Australian Government

Inspector-General of Taxation

Review into Tax Office audit timeframes

Report to the Minister for Revenue and Assistant Treasurer

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The Hon Mal Brough MP
Minister for Revenue and Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Minister

I am pleased to present to you my report of the Tax Office audit timeframes. The report has been prepared under section 10 of the *Inspector-General of Taxation Act 2003* ('the Act').

In accordance with the requirements of section 25 of the Act, I have provided the Commissioner of Taxation with the opportunity to respond to the report's findings and recommendations. His reply and associated comments on individual recommendations have been incorporated into the report. It will be noted that the Commissioner has agreed with all of my recommendations.

I offer my thanks for the co-operative approach of the Tax Office staff and the support and contribution of many professional bodies and businesses. The willingness of many to provide their time in preparing submissions and discussing issues with me and my staff is greatly appreciated.

Yours sincerely

David Vos

David R Vos AM
Inspector-General of Taxation

Contents

CHAPTER 1: INTRODUCTION

1.1 This is the report on the review conducted by the Inspector-General of Taxation (Inspector-General) of the time taken for the Australian Taxation Office (ATO or Tax Office) to complete audits of businesses. It was carried out pursuant to section 10 of the *Inspector-General of Taxation Act 2003* (IGT Act).

1.2 The review was announced on 23 November 2004. Its terms of reference are reproduced at Appendix 1 to this report. Details of how the review was conducted are given in Appendix 2.

1.3 The review was conducted pursuant to subsection 8(1) of the IGT Act, being a review conducted on the initiative of the Inspector-General. The decision to undertake the review was prompted by concerns raised by industry and tax practitioners.

1.4 Since announcing that this review was to be commenced, the Tax Office has made or proposed changes to its audit practices and staffing arrangements. These changes made or proposed by the Tax Office are noted in this report wherever relevant.

ACKNOWLEDGEMENTS

1.5 Sincere thanks are extended to those organisations representing small businesses, accountants and tax practitioners; and, small businesses, accountants and tax practitioners who prepared written submissions for this review made a particularly important contribution.

1.6 The Inspector-General of Taxation acknowledges with sincere thanks the cooperation of the Commissioner of Taxation and his staff.

CHAPTER 2: INSPECTOR-GENERAL'S SUMMARY AND RECOMMENDATIONS

CONTEXT

2.1 The Tax Office raised over $6.4 billion in tax, penalties and interest in 2003-04 as a result of 1 million compliance activities involving contact with a range of taxpayers and their representatives. Around 1,100 of these activities, raising over $2.53 billion in tax, penalties and interest, were audits of large businesses' compliance with income tax and employer obligations.

2.2 An audit activity generally involves a substantial level of taxpayer interaction and is more intrusive than other types of compliance activities. It has a greater potential to impact adversely on business. Businesses generally accept a level of Tax Office intrusion into their affairs from time to time. However, they find the adverse impacts resulting from excessive audit timeframes unacceptable. These impacts include general interest charge (GIC) liabilities created by unnecessary delays, administrative costs (including costs of professional advisers), anxiety levels and adverse market reactions.

2.3 Audits are a necessary element of Australia's taxation system. Australia's self assessment system relies on taxpayers fully and accurately complying with the taxation laws. The level of voluntary compliance is determined by a range of factors that shape taxpayers' behaviour and influence attitudes towards compliance. These factors, such as industry 'norms' and the economic environment, influence levels of compliance. Some level of failure to comply fully with the law, whether inadvertent or deliberate, is inevitable. Therefore, the Tax Office has a responsibility to undertake help and enforcement activities both to influence taxpayer behaviour towards voluntary compliance and to address non-compliance. It must assure the community that there is an acceptable level of compliance with the taxation laws.

2.4 The Tax Office has a two-fold approach to this responsibility. Audits are part of its broader strategy to deter, detect and address non-compliance ('active compliance strategies'). However, they are not the only type of activity the Tax Office undertakes to influence taxpayer behaviour and ensure compliance. 'Compliance assistance strategies' aim to assist taxpayers to understand their obligations and voluntarily comply without the intrusive means of audits.

2.5 There are a range of audit activities that the Tax Office undertakes, all varying in the level of taxpayer interaction and expected duration. These audit activities are directed at areas of greatest risk. The level of taxpayer interaction should be proportionate to the nature of the risk being addressed and such matters as the complexity of the issue and level of taxpayer assistance. The aim is to minimise the level of taxpayer interaction to that needed for the Tax Office to assure itself of a business's compliance level. That level of assurance may be influenced by the taxpayer's previous compliance behaviour, the amount of potential revenue involved and the need to maintain a Tax Office presence in higher risk areas. Comparable OECD member tax administrators consider that the Australian Taxation Office is a world leader in its approach to improving compliance levels.

2.6 It would not be useful to prescribe general timeframes in which the Tax Office must complete all its various audit activities, as some factors that influence audit timeframes are not within its direct control. Although the Tax Office is clearly accountable for its own governance of audits, it has limited influence over other factors, such as the complexities of business transactions and laws and the level of taxpayer assistance provided during audits. However, judgments can be made as to whether audit timeframes are excessive in particular circumstances.

CONDUCT OF REVIEW

2.7 The focus of the review was on the Tax Office's practices and approaches that could lead to excessive audit timeframes and result in undue adverse impacts on businesses. Businesses' concerns were tested by reviewing audit processes and management systems, examining a random sample of 386 audit case files and interviewing tax auditors, team leaders and senior tax officers.

FINDINGS

2.8 Overall, the review found that the Tax Office is actively seeking to make improvements that enable it to manage its audit programme in a manner that minimises audit timeframes. There is a recent increased management focus on reducing audit timeframes, as evidenced by the implementation of revised internal reporting and substantial internal structural changes, exploration of refinements to existing audit approaches and consideration of increased usage of forward compliance agreements.

2.9 However, an examination of sample cases revealed that there were examples of certain projects and isolated cases where the Tax Office took longer to finalise audits than it should have taken. These projects and cases typically involved matters of complexity and involved delays in decision-making on technical or strategic issues. Examples include, living away from home allowance audits, research and development syndicate audits and some transfer pricing audits. Although these cases may be exceptions, the delays experienced were significant. The Tax Office should have made appropriate and correct decisions on a timely basis to minimise the impact on affected businesses.

2.10 Since the start of this review, the Tax Office has announced certain measures which will have the effect of addressing other concerns. Two senior tax officers have been taken off line to model expert case management in the most complex cases and provide a means to more quickly identify emerging risk trends. Four more senior officers will be appointed to assist in this role. The Tax Office has adopted a practical approach to auditing substantiation issues in the GST area, thereby reducing the need to expose many small businesses to intrusive audits. A new Tax Office case management system will soon be implemented. This will provide functionality to enable increased use of previously provided taxpayer information and an improved case management capability. Further time is needed to implement these measures fully and evaluate their effectiveness in reducing excessive audit timeframes.

2.11 Notwithstanding the above, there is potential for the Tax Office to minimise the adverse impacts on businesses of excessive audit timeframes further. The following three areas outline where this potential lies.

Technical/expert support

2.12 The Tax Office has processes and trained staff directed towards ensuring consistency and accuracy of technical interpretation. The Tax Office is also bolstering case management skills through senior officer 'modelling' of expert management and resolution of the more complex cases in the small to medium-sized enterprise (SME) and large market segments.

2.13 However, there is potential to minimise the taxpayer's GIC burden by quickly coming to a correct final position after the point at which all information is gathered from the taxpayer. Submissions and a review of sample cases revealed that in a small proportion of audits, timeframes are unnecessarily and significantly extended where the Tax Office does not make a quick well-reasoned decision either in determining a technical view or in deciding on a forward strategy for the audit. These cases involve complexity and Tax Office uncertainty. They are more likely to involve audits of large businesses.

2.14 Additionally, there is potential to further minimise taxpayer administrative costs and potential GIC burden further by ensuring that the right technical support is provided to auditors before intensive information-gathering begins. Generally, the Tax Office sufficiently scopes the audit to minimise information requests. However, submissions and a review of sample cases revealed that there were some cases where the scope was not defined with sufficient particularity so as to avoid unnecessary information requests and extended timeframes.

Auditor case management

2.15 The Tax Office has a sophisticated system that identifies risk areas and determines the most appropriate response. The effectiveness of these processes will greatly influence whether there is a match between the taxpayer audit cost burden and the level of perceived risk. The Tax Office is seeking to reduce timeframes by increasing auditors' awareness of the taxpayer impacts and improving audit-monitoring and resolution of 'aged cases'.

2.16 However, from an examination of sample cases it is clear that the Tax Office has not remitted the GIC for significant periods of Tax Office-caused delays in many cases.

Related communication issues

2.17 The Tax Office has corporate aspirations, and processes, aimed at improving communication with taxpayers and the transparency of its audits.

2.18 However, there is potential to improve the quality of taxpayer dialogue and audit transparency further by:

- clearly articulating the expected timeframes of the audit at its outset
- ensuring that the current Tax Office procedures requiring taxpayer notification of commencement and finalisation of audit activities are followed by staff
- ensuring that taxpayers are notified of the progress of audits where those audits involve periods of Tax Office-caused delay
- allaying taxpayer concerns that the relevant technical specialist, in considering complex matters, takes account of the taxpayer's full commercial circumstances in determining the Tax Office view.

Other taxpayer concerns

2.19 Some of the other taxpayer concerns examined were indicative of the Tax Office's older approaches and practices that have already been addressed by Tax Office changes.

