outsourcing providers have a registered nominee on-site where preparation of income tax returns and related services are carried out.

It should be noted, that there are some cases where the Australian taxpayer directly contracts the tax agent services of an unregistered preparer based overseas.

OFF-SHORE OUTSOURCING ARRANGEMENTS – COMPLIANCE WITH PART VIIA OF THE ITAA36

Arrangements which involve off-shore outsourcing of preparation of returns (and other income taxation business) must be considered in reference to the provisions of section 251N of the ITAA36.

Section 251N of the ITAA36 prescribes that a registered tax agent must not allow any person to prepare income tax returns or transact taxation business on their behalf unless:

- the person is the registered tax agent's employee; or
- the person is a registered tax agent; or
- if the tax agent is a partnership, the person is a member of the partnership;

and only then under the '*supervision and contro*l' of the registered tax agent or a registered nominee of the registered tax agent.

WHAT CONSTITUTES AN '*EMPLOYEE*' FOR THE PURPOSES OF PART VIIA?

Unfortunately, the ITAA36 does not define '*employee'*. The ordinary meaning of 'employee' has been the subject of a substantial amount of judicial consideration. Whilst the judiciary have noted a number of indicators which may be indicative of an employment relationship, there is no exhaustive list. No one indicator in itself is determinative in all situations, as each case must turn on its own full set of facts.

Whilst the Tax Office has released various relevant rulings which discuss the characterisation of a working relationship for particular purposes, there is currently no general position or settled view as to what constitutes an employment relationship. There are a couple of '*employee vs. contractor*' calculators on the ATO web-site which have been developed to assist taxpayers in coming to an indicative view for tax purposes.

In context of the subject of off-shore outsourcing and the scenarios outlined above, it is important to note that a company cannot be 'employed', it can only be 'contracted'.

WHAT CONSTITUTES APPROPRIATE '*SUPERVISION AND CONTROL*' FOR THE PURPOSES OF PART VIIA?

There is an extremely limited amount of specific precedent available on what constitutes appropriate 'supervision and control' by a tax agent over their employee. In 1988, the Administrative Appeals Tribunal (AAT) laid down some guiding principles in their decision in *Re: S. & T. Income Tax Aid Specialists Pty Ltd and Christopher Forward and Tax Agents' Board, New South Wales, No. N86/255 and N86/256 AAT No. 3364:*

1 Supervision and control of employees involves more than simply a final checking and signing of returns prior to lodgment. It requires supervision and control of the process of return preparation and the transaction of other client income tax business.
2 Supervision and control obligations on tax agents and nominees should at least include:

- spot-checking of the original information upon which returns are based (such as receipts);
- supervision of the work conducted within the tax agent's practice (such as sitting in on interviews and being available to answer queries); and
- substantial supervision and control while the agent's office is open to transact tax business.

It is important to note that the AAT decision was made in 1988, being prior to the use of the internet, electronic communications and mobile telephones, which are widely (if not predominantly) used in this day and age to conduct business. However, the above guiding principles on appropriate supervision and control have remained the accepted view not only of the State Tax Agents' Boards (TABs) but also the Administrative Appeals Tribunal, with the more recent case of *Scott v Tax Agents' Board of Queensland 2001 ATC 2218* affirming these principles as being considered the minimum requirements.

In light of the considered opinion above, the question arises as whether adequate supervision and control can be exercised when the income tax returns and related transactions are being prepared on another continent? This is the key question at hand which will become the subject of much debate.

POTENTIAL RISKS ARISING FROM OFF-SHORE OUTSOURCING OF TAX AGENT SERVICES

TAX AGENT PORTAL ACCESS

- Some tax agents have given their User ID and password to outsourcing entities and some tax agents have applied for secondary digital certificates for (and received) off-shore outsourcing entities (which were not their employees).
- Usage of the Tax Agent Portal is not actively policed nor does the Tax Office verify that those who receive secondary certificates are in fact employees of the primary registered tax agent. The application process by which tax agents apply for secondary digital certificates is a self assessment system and the Tax Office has previously relied on the integrity of tax agents to register only their employees as holders of the secondary digital certificates.
- Use of the Tax Agent Portal by off-shore outsourcing entities is of significant concern due to the potential for exploitation of the detailed taxpayer information available for both view and modification. Very serious fraud and identity theft crimes could be committed through using and changing taxpayers' details within the Tax Agent Portal.

PRIVACY/CONFIDENTIALITY

- Whenever confidential financial data, particularly tax file numbers is transmitted electronically there is always a chance that the information could fall into the wrong hands, whether hijacked on the net by a hacker, or fraudulently used by persons on the receiving end. The issue becomes more important where the recipient of the information resides in another national jurisdiction, because Australian privacy laws will not apply in the foreign jurisdiction.
- Tax agents should not disclose any confidential client information to another party without the specific consent of the client (unless compelled by law to do otherwise). Clients should be informed up front (whether through a retainer letter or in a privacy statement) that the tax agent may use third-party service providers, including whether those third party providers are local or overseas.
- In terms of outsourcing of tax compliance work, generally the disclosure of personal information and tax file numbers to a third party provider relates to the primary purpose for which the information was collected (preparation of income tax returns and provision of accounting services) which falls within the respective exemptions of the *National Privacy Principles* (NPPs)

found in the *Privacy Amendment (Private Sector) Act 2000, Tax File Number Guidelines* and section 8WB of the *Taxation Administration Act 1953* (TAA53).

- Interestingly, outsourcing contracts which the Tax Office has seen to date between Australian tax agents and off-shore outsourcing providers, contain clauses which stipulate that client data remains the property of the outsourcing tax agent and all obligations with respect to Australian Privacy Laws remain with the outsourcing tax agent.

