

CHAPTER FIVE

THE LARGE BUSINESS & INTERNATIONAL DIVISION

In an intriguing reflection on the life of a taxman (or taxwoman), at the very same time the *Sunday* program was running the ‘soft on the big end of town’ line, we were being accused in a report in the print media of acting like communist Russia in our dealings with corporate Australia. *Michael Carmody, Commissioner of Taxation*¹

5.1 Assessing the performance of the Large Business and International (LB&I) Division is central to considering the wider issue of the ATO’s equitable treatment of taxpayers. In particular, the contention that the ATO is ‘soft on the big end of town’ requires an examination of LB&I, the division responsible for revenue collection from big business, large corporates and so-called high wealth individuals. Effective revenue collection from the large business sector is essential if the ATO is to demonstrate to other sections of the community that it is committed to treating all taxpayers equitably.

5.2 However, as noted in the introduction to the report, the Committee received comparatively little evidence on the performance of LB&I. The Committee’s assessment is therefore by necessity qualified.

5.3 Nonetheless, the evidence is notable for the high degree of consensus on both positive and negative aspects of the ATO’s performance. In this respect, the Committee believes it is reasonable to see the evidence as reflective of the views and experience of other taxpayers who deal with LB&I.

5.4 The soon to be introduced new business tax system has changed the picture significantly from that which faced the Committee at the start of the inquiry. For instance, in addition to changing the company tax rate, the new system will introduce ‘integrity measures’ aimed at curbing tax avoidance and improving the general anti-avoidance rule (known as Part IVA of the *Income Tax Assessment Act*). Such measures should not only strengthen the ATO’s ability to address compliance risks but also provide greater certainty and clarity for taxpayers on the intent of the law.

5.5 Consequently, the Committee concentrates in this chapter on issues that fall outside the ambit of the impending reforms under the new business tax system or may impact on the implementation and effectiveness of those reforms. In particular, the chapter examines the following matters relating to the performance of the LB&I Division:

- technical skills and service;
- ex-ATO staff moving to the private sector;

1 Michael Carmody , Commissioner of Taxation, ‘The Role of Settlements in Good Tax Administration or Don’t Believe Everything You See on the Box’, Speech to the Corporate Tax Association, 23 July 1998, p. 4.

- access to taxpayer information; and
- prosecution.

5.6 The next chapter examines the performance of the High Wealth Individuals Program.

A complex business environment

5.7 LB&I operates in a more complex tax and financial environment than the ATO divisions dealing with small business (SB) and individual non-business (INB) taxpayers. While its client base is markedly smaller than that of INB (37,000 entities as opposed to 8 million taxpayers and 24,000 tax practitioners respectively), LB&I faces a different set of challenges, possibly of a greater magnitude. The ATO characterised the difference according to a ‘spectrum of complexity’:

For most individuals, the law and our supporting rulings are often reasonably straightforward, with well-established precedence. For large corporations, the picture is often one of a tangled web of business entities, complicated further by international connections of parent or subsidiary companies.²

5.8 Factors such as globalisation, technological change and deregulation compound the underlying complexity of the large business environment. These factors tend to impact on the large business sector more than other taxpayer segments. Large businesses also usually have access to top range tax advisers. The tax affairs of LB&I clients can therefore reflect sophisticated tax planning, including innovative strategies that raise new issues at law or seek to exploit loopholes and grey areas. As well, large businesses and some high wealth individuals use global strategies to limit their tax obligations by ‘taking advantage of different tax regimes in different jurisdictions’.³

5.9 Consequently, revenue collection in this sector is neither as straightforward nor as easily addressed by process-driven approaches used in other divisions. Rather, it often involves lengthy and complicated audits. It also at times requires greater involvement from senior officers, particularly where it is necessary for judgement calls on issues where the law is hazy or a matter has escalated through legal manoeuvring and other stratagems.⁴

5.10 LB&I is structured to align its seven industry teams with particular business sectors, as follows:

- Banking and finance
- Insurance and superannuation
- Manufacturing
- Media and communication

2 Submission No. 83, p 12.

3 Submission No. 83, p 20.

4 Submission No. 83, p 11. For a tax practitioner’s perspective on the complexity of LB&I audits, see Mr Liebler, Submission No. 85, pp 7-8.