2.20 A review of sample case files revealed that extended timeframes due to serial examination of issues, serial audits of the same business and numerous information requests had generally been minimised by a revised approach. This approach seeks to identify and prioritise greater risks and test those risks through targeted information-gathering. Businesses in lower risk categories are excluded from audit selection. This is due to improved targeting of audits through greater analysis of internal and external information. The Tax Office also has increased its technical support for auditors through new training programmes, more systemic access to technical experts and new quality assurance processes to assess the accuracy and consistency of technical views.

2.21 Some other concerns examined revealed no prima facie evidence of underlying systemic issues. A review of sample audit case files revealed little evidence of not providing adequate reasons for amendment, duplicated information requests due to Tax Office staff turnover, notifying inappropriate people of the start of the audit or not being flexible in providing sufficient time for taxpayers to provide information.

2.22 The review also found substantial evidence of time lags between selecting cases for review and notifying taxpayers of the commencement of audits. However, these time lags were explained by the Tax Office undertaking preliminary internal reviews of taxpayers during this time in order to exclude from more intrusive audit approaches those cases of perceived lower risk. Delays caused by settlement negotiations were also found. However, these periods involved time taken to consider fully the risk of the Tax Office's view not being upheld in litigation and the costs and benefits of defending its view.

RECOMMENDATION 1

The Inspector-General recommends that the Tax Office:

(a) continues to expeditiously resolve those audits experiencing significant delays; and

(b) fully implements appropriate governance processes to ensure that, in future, the resolution of technical and strategic issues encountered during audits is expeditiously resolved in a manner that provides all parties with adequate opportunity to understand the relative merits of the other's views.

ATO Response

We agree with this recommendation. As reflected in your report, The Tax Office has significantly increased its focus on reducing audit timeframes including the deployment of our most senior and experienced officers to resolve complex cases and the implementation of issue management processes.

RECOMMENDATION 2

The Inspector-General of Taxation recommends that, before intensive information-gathering begins in an audit, the Tax Office ensures that appropriate technical input is brought to bear to develop the correct focus of the audit.

ATO Response

We agree with this recommendation. While our scoping processes are effective in most cases, your report has highlighted some areas in which we could improve the effectiveness of these processes. We are also taking on board lessons from the successful implementation of new approaches to the timely management of complex private rulings requests under which all players are brought together early to identify key issues requiring examination.

RECOMMENDATION 3

The Inspector-General recommends that the Tax Office fully implements appropriate governance processes to ensure that the general interest charge attributable to significant periods of Tax Office-caused audit delay is remitted.

ATO Response

We agree with this recommendation. Our GIC remission guidelines specifically deal with this circumstance and must be considered in all cases where delays are attributable to the Tax Office. We will review our governance processes to ensure these guidelines are uniformly applied.

RECOMMENDATION 4

The Inspector-General recommends that the Tax Office:

(a) clearly articulates to the taxpayer the expected timeframes of the audit at its outset;

(b) ensures that Tax Office auditors comply with procedures requiring taxpayer notification of commencement and finalisation of audit activities;

(c) notifies taxpayers of the progress of audits where those audits involve periods of Tax Office-caused delay; and

(d) in complex matters, allays taxpayer concerns by ensuring that the relevant technical specialist will take account of the taxpayer's full commercial circumstances in determining the Tax Office view.

ATO Response

We agree with this recommendation. In most cases the Tax Office applies these processes, but your report has highlighted areas where more rigour in our management of audit cases will improve the effectiveness of our communication with taxpayers and the transparency of our audit processes.

Chapter 3: The Tax Office's approach to business audit timeframes

Background

3.1 The Tax Office raised over $6.4 billion in tax, penalties and interest in 2003-04 as a result of over 1.1 million compliance activities involving contact with a range of taxpayers and their representatives. Of these amounts, around 116,000 activities, raising $3.23 billion in tax, penalties and interest fell within the scope of this review. Audits of large businesses' compliance with income tax and employer obligations comprised 1,100 of these activities, raising over $2.53 billion in tax, penalties and interest.

Definition of 'audits'

3.2 For the purposes of this review, the Inspector-General defined 'audits' as those Tax Office active compliance activities that are directed at ensuring compliance with taxation laws and involve an interaction with the business or its representatives. 'Active compliance activities' is a term used by the Tax Office to refer to those activities which are aimed at deterring, detecting and addressing non-compliance with the taxation laws.

3.3 The Tax Office defines 'audit' to mean a particular type of active compliance activity directed at ensuring compliance with taxation obligations. It includes activities which involve no taxpayer interaction and excludes activities which are preliminary to compliance checks but involve an intensive interaction with the taxpayer.

3.4 The definition adopted for this review ensures that a very broad range of activities is taken into account and more accurately reflects those activities commonly understood as audits. For example, audits include those activities involving visits to business premises to view documents and interview staff. They do not, however, encompass all active compliance activities. For example, most forms of automated data-matching are excluded because they do not involve taxpayer interaction.

Scope of review

3.5 The review focused on income tax, employer obligation and goods and services tax (GST) audits of businesses. However, large business GST audits were excluded as these are being reviewed by the Auditor-General. The Tax Office also announced that it would conduct an internal review of the large business GST audit area.

3.6 The relevant time periods reviewed were from auditors' contact with businesses selected for audit through to amendment or finalisation of the audit. This excluded from the scope of the review those delays experienced before communication with the taxpayer and interactions occurring after amended assessment, such as determination of objections.

Adverse impacts of audits

3.7 Audit activity generally involves a substantial level of taxpayer interaction and is more intrusive than other types of compliance activities. Typically, taxpayers incur additional compliance costs responding to information requests and internally reassessing their taxation compliance.

3.8 Businesses generally accept a level of Tax Office intrusion into their affairs from time to time. Taxation compliance is a significant cost for business and universal business compliance with taxation laws minimises the potential for unfair competitive advantages. However, businesses find the adverse impacts resulting from excessive audit timeframes unacceptable.

3.9 The Tax Office has a duty to ensure that it carries out audits efficiently, professionally and fairly. It also has a duty to minimise undue adverse impacts on businesses where the completion of audits is unnecessarily delayed.

3.10 Where an audit results in an increase in a business's taxation liability, that business will incur a general interest charge (GIC) burden for the tax shortfall. This will include those periods attributable to Tax Office-caused delays in cases where remission is not granted. While the Tax Office's GIC remission policy recognises that Tax Office-caused delays are a ground for full remission, sampling has revealed that this policy is not always properly considered. However, it is noted that from 1 July 2005 the quantum of this burden may be reduced. This will depend upon the changes resulting from the Treasury's Review of Income Tax Self Assessment to reduce the pre-amended assessment interest rate, becoming law.

3.11 Business administrative costs, both direct and indirect, are increased because of audit activity. Businesses expend resources in responding to information requests and incur costs in engaging professional advisers to assist with the conduct of the audit and consideration of technical positions. Businesses' resources are thus detracted from entrepreneurial activities.

3.12 Delays in finalising audits may also unnecessarily expose businesses to adverse market reactions. Prolonged exposure to contingent taxation liabilities may affect a business's capacity to raise capital and maintain financier support.

3.13 Audits may also raise anxiety levels for businesses. Businesses may feel disempowered where they perceive a lack of control or understanding in the process. Businesses may also find it more difficult to reconcile their attitudes and behaviours with the treatment response of the tax administrator. This situation may reduce their confidence in the administration and frustrate the administrator's aim of influencing compliance attitudes and behaviours.

Rationale for audits

3.14 Audits are a necessary element of Australia's taxation system. Australia's self assessment system relies on taxpayers fully and accurately complying with the taxation laws. The level of voluntary compliance is determined by a range of factors that shape taxpayers' behaviour and influence attitudes towards compliance. These factors, such as industry 'norms' and the economic environment, influence levels of compliance. Some level of failure to comply fully with the law, whether inadvertent or deliberate, is inevitable. Therefore, the Tax Office has a responsibility to undertake help and enforcement activities both to influence taxpayer behaviour towards voluntary compliance and to address non-compliance. It must assure the community that there is an acceptable level of compliance with the taxation laws.

3.15 Audits are an important means of determining broader compliance levels and shaping compliance. As well as validating compliance in individual cases, audits play a deterrent role. Audits also provide intelligence, particularly on novel matters of emerging risk. Taxpayers selected for audit also bear the compliance cost associated with achieving these outcomes.

Tax Office's general audit approach

3.16 The Tax Office has a two-fold approach to influencing voluntary compliance levels and addressing non-compliance. Audits are part of its broader strategy to deter, detect and address non-compliance ('active compliance strategies'). However, active compliance activities are not the only type of activity the Tax Office undertakes to influence taxpayer behaviour and ensure compliance. 'Compliance assistance strategies' aim to assist taxpayers to understand their obligations and voluntarily comply without the intrusive means of audits.

Audit strategy development and delivery

3.17 The Tax Office has a complex governance process to manage its compliance strategy and delivery. It involves a high-level committee that identifies and prioritises the compliance risks to be targeted. This committee is informed by a number of subcommittees. Information identifying risks is filtered up from operational levels. Compliance risks are considered from different perspectives and the outcome of the process is the publication of the *Compliance Program*[1] which articulates the identified compliance risks and priorities. Although not published, the compliance treatments for those risks over the coming year are also determined.

3.18 There is a complex hierarchy of performance measures and indicators of success. The Tax Office undertakes regular monitoring to track its performance against these measures and indicators.

