

CHAPTER 1

MANAGING COMPLIANCE RISKS

Introduction

1.1 Abusive tax planning arrangements pose a significant compliance risk for the Australian Taxation Office (ATO). This risk must be managed effectively if both the tax revenue and the integrity of the tax system are to be protected.

1.2 In its Interim Report of June 2001, the Committee rehearsed in detail the compliance risks posed by the rise of mass marketed schemes and discussed the ATO's response to them. In this Chapter of its third and final report, the Committee builds on that discussion in order to identify the ongoing risks posed by these types of scheme and the administrative arrangements required to manage them effectively.

1.3 The Committee examines the following issues in turn:

- Current levels of deductions and compliance risk;
- ATO communication strategies to the market; and
- ATO risk management strategy.

Current levels of deductions and compliance risk

1.4 In assessing the adequacy of ATO measures for preventing a recurrence of the mass marketed schemes crisis, the Committee has attempted to analyse developments in levels of disallowed deductions and compliance risk since the ATO's crackdown on schemes in 1998. However, the Committee is aware that it may be too early to determine accurately the effect of the ATO's campaign on the schemes market and on the compliance attitudes of those who invested in schemes.

1.5 One constraint is the variability of ATO data for recent years on levels of non-allowable deductions, which is discussed further below. The variable state of this data makes it difficult, for example, to get a firm grasp on the extent to which deductions have declined, which in turn poses problems for assessing the current level of compliance risk presented by mass marketed schemes.

1.6 The Committee notes that the Australian National Audit Office (ANAO) is planning to conduct an audit of the ATO's performance in aggressive tax planning¹ and expects the results of the audit to provide useful input to the question of the effect of ATO initiatives in this area. In the meantime, the Committee's conclusions are of a provisional nature.

¹ Evidence, p.709.

1.7 With these qualifications in mind, the Committee notes the results of an ATO internal evaluation, produced in June 2000, of its actions towards mass marketed schemes. The evaluation found that:

- After the marked increases in disallowable deductions from 1992-93 to 1996-97, deductions had levelled off;
- Despite curbing the growth in deductions, the level continued to be ‘unacceptably high, at around \$1 billion in 1998-99’; and
- ‘the ATO had been largely successful in putting an end to schemes that use non-recourse loans, effected by a round-robin flow of funds, to artificially inflate deductions relating to tax-shelter investments’.²

1.8 In addressing the level of compliance risk, the evaluation concluded:

The compliance problem has stopped growing and levelled-off. There is still a large amount of work to be done. The main problem appears to be a small group of habitual avoiders who continue to promote aggressive tax planning. The ATO needs to stay active and build on those strategies that have proven successful in the past.³

1.9 The evaluation estimated that ATO strategies had a major impact in containing the growth in deduction levels. ATO modelling based on the rate of growth of deductions from 1992 to 1997 calculated that non-allowable deductions may have continued to grow to around \$2 billion in 1998-99 and \$2.9 billion in 1999-2000. With deductions identified at June 2000 to be around \$1 billion for 1998-99, it appeared that growth had been capped.⁴

1.10 In the ATO’s view, the levelling off of deductions post-1998 suggested that its actions had brought about a change in taxpayer behaviour – a so-called ‘voluntary compliance effect’ – with taxpayers exiting the schemes market or switching to alternative allowable deductions.⁵

1.11 The ATO’s highly publicised campaign to attack the schemes market, and in particular the decision to target one of the largest schemes, Budplan, appeared to have also deterred promoters from launching similar large schemes onto the market in

² Commissioner of Taxation, *Annual Report 1999-2000*, October 2000, p.71, reporting the results of the Small Business Schemes Evaluation Report, June 2000. See also ATO Additional Information 15 June 2001.

³ ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.5.

⁴ ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, pp.18-22.

⁵ ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.5.