- Mining and petroleum
- Property and construction
- Services.

5.11 Reflecting the particular challenges of its business environment, LB&I also has seven teams arranged by subject specialisation:

- Capital gains
- High wealth individuals
- International
- Privatisation
- Research and development
- Development allowance
- Strategic intelligence.

5.12 LB&I's approach includes increased compliance coverage through more systematic use of tax return data, expanded intelligence on marketing of tax avoidance schemes and early warning of emerging threats to revenue and greater fieldwork. Consistent with the ATO's overall risk management strategy and compliance model LB&I targets 'key taxpayers' for close scrutiny, including in some cases ongoing contact to identify increases or decreases taxpayers expect in their future company tax instalments. LB&I also attempts to maintain contact with industry players on key issues – eg, compliance management, service delivery, transfer pricing, taxation rulings and litigation – and to clarify legal issues to help provide certainty for business planning.

LB&I Performance

5.13 The ATO defined the performance of LB&I mainly in terms of revenue collection and legislative measures. In particular, the ATO highlighted the trend since 1993-94 of growth in total company tax collections at a rate higher than growth in Gross Domestic Product (GDP).⁵ (Large companies account for 72 per cent of total company collections.)

5.14 It needs to be noted, however, that both calculating growth in company collections, and identifying the relative importance of the factors driving it, are complicated exercises (see Appendix 4). Consequently, the ATO erred on the side of 'conservative estimates' in its advice to the Committee on the extent to which growth in company collections reflected ATO initiatives as opposed to non-ATO factors such as company profitability and wider economic conditions. Once various adjustments are made, the ATO estimated that:

5 See the graph, 'Economic growth and tax performance – large companies', ATO Response to Question on Notice 6 August 1998 – E21 to E24, pp. 11-12.

...growth in company collection over the period 1993/94-1996/97 would have been in the range of 26% to 38%, depending on the assumptions used, and most probably in the region of 30%.

Both of the 26% and 38% estimates put growth in company collections well above the growth in nominal GDP [which increased by 19% for the period]. This is strong supporting evidence of a broadly-based improvement in effective tax rates. Part of this improvement is due to such factors as improving levels of sales, profit margins, etc. But some of this improvement is undoubtedly due to various compliance initiatives undertaken by the ATO during this period.⁶

5.15 Particular ATO measures behind this growth include a significant increase by 60 per cent in audit coverage of large corporate groups. For 1996-97 to 1998-99, 'direct audit dollars' for this segment increased from approximately \$270 million to \$450 million.⁷ LB&I targeting of critical risk issues such as transfer pricing has also seen a marked improvement in tax performance. LB&I record reviews of target companies resulted in tax collection increasing from \$68 million in 1996 to \$166 million in 1998-99.⁸

5.16 At the same time, compliance activity has also raised in additional tax and penalties \$370.8 million in 1995-96 financial year, \$1430 million in the 1996-97 financial year and \$793 million in the 1997-98 financial year.

5.17 As of July 1998, \$3.7 billion in losses had been disallowed over the previous 18 months, all of which had been accepted by taxpayers.⁹

5.18 LB&I has also attempted, through building up a deeper understanding of the factors driving the large business sector, to acquire what it calls legislative 'leverage', that is, strengthening the law to address tax avoidance and areas of high risk to revenue. Results from this activity includes significant legislative changes in relation to losses, offshore income and tax havens, withholding taxes, thin capitalisation, debt forgiveness, private company distributions, value shifting in regard to capital gains and the streaming of franking credits. The ATO has also litigated cases on transfer pricing, access to taxpayer information, tax benefit transfers and profit shifting to tax havens.¹⁰

Technical skills and service

5.19 The ATO's staffing of the LB&I Division reflects the complexity of the business environment and cases that it manages. Essentially, senior officers become increasingly involved as cases become increasingly complex. Escalation procedures are in place to indicate to staff when it is necessary to alert or seek input from senior level officers.¹¹

6 ATO response to Committee, 14 February 2000.

7 Evidence, p. 268 and Submission No. 83, p. 21.

8 Evidence, p. 301.

9 Submission No. 83, p. 22.

10 Submission No. 83, p. 22. See also 'Law Clarification Program Outcomes (during 1993-1998 impacting on Large Business)', attachment A, ATO Response to Question on Notice 6 August 1998 – E21 to E24, p. 7.