3.19 Audits are carried out by various areas within the Tax Office. For the purposes of this review, the relevant areas were: the GST, Small Business and Large Business and International Business and Service Lines (BSLs).

1 See for example, Australian Taxation Office, *Compliance Program 2004-05*, Canberra, August 2004.

General audit approach

3.20 There are a range of audit activities that the Tax Office undertakes ('compliance products'), all varying in the level of taxpayer interaction and expected duration. Each type of product is targeted to a particular revenue type and population of taxpayer. Compliance products are categorised according to different compliance strategies. The categories are: investigate and prosecute; audit and enforcement; and, review.

3.21 For example, the Tax Office states that audit and enforcement products are primarily used where it is reasonable to believe there is a risk of non-compliance. This risk is addressed by the use of audit products that involve the examination of records to establish the correct liability and enforce compliance. The audit and enforcement product set also includes products to ensure administrative compliance with obligations such as registration, lodgment, payment, regulatory responsibilities and withholding liabilities.

3.22 In contrast, the Tax Office states that review products are designed to maintain the integrity of the tax system by helping taxpayers to comply and remain 'on track' with compliance. These review products seek to encourage voluntary disclosures and improve voluntary compliance behaviours. The Inspector-General has treated these products as audits within the scope of this review.

3.23 Each compliance product set is further sorted into more specific Tax Office sub-products, depending on the type of activity. For example, a review product would include desk review activities, computer review activities and field review activities.

3.24 As at September 2004, the Tax Office had 91 review products, 79 audit enforcement products and 10 investigate and prosecute products. Since this time the Tax Office has started rationalising its compliance products. It also aims to use common descriptions of its compliance activities and develop consistency of internal reporting. A feature of this rationalisation is to incorporate a client impact perspective.

3.25 Audit activities are directed to areas of greatest risk. The level of taxpayer interaction should be proportionate to the nature of the risk being addressed and such matters as the complexity of the issue and level of taxpayer assistance. The aim is to minimise the level of taxpayer interaction to that needed for the Tax Office to assure itself of a business's compliance level. That level of assurance may be influenced by the taxpayer's previous compliance behaviour, the amount of potential revenue involved and the need to maintain a Tax Office presence in higher risk areas.

3.26 In the Inspector-General's discussions with tax administrators from comparable OECD member countries, there is a general consensus that the Australian Taxation Office is a world leader in its approach to improving compliance levels.

Factors affecting audit timeframes

3.27 It would not be useful to prescribe general timeframes in which the Tax Office must complete all its various audit activities, as some factors that influence audit timeframes are not within the direct control of the Tax Office. Although the Tax Office is clearly accountable for governance of its own audits, it has limited influence over other factors that substantially affect audit timeframes, such as the complexities of business transactions and laws and the level of taxpayer assistance provided during audits.

3.28 The Tax Office is in the process of determining benchmark timeframes for the range of audit activities it undertakes. Judgments can be made as to whether audit timeframes are excessive in particular circumstances.

Tax Office governance

3.29 The self assessment system relies on taxpayers to maintain adequate records and to apply the law correctly to their circumstances. This system poses a spectrum of compliance scenarios for the Tax Office, including, non-compliant activities outside of the system such as the cash economy, omitted entries such as undeclared income, overstated deductions, tax planning arrangements such as finer technical interpretational issues, and voluntary compliance. Therefore, the Tax Office must target and tailor its audit activities.

Risk identification and matching risk with activity

3.30 The Tax Office operates in a dynamic risk environment and will never be funded to deal with every risk that might emerge. Therefore, it must select those cases with the greater risk. Accurate risk identification minimises the impact of compliance costs on those taxpayers compliant with the taxation laws. Matching the risk treatment with the type of risk is essential to ensure a proportionate response to those risks.

3.31 Areas of risk are identified and prioritised. Generally, cases are selected from a pool of cases with characteristics indicating the identified risk. Those of identified higher risk, or 'outliers', are more likely to be audited than those of lower risk.

3.32 The Tax Office is also in the process of implementing measures that it expects will increase the accuracy of identifying those cases of risk and, therefore, potentially exclude from review those taxpayers in circumstances of lower risk. These measures include improving its data-mining and statistics analysis abilities.

3.33 For large business groups and high-wealth individuals, the Tax Office monitors and identifies potential risks on an ongoing basis. Tax Office audit teams are dedicated to specific large business groups. These teams are also responsible for providing Tax Office advice to these groups.

3.34 Broad-ranging audits are becoming less common. Scrutiny is becoming more focused on specific risk areas. The Tax Office is seeking to become more sophisticated in its risk identification and assessment process in the large business sector so that tax risks are identified, investigated and resolved on a timely basis. There is some evidence of the Tax Office gearing towards this approach. For example, it has for several years employed economists to compare businesses' economic performance with tax performance in its risk assessment process for large businesses. It has started to extend this practice to small to medium-sized enterprises (SMEs).

3.35 The Tax Office states that it seeks to target and tailor appropriate risk treatments to identified risks. It assesses risks by a variety of criteria. It views risk as involving more than merely determining the potential revenues at risk and the resources needed to recover those revenues. Educative and coverage roles are also important drivers to influence attitudes and behaviours towards voluntary compliance.

3.36 Alternatives to audits may also be open to achieving broader compliance. For example, the Tax Office has advised relative success in minimising audit timeframes through 'forward compliance agreements', such as Advanced Pricing Agreements in transfer pricing audits. The Tax Office advises that it is seeking to extend use of forward compliance agreements.

Resourcing

3.37 The Tax Office has a budget of $2.3 billion and over 21,000 staff to administer taxation laws that involve 15 million individual and business taxpayers and non-profit organisations and 300,000 self-managed superannuation funds. A little over half of these tax officials undertake activities with a compliance focus, utilising around 40 per cent of the Tax Office's budget. Around 5,500 of these officials are mainly involved in verifying taxpayer-provided information. This proportion of audit staff to total staff is similar to tax administrators in other comparable OECD countries apart from the United States of America.[2]

Technical support

3.38 The Tax Office has processes and trained staff aimed at providing consistent and accurate technical interpretation.

3.39 In 2002, two independent reviews[3] recommended changes to increase controls over determining the Tax Office view and improving technical support to minimise the risk of incorrect or inconsistent advice being provided. The Office of the Chief Tax Counsel now provides audit staff with access to subject specialists who are responsible for settling the Tax Office view. Technical decisions are now documented and accessible through the Tax Office's electronic Technical Decision-Making System (TDMS).

3.40 Audit staff are supported by escalation processes for technical issues, technical support tools, specialist technical forums and staff training. The Tax Office also has internal forums for providing guidance and settling views on certain specific technical issues, for example, the Part IVA panel and the International Strategy and Operations panel (for transfer pricing issues).

3.41 Some 380 auditors have completed the Tax Office's Compliance Officer Applied Auditor Accounting Program (COAAAP). A further 190 auditors are enrolled. The COAAAP was developed with and run in conjunction with the University of

2 Organisation for Economic Co-operation and Development, *Taxation Administration in OECD Countries: Comparative Information Series* (2004), Paris, October 2004.

3 Australian National Audit Office, *Audit Report No. 3 2001-02: The Australian Taxation Office's administration of taxation rulings*, Canberra, 2001; Sherman, *Report of an Internal Review of the Systems and Procedures relating to Private Binding Rulings and Advance Opinions in the Australian Taxation Office*, Canberra, August 2000.

NSW. Senior audit staff participating in the program are required to attend an intensive two-week course that is followed up by evidence of the auditor 'sustaining the learning' and 'transferring the learning' to the work place.

3.42 Audit processes may also require specialist technical input at an early stage of the audit. The Tax Office provides auditors with a range of measures to assist in narrowing the scope of audits. These include the initial risk identification, audit treatment products, initial audit-planning and hypothesis-testing audit methodology. In the case of project-focused work, auditors are also provided with pre-prepared information-gathering questionnaires. Auditors also have access to internal technical materials and a support network that provides for the escalation and resolution of technical issues.

3.43 The large business audit area's processes and structure have changed to meet better the needs of the large business segment. Officers are assigned to large business taxpayers to provide a single entry point for dealings with the Tax Office. The large business audit area is organised on an industry segment basis to deal with compliance and advice issues. Workshops with subject specialists may be conducted to identify and resolve technical issues arising during audits.

3.44 Governance processes for technical decision-making include audit manager review of auditors' decisions, the GST Case Assistance Panel (CAP) process and Technical Quality Reviews (TQR).

3.45 Auditors must complete a final audit report for their manager's approval before any decisions are made to finalise an audit. These reports are required to specify the legal basis and relevant evidence for the decision. Progressively over the last 15 months, the GST BSL has implemented a CAP process that reviews each case before finalisation. The panel consists of other team leaders, senior audit staff and technical advisers. The panel ensures that the audit was conducted appropriately, that all relevant risks were identified and tested and that the evidence gathered and expressed technical views were appropriate.

3.46 The TQR involves a review of technical decisions by internal and external tax specialists. Recent TQR panels reported no systemic problems. Identified errors during audits were considered 'one off' mistakes or oversights that should typically be picked up by team leaders or case officers following the set procedures.

Communication with taxpayers

3.47 Effective communication is essential to influencing taxpayer attitudes and behaviours towards voluntary compliance. Taxpayers may perceive that the Tax Office has not effectively communicated to them or heard and understood them.

