



Australian Government
Inspector-General of Taxation

Review into the ATO's use of benchmarking to target the cash economy

A report to the Assistant Treasurer

Inspector-General of Taxation

July 2012

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16 July 2012

The Hon. David Bradbury MP
Assistant Treasurer and Minister Assisting for Deregulation
Parliament House
Canberra ACT 2600

Dear Minister

Review into the ATO's use of benchmarking to target the cash economy

I am pleased to present my report of the review into the Australian Taxation Office's (ATO's) use of benchmarking to target the cash economy. It arose from concerns raised by small businesses, tax practitioners and their representative bodies during consultations on my work program.

Stakeholders generally supported benchmarks as a risk identification tool. However, concerns were raised with how they were developed and used in ATO compliance activities. Several recommendations seek to address this by improving ATO transparency and data integrity.

Some of the other recommendations are aimed at improving the ATO's risk identification and audit processes to exclude compliant taxpayers from audits thereby minimising unnecessary compliance costs.

I have also identified opportunities to improve ATO audit staff and taxpayer understanding of the evidentiary requirements to support taxpayer reported income and ATO penalty decisions. Recommendations in this regard seek to improve communication and the available guidance.

Opportunities to better support taxpayers and tax practitioners to improve small business record keeping were also identified, including consultations with the Federal small business commissioner, once appointed.

Overall, I have made eleven recommendations to the ATO – with nine agreed in full and two in part. The ATO has not agreed to publish geographic comparisons of benchmarks and, hence, some transparency concerns remain.

I offer my thanks to tax practitioner representative bodies, small business taxpayers and their tax agents for taking the time to prepare submissions and discuss issues with myself and my staff. I also thank ATO and Australian Bureau of Statistics officers for their professional cooperation and assistance.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Ali Noroozi', written over a horizontal line.

Ali Noroozi
Inspector-General of Taxation

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EXECUTIVE SUMMARY

The Inspector-General of Taxation's (IGT) review into the Australian Taxation Office's (ATO) use of benchmarking to target the cash economy was prompted by concerns raised by small businesses, tax practitioners and their representative bodies. In particular, concerns were raised in relation to various aspects of the ATO's approach in developing and using its benchmarks of small business financial performance ('the benchmarks') to address underreported income.

Overall, the review found that stakeholders were supportive of the use of benchmarks as a risk identification tool. They were, however, concerned with the benchmarks themselves in addition to the way the ATO was using them for compliance activities. In particular, concerns were expressed that the benchmarks did not account for business differences in an industry or for geographic differences. Furthermore, stakeholders were concerned about the data integrity of the inputs the ATO was using to develop their benchmarks. The IGT found that many of these concerns related to the transparency of the process and could be addressed by publishing the data inputs and methodology the ATO uses to develop the benchmarks as well as seeking and publishing independent third party assurance on the methodology. The IGT has also made recommendations to enhance the data integrity of the ATO's inputs.

Whilst stakeholders considered benchmarks to be a useful way for the ATO to exclude large numbers of likely compliant taxpayers from compliance activities, they were also of the view that being significantly outside the benchmarks was, in and of itself, not enough reason to commence audits. It was considered that the ATO should take into account additional factors to determine whether the risk warranted an audit. The review found that of over 7600 benchmarking audits, the ATO made adjustments in only 24 per cent of cases. The IGT believes that, whilst this is better than randomly auditing taxpayers in the cash economy population, the current approach can be improved to better exclude compliant taxpayers from audit selection.

The IGT observes that the ATO can analyse the completed audit case data to determine whether other factors can be considered as useful predictors of taxpayer compliance or non-compliance. The IGT has recommended that the ATO should use such research to refine its audit selection process, thereby ensuring that it focusses its resources on a higher proportion of non-compliant taxpayers and reducing compliance costs for compliant taxpayers.

The IGT also noted there was some confusion during ATO audits about the types of evidence the ATO would take into account in determining whether taxpayers had omitted income. The IGT found that the ATO could address this confusion by clarifying in its staff instructions and communication with taxpayers the evidence it is seeking during audits. This should also realign taxpayers' expectations with that of the ATO and improve the evidentiary basis for ATO audit decisions. In particular, the IGT has recommended that the ATO publish information regarding how the ATO takes into account taxpayer records during an audit and the evidence which a taxpayer may adduce should the taxpayer's records not meet the ATO's requirements.

The review also found that the evidentiary basis of penalty decisions resulting from benchmarking compliance activities could be improved. The review's findings are broadly consistent with past IGT reviews regarding the penalty decision making capability of ATO staff. The IGT considers that the administration of penalties, as a topic, is ripening for an IGT review in its own right. It has been a persistent stakeholder concern across all market segments in past IGT reviews.

The IGT also made a number of recommendations aimed at improving staff capability, reducing taxpayer compliance costs during the conduct of audits and improving small business record keeping into the future.

Overall, the IGT has made eleven recommendations to the ATO. The ATO has partially agreed with two and has agreed with the remainder.

CHAPTER 1 — OVERVIEW

CONDUCT OF THIS REVIEW

1.1 This is the report of the Inspector-General of Taxation's (IGT) review into the Australian Taxation Office's (ATO) use of benchmarking to target the cash economy. The report is produced pursuant to section 10 of the *Inspector-General of Taxation Act 2003* (the IGT Act 2003).

1.2 During public consultation for the IGT's 2011–12 work program, submissions were received from a range of taxpayers, tax practitioners and their representative bodies that raised concerns about the ATO's use of benchmarks in the cash business segment. Upon inclusion into the work program, the IGT undertook further community consultation to identify stakeholders' concerns. These concerns were reflected in the terms of reference which the IGT issued on 28 November 2011 and are reproduced in Appendix 1.

1.3 During the review, the IGT received a number of submissions from taxpayers and their representatives as well as professional bodies.

1.4 The IGT was also made aware that many small businesses and tax practitioners may not have the time or resources to make detailed submissions. To ensure that the IGT heard from a range of stakeholders affected by the ATO's cash economy benchmarking compliance activities, the IGT identified from representative bodies and the ATO's records those taxpayers and tax practitioners who had been subject to these ATO activities and directly contacted a number of them to better understand their experiences.

1.5 Stakeholders recognised the need for the ATO to have an effective risk identification tool. Whilst generally supportive of the ATO's use of benchmarking conceptually for risk identification, submissions and discussions raised a number of concerns in relation to the benchmarks themselves and the way in which the ATO used them for compliance activities.

1.6 Firstly, stakeholders raised concerns about the transparency of the ATO process for developing the benchmarks. In particular, stakeholders wanted more information on the data inputs and the methodology the ATO uses to arrive at a benchmark. Doubts were expressed regarding whether sufficiently similar businesses were being compared with each other. Stakeholders also sought greater assurance on the statistical validity of the process.

1.7 Secondly, concerns were raised about aspects of the ATO's approach in using benchmarking as a risk identification tool. Stakeholders were particularly concerned that the ATO appeared to equate those businesses with financial performance 'significantly outside' the benchmarks with those representing a higher risk of underreported income without consideration of other factors. As a result, they considered compliant taxpayers were being unnecessarily targeted. They believed that the costs associated with ATO compliance activities, especially audits, warranted

further risk identification work to be undertaken by the ATO beyond the use of benchmarks.

1.8 Thirdly, stakeholders expressed concerns as to whether the ATO had had sufficient regard to the individual circumstances of taxpayers during audit activity. In particular, whether ATO auditors consistently solicited and relied upon all available evidence in determining whether taxpayers had underreported their income.

1.9 Fourthly, stakeholders also raised concerns with the manner in which the ATO took into account taxpayers' compliance with record keeping obligations during audits as compared to their obligation to accurately report their income.

1.10 Lastly, stakeholders raised concerns about the ATO's use of benchmarks in issuing default or amended assessments. Stakeholders were concerned that the ATO used benchmarks instead of evidence more pertinent to the taxpayer's particular circumstances as a basis for assessing taxation liabilities.

1.11 The IGT review team has also discussed the above issues extensively with relevant ATO senior management and staff within its Cash Economy stream.¹

HOW THIS REPORT IS STRUCTURED

1.12 This report is composed of several related chapters, with each focussing on a particular issue. Chapter 2 provides the reader with background on the ATO's benchmark approach and the cash economy program.

1.13 Chapter 3 focuses on the development and communication of the small business benchmarks themselves and makes recommendations to improve transparency with a view to increasing confidence in the process and, ultimately, the benchmarks.

1.14 Chapter 4 considers the adequacy of the ATO's current use of benchmarks as a risk identification tool. This chapter seeks to improve the ATO's risk identification process and minimise taxpayers' compliance costs through a more staged approach to the ATO's information gathering and verification activities.

1.15 Where a taxpayer remains a concern to the ATO after the risk identification process, the ATO may commence an audit. Chapter 5 considers the distinction between records and evidence and its impact on the conduct of correspondence audits. Certain taxpayers may not have appropriate evidence to support their obligation to accurately report their income and expenses. In this case, the ATO may decide to amend their tax liability using a default assessment. Chapter 5 also considers the circumstances in which the ATO should use the applicable benchmark to issue default assessments.

1.16 Chapter 6 focuses on specific aspects of the way in which ATO auditors conduct various compliance activities under the benchmarking strategy. The conduct of correspondence audits is a particular focus, including the evidentiary basis for the

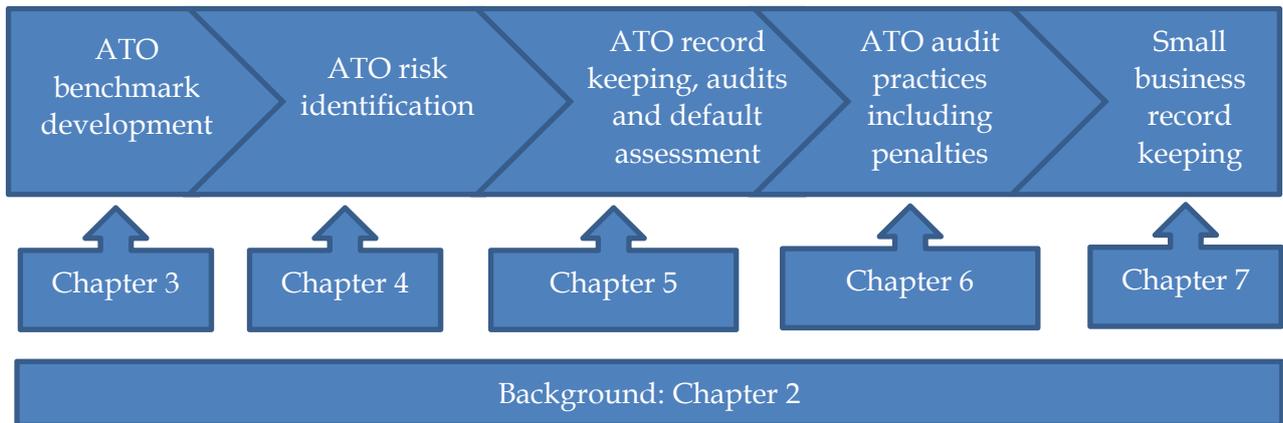
¹ The Cash Economy stream is located within the ATO's Tax Practitioner and Lodgment Strategy business line.

application of penalties and other practices that were observed to contribute to compliance costs.

1.17 The following chapter, chapter 7, takes a broader view of record keeping. This chapter makes recommendations to enhance the long term capability of the small business sector to maintain appropriate records and the ATO's ability to gain an assurance about the quality of a taxpayer's record keeping without intensive verification activity.

1.18 Also in chapter 7 the role of tax agents and BAS agents in helping small business owners to comply with their record keeping obligations is discussed.

Figure 1: Structure of this report



CHAPTER 2 — BACKGROUND

THE CASH ECONOMY

2.1 Business activity that is not reported as income for taxation purposes is referred to as the cash economy (or 'underground economy'²) by revenue administrations globally. The ATO considers the cash economy as a major tax integrity threat under its Enterprise Risk Management Framework, defining the risk as a 'failure to identify and respond to major threats posed by the cash economy which have the potential to undermine community confidence in the integrity of the system.'³

2.2 On its website, the ATO describes the cash economy as occurring when 'businesses deliberately use cash transactions to hide income to avoid paying tax.' The website further states that cash economy activities include businesses:

- paying wages 'cash-in-hand';
- skimming some or all of the cash takings;
- running a part of their normal business activities 'off-the-books';
- not reporting the value of goods and services provided in exchange for other goods and services; and
- operating underground – that is, avoiding their tax and superannuation obligations by not registering their business or lodging returns.⁴

2.3 For the purposes of its communication strategy,⁵ the ATO identified the following conditions that must exist for a business to underreport its cash income:

- Access to cash – the business must have access to cash transactions. Typically these businesses transact a significant volume of cash or have the opportunity to convert part of their income to cash.
- Opportunity – individuals operating the business must have the opportunity to hide cash transactions. Some businesses, particularly those which are smaller, do not have controls to ensure that all sales are recorded. Omitted cash income most commonly occurs where the beneficiary of the tax evasion, generally the business owner, controls some part of the cash recording and handling processes.

2 Or 'hidden economy', 'informal economy'. OECD Forum on Tax Administration SME Compliance sub-group Information note: *Reducing opportunities for tax non-compliance in the underground economy*, January 2012, para. 2

3 Australian Taxation Office, *Enterprise Risk Management Framework*, extract supplied by ATO, 29 May 2012.

4 Australian Taxation Office, *About the cash economy*, Australian Taxation Office, Canberra, 19 August 2011, viewed 21 June 2012, <<http://www.ato.gov.au>>.

5 Australian Taxation Office, *Communication Strategy Small Business Benchmarks*, 22 September 2009, page 10, supplied by ATO 23 January 2012.

- Motivation – the decision to engage in non-compliant behaviour is made by an individual or group of individuals in order to gain some benefit. Those participants are motivated to engage in such behaviour by a range of ‘drivers’, which may change over time as individuals’ circumstances change.

2.4 The ATO has estimated that there are 1.4 million businesses operating within the ‘cash business segment’.⁶ However, it is unknown how many within this segment would actually underreport their income.

THE ATO COMPLIANCE STRATEGY FOR THE CASH ECONOMY

2.5 In its Compliance Program 2009-10, the ATO said:

The present economic climate has increased competitive pressures on small businesses and created an environment where some will seek an unfair advantage. It is important that we support honest businesses by taking firm action against those seeking an unfair advantage.

When many in the business community are doing it tough, it is even more important that the system is seen as fair and equitable.⁷

Compliance detection and verification methods

2.6 In furtherance of this goal, the ATO has developed three main methods ultimately directed towards detecting the underreporting of income in the cash economy and verifying the income that is reported. These methods are:

- cash economy risk modelling;
- data matching; and
- performance benchmarking.

2.7 Each method is discussed below.

ATO cash economy risk modelling

2.8 The ATO cash economy risk model is based on a set of ‘business rules’. It was developed over a number of years using a number of tests to identify probable omitted income. The model was developed by a review of completed case work and debriefs of auditors. The model is also continuously updated in this way. The rules identify the risk of omitted income based on information contained in ATO systems, industry information and third party data. A total risk score is calculated which the ATO uses as a basis for further action. The model covers the 1.4 million businesses in the cash economy population.⁸

6 Australian Taxation Office, *Compliance Program 2011-12*, page 45.

7 Australian Taxation Office, *Compliance Program 2009-10*, page 16.

8 ATO communication to IGT, 31 May 2012.

ATO data matching

2.9 Data matching seeks to compare information from third party sources, such as other government agencies, banks, lands title offices and motor vehicle registries, with those reported by taxpayers in their income tax return. Inconsistencies may be indicative of underreported income upon which the ATO may take follow-up action.

2.10 Recently, the ATO has also approached data matching for the cash economy on an industry basis. For example, the ATO has targeted the building industry and the coffee shop industry. In the case of the coffee shop industry the ATO has acquired data from coffee suppliers in order to identify purchasers of coffee over a certain threshold.⁹ The ATO then compares these purchasing records with what was reported in the tax returns and activity statements of businesses to identify:

Businesses that do not report or under-report their sales

Businesses that may be running a part of their normal business activities off the books or operating underground by avoiding their obligations to register and lodge returns

Risks and trends of non-compliant behaviour by those involved in the coffee industry.¹⁰

Performance benchmarking

2.11 The ATO reports small business performance benchmarks as:

financial ratios developed to help you compare your performance against similar businesses in your industry. The benchmarks provide guidance on what figures we [the ATO] would normally expect a business in a particular industry to report.¹¹

2.12 The ATO advises that the purpose of these benchmarks is to identify businesses potentially not correctly or completely reporting their business income and expenses. In this respect, the ATO considers they provide a guide for businesses to compare their performance against others in their industry. The ATO also seeks to make it clear that good record keeping is an obligation for all businesses and to take the individual circumstances of taxpayers into account.¹² Businesses significantly outside of the benchmarks can expect a form of ATO engagement to better understand the taxpayer's specific position.

2.13 The number and types of ATO benchmarked industries is indicated on the 'Small business benchmarks' page of the ATO website.¹³ Out of the 1.4 million taxpayers that are considered by the ATO to be in the cash economy, the small business

9 Australian Taxation Office, *Coffee suppliers data matching*, Australian Taxation Office, Canberra, 22 June 2012, viewed 2 July 2012, <<http://www.ato.gov.au>>.

10 *ibid.*

11 Australian Taxation Office, *Small business benchmarks - Overview*, Australian Taxation Office, Canberra, 22 May 2012, viewed 2 July 2012, <<http://www.ato.gov.au>>.

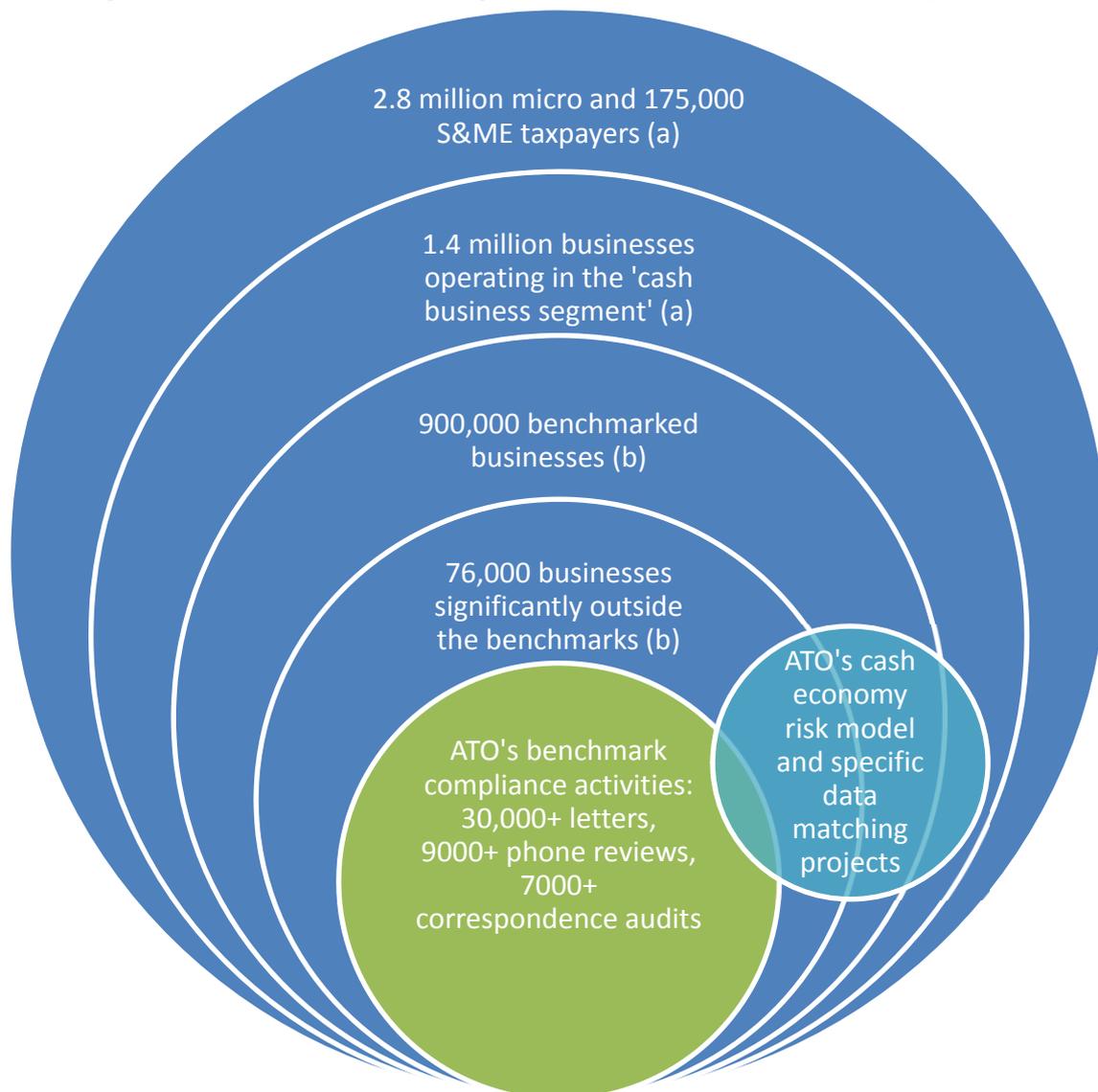
12 Australian Taxation Office, *Cash Economy Plan 2011-12*, supplied by ATO 23 February 2012.

13 Australian Taxation Office, *Small business benchmarks*, Australian Taxation Office, Canberra, viewed 2 July 2012, <<http://www.ato.gov.au>>.

benchmarks cover over 100 industries encompassing 900,000 businesses.¹⁴ Of these, the ATO has identified 76,000 businesses with financial performance that falls 'significantly outside' the benchmark range for their industry. The diagram below visually represents this break-up.

2.14 In this diagram, it is important to note that even if a taxpayer is not selected for compliance activity based on the benchmarks, they may still be subject to a cash economy audit or other compliance activity based on the cash economy risk model or other specific cash economy strategies such as data matching.

Figure 2: Where benchmarking activities fit in the cash economy



Source: (a) From the ATO Compliance Program 2011–12. (b) Australian Taxation Office, *ATO Small business benchmarks: Promoting a level playing field for Australian small business*, November 2011, supplied by ATO 24 November 2011.

Note: Diagram not to scale.

14 Australian Taxation Office, *ATO Small business benchmarks: Promoting a level playing field for Australian small business*, November 2011, supplied by ATO 24 November 2011.

2.15 Performance benchmarking is the focus of this review and issues arising in relation to it are discussed in the following chapters.

Governance of and funding for the ATO small business benchmarks

2.16 The ATO's 'Cash Economy' stream of the Tax Practitioner and Lodgment Strategy (TPALS) business line is largely responsible for managing the risk and ensuring compliance by taxpayers in the cash economy sector. The delivery of strategies directed towards this aim, including small business benchmarks, is overseen by the ATO's Cash Economy Leadership Group, comprising ATO senior executives and directors, who meet on a monthly basis. This group is responsible to the TPALS Risk Management Steering Committee, which reports to the TPALS Executive and ultimately to the ATO Executive for delivery of the strategy (see Appendix 2). This oversight is informed by a number of other internal groups who are responsible for specific aspects of the cash economy strategy, including benchmarking.

2.17 In the 2009 Federal Budget, the government allocated funding to:

Address the anticipated expansion of unfair competitive practices such as cash economy participation, non-compliance with employer obligations for income tax and superannuation and phoenix activity, with increased visibility in the community.¹⁵

2.18 As part of this funding, an allocation of \$9.965 million over four years (2009-10 to 2012-13) was made to develop small business benchmarks and conduct compliance activities based on these benchmarks (see Appendix 3).

2.19 As a result, the small business benchmarking strategy was predicted to raise \$18.5 million. The table below provides the basis for this estimate.

Table 1: Tax Revenue Estimates Summary

Promoting a level playing field for Australian small business — business performance benchmarks

	2009-10	2010-11	2011-12	2012-13	Total
Activities to be performed (comprised of assistance and compliance)	6,425	6,425	6,425	6,425	
Revenue (\$m)	4.1	4.4	4.9	5.1	18.5

(a) Source: Cash Economy — Budget Initiatives document — summation supplied to IGT on 19 June 2012.

2.20 The ATO has set out desired outcomes and success goals to measure the effectiveness of the small business benchmarking program. It identified the desired outcomes as:

- the ATO demonstrates it has the ability to effectively deter, detect and deal with the cash economy thereby increasing willing participation and community confidence in the integrity of the tax system;

¹⁵ Australian Taxation Office, *Promoting a level playing field for Australian small business: funding bid*, March 2009, supplied by ATO 22 March 2012.

- taxpayers and their registered agents understand the importance of recording and declaring all income, expenses and other tax related transactions; and
- intermediaries champion willing participation in the taxation and superannuation systems.

2.21 The ATO has identified the success goals as:

- taxpayers more accurately report all income, expenses and other tax related transactions;
- taxpayers demonstrate more timely lodgment of their returns and payment of their taxes;
- an improved ATO ability to deter and detect cash economy participation through the small business benchmarks and appropriate action being taken when identified; and
- registered agents and other intermediaries becoming more willing to champion the small business benchmarks.¹⁶

2.22 The ATO's small business benchmarks cover a range of businesses with turnovers below \$15 million¹⁷ and, therefore, affects taxpayers from both the micro enterprises and the small and medium enterprises (SME) market segments.¹⁸

Challenges and pressures

2.23 Effectively dealing with the cash economy can present many challenges for revenue authorities, including the following:

- underreporting of income can be difficult to detect due to the 'hidden' and dispersed nature of the economic activities concerned;
- identifying the most revenue-productive targets can be difficult due to the relatively large number of participants and the small amounts of tax involved (however, given the large numbers involved, the aggregate tax revenue at stake is sizable¹⁹);
- many participants have poor books and records and in some cases may not even be registered with the revenue body;
- even where some unreported transactions of a participant are detected, ascertaining the full extent of their unreported income for a fiscal period may necessitate exhaustive and often time-consuming inquiries by the revenue body;

16 Australian Taxation Office, *Tax Practitioner and Lodgment Strategy (TPALS) Cash Economy Measuring Compliance Effectiveness: Small Business Benchmarks 2010-11*, supplied by ATO 23 February 2012.

17 Australian Taxation Office, *Small business benchmarks - Overview*, Australian Taxation Office, Canberra, 22 May 2012, viewed 2 July 2012, <<http://www.ato.gov.au>>.

18 Australian Taxation Office, *Compliance Program 2011-12*, pp. 11 and 15.

19 Organisation for Economic Cooperation and Development (OECD) Forum on Tax Administration: SME Compliance sub-group, *Information Note: Reducing opportunities for tax non-compliance in the underground economy*, January 2012, viewed 23 March 2012, <<http://www.oecd.org>>.

- even where unreported income is assessed to the participant concerned, there may be difficulties in actually collecting the amounts of tax, interest and any penalties that are due;
- detecting and dealing with such non-compliance provides no guarantee that it will not be repeated into the future; and
- compliant taxpayers may become less compliant where they feel that the underground economy is not being properly addressed and that, as a result, they bear an unfair share of the tax burden.²⁰

2.24 Taxpayers and their advisors have also suggested to the IGT that a greater understanding of the pressures experienced by businesses in these segments was needed in designing relevant compliance activities. Although these pressures were not purported to justify non-compliance with the reporting obligations under the law, they were seen as impacting on businesses' ability to ensure compliance and include those set out below.

2.25 Firstly, regulatory costs, including tax compliance costs, are significant and generally borne regressively by micro and small businesses. Whilst many businesses may use the services of a bookkeeper and tax agent, certain taxpayers could consider the cost prohibitive and seek to manage their own record keeping and return preparation. This has the result of taking the business operator away from carrying on more productive activities. This situation can be contrasted with medium to large businesses that may have external or in-house accounting and tax resources the cost of which may be a lesser proportion of their operating expenditure.

2.26 Secondly, micro and small businesses operate in a more marginal or highly competitive environment that increases pressure to find cost savings. These savings, for some, may include attempts to reduce the overall tax compliance burden. This may be particularly so if they perceive an uneven playing field whereby their competitors are gaining an unfair advantage from tax non-compliance.

2.27 Thirdly, tax 'competency' in the micro and small business market segment is highly variable. Research²¹ commissioned by the ATO in 2008 also indicated that 13 per cent of micro businesses had neither engaged an accountant nor a bookkeeper. Of that population, 31 per cent reported not using an electronic record keeping system. In terms of knowledge, 21 per cent of micro businesses rated themselves as knowing only a little about their tax obligations and entitlements. However, it should also be noted that 93 per cent of micro enterprises use registered tax agents to lodge their tax returns and 50 per cent to lodge their activity statements.²² As such, the 'language' and communication required to engage with these taxpayers needs to be carefully considered in design and delivery to be effective.

20 *ibid*, para 4.

21 GfK bluemoon, *Profiling the micro business segment communication and information needs*, Final Report prepared for the Australian Taxation Office November 2008, viewed 20 February 2012, <<http://www.ato.gov.au>>.

22 Australian Taxation Office, *Compliance Program 2011-12*, page 11.

2.28 Lastly, operators run their businesses for a variety of reasons and motivations. As such, some may not dedicate as much time to certain business management aspects as other operations. Some may also run their own business for lifestyle and family related reasons and thus do not run their business purely for profit maximisation.

2.29 As discussed further below, the ATO advises that it seeks to take these factors into account through a differentiated approach to its compliance activities in relation to this market segment.

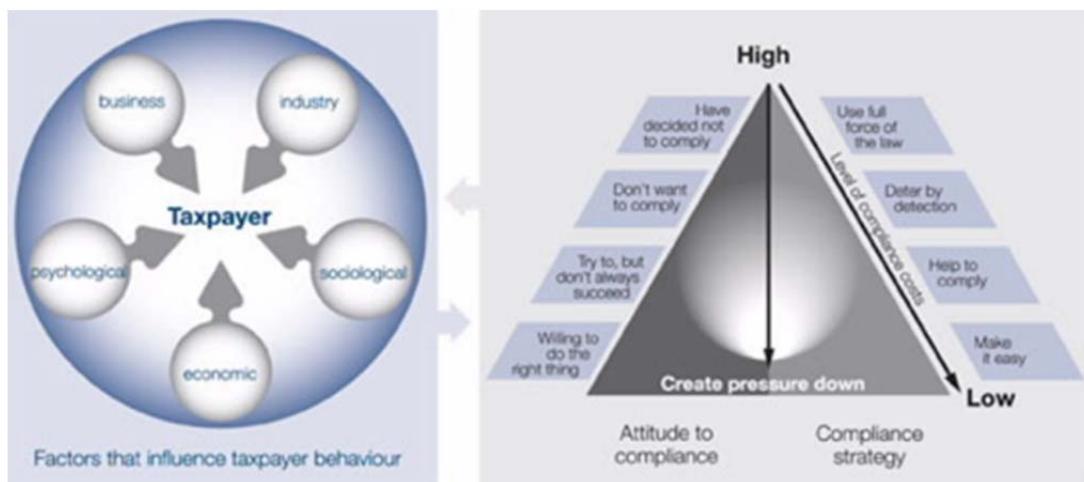
Risk based approach to compliance activities

2.30 The ATO uses a risk-based approach to identify taxpayers or transactions which it considers represent a higher risk of non-compliance.

2.31 This is based on the premise that the Australian self-assessment system requires that the majority of taxpayers voluntarily comply with their taxation obligations. Auditing all 1.4 million businesses operating in this market segment would be impractical with the cost of pursuing every cent of revenue not being commensurate to the amount actually collected.²³

2.32 In dealing with the cash economy, the ATO applies the 'compliance model' (see Figure 3 below), which seeks to treat taxpayers differently according to their different behaviours and attitudes towards compliance. It does this by adopting a variety of compliance strategies, approaches and products.

Figure 3: The ATO compliance model



2.33 The ATO compliance model includes a diagram known as 'BISEP', which recognises that taxpayer compliance behaviour is influenced by many factors – business, industry, sociological, economic and psychological. By understanding what drives non-compliant behaviour, the ATO can influence taxpayer behaviour by understanding how these factors affect compliance behaviours. For example, if a taxpayer operates in an industry where non-compliance is systemic at the industry

23 B. Quigley, speech to TIA National Convention Sydney 12 March 2009, *The Commissioner's powers of general administration: how far can he go?*, viewed 20 February 2012, <<http://www.ato.gov.au>>.

level, the ATO may work with industry bodies to develop strategies to improve compliant behaviour at the broad level.

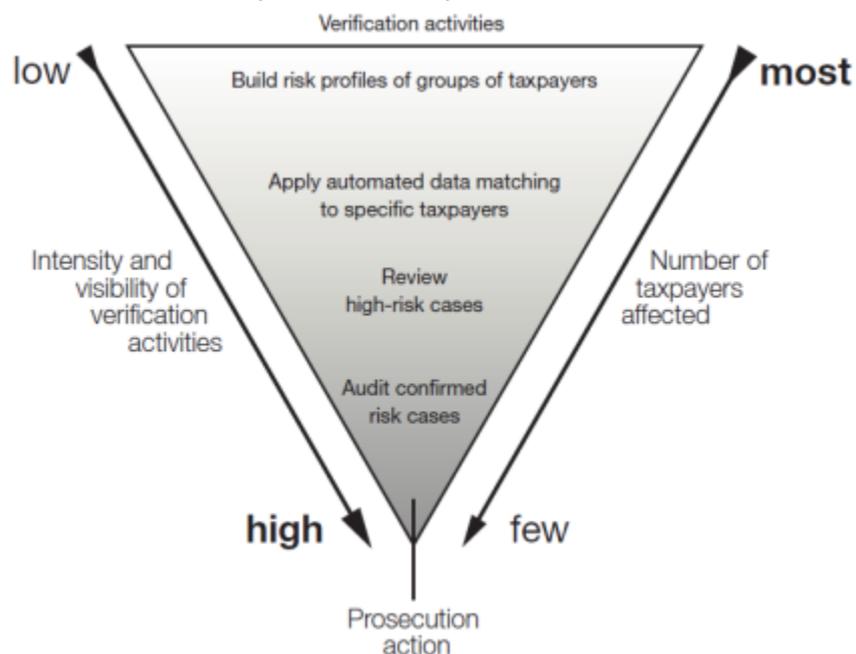
2.34 Furthermore, the ATO's differentiated approach to compliance means that the intensity and visibility (and usually compliance costs) of compliance activities generally increase with the risk.

2.35 This approach can be described as a type of 'funnel', where large numbers of taxpayers are risk profiled at the top (see Figure 4 below). Usually, such profiling takes place within the ATO without the need to contact the taxpayer, since it relies on information the ATO already has, such as that obtained from tax returns and activity statements, or information that is accessible from third parties, such as that obtained from financial institutions or other government agencies. Thus, this level of verification is effectively invisible to the taxpayer and the cost of compliance is low.