1997-98 and beyond.⁶ The evaluation concluded that ‘some scheme types have come and gone, while others have peaked and are now in decline’.⁷

1.12 However, more recent ATO data supplied in September 2001 reveals that non-allowable deductions did *not* level off in 1998-99 but continued to *climb* to around \$1.5 billion.⁸ Furthermore, the current figure of \$1.5 billion for 1998-99 marked an increase on the ATO estimate in May 2001 which was closer to \$1 billion.⁹

1.13 The Committee questioned the ATO about the reasons for the change in figures. It also sought current ATO figures for non-allowable deductions in 1999-2000 and 2000-2001, as well as the ATO’s view on the implications of the level of deductions over these years.

1.14 With regard to the variability of data on non-allowable deduction levels, the ATO stated:

The database is constantly being updated to reflect information made available to the ATO on new schemes we identify and additional information on schemes we already knew about as we progress our investigations.¹⁰

1.15 In addition to the complexity involved in detecting potentially tax abusive arrangements, another factor possibly behind the shifting state of deduction levels is the delay experienced with some taxpayers lodging late tax returns. The ATO states that ‘it usually takes between 3 to 6 months to gather sufficient information about a scheme in order to quantify the number of cases, deductions dollars involved, and overall nature of the scheme’.¹¹ Late tax returns, which reveal hitherto undetected schemes from earlier years, enable the ATO to uncover additional non-allowable deductions but with the result that earlier estimates need revising.

1.16 In terms of recent years, the ATO reported that it has identified non-allowable deductions of \$527 million in 1999-2000 and \$121 million in 2000-2001. Although the ATO noted that it is likely that these figures will need to be adjusted as more information comes to hand, it stated that ‘we still expect a significant reduction from earlier years’.¹²

⁶ ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.18.

⁷ ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.11.

⁸ See Attachment A to the Commissioner’s opening statement to the Committee.

⁹ ATO Additional Information 22 May 2001, see Attachment G.

¹⁰ ATO Additional Information 19 September 2001, p.3.

¹¹ ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.24.

¹² ATO Additional Information 19 September 2001, p.3.

1.17 Table 1 presents these latest figures combined with the levels of non-allowable deductions across the 1990s.¹³

TABLE 1. NON-ALLOWABLE DEDUCTIONS 1990-2001

| YEAR | NON-ALLOWABLE DEDUCTIONS \$Millions |
|------------------|--|
| 1990-91 | 2 |
| 1991-92 | 7 |
| 1992-93 | 54 |
| 1993-94 | 54 |
| 1994-95 | 176 |
| 1995-96 | 288 |
| 1996-97 | 666 |
| 1997-98 | 1100 |
| 1998-99 | 1500 |
| 1999-2000 | 527 |
| 2000-01 | 121 |

1.18 The \$527 million for non-allowable deductions in 1999-2000 represents a two-thirds reduction compared with the previous year of \$1.5 billion. In one sense, this amounts to a dramatic drop in deductions and lends support to the ATO's theory that its actions have brought about a 'voluntary compliance' effect. That is, it appears that many taxpayers who invested in mass marketed schemes have opted out of this market or switched to investing in legitimate arrangements (such as schemes with Product Rulings, for instance).

1.19 However, when compared against deduction levels for the preceding decade, the \$527 million is significantly more than the level of claimed deductions for the 1990-1995 period, that is, the period before the 'outbreak' in scheme deductions from 1996 to 1999. Even the preliminary figure of \$121 million for 2000-2001 represents a relatively high level of non-allowable deductions compared with the early 1990s.

¹³ Figures for 1990-91 to 1997-98 are based on ATO Submission No. 845B, Attachment 1. Figures for 1998-99 onwards are based on ATO Additional Information 19 September 2001, p.3.

However, the large falls in recent years do indicate that the action by the ATO is having results.

1.20 In interpreting the trends suggested by recent levels of non-allowable deductions, the ATO stated to the Committee:

We have been seeing a move towards a lesser number of participants in new schemes, but a higher level of deductions claimed by each taxpayer.¹⁴

1.21 This is consistent with the conclusion of the ATO internal evaluation of June 2000 (cited above), that the remaining problem appears to be ‘a small group of habitual avoiders’ – both promoters and taxpayers – engaged in aggressive tax planning and prepared, it would seem to the Committee, to brazen out the ATO’s attack on this activity.