3.48 The Tax Office undertakes qualitative surveys of taxpayer observations of its conduct. The staff Professionalism Survey reports a relatively high level of satisfaction with staff professionalism of the audit areas surveyed when compared with the Tax Office's benchmark. However, the survey identified that the Small Business General Field area was below the Tax Office's benchmark. This area has the lowest rating of the areas surveyed, for the propositions that 'staff have sufficient understanding of the issue' and 'staff understood my needs'. The GST Field and GST Compliance Verification Centre areas had the highest comparative scores.

3.49 Since the publication of the Inspector-General's forward work programme, the Tax Office has appointed an external adviser to conduct a qualitative survey of a number of the largest businesses in the large business segment. The focus of the survey was to ascertain why a number of the very largest companies had a lower level of satisfaction with staff professionalism than the high level of satisfaction indicated in the Tax Office's annual professionalism surveys. The Tax Office advises that it is in the process of considering the results of that survey. It is developing strategies to remedy this dissatisfaction and will consult further with that sector.

3.50 Also, there is a low level of complaint about auditors' attitudes towards businesses during audits. Seventeen of the 1276 complaints made to the Tax Office in 2003-04 related to the audit process. In his annual report, the Taxation Ombudsman states that 457 complaints were made to his office concerning Tax Office audits but none evidenced improper or overzealous actions.

Monitoring and reporting

3.51 The Tax Office's current monitoring and reporting systems primarily focus on managing resources. The Tax Office expects to broaden this focus to cover impacts on taxpayers. The new electronic case management system is designed to provide this functionality. This system is being progressively implemented and is expected to be operational for all auditors by the middle of next year.

3.52 Since the publication of the Inspector-General's forward work programme, the Tax Office has increased its management focus on audit timeframes. Improved processes have been implemented to identify 'aged cases' (cases where the cycle times have exceeded expected timeframes) and the reasons for extended timeframes. The Tax Office has also required individual aged cases to be progressively escalated to more senior official scrutiny where they remain unresolved. It is seeking to measure the effectiveness of the efforts to reduce the numbers of aged cases. This involves increased executive scrutiny, 'call overs' and panel reviews of aged cases.

Commercial and tax planning influences

3.53 Commercial and tax planning influences create complexities that require resource-intensive efforts to resolve. Increased international competition, greater demands for returns on working capital and increased regulatory compliance costs all drive business to reassess their funding and tax options. Changes in commercial arrangements give rise to potential tax consequences. Businesses require the tax administrator to provide certainty on the tax treatment of commercial arrangements on a timely basis.

3.54 Historically, audits of large businesses' tax compliance were typically long and wide-ranging. This reflected the increased likelihood of commercial and tax planning influences in the large business market. In recent times the Tax Office has been seeking alternative strategies to assure compliance. For example, it has recently tried to encourage senior business staff and directors to involve themselves in tax decision-making and view tax compliance as a corporate governance issue. It has also implemented a 'fast track' process for considering ruling applications on complex issues.

3.55 For the micro-business segment the quality of record-keeping, access to quality technical advice and competitive pressures create a degree of compliance risk.

3.56 The Tax Office has a corporate aspiration to be engaged in more meaningful dialogue with businesses to better understand commercial pressures and how they influence voluntary compliance. Ideally, this understanding should, amongst other things, identify opportunities to remove impediments to timely completion of audits.

Taxpayer assistance

3.57 Audit timeframes are directly affected by levels of taxpayer assistance. These levels depend upon the resources available to the taxpayer, their access to relevant information and technical expertise and their compliance attitude.

3.58 For example, small businesses have a reduced capacity to devote resources to dealing with audits but may seek assistance of a tax practitioner during audits. The commencement of audits can be delayed where the business and tax practitioner discuss amongst themselves who will bear the cost of the audit. The timely completion of audits may be affected where they involve reviews of transactions taking place many years ago. It may be difficult to marshal resources and engage witnesses as relevant personnel may have moved on and relevant documents may have been destroyed or misplaced. Compliance attitudes may also affect the quality and completeness of requested information.

General findings

3.59 Overall, the review found that the Tax Office is actively seeking to make improvements to enable it to manage its audit programme in a manner that minimises audit timeframes. There is a recent increased management focus on reducing audit timeframes as evidenced by the implementation of revised internal reporting and substantial internal structural changes, exploration of refinements to existing audit approaches and consideration of increased usage of forward compliance agreements.

3.60 However, an examination of sample cases revealed that there were examples of certain projects and isolated cases where the Tax Office took longer to finalise audits than it should have taken. These projects and cases typically involved matters of complexity and involved delays in decision-making on technical or strategic issues. Examples include, living away from home allowance audits, research and development syndicate audits and some transfer pricing audits. Although these cases may be exceptions, the delays experienced were significant. The Tax Office should have minimised timeframes by ensuring that it made appropriate and well-reasoned decisions on a timely basis.

3.61 Since the publication of the Inspector-General's forward work programme, the Tax Office has announced certain measures which would have the effect of addressing some taxpayer concerns. These measures are discussed below where relevant. Further time is needed to implement these measures fully and to evaluate their effectiveness in reducing excessive audit timeframes.

3.62 Some taxpayer concerns examined were indicative of the Tax Office's older approaches and practices that have already been addressed by Tax Office changes. Some other concerns examined revealed no prima facie evidence of an underlying systemic issue. These concerns are discussed below.

3.63 Notwithstanding the above, there is potential for the Tax Office to further minimise the adverse impacts on taxpayers of excessive audit timeframes.

ISSUES

Issue 1

The Tax Office does not quickly come to correct final positions in all audits involving significant complexity and uncertainty.

3.64 Submissions and a review of sample cases revealed that in a small proportion of audits, timeframes are unnecessarily and significantly extended where the Tax Office does not make a timely, well-reasoned decision either in determining a technical view or in deciding on a forward strategy for the audit. These cases involve complexity and Tax Office uncertainty. They are more likely to involve audits of large businesses.

3.65 More time is generally needed to understand complex transactions, determine the finer distinctions of complex technical issues and determine the best forward strategy to resolve an issue. Not all evidence may be available and the application of the law may be uncertain. The underlying policy of the law itself may be uncertain also. However, delays in making timely, well-reasoned decisions are unacceptable to businesses who require certainty on a timely basis. Excessive timeframes also increase the level of taxpayer anxiety and potential exposure to the GIC.

3.66 A review of sample cases indicated a number of cases, projects and issues which involved significant Tax Office delays in deciding the forward strategy, determining technical views or both. For example, senior officers spent three years and five months deciding on the forward strategy and settling technical views for certain living away from home allowance audits.

3.67 Business is of the view that such decisions could be made within a shorter time period, generally within three months. However, the Tax Office is concerned that a prescriptive time period may unduly affect the quality of its technical decisions. A likely result includes an increase in adverse impacts suffered by taxpayers challenging ill-considered views.

3.68 The Inspector-General is of the view that the resolution of technical matters should be done in a manner that quickly provides each party with adequate opportunity to understand the relative merits of the other's view. This approach requires confidence of decision-making in uncertainty situations, obtaining the right technical input as early as possible, appropriate case management of that technical input and appropriate audit strategy. Inherent in this approach is clear communication to taxpayers of what are seen as risks and why.

Confidence of decision-making in uncertainty situations

3.69 The Tax Office acknowledges that engendering confidence in senior audit staff to make timely and well-reasoned decisions in uncertain situations is an area that can be bolstered. In the more complex cases, early intervention to identify and resolve technical issues by drawing together the right people to focus on the issues could provide real benefits.

3.70 Since the publication of the Inspector-General's forward work programme, the Tax Office has redeployed two senior officers (a Deputy Commissioner and a First Assistant Commissioner) to help quickly resolve large business complex aged cases and model expert case management. It is also in the process of creating a further four senior positions to assist these senior officers in their role.

3.71 Further lead time is needed to implement these measures and evaluate their effectiveness in improving technical and strategic decision-making.

Right technical input

3.72 A review of sample cases indicated several audits involving complex novel issues where timeframes could have been minimised through earlier consultation with relevant leading subject specialists (both internal and external to the Tax Office).

3.73 For example, in earlier transfer pricing cases, the particular information needed to determine the issues in question could have been more quickly identified by consulting leading external expert economists at the outset of the audit. In one reviewed case this could have reduced timeframes by at least nine months.

3.74 In relation to transfer pricing cases, the Tax Office has increased its ability to minimise the adverse impacts of transfer pricing audit timeframes. It implemented audit procedures specific to transfer pricing, employed economists to focus on transfer pricing analysis, implemented a practice of remitting GIC from the point at which all information is gathered from the taxpayer and offered forward compliance agreements that potentially have the effect of reducing the scope and timeframes of future transfer pricing audits.

3.75 There are Tax Office internal processes that aim to identify and escalate matters to the appropriate decision maker where either technical complexity or uncertainty is encountered. For example, for large business audits since 2000, 'call over' panels and the technical escalation process have formalised the provision of senior executive staff input into decision-making.

3.76 However, the Tax Office accepts that notwithstanding these processes there were a number of cases that could have been progressed on a more timely basis. For the more complex cases, the two redeployed senior officers will also seek to marshal quickly the correct technical input as early as possible in audits. Further time is needed to implement these measures and to evaluate their effect in reducing excessive audit timeframes.

Case management of technical input

3.77 One cause for delays in the provision of technical input was the time some technical staff (internal and external to the Tax Office) took in providing their views.