2.36 For taxpayers identified as having greater risk, the ATO undertakes more specific verification activity. This may involve the ATO contacting the taxpayer for further information to verify compliance. It is often at this point that the verification activity becomes visible to the taxpayer. Informal information requests can be low intensity, whilst formal requests, such as in audits, can be regarded as high intensity.

2.37 Since more intensive activity usually requires more ATO resources, the number of taxpayers affected decreases. Also, as the intensity of the compliance activity increases, the compliance costs tend to rise with it.

Figure 4: Differentiation in intensity and visibility of verification activities²⁴



2.38 It should be noted that all taxpayers would normally be expected to incur a 'baseline' level of compliance costs in administering their tax affairs, such as

24 Australian Taxation Office, *Compliance Program 2008-09*, page 8.

maintaining adequate evidence of their income. Some taxpayers may seek to defer those compliance costs by, for example, not keeping records or failing to take care in accurately completing their tax returns. Conversely, taxpayers may be subject to additional compliance costs as a result of engagement from the ATO. Taxpayers who have sought to defer their baseline compliance costs by not maintaining adequate evidence of their income may subsequently find themselves incurring higher compliance costs if audited than a taxpayer who maintained adequate evidence.

2.39 The manner in which ATO compliance activities are conducted also has a direct bearing on taxpayers' compliance costs, both baseline and additional.

2.40 Both the ATO compliance model (Figure 3) and the ATO differentiation diagram (Figure 4) above highlight the importance of 'proportionality'. That is, the visibility, intensity and compliance costs imposed on the taxpayer from the compliance activity should be proportionate to the risk the taxpayer poses to the revenue and the integrity of the system. Since both models show a decreasing number of taxpayers affected by more intense compliance action, it is implicit that ATO risk assessment approaches should be just as successful at excluding compliant taxpayers from escalating compliance costs as they are at targeting non-compliant taxpayers.

The bottom of the ATO compliance model

2.41 The ATO compliance model assumes that the majority of taxpayers adopt the 'willing to do the right thing' attitude. These taxpayers are placed at the bottom of the ATO compliance model.

2.42 The ATO has strategies to 'make it easy' for these taxpayers operating businesses in cash economy industries to comply with their tax obligations – sometimes called 'help and educate' activities by the ATO.

2.43 One means by which the ATO executes these types of strategies is to make information and education products available from the ATO website. For example, the

records a small business should keep. Taxpayers can also download and use the Record Keeping Evaluation Tool which helps businesses self assess the quality of their record keeping.²⁵ From March 2000 until July 2010, the ATO also provided e-Record, which was a free electronic record keeping system. This product was withdrawn as it was no longer compatible with commercial record-keeping systems. Taxpayers were advised to adopt commercial accounting software programs.²⁶

2.44 The ATO also 'makes it easy to comply' at the bottom of the model through the availability of various ATO assistance visits. For example, the Small Business Assistance Program is taxpayer-initiated and is covered by the 'Commissioner's guarantee', meaning that any information provided to the ATO officer is confidential and cannot be used for any other purpose. Another example is through outbound contact to taxpayers in cash economy industries as part of the Cash Economy Program.

25 Australian Taxation Office, *Record keeping evaluation tool*, Australian Taxation Office, Canberra, 28 June 2012, viewed 2 July 2012, <<http://www.ato.gov.au>>.

26 Australian Taxation Office, *E-Record Withdrawal*, Australian Taxation Office, Canberra, 5 October 2010, viewed 20 February 2012, <<http://www.ato.gov.au>>.

These visits, aimed at new businesses, are not obligatory but taxpayers are encouraged to take advantage of the opportunity. The visits are not covered by the Commissioner's guarantee, however the intent of the visit is to provide the taxpayer a better understanding of record keeping. During these visits the ATO does not examine taxpayers' records for compliance purposes. Whilst these visits are a low intensity and low risk experience for the taxpayer, it is quite resource intensive for the ATO to undertake since it is a field based activity.²⁷

2.45 The ATO also runs free seminars and workshops for small businesses, including those who are thinking of starting a business and those who have just started. These include 'record keeping workshops'. These seminars are run by the Community Education and Assistance section of the ATO, rather than the Cash Economy stream.²⁸ Taxpayers can access the ATO website to either make a booking for their own group at their own venue or attend a scheduled seminar. The ATO website currently indicates that:

Due to competing priorities, we are currently unable to schedule any seminars. This will be reviewed over the coming months, with the aim of recommencing the seminars as soon as possible. We apologise for any inconvenience.²⁹

2.46 The ATO has advised, however, they aim to recommence these seminars from July 2012.³⁰

The top of the ATO compliance model

2.47 At the top of the ATO compliance model the ATO targets those who have decided not to comply with their tax obligations. These include taxpayers who have deliberately underreported their income. One of the main tools the ATO uses to detect such taxpayers is the 'cash economy risk model' which essentially uses a data matching method (described above) to ascertain whether businesses are reporting unrealistic levels of income.

2.48 Taxpayers identified under this model are usually subjected to a 'cash economy audit'. This is a field based activity which is held at the taxpayer's or tax agent's premises.³¹ These audits are intensive both in terms of scrutiny and required ATO resources. Due to such intensity, these audits are only performed on higher risk taxpayers.

The middle of the ATO compliance model

2.49 In the middle of the ATO compliance model, the ATO targets compliance activities of lesser intensity than those directed towards taxpayers with a higher risk of non-compliance. An example is the ATO's desk based correspondence audits which are selected on the basis of a business's financial performance when compared with

27 Description of Cash Economy compliance products supplied by ATO 18 January 2012.

28 Australian Taxation Office, *Speakers and seminars*, Australian Taxation Office, Canberra, viewed 13 July 2012, <<http://www.ato.gov.au>>.

29 *ibid.*

30 ATO communication to IGT received 8 February 2012.

31 Description of Cash Economy compliance products supplied by ATO 18 January 2012.

others in the same industry – that is selected on the basis of the small business performance benchmarks.

2.50 Under the benchmarking strategy, the ATO uses the taxpayer's financial performance variance from their industry benchmark as the main basis for determining the administrative treatment to which taxpayers will be subjected. The treatments vary from a help and educate letter, to a phone review, or a correspondence audit. Generally, the greater the variance, the more intense the treatment. That is, the ATO uses benchmark variance as a key risk indicator for determining a taxpayer's place on the compliance model.

HOW ATO SMALL BUSINESS PERFORMANCE BENCHMARKS ARE DEVELOPED

2.51 The ATO develops small business benchmarks for use in any particular year based on data from income tax returns and activity statements lodged with respect to that year. For example, in establishing benchmarks relevant to the 2008 income year, the ATO used income tax returns and activity statements lodged with respect to 2008.

2.52 The data from the returns and activity statements are selected for the benchmarks if they relate to taxpayers in ATO-identified cash economy industry segments. The data is then grouped according to 'ATO benchmarked industries'. These ATO benchmarked industries are derived from the industries set out in the publication *ATO Business industry codes*³². These 5-digit codes are an ATO adaptation of the Australian Bureau of Statistics' (ABS) ANZSIC codes (4-digit based). The ATO has adapted these ABS ANZSIC codes by adding a fifth digit to allow for a greater level of distinction of industries. For example, the 4-digit ABS ANZSIC code 4121 covers 'Fresh Meat, Fish and Poultry Retailing'. The ATO has used the fifth digit to distinguish between seafood, poultry and meat retailing.

2.53 In many industries, the ATO has not used the fifth digit to distinguish between sub-industries belonging to a code. For example, the ATO business industry code 41290 covers 13 listed types of 'Specialised food retailing' businesses such as bakeries, cake retailers, smallgoods retailers and confectionery retailers. None of these listed business types have their own particular 5-digit code. It is shared with the other 12 listed business types. By listing the 13 business types, the ATO assists those listed businesses to identify themselves as belonging to that shared 5-digit code. Appendix 4 provides more information about how the 4-digit ABS ANZSIC codes relate to the 5-digit ATO business industry codes.

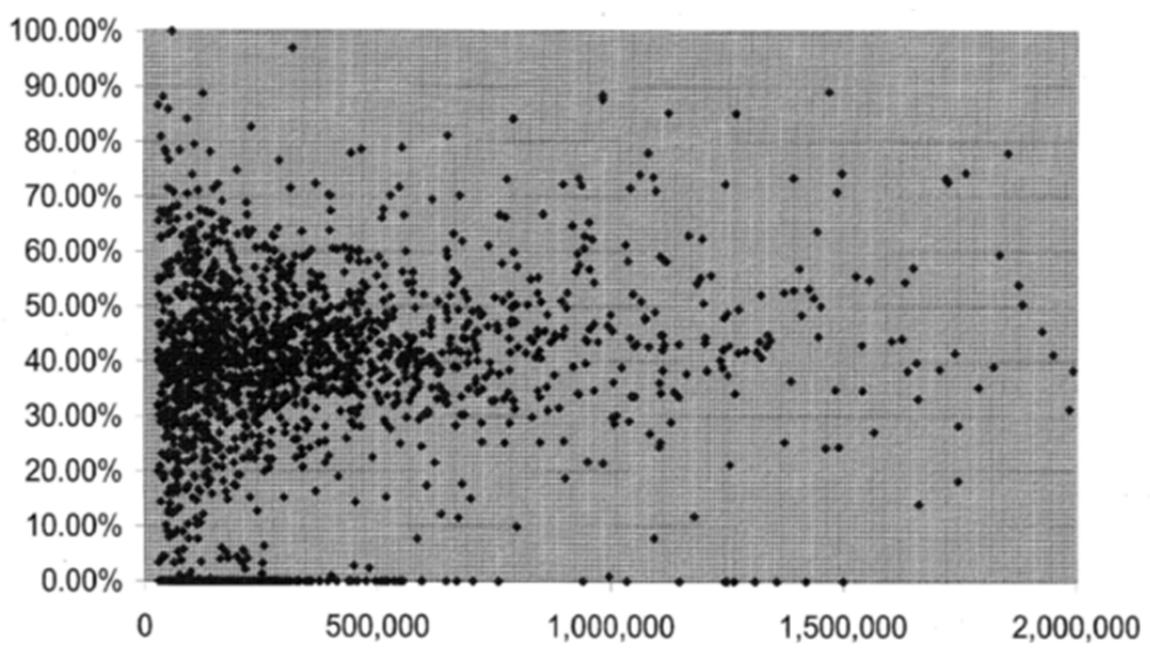
2.54 The ATO allocates businesses into ATO benchmarked industries using an automated process. The process initially uses the ATO business industry codes that taxpayers or their tax practitioners enter on the income tax return. It then examines, using keyword searches, the business descriptions and trading names provided by the businesses in their income tax returns and registration details in order to exclude businesses that appear to have entered an incorrect business industry code.

32 Australian Taxation Office, *ATO Business industry codes*, Australian Taxation Office, Canberra, 30 May 2012, viewed 2 July 2012, <<http://www.ato.gov.au>> NAT 1827-6.2012.

2.55 For the 2008 and 2009 income years, the ATO extracted data from the income tax return fields, such as cost of sales and turnover, and developed the ratios, such as cost of sales/turnover. For the 2010 income year onwards, the ATO also extracted data from activity statements to create a non-capital purchases/sales ratio, and a GST-free sales/total sales ratio.

2.56 These ratios are expressed as percentages. The ratios for each ATO benchmarked industry are collated and analysed for trends in turnover. That is, businesses in the same ATO benchmarked industry may tend to have different ratios or ratio ranges depending on their turnover sizes.³³ The following scatter graph shows that the ratios can concentrate in certain areas, and that this concentration may vary depending on the turnover.

Figure 5: Cost of sales to turnover ratio versus turnover for an ATO benchmarked industry³⁴



2.57 Once the data set of ratios has been determined and turnover ranges are assigned, the data set for each ATO benchmarked industry is cleansed of inappropriate outliers using the Mahalanobis Distance technique³⁵ which seeks to both identify and exclude taxpayers who:

- are unlikely to belong to that data set (that is, they may be in the wrong industry due to incorrect information on the income tax return or ABN application); or

³³ ATO communication to IGT 31 January 2012.

³⁴ ATO communication to IGT 30 January 2012.

³⁵ ATO communication to IGT 31 January 2012. – The Mahalanobis Distance technique is a statistical tool used to help determine whether particular data points (in this case, the ratios) properly belong to a particular set (in this case, an industry). Whilst the industry allocation technique uses the ATO business industry codes and keyword searches help to identify who belongs to an industry, the ATO's use of the Mahalanobis Distance adds an extra layer to the process to exclude those who may have selected the wrong industry, or who may have entered incorrect information in the income tax return labels.

- have ratios that are so far from the norm that there is a likely measurement error (which could be due to incorrect or inconsistent underlying information presentation in the income tax return labels, affecting ratios).

2.58 The turnover ranges are then reviewed to ensure they reflect the distribution of results after the statistical outliers have been excluded. The ranges are limited in number, usually three and sometimes two, to increase the usability of the benchmarks.³⁶

2.59 The ATO then identifies a pre-set proportion of the population around the mean, the upper and lower limits of this population representing the benchmark ratio range for that industry.

2.60 The benchmark ratios are then tested to determine whether a given benchmark ratio qualifies as a 'key performance benchmark' or an 'information performance benchmark'.

2.61 Where the population is normally distributed and homogenous and at least 50 per cent of the businesses in that ATO benchmarked industry report the source data in the tax return, the benchmark ratio based on that data qualifies as a key performance benchmark. Where the source data is reported by less than 50 per cent but more than 25 per cent of the population, the benchmark ratio based on that data qualifies as an information performance benchmark.

2.62 Where more than one benchmark ratio meets the criteria of a key performance benchmark, 'then industry knowledge and intelligence is utilised to select the most accurate predictors of turnover for an industry'.³⁷

2.63 The benchmarks are then published on the Small business benchmarks section of the ATO website.³⁸ Appendix 5 contains an example of a small business benchmark webpage for delicatessens.

2.64 On the ATO website, key performance benchmarks are referred to as 'key benchmark ratios'. Key benchmark ratios are those ratios which the ATO considers to be 'the most accurate predictor of business turnover for each industry'.³⁹ The ATO therefore uses these key benchmark ratios for risk identification purposes. It may also use the key benchmark ratio as a basis for amending assessments.⁴⁰

2.65 For example, the benchmark webpage for delicatessens for the 2009–10 income year states that a delicatessen with an annual turnover between \$65,000 and \$250,000 has a benchmark range of 53 per cent to 67 per cent. That is, for a delicatessen that

36 ATO communication to IGT 31 January 2012.

37 ATO communication to IGT 31 January 2012.

38 Australian Taxation Office, *Small business benchmarks*, Australian Taxation Office, Canberra, viewed 2 July 2012, <<http://www.ato.gov.au>>.

39 Australian Taxation Office, *Small business benchmarks - Overview*, Australian Taxation Office, Canberra, 22 May 2012, viewed 2 July 2012, <<http://www.ato.gov.au>>.

40 Australian Taxation Office, *Small business benchmarks: how we use the benchmarks*, Australian Taxation Office, Canberra, 22 May 2012, viewed 2 July 2012, <<http://www.ato.gov.au>>.

reports a cost of sales of \$100,000, the ATO would expect a reported turnover of between \$188,679 (53 per cent) and \$149,253 (67 per cent).

2.66 The ATO also publishes the information performance benchmarks for that ATO benchmarked industry. These are listed in a table titled 'benchmark ratio' on the same webpage. Businesses can use these additional information performance benchmark ratios for their own information. The ATO does not use information performance benchmarks for risk identification or amended assessment purposes.

2.67 It should be recognised that the development of benchmarks is effectively invisible to the taxpayers ultimately affected. That is, the ATO is using information already provided in tax returns and activity statements to establish the benchmarks. The process of creating benchmarks has limited compliance costs for the taxpayer or their representatives beyond their normal reporting and lodging obligations.

Cash sales benchmark and its withdrawal

2.68 Between November 2010 and April 2011, the ATO published another type of benchmark that was different to the performance benchmarks described above. This benchmark was known as the cash sales benchmark and was developed by using third party data from banks in relation to card sales (i.e debit and credit cards) and sales figures from Business Activity Statements (BASs).

2.69 The cash sales benchmark was calculated using the following formula:

(Total sales reported on BAS **minus** total credit and debit card transactions reported by banks) **divided by** total sales reported on BAS.⁴¹

2.70 In contrast to the financial benchmarks which indicate business performance (such as profitability and margins), the cash sales benchmarks simply indicate what the ATO expects a business in a given industry to receive in cash as a proportion of their total sales.

2.71 The cash sales benchmark applied to the 2009 year. The benchmark covered the following 15 industries outlined in the table below:

Table 2: Industries covered by the cash sales benchmark

Beauty services	Fuel retailing	Meat retailing and butchers
Clothing retailing	Garden supplies retailing	Newsagents
Coffee shops	Grocery retailing and general stores	Pubs, taverns and bars
Florists	Hairdressers	Restaurants
Fruit and vegetable retailing	Hardware and building supplies retailing	Takeaway food services

Source: ATO Media Release 2010/37 9 November 2010.

2.72 The ATO intended to use the cash sales benchmark to indicate the proportion of business sales which could be attributed to cash or cards. Upon launching the cash sales benchmark, the ATO said:

41 Australian Taxation Office, *Briefing – Cash sales benchmark error (dated 29/03/2011)*, supplied by ATO 23 February 2012.

Using these benchmarks, the ATO can determine the average proportion of cash sales a business should be making and which businesses are not reporting as much cash income as others in the same industry.⁴²

2.73 However, on 1 April 2011, the ATO publicly announced the withdrawal of the cash sales benchmark. The reason for the ATO's withdrawal was outlined publicly as being:

A review of the data used to calculate the cash sales benchmarks has identified inconsistencies in the way in which cash-outs paid by businesses to their customers were recorded. (An example of cash-out is when a customer requests additional cash when purchasing goods or services.) Accordingly, the ATO believes it is appropriate to withdraw the cash sales benchmarks at this stage.⁴³

2.74 At the time of withdrawal, the ATO had commenced around 1000 audits on the basis that they were outside the cash sales benchmark for two years⁴⁴ (that is, it was used as a key benchmark ratio). Before the benchmark's withdrawal, nine audits resulted in adjustments based on the cash sales benchmark.⁴⁵ These adjustments were later reversed.⁴⁶

2.75 As a result of the benchmark's withdrawal, the ATO publicly advised that:

Our current audit work involving these benchmarks we [sic] be limited to a review of taxpayers' records and where appropriate we will provide taxpayers with advice on areas where these records can be improved. We will continue to monitor their performance against benchmarks in future years.⁴⁷

2.76 The ATO has since advised the IGT that it will not be republishing the cash sales benchmark due to difficulty in obtaining consistent data on which to produce the benchmark and that it will formally publish such advice.⁴⁸

HOW THE ATO COMMUNICATED THE SMALL BUSINESS PERFORMANCE BENCHMARKS

2.77 After the small business performance benchmarks were developed, they were 'launched' during October 2009 by:

- publishing the benchmarks and explanatory information on the ATO's website;

42 Australian Taxation Office, *New ATO benchmarks focus on cash sales Media Release 2010/37*, Australian Taxation Office, Canberra, 9 November 2010.

43 Australian Taxation Office, *Cash sales benchmark withdrawn 1 April 2011 – Tax agent and BAS agent broadcast*, Australian Taxation Office, Canberra, 1 April 2011.

44 Australian Taxation Office, *Briefing – Cash sales benchmark error (dated 29/03/2011)*, supplied by ATO 23 February 2012.

45 Australian Taxation Office, *Update on status of Cash Sales Benchmark Casework* internal report dated 22 March 2012, supplied by ATO 22 March 2012.

46 *ibid.*

47 Australian Taxation Office, *Cash sales benchmark withdrawn 1 April 2011 – Tax agent and BAS agent broadcast*, Australian Taxation Office, Canberra, 1 April 2011.

48 ATO communication to IGT, 7 June 2012.

- referring to them in speeches by ATO executives and electronic communication to tax practitioners;
- distributing flyers to small businesses during assistance visits from ATO staff; and
- distributing fact sheets to industry associations.

2.78 After October 2009, additional communication of the performance benchmarks included:

- articles in the ATO's *The TAXAGENT* magazine;
- electronic communication to BAS service providers and state-based small business education networks; and
- discussion in various ATO consultative forums.

2.79 The small business benchmarks remain on the ATO website. When launched in October 2009 and throughout 2010, the small business benchmarks related to the 2008 income year. In 2011, the ATO updated the benchmarks to reflect income tax returns and activity statements for the 2009 income year. In February 2012, the ATO further updated its website to reflect income tax returns and activity statements for the 2010 income year.

HOW THE ATO USES THE BENCHMARKS FOR COMPLIANCE ACTIVITIES

2.80 Once the benchmark ranges have been established, the ATO compares the ratios of businesses within the ATO benchmarked industries to see who is within them, and who is outside of the benchmarks. The ATO is only concerned with businesses that underreport income. So, by way of example, a delicatessen with cost of sales of \$100,000, if it reported a turnover of \$200,000, then its cost of sales/turnover ratio is 50 per cent, which is below the benchmark and does not represent an underreporting risk.

2.81 Out of the 900,000 businesses that were the subject of benchmarking, the ATO identified 76,000 that were 'significantly outside the benchmark' and, therefore, represented an underreporting risk.⁴⁹

2.82 The ATO advises that it uses the performance benchmarks as a basis for case selection for a number of different types of compliance activities or 'products', that is bulk mail outs, record keeping assistance, phone reviews, record keeping audits and correspondence audits. The type of compliance activity a taxpayer is subjected to may depend upon the variation from the key performance benchmark. For cash economy audits, in addition to the benchmarks, the ATO uses the cash economy risk model as a basis for case selection.

⁴⁹ Australian Taxation Office, *ATO Small business benchmarks: Promoting a level playing field for Australian small business*, November 2011, supplied by ATO 24 November 2011.

2.83 The ATO has provided the table below (cash economy benchmark products) which provides an overview of the different compliance products the ATO uses. It should be noted that the table lists different types of 'outcomes' arising as a result of the compliance activity, including those that do not give rise to an adjustment of tax liability. However, the ATO's use of the term 'outcome' for the purposes of its reporting has a specific meaning – that is cases where a taxpayer's liability has been adjusted or a taxpayer has lodged an outstanding return as a result of the compliance activity. Each of these compliance products are described further below.

Table 3: Overview of benchmarking activities⁵⁰

Products	Form	Purpose	Outcome	Focus	Case source or general information
Bulk mail out	Letter	Help & educate; Encourage voluntary compliance	No further action / voluntary disclosure	Record keeping, help to comply	Benchmarks / Industry specific
Record keeping assistance	Field, voluntary	Help & educate; Encourage voluntary compliance	Help & educate	Record keeping, help to comply	New to business and low risk taxpayers from the risk model or slightly outside benchmarks
Phone review	Desk	Confirm entity & business description; Risk assessment	No further action; Escalation; Voluntary disclosure; Identify correct entity	Lodgment; Record keeping; Omitted income	Outside benchmarks, risk model, and third party data population
Record keeping audit	Desk and field	Help and educate and Compliance	No further action; Record keeping penalty with no, part, or full remission; Escalation	Record keeping	Outside benchmarks risk model population and cash economy analytical model population
Correspondence audit	Desk	Compliance	No further action; Lodgment; Amendment; Default assessment; Imposition and consideration of false and misleading statement penalty; Escalation for prosecution	Omitted income	Outside benchmarks
Specific audit field	Field	Compliance	No further action; Lodgment; Amendment; Default assessment; Imposition and consideration of false and misleading statement penalty; Escalation for prosecution	Omitted income	Internal and external referrals and escalations and third party data
Cash economy audit	Field	Compliance	No further action; Lodgment; Amendment; Default assessment; Imposition and consideration of false and misleading statement penalty; Escalation for prosecution	Omitted income	Highest risk scored population from the risk model.

50 ATO table supplied to IGT, 29 May 2012.

Bulk mail out letters program

2.84 During 2010, the ATO began compliance action based on the benchmarks for the first time. From May to December 2010, letters were sent to 37,847 taxpayers and to 20,967 of their tax agents (where the taxpayer indicated they had one) under a 'bulk mail out' letters program. The letters informed the taxpayer that they were outside the benchmarks and they ought to review their records to ensure all income (especially cash sales) had been disclosed.

2.85 The letter also indicated that:

If your business is selected for an audit or review, we may use the small business benchmarks to calculate your income tax or goods and services tax.⁵¹

2.86 If a business found an error in their records, then they were invited to disclose the error using an enclosed form. If the business was satisfied that their records were accurate and supported their tax returns, no further action was required.

2.87 The ATO focused on record keeping since 'a clear link exists between compliance with tax obligations and good record-keeping practices'.⁵²

2.88 Of these letters, 938 taxpayers made voluntary disclosures about errors they found when they reviewed their own records. Taxpayers made self-adjustments to their own BAS or income tax return in 187 cases. A large proportion, however, (9796 or around 26 per cent of recipients) responded to the ATO with a letter stating that their records and returns were correct, and provided reasons for why their businesses were outside of the benchmark.

2.89 In 2011, similar letters were sent to 22,344 taxpayers and to 9,660 of their tax agents. The letters informed the taxpayer of tools and services available to assist them with their record keeping obligations. The ATO advises that the majority of these letters (16,107) were sent to taxpayers in the coffee shop and plastering industries, as part of a separate ATO focus, and the remainder were sent to taxpayers in other industries that were outside benchmarks. These letters did not invite taxpayers to respond and did not include a response form. The letter did, however, provide information to the taxpayer on how they could notify the ATO if they identified an error or omission. As a consequence of this, very few responses were received.

Table 4: Bulk mail out letters program 2010 and 2011

	Taxpayer letters sent	Tax agent letters sent	Responses	Voluntary disclosure	Self adjustment
2010 Letters	37,847	20,967	9,796	938	187
2011 Letters	22,344	9,660	15	0	0

Source: Based on ATO data provided to IGT on 23 December 2011 and 31 May 2012. This table is a compression and combination of separate tables provided by the ATO.

51 Sample of ATO bulk mail out letter, sent to taxpayers on 20 September 2010. Supplied by ATO 23 December 2011.

52 Australian Taxation Office, *Compliance Program 2011-12*, page 12.

2.90 The ATO reports that during 1 July 2010 to 30 October 2011, around 3000⁵³ letter recipients made self-amendments to one or more of their BASs, while another 880 made voluntary disclosures of around \$2.6 million.⁵⁴

Record keeping assistance visits

2.91 The ATO has advised that its cash economy staff carry out record keeping assistance visits to 'new to business' and low risk taxpayers. The ATO initiates the visit by contacting the taxpayer by phone and explaining the purpose of the visit. The taxpayer is not obliged to accept the offer.

2.92 If accepted, the ATO officer will arrange a time and place as the visit is conducted at the taxpayer's premises. The visit focuses solely on the taxpayer's record keeping system and the officer does not examine the taxpayer records themselves unless requested by the taxpayer.⁵⁵

Phone reviews

2.93 Phone reviews are at the lower end of intensity of the ATO's compliance products. They are not carried out for the purpose of a financial outcome. The purpose of ATO phone reviews is to contact taxpayers to:

- confirm that the ATO business industry code and business description are correctly reported by the taxpayer;
- identify where the income from identified activity has been reported; and
- ensure business entities are aware of the need to meet their record keeping obligations and offer assistance in doing so.⁵⁶

2.94 At the conclusion of the phone review, the ATO officer records the information in Siebel (the ATO's case management system) and ends the compliance activity. The ATO officer may include in Siebel a recommendation that the reviewed taxpayer undergo a 'correspondence audit'. The information is then collated by the Cash Economy Risk & Strategy committee which then assesses the information and makes a decision on whether to escalate the case to a correspondence audit. Correspondence audits are discussed below.

2.95 After feedback from taxpayers and tax practitioners, the phone review was modified and restarted in April 2011. As a result:

- fewer questions are asked (now a maximum of 10 questions);
- the review takes about 15 minutes to complete, compared to 30 – 40 minutes previously;

53 These amendments were made regardless of whether the taxpayer formally notified the ATO of their intention to do so. Those that did notify the ATO are reflected in table 4.

54 Australian Taxation Office, *ATO Small business benchmarks: Promoting a level playing field for Australian small business*, November 2011, supplied by ATO, 24 November 2011.

55 ATO communication to IGT, 31 May 2012.

56 Description of Cash Economy compliance products supplied by ATO, 18 January 2012.

- tax agents can complete the review on behalf of taxpayers (they were originally designed to be answered specifically by the taxpayer⁵⁷); and
- the questions were published on the ATO website.⁵⁸

2.96 Commencing in January 2010, the ATO conducted a total of 9839 phone reviews up to April 2012. Since the phone review is designed to collect information and raise awareness of tax obligations, rather than directly detect underreported income, minimal outcomes are reported.

Table 5: Phone reviews

Phone reviews by financial year ⁵⁹	Nil outcome	Outcome
July 2010 — June 2011	5508	5
July 2011 — April 2012	4321	5
Total	9829	10

Phone reviews between versions ⁶⁰	Nil outcome	Outcome
July 2010 — April 2011(v1)	4771	3
April 2011 — April 2012(v2)	5058	7
Total	9829	10

Source: Table is compiled by the IGT from the ATO spread sheet data supplied on 23 December 2011 and 31 May 2012. These figures exclude early exit cases. Version 1 and Version 2 phone reviews are separated by the date 18 April 2011, when the revised phone review was introduced.

Record keeping audits

2.97 The ATO uses a ‘GST analytical model’ and the ‘Cash economy risk model’ to assist in selecting taxpayers for a record keeping audit. This compliance activity has both an educational and compliance nature to it.⁶¹

2.98 ATO officers call selected taxpayers and ask about their record keeping systems. ATO officers then, with the aid of a record keeping questionnaire document, make evaluations on the adequacy of the business’s record keeping systems and make recommendations to the business on improvements they need to make. ATO officers send the recommendations to taxpayers, along with the ATO guide *Record keeping for small business*.⁶²

57 ATO communication to IGT, 23 December 2011.

58 Australian Taxation Office, *Cash economy frequently asked questions: Cash economy phone review*, Australian Taxation Office, Canberra, 21 February 2012, viewed 23 February 2012, <<http://www.ato.gov.au>>.

59 July 2010 – June 2011 contained 31 cases listed as having an outcome, but only 5 of these cases reported revenue or lodgment against them. The remaining 26 cases have been added to the 5482 nil outcome cases. July 2011 – April 2012 contained 150 cases listed as having an outcome, but only 5 of these cases reported revenue or lodgment against them. The remaining 145 cases have been added to the 4176 nil outcome cases.

60 July 2010 – April 2012 contained 20 cases listed as having an outcome, but only 3 of these cases reported revenue or lodgment against them. The remaining 17 cases have been added to the 4754 nil outcome cases. April 2011 – April 2012 contained 161 cases listed as having an outcome, but only 7 of these cases reported revenue or lodgment against them. The remaining 154 cases have been added to the 4904 nil outcome cases.

61 ATO Record Keeping Audit Product Committee Minutes February 2011, supplied by ATO, 2 March 2012.

62 Australian Taxation Office, *Record keeping for small business* (NAT 3029), Australian Taxation Office, Canberra, May 2011.

2.99 After giving taxpayers one month to make improvements, ATO officers then follow up the recommendations with a field visit to see if the improvements have been implemented. If they have not, ATO officers may issue taxpayers with a record keeping penalty of up to \$2200. The detection of underreported income or the amendment of tax returns or business activity statements is not the main purpose of record keeping audits. The primary purpose is to improve record keeping standards in the community.⁶³

2.100 Under the benchmarking strategy, the ATO conducted 927 record keeping audits starting in March 2010. It should be noted that where taxpayers have financial performance that falls outside the performance benchmarks by a certain range they will not be selected for a record keeping audit, but may instead be selected for a correspondence audit.⁶⁴

Correspondence audits

2.101 Correspondence audits are a desk based activity where the ATO officer does not visit the taxpayer's premises during the course of the audit.

2.102 Before a taxpayer is contacted, an ATO officer will conduct some initial research to confirm the industry and business of the taxpayer and the applicability of the benchmark.

2.103 If the ATO determines that the wrong benchmark was applied, the audit may be closed before the taxpayer is contacted. Cases closed in this manner are known as 'early exit' cases.

2.104 Where the ATO officer is satisfied that the correct benchmark has been applied, the ATO officer will send an 'audit confirmation letter' to the taxpayer or their representative, notifying them of the commencement of the correspondence audit. See Appendix 6 for a sample of an audit confirmation letter. The audit confirmation letter requires the taxpayer to send sales records to the ATO for a sample quarter, usually April to June. The expected records include cash register reports, bank statements, daily sales summaries and reconciliations. Seven to ten days after the letter has been sent, the ATO auditor calls the taxpayer or their representative to discuss the audit and in particular:

- the nature of the business of the taxpayer, to ensure the correct benchmark has been applied;
- the reasons for variation from the benchmark;
- what kind of records the taxpayer must submit and why the taxpayer is being audited; and

63 Australian Taxation Office, *Penalties for not keeping records: what is our approach to record keeping and penalties?*, Australian Taxation Office, Canberra, 25 August 2010, viewed 2 July 2012, <<http://www.ato.gov.au>>.

64 ATO case selection methodology supplied 23 February 2012.

- to ensure that the taxpayer is able to submit the records by the due date (initially 28 days from the letter being received) or to negotiate a new due date where appropriate.

2.105 Once the ATO receives the records, the auditor assesses their quality and completeness to determine whether the sales figures reported in the BAS and income tax returns are supported. In making that determination, ATO officers are guided by:

- Taxation Ruling *TR 96/7 Income tax: record keeping – section 262A – general principles*;
- the ATO publication *Record keeping for small business guide*;
- the ‘Record keeping questionnaire’, an internal document; and
- ‘Record keeping audits – development guidelines’, an internal training document.⁶⁵

2.106 Where the records do not support the BAS or income tax return figures, the ATO auditor contacts the taxpayer to request further documentation to substantiate the sales figures. If the taxpayer does not provide any more records to substantiate the sales figures, the ATO officer issues an interim report to the taxpayer after it is approved by their team leader.

2.107 The interim report informs the taxpayer of the likely assessment if no further information is provided. The report usually applies the key benchmark to the taxpayer’s reported cost of sales or total expenses to determine a new sales or business income figure and related amended assessment. It also outlines any applicable penalties.