1.22 The trend towards fewer participants but higher non-allowable deductions per taxpayer, when taken with the significant fall in overall deduction levels, also suggests that the market for ‘mass’ or large-scale schemes has shrunk significantly while the more specialised, ‘boutique’ end of the market for ‘habitual avoiders’ and high-risk gameplayers remains a problem.

1.23 The Committee considers that the continued significant level of non-allowable deductions has several important implications for the integrity of the tax system and the ATO’s management of compliance risks. The Committee explores these, first, in relation to the promoter industry and targeting habitual avoiders, before examining ATO approaches to communicating with the market and risk management.

Promoter industry

1.24 The ongoing introduction of new abusive schemes onto the market place, as reflected in continuing significant levels of non-allowable deductions, tends to support the ATO view that ‘the growth of a highly competitive entrepreneurial promoter market ... has been the most significant driver of the growth in aggressive tax planning’.¹⁵

1.25 Assuming the ATO is correct in saying that schemes with non-recourse financing and round robin features are declining, then the emergence of new schemes suggests that promoters are devising new forms of artificial tax planning, or redesigning old models, to circumvent the ATO. According to the Commissioner:

I would like to be able to say that we have put schemes, and the actions of promoters, behind us. I cannot. ...

We continue to see the emergence of so-called ‘boutique schemes’ which are tailored to the circumstances of larger corporates and high income

¹⁴ ATO Additional Information 19 September 2001, p.3.

¹⁵ Evidence, p.795.

individuals. But stripped bare of their more sophisticated sounding features and offsetting transactions, you are left with something very akin to the mass marketed schemes, inflated deductions claimed where the economic return is substantially reliant on the claimed tax benefit. Recent film schemes are examples of this.¹⁶

1.26 In addition to film schemes, the ATO has also detected a rise in deduction claims for schemes based on retirement villages.¹⁷

1.27 The continued marketing of abusive schemes in the face of ATO counter-measures highlights the need for adopting and applying sanctions that target aggressive tax planners and promoters. In particular, the Committee sees the proposal that the ATO be given powers to apply to the courts for ‘injunctive relief’ to stop investments in abusive arrangements contrary to the law as an important measure.¹⁸

1.28 The ability to seek a court injunction on the marketing and selling of tax abusive schemes would equip the ATO with the power and flexibility to respond quickly to market developments before they gained momentum and got out of hand. Such powers would help prevent a recurrence of the ‘outbreak’ experienced with mass marketed schemes in the mid-1990s.

1.29 The ATO’s capacity to bring a matter of concern to the courts in this fashion would also send a strong and unequivocal message to the market and, in particular, the adviser industry. As is discussed later in this Chapter, being able to escalate its concerns to the level of the courts would provide the ATO with an important channel for signalling to the market that it is serious about its concerns and prepared to stand by them in court. Such a move would help dispel any notion that the ATO was avoiding having its position tested at law, as has been one of the views in currency among adviser-investor circles involved in the mass marketed schemes episode.

Recommendation

1.30 The Committee recommends that the Government provide the ATO with the necessary powers to enable it to apply to the courts for injunctive relief to prevent the marketing of and investment in tax abusive arrangements contrary to the law.

Targeting habitual tax avoiders

1.31 The Committee shares the ATO’s concern about (in the ATO’s words) the ‘unacceptably high’ level of ongoing non-allowable deductions. While the latest figures suggest that compliance risk with *mass* marketed schemes is significantly on the wane, the presence of a core group of ‘habitual’ avoiders participating in more sophisticated arrangements is disturbing.

¹⁶ Evidence, p.798.

¹⁷ ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.35.

¹⁸ See the Commissioner’s statement to the Committee, Evidence, p.798.

