



THE TAX INSTITUTE

20 December 2012

Mr Ali Noroozi
Inspector-General of Taxation
GPO Box 551
SYDNEY NSW 2000

By email: riskassessment@igt.gov.au

Dear Ali,

Review into aspects of the ATO's use of compliance risk assessment tools

The Tax Institute is pleased to have the opportunity to make a submission to you in relation to the "*Review into aspects of the ATO's use of compliance risk assessment tools*" (**Review**).

In our view, the Australian Taxation Office's (**ATO**) use of compliance risk assessment tools is a necessary part of their role as administrator of the federal tax system.

We set out below our comments in relation to the ATO's current use of compliance risk assessment tools and make some suggestions for improvement to the use of compliance risk assessment tools that the Inspector-General may wish to consider in making suggestions to the ATO for improvements to its risk management and compliance processes.

Discussion

1. Members' views on the ATO's current use of compliance risk assessment tools

Members of The Tax Institute have reported on various occasions their experiences with the ATO's use of some of its compliance risk assessment tools. In particular, members have reported to us their experiences in relation to the application of the "risk engine" tool to determine the risks associated with tax returns of clients that are individuals during Tax Time 2011 (income tax returns for the year ended 30 June 2011) as compared to the use of the same tool applied to individual tax returns during Tax Time 2012 (year ended 30 June 2012).

They have also reported their concerns in relation to the use of the "Risk Differentiation Framework" that has been applied to large businesses. Other compliance risk

assessment tools which have concerned our members include the use of data matching for certain types of disposals (CGT assets such as real property and shares) and certain types of income (eg foreign-sourced income).

Individual risk engine tool

In relation to the risk engine tool applied to individual tax returns, over 109,000 returns in refund positions were pulled out of the automatic processing system for further investigation during Tax Time 2011. This led to the issue of a letter to the tax agent or taxpayer concerned noting that the return was subject to further review which may take up to 12 weeks. Often, these returns were subject to substantial processing delays which extended well beyond the nominated 12 week period (eg 9 months). Tax agents and taxpayers were required to contact the ATO periodically to follow up the progress of the returns and they kept being told their query would be escalated and to wait a further 28 days (being the promised response time to queries per the Taxpayer Charter). As a result, The Tax Institute made an offer to its members to assist them to escalate their queries directly with the ATO, an offer which several members took up.

Once the returns were released, in some cases only small adjustments were made and in many other cases there were no adjustments made to the amount of refund claimed. Some common “themes” arose out of the process. For example, returns where items such as the “spouse rebate” and Education Tax Refund were claimed were the returns most likely to be delayed for processing by operation of the risk engine.

Many more thousands of individual returns were delayed by the application of the risk engine than were anticipated by the ATO (approximately 109,000 for 2011 as compared to approximately 26,000 for 2010). Based on the prior year experience, as the ATO had not anticipated such numbers for 2011, the ATO had not allocated sufficient resources to deal with the delayed returns. In the latter half of the financial year, the ATO began to work quickly to reallocate staff to deal with the huge numbers of delayed returns and find other faster ways to resolve the matters (for example, through the issue of default assessments).

Taxpayers were given opportunity to provide additional information to support claims for the refunds made (some members reported supplying a raft of additional information including all relevant receipts), but this did not necessarily assist the process or change the outcome. Tax agents spent much time and incurred associated costs to provide the additional information to substantiate the refund claims, much of which was irrecoverable. This caused much frustration to some of our members who were busy enough in their practices at this time without having this additional burden imposed on them to supply further information to the ATO and to spend time contacting the ATO on a number of occasions to follow up client tax returns. These delays also had the potential to have an adverse impact on the relationship between a tax agent and their client in that the agent was generally unable to explain to their client why there was such a delay in receiving their refund given they had such difficulty extracting further information from the ATO about the delays.

Our members have no complaints to date with the experience so far in Tax Time 2012 about the application of the risk engine. However, though the tool has been “tweaked” to resolve some of the issues that were experienced in 2011, it is not known what has been changed.

What is also not known are the factors used to devise the risk engine in the first place and the differences between the tool applied in 2010 and 2011 which caused such a substantial change in the results the ATO received from applying the tool. Also, what changes were made to the 2011 risk engine which have caused the application of this tool to markedly improve for 2012 and not give rise to the same experiences of 2011 are also not known. In this regard, there is not a great deal of transparency around the ATO’s use of the risk engine.

We note other issues in respect of the risk engine will be covered in the Inspector-General’s *Review into the Australian Taxation Office’s compliance approach to individual taxpayers – income tax refund integrity program*.

Risk Differentiation Framework

Information in relation to the Risk Differentiation Framework (**RDF**) is detailed in the *ATO Compliance Program for 2012-13* for large businesses and also on the “Businesses” web page of the ATO website which gives some explanation regarding the use of the tool. Therefore, there is some transparency to allow taxpayers to understand more about the tool. According to the information contained in the ATO Compliance Program, the Commissioner has progressively been writing to businesses explaining how the tool has been applied to them and noting some of the risks the ATO perceives about them. This is a positive step towards transparency in the use of this tool.