2.108 For example, in the case of a delicatessen with a reported cost of sales of \$100,000 and a reported turnover of \$125,000, it would have a cost of sales/turnover ratio of 80 per cent. The 2010 benchmark range for the delicatessen is 53 per cent to 67 per cent. The ATO is, therefore, expecting the delicatessen to report a turnover between \$149,253 (67 per cent) and \$188,679 (53 per cent). Should the delicatessen not have satisfied earlier ATO enquiries and not have had adequate records to support their business income figure, the ATO would apply the top of the benchmark range to the taxpayer’s reported cost of sales to derive a new business income figure of \$149,253.

2.109 The interim report gives the taxpayer an opportunity (14 days) to refute the ATO’s position and respond with any further records to substantiate the reported sales. Where the taxpayer does not respond, or their response is not satisfactory for the ATO, the audit is completed and the ATO officer sends the taxpayer an ‘audit finalisation letter’. If the ATO’s position has not changed since the interim report, the finalisation letter confirms that it will be making adjustments according to the interim report.

65 ATO communication to IGT, 23 January 2012.

2.110 The taxpayer may respond to the interim report with evidence advocating a different method of adjusting the income tax returns and BASs. If accepted, the finalisation letter may indicate acceptance of that method. The income tax returns and business activity statements are then adjusted in accordance with the finalisation letter. In either case, this is what the ATO calls a 'default assessment'.

2.111 If at any point, the auditor decides (in consultation with their team leader) that the records adequately evidence the taxpayer's BAS and income tax return figures, the audit can be finalised with no further action.⁶⁶ Furthermore, where the records are adequate, but the auditor identifies deficiencies or weaknesses in the taxpayer's record keeping, the finalisation letter to the taxpayer will also make recommendations to improve their record keeping.

2.112 Beginning in May 2010, the ATO began these correspondence audits on taxpayers whose financial performance was significantly outside the benchmarks. The first round of correspondence audits concerned the 2008 income year and relied on the 2008 small business benchmarks.

2.113 These taxpayers were outside the benchmarks to the extent that they were considered a higher risk, such that an advisory letter and phone review (discussed above) alone was considered not enough to address the risk. In this sense, the ATO has effectively placed these taxpayers higher up the ATO compliance model than those taxpayers who only received a letter or a phone call, but lower down the model than those who undergo a 'cash economy audit'.

2.114 The following table shows that overall, just under one quarter of correspondence audits resulted in an outcome.

Table 6: Completed correspondence audits July 2010 to April 2012

Year	Nil outcomes	Outcomes	Total	Outcomes as a percentage of total cases(a)
July 2010 — June 2011	3622	1104	4726	23.4%
July 2011 — April 2012	2169	775	2944	26.3%
Total	5791	1879	7670	24.5%

Source: Figures compiled by IGT from ATO spread sheet data supplied to IGT 23 December 2011 and 31 May 2012.

Note (a): Total cases = Nil outcomes + Outcomes.

Specific audits

2.115 The ATO also has advised that it conducted 'Specific audits' under the benchmarking strategy. There are two types of specific audits, only one of which is conducted within the benchmarking program. The first type is aimed at 'testing reporting of specific third party data transactions'⁶⁷ and is a field based activity. These audits would either result in no further action, an amended assessment or an escalation to a cash economy audit. These cases are non-benchmark related.

⁶⁶ Australian Taxation Office, *Taxpayers who are outside benchmarks – end to end process*, supplied by ATO, 24 November 2011.

⁶⁷ Description of Cash Economy compliance products supplied by, ATO 18 January 2012.

2.116 The second type of specific audit is 'to make amendments to the directors or partners' individual income tax returns as a result of compliance action relating to company or partnership returns.'⁶⁸ These cases are flow-on adjustments from benchmarking cases. These would usually result in an amended assessment. The ATO conducted 143 such specific audits under the benchmarking strategy since January 2010.

Cash economy audits

2.117 The ATO also conducts cash economy audits under the benchmarking strategy. Taxpayers would only be subject to a cash economy audit under the benchmarking strategy if they also met the requirements under the cash economy risk model, or during another compliance activity (for example a correspondence audit), where evidence emerged to justify an escalation to a cash economy audit. The ATO has conducted 276 cash economy audits under the benchmarking strategy since March 2010.

Summary of benchmarking activities

2.118 The following table illustrates the number of compliance activities associated with benchmarking from January 2010 to April 2012. As discussed above, cases which are recorded as an 'early exit' are where the compliance activity was created on ATO systems but closed before taxpayer contact was made.

68 Description of Cash Economy compliance products supplied by ATO, 18 January 2012.

Table 7: Summary of benchmarking strategy activities from January 2010 to April 2012.

Intensity and type	Product	Early exit	Nil Outcome	Outcome	Total initiated cases (a)	Early exit rate (b)	Total completed cases (c)	Strike rate (d)	Planned strike rate (e)	Objections	Objection rate (f)	Liabilities raised (g)
Highest (field, compliance)	Cash Economy Audit	65	133	143	341	19%	276	52%	60%	17	12%	\$5,856,166
(field, compliance)	Specific Audit	7	41	102	150	4%	143	71%	70%	14	14%	\$2,552,445
(desk, compliance)	Correspondence Audit	457	5791	1879	8127	6%	7670	24%	32%	235	13%	\$57,097,719
(field+desk, compliance)	Record keeping audit	526	823	104	1453	36%	927	11%	40%	3	3%	\$652,301
(desk, compliance)	Phone review	374	9829(h)	10	10213	4%	9839	<1%	0%	0	0	\$117,358
Total compliance (i)		1430	16448	2420	20298		18868			269		\$66,488,591
(letter, advisory)	Bulk mail out letters program 2010	n/a	n/a	n/a	37847 (j)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Lowest (letter, advisory)	Bulk mail out letters program 2011	n/a	n/a	n/a	22344 (j)	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Source: Figures compiled by IGT from ATO spread sheet data supplied 23 December 2011 and 31 May 2012.

Note (a): Total initiated cases = Early exit + Nil outcome + Outcome

Note (b): Early exit rate = Early exit / Total initiated cases

Note (c): Total completed cases = Nil outcome + Outcome

Note (d): Strike rate = Outcome / Total completed cases

Note (e): Source: 2011-12 Cash Economy Staff Allocation and Case Numbers, supplied by ATO, 23 February 2012.

Note (f): Objection rate = Objections / Outcome

Note (g): Liabilities raised = GST + 'other heads of revenue' including income tax. Liabilities in this column excludes penalties.

Note (h): ATO data initially indicated 9658 nil outcome cases and 181 outcome cases. However only 10 outcome cases had liabilities or lodgments recorded against them. The IGT has classified the remaining 171 cases nil outcome cases and added them to the nil outcome figure.

Note (i): Totals may be affected by the phone review product, which may not give a representative indication of the rest of the compliance products

Note (j): Figure excludes letters also sent to the taxpayers' representatives

2.119 It is apparent from the above table that, of the products designed to identify omitted income, the most frequently used product was the correspondence audit. By contrast, cash economy audits are the most intensive product but were low in number compared to correspondence audits. In terms of coverage, the bulk mail out letters program reached the most number of taxpayers.

2.120 The majority of submissions from stakeholders related to correspondence audits. We also received significant feedback on the phone reviews and the bulk mail out letters program. Whilst correspondence audits attracted the highest number of objections, they accounted for 13 per cent of outcome cases compared to a 12 per cent objection rate for cash economy audits.

2.121 The timeline below indicates when various benchmarking activities commenced.

Figure 6: Timeline of benchmarking activities



2.122 The timeline indicates that the bulk mail out letters program commenced at the same time that correspondence audits were initiated, and six months after the ATO launched the benchmarks. It should be noted that a second bulk mail out letters program was issued in October and November 2011.

2.123 The Cash Economy Plan 2011-12 shows how many full time equivalent (FTE) staff were allocated to the various compliance activities, how many cases were planned and how much revenue was expected. The plan originally broke up the products into their respective heads of funding (that is business as usual, 2009 Federal Budget Funding and 2010 Federal Budget Funding). For convenience, however, they are combined in the table below:

Table 8: Cash Economy Plan 2011–12

Product	FTE	Planned Cases	Planned Revenue (a)	Average FTE per \$10m in planned revenue(b)	Planned Average revenue per case (c)	Actual average revenue per completed case (d)
Cash economy audits	172.89	670	\$28.9m	59.82	\$43,134	\$25,832
Specific audits	19.71	360	\$5.5m	35.84	\$15,277	\$10,546
Correspondence Audits	139.19	4567	\$61.4m	22.67	\$13,444	\$8210
Record keeping audits	41.24	2260	\$0	n/a	\$0	\$171
Phone reviews	9.3	8858	\$6m	15.5	\$667	\$15

Source: Table compiled by IGT from data provided by ATO 23 February 2012.

Note (a): GST and Income tax excluding penalties in millions of dollars rounded up to the nearest \$100,000.

Note (b): These figures were calculated by the IGT as (FTE / Planned Revenue) x 10.

Note (c): These figures were calculated by the IGT. This is assumed to be the average per 'completed case', being those that include outcomes and nil outcomes.

Note (d): These averages were derived by the IGT from Table 7 above being Liabilities raised / Total completed cases.

2.124 It should be noted that the above activities are in relation to all of Cash Economy's activities, not just the benchmarking strategy. The ATO has advised the IGT, however, that the vast majority of correspondence audits and phone reviews were part of the benchmarking strategy. Conversely, record keeping audits, specific audits, and cash economy audits can all be initiated via other means and not just the benchmarking strategy.

2.125 The column 'average revenue per case' highlights that correspondence audits were not intended to raise as much revenue per case compared to cash economy audits. Cash economy audits are undertaken where the risk identified is greater, using the cash economy risk model.

2.126 It is also important to note, however, that the average cost of conducting a correspondence audit (in terms of FTE audit staff) is much lower than that for cash economy audits. So whilst correspondence audits are anticipated to yield less revenue per case, the ATO may conduct many more of these audits.

2.127 When compared to the results of actual cases conducted between January 2010 and November 2011, it can be seen that the average liabilities raised per completed case is lower than planned. This is particularly so for the 'higher risk' cash economy audits, and the 'higher volume' correspondence audits.

RECORD KEEPING

2.128 As discussed above, the focus of the ATO's benchmarking compliance activities is to ensure businesses report all their income and to verify that the businesses have sufficient records to evidence this income. Where the ATO considers that a business does not have adequate evidence (including those records that would meet the ATO's record keeping requirements), the ATO may decide to issue a default assessment. Thus, one of the key issues in determining whether income has been omitted is whether there is adequate evidence to substantiate the business's income. Keeping appropriate records provides one of the strongest forms of evidence.

2.129 Under self-assessment, taxpayers are not required to send documentation to the ATO to substantiate the figures they report in their BAS and income tax returns.

Nevertheless, section 262A of the *Income Tax Assessment Act 1936* (ITAA 1936) requires a person carrying on a business to, amongst other things:

(1) [to] keep records that record and explain all transactions and other acts engaged in by the person that are relevant for any purpose of this Act.

(3)(b) [to] keep the records so as to enable the person's liability ... to be readily ascertained ...

(4)(a) [to] retain those records until ... the end of 5 years after those records were prepared or obtained, or the completion of the transactions or acts to which those records relate, whichever is the later.

2.130 The retention of taxpayer records allows the ATO to undertake verification activities after lodgment to ensure that the figures that taxpayers report in their returns are correct.

2.131 The ATO issued *Taxation Ruling TR 96/7 Income tax: record keeping – section 262A – general principles*. This ruling sets out the kinds of records the ATO expects various types of businesses to keep.

2.132 Additionally, the ATO publishes educational materials to assist businesses with record keeping. This is due to the ATO identification of micro business record keeping as a systemic risk.⁶⁹ It therefore focuses its education activities on record keeping to help taxpayers to record and report all of their income and expenses so that it can be easily verified.

2.133 Whilst record keeping is the responsibility of the business owner (especially since most records are created when business transactions are performed by the business owner), several other stakeholders may be involved in the record keeping of the business. For example, some micro businesses may regularly engage a professional bookkeeper to ensure their records are correct and up to date (43 per cent according to ATO research⁷⁰). Many businesses also engage an accountant (79 per cent) for a number of reasons, including record keeping. Importantly, 93 per cent of all micro business tax returns are lodged by registered tax agents and 50 per cent use BAS agents to lodge activity statements.

2.134 It should be noted that the ATO's ability to initially verify the correctness a taxpayer's records is limited to the information to which the ATO has access. Whilst the ATO has direct access to a broad range of data sourced from taxpayer returns and many external third party sources, the ATO may need to request a broad range of records and responses directly from taxpayers.

⁶⁹ ATO Strategic Risk Register: Compliance; Risk SR2/2 - Issued August 2011.

⁷⁰ GfK bluemoon, *Profiling the micro business segment communication and information needs*, Final Report prepared for the Australian Taxation Office November 2008, viewed 20 February 2012, <<http://www.ato.gov.au>>.

CHAPTER 3 — DEVELOPMENT AND COMMUNICATION OF ATO BENCHMARKS

3.1 As stated earlier, overall, stakeholders were supportive of the use of benchmarks to target non-compliant taxpayers, subject to some important reservations that are set out further below.

3.2 In their support of benchmarks, taxpayers and tax practitioners recognised that the ATO needs an effective risk identification approach and supported the need for a level playing field as taxpayers were concerned with non-compliant taxpayers gaining an unfair advantage over them. In this respect, stakeholders considered that the use of benchmarks was an appropriate approach conceptually as it could exclude from ATO compliance activities those taxpayers that were more likely to be compliant. This was generally considered to be better than conducting random audits.

3.3 Certain tax agents also advised that their advice to certain clients to improve their record keeping did not always appear to have been readily acted upon, until the taxpayer was subject to ATO compliance activity. Accordingly, these tax agents believed that appropriate awareness strategies that are cooperatively effected by the ATO in conjunction with tax agents and advisors was a helpful approach.

3.4 Stakeholders, while generally supportive of the ATO's use of benchmarks for risk identification purposes did not, however, support their use as a basis for amended assessments. Concern was also raised about the communication and delivery of the benchmark program. It was felt that the approach could have been delivered in a more effective, positive and less invasive manner. Issues of seeking to take a more cooperative approach were also raised by tax advisors in particular.

3.5 These concerns raised questions about how the benchmarks are developed, such as the accuracy and applicability of the benchmarks upon which ATO activity in this area is very much reliant. The broader issues underlying these questions relate to the transparency of a robust benchmark methodology and the data integrity of the benchmarks' inputs. Aspects of these issues are discussed below.

TRANSPARENCY — COMMUNITY CONFIDENCE IN HOW THE ATO DEVELOPS ITS BENCHMARKS

3.6 All submissions to the review raised concerns about the ATO's methodology in developing the benchmarks.

3.7 Firstly, stakeholders expressed concern that there was little publicly available material that could give assurance that the ATO's methodology for developing the benchmarks was robust. In this respect, although the ATO's website publishes benchmark figures and mentions that the data is sourced from income tax returns and activity statements, it provides little extra information about the methodology for determining the benchmarks. However, it should also be noted that subsequent to submissions being received in this review, the ATO has changed its website to reveal

more information about how the benchmarks are formed, and how the ATO uses them.⁷¹

3.8 Secondly, submissions asserted that the benchmarks do not account for business differences within an industry or for geographic differences. Many submissions also referred to the ATO's withdrawal of the 'cash sales benchmark' as evidence that the underlying methodology is questionable.

3.9 As a result, these submissions argued, the adverse impacts included:

- exposing certain compliant taxpayers to unnecessary compliance costs; and
- improperly basing amended assessments on benchmarks without specific evidence pertinent to the taxpayer.

3.10 These stakeholder concerns are discussed below.

Public assurance that the benchmark methodology is robust

3.11 In relation to providing assurance that the benchmark methodology is robust, the ATO advises that it had conducted an internal review of the benchmarking methodology in June 2011. This review was conducted by the Revenue Analysis Branch (RAB),⁷² being a branch within the ATO that possesses statistical expertise. This branch is also separate from the TPALS and Cash Economy operations, the area conducting the benchmarking compliance activities. The review found that 'the overall process is sound and the results are robust'⁷³. The review also, however, recommended changes be made to:

- improve the statistical soundness of the calculations;
- provide more reliable data; and
- ensure that the population is normally distributed and homogeneous and, where it is not, to either not publish the benchmark or do so with qualifications.⁷⁴

3.12 The ATO implemented these changes during the course of the internal review.⁷⁵

3.13 Although the ATO has conducted this recent internal review, in discussions during the review, the ATO indicated its openness to an independent third party reviewer with statistical expertise analysing the benchmark methodology. Such a review could consider whether the methodology is statistically robust.

71 Australian Taxation Office, *Small business benchmarks – overview*, Australian Taxation Office, Canberra, 21 February 2012 <<http://www.ato.gov.au>>.

72 ATO communication to IGT, 31 January 2012.

73 ATO internal minute from RAB to Cash Economy Risk and Strategy dated 27 June 2011 supplied by ATO 31 January 2012.

74 *ibid.*

75 *ibid.*

3.14 It should be noted that the issue of whether the benchmarks themselves predict likely non-compliance is discussed in the next chapter.

IGT observations

3.15 It is important for the ATO to give public assurances about the processes used to create the benchmarks, such as publishing the methodology for developing benchmarks and the related assumptions. Such transparency would, in the IGT's view, be helpful in addressing certain stakeholders concerns and improving community confidence in the benchmarking methodology. This is especially pertinent since key benchmark ratios are used not only for audit selection, but also for taxpayer default assessments in those circumstances where the taxpayer has not provided acceptable evidence to support their reported income.

3.16 In doing so, however, there is a tension between the need for transparency, requiring the ATO to publish as much information as possible about how the benchmarks are developed and the risk that the disclosure of too much specific detail may lead to manipulation to avoid detection. Notwithstanding the recent updates to the ATO's website, the ATO could publish and better explain its methodology to allay concerns as far as it can and only reserve on those aspects that may give rise to a genuine and specific manipulation risk.

3.17 In relation to providing independent assurance that the benchmark methodology is robust, the IGT notes that New Zealand's Inland Revenue Department (IRD) has recently published industry performance benchmarks⁷⁶ which were developed by Statistics New Zealand and not the IRD itself.

3.18 In this respect and to further increase confidence in the benchmarks, the ATO could seek independent assurance from ABS or other appropriate independent third party assurer with statistical expertise, that the data and methods used to develop benchmarks are robust from a statistical perspective. The ATO could then publish that assurance on its website.

Industry and business differences

3.19 As referred to above, stakeholders asserted that the benchmarks do not appropriately take into account the various differences between businesses in a given industry that may affect their financial performance, including:

- different business models, such as online retailing versus bricks and mortar retailing;
- different entity types, such as companies and sole traders; and
- different business activities, such as those businesses spanning two or more industries.

⁷⁶ New Zealand Inland Revenue (IRD), *Industry benchmarks: About industry benchmarks*, IRD, Wellington, 19 April 2012, viewed 2 July 2012, <<http://www.ird.govt.nz>>.

3.20 One solution offered in submissions was to have a wider range of industry codes and divide some industries into smaller segments, each with their own benchmark ratios.

3.21 However, the ATO has advised that this render the benchmarks statistically invalid where the numbers in their segments are small. On its website,⁷⁷ the ATO announced it had removed some smaller segments that were applicable in the 2008 year and subsumed them into a wider category for the 2009 year. For example, for the 2008 year the take away food services industry included eight separate benchmarks for the following businesses:

- chicken shops;
- fish and chip shops;
- ice cream retailing;
- kebab shops;
- sandwich shops;
- sushi shops;
- takeaway pizza shops; and
- take away food services (not otherwise captured by the above benchmarks).⁷⁸

3.22 For the 2009 year, the sushi shops and sandwich shops benchmarks were subsumed into the takeaway food services industry benchmark.

3.23 The ATO advised that the reasons for subsuming the sushi shops and sandwich shops into the takeaway food services benchmarks for the 2009 year included the following:

Our analysis of the 2009 year financial data in respect of sushi and sandwich shops showed that the population size for that year was too small to pass the homogeneity and minimum population tests that all the key benchmarks must satisfy. As the sushi and sandwich shops are part of the takeaway foods industry, a decision was made to include those business types into takeaway foods.⁷⁹

3.24 A comparison between the benchmark ranges for sushi shops and sandwich shops with takeaway food services for the 2008 year can be made and are set out in the table below.

77 Australian Taxation Office, *Cash economy frequently asked questions: Cash economy phone review*, Australian Taxation Office, Canberra, 21 February 2012, viewed 23 February 2012, <<http://www.ato.gov.au>>.

78 Australian Taxation Office, *Takeaway food services – issued 2010*, Australian Taxation Office, Canberra, 7 October 2011, viewed 2 July 2012, <<http://www.ato.gov.au>>.

79 ATO communication to IGT, 20 March 2012.

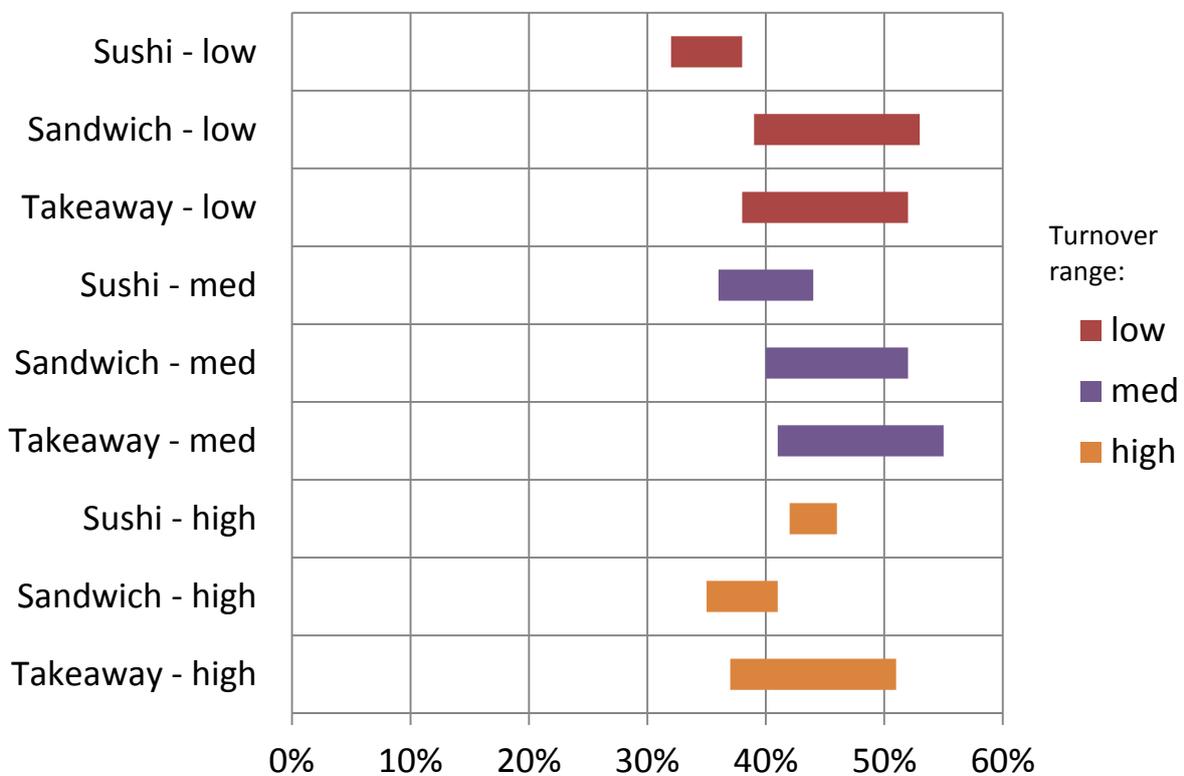
Table 9: Sushi takeaways and sandwich shops — 2008 benchmarks

Benchmark ratio Cost of goods sold / turnover	Annual turnover range		
	Low \$75,000 to \$200,000	Medium \$200,000 to \$600,000	High More than \$600,000
Sushi takeaways	32% — 38%	36% — 44%	42% — 46%
Sandwich shops and lunch bars	39% — 53%	40% — 52%	35% — 41%
Takeaway food services	38% — 52%	41% — 55%	37% — 51%

Source: Figures compiled from the separate 2008 benchmark pages for each of the above ATO benchmarked industries.

3.25 These benchmarks outlined in Table 9 above may also be expressed graphically (see below).

Figure 7: 2008 benchmark ranges for selected takeaway industries



3.26 The above table and graph show that at the low turnover range, the benchmark ranges for sushi shops have no overlap with sandwich shops or the more general category of takeaway food services. At the medium turnover range, sushi shops have some overlap with sandwich shops and takeaway food services. At the high turnover range, sushi shops have no overlap with sandwich shops, but are within the wider benchmark range of takeaway food services.

3.27 It should be noted that for a business to be selected for compliance verification a business’s particular performance ratio must be a higher percentage than the applicable key benchmark.

IGT observations

3.28 Community confidence in the key benchmarks relies on the premise that the businesses within the group are sufficiently similar so that variances in financial performance would indicate underreporting of income.

3.29 Stakeholders are essentially concerned about whether they legitimately belong to a particular ATO benchmarked industry if it contained a large variety of other types of businesses. For example, a sushi shop may consider itself sufficiently different to a sandwich shop, along with all other takeaway food shops. The fact that, for 2008, separate benchmarks existed for both sushi shops and sandwich shops apart from the takeaway food services benchmarks may indicate that these businesses are distinct enough to have different ranges of financial performance.

3.30 The IGT recognises that whilst businesses would have greater confidence in the benchmarks if they were more specific to their industry, there are also limitations to the level of specificity.

3.31 In the example above, the ATO determined that the population sizes for sushi shops and sandwich shops for the 2009 year were too small to be maintained as separate ATO benchmarked industries without affecting the statistical validity of the benchmarks. In deciding to combine these businesses into the takeaway food services ATO benchmarked industry, the ATO relied on the fact that 'sushi shops and sandwich shops are part of the takeaway foods industry'.

3.32 Whilst this may be true at a broad level, there is a risk in making assumptions that make the comparison of the businesses' financial performance less likely to indicate non-compliance and, therefore, less likely to identify potential underreporting.

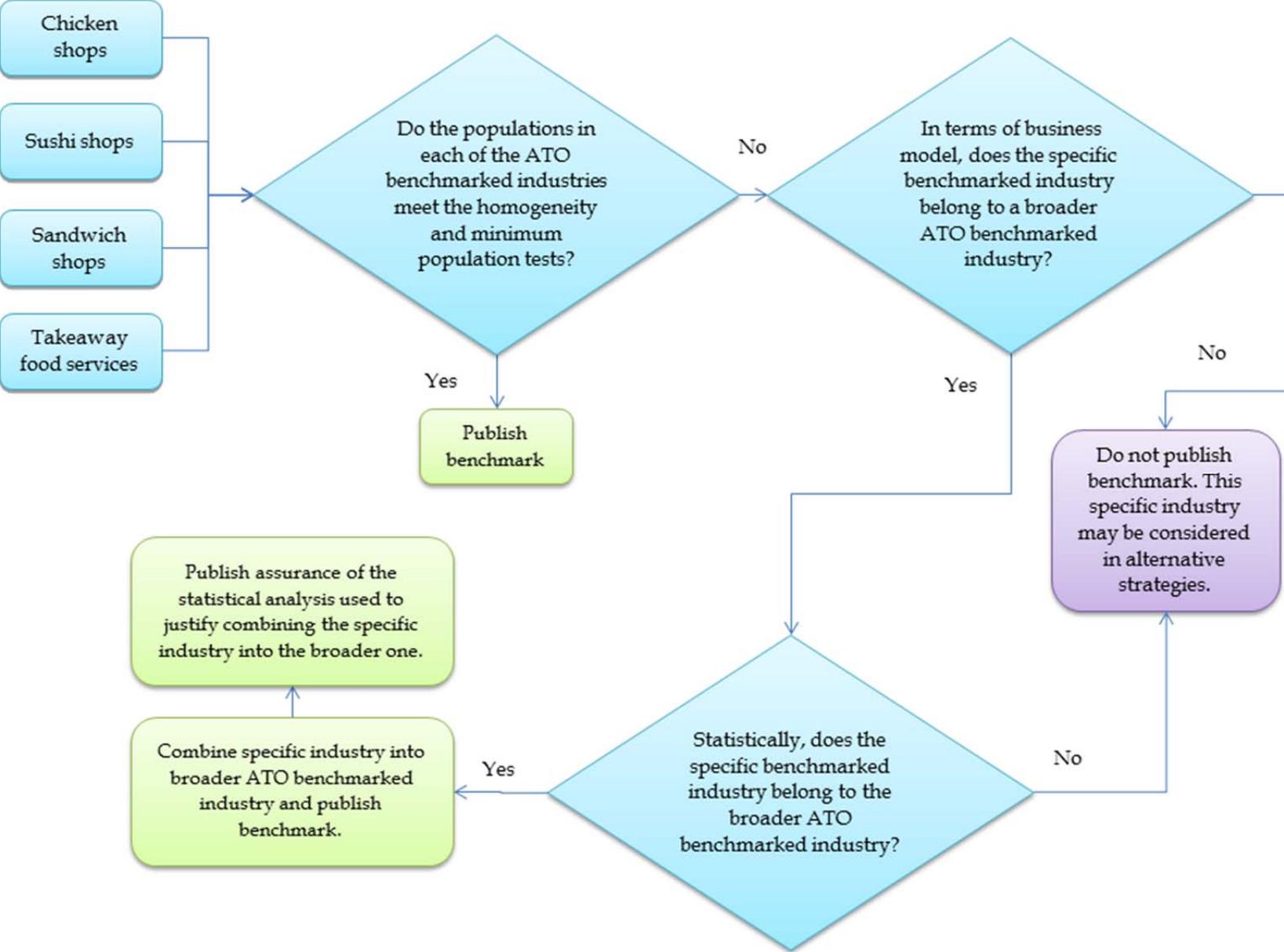
3.33 This risk could be minimised by the ATO undertaking analysis to satisfy itself and taxpayers that sushi shops and sandwich shops, at a statistical level, belong to the takeaway food services ATO benchmarked industry. Publication of this analysis would also help to engender community confidence in the benchmarks.

3.34 The above example also implies that different businesses within a broader industry classification will 'cluster' their financial performance at different points along the broader industry's benchmark range. One implication is that certain industries may tend to be selected for benchmarking compliance activity more by reason of commercial factors rather than potential underreporting.

3.35 The ATO has sought to mitigate this potential problem by widening the benchmark range or increasing the variance threshold before a case is selected for compliance verification.

3.36 In the IGT's view, however, where the statistical analysis indicates that these smaller ATO benchmarked industries are significantly different to the broader ATO benchmark industry into which they are intending to be combined, they should be excluded from that broader ATO benchmark industry. To better identify potential non-compliant taxpayers in these smaller industries alternative strategies could be considered rather than employing benchmarks as a risk identification tool in isolation. The following chart seeks to illustrate the circumstances in which combining an industry with another may or may not be appropriate.

Figure 8: Combining ATO benchmarked industries



Geographic differences

3.37 A consistent concern raised in submissions was whether benchmarks appropriately take into account geographic differences. Examples included the difference between businesses located in different states and territories, between metropolitan and country businesses, between shopping malls and on streets, certain city suburbs and the central business district itself.

3.38 These differences were thought to materially affect financial performance of businesses, in particular the effect of differing freight and labour costs, and may also indicate seasonal issues, such as those experienced in holiday towns or in fruit picking districts.

3.39 To help understand the issues, stakeholders have suggested that the ATO should publish benchmarks based on states or localities or at least show why they have not done so.

3.40 In relation to the difference of cost of sales average ratios between metropolitan and country businesses, the ATO advises that the difference is only three percentage points (see Table 10 below).⁸⁰ This analysis was conducted by assigning the population used to develop the small business performance benchmarks to either country or metro based on their business postcode and a list of reference postcodes. Following the same methodology used to develop the performance benchmarks, the ATO then calculated cost of sales ratios for each entity and thereafter assigned each to a turnover range. From these figures, averages (that is the mean) were then calculated.

3.41 For all industries combined, the ATO provided the following table comparing cost of sales ratios averages (that is the mean).

Table 10: ATO country and metro cost of sales ratios for the 2009 year — comparison of means

Turnover range	Country (mean)	Metro (mean)	Difference
Low turnover range	44%	41%	3%
Medium turnover range	50%	46%	3%*
High turnover range	55%	51%	3%*

Source: ATO communication to IGT, 31 January 2012.

* the discrepancy of 1% for each is presumed due to rounding.

3.42 The ATO also provided a comparison for the restaurant industry segment as identified (see Table 11 below).

Table 11: ATO comparison of Country and Metro restaurant industry cost of sales ratios for the 2009 year

Turnover range	Country (mean)	Metro (mean)	Min Benchmark	Max Benchmark
Low	37.10%	35.83%	32.81%	39.19%
Medium	37.11%	37.47%	34.10%	39.90%
High	32.87%	34.58%	30.99%	36.93%

Source: ATO communication to IGT, 31 January 2012.

⁸⁰ ATO communication to IGT, 31 January 2012.

3.43 Table 10 above shows that, broadly for both country and metro businesses in all benchmarked industries, there are some differences in the average cost of sales ratios – three percentage points. With respect to the restaurant industry in particular, Table 11 above shows there are some minor differences in the average cost of sales ratios as between country and metro restaurant businesses.

3.44 Importantly, in the case of the restaurant industry, the benchmark range used by the ATO (as indicated by the Min Benchmark and Max Benchmark columns above) seeks to accommodate those differences.

3.45 The ATO has also advised that it seeks to adjust the cost of sales figures data obtained from tax returns. However, labour cost amounts are the only adjustment made, removing it from the cost of sales figures. Therefore amounts such as freight would remain in the cost of sales figure.⁸¹ The question remains as to whether geographic differences, such as the increased cost of freight, affect the accuracy of the benchmarks materially.

IGT observations

3.46 Based on the ATO material outlined in Table 11 the differences in the average of cost of sales ratios between country and metro restaurant businesses may not be as wide as they may have been perceived. Suggested reasons for these similar average performance ratios include that higher labour and freight costs are passed on in the form of higher prices.

3.47 This analysis, although a national average, indicates that the ATO may foster greater community confidence in the benchmarks by publishing this type of information for other industries.

3.48 The ATO has not, to date, conducted any similar analysis with respect to differences between states and territories. For example, submissions expressed the view that states experiencing a mining boom may mean businesses are operating under substantially different conditions compared to those states that are not experiencing a mining boom. It was also suggested that states with particular remoteness or transport access issues may also have important differences that need to be considered. To allay stakeholders' concerns, it would be beneficial if the ATO conducted and published such an analysis similar to that done for the country/metro comparison.