SECURITY/IDENTITY THEFT/FRAUD

- A tax agent is responsible for the actions of their staff and liable for their actions. However, when processes are transferred to an outsourcer, the outsourcing entity and their staff are not directly responsible to the tax agent. This causes legal, security and compliance issues which need to be addressed through the contract between the tax agent and the outsourcing entity.
- Potential identity theft and fraud are specific security issues and it can be argued that fraud is more likely to occur when outsourcers are involved due to a lack of 'nexus' between the parties.
- These issues are further exacerbated when dealing with off-shore outsourcing entities as any necessary recourse is limited to the contract provisions and the jurisdiction governing the contract (which in some circumstances, depending on the relevant contract clause, may be the country in which the outsourcing entity is based).
- An example is the high profile case involving Citibank in April of 2005. Citibank workers in India (employed by an outsourcing services company) were arrested on charges of defrauding four Citibank account holders living in New York, for the amount of $350,000. The call centre workers acquired the passwords to customer accounts and transferred the money to their own accounts opened under fictitious names. Citibank did not find out about the problem until the American customers noticed discrepancies with their accounts and notified the bank. Citibank made a complaint to local authorities who arrested the call centre workers on charges of fraud.[8]

DOCUMENT REPATRIATION

- There are a number of potential risks and issues which arise with respect to record-keeping and management of taxpayer data held by off-shore outsourcing providers.
- "A taxpayer's record keeping obligation is personal to them and cannot be shifted by their tax agent entering into a contractual arrangement with an outsourcing provider. These record keeping obligations include a requirement that the records be readily accessible to the Tax Office. This would mean that a taxpayer should be able to, if requested by the Tax Office, produce records within a reasonable time no matter where in the world the records are kept and by whom.[9] The consequences of not keeping records and making them available include possible prosecution and vulnerability in any tax dispute with the Tax Office."[10]
- Potential scenarios which may make document repatriation difficult are:
  i. Off-shore outsourcing provider goes into liquidation;
  ii. Off-shore outsourcing provider has not paid their web hosting fees, and the web-host blocks access to the online server due to the fee dispute; or
  iii. Off-shore outsourcing provider exercises a '**lien'** over client documents in respect of unpaid fees.

[8] Ribeiro, John, "Indian call centre workers charged with Citibank fraud", 7 April 2005, Computerworld, http://www.computerworld.com/securitytopics/security/cybercrime/story/0,10801,100900,00.html
[9] Refer to section 262A and section 263 of the ITAA 1936.
[10] Dwyer, Peter, "*Non-binding Discussion Paper – Electronic record-keeping – outsourcing and use of websites*", 2007, Australian Taxation Office.

LIENS - CAN AN OFF-SHORE OUTSOURCING PROVIDER HOLD A LIEN OVER A CLIENT'S RECORDS FOR UNPAID FEES?

- A lien is a form of security. Under Australian law it is a common law right which permits person 'A' to retain the property of person 'B' until person 'B' satisfies an outstanding debt to person 'A'. So in the context of the tax profession, a tax agent may be engaged by a client to prepare an income tax return. If the client refuses to pay, the tax agent may (subject to certain criteria and exceptions) be entitled to 'exercise a lien' over the documents until payment is made.
- The criteria for determining when a tax agent has the right to exercise a lien over a client's documents is not straight forward and care should be taken before exercising a lien as an improper exercise of a lien may result in disciplinary action (not to mention a potential law suit instigated by the client). Most recognised professional associations do not encourage members to hold documents in lien over unpaid fees.
- There are a number of instances in which third parties have a right to possess the relevant documents despite a lien. The Commissioner of Taxation is one such third party, having the power to serve a notice on the tax agent requesting the accountant to produce any of the client's documents in their possession. An Australian tax agent is subject to the laws and regulations of Australia, and so in most cases will comply for fear of penalty.
- However, accountants in overseas outsourcing centres need have little concern for the Australian Commissioner of Taxation's notices as they are not subject to the Australian jurisdiction. Therefore the possibility exists that an off-shore outsourcing provider may hold a lien over client documents where there are any outstanding payments.
- Potentially, there may not be a high risk of such action being taken, given that it would not encourage repeat or referral business, which it appears many off-shore outsourcing providers rely on, but it remains a risk to the taxpayer, the tax agent and the Commissioner.

POTENTIAL LIMITING OF ENTRY-LEVEL EXPERIENCE FOR LOCAL ACCOUNTANTS

- Given that off-shore outsourcing currently is primarily with respect to transactional processing, there is the potential in the long-term for outsourcing to limit the tax preparation experience of entry-level accountants.[11]
- New and junior accountants in Australian offices which outsource transactional tax compliance work may require new or further training to replace the lost experience in preparing income tax returns. New tax professionals may take longer to understand and appreciate the tax effects of transactions "because they will miss the learning that takes place when someone actually works with and comes to understand the internal logic of the forms."[12]

POTENTIAL FOR EVEN LESS LOCAL ENTRANTS TO THE TAX PROFESSION

- If off-shore outsourcing of transactional compliance work becomes the commercial choice of current tax agents, potential entrants to the tax profession may be put off by a perception that there will be little opportunity for them with the bulk of tax work being outsourced overseas to cheaper labour markets.

SUB-CONTRACTING OUT OF OUTSOURCED SERVICES

- Unless sub-contracting is prohibited by agreement through specific clauses in an outsourcing contract (or employment agreement if the services are being provided by overseas employees), there is a risk that during peak periods, an Australian tax agent's work may be sub-contracted out by the primary outsourcing entity to another off-shore outsourcing provider (possibly without the tax agent's knowledge) so as not to lose long-term customer patronage.