11 ATO, 'Escalation processes for significant interpretative issues', 14 February 2000.

Cases that might begin as quite simple can develop – sometimes with the intervention of legal manoeuvring – into very complicated ones.... This means that appropriately experienced and qualified senior staff are quite properly required to exercise judgement in complex cases.¹²

5.20 Often cases involve contested or ill-defined areas of the law, highly technical matters and emerging issues driven by developments in financial instruments, technology and foreign markets and tax regimes. Any one, or a combination of these factors, requires technically skilled and specialised staff. In some instances, expert advice from outside the ATO itself, such as academics and tax professionals, is required to clarify and resolve an issue. To address these business challenges:

LB&I has highly developed internal processes to ensure that appropriate expertise within – and increasingly from outside – the ATO is brought to bear on issues. We have also endeavoured to increase the level of transparency and accountability in decision making through:

- the establishment of specialist cells, transfer pricing and industry segment review panels and a peak technical forum;
- the use of external experts to test the probity of taxpayer claims;
- quality assurance surveys on technical decision making; and
- internal audit processes to ensure appropriate reviews and collaboration take place.¹³

5.21 Despite these measures, and despite claiming that it has strengthened its economic research, intelligence and fieldwork capabilities, the Committee heard criticism of LB&I's technical skills. Although general improvements were noted, tax practitioners claimed that the Division suffered from a lack of skilled staff with appropriate experience, particularly in commercial matters. Both the Taxation Institute of Australia (TIA) and Arthur Andersen believed insufficient resources were devoted to staff training and education. Both organisations argued that these deficiencies resulted in lower levels of service, delays in issuing advice and consequently additional compliance costs for taxpayers.¹⁴

5.22 In contrast, the ATO pointed to LB&I's favourable results from its Quality Assurance (QA) reviews. These reviews, which occur quarterly across all ATO business lines, address the technical quality of random case samples. The main criteria assessed are whether the ATO understood the client's questions, provided an accurate and consistent answer, with sound explanation, in a readily understood manner. Internal committees comprising three senior ATO officers review most of the cases, although the Australian Government Solicitor and an internal consultant also review a sample of cases. According to the Commissioner, the review process has shown a 'trend of continuing improvement' with LB&I cases receiving 100 per cent pass marks' for understanding client questions and

12 Submission No. 83, p. 12.

13 Submission No. 83, p. 23.

14 Submission No. 6, p. 5. Submission Nos 17, pp1-2 and 17A, pp2, 14-15. See also Evidence, p. 203.

accurate decisions and 80 per cent 'A' level grades. ATO data show that the review results for LB&I are not only above other business lines but are also the most consistent.¹⁵

5.23 The Commissioner also indicated that independent external representatives are used to review a random selection of written ATO work ranging from private rulings through to disputes and audit case work. These external representatives are selected for their expertise in particular fields. The results from these external reviews are considered by the ATO's Professional Excellence Forum - which also involves external representatives - and assist in decisions on improvements such as training and skills and refining work practices. The Professional Excellence Forum is involved in development and implementation of a professional excellence framework which is designed to improve the quality of decision making. As well, external review results also feed into the ATO's performance management and reward systems.

5.24 The Committee considers that the QA review process is an important learning and improvement tool for the ATO. Drawing on independent external expertise should help promote the business relevance of technical decision making by the ATO.