3.49 It should be noted, however, that further analysis to distinguish between specific geographical differences may be difficult to accomplish consistently without imposing greater costs.

Cash sales benchmark

3.50 As referred to above, submissions also pointed to the ATO's withdrawal of the cash sales benchmark as a reason to question the methodology of the performance benchmarks.

81 ATO communication to IGT, 20 March 2012.

3.51 The history of the cash sales benchmark is very unfortunate for those taxpayers who were inadvertently affected, particularly where they were subject to ATO default assessment, although these assessments were later reversed.

3.52 The ATO advises that the cash sales benchmark relied on a different data source (that is the financial institutions' records) and methodology to that of the financial performance benchmarks. The reasons for the ATO's withdrawal were inconsistencies in the way in which the financial institutions record cash-outs paid by businesses to their customers. By way of comparison, the performance benchmarks rely on information reporting in taxpayers' income tax returns. This indicates that community confidence in the benchmarks also relies on the integrity of the data inputs, which is an issue discussed further below.

3.53 In the light of the above discussion on the transparency of aspects of benchmarks, the IGT makes the following recommendation.

RECOMMENDATION 3.1

The ATO should improve community understanding and confidence in the ATO's industry performance benchmarks by publishing material that seeks to provide assurance that the methodology to develop the benchmarks is robust and communicating it more broadly. Such material should include:

- (a) all current benchmarking inputs and methodology (except for specific aspects giving rise to genuine manipulation concerns);*
- (b) assurance from an independent party with statistical expertise about the robustness of the benchmarking methodology;*
- (c) assurance that the types of businesses included in ATO benchmarked industries are sufficiently similar to each other to compare financial performance; and*
- (d) appropriate comparisons and explanations of ratios between
 - (i) country and metro businesses within each benchmark; and*
 - (ii) states and territories on an aggregated basis.**

ATO response: Partially agree

The ATO agrees with sub-recommendations 3.1(a), (b) and (c) and disagrees with sub-recommendation 3.1(d).

We agree to enhance our existing communication and materials about benchmarks to provide more detailed information about how benchmarks are developed.

We will seek assurance from an independent party with statistical expertise on the robustness of the benchmarking methodology and will publish this, along with assurance on the similarity of business in benchmarked industries, and further information about the inputs and methodology for benchmarks.

In relation to sub-recommendation 3.1(d), we appreciate the underlying intent of this recommendation and are committed to providing information which will improve understanding and confidence the community has in the industry benchmarks.

However, we are concerned that publishing large numbers of additional country and metro benchmarks, or benchmarks for comparison between states and territories on an aggregated basis, will not assist and has the potential to cause confusion.

We note that your report includes tables following paragraph 3.41, which reflect that any differences associated with locality are not significant (there being less than 3% difference between country and metro averages).

Our experience shows that while prices of goods and services may be higher in certain states, territories and regions, the costs of the inputs to those goods or services are also generally higher. This results in the relatively small variation noted above.

3.54 As referred to above, stakeholders raised concerns with aspects of the data integrity for benchmark inputs. These are discussed below.

DATA INTEGRITY — CORRECT INDUSTRY ALLOCATION IDENTIFICATION

3.55 Stakeholders raised concerns about the process the ATO uses to allocate businesses to ATO benchmarked industries.

3.56 After cases are selected and allocated to an ATO officer, the officer conducts some initial internal research, such as checking ATO systems or the business's website, to determine whether the business is still operating or the correct benchmark has been applied. The ATO officer may end the correspondence audit before contacting the taxpayer or sending the audit confirmation letter where the ATO officer determines that the business:

- has ceased trading;
- actually belongs to a different ATO benchmarked industry, and the business's ratios now report within the benchmarks for that correct industry; or
- does not belong to the ATO benchmarked industry, and does not appear to belong to any other ATO benchmarked industry.

3.57 As previously stated, these cases referred to above are recorded as an 'early exit' by ATO audit teams.

3.58 The ATO has also advised that there are instances where an auditor may be satisfied that the correct benchmark was applied and commences the audit but the audit may still be closed 'early'. This may occur where upon contacting the taxpayer, the auditor may agree with the taxpayer that one of the three circumstances described above are satisfied and closes the audit. Since the taxpayer has already been contacted, however, it is not reported as an 'early exit', but rather as a 'nil outcome' by the ATO.

3.59 A 'nil outcome' also denotes a case in which the ATO has verified that the taxpayer has appropriate records and all income has been reported.

3.60 The following table indicates the proportion of initially selected cases from January 2010 (when benchmark strategy compliance activities began) until April 2012 which were closed as 'early exit'.

Table 12: Early exit rates

Intensity	Product	Early exit	Total initiated cases	Early exit rate (a)
Highest (field)	Cash Economy Audit	65	341	19%
(field)	Specific Audit	7	150	4%
(desk)	Correspondence Audit	457	8127	6%
(field+ desk)	Record keeping audit	526	1453	36%
(desk)	Phone review	374	10213	<1%

Source: Figures compiled by IGT from ATO spread sheet data supplied on 23 December 2011 and 31 May 2012.
Note (a): rounded to the nearest per cent.

IGT observations

3.61 The early exit rates give an initial indication of the integrity of the data used to create the above compliance activities. This integrity is subsequently confirmed or contradicted by profiling work which the auditor undertakes before contacting the taxpayer or otherwise terminating the compliance activity.

3.62 The IGT supports the process of the auditor conducting internal research before contacting the taxpayer to commence the audit. It is important that automatic filters and processes, such as those used to allocate businesses to ATO benchmarked industries, be supported by audit officer analysis and interpretation. It is appropriate that auditors be satisfied that the audit ought to proceed, and not commence the audit simply on the basis that the case was allocated to them.⁸²

3.63 With respect to correspondence audits, an early exit rate of 6 per cent indicates that the case selection methodology is 'initially supported' in that the limited profiling of auditors only closed a small proportion of cases prior to commencement. For a more accurate profile, auditors would normally need to contact the taxpayer or tax agent for business specific information.

3.64 As noted above, the ATO benchmarked industry allocation process partially relies on the use of ATO business industry codes. Whilst the preceding section indicates that this process is initially supported by the low early exit rates, stakeholders raised specific concerns with respect to the use of ATO business industry codes in this process. These concerns are addressed below. It should be noted that, in their submissions, stakeholders often used the term 'ANZSIC codes' to refer to the ATO business industry codes.

DATA INTEGRITY — LIMITATIONS WITH INDUSTRY CODES AND ERRORS IN IDENTIFYING CORRECT CODES

3.65 The ATO benchmarking process categorises taxpayers into certain ATO benchmarked industries based on the ATO business industry codes (a 5-digit code derived from the ABS's 4-digit ANZSIC codes) and other tax return data.

82 Correspondence audit procedures - supplied by ATO, 27 January 2012.

3.66 In completing tax returns, taxpayers and their representatives often rely on the ATO's publication *Business industry codes* to locate their correct code. These ATO codes are presented in a web-based (that is PDF) booklet in two lists:

- alphabetically, independent of hierarchy or grouping for example 'Abalone Fishing' is followed immediately by 'Abattoir operation – except poultry'; and
- hierarchically, with businesses grouped under broader industry categories.

3.67 The introduction to the ATO booklet indicates:

Only use codes from Business industry codes 2012, and take care to describe your business activity as accurately as possible. An incorrect code may result in clients not receiving necessary service or material from the ATO, or could lead to incorrect targeting of compliance activities.⁸³

3.68 Stakeholders have advised the IGT that the codes and industries supplied in the *Business industry codes* booklet have certain inadequacies. Common complaints in the submissions are:

- Variations in business models are not accounted for. For example, wholesale versus retail or business-to-business versus business-to-consumer.
- The method of searching for the correct industry in itself is not intuitive. There is no ability to 'drill down' into categories or there is insufficient explanation or linking or cross referencing to other potential categories.
- Specific subtypes of industries that may logically fall under a wider category but have very different cost structures are not accounted for. For example, a commercial painter is considered a 'painter' and thus treated the same as a domestic painter. Those in the industry consider commercial and domestic painters to be completely different businesses.
- The 'not elsewhere classified' (NEC)⁸⁴ option is not included for some industries, so businesses are forced to choose something that is not precise.
- Certain businesses are not identified at all. For example, home theatre installers.
- Mixed businesses are not accommodated.
- Although the name of the industry may be correct in a general sense, the description attached to the industry does not actually reflect the reality of the taxpayers' business or there are other specific factors that render the classification inaccurate.

3.69 Industry names themselves may be oddly worded and do not reflect plain language usage. Furthermore, taxpayers' and even some tax agents' do not have a

83 Australian Taxation Office, *ATO Business industry codes*, Australian Taxation Office, Canberra, 30 May 2012, viewed 2 July 2012, <<http://www.ato.gov.au>> NAT 1827-6.2012.

84 Some industries categories are broken down into more specific subtypes, and where the business does not fall into these subtypes, they usually have the option of choosing 'NEC'.

strong awareness of the codes and their use for potential or actual audit by the ATO. This, combined with the difficulties above and pressures to minimise compliance costs, has resulted in taxpayers and tax agents:

- choosing a code just because they need to enter 'any value' in that label in order to continue completing the tax return;
- rolling over the code from last year's tax return without much thought on additional action; and
- 'wasting' significant time in searching for a code that may or may not be more accurate.

3.70 As a result of this general lack of awareness, concerns were raised by other stakeholders that:

- benchmark data is therefore not truly reflective of the actual population; and
- certain taxpayers are being incorrectly selected.

3.71 The ATO advised that businesses are not allocated to an ATO benchmarked industry on the basis of the ATO business industry code alone. Rather, some data adjustments are undertaken. That is, a business must also have certain keywords present in its trading name and/or business description (from the income tax return) to qualify for the relevant benchmarked industry.⁸⁵ For example, if a book retailer (code 42442) incorrectly chose the code 42441 (newsagents), it would not be allocated to the newsagency ATO benchmarked industry unless the book retailer also had 'newsagency' related keywords in its trading name or business description.⁸⁶

3.72 During discussions with the IGT, the ATO advised that ATO staff have internal access to an ABS-developed and maintained custom software program, called the 'ANZSIC Coder'⁸⁷ referred to in this report as the 5-digit Coder. This 5-digit Coder allows staff to:

- enter a keyword, and search for possible 5-digit ATO business industry code matches;
- enter all or part of a 5-digit ATO business industry code and see what industries it relates to;
- view a hierarchy of industries and drill-down to more specific industries; and
- view the description and primary activities for a given 5-digit ATO business industry code.

85 ATO communication to IGT, 31 January 2012.

86 ATO communication to IGT, 31 January 2012.

87 Australian Taxation Office, *Industry coding of business returns - August 2002*, Australian Taxation Office, Canberra, 28 March 2006, viewed 2 July 2012, <<http://www.ato.gov.au>>.

3.73 ATO staff can use this program to help ascertain whether the taxpayer has used the correct ATO business industry code. For example, an ATO officer may use the coder whilst reviewing the business description on an income tax return or while having a phone conversation with a taxpayer or their tax agent about their business activities.

3.74 The ATO has advised that, since 2002, the 5-digit Coder and associated data files were made available to developers of Electronic Lodgment Service (ELS) software. It indicated that 'some ELS software producers have included the coder in their software while others have built similar functionality into their software' using the associated 5-digit Coder data files.⁸⁸

IGT observations

3.75 The ATO's benchmark development process does not solely rely on the ATO business industry code selected by the taxpayer or their tax agent in their income tax returns as some data adjustments are undertaken. This measure mitigates the risk of incorrect industry allocation to a certain degree. The IGT is of the view, however, that the ATO can strengthen data integrity by making it easier for taxpayers and tax agents to select the correct ATO business industry code in the first instance.

3.76 The IGT considers that the ATO may better support more accurate code identification and entry in the Australian Business Number application form and tax returns in a number of ways.

3.77 First, the ATO could make it easier for taxpayers and tax agents to find the right code, for example, by modernising and publicly releasing the ABS-developed 5-digit Coder described above. The 5-digit Coder is currently used within the ATO as an installable program. Widespread adoption may be more likely if the coder is web-based, therefore not requiring the user to download any program. Web-based versions also ensure users have access to the most up to date database. Whilst the ABS itself currently has a web-based search facility for its 4-digit ANZSIC codes,⁸⁹ it does not have the same information or functionality as the 5-digit Coder used within the ATO.

3.78 Second, the ATO could give taxpayers and tax agents the ability to find the right code through either browsing (that is drilling down through a hierarchy) or searching. The 5-digit Coder currently used in the ATO has both a browse and search function.

3.79 Third, the ATO could better communicate with taxpayers and tax agents at the time of lodgment about the importance of improving ATO code identification. For example, electronic lodgment programs could provide a prompt at the Business industry code field to remind users about the importance of the code and providing a link to the coder.

⁸⁸ *ibid*; ATO communication to IGT, 30 March 2012.

⁸⁹ Australian Bureau of Statistics, *ANZSIC 2006 Search facility*, Australian Bureau of Statistics, Canberra, 25 September 2008, viewed 6 June 2012, <<http://www.abs.gov.au>>.

3.80 Fourth, the ATO may consider adding ‘primary activities’ to existing ATO Business industry codes for those ATO benchmarked industries that are currently accounted for under a residual category within the code. For example, whilst kebab shops are their own ATO benchmarked industry, they are not mentioned in the *Business industry codes*. Rather, they would belong to code 45120 by virtue of the residual category ‘Take away foods – retailing’. By specifically mentioning them, kebab shops may join the already listed pizza shops and hamburger shops as businesses that can readily identify themselves as belonging to the shared code 45120. This measure, however, does not assist the ATO to determine if the business is a kebab shop. The code only indicates to the ATO that the business is a takeaway food retailer. In this case, the ATO would continue to rely on keywords in the trading name and business description in the income tax return to help it identify the business as a kebab shop. The intent is to assist the taxpayer or tax agent to quickly select the correct code, even if it is currently general in nature.

3.81 Fifth, where the current ATO Business industry code system does not provide the current level of granularity required for benchmarking purposes, the ATO may consider increasing the use of the fifth digit in the ATO Business industry codes to provide it. To illustrate this point, ATO Business industry code 41290 is currently shared by 12 specific food retailers. An option may be to create, for example, code 41291 to cover bread shops and bakeries, code 41292 for delicatessens and small goods retailers, code 41293 for cake shops and patisseries. That is, there is potential to customise the fifth digit to create a unique code for each ATO benchmarked industry.⁹⁰ This may also provide a useful opportunity to enhance the data integrity or the information collected in benchmarking for future compliance activities.

3.82 Although greater granularity could be provided, it is important to note that such a task may be a significant undertaking and that such action should be commensurate with the aims of maintaining reasonable consistency over time to minimise user and comparative difficulties. Such an undertaking may necessarily require consultation with Government and the ABS.

RECOMMENDATION 3.2

To assist taxpayers and tax agents in identifying the correct ATO business industry codes, the ATO should take the necessary steps (and where necessary, work with the ABS) to provide public access to the ABS developed 5-digit Coder.

ATO response: Agree

The ATO will consult with the ABS and take steps to make the 5-digit coder publicly available within the capacity of the forward information technology program of the ATO.

⁹⁰ See Appendix 4 for an explanation of how this fifth digit works, and how it relates to the ABS four digit system.

RECOMMENDATION 3.3

The ATO should improve its support for tax agents and taxpayers in helping them to include the correct ATO business industry code in the tax return form, such as by:

- (a) enhancing communication regarding the importance of correct industry code selection and the impacts it may have in subsequent ATO compliance activities; and*
- (b) assuming the 5-digit Coder is made publicly accessible, seeking external user feedback on the coder's operation to identify improvements required to make it more effective, including the code structure used for the fifth digit.*

ATO response: Agree

The ATO will enhance our communication about the importance of correct industry code reporting on tax returns through existing channels, including 'Tax Time' briefings and support materials.

The ABS has responsibility for the ANZSIC code structure which is subject to an international framework (4 digits). They have an existing public consultative mechanism, which includes linking new business descriptions to existing industry groupings. The ATO will seek feedback from key stakeholders, including industry representatives, when adding or removing a new sub-group at the 5th digit level.

DATA INTEGRITY — LIMITATIONS WITH INDUSTRY CODES FOR MIXED BUSINESSES

3.83 Stakeholders raised concerns that since mixed businesses are only accounted for by one industry code on the income tax return, any benchmark is unlikely to apply accurately. Stakeholders were concerned, therefore, that mixed businesses faced the risk of being incorrectly chosen for a correspondence audit, or even the prospect of having a default assessment issued against them on the basis of an incorrect benchmark.

3.84 Certain tax agents reported that they could satisfy the ATO by disaggregating their clients' financial reports into their separate business lines and calculating individual ratios for each of the 'industries' and show how it falls within the benchmarks. However, it is a costly and time consuming exercise. Further, the IGT was advised that generally small businesses of this nature do not disaggregate their different activities as part of their normal record keeping (that is such a process is not aligned with natural business systems).

3.85 With the exception of mixed primary/non-primary production activities, the existing income tax return form and related schedules do not provide for any distinction between the business lines of a mixed business. The ATO has advised, however, that several income tax return schedules contain labels that allow a taxpayer to indicate that it is a mixed business.⁹¹ Where the taxpayer has done so, the ATO will

⁹¹ Business and Professional Items for Individuals: P3 Label B; Company Tax Return: 3 Label E1; Partnership Tax Return and Trust Tax Return: 2 Label B1.

not use that taxpayer for calculating industry benchmarks, nor will the ATO select that taxpayer for benchmark related compliance activity.

3.86 The ATO also advises that where the mixed business label has not been completed, then the taxpayer may be selected for compliance activity. In the case of a correspondence audit, the auditor will often identify whether the taxpayer is a mixed business during the phone call that occurs after the audit confirmation letter is sent. During that phone call, the auditor will discuss the nature of the business and the taxpayer's record keeping practices. The auditor may decide to close the audit early if they determine there is a low risk.

3.87 Alternatively, where the auditor has reason to believe that the taxpayer has not correctly recorded all of their income, they may proceed with an audit as planned. In such cases where the audit proceeds, if the auditor determines there has been omitted income, the auditor will seek to use disaggregated sales or cost of sales figures to apply the relevant benchmarks on a weighted basis. Where disaggregated figures are not available, the auditor will ask the business owner to provide purchase records and the owner is to 'apportion these expenses between each enterprise as it believes would be appropriate and provide this information to the auditor.'⁹²

3.88 The ATO has advised the IGT that before, and at the time an interim report is issued, taxpayers may supply extra information for example:

The taxpayer can provide a statement and evidence where they are a mixed supply and the relevant benchmark does not apply, for example mixed food retail/take away businesses.⁹³

3.89 The ATO has also advised⁹⁴ that:

The methodology we used to select businesses that fall into industry categories seeks to exclude those that identify themselves as mixed businesses.

When we carry out an audit activity the ATO takes into account the personal circumstances of the business we are reviewing. If it is identified as a mixed business, the ATO may apply the benchmarks proportionally to the separate business types.

3.90 By way of example, one Siebel case took 288 working days and resulted in a complaint by the taxpayer/tax agent after an interim report was issued. The auditor did attempt to disaggregate the business, and applied two different benchmarks to two different parts of the business. The auditor was not satisfied with the quality of the records, and thus proposed default assessments. Once the taxpayer lodged a complaint, the case was reviewed by another officer. The case was subsequently closed with no further action on the basis that the business actually had four distinct business lines (rural petrol station, tyre shop, hardware shop, agricultural supplies shop), of which only one business line was outside the benchmark. For that one business line, it

92 Australian Taxation Office, *Small business performance benchmarks default assessment calculation method - mixed enterprises*, supplied by ATO, 31 May 2012.

93 ATO communication to IGT, 23 January 2012.

94 ATO communication to IGT, 31 January 2012.

was determined that particular agricultural purchases did not fit in that benchmark, and that once removed, the business line fell into the benchmark. The reviewing officer also came to a different conclusion about the risk posed by the quality of the records. Importantly, the reviewing officer also concluded that the 'taxpayers business activity does not fit within the parameters of the benchmark'.

IGT observations

3.91 The benchmarking approach is generally premised on comparing the financial performance of like businesses. In the circumstances of mixed businesses, this may be difficult to do. Therefore, an attempt to further refine the relative risks of mixed businesses' non-compliance should not be based on a comparison of financial performance with other businesses.

3.92 By using the mixed business indicators on tax returns to exclude mixed businesses from the calculation of benchmarks, the ATO has recognised the limitations of the benchmarks as currently implemented. The IGT welcomes the ATO approach.

3.93 Nevertheless, the IGT is concerned that a mixed business can be the subject of an audit by reason of not completing the mixed business label on the tax return. If they had done so neither the taxpayer nor the ATO would have needed to consider a benchmarking originated audit.

3.94 Stakeholders have cited examples of disaggregating business lines to show the ATO each business line is within the applicable benchmarks so as to close the audit early. The IGT is of the view that businesses and their advisors would usually take this course of action if they perceive that it would be cheaper to do so than allowing the audit to take its normal course by supplying the ATO with the requested records.

3.95 Stakeholders also cited an example of using disaggregation to refute a default assessment based on the benchmark.

3.96 These are difficulties that are faced by taxpayers and auditors alike in disaggregating mixed business. The IGT is of the view that it would be generally impractical for the ATO to require small businesses to disaggregate business lines for the simple purpose of testing whether they are within the benchmarks. To do so would be to impose unnecessary compliance costs, especially since the ATO may be able to take into account risk factors other than benchmarks.

3.97 Whilst it may be difficult to benchmark mixed businesses, they, like any other affected business, may be subject to ATO review for adequacy of record keeping or underreporting income or seeking excessive deductions. It is therefore important that the ATO consult with the community on how to best engage with mixed business owners.

3.98 The ATO benchmarking strategy is generally useful for comparing like businesses' financial performance. Mixed businesses, however, are typically difficult to compare. In addition to the benchmarks, the ATO currently uses other models and approaches to address the cash economy, such as the cash economy risk model and data matching projects. The IGT believes that there is scope for the ATO to consider

other risk models to address cash economy mixed businesses in a manner that minimises compliance costs.

RECOMMENDATION 3.4

To minimise compliance costs and improve mixed businesses risk identification, the ATO should consult with tax agents and taxpayers with a view to developing and employing alternative risk models and approaches to assess the risk of underreporting by mixed businesses.

ATO response: Agree

The ATO will consult with tax agents and taxpayers with a view to reducing compliance costs for mixed businesses and improve risk identification for those businesses.

DATA INTEGRITY — BUSINESSES ‘CODE’ THEIR EXPENSES DIFFERENTLY IN TAX RETURNS, AFFECTING THEIR OWN BENCHMARKS

3.99 Concerns were raised that some taxpayers were outside of the benchmarks (usually the cost of sales benchmark) because of the way they recorded their expenses and what they included in cost of sales. Cost of sales is a field on both the Company Tax Return (Question 6 Expenses, label A) and the Business and Professional Items Schedule for Individuals (P8 Label KLM). For example, some include in their cost of sales:

- only the cost of stock;
- cost of labour;
- cost of rent;
- capital acquisitions; and
- lottery sales minus commissions (for example newsagents), rather than only adding sales commissions to business income on a net basis.

3.100 One tax practitioner representative body advocated for the ATO to provide more education about common errors that tax practitioners make, in particular, the inclusion of labour in cost of sales. In this respect, the ATO has advised that it intends to develop a fact sheet to assist tax return preparers to correctly calculate the cost of sales figures.⁹⁵

3.101 In terms of calculating the benchmarks, the ATO states that it takes into account whether wages are incorporated in the cost of sales figures. Where a taxpayer has indicated wages in another label on the income tax return form and has indicated

95 ATO communication to IGT, 31 May 2012.

that the wages are part of cost of sales, the ATO will deduct the wages figure to reduce the cost of sales figure.⁹⁶

3.102 The ATO has advised that it also makes this same subtraction (where applicable) when calculating default assessments based on the benchmark.⁹⁷

IGT observations

3.103 Whilst the practice of including labour in the cost of sales varies, it is not necessarily incorrect to do so. Where labour is directly attributable to the acquisition or conversion of inventory, then it is appropriately included as part of cost of sales. For example, a bicycle shop that buys parts and assembles bicycles before selling them would include labour in their cost of sales.⁹⁸

3.104 With respect to cost of sales, therefore, the IGT appreciates that the ATO practice of subtracting labour from the cost of sales figures ensures that the data is not affected by the practice of including or excluding labour from cost of sales. This assumes, however, that return preparers are correctly entering the details in the return and schedules.

3.105 The issue of taxpayers correctly entering their figures and details in the tax return is further complicated when taxpayers erroneously include other amounts in the cost of sales figures. These amounts include capital costs or other overheads, and expenses not directly related to the acquisition, conversion or manufacture of goods. Once these incorrect figures have been entered into the tax return and lodged, there is little the ATO can do to detect this error.

3.106 The responsibility to correctly complete a tax return is that of the taxpayer. The taxpayer's agent or representative has certain duties and responsibilities too. Nevertheless, the ATO is in a position to assist taxpayers and tax agents in correctly entering cost of sales amounts. The optimal means to do this could be through a systems change, so that when costs of sales is entered on a field on an electronic tax return form, a prompt is triggered to remind the tax practitioner what types of items to include or exclude in this field. Such a change, however, may involve complexities as alterations of the ATO's information technology upgrade schedule may be limited. As an alternative measure, the ATO could assist through a targeted communications strategy.

3.107 The ATO could also make it easier for small businesses to correctly complete the return and schedules by tailoring the returns to their needs.

⁹⁶ *Income tax labels used to calculate benchmarks*, supplied by ATO, 23 February 2012.

⁹⁷ ATO communication to IGT 23 January 2012.

⁹⁸ West Australian Small Business Development Corporation (SBDC), *Components of a profit and loss statement*, SBDC, Perth, 2012, viewed 2 July 2012 <<http://www.smallbusiness.gov.au>>.

RECOMMENDATION 3.5

The ATO should seek to continue to improve the data integrity of benchmark inputs by, for example, better assisting taxpayers and tax agents to include the correct items of costs in the cost of sales label on the income tax return.

ATO response: Agree

The ATO will enhance our communications about benchmarks to assist taxpayers and tax agents to include the correct items of costs in the cost of sales label on the income tax return by improving our website material and advice to tax agents.

BULK MAIL OUT LETTERS PROGRAM — IMPACTS

3.108 Stakeholders raised concerns about the first bulk mail out of advisory letters to taxpayers and tax agents regarding the benchmarks. As mentioned above in Table 4, 37,847 businesses (and 20,967 of their tax agents) were sent letters in 2010 advising them that they were outside the small business benchmarks. A sample of the first batch of letters is included in Appendix 7.

3.109 These letters included instructions such as:

If you think you may have made an error or left something out, we have enclosed a form that will help us correct anything that might need to be corrected. ...

If you are satisfied that you are meeting your tax obligations correctly, you do not need to contact us or do anything further.

3.110 The letter indicates that the taxpayer or tax agent need not respond to the ATO if they were satisfied that there were no errors. Nevertheless, a significant proportion of letter recipients (9796 or 25.8 per cent) wrote a letter to the ATO for no other reason than to provide an explanation of why they were justifiably outside the benchmarks. Submissions advised the IGT that a proportion of taxpayers wrote to the ATO directly while others asked their tax agent to do so. Certain tax agents charged their clients to write these letters on their behalf, while others indicated that they did not or could not charge their clients, despite each letter taking significant time to complete. In either case, a compliance cost is borne either by the taxpayer in the form of fees, or by the tax agent in the form of uncharged work.

3.111 The original enclosed form issued in May 2010 letters, called the Correcting Tax Errors form, was designed only to allow the taxpayer to notify the ATO of any errors the taxpayers found when reviewing their business records. Subsequent versions of the form contained an extra tick box stating:

No, I do not need to make a correction. However, I would like to provide an explanation.

3.112 Despite this modification, none of the advisory letters themselves indicated when or why the taxpayer ought to provide such an explanation. While the addition of this tick box may indicate that the ATO was expecting explanations from business owners, the letter did not provide a prompt to do so.

3.113 Furthermore, stakeholders also observed that after sending in an explanation (rather than a notification of an error) they did not receive any acknowledgement from the ATO and were thus left in a position of uncertainty about whether the ATO was satisfied with their explanation. One representative group also expressed concerns that the explanations given were not recorded by the ATO since some of their clients were later chosen for an audit. When the tax agent asked why the ATO did not consider the explanation previously given to the advisory letter, the auditor did not have a record of it.

3.114 Stakeholders further submitted that the tone of the letters was accusatory. Tax practitioners indicated that many of their clients experienced stress as a result or were unsure of why they were receiving the letters. Tax practitioners also raised concerns that some of their clients attributed the receipt of these advisory letters to their agent's mismanagement, with some tax practitioners relaying the business's sentiment that they 'wouldn't have attracted the attention of the ATO if their agent was doing their job properly'.

3.115 Some tax agents expressed frustration with the fact that the letters were sent directly to taxpayers, even where the tax agent was listed as the authorised contact. Tax agents submitted that they received phone calls from clients regarding benchmarking letters which the tax agent knew nothing about. Tax agents felt this 'put them on the back foot', and expressed concern that it made them look unprofessional and undermined their relationship with their client. One representative body expressed the view that if the tax agent is the authorised contact, then all communication should go to them first, and it is their prerogative rather than the ATO's, to determine how to approach the client. Nevertheless, some tax agents also expressed the view that they did not mind having the ATO contact their clients directly for these types of matters, as long as the tax agent was given the choice or at least informed first.

3.116 The ATO has made changes⁹⁹ to their benchmark advisory letters stemming from feedback and complaints received from letter recipients, and feedback from ATO consultative groups. The ATO advises that these changes include:

- where a tax agent is listed, the ATO will send a letter to them first, indicating that the ATO will send a benchmark advisory letter to their client between 5 days to 2 weeks later;
- where a taxpayer or tax agent provides a response to the ATO (be it a notification of an error or an explanation), the ATO will send an acknowledgement letter to them (in June 2011, the ATO sent 17,000 acknowledgement letters to those who responded during the period 1 July 2010 to March 2011);
- since May 2011, all cash economy letters are user tested in the ATO's Simulation Centre to address the issue of tone, content and readability of the letters;

99 ATO communication to IGT 23 December 2011.

- engaging an external consultant to provide feedback on some cash economy letters (that is data matching letters) and incorporating that feedback into all their other cash economy letters; and
- where an explanation is provided in response to an advisory letter, the ATO now scans this response and attaches it to the taxpayers' file in Siebel, so that the response is now considered by the ATO before deciding on potential compliance action.¹⁰⁰

3.117 These updated letters were sent in November and December 2011. A copy of this letter to taxpayers can also be found in Appendix 7. The letter provides more detail about record keeping requirements and where taxpayers can obtain assistance. It also does not include an enclosed form for notifying errors.

IGT observations

3.118 The IGT is of the view that many of the issues raised by stakeholders in relation to the first bulk mail out letters program can be attributed to the original design of the letters themselves and the process of issuing the letters and handling the responses. The ATO did not, at that time, have a process in place to adequately record the explanatory responses to its letters.

3.119 The ATO's practice of contacting the taxpayer directly where the tax agent was an authorised contact appeared to be based on the assumption that, in relation to the matters raised by the letter, the taxpayer rather than the tax agent was best placed to action the letter. Whilst this may be true, the ATO did not fully appreciate the practical importance taxpayers place on their tax agent in dealing with the ATO.

3.120 The IGT considers that given the important role that tax agents play in this particular market segment (some 95 per cent of taxpayers are represented), it is important that the ATO liaise directly with tax agents to ensure they are appropriately informed of any actions of this kind in the future.

3.121 The IGT acknowledges the iterative improvements the ATO has made in relation to its letters program, in particular, the second bulk mail out letters program being based on the feedback provided. The introduction of user testing will also be beneficial in addressing design issues before letters are issued in such a manner.

3.122 It remains to be seen whether the above recent improvements address the concerns of taxpayers and tax agents. However, in future, the ATO should consider preceding such 'bulk' programs with a pilot and/or consultation with relevant stakeholders.

100 ATO communication to IGT, 30-31 January 2012.

CHAPTER 4 — ATO BENCHMARKS AS A RISK IDENTIFICATION TOOL IN ISOLATION

4.1 As outlined in the previous chapter, benchmarks were generally considered by stakeholders to be a useful ATO risk identification tool for non-compliance in that they excluded a large number of likely compliant taxpayers from ATO compliance activities.

4.2 However, stakeholders also raised strong concerns about the use of it as a risk identification tool in isolation because they considered that many compliant taxpayers were selected for compliance verification activities which impose significant costs.

4.3 They were of the view that being significantly outside the benchmarks was, in and of itself, not enough reason to warrant compliance verification, and that additional indicators should be considered to determine whether the risk of underreported income was sufficient to commence action which imposed a significant compliance burden.

4.4 In particular, stakeholders considered that, as far as reasonably possible, the ATO's correspondence audits should be improved to provide for the use of reliable predictors of non-compliance before the imposition of a costly compliance burden such as being required to send numerous records to the ATO.

4.5 These issues outlined above are discussed in more detail below.

Variance from the benchmark as an indicator of underreported income

4.6 Under the benchmarking strategy, where a taxpayer's variance from the benchmark reaches a certain threshold and certain exclusions do not apply, they will be automatically selected for compliance activities. That is, the degree of variance from the benchmarks is the primary means of case selection, including phone reviews and correspondence audits.¹⁰¹ However, it should be noted that the ATO has not undertaken any analysis to establish whether such variance is indicative of the level of risk to the revenue. For example, it does not use its existing correspondence audit results to compare the business's variance from the benchmark with audit outcome results.¹⁰²

4.7 In relation to phone reviews, stakeholders have provided positive feedback on the ATO's most current approach. These reviews seem to be quick and involve minimal preparation – two to three hours as reported by some tax practitioners.

4.8 However, those stakeholders involved in correspondence audits provided significant feedback on the conduct of those audits and, in particular, what they observed as compliant taxpayers being wrongly selected. Submissions indicated that a

101 ATO case selection methodology supplied 23 February 2012.

102 ATO communication to IGT 20 March 2012.

large number of cases were, after varying degrees of intensity, concluded with no further action. For some representative groups, the targeting of correspondence audits was perceived to be largely 'random' or a 'scattergun' approach.

Compliance costs

4.9 Correspondence audits usually require the taxpayer or their tax agent to provide hard copies of records, usually for a nominated quarter of the year in review (often April–June). This is one of the more intense high volume ATO compliance activities conducted under the ATO's benchmarking strategy.