3.78 Since the scoping of this review, the Tax Office has progressively implemented governance measures to identify audits involving significant delays and resolve them. All audit areas are developing benchmarks for audit cycle times (in some areas benchmarked cycle times are being tailored to the specific audit activity), implementing exception reporting for aged cases, ensuring senior official review through call over panels and implementing systems to support aggregated managerial reporting.

3.79 These measures will assist to identify delays in obtaining technical input and enable improved case management of that input.

Audit strategy

3.80 Audit strategies are varied and may have variable impacts on audit timeframes. One particular strategy identified as having a significant impact on audit timeframes was that of project-based audits involving technical uncertainty.

3.81 Project-based audits aim to create administrative efficiencies by focusing audit resources on a particular risk common to a number of taxpayers. As there are often large numbers of taxpayers falling within the potential scope of project focuses, thresholds for selecting cases are generally set on the basis of the quantum of potential revenue at risk. This allows auditors to focus on the minority of cases involving the most risk and provide 'leverage' in shaping compliance behaviours in the broader relevant industry. Therefore, this minority bears the compliance cost for that industry.

3.82 Although there are administrative efficiencies, care should be taken to ensure that they are not gained at the expense of appropriately considering the individual circumstances of each taxpayer. The Inspector-General has discussed this issue in his report into the remission of the GIC for groups of taxpayers in dispute with the Tax Office.

3.83 Submissions and a review of sample case files indicate that the Tax Office's approach in these circumstances is to determine its technical view applying to the broader industry before settling current audits. Where strategic or technical decisions on these projects are delayed, involving a great number of audits, the result is an increase in the potential GIC burden and taxpayer anxiety.

3.84 For example, examination of trust losses involved a substantial number of taxpayers and a number of audits have taken over six years to date. This timeframe includes over three years where the project was put on hold due to reallocation of resources to other areas of overriding priority, being the implementation of the new tax system. Taxpayers were not informed of the delay. Overlapping periods of 14 months were spent deciding on a forward strategy and 20 months in resolving a range of technical issues.

3.85 Since the scoping for this review, the Tax Office is reconsidering its general audit approach for future small business aggressive tax planning audits. This includes 'identifying the gaps and potential improvements in existing approaches', 'determining options for breakthrough strategies' and 'minimising the possible reoccurrence of blockers to timely completion'.

3.86 The Tax Office is also considering alternative risk treatments and re-evaluating its communication to individuals involved in these groups. It recognises that adverse impacts can be reduced where there is clear and open communication about the reasons for extended timeframes. This issue is discussed further below.

3.87 The Inspector-General applauds the Tax Office's recent moves to focus on and expeditiously resolve delayed audits. In matters involving significant complexity and Tax Office uncertainty, there is potential to minimise the taxpayer's GIC burden from the point at which all information is gathered from the taxpayer by coming to a timely, well-considered final position quickly.

RECOMMENDATION 1

The Inspector-General recommends that the Tax Office:

(a) continues to expeditiously resolve those audits experiencing significant delays; and

(b) fully implements appropriate governance processes to ensure that, in future, the resolution of technical and strategic issues encountered during audits is expeditiously resolved in a manner that provides all parties with adequate opportunity to understand the relative merits of the other's view.

ATO Response

We agree with this recommendation. As reflected in your report, The Tax Office has significantly increased its focus on reducing audit timeframes including the deployment of our most senior and experienced officers to resolve complex cases and the implementation of issue management processes.

Issue 2

By not commencing all audits with the correct focus, the Tax Office makes unnecessary information requests and unnecessarily extends audits.

3.88 A review of sample cases revealed that in a small but significant proportion of cases, auditors were not determining the focus of the audit before intensive information-gathering began. Audit timeframes and the number of information-gathering requests could have been reduced by ensuring sufficient narrowing of issues and information identification at the outset of intensive audit activity.

3.89 Taxpayer compliance costs and exposure to a potential increased GIC burden in that small proportion of cases were therefore unnecessarily increased. Submissions also argue that broad information-gathering is contrary to the principles of self assessment.

3.90 Of the reviewed sample cases, 44 audits involved insufficiently defined issues or insufficiently targeted information requests (11.4 per cent). The great majority of these audits were of micro-businesses and SMEs (81.82 per cent). An insufficiently defined issue is one that either does not clearly articulate the specific technical issue to be resolved with sufficient particularity or does not identify the specific evidence required to determine that issue. These audits averaged 2 to 3 times the number of information requests and averaged 1½ times the audit timeframe in comparison with audits that had sufficiently defined the issues at the outset.

3.91 Factors minimising these impacts were:

- where the issue to be determined was one of verification rather than technical interpretation
- where the Tax Office had previously used a 'review' product that preceded the more intensive audit activity
- where the auditor demonstrated understanding of the audit planning's purpose to narrow the hypothesis with sufficient particularity and identify the specific information needed to determine the issue in question, and
- where expert case management support and comparatively greater complex audit experience were available.

3.92 Seven of these cases involved a lack of sufficient taxpayer assistance. These cases averaged 1½ times the number of information requests and double the timeframe, for large business audits, and 1½ times the timeframe for micro-business audits.

Audit-planning

3.93 The audit-planning process aims to ensure that auditors narrow the audit focus to those issues that need to be determined and the information needed to be gathered to determine those issues.

3.94 Part of the audit-planning process involves articulating the audit hypothesis and evidence needed to test that hypothesis. Hypothesis-testing involves identifying the risk, articulating a hypothesis with sufficient particularity and identifying the relevant legal issues and information needed to be gathered to determine the issues. Tax Office auditors seek to clarify this articulation by 'workshopping' the issues with others.

3.95 The level and type of technical input during workshops will vary according to the market segment, compliance risk, technical knowledge of the auditor and usefulness of available information about the taxpayer's affairs. In the more complex larger business audits, workshops may involve relevant subject specialists and other technical experts. For small business audits this may involve a 'technical mentor'. More frequently for micro-business audits this will involve the audit manager signing off on the audit plan after a discussion with the auditor.

3.96 For the large business audit area, the Tax Office has advised that it is considering further enhancing its approach to defining issues before intensive information-gathering by ramping up the technical and strategic expert involvement at initial workshops. The GST area has also recently implemented a Case Assurance Panel (CAP) process which will include a focus on appropriate scoping of the audit at its initial stages.

3.97 Audit manager review of case-planning seeks to ensure effective case-planning. However, in a small proportion of the small business cases reviewed, case files evidenced an inadequate completion of audit plans. Some plans were not being completed or completed after finalisation of the audit. Also, in project-focused work, some information-gathering questionnaires were not tailored to the individual circumstances of the taxpayer. These audits typically resulted in broader information-gathering requests and longer audit timeframes.

3.98 The Tax Office has identified inadequate completion of the audit-planning as an issue arising in a small proportion of small business audit cases. It states that it is reinforcing the importance of this process with its audit areas.

3.99 Ineffective case-planning may also adversely affect downstream events, such as legal proceedings, flowing from those audits.

3.100 The Tax Office has governance measures that assess whether initial risk identification accurately identified a case of risk ('strike rate') and whether initial planning was conducted ('audit quality assurance reviews'). However, these measures do not assess the quality of initial planning or its effect on information requests or audit timeframes.

Taxpayer assistance

3.101 Taxpayer assistance will also significantly affect auditors' capacity to articulate audit hypotheses with sufficient particularity. Factors such as the amount of relevant publicly available information, the identification of tax advisers and the quality of record-keeping will impact on audit timeframes.

3.102 In the Inspector-General's view, further reductions in the number of information requests and audit timeframes can be achieved for this small proportion of cases involving insufficient narrowing of issues and information identification.

RECOMMENDATION 2

The Inspector-General of Taxation recommends that, before intensive information gathering begins in an audit, the Tax Office ensures that appropriate technical input is brought to bear to develop the correct focus of the audit.

ATO Response

We agree with this recommendation. While our scoping processes are effective in most cases, your report has highlighted some areas in which we could improve the effectiveness of these processes. We are also taking on board lessons from the successful implementation of new approaches to the timely management of complex private rulings requests under which all players are brought together early to identify key issues requiring examination.

Issue 3

The Tax Office does not remit the general interest charge for periods of Tax Office-inactivity during audits.

3.103 A review of sample cases indicates a substantial number of audits involve periods of Tax Office inactivity of more than 30 days. The Tax Office's GIC remission policy recognises that Tax Office-caused delays are a ground for full remission. However, sample cases reveal that the GIC was not remitted for periods of Tax Office inactivity in many cases. The Tax Office does not currently have a system to ensure that auditors identify periods of inactivity to enable future consideration of remitting the GIC when finalising the audit.

3.104 Of the 386 audit case files reviewed, 85 (21.8 per cent) involved inactivity of more than 30 days. The average period of delay for these cases was 242 days (median of 180 days). These cases were spread across audits of large business, SME and micro-businesses and across a range of Tax Office projects and teams.

3.105 Periods of inactivity are periods in which the audit team is not waiting on responses from other Tax Office areas or taxpayers themselves. Thirty days was seen as an adequate amount of time to allow auditors to take leave without the need to backfill their position and adequate time for auditors to determine and document their views on the issues and proposed action. The main reasons for inactivity were extended auditor leave and reallocation of auditors to other activities of overriding priority.

3.106 Chapter 93 of the *ATO receivables policy* recognises that Tax Office-caused delays are a ground for GIC remission. However, a significant number of sample cases indicate that the GIC is not being remitted for periods of auditor inactivity.