Application of the RDF may be useful for the ATO, however, taxpayers to whom the tool is being applied need to know what information the ATO has about them (for example the risks the ATO believes apply to the particular taxpayer) and therefore what changes they might be able to make (for example to their level of compliance) to positively influence the “categorisation” the ATO has made of them. This requires open communication between the parties to ensure the tool is being used fairly. We understand that this particular application is new. Therefore there is opportunity now for the Inspector-General to make prospective constructive observations to the ATO about how to best and fairly use the RDF rather than retrospectively look at how the RDF has been used and what could have been done better, particularly as the RDF will be rolled out to the SME market in the near future and varied slightly to appropriately apply to this market.

Data Matching

The ATO also uses data matching as a risk compliance tool to ensure particular items of income and gains from disposals are reported. We note that the use of data matching is also the subject of another review being undertaken by the Inspector-

General entitled *Review into the Australian Taxation Office's compliance approach to individual taxpayers – use of data matching*.

We note that in relation to the running of the data matching programs, taxpayers are either given a short amount of time to respond (eg the CGT real property data matching letters) or advised they only need to respond if there is an issue (eg the foreign source income letters). Taxpayers who have determined that they do not need to respond or have already appropriately accounted for the income/disposal being queried by the ATO found that they subsequently received correspondence following up the matter, sometimes even including an assessment, where in fact the disposal had already been reported by the taxpayer to the ATO. This has caused much frustration to taxpayers and tax agents and also imposed an irrecoverable time and money cost on tax agents who were not always able to recover fees for time spent responding to these queries.

2. Suggestions for improvement

In making some suggestions for improvement, we have responded to a number of the questions contained in the Terms of Reference for the Review. The numbers used correspond to the numbers for the questions to which we have provided a response.

Q15. How should the ATO measure the effectiveness or accuracy of its risk assessment processes?

The ATO should regularly review the risk assessment processes it has applied to particular situations to determine whether the risk assessment process has given rise to the results the ATO anticipated or whether the results are misaligned with the expected results. Where excessive numbers of taxpayers have been subjected to the risk assessment process, the ATO could sample a cross-section of taxpayers that have been subject to the process to assess the effectiveness or accuracy of the risk assessment process that has been applied. Where smaller numbers of taxpayers are involved, the results from all taxpayers involved should be reviewed.

We acknowledge this may be a resource-intensive process. However, where the ATO intends to utilise the same risk assessment process in other areas, there is value in the ATO investing the resources to ensure the risk assessment process is as effective and accurate as it could be or to identify areas of improvement in the process to ensure effectiveness and accuracy in the particular tool's future use.

Q16. Should the ATO conduct random audits of a sample population as a means to establish an evaluation benchmark and assist in refining its risk assessment tools? This would involve some compliant taxpayers being audited. The ATO does not currently conduct random audits but other countries such as the USA, Canada and the UK do.

Per the response provided to Q15 above, the ATO should audit their own processes rather than audit taxpayers to make this assessment.

Q17. What relationship should there be between the ATO's risk assessment processes and its compliance activities?

Risk assessment processes are focused on identifying where "risks" might lie with respect to taxpayers complying with their tax obligations. Compliance activities are focused on ensuring taxpayers understand and comply with their tax obligations and assisting taxpayers who have difficulty (for many reasons) in complying.

Compliance activities focus on the positive engagement¹ of taxpayers with the ATO and risk assessment processes focus on the negative engagement² of taxpayers with the ATO. In this regard, each represents one part of the overall nature of engagement a taxpayer may or may not have with the ATO. Therefore, there should be a clear link between the ATO's risk assessment processes and its compliance activities.

Q18. Should there be a clear distinction between the ATO's risk assessment processes and its compliance activities? Please explain your views.

On the basis that the ATO's risk assessment processes are focused on a different aspect of taxpayer engagement with the ATO than the ATO's compliance activities, there should be a clear distinction between these two types of activities. That said, there is a clear link between the two (as noted on response to Q17) and therefore the nature of risk assessment processes should complement and support the activities undertaken for compliance purposes.

Q19. What influence, if any, should the risk assessment process have on the application of any penalties or interest?

The risk assessment process should be independent of the application of interest and penalties. Interest and penalties should be applied objectively to each situation in which they could have application, regardless of the "risk profile" of the particular taxpayer or whether the taxpayer has been subject to a risk assessment process. If the risk assessment process formed part of the application of interest and penalties, this could prejudice how penalties and interest may be applied to certain taxpayers who, for example, fell under a risk assessment process and those who fell outside of a risk assessment process.

¹ We consider that "positive engagement" of taxpayers with the ATO involves taxpayers actively complying with their tax obligations.

² We consider that "negative engagement" of taxpayers with the ATO involves the ATO having to actively pursue taxpayers (for example through a risk review or audit process) to ensure taxpayers comply with their tax obligations.

Q22. What role should ATO officer qualitative or judgment based inputs play in these assessments? Please explain your views.

Some of the risk assessment tools available to the ATO to apply to taxpayers are not yet sufficiently refined mechanisms to differentiate between “real risks” and minor/moderate risks. ATO officer qualitative or judgement based inputs imposed on the outcomes of these tools could potentially result in a taxpayer being unfairly “perceived” as a risk.

