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Benchmarking Tax Administrations in Developing Countries: A Systemic Approach

Jaime Vázquez-Caro and Richard M. Bird *

Abstract

Benchmarking as a way of establishing standards for evaluating the performance of tax administrations has become increasingly popular in recent years. Two common approaches to benchmarking are ‘benchmarking by numbers’ – the quantitative approach -- and ‘benchmarking by (presumed) good institutional practice’ – the qualitative approach. Both these approaches consider each component or aspect of the tax administration separately. This paper suggests a contrasting approach to benchmarking, the purpose of which is less to allow others to assess the performance of a tax administration than it is to permit an administration to understand and improve its own performance. This systemic approach is more conceptually and operationally difficult because it requires considering how all aspects of the administrative system function as a whole in the context of the environment within which that system is embedded and operates. On the other hand, it is also more directly aimed at understanding and improving the key operational strategies that define good, better and best tax administrations.

1. INTRODUCTION

Benchmarking as a way of establishing standards for evaluating the performance of tax systems has become increasingly popular in recent years.¹ The concept of benchmarking, which emerged from management literature, can be thought of as a systematic process for identifying and measuring ‘performance gaps’ between one's own outputs and processes and those of others, usually those recognized as leaders in the field. Alternatively, in some instances the gap assessed is that between actual performance and some hypothetical ‘ideal’ performance. In either case, the motivation underlying such studies is presumably that by identifying such gaps one

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¹ See Gallagher (2005) as well as the database and discussion to be found on the website <http://www.fiscalreform.net/>. For examples of benchmarking in developed countries, see Australian Tax Office (2001) (an example of international benchmarking with respect to a major administrative change), and Canada Revenue Agency (2008) (an example of benchmarking performance against established service standards over time). For an overview of comparative tax administration practices in (mainly) developed countries, see OECD (2009); similar data for a number of African countries may be found in International Tax Dialogue (2010). Robinson and Slemrod (2009) is a first attempt to incorporate some of the useful information collected by the OECD into a more systematic cross-country study. The OECD data, though very valuable, must be used very carefully for such purposes owing to the many comparability problems that remain to be sorted out.

can perhaps first begin to understand why they exist and then to understand how the gaps might be closed in the country being studied.

1.1 Why Benchmark?

To illustrate the need for some kind of benchmarking, consider a possibly apocryphal story. Some years ago the director of railways in India, a country in which railways traditionally constitute the core of the transport system, was asked “Why do you bother to have a timetable when the trains are always late?” His reply was both simple, and accurate: “How would you know they were late if we did not have a timetable?”²

As this story suggests, from one perspective benchmarking is in effect a way of establishing a ‘timetable’ -- a set of clear and ideally measurable objectives against which to measure performance. These objectives may be an idealized vision of what should be. They may be a more or less well-based estimate of what should happen if the system worked well. Or they may simply be based on past experience or on the average outcomes suggested by experience elsewhere. However such benchmarks are established, once they exist not only has a standard against which to judge reality been set, but, more importantly, we know what information needs to be collected -- how late are the trains? -- in order to determine the extent to which the goals established are actually met. Although there are almost always elements of judgment in making such measurements, the basic framework for analysis is nonetheless established by the timetable (the benchmark, or standard).

Even when there is not only a timetable but also information on the extent to which it is not met, however, we are only at the beginning of analysis. To continue with the railroad story, we may know how many trains are late and by how much. But the real questions are: why are they late, and what can be done to improve matters? Trains may be late for many reasons: system design failures (inappropriate signal configurations), environmental factors (landslides, floods), operating problems (breakdowns), human error (crew asleep or poorly trained). At best, all that benchmarking exercises can do is to tell us that there is something that should probably be looked at more closely. They cannot and do not tell us exactly what happened, why it happened, or how it can be fixed.

Most benchmarking exercises understandably emphasize quantitative measures of success. However, what can be measured and what matters are not always the same. An additional problem with some benchmarking of tax administrations, especially in developing countries, is that many such exercises have been carried out more by outsiders, such as those who pay (donor agencies) or those who criticize (NGOs), than by tax administrations themselves. If those who must generate most of the critical data needed for a benchmarking exercise are aware that they will be judged by it and they see no direct benefits for themselves from accurate reporting, accurate reporting is unlikely to ensue.³

² We owe this story to Arindam Das-Gupta, whose pioneering paper on tax benchmarking in India (Das-Gupta (2002) is well worth consulting. For another early study, on eastern Europe and central Asia, see Bird and Banta (2000).

³ If those responsible for providing data know that what they report will be used to assess their performance, they are unlikely to be totally uninterested and objective reporters: in the words of the original formulation of ‘Goodhart’s law’ “any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes” (Goodhart 1975).

Performance is usually defined as the relationship between what an institution does – its outputs – and what it uses to do it with – its inputs. What most benchmarking exercises do is essentially to consider (some) inputs --for example, money, people and the extent and nature of IT (information technology) -- and (some) outputs -- for example, revenue collection, arrears and evasion detected – with respect to a particular set of activities packaged within a particular organizational structure. In addition, benchmarking exercises may sometimes also consider a few aspects of the rather dark box within which policy design (architecture), implementation systems (engineering), and operations (management) combine to turn inputs into outputs. Even the most extensive benchmarking study, however, can neither tell the whole story nor permit direct inferences about causality.

As noted earlier, the information obtained from such exercises is more likely to be useful if it is in the interest of those who provide the information to do so accurately. It is also more likely to result in meaningful change if it is in sufficient detail (for example, setting out clearly the relative importance of non-reporting, underreporting and non-payment as components of the tax gap by economic sector) to help managers identify risks and deal with them. To put this point another way, as we develop in more detail later, the objectives that are benchmarked must be congruent with the real strategic objectives of the organisation. In addition, in principle input from clients (taxpayers) with respect to the level and quality of service and compliance costs should also be included in benchmarking exercises.⁴ Finally, international benchmarking comparisons must take into account at least the key relevant aspects of the different environments (income level and distribution, growth rate, inflation rate, degree of ‘informality,’ etc.) within which the activities being compared take place.⁵

Much real-world benchmarking of tax administrations is deficient in one (or sometimes all) of the respects just mentioned. Nonetheless, the basic logic of benchmarking is sound and should in principle be both attractive and useful even to those who are being benchmarked: if other organizations deliver similar services better than you do, why not learn from them? Modifying and adapting the successful practices of others has always been an important way in which individuals and organizations improve their performance. Indeed, tax administrations around the world are currently increasing the extent to which they share information with other administrations in an effort to improve both their own performance and to control tax evasion and avoidance practices that have become increasingly ‘globalized’ in recent

⁴ An important question that is not explored here is the extent and manner in which surveys with respect to how the public perceives the revenue administration should be explicitly factored into the discussion. For example, in an interesting early Indian study of public sector agencies such as hospitals and electricity distributors, perceptions with respect to staff behaviour (eg, with respect to corruption) and the amount and reliability of the information provided to the public were found to overlap strongly with perceptions of the quality of the service provided (Paul 1995). See also Reinikka (1999) for an overview of possible uses of surveys and especially Kelly and Hopkins-Burn (2010) on the interesting New Zealand Inland Revenue experience with customer service surveys.

⁵ This important ‘environmental’ issue is not discussed further here: for reviews of the importance of understanding in detail the setting within which revenue administrations must function, see Gill (2000) as well as Vazquez-Caro, Reid and Bird (1992).

decades. Such information exchanges are obviously useful and are likely to become even more important in the future.⁶

One common aim of benchmarking tax administrations is of course to improve their operation, for instance, by allowing consultants and international agencies to provide somewhat more objective ‘grading’ or ‘ranking’ appraisals of tax administrations in developing countries than they might otherwise be able to do.⁷ However, if, as is often the case in developing countries, the intended objective at least in principle is ultimately to provide some useful guidelines for restructuring a particular tax administration – as it were, to lay the basis for a ‘re-engineering’ strategy so objectives may be achieved more efficiently and effectively -- most benchmarking exercises fall far short.⁸ Benchmarking may sometimes be useful to identify areas of weakness – symptoms. As already mentioned, however, it seldom provides either clear explanations of the underlying problems or insights that are helpful in resolving those problems. Nonetheless, even incomplete and partial benchmarking may sometimes further such important (though usually implicit) objectives as encouraging administrations to collect and analyse data that they need to collect and analyse if they want to know what they are doing. If a benchmarking exercise also serves to establish a potentially useful ‘best practice’ standard of behaviour to which they should aspire, that is another bonus. Unfortunately, most existing examples of benchmarking are too narrowly conceived to serve such purposes.

In the next section, we discuss briefly three alternative approaches to benchmarking tax administrations and make the case for what we label the ‘systemic’ approach. In the balance of the paper, we then set out a basic framework for systemic benchmarking. We conclude with a brief consideration of why this approach has not, to date, been widely accepted.

⁶ See Keen and Lighthart (2006) for a careful discussion of the uses and limitations of information exchange in tax administration and OECD at <http://www.oecd.org/dataoecd/15/43/2082215.pdf> for a model tax information exchange agreement (TIEA); a list of existing TIEAs may be found at http://www.oecd.org/document/7/0,3343,en_2649_33767_38312839_1_1_1,1,00.html. For different perspectives on current and prospective future trends along these lines, see Pinto and Sawyer (2010) and Eccleston (2010). It should perhaps be noted that, like all good things, international information exchange carries some risk. For instance, excessive attention to interactions with other national administrations may sometimes result in the entrenchment of what turn out to be systematic errors. To illustrate, it may perhaps be argued that in the past discussions in such international organizations as the Inter-American Centre of Tax Administrators (commonly known by its Spanish acronym, CIAT) may at times -- for example by emphasizing the importance in the early stages of adopting IT of focusing on such ‘best practices’ as taxpayer identification numbers to ‘automate’ taxpayer accounts -- have inadvertently diverted attention from more important and much broader issues such as how best to use the new technology to improve the control of evasion and the services provided to taxpayers. For other examples of the misuse of technology in tax administration, see Bird and Zolt (2008).

⁷ The search for a clear and simple numerical answer to inherently complex questions appears to be never-ending: for a critical evaluation of earlier attempts to establish ‘tax effort’ targets for developing countries, see Bird (1976). Of course, one complaint does not an avalanche stop, so recently one of the authors gave in and contributed to the continuing flood of international tax ratio comparisons in Bird, Martinez-Vazquez, and Torgler (2008).

⁸ For an excellent discussion of the kind of basic re-engineering that is inevitably required when a major administrative restructuring is taken seriously, see the case of Singapore discussed in Sia and Neo (1997).

2. APPROACHES TO BENCHMARKING

Three broad approaches to benchmarking may be found in practice and in the literature. The first, and by far the most popular, is 'benchmarking by numbers' – the quantitative approach. The second, also popular, is 'benchmarking by (presumed) good institutional practice' – the qualitative approach. In practice, mixed varieties of these two approaches are also commonly found. It is easy to mix them because both approaches share an important common characteristic: they consider each component or aspect of the tax administration separately. In contrast, the third approach -- the systemic approach set out later in this paper -- requires considering how all aspects of the administrative system function as a whole in the context of the environment within which that system is embedded and operates.

2.1 Benchmarking by Numbers

As a simple example of (prescriptive) benchmarking by numbers, a recent World Bank study (Le, Pham and De Wulf 2007) suggested that the following quantitative benchmarks might be used (along with other indicators) to measure 'success' in revenue administration reform projects such as those that have been financed by the Bank⁹: (1) administrative cost should decline by 30% over project period and (2) compliance cost should be reduced by 2% of tax revenue over project period. These numbers were based largely on a number of different and not always directly comparable studies carried out in a disparate set of countries and circumstances by a variety of scholars and institutions. OECD (2009), for example, found that administrative costs varied from a low of 0.45% of revenue collected in the U.S. to a high of 2.41% in the Slovak Republic, while the similar range in a group of non-OECD countries was from 0.60% in Chile to 5.8% in Cyprus. While less easily obtainable, similar variations may be found in compliance costs: for example, Evans (2008) reports that the costs of complying with such broad-based taxes as income taxes and VATs range between 2 and 10% of the revenue collected.

None of these numbers has any clear interpretation, however. For example, as OECD (2009) notes, the administrative cost ratio is a poor indicator of the effectiveness of any tax administration for the obvious reason that it takes no account of the extent to which the actual revenue base captured by the system differs from the potential revenue base that should, according to law, be captured. It tells you how much it costs per dollar to collect revenue, not how effectively the administration collects the revenue it should collect. It may thus be a partial measure of administrative *efficiency*, but it is definitely not a useful measure of administrative *effectiveness*. Indeed, it is not even a very useful indicator of comparative efficiency both because many different factors may affect such ratios and because countries measure these data in very different ways. Compliance costs are usually even trickier to measure, let alone to interpret.

2.2. Benchmarking by Good Institutional Practices

Much the same can be said about using such descriptive features as the existence of a tax code or of a large taxpayer unit as indicating good practice and its absence as demonstrating the opposite. For example, in a study some years ago one of us

⁹ For an earlier review of some of the extensive World Bank assistance in this area, see Barbone et al. (1999).

included the existence of a fiscal analysis unit as an example of good practice on the assumption – subjective, but based on considerable cross-country experience -- that the non-existence of such a unit made it less likely that there was either a sustained high-level commitment to change or a coherent strategy for change (Bird and Banta 2000). A somewhat similar approach is carried to an extreme by the European Commission (2007) in a document that lays out the ‘fiscal blueprint’ against which the tax administration in countries applying for admission to the European Union (EU) is to be assessed.

The EU example is particularly noteworthy because point-values are established for several different components of each of 14 different aspects of tax administration with pass marks (‘desired scores’) set for each. In other words, not only are a large number of presumably desirable characteristics such as ‘clear rules and procedures that require the prompt and accurate recording of all tax audits undertaken’ given a numerical score compared to the maximum score of 100, but each of these many characteristics is assigned a certain weight in deriving the overall score, and a ‘pass’ level is set for each. Despite all the numbers, however, the evaluation of most of the features singled out in European Commission (2007) depends entirely on subjective judgment in several key respects – to determine how any country’s administration scores in any particular category, to determine what would constitute a perfect score, to set the pass score in each category, and to weight the results for different categories. Qualitative benchmarking in its most (superficially) scientific guise!

Whether using real numbers, estimated numbers, or completely subjective numbers, such exercises in benchmarking by the numbers dodge some large and uncomfortable questions. In practice, the operational practices in any administration necessarily respond to strategic realities and practices.¹⁰ How tax administrations perform in practice largely reflects several underlying determinant factors such as the context or environment of tax administration within the public sector as well as, more broadly, the economic environment (e.g. the size of the informal sector), the political environment (e.g. the degree of support for effective enforcement), the legal and regulatory framework, and the managerial system of the tax administration. The point, of course, is that simply measuring the performance of those activities that can be measured or subjectively assessing performance in specified institutional activities and then comparing that performance either to countries considered to have superior performance or to some subjectively established goal (or to a regional or other average) does not help provide a meaningful basis for diagnosing the ills of any particular administration unless one also considers closely the environment in which it functions.

2.3. The Need for Systemic Benchmarking

In order to establish the underlying causes of the problems that a benchmarking analysis may uncover, at least the most important among the many factors that can explain differences in performance among tax administrations must be taken explicitly

¹⁰ We emphasized many of these points in our earliest joint work on this subject (Vazquez-Caro, Reid and Bird 1992). Although much of our subsequent work along these lines was done in specific country contexts and has not been published, some aspects are developed to some extent in the following papers: Bird (1989, 2004); Bird and Casanegra (1992); Bagchi, Bird and Das-Gupta (1995); Bird and Banta (2000); Vazquez-Caro (1992); and Vazquez-Caro and Ospina (2006).

into account.¹¹ In addition, such a study must also provide a vision of the reference system for any given administration as well as a guide on how to adapt its practices to meet a set of observed -- or perhaps ideal, or perhaps simply satisfactory -- standards.

To put this point another way, the aims of the kind of operationally focused systemic benchmarking approach sketched in this paper are, first, to uncover and understand the issues on which successful organizations have focused in order to improve their performance and, second, to assess the extent to which, and how, the administration under study deals with these issues given the context in which it works. From this perspective, the key point in using benchmarking as a guide to restructuring tax administration becomes not so much to define a particular set of benchmark indicators but instead to identify the management practices -- good, better, and best -- that underlie and explain a set of good indicators. With this approach, the 'gaps' that need to be focused on and the steps that need to be taken to improve tax administration in any particular case are set out in a way that is operationally more meaningful for tax administration management —albeit perhaps in a form that is less obviously quantifiable or directly comparable across countries than may be to the taste of benchmarking aficionados looking for a quick and quantifiable checklist against which to 'grade' different tax administrations.

The next section outlines the basic analytical approach suggested. We then turn to the problem of defining an appropriate reference system to implement this approach. Finally, to illustrate how this approach may be applied we outline the major factors determining successful tax administration and some basic benchmarks that may be used to measure those factors. To some extent, this discussion draws on work done for a large developing country that wished to benchmark its practices in controlling tax evasion and avoidance by large taxpayers against similar practices in several developed countries – Australia, Canada, France, New Zealand and the United States - - that were chosen as comparators because their tax administrations were considered to exemplify superior performance in terms of collection and compliance as well as general management processes.¹²

3. SYSTEMIC BENCHMARKING

As in the case of the railway timetable example with which this paper began, to identify appropriate benchmarks one must first ask why, exactly, one wants to benchmark in the first place. Suppose, for instance, that the main objective is – as it was in the study mentioned above -- to reduce evasion and avoidance by large taxpayers—the main direct channel through which most revenue is collected in most countries.¹³ If this is the goal, then an appropriate benchmark might be, for example,

¹¹ This point is discussed and illustrated in such earlier studies as Vazquez-Caro, Reid and Bird (1992) and Gill (2000). In the present paper, however, we focus more specifically on the legal and regulatory framework and especially on managerial practices.

¹² Information restrictions prevent us from going into detail on this study, which was undertaken by Jaime Vázquez-Caro in association with several colleagues, including Agélic Leguizamó, Álvaro Herrera and José Ospina. In addition to the documents from ATO, CRA, and the OECD specifically referenced in this paper, the discussion also draws on annual reports and other documents found on the websites of the national tax administrations of France, New Zealand, and the United States.

¹³ As Bird (2002) emphasizes, large taxpayers (mainly corporations, of course) are much more important to revenue administration than is measured by the taxes they themselves pay: they are also critical 'tax agents' withholding and collecting personal income taxes and payroll from employees as well as value-added and excise taxes.

the best practices applied in countries like those just mentioned that have demonstrably high compliance levels and appear on the whole to control evasion and avoidance strategies by large taxpayers fairly well.¹⁴ Assuming that this rather vague ‘standard’ is taken as a starting point, two questions then need to be answered: (1) What constitutes best practice in tax administration? (2) What is the optimal international standard? Both questions are complex.

Often, international practice – as set, for instance, by what ‘good’ administrations are doing -- is proposed for implementation in a particular country on the assumption that the selected practice fits all situations. However, although segregated large taxpayers units (LTUs) and integrated management systems as well as such features as voluntary compliance, bank collection and returns processing, withholding, and the like are common in ‘good’ tax administrations, they are not always or necessarily good prescriptions for developing countries.

For such practices to become integral parts of ongoing tax administration systems in particular developing countries they often need careful and sometimes substantial development and context modification. As an example, the implementation in Uruguay of a model of large taxpayers’ administration originally designed to cope with the Bolivian crisis of the mid-eighties has been viewed by many as a good example of ‘technology transfer’ (Silvani and Radano 1992). On the other hand, both the staff of the tax administration and many small and medium taxpayers in Uruguay at the time complained that while the large taxpayers unit (LTU) may have resulted in better services for large taxpayers, it created chaos for the rest. Since presumably, tax administrations should be equitable in satisfying their legal mandate, providing excellent service to those with money and no service (or bad service) to those that are poorer hardly seems an appropriate outcome. This does not mean that the LTU approach is wrong per se or even that it was the wrong thing to do in Uruguay at the time.¹⁵ But it does suggest that a good revenue administration also needs to consider how to improve services to ‘non-large’ taxpayers as well -- or perhaps in some instances even to exclude them from being expected to meet all the legally required formal tax obligations.¹⁶

Three distinctions may help identify ‘best’ practices more precisely: between strategic and operational practices; between explicit and implicit practices; and, finally, between good, better and best practices. We discuss each in turn.

3.1. Strategic and Operational Practices

What constitutes a complete, congruent and modernized tax administration system?¹⁷ A framework that captures both levels and processes is needed to identify specific country gaps in tax administration strategy and managerial practices against any reference base. We use the concepts of *strategic* and *operational* practices to

¹⁴ Though of course even the ‘best’ remains far from perfect, as discussed recently for Canada by Larin and Duong (2009).

¹⁵ As Baer, Benon and Toro (2002) argue, LTUs have proven to be useful in a number of countries.

¹⁶ The two points mentioned in the text, for example, are suggested by the emerging literatures on the ‘state-capacity building’ importance of good tax administration (Brautigam, Fjeldstad and Moore 2007) and on the appropriate tax treatment of small and micro enterprises (International Finance Corporation 2007) – literatures that, it should be noted, are by no means always in agreement.

¹⁷ For a full discussion of the notion of “congruence” in this context, see Gill (2000).

differentiate two related but quite different levels of practices determining tax administration performance.

Most important are strategic practices that shape tax administration and that are themselves shaped both by those who design administrative structures (legislatures and top executives) and by those who execute them – for example, the top management of the Australian Tax Office (ATO) or Canada Revenue Agency (CRA). The broad rules of the tax game are set by legal mandates in the form of specific substantive laws as well as by procedural law and administrative law in general. Management interprets these rules by creating institutional, technological and operational ways to secure compliance. The strategic practices that tax administration management adopts in addressing particular issues ultimately become operational practices.

To put this point another way, underlying any operational practice in principle there is presumably either some element of the legal mandate or an identifiable response to specific environmental conditions. If the results observed in any particular operational area are unsatisfactory, this approach to benchmarking suggests that the root cause may be either the absence of appropriate laws and regulations or an inappropriate managerial approach addressing the specific issue. It is obviously important to know which of these problems exist.

In practice, many benchmarking efforts even in developed countries focus on such *operational practices* as audit and taxpayer service. For example, the Canada Revenue Agency (CRA) reports that in 2006–07 only 36% of actuarial valuation reports met its ‘service standard’ of being completed within nine months, compared to the expected target of 80% (Canada Revenue Agency 2008). If this ‘target’ makes sense, then presumably what this suggests is that CRA is not doing a terribly good job in this area. However, neither the target nor the reported performance can be meaningfully interpreted except in the context of the underlying strategic practices. This point emerged clearly in an early benchmarking exercise in Colombia in the mid-1970s, when area directors were directed to create performance tables for their respective areas and comparative tables were then constructed to compare the performance of administrative units of similar size and complexity with respect to such factors as the percentage increase of taxes generated by audit interventions, efforts to control tax arrears, and the number of appeals. This exercise proved useful in making regional tax administrators aware that their results were being assessed and compared, and has remained a regular part of tax management in Colombia. However, it soon became clear that any given result could almost always be explained not only by managerial performance but also by such ‘exogenous’ factors as legal loopholes or changes, budgetary problems, and commodity booms or busts and even the weather.¹⁸ Even within the context of one country with a uniform legal system many of the questions that emerged from benchmarking often need to be answered in strategic rather than simply operational terms.

¹⁸ For an interesting and much more systematic quantitative attempt to compare the ‘productive efficiency’ of tax offices (in Belgium), see Moesen and Persoon (2002); other relevant country studies of aspects of this issue, with varying degrees of sophistication, include Hunter and Nelson (1996) on the United States, Klun (2004) on Slovenia, Serra (2005) on Chile, Forsund et al. (2006) on Norway, von Soest (2007) on Zambia, and HMRC (2010) on the United Kingdom.

On the international level, even more factors come into play. In some countries, for instance, the person responsible for VAT is considered an agent (like a withholding agent) whereas in others—like most Latin American countries at the end of the 20th century—the person responsible for VAT is considered to be a taxpayer. The first definition is much more stringent because it assumes that if the money is not deposited, the person responsible for VAT is stealing the money. He is committing a criminal offense. Obviously, these two approaches may generate completely different attitudes toward delinquent VAT taxpayers.

Similarly, the statute of limitations differs from country to country in terms of time limits and consequences. For example, in most developed countries there is no time limit in evasion cases where there is fraud. Even when there is no fraud, taxpayers may sometimes be audited up to 10 years later. In contrast, many developing countries impose much more rigid time limits on administrative action. In Colombia, for example, returns, even if fraudulent, may only be audited within two years of filing. To counter the obvious adverse effects on revenue of such limits on ‘normal’ good tax administration practice, Colombia has introduced substantial withholding on all types of income and sales combined with a complex and slow system of tax rebates. The initially bad strategic practice of legally overly restrictive limits on auditing thus resulted in the introduction of still worse operational practices in the form of deliberate over-withholding and an inadequate refund system.

Each country has its own complex legal apparatus of thresholds, taxpayer definitions, base definitions, standard deductions, inflation adjustments, exclusions, exemptions, statutes of limitations, penalties, amnesties, tax return forms, audit methods, and collection strategies. Each thus has a unique country-specific system that establishes and defines different risk conditions and attitudes for both administration and taxpayers. One cannot interpret simple international comparative ‘benchmarking by numbers’ exercises without clearly understanding all these factors.¹⁹

3.2. Explicit and Implicit Practices

Even when a particular operational practice is perceived as a success, that success may rest on some embedded practices that are simply taken for granted. For example, an important *implicit practice* guiding the Canada Revenue Agency is the concept of the ‘protection of the base’ that CRA labels as the underlying value defining its strategic vision. Such implicit values may be reflected in many different ways in different aspects of the administrative system and may also influence legal developments. In Canada, for example, the design of tax forms -- the instruments through which the administration filters the legal framework at the individual level at the moment of compliance -- is not usually identified as a good practice. However, it clearly *is* good practice in the sense that it is an operational reflection of CRA’s strategic position regarding the information it requires in order to protect the tax base. Indeed, in most developed countries, return forms reflect a conscious information gathering strategy. They are set up to provide detailed information on the determination of the tax base,

¹⁹ Of course, earlier writers recognized many of the problems with benchmarking and performance measurement and have proposed different approaches and solutions: for some interesting examples, see Behn (2003), Nordegraaf and Abma (2003), Propper and Wilson (2003), Pollitt (2006), Hood (2007), Aberbach and Christensen (2007), van Stolk and Wegrich (2008). However, no previous paper of which we are aware has taken the same ‘management’ focus as the present paper.

often with annexes to further explain individual base situations based on qualitative profiling of the taxpayer.²⁰

In contrast, in most developing countries little or no effort is made to capture detailed base information as part of the sworn return. The emphasis is on the payment part, not the tax base part, of the form. Indeed, in practice tax administrations in many developing countries are happy to accept payments even when mandatory forms are not submitted or when most required fields on forms have not been completed.

Such implicit, accepted but largely invisible practices as how forms are designed (and distributed, and dealt with once received) may be more important than more *explicit practices* (such as audit frequency) in explaining success or failure. If a tax administration has no reliable information on the reported tax base -- let alone meaningful estimates of the potential tax base -- it has no real basis for assessing its performance. Unless such practices are clearly recognized, comparison between administrations, let alone the transfer of knowledge from one tax administration to another is unlikely to be very useful.

For example, many low-income developing countries seem unlikely to be able to pursue the 'no return' policies currently in place, or advocated, in a number of developed countries.²¹ The latter can follow this path -- as, to a limited extent, have a few medium-income countries like Chile and Singapore (Bird and Oldman 2000) -- largely because they have both developed financial structures and good tax administrations. When countries are not so fortunate as to be able to 'ride' on a basically well-developed financial system that encompasses most of the potential tax base (Gordon and Li 2009), however, they must work much harder to gather the information needed to improve their tax systems -- and of course they have fewer resources with which to do so. Close attention to the nature, quantity and quality of the information flowing into the tax administration is especially crucial in poor countries. Equally, however, it is especially difficult for such countries to deal with this issue. Before one can 'protect' the revenue base, one must have a good idea of what that base consists and where it is located.

3.3. Good Practices and Best Practices

To identify the *best* strategic (implicit or explicit) practices that may provide a useful standard for assessing operational practices in any country is at least a four-stage process. First, one must identify the relevant strategic practices. Second, in each country selected as a comparator one has to select *good* practices. Performance of any activity may be considered good when the result is both *effective* (what is done is what should have been done in the specific conditions) and *efficient* in terms of costs, resources and time. Third, one must determine the *best* practices at the country level.

²⁰ For similar reasons, scholars such as Oldman (1965) have recommended that penalty structures should be designed to take into account not only the direct tax escaped by an offender but also the 'indirect cost' imposed as a result of his failure to provide information required to monitor the transactions of others. Interestingly, as Arendse (2010) reports for South Africa, taxpayers often do not perceive -- or are not persuaded by -- this rationale and hence tend to think that automatic penalties for such 'information gap-causing' activities as failing to file on time are excessively high.

²¹ A good example is the Danish system called TASTSELV—the automated tax process or 'no touch strategy' as described in <http://www.itdweb.org/documents/public/denmark.TASTSELV%20-%20the%20automated%20tax%20administration.pdf>.

To do so, one has to compare good practices and establish that there is a qualitative or quantitative relative advance (beyond 'normal' improvement or the past average of the tax administration). Finally, one has to compare best country practices within a holistic view of the tax system in the country being benchmarked in order to establish a target that is appropriate for that country, given its capacities and the problems it faces.

To do all this requires the collection and analysis of information on each process being benchmarked in its specific context in order to be able to compare them both quantitatively (if data are available) and qualitatively, while at the same time trying to understand the logic behind the practices in each environment. In particular, one needs to consider what factors appear to determine the success of any good (let alone best) practice. To do so, one needs a clear view with respect to three distinct aspects of the practice being benchmarked: first, *reality* in the sense of how the practice is adjusted to the specific circumstances of the case in hand as well as how it might be customized; second, *capacity* in the sense of the available operational implementation capacities in terms of resources such as staff; and third, the environmental (legislative, cultural) *setting*. The flavour of what needs to be done is nicely captured in CRA's statement that "performance targets are established by our management teams through analysis of affordability constraints, historical performance, the complexity of the work involved, and the expectations of Canadians" (Canada Revenue Agency (2009, p.15).

Summing up, in the approach suggested here, best practice benchmarks should reflect the application of the most advanced knowledge of the state of the art in the sector, the response to specific pressures that may have forced creative solutions which respond to a systemic view, and, not least from a dynamic perspective, the capacity to alter paradigms through innovation and risk taking. This is obviously both a demanding and to some extent an inherently 'fuzzy' task. In the remainder of the paper we describe how such systemic benchmarking might work.

4. FINDING THE POLAR STAR

For centuries, navigators have used the polar star for guidance.²² Is there an equivalent 'pole star' that may be used as a reference point for reforming tax administration management? An appropriate starting point for developing countries that wish to improve (modernize) their revenue administration may perhaps be found in a set of underlying values that are found in 'good' tax administrations in developed countries such as Canada and Australia. These values, which unfold as strategic practices that in turn structure operational practices arguably include the following:

- A high level of commitment to protect the tax base
- A cooperative (or collaborative) compliance model
- Concern for equity above maximization of collection

²² Potentially, there are both north and south polar (or pole) stars, depending on the stellar configuration, but most attention was historically paid to the north star in celestial navigation. While stars' positions change throughout the night, the pole star's position in the sky does not, so it is a dependable indicator of the direction north.

- Rationalization of transaction costs related to tax compliance
- Strategic management development within the changing role of tax administration as the country changes
- The ‘internationalization’ of tax administration as a response to limitations in the coverage of national tax systems
- Standardization of tax processes based on automation and the formalization of processes and deeper use of the internet
- Major focus on the development and satisfaction of human resources

The sharp differences between most developed countries and most developing countries with respect to most of these factors explain many of the observed differences in their tax administration performance once one adjusts for the very different environments that (on average) these two (very heterogeneous) classes of countries provide for tax administration. Most strikingly, practices in most good developed country administrations have steadily moved towards redefining the relationship between taxpayers and tax administration from the long-standing ‘adversarial’ legal approach—taxpayers try to cheat and tax officials try to catch them—to a new model of cooperative compliance, in which the central role of the revenue administration is to foster and encourage tax compliance rather than simply to seek out those who fail to comply and punish them appropriately.²³

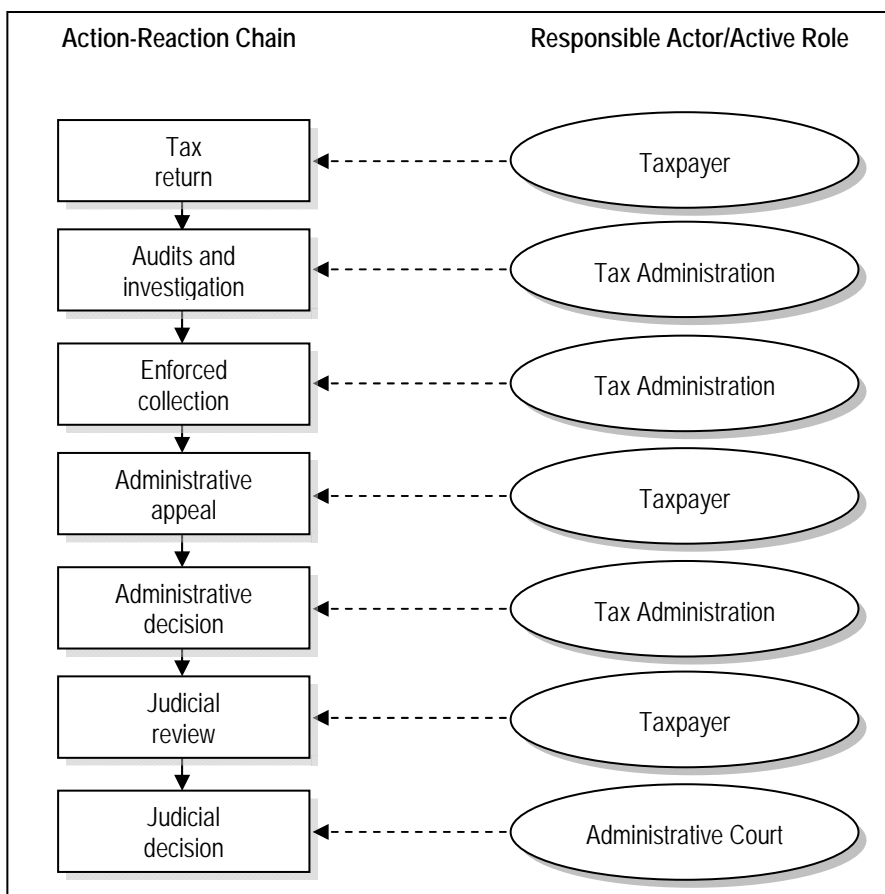
4.1 The Adversarial Approach

“Catch Me if You Can!”²⁴ Models of hunter and hunted, predator and prey, thief-catcher and thief, have at times been used to explain the relation between revenue administrations and taxpayers. Such an inherently adversarial approach may be depicted as a sequence of actions in which each party acts individually and without communication with the other party, who then reacts. This adversarial sequence of ‘action’ and ‘reaction’ begins with the assumption that there is an initial risk of cheating by the taxpayer. It further assumes that the main task of the revenue administration is to detect such cheating through the audit process and then to punish it appropriately. At each stage of this approach, taxpayers are almost always allowed to defend themselves through a variety of administrative and judicial measures. The working process is sequential: (1a) You declare, (1b) I verify; (2a) you appeal and stop paying, (2b) I analyze and resolve the appeal; (3a) you open judicial review...and so on (Figure 1).

²³ The ‘cooperative compliance’ model set out in Braithwaite (2003), among other places, is most explicitly applied in Australia (see ATO, 2000 and 2009). An even broader ‘fiscal exchange’ perspective is suggested in Whait (2010)

²⁴ This is the title of a chapter (on audit and assessment) in Radian (1980).

FIGURE 1: ADVERSARIAL MODEL OF ADMINISTRATION-TAXPAYER INTERACTIONS



As tax systems become more complex, however, this sequential model becomes increasingly limited. For example, when different jurisdictions are claimants for a multinational tax base, or there is general hostility against taxes, it becomes difficult (for both sides) to manage tax obligations and may be quite costly for whoever loses out in the process. All too often, the adversarial approach results in a relatively unproductive tax administration and substantial tax evasion.

4.2. The Cooperative Approach

For these reasons, most developed country tax administrations have largely rejected the adversarial approach and moved towards cooperative compliance as a new way to relate with taxpayers, particularly with large taxpayers and those with international operations. This evolution towards cooperative schemes, especially but not exclusively with respect to large taxpayers, is evident in Canada and Australia, for example. Payroll taxes, personal income tax withholding, corporate taxes, sales taxes, excise taxes – in every instance a relatively small number of organizations are directly responsible for channeling most taxes to governments.

The distinguishing characteristic of this model is that, instead of being sequential like the adversarial approach, there is now some degree of conscious interaction between administration and taxpayer at each step of the taxing process in an attempt to find agreement and closure, within legal parameters. The party primarily responsible for

each step of the tax compliance process remains the same, but the other party is now expected to assist and participate in achieving a satisfactory resolution. For example, compliance with tax declaration and return requirements is facilitated by attempting to obtain consensus on the interpretation of the tax law; audit cases are selected primarily through risk analysis carried out according to risk factors made known to the taxpayer; and audits are carried out according to a plan agreed with the taxpayer to lessen the transaction costs on both sides.²⁵ The idea is to reduce the probability of conflict at every step and to increase the likelihood of reaching satisfactory closure. The administrative objective is to engage in the least costly combination of enforcement and dispute resolution activities (fewer audits, fewer judicial reviews) while improving compliance (immediate and future). For the taxpayer, the main gain is to reduce compliance costs (including psychic and uncertainty) costs.