1.32 The persistent involvement of this taxpayer segment with aggressive promoters and schemes presents a particular challenge to the ATO. It appears that the broad-gauge measures used by the ATO to manage the compliance risk associated with large-scale mass marketed schemes may be less effective in addressing the tax planning behaviours of habitual avoiders. A more targeted approach would seem necessary for tackling these scheme participants.

1.33 The Committee believes that targeted strategies that have proven successful with comparable taxpayer segments may provide useful models for the schemes arena. In particular, the compliance strategies used in relation to High Wealth Individuals (HWIs) could serve as starting point for developing appropriate measures. Some of the approaches trialed effectively with HWIs have already been adopted for scheme participants. For example, the ATO is using expanded tax returns (now called current year data collection)¹⁹ for taxpayers and promoters with two or more years participation in schemes as a means of enhancing its intelligence on market developments and tax planning techniques in this area.

1.34 To some degree the ATO is involved in a battle of attrition with habitual participants in sophisticated aggressive tax arrangements. By definition, this group appears willing to 'tough it out' in gameplaying with the ATO. The co-existence of this taxpayer segment and an aggressive promoter market points to the need for the ATO to adopt a mix of strategies that addresses both the supply-side and demand-side of this compliance problem. To combat the particular compliance risks that these groups pose will require the ATO to adopt both a long-term approach to seemingly ingrained non-compliance behaviours and one that can respond flexibly to new tax planning strategies.

1.35 The Committee discusses some broader perspectives on taxpayer cultures and compliance strategies in Chapter 2.

ATO communications strategies: warning the market?

1.36 In the Interim Report of June 2001 the Committee raised some concerns about the clarity of ATO statements and signals to the market before it moved to disallow scheme deductions in late 1997. In this report the Committee is mainly interested in finding ways of improving the ATO's communication with the market, particularly tax practitioners.

1.37 In Chapter 3 the Committee discusses the views of tax professionals towards the ATO signals on matters of law.

¹⁹ See the discussion on information and intelligence collection in the section on risk management later in the Chapter.

Effective signalling?

1.38 The ATO has maintained that it signalled its concerns about abusive features of schemes prior to the dramatic rise in mass marketed schemes in 1996-98. The ATO has pointed to the combination of public statements and audits on schemes that, it believed, should have at least put the market on notice that it had reservations about the legitimacy of these arrangements.²⁰

1.39 Apart from the concerns mentioned in the Interim Report, the Committee questions whether the ATO's auditing of schemes and subsequent disallowance of deductions during the late 1980s and early 1990s was widely known among the ranks of the tax profession, let alone the market place. For example, one of the barristers who provided advice to scheme promoters, Mr Robert O'Connor QC, told the Committee that he was not aware that the Commissioner had disallowed deductions in the audited schemes.²¹

1.40 In the Committee's view, targeting promoter networks and their trusted advisers with field audits should have put this group on caution. But it is doubtful that news of ATO audit activity would have percolated to the middle and small tier advisory and accounting firms upon whom many of the 'average' taxpayers caught up in schemes relied.

1.41 With the benefit of hindsight, the Committee considers that a stronger signal would have been sent if the ATO had moved earlier in taking its concerns about schemes to the courts. Such a dramatic step would have been more difficult for tax practitioners to ignore, in addition to being a significant warning shot for aggressive promoters. The publicity surrounding a court action might also have alerted many investors to the ATO's concerns. It would have dispelled the notion that the ATO was attempting to change the law by way of 'fiat', or was avoiding having its position tested in the courts.

1.42 In terms of communicating its concerns to the taxpayer community, the Australian National Audit Office suggested that an effective ATO strategy would involve a mix of audit activity and educational programs. Such an approach might involve the ATO:

sitting down and saying, 'It seems like we've got a problem in this particular area; we'd better start educating taxpayers and the general community in our expectations of them.' That could be done by putting out through speeches or through education campaigns that there is a concern with mass marketed schemes. It would not just be a case of going in there, doing audits and applying penalties.²²

²⁰ See, for instance, ATO Additional Information 22 May 2001, pp.4-5.

²¹ Evidence, p.735.

²² Evidence, pp.707-708.