Though it would be useful to incorporate some level of qualitative or judgement based input into the risk assessment process, we have some concern that ATO officers may not necessarily be fully equipped with the relevant training and practical business knowledge to be able to incorporate a qualitative element into the risk assessment process. This could potentially lead to different results arising in the same set of circumstances depending on the particular ATO officer's experience.

Q23. How should the different types of information be applied? Should the ATO use only objectively verifiable information first, filtering out certain taxpayers before applying qualitative or judgement based inputs? Should the ATO place different weight on different types of information?

If it is regarded as necessary to include qualitative or judgment based inputs in a risk assessment process, then yes, the ATO should always apply objectively verifiable information first, filtering out certain taxpayers before any subjective information/inputs are brought in to the process.

Q24. How can the transparency of the ATO's risk assessment processes be improved without reducing their effectiveness as a means of capturing non-compliance?

At a minimum, descriptive information about a particular risk assessment process should be made available on the ATO website so that taxpayers are able to gain a good understanding about the purpose of a risk assessment process and what the ATO intends to achieve by applying it. This would also inform taxpayers that the ATO is using this tool, even if the taxpayer is not made aware that it is being applied to them.

Once a taxpayer is made aware a particular risk assessment process is being applied to them, they should directly be given information about the process from the ATO. This would give them the opportunity to make further enquiries about the process so they can understand the purpose of the process and how it might apply to them, as well as the next steps/ consequences if the process uncovers what the ATO perceives to be a “risk” about the taxpayer.

Q25. In what circumstances and how should the ATO communicate the result of the risk assessment to the affected taxpayer? In which cases should it not? Please explain your view.

Unless it is impractical to do so, the taxpayer (or their tax agent if they have one) should be advised when they are being subject to a risk assessment process. The taxpayer (or their tax agent) should first be contacted by telephone to alert them to the fact that the ATO is running a risk assessment process. This should then be followed up in writing so that both the taxpayer and the ATO each have a written record.

The result of the process (adverse or otherwise) should be communicated to the taxpayer so they know whether anything is to follow on from the process (eg an audit) or that the process has concluded and the matter is closed.

In the case of the application of the risk engine for refund integrity checking that applies to all individual taxpayers, it would not be practical to inform every taxpayer individually that they are being subject to this process. It is sufficient if the ATO publicises the use of this process generally (eg on its website). However, where a return is pulled out for further investigation, then the taxpayer should be notified individually.

Q26. Where the ATO communicates as the result of the risk assessment process, how frequently should it do so?

This will depend on the nature of the risk assessment process being applied. If it is a short-term process, for example the application of the risk engine for refund integrity checking, unless the process is dragging out for an extended period of time, say more than three months, it may be sufficient for the ATO to communicate once only while the risk assessment process is being undertaken and once when it has been concluded.

For a process like the application of the Risk Differentiation Framework, as this appears to be the type of tool that the ATO will use on an ongoing basis, it is suggested that there should be regular correspondence between the ATO and taxpayer to whom the tool is being applied, to give the taxpayer opportunity to query the ATO's application of the tool to them and if necessary, the opportunity to dispute it. An absence of regular communication would not give the taxpayer any recourse to gain further information about how the tool is being applied to them and what impact it may have on their treatment by the ATO.

Q27. What opportunities should be afforded to taxpayers to comment on, or review, ATO risk assessments?

Taxpayers (or their agent where appropriate) should be afforded several opportunities to comment on or review an ATO risk assessment being carried out on them, especially where the process takes a substantial amount of time to complete. This regular communication is particularly important to ensure the ATO officer carrying out the assessment has all relevant information available to it to make a proper

assessment and ensure the officer is not making an assessment based on incorrect information.

Q30. When obtaining information pertaining to risk assessment processes:

- a) how often should the ATO request information to ensure information is up to date;*
- b) when should the ATO seek the information from taxpayers directly or from third parties; and*
- c) how can the ATO balance the need for information with the compliance costs incurred by taxpayers or third parties in satisfying ATO information requests?*

- a) How often the ATO should request information to ensure information it has is up to date depends on the length of the risk assessment process. Once should be sufficient in short-term processes; in the case of the long-term application of a tool like the Risk Differentiation Framework, it would be wise for the ATO to obtain information either biennially, or annually.
- b) If the ATO is able to obtain third party information, it should do so that taxpayers do not have to spend time providing information the ATO can obtain elsewhere. However, where the ATO is relying on third party information, it should verify this information with the taxpayer to ensure it is correct prior to drawing any conclusions about the taxpayer and not incorrect or out of date.
- c) To ensure no more compliance costs are incurred by taxpayers or third parties than are necessary, the ATO could request information over the telephone rather than requiring written responses, which take longer to prepare. The ATO could also set up a time to discuss the matter with the tax agent/taxpayer/third party so that the tax agent/taxpayer/third party can have the relevant information handy to be able to quickly answer questions. This could be an efficient way for all parties to correspond in these types of matters.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on (02) 8223 0011.

Yours sincerely



Ken Schurgott
President