Clearly, whether such an approach is successful or not depends largely on the extent to which both sides perceive the possibility—and the potential gains to them—of developing a larger ‘trust’ space, for example as a result of more interaction in the relationships at different stages of the process, pre-agreed higher compliance levels, lower transaction costs, higher voluntary compliance and lower levels of uncertainty. Of course, when these conditions are not met—when some taxpayers simply refuse to play the new cooperative game—the traditional process always remains as an option to be used by exception. However, when more ‘trust-based’ relations with taxpayers can be developed, both the tax administration and the tax system in general can become more effective and less costly by reducing uncertainty (and thus risk and costs) in both the tax process and its outcomes for both taxpayer and administration. Moreover, although adopting a more cooperative approach to revenue administration requires at least some initial degree of trust to operate successfully, over time this approach may also in itself prove to be one important way in which more such trust (social capital) may be built.²⁶

An additional important potential gain from moving to the cooperative approach is that it facilitates a better and more permanent system of monitoring compliance, particularly with respect to the larger entities that collect most revenues. Since the cooperative system works more in ‘real time’ there is less need than under the adversarial system to figure out what happened in the often non-traceable past and more opportunity to focus on what is going on in the present (and might go on in the future). In lieu of the action-reaction system of the adversarial approach, under the cooperative compliance concept rather than waiting for interpretation errors to happen -- with the result often being often complex audits and large tax values under discussion -- to the extent possible taxpayers and tax administration try to reach an

²⁵ Of course, most tax administrations are reluctant to reveal such ‘trade secrets’ for fear of making life too easy for would-be evaders, just as the police do not publicize their patrol routes. Such secrecy may make life a little more difficult for stupid criminals, but it is often equally sensible to make it clear that certain buildings and activities are strongly guarded. Striking the right balance between the two strategies is always a tricky matter. For further discussion of audit design and execution, see e.g. European Commission (2010), Khwaja, Awasthi, and Loeprick (2010), and Biber (2010, 2010a).

²⁶ As Brautigam, Moore and Fjeldstad (2007) emphasize, good (cooperative compliance) tax administration not only requires some degree of trust; it is also in itself an important way in which such trust may be built.

agreement on the interpretative determinants of the information to be included in tax returns.²⁷

When this system works well, each party has both increased knowledge of the other party's attitudes and expectations and greater clarity in the rules of the tax game. With continuous interaction, taxpayer and tax administration get to know each other better. The tax administration maintains protection of the tax base via a sort of regulated consensus between the tax administration and the taxpayer throughout the different steps of the tax process.²⁸ For example, the administration develops credible evasion and avoidance risk analysis to back up and guide the discussion as well as the necessary built-in transparency to deal with corruption risks.²⁹ For taxpayers certainty is increased by greater clarity in the rules and procedures of the tax relation, as the tax administration's specific positions on the application of the tax law are extensively discussed and conveyed through various mechanisms.

5. IMPLEMENTING COOPERATIVE COMPLIANCE

Viewed from this cooperative perspective, the universe of relations and operational practices in the taxing process in countries with good administrations is quite different from that which still exists in many developing countries.³⁰ Broadly interpreted, cooperative compliance is a concept that cuts transversely across the contents of all substantive processes of tax administration. If improperly or inappropriately implemented, however, this approach carries with it possibly enormous risks to the revenue. It is therefore critical to look closely at how the managerial and operational practices through which this strategic focus is implemented have to be structured in order to attain positive results in terms of increased compliance and reduced administrative costs for tax agencies as well as reduced compliance costs for taxpayers, while simultaneously increasing the overall equity and efficiency of the tax system and reducing the risks of evasion, avoidance and corruption.

At least six major factors seem critical to a successful transition to the cooperative compliance model: structured risk management, viewing the taxpayer as a customer, the quality of the tax laws, appropriate international networking, a wide range of consultative arrangements, and generalized use of internet-based technology. In the balance of this section we discuss each of these points in turn.³¹

²⁷ For example, the spread in recent years of advance pricing agreements (APAs) is an attempt to deal 'up front' with some of the complex problems arising from international transfer pricing arrangements rather than trying to deal with such problems long after the fact in what usually turns into an extremely long, costly, and ultimately not very satisfactory dispute resolution process (Altman, 2006). Of course, the simple existence of an APA does not mean that similar disputes and delays may not ensue; but sometimes it helps.

²⁸ For obvious reasons, tax officials do not like to call such discussions 'negotiations.' Indeed, provided the process follows a clear set of principles -- for example, with respect to the range of discretion available to officials at different levels and the internal review system -- and is as fully transparent as consistent with taxpayer confidentiality, it is the antithesis of the sort of exercise of unaccountable discretion by officials that often underlies corruption.

²⁹ For an interesting discussion of how some Brazilian state tax administrations have, by building up their detailed knowledge of industry supply chains, strengthened both their risk analysis and their credibility in the eyes of taxpayers, see Pinhanez (2008).

³⁰ For an early view, of the traditional approach to tax administration, unfortunately still relevant in some developing countries, see Radian (1980).

³¹ We do not discuss here another important factor -- the attitude of tax administrations in terms of respecting, supporting and promoting the quality and welfare of their employees. Happier and more

5.1. Risk Analysis

Risk analysis is how modern organizations commonly conceptualize and define managerial actions. How tax administrations manage tax evasion risks, for instance, obviously depends in part on the accuracy of accounting records. As the world has just learned with respect to the financial sector, however, even the best accounting records do not provide a complete picture of risk, so tax administrations have developed other techniques to control risks such as risk-based auditing.³²

If the cooperative compliance approach is to be effective, a new operational setting with central units focusing on different compliance risks is needed. In effect, with this approach the headquarters function becomes a complex (and usually heavily automated) ‘back office’ intended to improve and support audit delivery at the operational ‘front end’ of the tax system.

Risk analysis starts with the segmentation of clients and the identification of the type of risks each client or group of clients poses. In some countries such risk analysis is developed jointly with taxpayers, as in some Brazilian states (Pinhanez 2008). More often, risk analysis is developed internally but shared to some extent with taxpayers.³³ When this level of risk analysis is carried out appropriately, and the riskier points are identified and closely monitored, tax administrations obviously increase their ability to protect the revenue base.

From the perspective of the tax administration, risks may be classified as relatively *controllable* or *non-controllable*. Non-controllable risks may or may not be *insurable*. Risks arising from the basic design and vulnerability of the law and its interpretation fall into the uninsurable non-controllable category from the perspective of the tax administration: these are the cards they are given to play in the ‘game’ of tax evasion.

Since risk analysis is done within the formal rules of the game (laws and regulations) that define what the tax administration does, these rules define the legal and regulatory risk environment. Too many base exemptions, for example, break the generality of the system and make it vulnerable to evasion and corruption. More complex systems, with more lines drawn between what is taxable and what is not, are open to more interpretation. Similarly, the shorter the period during which an administration may initiate an audit, the higher the risks that are likely to be taken by risk-taking taxpayers.

skilled tax officials may not make taxpayers any happier, but unhappy and untrained officials can definitely make them miserable. (Recall that, as mentioned earlier, we also do not discuss in this paper the many important ‘environmental’ differences between developed and developing countries, highly relevant though such factors undoubtedly are in determining just how and to what extent the approach suggested here may perhaps be implemented in any particular country.)

³² See e.g. European Commission (2010) and Khwaja, Awasti and Loeprick (2010).

³³ The United States appears in some respects to take this to what some might consider an extreme, perhaps in an attempt to deter potential evaders. For example, the series of Audit Technique Handbooks by industry available on line (<http://www.smallbusinessnotes.com/operating/taxes/mssp.html>) presents a rather terrifying 20-40 pp. outline of the kinds of questions that an auditor – obviously a most unusual auditor, who is unconstrained by time, other work, or any interest in the size of the potential tax liability involved -- is reportedly instructed to verify in the course of an audit of, for example, a retail filling station.

Taxpayers, like tax policy makers, may also change the rules of the game. For example, if enough people play the tax ‘lottery’ and evade in the expectation that they will escape audit, then over time this becomes the game being collectively played and the environment for tax administration has changed for the worse.

Good risk analysis requires the administration to have a deep understanding of the taxpayer population. As noted earlier, good tax administrations have developed many ways to gather and cross information by, for instance, designing tax forms to request information useful to identify avoidance risks; by requiring promoters of so-called ‘aggressive avoidance’ schemes to register³⁴; by opening multiple access channels and services for tax advisors; and in general, by gathering any information that helps the administration understand the nature of the activities of the taxpayer and with it, its risks.

As the tax administration learns more, its improved ability to assess and manage risks should lead to a reduction of risks as taxpayers learn that they cannot play the system without being detected. In Brazil, a developing country that has both high tax levels and substantial subnational taxing powers, even some state sales tax administrations have in recent years managed to improve their performance significantly by improving their in-depth knowledge of industry supply chains and thus upgrading their understanding and analysis of evasion risk (Pinhanez 2008).³⁵ If this process goes far enough, eventually a new ‘tipping point’ may be reached -- this time, however, to the benefit of the tax administration.

5.2. Service Standards: Valuing the Taxpayer as a Customer

Customer orientation is the backbone of collaborative tax administration. Client focus is a major concern when many tasks essential to the revenue process are performed by clients themselves and the quality of the data they supply is essential to the performance of the tax administration. The best developed country tax administrations have thus shifted to essentially a ‘client-centered’ organizational structure. One aspect of customer orientation is taxpayer segmentation to define an organizational strategy, as in the creation of Large Taxpayer Units (Baer, Benon and Toro 2001). Others have suggested that similar specialized attention is needed with respect to the other end of the business taxpayer spectrum – micro and small enterprises (IFC 2007).

But client orientation goes far beyond the organizational division of work. In France, for example, the move towards centralizing functions around clients includes the designation of high level individual staff members as the ‘access interface’ for large taxpayers with the administration. Revenue administrations more generally would seem well advised to consider adopting and extending this practice if they are really interested in getting taxpayers as much ‘on side’ as possible. It is all too easy for even compliant taxpayers with somewhat complex tax situations to be driven mad by dealing with a recalcitrant bureaucracy that sends them from place to place and person

³⁴ See Larin and Duong (2009) for discussion of the problems such schemes are intended to deal with; it remains questionable, however, how effective such control efforts really are.

³⁵ Interestingly, the data generated by this new administrative focus has already led to some path-breaking analysis of the interaction between taxation and ‘informality’ in Brazil (de Paula and Scheinkman 2009, 2009a). For equally revealing studies again drawing on the newly detailed data available in other Latin American countries, see Pomeranz (2010) on Chile and Anton and Fernandez (2010) on Mexico.

to person, continually asking for the same information. Once any issue has arisen, it would seem to be simply 'good business' to identify a single contact person through whom taxpayer-administration interactions are routed to reduce compliance costs and foster continued good relations with clients.

The emergence of specific, and publicly reported, service standards in good tax administrations around the world symbolizes the move to treating, and valuing, taxpayers as "customers" or "clients." Currently, for example, the Canada Revenue Agency assesses its service performance annually against 41 explicit "service standards" (CRA 2008). It would seem a logical next step – though perhaps one unlikely to be popular with many revenue officials – to take this concern with client relations seriously and identify clear contact points for taxpayers with complex issues. Even if the revenue amounts involved may not be not 'large' from the administration's perspective, they likely are for the taxpayer, and the potential for generating bad will by giving clients the 'telephone runaround' when they try to find out what is going on is high.

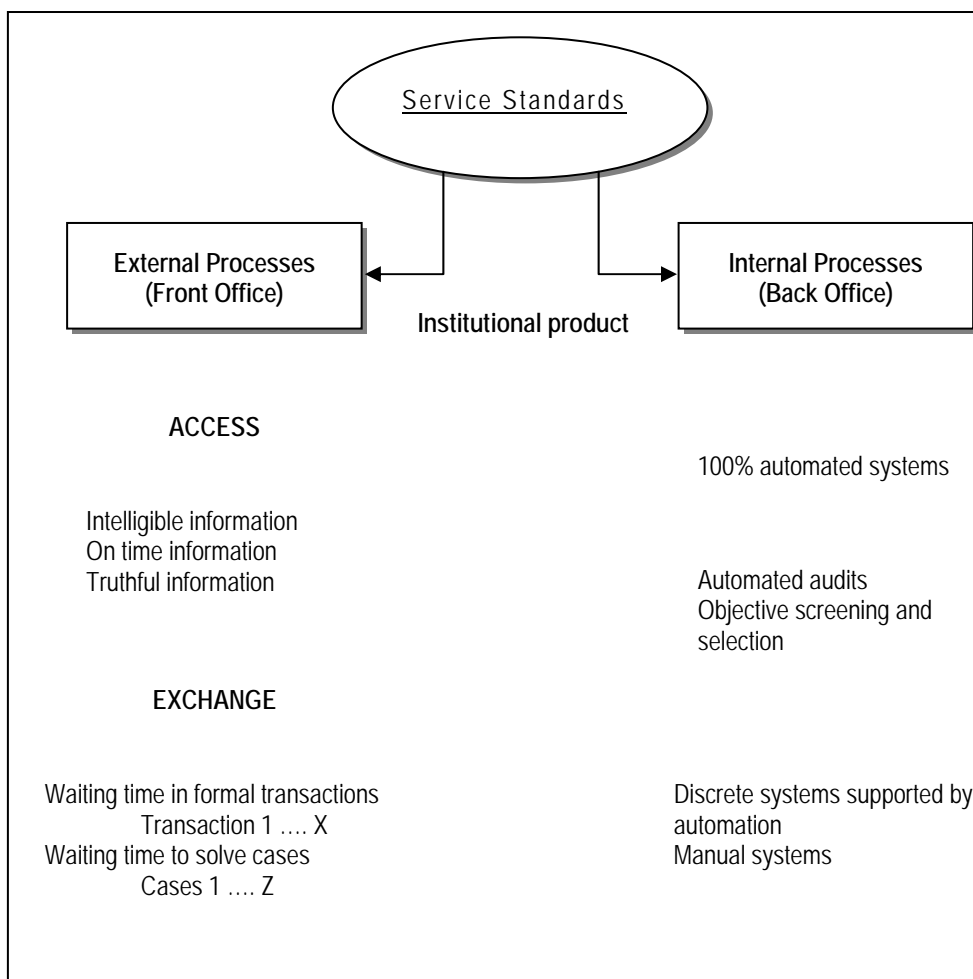
The establishment of specific services, service standards and compliance policies for taxpayers, even if not directly (or at least measurably) related to increased revenue may thus be an important step in improving administration. Once in place, service standards should guide the relationship with taxpayers and should be consistently improved. In effect, this approach creates a kind of 'quasi-contract' between taxpayers and management which, while defining service standards in terms of technical and operational feasibility, ideally permits deviations for the benefit of the taxpayer wherever possible. When, as is at least in principle true in the Canadian case cited earlier, compliance with these standards becomes an important component in the annual reports of the tax administration, this approach may provide an endogenous stimulus for permanent improvement.³⁶

In addition, as illustrated in Figure 2, service standards may affect the internal organization of tax entities. Although service standards are almost entirely related to external processes dealt with by the front desk (interface with taxpayers) of the tax administration, if they are to be effectively delivered substantial realignment of the internal processes of the back office is also usually required. When taxpayers are placed at the center of the process such investment in administrative design should both provide benefits to citizens and increased efficiency as taxpayers are better able to influence the quality of service they receive.³⁷

³⁶ Crandall (2010) provides a useful recent review drawing in part on Canadian experience as well as some useful general discussion of the uses of internal performance measurement systems in developing countries. In addition to distinguishing the strategic and operational uses of such systems, this paper also briefly discusses performance measurement at the level of the individual official, an issue not discussed here.

³⁷ A good example is the Danish system called TASTSELV cited earlier (in note 21). See also the discussion of the Singapore experience in Bird and Oldman (2000).

FIGURE 2: EFFECT OF SERVICE STANDARDS



5.3. The Quality of Tax Law

Other aspects of revenue administration may also benefit from incorporating more ‘client-focused’ policies. In many developing countries, for example, the administration has to cope with poorly conceived laws that generate major risks to the integrity of the tax system. Tax law in a changing world is inevitably open-ended and never a complete, coherent and simple set of rules. The problems arising from the quality (complexity, inadequacy, incoherence) of tax law have become a political issue in many countries and have resulted both in ‘bills of taxpayer rights’ in some countries (e.g. Canada) and in others to major efforts – in the case of Britain in part with the aid of a private ‘think tank’ (the Institute for Fiscal Studies) -- at ‘simplifying’ tax law in various ways.³⁸ Seldom, however, have the damaging effects bad laws have on the quality of administration been adequately taken into account.

In all too many countries, for example, tax administration has suffered greatly from the propensity of governments to grant various tax incentives and ‘tax expenditures’

³⁸ For an extensive treatment of taxpayers’ rights, see Bentley (2007). On the simplification project in the UK, see, for example, Institute of Fiscal Studies (1998).

without much care about their implications for either revenue collection or avoidance and evasion practices. At the level of interpreting tax law, the possibilities are even more open-ended. Exemptions and explicit and implicit loopholes embedded in tax laws invariably generate a complex system that requires considerable interpretation by tax officials in order to be applied to the almost infinitely varied real life situations of taxpayers.

5.4. Consultation

Considerable specialized human capital on both the public and private sides of the tax relation may be required to deal with such issues. For example, at the OECD as well as in the United States, Canada, Australia, and elsewhere extensive and sometimes prolonged discussions carried out in various internal and external ‘knowledge groups’ have at times driven developments in dealing with tax avoidance, particularly international tax avoidance. Australia and New Zealand in particular have made major efforts to engage ‘stakeholders’ in the tax system in discussions of a wide range of issues including tax policy and assessments of administrative performance.³⁹

5.5. The International Dimension

In recent years, a key aspect in protecting the tax base at the country level has increasingly been the establishment of a complex and increasing international network of more or less formal arrangements intended to cross check and/or monitor increasing volumes of international trade and financial transactions. Many such arrangements have taken place under the aegis of the OECD (Eccleston 2010). The internationalization of the tax base has thus increasingly resulted in the ‘internationalization’ in many ways of both tax policy and tax administration. In particular, tracing financial transactions (e-financial transactions) has become a major strategic concern of tax administrations everywhere, although as yet it is not clear that such activities have significant results in terms of improving outcomes.

5.6. New Technology

Finally, information technology (IT) is increasingly a key support of cooperative compliance strategy. In Canada, for example, initial automated audits, including source deduction and information crosschecks, are followed by subsequent reviews, verifications, examinations and audits with the objective of promoting the accurate reporting of income and trade data, with the aim of reducing problems arising from insufficient tax remittances as well as facilitating the early detection of reporting errors. The idea is to avoid unproductive audits and to focus resource-intensive efforts on higher risk segments while at the same time reducing the compliance burden for individuals and businesses.

³⁹ Although Canada has done less in this respect (Arnold 2011), a particularly explicit statement on this issue was made in Canada some years ago: “We will accelerate our work with interested provinces, territories, and First Nations to create new opportunities for co-operation and partnerships. We will strengthen partnerships with other government departments and governments to provide single-window service. We will collaborate with tax professionals to promote compliance. We will work with the private sector to build links to CCRA programs and services where it is in our mutual interest (Canada Customs and Revenue Agency (CCRA) 2003). (CCRA became CRA, Canada Revenue Agency, in 2004.) South Africa has perhaps done more along these lines than most developing countries, as discussed by Bentley and Klue (2010) and Smulders and Naidoo (2010).

Increasingly, a key determinant of good tax administration today is the extent to which compliance and taxpayer service can be managed and implemented through web-based technology. The appropriate design and implementation of such technology may not only improve the quality of service at all levels; it may also reduce transaction costs to taxpayers significantly. Different services ranging from simply information on laws and regulations up to e-filing are provided on the web by a number of developed countries. Importantly, in almost every case, such services were extended on a voluntary, not mandatory basis: that is, taxpayers do not have to do it this way unless they perceive sufficient benefits to themselves from doing so. However, judging from the 'market test' of high take-up rates of such services in countries such as Denmark and, among developing countries, Chile, moving towards web-based tax administrative systems seem clearly the way to go.⁴⁰

6. BENCHMARKING THE COOPERATIVE COMPLIANCE MODEL

Appropriate performance measures depend upon the objectives sought. With the cooperative compliance approach that is now the basic way good revenue administrations operate, the main objective is not simply to expand collections but to ensure that everyone pays his or her 'fair share.' Performance under this model cannot be improved simply by increasing the number of audits. Indeed the more successful this approach is, presumably the fewer audits, the fewer formal appeals and the fewer enforcement actions to collect taxes in arrears are needed to improve or maintain collection levels. Tax administrations pursuing an approach aimed at creating an environment through facilitating cooperative compliance so that taxpayers are less likely to cheat or delay payment thus need to measure their performance differently than when their dominant aim is to catch cheaters and penalize those who do not cooperate.

To illustrate, Table 1 provides an illustrative list of several items that seem appropriate in assessing the gaps between the performance of a particular tax administration and that of a good, better, or perhaps even 'best practice' administration.

⁴⁰ As early as 2004, the first year of Denmark's 'automated' system, less than 10% of the taxable population made any corrections to the pre-filled return. In Chile in 2005, 96% of taxpayers filed over the Internet, and 57% of the 1.2 million (out of 1.7 million) who received a pre-filled return accepted it without adjustment. Not all stories are so immediately successful, of course: in Malaysia only 20% e-filed in 2007 apparently more because most taxpayers saw no advantage in doing so than because they found it difficult to do so (Manaf, Ishak and Warif 2010).

TABLE 1: STRATEGIC OBLIGATIONS IN MANAGING A TAX ADMINISTRATION

• Establish basic internal and control systems of tax administration
• Greater concern for equity than maximization of collection
• 'Internationalization' of tax administration
• Formalization and standardization of cooperative compliance processes
• Migration to web-based interactive processes
• Client focus
• Deeper risk analysis
• Tax forms information strategy
• Participation in shaping of legal framework
• Knowledge networking in society: Consultative arrangements
• Development of knowledge organization (across departments)
• Human resource policies

Once a reference system identifying such objectives and the strategic practices derived from them is identified, then corresponding benchmarks for each of the analytical dimensions can be established. Of course, the precise specification of such measures is always context-dependent: in Canada, for example, CRA has no formal role in preparing tax laws and its relations with the legislature are largely confined to its budgetary appropriation, its annual report and responses to questions raised in reports by the Auditor-General. In contrast, in other countries, the revenue administration may play a different and more autonomous role with respect both to legal drafting and relations with the legislature.

The set of benchmark indicators in Table 2 is intended simply to illustrate how a particular administration might be assessed in terms of achieving the objectives set out in Table 1. Clearly, many of the indicators suggested must be derived from qualitative analysis although it may be possible in some cases to quantify them to some extent – for example, on the basis of expert evaluations (as in the EU ‘fiscal blueprint’ discussed earlier) or experience in other jurisdictions.⁴¹ There is also some overlap with the sort of performance service standards currently used in Canada and other countries to assess performance. However, in line with the intent of systemic benchmarking -- namely, to evaluate the overall performance of the tax administration in achieving its strategic objectives (as set out, for example, in Table 1) -- the objectives considered in Table 2 and hence the measures suggested are on the whole considerably broader than those usually established by such ‘performance standards.’ It is neither useful nor meaningful to evaluate particular aspects of tax systems (such as administrative costs) or particular institutional characteristics (such as functional organization) without considering carefully how such practices relate to systemic

⁴¹ As a further example, presumably one might devise quantitative measures of such indicators as horizontal equity, compliance levels, and audit interventions, although we have not attempted to do so here.

improvements based on the best practices observed in well-functioning administrations.

TABLE 2: BENCHMARKING MANAGERIAL PRACTICE

BENCHMARKS	OBJECTIVES	RESULT INDICATORS
<ul style="list-style-type: none"> ▪ Basic internal and control systems of tax administration 	<p>Assess the built-in efficiency and vulnerability of tax administration</p> <p>Is there a:</p> <ul style="list-style-type: none"> ○ secure and updated taxpayer account system? ○ secure system of storing tax returns base information? ○ secure and updated registry of taxpayers 	<ul style="list-style-type: none"> ○ efficient and accurate operation of these systems ○ deterrence of fraud and corruption
<ul style="list-style-type: none"> ▪ Higher concern for equity than maximization of collection 	<p>Assess equity as a tax administration priority.</p>	<ul style="list-style-type: none"> ○ Higher horizontal equity ○ Higher compliance ○ Proper collection levels
<ul style="list-style-type: none"> ▪ "Internationalization" of tax administration 	<p>Assess the level of international tax administration activity.</p> <ul style="list-style-type: none"> ○ Services ○ Audit 	<ul style="list-style-type: none"> ○ Higher horizontal equity ○ Better compliance (collection) levels from international taxpayers
<ul style="list-style-type: none"> ▪ Formalization and standardization of cooperative compliance processes 	<p>Development of operational practices to implement the cooperative compliance model</p> <p>Assessment of the instruments for achieving cooperative compliance</p>	<ul style="list-style-type: none"> ○ Established protocols of intervention ○ Manuals ○ Definition of operational practices
<ul style="list-style-type: none"> ▪ Migration to web-based interactive processes 	<p>Assess the depth of web-based processes and their impact on the internal operation of tax administration</p>	<ul style="list-style-type: none"> ○ Number of totally automated interactive transactions ○ Number of transactions with Internet access
<ul style="list-style-type: none"> ▪ Client focus: 	<p>Assess the priority given to clients</p> <ul style="list-style-type: none"> ○ Self-propelled definition of service standards ○ Segmentation of taxpayers 	<ul style="list-style-type: none"> ○ Improved services ○ Enforceable service standards ○ Focused audit interventions by segments
<ul style="list-style-type: none"> ▪ Deepening of risk analysis 	<p>Does the administration have a system that covers all risks inherent to the operation of the tax system?</p> <ul style="list-style-type: none"> ○ Taxpayer risks ○ Sectoral risks ○ Corruption risks 	<ul style="list-style-type: none"> ○ Reduction of non-compliance due to deterrence ○ Higher effectiveness of tax audit targeting
<ul style="list-style-type: none"> ▪ Tax form information strategy 	<p>Does the tax administration rely heavily on information provided by the taxpayer?</p> <p>Is risk analysis embedded in the contents and approach of the tax forms?</p> <p>Do tax forms include qualitative information for taxpayer profiling?</p>	<ul style="list-style-type: none"> ○ The possibility of deep computerized audits ○ Dissuasive effects generated by the contents of forms
<ul style="list-style-type: none"> ▪ Participation in shaping of legal framework 	<p>Is tax administration an important stakeholder in the definition of tax legislation?</p>	<ul style="list-style-type: none"> ○ Number of legal initiatives drafted by tax administration ○ Number of interventions of tax administration experts in Parliament
<ul style="list-style-type: none"> ▪ Knowledge networking in society: Consultative arrangements 	<p>Is consensus a basis for interpreting and implementing tax legislation?</p> <p>Is private expertise embedded in regulatory developments?</p>	<ul style="list-style-type: none"> ○ Number of private-public institutions dealing with taxation ○ Number of administrative general rulings conceived collectively with civil society stakeholders ○ Number of meetings with knowledge-based and/or civil society groups
<ul style="list-style-type: none"> ▪ Development of knowledge organization 	<p>Is knowledge and staff development a priority in tax administration?</p>	<ul style="list-style-type: none"> ○ Training impact on tax administration performance

Copying even the best practices of the best systems is of course not a guarantee of success when the systemic context in which the practice is embedded is fundamentally different. To be useful as a guide to systemic improvement of any particular country's revenue administration, benchmarking needs to be reformulated as a system-to-system comparative exercise. There is still much to be learned with respect to how to carry out such exercises. Consider, for example, how much one would need to know about all the systemic aspects highlighted in Table 2 in order to be able to understand or make productive use in any particular country of the valuable (but often rather baffling) comparative information on tax administration so usefully compiled in recent years by the OECD (2009). Even if one does understand, in depth, just what is being done (and why it is being done) in any particular country, one may of course still be properly skeptical of how useful it really is to think of transferring ways of doing things from one country to another, particularly when the two are very different—for example, Australia and Papua New Guinea.⁴² An analogy might be trying to improve a bicycle by studying a Boeing 747.

Nonetheless, one conclusion seems clear from experience to date with attempts to benchmark revenue administrations in developing countries. The best way to transfer 'best practice' is to begin by being clear about the conceptual approaches to tax administration underlying different systems. Whether or not such approaches are explicitly recognized as such by those who actually run the tax administrations in question, every administration is shaped by a set of on-going strategic practices. These practices need to be singled out and assessed in order to understand both how their interdependence affects outcomes and what outcomes are relevant measures of 'success.' While we still have much to learn about how best to do this, future efforts at tax administration reform in developing countries may prove more useful and successful in the long run if they take the broader systemic approach suggested here rather than narrowly focusing on such particular institutional features as the degree of autonomy of the revenue administration or such quantitative but hard to interpret measures as the administrative cost per dollar collected.

7. CONCLUSION

Several key lessons for would-be tax administration reformers about benchmarking are suggested in this paper:

1. Benchmarking is not a simple process of blindly adopting the practices of others, even if they are considered by experts to be 'best in class.'
2. Presumably the motivation for benchmarking is to spot opportunities for change and improvement. In the case of revenue administration such opportunities are often 'soft' (qualitative) in nature and difficult to identify. Concentrating only on gathering data on 'hard' (quantifiable) systems, as economists in particular seem programmed to do, is likely to result in severely incomplete information and may result in changes (such as new technology) being implemented in an unsustainable manner.⁴³

⁴² For an early review of the tax system in Papua New Guinea, see Bird (1989a). As discussed in Bird (1989), this example of course simply reinforces the critical importance of understanding in depth the environment within which the tax administration must function.

⁴³ On the interplay between technology and tax administration, see Bird and Zolt (2008).

3. It is important to gather information also on such critical ‘soft’ elements of organisational ‘culture’ as management philosophy, behaviors and style, the degree of participative management, communication and recognition, empowerment, and ‘ownership.’⁴⁴
4. Even those in international agencies or elsewhere who may be unable (or unwilling) to go very far along the path suggested in the last point need to understand clearly that to be meaningful benchmarking must at a minimum be clearly linked to the overall strategic plan or strategy of the administration. As Casanegra and Bird (1992) noted some years ago, when there is no such strategy attempts to reform tax administration, with or without benchmarking exercises, are almost inevitably a waste of time.

Of course, it is also essential that those who are politically and managerially responsible for tax administration both understand and support any benchmarking exercise if it is to have any useful effects. To illustrate this point, the country study in the course of which much of the argument above was originally developed turned out to be not particularly productive. The reason is simple. The objectives of the client country’s operational team were different and focused within a different management paradigm. They did not want to hear that to be able to implement ‘best practices’ from developed countries they had first to adopt a completely different approach to tax administration. Rather than re-engineering their whole system, their focus within their existing paradigm was primarily on adopting new ‘add-on’ techniques to be measured by the achievement of detailed quantitative objectives -- without paying attention to the critically different meanings measures of such activities as audit and taxpayer services may have under different strategic approaches to the task of administering a tax system.

This reaction was not surprising. Most people who are overweight want to believe that there is a simple ‘magic bullet’ that can resolve the problem. They want a pill, a potion, or a machine that will make the problem go away. They do not want to hear that what they really need to do is to change their diet and exercise regime for life. Similarly, administrators understandably want to avoid such difficult, time-consuming, and often conflict-laden tasks as rethinking what they are really doing and re-engineering their whole organizational structure and processes to do it better. It always seems much easier to buy a new IT approach off the shelf or to hire additional or better qualified (and paid) staff than to change how one does business. It seems easier; but it is also on the whole seems much less likely to produce ‘good’ or ‘better’ results, let alone the ‘best’ results that are presumably the desired end goal.

As mentioned briefly earlier, an additional important aspect of systemic benchmarking that has often been unduly neglected is the need to pay close attention to the legal system, which is fundamental to the operation and hence the feasibility of any approach to revenue administration. Poor laws erode the possibility of successful administration, and if such erosion possibilities are overwhelming—as they are in

⁴⁴ As emphasized earlier, it is of course extremely important to understand the environment within which the administration functions: see Gill (2000). An important aspect of this environment may be what Nerré (2008) calls ‘tax culture’; for an interesting exploration of the very different ‘cultures’ in China and Australia, for example, see Huang (2010) and for an empirical look at some of the relevant factors, see Bird, Martinez-Vazquez and Torgler (2008).

some developing countries—attempts to improve fiscal outcomes by modernizing administration are unlikely to be rewarding, although they are all too likely to be costly. In addition to the quality (and quantity) of substantive tax laws, many other legal aspects need to be critically benchmarked against good practice to determine the extent to which they provide adequate underpinnings for such critical activities of a good revenue administration as risk management, service standards, web-based administration, and the implementation of cooperative compliance.

Finally, to end as we began, one must always remember that benchmarking and diagnosis are very different. Even the best benchmarks, however useful, can never replace the educated eye of an expert in providing a diagnosis of a given situation—although they can certainly help by directing that eye to problematic areas. Just as medical doctors must interpret test results (which, incidentally, are also usually ‘benchmarking’ against presumably relevant and reliable information), those who wish to improve the dark art of revenue administration must understand in depth not only exactly what is meant by specific benchmarks but also (and equally in depth) the context within they are interpreted in order to provide sound recommendations. Better diagnostic tools may improve diagnosis, but even the best tool cannot replace a good doctor. Similarly, even the best designed tax administration in any particular context is unlikely, in the end, to function well unless it has both adequate political support (including resources) from the top and a good management team in place.

In conclusion, benchmarking can be a useful tool for tax administration modernization efforts (Gallagher 2005; Crandall 2010). However, it seems more than time to reconsider the appropriate reference standard to which administrations in emerging countries are benchmarked. Over the last few decades tax administration management in countries such as Australia and Canada has altered in important ways from the old coercive tradition still found in most developing countries towards the new cooperative compliance approach discussed above, in addition to broadening their horizons to include the international aspect and substantially advancing their use of technology. As yet, however, few emerging countries (even countries like Chile and Mexico that have made substantial modernization efforts in terms of the technology they employ) have as yet moved very far in this direction.⁴⁵

No doubt countries will never be able to improve their tax administrations much in advance of the changes in the underlying political, economic, and social environment that are ultimately needed to support and sustain such improvements. Since taxation is one of the principal interfaces between state and society, however, some significant environmental factors themselves depend on how the tax system is designed and implemented.⁴⁶ Indeed, it may not be too much to say that the improvement of many developing countries may in the end depend to a substantial extent upon the improvement of their revenue administrations.⁴⁷ A more comprehensive approach to ‘systemic benchmarking’ along the lines sketched in this paper may perhaps play a critical role in facilitating that improvement.

⁴⁵ Bird and Zolt (2008) survey the use of IT in developing country tax systems.

⁴⁶ An interesting historical example of this interdependence is the change in France’s tax system during the 18th century, and particularly in how it was administered – a change that Kwass (2000) argues was directly instrumental in bringing about the French Revolution at the end of the century.

⁴⁷ In addition to Brautigam, Fjeldstad and Moore (2007), see the interesting models set out in Besley and Persson (2010) and Cardenas and Tuzeman (2010).

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Listed Corporations and Disclosure: Australia and New Zealand – A Contrasting Yet Converging Dynamic

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Abstract

The requirements for listed corporations to disclose material tax-related information has been in the spotlight over the last few years in Australasia, especially in regard to the large banks that have a major presence on both sides of the Tasman. In this paper we examine how listed companies have made disclosures in their financial statements in relation to material tax disputes with the respective revenue authorities. We suggest that the more recent cooperative compliance agreement initiative may have a significant impact going forward. For the analysis we draw some common themes from the companies reviewed, including that companies will tend to make disclosures only after their tax positions have been challenged by the revenue authorities and they intend to dispute the revenue authority's approach.

1. INTRODUCTION

The legislature and other regulatory bodies impose various obligations on directors of companies to ensure that shareholders and other stakeholders have the most recent relevant information available to them to determine whether to invest in or divest from, a company. In this paper we investigate these obligations in the field of taxation, and particularly the manner in which large corporate entities, quoted on the Australian Securities Exchange (ASX) or the

New Zealand Stock Exchange (NZX), or both, complies with these obligations.¹ The emphasis of our enquiry is on companies and their directors' dealings with the Australian

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¹ This paper does not deal with Fin 48, a requirement by the United States Internal Revenue Service that requires certain companies to disclose, in their returns, uncertain tax positions. The reason for this is that this paper deals exclusively with the requirements of legislation in Australia and New Zealand.

Taxation Office or the New Zealand (NZ) Inland Revenue Department (ATO and IRD, respectively).²

Both countries have similar requirements relating to the disclosure obligations of quoted corporate entities. In section 2 of the paper we look at the disclosure requirements of companies in Australia. Section 3 briefly considers the equivalent regime in NZ with respect to the NZX Listing Rules and company reporting obligations. Section 4 then considers how various companies with trans-Tasman links comply with their obligations. This section is limited to an examination of the big four Australian banks³ which have wholly owned subsidiaries in NZ. In section 5 we review how several Australian companies have complied with their disclosure obligations and the final section sets out our conclusions.

This review reflects a significant imposition of obligations relating to disclosure. From the data collected we conclude that companies generally comply with their disclosure obligations where there is a dispute with the ATO or IRD. It seems that where tax is concerned large corporations invariably rely on the opinions of their professional (or other) advisors to determine whether or not to make disclosure in situations where there is no dispute with the revenue authorities, and where there are no contrary opinions expressed by the Commissioner. With the law in its current form there would appear to be no obligation on directors to disclose any positions they take which are not challenged by the revenue authorities, but a disclosure requirement may exist where different opinions are held by the revenue authority on the tax outcome of a particular transaction to those held by a company. In our opinion this approach is followed irrespective of the degree of aggressiveness reflected in the tax position taken, either generally or in relation to any particular transaction.⁴

The paper now considers Australia and those aspects of the *Corporations Act 2001* (Cth) (the Corporations Act) and the various regulations of the ASX that impact on the duty to make disclosure.

2. DISCLOSURE REQUIREMENTS IN AUSTRALIA

2.1 Continuous disclosure –The Corporations Act 2001 (Cth)

The obligation to make continuous disclosure under the Corporations Act has been imposed on what are described as ‘disclosing entities’. The Corporations Act distinguishes between listed disclosing entities, where the listing rules of a listing market in relation to that entity require the entity to notify the market operator of information about specified events or matters as they arise for the purpose of the

² This paper concentrates on the disclosure obligations of listed disclosing entities that are companies where the obligation to disclose arises out of dealings between the company and the relevant tax authority. As such, areas requiring disclosure such as directors’ remuneration, are not considered.

³ Often NZ companies are wholly owned subsidiaries of Australian companies. This is the case with the four largest banks in NZ which are subsidiaries of the Big Four Australian banks (ANZ Banking Group – ANZ National Bank; Commonwealth Bank of Australia – ASB Bank; National Australia Bank - Bank of New Zealand; Westpac Banking Corporation- Westpac NZ). As a result issues around tax must be reflected in the financial statements of the holding company rather than the NZ subsidiary.

