

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

Question No: AET 97

Topic: Audits and Litigation

Hansard Page: Written

Senator Bushby asked:

I note that in the AFR on 16 Feb 2011 there is a report that the Inspector General of Taxation will be investigating your audits of small businesses and high-wealth taxpayers.

I also note that ATO has received criticism for being too aggressive in their approach and/or failing to take into account key documents and arguments. (Denlay case in the 2010 Qld Appeal Court where the court was critical of ATO for taking steps in bankruptcy against a taxpayer who was in the process of lodging an objection to an assessment and the more recent AAT case *AAT Case [2011] AATA 26, Re James and Anor and FCT*).

1. What were the costs to the ATO of these two actions?

Report by the Weekly Tax Bulletin re James and Anor and FCT was as follows:

The Tribunal was critical of the ATO's stance on a number of issues, including:

- ***Purchasers' admissions:*** The AAT noted on several occasions that the purchasers of the business had admitted at various times and in various documents that they remained indebted to the taxpayer for the balance of the purchase price, contrary to the Commissioner's argument that the taxpayer had failed to produce evidence of the existence of the amount of the purchase price owing to the taxpayer (see para [32]). In this regard, the AAT also stated that the ATO had simply ignored the evidence of the purchasers having made an express admission in writing, without any qualification at all, of their indebtedness to the taxpayer in the sum then still owing of \$20,484,772 (see para [33]).
- ***Privately authored documents:*** The AAT said the Commissioner was dissatisfied that, in order to establish some of his own actions or transactions, the taxpayer relied on documents that were "authored" and signed only by him. This complaint related in particular to the 2 trust instruments on which the taxpayer relied. The Tribunal said:

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

"Absent fraud, the standard of proof for establishing a 'secret' trust is the same as it is for any other trust. It is the ordinary civil standard of proof on the balance of probabilities. The ATO's adverse comment about the 2 trust instruments is reminiscent of complaints by King Henry VIII in the sixteenth century, who did his best to have trusts abolished altogether because of their tendency to facilitate tax avoidance".

- **Statute of Limitations:** The AAT considered it "a matter for remark" that, during the course of one of the ATO interviews of the taxpayer in 2005, a member of the ATO audit team "thought it appropriate to engage in a contest with Mr James about the applicability of the Statute of Limitations" to a document. The AAT said the period of limitation is 6 years, in both Queensland and New Zealand and that "the ATO officer wrongly insisted the limitation period was only 3 years. The ATO officer was quite wrong in his opinion, which in any event was not relevant to Mr James' tax liability".

2. Have these instances provided any lessons regarding the obligation of the ATO to be vigilant in respecting the taxpaying community and that legal action in the courts needs to be considered as a last resort?

3. How do you ensure that you do not have some audit teams who are running along substantially more aggressive lines than others? Do you consider now, in relation to the Denlay bankruptcy case, and the AAT case that there needed to be more quality control exercised by senior tax office officials.

4. What are the criteria that ATO uses to rank from high to low the tax risk assessment category into which certain business taxpayers should fall?

5. How do you ensure that these are objective and balanced?

6. Do, for example, they take into account the cooperation of taxpayers in willingly providing information and / or volunteering to extend statutory periods beyond which the ATO cannot act against the taxpayer?

7. Is the taxpayer's risk rating in any way impacted by whether the taxpayer has initiated litigation against a tax assessment?

8. Who / which branch in the ATO is responsible for ATO being a model litigant as per the government model litigant rules and what steps have been taken to review these cases and develop a fairer approach to the audit and litigation process?

9. Some in the tax professional community suggest that there is a noticeable absence of timely advice from the ATO following decision in the Administrative Appeals

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

Tribunal (AAT) and the courts that are inconsistent with ATO policy or administration. For example, it has been suggested that the ATO has not responded publicly to the decision in *FCT v Word Investments (2008) 236 CLR 204*, and has instead continued business as usual. Is this true and have there been any other cases in the same vein?

10. How can practitioners do their job without guidance following such decisions?

11. Does this arise because the ATO has insufficient resources to handle its case load or does it have too much litigation on its agenda, or some other reason?

Answer

1. Within the ATO, the Legal Services Branch is responsible for the carriage of our litigation cases. This includes in some of our litigation representing the Commissioner of Taxation in courts and tribunals. In more complex litigation cases, the ATO engages external solicitors and barristers.