5.25 The Committee also notes that the ATO has made considerable strides in establishing systems and measures to improve both the consistency and quality of its decision making. Escalation procedures require case officers to seek the input of tax counsel when significant issues arise. The ATO's centralised computer system for private rulings also requires officers to escalate issues if a case involves a departure from established rulings. As discussed later in this chapter, the ATO has sought industry input in developing measures to improve audit case management and resolve delays in finalising field work.

Ex-ATO staff in the private sector

5.26 The movement of former ATO officers to work in the private sector raises two issues. One relates to concerns that the ATO is being denuded of highly experienced staff from key positions; following on from this is the concern that former staff are privy to 'inside information' which could be misused or lead to a potential conflict of interest.

An ATO 'brain drain'?

5.27 Some witnesses suggested that one of the causes of the skills deficit in LB&I was due to the loss of highly skilled ATO staff to the private sector.¹⁶ The ASU in particular raised concerns about this development. A specific case cited by the ASU involved the shift of key staff responsible for the development of policy and public rulings on transfer pricing issues to private sector firms on salaries significantly greater than their income in the public sector.¹⁷

5.28 The inability of the ATO, within the constraints of the Australian Public Service's salary structures, to compete with the private sector means that it is potentially vulnerable to losing critical staff. The wider implication is that the loss of highly skilled and experienced

15 Information from the Office of the Chief Tax Counsel provided to the Committee, 8 March 2000.

16 Submission No. 17, p. 1.

17 Submission No. 91A, p. 1 and Evidence, p. 89.

personnel weakens the ATO's ability to manage the tax system while conferring a significant advantage to large business and the tax industry.

5.29 The movement of some ATO staff to the private sector may have potential benefits and risks. For instance, ATO officers working in the tax industry or for large businesses are in a position to bridge the gap between the two sectors. They have the potential to help improve understanding on both sides of not only technical issues but also the perceptions and organisational interests of the ATO and private sector. Two-way movement between the private sector and the ATO may also be desirable where it leads to cross-fertilisation of ideas on emerging tax matters, organisational cultures and core business interests and priorities.¹⁸

5.30 However, even the loss of a small number of experienced and senior staff could have serious ramifications for the ATO's corporate knowledge, leadership and expertise in critical areas. Experienced staff with not only specialist knowledge but also extensive operational experience are hard assets to replace.

5.31 In response, the ATO indicated that over the last two years two Senior Executive Service (SES) officers and 13 senior staff have moved to the private sector. In view of LB&I's total staffing of over 1,200 officers, this level of staff movement does not appear significant or threatening. Four staff have left the transfer pricing section over the same period of time. The ATO indicated that this had not delayed or impacted on the work of the area, not least because other staff had been quick to fill the vacant positions. As well, the input of external experts had mitigated any loss of experience and specialist knowledge.¹⁹

5.32 The Committee considers that, on the basis of the above evidence, the movement of specialist staff from the ATO is not of the magnitude to seriously erode the technical capacity of LB&I. However, the Committee notes the high demand for experienced tax specialists during the current transition phase with tax reform implementation. The ATO needs to monitor the situation closely to ensure that it maintains both adequate expertise and experience and the ability to attract staff with appropriate skills.

Risks

5.33 While there may be benefits to be had by ATO staff moving into advisory positions in the private sector, there is the potential risk for former officers to misuse information and knowledge acquired at the ATO. The main areas of risk include the divulging of sensitive operational information, such as intelligence and ATO targeting of non-compliance, and confidential taxpayer information, particularly that of competitors. Seeking favours from former colleagues remaining inside the ATO is another possible risk, although this should be distinguished from networking or seeking to expedite a matter.²⁰

5.34 The Committee was particularly concerned to assess the extent of this risk and identify evidence of breaches of confidentiality or conflicts of interest occurring.