⁴ There is no empirical evidence for this conclusion but is inferred from the paucity of information in financial reports both in Australia and NZ about what could be described as uncertain tax positions.

operator making that information available to participants in the market, and those that do not have this requirement.⁵

The obligations were inserted into both the Corporations Act⁶ and the ASX listing rules for a number of reasons. These include the need to overcome the inability of general market forces to guarantee adequate and timely disclosure by disclosing entities and to encourage greater securities research by investors and advisers. This ensures that security prices should quickly and effectively reflect underlying economic values; it should also lessen the possible distorting effects of rumour on securities prices, encourage the growth of information systems within disclosing entities, and assist directors to make decisions and to comply with their fiduciary duties.⁷

In general, listed disclosing entities are required to immediately disclose material price sensitive information to the relevant market operator so that it can be made available to investors. Entities are permitted to withhold information from immediate disclosure if such disclosure would result in premature disclosure of potentially misleading or commercially damaging information. This information may only be withheld so long as it remains confidential.⁸ The Australian Securities and Investments Commission (ASIC) have primary responsibility for enforcement of these obligations.⁹

The continuous disclosure requirements require directors of listed disclosing entities to advise the stock market of the company's risk inter alia in the area of tax¹⁰ if there is information that a reasonable person would expect, if the information was generally available, to have a material effect on the price or value of the shares held by them.

The meaning of generally available was considered in *R v Firms*¹¹ where Mason P (Hidden J concurring) was of the view that information was generally available even if the persons to whom it was available were not in Australia. Carruthers AJ, in delivering a dissenting judgment, felt that the meaning of 'generally available' was limited to information that was available to persons in Australia.

Section 677 of the Corporations Act provides that a reasonable person would be taken to expect information to have a material effect on the price or value of a company's

⁵ Section 674 Corporations Act deals with the former category of listed disclosing entities whereas section 675 deals with both categories of disclosing entities. Regulatory Guide 198 issued by Australian Securities and Investments Commission (ASIC) deals with the continuous disclosure obligations of unlisted disclosing entities. This paper deals only with listed disclosing entities that are companies covered by section 674 Corporations Act. Section 674 refers to the ASX listing rules, which are discussed in section 2.2 of this paper, and gives them the force of law.

⁶ It is beyond the scope of this study to consider the civil and/or criminal penalties that could be imposed for a breach of the disclosure obligations imposed on directors and the companies they represent.

⁷ See Disclosing Entity Provisions Relief issued by ASIC under Regulatory Guide 95 paragraph 19.

⁸ Explanatory Memorandum to the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure Bill 2003 paragraph 4.223; available at: [http://intelliconnect.wkasiapacific.com/scion/secure/index.jsp?1288824020533=&link_type=7#page\[15\]](http://intelliconnect.wkasiapacific.com/scion/secure/index.jsp?1288824020533=&link_type=7#page[15]) (accessed 12 November 2010).

⁹ ASIC also has direct responsibility for monitoring and enforcing continuous disclosure by unlisted disclosing entities. The continuous disclosure rules that apply to these entities are contained solely in the Corporations Act. See Explanatory Memorandum, above n 8, paragraph 4.226.

¹⁰ Sections 674 and 675 Corporations Act. The ASX must be immediately advised of this information: ASX Listing Ruling 3.1.

¹¹ *R v Firms* [2001] NSWCCA 191.

securities if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of the securities. In *Australian Securities & Investments Commission v Fortescue Metals Group Ltd [No 5]*¹² ASIC launched proceedings against the defendants on the basis that certain disclosures made under the continuous disclosure provisions were false and misleading.¹³

Fortesque was successful before Justice Gilmour in the court of first instance. However, the Full Bench of the Federal Court unanimously found in favour of ASIC.¹⁴ Keane CJ delivered the lead judgment with Emmett and Finkelstein JJ delivering short concurring judgments.

Keane CJ (at paragraphs 117-119) concluded that the gravamen of the announcements made by the defendants was that the parties had agreed upon terms summarised in the announcements. These statements would have been understood as conveying the historical fact that agreements containing terms accurately summarised in the announcements had been made between the parties. Ordinary and reasonable investors would have taken this announcement to mean that the uncertainty which had previously attended the financing and construction of the railway for the Project was now resolved. This was the evident intention of the announcement. As such the public statements would have been understood as statements of fact by ordinary and reasonable members of the investing public. As the framework agreements were not enforceable agreements ASIC's case under s 674 was successful. Once the misleading statements had been made s 674 required that they be corrected. They were not. The learned judge stated:¹⁵

That is because the misleading statements by FMG were apt to create an understanding on the part of common investors that FMG had secured the construction of the infrastructure for the Project on terms as to deferred payment. In the state of affairs brought about by FMG's misleading statements, there can be no room for any suggestion that the corrective information which FMG was obliged to provide was not material within the meaning of s 677 of the Act. There can be no serious suggestion that FMG was not obliged by s 674(2) to correct the impression created by the misleading statements which FMG made. It would be fanciful to suggest that information showing that FMG had misled the market about having secured binding contracts for the building and finance of the Project would not have influenced common investors in deciding whether to acquire or dispose of FMG's shares.

Because of the intimate knowledge and understanding that the CEO of Fortescue had about its affairs and his part in making the statements he too was found to have

¹² *Australian Securities & Investments Commission v Fortescue Metals Group Ltd [No 5]* [2009] FCA 1586.

¹³ The allegation was that the defendants falsely made various public announcements in the press, to the investing public that certain framework agreements concluded with some Chinese companies were enforceable agreements whereas in fact they were not.

¹⁴ *Australian Securities & Investments Commission v Fortescue Metals Group Ltd [No. 5]* [2011] FCFCA 19.

¹⁵ *Id.*, at paragraph 189.

contravened the Corporations Act. It is interesting to note the penultimate paragraph of Keane CJ's judgment states:¹⁶

It is a curiosity of this case that there was no evidence that any member of the investing public was misled by, or suffered loss as a result of FMG's contraventions of the Act. Presumably, that is because those who invested in FMG have profited handsomely from that investment. This circumstance may be said to raise a question as to whether the prosecution of this case by ASIC was a game worth the candle. It is not, however, for this Court to call into question the exercise of ASIC's discretion to determine which cases it should pursue in the discharge of its regulatory functions.

In the final paragraph Keane CJ states:¹⁷

In my respectful opinion, ASIC's allegations of misconduct on the part of FMG and Forrest were wrongly rejected by the trial judge. The trial judge erred in characterising FMG's public announcements as statements of opinion which could be justified, in terms of the requirements of s 1041H and s 674 of the Act, on the basis that the opinions were honestly and reasonably held. The terms of the framework agreements did not oblige the Chinese Contractors to build and transfer the infrastructure for the Project. And once FMG has made misleading statements about the terms of the framework agreements, FMG was required by s 674(2)(c) of the Act to correct the position.

In *Jubilee Mines*¹⁸ Martin CJ was of the view that (at paragraph 57) the question of whether a reasonable person would be taken to expect information to have a material effect on the price or value of securities, is to be taken to be affirmatively answered if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, or buy or sell those securities. His Honour continued:¹⁹

On the face of it, the scope of information which would, or would be likely, to influence persons who commonly invest in securities in deciding whether or not to subscribe for, or buy or sell those securities is potentially wider than information which a reasonable person would expect to have a material effect on price or value, because there is no specific requirement of materiality in the former requirement.

In *Flavel v Roget*,²⁰ a case in which criminal charges were laid as a result of an alleged failure to comply with the obligation to make continuous disclosure, O'Loughlin J felt that the test to determine if documents should have been disclosed required first, the contents of the document itself must be assessed, and second that assessment must

¹⁶ Id, at paragraph 201.

¹⁷ Id, at paragraph 202.

¹⁸ *Jubilee Mines NL v Riley* [2009] WASCA 62. Le Miere AJA agreed with the Martin CJ.

¹⁹ Id, at paragraph 59.

²⁰ *Flavel v Roget* (1990) 8 ACLC 237; available at: [http://intelliconnect.wkasiapacific.com/scion/secure/index.jsp?1292542717082=&link_type=7#page\[5\]](http://intelliconnect.wkasiapacific.com/scion/secure/index.jsp?1292542717082=&link_type=7#page[5]) (accessed 15 December 2010).

then be made within the framework of the company and its affairs as they existed at the time of the execution of the memorandum. His Honour continued:²¹

Sometimes this second test may not be necessary; sometimes the nature of the document might speak for itself. Its importance might be of such magnitude that, irrespective of the size of the company, irrespective of the general affairs of the company, irrespective of the state of the economy of the country, its importance achieves such prominence that immediate advice to the Home Exchange is the only course of action to adopt. But there can be many cases where the contents of the document are not susceptible to such an immediate and obvious evaluation. Much will depend upon the identity of the particular company; what one company should advise the Stock Exchange might not have to be advised by a second company; what should be advised by a company at one stage in its career might not have to be advised at another stage of its career because of changed circumstances.

In our opinion the views expressed in *Fortescue*, *Jubilee Mines* and *Flavel* should be seen as amplifying and explaining the views expressed in each successive case. As will be shown below boards of directors seem to take the view that, subject to advice being given, they need not disclose potential disputes with the ATO, even though the sums involved may be material, until a review is in progress or more usually after an amended assessment has been issued.

2.2 Continuous disclosure –the ASX Listing Rules

The ASX Listing Rules (Listing Rules) provide that timely disclosure must be made of information which may affect the price or value of securities issued by a company.²² The Listing Rules govern the admission of companies (and other entities) to the official ASX list, the quotation of their securities, and suspension of securities from quotation and removal of entities from the official list. The Listing Rules constitute a contract between the ASX and listed entities. Information need not be disclosed if this would breach a law or reveal trade secrets.²³

The Listing Rules must be interpreted in accordance with their spirit, intention and purpose by looking at substance rather than form and in a manner that promotes the principles on which the listing rules are based.²⁴ Notwithstanding the forgoing, in certain circumstances disclosure may not be made if it would be inimical to the legitimate commercial interests of the disclosing entity if that confidential information would be disclosed and it would not adversely affect market integrity.²⁵ Listing Rule 3.1 also draws a distinction between continuous disclosure and the information to be contained in such documents such as financial statements and annual reports or prospectuses as provided by the Corporations Act.²⁶

²¹ Id, at page 243.

²² ASX Listing Rule 3.1.

²³ ASX Listing Rule 3.1A. Other exceptions are also mentioned in this rule.

²⁴ ASX Listing Rule 19.2.

²⁵ See ASX Listing Rules 3.1A.1 to 3.1A.3 for the criteria when information need not be disclosed.

²⁶ See section 2.3 below.

In Guidance Note 8 on continuous disclosure, the ASX notes.²⁷

Once a director or executive officer becomes aware of information, he or she must immediately consider whether that information should be given to ASX. An entity cannot delay giving information to ASX pending formal sign-off or adoption by the board, for example.

Companies listed on the ASX must also have regard to the ASX Corporate Governance Principles and Recommendations. These recommendations, as their name suggests, do not purport to lay down hard and fast rules which directors and managers of companies must follow but are simply recommendations to enable investors to assess the governance processes in a company listed on the ASX board. Even if companies do not follow the recommendations the ASX may be satisfied if the company identifies the recommendation(s) it has not followed, and explain how their practices accord with the spirit of the relevant Principle. The two most important of these from a tax context are Recommendations 5 and 7.

Recommendation 5 provides that listed companies must make timely and balanced disclosure so as to ensure compliance with the ASX listing rules and to ensure accountability at a senior executive level for that compliance. Recommendation 7 provides companies must recognise and manage risk, and as such establish a sound system of risk oversight and management and control. Tax is a potential minefield for any company due to the complexity of the laws. As such tax raises significant risk issues that must be recognised and managed.

In terms of the continuous disclosure requirements under both the Corporations Act and ASX Listing Rules any dispute with the ATO which is sufficient to impact on the value or price a company's shares must be disclosed. The paper now turns to the issues associated with financial and tax accounting.

2.3 Financial and tax accounting issues

Tax plays an important role in determining how much a company has available for distribution, investment or both. It is important that provisions for tax and other liabilities be accurately disclosed in the company's financial statements. This obligation is in addition to the continuous disclosure obligations mentioned above.

The Australian Commissioner of Taxation (the Commissioner) has noted that:²⁸

Any substantial move towards convergence of tax and accounting treatments will require a meeting of minds between the accounting and tax professions and government...In Australia there is no systematic connection between the income tax law and accounting concepts or standards. However, the two interrelate in various ways.

The reason for the differences between financial and tax accounting can largely be found in the divergent reasons for each of the different reporting mechanisms. The

²⁷ See ASX Listing Rules, at paragraph 18.

²⁸ Paper delivered to 15th Australasian Tax Teachers Association Conference by Michael D'Ascenzo, Second Commissioner, Australian Taxation Office and Andrew England, Assistant Commissioner, Australian Taxation Office, University of Wollongong 31 January 2003 The Tax and Accounting Interface.

primary purpose of the tax system is to raise revenue for the government and partially to influence certain social or political aims of the government. The primary purpose of financial accounting, on the other hand, is to provide stakeholders with information to assist in investment and other decisions. Ultimately the differences between tax and financial accounting may be substantial depending on the jurisprudential enquiry conducted by the court in determining the meaning given to the words used in a statute.²⁹

The Corporations Act imposes obligations in relation to the financial statements of companies. Under Parts 2M.2 and 2M.3 of the Corporations Act directors must, for example, furnish a declaration stating whether in their opinion the financial statements of the company, and notes to such statements, are in accordance with the Corporations Act and drawn in compliance with accounting standards.³⁰ They must also reflect a true and fair view of the company's affairs.³¹ These requirements need to be read in conjunction with each other.

If the company is listed on a stock exchange a section 295A declaration must be made by the CFO and CEO of the company that in their opinion the prescribed requirements of the Corporations Act in relation to the financial statements have been met. It is this declaration that is intended to be used by the board when making the declaration referred to in the preceding paragraph.

The Australian Accounting Standards Board (AASB) have prescribed that all information that is material must be disclosed in the financial statements of a company. Materiality means that an item is material if its omission, misstatement or non-disclosure has the potential, individually or collectively to either influence the economic decisions of users taken on the basis of the financial report or affect the discharge of accountability by the management or governing body of the entity.³²

In addition the directors' report for a financial year must contain the following: a review of operations during the year of the entity reported on and the results of those operations; details of any significant changes in the entity's state of affairs during the year; and the entity's principal activities during the year and any significant changes in the nature of those activities during the year. The directors' report must also give details of any matter or circumstance that has arisen since the end of the financial year that has significantly affected, or may significantly affect the entity's operations in future financial years; or the results of those operations in future financial years; or the entity's state of affairs in future financial years.³³

²⁹ For an overview of the issues involved with financial and tax accounting, see for example, TM Porcano and AV Tran, "The Relationship of Tax and Financial Accounting Rules in Anglo-Saxon Countries" (1998) 33(4) *The International Journal of Accounting* 433-454; AV Tran, "The Gap between Accounting Profit and Taxable Income" (1997) 13(4) *Australian Tax Forum* 507-534; and more recently AV Tran and Yi Heng Hu, "Effective Tax Rates of Corporate Australia and the Book-Tax Income Gap" (2008) 23(3) *Australian Tax Forum* 233-268.

³⁰ Section 296 Corporations Act.

³¹ Section 297 Corporations Act. Section 295(3)(c) of the Corporations Act requires information not contained in the financial statements to be recorded in notes to them where necessary to give a true and fair view of the company's affairs.

³² Accounting Standard AASB 1031 paragraph 9.

³³ See generally sections 298 to 300B of the Corporations Act.

In March 2009, in an attempt to refine current accounting standards and to bring greater equivalence to tax and financial accounting, the International Accounting Standards Board (IASB) issued an exposure draft, ED/2009/2, on how to reflect uncertain tax positions in financial statements of a company.³⁴ This exposure draft provided that:³⁵

Uncertainty about whether the tax authorities will accept the amounts reported to them by the entity affects the amount of current tax and deferred tax. An entity shall measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, *assuming that the tax authorities will examine the amounts reported to them and have full knowledge of all relevant information*. Changes in the probability-weighted average amount of all possible outcomes shall be based on new information, not a new interpretation by the entity of previously available information.

An accompanying document to the exposure draft describes the basis for the conclusions reached by the IASB. Paragraph BC 57 of this latter document states that an entity should only recognise tax benefits to the extent it is more likely than not that the tax authorities will accept them. Where tax outcomes are less certain the reason for adopting the weighted average test is that this uncertainty is included in the measurement of tax assets and liabilities by measuring current and deferred tax assets and liabilities using the probability-weighted average of all possible outcomes. This explanation is qualified as follows:³⁶

The Board does not intend entities to seek out additional information for the purposes of applying this aspect of the proposed IFRS. Rather, it proposes only that entities do not ignore any known information that would have a material effect on the amounts recognised.

Possibly even with this qualification the natural consequence of all the forgoing would seem to require financial statements to disclose, for the benefit of stakeholders including the revenue authorities, that an aggressive tax policy has been adopted or even that a tax minimisation scheme had been implemented. Certainly this would appear to be the case where there are divergent views about the tax consequences of structuring a transaction in a particular way. Another potential problem area is the transfer pricing rules where opinions can be markedly different. Presumably the more aggressive the scheme the less likely it would be that the tax authorities would accept the outcome and the greater the potential for a tax liability to arise. If this is the correct interpretation of the recommendation then effectively this would act as a 'red flag' to tax authorities to audit a particular taxpayer or at the very least to audit the transaction in question. If this interpretation was followed it has the potential to reduce, if not eliminate, significant avoidance and possibly even tax minimisation schemes, irrespective of whether they would ultimately be accepted by the courts or not.

³⁴ Australia follows the recommendations of the IASB if the recommendations are implemented as policy.

³⁵ IASB, ED 2009/2, at paragraph 26 (our emphasis).

³⁶ Id, at paragraph BC 63.

Another and possibly more probable view is that companies (taxpayers) (leaving aside those areas such as transfer pricing where divergent opinions are readily found), in following the requirements of the IASB will take a different and more nuanced approach. This statement is made on the basis that the taxpayer has received unequivocal advice from their professional team that a scheme is valid and effective for tax purposes and the Commissioner has not made any statement in which he deals differently with this interpretation of the law. On this basis, and given the nature of the advice received, taxpayers that enter into tax minimisation and even avoidance schemes would not be obliged to highlight such schemes as even on a weighted probability basis there would be no prospect of a challenge, let alone a successful one.³⁷

While writing this paper the AASB have noted that this exposure draft is to be revised and put out for further comment.³⁸ As far as we have been able to ascertain the revised exposure draft has not been issued as at the date of writing. For sake of completeness the next aspect we consider is auditor independence although in our view it is not directly connected to the obligation to make disclosure.

2.4 Auditor independence

The auditor independence provisions of *Sarbanes-Oxley Act 2002* (USA) now require the auditor of companies doing business in the USA to be independent of those giving tax and other non audit advice.³⁹ While there are similar rules in Australia,⁴⁰ it is not regarded as being a breach of auditor independence rules if the auditor furnishes tax advice in addition to performing the audit function. Section 290.180 of the Australian Code of Ethics for Professional Accountants provides:⁴¹

In many jurisdictions, the Firm may be asked to provide taxation services to an Audit Client. Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to Independence.

Section 300 Corporations Act provides that the report of a financial company must include specific information in relation to its auditors. This includes details of the amounts paid or payable to the auditor for non-audit services provided, during the year, by the auditor (or by another person or firm on the auditor's behalf); a statement

³⁷ See extracts from the National Australia Bank Ltd and Westpac Banking Corporation Ltd Annual Reports in section 4 below as an example of where this latter approach would presumably apply. It certainly cannot be the function of a taxpayer to second guess the Commissioner and assume a challenge when, on the information available to it, no challenge would be forthcoming.

³⁸ GAAP Alert No.18/2009, issued by Colin Parker.

³⁹ In July 2005 The Public Company Accounting Oversight Board published rules as to when an auditor is deemed to be independent of other advisors. See Daniel Korb, *Shelters, Schemes and Abusive Transactions: Why today's Thoughtful US Tax Advisors Should tell their clients to 'Just say no'*, in W Schon (Ed), *Tax and Corporate Governance* (Springer-Verlag Berlin Heidelberg, 2008).

⁴⁰ See, for example, sections 324 CA to CK of the Corporations Act.

⁴¹ The Code of Ethics for Professional Accountants is based on Code of Ethics for Professional Accountants (as published in the Handbook of International Auditing, Assurance, and Ethics pronouncements) of the International Ethics Standards Board for Accountants, published by the International Federation of Accountants (IFAC) and is used with permission of IFAC (Code of Ethics for Professional Accountants).

whether the directors are satisfied that the provision of non-audit services, during the year, by the auditor (or by another person or firm on the auditor's behalf) is compatible with the general standard of independence for auditors imposed by the Act; and a statement of the directors' reasons for being satisfied that the provision of those non-audit services, during the year, by the auditor (or by another person or firm on the auditor's behalf) did not compromise the auditor independence requirements of this Act.

Section 307C requires auditors to furnish a written declaration that, to the best of their knowledge and belief, there have been no contraventions of the auditor independence requirements of the Act in relation to the audit or review; and no contraventions of any applicable code of professional conduct in relation to the audit or review other than as stated in the declaration.

We now turn to briefly considering a relatively new initiative, namely cooperative compliance agreements.

2.5 Cooperative compliance agreements

A cooperative approach between a revenue authority (in this context either the ATO⁴² or IRD) with large enterprises involves the sharing of some responsibilities to ensure that effective compliance management systems are in place. A cooperative compliance approach has several benefits for both the revenue authority and the corporate taxpayers, namely:

- taxpayers have more real-time certainty about tax risks and compliance costs;
- the revenue authority can make real-time decisions about risk because taxpayers openly disclose their affairs; and
- more discussion allows the revenue authority and the corporate taxpayer to work through issues as they arise, whether it is a technical tax matter, new legislation or administration.

The ATO has had such an initiative in place since 2000, developing this into a Cooperative Compliance Model.⁴³

The purpose of these forward compliance arrangements with the ATO is to lead to an environment less likely to produce surprises; a reduced likelihood of audit; concessional remission of administrative penalties and interest that apply in the event of tax shortfalls; and and more certainty, trust and ultimately less compliance cost . They require significant input both from the ATO and the taxpayer.⁴⁴

The Cooperative Compliance Model outlines the relationship the ATO is seeking with large business and the wider community. This model is premised on a cooperative

⁴² The ATO refers to these as forward compliance agreements. To date, only a limited number of such agreements have been concluded with the ATO in relation to GST and excise duties only.

⁴³ For further details see ATO, Cooperative Compliance: working with large business in the new tax system (2000); available at: <http://www.ato.gov.au/businesses/content.asp?doc=/content/22630.htm> (accessed 16 February 2011).

⁴⁴ See ATO, Forward Compliance Arrangements (2008) available at <http://www.ato.gov.au/content/00110436.htm> (accessed 1 May 2011.)

relationship that is based on mutual respect and responsibility. Thus in the Australian context there are a few large corporate taxpayers that have forward compliance agreements in place which, while beyond this study, may be able to be evaluated for their impact on tax-related activities and associated disclosures.

The IRD embarked on a similar initiative after investigating developments in this area internationally in 2009. In the IRD's view⁴⁵ the relationship will be one that is guided by a written agreement, reviewed annually, between a company's board of directors and the Commissioner of Inland Revenue (Commissioner). This agreement will set out the responsibilities of both parties and provide a framework for the progression and resolution of issues. The expectation of such an agreement is that it brings with it a whole-of-organization commitment and is thus at the Commissioner/Board of Directors level. The IRD suggests that there are four key characteristics of a cooperative compliance relationship:⁴⁶

- *Tax governance* - to further assure us that the tax direction and appropriate risk of a taxpayer is driven from the board level, the taxpayer will need to have a sound corporate tax governance framework.
- *Open disclosure* - on a real-time basis on all material tax issues to include:
 - disclosure of significant tax risks and access to relevant working papers
 - working openly during the preparation of the tax return so that all key issues are disclosed.
- *Tax certainty* - working with taxpayers to resolve disclosed tax issues promptly and effectively by providing certainty around transactions and return filing as follows:
 - *Transactions* - advice will be provided through the products in the advice matrix, with binding rulings the main way to provide certainty. For issues where a binding ruling may not be appropriate we'll determine, on a real-time basis, whether we see the transactions as a risk that may or may not be subject to later review.
 - *Risk review* - we'll ensure our risk reviews are completed within two months of the returns being filed. Any risks identified will be dealt with immediately through further investigation and the normal disputes process. If no risks are identified, there'll be no further review of that return.
- *Relationship management* - we'll build on our existing account manager relationships, taking a more strategic approach with taxpayers and staff. If it suits the taxpayer, a more formal relationship with Inland Revenue Senior Management will be available.

⁴⁵ See further, IRD, Large Enterprises Update (2010) Number 10 (February 2010); available at: <http://www.ird.govt.nz/aboutir/newsletters/corporates-contact/2010/large-enterprises-2010-02.html> (accessed 16 February 2011).

⁴⁶ Id.

The paper now considers the disclosure obligations of directors in NZ as required for stock exchange listing and financial reporting by issuers.

3.0 NEW ZEALAND DISCLOSURE REQUIREMENTS

In comparison to Australia, New Zealand takes a lighter regulatory hand to disclosure requirements in that it is less prescriptive in what companies need to disclose in their financial statements and to the NZX. For New Zealand listed companies (that is, those on NZX or the smaller sub-exchanges) companies and other entities which issue securities have obligations under the NZX Listing Rules⁴⁷ to keep the market constantly informed on matters that may affect the price of their securities; that is, listed issuers are required to disclose material information immediately. Continuous disclosure is the requirement for listed companies to provide timely advice to the market of information required to keep the market informed of events and developments as they occur.

The NZX provides guidance for listed companies,⁴⁸ including examples of situations when disclosure should be made. One of the aims behind this NZX guidance is to provide a process that is moving toward closer alignment with ASX disclosure requirements. Interestingly none of the examples directly refer to taxation issues, although material legal proceedings would include tax disputes. One issue is when would a dispute between a listed company and Inland Revenue be material – apart from issues of the financial amount, would this requirement to disclose arise at the audit phase, once discrepancies have been notified, at the time of a notice of proposed adjustment (NOPA), when the full dispute resolution process is underway, or when the dispute enters the court process? Clearly the last step would comprise legal proceedings, although arguably even at the time of a NOPA being issued it is almost inevitable suggesting that disclosure may be necessary.

A further requirement for directors of listed companies is set out in Appendix 16 to the NZX Listing Rules, which contain provisions regarding what the NZX sees as a Code for Best Practice Corporate Governance. This includes the company having a Code of Ethics that its directors should follow, along with recommended practice for the composition of the Board and subcommittee of the Board.

Companies that meet the requirements of an issuer must prepare external financial reports in accordance with the Financial Reporting Act 1993 (NZ), and frequently New Zealand equivalents to International Financial Reporting Standards (IFRS). Disclosure requirements are as prescribed by standards issued by the Accounting Standards Review Board (ASRB) and have the full sanction of law. This is in addition to the very general nature of the disclosure obligations set out in Part 12 of the Companies Act 1993 (NZ).

Having considered the reporting requirements in both Australia and NZ the paper turns to consider how specific companies in each country comply with their obligations. The first series of companies considered are those with trans-Tasman

⁴⁷ NZX, Listing Rules (August 2010), sec 10. This applies for all NZX markets (NZSX, NZDX and NZAX). These are available at: <http://www.nzx.com/market-supervision/rules> (accessed 16 February 2011).

⁴⁸ NZX, Guidance Note – Continuous Disclosure (March 2005); available at http://static.nzx.stuff.co.nz/legacy/sxdx_continuous_disclosure.pdf (accessed 16 February 2011).

links (companies listed on the ASX but with wholly owned subsidiaries in NZ that have encountered problems with the IRD), and then Australian companies.

4.0 TRANS-TASMAN COMPANIES

4.1 National Australia Bank Limited (NAB)

The NAB in its 2008 annual financial report recorded that as a result of an audit by the IRD of subsidiaries of the NAB (principally the Bank of New Zealand (BNZ)) had received amended assessments for income tax of approximately NZ\$416 million. In addition interest of NZ\$217 million would be payable on this amount. The NAB noted that:⁴⁹

The Group is confident that its position in relation to the application of the taxation law is correct and it is disputing the IRD's position with respect to these transactions. The Group has legal opinions that confirm that the transactions complied with New Zealand tax law. The transactions are similar to transactions undertaken by other New Zealand banks. The Group has commenced legal proceedings to challenge the IRD's assessments.

The amount of tax inclusive of interest was in excess of NZ\$600 million yet it was only after an amended assessment was issued that the disclosure was made. The sums of money involved were substantial, even when considering the size of the NAB. It seems from reading the NAB's financial statements that it had received expert advice that there was nothing untoward about the transaction it had entered into from a tax perspective. It was only once the Commissioner indicated an opposing view, and then reinforced this view by issuing the amended assessment, that this was disclosed.

The 2009 NAB annual financial report noted that:⁵⁰

Income tax expense of \$2,394 million in 2009, was \$2,355 million higher than 2008...Lower tax expense as a result of lower earnings has been offset by one-off tax items totalling \$848 million in the current period relating to amended tax assessments issued by the New Zealand Inland Revenue Department (IRD).

The directors' report for the 2009 income year stated:⁵¹

In July 2009, the New Zealand High Court found against Bank of New Zealand ("BNZ") with respect to an appeal against amended tax assessments issued by the New Zealand Inland Revenue Department ("IRD") regarding certain structured finance transactions undertaken by the business. BNZ (BNZ is a wholly owned subsidiary of NAB in NZ) is appealing this outcome. A provision of \$542 million has been established to reflect the impact of the

⁴⁹ 2008 Annual Financial report at page 107; available at: http://www.nabgroup.com/vgnmedia/download/2008AFR_Final.pdf (accessed 5 October 2010). Whether the third last sentence of the extract may constitute a waiver of legal professional privilege is beyond the scope of this paper.

⁵⁰ 2009 NAB Report of the Directors, at page 5; available at: http://www.nabgroup.com/vgnmedia/download/2009afr_new.pdf (accessed 5 October 2010). All figures are in Australian dollars unless otherwise stated.

⁵¹ Id, at page 10. All figures are in Australian dollars unless otherwise stated. For the High Court judgment see *CIR v BNZ* (2009) 24 NZTC 23,582 (HC).

High Court decision, representing the amount of primary tax in dispute, interest, legal and other costs.

Note 42 of the financial statements stated inter alia that provision had been made for the tax and interest liability to IRD but that an appeal had been noted. That appeal was discontinued and payment made.⁵²

The 2010 annual report⁵³ noted the following in relation to the NAB's NZ subsidiary:

At 30 September 2009, BNZ had provided for tax on its structured finance tax case of \$542 million. This provision was created after the New Zealand Inland Revenue Department (IRD) successfully challenged six structured finance transactions undertaken by BNZ. The provisions raised covered the full potential primary tax liability, plus interest. The IRD was also in dispute with other New Zealand banks in relation to similar transactions.

On 23 December 2009, all the New Zealand banks settled with the IRD for 80% of the primary tax in dispute. Normal interest charges were applied, but no penalties were imposed. The parties have agreed that all matters relating to the transactions are now concluded. As a result of this settlement, BNZ has released the unused portion of the provision previously made.

It is of interest to note that the large amount of tax seemed to have no impact on the price of the NAB's shares, nor did the bank seem to suffer any reputational damage as a result of the actions of the IRD even though findings of avoidance were made by the High Court of NZ

4.2 St George Bank Ltd and Westpac Banking Corporation Ltd

4.2.1 St George Bank

St George Bank Ltd (St George) amalgamated with Westpac Banking Corporation Ltd (Westpac) in 2008. It is for this reason that it is mentioned in this section of the paper. St George noted in its 2007 annual financial report⁵⁴ that the ATO had denied St George interest deductions on its subordinated notes issued to St George Funding Company LLC as part of a depositary capital securities transaction undertaken in 1997. St George noted that it maintained its position that the amounts in question were properly deductible. Accordingly, St George had not charged to its income statement any amount due under the amended assessments. It may be of some interest that the annual report stated that the Bank's auditors, KPMG, concurred with this view.

⁵² For a detailed discussion of the progress of the litigation between the IRD and the four big Australian banks and the terms of settlement between the parties see AJ Sawyer, "Analysing the New Zealand Banks' 2009 'Surprise' Settlement with Inland Revenue" (2010) 25(12) *Journal of International Banking Law and Regulation* 601.

⁵³ 2010 NAB Annual Report, available at: http://www.nabgroup.com/vgnmedia/download/20101027_Appendix4E.pdf (accessed 22 January 2011). All figures are in Australian dollars unless otherwise stated.

⁵⁴ St George Bank Ltd, 2007 Annual Report; available at: http://www.stgeorge.com.au/resources/sgb/downloads/annual_report/annual_report07.pdf (accessed 6 October 2010).

The matter was heard by the Federal Court in July 2007. St George lost this litigation and the deduction claimed was disallowed.⁵⁵ On appeal to the Full Bench of the Federal Court St George was again unsuccessful.⁵⁶

4.2.2 Westpac Banking Corporation Ltd (Westpac)

The 2008 annual financial report⁵⁷ of Westpac also referred to the actions of the IRD and noted that the claim inclusive of interest but excluding penalties amounted to NZ\$882 million as at 30 September 2008. This report noted however that it had received a ruling from the IRD approving a structured finance scheme and that all the schemes in respect of which IRD had issued amended assessments were essentially in similar terms. Notwithstanding this statement, Westpac lost the litigation in the NZ High Court⁵⁸ which result was noted in the 2009 annual report. This annual report stated that Westpac raised its tax provisions relating to this litigation to NZ\$918 million (A\$753 million).

In December 2009 the claim of the IRD against Westpac was settled. The 2010 annual report had this to say about the claim of the IRD:⁵⁹

On 23 December 2009, Westpac reached a settlement with the New Zealand Commissioner of Inland Revenue (CIR) of the previously reported proceedings relating to nine structured finance transactions undertaken between 1998 and 2002.

Under the settlement, Westpac agreed to pay the CIR 80% of the full amount of primary tax and interest and with no imposition of penalties. All proceedings have been discontinued and the other terms of the settlement are subject to confidentiality. Westpac provided in full for the primary tax and interest claimed by the CIR as part of its 2009 result, and consequently there has been a write back through income tax expense in the year ended 30 September 2010.

4.3 The Commonwealth Bank of Australia Ltd

The Commonwealth Bank of Australia Ltd (CBA) was a party to a similar set of structured financial arrangements that were challenged by the IRD with respect to its NZ subsidiary ASB Bank Ltd. In its 2007 annual financial report the CBA noted that amended assessments had been received in respect of three transactions but that it was confident that the tax treatment it had adopted for these investments was correct, and

⁵⁵ St George Bank Limited v Commissioner of Taxation [2008] FCA 453.

⁵⁶ St George Bank Limited v Commissioner of Taxation [2009] FCAFC 62.

⁵⁷ The 2009 annual report of Westpac; available at: http://www.westpac.com.au/docs/pdf/aw/ic/WAR2008_AnnualReport.pdf (accessed 22 January 2011).

⁵⁸ CIR v Westpac (2009) 24 NZTC 23,834 (HC).

⁵⁹ Westpac 2010 Annual Report; available at: http://www.westpac.com.au/docs/pdf/aw/ic/WBC2010_Annual_Report_ASX.pdf (accessed 22 January 2011).

any assessments received would be disputed.⁶⁰ The amount in dispute was not specified.

The 2010 annual financial report noted the following:⁶¹

Tax on NZ structured finance transactions

A \$171 million tax expense on New Zealand structured finance transactions was recognised in the year ended 30 June 2010 representing a significant one-off impact of an adverse tax ruling between ASB Bank and the New Zealand Commissioner of Inland Revenue settled in December 2009. The settlement represented 80% of the amount of tax and interest in dispute.

It is unclear how the above amounts are made up having regard to the information contained in the CBA's earlier annual reports as they were silent on the matters involving ASB and its dispute with the IRD.

5.0 AUSTRALIAN COMPANIES AND TAX WITH SIGNIFICANT LITIGATION EXPOSURE

5.1 Futuris Corporation Ltd

The 2007 annual financial report of Futuris Corporation Ltd (Futuris)⁶² noted that during the year Futuris received amended assessments denying capital losses previously utilised. Futuris was of the opinion that no provisioning was required in respect of the amended assessments. Challenges were noted to the assessment both under Part IVC of *Taxation Administration Act 1953* (Cth) (TAA) but also section 39B of the *Judiciary Act 1903* (Cth). The challenge under the *Judiciary Act* was successful before the full bench of the Federal Court but the Commissioner appealed to the High Court of Australia. The annual report continued:⁶³

At 30 June 2007, the provision for taxation is sufficient to cover any anticipated payments under the assessments, should the ATO be ultimately successful.

The Group's tax returns for 2002 and 2003 are being audited as part of the ATO's large business audit program.

The 2008 annual financial report for Futuris⁶⁴ noted that management considered the current provisioning in relation to this matter to be adequate and would vigorously defend the assessments through the appeal process. It continued that during the period 22 May 2008 to 31 July 2008 several subsidiaries of Futuris had received assessments

⁶⁰ CBA 2007 Annual Report; available at: http://www.commbank.com.au/about-us/shareholders/pdfs/annual-reports/2007_Full_Annual_report_final.pdf (accessed 5 October 2010). Figures are in NZ dollars.

⁶¹ See http://www.commbank.com.au/about-us/shareholders/pdfs/annual-reports/Commonwealth_Bank_2010_Annual_Report.pdf (accessed 18 February 2011).

⁶² The 2007 annual financial report of Futuris Corporation Ltd; available at: [http://investor.elders.com.au/assets/documents/publications/Financial%20Reports%20\(Annual\)/financialreports_54.pdf](http://investor.elders.com.au/assets/documents/publications/Financial%20Reports%20(Annual)/financialreports_54.pdf) (accessed 6 October 2010).

⁶³ Id.