4.10 The general contention in submissions to this review was that these audits impose significant compliance costs on taxpayers and tax agents. It is important to appreciate that a baseline level of compliance costs is expected to be borne by taxpayers as a feature of the self-assessment system. The particular concern raised was in relation to increased compliance costs that could have otherwise been avoided or minimised.

4.11 Where a taxpayer is meticulous with its record keeping it incurs 'baseline' compliance costs – that is those costs involved in recording and maintaining evidence of income and expenses, and providing to the ATO access to these records. In relation to a desk audit additional costs are incurred in collating and transmitting these records to the ATO – such as printing out the records and freighting the boxes to the relevant ATO office (where the ATO does not receive electronic transmissions of records). Taxpayers and tax agents also reported difficulty and added expense in gathering and supplying certain records in the timeframes provided for a range of reasons.

4.12 A few examples are outlined below that reflect some of the more costly cases brought to the IGT's attention.

4.13 One tax agent wrote responses on behalf of all his clients who received a letter from the initial bulk mail out letters campaign mentioned earlier. He did not charge for these letters, which took on average about 45 minutes each.¹⁰³ Another tax agent charged \$8000 to handle an audit due to the amount of work involved, while another agent charged \$4500 to handle another audit (\$180 per hour for more than 20 hours' work).

4.14 As a result of these costs, some tax agents turn away clients who the ATO consider may have record keeping concerns, since the agent believes they will not be able to recover the fees from them.

4.15 One representative group said:

Some practitioners find these services difficult to recoup fees from, as client resist paying for what they consider unnecessary compliance activities. This is especially in cases where the benchmark is poorly targeted in the first place.

103 The ATO considers they did not ask for responses. However, the IGT notes that approximately 25 per cent of recipients of the first tranche of this bulk mail out did respond. This could indicate that the letter was not sufficiently tested with the target market segment. The response rate for the second tranche was substantially less indicating that the ATO had made the necessary changes to the letter.

4.16 Tax agents generally felt that the ATO has effectively 'outsourced' a lot of the auditing administration work to the tax agent. This is especially the case in terms of collating and sending records to the ATO. A range of stakeholders felt it would have been better and cheaper for them to have a field audit instead.

4.17 It is apparent that the conduct of the auditor has an impact on the level of compliance costs borne by the taxpayer. This varies with respect to the amount of research undertaken during the beginning of an audit.

4.18 One case reviewed by the IGT is illustrative of conduct that reduces taxpayers' compliance costs. In a correspondence audit, the auditor called the tax agent as part of their research. They established that whilst they were 'roughly' in the same industry of 'roofing services', the actual business did not reflect the description of the industry in the benchmark. That is, the benchmark applies to businesses that mainly install tiles, and does some restoration and plumbing. The taxpayer in question only did restoration. As a consequence of the auditor's discussion with the taxpayer, the case was withdrawn from the program before the standard audit letter was sent.

4.19 In another case, by way of contrast, a dam maintenance technician was incorrectly classified as a roofing services provider. The initial auditor clarified that roofing was the wrong benchmark to use, but then sought to apply the plumbing benchmark in substitution. An audit then proceeded on the basis that the taxpayer was now outside the plumbing benchmarks. After 5 months of communication between the taxpayer and auditor about getting records together, the case was then reallocated to another auditor, who determined that the plumbing benchmark was not appropriate for dam maintenance. This auditor established that there was in fact no benchmark for this type of taxpayer and closed the case with no further action on that basis within days of receiving the case.

4.20 Stakeholders argued that due to the costs imposed, it was important that the correspondence audits were targeted towards likely non-compliant taxpayers only.

Strike rates

4.21 Strike rates are one means to examine whether the current case selection methodology is effective at targeting non-compliant taxpayers. They can also be useful in understanding whether compliant taxpayers have been identified incorrectly. A 'strike rate', as the name implies, is the proportion of completed cases that resulted in an increase in income tax or GST divided by the total number of cases selected and conducted (that is the total number of cases, excluding early exit cases). As previously noted, these are also known as outcome cases, where there is a 'strike'.

4.22 An overview of ATO strike rates is provided in the table below and is compiled by the IGT from ATO sources. Strike rates for some of the ATO compliance products are discussed thereafter.

Table 13: Strike rate for benchmarking activities from May 2010 to April 2011

Intensity	Product	Outcome cases	Total completed cases	Planned strike rate (a)	Actual strike rate	Liabilities raised (b)
Highest (field)	Cash Economy Audit	143	276	60%	52%	\$5,856,166
(field)	Specific Audit	102	143	70%	71%	\$2,552,445
(desk)	Correspondence Audit	1879	7670	32%	24%	\$57,097,719
(field)	Record keeping audit	104	927	40%	11%	\$652,301
Lowest (desk)	Phone review	10	9839	0%	<1%	\$117,358

Source: Figures compiled by IGT from ATO spread sheet data supplied 23 December 2011 and 31 May 2012.

Note (a): Planned strike rates taken from 2011-12 Cash Economy Staff Allocation and Case Numbers supplied by ATO 23 February 2012.

Note (b): Liabilities include GST, Income Tax, PAYG withholding and PAYG instalments, but excludes penalties.

Phone reviews

4.23 As set out in the table above, from May 2010 until April 2012, the ATO conducted 9839 phone reviews. Of these, 9829 (99 per cent) resulted in no further action whilst less than one per cent resulted in an outcome. Since phone reviews are primarily designed to gather information and to increase the taxpayer's awareness of record keeping obligations rather than to check if income is correctly reported no strike is expected.

Record keeping audits

4.24 During the same period, the ATO conducted 927 record keeping audits. Of these, 104 cases resulted in the application of record keeping penalties or adjustments to income or GST liabilities.

Correspondence audits

4.25 From May 2010 until April 2012, the ATO conducted 7670 correspondence audits. Of these, 24 per cent resulted in an outcome, being an amended assessment on some basis agreed to by the taxpayer or a default assessment. The other 76 per cent resulted in no further action.

4.26 The IGT has inspected a sample of nil outcome correspondence audit cases. The most common reasons for recording these cases as a 'nil outcome' were:

- After a phone conversation between the ATO officer and the taxpayer or their agent, the ATO officer determined that the taxpayer was in the wrong ATO benchmarked industry and was either within the benchmark range of the correct ATO benchmarked industry or no benchmark existed for the industry to which the business belonged.
- After the commencement of the audit, the ATO officer and taxpayer discussed the fact that the taxpayer had a mixed business and selected the main business for their 5-digit ATO business industry code. The taxpayer supplied some documentation disaggregating their business into their separate lines. The ATO officer, after ascertaining the ratios for each business line, determined they were all within the benchmarks. Alternatively, one business line was out of the benchmarks, but the amount at risk was low. Depending on whether the business already keeps disaggregated business records, this type of case can have a lower or higher compliance cost. Smaller businesses do not tend to keep disaggregated accounts and

would therefore need to expend additional time or money to disaggregate them for the ATO.

- The taxpayer was in the correct industry, they supplied all required records, and the auditor was satisfied that the records evidenced the figures reported in their BASs and income tax return. That is, the audit ran its full course and was found to be compliant.

Specific audits

4.27 As indicated in chapter 2, most benchmarking specific audits flow on from other compliance activities. For example, where an ATO correspondence audit on a partnership has resulted in an adjustment to the sales figures of the partnership business, it will necessarily require an adjustment to the income distributions of the partners. The specific audit is the ATO compliance product used to determine that adjustment. As such, higher strike rates are expected. They are not selected on the basis of variance from the benchmark.

Cash economy audits

4.28 The highest intensity benchmarking audit product is the 'Cash Economy Audit'. Under the benchmarking strategy, this involves ATO officers visiting the taxpayer's business premises (a field presence). The ATO conducted 188 cash economy audits over this same period, with 55 per cent resulting in an outcome or strike rate from an ATO perspective.

4.29 Under the benchmarking strategy, these cases may be selected as a result of either a significant variance from the benchmark in addition to being identified as a risk under the cash economy risk model or escalated by an ATO officer from a correspondence audit.

IGT observations

4.30 The ATO's case selection methodology appears to hypothesise that a higher variance from the benchmark presents a higher underreporting risk than those with a lower variance. Cases which have a variance below a certain threshold may be selected for a record keeping audit, whilst other cases above the threshold are excluded from record keeping audits, but may be instead selected for the more intense correspondence audit.

4.31 It should be noted that the process the ATO undertook to identify cases selected for correspondence audit involved a significant amount of filtering, starting from 1.4 million potential cash economy taxpayers. From this figure, the ATO has used the benchmarks to select 7670 taxpayers for correspondence audits from May 2010 to April 2012.

4.32 As correspondence audits have a strike rate of 24 per cent this may suggest that a higher variance from the benchmark does not necessarily, of itself, indicate likely underreporting of income. This is not to say that the variance from the benchmark is ineffective at targeting a proportion of underreported income. As a starting point for risk hypothesis testing, benchmarks have identified non-compliant taxpayers.

4.33 However, it is equally true that correspondence audits may be better targeted by not commencing them solely based on benchmarks. The correspondence audit strike rate of 24 per cent is better than auditing a random sample of the 1.4 million cash economy population. However, the IGT believes that the current approach may be improved in better targeting its correspondence audits towards likely non-compliant taxpayers.

4.34 The IGT notes that the overall strike rate may be affected by a lack of distinction between nil outcome cases where audits are closed early as opposed to where the audit runs its course and the taxpayer is found to be compliant. Classifying both of these types of cases as 'nil outcome' prevents the ATO from understanding the true extent to which audit nil outcomes can be attributed to either incorrect case selection or taxpayer compliance with the law.

4.35 The ATO should consider reporting their cases in such a way as to make a distinction between those cases which are closed due to incorrect case selection shortly after taxpayer contact is made and those cases where the risk hypothesis is tested by the ATO.

4.36 It is the IGT's view that that the ATO could do more to bolster the risk identification process before commencing a correspondence audit, with its associated compliance costs and intensity. There may be many reasons why a business falls outside of the benchmarks that are not related to non-compliance with the tax laws. For example, some taxpayers may be simply better at their business than others and there may be different personal motivations affecting costs (such as wanting to use better quality materials, employing more staff because they want to spend more time with their family, etc.).

4.37 However, regardless of the taxpayer's motivations for running their business, they are still required to maintain adequate evidence of their reported income and expenses. The challenge for the ATO is to use a method to identify potential underreported income, which may ultimately be evidenced by inadequate record keeping. Benchmarks are but one indicator and the ATO should use other indicators to refine the targeting of its compliance verification activities away from compliant taxpayers and towards more likely non-compliance taxpayers.

Other indicators of underreported income

4.38 Stakeholders expressed a variety of views about what these other indicators were, and the means by which the ATO could access information relevant to those indicators.

4.39 Firstly, stakeholders suggested that the presence or lack of cash controls may point to underreported income, and that the ATO could infer the presence of such controls by whether the business employs staff with access to cash. If so, the business owner has a stronger incentive to have cash controls in place, to minimise theft. Conversely, if the business is family run such cash controls may be less likely to be in place. It was considered that the ATO could identify such businesses from employment declarations lodged with the ATO without the need to contact taxpayers.

4.40 Secondly, it was suggested that businesses predominantly dealing with other businesses (that is 'business-to-business') are more likely to have better record keeping since their business customers would normally require invoices.¹⁰⁴ Furthermore, it was also considered that business customers are more likely to pay electronically compared to retail customers who are more likely to pay in cash. However, it was acknowledged that the ATO could have difficulties in identifying such taxpayers without verifying their records first.

4.41 Thirdly, stakeholders expressed the view that the 'tax competency' of the business operator may have a bearing on their compliance¹⁰⁵ and, as such, the ATO should consider this as an additional step in the risk identification process. Such tax competency could be affected by the business owner employing a bookkeeper to maintain its records.

4.42 Stakeholders also suggested that another indicator of underreported income is where the reported business income is unrealistic given the level of taxpayer assets, household expenses or living standards. In this respect, where such business income appears unrealistically low, the ATO could make enquiries about whether the taxpayer has other non-business income or if someone else is financially contributing to the household. To a certain extent, the ATO does this through its cash economy risk model.

4.43 There was a variety of stakeholder views, however, on how the ATO may best obtain information on these factors. For example, the business may need to complete additional fields in a tax return on a regular basis or the ATO may contact the business by phone to make additional enquiries. In this respect, it was acknowledged that there may be difficulties in either redesigning income tax returns for a small proportion of the total taxpaying population or evidencing taxpayers' representations over the phone without imposing substantial additional compliance costs.

4.44 The ATO itself is also aware of a range of indicators which may potentially point to a higher risk of underreported income in the cash economy, including:

- lack of proper record keeping practices; and
- poor lodgment history.¹⁰⁶

4.45 Further, the ATO is aware that large franchise retailers are a low record keeping risk since the franchisors have computer record keeping systems in place.¹⁰⁷

4.46 The ATO also advises that it excludes classes of taxpayers from compliance activities on certain factors. None of these factors, however, relate to any of the indicators described above.¹⁰⁸

104 See also, Australian Taxation Office, *The Cash Economy under the New Tax System*, Australian Taxation Office, Canberra, September 2003 Page ix.

105 *ibid*, page 17.

106 ATO communication to IGT 23 February 2012.

107 ATO Record Keeping Audit Product Committee Minutes 25/08/2011, supplied by ATO 2 March 2012.

108 ATO case selection methodology supplied 23 February 2012.

4.47 The following table shows how the various indicators mentioned above are used or not used by the ATO when deciding to commence a correspondence audit. In the third column, the ATO has advised the indicators for which it has ready access.

Table 14: Indicators of underreported income used or not used by the ATO for correspondence audits

Indicators referred to by stakeholders and the ATO	Indicators currently used by ATO in deciding to commence correspondence audit	Indicators the ATO can use
The presence and adequacy of cash controls	No	No
Whether the business employs staff	No	Yes
Whether the business has access to cash	Yes. Note the ATO selects businesses in cash economy industries.	Yes
Whether the business mainly deals with consumers or other businesses	No	No
The skill of the person responsible for record keeping	No	No
Whether the business engages the services of a tax agent and/or bookkeeper	No	Yes
Whether the business is significantly outside the benchmarks	Yes	Yes
Whether the business is deriving 'unrealistic' income	No	Yes

Source: ATO table supplied to IGT 21 May 2012

4.48 As noted in chapter 2, the ATO may undertake phone reviews of taxpayers where their financial performance is outside the applicable benchmark range. Some of these phone reviews may result in a recommendation by the ATO officer that the reviewed business be the subject of a correspondence audit. Out of 8127 correspondence audits, the ATO has identified 216 which were escalated from previous phone reviews. The table below provides the results as to these case product outcomes.

Table 15: Correspondence audits escalated from phone reviews

	Number of cases	Percentage of all cases
Early exit	13	6%
Nil outcome	190	88%
Outcome	13	6%
Total	216	100%

Source: ATO data supplied to IGT, 21 March 2012.

4.49 The above table demonstrates that the phone review in its current form is not a particularly effective means of identifying non-compliant taxpayers. The strike rate of these cases (6 per cent) is much lower than the general correspondence audit strike rate (24 per cent).

IGT observations

4.50 The IGT believes that the targeting of the ATO's correspondence audits may be improved by supplementing the case selection methodology with additional steps before taxpayers incur significant compliance costs, such as collating and sending records to the ATO. Whilst stakeholders presented a range of views on what other

additional steps the ATO should take, the IGT is of the view that there is an important balance to be sought between the quality of the information sought and the compliance cost impact on taxpayers who may be required to supply additional information (either by phone or in writing) over and above their baseline costs.

4.51 It is instructive that many correspondence audits once commenced terminate early, after the auditor and tax agent/taxpayer discuss the issues over the phone. During that call, ATO officers are able to terminate the audit due to incorrect assumptions or details, such as the incorrect application of ATO business industry codes. It was also reported to the IGT that in certain cases audits were terminated where the taxpayer explained the benchmark variance to the satisfaction of the auditor.

4.52 The IGT recognises that the ATO needs to strike a balance between reducing compliance costs for taxpayers, whilst at the same time collecting enough information about those taxpayers to make an informed risk assessment. The IGT also recognises that there is a limit to the use of general analysis and broad metrics and that more specific taxpayer information is required in appropriate circumstances. The ATO has two options in obtaining more specific taxpayer information, namely, by way of direct contact or otherwise by third party data.

4.53 The advantage with the use of third party data is that it does not require contact with the taxpayer or any extra cost, such as completing additional forms. Thus compliance costs are minimised. In the case of benchmarking, however, once a taxpayer has been identified as being outside the benchmarks, much of the information for risk assessment (such as cash controls or record keeping practices) is accessed by direct taxpayer contact. Currently, this type of ATO activity takes place after the correspondence audit has technically started (and after the Confirmation of Audit letter is sent).

4.54 The IGT believes that such interaction should be by 'separate enquiry' prior to the correspondence audit. Making separate enquiries of the taxpayer prior to audit commencement will give the ATO an opportunity to make a more robust risk assessment (and if necessary, an opportunity for the taxpayer to directly supply additional information) enabling more accurate audit selection. Such an enquiry may be by way of a phone call or written correspondence.

4.55 ATO officers already perform these information gathering exercises, either as a phone review or as part of a correspondence audit. The IGT is of the view that auditors should undertake this information gathering consistently and separately from correspondence audits.

4.56 As indicated in Table 14 above, the IGT recognises that information about other indicators such as whether a particular business can be described as business-to-business or business-to-consumer or whether the business uses a bookkeeper may not be as easily compiled from ATO systems. Nevertheless, the IGT believes that information about these indicators should be sought from the taxpayer as part of the risk identification process prior to the commencement of any audit.

4.57 To ensure compliance costs are minimised, the IGT considers that the ATO should use a staged approach in its information gathering as part of its risk identification process. The approach should also accommodate less formal means

where possible. Information gathering that occurs in a less formal context than that of a formal audit may also reduce taxpayer stress given its lower intensity.

4.58 By using a review process to gather information about the indicators of underreporting or business characteristics, the ATO would also be able to better report on indicators or characteristics that may eventually result in audit outcomes. This could be fed back into the risk identification process for future compliance selection.

Validating other identifiable indicators of underreported income

4.59 Importantly, the ATO now has completed over 7600 correspondence audit cases. In approximately 5700 cases, the ATO either found the taxpayer to be compliant or of low risk. In approximately 1800 cases, the taxpayer underreported income. This volume of cases is a potentially useful source of data which could be analysed to identify whether there are characteristics that can be used by auditors to predict either underreporting of income or full compliance. If such predictors exist, they could potentially be used early in audits to minimise not only taxpayers' compliance costs but also free up ATO resources more quickly to focus on likely non-compliance.

RECOMMENDATION 4.1

To more accurately target non-compliant taxpayers and reduce the number of compliant taxpayers being audited, the ATO should consider improvements including:

(a) examining completed correspondence cases to identify whether additional useful predictors of underreporting and/or compliance exist and use such predictors to refine the risk identification process; and

(b) implementing strategies to exclude compliant and low risk taxpayers from correspondence audits at the earliest point possible.

ATO response: Agree

The ATO will undertake a program to review completed cases with a view to refining its risk identification process. In addition it will modify the existing correspondence audit product to identify and exclude compliant and low risk taxpayers at the earliest point possible.

CHAPTER 5 — RECORD KEEPING, AUDITS AND DEFAULT ASSESSMENT

5.1 Stakeholders have raised concerns that correspondence audits expose many taxpayers to the risk of increased tax liabilities and penalties for what they perceived to be technical record keeping deficiencies rather than omitted income evidential requirements. The interaction between taxpayers' record keeping obligations and the ATO's identification of omitted income in the context of audits and default assessments is discussed later in this section.

RECORD KEEPING OBLIGATIONS

5.2 As mentioned in chapter 2, taxpayers have an obligation under section 262A of the ITAA 1936 to keep records of their business transactions 'so as to enable the person's liability under this Act to be readily ascertained'. Furthermore, where a taxpayer fails to keep or retain records as required by section 262A, they may be liable for a \$2200 administrative penalty under section 288-25 of Schedule 1 to the *Taxation Administration Act 1953*.

5.3 Taxpayers may enlist the services of a tax practitioner to assist with the management of their tax affairs, including record keeping. In this respect, the ATO advises that 93 per cent of micro businesses use registered tax agents to lodge income tax returns and 50 per cent use a BAS agent to lodge Business Activity Statements.

5.4 Tax agents and BAS agents are regulated by the *Tax Agent Services Act 2009* (TASA 2009) which includes a Code of Professional Conduct, pursuant to section 30-10 of the TASA 2009. One principle of this Code is:

(9) You must take reasonable care in ascertaining a client's state of affairs, to the extent that ascertaining the state of those affairs is relevant to a statement you are making or a thing you are doing on behalf of a client.

5.5 The Tax Practitioners Board (TPB) administers the TASA 2009 and the Code. In this respect, the TPB has issued an Explanatory Paper¹⁰⁹ which sets out its interpretation of the principle above:

124. It should be noted at the outset that this requirement under the Code does not create a requirement that a tax agent or BAS agent effectively 'audits' all of the agent's clients before providing tax agent services to avoid breaching the Code.

125. Rather, this requirement is a duty of tax agents and BAS agents to take care beyond placing complete reliance on the accounts prepared, or work done, by a person without considering their level of knowledge and/or understanding of the taxation laws and the

¹⁰⁹ Tax Practitioners Board, *Explanatory Paper TPB 01/2010 Code of Professional Conduct*, Tax Practitioners Board, 16 December 2010, viewed 2 July 2012 <<http://www.tpb.gov.au>>.

correctness of their work to ensure that the information upon which the provision of the tax agent's services is based is accurate.

126. In most cases, this will require that a tax agent or BAS agent ask the client appropriate questions, based on the agent's professional knowledge and experience, to ascertain the accurate factual basis upon which the tax agent services are provided and, where appropriate, to obtain supporting documents and records evidencing these facts.
...

128. Taking reasonable care will in many cases require that a tax agent or BAS agent ask questions based on their professional knowledge and experience in seeking information. Where there are grounds to doubt the information provided by a client, the tax agent or BAS agent must take positive steps and make reasonable enquiries to satisfy themselves as to the completeness and/or accuracy of that information.

129. Where a statement provided by a client seems plausible and is consistent with previously established statements and the agent has no basis on which to doubt the client's reliability or the veracity of the information supplied, the tax agent or BAS agent may discharge their responsibility by accepting the statement provided by the client without further checking.

130. However, if the information supplied by a client seems implausible or inconsistent with a previous pattern of claim or statement, further enquiries would be required.

131. Again, whilst there is no requirement to audit, examine or review books and records or other source documents supplied by a client, a tax agent or BAS agent does not discharge their responsibility in such a case by simply accepting what they have been told.

5.6 The TPB's interpretation indicates that whilst small business record keeping is the responsibility of the taxpayer, tax practitioners do have certain duties as noted.

THE ATO APPROACH TO RECORD KEEPING

5.7 The ATO has identified micro business record keeping as a strategic risk to the tax system. In particular, the risk is that if a business does not accurately record their income, the business may subsequently underreport income in their tax return.¹¹⁰

5.8 As mentioned in chapter 4, the ATO reports that inadequate record keeping often arises 'due to a lack of understanding and low skill levels, rather than any deliberate intention not to comply.'¹¹¹ The ATO therefore addresses this risk through a range of activities and publications, with the focus on help and education, including the following:¹¹²

110 ATO Strategic Risk Register: Compliance; Risk SR2/2 - Issued August 2011

111 Australian Taxation Office, *The Cash Economy under the New Tax System*, Australian Taxation Office, Canberra, September 2003, page 17.

112 Australian Taxation Office, *Penalties for not keeping records: what is our approach to record keeping and penalties?*, Australian Taxation Office, Canberra, 25 August 2010, viewed 2 July 2012, <<http://www.ato.gov.au>>.

Our emphasis is to improve record keeping practices through help and education.

We have field officers who visit businesses and assess their record keeping practices. They will provide a written report to each business, including any suggestions for improvement.

If we visit you and assess your records as needing improvement, we generally give you an opportunity to improve your record keeping to an acceptable standard before we consider applying a penalty.

If we believe that a weakness in your record keeping may lead to non-compliance with the tax laws, we may make a return visit to ensure you have improved your record keeping practices.

5.9 This approach is also reflected in Law Administration Practice Statement *PSLA 2005/2 Penalty for failure to keep or retain records*.

5.10 The ATO also conducts record keeping audits as a compliance tool which allows the ATO to verify the extent to which taxpayers are complying with their record keeping obligations under section 262A of the ITAA 1936.

THE ROLE OF RECORDS AND OTHER EVIDENCE IN CORRESPONDENCE AUDITS

5.11 The ATO has indicated that it focuses on record keeping since 'a clear link exists between compliance with tax obligations and good record-keeping practices.'¹¹³ With reference to the cash economy benchmarking strategy in particular, the ATO advises on its Small business benchmarks webpage:

If you find you are outside the benchmarks for your industry, you should check that you have correctly recorded and reported income and deductions for your business. To do this you should review your record-keeping practices to ensure they meet the legal requirements.¹¹⁴

5.12 With respect to the correspondence audit, the audit confirmation letter advises the taxpayer:

You need to record all your business income and keep records that enable us to readily ascertain your tax liability.¹¹⁵

5.13 The letter also highlights that the taxpayer is required to 'keep detailed records of every sale unless you conduct and retain reconciliations of your daily sales and banking'. The letter requests specific types of records along with 'any other relevant information'.

113 Australian Taxation Office, *Compliance Program 2011-12*, page 12

114 Australian Taxation Office, *Small business benchmarks - Overview*, Australian Taxation Office, Canberra, 22 May 2012, viewed 30 May 2012, <<http://www.ato.gov.au>>.

115 A sample audit confirmation letter is attached as Appendix 6. Letter supplied by ATO, 7 June 2012.

5.14 The letter advises the taxpayer that the ATO:

will examine your records and other information you supply to support your reported income. If your records do not support your reported income or you fail to provide the information requested, we will use the benchmark figures as a reasonable basis for making a revision assessment.

5.15 Where the evidence provided supports the income figures reported in the tax return, the case would normally be closed with no further action and recorded as a 'nil outcome'.

5.16 Where a taxpayer does not produce the specifically requested records, the taxpayer may nevertheless supply other evidence to support the income figures reported in their tax return. For example, a taxpayer may not have all the records that comply with their technical record keeping obligations, but they may have sufficient evidence of regular cash deposits into a business bank account and a record of wages and other expenses being paid out of the cash register before banking. Other evidence may include indications of margins such as price lists and purchase records.

5.17 In the event the taxpayer cannot provide acceptable evidence to show how they arrived at their reported income figure in their income tax return, the ATO would then regard that as evidence of underreported income.

5.18 A taxpayer may also submit evidence which supports an income figure different to that indicated on their tax return. The ATO would then move to adjust the taxpayer's income tax liability to align with the evidence. In these circumstances, whilst underreported income is detected, the ATO does not apply the benchmark to calculate it.

5.19 There may be other occasions where the taxpayer does not provide any acceptable evidence to substantiate any particular income amount. In such cases, the ATO advises they do not rely on taxpayer specific information and would instead move to apply the benchmark as a basis for assessment. As indicated in chapter 2, where the ATO applies the benchmark, it applies the highest percentage in the relevant benchmark range for that industry and that turnover range. This has the effect of amending the taxpayer's income to the lowest amount available within the benchmark range. In the case of applying the cost of sales benchmark, the percentage is applied to the taxpayer's cost of sales as reported on their tax return. The assumption here is that the cost of sales figure is correct as taxpayers tend to have a greater incentive to keep good records of expenses which may be tax deductible.

5.20 By applying the benchmark percentage to the taxpayer's actual reported cost of sales, the ATO considers that this takes into account the particular circumstances of the business and is thus a reasonable basis for assessment. The ATO has also advised that in the case of correspondence audits, it does not seek to use personal living expenses or asset betterment methods as a basis for assessment as it is more resource intensive and the combination of the taxpayer's reported cost of sales and the benchmark already suffices. This can be compared to the ATO's approach in cash

economy audits where obtaining personal living expenses and third party data verification is part of the audit process.¹¹⁶

5.21 Nevertheless, the ATO advises that the taxpayer may undertake such an analysis of their own volition to rebut the ATO income figure based on the benchmark.

5.22 The ATO provides the following guidance to the auditor about the reason for the correspondence audit and how it should be conducted:

Assessments must take into account the individual circumstances of the taxpayer. For instance if the taxpayer can provide evidence of their actual cost of sales ratios, and can satisfy record keeping requirements of PSLA 2005/2, use the taxpayer's figures rather than a benchmark ratio as the basis for the assessment. ...

The records requested are to test the integrity of the record keeping system of the taxpayer in order to support their claims. The other information and evidence requested leaves it open to the taxpayer to provide whatever they consider relevant to their situation.¹¹⁷

5.23 The following is an extract from a Best Practice Guide circulated via email in October 2010 to Cash Economy staff conducting correspondence audits:

We should also seek to obtain contentions in relation to benchmarks and any other relevant contentions relating to profit margins. Clients should be advised to support their contentions with physical evidence rather than making general broad statements about what may be affecting their margins.

We should also attempt to obtain information in relation to supplies and COGS [that is Cost of Goods Sold] calculations, particularly where the client appears to have a mixed business.

Goods for own use and wastage should also be discussed.¹¹⁸

5.24 The above requires auditors to seek information not just relating to sales figures, but also relating to margins. Evidence requested for cost of sales ratios is not indicated in any correspondence to taxpayers and it is up to the auditor to ask for that information. For example, if a takeaway shop had records relating to sales that gave rise to some concern, but was able to show their cost of sales ratios (for example their margins), by comparing the cost of acquiring food and the sale prices as indicated by their menus, then that ratio could be used to reconstruct a new business turnover. However, a review of audit confirmation letters¹¹⁹ shows that none of the audit letters provide any guidance as to other evidence that the taxpayer might be able to provide in support of the taxpayer's original assessment should the business records not meet ATO expectations.

116 Australian Taxation Office, *Small business benchmarks: how we use the benchmarks*, Australian Taxation Office, Canberra, 22 May 2012, viewed 30 May 2012, <<http://www.ato.gov.au>>.

117 ATO communication to IGT, 23 February 2012.

118 'Cash Economy Update Issue 5' email to Cash Economy staff, dated October 2010, supplied to IGT 23 February 2012.

119 Audit Letters supplied by ATO, 23 December 2011.

THE EVIDENTIARY BASIS FOR DEFAULT ASSESSMENTS

5.25 Under subsection 167(b) of the ITAA 1936, where the Commissioner is not satisfied with the return furnished by any person:

the Commissioner may make an assessment of the amount upon which in his or her judgment income tax ought to be levied, and that amount shall be the taxable income of that person.

5.26 These are commonly referred to as 'default assessments'.

5.27 As discussed above, where the ATO is not satisfied with the records or other evidence provided by the taxpayer during an audit, it will 'use the benchmarks as a reasonable basis for making a revision assessment'. That is, the ATO will issue a default assessment.

5.28 Concerns were raised by stakeholders that the use of benchmarks for a default assessment is unreasonable since the benchmark is a generalised statistic. It was submitted that the figure estimated may not resemble reality for the taxpayer (being too high or even too low in some cases).

5.29 A key stakeholder contention underlying this position was the concern that the ATO was effectively 'making up' or 'creating income' that taxpayers did not have. This is a particularly difficult situation as it may act to create taxpayer resistance in certain circumstances by instilling a sense that the ATO is telling the business they are not making enough money or that the taxpayer is not a good business operator.

5.30 It was suggested in submissions that if the ATO wants to effect default assessments, it needs to apply more rigour in the process to understand the specific financial circumstances of the taxpayer (as it does with other default assessment processes such as betterment assessments) before using the benchmark. The ATO policies and processes for issuing default assessments is discussed below.

ATO policies on default assessments

5.31 When issuing default assessments, ATO staff are required to follow Law Administration Practice Statement, *PSLA 2007/24 – Making default assessments: section 167 of the Income Tax Assessment Act 1936 and similar provisions*. This instruction applies to all ATO officers, not just those in the Cash Economy or TPALS areas who conduct benchmarking compliance activities. Paragraph 8 states that:

Section 167 allows the Commissioner to make an assessment of the amount upon which, in his or her judgment, income tax ought to be levied. Given the objective nature of this judgment, tax officers must ensure that their decisions are fair, that they are made on reasonable grounds (see paragraph 9 of this practice statement), that there is sufficient information available to them to make a genuine judgement, and that they consider the relevant individual circumstances in accordance with the law, the commitments made in the taxpayers' charter and the principles of the compliance model.

5.32 Paragraph 9 of the Practice Statement lists the following as being reasonable grounds:

- information provided by third parties,
- any internal or external data matching information,
- indirect audit methodologies (such as sources and application of funds, 'T' accounts or asset betterment assessments),
- relevant economic statistics, or
- extrapolation from previous years returns.

5.33 In 2010, the ATO's Active Compliance Steering Committee issued a *Default Assessment – End to End Process* document which gives greater guidance to its compliance staff about the context, policy framework and procedures to be followed when considering default assessments. In particular:

The Commissioner may use a rationally-based process to make a genuine ascertainment of the taxpayer's taxable income. Any basis used must be reasonable, credible and defensible. The basis must, as much as practical, take into account the taxpayer's particular circumstances. The information taken into account in making an assessment must have a rational connection to the taxpayer's individual situation.¹²⁰

5.34 This document indicates that it is the norm for default assessments across the ATO to be based on information pertaining to the taxpayer's individual circumstances.

5.35 In relation to the benchmarking strategy, such an approach is supported in the ATO's funding bid for the strategy:

In conducting audits and making default assessments business taxpayers will be given every opportunity to provide evidence. Benchmarks will only be used in the absence of other evidence. For instance where the ATO has third party data that identifies trading stock purchases but the taxpayer is unable to provide records of sales; mark-up benchmarks could be used to determine sales. Even so, this would take into account any reasonable contentions made by the taxpayer.¹²¹

5.36 In this respect, most default assessments arise during correspondence audits. Of the 228 default assessments issued, 223 were the result of these audits.

5.37 As previously discussed, the ATO considers that applying the benchmark to a taxpayer's cost of sales is a reasonable basis on which to issue default assessments, where the taxpayer has inadequate evidence to support their reported income.

120 ATO Default Assessment End to End Process, April 2010, Page 7, supplied by ATO 27 January 2012.

121 Australian Taxation Office, *Promoting a level playing field for Australian small business: funding bid*, March 2009, supplied by ATO 22 March 2012.

IGT observations

5.38 There may be circumstances where the ATO does not give the taxpayer a reasonable opportunity to provide information to augment or otherwise contest a potential default assessment. This runs the risk of prolonging a dispute that may not have a sound basis, may run up costs and possibly even require taxpayers to pay tax on income not earned. That is, even if a taxpayer has records that do not meet ATO expectations, they may have an alternative basis to support their reported income level. The importance of the ATO applying greater rigour to the default assessment process in avoiding the potential for perceptions of unfairness or oppression is critical.