3.107 Of the 386 sample cases examined, 118 resulted in an adjustment or amended assessment. Twenty-nine of these 118 cases involved auditor inactivity (24.58 per cent), averaging a period of auditor-inactivity delay of 209 days (median of 151 days). At current rates of the GIC, this average period of delay amounts to an extra 7 per cent of the adjusted primary tax liability. However, proposed changes to the GIC currently in the Parliament would have the effect of reducing any interest burden for those delays occurring after 1 July 2005. These legislative amendments, if enacted, will implement the Treasury's recommendations arising from its Review of Income Tax Self Assessment.

3.108 There is no current system to ensure that auditors identify periods of inactivity for future consideration of GIC remission at the case finalisation stage. However, the Tax Office states that it is now considering implementing such a system. Further, the Tax Office states that is in the process of implementing a new case management system that incorporates an automated case milestone-setting and review control.

3.109 The Inspector-General is of the view that the GIC attributable to periods of Tax Office inactivity should be remitted in full in accordance with the current Tax Office policy.

RECOMMENDATION 3

The Inspector-General recommends that the Tax Office fully implements appropriate governance processes to ensure that the general interest charge attributable to significant periods of Tax Office-caused audit delay is remitted.

ATO Response

We agree with this recommendation. Our GIC remission guidelines specifically deal with this circumstance and must be considered in all cases where delays are attributable to the Tax Office. We will review our governance processes to ensure these guidelines are uniformly applied.

Issue 4

The Tax Office does not clearly articulate expected audit timeframes to taxpayers at the outset of audits.

3.110 The Taxpayers' Charter states that the Tax Office will, in most circumstances, notify taxpayers of intended audit action in writing and explain the expected duration of the activity. A review of sample cases revealed that audit notification letters rarely articulated or indicated the expected duration of the audit. Taxpayers are concerned that there is no indication of what to expect and they perceive a lack of transparency and accountability in the Tax Office's audit processes.

3.111 A review of sample cases revealed that notification letters generally outlined a reasonable scope of the intended audit activity. However, only 8 of the 203 case files evidencing initial notification of audits provided a clear articulation of expected timeframes at the outset of the audit (3.94 per cent). Twenty of these 203 cases were in the large business segment of which 5 evidenced a clear articulation of expected timeframes at the outset of audit activity (25 per cent). The large business area advised that it would discuss expected timeframes with the business at their initial audit meeting. Also, key client managers would be in regular communication with the business.

3.112 This general failure to communicate expected timeframes is likely driven by the Tax Office not previously having benchmark audit timeframes for the range of audit activities it undertakes. However, since the scoping of this review the Tax Office has started to develop and implement benchmark cycle times.

3.113 In a related matter, taxpayers also expressed concern that they were unaware of the escalation process for disputes with the Tax Office arising during audits. These concerns could be addressed by clearly articulating the Tax Office's existing escalation process to businesses at the outset of any audit activity.

3.114 Additionally, different audit areas within the Tax Office, and even different project teams within the same audit areas, were inconsistent in the matters canvassed in their notification letters. Letters appeared more likely to manage taxpayer expectations where they referred to the following matters: the nature of the activity; the initial focus of the audit; the initial documents required; additional documents that might be required; encouraging the taxpayer to internally review their compliance; outlining common areas of non-compliance; pointing out penalties might be imposed if errors are detected but reduced if voluntary disclosures are made; indicating the expected duration of the activity; and that this duration would be affected by timely provision of complete information.

3.115 In the Inspector-General's view, taxpayers' expectations would be better managed by clearly articulating the expected timeframes for the audit and the circumstances that would substantially affect those timeframes. The most appropriate delivery and articulation of these timeframes would be best developed in consultation with the relevant taxpayers.

Issue 5

The Tax Office does not ensure that it follows its audit procedures of notifying taxpayers, in appropriate circumstances, of the commencement or finalisation of audits.

3.116 Tax Office audit processes require auditors to notify, in appropriate circumstances, the commencement and finalisation of an audit. Audit managers are required to approve the finalisation of audits. This includes a check that the appropriate letters have been issued to the taxpayers. However, a review of sample audit case files indicated a small but significant departure from these procedures. Not notifying taxpayers of the commencement or finalisation of audits may increase taxpayer anxiety.

3.117 The notification of commencement of audits is also important to determine the level of penalty remission for any voluntary disclosures made and has implications for any audit insurance taken out by businesses. Voluntary disclosures made before an audit starts can reduce the level of penalties significantly more than those made after the audit commences. This issue is being addressed by the Tax Office in consultation with the tax profession through its Accountants Tax Practitioners' Forum Audit Working Group.

3.118 A review of sample cases revealed that an audit commencement letter or phone call had not been sent or made in 11 out of 203 (5.42 per cent) audit case files reviewed where it was appropriate to notify taxpayers of the commencement of audits and where the case file was adequately maintained.

3.119 A finalisation letter was not sent in 19 out 170 (11.18 per cent) audit case files reviewed where it was appropriate to notify taxpayers of the finalisation of audit activity and where the case file was adequately maintained.

3.120 Current audit case management systems do not allow audit managers to be automatically alerted of the non-issue of commencement or finalisation letters. Current systems rely on either the auditor raising this issue with the audit manager or the audit manager reviewing the correspondence file for the audit. However, within the next year the Tax Office intends to implement a new case management system. This system will provide the functionality for audit managers to be automatically alerted of the non-issue of commencement or finalisation letters.

3.121 The Tax Office undertakes regular quality assurance processes to check auditors' compliance with procedures. However, these processes only select a small number of sample cases. The process does not allow remedial action to be taken in individual cases of non-compliance in a manner that minimises the adverse impacts on taxpayers.

Issue 6

The Tax Office does not inform taxpayers of the progress of audits where those audits experience Tax Office-caused delays.

3.122 The Taxpayers' Charter states that taxpayers will be kept informed of progress of their audit. However, a review of sample audit cases indicated that taxpayers are rarely informed either of Tax Office delays, of the periods of Tax Office inactivity during audits, or, of whether the GIC will be remitted for these periods of delay.

3.123 Taxpayers are concerned that there is no indication of whether, why and how long the audit will be extended. They reasonably expect to be notified of delays to assist with their resource allocation and timely provision of information and views. They perceive a lack of transparency and accountability in the Tax Office's audit processes.

3.124 A review of sample case files revealed that the Tax Office notified taxpayers, in writing or orally, of delays in 18 of the 386 cases. Of those delays involving Tax Office inactivity for more than 30 days, only 7 of 85 cases (8.24 per cent) were notified of the delays. In no case was the taxpayer advised whether the period of inactivity would be grounds for GIC remission.

3.125 The Tax Office was unable to point to governance measures ensuring the notification of existence of delays, the reasons for delay and the effect on GIC remission of those delays.

3.126 In the Inspector-General's view, the Tax Office could improve community confidence in its audit processes were it to maintain regular communication with taxpayers on the progress of audits where they take a significant amount of time to complete.

Issue 7

The Tax Office should allay taxpayer concerns that the relevant technical specialist will not take account of the taxpayer's full commercial circumstances in determining the Tax Office view.

3.127 Submissions generally recognised that auditors understood their commercial circumstances. However, they expressed concern that Tax Office technical specialists might not consider their full commercial circumstances in determining the Tax Office view. They expressed concern that specialists' views might be coloured where they did not appreciate congruencies with commercially orientated arrangements. These concerns were raised most vigorously where audits involved complex issues or large amounts of potential revenue. However, a review of sample audit case files indicated that taxpayer access to the relevant technical decision maker was provided in all cases where requested.

3.128 Tax Office auditors may refer matters of technical complexity to technical specialists for resolution. In these circumstances, taxpayer access to Tax Office technical specialists serves two purposes. It:

- expedites resolution of complex cases and reduces serial requests for information because of a real time conversation aimed at narrowing issues and determining the relevant evidence needed, and
- affords procedural fairness to the taxpayer.

3.129 There is no Tax Office policy or process which requires taxpayer access to technical specialists when determining the Tax Office view during an audit. However, a review of sample cases indicated that in all four cases in which access was requested, it was granted. The Tax Office also asserts that for the more complex audits it will ensure that the relevant subject specialist communicates with the taxpayer. It states that this approach is consistent with the Tax Office's corporate aspiration of transparency of the audit process as outlined in the large business area's *Cooperative Compliance Model*.

3.130 The Inspector-General encourages the Tax Office to continue its practice of allowing taxpayer access to Tax Office technical specialists where the specialists make decisions relating matters of complexity in their audit. The Inspector-General notes that this issue causes particular concern to the large business segment and that the Tax Office could do more to allay the segment's concerns.

RECOMMENDATION 4

The Inspector-General recommends that the Tax Office:

(a) clearly articulates to the taxpayer the expected timeframes of the audit at its outset

(b) ensures that Tax Office auditors comply with procedures requiring taxpayer notification of commencement and finalisation of audit activities

(c) notifies taxpayers of the progress of audits where those audits involve periods of Tax Office-caused delay, and

(d) in complex matters, allays taxpayer concerns by ensuring that the relevant technical specialist will take account of the taxpayer's full commercial circumstances in determining the Tax Office view.

ATO Response

We agree with this recommendation. In most cases the Tax Office applies these processes, but your report has highlighted areas where more rigour in our management of audit cases will improve the effectiveness of our communication with taxpayers and the transparency of our audit processes.