[11] Robertson, Jesse; Stone, Dan; Niederwanger, Liza; Grocki, Matthew; Martin, Erica and Smith, Ed, "Offshore outsourcing of tax-return preparation", *The CPA Journal*, June 2005.
[12] Robertson, Jesse; Stone, Dan; Niederwanger, Liza; Grocki, Matthew; Martin, Erica and Smith, Ed, "Offshore outsourcing of tax-return preparation", *The CPA Journal*, June 2005.

- The risk of sub-contracting may be quite high given India's recent employee attrition rates and the fluidity of their outsourcing labour force. This is of particular concern in light of the supervision and control requirements on an Australian tax agent as currently in force.

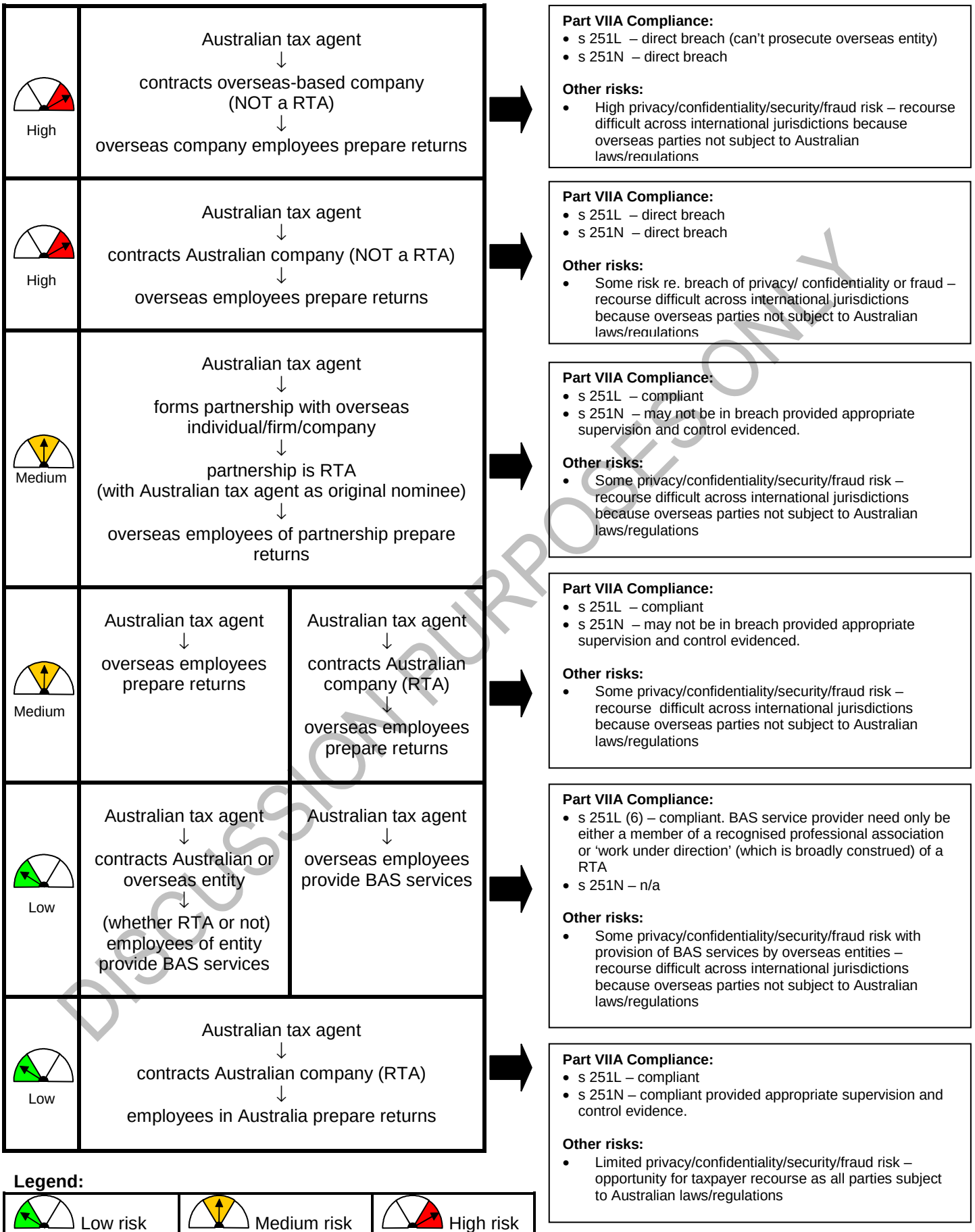
OFF-SHORE OUTSOURCING ARRANGEMENTS – POENTIAL LEVELS OF RISK

Attached as **Appendix 1** is a snapshot diagram of various possible off-shore outsourcing arrangements that placed on a scale of risk. The level of risk is determined in light of:

- whether the arrangement complies with Part VIIA; and
- potential privacy/client data integrity issues.

The 'levels of risk' diagram qualifies each example by stating that the off-shore outsourcing arrangement may be consistent with Part VIIA of the ITAA36 provided appropriate 'supervision and control' evidenced. What is appropriate 'supervision and control' is a matter for the TABs.

OUTSOURCING TAX AGENT SERVICES – LEVELS OF RISK



Legend:

Low risk	Medium risk	High risk

RTA – Registered tax agent
s 251L ITAA36 – Unregistered tax agents not to charge fees for tax services
s 251N ITAA36 – Preparation of returns on behalf of tax agents may only be done by their employees or other tax agents; tax agent must maintain supervision and control over those persons preparing tax returns on their behalf.

Joint Committee of Public Accounts and Audit

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Bi-annual Hearing –30 April 2008

Question	3
Topic:	Tabling of ATO / Treasury Protocol
Hansard Page:	PA 19

CHAIR: But you have signed a new protocol with Treasury regarding advice. Are you able to table a copy of that protocol?