5.39 An analysis of objection outcomes and their reasons may indicate the degree to which evidentiary issues arise during audit, default assessment and objection processes.

Default assessments and objections

5.40 The table below indicates that out of 2420 outcome cases from July 2010 to April 2012, 228 cases were classified as default assessments. Of the 228 cases, 185 were cases where the only outcome was an income tax default assessment. The other 43 cases contained an income tax default assessment outcome as well as another outcome. The rest of the outcome cases were the results of ATO activity statement revisions, amendments of previously lodged returns, lodging outstanding returns or making voluntary disclosures.

Table 16: Revenue outcomes for benchmarking activities July 2010 to April 2012

	Cases	% of cases	Tax liabilities raised (\$ million)	% of tax liabilities raised	Penalties raised (\$ million)	% of penalties raised	Objections lodged
Cases where the outcome is a default assessment only	185	7.6%	\$18.6	27.9%	\$13.6	41.8%	39
Cases where the outcome includes a default assessment and another outcome (a)	43	1.7%	\$4.1	6.2%	\$2.6	8%	13
Cases where the outcome does NOT include a default assessment	1707	70.5%	\$40.9	61.5%	\$14.8	45.5%	179
Cases where information was not available as to any outcome	485	20%	\$2.8	4.2%	\$1.5	4.5%	38
Total (b)	2402	99.8%	\$66.5	99.8%	\$32.7	99.8%	269

Source: Table compiled by IGT case data supplied by ATO 23 December 2011 and 31 May 2012.

Note (a): Cases may have multiple outcomes, for example, a default assessment for income tax, and an ATO activity statement revision.

Note (b): Totals may not equal due to rounding.

Note: Where the field value for 'Amendment' and 'Voluntary disclosure' was recorded as 'unavailable' or 'not available', but the other three fields have values such as 'yes' or 'no', Amendment and Voluntary disclosure was converted to 'no'.

5.41 The table above demonstrates that although default assessments accounted for 9 per cent of benchmarking compliance cases, they represent 34 per cent and 49 per cent of taxes and penalties raised respectively under the benchmarking strategy.¹²²

5.42 Where a taxpayer is dissatisfied with an assessment, including a default assessment, they may lodge an objection against it.¹²³ In information provided by the ATO, 269 objections relating to benchmarking were lodged between July 2010 and April 2012. Of these, 259 have been finalised with 10 remaining on hand.¹²⁴ The results of these objections are summarised in the table below.

Table 17: Results of objections

Allowed in full	61
Allowed in part	120
Disallowed	61
Withdrawn	7
Invalid	7
Other	3

5.43 The following table indicates the types of cases that generated these objections, and the rate at which the objections are allowed, either in full or in part.

Table 18: Rate of dispute for benchmarking activities

	Cases	Objections lodged	Percentage of cases to which were objected	Objections allowed in full	Objections allowed in part	Objections disallowed	Allowance rate (a)
Cases where the outcome is default assessment only	185	39	21.1%	8	23	3	79%
Cases where the outcome includes a default assessment and another outcome (b)	43	13	30.2%	1	9	1	76%
Cases where the outcome does NOT include a default assessment	1707	179	10.5%	39	74	47	63%
Cases where information was not available as to any outcome	485	38	7.8%	13	14	10	71%
Total	2420	269 (c)		61 (c)	120 (c)	61 (c)	67%

Source: IGT compiled table from ATO data supplied on 7 June 2012.

Note (a): Objections allowed in full and in part / Objections lodged

Note (b) Other outcomes may include ATO activity statement revision, or lodgment of outstanding returns.

Note (c): Objections allowed in full, in part and disallowed do not add up to 269 since there are other types of objection outcomes, such as withdrawal or an invalid objection.

5.44 The table above shows that cases involving a default assessment had a higher rate of dispute compared to other case outcomes. Furthermore, these objections

122 Default assessment only cases + Default assessment with other outcomes cases.

123 Section 175A of the *Income Tax Assessment Act 1936* and Part IVC of the *Taxation Administration Act 1953*

124 IGT compiled figures from ATO case data of objection outcomes supplied 7 June 2012.

had a higher proportion of which resulted in the objection being allowed in full or allowed in part (79 per cent and 76 per cent) compared to other objections not involving a default assessment (63 per cent and 71 per cent).

5.45 The following table shows the reasons for those objections which were allowed in full and those which were allowed in part. Where the reason outcome relates to objections involving default assessments, the number of these objections is shown brackets.

Table 19: Reasons for objection outcomes — July 2010 to March 2012¹²⁵

	Allowed in full	Allowed in part
1. Additional information provided	1	3
2. Evidence — Incomplete supporting evidence provided by taxpayer	11 (1)	28 (9)
3. Evidence — Audit adjustment not supported due to incomplete research, error in calculation, supporting evidence not used or requested by auditor	18 (2)	16 (1)
4. Evidence — Audit evidence incomplete to support audit decision	7 (1)	8 (2)
5. Evidence- Evidence is outside the scope of the audit so not used by auditor as part of decision making process	6 (2)	10 (4)
6. Evidence- Evidence penalty not supported	–	8 (3)
7. Interpretation — Auditor interpreted ATO view incorrectly or did not apply ATO view	1	–
8. Interpretation — Auditor behaviour not supported	3	7 (1)
9. Interpretation — Auditor interpreted application of penalty incorrectly	1	4
10. Interpretation — Auditor interpreted [penalty] remission provisions incorrectly	–	1
11. Procedural — Auditor calculated penalty and/or adjustment incorrectly	2	7 (2)
12. Procedural — Auditor did not apply procedures correctly	–	1
13. Unknown	11 (3)	23 (7)
Total	61(9)	116(29) (a)

Note (a): Total differs from Table 17 above since four objections allowed in part had 'disallowed' type reason codes against them.

IGT observations

5.46 The above table shows that the most common reason for an objection involving a default assessment to be allowed in full or allowed in part relates to the completeness of the evidence that was provided by the taxpayer during the course of the audit. The above list of outcome reasons seek to make a distinction between instances where the taxpayer has not provided sufficient evidence during the audit, despite being requested to do so (reason 2), and instances where such evidence was not provided because the auditor did not use or request it (reason 3).

125 IGT compiled figures from ATO case data of objection outcomes supplied 7 June 2012.

5.47 As discussed previously, the ATO will accept ‘records’ as well as ‘other evidence’ during a correspondence audit. The IGT is of the view that this distinction between records and other evidence may be a source of mismatched expectations between auditors and taxpayers as to what information is being requested of the taxpayer. This mismatch may be a reason why evidentiary issues are prevalent in the objections outcomes outlined above.

THE DISTINCTION BETWEEN ‘RECORDS’ AND ‘OTHER EVIDENCE’

5.48 The IGT believes that there is a distinction to be drawn between a taxpayer’s compliance with their record keeping obligations under section 262A of the ITAA 1936 and their ability to substantiate their income during an audit.

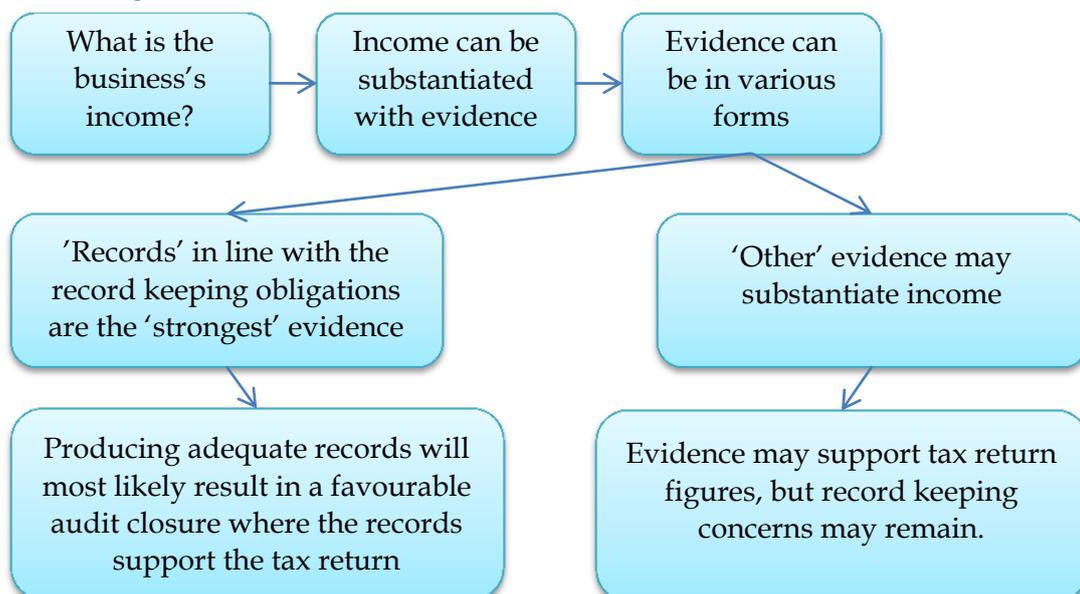
5.49 Income can be substantiated through the provision of a range of evidence. The strongest evidence a taxpayer can provide in the ATO’s view is outlined in Taxation Ruling TR 96/7 *Income tax: record keeping – section 262A – general principles* and the ATO’s guide, *Record keeping for small business*.

5.50 Non-compliance with record keeping obligations in itself, however, is not conclusive evidence of underreported income. A taxpayer still has open to them the opportunity to provide other evidence (not necessarily ‘records’ in the strict sense contemplated above) to substantiate their income. This evidence may be used to indicate the assessable income or taxable income for a business.

5.51 Alternatively, the taxpayer may adduce other evidence to refute an ATO contention. For example, where the ATO proposes to apply the industry benchmark to establish a revised business income figure, the taxpayer may submit evidence, such as personal living expenses or asset betterment, to indicate that the revised income figure is not reasonable since the purported extra income is inconsistent with the taxpayer’s consumption or accretion to wealth.

5.52 The distinction between the different types of evidence sought by the ATO, and that may be adduced by the taxpayer, are summarised in the diagram below.

Figure 9: Evidence to substantiate income



5.53 The ATO has directed the IGT to a number of cases in which the ATO considered the taxpayer records to give rise to some concerns but the ATO did not use the benchmark to make an adjustment. For example, in a case involving a clothing retailer, it was found that the taxpayer did not produce or keep basic documentation, such as sales summaries or reconciliations. However, other documentation such as bank statements and ledger reports were submitted, along with written explanations of how the business operated.

5.54 Whilst the ATO auditor initially determined¹²⁶ that the taxpayer did not keep their records 'in a such a manner as to enable us to readily ascertain your tax liability', the case did not result in an adjustment since the taxpayer's low business income figure was better explained, not by the underreporting of cash income, but rather by the fact that the taxpayer had taken out a loan against their home to keep the business afloat.

5.55 At the conclusion of the audit, the taxpayer was sent a letter indicating the ATO had finalised the audit with no further action. The letter also advised the taxpayer:

However, your record keeping practices were inefficient and lacked the level of detail required of a business that has a significant sales turnover and deals in cash transactions. As such, we have included some information below in this report to assist you with record keeping requirements.

Please note that you need to keep your business records for five years, including all records examined as part of this audit.

5.56 The letter then makes specific recommendations with respect to the production and maintenance of certain types of source documents.

5.57 It is the IGT's view that the ATO justifiably asks for records at first instance in the audit confirmation letter since this is the strongest evidence that taxpayers can produce to substantiate their reported business income. However, it is also important, as can be seen in the case above, that the ATO inform the taxpayer that it will accept other appropriate evidence to assist it in making a judgement about the likelihood of underreported income.

5.58 Compliance with record keeping obligations requires an investment of time and money on the part of the taxpayer which may be regarded as part of the baseline compliance cost that all taxpayers are expected to incur in a self assessment taxation system. Not complying with record keeping obligations exposes them to the possibility of greater compliance costs should the ATO ask them to substantiate their income in the event of an audit. In such situations, the taxpayer is then in the tenuous position of having to produce alternative evidence which may or may not satisfy the ATO that the income figure reported in the tax return is correct. Taxpayers may incur significant compliance costs in engaging the services of tax and/or legal practitioners to help reconstruct records or compile other evidence to support the income tax return figures.

126 This finding is in the interim report that was never sent to the taxpayer since the decision was made to NFA the case. The reason for closing the case, however, was not related to record keeping.

5.59 The IGT also notes that the ATO's inclusion of record keeping advice in audit finalisation letters even where there is no adjustment, as in the case above, complements the ATO's help and education approach to addressing the record keeping risk in the tax system.¹²⁷

AWARENESS OF OPPORTUNITIES TO PROVIDE ALTERNATIVE EVIDENCE

5.60 During consultations with stakeholders, however, the IGT noted there was confusion among taxpayers and their tax agents about whether correspondence audits were, in effect, record keeping audits. In particular, certain stakeholders submitted that they felt that non-compliance with record keeping obligations of itself was evidence of underreported income and was thus a threshold that the ATO used to determine whether to apply the benchmark in a default assessment.

5.61 Certain stakeholders asserted that ATO auditors appeared focussed on the quality of the records submitted almost to the exclusion of other evidence. In other cases drawn to the IGT's attention, taxpayers voluntarily completed a personal living expenses analyses or personal financial position statements, which were accepted by the ATO. Importantly, such analyses and statements were not requested or performed by the auditors.

5.62 Furthermore, notwithstanding it is ATO policy to give taxpayers an opportunity to produce other evidence besides business records to substantiate the income figures in the tax return, stakeholders submitted that they did not think that such an opportunity was available or was consistently communicated by the ATO.

IGT observations

5.63 In the IGT's view, the misalignment between ATO and taxpayer expectations of the audit process, especially with regard to the role of 'records' and 'other evidence,' can be addressed by the ATO better communicating the audit process to taxpayers and tax agents.

5.64 The IGT believes there are aspects of the written communication which may have caused some confusion about the nature of correspondence audits. For example, it may not be immediately clear in the audit confirmation letter that the ATO is seeking to establish whether the taxpayer has underreported their income. Where it does mention the reporting of income, the same sentence also indicates the taxpayer is required to effectively demonstrate compliance with their record keeping obligations.

5.65 The same letter then lists (helpfully) the types of records the ATO is requesting, followed by the comment that the taxpayer is required to keep these records. The letter also indicates that, *'If your records do not support your reported income or you fail to provide the information requested, we will use the benchmark figures as a reasonable basis for making a revision assessment'*. It may not be immediately apparent to some taxpayers that the ATO also mentions 'information' as well as 'records'.

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5.66 For example, an auditor may ask for cash register tapes and the taxpayer may focus on answering that question, rather than considering other evidence to support reported income. If the auditor had asked how the cash takings were evidenced and recorded, then the taxpayer may have provided different evidence. Such a miscommunication could be avoided by ensuring that the taxpayer is aware that, although the auditor is looking for the strongest evidence of income which complies with the record keeping requirements, there may be other means to evidence their income.

5.67 Where the ATO is initially not satisfied with the records and information provided, it will issue an interim report to the taxpayer outlining its findings. The interim report effectively indicates the judgment made by the ATO officer about the quality of the taxpayer's records or record keeping processes. The interim report commonly includes the phrase:

We have analysed the records you provided and it is determined that these records were not kept in such a manner as to enable us to readily ascertain your tax liability due to the following reasons.

5.68 However, an examination of a sample of interim reports, including those provided by the ATO, show that ATO auditors have been including factors which do not relate to record keeping. For example, factors considered in this judgment included:

- Not providing an explanation of why the business is reporting outside the benchmarks.
- The taxpayer has provided an explanation of why the business is reporting outside the benchmarks, but the ATO does not accept the explanation since it is too general in nature.
- The reported income figure does not appear consistent with the apparent lifestyle of the taxpayer, that is, the income would be insufficient to meet the cost of living for their household.

5.69 Thus, whilst the ATO may have taken into consideration the 'other information' provided by the taxpayer, they are included under what appears to be a judgment about the manner in which the taxpayer kept their records, and not an overall judgement about whether the taxpayer has discharged the onus to substantiate the income reported in their tax return. In this sense the distinction between complying with the record keeping obligations and disproving the existence of omitted income is in the IGT's view being blurred.

5.70 One may get the impression, therefore, that the ATO uses compliance with record keeping obligations as the threshold for deciding to issue a default assessment.

5.71 Despite the fact that there are staff instructions, stakeholders have raised concerns that ATO auditors do not consistently communicate the fact that additional evidence may be useful in substantiating the reported income tax return figures, or at

least providing an alternative basis for default assessment. The IGT considers that there are some aspects of ATO staff instructions¹²⁸ that may not adequately support auditors in making the distinction between records and other evidence and communicating it to taxpayers.

5.72 Furthermore, there is a mismatch of expectations in relation to the types of evidence the ATO would rely on. In particular, certain stakeholders have expressed that the ATO has, in the past, proactively used asset betterment and personal living expenses as a basis for default assessment. The view of those stakeholders was that the ATO should continue to do that in the case of correspondence audits, in preference to the benchmark. As noted above, it is ATO policy not to proactively pursue this type of evidence in correspondence audits.

5.73 The IGT considers that, even where objection outcome reasons list 'incomplete supporting evidence provided by taxpayer' (where it is implied that such evidence was properly requested by the auditor), certain cases may be attributable to taxpayers not understanding the distinction between records and other evidence since ATO documents themselves do not consistently make such a distinction.

5.74 It is the IGT's view that taxpayers would receive more consistent treatment, and have a greater understanding of the intended ATO process, if the ATO:

- produced clear guidelines to ATO staff about the correspondence audit process, in particular, the distinction between records as 'strongest evidence' and other information as 'other evidence', and the role they both play in relation to substantiating income;
- instructed ATO officers to make the taxpayer aware that they have the opportunity to provide 'other information' besides records, including examples of what that other information may entail;
- clearly communicated to taxpayers in the audit confirmation letter the process of the audit, including that the focus is on 'omitted income' and that the request for records is just a means to that end (this should include how the ATO treats 'records' and 'other evidence');
- made taxpayers aware in the same letter of other information the ATO seeks (for example information relating to margins or cash flows, etc.); and
- informed taxpayers that they have an opportunity to provide asset betterment or personal living expenses information of their own volition even though the ATO does not proactively seek such information.

DEFAULT ASSESSMENTS AND POTENTIAL SMALL BUSINESS REGULATORY COSTS

5.75 Certain stakeholders contended that situations arose where taxpayers did not object to default assessments, although they considered them excessive.

128 ATO communication to IGT, 31 May 2012.

5.76 The ATO considers that taxpayers who comply with their record keeping obligations would be in a better position to prove they had not omitted income and therefore not be subject to default assessments. In this sense, the ATO considers that the taxpayer has deferred their baseline compliance costs by not keeping adequate records.

5.77 The IGT is of the view that the ATO should also consider the pressures faced by small businesses, such as the regulatory burden (including that imposed by non-tax compliance obligations) have a highly regressive effect. These are not tendered as an excuse for taxpayers not complying with their obligations under the law. However, it is important that the ATO distinguish between taxpayers who have made a deliberate choice not to comply with the record keeping obligations under the law and those that need assistance and have not had reasonable opportunity to explain the figure reported in their return. Therefore, there is a need to clearly establish at outset of an audit what the audit is seeking to test, what the ATO will consider the strongest evidence (that is compliance with record keeping requirements) and, in the event such evidence does not exist, that the ATO requires a cogent explanation based on appropriate evidence. The importance of clearly establishing these evidence requirements at the outset of an audit is highlighted in the above discussion on objection outcomes.

5.78 Whilst default assessments can be challenged through the objection process, the IGT is concerned that, in an increasingly complex tax system and regulatory environment, the costs involved in small businesses lodging objections is regressive and may in certain cases be practically prohibitive. In this regard, it is worthwhile noting the following:

- the cost of engaging tax professionals in a low margin business may make it uneconomical;
- it may require the personal attention and time of the business owner, who may be the main person running the business and cannot afford to be away from the business;
- it may take a substantial emotional toll on business owners;
- the taxpayer will be unable to recover their costs in successful appeals to the Administrative Appeals Tribunal, as the costs in that forum fall upon each party directly – there is no sharing or directing on costs; and
- the high cost of litigating the issue in the Federal Court of Australia.

5.79 During the course of the IGT review, the ATO did acknowledge that in the very early period of the use of benchmarks that certain taxpayers were subject to default assessment prematurely. The ATO has subsequently sought to improve their processes by developing a '5-point process'. This process is reflected in the ATO 'end to end process' document supplied to the IGT and is included in Appendix 8.

5.80 Given the importance of the issue and the relatively small number of default assessment cases, the IGT considers that the ATO's revised approach in conjunction with the recommendations below should ensure future default assessments are subject

to appropriate rigour by providing taxpayers and their representatives the means to hold ATO auditors to account and promote consistent practice.

ENCOURAGING BETTER RECORD KEEPING

5.81 As mentioned above, where a correspondence audit results in no adjustment to the taxpayer's reported income, but the records still give rise to certain concerns, the auditor may include recommendations for the business to improve their record keeping. That is, it is possible for a taxpayer to have not met the ATO's record keeping expectations but still, by virtue of other evidence they have provided, substantiate their reported income.

5.82 The IGT is of the view that taxpayers with inadequate record keeping practices in these situations may be encouraged to improve their future record keeping simply by virtue of the fact that these taxpayers have already borne the higher compliance of an audit which may have been mitigated had the taxpayer been keeping adequate records at first instance. This will assist tax practitioners to persuade their clients to maintain better records and thereby reduce some of the practitioners' unrecoverable costs.

5.83 Nevertheless, the IGT also believes that some taxpayers may continue to attempt to defer their compliance costs and decide not to improve their record keeping practices. It is appropriate in these circumstances that the ATO continue to apply pressure to these taxpayers to improve their record keeping.

5.84 As indicated in chapter 2, the ATO currently uses record keeping audits as a combined education and verification tool to improve record keeping standards. The IGT believes that correspondence audits, to the extent that they examine the records and record keeping practices of the business, present an education opportunity. The ATO already takes advantage of this opportunity by providing record keeping recommendations.

5.85 It is the IGT's view that the ATO should reserve the right to apply its record keeping penalties consistent with practice statement *PSLA 2005/2* – that is where the taxpayer has been given an opportunity to improve their record keeping, but fails to do so upon future verification activity, a record keeping penalty may apply.

RECOMMENDATION 5.1

(1) The ATO should consult with taxpayers, tax practitioners and their representative bodies with a view to publishing guidance on what taxpayers and their advisors can expect during cash economy benchmarking compliance activities, including:

- (a) the type of activities and circumstances in which these compliance activities may be used and the manner in which these will be conducted; and*
- (b) more effective escalation processes where the ATO's officers do not meet the expectations set out in the guidance.*

(2) In relation to ATO correspondence audits such published guidance should include the following:

- (a) the ATO considers that the strongest evidence to support reported income are records meeting the ATO's record keeping requirements;*
- (b) where the above record keeping requirements may not be met, the ATO will allow taxpayers to provide a cogent explanation supported by appropriate evidence;*
- (c) where the ATO accepts such an explanation as supporting the taxpayer's reported income, the ATO may still impose record keeping penalties if the taxpayer has been previously given an opportunity to improve their record keeping; and*
- (d) where the ATO does not accept the explanation, how the ATO will calculate the amended assessment by taking into account the taxpayer's personal circumstances.*

ATO response: Agree

The ATO will consult with taxpayers, tax practitioners and their representative bodies with a view to publishing enhanced guidance about the ATO conduct of cash economy compliance activities and escalation processes for taxpayers and their advisers.

CHAPTER 6 — ATO AUDIT PRACTICES AND APPROACHES

6.1 Stakeholders have raised a number of concerns with aspects of the ATO's practices and approaches in correspondence audits, including:

- some auditors' evidentiary basis and reasoning for culpability penalties, especially in relation to penalties for intentional disregard of the taxation law; and
- practices and approaches that unnecessarily increased taxpayers' and tax agents' compliance costs.

6.2 These issues are discussed below.

PENALTIES

6.3 In relation to the evidentiary basis and reasoning supporting penalty decisions, submissions singled out for particular comment the 75 per cent penalty for intentional disregard of the taxation law.¹²⁹

6.4 The main concern centred on some auditors' reliance on the lack of adequate record keeping as evidence of the misstatement penalty. As summarised by one submission, the ATO officer's approach appeared to be:

- the taxpayer has put \$X in their tax return
- under a correspondence audit, the taxpayer cannot substantiate \$X
- the ATO applies benchmark and substitutes turnover with \$Y
- since \$Y does not equal \$X, \$X must therefore be false and misleading
- because everyone knows the law requires you to keep records for everything, there is an intentional disregard of it.

6.5 In an examination of a small number of relevant ATO case files, the IGT observed a similar approach. For example, in one correspondence audit case in March 2011, an ATO auditor wrote in a Siebel case note: '[The tax agent] queried the 75 per cent penalty and wordings of the letter. I advised [the tax agent] that where client liability is worked out by the tax office, a minimum penalty of 75 per cent applies.'

6.6 The reasons for decision in the final audit letter for this case indicated that an intentional disregard for the law penalty was justified since intentional disregard was evidenced by:

- The taxpayer not providing a satisfactory variance explanation.

129 Section 284-90 of Schedule 1 to the Taxation Administration Act 1953

- The difference between the reported income figure and the benchmarked figure 'is significant'.
- The records were not of an adequate standard.
- A reasonable person knows about record keeping.
- It can be inferred, therefore, that failure to keep records was systemic and not accidental.

6.7 The IGT is of the view that the factors above considered by the auditor have limited connection with the behaviour of the taxpayer at the time the shortfall occurred. The IGT also examined four other penalty decisions (covering lack of reasonable care, recklessness and intentional disregard). Each of these decisions listed factors which did not relate to the behaviour of the taxpayer at the time the shortfall occurred (among other factors which did relate).

6.8 With respect to making a finding of intentional disregard it is important to note ATO binding advice on the matter such as paragraphs 109-116 of Miscellaneous Tax Ruling *MT 2008/1*. Importantly:

113. Dishonesty is a requisite feature of behaviour that shows an intentional disregard for the operation of the law. This is another significant difference between this type of behaviour and behaviour that shows a want of reasonable care or recklessness where dishonesty is not an element.

114. Evidence of intention must be found through direct evidence or by inference from all the surrounding circumstances, including the conduct of the entity.

6.9 By way of contrast, the ATO's staff instructions on the 50 per cent penalty for recklessness states:

106. A finding of dishonesty is not necessary to a finding of recklessness. It is sufficient that the person's behaviour objectively displayed a high degree of carelessness and indifference to the consequences.

Example 17

Company YZ which carries on a small business, was subject to a record keeping audit. At the end of the audit the tax officer advised the company about the areas where the records were inadequate and what was required to remedy the situation. The company was advised that it was unlikely that the correct amount of taxable income would be returned if the suggested improvements to their record keeping practices were not implemented in full. Rather than following the advice the entity made minor changes to their record keeping system which did not improve the adequacy of their records.

Two years later the entity was subject to an income tax audit. A shortfall amount was detected which was caused by inadequate record keeping. The facts indicate that the shortfall amount was caused by the entity's recklessness.¹³⁰

6.10 The Explanatory Memorandum to the *Taxation Laws Amendment (Self-Assessment) Act 1992*, which inserted section 226J in the ITAA 1936, being the predecessor to the current intentional disregard penalty, says:

Where a taxpayer excludes from its assessable income an amount knowing it to be assessable, or claims a deduction, rebate, credit or offset knowing that it is not allowable, the taxpayer will be liable to a penalty of 75% of a tax shortfall or franking tax shortfall so caused.

6.11 In the context of correspondence audits where the ATO determines that the business's records are inadequate, the IGT is of the view that it would be inappropriate to simply impose an intentional disregard penalty purely on the basis of poor record keeping. This is because, in these circumstances, the false or misleading statement is directly due to inadequate record keeping, rather than a taxpayer taking an explicit position on the assessability of an amount that is contrary to law.

6.12 The IGT considers that there is an important distinction between a taxpayer's knowledge about record keeping obligations (which results in inadequate record keeping) and a taxpayer's knowledge about whether a given amount is assessable (which results in a shortfall).

6.13 The ATO has also identified, in various quality assurance reports (Integrated Quality Framework or IQF reports) from April 2010 to February 2012, the incorrect application of penalties as an area for improvement in audit practice.¹³¹ In particular, the ATO reports indicated that:

- auditors were not correctly applying the appropriate penalty, both where the behaviours justified a higher penalty than the one actually applied, and where the behaviours justified a lesser penalty than the one actually applied; and
- auditors were not clearly linking the observed behaviours with their findings of either lack of reasonable care, recklessness, or intentional disregard for the law.

6.14 The use of 'standard penalty text', whilst possibly improving consistency, also presents another issue, as highlighted in another penalties training package:¹³²

Intentional disregard template developed for benchmarking project used for 50% penalties decisions. Templates preventing people from critical thinking.

130 Law Administration Practice Statement PS LA 2006/2 *Administration of shortfall penalty for false or misleading statement*.

131 ATO communication to IGT, 23 February 2012 and 31 May 2012.

132 ATO communication to IGT, 23 February 2012.

6.15 The same package also highlights issues with respect to capacity and capability:

Team leaders or penalty decision approvers under a lot of pressure and don't devote sufficient time to reviewing and approving penalties

Officers undertaking non face to face enquiries tend to diminish their penalties facts and evidence gathering skills.

6.16 The issue of staff capability with respect to penalties is not new, nor is it confined to the ATO's cash economy or correspondence audits.

6.17 As early as 1993, the Joint Committee of Public Accounts (as it was then known) raised concerns about ATO auditors raising culpability penalties (such as intentional disregard):

Based on the need to maintain taxpayer compliance, administrative penalties need to be set in such a manner as to effectively deter wilful behaviour but not penalise inadvertent error. Culpability, as the word implies, has a technical legal meaning and the Committee considers ATO auditors should not have the power to impose culpability penalties. While the Committee has concluded it would be preferable if culpability penalties were abolished, it recognises this was not a position that administrators would necessarily agree on. In the absence of a move to abolish culpability penalties the Committee concludes that it is essential that an officer with legal qualifications from outside the Audit Group of the ATO consider and determine culpability penalties.¹³³

6.18 In response, the ATO rejected the recommendation to have culpability penalties be determined only by legally qualified officers:

This recommendation is not supported. These decisions are not highly technical nor do they require special skills – what is required is a practical application of the law to the facts. A range of rulings and guidelines is available for this purpose, and the ATO does not regard this as the sole domain of legally qualified officers.¹³⁴

6.19 In 2000, the Australian National Audit Office (ANAO) tabled its report *Administration of Tax Penalties*.¹³⁵ It found, amongst other things, that 'ATO staff training in relation to penalties could be enhanced by including the linkages between the Taxpayers' Charter, the Compliance Model and the imposition and remission of penalties. Also, training materials could be improved by providing analyses of the different gradations of non-compliant behaviour and the appropriate enforcement strategies to be applied. The ATO has advised of its intention to develop its training accordingly'.

6.20 As a result of the ANAO report, the ATO began implementing some recommendations and also commenced an internal review into the administration of penalties.

133 Joint Committee of Public Accounts, *Report 326 An Assessment of Tax*, Canberra, November 1993, para. 12.30.

134 Government response to Report 326, paragraph 183, September 1994.

135 Administration of Tax Penalties, Auditor-General Report No. 31, 1999-2000.

6.21 In 2005, the IGT's *Review into the Tax Office's Administration of Penalties and Interest Arising from Active Compliance Activities* noted that since the ATO had not yet completed its internal review, 'the Inspector-General will defer more substantive consideration of this topic until after the Tax Office's implementation of recommendations from its internal review and this report'. The IGT in its December 2007 follow up review (chapter 5) did acknowledge the ATO had enhanced the penalty decision making capability of its staff through that the creation and delivery of penalty training packages, the establishment of dedicated penalty teams, the review of penalty decisions as part of the quality assurance process (as evidenced by the IQF reports quoted above) and the use of technical officers in the penalty decision making process.

6.22 In June 2008, the JCPAA received submissions that penalty decisions were still of concern.¹³⁶ The Committee stated:¹³⁷

that it may be prudent for the ATO's external scrutineers (the ANAO, Inspector-General of Taxation and the Ombudsman) to conduct additional work on the ATO's penalty and debt practices to ensure that the ATO's performance continues to improve over time. For example, the Inspector-General's review of GST audits for large taxpayers found issues with the ATO's decisions on shortfall penalties. These included a significant number of cases where the ATO:

- concluded that a taxpayer was reckless, despite the matter being arguable at law;
- applied the penalty at the full rate, despite prior disclosure by the taxpayer; and
- applied a different penalty rule to large and small taxpayers.

The Committee believes penalty and debt decisions warrant continued external scrutiny.

6.23 In 2009, the IGT also recommended in the *Review into aspects of the Tax Office's settlement of active compliance activities* that the ATO improve the evidentiary basis for penalty decisions, among other things (recommendation 16).

6.24 More recently, the IGT recommended in the *Review into the ATO's small and medium enterprise audit and risk review policies, procedures and practices* that SME officers improve the evidentiary basis for compliance decisions (including penalties) by using the Facts and Evidence worksheet to develop technical positions (recommendation 3.4). The IGT also made a number of recommendations to improve staff technical capability and support, such as improving ATO officers' understanding of commercial and business issues and strengthening staff training (including the involvement of external experts).

6.25 The IGT commends the ATO for including penalty decisions in its IQF processes. Due to this process, the ATO was able to recognise a capability gap in penalty decision making and implement a training schedule to help bridge that gap. The IGT notes that in its October 2011 IQF report, the ATO had rolled out penalties

136 Joint Committee of Public Accounts and Audit, *Report 410: Tax Administration*, Canberra, June 2008, paragraph 6.21.

137 *ibid*, paragraph 6.30.

training to all Cash Economy staff nationally in recognition of capability issues. Nevertheless, the IGT still has concerns about the ATO's application of shortfall penalties more generally.

6.26 As this is a recurring issue across a number of areas in the ATO over extended periods of time, in addition to the following recommendation, the IGT will consider a broader review of penalty decision making as a topic in his forward program.

RECOMMENDATION 6.1

The ATO should improve the robustness of correspondence audit penalty decisions by, for example, providing clearer staff guidance on the specific types of evidence which would tend to indicate the application of different penalties.

ATO response: Agree

The ATO will draw from its current Integrated Quality Framework process, improved examples of the application of different penalties as guidance for staff.