⁶⁴ The 2008 Financial report of Futuris Corporation Ltd; available at: [http://investor.elders.com.au/assets/documents/publications/Financial%20Reports%20\(Annual\)/f08fullresults.pdf](http://investor.elders.com.au/assets/documents/publications/Financial%20Reports%20(Annual)/f08fullresults.pdf) (accessed 6 October 2010).

denying the utilization of losses arising from the funding activities of Futuris' inter-company financier. The assessments were attributable to the 2003 year. In total, the primary tax assessed was \$14.7m, penalties of \$3m and interest of \$7m. A provision had been raised against this potential exposure. The Group was confident of the position it had adopted and intends to defend vigorously the deductions claimed. There were similar notifications in the 2009 annual financial report.

Futuris lost the appeal in the High Court under the Judiciary Act but was able to prosecute its appeal under Part IVC TAA. In 2010 the matter relating to the sale of the building products division was heard by the Federal Court on the merits and Futuris was successful.⁶⁵ The Commissioner has appealed to the Full bench of the Federal Court against the decision. At the time of writing the appeal has yet to be determined.

5.2 Caltex Australia Group (Caltex)

In 2006 Caltex issued a media release referred to a statutory demand made by the ATO for payment of monies alleged by the ATO to be owing in respect of excise duty in relation to certain liquid fuel by-products used in the refining process and that Caltex should have paid the excise duty on such fuel usage over the past four years. The 2006 media release continued:⁶⁶

Caltex is of the strong view that the excise duty legislation does not apply to the refineries' own use of such fuels in the refining process and has instituted legal proceedings in the Federal Court against the ATO in this regard. No liability has been recognised as at 30 June 2006, as Caltex is of the view that this legislation is not applicable to this type of fuel usage. Should Caltex be unsuccessful in its legal action, it may be liable for additional interest on that sum. Due to a change in the excise legislation any future purported excise duty on this type of fuel usage ceased from 1 July 2006.

This notification was repeated in the 2006 and 2007 annual financial reports. The challenge by Caltex came before the Federal Court in December 2008 which ruled in favour of Caltex.⁶⁷ The 2008 Preliminary Final Report⁶⁸ repeated the above and noted that:⁶⁹

Caltex was of the strong view that the excise duty legislation does not apply to the refineries' own use of such fuels in the refining process and instituted legal proceedings in the Federal Court against the ATO. The Federal Court has ruled in favour of Caltex and the ATO has not appealed the decision. Consequently, no liability has been recognised as at 31 December 2008.

5.3 BHP Billiton Ltd (BHP)

⁶⁵ Futuris Corporation Limited v Commissioner of Taxation [2010] FCA 935.

⁶⁶ See <http://www.caltex.com.au/latestnews/pages/newsitem.aspx?id=12877> (accessed 17 February 2011).

⁶⁷ Caltex Australia Petroleum Pty Ltd v Commissioner of Taxation [2008] FCA 1951.

⁶⁸ 2008 Caltex preliminary final report; available at: http://www.caltex.com.au/InvestorCentre/Documents/FinancialResults/2008_Full_Year_Financial_Report.pdf (accessed 27 January 2011).

⁶⁹ Id.

The 2008 annual financial report of BHP noted the following.⁷⁰ The ATO had issued assessments against subsidiary companies, primarily BHP Billiton Finance Ltd, in respect of the financial years 1999 to 2002. The assessments related to the deductibility of bad debts in respect of funding subsidiaries that undertook certain projects. BHP Billiton Finance Ltd lodged appeals on 17 July 2006. The amount in dispute at 30 June 2008 for the bad debts disallowance was approximately US\$1,162 million (A\$1,224 million) (net of tax), being primary tax US\$656 million (A\$691 million), penalties of US\$164 million (A\$173 million) and interest (net of tax) of US\$342 million (A\$360 million). An amount of US\$606 million (A\$638 million) in respect of the disputed amounts was paid pursuant to ATO disputed assessments guidelines, which require that taxpayers generally must pay half of the tax in dispute to defer recovery proceedings. Upon any successful challenge of the assessments, any sums paid will be refundable with interest.

The 2008 report continued that in November 2007 and March 2008, the ATO issued further assessments disallowing capital allowances claimed on the plant and equipment funded by the loan from BHP Billiton Finance Ltd relating to the above project. The amount in dispute at 30 June 2008 is approximately US\$629 million (A\$662 million), being primary tax US\$368 million (A\$387 million), penalties US\$92 million (A\$97 million) and interest (net of tax) of US\$169 million (A\$178 million). BHP had lodged objections against the amended assessments which have been disallowed by the ATO. Subsequently BHP lodged appeals against some of these objection decisions, and indicated that it would lodge the remainder by October 2008.

The 2008 annual financial report also made mention of another dispute with the ATO in respect an assessment for Petroleum Resource Rent Tax purposes in relation to sales of gas and LPG produced from the Gippsland Joint Venture. Petroleum Resource Rent Tax had been paid and expensed based on the ATO's assessment, and any success in the dispute would result in a book and cash benefit. Given the complexity of the matters under dispute, it is not possible at this time for BHP to accurately quantify the anticipated benefit to BHP Billiton Petroleum (Bass Strait) Pty Ltd.⁷¹

In its 2009 annual financial report BHP repeated the information set out above. It recorded that the matter relating to the claim for bad debt deductions was heard in the Federal Court in January 2009. BHP Billiton was successful on all counts. The ATO appealed and the matter was proceeding to the Full Federal Court.⁷²

The 2010 annual financial report recorded that the ATO the matter was heard in the Full Federal Court in November 2009. It continued:⁷³

⁷⁰ BHP 2008 Annual Report; available at: <http://www.bhp.com.au/bbContentRepository/docs/annualReport2008.pdf> (accessed 17 February 2011).

⁷¹ 2008 financial report of BHP Billiton; available at: <http://www.bhpbilliton.com/bbContentRepository/docs/annualReport2008.pdf> (Accessed 8 October 2010).

⁷² 2009 BHP annual report; available at: <http://www.bhpbilliton.com/bbContentRepository/docs/annualReport2009.pdf> (accessed 7 October 2010).

⁷³ 2010 BHP annual report; available at: <http://www.bhpbilliton.com/bbContentRepository/docs/bhpBillitonAnnualReport2010.pdf> (accessed 7 October 2010).

BHP Billiton was again successful on all counts. The ATO sought special leave to appeal to the High Court only in relation to the Beenup bad debt disallowance and the denial of the capital allowance claims on the Boodarie Iron project. The High Court has granted special leave only in relation to the denial of the capital allowance claims on the Boodarie Iron project. A date for the appeal has not yet been set. As a result of the ATO not seeking to challenge the Boodarie Iron bad debt disallowance, the ATO refunded US\$552 million to BHP Billiton including interest. BHP Billiton also expects that as a result of the High Court not granting special leave for the Beenup bad debt disallowance, the ATO will refund the amount paid in relation to this dispute of US\$62 million plus interest. BHP Billiton settled the Hartley matter with the ATO in September 2009.

The amount remaining in dispute following the decision of the High Court for the denial of capital allowance claims on the Boodarie Iron project is approximately US\$435 million, being primary tax of US\$328 million and US\$107 million of interest (after tax).

The matter was heard by the High Court in late 2010 but at the time of writing a decision has not as yet been handed down.

6.0 THE NATURE OF DISCLOSURES MADE AND CONCLUDING COMMENTS

From all the corporate disclosures considered in this paper a number of what appear to be universal comments can be made and themes extracted from these disclosures collectively. These are as follows:

1. When a dispute arises between a listed disclosing entity and the ATO or IRD, the existence of that dispute is noted in that company's financial report for the year.
2. Such notification only appears after the tax authority in question has made its position clear either by issuing an amended assessment or a statutory demand as was the case with Caltex, or a NOPA (as was the case for the NZ banks).
3. All such notifications make the point that in the opinion of the company (board of directors) the claim by the relevant tax authority is without merit. This unequivocal view of the law can only be as a consequence of advice received by these companies as to the legal and tax consequences of the various transactions concluded by them from both their external and internal tax experts.
4. There is no disclosure of what could be described as uncertain tax positions where there is no certainty as to the outcome of a dispute should one arise. The fact that uncertain positions are not disclosed makes it more difficult for the revenue authorities to determine that a transaction is potentially subject to dispute and currently (prima facie) affords an advantage to the taxpayer. Examples of where such uncertain positions could easily occur are with international transactions between same members of the group. This may be mitigated in part through the cooperative compliance agreement process for companies that choose to enter into such an agreement with the ATO and/or IRD.
5. The approach set out in 4 above seems to be followed irrespective of the tax profile of the company concerned. Although there is no empirical evidence to support this view, there can be no doubt, we would argue, that different

companies follow different tax strategies. Some are more aggressive than others and some knowingly embark on what could turn out to be tax avoidance schemes.

The fact that each of the companies considered appeared to disclose all disputes with the relevant revenue authority does not mean that this is indeed the case where the continuous disclosure rules are being considered. For example, for a company such as BHP, with a dispute of say \$1 million, this would have an insignificant impact on its share price, whereas a dispute of this size could be quite significant for other companies, and consequently require disclosure.

However, when one looks at the rules (such as the ASX Listing Rules and NZX Listing Rules and associated statutory reporting obligations) relating to financial statements and the notes to such accounts, it may well be necessary to disclose all material disputes⁷⁴ with the revenue authorities as the financial statements must be prepared in compliance with international financial reporting standards, and must reflect a true and fair view of the company's affairs.⁷⁵ These requirements, read in conjunction with each other, suggest that all material disputes must be disclosed. The question is when is a dispute 'material' such that it has reached the point that disclosure is required – is this when an amended assessment is issued and it is disputed by the company, or at some earlier stage? We would suggest that once there is a clear difference in view between the revenue authority and the taxpayer, and this difference can be quantified, and sum is material, then disclosure should be made. The fact and the basis for a dispute, albeit the amount is small in numerical terms, could well have a disproportionate impact on the views of investors and other stakeholders with respect to the company in question.

⁷⁴ What is material may well depend on the particular circumstances of each company. For example a dispute between the ATO and BHP where the sum involved is say \$1 million may not be material yet with Futuris it may well be. In the author's opinion corporations should disclose all disputes with the revenue authorities especially where there are allegations of tax avoidance being made.

⁷⁵ Section 297 Corporations Act. Section 295(3)(c) of the Corporations Act requires information not contained in the financial statements to be recorded in notes to them where necessary to give a true and fair view of the company's affairs.

VAT on Intra-Community Trade and Bilateral Micro Revenue Clearing in the EU

Christian Breuer* and Chang Woon Nam⁺

Abstract

This study discusses European Commission's recent proposal to combat VAT fraud by taxing intra-Community supplies at a common rate of 15%, accompanied by the internal correction of input-tax gap between an importing firm and its own national tax authority, which is caused by the national VAT rate differing from 15%. It attempts to put this proposal into perspective by linking it to the overall aims of value added taxation in Europe and by comparing it to other alternative mechanisms examined in the literature. Especially issues of bilateral VAT revenue clearing between EU countries, which arise from the Commission's proposal, are highlighted.

1. INTRODUCTION

According to the basic principle of the EU VAT Directive, the common EU VAT regime should ideally be neutral concerning the origin of goods and their stage of production or distribution, so that a single market which guarantees fair competition can be realised. At the same time a business in the EU which has a full right to deduct should be unaffected by the taxation of intra-EU trade, and would apply the same principle to cross-border purchases as it does to domestic ones, and pay the VAT due to its supplier and reclaim this as input tax on its VAT return.

Despite the introduction of the single market and the abolition of border controls in 1993, the destination principle still applies for the cross-border trade between firms in the EU, which are taxed with the zero-rate.¹ Since 1993 the member states must monitor the proper rebate of VAT credits for intra-EU supplies to and the proper payment of VAT on intra-EU acquisitions from other members by checking the books of registered enterprises.² Apart from the compliance asymmetry – the different VAT treatment of domestic and cross-border supplies – which cause non-symmetric compliance costs, the prevailing transitional VAT system has been criticised since the

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¹ The Draft Directives of 1987 and 1989 which stipulated VAT rate bands and revenue distribution through cross-border VAT crediting in conjunction with a tax clearing mechanism did not find unanimous support in the European Council. For this reason, such a transitional VAT system was then implemented by the Directives 91/680/EEC and 92/77/EEC. Yet the origin principle applies to the direct imports of households, although for some specific cases (including household purchase of cars) the destination principle still prevails. In addition an EU-wide minimum VAT standard rate of 15% was introduced.

² In this context VAT identification numbers were introduced to identify registered business from other member countries, and firms were obliged to provide detailed information on the intra-EU trade under the VAT Information Exchange System and Intrastat system.

deferred payment system breaks the VAT chain at the borderline of domestic and foreign tax administration (European Commission 1996; Lockwood, de Meza and Myles 2005). It was expected that such weaknesses in VAT control would be exploited by VAT frauds, given the fact that in the EU there has always been a permanent and huge flow of commodities which circulate free of VAT after the export VAT rebate in the exporting country has been granted and before the deferred VAT payment in the importing country becomes effective (see also Genser 2003; Cnossen 2008b).³ “Goods allegedly destined for export (at which prior stage VAT had been refunded) might be re-imported and diverted to the shadow economy, and imported goods (which would leave another member state free of VAT) might not be included in the importer’s VAT return. [Even more seriously], a chain of artificial transactions from the import to the export stage could be created resulting in net VAT funds being paid without VAT ever having been collected in previous stages, a phenomenon which goes by the name of carousel fraud” (Cnossen 2008a: 3). More precisely the carousel fraud – also called missing trader intra-Community (MTIC) fraud – takes place when “fraudsters register for VAT, buy goods [tax]-free from another member states, sell them on at VAT inclusive prices and then disappear without paying the VAT due” (Cnossen 2008a: 16).

In order to solve the problems surrounding such carousel frauds caused by the break in the VAT-collection chain, several reform proposals for the future European VAT system have been made in the literature (Bird and Gendron 2000; Genser 2003). According to the viable integrated VAT (VIVAT) recommended by Keen and Smith (2000), for example, a common Euro-VAT rate is imposed on all the business-to-business (B2B) cross-border supplies between the EU member states (the so-called exporter rating), whereas a national retail sales tax is charged on sales to final consumers. Since the Euro-VAT rate is the same throughout the EU, a *multilateral* clearing can be used to fill the revenue gaps caused by the difference between intra-EU supplies and acquisitions of the individual countries. However, such a uniform exporter rating does not provide the solution of problems related to “the break in the VAT-audit trail. Importing member states would still not be able to audit importers’ invoices (received from exporters in other member states) for which they have no authority. This would provide a powerful incentive to fake importers’ invoices, showing VAT eligible for credit instead of no VAT as under the current regime” (Cnossen 2008a: 9).

As an option of the ‘more far-reaching measures to tackle VAT fraud’, the European Commission (2008) suggests a taxation of intra-EU supplies of goods at the common EU minimum VAT rate of 15%, which resembles very much the VIVAT.⁴ Yet, the

³ In 2006 with over two and a half million businesses across the EU, intra-EU purchases reached over €2,400 billion. In addition, for the majority of member states the value of intra-EU supplies of goods has recently accounted for around 10% to 20% of their total supplies (European Commission 2008).

⁴ Regarding the European Commission’s idea of changes in the current VAT systems as a possible option to combat against the VAT fraud, either through a generalised reverse-charge system where liability for VAT payments would be shifted from the supplier to the purchaser, or by taxing intra-Community supplies of goods, “the ECOFIN Council of 5 June 2007 also expressed the view that the preferred system of taxing intra-Community supplies should be based on taxation in the member states of departure and not in [those] of arrival ... [and] noted also that a majority of member states expressed reservations about the optional generalised reverse-charge mechanism ...” (European Commission 2008: 4), in which the liability for VAT is shifted from suppliers to purchasers of taxable goods and services.

Commission's reform model is additionally equipped with the internal correction of input-tax gap between the company that made the cross-border acquisition and the tax authority within the same country, which is caused by the difference between the national and the common EU VAT rates. This extra feature not only compensates the weakness of the VIVAT regarding the auditing problems of importers' invoices mentioned above but also makes the input-tax reimbursement possible according to the VAT rate and the deduction rules of destination country.⁵

This study attempts to put this proposal into perspective by linking it to the overall aims of value-added taxation in Europe and by comparing it to other alternative mechanisms to tax intra-Community trade as described in the literature. In particular this study focuses on the issues of bilateral revenue VAT clearing between EU member states, which would take place on the basis of a micro-model of firms' trade declarations.⁶

The study is structured as follows. Following this introductory part, Section 2 illustrates, based on a simple two-country model endowed with a single firm and household, the scope of VAT revenue clearing caused by the introduction of the origin principle on the B2B intra-EU supplies under the additional consideration of different VAT regimes (including a full switch to the origin principle and VIVAT). Section 3 describes the novel and distinct features of the European Commission's latest reform proposal in the same model framework and examines its advantages and shortcomings compared to the current transitional system and other previous VAT reform proposals. The final section summarises the major findings and concludes.

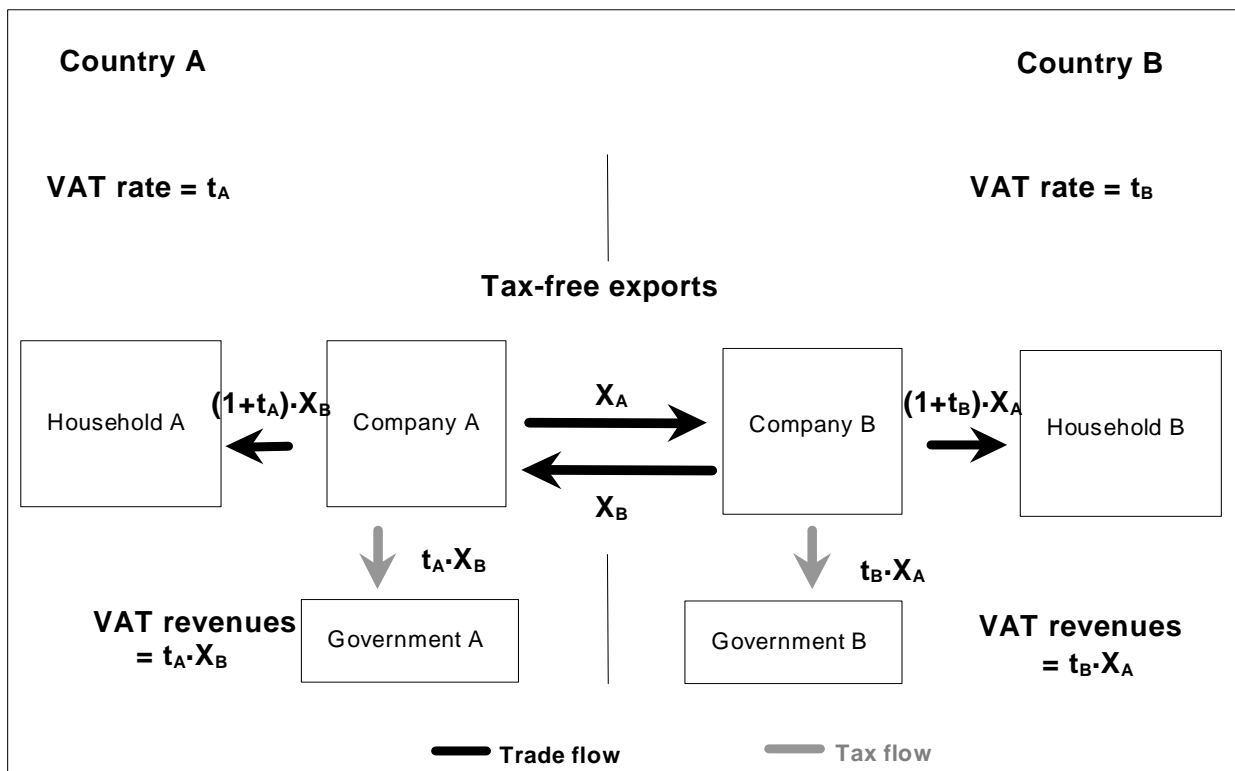
2. REVENUE CLEARING IN DIFFERENT EUROPEAN VAT SYSTEMS

A switch from the destination to the origin principle applied to the intra-EU supplies would cause VAT revenue changes in the individual EU countries. In order to correct such VAT revenue imbalances among the member states and to guarantee neutrality, a clearing mechanism is necessary. In the following it is assumed that there are two countries, *A* and *B*, and that each country has a (registered) company and a household. The intra-EU trade takes place between company *A* and company *B*, which consists of export volume of X_A (from *A* to *B*) and X_B (from *B* to *A*), while $X_A > X_B$. Then in country *B* the imported X_A is further sold to household *B* without any value added made by the domestic company *B*. The same process occurs with X_B in country *A*. The (standard) VAT rate imposed on these 'domestic' sales amounts to t_A in country *A* and t_B in country *B*, while $t_A > t_B > 0$.

⁵ However, this reform approach would still provide an incentive to produce false import invoices through 'third countries' in order to qualify for a tax credit.

⁶ According to the European Commission (2008), EU countries would become dependent on each other for around 30 billion euros of VAT revenue – approximately 10% of total receipts. The Netherlands, Germany, Belgium and Ireland would emerge as the largest net contributors to the clearing system. For the bilateral micro-clearing, there are three options for gathering such microeconomic data: collection by means of (i) the normal VAT declaration, (ii) a monthly recapitulative statement with global amounts for customer/supplier, and (iii) a monthly recapitulative statement at invoice level by suppliers and purchasers. The Commission prefers the second option.

FIGURE 1: INTRA-EU TRADE AND DESTINATION PRINCIPLE



As illustrated in Figure 1, the B2B cross-border supplies are tax free in the present transitional regime. Moreover, in country A the final consumption of the imported goods from country B (X_B) bears the VAT burden with an own tax rate of A (t_A). Consequently, when the destination principle prevails, the total VAT revenue for government of country A amounts to

$$T_{A,DES} = t_A \cdot X_B \quad (1)$$

Analogously for government B the following applies:

$$T_{B,DES} = t_B \cdot X_A \quad (2)$$

Under the origin principle, treating domestic and intra-EU sales alike, exports from country A to country B (X_A) are subject to t_A and initially generate VAT revenue for government A amounting to $t_A \cdot X_A$ (see Figure 2). In addition, the final consumption of the imported goods from country B (X_B) bears the VAT burden with t_A in country A. Yet company A is entitled to deduct the VAT sum paid to company B ($t_B \cdot X_B$) when importing the volume of X_B from country B, and such VAT credits are granted in the destination country A.

The total VAT revenue for government A now amounts to

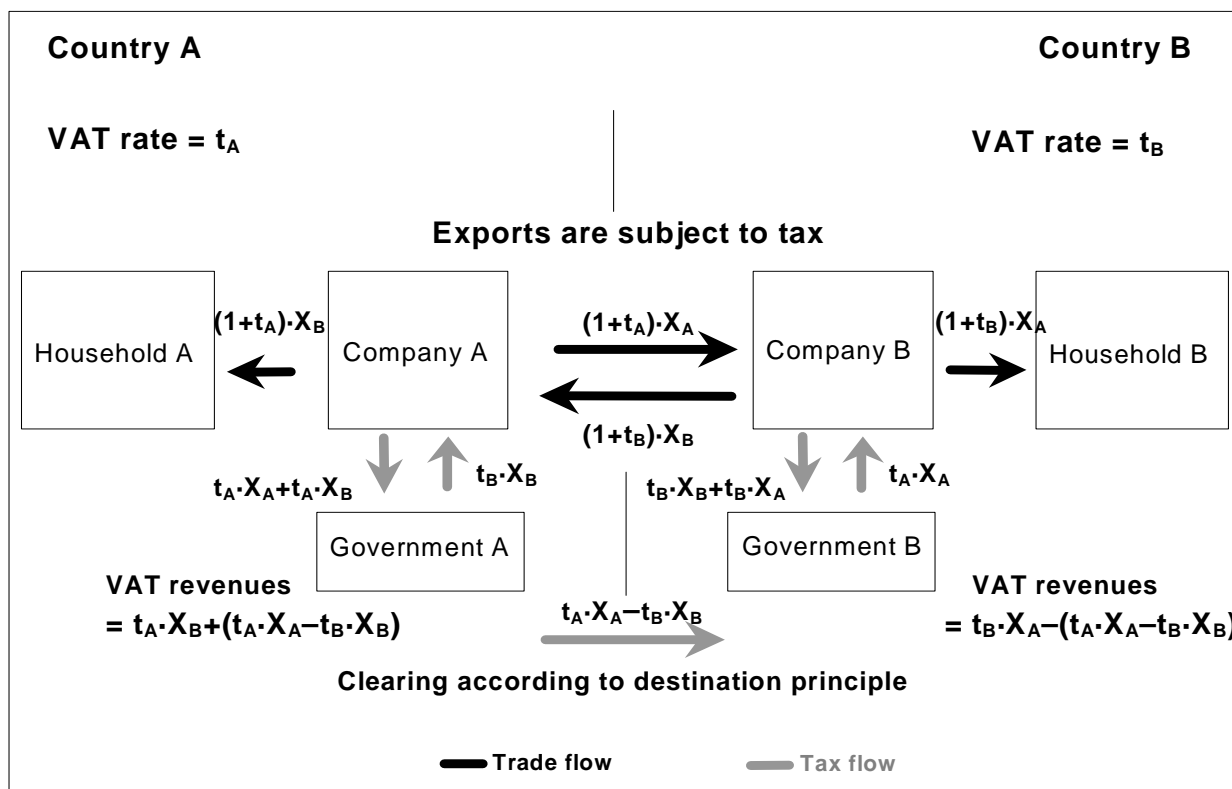
$$T_{A,ORI} = t_A \cdot X_B + (t_A \cdot X_A - t_B \cdot X_B) = T_{A,DES} + (t_A \cdot X_A - t_B \cdot X_B) \quad (3)$$

In a similar way one can also yield for government *B*

$$T_{B,ORI} = t_B \cdot X_A - (t_A \cdot X_A - t_B \cdot X_B) = T_{B,DES} - (t_A \cdot X_A - t_B \cdot X_B) \quad (4)$$

Movement from the destination to the origin principle alters the level of VAT revenues of the individual countries *A* and *B*. Since $t_A \cdot X_A > t_B \cdot X_B$, a clearing of the total amount of $(t_A \cdot X_A - t_B \cdot X_B)$ should take place between government *A* and government *B* in order to safeguard the revenue neutrality.

FIGURE 2: INTRA-EU TRADE AND PURE ORIGIN PRINCIPLE



Under the VIVAT, a common EU VAT rate ($t^* > 0$) is imposed on the B2B cross-border supplies between country *A* and *B* based on the origin principle, while sales to domestic customers (i.e. household *A* and *B*) are subject to the national VAT rate (i.e. t_A and t_B). In this framework company *A* can claim, for example, EU VAT credits on intra-EU acquisition from company *B* ($t^* \cdot X_B$) from government *A*, while company *B* can claim $t^* \cdot X_A$ from government *B*.

Consequently, when the VIVAT is implemented, the total VAT revenue for government *A* reaches

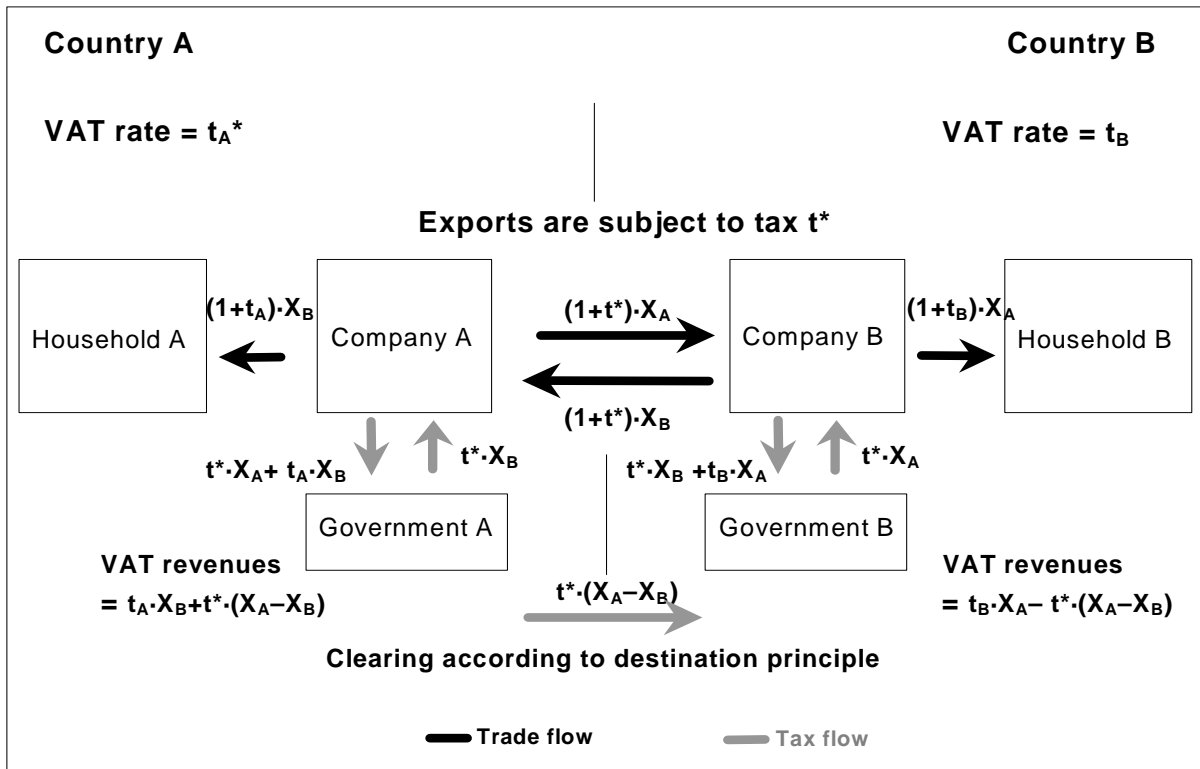
$$T_{A,INT} = t_A \cdot X_B + t^* \cdot (X_A - X_B) = T_{A,DES} + t^* \cdot (X_A - X_B) \quad (5)$$

while for government *B* the following applies:

$$T_{B,INT} = t_B \cdot X_A - t^* \cdot (X_A - X_B) = T_{B,DES} - t^* \cdot (X_A - X_B) \quad (6)$$

As expressed by equation (5) and (6), the introduction VIVAT should also be accompanied by a clearing system in which the total sum of $t^*(X_A - X_B)$ would be transferred from government A to government B. In the context of such a cross-border fiscal transfer, revenue neutrality is ensured for both countries (see Figure 3).

FIGURE 3: INTRA-EU TRADE AND VIVAT



3. EUROPEAN COMMISSION’S VAT REFORM PROPOSAL WITH A BILATERAL CLEARING

In the following the major features of the European Commission’s VAT reform model are introduced in more detail based on the same two-country model framework. The *current, transitional* VAT system remains basically applicable except where specified differently below. Company A (or company B) making an intra-EU supply charges, at a common rate (t^*) of 15%, VAT to its counterpart in another EU country. As is the case in most member states the standard VAT rate t_A and t_B are assumed to be larger than t^* . Therefore

$$t_A > t_B > t^* \text{ where } t^* > 0 \tag{7}$$

Yet, in order to guarantee the neutrality of the system the purchasing company declares, in cases where the country is not entitled to deduct the VAT in full, an intra-EU acquisition in the country of arrival (destination) and accounts for the VAT difference that occurs, either positive or negative, between t^* charged on the operation and the domestic rate applicable in that country. In this context a type of (internal) input tax clearing takes place between the company and the government within the same country. In our example shown in Figure 4 such correction amounts to $(t_A - t^*) \cdot X_B$ for company A, while the sum reaches $(t_B - t^*) \cdot X_A$ for company B.

The purchasing company is now entitled to deduct the VAT it has paid to its supplier and the VAT it has accounted for because of the rate difference via the VAT return and according to the right-of-deduction rules of the country of arrival (“internal clearing”). As a consequence, company *A* can deduct $tA \cdot XB (= t^*XB + (tA - t^*) \cdot XB)$, while for company *B* the sum amounts to $tB \cdot XA (= t^*XA + (tB - t^*) \cdot XA)$. Under all circumstances the purchasing company needs to have an invoice from the supplier before being allowed to exercise its right of deduction.⁷

Hence, the VAT revenue for government *A* now amounts to

$$TA,EC = tA \cdot XB + t^* \cdot (XA - XB) = TA,DES + t^* \cdot (XA - XB) \quad (8)$$

while for government *B* the following applies:

$$TB,EC = tB \cdot XA - t^* \cdot (XA - XB) = TB,DES - t^* \cdot (XA - XB) \quad (9)$$

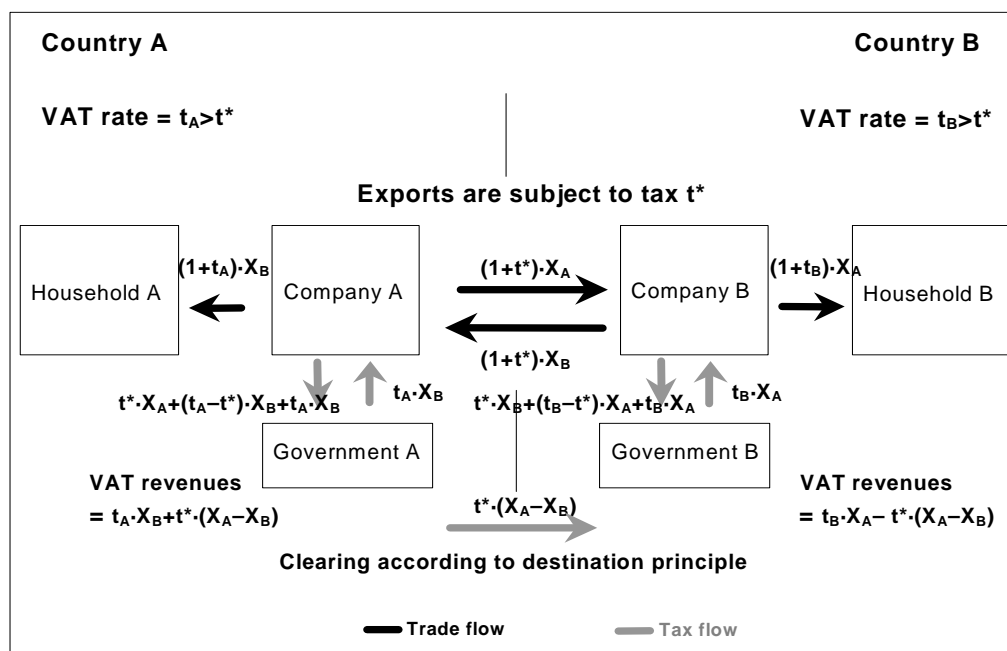
Since $TA,EC > TA,DES$ and $TB,EC < TB,DES$, a (cross-border) bilateral clearing mechanism is again necessary between the involved member countries to ensure that the VAT receipts accrue to the country where the intra-EU acquisition has taken place. As the case with the VIVAT, the sum of $t^* \cdot (XA - XB)$ should also be transferred from government *A* to government *B* in this integrated reform model, aimed at achieving revenue neutrality.

Ceteris paribus when t^* becomes lower, the aforementioned internal input-tax clearing within a country occurs in a larger scale, while the member states’ revenue dependency on the cross-border clearing sum declines. Under the condition $t^*=0$, that is equivalent to the application of destination principle, or $XA = XB$, no bilateral clearing mechanism is necessary between the involved countries *A* and *B*.

With this reform proposal the European Commission has shown its intention to lay aside its preference for compliance symmetry and tolerate the different tax treatment of domestic and intra-EU supplies within an integrated transitional VAT system. The introduction of exporter rating to the intra-EU supplies with a common EU minimum VAT rate of 15% additionally equipped with the internal correction of input-tax gap between an importing company and its own national tax authority, which is caused by the national VAT rate differing from the common rate of 15%, can be seen as an improvement of the VIVAT. This extra feature in the system would more effectively induce companies to declare their intra-EU acquisitions at home and reduce the possibilities of faking import invoices within the EU. In this context the member states would also be better able to collect microeconomic data required for the revenue clearing from taxable persons in the countries of departure and those of arrival of goods. However, such a supplement appears to make the entire VAT coordination more complicated, requiring higher compliance and administrative costs.

⁷ In other words, linking supply and acquisitions listings is a crucial prerequisite for the success of this reform model, which is also necessary to respond to the inherent risk of deduction without a corresponding payment. “As a further step, and [also ...] to minimise the number of mismatches between these listings, it could be an option to change the rules governing the time the tax becomes chargeable, and to link it entirely to the issuing the invoice insofar as the VAT becomes due in any case if an invoice has not been issued within a certain period” (European Commission 2008: 5).

FIGURE 4 INTRA-EU TRADE AND EU RECOMMENDATION FOR EXPORTER RATING AND BILATERAL CLEARING



Concerning the internal clearing mentioned above, the choice of the common EU VAT rate t^* seems to be a critical matter. For instance, if t^* is set much higher than the national VAT rate (say $t^* = 30\%$), the system would *ceteris paribus* provide stronger incentives for firms to declare their intra-EU acquisitions, since they would additionally get money back from their own national tax authority. Moreover, the dependence of VAT revenues in a form of transfers from foreign countries would increase, which would, however, make the individual countries more active in the improvement of tax administration and its cross-border coordination in the EU. On the other hand, such a higher VAT on intra-EU supplies might induce traders to purchase lower-rated domestic commodities over high-rated imports, even though the import VAT would be fully creditable and refundable, if required.

The supranational (macro as well as micro) VAT revenue clearing system has been judged to be inappropriate for the purpose of VAT coordination in the EU (see also Genser 2003; Gebauer, Nam and Parsche 2005). Instead, a new concept of bilateral clearing system between the member states is recommended, following the subsidiarity principle. Apart from enhancing the incentive compatibility, this proposal more strongly underscores that VAT administration and revenue collection are exclusively a national matter. It also means that each country would be involved in 26 different bilateral clearing processes in the case that the number of member states remains unchanged. In other words, a total number of 351 bilateral clearings would take place in the EU 27 simultaneously. In this context, in addition to an intensive cooperation and information exchange between nations, an EU-wide coordination and harmonisation of procedures and practices related to VAT administration, declaration, collection, monitoring, auditing, etc. appears to be still required in order to make the entire clearing mechanism more transparent and efficient (see also European Commission 2007).