Issue 8

Some taxpayer concerns either were indicative of older Tax Office approaches that have since been addressed by previous Tax Office changes or revealed no prima facie evidence of an underlying systemic issue.

Inadequate reasons for amendment

3.131 Submissions expressed some concern with the Tax Office's technical competence and expression of its technical views. Underlying these concerns is a perception that, when considering contentious issues, the Tax Office prefers a view that requires taxpayers to conduct their affairs in a manner imposing the most tax. This particular concern is outside the scope of this review.

3.132 However, audit timeframes can be directly affected where a reasonable hypothesis has not been communicated to the taxpayer so that they can prepare to answer the case.

3.133 Eighty-five of the 386 sample cases reviewed resulted in an adjustment of liability and also retained the relevant correspondence on file. Four of these 85 cases did not provide adequate reasons for amendments. One case was conducted in the early 1990s and the reasons had subsequently been provided to the taxpayer. Two cases failed the Tax Office's technical quality review but involved verification issues rather than complex technical interpretation issues. One case effectively used the threat of an amendment to encourage a taxpayer to provide the information requested. This case evidenced a significant amount of taxpayer resistance to providing the requested information.

3.134 For large business audits there is a procedural requirement to issue a 'position paper' where there is a likelihood of dispute. A position paper sets out the facts and issues under review and the Tax Office's technical view. It aims to communicate to the taxpayer the results of the audit so that the taxpayer is in a position to respond prior to the audit's finalisation. The Tax Office policy is that the taxpayer should be given a reasonable time to review the paper and invited to supply any additional material facts relevant to the issue and its views on the operation and interpretation of the law.

3.135 Submissions from the large business segment vigorously criticised the inequitable amount of time given to businesses to consider position papers in comparison to the time the Tax Office took to draft them. A review of sample cases indicated a prima facie basis to support this view. The time periods from the date at which all information was provided through to issuing a position paper were generally longer than the time periods given to taxpayers to consider the position paper.

3.136 However, the Tax Office states that for large business audits the audit team is in constant dialogue with taxpayers and that these taxpayers would be aware of the issues the Tax Office is considering in the period leading up to the issuing of the position paper. Also, through its 'review' process the Tax Office aims to articulate its concerns clearly to the business before commencement of more intensive audit activity. The Tax Office states that during client visits it aims to articulate and test the hypothesis for the identified risks through discussing the events and issues that have led to the review.

3.137 The Tax Office is of the view that in this market segment, taxpayers are aware of the facts and aware of the tax consequences and risks before arrangements are entered. Therefore, businesses will have an understanding of the issues involved and the potential Tax Office view before the audit. Additionally, the Tax Office states that in any event it will enter dialogue with the taxpayer after position papers are issued to provide adequate opportunity for all parties to appreciate the relative merits of the others' views.

Serial examination of issues

3.138 Submissions raised concerns that issues arising during audits were generally investigated and determined on a serial basis. One information request would raise further issues that auditors would seek to audit. This had the effect that an audit would continue for a long period of time and cover a range of different issues serially.

3.139 A review of sample case files revealed that this approach was followed where cases typically involved indications of higher risk non-compliance activity. This included where little public or internal information was available on the taxpayer, taxpayers vigorously resisted Tax Office information requests and the little information that was obtained indicated further risks requiring priority review.

3.140 For other types of taxpayer behaviour, a review of sample cases revealed no evidence of audits serially exploring issues. Additionally, sufficient boundaries for auditors were provided by using hypothesis-testing and audit approaches and treatments based on risk identification. Audit procedures also require audit managers to approve any expansion of the scope of an audit and for that to be communicated to the taxpayer.

Duplicated information requests

3.141 Submissions expressed concerns that Tax Office auditors asked taxpayers for information that had been provided previously in the audit. However, a review of sample cases revealed little incidence of duplicated information requests in the same audit. Of the 352 cases in which information was requested only 4 evidenced duplicated information requests (1.04 per cent). Half these cases were due to a combination of staff turnover and poor file management.

3.142 There was minimal evidence of the same information being requested in different audits. However, it was difficult to assess the extent of this occurrence accurately due to the segregation of audit files and difficulty in linking them. Current arrangements rely on the taxpayer notifying the auditor of previously provided information and that auditor accessing those records from that other area. The Tax Office systems for file management vary amongst its different areas. Therefore, there is potential for information to be requested by one area where it has been already been previously provided to another area of the Tax Office.

3.143 The Tax Office advises that it will be implementing a new electronic case management system over the next year which will provide easy auditor access, in appropriate circumstances, to records of all Tax Office interactions with taxpayers. The Tax Office is considering implementing a means, subject to funding, to capture taxpayer provided paper records electronically, and enabling access to those records as part of the electronic case management system.

Serial audits of same entity

3.144 Submissions expressed concern that the Tax Office continually audits large businesses. A review of Tax Office policies and statistics revealed that the Tax Office more frequently audited businesses in that sector because it was seen as a greater potential risk due to the amounts of revenue generated by that sector. For the top 200 companies and high-wealth individuals, the Tax Office has a policy of reviewing each taxpayer within that group on a three-year cycle.

3.145 For 2003-04, the large business segment comprised 1,450 groups that provided 52 per cent of the Government's revenue. Sixty-six per cent of corporate collections were from this segment. Large market income tax audit activities raised $2.53 billion in tax, penalties and interest. As at the end of March 2005, 66 per cent of income tax audits in this segment ended in an amendment or adjustment, raising $551.7 million in tax, penalties and interest. This percentage excludes a range of compliance activities, such as 'reviews', that are directed at 'helping taxpayers to comply and remain on track with compliance'. These excluded activities are not intended to result in an amendment of adjustment. However, they are considered by some to form part of the Tax Office's audit programme as they increase businesses' compliance costs for those subject to them.

3.146 The Tax Office states that it will consult with this segment when seeking to improve its matching of audit treatments to compliance behaviours.

3.147 In the Inspector-General's view, there are strong public policy reasons for the Tax Office to maintain regular monitoring of compliance in this area. However, the intensity of this activity should depend upon the level of assurance the Tax Office has of the taxpayer's compliance with taxation obligations.

Notifying an inappropriate person

3.148 Submissions expressed some concern that the Tax Office was not notifying the appropriate representative of the taxpayer of an audit's commencement. A review of sample case files and relevant procedures revealed minimal evidence of inappropriate people being notified.

3.149 Of the 386 cases reviewed, six (1.55 per cent) did not evidence notification of the appropriate representative of the audit. Two cases evidenced delays caused by initial discussions between the taxpayer and their agent as to who would be the best contact for audit and how the cost of representation during the audit would be met. There were two cases where the commencement letter was sent to the wrong taxpayer. Two involved the taxpayer providing incorrect taxpayer representative information.

3.150 The Tax Office has detailed policies and procedures specifying who an authorised taxpayer's representative is and whom should be contacted where a taxpayer has an authorised representative. A review of sample cases revealed that auditors followed the required procedures. Additionally, it was observed that timeframes were minimised where auditors confirmed the appropriate representative by telephone at first instance before sending a notification letter.

Delay in notifying start of an audit

3.151 Submissions expressed concern that the Tax Office did not notify taxpayers as soon as it had identified those taxpayers for potential audit.

3.152 This delay is justified on the grounds of minimising taxpayers' exposure to potentially unnecessary compliance costs. Although cases may have been selected for potential audit it does not follow that all selected taxpayers will be subjected to an audit. Competing demands on Tax Office resources and changing priorities may not enable the Tax Office to conduct audits of all those identified. Further, auditors spend the initial time periods narrowing the scope of the risk to be tested and excluding from more intensive audit activity lower risk taxpayers. For example, during the 2003-04 year the GST Business and Service Line (BSL) did not audit over 22,000 businesses that were selected for potential audit.

3.153 Submissions also raised related concerns about the delay in selecting taxpayers for audit and the delay in notifying taxpayers of the commencement of an audit. The former issue is outside scope of this review. The latter issue is relevant to reducing penalties by making voluntary disclosures before audit activity commences. This issue is being resolved by the Accountants Tax Practitioners' Forum Audit Working Group in consultation with tax practitioner representative bodies.

Insufficient time to respond to information requests

3.154 Submissions raised concerns that auditors often require taxpayers to provide information within short periods of time. A review of sample cases and interviews with tax officials revealed no evidence of a systemic issue of not providing taxpayers with sufficient time to provide information.

3.155 A review of audit procedures and sample cases revealed that taxpayers were asked to provide information in periods generally ranging from 14 to 28 days. The Client Verification Centre of the GST BSL generally gave taxpayers two days to provide information before a decision whether to escalate to field review was taken. These periods did not, of themselves, appear to consider the business cycles of taxpayers. Additionally, only the GST field's audit procedures expressly asked auditors to consider the other demands on taxpayers' and their representatives' time when requesting information.

3.156 However, taxpayers' requests for extensions of time to provide information were almost always granted unless the taxpayer had previously continually delayed in responding to information requests. Additionally, sample cases revealed little use of formal information-gathering powers against taxpayers except in those cases involving taxpayers who had previously requested a number of extensions of time but had not provided the information requested. Also field visits were, with the exception of 'walk ups' (general registration checks of certain types of businesses, such as taxi drivers), always conducted at a date and time negotiated with the business.