1.43 The Committee notes that the approach suggested by the ANAO reflects, to a large extent, the ATO's response to mass marketed schemes from 1998 onwards.²³ In addition to the action taken to disallow deductions, the ATO issued a number of speeches and media releases that attracted media coverage.²⁴ The ATO's position on aggressive tax planning in general and mass marketed schemes in particular has been a recurring theme in the Commissioner's and other senior officer speeches since 1998.²⁵

1.44 Most importantly, the ATO introduced the Product Ruling system which provides for both promoters, advisers and investors alike the ATO's view on the tax benefits of investment products. Many witnesses, particularly those from the professional bodies, support the Product Ruling system for providing certainty on the tax implications of schemes. The system has also made it harder for aggressive, 'rogue' promoters and advisers to market schemes that do not have a product ruling. According to the Australian Forest Growers:

The ATO's product ruling system has proven to be a very constructive initiative, supported by the managed investment industries, investors, accountants and advisers. Product rulings have become a standard reference for inclusion in a prospectus – without a product ruling, it is now much more difficult to attract investors. Product rulings also provide the ATO with an efficient mechanism for monitoring 'tax effective' schemes.²⁶

Early warning to the market and taxpayers

1.45 The Committee has previously suggested that another way of providing certainty would be for the ATO to provide early warning to the market and community of its concerns about the tax effects of certain arrangements, even in instances where it has yet to reach a concluded view.²⁷ While it recognises the risks of the ATO acting precipitately and possibly distorting the market, the Committee nonetheless believes that the benefits of early warning outweigh the costs of either precipitate or, more importantly, delayed action.

1.46 It is evident that a number of peak tax bodies, such as the Institute of Chartered Accountants of Australia (ICAA) and the Taxation Institute of Australia (TIA), also see it as preferable that the ATO provide early warning to professional

²³ The ANAO framed its suggestion by referring to the ATO Compliance Model, which is discussed in Chapter 3.

²⁴ See ATO Submission No. 845, Attachments A and B.

²⁵ For example, Michael Carmody, Commissioner of Taxation, 'Taxation...Current Issues and Future Directions', Speech to the Australian Institute of Company Directors, Perth, 1 May 2001. See also Michael O'Neill, Assistant Commissioner of Taxation, 'Taxes, Death & Civilisation: A look at year end "tax effective products"', 15 May 2001, <http://www.ato.gov.au/content.asp?doc=/content/corporate/sp200103.htm> (6 June 2001).

²⁶ Submission No. 851, p.16.

²⁷ Senate Economics References Committee, *Report on the Inquiry into the Operation of the Australian Taxation Office*, March 2000, pp.36-37.

bodies of its concerns about particular arrangements, including in cases where the ATO's views are only preliminary.²⁸

1.47 The Committee therefore endorses the Commissioner's recent statement that the ATO intends to develop procedures to issue early public advice of its concerns about the tax issues around financial products and other arrangements. In evidence to the Committee, the Commissioner outlined the ATO's current thinking on this issue:

at what point do we go public in expressing our concerns about particular arrangements? Going early has the advantage of putting people on notice that we may disagree as to claimed tax benefits. On the other hand, going before we have full details and are able to come to a concluded view runs the risk of commercial damage to what may prove to be a legitimate product. We have now concluded that the weight of public interest is in going earlier. For this purpose we will be developing appropriate protocols in doing that.²⁹

1.48 Since making that statement the ATO has established an early warning system. On 20 December 2001 the Commissioner announced that the ATO would be issuing a Taxpayer Alert bulletin 'when we have concerns about particular arrangements but have not come to a concluded view'. The Commissioner also said that 'the Taxpayer Alerts will warn taxpayers and tax advisers that the Tax Office may not agree with the tax benefits being claimed in respect of a particular arrangement'.³⁰ Taxpayer Alerts can be accessed on the ATO's website.³¹

1.49 The ATO published its first Taxpayer Alert on the same day as the Commissioner's announcement. The alert addressed a home loan unit trust arrangement that the ATO said 'appears to be about seeking deductions for essentially private expenditure'.³²

1.50 The Committee is pleased to note that, while Taxpayer Alerts will not cover all tax planning issues under ATO scrutiny, the system is intended to give early warning of 'significant and new emerging tax planning issues' under ATO risk assessment. The experience with the outbreak of mass marketed schemes in the mid-1990s highlights the importance of the ATO moving as early as possible to alert the market about new and emerging arrangements that it considers are tax abusive.