In order to justify the effectiveness and superiority of the VAT reform recommendation the European Commission should thoroughly evaluate benefits and costs related to its introduction.⁸ In particular the Commission should make it clear whether the potential to combat VAT fraud is worth the additional administrative costs and complications raised by the need for revenue clearing. The answer to this question will partly depend on the current extent of VAT fraud and on the extent to which this fraud can be eliminated by the proposal. In this context, it should be borne in mind that the recent Commission's VAT reform model primarily targets the prevention of carousel fraud. Yet there are other types of VAT fraud including (1) shadow economy fraud, (2) suppression fraud, (3) insolvency fraud and (4) bogus traders (Cnossen 2008a).⁹ According to the data collected by Cnossen (2008a), the 'shadow economy' and the 'artificial tax avoidance (including insolvency fraud)' were the major reasons for VAT revenue losses in Germany, comprising shares of ca. 50% and 21% of total revenue losses for the period 2001-02, while the carousel fraud amounted to around 10% in the same period of time. In the UK, the share of total VAT revenue loss caused by the carousel fraud was estimated to be around 12% for 2006-07, indicating the fact that the VAT revenue loss associated with the carousel fraud is only a fraction of the total VAT frauds committed in the individual EU member states.

Repeatedly, an important prerequisite for the implementation of such a bilateral clearing is that the discrepancy between the total intra-EU imports and exports made by the two involved countries should in essence be zero, which would be derived on the basis of firms' intra-EU trade declarations. Yet, according to the European Commission (2008), the total amount of excess of total (recorded) intra-EU imports over exports reached approximately €80 billion in 2006 in the EU. The reasons for such a mismatch also "include the level of estimation by member states of non-submitted returns; errors on the returns; threshold under which statements are not required; territorial issues; and the inclusion of goods for onward processing" (European Commission 2008: 14).

One of the major reasons why the consideration of introducing supranational micro as well as macroeconomic clearings has been in vain is the failure of correct measurement of the volume of intra-EU trade on the national level. Since clear information on tax rates in the member states prevails, the European VAT coordination including the movement from destination to origin principle would also be feasible if such high quality intra-EU trade data were available in the EU. To a large extent this would also be the result of the minimised VAT evasion in the EU. In this context, Cnossen (2008a) correctly points out that a proper domestic and multi-jurisdictional audit aimed at better identifying the true intra-EU trade volume would well obviate the need for costly design change of VAT system, accompanied by reporting requirements, which might be more burdensome than those under the

⁸ The major criticism of the introduction of the VAT reverse charge system in Germany was the large scale excess of anticipated short- and medium-term costs over the potential benefits (Gebauer, Nam and Parsche 2007).

⁹ The first type of VAT fraud generally comprises many individuals rendering various services tax-free, often by using and buying taxable inputs from their own or employer's business. The second fraud type occurs typically when firms understate their sales or inflate their claims for VAT on purchases. The insolvency fraud takes place when firms buy taxable goods and sell them further at inflated prices, providing high tax credits to purchasers, but declare its insolvency without paying their VAT liabilities. In the case of the fourth type, fraudsters register for VAT, make false claims for input-tax reimbursement from the tax authority and then disappear (Cnossen 2008a).

prevailing deferred payment. Moreover, the optimal exploitation of current legal and administrative cooperation arrangements made among member countries appears to be more effective in handling the cross-border VAT evasion than the implementation of a new reform model with the exporter rating.

4. CONCLUSION

This study examines the EU's ongoing efforts aimed at searching for an efficient European VAT system that fits its single market concept. Unfortunately the previous attempts have been unable to achieve a satisfactory solution, which calls for a reopening of public discussions and policy actions on this matter in the EU. The European Commission's recent VAT reform model, applying the exporter pricing to the intra-EU supplies with a common EU minimum rate (15%), would compensate for the weakness of the deferred payment system which breaks the VAT chain and causes VAT fraud in a single market, and allows the different tax treatment of domestic and intra-EU supplies. The additional provision of an internal correction of the input-tax gap between an importing firm and its own national tax authority, which is caused by the national VAT rate differing from the common EU rate, would largely compensate for the weakness of the VIVAT: this novel feature would more effectively lead companies to declare their intra-EU acquisitions at home and reduce the possibilities of manipulating import invoices within the EU. Consequently the EU countries would also be better able to gather microeconomic data required for revenue clearing from taxable persons in both countries of departure and arrival of goods. However, apart from the incentives still provided for producing false import invoices through third countries, which are aimed at qualifying for a tax credit, the European Commission's reform approach is likely to make the entire VAT coordination more complicated, requiring higher compliance and administrative costs. Moreover, the choice of a common VAT rate appears to be critical, since a higher common rate than the national one would encourage firms to declare their intra-EU acquisitions but lead them to buy lower-rated domestic goods over higher-rated imports, while the national VAT revenues would become more strongly dependent upon the clearing system.

Instead of a less-incentive supranational VAT revenue clearing system, a bilateral one is recommended on the basis of firms' intra-EU trade declarations as mentioned above. Such a bilateral clearing method would further stimulate not only the member countries' efforts aimed at enhancing their technical and organisational tax administration as well as revenue collection systems but also the EU-wide cooperation in the field of information exchange and harmonisation of VAT procedures. However, a challenging aspect is that each country would be involved in 26 different bilateral clearing processes simultaneously in the EU 27, a number which may grow gradually.

In order to further examine the applicability of the Commission's recent VAT reform recommendation, a thorough *ex ante* evaluation of benefits and costs related to its introduction is necessary. Especially the Commission should make it clear whether the potential to combat VAT fraud is worth the additional administrative costs and complications raised by the need for revenue clearing. To be sure this will depend on the current extent of VAT fraud and on the extent to which this fraud can be eliminated by the proposal. In this context it should be repeatedly emphasised that the Commission's reform model primarily targets the prevention of carousel fraud and that the VAT revenue loss associated with this fraud type appears to be only a fraction of the total VAT frauds committed in the individual EU member states. Other types of

VAT fraud like shadow economy fraud, suppression fraud, insolvency fraud and bogus traders can hardly be tackled by this reform proposal.

The failure of VAT coordination in the EU mainly originates from the failure of a correct measurement of the volume of intra-EU exports and imports on the national level. For example, a smooth movement from destination to origin principle would be feasible if high quality intra-EU trade data were available in the EU. Certainly this would also be the result of the minimised VAT evasion in the EU. In this context a proper domestic and multi-jurisdictional audit aimed at identifying the true intra-EU trade volume seems to obviate the need for a costly design change of VAT system, equipped with more burdensome reporting requirements than those under the current deferred payment. Furthermore, the optimal exploitation of legal and administrative cooperation arrangements (in the fields of tax administration, declaration, collection, monitoring, etc.) made among member countries would eventually be more promising to handle the cross-border VAT evasion than the introduction of exporter ratings.

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Travelex and American Express: A Tale of Two Countries – The Australian and New Zealand Treatment of Identical Transactions Compared for GST.

Kalmen Datt and Mark Keating*

Abstract

This article deals with the vexing question of the characterisation of supplies. In doing so it looks at two recent Australian cases on this issue – *Travelex Ltd v Commissioner of Taxation* and *Commissioner of Taxation v American Express Wholesale Currency Services Pty Limited*. After reviewing the decisions and considering their implications from an Australian perspective, the paper describes how New Zealand would deal with identical fact scenarios.

1. INTRODUCTION

This article deals with the vexing question of the characterisation of supplies. In doing so it looks at two recent Australian cases on this issue and then compares the results with what would have been the situation in New Zealand (NZ).

The first is *Travelex Ltd v Commissioner of Taxation*¹(Travelex). This case considered the GST characterisation of a supply of foreign currency on the departures side of the Customs barrier at Sydney International Airport for use overseas. The issue here was whether the supply of such currency was both a financial supply (input taxed)² and GST free. If this question was answered in the affirmative the taxpayer would be entitled to input tax credits in relation to the acquisitions made to make these GST free supplies. This case was dependant on the meaning to be ascribed to the term ‘rights’ when used in section 38-190(1) item 4 of the *A New Tax System (Goods and Services tax) Act 1999* (the GST Act).

The second is *Commissioner of Taxation v American Express Wholesale Currency Services Pty Limited*³. This case considered how to characterise late payment fees

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¹ *Travelex Ltd v Commissioner of Taxation* [2010] HCA 33.

² The NZ equivalent of input taxed supplies are exempt supplies whilst the NZ equivalent of GST free supplies are zero rated supplies. These terms are used interchangeably depending on the GST regime of the country being considered.

³ *Commissioner of Taxation v American Express Wholesale Currency Services Pty Limited* [2010] FCAFC 122

charged to the holders of both credit and charge cards for late payment of their monthly account. This case turned on the interpretation of the financial supply rules in terms of the GST Act read with the GST regulations.

Section 1 of this paper reviews those decisions. Section 2 considers each of the above cases and their implications from an Australian perspective. Section 3 describes how NZ would deal with the identical fact scenarios. Section 4 sets out the authors' conclusions.

The article now considers each of the *Travelex* and *American Express* cases.

2 THE CASES

2.1 Travelex

This is a matter that came before the High Court. The facts of the case were simple. An employee of Travelex acquired foreign currency from it on the departures side of the customs barrier at Sydney International Airport for use overseas. It was common cause that the supply of foreign currency was a financial supply and accordingly input taxed.

The issue for determination by the High Court was whether the supply was also a supply of rights for use outside Australia and as such GST free under section 38-190 (1) item 4 of the GST Act.⁴ If the answer was in the affirmative then Travelex would be entitled to claim input tax credits on acquisitions made with a view to making these GST free supplies. The question was whether the supply of the foreign currency was a supply of rights.

2.1.1 The Majority View

On the issue whether the supply of foreign currency on the facts of the case GST free, French CJ and Hayne J held that the supply of the foreign currency was a supply of a right to use in the foreign country. They concluded that currency is no more than a 'token' and that such 'currency has value only because of the rights that attach to it.' As Travelex had transferred all the rights that attached to the currency, this constituted a supply of rights within the scope of section 38-190(1).

Heydon J concurring (at paragraph 47) said:

The legal substance of the transaction was the supply of rights. The rights supplied were the rights enjoyed by the holder of the currency as created by the statute law of Fiji. The handing over of the pieces of paper constituted, evidenced, and was not capable of disaggregation from, the supply of rights. Apart from those rights, the pieces of paper had little value.

From the majority judgments in *Travelex* it would appear that for the purposes of section 38-190(1) item 4 the nature of the right obtained is immaterial. French CJ and Hayne J noted (at paragraph 27) that:

⁴ This section provides that the supply of a right is GST free if the rights are for use outside Australia; or the supply is to an entity that is not an Australian resident and is outside Australia when the thing supplied is done.

Because the supply is a supply of property in the currency, the supply is a supply 'in relation to' the rights that attach to the currency, without which property in the currency would be worthless.

Catterall⁵ noted in his commentary on the case that:

In drawing the conclusion that a supply of money involved a supply of rights, they rejected the Commissioner's contention that those rights were only incidental to possession of the currency. With an implicit reference to the oft-quoted notion of GST as a "practical business tax" they noted that their findings did not amount to any "juristic disaggregation and classification of rights" that fails to reflect "the practical reality of what is in fact supplied" (in the words of Edmonds J in the Federal Court). Further, because s 38-190 requires only that there be a supply in relation to rights, they rejected the submission that those rights had to be of a particular nature or have a particular content.

2.1.2 The Minority View

Crennan and Bell JJ delivering a minority judgment took a different approach. They were of the view that in interpreting the GST Act and its regulations the task was to determine a clear legislative intention to either impose or exempt a supply from taxation. In determining if the supply of money was a supply of a right/s as envisaged by the GST Act they looked for guidance to section 9-10 (2) (e) of the GST Act which provides that a supply includes a creation, grant, transfer, assignment or surrender of any right. The basis of their reasoning was that to understand (at paragraph 95):

the use of each of the terms "goods", "real property", "rights" and "services", in the table in s 38-190(1), requires consideration of the use of those same terms as set out in s 9-10(2), and consideration of any relevant statutory definitions in s 195-1. Both sections are contextually important for construing s 38-190. If the terms "goods", "real property", "rights" and "services" were to have different meanings in the legislation, depending on whether they were being used in the context of imposing tax, or in the context of indicating GST-free status, that fact would need to emerge clearly from the legislation. The overall structure of the legislation, in the absence of indications to the contrary, favours construing consistently terms which are repeated in the legislation.

As such the right must be transmissible by the supplier. They concluded that the holder or owner of bank notes has certain rights that are the incidents of ownership of the corporeal item – the bank notes or coins. A supplier of such corporeal items will not necessarily know what incidents of ownership an acquirer will exercise. Rights that are the incidents of ownership of a thing are not themselves separate things, within the meaning of the GST Act, which can be transmitted independently of the supply of the thing owned. The minority therefore concluded that the supply was not one in relation to a right.

⁵ Catterall M, Travelex — is it right to call money a right?, 07 October 2010 Australian Tax Week 7 October 2010

2.1.3 Decision impact statement

The Commissioner has issued a decision impact statement⁶ on this judgment. The Commissioner states the effect of the High Court judgment is that the expression 'a supply that is made in relation to rights' covers the supply of a thing (other than goods or real property) such as foreign currency where the thing supplied only has value because of rights that attach to it and those rights are transferred.

The Commissioner also accepted, correctly it is submitted, that if a supply of foreign currency conversion takes place in Australia it is GST-free, whether or not it takes place in the departure lounge or elsewhere if the foreign currency is for use outside Australia. Whether the foreign currency is for use outside Australia in any particular transaction would be a question of fact.⁷

2.1.4 Intention of the purchaser relevant for GST supplies?

The majority of the High Court considered that the intended use of a supply by the purchaser was relevant to its correct GST treatment. The majority judgments simply took it for granted that the intended use of the currency by the customer while travelling overseas demonstrated that the supply was for export. Haydon J concluded (at paragraph 56) that:

The rights evidenced by the currency were for use outside Australia: Mr Urquhart acquired the currency with the intention of spending it in Fiji, and that intention was confirmed by the fact that he did spend it there.

Likewise, French CJ and Hayne J noted (at paragraph 35):⁸

Where it is evident that the currency is to be used overseas, the rights that attach to the currency are for use outside Australia.

These statements indicate that the purpose of the purchaser may be relevant to determining the GST treatment of a supply. It may therefore apply to other instances where the intentions of the purchaser should be taken into account under the relevant provisions. Crennan and Bell JJ in their dissenting judgment agreed with the majority on this aspect of the case.

Potentially, this signifies that the particular subjective intention of the purchaser in some instances could be determinative of the correct GST treatment of a supply. It further raises the question of how suppliers are to ascertain their customers' purposes to enable them to account correctly for the GST on particular supplies. However, French CH and Hayne J dismissed these practical problems (at paragraph 36):

It may be accepted that, as the Solicitor-General submitted, there may be practical difficulties in administering the relevant provisions of the Act where the use to be made of the rights turns on the recipient's intention. Those difficulties, however, do not provide any basis for reading down those

⁶ Released 23 December 2010:

<http://law.atolaw.gov.au/atolaw/view.htm?docid=%22LIT%2FICD%2FS79of2010%2F00001%22>.

⁷ Decision impact statement *Travelex Ltd v Commissioner of Taxation*:

<http://law.atolaw.gov.au/atolaw/view.htm?Docid=LIT/ICD/S79of2010/00001> accessed 27 January 2011.

⁸ At [35]

provisions, or for reading the connecting expression "in relation to" in a way that departs from the construction which has been identified. Difficulties in deciding whether the supply is "for use outside Australia" do not bear upon what is meant by a supply "in relation to" rights.

This approach is significant because the courts have previously expressed divergent views as to the relevance of the intention of the purchaser in categorising a supply. For instance, the purpose of the buyer has often been considered when determining how to interpret the meaning of the phrase 'residential premises to be used predominantly for residential accommodation' in section 40-65 GST Act.⁹

The article now turns to the *American Express* case.

2.2 American Express

American Express (Amex)¹⁰ carries on the business inter alia as an issuer of charge and credit cards to customers to enable them to acquire goods and services without having to make simultaneous payment at the time of acquisition. Payment for these acquisitions has to be made by customers to Amex within a fixed time. The charge card conditions provide for payment of an identified amount as 'liquidated damages' if payments to Amex were not made on time. The credit card conditions provide for a 'late payment fee.' Amex in part made taxable supplies and as such, it was entitled to input tax credits on acquisitions to make these supplies. At issue in the appeal was whether these 'damages' and 'fees' (hereafter jointly referred to as Late Payment Fees) should be taken into account in determining the proportion of Amex's input taxed supplies in relation to its total supplies.

Amex used a methodology determined by the Commissioner in GSTR 2000/22 to calculate its entitlement.¹¹ This method for calculating the input tax credit entitlement was based on dividing revenue derived from input taxed supplies by total revenue. In submitting their Business Activity Statements Amex did not include these fees as revenue from its input taxed supplies. The issue was whether Amex was entitled to omit the fees from the calculation.

In the court of first instance, the Commissioner contended the supply of a charge or credit card was an input taxed supply, and that the Late Payment Fees were consideration for that supply. The case was conducted by both parties on this basis. The supply of both types of card and associated entitlements was said to comprise the supply of an interest under a debt, credit arrangement or right to credit, being one definition of the term financial supply in the GST Regulations. The Commissioner asserted that the Late Payments Fees were consideration for financial supplies which

⁹ There have been a number of decisions in the Federal Court that have reached conflicting decisions on this aspect. Compare for example *Toyama Pty Ltd v Landmark Building Developments Pty Ltd* [2006] NSWSC 83 and *Sunchen Pty Ltd v Commissioner of Taxation* [2010] FCA 21 and *Marana Holdings Pty Ltd v Federal Commissioner of Taxes* [2004] FCAFC 307. The problem raised by these various cases may have been put to rest by the full bench decision in *Sunchen Pty Ltd v Commissioner of Taxation* [2010] FCAFC 138.

¹⁰ Although these disparate activities were carried on by separate companies nothing turned on this.

¹¹ GSTR 2000/22 has since been replaced by Goods and Services Tax Ruling GSTR 2006/3. Although the formula used by the taxpayer was contained in a ruling, and accepted by both parties as being correct, the Commissioner did not make a determination as to the methodology to be used in such cases as prescribed by section 11-30 (5) of the GST Act.

were input taxed. Amex contended they were damages for breach of contract, and not consideration. The primary Judge found for the taxpayer.

On appeal to the full bench of the Federal Court the Commissioner was granted leave by Kenny and Middleton JJ to extend the grounds of appeal to contend that the proper question was not whether the Late Payment Fees were consideration for the making of financial supplies, but simply whether they constituted revenue derived from the making of financial supplies. The central question, now, according to the Commissioner was whether, in applying the formula, the fees are 'revenue derived from input taxed supplies' and therefore be included in both the numerator and denominator of the formula.

The majority noted that the central question in the case concerned the relationship between the Late Payment Fees and the making of Amex's supplies, and the proper classification of those supplies under the GST Act. They noted that three questions had to be answered to enable a decision to be reached. These were the following.

- Is the right to present the credit or charge card as payment (without having immediately to part with money) an 'interest' as defined in the GST Regulations? Is that right something 'recognised at law or in equity as property in any form'? (Regulation 40.5.02)
- If so, is the interest of a kind mentioned in regulation 40-5.09(3) namely an interest in or under a 'credit arrangement or right to credit'?
- If the answer to the forgoing were in the affirmative was the interest an interest in or under a payment system? This question was important as GST regulation 40.5.12 excluded from the concept of financial supplies interests in or under a payment system. If a supply is mentioned both in GST regulation 40.5.09 as being a financial supply and GST regulation 40.5.12 as not being such a supply the later takes precedence in terms of GST regulation 40.5.08 (2).

Each question is considered separately below.

2.2.1 Is the right to present the credit or charge card as payment (without having immediately to part with money) an 'interest'?

The majority noted that GST Regulation 40.5.02 to the GST Act provides that an interest is anything recognised at law or in equity as property in any form. The majority, relying on the various judgments handed down in *Yanner v Eaton*¹² gave a broad meaning to the word 'interest.' In doing so they held that the word 'property' in the definition can be applied to different kinds of relationships between a person and a subject matter, and can be understood as referring to the degree of power that is recognised in law as power permissibly exercised over the thing. As such they concluded (at paragraph 148) that:

Cardholders agreeing to the terms gain a bundle of rights in relation to the card, the most important of which is the right to present the card as payment and incur a corresponding obligation to pay Amex at a later date. This is sufficient to constitute an interest under the broad definition of 'interest' in

¹² *Yanner v Eaton* [1999] HCA 53; (1999) 201 CLR 351.

the GST regulations. This reasoning recognised the central feature of the rights supplied to cardholders, being immediate access to goods or services charged on the card in return for their promise to repay Amex at the end of each month. They concluded that the first question be answered in the affirmative.

Dowsett J, delivering a dissenting judgement, was of the view that it was necessary to distinguish between legal or equitable property on the one hand and personal contractual rights on the other when considering the definition of an interest in GST regulation 40.5.02. He stated (at paragraph 31) that the relationship between Amex and a cardholder no doubt involves substantial contractual rights, but contractual rights are not necessarily property. He concluded that the cardholder was a bailee. As such he found (at paragraph 39) that:

These rights and obligations seem generally to be personal rather than proprietary. Certainly, nothing supplied to the cardholder is capable of being assigned, and the relevant arrangements are determinable at will. The American Express facilities are no doubt quite complex. To the extent that they are capable of being "owned", the owner is, presumably, American Express. A cardholder acquires no interest in them, but rather a contractual right to utilize their services.

He concluded there was no supply by Amex of an interest as envisaged by GST regulation 40.5.02.

2.2.2 Was the interest supplied by Amex an interest in a credit arrangement or right to credit?

It was common cause between the parties that the supply of credit cards involves a right to credit, as a cardholder may elect to pay less than the entire balance on the card and accrue interest as a result. There was a dispute, however, on the issue of a charge card. On this latter issue the majority held that (at paragraph 154):

As Stone J observing in considering the *Bankruptcy Act 1966* (Cth), in which 'credit' is undefined, '[b]roadly speaking, the term ['credit'] means the provision of funds either directly to the person obtaining the credit or to a third party provider of goods and services to that person subject to the obligation of the person obtaining credit to pay at a later time': see *Fitzgibbon v Inspector General in Bankruptcy* (2000) 180 ALR 475 at 479 [15]. This is the interest supplied by Amex Intl to charge card customers. Whilst, as the respondents say, one must focus on the 'contractual arrangement', the focus is on the entire contractual arrangement considered contextually and as a whole.

As a result they found the supply of the right to use a charge card was a supply of an interest in or under a credit arrangement or right to credit within the meaning of regulation 40.5.09 of the GST Regulations. Dowsett J agreed with the majority on the meaning of 'credit.' However even though these supplies are financial supplies they would be excluded from that definition by regulation 40.5.12 if they were supplies in or under a payment system. It is this final question to which this article now turns.

2.2.3 Are these supplies in or under a payment system?

The dictionary to the GST regulations defines 'payment system' as 'a funds transfer system that facilitates the circulation of money, including any procedures that relate to

the system.’ The majority held (at paragraph 174) that a cardholder obtains the ability to initiate Amex’s provision of payment to a third party (the merchant) in exchange for an obligation to pay Amex at a later date but the GST scheme does not evidence an intention that such an interest count as an interest in a payment system. They explained why (at paragraphs 180 et seq) in the following terms:

A merchant who agrees with Amex Intl to accept its cards as payment from customers has a right to receive payment from Amex Intl in accordance with the procedures governing the system. It was not suggested that a cardholder has any legal right to enforce the procedures which ultimately result in payment to the merchant, and a cardholder would have no apparent interest in doing so. Once the cardholder has presented the card and the card has been accepted by the merchant, what happens next is not the cardholder’s concern. Even assuming Amex Intl operates a payment system, it does not seem to us that it supplies cardholders with an interest, enforceable at law or equity, in or under that system.

As support for the above conclusion the majority referred to GST Regulation 40.5.09(3), that provides that the supply of an interest in or under a credit arrangement or right to credit is a type of financial supply. The court reasoned if GST Regulation 40.5.12 were to apply to supplies to charge card and credit cardholders, there would be no room for the operation of this provision. They noted that is a well-established rule of statutory interpretation that such a sense is to be made upon the whole as that no clause, sentence, or word shall prove superfluous, void, or insignificant, if by any other construction they may all be made useful and pertinent.

The court accepted that GST regulation 40.5.08¹³ was intended as a "tie-breaker" provision. However, the fact that the regulations include a "tie-breaker" provision to address potential inconsistencies does not mean that the Court should avoid resolving inconsistencies where possible or treat apparent inconsistencies as intentional. Rather, the sensible interpretation, and the one compelled by principles of statutory construction, is that both regulation 40.5-09 and 40.5-12 are to operate fully, and the "tie-breaker" provision is only intended to address unforeseen and irresolvable inconsistencies that might subsequently arise. The potential inconsistency here is avoided by an available construction under which the interests supplied by Amex to cardholders fall within Regulation 40.5-09 but not Regulation 40.5-12.

Another basis for their conclusion was that if the supplies in question were not input taxed supplies, they would have to be treated as taxable supplies. If they were, then the respondents, and other credit card companies, would be required to charge and pay GST on membership fees and similar payments received from cardholders. Such an outcome would drastically transform the operation and administration of these kinds of credit facilities and be inconsistent with the intent behind the GST regime to

¹³ This provides:

- (1) For subsection 40-5 (2) of the Act, a supply is a financial supply if the supply is mentioned as:
 - (a) a financial supply in regulation 40-5.09; or
 - (b) an incidental financial supply in regulation 40-5.10.
- (2) However, if a supply is mentioned in regulations 40-5.09 and 40-5.12, the supply is not a financial supply.

exclude tax on what are clearly financial services. The final question was answered negatively.

By virtue of the answers reached to the three questions posed the majority found in favour of the Commissioner.

2.2.4 Leave to appeal to the High Court

The taxpayer sought leave to appeal to the High Court. This application was referred to a five-judge panel to determine and was finalised on 4 May 2011. The grounds on which the application was founded are described below.

First was the meaning given to “property” by the majority in the Federal Court. Amex¹⁴ submitted that the learned judges delivering the majority judgment in the Federal Court had misconstrued the provisions of the GST ACT by ignoring the distinction between property and personal rights. Counsel for the applicant noted that in sections 9-5 and 9-10, which deal with taxable supplies and the meaning of supply, the word “interest” or “property” is not mentioned. The concept of financial supplies on the other hand is specifically limited to property. The consequence of this is that to have a taxable supply one does not need to supply property but for a financial supply one does. The rights given by Amex were contractual in nature and did not possess the attributes of property. The respondent Commissioner in its written submissions said:

The concept invoked is one of identifying that which is protected by law or equity; personal rights, including those which are personal to the holder and (before termination) those which are terminable at will, may be "property" for this purpose.¹⁵

The next ground was directed towards the question whether the Late Payment Fees were part of a payment system as described in Regulation 40.5.12 and, as such, not a financial supply. De Wijn QC on behalf of Amex submitted that the majority proceeded on the assumption that the payment system that was being supplied had to be property. This, in his submission, was incorrect because it only has to be property to be a financial supply, not to be a taxable supply and regulation 40.5.12 refers to taxable supplies. If the supply fell under regulation 40.5.12 then the supply is not a financial supply and there is no need to consider whether the regulation 40.5.09 applies.

In addition the submission was made that to describe a payment system as being one that excluded the payer is incorrect and difficult to accept.¹⁶ Counsel for Amex said that:¹⁷

¹⁴ Transcript of application for leave to appeal in the Amex case:
<http://www.austlii.edu.au/au/other/HCATrans/2011/26.html> accessed 25 February 2011. See also the applicants written submissions:
http://www.hcourt.gov.au/assets/cases/s238-2010/american-express_app-sub.pdf accessed 15 April 2011.

¹⁵ Respondents written submissions at paragraph 10:
http://www.hcourt.gov.au/assets/cases/s238-2010/American-Express_Res.pdf accessed 15 April 2011.

¹⁶ Ibid.

¹⁷ Ibid.

In particular, the majority fell into error by using Schedule 8 as examples of property – that is one of the things they hook their decision on – when, in fact, they were examples of taxable supplies, in this case being the supply of an interest under a payment system which, of course, did not need to be property. That very conclusion of the majority throws up the mismatch which we referred to in our submissions.

The next point was that where there is an election made to defer payment in the case of credit cards there is no supply of credit for consideration as cardholders pay on the due date on receipt of a monthly statement. If they pay late it was conceded there was a charge for interest. In relation to the charge cards if there was a default and there was a requirement to pay liquidated damages that would not convert the sale of goods into an input tax supply because the liquidated damages are by way of damages. They are not consideration for any supply.¹⁸ In its written submissions it was stated that (at paragraph 27):

Amex supplies the right to present the card on the terms set out in the cardholder agreement. The corresponding obligation incurred by the cardholder for the "right to present the card" is to pay Amex on the due date. Amex does not supply the cardholder's obligation to pay Amex.¹⁹

The applicant submitted that there was a fundamental error in the way the majority interpreted the legislation. The submission states (at paragraph 35):

The majority fundamentally misunderstood the critical question posed by the legislation. They incorrectly perceived the question to be whether Amex "supplies cardholders with a property interest" in "a payment system": FC [173]. This fundamental misunderstanding is perhaps explained by confusing what is required under r 40-5.09 with what is required under r 40-5.12. The former requires the supply of a property interest (with the result that the supply of the property interest which is a financial supply will not be a taxable supply), the latter does not *require* such a supply. If the thing supplied comes within the items described in the table to r 40-5.12 it will be a taxable supply regardless of whether it constitutes a property interest. This critical difference between the two clauses was simply not appreciated.²⁰

The proposed appeal raises fundamental issues about the GST and particularly how one is to interpret the financial supply provisions contained in the GST Regulations. On 5 May 2011 the High Court consisting of French CJ, Gummow, Hayne, Heydon and Kiefel JJ refused the application for leave to appeal. The short judgment of the court handed down by the Chief Justice *inter alia* stated:

Having regard to the way in which the applicants chose to conduct their cases at trial this case, in our opinion, is not a suitable vehicle in which to explore

¹⁸ A challenge was also made to the grant of the application for leave to amend the grounds of appeal by the Commissioner but this is beyond the scope of this article.

¹⁹ Applicants written submissions:

http://www.hcourt.gov.au/assets/cases/s238-2010/american-express_app-sub.pdf accessed 15 April 2011.

²⁰ *Ibid.*

questions about the proper construction and application of regulation 40-5.12 made under the Act.²¹

The result of this decision is that important issues around the interpretation of the Financial Supplies provisions in the GST legislation still need to be clarified by the High Court. Pending that decision the view of the majority before the full bench of the Federal Court stands.

As will be seen below New Zealand does not have the same problems with its legislation.

Interestingly in *Waverley Council v Commissioner of Taxation*²² the issue was whether an administration fee charged by the taxpayer for credit card payments should be subject to GST. The Tribunal held it should not be taxable as the fee was simply part of the payment the customer makes for accessing the credit facility and therefore should be treated GST-free on the same grounds as the other part of the payment. Accordingly, the administration fee was not subject to GST.²³ This finding is not in conflict with the majority view in *American Express*.

The article now turns to a consideration of how the NZ GST regime would deal with similar transactions.

3. NEW ZEALAND TREATMENT OF FINANCIAL SUPPLIES THAT INCORPORATE FINANCIAL SERVICES

Although obviously decided under the particular (and sometimes peculiar) statutory provisions of the Australian GST legislation, the fundamental questions in both the *Travellex* and *American Express* cases are pertinent to the operation of the New Zealand *Goods and Services Tax Act 1985*. However, as discussed below, the decisions reached by New Zealand courts in identical cases would not necessarily be the same.

3.1 Travellex

As under the Australian regime, the New Zealand *Goods and Services Tax Act 1985* (“NZ GST Act”) also stipulates that where a supply is both an exempt financial service and a zero-rated supply, then the zero-rating provisions should prevail.²⁴ Accordingly, the general issue in the *Travellex* case (whether an indisputably financial service²⁵ should nevertheless be zero-rated) could potentially arise.

Like Australia, the supply of certain rights for use outside of NZ can also be zero-rated. However, unlike the equivalent Australian provision, the nature of those ‘rights’ is much more narrowly defined under the NZ GST Act. By contrast with the rather nebulous wording under consideration in *Travellex*, the rights that can be zero-rated in NZ are only those relating to intellectual property, confidential information

²¹ Transcript of application for leave to appeal:

<http://www.austlii.edu.au/au/cases/cth/HCA/Trans/2011/114.html>

²² *Waverley Council v Commissioner of Taxation* [2009] AATA 442.

²³ See also ATO ID 2008/116 Goods and Services Tax: GST and credit card surcharge for payment of an Australian tax, fee or charge which is to the same effect.

²⁴ See s 14(1B)(a) NZ GST Act.

²⁵ The exchange of currency is a financial service under s 3(1)(a) NZ GST Act.

and trade secrets.²⁶ Other types of rights, including rights in respect of other types of real and personal property, cannot be zero-rated under the New Zealand regime.

While the definition of ‘money’ in the NZ GST Act also includes foreign currency, the kind of ‘rights’ in respect of that currency that required such detailed examination in *Travelex* simply would not arise under the New Zealand regime. Instead, the NZ GST Act makes it clear that GST will not apply (whether as standard-rated, zero-rated or as an exempt financial service) on the supply of currency itself. Only the *service* of supplying that currency (in practice, the commission charged to customers on that supply) are caught under the NZ GST Act and is treated as an exempt supply under s 3(1) NZ GST Act. Furthermore, if that service is physically performed in New Zealand to a person who is also physically present in the country, it would not qualify for zero-rating.²⁷ It is only if the supply took place outside New Zealand (i.e., from an exchange booth operated by a New Zealand taxpayer in another jurisdiction), would it qualify for zero-rating.²⁸

Interestingly, the Australian High Court appears to have ignored the distinction between the GST treatment of the exchange of the foreign currency and the service of supplying that currency. This distinction was recognised by at least one Australian commentator who noted:²⁹

It is also worth noting that the High Court regarded the supply in question as being solely the supply of foreign currency, rather than the supply of a currency exchange service. While the supply of foreign currency was clearly for use outside Australia, the currency exchange service occurred in Australia.

The supply of currency services anywhere in New Zealand, including in departure lounges to departing passengers, therefore cannot be zero-rated.³⁰

From a New Zealand perspective, the entire case seems to have arisen from loose drafting of Section 38-190(1) of the GST Act, particularly the nature and scope of the “rights” to be given GST-free status. Such an open-ended term obviously invites taxpayers to test its boundaries, as the taxpayer did in *Travelex*. However, a more carefully targeted definition of those rights, as in the NZ GST Act, would have clearly identified what rights were properly zero-rated. Given the underlying policy of all GST regimes to exempt all types of financial services to consumers, such a provision would almost certainly have excluded the supply of foreign currency.

3.2 American Express

Again the *American Express* decision is curious from a New Zealand perspective for the complex statutory framework and extended judicial analysis necessary to conclude whether or not Late Payment Fees paid in respect of a credit or debit card constitute the supply of financial services. The question of whether the customer had acquired

²⁶ See s 11A(1)(n) and (4) NZ GST Act .

²⁷ See s 11A(2) NZ GST Act

²⁸ Under s 11(A)(1)(f) and/or (j) NZ GST Act.

²⁹ See Catterall M, *Travelex — is it right to call money a right* Australian Tax Week, 2010 No 40, 7 October 2010.

³⁰ In contrast to the ATO’s Decision Impact Statement, which now appears to accept that the supply of foreign currency anywhere in the country may in some instances be GST-free, and not merely supplies from bureaux operating past the customs departure point.

“an interest” under the credit card agreement simply does not arise in New Zealand. In that respect the decision is a product of the uniquely complex statutory regime applying to financial supplies under the Australian GST regime.

Nevertheless, *American Express* is interesting from a New Zealand-perspective for its consideration of the extent to which the nomenclature given by the parties in their contracts to various supplies governs its GST treatment. In particular, Amex was careful to specify in its contract with customers that the Late Payment Fees were not interest charges. In particular, the charge card agreements stipulated the fees were liquidated damages whereas the credit card agreements described them as late fees. That designation of those fees by the parties was neither a sham nor mislabelling. From its analysis of the respective contracts, the Full Federal Court also accepted that the fees were not a charge of ‘interest’. Notwithstanding this the majority of the Full Federal Court concluded those fees were nevertheless “revenue derived from” the making of financial supplies.

The case turned on the arguably commonsense approach as to whether the fees were revenue derived by Amex from the card facilities. The majority of the Full Federal Court found they were. However, that conclusion appears to overlook the careful distinction drawn in the contract that the fees were simply penalties payable for breach of the contract and therefore were not themselves a financial supply.

The distinction between the underlying contract and amounts payable for breach of that contract has repeatedly been made in New Zealand. The New Zealand Inland Revenue Department (IRD) has released an updated version of Interpretation Statement IS3387 - *GST Treatment of Court Awards and Out of Court Settlements*,³¹ which clearly stipulates GST must be considered separately for the supply made in the underlying contract and any payment or damages payable as a result of breach of that contract. That policy acknowledges the obligation to pay damages will result from a wrongful act by one party and:

The Commissioner considers that the appropriate focus is whether the payment is for any supply that has been made, and not the action that gave rise to the award. ... When a payment is made ... and it is consideration for a taxable supply (or an adjustment to a consideration for a taxable supply) this will be taxable. If the payment is made for compensation or damages it is not taxable.

The policy ultimately emphasises:

the importance of the distinction between payments and receipts made in the course of a taxable activity and the requirement these are linked to supplies in order for GST liability to arise. Loss may be suffered in connection with a supply. Where payments are compensatory, and relate to loss, the nexus is with the loss, rather than the supply that caused the loss.³²

³¹ The current policy was published in October 2002, updating an earlier policy issued in Tax Information Bulletin (TIB) Vol 1, No 11, June 1990

³² The policy cites two cases in support of this reasoning: *Montgomerie v CIR* (2000) 19 NZTC 15,569 (CA) (involving partial recovery by a liquidator); and *Case S77* (1996) 17 NZTC 7,483 (involving allegations of negligence).

The distinction between the underlying obligation and the subsequent penalty for non-payment of that obligation has also been recognised for income tax purposes, even where the subsequent penalty is specifically described as ‘interest’. In *C of IR v Buis*³³ the taxpayer was successful in an action to recover unpaid workers’ compensation under New Zealand’s Accident Compensation regime (ACC). The taxpayer received unpaid compensation from previous years plus an award for ‘interest’ from the date the payments were originally due. Tax was obviously payable upon the workers’ compensation³⁴ but the taxpayer disputed the taxability of the ‘interest’.