In the Administrative Appeals Tribunal (AAT) case reported in the Australian Financial Review, the Commissioner was represented by an in-house officer from the Legal Services Branch. We are not able to provide the specific costs of this matter. Although we record and monitor our total annual costs for running in-house legal services we do not keep records of the costs of individual cases where only in-house officers are used.

In relation to the Denlay matter, the Commissioner of Taxation appealed to the Queensland Court of Appeal in relation to two cases concerning Mr and Mrs Denlay. The appeals were heard together and the Commissioner engaged external legal counsel to appear on his behalf, with in-house officers attending as solicitors. The cost of engaging external legal counsel was \$8,181.25. The Court of Appeal awarded costs to Mr and Mrs Denlay.

2. Yes we have made some changes to our processes as a result of reviewing these cases. We undertake regular reviews of the outcomes of cases, including reviewing comments from members of the tribunal and the judiciary to identify opportunities to improve our processes. In response to the recent comments from the Administrative Appeals Tribunal we have strengthened the parameters for determining when we should engage external counsel to undertake the carriage of a case. These parameters include a consideration of the factual and legal complexity of the matter, whether there is a need for detailed cross examination, the expected length of hearing and the volume of documentary evidence. Also, in any Administrative Appeals Tribunal case which is to be set down for hearing which does not have counsel, it is now a requirement that the case officer must prepare a formal

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

submission for approval to the Assistant Commissioner, explaining why the hearing should be conducted in-house without the use of counsel.

Under the ATO's Practice Statement on Conduct of Litigation (PS LA 2009/9) factors to be taking into account when considering whether to engage counsel include:

- the taxpayer is a high net wealth or prominent taxpayer
- the taxpayer has a history of audits or investigations by the ATO
- any inconsistency in the ATO position
- the taxpayer is represented by a large accounting or legal firm
- senior counsel is being briefed for the taxpayer, and
- significant volumes of material or a very complicated factual matrix are involved.

The ATO has also reviewed the Denlay case and has circulated a briefing note regarding future recovery proceedings involving a stay application by the taxpayer. Where other avenues of recovery are available, we will provide undertakings to the court that bankruptcy proceedings will not be started whilst there is an objection or tax appeal in process. However, in cases where there is dissipation of assets or where the taxpayer is party to a contrivance to avoid his liability to pay tax, bankruptcy may still be considered an option.

The ATO does regard litigation in the courts as a last resort for resolving disputes and always aims to resolve issues as early as possible through internal review and look to the court/tribunal system to resolve these disputes as a last resort. The vast majority of these are resolved at the objection stage. In 2009–10, there were 654 tax appeals representing about 3% of objections lodged. In the same year, there were 21,605 disputes most were objecting to audit outcomes. They represent less than 0.1% of the 3.12 million contacts, reviews or audits in that year. Taxpayers initiated 97% of the tax appeals, the remaining 3% initiated by the ATO are appeals by the ATO against adverse decisions.

An exception to this approach is that in some circumstances where it is important to clarify uncertainty on issues of significance to the tax and superannuation system, the ATO funds test cases. To do this, financial assistance is provided to taxpayers whose litigation is likely to provide certainty on important issues as well as provide a fair and independent resolution of disputes.

3. The ATO takes the professionalism of its audit teams seriously.

The ATO ensures that audit teams comply with published practices, procedures and guidelines through:

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

- routinely checking the quality of sampled audit cases, both open and closed cases in accordance with the Integrated Quality Framework quality processes
- asking taxpayers who have been reviewed or audited to complete Client Feedback questionnaires which asks questions about auditor professionalism, and
- understanding and acting on taxpayer feedback. The ATO has published information on how taxpayers can exercise their right to make a complaint. This information is available through www.ato.gov.au and in different ATO publications. Taxpayers can complain:
 - in person including by asking for the matter to be escalated to the tax officer's manager
 - in writing
 - by fax
 - by phone, or
 - by lodging a complaints form online, in line with our published advice.

Audit staff undertake training and mentoring by senior officers and follow policies and procedures to drive consistency in audit practice, to ensure staff carry out audits in accordance with our Taxpayers Charter commitments.

Regular surveys of taxpayers such as the Professionalism and Business Perceptions Surveys as well as the management of client complaint matters monitor and inform on-going programs designed to maintain our professionalism levels in line with community expectations.