1.51 The Committee considers that the ATO's communications could be further enhanced by establishing formal procedures for indicating its view with tax professionals through peak bodies and other forums. The gaps in communication with

²⁸ See National Tax Liaison Group, Minutes 9 March 2001 meeting, p.14.

²⁹ Evidence, p.799.

³⁰ ATO, 'Early Warning – Taxpayer Alerts', Media Release – Nat01/89, 20 December 2001.

³¹ See www.ato.gov.au.

³² Taxpayer Alert TA 2001/1, <http://law.ato.gov.au/atolaw/view.htm?docid=TPA/TA20011/NAT/ATO/00001>.

the market during the mass marketed schemes experience point to the need for a formalised and targeted approach to communicating with tax professionals, rather than relying on word of mouth. The ATO's current efforts to develop, through the National Tax Liaison Group (NTLG),³³ cooperative arrangements with professional bodies in relation to aggressive tax planning indicate one avenue by which formal channels of communication could be established.³⁴

Recommendation

1.52 The Committee recommends that, to strengthen lines of communication with the tax industry and market, the ATO establish formal procedures for indicating its concerns about emerging compliance risks through peak bodies and other forums such as the National Tax Liaison Group.

TaxPack warning

1.53 The Committee also believes that the ATO should include information on tax effective schemes in the annual *TaxPack*. As one of the direct channels of communication between the ATO and most individual taxpayers, the *TaxPack* should be used as a key link in ATO strategies to educate taxpayers on tax issues of concern.

1.54 Although the scale of the compliance risk associated with the schemes market has declined, the continued marketing of tax abusive schemes means that taxpayers need to remain on guard. The Committee considers that it is still necessary for the ATO to remind taxpayers of the need to tread carefully when considering investing in arrangements which claim to have tax benefits.

1.55 Communicating directly with taxpayers via the *TaxPack* would complement and reinforce the ATO's overall information and awareness-raising strategies on tax effective schemes. Those strategies have been effective in attracting media coverage and reaching target groups such as tax professionals and scheme participants. The ATO's webpage also contains important information relating to its concerns about tax-driven schemes, including regular updates on relevant developments.

1.56 Although these are necessary elements in the ATO's campaign on the issue, it is likely that sections of the community are not aware of this information or are unable to access it (eg, because they do not have internet access or are hesitant to approach the ATO). The ATO should therefore use the *TaxPack* to maximise the coverage and reach of its awareness campaigns on issues of concern such as those relating to schemes.

³³ In addition to the ATO and Treasury, the NTLG comprises representatives from the Taxation Institute of Australia; Certified Practising Accountants; Institute of Chartered Accountants of Australia; Association Of Taxation Management Accountants; National Institute of Accountants; National Tax and Accountants Association; Taxpayers Association; and the Law Council of Australia.

³⁴ See National Tax Liaison Group, Minutes 9 March 2001 meeting, pp.12-15.

1.57 In particular, the attention of taxpayers should be drawn to the following matters relating to tax effective schemes:

- the ATO's general concerns and position on scheme arrangements;
- the importance of Product Rulings in providing certainty;
- the penalty and interest charges that can result from ATO disallowance of non-allowable deductions;
- the fact that ATO payment of tax refunds does not mean that the ATO has *approved* the reason for the refund; and
- the ATO's legal power to investigate the validity of tax returns within varying prescribed time frames, as well as the reasons why these powers are necessary to protect the integrity of the tax base under a self assessment system.