3.157 Interviews with auditors and audit managers revealed an awareness of the competing priorities on tax agents, particularly those representing micro-businesses. These tax agents have a large number of clients with varying quality of business records and sometimes struggle with the cost of complying with changes to the taxation laws. They also have few available resources to devote to dealing with intensive audits and advise that they may not recover their costs for all their time spent in so doing. Auditors expressed a reluctance to exercise formal information-gathering powers where these agents had substantial competing demands on their time but were willing to comply.

3.158 Since the scoping for this review, the Tax Office has adopted a practical approach to auditing substantiation issues in the GST area, thereby reducing the need to expose many small businesses to intrusive audits.

Delay caused by protracted negotiations

3.159 Some submissions raised a concern that the Tax Office was delaying settlement negotiations by adopting a policy of not settling for less than 100 per cent of the primary tax liability even where the basis for liability was uncertain. The issue of whether the primary tax should be reduced is outside the scope of this review. Negotiations aimed at resolving audits should seek to reach a point quickly at which all parties understand the merits of the others' view. This may or may not result in an agreement between the parties.

3.160 A review of sample cases indicates that the more complex the case, the more likely that negotiations to resolve the audit would result, and the more protracted the negotiations would be. From those sample case files reviewed, negotiations in micro-business and SME audits averaged two to three months (4 cases of the 55 resulting in amended assessments), whereas negotiations in large business audits averaged six to nine months (9 cases of the 18 resulting in amended assessments).

APPENDIX 1: TERMS OF REFERENCE

A1.1 In accordance with subsection 8(1) of the *Inspector-General of Taxation Act 2003*, the Inspector-General conducts the following review on his own initiative.

A1.2 The Inspector-General will review whether the length of time taken to complete Tax Office active compliance activities directed at businesses is reasonable in particular circumstances. It will focus on:

- the relevant governance processes and benchmarks;
- the nature and cause of that length of time;
- the extent and impact of that length of time;
- the identified risks to business, the Revenue and other areas of the community; and
- practices which may reasonably minimise the adverse impacts that the length of time may have on businesses while providing reasonable assurance that the risk to the Revenue is minimised.

APPENDIX 2: CONDUCT OF REVIEW

A2.1 On 27 July 2004, the Inspector-General consulted representatives from selected industry, business, accounting, legal practitioner and tax organisations about the prioritisation of his work programme for the following six months. On the basis of strong feedback, the Inspector-General announced that he would undertake a series of reviews around the theme of Tax Office audit/verification activity. The Inspector-General subsequently scoped the, then, potential review into the time taken to complete audits with the Tax Office.

A2.2 On 23 November 2004, the Inspector-General announced on his website, www.igt.gov.au, the terms of reference for the review and invited public submissions. Sixty-nine submissions were received from tax profession representative organisations and small businesses. It is interesting to note that taxpayers were generally reluctant to provide details of their audit on the grounds that they feared retribution for doing so. Nonetheless concerns were raised in a manner that generally did not identify individual cases. These concerns were tested by interviewing tax officials, viewing relevant audit procedures and reviewing a sample of audit case files.

A2.3 A total of 386 audit case files were examined. These files related to a wide range of audit types, market segments, audit teams in a variety of States and regions, revenue types and complexities of issue. They were of audits either completed during or after 2003-04 or still in progress. A number of the selected audit case files were of cases commenced more than five years previously. This allowed an examination of approaches and practices before significant changes were made to the Tax Office's audit approaches.

A2.4 Two sets of cases for each market segment (micro-business, SME and large business) in income tax and GST audit areas were selected for review except for GST large business audits. One data set comprised the top five projects or audit areas averaging the greatest number of cases irrespective of average timeframes. The other data set comprised the top five projects or areas averaging the longest timeframes. Both sets included cases from two different audit teams within the same project or area. Specific cases were then selected from those teams and areas from three different time bands: those taking the least, median and most amount of time to complete. This allowed comparison of like cases with varying timeframes. The two data sets also ensured that the results would not be unduly distorted by selecting cases of longer timeframes.

A2.5 The source data was obtained from the Small Business, GST and Large Business and International BSLs. However, it was not pointed out until after the testing phase for this review had completed that the small business aggressive tax planning audit cases had been excised from the source data. These case lists were subsequently provided.

A2.6 Inspector-General staff visited the Tax Office's national, Sydney, Parramatta, Penrith, Hurstville, St Leonards, Newcastle, Terrica Place (Brisbane), Moonee Ponds, Casselden Place (Melbourne), Box Hill and Geelong offices to interview Tax Office staff, access documents and view audit case files.

OTHER RELEVANT DOCUMENTS

A2.7 During the course of the review, the Inspector-General was made aware of the following documents which related to aspects of the Tax Office's audit programme:

- Australian National Audit Office, *Audit Report No. 37 2000-01: The use of audit in compliance management of individual taxpayers*, Canberra, 2001.
- Australian National Audit Office, *Audit Report No. 3 2001-02: The Australian Taxation Office's administration of taxation rulings*, Canberra, 2001.
- Australian Taxation Office, *Compliance Program 2004-05*, Canberra, August 2004.
- Australian Taxation Office, *Cooperative Compliance: working with large business in the new tax system*, Canberra, November 2000.
- Cash Economy Task Force, *Improving Tax Compliance in the Cash Economy*, Canberra, April 1998.
- Commonwealth Ombudsman, *Annual Report 2003-04*, Canberra, 2004.
- KPMG, *KPMG Survey of Corporate Taxpayers' Goods and Services Tax (GST) Audit Experience*, February 2005.
- Organisation for Economic Co-operation and Development, *Taxation Administration in OECD Countries: Comparative Information Series* (2004), Paris, October 2004.
- Organisation for Economic Co-operation and Development, *Taxation Compliance Risk Management: Use of random audit programs* (2004), Paris, September 2004.
- Organisation for Economic Co-operation and Development, *Taxation Compliance Risk Management: Managing and improving tax compliance* (2004), Paris, October 2004.
- Organisation for Economic Co-operation and Development, *Risk Management – Practice Note*, Paris, June 1997 (amended May 2001).
- Sherman, *Report of an Internal Review of the Systems and Procedures relating to Private Binding Rulings and Advance Opinions in the Australian Taxation Office*, Canberra, August 2000.
- The Treasury, *Report on Aspects of Income Tax Self Assessment*, Canberra, August 2004.

APPENDIX 3: LETTER FROM COMMISSIONER OF TAXATION

Mr David Vos AM
Inspector-General of Taxation
GPO Box 551
SYDNEY NSW 2001

Dear David

DRAFT REPORT: REVIEW INTO TAX OFFICE AUDIT TIMEFRAMES

Thank you for the opportunity to comment on your draft report to the government on the above subject.

We have, in recent years, sought to rebalance our compliance program to increase our focus on audit. As part of this rebalancing, we have invested significantly in improving our internal governance processes that support our audit program and have implemented a range of new issues management processes designed to ensure that we reach timely well reasoned positions, and that we minimise audit cycle times. At the same time, we have improved our communication to the community and the transparency of our operations through initiatives such as the publication of the annual Tax Office Compliance Program. The Compliance Program lets people know what they can expect from us in the current year and provides a report back on how we have performed against our commitments in the previous year.

It is this commitment to transparency and public accountability, and our consistent delivery of the government's revenue outcomes, that has led comparable OECD member tax administrators to regard us a world leader in improving compliance levels. We appreciate your acknowledgement of this achievement in your report.

We also acknowledge that there is always room for improvement in our performance and, in this context, we see this report as assisting us in our drive to improve our internal governance processes and to increase the effectiveness and transparency of our audit processes.

In respect to the four key recommendations in the report, our response is as follows:

The Tax Office:

(a) continues to expeditiously resolve those audits experiencing significant delays; and

(b) fully implements appropriate governance processes to ensure that, in future, the resolution of technical and strategic issues encountered during audits is expeditiously resolved in a manner that provides all parties with adequate opportunity to understand the relative merits of the other's view.

We agree with this recommendation. As reflected in your report, The Tax Office has significantly increased its focus on reducing audit timeframes including the deployment of our most senior and experienced officers to resolve complex cases and the implementation of issue management processes.

Before the intensive information gathering begins in an audit, the Tax Office ensures that appropriate technical input is brought to bear to develop the correct focus of the audit.

We agree with this recommendation. While our scoping processes are effective in most cases, your report has highlighted some areas in which we could improve the effectiveness of these processes. We are also taking on board lessons from the successful implementation of new approaches to the timely management of complex private rulings requests under which all players are brought together early to identify key issues requiring examination.

The Tax Office fully implements appropriate governance processes to ensure that the general interest charge attributable to significant periods of Tax Office-caused audit delay is remitted.

We agree with this recommendation. Our GIC remission guidelines specifically deal with this circumstance and must be considered in all cases where delays are attributable to the Tax Office. We will review our governance processes to ensure these guidelines are uniformly applied.

The Tax Office:

(a) clearly articulates to the taxpayer the expected timeframes of the audit at its outset;
(b) ensures that Tax Office auditors comply with procedures requiring taxpayer notification of commencement and finalisation of audit activities;
(c) notifies taxpayers of the progress of audits where those audits involve periods of Tax Office-caused delay; and
(d) in complex matters, allays taxpayer concerns by ensuring that the relevant technical specialist will take account of the taxpayer's full commercial circumstances in determining the Tax Office view.

We agree with this recommendation. In most cases the Tax Office applies these processes, but your report has highlighted areas where more rigour in our management of audit cases will improve the effectiveness of our communication with taxpayers and the transparency of our audit processes.

Yours sincerely

Michael Carmody
COMMISSIONER OF TAXATION

18 July 2005