Mr Quigley: Yes. It is on both our website and the Treasury website but we can certainly provide it to the committee.

Mr D'Ascenzo: Yes, we will provide it to the committee.

CHAIR: Is it different in aspects that are important?

Mr Quigley: It spells out, more than the previous one, what the various responsibilities of the two agencies are. One I should pick up on, because Mr Neumann talked about litigation, is it is always our interpretation—Treasury do not say to us, 'The law says this.' The shoe is on the other foot; we advise Treasury of what our interpretation of the law is. But we may at times, as Mr D'Ascenzo implied, ask them: 'What was the original policy here?' because if we are faced with two alternative interpretations, for instance, we will look to see whether we will be able to interpret the law consistent with what the policy position is, and that is what we attempt to do.

Australian Taxation Office response:

A copy of the ATO/Treasury Protocol is attached. The protocol can be found on the Tax Office website at:

http://atogovau/print.asp?doc=/content/31659.htm

A T O home

Review of the ATO/Treasury protocol

This protocol provides an agreed framework for working arrangements between the Treasury and the Australian Taxation Office for delivering advice to government on tax policy and on the design and development of legislation and related administrative guidance material and products to implement the government's policy. This protocol covers all laws administered by the Commissioner of Taxation and is also relevant to the Commissioner's role as Registrar of the Australian Business Register.

Objectives of the tax design process

The objectives of the tax design process are to provide the government with the best possible advice for making tax policy decisions, as well as producing law and administrative products that give effect to the policy intent set by the government in a way that meets the needs of users of the tax system.

Tax policy, legislation and administration are integrally related and interdependent. Recognising this, the tax design process aims to ensure that the administrative, compliance and interpretive experience of the Tax Office fully contributes to those policy and legislation processes and that there is a high level of integration across the policy, legislative and administrative aspects of tax changes.

Roles of both agencies in the tax design process

Treasury, through its Revenue Group, has primary responsibility for advising on tax policy and the design of tax laws.

The Commissioner of Taxation, as statutory head of the Tax Office, is responsible for the interpretation and administration of tax laws.

Treasury and the Tax Office will work cooperatively to provide high quality advice to the government on tax system issues, consistent with the integrated design approach outlined above. Subject to government and legal requirements, both agencies will share information at all stages of the process.

Tax Office and Treasury responsibilities

In designing new tax policies and laws

In meeting its accountability for advising on tax policy, Treasury formulates and provides advice to government on options, prepares official costings, and produces regulation impact statements where required.

In designing tax laws, Treasury is responsible for:

- instructing legislative drafters
- producing explanatory materials
- conducting community consultation on tax policy and draft legislation, in accordance with government requirements
- managing the legislation program, and
- assisting the government to secure passage of Bills through the Parliament.

The Tax Office contributes its views and experience to all stages of the tax policy and legislation design process. To meet this accountability and role in the law design function, the Tax Office will provide advice to Treasury on:

- the administrative and interpretive aspects of tax design;
- material that may form the basis of official costing of tax proposals, including administrative costs and the compliance implications of policy advice; and
- issues that emerge through its experience in administration, including compliance costs and other issues that may arise for taxpayers in complying with proposed tax laws.

To the extent that interpretation of proposed legislation is required prior to enactment, Treasury will provide the Tax Office with the policy intent and outcome intended in relation to a particular matter, and the Tax Office will provide its views as to whether the provisions achieve that end, recognising that, formally, it is the Office of Parliamentary Counsel which is to be satisfied that legislation is legally effective to implement government policy.

Advice to the Minister

Treasury and the Tax Office will seek to reach agreement on tax policy and legislation matters wherever possible. Where agreement cannot be reached, Treasury will ensure that the Tax Office view is provided to the Minister in a form agreed by the Tax Office, or the Tax Office may advise the Minister separately in consultation with Treasury.

For enacted law

The Tax Office has the role of interpreting enacted tax law (subject to the courts) in order to administer them.

In forming its view on the interpretation of enacted law, the Tax Office routinely consults Treasury, the

professions, affected taxpayers and the public.

Circumstances in which the Tax Office may consult Treasury during the course of its interpretation of enacted law include:

(i) *Where more than one possible interpretation is open.* In these circumstances the Tax Office may invite Treasury's comments on the purpose or object of the legislative provisions in question.

(ii) *Where, having settled on its interpretation, the Tax Office is concerned that the law may give rise to unintended consequences, for example, unnecessary compliance costs or inappropriate outcomes.* In these circumstances the Tax Office may notify Treasury and Treasury may advise the Minister accordingly, or the Tax Office may advise the Minister directly in consultation with Treasury where appropriate.

What weight can be given to Treasury's views on purpose or object?

Any comments Treasury provides to the Tax Office are not determinative. The Tax Office can, nevertheless, consider Treasury's view along with the views of other stakeholders in arriving at an interpretation which, as far as possible, is consistent with the purpose or object of the law, given the words of the law and its statutory context.

Communications between the Tax Office and Treasury on tax and superannuation matters are confidential as they are, effectively, in the nature of communications between an agency and the government.

To facilitate the purposive approach to interpretation, when developing legislation and treaties, Treasury will seek to ensure the purpose or object of provisions is explicitly outlined on the face of the law or tax treaty and reinforced in publicly available extrinsic material, such as explanatory memoranda and second reading speeches.

Advice to the Minister

The Tax Office will advise the Minister on administration matters in consultation with Treasury.