Decisions relating to legal recovery action, including insolvency proceedings, are made by senior ATO officers. The ATO engages external consultants to conduct regular independent reviews of our management of insolvency cases. The 12 reviews completed to date have found that in no case did the ATO's actions lead to premature bankruptcy or wind-up. All decisions made in relation to the Denlay case were consistent with the ATO Receivables Policy and based on the information available at the time.

In light of the decision in *Deputy Commissioner of Taxation v Denlay & Anor* [2010] QCA 217, the ATO issued guidelines to its staff about dealing with applications for the stay of recovery proceedings. These guidelines ensure that staff give due consideration to the judges' findings.

4. The ATO conducts a range of risk assessments, data matching and risk profiling measures to assess the risk of taxpayers. Specifically, as an example, in the small-to-medium enterprises (SME) market, the risk assessment process commences with stratification of market segments within the SME market and identification of taxpayers within those segments. Some examples of market segments that we use on occasion are:

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

- high net wealth individuals
- \$2 million - \$10 million turnover market segment
- \$5 million - \$30 million net wealth segment- \$100 million
- \$250 million turnover market segment.

Taxpayers are then risk profiled in that market segment using an automated process which applies a range of pre-determined tests (criteria, thresholds, flags etc) against data for the segment. These rules, flags etc are housed within our Risk Assessment and Profiling Tool, and within a model – the Risk Differentiation Framework – which segments the SME market according to higher versus lower likelihood (of non-compliance) and higher versus lower consequence (of non-compliance).

The primary source of information used to profile taxpayers is the income tax return and related schedules supplemented by third party data such as ASIC information. Some risk tests use calculations based only on the latest return lodged, others are based on returns over a longer period of time. The types of issues which the rules, thresholds and flags consider include the taxpayer's tax performance over time and other tests designed to flag where there may be matters requiring following up in relation to specific tax risk themes such as capital gains tax or transfer pricing. This initial process generates an overall view of the issues within a market segment, and also produces an initial snapshot of any potential questions that may apply to a particular taxpayer - either a single entity or a corporate group. The risk assessment refines the population being considered and raises questions for further enquiry. This process forms the basis for case selection within the ATO in relation to the SME market.

A case may go through a number of stages of internal review, by a team or an individual officer. It is at this point that the ATO's view of a taxpayer's compliance risk is no longer auto-generated information from our systems, but begins to be the considered opinion of a case officer and based on their further analysis of the taxpayer:

- the perceived risks may be adequately explained by the further available information, and no further action is necessary , or
- alternatively, after this internal review process , we may have identified additional risks or issues or still have questions around some matters. At this point, we may commence a review with the taxpayer (e.g. a Preliminary Risk Review) and request further information (e.g. financial statements) and clarification of identified issues.

5. As detailed above, the ATO utilises sophisticated risk profiling tools. The outcomes from applying these tools are analysed and the tools improved as a result of further senior officer reviews, auditor scrutiny and feedback on their operation.

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Additional Estimates

23 – 24 February 2011

6. The ATO takes into account the compliance history of the taxpayer and the extent of cooperation provided by the taxpayer in determining penalties to be imposed if there is an adjustment required to a taxpayer's lodged return.

The factors referred to are also taken into account after the initial risk assessment and before or during the course of an amendment. The law enables the Commissioner to reduce any culpability penalties that may apply by 80% where there is a voluntary disclosure prior to an amendment, and by an additional 20% where there is co-operation during an audit.

7. The taxpayer's risk rating is not impacted by whether the taxpayer has initiated litigation against a tax assessment.

8. The Legal Services Branch is responsible for coordinating the ATO's legal services. This includes ensuring we adhere to the Attorney-General's Legal Services Directions, including the Model Litigant Obligation, as well as relevant court and tribunal rules and directions, and other relevant policies and guidelines. The ATO's approach to act as a model litigant is explained in Practice Statement Law Administration 2009/9 (PS LA 2009/9) which provides directions to ATO officers about the conduct of litigation.

As part of the management of litigation cases, senior officers review their outcome and, where relevant, take this into account in determining our future procedures and practices. Following on from the recent Administrative Appeals Tribunal case, we have made changes to our procedures. We have revised the parameters for determining when we should engage external counsel to undertake the carriage of a case. Consideration will be given to factors such as the need for detailed cross-examination, factual and legal complexity and expected length of the hearing in determining whether to engage counsel.

The ATO's performance as a model litigant is covered in the Commissioner's Annual Report to Parliament, as well as relevant reporting by the Attorney-General's Department.