ATO AUDITOR CAPABILITY — MINIMISING COMPLIANCE AND ADMINISTRATIVE COSTS

6.27 In submissions, taxpayers and tax agents cited positive examples of ATO auditors conduct, including:

- making genuine attempts to understand the business and carefully examine records; and
- having a good knowledge of the industry they were auditing.

6.28 Stakeholders suggested that staff who demonstrated these good skills and understanding should be encouraged to support and train other auditors, rather than newer staff having to start from scratch.

6.29 However, a number of taxpayers and tax agents also reported negative experiences with some ATO auditors. This undermined their confidence that the ATO took into account their particular circumstances in correspondence audits. These stakeholders reported that, amongst other things, the auditors:

- were poor communicators, very difficult to reach or disinterested in engaging with the taxpayer;
- appeared inexperienced (for example they did not examine the records properly, followed a script from which they would not deviate and did not necessarily understand what they were asking for from the business or they had a lack of tax knowledge);
- had difficulty understanding the basic nature of the business (for example a small discount variety store is substantially different to a large chain variety store; new

businesses having different cost structures during the establishment stage or more generally; or that some businesses are not always profit driven), their practice (for example that the small business owner would pay their staff wages from cash in the till) or the industry to which the business belonged (for example having to explain the industry process to the ATO auditor); and

- did not understand or appreciate how much work was involved in meeting ATO demands for records (that is unreasonable time frames).

6.30 Furthermore, certain stakeholders reported that the ATO officers auditing them appeared to have more faith in the benchmarks than in what businesses and their agents were telling them, with some reporting that some auditors were overly aggressive and openly questioned the veracity of the agent.

6.31 Certain stakeholders also raised procedural issues, with some reporting that auditors:

- did not apply principles of natural justice, and issued amended assessments before the taxpayer had an adequate opportunity to respond; and
- leaving halfway through an audit, with the next auditor wanting to start from scratch again.

IGT observations

6.32 During the IGT's *Review into the ATO's small and medium enterprise audit and risk review policies, procedures and practices*, research¹³⁸ commissioned by the ATO showed some characteristics which indicated the difference between 'expert' compliance officers and 'less experienced' compliance officers. Among the relevant characteristics, the following would appear to explain the divergent stakeholder experiences set out above:

- Investigative ability: Identifying critical information sources and asking a range of questions to uncover valuable information.
- Confidence: Expresses confidence in moving a case forward, knowing what steps to take next and consulting others. Able to maintain momentum on a case when faced with uncertainty.¹³⁹

6.33 Whilst this research was commissioned for the SME business line, the IGT is of the view that it is of value to TPALS as well. In particular, less experienced officers may be less confident in terms of progressing a case or making conclusions about the taxpayer's business practices. Thus it is important that the Cash Economy Branch maintains its monthly call over practice.¹⁴⁰ The monthly call over allows an auditor and their team leader to discuss the progress of the auditor's cases on hand, and to assist the auditor in progressing the case. The IGT commends the ATO's practice of monthly call overs to support its audit staff. The IGT also recognises that staff in the Cash

138 Inside Story researched commissioned by ATO for S&ME Compliance Officer Research, July 2010.

139 *ibid.*

140 ATO communication to IGT, 8 May 2012.

Economy Branch are composed of officers with a variety of experience and tenure. Staff with experience in certain industries should be recognised and actively mentor other officers to share their knowledge about the operations of businesses in certain industries. This is particularly important in areas where a team leader has many staff.

6.34 Auditors should also have a clear understanding about the nature of the benchmarks and be in a position to explain to a taxpayer or their agent why a particular benchmark is applicable to their business. Ultimately, this requires the auditor to make appropriate enquiries to understand the business being carried on by the taxpayer and the industry to which it belongs.

6.35 The IGT notes that the ATO's cash economy stream IQF reports show that there are practice issues in relation to staff keeping proper records and documentation of compliance activities.¹⁴¹ Poor documentation hinders the IQF's ability to detect and address practice issues. The ATO should ensure that staff are adequately documenting the facts on which they are relying to make decisions as well as the reasons for their decisions.

6.36 This is a particularly important credibility issue for the ATO as it is seeking to ensure taxpayers are themselves maintaining a high standard of record keeping. See chapters 2 and 5.

6.37 It is the IGT's view that lessons can also be taken from the way in which these audits were conducted. The ATO could identify any systemic causes of objections in benchmarking audits and adequately support audit staff to address any capability gap or correct any formal or informal procedures.

RECOMMENDATION 6.2

To enhance staff capability, the ATO should:

- (a) ensure staff with knowledge or experience in certain industries and businesses are recognised, and have them mentor other less experienced auditors when they are undertaking work in relation to such industries and businesses;*
- (b) analyse the underlying causes of objections being allowed to identify common themes and address these directly with auditors and team leaders; and*
- (c) ensure that auditors are aware of their own recording and documentation requirements for all compliance activities and ensure that other practice issues arising from the IQF process are addressed.*

141 ATO communication to IGT, 23 February 2012 and 31 May 2012.

ATO response: Agree

We will implement a process to incorporate feedback from case analysis (including objections), IQF analysis and relevant industry knowledge into broad-based capability development programs and team-specific development.

This will include making it clear that there is an expectation that more experienced officers mentor those with less experience.

PROVISIONS OF HARD COPY AND ELECTRONIC RECORDS

6.38 Tax agents raised the issue of the ATO not accepting records electronically during audits, requiring them to print out reports from accounting software and fax or mail the document to the auditor. For example, a tax agent reported that she had to send 'boxes' of records to the ATO, all of which had to be photocopied first. The client was charged \$8000 by the tax agent for handling the case. Importantly, in some cases, the act of photocopying can be so time consuming that a client does not bother to make copies of the records first and simply sends the originals direct to the ATO. One representative group indicated that the use of hard copies and mailing caused lag between the delivery and receipt of records which extended the time taken for the audit to complete. It was also suggested that it would have been cheaper and faster to pay for the ATO officers travel costs and visit the premises and inspect the original documents on site. This would also have the added benefit of allowing the auditor to ask questions, as well as opportunities to observe the running of the business.

6.39 Some tax agents mentioned that cloud accounting software is becoming more prevalent with their clients. Cloud accounting platforms allow small business owners to perform their record keeping on internet based software. The client then grants limited access to the accountant to check the financials and complete tax returns based on those financials. The client may even grant limited access to a financial institution where the financial institution was to check financial health before granting loans.

6.40 It was suggested that accessing such records would significantly reduce compliance costs imposed by audits. In this respect, the IGT is aware of at least one case where the tax agent granted limited access to their online accounting system to the ATO auditor.

6.41 With respect to email communication with taxpayers, ATO staff are guided by a variety of practices statements and instructions. Corporate Management Procedures and Instructions *CMPI 2006/07/09 Email security in the Australian Taxation Office* is an example of such an instruction. It provides that 'IN-CONFIDENCE'¹⁴² emails may be exchanged with external parties, such as taxpayers, when:

no alternate, secure channel exists that reasonably meets the external party's and ATO needs and expectations. Alternate channels include ATO portals, phone, fax or postal services, hard copy documents, encrypted CD's and DVD's, and ... the external party has initiated the exchange of IN-CONFIDENCE emails.¹⁴³

142 ATO Corporate Management Procedures and Instructions *CMPI 2006/07/09* Paragraph 32 indicates that 'the majority of client information falls within the IN-CONFIDENCE category'.

143 *CMPI 2006/07/09*, paragraph 34.

6.42 The IGT considers that, since the ATO appears to prefer channels other than email and that the taxpayer is required to initiate the exchange of email, auditors may not consistently communicate the availability of email as a possible channel of providing evidence.

RECOMMENDATION 6.3

To reduce compliance costs and time frames the ATO should make it easier for businesses to deliver their records electronically for inspection.

ATO response: Agree

The ATO will expand the use of the existing bulk data exchange facility to make it available for businesses and their representatives involved in cash economy audits.

CHAPTER 7 — IMPROVING RECORD KEEPING INTO THE FUTURE

7.1 Recent ATO research¹⁴⁴ shows that record keeping is not perceived to be an area to which small business dedicate much effort. Small business participants in the research saw it as 'a necessary chore' and tended to fit it in when they could, arguing that 'it could get in the way of the real task of getting and doing work'.

7.2 Although many displayed this attitude they did have systems in place, such as common software packages, and used expert advice, such as from accountants and tax agents, to help them meet these obligations.

7.3 Tax agents themselves identified three 'levels', or types, of relationship with their clients based on their clients' record keeping and reporting behaviour:

Most prevalent were those clients who were felt to be honest and transparent in their reporting and as much as possible kept accurate and orderly records of their transactions.

The second level consisted of clients whom they often had to chase for accurate or complete records.

Dialogue with these clients focused on informing them that of operating 'outside the norm' which increased their risk of audit.

This warning was not without self-interest, as they knew that if enough of their clients were audited it increased the risk that they themselves could come under scrutiny.

Lastly (and reported as being a very small minority), there were clients who the agents felt were behaving 'irresponsibly' and clearly misrepresenting their income and transaction history.

Tax agents reported that they would terminate any relationship with such a client if they found out they were behaving in this way as they posed a risk to their own practice. It was highly undesirable to have any kind of relationship with such clients.¹⁴⁵

7.4 In this review, stakeholders have raised concerns that not only is the law itself general in nature (section 262A of the ITAA 1936), but also the ATO's ruling on record keeping, Taxation Ruling TR 96/7 *Income tax: record keeping – section 262A – general principles*, is not specific enough. Also, some have mentioned that the ATO needs to provide more record keeping assistance, or alternatively, needs to better communicate that such assistance is available.

7.5 In the IGT's view, there can be large expectation variations between the ATO and taxpayers as to what they consider proper record keeping documentation. For

144 Australian Taxation Office, internal communication in relation to GfK bluemoon's report, *Cash Economy: Small business benchmarks and record keeping*, a report prepared for the ATO, July 2011.

145 *ibid.*

example, some tax agents report that the records being asked of taxpayers by auditors is too onerous ('boxes and boxes') and beyond what is actually required, such as asking a restaurant for waiters' dockets from 2 years ago, when TR 96/7 only requires a cash register 'Z' total readout plus last month's cash register till roll.¹⁴⁶

7.6 Another tax agent pointed out that a client had all the records, except for last month's duplicate till roll, which caused the auditor to dismiss the quality of all of the records provided and substitute it with a default assessment.

7.7 It should also be noted that not all stakeholders believe that the record keeping requirements are onerous as:

- electronic bookkeeping software was cheap and prevalent;
- help can be provided early in establishing these systems;
- there is an incentive to get records right to claim input tax credits.

7.8 In general, whilst stakeholder concerns were raised in the context of the ATO's benchmarking strategy, issues relating to record keeping go beyond the benchmarking strategy and affect small businesses generally. The ATO's research¹⁴⁷ indicates that differentiated approaches to improve small business record keeping are needed and should be based on the different taxpayer attitudes to record keeping and the different types of relationships with their tax agents.

INDUSTRY SPECIFIC RECORD KEEPING GUIDANCE — 'PRACTICAL COMPLIANCE'

7.9 In addition to TR 96/7 and the *Record keeping for small business* booklet, the ATO publishes industry specific record keeping guidance on their website. These industries include:

- Primary production;
- Pubs and clubs;
- Restaurant and catering;
- Retail;
- Service; and
- Wholesale.

7.10 These facts sheets are useful in that they provide more specific guidance about how a business should keep their records. For example, the restaurant and catering fact sheet recognises that restaurants tend to use a cash register, and provides guidance accordingly. The fact sheet then acknowledges that for 'food-court, fast-food or

¹⁴⁶ Taxation Ruling TR 96/7 *Income tax: record keeping – section 262A – general principles*, paragraphs 12 and 13.

¹⁴⁷ Australian Taxation Office, internal communication in relation to GfK bluemoon's report, *Cash Economy: Small business benchmarks and record keeping*, a report prepared for the ATO, July 2011.

takeaway businesses it is impractical to record every individual transaction as this would seriously impair the normal conduct of the business.’¹⁴⁸

7.11 This can be contrasted with the requirements of section 262A of the ITAA 1936 to ‘keep records that record and explain all transactions ... relevant for any purpose of this Act’. Thus the ATO is able to allow taxpayers to achieve ‘practical compliance’ as opposed to ‘strict compliance’.

7.12 The role of industry representative bodies and tax practitioners is crucial. Industry specific record keeping guidance will only be credible to small business taxpayers if they believe it is reasonable from the perspective of their peers and their advisors, and not just the revenue authority.

7.13 In this respect, the ATO as a ‘brand’ will always have its limitations. Research commissioned by the ATO in July 2011 about the small business benchmarks (although not requested by the ATO to do so) recommended that the small business benchmarks be relaunched with a focus on telling small businesses that the benchmarks provide an indication of whether they are likely to be audited, and that the benchmarks provide a way for the ‘ATO to more accurately identify potential tax cheats.’¹⁴⁹

7.14 Importantly, the reason for the recommendation to reduce the focus on the ‘level playing field’ message was that ‘statements suggesting that the benchmarks were ‘designed to help businesses’ were often taken with a pinch of salt’ by small businesses.¹⁵⁰ Similarly some tax agents ‘perceived that the benefits emerging from the benchmarks would most strongly advantage the ATO rather than small businesses. Although they recognised the potential value for some small businesses, the benchmarks were perceived as a tool made more for the benefit of the ATO than for small businesses themselves.’¹⁵¹

7.15 This highlights the need to engage taxpayer representative groups and tax agents not only to ensure that any industry specific record keeping guidance is in fact appropriate for that industry, but that it also has the credibility needed for acceptance by the taxpayer. In some circumstances, the ATO may need to rely on other organisations’ branding and communication channels to achieve this goal.

7.16 The IGT recognises that this same research highlighted that industry associations greatly vary in their size and scope and the nature of the services they provide to their members. Furthermore, as a communication channel, ‘most acknowledged they were not interested in ‘mass communication’ from the ATO given they lacked the capacity to ‘digest’ communication and make it more appropriate for

148 Australian Taxation Office, *Record keeping in the restaurant and catering industry – recording income in a restaurant*, Australian Taxation Office, Canberra, 25 October 2010, viewed 2 July 2012, <<http://www.ato.gov.au>>.

149 GfK bluemoon, *Cash Economy: small business benchmarks and record keeping*, a report prepared for the ATO, July 2011, page 51.

150 *ibid*, page 31.

151 *ibid*, page 41.

their members. There was however some strong desire for more industry specific communication from the ATO.¹⁵²

7.17 Since industry bodies have a strong desire for industry specific communication from the ATO, it is reasonable that these bodies assist in the development of industry specific record keeping guidance.

7.18 In addition, it should also be recognised that record keeping requirements may need to be augmented to accommodate the legal structures adopted by small business owners. For example, company structures may have specific record keeping requirements compared to trust structures or sole traders. These aspects should also be subject to consultation and may require an important overlay element that is in addition to the specific industry requirements for a given taxpayer's circumstance.

7.19 An approach that seeks to establish independent but appropriate standards for each specific industry and business structure type with input from the relevant stakeholders provides for greater conformity and oversight than situations where the ATO has, or is perceived to have, created the rules internally.

The role of the ATO in providing record keeping assistance

7.20 In February 2012, the Office of Tax Simplification (OTS) in the UK reported on the ways which Her Majesty's Revenue and Customs (HMRC) administration could be improved for the benefit of small businesses.¹⁵³ With respect to record keeping, and 'practical compliance', the OTS stated:

In particular new businesses need to be made fully aware of the importance of good business records very early on in the life of the business. Where professional help has not been sought, HMRC is probably best placed to highlight this. At the very least we recommend that HMRC sends all new small businesses a simple easy to read leaflet setting out the minimum records needed and where further guidance may be found. For those businesses that have internet access recommending that they work through the online business records review tool (ensuring that the business is given the URL) would be a good way to guide new and existing businesses through what records they need to keep.¹⁵⁴

7.21 Similarly, the ATO has available on its website the Record Keeping Evaluation Tool which helps small businesses find out which records it needs to keep, understand how their record keeping rates and, if appropriate, consider suggestions for improvement.¹⁵⁵

7.22 The ATO provided the following download statistics for the Record Keeping Evaluation Tool which indicates the level of usage of this tool.

152 *ibid*, page 48.

153 HM Treasury, *Office of Tax Simplification Small business tax review: Final report – HMRC administration*, HM Treasury, London, February 2012, viewed 20 March 2012, <<http://www.hm-treasury.gov.uk>>.

154 *ibid*, paragraph 4.11.

155 ATO communication to IGT, 2 April 2012.

Table 20: Download statistics for the ATO's Record Keeping Evaluation Tool

2006–07	2007–08	2008–09	2009–10	2010–11	2011–12 (to 28 Feb 2012)
15,164	14,090	20,597	19,759	16,255	13,058

Source: ATO data supplied to IGT, 29 March 2012.

7.23 The IGT considers that these download statistics are relatively low when considering the fact that there are an estimated 1.4 million businesses operating in the cash business segment.

7.24 In terms of awareness, the OTS report found that:

Good business records, appropriate to the needs of the business, are crucial for all sizes of business. Small businesses may not initially seek advice on business records by which time errors may have been made and documents and information lost. We think that HMRC should, when small businesses are first set up, be more proactive in ensuring that they understand precisely what records they should keep and what their obligations are in other respects. It is not sufficient in our view to have information available online, HMRC should take more responsibility for encouraging and assisting businesses to access the information or take professional advice.¹⁵⁶

7.25 In Australia, the Joint Committee of Public Accounts and Audit (JCPAA) also expressed similar concerns about businesses' awareness of ATO assistance:

The Committee felt that the 'no strings attached' small business advisory service was a commendable initiative by the ATO and encourages wide business sector participation. To maximise uptake, the Committee recommends that the ATO consider additional cost effective promotion of this service – for example through the existing communication channels of correspondence to taxpayers; through tax information brochures; and through key industry bodies such as Council of Small Business of Australia.¹⁵⁷

7.26 The ATO has a variety of record keeping information available on its website. However, as indicated by the Tasmanian Regional Tax Practitioner Working Group in July 2010,¹⁵⁸ 'the majority of clients are not actively aware of the ATO record keeping publications and would not search for them on our [the ATO] website'.

7.27 The ATO advised that taxpayers may freely request the abovementioned 'no strings attached'¹⁵⁹ Small Business Assistance Visits. Information about the visits is available on the ATO website and publicised at various business exhibitions and summits. Furthermore, the ATO seeks to provide information about available assistance through the publications of business and industry associations.

156 HM Treasury, *Office of Tax Simplification Small business tax review: Final report – HMRC administration*, HM Treasury, London, February 2012, viewed 20 March 2012, <<http://www.hm-treasury.gov.uk>> paragraph 4.10.

157 Joint Committee of Public Accounts and Audit, *Report 426 Biannual Hearing with the Commissioner of Taxation*, Canberra, November 2011, paragraph 1.76.

158 Australian Taxation Office, *TAS RTPWG minutes, July 2010*, Australian Taxation Office, Canberra, 2 February 2011, viewed 31 May 2012, <<http://www.ato.gov.au>>.

159 Joint Committee of Public Accounts and Audit, *Report 426 Biannual Hearing with the Commissioner of Taxation*, Canberra, November 2011, paragraph 1.68.

7.28 Importantly, the ATO's Small Business Assistance Program also makes outbound phone calls to sectors which it believes might be at risk of needing extra help (be it record keeping or other tax matters). The phone calls ensure that taxpayers are aware of the free ATO assistance available to them. It targets these sectors through various channels, such as:

- local councils or industry associations;
- communities where a large business has closed down, and other businesses may be struggling as a result;
- those with a history of late payment or late lodgment; and
- those who have recently registered for GST or PAYG Withholding.

7.29 Importantly, those outside the benchmarks have not been targeted, apart from record keeping assistance visits which are non-compulsory face to face assistance visits offered through outbound phone calls. It is the IGT's view that businesses outside the benchmark could also be targeted for outbound phone calls, alerting them to the availability of Small Business Assistance Visits.

7.30 The ATO advises that small businesses can also obtain record keeping assistance through a variety of agencies, not just the ATO. For example, small businesses may:

- go to a Business Enterprise Centre;¹⁶⁰
- attend a mobile office staffed by Centrelink and the ATO (visits regional communities); and
- receive information from an industry association newsletter, which often sources their information from ATO publications.

7.31 Furthermore, the ATO has advised that it regularly works with other government agencies, at the Federal, State and local level, to deliver small business assistance. This is also useful since small businesses often have reporting obligations other than taxation.

7.32 The variety of obligations, along with their various sources of assistance, is in itself a source of complexity for small business, not only here but in the UK. HMRC have launched 'My New Business'¹⁶¹ which is a website designed to provide both tax and non-tax assistance to small business. The concept of a 'one stop shop' or 'portal' is nothing new in Australia. The Business Enterprise Centres Australia website aggregates tax and non-tax information for small businesses. All Australian States and

¹⁶⁰ Business Enterprise Centres are community-based not-for-profit business assistance organisations which offer business advice and support to small and micro businesses, <<http://www.becaustalia.org.au>>.

¹⁶¹ <<https://online.businesslink.gov.uk/hub/action/render?pageId=mynewbusiness&site=1000>>

Territories as well as the Commonwealth¹⁶² also have government websites that act as small business portals.

7.33 In this respect, the IGT understands that the Federal Government will appoint a Federal small business commissioner in the second half of 2012, with the Commissioner:

- providing small businesses with a new voice to highlight their issues to the Australian Government;
- providing a one stop shop for small business services and information; and
- ensuring the interests of small business remain at the forefront of Government policy making.¹⁶³

7.34 The IGT regards the establishment of the Office of the Small Business Commissioner as an opportunity to simplify and enhance the way in which small businesses access tax and non-tax information including record keeping assistance.

THE INITIAL BULK MAIL OUT LETTERS PROGRAM — A MISSED OPPORTUNITY

7.35 Another issue related to record keeping is the ATO opportunity to use its letters program to promote educational products and services. The ATO approach with the bulk mail out letters program was to identify small businesses that were outside the benchmarks and invite them to review their records for omitted income.

7.36 In 2010, 37,847 letters were sent to taxpayers notifying them that they:

- were in a benchmarked industry;
- were outside the benchmark for that industry; and
- should review their records and disclose any errors found.

7.37 Importantly, none of these letters (there were four versions) contained any information about how to get help with record keeping.

162 See for example: Commonwealth <<http://www.business.gov.au/Pages/default.aspx>>

ACT <<http://www.business.act.gov.au/>>

New South Wales <<http://www.smallbiz.nsw.gov.au/Pages/default.aspx>>

Northern Territory <<http://www.nt.gov.au/dbe/business/Pages/default.aspx>>

South Australia

<<http://www.sa.gov.au/subject/Business%2C+industry+and+trade/Starting+and+managing+a+business>>

Queensland <<http://www.business.qld.gov.au>>

Tasmania <http://www.development.tas.gov.au/economic/business_point>

Victoria <<http://www.business.vic.gov.au/BUSVIC/HOMEPAGE/>>

Western Australia <<http://www.smallbusiness.wa.gov.au/>>.

163 Gillard, J (Prime Minister of Australia), O'Connor, B (Minister for Small Business), *Government appoints Small Business Commissioner*, Media Release, 14 March 2012, Department of Prime Minister and Cabinet, Canberra, viewed 26 June 2012, <<http://www.pm.gov.au>>.

7.38 In 2011, 22,344 letters were sent to taxpayers with the same essential message, but this time included a recommendation to access the website, www.ato.gov.au/recordkeeping, to access tools and publications.

7.39 The ATO advises that during 2010, the bulk mail out letter program occurred concurrently with the start of the correspondence audit strategy. That is, there was no deliberate lag between businesses receiving an education letter and businesses being subject to correspondence audits. Furthermore, the ATO indicated that during 2010, it was not a prerequisite that a business receive an education letter before being subject to a correspondence audit.

7.40 The IGT is of the view that the letters program was a missed opportunity for the ATO to promote the products and services available to small business taxpayers with respect to record keeping, especially the Small Business Assistance Visits.

7.41 Timing is also an important issue. Whilst the bulk mail out letter program was an important 'self-management' initiative, the letters and educational prompts are with reference to a year of income in which a taxpayer has already created their records and lodged their tax return and activity statements.

7.42 Notwithstanding this, the letters could have provided encouragement for taxpayers to obtain educational assistance to implement new record keeping systems for the future.

THE ROLE OF TAX PRACTITIONERS IN PROMOTING RECORD KEEPING

7.43 The ATO has the opportunity to allow tax practitioners to take a more proactive role in their clients' record keeping. By doing so, the tax practitioner may have greater control over the likelihood that, and manner in which, their client is selected for compliance action.

7.44 The ATO has indicated that it is developing a *Guide for Tax Practitioners – Best practice: Assisting clients to correctly report income including cash transactions*. The aim is to ensure that tax practitioners are aware of the ATO's expectations with respect to record keeping and the reporting of income. The ATO consulted with tax agents of low risk cash economy clients to understand how they influenced their clients.¹⁶⁴ The ATO has advised that the guide is being developed in consultation with the Tax Practitioners' Board, tax agents and professional associations.

7.45 The IGT encourages the ATO to continue the development of this guide. Furthermore, the IGT is of the view that the ATO should encourage small businesses to seek the assistance of tax professionals to enhance the record keeping capability of the business. This can be achieved by either the business operator receiving training in bookkeeping or by the business operator deciding to engage the services of a tax agent or bookkeeper to perform the work.

¹⁶⁴ ATO communication to IGT, 31 May 2012.

7.46 It is generally appreciated that tax agents, BAS agents and other advisors play a vital role in the self assessment tax system and their collective support and engagement needs to be fostered and supported in improving the tax system's operation. While most taxpayers do their best when engaging with the ATO, it is important to appreciate that they also consider their tax agent to be a personal trusted advisor in managing their way through the tax system.

7.47 Research¹⁶⁵ suggests that of all the time and activities spent throughout the year complying with tax laws, on average small businesses spend up to 65 per cent on record keeping. From a time perspective, small businesses would benefit from external help with their record keeping.

7.48 The ATO, therefore, should consider encouraging small businesses to engage with their tax practitioners in relation to record keeping. For example, where a tax practitioner demonstrates knowledge of best practice and an ability to teach it to small businesses or assess them, the ATO could recognise the tax practitioner as a 'record keeping advisor'. This would provide an incentive for the tax practitioner to adopt the best practice guide.

7.49 In the long run, these recognised tax practitioners could review small business records and provide a degree of assurance to the ATO about the adequacy of taxpayers' record keeping systems, such as that provided in prudential reviews. This assurance could be considered relevant in deciding to exclude compliant taxpayers from future audit selection processes. This would provide an incentive for small businesses to seek tax practitioners for this service, with the benefit being that the review was carried out by someone that knew the business better than perhaps an ATO officer over the phone.

7.50 General acceptance of the Best Practice Guide is essential to ensuring that it is widely adopted by tax practitioners and applied to their small business clients in good faith. Consultation with a wide range of tax practitioners is therefore vital.

¹⁶⁵ Lignier and Evans, *Paper 5 The rise and rise of tax compliance costs for the small business sector in Australia*. Presented to the 10th International Tax Administration Conference Atax UNSW, April 2012.

RECOMMENDATION 7.1

The ATO should foster better record keeping and accurate reporting of income in a manner that minimises overall costs for small businesses through a variety of means including:

(a) the development of industry specific record keeping guidance in consultation with small business owners, industry associations, tax agents and bookkeepers;

(b) consultation with the new Federal Small Business Commissioner about the possibility of a 'one-stop shop' for information on small business record keeping and reporting of income;

(c) improvement to promotion of its publications and assistance in relation to record keeping (including small business assistance visits) through a diverse range of channels including tax agents;

(d) making those small businesses falling outside the benchmarks aware of the ATO's 'no strings attached' assistance visits;

(e) consultation with relevant tax practitioner representative bodies with a view to establishing a 'taxpayer record keeping assurance process' which could be used as a factor in excluding compliant taxpayers from audit selection.

ATO response: Partially agree

The ATO agrees with sub-recommendations 7.1(a) to (d). We disagree with sub-recommendation 7.1(e).

As part of the Compliance Program, where the ATO identifies an industry of particular focus for the cash economy we will work with relevant stakeholders on the development of industry specific record keeping guidance in accordance with element 7.1(a).

The ATO agrees to consult with the Federal Small Business commissioner, once appointed, on the possibility of a 'one-stop shop' for information on small business record keeping and reporting of income

As part of the enhanced communication processes, the ATO will improve the promotion of its publications and assistance visits in accordance with sub-recommendations 7.1(c) and 7.1(d).

In relation to sub-recommendation 7.1 (e), we are concerned that too specific a focus for the suggested consultations may restrict their scope and outcome.

We are also concerned that a 'taxpayer record keeping assurance process' may not lead to reduced costs for small businesses in line with your intent. Further, it is doubtful whether it is appropriate for the ATO to establish an 'assurance' process as envisaged in this sub-recommendation.

That said, the ATO will continue to support small businesses and to foster better record keeping and, through consultation, develop further ways to minimise overall costs for small businesses.

APPENDIX 1 — TERMS OF REFERENCE AND SUBMISSION GUIDELINES

BACKGROUND

In 2009, the Australian Taxation Office (ATO) established key ratios to compare the financial performance of taxpayers, with a turnover of up to \$15 million, against similar businesses in the same industry, often referred to as 'small business benchmarks'. To date the ATO has released benchmarks for more than 100 industries encompassing over 900,000 small businesses. Also, further benchmarks are planned for release in the coming year.

The ATO has stated in its 2011-12 Compliance Program that it has identified 46,000 businesses who may be under-reporting their cash income based on these benchmarks. The ATO has used these benchmarks in its cash economy compliance activities both as a risk assessment tool and as a basis for issuing default assessments since 2010.

Benchmarks are used as a risk assessment tool by the ATO to identify taxpayers who may be under-reporting income in their returns, particularly in relation to cash sales. Taxpayers who report income outside the relevant benchmark may be selected for compliance action by the ATO. Such taxpayers must provide documentation to the ATO to substantiate any shortfall.

Where the ATO is not satisfied with the reasons for a taxpayer's variation from the benchmark and their record keeping practices, the ATO has indicated that these benchmarks may be used to issue amended or default assessments to that taxpayer.

Concerns have been raised with the Inspector-General of Taxation (IGT) by taxpayers and tax agents about the ATO's use of small business benchmarks. In general, these concerns related to whether:

- a large number of compliant taxpayers are unnecessarily being targeted and thereby are being subjected to unnecessary compliance costs;
- the benchmarks adequately account for variations among businesses in the same industry, with some taxpayers expressing the view that no two business are alike;
- it is appropriate for the ATO to use these benchmarks as a basis to issue amended or default assessments or should the ATO, before taking such action, examine taxpayer specific information such as unexplained asset accumulation or personal expenditure; and
- the ATO's expectations in relation to small business record keeping are reasonable and clearly communicated.

TERMS OF REFERENCE

In accordance with subsection 8(1) of the *Inspector-General of Taxation Act 2003* (IGT Act), the IGT on his own initiative will conduct the following review:

The IGT will review aspects of the ATO's small business cash economy compliance activities with a focus on:

Risk identification

1. *The benchmarking process and its ability to identify under-reporting income by taxpayers, including whether:*
 - (a) *compliant taxpayers are incorrectly captured;*
 - (b) *imposed compliance costs are proportionate to the risks involved;*
 - (c) *the ATO's underlying benchmark methodology, related data inputs and identification process are sufficiently transparent;*
 - (d) *the ATO takes into consideration any resulting taxpayer concerns;*

Differentiation

2. *The benchmarking process and its ability to take into account material differences between taxpayers in a given industry category, including:*
 - (a) *different external business factors such as locality;*
 - (b) *businesses providing multiple goods or services being inappropriately categorised in a single industry identification process;*
 - (c) *business owner specific factors that may explain variances;*
 - (d) *different business measures that govern the handling and recording of cash;*

Basis for amended or default assessments

3. *The fairness and reasonableness in using the benchmarking process as a basis for determining and issuing amended or default assessments, including:*
 - (a) *circumstances in which the ATO issues assessments based on benchmarking data;*
 - (b) *where business records are considered inadequate, whether the ATO uses other information or evidence to assess the profits of the business, for example unexplained assets accumulation or personal expenditure records;*
 - (c) *difficulties that taxpayers and tax agents face in seeking to challenge these assessments (such as proving that they did not earn the alleged additional income);*
 - (d) *approaches and reasons taxpayers and tax agents may have taken in settlement of these disputes both pre and post assessment;*

Record keeping

4. *The ATO's small business record keeping expectations, including whether:*
- (a) *the record keeping requirements are appropriate, given the size, specific nature and resources of small businesses;*
 - (b) *alternative forms of evidence are acceptable in satisfying ATO expectations;*
 - (c) *public guidance and direct assistance provided to taxpayers and tax agents for record keeping requirements are adequate and sufficiently differentiated;*

ATO approach, processes and practices

5. *The ATO approach, processes and practices in conducting compliance action and audits involving small business benchmarks, including whether:*
- (a) *taxpayer compliance costs are minimised and voluntary compliance is promoted, by the ATO:*
 - i. *alerting taxpayers and tax agents to common record keeping and reporting errors and inviting them to voluntarily disclose any such errors;*
 - ii. *taking a considered approach to information gathering;*
 - iii. *undertaking careful review of taxpayers' affairs before proceeding to audit;*
 - (b) *communication with small businesses by ATO staff is appropriate and timely, including notification of their rights and obligations as a taxpayer, the reason for the review or audit, the audit plan and the dispute resolution process;*
 - (c) *ATO staff seek to understand the taxpayer's business;*
 - (d) *ATO staff engage with taxpayers and tax agents to consider the facts and reasons for benchmark variance;*
 - (e) *taxpayers and tax agents are given adequate time and opportunity to present facts and reasons for benchmark variance;*
 - (f) *taxpayers and tax agents experience practical and administrative difficulties in seeking to challenge ATO staff decisions.*

SUBMISSION GUIDELINES

In connection with the above terms of reference, we are seeking taxpayer submissions which detail accounts of micro and small business taxpayers who have been subject to compliance activities (such as audits) involving the ATO's use of small business benchmarks. This may include audits in which the ATO indicated that the taxpayer was being audited because their reported figures were significantly outside the benchmarks for their industry segment.

We envisage that, broadly, your submission will be divided into two parts:

(i) a detailed account of your experience with ATO audits involving the use of small business benchmarks; and

(ii) any opportunities to improve ATO approaches or processes.

Specifically, it is important to provide a detailed account of particular ATO practices and behaviours that, in your view, contributed to an unreasonable process and/or outcome. The IGT is also seeking examples of positive ATO practices and behaviours that contributed to the timely and effective resolution of the audit.