Monitoring and review of protocol

The Taxation Policy Coordination Committee (TPCC), comprising senior leadership of each agency, will oversee the operation of this protocol. The TPCC will review the protocol from time to time, and may agree to amend it at any time for the benefit of effective working relationships.

A Tax Office and Treasury Liaison Committee will monitor work flows between the agencies. Both

agencies will further develop and enhance the design of tax laws and provide the underlying working mechanisms to support this protocol.

Related materials

- Tax Office Practice Statement Law Administration PS LA 2004/6
- Tax Office Practice Statement PS CM 2003/14 (CGR) Provision of Formal ATO Advice to Treasury

Last Modified: Tuesday, 25 March 2008

Joint Committee of Public Accounts and Audit

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Bi-annual Hearing – 30 April 2008

Question 4

Topic: Update on Mr Petroulias

Hansard Page: PA 24

Senator WATSON: Could you give us the progress in relation to the Petroulias prosecution?

Mr D'Ascenzo: I haven't followed it recently!

Ms Granger: I think it is still before the court.

Mr D'Ascenzo: I think it went through court.

Ms Granger: It is still before the court.

CHAIR: If it is still before the court then there is a restriction on what we can do.

Senator WATSON: There has been a big issue concerning the tax office's administration.

Ms Granger: ***We will take that on notice and see what we can say.***

CHAIR: I think that might be the right approach.

Australian Taxation Office response:

The Commonwealth Director of Public Prosecutions (CDPP) is responsible for the prosecution of Mr Petroulias. The Tax Office has provided administrative assistance and litigation support to the CDPP throughout the prosecution.

Mr Petroulias joined the Tax Office in 1997 from private practice.

He was charged on 24 March 2000 in relation to favourable tax rulings issued by him to tax scheme promoters. He was charged with:

- defrauding the Commonwealth
- corruption; and
- unauthorised publication of tax office information.

The three matters first came to trial before Justice Sully in the Supreme Court of NSW in April 2005 which resulted in a hung jury in August 2005.

The CDPP decided to conduct a re-trial of the matter in the Supreme Court of NSW before Justice Johnston which resulted in an aborted trial in May 2007 following the discharge of the jury due to the empanelment of a disqualified juror.

A third trial before Justice Johnston in the Supreme Court of NSW commenced in June 2007. On 17 December 2007, the jury returned a guilty verdict on two of the three charges relating to corruption and unauthorised publication of Tax Office information.

On 18 December 2007, the jury was not able to reach a verdict on the charge relating to Defrauding the Commonwealth. The jury was then discharged.

Mr Petroulias was admitted to bail but required to comply with strict bail conditions. Sentencing was to occur on 28 March 2008 but was adjourned to 16 May 2008 and 23 May 2008 and continued the following week to permit evidence with respect to sentencing to be given. Submissions on sentencing concluded on 30 May 2008 and proceedings were adjourned to 20 June 2008 to allow the matters to be considered and a sentence to be determined by the Judge.

On 20 June 2008, Justice Johnson in the Supreme Court of New South Wales pronounced sentence on Mr Petroulias. Mr Petroulias was sentenced to imprisonment as follows:

- **Corruption:** Head Sentence: one year nine months 20/06/2008 – 19/03/2010
- **Unauthorised publication of tax office information:** Head Sentence: one year eight months 20/12/2009 – 19/08/2011

The sentences will be served partly cumulative giving rise to a total head sentence of **three years and two months imprisonment** (20/06/2008 – 19/08/2011), with a fixed single non-parole period of two years dating from 20 June 2008 to expire on 19 June 2010.

In relation to a related offence of larceny, Justice Johnson remitted the charge back to the Local Court where it will be now up to the CDPP to determine whether or not this charge will be pursued.

Joint Committee of Public Accounts and Audit

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Bi-annual Hearing – 30 April 2008

Question	5
Topic:	Prosecution of Pheonix companies
Hansard Page:	PA 26-27

CHAIR: I am going to allow you to ask that, but I would like to raise some specific things that have come out of our work. I will draw you back to work that we did in our previous hearings in alerting the ATO to the fact that superannuation was not being put aside for ordinary people. When a firm collapsed, they lost it, which was a great deal of money to them but a very small amount in terms of the amounts that you deal with all the time. That work has continued. Special funding was given to you to continue that work. One of the areas in which we see this happening again is in phoenix companies. We have asked you in previous hearings about companies that are serial offenders in terms of phoenixing. We see contractors, particularly in the building and construction industry—as you have alerted us to—along with the employees of these firms, losing a considerable amount of money. I note that you replied to us that ASIC is taking action. Yes, I know that in my own electorate four directors have been stood aside. That is good. They are not able to participate again in those sort of phoenix building companies. But could you just tell us how much progress you are making in that, and how much you and ASIC are working together to stop that in a period of our economic history when growth is real and, on the ground, it does have some negative consequences when this is allowed to happen.

Ms Granger: First of all, if I could just give you some results around the Phoenix Project itself, and then I might ask Ms Vivian if she has got any more on the ASIC relationship. This is a difficult area. I am not going to pretend for a moment that it is not difficult for us.

CHAIR: From the public's aspect, it sometimes looks really easy for the people setting up the 'phoenix' companies—much too easy.

Ms Granger: In terms of results, last year's result is: over $93 million in tax and penalties and 234 cases finalised. I think in our testimony last time we said that our focus is on serial offenders. If it happens once, it is very difficult to distinguish between—

CHAIR: An experiment that did not work.

Ms Granger: Or economic circumstances—there is a lot of failure. This typically happens in the micro part of the market—so turnover is around $2 million or maybe a little bit higher. This year to date 82 have been finalised with $20 million in tax and penalties, and we expect somewhere between $40 million and $45 million in the next few months from another 40 cases. So we are working on this. There have also over the years been a number of prosecutions of directors—successful outcomes there. But I would not for one minute say that this is not a difficult area. On the super—

Senator HOGG: Can I just stop you there. **Did those prosecutions lead to recovery of money as well, or are they just straight out of prosecution.**

Ms Granger: I do not have that information.