1.58 In the Committee's view, it is crucial that the last two points – that a refund does not amount to ATO approval and the powers of review available to the ATO and period over which they apply – are highlighted in *TaxPack* information on schemes. Much of the violent taxpayer backlash against the ATO's disallowance of mass marketed schemes deductions springs from a pervasive failing by taxpayers to understand these basic features of the self assessment system. As the Committee and the Commonwealth Ombudsman have stated previously, the ATO needs to strive to raise the level of understanding among the community on these fundamentals of the Australian tax system.

Recommendation

1.59 The Committee recommends that the ATO include information about tax effective schemes in the *TaxPack* to improve general taxpayer awareness of the issues and potential risks surrounding tax effective schemes. This information should highlight the ATO's powers at law to review tax returns after deductions have been paid.

Risk Management Strategy

1.60 This section examines the ATO's management of the risk posed by mass marketed schemes.

1.61 It is crucial for risk identification, pre-emption where possible and action if necessary that the ATO's risk management strategy works effectively. A sound risk management framework involves, among other things, the following key features:

- monitoring and reassessment of existing risk areas;
- sampling and intelligence gathering to identify emerging risks;
- developing strategies to deal with the identified risks (also called risk treatment); and

- continual monitoring and review of risks.³⁵

1.62 As outlined in its Interim Report, the Committee identified some problems with the ATO's management of the risks presented by mass marketed schemes in the early to mid 1990s. These related primarily to a seeming lack of coordination among the various arms of the ATO dealing with risk identification, analysis of intelligence and audit findings, and treatment of the scheme related risks.

1.63 The Committee discussed its concern about these matters with the Australian National Audit Office. The ANAO has done a number of performance audits of ATO risk management in specific areas of its operations,³⁶ beginning with an audit of the ATO's overall risk management framework in 1996-97.³⁷ Although the ANAO has not audited ATO operations in relation to mass marketed schemes, the Committee considered that its understanding of ATO approaches and practice would provide an insight into the state of ATO risk management in the early and mid 1990s.

1.64 The ANAO reported that, from 1987 to around 1994-95, the ATO was gradually developing risk management techniques in response to the introduction of self assessment. However, at this stage the ATO's approach was neither a holistic nor a formal process. In 1994-95, the ATO formalised its processes to attempt to 'identify and deal with risks at the highest level'.³⁸

1.65 The ANAO's 1996-97 audit of ATO risk management concluded that while the ATO framework was close to 'cutting edge' within the public sector, 'they had a long way to go in actually capturing all the risks and putting some priority back into business operations'.³⁹ Three key areas were earmarked for attention:

- improving the consistency and transparency of the risk management process and resulting decisions;
- conducting a more comprehensive and better documented risk identification and assessment of risk; and
- adopting a better coordinated and holistic approach to treating high priority risks.⁴⁰

1.66 The Committee notes, for example, that the lack of effective processes in these areas would explain, among other things, the ANAO's 1996-97 audit findings

³⁵ These principles were derived from the following ANAO reports: ANAO, *Risk Management in ATO Small Business Income*, Audit Report No.37 1997-98; ANAO, *Risk Management of Individual Taxpayers Refunds*, Audit Report No.27 1999-2000 and ANAO, *Risk Management in Commercial Compliance: Australian Customs Service*, Audit Report No.6 1997-98.

³⁶ See the footnote above.

³⁷ ANAO, *Risk Management: Australian Taxation Office*, Audit Report No.37 1996-97.

³⁸ Evidence, p.705.

³⁹ Evidence, p.704.

⁴⁰ Evidence, p.706.

that there were communication gaps between local offices and the ATO central office such that ‘not all the information was filtering to the top’ of the ATO.⁴¹ This is a problem common to large organisations, especially ones with a network of branch and local offices. However, it is also consistent with the Committee’s finding from an earlier inquiry that indicated a tendency of the ATO central office to ignore or overlook intelligence from local and regional offices on emerging or localised risks.⁴²

1.67 Encouragingly, the ATO’s adoption of a formalised risk management strategy coincided with and was arguably responsible for a coordinated and proportionate response to a crucial local level intelligence alert. This was the alert that galvanised the ATO into escalating its approach to mass marketed schemes.