Interest is normally taxable income.³⁵ However, the definition of ‘interest’³⁶ specifically requires the payment be made ‘in respect of or in relation to money lent.’³⁷

As the ‘interest’ paid by ACC was in respect of its underpayment, and not as a result of money lent by the taxpayer, France J ruled the payment did not fall within the scope of that section and thus was free of tax:³⁸

The payment is not made because the claimant has loaned the money, or because the claimant has been deprived of its earning potential. It is made in a sense because the claimant is a “victim” of an inadequate processing of his or her claim. It is payment made because of default on the part of the payer, not because of anything at all done by the payee.

Under the relevant statutory ACC scheme ‘interest’ paid to a successful claimant because weekly compensation is paid late is in the nature of a fine. It is not intended to compensate for the period of non-payment and is not taxable under ordinary concepts. IRD have accepted the general effect of this decision that a penalty for late-payment is not ‘interest’ under the statutory regime.³⁹

This New Zealand treatment of interest for breach of contract or as a penalty for late payment certainly would sit uneasily with the conclusion reached by the Full Federal Court in *Amex*. Instead, it appears the Full Federal Court’s determination to interpret GST as a ‘practical business tax’ may have resulted in it overlooking the distinction between the GST effect of the underlying financial supply of the credit and charge card, and the fees charged to customers for non-payment.

For instance, the leading New Zealand case on how financial transactions should be interpreted under the revenue Acts is *Marac Life Assurance Ltd v C of IR*.⁴⁰ In that

³³ (2005) 22 NZTC 19,278 (HC), upholding the TRA decisions in Case W54 (2004) 21 NZTC 11,508 and Case W58 (2004) 21 NZTC 11,548.

³⁴ Under s CF1 NZ Income Tax Act 2007.

³⁵ Under s CC4 NZ Income Tax Act 2007.

³⁶ Under s YA1 Income Tax Act 2007.

³⁷ In Australia the same position appears to be the case. See for example the statement by the High Court in a unanimous judgment in *Federal Commissioner of Taxation v Myer Emporium Ltd* [1987] HCA 18; (1987) 163 CLR 199 where the following statement was made (at paragraph 35):

“Interest is regarded as flowing from the principal sum (*Federal Wharf Co. Ltd. v. Deputy Federal Commissioner of Taxation* [1930] HCA 30; (1930) 44 CLR 24, at p 28) and to be compensation to the lender for being kept out of the use and enjoyment of the principal sum”.

³⁸ (2005) 22 NZTC 19,278, at [54]

³⁹ See QB 09/03: Decisions on application of section CA 1(2) — common law interest and income under ordinary concepts. Note, however, that contrary to the *Buis* decision, NZ IRD maintains that such payments may constitute “income under ordinary concepts” under s CA1 NZ Income Tax Act 2007.

⁴⁰ *Marac Life Assurance Ltd v C of IR* [1986] 1 NZLR 694 (CA).

case Marac took advantage of tax concessions granted to life insurance policies by issuing investments called 'life bonds'. The bonds were issued for a lump sum amount and carried 'bonuses' equating with market interest rates that mirrored debt investments. However, the bonds incorporated a small element of life insurance, which effectively required Marac to repay the original lump sum plus all bonuses for the whole period of the investment immediately upon the death of the investor. This 'mortality risk' element represented only 0.5% of the amount subscribed by each holder.

In economic terms the investment constituted a fixed term loan that was repayable with interest upon maturity – but the specific contractual terms conformed in all respects to definition of a life insurance policy. Not surprisingly the IRD contested that treatment and sought to deny the tax benefits obtained by investors under the policies.

The Court of Appeal unanimously rejected the Commissioner's arguments. The court's examination of the parties' contract confirmed that it complied with the legal form for a life insurance policy and therefore the terminology used in that contract was correct. As a result the Court refused to over-ride that agreement:⁴¹

[The parties] are free to enter into whatever lawful financial arrangements will suit their purposes. They cannot be treated as having entered into a different arrangement which would or might have achieved somewhat similar economic advantages and whether or not they ever had that alternative in contemplation. If Marac life bonds are policies of life insurance that is the end of the inquiry.

Accordingly the Court directed that the tax consequences must be determined according to the legal form of the agreement between the parties and not according to the economic results achieved or the overall economic consequences.

The reasoning in the *Marac* case has been adopted and applied in a number of GST cases. The most recent application of this principle in GST is the unanimous Court of Appeal decision in *CIR v Gulf Harbour Development Ltd.*⁴² This case concerned the GST treatment of the sale of participatory securities in a company that operated a golf course and country club. Membership to the country club and access to its facilities was granted as a right of share ownership. As the ownership and transfer of 'participatory securities' is a financial service,⁴³ the company treated the sale of these shares to members as GST exempt.⁴⁴ The consequence of this treatment was that membership and operation of the country club remained exempt for GST. The IRD contested this treatment on the grounds the shares were merely a device to obtain a favourable GST treatment and did not reflect the practical or economic reality of the agreement between the parties.

The Court of Appeal rejected Inland Revenue's argument on the grounds it called for an 'economic as opposed to a legal substance' approach to statutory interpretation that

⁴¹ At 705.

⁴² (2004) 21 NZTC 18,915 (CA)

⁴³ As defined in s 3(2) NZ GST Act 1985.

⁴⁴ Under s 14(1)(a) NZ GST Act 1985.

is generally impermissible in a tax context. Most importantly, citing the *Marac* case, the court refused to over-ride the actual agreement entered into between the parties.⁴⁵

It is also undeniable that the rights to membership arose exclusively from that equity security. As Mr McKay submitted, no independent source or origin of those rights exists. Membership rights are as inherent in these shares as a dividend right normally is. ... Everyone who buys a share in a company buys it to acquire the rights attaching to that share. A share is in all cases a “vehicle” for acquisition of the rights attached to it. The fact that in this case the rights attached to the shares were rights to membership in the country club does not alter what one is acquiring. It may well be that, in marketing the shares, rather more emphasis was placed on “membership of the golf club” than on the “share” element... But that did not matter.

It appears the Full Federal Court simply concluded that, as the fees were payable under the card agreement, they were revenue derived from the provision of the charge or credit card – rather than as liquidated damages payable for default by the cardholder, as specified in the contract. While those fees became payable under the terms of the contract under which the cards were originally supplied, that alone would not normally dictate its GST treatment. It is therefore questionable whether damages paid for breach of contract would constitute “revenue derived from” that contract.⁴⁶

3.3 Relevance of the Purchaser’s Purpose When Determining Correct GST Treatment of Supply

A significant aspect of the *Travellex* decision was the comments that the GST treatment of a supply may sometimes be determined by the purpose of the purchaser. Again, this issue has been considered by New Zealand courts when considering the correct GST treatment. For instance, in the *Gulf Harbour* case, part of IRDs argument was that purchasers had no interest in the participatory securities but only acquired them for the purpose of obtaining membership of the country club. Again, this argument was rejected, the court stating simply:

How the offer was marketed and why people purchased the shares are irrelevant.

That view has been consistently applied by New Zealand courts when analysing the GST treatment of a supply. Another example is *Auckland Institute of Studies Ltd v CIR*,⁴⁷ where the court had to determine whether a company supplying tuition services in New Zealand to foreign students could zero-rate part of its tuition fees to account for all ancillary services provided to those students prior to their arrival in this country. The company claimed that some students would have been unable to enrol for its courses without receiving those ancillary services and therefore should be entitled to treat such services as separate, zero-rated supplies. The Court rejected that argument on a number of grounds but in doing so advised that the correct GST treatment of any supply must be determined according to ‘the view of the objective consumer’ and not by reference to the purposes of individual customers.

⁴⁵ At [24] – [26].

⁴⁶ Statement IS3387 - GST Treatment of Court Awards and Out of Court Settlements

⁴⁷ (2002) 20 NZTC 17,685

Likewise, in *Wilson & Horton Ltd v CIR*⁴⁸ the Court of Appeal rejected as impractical any interpretation of the Act that required a supplier's GST treatment to depend upon having to determine the direct or indirect purpose of each customer. There a newspaper publisher had treated as zero-rated all advertising placed by non-residents, even if that advertisement may also have provided an ancillary benefit to New Zealand residents. IRD contested that zero-rated treatment on the grounds the publisher should have determined whether and to what extent each advertisement would benefit residents. Such an approach would have imposed obligations on the publisher to ascertain the purpose of each customer placing an advertisement, something that was both impractical and would have led to uncertainty in the operation of the Act. Rejecting that argument Penlington J concluded:

This exemption, if construed as the Commissioner contends, would cause inconvenience and difficulties in its operation. At times it would be unworkable and impractical. It is unlikely Parliament intended this result. The supplier of the services in New Zealand ... would be placed in a position of having to make an inquiry into and an assessment in every case of the possible benefits which might arise from the contract without having any guiding criteria. The supplier would be dependent on such information as might be made available to it from the [recipient] and on such local information as it has available about the subject matter of the services. Often, as it was pointed out in the argument, there will be no time to make the assessment and in cases of doubt it will often be impractical and indeed sometimes impossible to take legal or accounting advice because of time constraints. ... [These practical problems] in my view strongly points to the absence of such a requirement that the supplier should make this kind of inquiry and assessment. The Act is a taxing statute. Its terms should be explicit and unambiguous.

This New Zealand approach follows the stance taken by UK courts under the VAT legislation. For instance, in *British Railways Board v C & E Commrs*⁴⁹ all judges emphasised that it was irrelevant what "the motive or intention of the person receiving the service" might be. Accordingly, the Australian approach is at odds with the normal operation of GST as a transaction tax based on the nature of the supply and not according to the purpose of individual purchasers. As foreseen by the majority in *Travelex*, that approach is likely to cause unnecessary uncertainty and administrative difficulties for both taxpayers and the ATO. It is therefore remarkable that the High Court would have adopted this interpretation.

4. CONCLUSION

The High Court's judgment in *Travelex* significantly extends the scope of the supply of rights under Div 38-190(1), almost certainly beyond what was originally intended. What are clearly financial supplies made to persons in Australia may now be GST-

⁴⁸ (1995) 17 NZTC 12,325 (CA)

⁴⁹ [1977] 1 WLR 588

free, which appears contrary to the underlying policy of the regime to treat such supplies as input taxed. As noted by one commentator:⁵⁰

It is also worth noting that the High Court regarded the supply in question as being solely the supply of foreign currency, rather than the supply of a currency exchange service. While the supply of foreign currency was clearly for use outside Australia, the currency exchange service occurred in Australia. This approach to analysing the supply is quite different from that adopted in other GST/VAT jurisdictions

This would have accorded with the NZ approach.

More importantly, the majority decision in *Travellex* now permits suppliers to consider the use or purpose of the recipient when determining the correct GST treatment. In effect, the subjective aims of that purchaser may now be relevant to classifying that supply – yet provides no guidance on how the purchaser’s purpose should be determined. Despite the Commissioner pointing to the administrative difficulties this approach poses for both taxpayers and the ATO, the High Court found in some instances the purchaser’s purpose may be determinative. It will be interesting to see how this approach operates in practice

Likewise, the Full Federal Court decision in *American Express* appears to ignore the distinction between the underlying contract and any damage payable for breach of that contract. While fees charged by Amex arose out of the financial service of a credit or charge card, and therefore in substance fell within the definition of financial supply, they were not payable simply as a result of that supply but directly because of their failure to pay the agreed amount by the due date.

It would seem that the views of the New Zealand courts may be of some interest to the High Court when the issues raised about the interpretation of the Financial Supply provisions is finally ventilated. Certainly, the full bench decision does not sit easily with the way in which identical transactions would be treated in New Zealand which, in the author’s opinions, has the purest GST regime possibly in the world.

⁵⁰ M Catterall, “Travellex — is it right to call money a right?” Australian Tax Week, 2010 No 40, 7 October 2010

Tax Risk Management Practices and their Impact on Tax Compliance Behaviour – The Views of Tax Executives from Large Australian Companies

Catriona Lavermicocca*

Abstract

This paper presents the results of in-depth interviews with 14 tax managers from large Australian corporations and constitutes a part of the ongoing research for the purposes of the completion of a PhD. The results detailed in this paper give an insight into the tax risk management practices of large corporations in Australia, tax risk decision making and the variables that impact tax risks and the ability to manage those tax risks. The views of tax managers on the impact of tax risk management practices on compliance behaviour are also discussed and used to identify issues requiring further research.

1. INTRODUCTION

Revenue authorities around the world have identified that the management of tax risks by large corporate taxpayers is an important part of an effective tax function, one that will assist in improving tax compliance.² Specifically the Australian Taxation Office (ATO) emphasise in numerous announcements and statements that directors need to be informed concerning tax risks and corporate governance practices of a large corporation require a comprehensive tax risk management system. The significance of tax risk management is demonstrated in the number of surveys by large international

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² Carmody, M. Commissioner of Taxation 'Large Business and Tax Compliance; A Corporate Governance Issue' Leaders' Luncheon 10 June 2003; D'Ascenzo, M. Commissioner of Taxation 'Top End Tax Risk Management-The Journey Continues' Speech to the PricewaterhouseCoopers Boardroom Dinner, Brisbane 28 June 2006; Killaly, J. Deputy Commissioner of Taxation Large Business and International 'Tax Risk Governance: The Corporate and Personal Dimensions' Australian Institute of Company Directors Sydney 18 July 2007; HMRC (UK) 'Approach to Compliance Risk Management for Large Business' March 2007; Butler, D. New Zealand Commissioner of Inland Revenue 'Corporate Insolvency-Tax Risk Management' at the New Zealand Law Society Taxation Conference September 2006; OECD Forum on Tax Administration 'Seoul Declaration' 2006; Ireland Revenue Authority 'The Cooperative Approach to Tax Compliance' 2005

professional firms concerning tax risk management practices and in the responses to those surveys by respondents.³

Globalisation and more sophisticated financial markets put pressure on revenue authorities to deal with more complex risks and, although new technology improves the ability to monitor those risks, Braithwaite identified that 'a shift is needed in tax compliance strategy to risk analysis of the risk management systems of taxpayers and tax agents'.⁴ The identification of tax risk management as a responsibility of directors by the ATO reflects such a shift in strategy as identified by Braithwaite.⁵

The ATO has stated that, in carrying out their risk review of large corporate taxpayers, the tax risk management practices of the taxpayer will be a consideration in the determination of the level of risk to the revenue and the extent to which that taxpayer would be subject to ATO scrutiny.⁶ The ATO expects that as a result of directors being informed concerning tax risks there will be consequential improvements in tax compliance by the large corporate sector. Further in identifying tax risk management as an integral part of ensuring tax compliant behaviour it is possible that there will be savings in the audit costs incurred by the ATO. The review of large corporate tax compliance by the ATO may increasingly be limited to ensuring that a good tax risk management system is in place.⁷

Ultimately the in-depth interviews with tax decision makers in large Australian corporations conducted as part of this research give an insight into the motivators and consequences of the demand for information concerning tax risks.

Whilst it is anticipated that the directors and tax managers in a large Australian company will consider, and in many cases apply the ATO's recommendations concerning tax risk management, this research looks at what large corporations are actually doing from a tax risk management perspective, who the tax decision makers are and the views of tax managers as to the impact on tax decision making as a result of the adoption of a tax risk management system.

Where a tax risk management system has been adopted by a participant this research investigates what motivated the company to adopt the particular tax risk management system and develop an understanding of the variables that have an impact on corporate decision making with respect to tax risks.

³ Henderson Global Investors 'FTSE350 Survey Report' (2005) and their 'Responsible Tax Report' (2005); Ernst and Young 'Tax Risk Management: The Evolving Role of Tax Directors' (2004); Ernst and Young 'Tax Risk: External Change, Internal Challenge, Global Tax Risk Survey' (2006); Ernst and Young 'Tax Risk: External Change, Internal Challenge-The Australian Perspective, Global Tax Risk Survey' 2006-2007; Ernst and Young 'Global Tax Risk Survey 2008'; Ernst and Young 'Steady Course, Unchartered Waters- The Australian Perspective from the Third Ernst and Young Global Tax Risk Survey 2008'; KPMG 'Tax Department Survey' (2005)

KPMG 'Tax Department Survey' (2006); KPMG 'The Rising Tide-Regulation and Stakeholder Pressure on Tax Departments Worldwide' (2006)

⁴ Braithwaite, J. 'Markets in Vice, Markets in Virtue' 2005 Federation Press 85

⁵ Ibid

⁶ D'Ascenzo, M. Commissioner of Taxation 'Top End Tax Risk Management-The Journey Continues' to the PricewaterhouseCoopers Boardroom Dinner, Brisbane 28 June 2006 2; Killaly, J. Deputy Commissioner, Large Business and International, The Australian Taxation Summit, 15-17 February 2006, The Grace Hotel Sydney

⁷ D'Ascenzo, M. 'Individual Interests and Community Needs-Focus on Legal Professional Privilege' The Australian Italian Lawyers Association Tax Seminar, Melbourne 18 September 2003 2

Based on the views of the tax managers interviewed, this research indicates that the management of tax risks does not in itself result in a lower level of tax risk but rather that the directors and tax decision makers are more informed about the tax risks that the organisation faces and that the tax position ultimately taken should not result in any surprises for the board of directors.

This research also gives an insight into the impact of ATO statements and announcements on tax decision makers in a large corporation. The views of the ATO concerning tax risk management practices have been considered and in many cases adopted by large corporate taxpayers despite the fact that to a large extent the requirement to manage tax risks is not based on a piece of legislation or case law but rather on what the ATO considers is best practice. The adoption of a tax risk management system by large corporate taxpayers suggests that the ATO's views on best practice are considered and adopted by large corporations.

2. LITERATURE REVIEW

Literature on tax compliance behaviour almost exclusively focuses on individuals rather than corporations. Listed corporations in which the shareholders and directors are not the same individuals require a different conceptual framework.

2.1 Models of tax compliance behaviour

In establishing the impact of tax risk management practices on large corporate tax compliance behaviour the existing literature gives only limited indication as to the likely impact of a tax risk management system on compliance behaviour.

Economic deterrence models of tax compliance are based on an assumption that the taxpayer, in making decisions concerning tax compliance, aim to maximise utility. Accordingly the tax compliance question can be viewed as a question of risk preferences in respect of which econometric equations could be used to predict taxpayer behaviour if sanctions for non-compliance and the likelihood of audit are varied. The ultimate incidence of corporate tax however is uncertain and depends on how the corporate taxes are redistributed between shareholders, customers and employees.

Shareholders may not bear the consequences of a tax adjustment where the company operates in a market that would allow the increased costs to be passed on to the customer. Alternatively those costs could be borne by employees in reduced bonuses or wages or in a reduction in the number of employees. With respect to a corporation no absolute or predetermined link exists between additional tax and or penalties and the ultimate individual who bears the increased liability.

Slemrod argues that the assumption of risk aversion that underlies economic deterrence models of tax compliance, are not appropriate for listed corporations in which the shareholders hold diversified portfolios. As a result of diversified shareholdings the corporation should make decisions as if it is risk neutral even if individual shareholders are not.⁸

⁸ Slemrod, J. 'The Economics of Corporate Selfishness' *National Tax Journal* Dec 2004 877

Social and psychological deterrence models of tax compliance argue that the decision concerning tax compliance is more than just a cost-benefit calculation and other factors like morality, characteristics of the taxpayer and perceptions of fairness of the tax system amongst other factors play a part in an understanding of the tax compliance decisions. The separation of ownership and control in a corporation suggests that social and psychological deterrence models need to consider individual tax decision makers within the corporation rather than the corporation itself. Individual tax decision makers have a duty to make decisions within the tax laws in the best interests of the company as a whole.

Tax morality may not have a role in understanding a corporation's tax compliance behaviour where the corporate objectives are based on purely financial or economic goals. Usually decisions by corporate managers are based on economic or financial measures and management that does not take advantage of legal opportunities to minimise tax may breach their duty to shareholders to act in the best interests of the corporation as a whole.

Decisions with respect to tax compliance depend largely on corporate policy. It is expected that the existence of a comprehensive tax risk management system would ensure that decisions concerning tax risks are based on director approved policy.

2.2 Impact of Decision Making Structures in a Large Corporation

The actions and interactions of directors and employees of a company influence the tax behaviour of a company so in looking at factors that impact on tax compliance it is necessary to look at decision making structures within the organisation and at the decision maker themselves. The interests of decision makers within a corporation may very well differ from those of the shareholders due to differing risk and decision outcomes although a variety of measures, including good corporate governance practices, are usually put in place so that the decision maker's interests are aligned with those of the shareholders.

A listed company, in which the shareholding is spread widely amongst a number of shareholders, is going to see a greater divergence between the interests and responsibilities of the directors and shareholders than a private, closely held company.⁹ In imposing financial penalties on a company for tax non-compliance, a director's role in the approach taken is not recognised. As noted by Slemrod in his research into corporate income tax compliance,

'Little is known about how and why, holding constant the chance of getting caught and the penalty for non-compliance, corporations differ among themselves in their aggressiveness, regarding pushing the envelop of the tax law, and whether their behaviour would respond to initiatives designed to strengthen intrinsic motivation.'¹⁰

During 2006 the HMRC in the UK funded a qualitative study comprising interviews with the tax managers responsible for corporate tax in 37 large groups in the UK and identified that tax managers were not receiving bonuses or incentives that were based

⁹ Keinan, Y. 'Corporate Governance and Professional Responsibility in Tax Law' *Journal of Taxation and Regulation of Financial Institutions* 2003 17(1) 10, 18

¹⁰ Slemrod, J. above n 7, 882

on their ability to reduce the corporation's tax bill.¹¹ In addition there is evidence that the emphasis on taxation as an important risk area within a corporation has had an impact on performance measurement in tax departments within a large corporation as tax managers become more risk averse and greater emphasis is placed on accuracy and compliance as apposed tax minimisation as a contributor to shareholder returns.¹²

As highlighted by Ernst and Young in a report detailing results of its worldwide survey of tax directors '2004 Tax Risk Management'

The shift in emphasis to tax risk management has become more pronounced such that tax directors are now being measured on it-they are expected to deliver in this area more than in some of the traditional measures such as effective tax rates. This perhaps, more than any other finding in our survey, emphasizes the profound change and expectations companies have for tax directors and the global tax function.¹³

To effect a change in the tax compliance behaviour of a large corporation, models of organizational decision making suggest that there needs to be a change in the tax compliance priorities of the leaders of that corporation.¹⁴ It is anticipated that the identification of directors as accountable for tax decision making would have a positive impact on compliance because it produces personal liability concerns for the decision makers within the corporation. The ATO tax governance guidelines and other publications giving tax decision makers clear guidelines on what they need to do to manage tax risks provide an indication of what is acceptable and helps tax decision makers avoid ethical uncertainty and reach consensus.

Research in relation to the reduction in the popularity of tax shelters in the US suggests that ATO announcements concerning tax risk management practices, the requirement for directors to be informed concerning tax risks, as well as specific guidance on the issues that director's should be considering in relation to tax risk, will encourage the development of a more tax compliant or less tax aggressive group norm within large corporations in Australia.¹⁵

Changes introduced in the UK by the HMRC, in which the HMRC identified the importance of the tax risk profile that a large corporation takes in the determining the detail of investigation by HMRC has influenced the behaviour of UK companies in terms of tax governance, transparency and openness.¹⁶ However research by Freeman, Loomer and Vella identified that the attitude of respondent UK companies to tax planning had not changed as a result of the risk rating process.¹⁷ The fact that the risk

¹¹ Prepared for HM Revenue and Customs by FDS International 'Large Groups' Tax Departments: Factors that influence Tax Management' A Qualitative Study, September 2006

¹² Ernst and Young 'Tax Risk: External Change, Internal Challenge, Global Tax Risk Survey 2006'

¹³ Ernst and Young 'Tax Risk Management The Evolving Role of Tax Directors' 2004, 6

¹⁴ Morse, S. C. 'The How and Why of the New Public Corporation Tax Shelter Norm' *Fordham Law Review* (2006) 75, 961; Lavermicocca, C 'Managing Tax Risk and Compliance' (2009) 13(2) *Tax Specialist* 66

¹⁵ Ibid

¹⁶ Freedman, J., Loomer, G and Vella, J. 'Corporate Tax Risk and Tax Avoidance: New Approaches' (2009) 1 *British Tax Review* 74, 88

¹⁷ Ibid

rating approach did not have a significant impact on the approach to tax planning by large business in the UK was also supported by the HMRC's own research.¹⁸

Freeman, Loomer and Vella suggest that the risk rating approach has not been successful in altering attitudes to tax planning in the UK because of a failure of the HMRC to demonstrate that a more conservative approach to tax planning, no matter the type or size of the corporation, would result in a low risk rating and the lack of significant and clear incentives to alter tax planning behavior.¹⁹ Of the respondents that did take a conservative approach to tax planning they did so, not purely as a matter of choice, but as a result of other factors such as 'the industry or line of business they are in, their particular legal structure, or their low corporate tax bill.'²⁰

2.3 Changing role of tax departments

A review of tax reporting by the FTSE 350 in the UK by PricewaterhouseCoopers in 2007 identified the changing role of tax departments within a large corporation. The PricewaterhouseCoopers review suggests that information concerning a corporation's taxes is being used by a wide range of stakeholders and as a result there is a need for more information about the taxes a corporation pays.²¹

Whilst historically many multinational corporate groups took a decentralised approach to tax compliance the requirement for boards to take a more active interest in ensuring compliance with the tax laws has seen a move to more centralised decision making in the global tax director.²² A move towards tax decision-making at a more senior level highlights a need to ensure that appropriate information is provided to tax decision makers on a timely basis.

3. RESEARCH AND CONDUCT

This qualitative research project consists of in-depth interviews with tax managers from large Australian corporations (turnover exceeding \$250 million). The purpose of this research project was to gain an understanding of the tax risk management practices and the tax manager's views as to the impact of those practices on tax decision making and tax compliance behaviour. A total of 15 in-depth interviews were carried out in which 19 open ended questions (Attachment 1) were asked relating to tax risk and tax decision making. Ultimately the results of this research will be used to inform the drafting of a subsequent large scale survey instrument to collect data on this research topic for the purposes of completion of a PhD.

Participants were recruited through a number of avenues. The Corporate Tax Association was contacted via email to determine whether any of their member companies would be interested in participating in this research. Similarly the author contacted professional accounting bodies and advisory firms in an effort to recruit participants. In addition the author ascertained potential participants based on

¹⁸ *Research to Support the Implementation of proposals in the Review of Links with large Business* HMRC Research Report 58 (December 2007), 27

¹⁹ Freedman, J., Loomer, G and Vella, J. above n 15

²⁰ Ibid 89

²¹ PricewaterhouseCoopers 'Tax Transparency Framework- a suggested framework for communicating your total tax contribution' May 2007

²² Lambert, C. and Lucas, J. 'Managing Global Tax Compliance' July 2006 *International Tax Review* 34

turnover and contacted the relevant tax manager via telephone or email. Each potential participant was provided with a copy of the letter of consent (Attachment 2), details of the research topic and proposed questions to be addressed during the interview. Participation was voluntary, there was no coercion and participants were advised that all individual responses would remain confidential.

Interviews were conducted face to face or via telephone depending on the participant's preference. Of the 15 participants, 12 were large public companies and 2 were large private companies each with a turnover exceeding \$250 million. In addition a tax partner with a large 'Big 4' international accounting firm was interviewed to obtain their view on tax risk management practices of large corporate clients and the impact of those practices on tax compliance behaviour. All interviews were carried out between October 2009 and June 2010 and lasted between 45 minutes and 1 hour 30 minutes. Interviews were conducted and notes taken by the author of this paper.

Due to the small scale of this research the results are not held out to be representative of all large Australian corporations. The participants were selected from a variety of industries, including mining, transport, retailing, construction, banking, manufacturing and utilities and responses reveal a broad range of opinions and approaches to tax risk management. The tax risk management practices identified and the views of participants on the impact of those practices were used as a basis for analysis and the identification of propositions relating to the demand for information concerning tax risks. The responses to open ended questions were analysed by coding responses then isolating key concepts and themes. The propositions arising from this research are qualitative in nature only.

The views of the tax partner participant and the results of the *Ernst and Young Global Tax Risk Survey (2008)* provide an additional insight into the approach to tax risk management by large Australian corporations and were used in this research as a source of validation of the views of tax managers.²³

4. TAX RISK MANAGEMENT SYSTEMS IN LARGE AUSTRALIAN CORPORATIONS

All of the 14 corporate participants advised that they evaluated tax risks and that tax risk management was an important part of the tax function. Seven participants had a comprehensively formalised and documented tax risk management system and a further four participants said that their tax risk management system was only partially formalised and that the documentation of their tax risk management was still in progress. Interestingly of the three participants that had a completely informal and undocumented tax risk management system two were private companies. All participants were aware of ATO statements on tax risk management.

Those participants with an entirely informal and undocumented tax risk management system said that they do comprehensively manage tax risks but that they did not feel the need to formalise or document the process. The management of tax risks in those organisations required a more informal approach in which 'gut instinct' and the 'smell test' was applied to determine the tax risk applicable to a transaction. All participants

²³ Ernst and Young 'Steady Course, Uncharted Waters- The Australian Perspective from the Third Ernst and Young Global Tax Risk Survey 2008'

felt that they were inherently ethical in their approach to tax compliance and as a consequence tax risks were minimised.

In the case of private company participants there was a strong and clear line of communication between the tax manager, the directors and shareholders and this may explain why those participants did not feel the need to document the procedure. The number of tax staff employed by the private company participants was limited to two or three persons including the tax manager and each staff member had a comprehensive understanding of the tax issues facing the organisation and a mandate from directors and shareholders to ensure that the company was tax compliant.

One participant who had experience with tax risk management systems in a number of large Australian corporations noted that in some cases the tax risk management system is formalised and documented but not actually being put into practice. In addition the tax partner participant, who was interviewed for the purposes of this research, referred to a problem he saw with clients when the overseas parent company had drafted the tax risk management policies but they were not operationalised in the Australian entity.

What the comments of all participants indicate is that effective tax risk management requires decision makers within the relevant organisation to enforce and apply a culture of identifying and considering tax risks rather than just ensuring the existence of a formalised and documented tax risk management system. Whilst a variety of documented tax risk management procedures were identified an over arching risk policy within the organisation to comply with all laws, combined with operational procedures to ensure compliance with that risk policy, are required to minimise tax risks.

All participants did give the impression that tax risk management is still an emerging issue and as pointed out by the tax partner participant 'surprises still do arise where a client has not addressed the issue'. All tax risk management systems of participants were based on a culture of compliance within the organisation. Further the *Ernst and Young Global Tax Risk Survey (2008)* identified that increasingly large Australian companies have in place a broad risk assessment program for tax however only 36% have documented procedures for managing tax risk that extend beyond specific statutory requirements.²⁴

5. TAX RISKS DEFINED

Tax uncertainties give rise to regulatory and compliance risk and dealing with those risks pose a significant challenge for corporations. Until recently tax risk management and tax internal controls were rarely discussed or written about and the tax department within a corporation tended to operate in isolation from the board of directors.

Tax uncertainties create tax risks and managing tax risk is about managing those uncertainties. A narrow view of tax risk would include 'uncertain tax positions and vulnerabilities in tax financial controls and reporting'.²⁵ In comparison a broader definition and one that reflects the current view on risks includes,

²⁴ Ibid 5

²⁵ Ernst and Young above at n 12, 5

any event, action, or inaction in tax strategy, operations, financial reporting, or compliance that adversely affects either the company's tax or business operations or results in an unanticipated or unacceptable level of monetary, financial statement or reputational exposure.²⁶

PricewaterhouseCoopers in their publication, 'Tax Risk Management' outline seven broad categories of risk associated with taxes²⁷ including transactional, operational, compliance, financial accounting, portfolio, management and reputational risk.

Effective tax risk management by a large corporation requires a clear definition of what constitutes a tax risk. An evaluation of any tax risk management system would include an understanding of what tax risks were actually being managed. Only five of the participant companies managed tax risks based on a clear definition of what constitutes a tax risk. All five participants that had a clear definition of what constitutes a tax risk were public companies.

Participants who did not have a definition of tax risk said that the systems they have in place ensure that they consider all scenarios that give rise to uncertainty in relation to tax outcomes. Four participants who did not have a definition of tax risk noted that the criteria they used to identify a tax risk is very much based on an application of the 'smell test' or 'gut feeling' whilst one participant worked on a rough rule of thumb in establishing the existence of a tax risk where the tax consequence of a transaction was uncertain. All tax managers that were interviewed were very experienced tax professionals and a number felt that experience allowed them to be a good judge of the tax risks associated with a transaction.

Three participants expressed concern with the ATO's definition of tax risk and noted that the corporation's definition is likely to be quite different. The ATO statements concerning tax risk have focused on the risk that a tax position may not comply with the law but does not address the fact that from the company's perspective a tax risk includes not only the risk that the organisation may adopt a tax position that does not comply with the law but also the risk that they may fail to take up a concession or tax approach that does comply with the law and would result in a tax saving (eg a failure to apply for a research and development concession that the organisation would qualify for).

The view of the tax partner participant was that to a large extent large companies are concentrating on financial tax risk and really only consider other tax risks like reputation when there is a major or unusual transaction. The lack of a comprehensive evaluation of all types of tax risks suggests that there are some limitations in a corporation's ability to manage tax risks and accordingly the tax decision maker's ability to make informed decisions.

²⁶ Ernst and Young above at n 12, 12

²⁷ PricewaterhouseCoopers 'Tax Risk Management' (2004) -This analysis is not by type of tax and they include all types of tax under tax risk management

6. KEY TAX RISK DECISION MAKERS

Key tax risk decision makers identified by participants include the following;

- Board of directors
- Chief financial Officer/Director
- Tax manager (Australia)
- Tax manager(Global)
- Risk Management Committee

Participant's responses indicate that the board of directors are usually involved in the adoption and approval of a tax risk management system but the day to day application of that system to the organisation's transactions occurred in the tax department within the corporation.

Of the 12 public company participants, 11 indicated that the board of directors were a driving force in the adoption of a tax risk management system. Where a formal tax risk management system had been adopted, typically the tax department within the organisation was responsible for its formulation and subject to approval by the board of directors. Consistent with participant responses the *Ernst and Young Global Tax Risk Survey (2008)* reported that 96% of large Australian company respondents have an individual with overall responsibility for managing tax risk.²⁸

One public company participant noted that the tax risk management system that was put in place was based on a system adopted by the group internationally. In the case of the two private company participants the tax risk management systems were informal and the tax manager within the organisation was responsible for the development and application of tax risk management practices without the board of director's approval. Thirteen of 14 directors did send out a clear directive in these instances that there are to be no surprises in relation to tax.

All participants emphasised that the decisions in relation to tax risk management are based on a culture of compliance so although the directors are not involved in the day to day consideration of tax risks the tax managers know the approach to tax risks that they should take. The tax manager reports material tax issues to the Board and there are clear directives from the Board that they want to be informed concerning material tax risks. The tax managers who participated in this research emphasised that it was an important part of their role within the organisation to keep directors fully informed concerning tax risks.

Participants were asked what performance measures were used to evaluate their performance and whilst a myriad of factors were considered in evaluating the performance of the tax manager only one participant advised that it did include an evaluation of the effective tax rate for the period amongst a number of other variables. The responses concerning evaluation of performance of tax managers in large Australian corporations indicate that there is no overriding pressure on tax managers to minimise tax to maximise their remuneration.

²⁸ Ernst and Young above at n 12, 9

Participants did point out however that performance measures do not necessarily want to reward a reduction in tax risk all the time as an integral part of a successful business is the taking of informed risks. Interestingly, one participant highlighted that there is such a demand for franking credits by shareholders in the relevant corporation that the tax manager is encouraged to pay more income tax than the company is strictly required to under the law.

7. KEY MOTIVATORS TO CONSIDER AND EVALUATE TAX RISKS

Key motivators to consider and evaluate tax risks identified by participants include the following;

- Directors
- ATO
- Good business practice
- SOX Reporting
- Reputational concerns
- High profile tax disputes
- Staff other than directors
- Pressure from business units
- Shareholders
- ASX listing rules
- History of problems in the past
- Fin 48

7.1 Directors

Responses from all participants emphasised that directors are concerned about tax risks and that they want to be informed in relation to material tax risks. The majority of tax managers stated that the directors are the most important driving force in the identification and management of tax risks in Australia although some of the other motivators listed may be the reason why the directors have put tax risk management on the agenda.

Comprehensively there was an acceptance by participants that directors consider tax risk management as an essential part of good business practice. Arguably a large company that does not consider and evaluate tax risks would be considered in breach of good business practice and ultimately the directors may be held accountable for that failure.²⁹

²⁹ Section 180 of the *Corporations Act* applies to both directors and officers of a corporation and imposes a statutory duty to act with due care and diligence. There is no definitive standard that applies to all

Thirteen of the 14 corporate participants noted that there had been an increased demand by directors for information concerning tax risks and clear indications from the Board that they do not want any surprises in relation to tax. The management of tax risks was considered by participants as a means by which any potential tax risks could be identified and to ensure the ultimate tax position that is taken by the corporation is one based on informed decision making. *The Ernst and Young Global Tax Risk Survey (2008)* identified that 80% of Australian company directors surveyed have full and timely involvement in material tax transactions.³⁰

7.2 ATO

All participants were aware that the ATO had identified tax risk management as part of good corporate governance practice and that the existence of a tax risk management system would be a variable in the evaluation by the ATO of the corporate taxpayer's risk to tax revenue. Tax managers felt that the board of directors were aware of the ATO's view that directors be informed concerning tax decision making and the level of tax risk (with one exception) and that this was an important motivation for the adoption of a formalised tax risk management system. Despite comments by participants that the ATO announcements had motivated adoption of a formalised tax risk management system the majority of participants said they already had a tax risk management system in place and that the impact of ATO announcements was largely with respect to the improved documenting of what was already being done.

One participant noted that the pressure to adopt a tax risk management system had come from the global tax manager located overseas and that the corporate group had adopted a formalised system internationally based on pressures from the revenue authorities in Australia and other foreign jurisdictions in which they carry on business.