Senator HOGG: All right. ***If you could take that on notice.***

Australian Taxation Office response:

Where a person is convicted of an offence against the law of the Commonwealth, under section 21B of the *Crimes Act 1914*, the court may order the offender to make reparation to the Commonwealth in respect of any loss suffered.

From 2000 until April 2008 there have been nine cases involving the prosecution of directors involved in Phoenix behaviour:

- Reparation orders have been made with respect to two of these matters.
  - In one of these matters a reparation order of $350,000 was reduced to nil on appeal. The Appeal Judge concluded that it would serve no purpose to keep the reparation order in place as there was no reasonable prospect of the defendant being able to pay and it was highly likely the defendant would be made bankrupt for a second time.
  - In the other matter, a reparation order for $50,000 was ordered and the Tax Office is currently pursuing the collection of the outstanding reparation order.
- In another case the *Proceeds of Crime Act 2002* (POCA) was used to seize assets totalling $3.4m, however the Commonwealth Director of Public Prosecutions (CDPP) advised that whilst funds were seized under POCA orders, they were all dissipated through legal expenses, living expenses etc. and no funds were transferred to Consolidate Revenue.
- Reparation orders were sought by the CDPP in one case but not granted.
- Reparation orders were not sought by the CDPP in the remaining five cases for the reasons below.
  - Case 1 - The Tax Office had already commenced normal debt recovery action and the company has paid the agreed tax and penalties.
  - Case 2 - The defendant was an undischarged bankrupt at the time of sentencing and had no means to pay.
  - Case 3 - The defendant did not personally benefit from the criminal activity.
  - Case 4 - Reparation order was not appropriate for the type of offence – false representation (s29B Crimes Act). In this circumstance it is not necessary for the prosecution to prove that the Commonwealth was defrauded or cheated, nor is it necessary for the prosecution to prove that the defendant in fact obtained money or advantage. In view of the fact that there was no necessity to prove that the Commonwealth was defrauded, and the fact that the debt created from the tax liability was paid in full prior to the Court hearing, no reparation order was sought. (This prosecution has only be partly heard; further charges are still before the courts. The CDPP intend to seek reparation orders if successful on these charges)
  - Case 5 - The defendant is deceased.

The Tax Office has not prosecuted phoenix matters under provisions other than the *Crimes Act 1914*, Criminal Code, *Income Tax Assessment Act 1936* and *Taxation Administration Act 1953*. We sought advice from the CDPP in respect of the potential

application of the *Crimes (Taxation Offences) Act 1990* (CTOA) to Tax office Phoenix scheme cases. The advice from the CDPP (13 July 2006) concluded that:

> *For almost all, if not all, matters that might come within the scope of the CTOA, there is an available alternative offence, namely defraud contrary to s135.1 of the Criminal Code or conspiracy to defraud under s135.4 of the Criminal Code.*
>
> *There are significant advantages to prosecuting under the comparatively straightforward defraud and conspiracy to defraud provisions rather than the more complex provisions of the CTOA.*

Joint Committee of Public Accounts and Audit

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Bi-annual Hearing – 30 April 2008

Question	6
Topic:	Draft Determinations - TD 2008/D4 and TD 2008/D5
Hansard Page:	PA 29

CHAIR: I want to move to the recent ruling you made that was very contentious about products—deferred purchase agreements in particular were involved—that meant a capital gains tax would be payable even though the income had not been realised from that product. It had mixed reviews from industry. Would you comment on that in terms of people looking at these investment products and perhaps now incurring a debt that they were not really advised would be possible?

Mr D'Ascenzo: Perhaps we can provide a briefing to the committee on that. Basically we went through a public rulings panel which does include a number of external experts. We consider how the law applies. While the matter is not free from doubt that was our position and we made that public, given that the people involved in this industry were interested in our view. That is our role.

Australian Taxation Office response:

A Deferred Purchase Agreement (DPA) warrant is a retail investment product under which an investor receives shares or units (called 'delivery assets') at a specified date, typically five years after entering into the contract. The number and value of delivery assets received by the investor depends on the performance of share market indices, unrelated to the delivery assets, during the period of the DPA warrant.

The Tax Office view outlined in the draft Taxation Determination TD 2008/D5 is that an investor in a DPA warrant makes a capital gain (or realises a capital loss) when the rights under the DPA warrant are satisfied by delivery of the shares or units. The amount of the gain or loss is the difference between the amount invested and the market value of the delivery assets at maturity.

The Tax Office recognises that in a simple contract for the purchase of assets with a deferred settlement, no CGT liability arises at maturity. However, a DPA warrant is not a simple contract for the purchase of delivery assets. It is a two-stage transaction involving, firstly, the acquisition of a CGT asset comprising the DPA rights (that is, the exposure to the unrelated share market index) and, secondly, the realisation or satisfaction of those assets by the transfer of the delivery assets.

The Tax Office acknowledges that, based on the analysis in TD 2008/D5, the investor incurs a tax liability without a matching cash flow in which to meet that liability. However, the Tax Office does not accept as a general principle that a CGT liability should only arise when there is a receipt of cash.

In the case of DPA warrants, the delivery assets are highly liquid and freely tradeable by the investor. In addition, most DPA warrants offer a sale facility for the disposal of the delivery assets for cash.

The Tax Office will consider feedback on the draft determinations and finalise its views. The final determinations are expected to issue around 25 June 2008.