As far as possible, these practices should address the terms of reference above.

In investigating the ATO's use of small business benchmarks in compliance activities, it would be useful to provide a time line of events outlining your key interactions with the ATO including information requests, key correspondence, the issuing of interim findings, ATO amended assessments and penalties (if relevant) and the outcomes of any objections or appeals.

Your submission should also list alternative actions, practices or behaviours which, in your view, could minimise the adverse effects of these ATO compliance activities.

Lodgment

The closing date for submissions is 3 February 2012. Submissions can be sent by:

Post to:

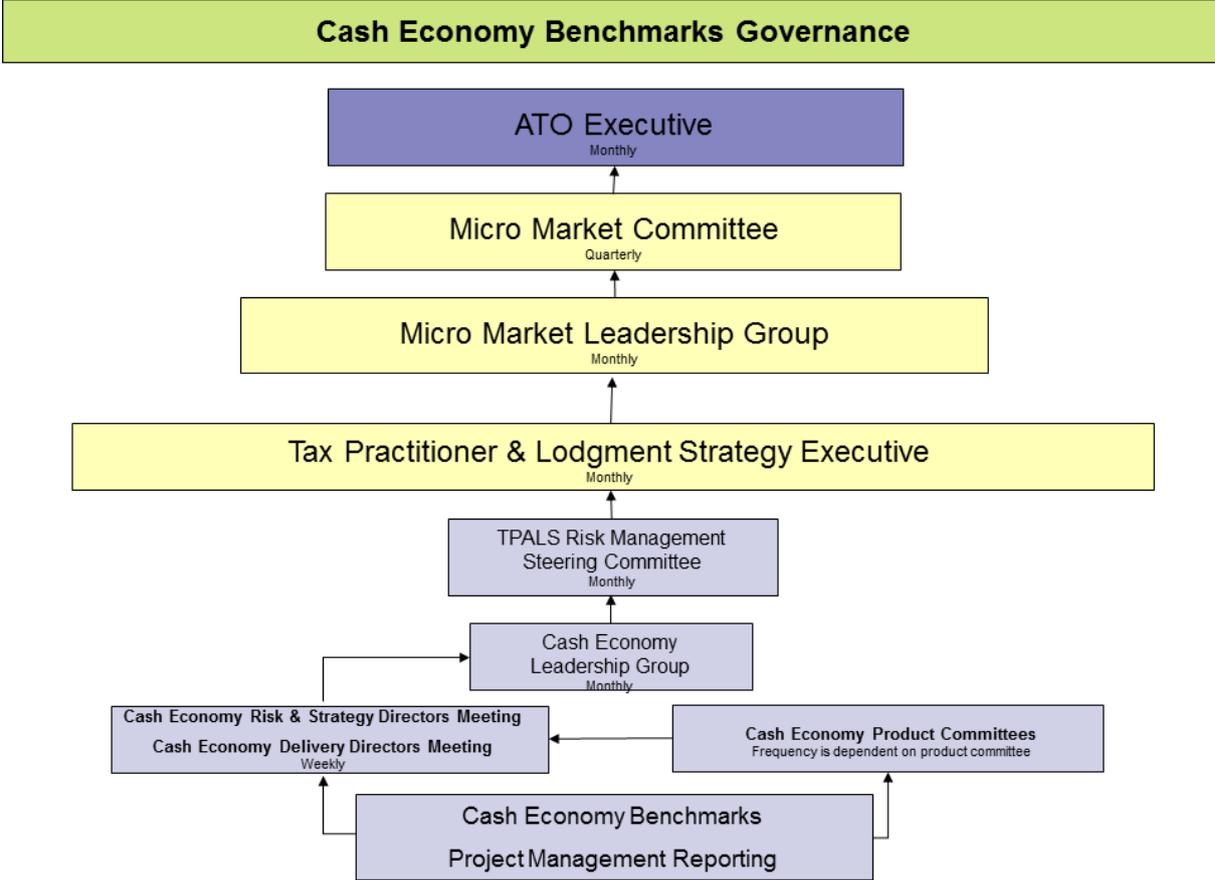
Inspector-General of Taxation
GPO Box 551
SYDNEY NSW 2001

Email to: [for enquiries regarding this review, please email enquiries@igt.gov.au]

Confidentiality

Submissions provided to the IGT are in strict confidence (unless you specify otherwise). This means that the identity of the taxpayer, the identity of the adviser and any information contained in such submissions will not be made available to any other person, including the ATO. Sections 23, 26 and 37 of the IGT Act 2003 safeguard the confidentiality and secrecy of such information provided to the IGT – for example, the IGT cannot disclose the information as a result of an FOI request, or as a result of a court order generally. Furthermore, if such information is the subject of client legal privilege (or legal professional privilege), disclosing that information to the IGT will **not** result in a waiver of that privilege.

APPENDIX 2 — CASH ECONOMY BENCHMARKS GOVERNANCE



APPENDIX 3 — BENCHMARK FUNDING

A3.1 The table below sets out the funding for the Benchmark project provided for in the 2009 Federal Budget.

Table 21: Funding received for 2009-2013 Business performance benchmark project

Announcement date	May 2009 Federal Budget											
Period covered	2009–10			2010–11			2011-12			2012–13		
	FTE	Salary \$000	Supplier \$000	FTE	Salary \$000	Supplier \$000	FTE	Salary \$000	Supplier \$000	FTE	Salary \$000	Supplier \$000
Cash Economy	26.26	2,153	173	25.57	2,064	167	26.53	2,164	175	26.36	2,185	177
Marketing Communications	2	178	57	1	90	88	1	91	25	1	91	87
Deliverables	Cases	GST	Total HOR	Cases	GST	Total HOR	Cases	GST	Total HOR	Cases	GST	Total HOR
Telephone review	5800	182,700	435,000	5800	182,700	435,000	5800	182,700	435,000	5800	182,700	435,000
Record Keeping Review	300	31,500	75,000	300	31,500	75,000	300	31,500	75,000	300	31,500	75,000
Record Keeping Audit	50	0	0	50	0	0	50	0	0	50	0	0
Single Issue Audit	275	363,000	3,630,000	275	382,800	3,828,000	275	440,000	4,400,000	275	460,625	4,606,250

(b) Source: Cash Economy Reporting and Planning; Budget Initiatives document

(c) **Note:** Supplier amounts are net, as corporate overhead costs have been removed. The effect of the Efficiency dividend is not reflected in these figures.

APPENDIX 4 — ANZSIC AND ATO BUSINESS INDUSTRY CODES

A4.1 This appendix describes how the ATO's 5-digit business industry code system relates to the ABS's 4-digit ANZSIC system. It will use a fish retailer and a delicatessen as examples to show this relationship.

A4.2 The ABS ANZSIC system is firstly divided into 19 divisions, described by one letter, (A to S). Fish retailers and delicatessens belong to Division G – Retail Trade.

A4.3 All divisions are subsequently broken down into subdivisions, numbered sequentially and independently of the division to which it belongs. Subdivisions are numbered with two digits. There are a total of 96 subdivisions. Fish retailers and delicatessens belong to Subdivision 41 – Food retailing.

A4.4 All subdivisions are subsequently broken down into groups. Each group is numbered with three digits, the first two digits derived from the subdivision to which it belongs. Fish retailers and delicatessens belong to Group 412 – Specialised food retailing.

A4.5 All groups are subsequently broken down into classes. Each class is numbered with four digits, the first three digits derived from the group to which it belongs. Fish retailers belong to Class 4121 – Fresh meat, fish and poultry retailing. Delicatessens belong to Class 4129 – Other specialised food retailing, for example:

- 1 Division G – Retail trade
 - 1 Subdivision 41 – Food retailing
 - 1 Group 412 – Specialised food retailing
 - 1 Class 4121 – Fresh Meat, Fish and Poultry Retailing
 - 2 Class 4122 – Fruit and Vegetable Retailing
 - 3 Class 4123 – Liquor Retailing
 - 4 Class 4129 – Other Specialised Food Retailing.

A4.6 This is the end of the ABS 4-digit ANZSIC classification system. The ATO has added a fifth digit to this system to provide an extra degree of granularity. For example, Class 4121 is broken down another level. There are three ATO industry codes under Class 4121. They are:

- 1 41211 – Butchers, butcher shops – retail
- 2 41211 – Meat retailing – except canned meat

- 3 41212 – Fish retailing – fresh
- 4 41212 – Seafoods retailing – fresh
- 5 41213 – Poultry retailing – fresh.

A4.7 Although there are five industries listed, there are only three unique codes. If a fish retailer enters their business industry code as 41212, they will be indistinguishable from a 'seafoods retailer' who enters the same code. That is, fish retailers and seafood retailers are separately mentioned in the codes to allow fish retailers and seafood retailers to easily recognise their own industry and select that code, even if they share the same code. They are not numerous enough to justify their own unique code from each other.

A4.8 In the case of delicatessens, they belong to the ATO business industry code 41290 – Delicatessens (in bold below). It should be noted that in this case, the ATO has only added a zero as the fifth digit to class 4129. Although the ATO has listed twelve specific industries and a thirteenth residual category, they all share the same 41290 code. That is, the ATO cannot distinguish between these businesses on the basis of the business industry code alone, and in this particular case, provides the same level of granularity as the ABS 4-digit class. As with the above example, the purpose of separately listing specific sub-industries is to allow those businesses to easily identify themselves as belonging to that code. Where a business cannot identify itself against a specific sub-industry, it may nevertheless choose code 41290 by virtue of the residual 'not elsewhere classified' (nec) listing at item 13.

- 1 41290 – Bakeries and hot bread shops
- 2 41290 – Biscuits retailing
- 3 41290 – Bread retailing
- 4 41290 – Bread vendors
- 5 41290 – Cakes retailing
- 6 41290 – Confectionery retailing
- 7 **41290 – Delicatessens**
- 8 41290 – Eastern foods retailing
- 9 41290 – Gourmet shops
- 10 41290 – Health foods retailing
- 11 41290 – Pastries retailing
- 12 41290 – Smallgoods retailing
- 13 41290 – Specialised foods retailing nec

APPENDIX 5 — EXAMPLE OF A SMALL BUSINESS BENCHMARK WEBPAGE



Australian Government
Australian Taxation Office

Delicatessen — issued 2012

Industry overview

Businesses in this industry sell smallgoods including cooked meats, cheese and other fine foods.

Some businesses may also operate a café or sandwich shop as a part of their business.

Performance benchmarks

These performance benchmarks are developed using information reported on income tax returns and activity statements for the 2009-10 year. Performance benchmarks are updated annually.

 To review a comparison of previous years benchmarks, refer to [previous year](#).

These benchmarks show a number of different financial ratios of business income to business expenses, to help businesses compare their performance against similar businesses in an industry.

The key benchmark ratio for this industry is cost of sales to turnover. This ratio is likely to be the most accurate predictor of business turnover. For businesses that do not report cost of sales or only report a small amount, total expenses to turnover can be used to predict turnover.

 Businesses operating outside the key benchmark may be contacted by us.

During an audit, if a business does not have records to support their reported income and expenses, we may use benchmarks and other information available to assess the profits of the business.

 For information about calculating benchmarks, refer to [Small business benchmarks](#).

Key benchmark ratio	Annual turnover range		
	\$65,000 — \$250,000	\$250,000 — \$500,000	More than \$500,000
Income tax return			
Cost of sales/turnover	53% — 67%	60% — 71%	61% — 74%
Average cost of sales	60%	66%	68%
Total expenses/turnover	84% — 91%	87% — 92%	89% — 94%
Average total expenses	87%	89%	91%

Activity statement			
Non-capital purchases/ total sales	74% — 85%	75% — 85%	72% — 84%

Benchmarks are published as a range representing the ratios reported by businesses grouped either side of the average. Publishing benchmarks as a range allows for variations across financial years, regions and business models.

The following benchmarks are made available as a guide for businesses to review their performance and business practices against other similar businesses.

The following expenses are not reported by every business, so one or more of these benchmarks may not apply to an individual business.

Benchmark ratio	Annual turnover range		
Income tax return	\$65,000 — \$250,000	\$250,000 — \$500,000	More than \$500,000
Labour/turnover	5% — 9%	7% — 14%	7% — 13%
Rent/turnover	9% — 14%	6% — 11%	5% — 8%
Motor vehicle expenses/turnover	2% — 3%	1% — 2%	1%

Definitions

Cost of sales

Cost of anything produced, manufactured, acquired or purchased for either:

- manufacture
- sale or exchange in deriving the gross proceeds
- earnings of the business.

For the purposes of calculating the benchmark, cost of sales excludes labour.

Labour

Salary or wage payments, including contractor payments (amounts exclude GST). Labour does not include payments to associated parties — for example, labour provided by a business owner or business partner.

Total expenses

Total expenses reported on the income tax return less payments to associated parties (amounts exclude GST).

Non-capital purchases

Purchases reported at label G11 on your activity statement. Non-capital purchases include trading stock and normal running expenses, such as:

- stationery and repairs
- equipment rentals
- leases.

Total sales

Total sales reported on activity statements (amounts include GST). This includes all your:

- GST-free sales
- input taxed sales
- taxable sales.

Turnover

Total revenue received from providing goods or services each year, excluding GST.

More information

For more information about small business benchmarks, refer to [Small business benchmarks](#).

For more information about your tax obligations as a small business operator, refer to:

- [Record keeping for small business \(NAT 3029\)](#)
- [GST for small business \(NAT 3014\)](#)
- [Tax basics for small business \(NAT 1908\)](#).

Last Modified: Tuesday, 21 February 2012

Our commitment to you

We are committed to providing you with accurate, consistent and clear information to help you understand your rights and entitlements and meet your obligations.

If you follow our information and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we will take that into account when determining what action, if any, we should take.

Some of the information on this website applies to a specific financial year. This is clearly marked. Make sure you have the information for the right year before making decisions based on that information.

If you feel that our information does not fully cover your circumstances, or you are unsure how it applies to you, contact us or seek professional advice.

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<http://www.ato.gov.au/businesses/PrintFriendly.aspx?ms=businesses&doc=/content/00306298.htm&pc=001/003/102/001/005&mnu=0&mfp=&st=&cy=>

accessed 27/03/2012

APPENDIX 6 — SAMPLE CORRESPONDENCE AUDIT CONFIRMATION LETTER

GPO Box 9990 IN YOUR CAPITAL CITY



Australian Government
Australian Taxation Office

Reply to: PO Box 9977
Parramatta NSW 2124

Our reference:
Contact officer:
Phone:
Fax:
ABN:

12 August 2011

Confirmation of audit

Dear Mr

We are writing to let you know we are auditing your activity statements and income tax return for the tax period **1 July 2009 to 30 June 2010**.

Preparing for your audit

You have been selected for audit because the cost of goods sold (COGS) \$75,860 to total sales ratio reported in your 2010 income tax return are significantly outside the benchmark for your industry. Your COGS to total sales is 57%.

Your industry has a COGS to total sales benchmark range of 29 - 41%.

In applying the benchmarks we use the higher end of the benchmark range as this will result in the minimum amount of income that we would expect from your business operation.

If we applied the industry COGS benchmark of 41% your 2010 business income would be a minimum of \$176,419, which is greater than your reported amount of \$134,161. This would result in an increasing adjustment to your business income for the year of \$42,258.

For more information or to check your business benchmarks visit
www.ato.gov.au/businessbenchmarks

Record keeping and records required for the audit

You need to record all your business income and keep records that enable us to readily ascertain your tax liability. You must keep detailed records of every sale unless you conduct and retain reconciliations of daily sales and banking.

As part of this audit you are required to supply detailed records for the period **1 April 2010 to 30 June 2010** that include:

- an explanation of why your business is reporting outside your industry segment benchmarks, including details of how you calculate your sales prices
- an explanation of how you record receipts of cash income used for business or personal purposes
- all sales records for the quarter, such as sale invoices, sale receipts, cash register journal rolls and point of sales system printouts
- daily sales reconciliations of total sales records and cash in the cash drawer, including amounts not deposited to business accounts, drawings, wages and other cash expenses
- reconciliations of amounts deposited in your business bank account and/or recorded in your cash book or similar record and amounts reported on your activity statement at label G1, including copies of all bank statements
- detailed profit and loss statement and balance sheet records for the 2010 financial year
- any other relevant information.

Please forward copies of these records and other information to xxxxxxxx by **13 September 2011** to the reply to address at the top of this letter.

We will examine the records and other information you supply to support your reported income. If your records do not support your reported income or you fail to provide the information requested, we will use the benchmark figures as a reasonable basis for making a revision assessment.

What will happen next?

We will contact you in 7-10 days from the date of this letter to discuss any questions or issues you may have in relation to the audit.

Based on similar audits we expect to complete the audit by 6 December 2011. If we take longer, we may reduce any interest charges that apply. However this will depend on the circumstances that cause the delay.

If we raise default assessments or make increasing adjustments we will issue you with an interim report to explain our findings. You will have an opportunity to comment on these findings.

Once the audit is finalised we will send you notices of assessment for any adjustments made to your activity statements and income tax returns. We will also send a penalty notice for any penalties imposed.

Penalties and charges you may face

Where we make a default assessment or revise the amounts you have reported, you may be liable for a penalty of up to 90% on any tax you owe.

Where any amount is not paid by the due date, the general interest charge (GIC) accrues on the outstanding balance until the entire amount has been paid and is calculated on a daily compounding basis. GIC is currently imposed at a rate of 12.00 percent per annum (reviewed every three months). GIC is tax deductible in the year that it is incurred.

Your rights and obligations

Enclosed is an *Audit information sheet* which explains your rights, obligations and what you can expect during this audit.

For more information

If you have any questions in relation to the audit or outstanding returns, please phone 13 28 69 between 8.00am and 5.00pm, Monday to Friday, and ask for xxxx xxxxxx on extension xxxxx.

Yours sincerely

Cheryl-Lea Field
Deputy Commissioner of Taxation

Encl. *Audit information sheet*

APPENDIX 7 — SAMPLE BENCHMARK ADVISORY LETTERS

A7.1 This advisory letter was sent to taxpayers directly in May 2010, being the first tranche of letters to issue under the benchmarking strategy's bulk mail out letters program.

PO Box 908 ALBURY NSW 2640

<Title> <First Name> <Surname>
<Suffix><Organisation>
<Address Line 1>
<Address Line 2>
<LOCALITY> <STATE> <POSTCODE>

Our reference: Sbb-
Phone: 132866
ABN: <Number >

<Issue Date>

Important information about your tax performance

Dear <Sir/Madam>,

The Australian Taxation Office has developed small business benchmarks to help businesses meet their tax obligations.

Benchmarks provide information about average business costs in relation to turnover or sales for particular industries. Benchmarks contain ratios that are used to compare and check your tax performance.

You can view the benchmarks on our website www.ato.gov.au/businessbenchmarks.

Your tax performance

We have compared your business performance with the small business benchmarks for <business type>.

For the 2008 financial year, your business reported <key benchmark ratio> which are below the benchmark ratio. This is the key benchmark ratio for your industry.

Reporting below the benchmark ratio may be an indication that you have not correctly reported all of your cash transactions, including cash purchases, cash sales and the payment of cash wages.

How we use benchmarks

Comparing a business against the benchmarks for its industry is one way we identify businesses for audit or review.

We use benchmarks to identify businesses that may be participating in the cash economy and not reporting all of their cash transactions.

When we select businesses for audit or review, we may use benchmarks to:

- work out if the business's records are accurate and complete
- assist in calculating income tax or GST obligations where there is insufficient or unreliable information provided to us.

Benchmarks also assist us in making sure employers are meeting all of their obligations, including pay as you go withholdings and the payment of superannuation guarantee.

What you should do

To ensure that your tax return and activity statements correctly record your business activity:

- check you have recorded and reported all cash transactions
- consider how your business compares to the rest of your industry and turnover range
- make sure you have not made a mistake on your tax return or activity statements.

If you are satisfied that you are meeting your tax obligations correctly, you do not need to contact us or do anything further.

If you have made a mistake

If you think you may have made an error or left something out, we have enclosed a form that will help us correct anything that might need to be corrected. Please complete the form and return it in the enclosed pre-addressed envelope.

If you voluntarily tell us about any errors or omissions, the tax law allows for a *reduction* in penalties. If you tell us *before* an audit begins the ATO may be able to reduce these penalties even further.

However, if you want to discuss this letter, find out what your tax obligations are or contact us for assistance, please telephone 13 28 66 or talk to your tax agent.

Yours sincerely

Shane Reardon
Deputy Commissioner of Taxation

Voluntary disclosure form

Correcting tax errors

Our ref: Sbb-

- Complete this form if you think you need to make a correction to an activity statement or income tax return.
- In order to help us assist you with your tax obligations please complete sections A and B below and return it to the Australian Taxation Office in the pre addressed envelope provided..
- Keep a copy of this form and any supporting documents for your own records and return the original to the Australian Taxation Office in the pre addressed envelope provided or you can post to: Cash Economy Risk and Strategy, Australian Taxation Office, GPO Box 1275, ADELAIDE SA 5001.

Section A:

1 Name <Title> <First name> <surname> / <Legal name>

2. Trading name/business name

3. Tax file number (TFN)

<input type="text"/>							
----------------------	----------------------	----------------------	----------------------	----------------------	----------------------	----------------------	----------------------

OR

Australian business number (ABN) <ABN number>

4. Current postal address

<input type="text"/>	
<input type="text"/>	
State/Territory	<input type="text"/>
Postcode	<input type="text"/>

Declaration

Before you sign this form

Please check that you have provided true and correct information in **Section B**.

Penalties

Please be aware that penalties may be imposed for giving false or misleading information.

Privacy

We are authorised by the *Taxation Administration Act 1953* to collect your tax file number (TFN). It is not an offence not to provide your TFN. However, failure to provide your TFN may result in a delay in correctly identifying your tax records and processing your voluntary disclosure.

We are authorised by the *A New Tax System (Goods and Services Tax) Act 1999* to ask for the information on this form. We need this information to help us process your voluntary disclosure. Where authorised by law to do so, we may give this information to other government agencies authorised by law to receive it. These agencies include Centrelink, the Departments of Family and Community Services, Veterans' Affairs and Education, Science and Training.

A7.2 This letter was sent to taxpayers in August and September 2010.

PO Box 908 ALBURY NSW 2640

<Title> <First Name> <Middle Name> <Surname>
<Officer title>
<Suffix><Organisation>
<Address Line 1>
<Address Line 2>
<LOCALITY> <STATE> <POSTCODE>
<COUNTRY>

Reply to: <PO Box 1127>
<ALBURY NSW 2640>
Our reference: <Our reference>
Phone: 13 28 66
<Client ID>: <ABN>
<Letter Date>

Recording your business transactions

We recommend that you take the time now to review your activity statements and tax returns.

Dear <Title> <Surname>

We are writing to you because the figures you have reported on your income tax return are significantly outside the small business benchmarks for your industry.

<In your <XX> income tax return you reported business income of <\$XXX,XXX> and <cost of goods sold> of <\$XXX,XXX>, which is <XX%> of your reported business income. The benchmark ratio for your industry is between <XX% to XX%>. If we applied the benchmark ratio to your <cost of goods sold> your business income would be <\$XXX,XXX to \$XXX,XXX>. Reporting outside the small business benchmark for your industry may indicate that you have failed to report all of your transactions, including cash transactions.>

Comparing a business against the benchmarks for its industry is one way we identify businesses for audit or review. Other indicators we use include:

- identifying businesses that report net income that appears to be lower than required to support the business operators personal living expenses
- identifying businesses with the opportunity for cash economy activity
- using information from organisations such as Centrelink, business trade suppliers and banks
- reviewing information provided by the community.

If your business is selected for an audit or review, we may use the small business benchmarks to calculate your income tax or goods and services tax

What you should do

If you think you may have made an error or left something out, we have enclosed a form that will help us correct anything that might need to be corrected. Complete the form and return it in the enclosed pre addressed envelope.

Why you should do this

If you voluntarily tell us about any errors or omissions, the tax law allows for a *reduction* in penalties. If you tell us *before* an audit begins the Australian Taxation Office may be able to reduce these penalties even further.

If you are satisfied that you are meeting your tax obligations correctly, you do not need to contact us or do anything further.

If you use a tax practitioner, they have been advised that this letter has been sent to you. If you have any questions, please phone <13 28 66> between <8.00am> and <6.00pm>, <Monday to Friday>.

Yours <sincerely/faithfully>

<James O'Halloran>
<Deputy Commissioner of Taxation>



Correcting tax errors

- Complete this form if you think you need to make a correction to a business activity statement or income tax return.
- In order to help us assist you with your tax obligations please complete Section A and B below and return it to us in the pre addressed envelope provided.
- Keep a copy of this form and any supporting documents for your own records and return the original to the Australian Taxation Office in the enclosed pre addressed envelope. If you have mislaid the envelope the address is: Cash Economy Risk and Strategy, Australian Taxation Office, PO Box 1127, Albury, NSW, 2640.

TICK THE BOX THAT APPLIES TO YOU: Yes, I need to make a correction to my Business Activity Statement or Income Tax Return.

No, I do not need to make a correction. However, I would like to provide an explanation.

Section A:

1. Name		<Title> <First name> <surname> / <Legal name>	
2. Trading name or business name			
3. Australian business number (ABN)	<ABN number>		
4. Current postal address			
State or territory		Postcode	

Section B: Details of your correction

What error(s) have you made in your income tax return/s and/or business activity statement(s)?

Note: If you need more space, attach separate pages to this form with the additional detail. Mark each page with your name, ABN, and the date.

To help us make a correction to your tax return/s or activity statement/s please provide

- tax type it relates to – for example, GST or income tax
- year of the assessment or period of the activity statement to be adjusted
- reported amount and the actual amount it should be
- reason for any errors.

A7.3 This letter was sent to taxpayers in November and December 2011.

<PO Box 908 ALBURY NSW 2640>

<Title> <First Name> <Middle Name> <Surname>
<Suffix><Organisation>
<Address Line 1>
<Address Line 2>
<LOCALITY> <STATE> <POSTCODE>
<COUNTRY>

<Client ID>: <ABN/TFN>
Phone: <Phone>

<Letter Date>

Information to help you meet your record keeping obligations

Dear <Title> <Surname><Sir/Madam>

[Option 1 – Insert for coffee shops or plasterers specific industry]

<We're writing to help your business meet its record keeping and tax obligations. This year we're paying particular attention to <industry type> to improve compliance in this industry. Our records indicate that you operate within this industry.>

[Option 2 – Insert for other industries]

<We're writing because you operate a business in an industry with a high number of cash transactions which increases the risk that you may not correctly report all of your income. Some businesses in your industry do not meet their reporting and other tax obligations so we are providing you with information to help you comply.>

Your record keeping requirements

All business income and expense transactions need to be correctly recorded and reported. Generally, the law requires you to keep your records for a minimum of five years. Keeping good records will help you avoid penalties and prosecution.

Good record keeping also makes good business sense. It provides evidence to lenders and prospective buyers on how well your business is performing.

What you should do

To ensure you are meeting your record keeping and tax obligations, we recommend you:

[Insert the following bullet points when fact sheet is included]

- <read the enclosed fact sheet, *Minimum record-keeping requirements for small business*
 - access the tools and publications available on our webpage, www.ato.gov.au/recordkeeping
- [Insert following bullet point if the taxpayer is in an industry with an established benchmark]*
- <use the small business benchmarks available at www.ato.gov.au/businessbenchmarks to review your business performance. The <industry type> benchmarks should be the ones applicable to your business>
 - review your business records - including all cash transactions
 - notify us as soon as you identify any errors. (Go to www.ato.gov.au/correctingtaxerrors for information on how to do this). Letting us know about errors will help reduce any penalties that may otherwise apply.

If you are satisfied that you are meeting all your tax obligations you do not need to contact us or do anything further.

For more information

If you use a registered tax or BAS agent, we will send them a copy of this letter and you may wish to discuss it with them. If you have any questions, please phone <13 28 66> between <8.00 am> and <6.00 pm>, <Monday to Friday>.

What you need if you phone us

We need to know we're talking to the right person before we can discuss your tax affairs. We'll ask for details only you or someone you've authorised would know. An authorised person is someone

who you've previously told us can act on your behalf. If you can, please have your tax file number (TFN) or Australian business number (ABN) with you.

Yours <sincerely><faithfully>

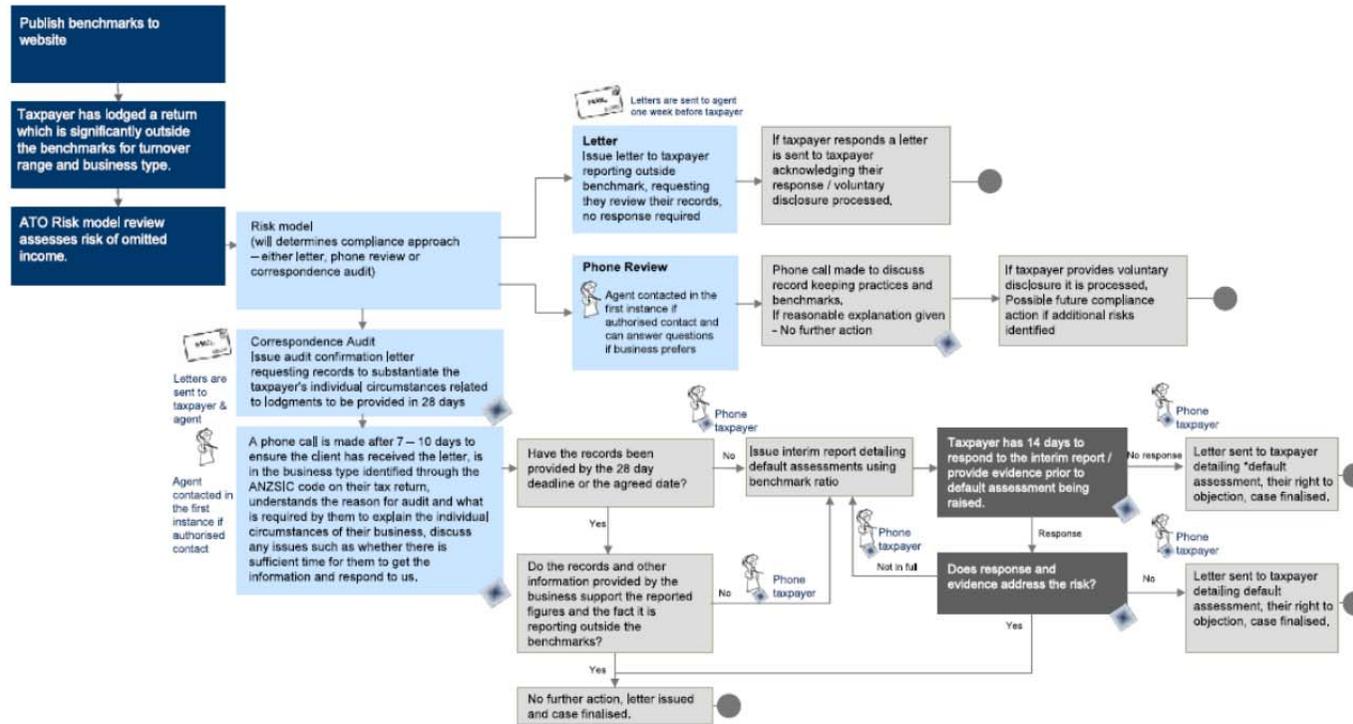
<Deputy Commissioner name>
Deputy Commissioner of Taxation

APPENDIX 8 — ATO END TO END PROCESS FOR TAXPAYERS OUTSIDE BENCHMARKS

A8.1

Taxpayers who are outside Benchmarks - End to End Process

A business may report their performance as outside the ATO small business benchmarks for a variety of reasons. Benchmarks are a guide – we always take individual circumstances into account based on business records. That is why it is important that a business has appropriate and complete records which support their performance.



A default assessment under section 167 of the Income Tax Assessment Act can be made where:

- a person makes default in furnishing an income tax return
- the Commissioner is not satisfied with the return furnished by any person
- the Commissioner has reason to believe that any person who has not furnished a return has derived taxable income.

The majority of default assessments made by cash economy are aligned to the second dot point.

The marker highlights points throughout the process where taxpayers have been given the opportunity to provide information on individual circumstances.

*Default assessments are calculated on the most appropriate benchmark relevant to the taxpayers turnover range.

APPENDIX 9 — ATO RESPONSE



Australian Government
Australian Taxation Office

SECOND COMMISSIONER OF TAXATION

Mr Ali Noroozi
Inspector-General of Taxation
GPO Box 551
SYDNEY ACT 2001

Dear Ali,

Inspector-General of Taxation's review into the ATO's use of benchmarking to target the cash economy

Thank you for your letter of 25 June 2012 and for the opportunity to provide comments on the proposed report on your review into the ATO's use of benchmarking to target the cash economy.

General observations

I am pleased to note the observations in your report that stakeholders were generally supportive of the ATO's use of benchmarking to support risk identification and improve the targeting of our compliance activities.

Benchmarks are just one of the tools we use to manage the risk of under-reported income in the cash economy. The benchmark ratios are not a normative statement of what the ATO independently thinks is a 'right' amount, they are the statistical representation of the actual amounts reported to the ATO by businesses. This makes them a valuable tool for businesses to assess their own performance against others in their industry.

I note that a number of your recommendations are about providing the community with greater information about benchmarks. Providing additional information will assist in dispelling misconceptions about benchmarks and the ATO's use of them. In this regard, we are particularly concerned to improve the community's understanding of the circumstances in which the ATO issues default assessments. We provide taxpayers with several opportunities to provide evidence of their income and expenses before resorting to a default assessment within the range of their industry peers using the relevant benchmark.

ATO response to the Inspector-General's recommendations

Our responses to your specific recommendations are included at Attachment 1. I understand that you will include these under the relevant recommendations in your final report.

Of your 11 recommendations, we agree in full with 9 and with 2 in part. While we agree with the majority of those 2 recommendations, we do not agree with the specific suggestions in sub-recommendations 3.1 (d) and 7.1 (e). Nevertheless, we agree with the underlying intent of improving community understanding and

confidence in benchmarks and minimising overall costs for small business. We have committed to undertake a range of activities to improve communication and education about benchmarks and will continue to consult with taxpayers and their advisers to explore further ways to minimise costs for small businesses.

We will also use your recommendations, building on our own continuous improvement processes, to enhance the benchmarking process and improve its effectiveness in addressing under-reporting of income by businesses.

Acknowledgements

I would like to thank you for the collaborative manner in which this review has been conducted and your inclusion of contextual information on benchmarks.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Bruce Quigley', with a long horizontal flourish extending to the right.

Bruce Quigley
Second Commissioner, Compliance
11 July 2012