5.35 The only evidence of improper conduct of this nature was the cases portrayed in the *Sunday* program (discussed in chapter one). Witnesses from both the private sector and the

18 See Evidence, pp. 302-303.

19 Evidence, p. 302.

20 See Evidence, pp. 89-90.

ATO were unanimous in stating they had neither personally come across any evidence of former officers seeking favours or misusing inside knowledge, nor had they heard of any such breaches from colleagues in the industry. An ATO officer from the ASU stated:

I am not aware of any of the people at a senior level who have left and gone to the private sector interfering or trying to gain favour on a particular matter they have raised with the office [ATO]. I think that would be nearly the position I would expect of every officer within the Australian tax office.²¹

5.36 Private sector witnesses echoed this view. Two senior staff from a major accounting firm stated they were unaware of any attempts by ex-ATO staff to obtain favours, both inside their firm and in the wider tax industry.²² Mr Wachtel, Partner in National Tax Competence in Arthur Andersen, emphasised the importance the firm placed on preventing conflicts of interest arising. But he also pointed out the distinction between conflicts over client knowledge and the legitimate practice of former ATO staff utilising technical expertise acquired during their time in the ATO:

We are more concerned about ensuring you do not use information you had from the tax office re a particular taxpayer... and that you would not work on a matter where you were involved on the other side [ie, client] in the past. But we do not impose restrictions about what we regard as generic technical know-how in regard to those particular practice areas. We therefore would not preclude an ex tax office person who worked, let us say, as a mining specialist. We would expect that person, once they had joined us, to work in advising clients in the mining industry.²³

5.37 The ATO also has protocols in relation to handling cases where conflicts of interest may arise. In instances where an officer receives a request from someone outside the ATO with whom he or she has a relationship, the officer is required to refer the matter to another staff member and to not be involved in the handling of the case.

5.38 Part of the procedure for staff leaving the ATO involves an exit interview. At the interview the officer is required to return material belonging to the Commonwealth (records, laptop computers and so on) and hand over access passes, passwords to ATO systems and databases and any material used in conjunction with their job. As well, the officer is reminded of the secrecy obligations under the Income Tax Assessment Act that continue to apply after the officer's period of service in the ATO.²⁴

Access to taxpayer information

5.39 Access to taxpayer information is a general problem but is said to be particularly acute for auditors working in the LB&I division. Some ATO staff claim widespread manipulation by business and high wealth individuals of both Legal Professional Privilege (LPP) and the extension of this privilege to Accountants Working Papers (AWP). Vital information is supposedly being concealed under the cloak of privilege:

21 Evidence, p. 90.

22 Evidence, pp. 70-72.

23 Evidence, p. 72.

24 *In camera* Evidence, pp. 229-230.

Large corporates and specialist tax advisers who are familiar with the ATO's processes are taking full advantage of them and are hiding information from ATO auditors. Even the most diligent auditors are being frustrated in their efforts to obtain necessary information.²⁵

5.40 This concealment results in protracted audits and ties up resources. According to a former auditor, '[I]nstead of a case taking six to 12 months to finish, it is rolling on for years running into brick walls'.²⁶

5.41 The implications of these access problems extend beyond the finalisation of particular tax audits. The compliance model used by LB&I depends on taxpayer information in order to make a risk assessment of particular taxpayers and market segments. Audit priorities and compliance strategies are tailored according to such risk assessments. Without adequate information this approach is hampered.²⁷

5.42 The problem is alleged to be extensive, including not only high wealth individuals and large corporates but also 'pockets of middle-ranking businesses who utilise good lawyers and have good accountants and they know how to protect themselves from access'.²⁸ However, a 1999 ATO review revealed only 23 cases where LPP or accountants claims for confidentiality were posing difficulties out of a caseload of 850. Notwithstanding the low proportion of problem cases, the ATO stated 'it needs to be acknowledged that there are cases where staff experience extreme difficulties in obtaining the information they need and taxpayers and advisers are being cautious almost to the point of obstruction'.²⁹

5.43 Witnesses from the ASU also criticised what they saw as the ATO executive's persistence with a strategy predicated on cooperation and working partnerships with large business taxpayers. Despite 'substantial disquiet amongst senior ATO auditors',³⁰ the ASU claims ATO's response to the access problem has been limited to the establishment of regional Access Networks. The networks are intended to identify access problems and provide support for field officers.³¹ The implication is that the networks address the symptom, not the cause of the problem, the gravity of which requires legislative solutions.