Joint Committee of Public Accounts and Audit

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Bi-annual Hearing – 30 April 2008

Question	7
Topic:	Guidelines on 'audit' and 'review'
Hansard Page:	PA 31-33

Senator WATSON: The question has been raised about the use of the term 'audit' versus 'review'. It has been put to the committee that these two issues, rather than being looked at separately, or administered separately, are being merged. I understand, for example in relation to the SMSF funds, that you have had a high level of tolerance. There is an education process and then, obviously, there is an expectation that there will be compliance. Then, if there is failure, you will come down with, ultimately, the full force of the law. I can understand that. But, that aside, there is still this problem that the review process—in which you might ring up and ask for an additional receipt, or an explanation—is being merged in terms of the beginning of an audit, as it were. So the concept of audit and review in terms of administration is being lost. Would you like to comment, or disagree?

Ms Granger: **My first reaction is we do actually have clear guidelines to indicate when something is being moved from review into audit. If there is an issue about that, there is actually a quite clear protocol about how that happens, so that people are clear.**

Senator WATSON: Is that on your website?

Ms Granger: ***I believe so, but I will check for you.*** In terms of broader strategy, I would say that it is actually important for us to have a range there. These days, as part of a project we will often write to taxpayers who may potentially be reviewed—even before they are reviewed—and say: 'We think you have an issue here. Would you please have a look? There is an opportunity for you to come in at no penalty, or low penalty.' We send out letters pre-assessment. So, there is even more of a range of techniques that we will use to try and influence people to get back on track and, more broadly, to focus on that. In that sense, it is a whole strategy. Whether or not it is clear to a taxpayer which particular part of the process they are in—if that is where your direction is going—I do believe we have quite clear guidance. I think there are occasionally questions like, 'Am I in review or am I in audit?' Usually that is in the context of what the consequences are for penalty remissions: 'Have I made a voluntary disclosure?' Or, if it has already gone to audit you can still get reductions—but not to the same level if we have taken another step, obviously. That is usually where I am aware of the tension.

Mr GEORGIOU: I think the underlying point is that what is actually an audit is initially presented as a review.

Ms Granger: ***As I said, we do have guidelines on that, but if there are particular incidents I am happy to look at those and follow those up. But it is quite common to start with a risk review and then move to audit.***

D'Ascenzo: It may progress there, but actually there is a trigger, and one trigger is that we do send an audit letter to say, 'Now we are starting an audit.'

Mr GEORGIOU: I think the point is that something that is most likely to end up as an audit draws information in under the category of review, which is quite different from the sort of information that you would get and the facility with which you get the information if you declared it to be an audit to begin with.

D'Ascenzo: I am not sure that is the case, actually. I am not sure there is any difference in the process. The review allows people to explain—say, in the example we gave of the cash economy—why they are an outlier. Then, if you have that review, there is no explanation and we say, 'Now we are going to audit you,' I am not sure how that would make a difference.

Mr GEORGIOU: They may be a little more reticent in responding without advice—and spontaneously—if they appreciated that this was actually the beginning of an audit rather than a generally open-ended, non-purposive review.

Ms Granger: We encourage people to involve their advisers—in fact we have protocols around that—but I would actually turn that around and say the opposite: We encourage people to be as full and frank as early as possible, and there are benefits to doing it. Holding out to audit is not a good idea.

Australian Taxation Office response:

Various Tax Office publications, available on our website *ato.gov.au*, outline our processes for reviews and audits including what we will do when we move between the two processes.

The Taxpayer Charter booklet, *If you're subject to an enquiry or audit*, provides a description on what might occur during a review and an audit, noting the differences. Furthermore, at page 6 of the same booklet, we outline our notification procedures for reviews and audits:

> *In most circumstances, we will tell you about a review or audit before we visit you.*
>
> *We send a letter, normally to the address where you have asked us to send your mail. Sometimes we will contact you by phone first to arrange an interview time.*
>
> *Our letter will:*
>
> - *tell you the name and phone number of the tax officer you will be dealing with;*
> - *explain what we intend to cover and how long we expect it to take;*
> - *let you know the information and records the tax officer will need to see at this stage;*
> - *tell you that you may have a representative present at any stage, and*
> - *tell you about your rights and obligations.*

For taxpayers with complex business activities, two other booklets are available on our website which set out how we undertake risk reviews and audits and what taxpayers can expect. They are:

- *Wealthy and wise: a tax guide for Australia's wealthiest people*, where pages 26 to 43 of that publication, outline our processes and expectations for risk reviews and audits, and

- *Large business and tax compliance 2006*, where pages 45 to 55 of that publication outline how we conduct large business risk reviews and audits.

Both of these publications also state the expectations we have of our staff in communicating with taxpayers, especially in notifying taxpayers when we intend to undertake an audit on the risks that were confirmed during the risk review process. Those notification procedures include an audit confirmation letter from the Tax Office outlining any initial information requirements.

Given that we review taxpayers for a variety of risks, the information we will review depends on factors such as the disclosures, financial affairs, events, tax outcomes or the tax profile which has given rise to the review and the complexity of the taxpayer's affairs. Through these reviews we seek to analyse an appropriate level of information so we can identify and assess risks, and where necessary, determine an appropriate treatment strategy. At the same time it is an opportunity for the taxpayer to explain their facts and circumstances.

If it becomes clear in the course of these reviews that a risk or discrepancy has been confirmed from the information available, our protocol is to keep the taxpayer informed because it may be appropriate for the discrepancy to be corrected in a timely manner by an adjustment without needing to undertake an audit.