9. In all cases where a Court / Tribunal decisions are contrary to the Commissioner's interpretation of the law, the decision is reviewed by a senior officer and a Decision Impact Statement is published to advise the community of the Commissioner's response to the decision and what administrative action will be taken as a result of the decision. The Decision Impact Statement will advise the ATO's intended actions which can include appealing or accepting outcomes and whether rulings will need to be reviewed. Note: (Decision Impact Statements are not prepared for adverse AAT decisions, where the Tribunal has determined not to publish the decision.

Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

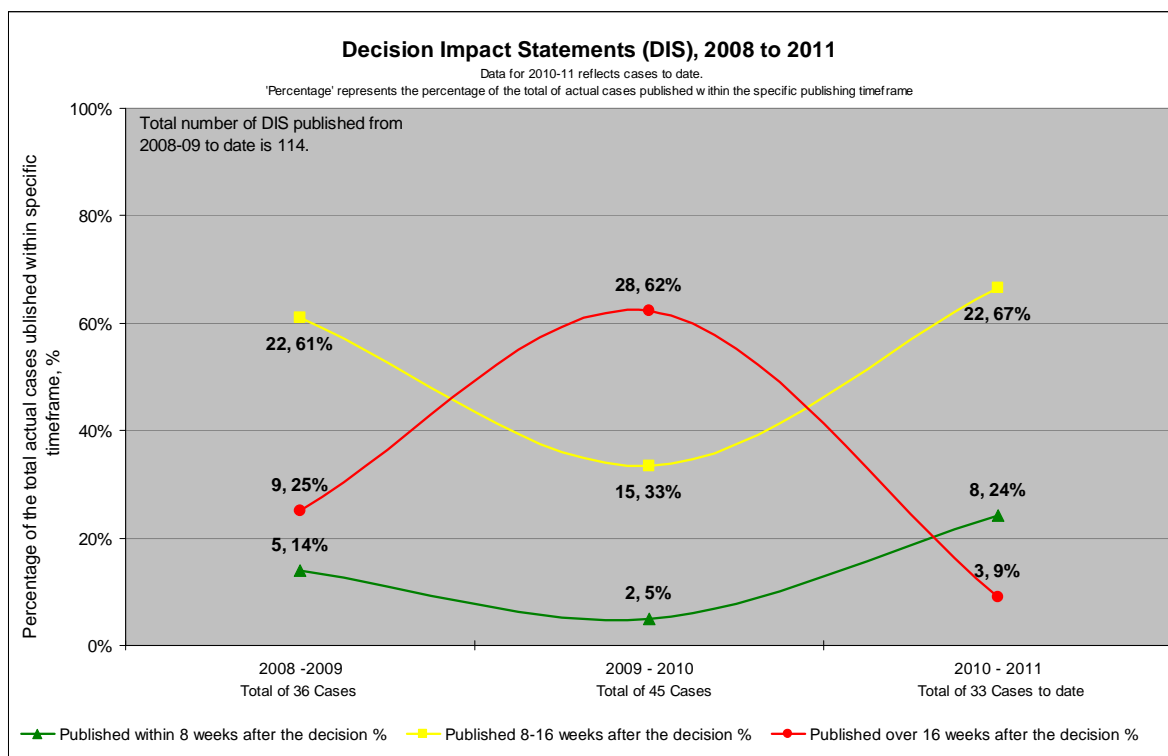
Additional Estimates

23 – 24 February 2011

The decision of the High Court in *Word Investments* was handed down on 3 December 2008. Prior to publishing a Decision Impact Statement in May 2009, the ATO carefully considered the broader implications of the decision, particularly having regard to the fact that the views of the High Court were contrary to the ATO's previous interpretation of the law, as expressed in public rulings TR 2005/21 and 2005/22. These public rulings, which are available to the community on the ATO's website, have been flagged as being subject to amendment as a result of the decision in *Word Investments*. This ensures that the community is not misled into believing that the ATO maintains views that are contrary to the High Court's decision.

10. The decisions themselves provide the best guidance. Nevertheless the ATO's practice is to inform the community of the potential impact of court or tribunal decisions in significant litigation cases. Every effort is made to reduce the time within which Decision Impact Statements are published after a decision in a significant case.

However, as recognised by the IGT at para 9.163 of the report into the *Follow-up review into the ATO's implementation of agreed recommendations included in the six reports prepared by the Inspector-General of Taxation between June 2006 and October 2008*, there are some cases that may take longer than the set timeframe given the complexity of the law surrounding particular decisions.



11. No.