All participants said that they were managing tax risks before the ATO focus. Four participants emphasised that ATO statements and announcements had not had an impact on the tax risk management practices whilst four other participants did believe that the ATO had put tax risk management on the agenda of large companies in Australia. As a result of ATO statements and announcements directors recognised that they were considered by the ATO as the persons ultimately responsible for the tax position the organisation takes and in recognising that they would need to be informed concerning the tax risks.

Ideally the risk profile adopted by an organisation that had a comprehensive tax risk management system would be one that was based on informed decision making. Importantly all participants did not consider the ATO focus on tax risk management caused the directors and consequentially the organisation to take a position that was more or less tax risk averse.

Five participants felt that the ATO views were an important consideration in any decision as to the systems and procedures that would be put in place to manage tax risks and a further four felt that the ATO focus only led to improved documentation of what they were already doing.

directors and officers as the test in Section 180 is determined by considering the circumstances of the particular company and also the individual director's responsibilities within the company.

³⁰ Ernst and Young above at n 12, 5

Two participants pointed out that a consequence of the ATO focus on the management of tax risk was that, individuals employed within the organisation but outside the tax department, were more likely to listen to the tax department's concerns or comments with respect to a particular transaction or strategy. That is, the ATO raised the profile of tax within the organisation.

What the comments of participants suggest is that the ATO focus on tax risk management and the adoption of tax risk management best practice by large corporations has resulted in more informed tax decision making but not necessarily a lower risk profile. A company may choose to take a high or low risk profile and the tax risk management system ensures that the directors and tax managers are aware of the potential variables and consequences of that decision. According to the *Ernst and Young Global Tax Risk Survey (2008)* 'Australian companies have become neither more nor less risk averse regarding tax planning in recent years.'³¹

7.3 Good Business Practice

All participants identified tax risk management as a key element of good business practice. That is, tax risk is just one of the risks that the corporation faces and accordingly it needs to be managed like any other risk. Six participants identified good business practice as a key motivator for establishing a tax risk management system.

7.4 SOX Reporting

The Enron collapse in the US in 2001 put corporate governance on the business and political agenda and one of the responses of the US Federal government was to introduce tough new legislation in the form of the Sarbanes-Oxley (SOX) Act of 2002.

Most listed US corporations have been affected by Section 404 of the SOX Act which requires an annual report by management regarding internal controls, procedures for financial reporting and an attestation as to the accuracy of the internal control report by the company's auditors. The requirements in Section 404 impact on a corporation's risk management systems including tax risk management, as directors are required to attest to the internal control systems that are in place.

The impact of SOX has also been felt in Australia, as Australian subsidiaries of US-registered reporting entities are obliged to comply with Section 404 for financial years ending after 15 November 2004. Also Australian entities issuing securities in the US must comply with Section 404 after 15 July 2006 or 2007 depending on the characteristics of the securities issued.

As a result of Section 404 there has been a focus on internal control systems in relation to tax risk and accounting for income taxes because of the formal requirement to report material weaknesses. The four participants who were required to report in the US identified that SOX reporting was a motivator in the decision to adopt a tax risk management system.

7.5 Reputational Concerns

³¹ Ernst and Young above at n 12, 8

Three participants felt that the importance of the organisation's good reputation had been a key motivator in establishing a tax risk management system. Each participant who highlighted reputational concerns said that the organisation would be most concerned if they were perceived as non-compliant with the tax laws or considered to have taken an aggressive tax position. All participants commented on the importance of the organisation's reputation and demonstrated a real concern that any negative publicity concerning tax compliance would affect the organisation's profitability.

The importance of reputation to large business and the consensus that aggressive or non-compliant tax behaviour will negatively affect that reputation and ultimately the profitability of the business, suggests that any measures by the ATO to improve large corporate tax compliance should incorporate the publication of details of taxpayers who are aggressive or non-compliant. No participant indicated that they do take an aggressive tax position but rather that they made every effort to comply and one of the motivators was the concern for the organisation's reputation.

Interestingly the participant's concerns expressed for the negative impact on reputation of a tax aggressive or non-compliant position was not demonstrated in a Pilot Study of large corporations in the UK.³² Few of the respondents in the Pilot Study of large UK corporations were concerned with the public's perceptions of their tax policy and planning behaviour. The authors of the Pilot study suggest that the lack of concern for negative publicity concerning tax compliance behaviour could be due to the fact that in the UK there had been very little reporting of corporate tax compliance issues, perhaps on the basis that the issues are too complex or obscure for the media or public to understand.³³

7.6 High Profile Tax Disputes and History of Problems in the Past

Two participants (one public company and one private company) felt that a number of high profile tax disputes that had been publicised in the past forced them to think of the organisation's tax risk position and to ensure that the organisation or its directors were not exposed. Further one participant had been involved in tax disputes in the past and wanted to ensure that they were fully informed as to any tax risks in the future as they wanted to avoid further tax litigation.

What these responses and those relating to reputational concerns indicate is that corporate decision makers want to know what the tax risks are and believe a comprehensive tax risk management system is a means by which business decisions can be based on full and complete information. Again the participant's responses indicate that tax risk management is about informed decision making not necessarily the reduction of tax risk.

7.7 Other Motivators

Other motivators include, pressure from staff, business units and shareholders, ASX listing rules that require good corporate governance practices, a history of problems in the past and Fin 48 reporting. One participant noted that the business units of the

³² Freedman, J., Loomer, G and Vella, J. 'Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC' Report of a Preliminary Study June 2007 Oxford University Centre for Business Taxation

³³ Ibid

organisation are always pushing a variety of products and money making ventures and the existence of a tax risk management system allows tax to go back to them with concerns from a tax perspective and as a result the tax department is more likely to be listened to.

7.8 Views of a Big 4 Tax Partner

Based on the tax partner participant's experience with a range of large Australian corporations, the extent to which clients were evaluating tax risk depended to a large extent on the industry in which they operate and whether they operate internationally. In addition the tax partner participant felt that the introduction of International Financial Reporting Standards (IFRS) in Australia will have a significant impact on the need to identify and manage tax risks in the future. Tax reporting of uncertain tax positions for IFRS is based on a weighted average compared to the previous FIN 48 which had limited application to Australian subsidiaries of US corporations because in many cases the Australian entity was not material and so the tax risks were not reported.

Also the tax partner participant felt that the increase in information sharing as a result of the creation of the G20 group of countries will have implications on tax risk and compliance behaviour as information exchange will provide greater certainty as to the application of the tax laws to member countries.

8. FACTORS THAT AFFECT THE LEVEL OF TAX RISK

The tax risks faced by large corporate taxpayers can ultimately result in the organisation failing to comply with the tax law. It is anticipated that measures aimed at reducing the tax risks an organisation faces would result in an improvement in the level of tax compliance and is of interest to the organisation and the relevant revenue authority. This research gives an insight into the tax manager's views as to the factors that impact the level of tax risk that a large corporation faces in seeking to comply with the Australian income tax laws.

Importantly not all tax risks can be controlled by the organisation and as demonstrated in the responses of participants, tax risk management is largely about ensuring that decision makers are informed as to the tax risks that do exist, on a timely basis.

Participants were asked what, in their view, were the factors that affected the level of tax risk that the organisation faced and the responses of participants include:

- Uncertainty/complexity of tax laws
- Limitations of ATO staff
- Complexity of business transactions
- Staff turnover
- Staff not following guidelines
- Limited information provided to tax staff by other divisions
- Time constraints

- Demand for franking credits
- Change in ATO interpretation /approach to a tax issue
- Level of concern for reputation
- Size of the transaction
- Growth of the business
- Global nature of the business
- Economic environment

8.1 Uncertainty/complexity

These results suggest that the uncertainty and complexity of the income tax laws in Australia are a major contributor to tax risk and ultimately contributes to a failure of the organisation to comply with the income tax laws. This was the view of all tax managers even though all participants were highly qualified and experienced in the application of the income tax laws in Australia and in most instances had a significant amount of staff in the tax department.

All participants used expert external advisors (Big 4) to get a tax opinion where they were unsure of the correct tax treatment and a majority of participants regularly applied for a private ruling from the ATO in an attempt to obtain some certainty. Of some interest was the fact that only one of the participants was interested in entering into an Annual Compliance Agreement (ACA) with the ATO. On the whole participants felt that the costs of preparing and negotiating an ACA with the ATO would be so high without sufficient consequential benefits. The tax partner participant also noted that on the whole clients were not interested in entering into an ACA with the ATO as they are seen as too costly and time consuming.

A number of participants noted that no matter how good a tax risk management system the limitations of ATO in understanding, interpreting and applying the tax law to their business and the uncertainty/complexity of the tax laws mean that the best tax risk management system cannot foresee the risks that a particular tax treatment will not be accepted by the ATO or considered incorrect in the courts. The tax partner participant also expressed concerns with the expertise of the ATO staff. The level of complexity of business transactions was also noted as a limitation in the ability to manage tax risks.

The significance of uncertainty and complexity of the tax laws as a major contributor to tax risk suggests that the acceptable level of tax risk, to a large extent, is not within the control of the large corporate taxpayer in Australia. This is supported by the fact that participants also identified uncertainty and complexity of tax laws as a factor that limits the ability of participants to manage tax risks effectively. A reduction in the complexity and uncertainty of the tax laws it is anticipated, would reduce tax risk, allow better management of tax risks and more informed tax decision making. Ultimately in a review of Australian income tax laws the benefits of less complexity and uncertainty must be evaluated against the potential loss to revenue of a more simplified approach to taxation.

This research does highlight that the lack of certainty as to how the laws will apply is a real concern and in a number of instances participants noted that negotiations with the ATO have resulted in acceptance of the ATO position despite the fact the participant had obtained advice to support their original alternative position.

8.2 Staffing

Factors internal to the organisation that have an effect on the level of tax risk relate to staff turnover and the flow of information to the staff in the tax department. Six participants said that at times other business units of the corporation may fail to provide tax with full and complete information to determine the correct tax treatment and this is a significant limitation in the ability to manage tax risks. In addition three participants noted that the pressure from other business units of the organisation on the tax department to accept new products or arrangements limit the ability of the tax department to manage tax risks.

However by way of contrast a number of participants commented that the fact that the ATO had put tax risk management on the agenda had resulted in other sectors of the organisation listening to the issues raised by the tax department where they had not been so receptive in the past.

Staff turnover was an issue with participants that had a large tax department as well as those with a small tax department. What participants did highlight was that good systems for recording transactions would minimise the tax risk impact of this variable. Staff turnover affects the ability to manage tax risks because, although the tax risk management system ensures informed decision making, if the person who is informed concerning tax risks leaves the organisation there will be a gap in knowledge within the organisation. A number of tax managers pointed out that they enforce detailed record keeping in the tax department in an effort to limit the effect of staff turnover on tax risk management.

Time constraints is an issue for one of the private company participants who felt there was so much time consumed on tax compliance issues that tax risk management was more of an after thought. The same participant noted that, because the organisation takes a conservative approach to tax compliance and that there are very few unusual transactions, the level of tax risk was anticipated to be very low and as a result the informal approach to tax risk management was most appropriate.

By way of comparison the third party tax partner participant's view was that the extent and quality of tax risk management systems can at times be limited because of the lack of technical qualifications of the in-house tax person as their skills remain static and are quite often not up to date. The *Ernst and Young Global tax Risk Survey (2008)* identified that 76% of Australian respondents to that survey felt that they had insufficient resources to cover tax function activities.³⁴

8.3 Demand for Franking Credits

Interestingly four participants highlighted that the organisation may very well be reporting a taxable income more than they would if they had applied appropriate and comprehensive tax planning to their business and made use of all available

³⁴ Ernst and Young above at n 12, 5

concessions. One participant said that at times the decisions the organisation makes in relation to transactions is 'crazy' and if the transactions had been done another way significantly less income tax would have been paid. The demand for franking credits, that reflect the payment of tax at the corporate level and passed on to the shareholders, suggests that in some instances the organisation will pay more tax than it should under the tax laws because of the demand from shareholders in Australia for fully franked dividends. This appeared to be most relevant for Australian ASX listed companies.

In addition it was suggested by one participant that, a corporation with significant carry forward tax losses is less likely than a corporation with a large taxable income to be concerned about tax planning and tax minimisation and accordingly the level of tax risk is likely to be inherently lower.

8.4 Other factors

Other factors that affect the level of tax risk include change in ATO interpretation of the tax laws, concern for reputation, size of business transactions, business growth, the increasingly global nature of the business and economic environment. To a large extent the corporate taxpayer has limited control over these variables. Interestingly when tax managers were asked about the greatest challenges they faced over the next 24 months, 72% of Australian respondents to the *Ernst and Young Global Tax Risk Survey (2008)* indicated transaction activity or other business changes as most important compared to 43% globally.³⁵

The political, legal and business systems of the country in which the corporation carries on business does have implications on the ability to manage tax risks. Where the participant carries on business in countries where the legal systems are undeveloped and political systems are subject to corruption the ability to manage tax risks is limited.

The creation and application of a tax risk management system is a cost to the organisation and four participants noted that the cost, time and staffing required for a comprehensive tax risk management system is a concern to them and limits their ability to put in place the appropriate tax risk management measures. The costs need to be compared to the benefits of a tax risk management system and some participants did not see any substantial financial benefits of a formalised tax risk management system. The tax partner participant observed that although the costs to the ATO are potentially reduced by the reduction in audit field work and an emphasis on the review of risk management systems those costs savings are reflected in additional costs incurred by large corporate taxpayers in managing tax risks.

Certainly a comprehensive tax risk management system will assist in identifying risks and ensuring the tax decision makers are informed as to the risks when making a decision but does not necessarily reduce those risks or ultimately improve tax compliance. If you consider uncertainty and complexity of the tax laws and the other factors highlighted by participants as affecting the level of tax risk, significant tax risk will remain for large corporate taxpayers in Australia despite the existence of a comprehensive tax risk management system.

³⁵ Ernst and Young above at n 12, 7

9. CRITERIA USED TO DETERMINE THE ACCEPTABLE LEVEL OF TAX RISK

Participants identified the following criteria used to determine the acceptable level of tax risk;

- No acceptable level of tax risk
- Materiality
- Disclosure requirements
- Likely impact on reputation
- Gut instinct, experience and judgement

Whilst directors clearly want to be informed concerning the tax risks facing an organisation all participants indicated that that would not necessarily result in a lower level of acceptable tax risk. Decision makers in a large corporation are required to take risks in making business decisions and risk management seeks to ensure that business decisions are based on knowledge of the potential risks. Participants were asked what they considered to be relevant in the determination of acceptable risk that is, what characteristics of a particular transaction or arrangement would be considered by the tax decision maker in deciding the level of tax risk that is acceptable.

Whilst seven participants indicated that no level of tax risk is acceptable, a review of the tax risk management systems and responses to this question indicate that participants recognise that there will always be some risk and the criteria they use to establish whether the risk is acceptable includes a consideration of the materiality of the transaction and any requirement to disclose the transaction under relevant reporting requirements. Four participants stressed the importance of maintaining their reputation as good corporate taxpayers and that the potential impact on a firm's reputation of any negative publicity concerning tax compliance would result in a lower level of acceptable tax risk.

Three participants had clear guidelines on the relevant variables to be considered in determining whether a transaction had an acceptable level of tax risk and these variables were given a variety of weightings and acceptable scores. Four participants noted that the overriding criteria used to evaluate acceptable tax risk included 'gut instinct', experience and judgement of the tax experts within the organisation.

An interesting and relevant view of the tax partner participant was that, in his experience and after working extensively overseas, the ethical nature of Australian business people was an important factor in the inherently tax compliant behaviour that he sees in advising large corporate taxpayers in Australia.

An understanding of the variables that a large corporation considers in determining acceptable tax risk would be relevant in the formulation of measures by regulators and companies to reduce tax risk and ultimately improve compliance.

10. TAX MANAGER'S VIEW AS TO THE IMPACT OF TAX RISK MANAGEMENT PRACTICES

All participant tax managers said that they did not believe that the corporation was more or less tax risk averse as a result of the identification and management of tax

risks. All participants said that they had always adopted a low tax risk profile irrespective of the existence of a tax risk management system.

The consequences of adopting a tax risk management system identified by participants include:

- No impact
- More informed tax decision making
- Better documented risks
- Tax risks minimised
- Greater range of risks being identified
- Better managed tax risks

Six participants felt that a tax risk management system had no impact on the corporation's tax decision making as those participants believed that they had always managed tax risks and that the identification of a process or system that had always occurred informally in the past resulted in a change in form rather than substance to the management of tax risks and tax decision making.

Five participants felt that the tax risk management system had resulted in more informed tax decision making and better documented risks were also identified by five participants. Two participants identified that a comprehensive tax risk management system would ensure that tax risks would be minimised. Additional consequences including a greater range of and better managed tax risks were identified by two participants.

A number of participants felt that although they had adopted a low tax risk profile the ATO was still regularly reviewing, contacting and requesting information from them. All participants who made this observation said that they had a good relationship with the ATO but questioned the connection between low risk and a low level of inquiry by the ATO. This is consistent with research in the UK, including a Pilot and Main Survey, regarding the HMRC (UK) risk rating approach aimed at improving tax compliance and reducing tax avoidance by large corporations.³⁶

The tax partner participant in this research noted that, based on his experience with a broad range of clients from different industry groups, even if the corporation's tax risk management system adopts a low tax risk approach the ATO will still audit and investigate the detail of transactions. The tax partner participant view was that the consideration of a large corporation's tax risk management systems by the ATO will not change the tax risk behaviour of those corporations unless the decision makers within the corporation see evidence of real benefits to a lower tax risk approach.

11. CONCLUSIONS

The views of participants highlight who are the key tax risk decision makers and give an insight into the tax risk management practices of large corporations in Australia. Tax managers and directors are interested in tax risk and a variety of systems are used by corporations to ensure that the tax manager and directors are informed of any

³⁶ Freedman, J., Loomer, G and Vella, J. above n 15, 88

potential tax risks as well as the corporation's tax risk profile. Directors did not want surprises in relation to tax and participants felt that the impact of a tax risk management system was primarily in relation to significant improvements in documentation in relation to tax risks and more informed tax risk decision making. All participants felt that the theory concerning good tax risk management had been put into practice within the organisation however some participants were still in the process of formalising the tax risk management system.

What does not appear to be a consequence of tax risk management is a reduction in the acceptable level of tax risk. Directors accept that good governance requires them to be informed about tax risks and to be involved in tax decision making and a tax risk management system will assist in this process but will not change the acceptable level of tax risk for that corporation. Significantly all participants indicated that tax decision making was based on a low risk profile.

This research notes the difference in approach to tax risk by the ATO compared to tax decision makers in a large corporation. Tax risk from the ATO's perspective relates to the risk to revenue as a consequence of a taxpayer failing to comply with the tax laws whilst the tax decision makers in a large corporation are concerned not only with a failure to comply with the tax laws but also a failure to apply a tax concession to which the organisation was eligible.

Participants gave some insight into the variables that affect the level of tax risk a large corporation faces and the ability to manage them. Many variables identified are external to the organisation including complexity and uncertainty in the tax laws, reputational concerns, as well as the size and complexity of transactions. Measures aimed at influencing external variables that have an impact on the level of tax risk could be used by governments to reduce tax risk and as a consequence improve the level of tax compliance.

Despite the fact that many variables impact tax risk this research indicates that well qualified staff employed in the tax department are essential to ensure that the tax risk management system provides useful information to the directors. 'Gut instinct' and the 'smell test' are still used by the tax managers in large corporations to evaluate transactions and arrangements even though there may be a formal tax risk management system operating in the organisation. Arguably the effective management of tax risks will always include some informal or undefinable element.

Interestingly comments by the tax partner participant and the *Ernst and Young Global Tax Risk Survey (2008)* of large Australian corporation's tax risk management practices offer support for a number of the observations made in this paper.

12. FURTHER RESEARCH

As noted at '3. Research design and conduct' the purpose of this research was to gain an understanding of the tax risk management practices and the tax manager's views as to the impact of those practices on tax decision making and tax compliance behaviour. The understanding gained from these in-depth interviews will be used to draft a subsequent survey of relevant tax managers from Australian corporations for the purposes of the author's PhD data collection.

As this research was small in scale generalisations cannot be made in relation to the wider population of large Australian corporations. This research does however give

the author an understanding of the key issues and practices relating to tax risk management and the potential impact on tax decision making as a result of those tax risk management practices. This understanding will inform the subsequent survey.

ATTACHMENT 1

**Interviewer : Catriona Lavermicocca
PhD student UNSW**

Project description: In-depth interviews

This research project forms part of the data collection for the purposes of completion of a PhD in Taxation at the Australian School of Taxation (ATAX) at UNSW. The title of the PhD thesis is 'Tax risk management as a corporate governance issue in Australia and the impact on income tax compliance by large corporate taxpayers'.

Proposed questions for in-depth interviews concerning tax risk management

1. To what extent does your organisation consider/evaluate tax risks?
2. Does your organisation have clear statements/guidelines on what constitutes a tax risk?
3. Who (not by name but by title) in the organisation determines the acceptable level of tax risk?
4. Do the organisation's corporate governance guidelines require tax risks to be managed?
5. Does your organisation have a tax risk management system?
6. What systems/procedures does your organisation have in place to ensure that tax risks are managed? To what extent are those systems/procedures documented and reviewed for compliance?
7. Have there been any recent changes in the approach the organisation takes to tax risk management?
8. What criteria are used to determine the acceptable level of tax risk in your organisation?
9. What factors do you consider have an impact on the level of tax risk that the organisation faces?
10. What limitations, if any does the organisation face in managing tax risks?
11. What pressures do you believe have had an impact on the organisation's decision to adopt/not adopt a tax risk management system?
12. To what extent have the following had an impact on the organisation's decision to adopt/not adopt a tax risk management system?
 - ATO
 - Shareholders
 - Customers
 - Stock market/listing rules
 - Directors
 - SOX legislation

13. What influence have the ATO announcements had on your organisation's tax risk management practices?
14. Have you received any correspondence from or entered into discussions with the ATO concerning tax risk management and tax decision making practices?
15. Who (not by name but by title) are the key tax decision makers in your organisation? Is there any board/director involvement in tax decision making and if any, what is the level of that involvement?
16. What are the performance measures in respect of the key tax decision makers in your organisation?
17. What do you consider to be the impact of tax risk management systems on the determination of the acceptable level of tax risk?
18. Is the organisation more or less tax risk averse (or has there been no change) after the introduction of a tax risk management system?
19. To what extent does the organisation consider corporate social responsibility issues and if so does that include a consideration of the organisation's tax compliance profile?

ATTACHMENT 2

UNSW



FACULTY OF LAW

**THE UNIVERSITY OF NEW SOUTH WALES
PARTICIPANT INFORMATION STATEMENT AND CONSENT FORM**

**In-depth interviews concerning tax risk management as a corporate governance issue in
Australia and the impact on income tax compliance by large corporate taxpayers**

Participant selection and purpose of study

You are invited to participate in a study of the tax risk management practices of large Australian corporations. We hope to learn what are the tax risk management practices adopted by large Australian corporations, the motivators for the adoption of a tax risk management system and the impact of those systems on the corporation's income tax compliance behaviour. You were selected as a possible participant in this study because we understand that you are employed by a large Australian corporation (turnover in excess of \$100 million per annum) and have some knowledge of the tax risk management practices adopted by the organisation.

Description of study and risks

If you decide to participate, we will contact you to organise an appropriate time and place to conduct an interview. It is envisaged that the interview will be either face to face or via telephone depending on what is most appropriate determined by your preference and location. A copy of the questions that will be asked can be provided prior to the interview if requested. The interview will run for a maximum of two hours and will not be recorded although the investigator will take notes during the interview. If requested a copy of the notes taken will be provided to you for approval. All notes will be kept securely in a locked filing cabinet and all responses will remain confidential.

Confidentiality and disclosure of information

Any information that is obtained in connection with this study and that can be identified with you will remain confidential and will be disclosed only with your permission, except as required by law. If you give us your permission by signing this document, we plan to use the results of the interview with you to develop a survey instrument to collect data on tax risk management practices for the purpose of preparation and completion of a PhD on 'Tax risk management as a corporate governance issue in Australia and the impact on income tax compliance by large corporate taxpayers'. In any publication, information obtained in the interview with you will be provided in such a way that you or your organisation cannot be identified.

Complaints may be directed to the Ethics Secretariat, The University of New South Wales, SYDNEY 2052 AUSTRALIA (phone 9385 4234, fax 9385 6648, email ethics.sec@unsw.edu.au). Any complaint you make will be investigated promptly and you will be informed of the outcome.

Feedback to participants

If requested a copy of the notes taken during the interview will be provided to you for your approval.

Your consent

Your decision whether or not to participate will not prejudice your future relations with the University of New South Wales. If you decide to participate, you are free to withdraw your consent and to discontinue participation at any time without prejudice.

If you have any questions, please feel free to ask us. If you have any additional questions later, Ms Catriona Lavermicocca Ph: 0414895924 will be happy to answer them.

You will be given a copy of this form to keep.

**THE UNIVERSITY OF NEW SOUTH WALES
PARTICIPANT INFORMATION STATEMENT AND CONSENT FORM (continued)**

**In-depth interviews concerning tax risk management as a corporate governance issue in
Australia and the impact on income tax compliance by large corporate taxpayers**

You are making a decision whether or not to participate. Your signature indicates that, having read the information provided above, you have decided to participate.

.....
Signature of Research Participant

.....
Signature of Witness

.....
(Please PRINT name)

.....
(Please PRINT name)

.....
Date

.....
Nature of Witness

REVOCAION OF CONSENT

**In-depth interviews concerning tax risk management as a corporate governance issue in
Australia and the impact on income tax compliance by large corporate taxpayers**

I hereby wish to **WITHDRAW** my consent to participate in the research proposal described above and understand that such withdrawal **WILL NOT** jeopardise any treatment or my relationship with The University of New South Wales, (*other participating organisation[s] or other professional[s]*).

.....
Signature

.....
Date

.....
Please PRINT name

The section for Revocation of Consent should be forwarded to Dr Margaret McKerchar, Atax, Faculty of Law, University of New South Wales, Kensington NSW 2052

Towards Effective and Efficient Identification of Potential Tax Agent Compliance Risk: A Stratified Random Sampling Approach

Ying Yang, Esther Ge, Ross Barns*

Abstract

We propose to use a stratified random sampling approach to identify whether a tax agent's return preparation behaviour is significantly different from its industry norm. Given a tax agent TA , our approach creates a statistically sufficient number of notional peers for it. These peers comprise a reference group for TA , and the expectation for TA 's tax return behaviour can be derived there from. By comparing TA 's actual behaviour against its expected behaviour, one can infer whether TA behaves abnormally and to what degree TA incurs potential compliance risk. The novelty and advantage of our approach includes (1) effective and efficient risk identification, (2) an easy-to-understand methodology, (3) easy-to-explain results, (4) no need for any pre-defined threshold values and hence less able to be undermined by "game players" who seek to make claims just under the threshold, and (5) low cost of identification as our approach conducts unsupervised learning that does not demand a supply of labelled tax agents¹ as training data.

1. INTRODUCTION

Individual income tax is a major revenue source for the Australian government. Over 72% of individual taxpayers choose to lodge their income tax returns via tax agents (also known as tax practitioners). Therefore it is of significant importance for the Australian Taxation Office to promote voluntary compliance with tax laws, and meanwhile identify and deter non-compliance behaviours in the tax agent industry. Successfully doing so will help protect government revenue and maintain community confidence in the Tax Office's administration of Australia's Taxation system.

However, it is a nontrivial task to accomplish effective and efficient identification of tax agent compliance risk. The challenges are imposed by the large number of tax agents in operation, the large number of individual tax returns lodged by tax agents, and the fact that the tax agent client bases are immensely diversified. Currently there are over 20,000 tax agents handling about 12 million individual tax returns per year in Australia.

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¹ A labelled tax agent is one that has been classified as compliant or non-compliant by a tax audit. The course of delivering such a verdict is often an expensive and time-consuming process.

A definitive solution to tax agent compliance risk identification is to check every single tax return lodged by every single tax agent and then reach a conclusive statement. However such a solution is neither practical nor sustainable due to resource constraints. As such the Australian Taxation Office business model is founded on a risk management basis, and applies a range of defensible approaches to analyse tax return preparation behaviour of taxpayers and tax agents.

Particularly in this paper we propose a novel defensible solution that is able to deliver effective and efficient identification of tax agent compliance risk. Given a tax agent T A, our approach uses stratified random sampling to create a statistically sufficient number of notional peers for T A. These peers comprise a reference group for T A and the expectation for T A's tax return behaviour can be derived therefrom. By comparing T A's actual behaviour against its expected behaviour, one can infer whether T A behaves abnormally and to what degree T A incurs potential compliance risk.

As a matter of demonstration convenience and without losing generality, this paper examines a tax agent's compliance risk in terms of rental behaviours. We assume that the tax agent behaviours are gross income and gross expense of residential rental properties lodged by tax agents on behalf of their clients. We also assume that rental gross income and expense are affected by rental location. For a rental property, gross income is the rent that landlords receive from tenants. Gross expense is the total cost that landlords incur in order to derive the rent, including bank loan interest, capital works (such as repairs and maintenance) and other expenses (such as council rates). A landlord should return rental income, and meanwhile can claim a deduction for rental expenses incurred in deriving the rental income. For the sake of simplicity, we adopt the term "a tax agent's rental properties" as a shortcut reference to the rental properties owned by this tax agent's clients and lodged in individual income tax returns by this tax agent on behalf of its clients.

It is very important to note that our paper aims at providing a generic framework for agent risk identification, and the above assumptions are made purely for illustration purpose. When reimplementing our method in their fields, researchers and practitioners should substitute their proper domain knowledge for our assumptions in order to better suit their own applications. For instance, if one deems an agent's behaviour of interest is affected by clients' jobs and incomes, the notional peers should be created with regard to client job categories and income ranges.

Nonetheless, our proposed theoretical foundation and practical methodology (such as how to obtain peers by stratified random sampling, how to calculate z-score, how to calculate risk score, how to illustrate identification results, how to explain those results and how to avoid technical pitfalls) will stay the same.

The rest of this paper is organised as follows. Section 2 introduces the definition of peers for a tax agent and proposes how to create the peers. Section 3 explains how to compare a tax agent against its peers in order to evaluate its potential compliance risk. Section 4 applies our method to the Australia national tax agent data and illustrates the risk identification results. Section 5 highlights some technical issues to help peer researchers and practitioners circumvent possible pitfalls when re-implementing our method in their fields. Section 6 presents related work. Section 7 gives concluding remarks.

2. HOW TO CREATE PEERS FOR A TAX AGENT

Given a tax agent T A, our approach creates a statistically sufficient number of peers for T A. These peers comprise a reference group (the industry norm) against which T A is compared. This section first introduces the definition of a peer and then proposes how to create peers.

2.1 Definition of a peer

For a tax agent T A, a peer needs to satisfy the following two criteria.

- (a) Each peer should have the same number of rental properties as T A does. Note that only those rental properties lodged by actual tax agents are included in a peer's property base.
- (b) Since rental gross income and expense are affected by rental location², each peer's rental properties should have the same location distribution as T A's. Particularly in this paper, we use postcodes to indicate locations.

Thus each peer is a notional (rather than an actual) tax agent, but its property base is composed of real rental properties. We choose to use notional peers rather than actual tax agents to form a reference group for T A because in reality every actual tax agent has its unique client base, and the client bases across different tax agents are immensely diversified and are often incommensurable. Thus it is often a problem to measure whether an actual tax agent is similar enough to T A to qualify for being T A's peer. Such a problem is usually no less complicated than the risk identification problem itself.

2.2 How to create a peer

We create a notional peer by stratified random sampling with replacement. The sampling is stratified because it keeps the geographic distribution of a sampled population (a peer's rental properties) equal to the distribution of the original population (the actual tax agent's rental properties).

For example, assume T A's rental properties distribute as in Table 1, which shows that T A has 33, 21, 18 and 12 rental properties in Postcode 3048, 3064, 3000 and 3029 respectively. Postcode 3048, 3064, 3000 and 3029 each in total have 509, 1475, 9734 and 2303 rental properties lodged by various tax agents.

According to Table 1, in order to create a peer for T A

- (1) we randomly pick 33 rental properties from the total 509 ones in Postcode 3048, 21 rental properties from the total 1475 ones in Postcode 3064, 18 rental properties from the total 9734 ones in Postcode 3000, and 12 rental properties from the total 2303 ones in Postcode 3029;
- (2) the resulting 84 (=33+21+18+12) picked properties comprise the property base of the notional peer;

² As explained in Section 1, such an assumption is for illustration purpose only and can be changed for different behaviours according to appropriate domain knowledge.

(3) we replace the picked properties back to their respective suburbs to get ready for the next sampling.³

As a result, this peer has 84 properties that follow the same geographic distribution as T A's total 84 properties.

Note that to create a peer for T A, T A's rental properties (together with other actual tax agents') are also included for the purpose of sampling.

Postcode	No. of Rental Properties Lodged by Tax Agent(s)	
	By T A	By all Tax Agents
3048	33	509
3064	21	1475
3000	18	9734
3029	12	2303

TABLE 1: THE GEOGRAPHIC DISTRIBUTION OF T A'S RENTAL PROPERTIES

2.3 How to create many peers

To create a second peer for T A, we can repeat the above three steps in Section 2.2, then repeat them again to create a third peer, and so on and so forth until we have a statistically sufficient number of peers to form a reference group. As a rule of thumb, 1000 peers is usually statistically sufficient to present the industry norm [1, 2]. However, if computing power and time allows, the more peers the better. Hence in this particular study, we use 10,000 peers.

Because of the randomness of the sampling procedure, every peer will have a different property base that might overlap somewhat with other peers' bases, and seldom will the same property base be created twice.⁴ Thus, the 10,000 peers offer a spectrum to describe how diversified a tax agent can behave if lodging rental properties similar to T A's. From such a spectrum we can find out whether T A's behaviour is abnormal, and if yes, how much potential risk it possesses.

³ Such a procedure is called sampling with replacement. In theory, one can do sampling without replacement as well. But we prefer the former to the latter because of the following two reasons:

(1) Sampling with replacement ensures that every property has the same probability to be included into any peer's base. (2) Sampling with replacement ensures that every peer is independent of each other. This contrasts to sampling without replacement, where the current peer's property base depends on what properties have not been picked up for previous peers' bases. The detailed mathematical explanations are beyond the scope of this paper.

⁴ In theory, the probability of the same property base appearing twice equals to:

$$\begin{aligned}
 & \frac{1}{84} \times \frac{1}{84} \times \frac{1}{84} \times \frac{1}{84} \\
 = & \frac{1}{84 \times 84 \times 84 \times 84} \\
 = & 47 \times 10^{-187}
 \end{aligned}$$

where C_n^r is the maths symbol indicating how many different combinations one can have if selecting r items from n items.

3. HOW TO EVALUATE A TAX AGENT'S POTENTIAL COMPLIANCE RISK

We evaluate an actual tax agent T A's potential compliance risk by comparing T A against its notional peers.

3.1 The normal distribution

Since T A's peers are created by random sampling with replacement and with stratification according to T A's rental properties' postcodes, all the peers are equal-size random samples from the same population. According to the central limit theorem [5], the mean rental gross income values of the peers will follow a normal distribution. Likewise, the mean rental gross expense values of the peers will also follow a normal distribution, as illustrated in Figure 1.

3.2 The z-score

Because of the normal distribution, it is appropriate to use the z-score to measure whether T A's rental gross income or expense is abnormal:

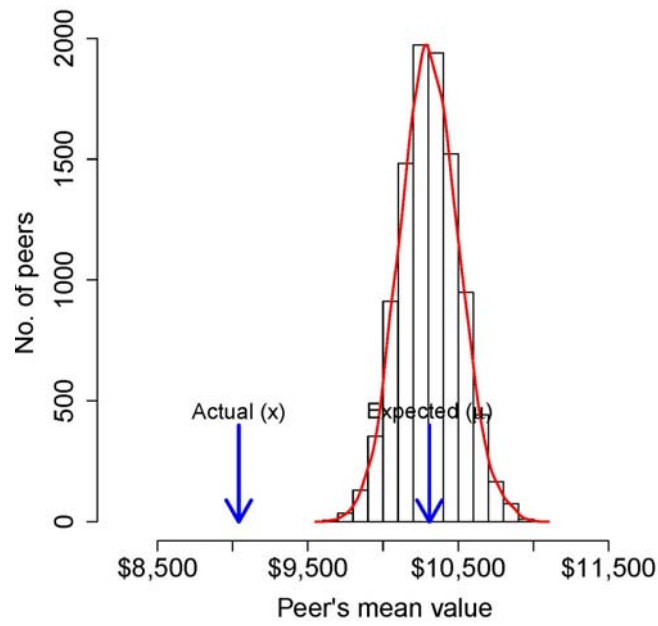
$$z = \frac{x - \mu}{\sigma}, \quad (1)$$

where corresponding to Figure 1

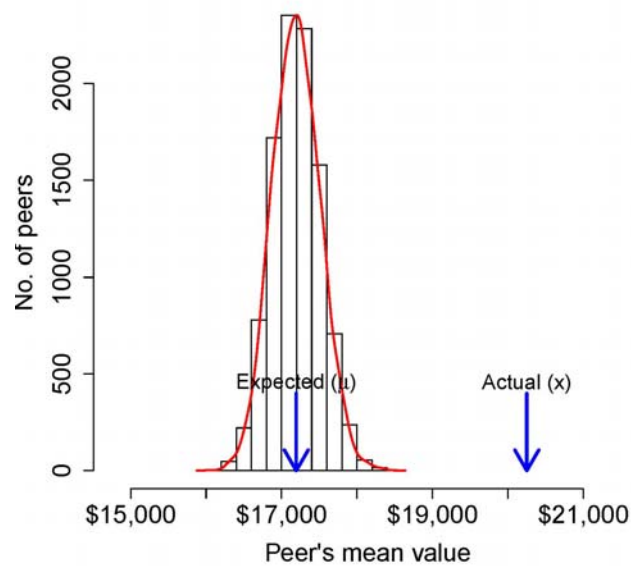
- x is T A's actual mean rental gross income (or expense);
- μ is the average value across all 10,000 peers' mean rental gross income (or expense) and hence is the expected value for T A;
- σ is the standard deviation of the 10,000 peers' mean rental gross income (or expense).