How we conduct our risk reviews and audits is also important to our administration of shortfall penalties. Reviews and audits are mentioned in various practice statements and tax rulings because various reductions in shortfall penalties are possible in the course of our compliance activities. An 80 per cent reduction of the shortfall penalty will generally apply through the exercise of a Commissioner's discretion when a voluntary disclosure is made by a taxpayer during a risk review. If a voluntary disclosure is made before an initial audit meeting, that disclosure may result in the application of the Commissioner's discretion to also allow an 80 per cent reduction in shortfall penalties. Other voluntary disclosures made during an audit will result in a 20 per cent reduction in shortfall penalties if the disclosure can reasonably be estimated to have saved the Commissioner a significant amount of time.

We have recently consulted with members of the National Tax Liaison Group and other members of the tax profession to ensure that our review and audit protocols are aligned with the draft ruling MT 2008/D3 – *Shortfall penalties: voluntary disclosures* and Law Administration Practice Statement PS LA 2006/2 – *Administration of shortfall penalty for false or misleading statement.* This consultation also coincided with our on-going revision of both documents.

We confirmed at this meeting that the draft ruling in no way changes our guidelines in relation to how we conduct risk reviews and audits. We also agreed that we needed to review our correspondence and publications to ensure that any commentary on risk reviews and audits was clear so that taxpayers could understand the impact of making a voluntary disclosure in the course of these activities.

As a result of this consultation, a number of improvement suggestions have been made by members of the tax profession. These are now under consideration by us as we work to finalise MT 2008/D3.

Joint Committee of Public Accounts and Audit

ANSWERS TO QUESTIONS ON NOTICE

Australian Taxation Office

Bi-annual Hearing – 30 April 2008

Question	8
Topic:	ANAO Audit on High Risk Income Tax Refunds
Hansard Page:	PA 33

CHAIR: Just before we conclude, as we are an audit committee I would like to just draw your attention to the recent report by the Australian National Audit Office on high-risk income tax refunds. They said that you classify over half the amount of all claimed income tax deductions as high risk and hold them for further processing. However, of those high-risk amounts you only amend three to six per cent. That is a fairly significant mismatch between risk identification and a response to that risk. Can you explain? Have you got it wrong? Is your risk assessment tool incorrect? What is the barrier?

D'Ascenzo: Again, we might take that notice, but my reading of the report was that overall the ANAO were supportive of the approach we are taking.

Ms Vivian: Up to 31 March, we had identified about 63 and a bit as potential high-risk refunds out of 9.3 million income tax refunds. That is only 0.7 per cent.

CHAIR: The Audit Office said you classify over half the amount of all claimed income tax deductions as high risk and hold them for further processing.

Ms Vivian: We will have a look and take that on notice, I think.

CHAIR: And you only amend three to six per cent of them when you actually look at that 50 per cent.

Ms Granger: We will take that on notice.

Australian Taxation Office response:

The ANAO report refers to half the **value** of all income tax refunds being identified for risk refund reviews. Although this is correct, as noted in the report, the number of refunds identified as potential candidates for review is only a small proportion (141,699 or approximately 2 per cent) of the total number of income tax refunds issued as at 26 April 2008.

Implementation of automated risk assessments results in less than half of these potential candidates for review being subject to manual examination. As a proportion of those income tax refunds, held and manually examined, the rate of adjustment has increased from 6.97 per cent in 2004-05 to 15.7 per cent in 2006-07. The difference reflects the impact of the Tax Office automated processes (Risk Assessment Tools) which enable the release of a significant number of income tax refunds without adding further delay. Table 3.2 on page 51 of the ANAO report provides the figures illustrating this in detail (see attached).

Table 3.2

High risk income tax refunds reviewed by RAP Tools and case outcomes

Details	2004–05	2005–06	2006–07
High risk income tax refunds subject to review and/or verification	188 434	200 015	202 705
High risk income tax refunds reviewed by the RAP Tools	136 651	156 446	169 295
Per cent of high risk income tax refunds reviewed by the RAP Tools	72.5%	78.2%	83.5%
High risk income tax refunds that passed the RAP Tools tests	98 249	127 903	131 748
Per cent of high risk income tax refunds that passed RAP Tools tests	71.9%	81.8%	77.8%
High risk income tax refunds adjusted following review and/or verification (individuals)	2926	4074	4698
High risk income tax refunds adjusted following review and/or verification (micro enterprises)	3363	6218	6457
Per cent of high risk income tax refunds adjusted following review and/or verification	3.34%	5.15%	5.5%
Value of high risk income tax refund adjustments following review and/or verification (individuals)	$16.1 m	$41.2 m	$27.4 m
Value of high risk income tax refund adjustments following review and/or verification (micro enterprises)	$320.5 m[1]	$47.89 m	$48.69 m

Note 1: This figure reflects the revised figure reported in an erratum to the *Commissioner of Taxation 2004–05 Annual Report*, following an internal review and subsequent broad re-classification of results for that year. The figure is not comparable with subsequent years results as those later years reflect the full implementation of the Tax Office's revised classification/definition of active compliance results. This had the effect of reducing the value of 'accounting adjustments' recorded, as active compliance. The Tax Office has determined that 'where an internal system could or should, be able to identify a particular issue – and where the client calculates the tax correctly – then any adjustments should not be classified as active compliance'.[37]

Source: Australian National Audit Office analysis of Australian Taxation Office data.

Developing the Risk Assessment Profiling Tool

3.11 To maintain refund integrity in a dynamic environment it is important that the Tax Office collects, analyses and uses risk based information to support ongoing development of its information technology systems. While the Refund Integrity Team does not have a formal process for routinely identifying, monitoring and reporting risks relevant to the administration of high risk income tax refunds; it conducted a number of information gathering

[37] Australian Taxation Office – Active Compliance Steering Committee Submission Paper dated 22 August 2006, Operations – High Risk Refunds.