5.44 The ATO indicated to the Committee that the issue of access to information is multi-faceted involving not only staff concerns but also complaints from business clients. In addition to the problems outlined by the ASU, ATO management have been concerned about delays in case work and the need to adopt a 'real time' approach to identifying and treating risk. Industry clients have similarly expressed concern over delays in audit work. In this context, the ATO commissioned an external expert to head a team to examine LPP.³²

25 Australian Services Union Taxation Officer's Branch, Submission No. 91, p. 4. See also Evidence, pp. 91-97.

26 Mr Thorburn, Evidence, p. 92.

27 Submission No. 91, p. 4.

28 Mr Thorburn, Evidence, p. 93.

29 ATO, 'Remedial Action re Legal Professional Privilege', 8 February 2000, p. 1.

30 Submission No. 91, p. 4.

31 Submission No. 91, p. 2. See also Evidence, p. 93.

32 ATO, 'Remedial Action re Legal Professional Privilege', p. 1.

5.45 The review indicated that staff had a mixed view of the ATO guidelines on access, some identifying limitations while others did not see them as impeding access. Furthermore, the review highlighted room for improvement in teamwork between ATO managers and field staff, as well as identifying cases where taxpayers were misapplying privilege.³³

5.46 The Commissioner signalled in September 1999 a tougher approach by the ATO towards LPP and AWP.³⁴ The new approach was characterised as ‘not attempting to overturn Legal Professional Privilege’ but a ‘reshaping’ of the ATO’s approach to it. Specific measures include:

- establishing specialist adviser roles in the existing Legal Services Practice to support field staff to respond quickly and appropriately to LPP claims. As well, advisers will monitor the nature of LPP claims, establish mechanisms to resolve disputes and provide quality assurance checks on ATO field officers, taxpayers and their advisers;
- legal challenges to dubious LPP claims, including court action if required;
- independent arbitration of disputes, if agreed mutually by the ATO and taxpayer; and
- a program of ‘strategic litigation’ for LPP to resolve grey areas of the law, including prosecution in cases involving evidence of false and misleading statements and obstruction.

5.47 Acknowledging that the privilege concessions granted to AWP had gone too far, the Commissioner indicated that the new approach to LPP would extend also to accountants. In addition, the Commissioner threatened the withdrawal of AWP concessions where insufficient information is provided for the ATO to determine the taxation consequences or intended purpose of particular transactions and arrangements.

5.48 Complementing this tougher approach have been measures aimed at improving audit case management that have involved input from key industry bodies, particularly in relation to resolving delays. The ATO also indicated that there is a significant attempt to adopt a more cooperative and preventative approach to handling difficult cases.³⁵

5.49 It is obviously too early to assess the effectiveness of these measures, suffice it to say that they indicate a willingness by the Commissioner to address the issue forcefully and with resources. The foreshadowing of legal measures including litigating where necessary should address the concerns of some ATO officers about the ATO executive’s preparedness to tackle the problem.

5.50 The Committee welcomes the ATO’s response to this issue. Access to information is not simply an operational problem; it involves equity issues as well. Abuse of the privileges

33 ATO, ‘Remedial Action re Legal Professional Privilege’, p. 2. See also the Interim Report on LPP in the Taxation System prepared by Associate Professor Sue McNicol, July 1999.

34 Michael Carmody, Commissioner of Taxation, ‘A Question of Balance’, Address to the American Club, Sydney, 17 September 1999.

35 ATO, ‘Remedial Action re Legal Professional Privilege’, p. 2.

and concessions covering taxation advice for those who can afford it compounds the structural inequity facing those taxpayers who are unable to afford professional advice (as discussed in chapter 3). A firm stance on the use of LPP and AWP is necessary if tax planning that seeks to undermine the intent of the law is to be prevented.

5.51 The Committee requests that the Australian National Audit Office consider monitoring the measures proposed by the ATO in respect of Legal Professional Privilege and Accountants Working Papers.