Thus a z-score is a standardised version of the raw difference between T A's actual and expected values ($x - \mu$). It tells us how many counts of standard deviations T A's actual value falls away from the average value of its peers, and in which direction [5]. T A's z-score is positive if its value is bigger than the peers' average, and negative otherwise. For example, the z-score according to Figure 1(a) will be negative because $x < \mu$, which indicates that the tax agent declares less rental gross income than expected. The z-score according to Figure 1(b) will be positive because $x > \mu$, which indicates that the tax agent claims more rental gross expense than expected.

It is important to emphasise that to measure the difference between T A's actual and expected values, the standardised difference (z-score) be more statistically sound than the raw difference ($x - \mu$). It is because the former not only takes into consideration the raw difference, but also the diversity of the peers from which the expected value (μ) and thus the raw difference are drawn. For instance, as illustrated in Figures 2(a) and 2(b), although Tax Agents A and B are equal in terms of ($x - \mu$), A's anomaly is more significant than B's due to the fact that A's peers are tightly around the expected value while B's peers are more diversified and loose.

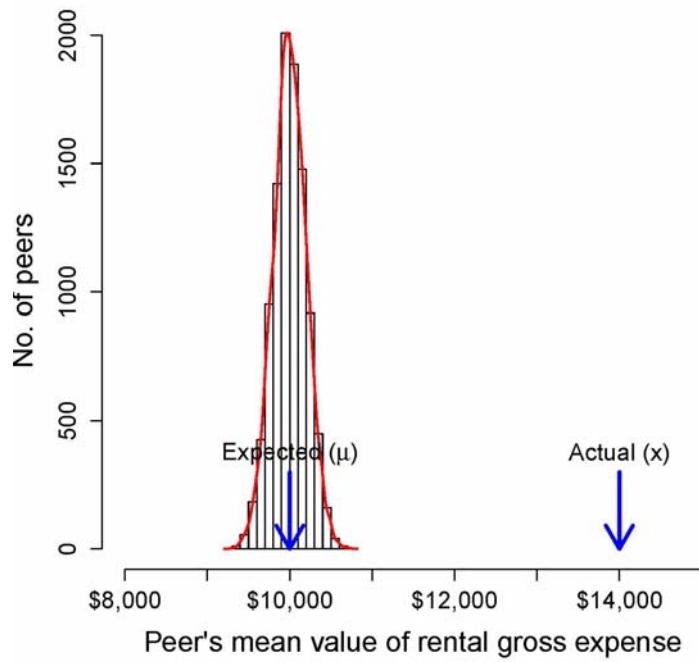


(a) Rental gross income

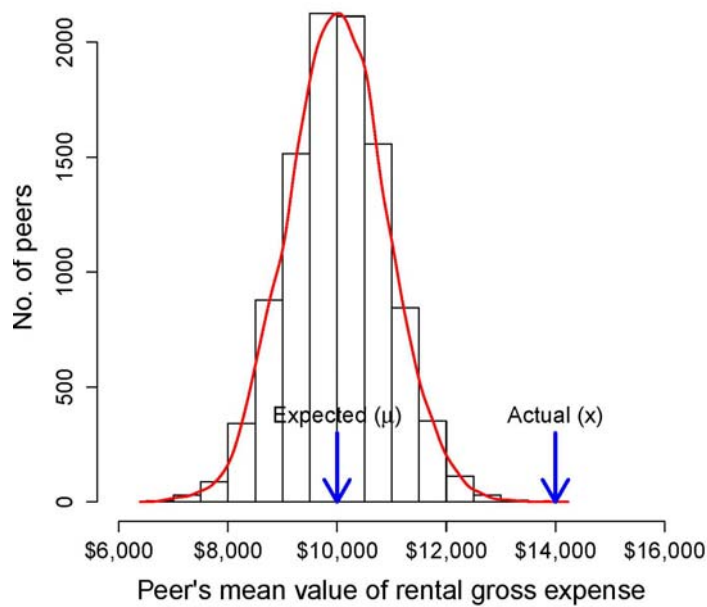


(b) Rental gross expense

FIGURE 1: Due to random sampling, the mean rental gross income or expense values of the peers will follow a normal distribution respectively.



(a) Tax Agent A



(b) Tax Agent B

FIGURE 2: To measure the difference between T A's actual and expected values, one should use the standardised difference (z-score) rather than the raw difference ($\bar{x} - \mu$)

3.3 The risk score

The risk score combines both the risk of underreporting rental gross income (z-score(income)) and the risk of overclaiming rental gross expense (z-score(expense)). Because a z-score is a standardised value that calculates how many counts of standard deviations the actual value of a tax agent falls away from the average value of its peers, z-score(income) and z-score(expense) are commensurate and hence we can apply mathematical operations on them to calculate the risk score. For T A we can calculate its z-score of rental gross income, z-score(income), as well as its z-score of rental expense, z-score(expense). The lower the value of z-score(income), the less the rental gross income declared by T A than its peers, and hence the higher the possible compliance risk T A possesses. On the contrary, the higher the value of z-score(expense), the more the rental gross expense claimed by T A than its peers, and the higher the possible compliance risk T A possesses. Accordingly, we can use Formula (2) to calculate a composite risk score that indicates T A's potential compliance risk, taking into consideration both expense and income. The higher the risk score, the higher the potential compliance risk T A incurs.

$$\text{Risk score} = \text{z-score}(\text{expense}) - \text{z-score}(\text{income}) \quad (2)$$

4. CASE STUDY

This section applies our proposed stratified random sampling approach to over 15,000 tax agents that lodged altogether over 1.45 million residential rental properties in a tax return year. To protect privacy, we have left out the exact year information and have substituted dummy index numbers for real agent identities. If a property has multiple stakeholders associated with the same tax agent, its gross income is the sum value across all the stakeholders' shares. Likewise its gross expense. This property should be counted only once. Otherwise, if a property has multiple stakeholders associated with different tax agents, we advise to exclude this property from the input data.

4.1 Risk profiling for a single tax agent

For each actual tax agent, we demonstrate the risk identification results using one table and two figures. We take Tax Agent X as example to explain in detail what the table and figures tell us. Tax Agent X has 443 rental properties. Accordingly each of its peers has 443 rental properties as well. For the tax agent as well as every peer, we can calculate its mean value averaged across the 443 properties in terms of rental gross income and rental gross expense respectively. We report the resulting statistics in Table 2 when comparing Tax Agent X with its peers.

- No. of properties: number of rental properties owned by this tax agent's clients and lodged in individual income tax returns by this tax agent on their behalf.
- X's actual \$ value per property: this tax agent's mean rental gross income or expense value.
- X's expected \$ value per property: the average value across all the peers' mean rental gross income or expense values. It is the expectation for this tax agent drawn from the peers' behaviours.
- Peers' minimum \$ value per property: the smallest mean rental gross income or expense value among all the peers.

- Peers' maximum \$ value per property: the biggest mean rental gross income or expense value among all the peers.
- Peers' standard deviation: the standard deviation of the peers' mean rental gross income or expense values.
- z-score: the standardised difference between the tax agent's actual rental value and its expected value drawn from its peers.
- Risk score = z-score(gross expense) - z-score(gross income). It is used to rank actual tax agents in terms of compliance risk. The higher the risk score, the higher the potential compliance risk.
- Risk rank: this tax agent's rank among all actual tax agents in terms of compliance risk. The most risky tax agent is ranked as 1, the second most risky is ranked as 2, and so on and so forth.

No. of properties = 443		
	Expense	Income
X's actual \$ value per property	\$28,153.76	\$10,879.22
X's expected \$ value per property	\$15,606.33	\$11,605.86
Peers' maximum \$ value per property	\$13,361.91	\$10,232.96
Peers' maximum \$ value per property	\$18,465.19	\$13,259.61
Peers' standard deviation	591.62	407.96
z-score	21.21	-1.78
Risk score = z-score(expense) – z-score(income) = 22.99		
Risk rank = 1		

TABLE 2: STATISTICS OF THE ACTUAL TAX AGENT AND ITS PEERS

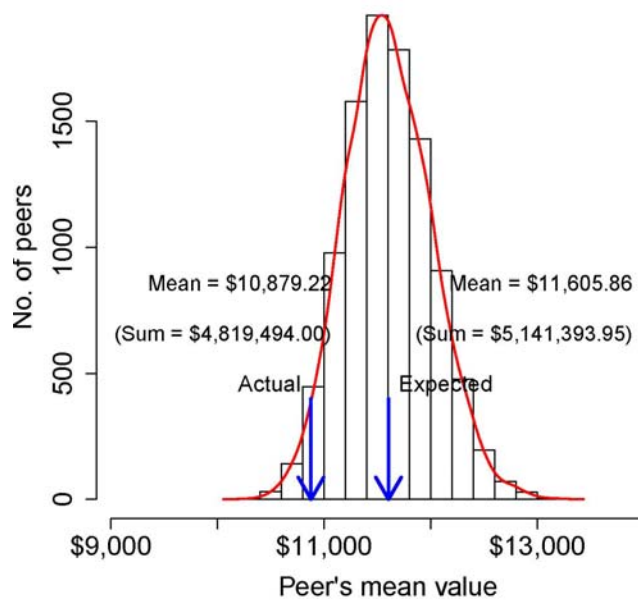
Furthermore, Figure 3 graphically portrays the information of Table 2. It shows where Tax Agent X sits in the context of its peers, when the return behaviour is the mean rental gross income (or expense) value.

Figure 3(a) shows the number of peers with specific mean rental gross income values. Most peers have their mean income values around \$11,600. A few go up to \$13,200, a few go down to \$10,200, and the standard deviation is 407.96. The average value across all the peers' mean income values is \$11,605.86, which is the expected mean value for Tax Agent X's rental gross income. In reality, Tax Agent X's mean income is \$10,879.22, which is lower than the expectation and incurs a z-score of -1.78

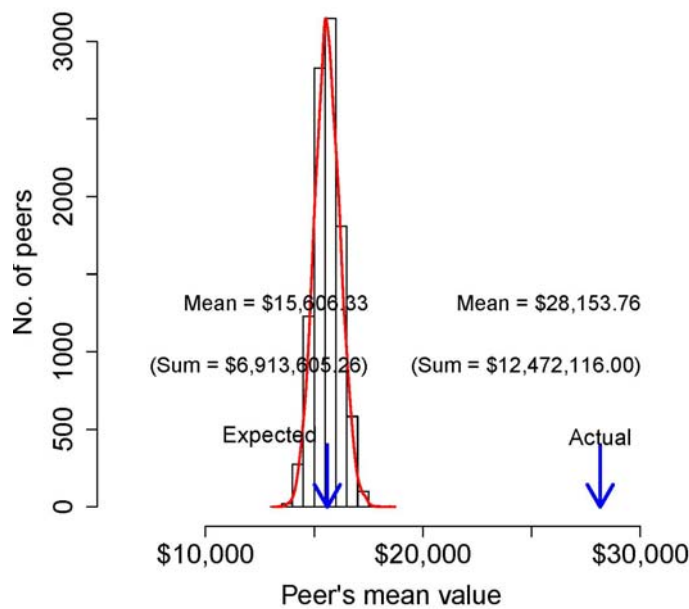
$$\left(= \frac{10879.22 - 11605.86}{407.96} \right).$$

Figure 3(b) shows the number of peers with specific mean rental gross expense values. Most peers have their mean expense values around \$15,600. A few go up to \$18,400, a few go down to \$13,300, and the standard deviation is 591.62. The average value across all the peers' mean expense values is \$15,606.33, which is the expected expense value for Tax Agent X. In reality, Tax Agent X's mean expense value is \$28,153.76, which is much higher than the expectation and incurs a z-score of 21.21

$$\left(= \frac{28153.76 - 15606.33}{591.62} \right).$$



(a) Rental gross income



(b) Rental gross expense

FIGURE 3: Compare Tax Agent X's mean rental gross income and mean rental gross expense respectively against its peers'. X underreports its rental income but overclaims its rental expense.

Thus, Tax Agent X underreports its rental income but overclaims its rental expense. Overall it incurs a risk score of 22.99 ($= 21.21 - (-1.78)$), which is the highest among all actual tax agents and hence is ranked number 1 in terms of potential risk.

In case that readers want to know sums in addition to mean values, we also show in Figure 3 that if all the 443 properties are considered, the total rental expense value claimed by Tax Agent X is \$12,472,116.00 that is significantly more than the expectation drawn from the peers (\$6,913,605.26); and the total rental income value declared by Tax Agent X is \$4,819,494.00 that is less than the expectation drawn from the peers (\$5,141,393.95).

4.2 Risk profiling for the tax agent industry

In addition to profile for each individual agent, our approach can also illustrate the global compliance picture of the tax agent industry. These collective results provide insight into the compliance level of the tax agent industry, and help the Australian Taxation Office promote and assist a capable and well-regulated tax and accounting profession.

Following the same line of reasoning as explained in Section 4.1, our approach can assign a risk score to each tax agent by comparing the tax agent against its own peers. Because the z-score and thus the risk score are standardised values, different tax agents' risk scores are commensurate.

Figure 4 illustrates the distribution of risk scores of over 15,000 actual tax agents operating in a tax return year. The higher the risk score a tax agent gets, the higher the compliance risk the tax agent potentially possesses. Most agents have risk scores close to 0, which indicates their behaviours are close to the expectation drawn from their peers. In contrast, a few tax agents (such as A, B and C at the right end of the spectrum) have abnormally high positive risk scores and are identified as potential high risk.

Figure 5 illustrates individual tax agents' risk scores for a tax return year, where on average one agent lodged 92 rental properties. For the sake of clarity, we only illustrate in Figure 5 those tax agents that have more rental properties than average, which results in 5075 tax agents. In this particular figure, we depict the top 5% tax agents as red triangles to represent risk agents. Blue circles represent non-risk tax agents. However, this cut-off percentage value can be tailored in practice to take into consideration available audit resources.

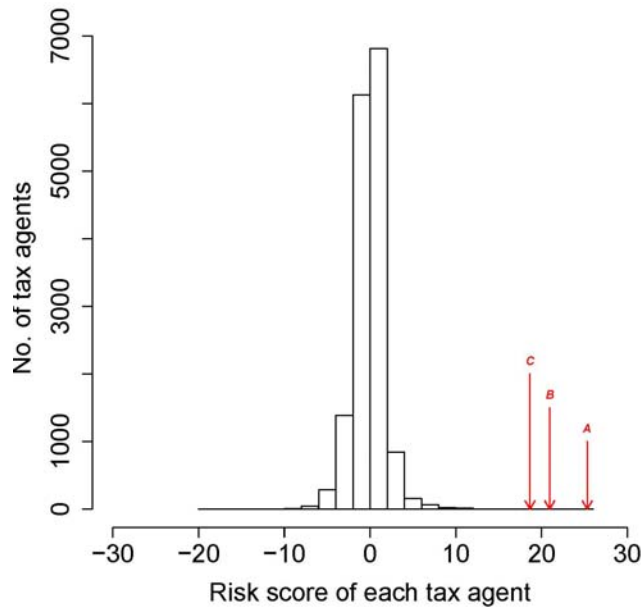


FIGURE 4: The risk score distribution of over 15,000 actual tax agents operating in a tax return year.

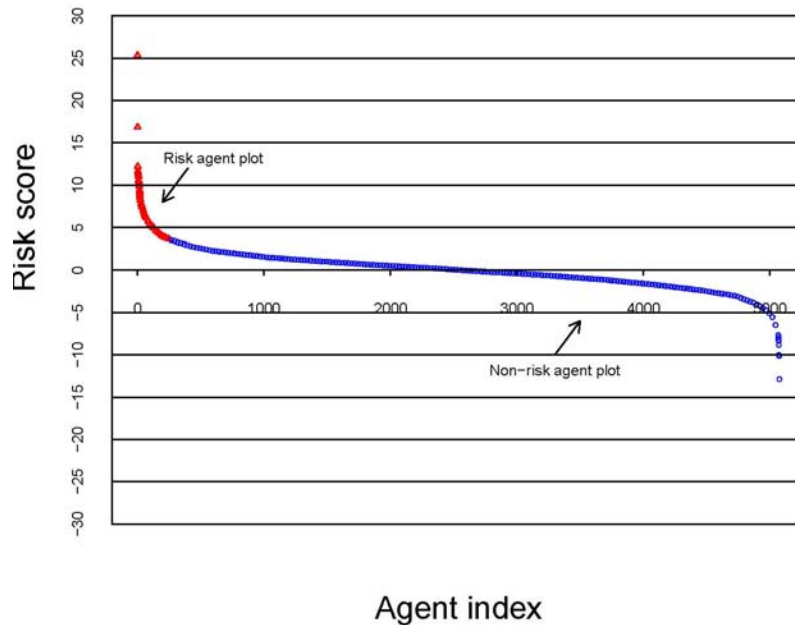


FIGURE 5: Individual tax agents' risk scores for a tax return year.

4.3 Efficiency

Our proposed stratified random sampling algorithm is very efficient. Given the rental data of over 15,000 tax agents and over 1.45 million residential rental properties in a tax return year, our approach can accomplish calculating the z-score of any rental behaviour for each and every tax agent within two hours using a computer of the following configuration:

- cpu model name: Dual-Core AMD Opteron(tm) Processor 2220;
- cpu speed: 2800.469 MHz;
- cache size: 1024 KB;
- memory: 8179380 KB.

5. FURTHER DISCUSSION

We now highlight some technical issues to help peer researchers circumvent possible pitfalls when re-implementing our method in their fields.

5.1 What behaviour to evaluate

This particular paper examines a tax agent's compliance risk in terms of rental behaviours. As illustrated in Figure 6, there exist many rental behaviours that one can evaluate. We have proposed to choose rental gross income and gross expense respectively. That is not an arbitrary decision. Instead the choice is made in order to achieve an appropriate trade-off between providing enough details and providing the big picture of a tax agent.

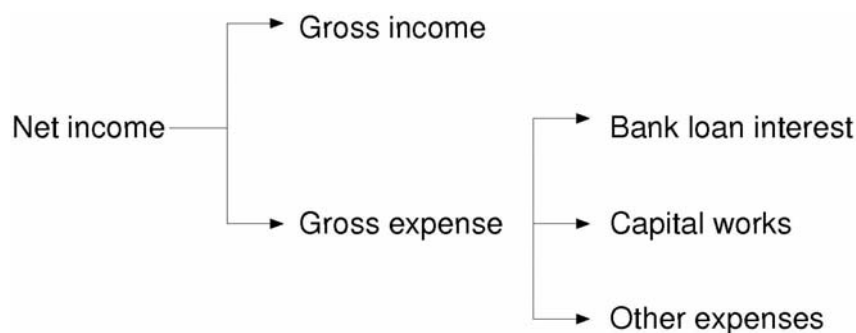


FIGURE 6: Alternative rental behaviours to evaluate

For example, rental net income is a composite quantity that reflects the (possibly distinct) reporting behaviours of gross income and gross expense. It equals to gross income minus gross expense. Our stratified random sampling approach can compare Tax Agent X's mean net income value against its peers', and accordingly produce a risk profile like Figure 7. It is observed that the average rental net income reported by Tax Agent X is \$-17,274.54, while the expectation¹ drawn from its peers is \$-3,996.04. Hence Tax Agent X declares much less net income than expected and

possesses potential compliance risk. But there can be many reasons behind such a symptom. Possibly Tax Agent X correctly reports gross income but significantly overclaims gross expense; or possibly it correctly claims gross expense but significantly underreports gross income; or possibly it both underreports gross income and overclaims gross expense. However, an analysis of net income alone would not reveal these useful details.

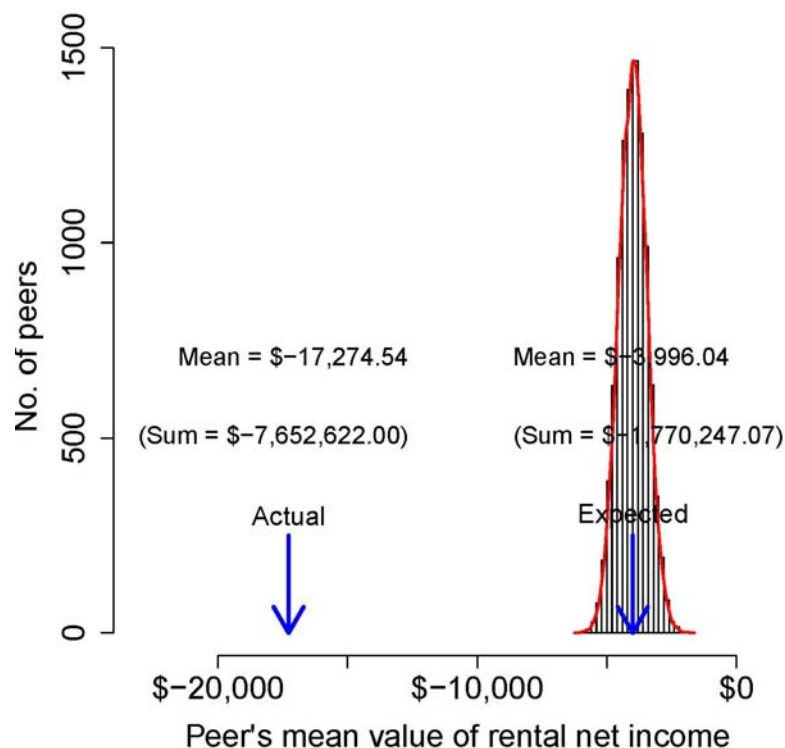


FIGURE 7: Compare Tax Agent X's mean rental net income against its peers'.

Alternatively one can use behaviours more detailed than gross income and gross expense. For instance, gross expense can be further divided into expenses of bank loan interest, capital works and other expenses. Our stratified random sampling approach can compare respectively a tax agent's mean of gross income, mean of bank loan interest, mean of capital works and mean of other expenses against its peers', and calculate the z-score for each behaviour. In such a case, the risk score should be calculated by Formula (3). However Formula (3) is sometimes over sensitive to small components and thus loses the big picture. For example, one agent does not overclaim expenses. But it puts all expense values into the item "other expenses". Because few agents do such a thing, this tax agent incurs a significantly high z(other expenses), which dominates its z(bank loan interest), z(capital works) and z(gross income). Hence overall this tax agent incurs a high risk score. But this is an education issue rather than a compliance risk issue. Hence we suggest to avoid choosing over-detailed behaviours unless you are especially interested in some specific rental behaviour of a tax agent rather than its overall rental compliance level.

$$\text{Risk score} = \frac{z(\text{bank loan interest}) + z(\text{capital works}) + z(\text{other expenses})}{z(\text{gross income})} \quad (3)$$

Note that $z(\text{gross expense}) = z(\text{bank loan interest}) + z(\text{capital works}) + z(\text{other expenses})$. However, $z(\text{gross expense}) \neq z(\text{bank loan interest}) + z(\text{capital works}) + z(\text{other expenses})$ because a z-score is a standardised value. Instead $3z(\text{gross expense}) \approx z(\text{rental interest}) + z(\text{capital works}) + z(\text{other expenses})$.

5.2 The central limit theorem

According to Moore [5], the central limit theorem says that the distribution of a sum or average of many small random quantities is close to normal. The theorem suggests why the normal distributions are common models for observed data. Any variable that is a sum of many small influences will have approximately a normal distribution. How large a sample size n is needed for \bar{x} to be close to normal depends on the population distribution. More observations are required if the shape of the population distribution is far from normal.

CENTRAL LIMIT THEOREM

Draw a simple random sample of size n from any population with mean μ and finite standard deviation σ . When n is large, the sampling distribution of the sample mean \bar{x} is approximately normal:

\bar{x} is approximately $N(\mu, \frac{\sigma}{\sqrt{n}})$.

Translated into our context, the theorem indicates that if a tax agent has too few rental properties, its peers' mean values of gross income (or gross expense) might not follow a normal distribution. An example is illustrated in Figure 8. In such a case, the z-score is no longer applicable. Hence it is compulsory to confirm that the peer values follow a normal distribution before using the z-score statistic.⁵

⁵ In statistics, there exist a few methods to perform a normality test, such as the Kolmogorov-Smirnov test, the Anderson-Darling test, the Shapiro-Wilk Test and the Skewness-Kurtosis All test. There also exist graphical techniques such as the Q-Q plot to compare two probability distributions by plotting their quantiles against each other.

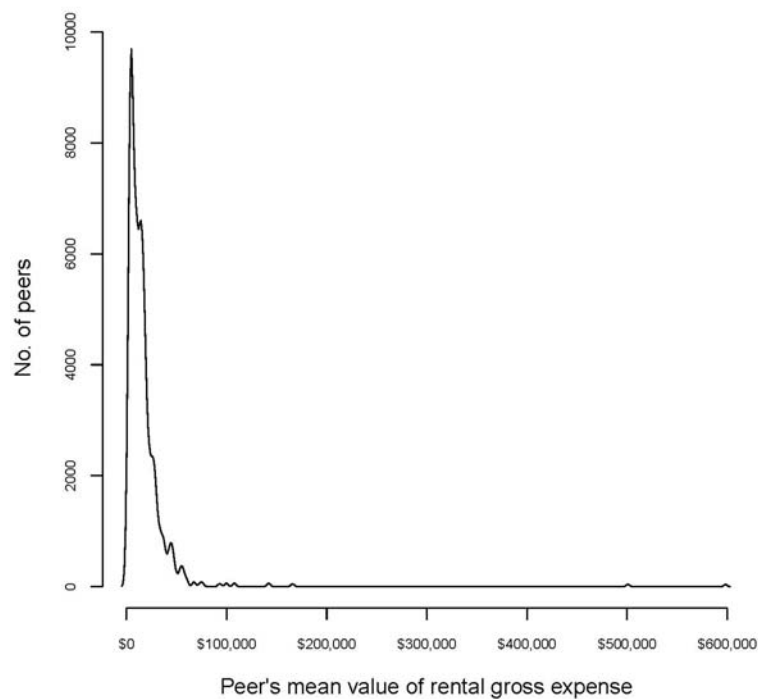
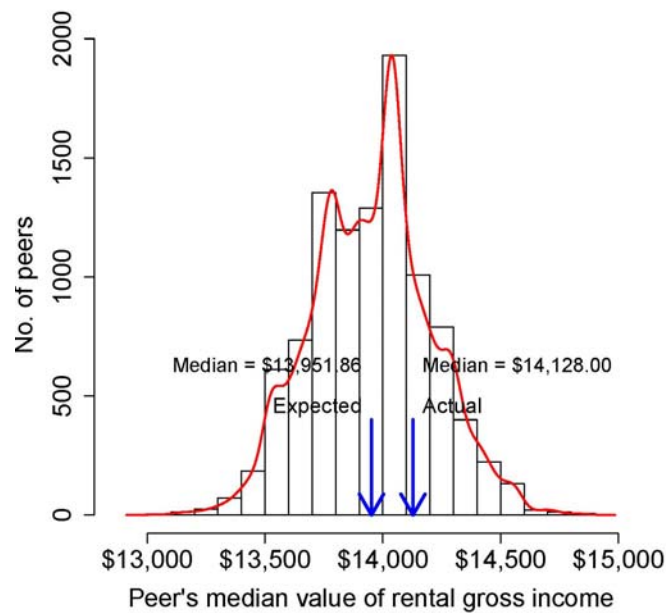


FIGURE 8: A small tax agent has only one rental property. Its peer means does not follow a normal distribution.

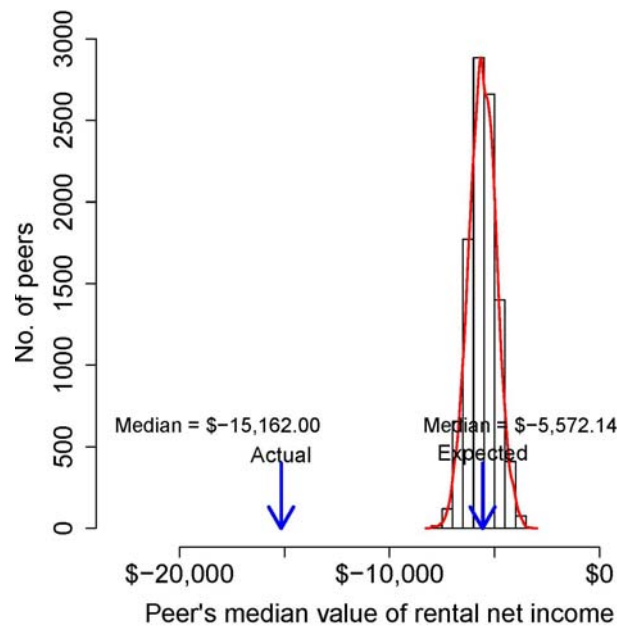
5.3 Median vs. mean

Sometimes people are interested in a tax agent's median rental value instead of its mean rental value.⁶ Extra cautions are required when applying our stratified random sampling approach to compare a tax agent's median value against its peers'. Although it applies to the mean statistic, the central limit theorem does not necessarily apply to the median statistic. That is, the peers' median rental values do not necessarily follow a normal distribution. For instance, as illustrated in Figure 9(a) the median rental gross income values of Tax Agent Y's peers assume a bimodal distribution instead. As a result, a z-score is not always applicable and we cannot use Formula (2) to calculate the risk score. Nonetheless, it happens in this particular case that the median rental net income values of Tax Agent Y's peers still follow a normal distribution as depicted in Figure 9(b). Thus it is acceptable for one to calculate the z-score of Tax Agent Y's net income and evaluate its potential compliance risk therefrom. Hence same as concluded in Section 5.2, one must check peer values' distribution before using the z-score statistic.

⁶ Median is often a method of choice to avoid skewness introduced by a few extremely large or small values in the population. By random sampling, our approach can successfully avoid the skewness problem and hence does not need to use the median statistic.



(a) For Tax Agent Y, the peers' median values of rental gross income follow a bimodal distribution instead of a normal distribution. Hence a z-score is not applicable.



(b) For Tax Agent Y, the peers' median values of rental net income do follow a normal distribution. Hence a z-score is applicable.

FIGURE 9: The central limit theorem does not cover the median statistic. If using median instead of mean to measure tax agent behaviour, one should always check whether peer median values follows a normal distribution before adopting the z-score to quantify a tax agent's potential compliance risk.

5.4 Ratio

In general, we discourage using ratio values as behaviour, such as $behaviour = \frac{rental\ gross\ expense}{rental\ gross\ income}$. It is because a small denominator value will blow up the ratio and distort the behaviour. The extreme is when denominator is 0 and the ratio becomes infinitely big. Even if we replace 0 with some positive value to solve the infinity problem, the distortion problem still exists. Table 3 shows a true story. Tax Agent Z has 18 rental properties, whose rental gross income and gross expense are listed in Table 3. 10 out of the 18 properties have \$0 gross income. In order to calculate the ratio of gross expense divided by gross income, we replace \$0 rental gross income with \$1. The ratios are then calculated accordingly for each property.

Property	Gross Income	Gross Expense	Ratio ($\frac{Gross\ Expense}{Gross\ Income}$)
a	\$14,190	\$26,136	1.84186046511628
b	\$10,469	\$25,867	2.47081860731684
c	\$13,543	\$39,424	2.91102414531492
d	\$12,960	\$39,508	3.04845679012346
e	\$7,359	\$37,899	5.15002038320424
f	\$2,700	\$24,492	9.07111111111111
g	\$1,603	\$26,880	16.7685589519651
h	\$1,587	\$28,954	18.244486452426
i	\$1	\$0	0
j	\$1	\$492	492
k	\$1	\$2,410	2410
l	\$1	\$4,852	4852
m	\$1	\$6,652	6652
n	\$1	\$11,278	11278
o	\$1	\$14,191	14191
p	\$1	\$15,927	15927
q	\$1	\$16,299	16299
r	\$1	\$19,885	19885

TABLE 3: RATIO IS OFTEN A DISTORTED BEHAVIOUR.

Next we use our stratified random sampling method to create all the peers. Since the mean statistic for ratios does not have a proper meaning, we calculate the median ratio value for the tax agent as well as for every peer. Assume the peers' median ratio values follow a normal distribution.

- The risk score is calculated as follows:
- Tax Agent Z's actual median ratio = 255.12
- Tax Agent Z's expected median ratio = 1.94
- Peers' minimum median ratio = 0.99
- Peers' maximum median ratio = 3.21
- Standard deviation of peers' median ratios = 0.26
- Risk score = z-score = 979.81

- Risk rank = 1.

Thus Tax Agent Z incurs a very high risk score of 979.81 and is ranked as top risk, whereas the second highest risk score among all tax agents is only 33.33. We suggest that Tax Agent Z's risk is largely exaggerated and ratio is the reason to the distortion. Hence one needs to be very cautious when using ratio.

6. RELATED WORK

Our concept of "notional peers" is inspired by Bloomquist, Albert and Edgerton's bootstrap approach to evaluating preparation accuracy of tax agents [1]. In Bloomquist etc.'s study the tax agent behaviour is the AUR discrepancy rate, which equals to the number of tax returns lodged by a tax agent with potential misreported values divided by the total number of tax returns lodged by that tax agent. The misreported errors of tax returns are identified by the Automated Underreporter (AUR) program of the US Internal Revenue Service. Assume a tax agent T A lodges 12 tax returns of Postcode 20134 and 45 tax returns of Postcode 20143. The bootstrap approach creates T A's notional peers and evaluate T A's compliance risk by the following steps.

Step 1: Randomly pick 12 and 45 tax returns from all the tax returns of Postcode 20134 and Postcode 20143 respectively. The resulting 57 (= 12 + 45) picked tax returns will contribute to create a notional peer Peer1 for T A as in Step 2.

Step 2: For each of the above 57 tax returns, a uniform random number ($0 \leq u < 1$) is generated. If the value of u is less than or equal to the AUR discrepancy rate of the tax return's corresponding Postcode, a value 1 is added into Peer1's base; otherwise, a value 0 is added into Peer1's base.

Step 3: Compute Peer1's AUR discrepancy rate as $\overline{D}_1 = \frac{1}{57} \sum_{i=1}^{57} x_i$ where $x_i \in \{0, 1\}$.

Step 4: Repeat Steps 1-3 for 1000 times, creating 1000 notional peers for T A. The expected AUR discrepancy rate for T A equals to the average value of the 1000 notional peers' AUR discrepancy rates: $\tilde{\mu} = \frac{1}{1000} \sum_{j=1}^{1000} \overline{D}_j$.

Step 5: Obtain the one-tailed 95% confidence interval by sorting the 1000 peer AUR discrepancy rates in ascending order and selecting the cutoff as the 950th value.

Step 6: If T A's AUR discrepancy rate exceeds the 95% confidence interval (the 950th value), it is identified as being a potential risk.

We respectfully suggest that the bootstrap approach does not quantify tax agent compliance risk. Consequently, it does not compare risk degrees across different tax agents to offer a risk ranking among multiple tax agents. However a proper risk ranking is highly desired in tax administration organisations such as the Australian Taxation Office because it enhances the effectiveness and efficiency of tax audit under resource constraints. Hence we have instead proposed a stratified random sampling approach where we have proved via the central limit theorem that one can use the z-score to quantify potential tax agent risk regarding a behaviour. Meanwhile, since z-

scores are commensurate across different behaviours, we can apply mathematical operations on them to calculate a collective risk score for each tax agent. Multiple agents can be ranked according to their risk scores. These scores together with our proposed descriptive illustrations can provide important insight into the integrity and compliance level of a single tax agent as well as of the whole tax agent industry. Hsu etc. reported to use supervised learning to improve the audit selection procedure at the Minnesota Department of Revenue [3]. In the machine learning and data mining fields of computer science, there exist supervised learning versus unsupervised learning approaches [4, 6]. Supervised learning needs training data, that is, an unbiased and representative sample of the whole population where each of the sample returns has a known outcome (compliance or non-compliance). From the training data supervised learning infers a classifier to differentiate between compliance and non-compliance tax returns. This classifier is then used to classify other unlabelled tax returns. In their particular work, Hsu etc. had access to tax returns with auditing results and trained a naive Bayes classifier therefrom. In contrast, we lack the luxury of having good training data of agent compliance risk due to the fact that tax agent client bases are immensely diversified. Thus our proposed approach is unsupervised learning that does not demand a supply of labelled agents. As a result, our approach is of very low cost and can be easily made operational. A traditional risk identification approach in the Australian Taxation Office is to use business expert rules. A rule system often first specifies non-compliance patterns according to domain experts' previous experience, and then sifts current data through those patterns. Tax agents that match any pre-specified behaviours will be deemed as suspicious. Thus such an approach heavily relies on historical data and previous experience, which are very valuable but will always be one step behind the current data and the newly emerging information presented by the current data. In contrast, our proposed approach is purely data driven. It explores typically large amount of data and discovers knowledge presented by the data. As a result, it can be perfectly synchronised with the current data and is very good at discovering new information that often goes beyond our existing knowledge base. Another advantage of our approach over a rule system is that our approach is robust to infiltration. A rule system often holds a few critical man-made threshold values such as w in the rule "if (rental gross expense) $> w \times$ (rental gross income) then 'risky'". If fraudsters find out these thresholds, it is relatively easy for them to manipulate their return values so as to make claims just under the threshold and thus to avoid being identified. On the contrary, if fraudsters intend to deceive our proposed system, they have to know the behaviours of their peers. Since the peers are randomly sampled from the whole population, the fraudsters have to know the behaviours of the whole population, which information is very difficult to obtain. Hence our approach is much more robust to malicious intrusions than a rule system.

7. CONCLUSION

In this paper we have shared our positive experience of delivering effective and efficient identification of potential tax agent compliance risk, which is traditionally a very demanding and expensive task that consumes substantial amount of auditing resource and time. Meanwhile we have shared the lessons we have learnt throughout the process. In particular, we have proposed to compare an actual tax agent T A with its notional peers in order to measure the potential risk of T A's return preparation behaviours. The notional peers are created via stratified random sampling such that they are commensurable with T A and that they offer a proper industry norm for T A. According to the central limit theorem, the peers' preparation behaviours will follow a

normal distribution. Therefore one can use the z-score to quantify the degree of T A's compliance risk potential.

We have also proposed to profile agent compliance risk through well designed illustrations. Such illustrations are easy to understand, and at the same time provide important insight into the integrity and compliance level of a single tax agent as well as of the whole tax agent industry.

We have applied our proposed method to the Australian tax agent rental data. Our preliminary results are well received and welcomed by executives and auditors in the Australian Taxation Office. Further field assessments are being undertaken on the method outcomes, which we expect to be able to help the Australian Taxation Office promote and assist a capable and well-regulated tax and accounting profession.

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