1.68 In March 1996 the Northbridge office of the ATO’s Strategic and Research Analysis Unit in WA,⁴³ using data from locally processed 221D instalment variations, reported on the emerging compliance risk with franchise schemes using limited recourse financing.⁴⁴ It rated the risk to the revenue as ‘*high and potentially very high*’.⁴⁵

1.69 This report set wheels in motion within the ATO that led to the establishment, under a senior level officer, of the national project team that coordinated an office-wide approach to improving the ATO’s understanding of mass marketed schemes and responding to them.⁴⁶

1.70 The Committee notes that since commencing action against mass marketed schemes the ATO has gone on to establish a management framework designed better to coordinate related activities dealing with aggressive tax planning in general. ATO functions dealing with Strategic Intelligence and Analysis and Tax Planners (as well as the High Wealth Individuals Taskforce) come under the control of a First Assistant Commissioner. The same First Assistant Commissioner also co-chairs the ATO Aggressive Tax Planning Steering Committee.⁴⁷ The ANAO has approved of this corporate governance framework.

1.71 The ATO has also centralised responsibility and coordination for monitoring new and emerging mass marketed schemes in its Pultney Office in Adelaide. A range of intelligence and information sources is used to provide coverage of market

⁴¹ Evidence, p.708.

⁴² See Senate Economics References Committee, *Report on the Inquiry into the Operation of the Australian Taxation Office*, March 2000, pp.81-83.

⁴³ SRA was the forerunner of the Strategic Intelligence and Analysis Unit.

⁴⁴ SRA, ‘Limited Recourse Financing: Discussion Paper’, in ATO Additional Information 22 May 2001.

⁴⁵ SRA, ‘Limited Recourse Financing: Discussion Paper’, p.8, italics in original.

⁴⁶ It also led to improvements in data capture with 221D forms in order to provide the ATO with ‘early intelligence on schemes’. See ATO National Office Minute, 21 August 1997, in ATO Additional Information 22 May 2001.

⁴⁷ As reported in ANAO, *High Wealth Individuals Taskforce: ATO*, Audit Report No. 46, 1999-2000, p.46.

developments. For example, the ATO detected 98 new schemes for the 1998-99 financial year based on information from, among other things, Current Year Data Collection,⁴⁸ Strategic Intelligence Analysis, High Risk Refund checking,⁴⁹ applications for 221D variations and private binding rulings, and the High Wealth Individuals area.⁵⁰

1.72 In addition, the ATO is developing a 'real time intelligence' capacity to provide it with early warning of compliance risks. This real time strategy includes seeking information on current tax planning techniques from accounting and legal firms, financial institutions and other elements of the tax and finance industry.⁵¹

1.73 This ability to capture information on new schemes suggests significant improvements in the ATO's ability to monitor market developments and detect emerging compliance risks. In particular, the use of private binding ruling applications to detect potentially risky schemes is in marked contrast to the pre-1998 period where a small number of applications not only failed to trigger alarm bells within the ATO but even led at times to positive ATO rulings. It also provides some support for ATO assurances that it has moved more onto the front foot in addressing risks before they escalate to alarming levels.⁵²

1.74 The enhanced intelligence capability that comes from using a wide range of information sources also demonstrates the benefits of grouping related activities under a central management structure. The Committee believes that this approach is consistent with sound risk management principles and ANAO recommendations for the ATO to employ more comprehensive and coordinated measures for risk identification and assessment.

⁴⁸ Current Year Data Collection requires taxpayers involved in mass marketed schemes for two or more years to provide early lodgement of expanded responses to an ATO questionnaire. It captures both scheme participants and promoters.

⁴⁹ High Risk Refund checking involves close scrutiny of large refund cases and more detailed investigation where suspect cases are detected.

⁵⁰ ATO Additional Information 15 June 2001, Small Business Schemes Evaluation Report, June 2000, p.34.

⁵¹ Evidence, p.799.

⁵² Evidence, p.2 and p.485.

