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# Benchmarking Tax Administrations in Developing Countries: A Systemic Approach

Jaime Vázquez-Caro and Richard M. Bird


## Abstract

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


## 1. INTRODUCTION

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

The authors are, respectively, an economic consultant in Bogotá, Colombia, and Professor Emeritus of Economics, University of Toronto, Canada. They are grateful to Raul Junquera-Varela and Jackie Coolidge for helpful comments on an earlier version of this paper, which was originally presented at the 9th International Conference on Tax Administration, Sydney, April 2010. Corresponding author: Richard M. Bird, Rotman School of Management, University of Toronto, 105 St. George Street, Toronto, ON, Canada M5S 3E6. Email: rbird@rotman.utoronto.ca

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

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

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

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

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[4] An important question that is not explored here is the extent and manner in which surveys with respect to how the public perceives the revenue administration should be explicitly factored into the discussion. For example, in an interesting early Indian study of public sector agencies such as hospitals and electricity distributors, perceptions with respect to staff behaviour (eg, with respect to corruption) and the amount and reliability of the information provided to the public were found to overlap strongly with perceptions of the quality of the service provided

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

One common aim of benchmarking tax administrations is of course to improve their operation, for instance, by allowing consultants and international agencies to provide somewhat more objective 'grading' or 'ranking' appraisals of tax administrations in developing countries than they might otherwise be able to do.[7] However, if, as is often the case in developing countries, the intended objective at least in principle is ultimately to provide some useful guidelines for restructuring a particular tax administration – as it were, to lay the basis for a 're-engineering' strategy so

## 2. APPROACHES TO BENCHMARKING

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

### 2.1 Benchmarking by Numbers

As a simple example of (prescriptive) benchmarking by numbers, a recent World Bank study (Le, Pham and De Wulf 2007) suggested that the following quantitative benchmarks might be used (along with other indicators) to measure 'success' in revenue administration reform projects such as those that have been financed by the Bank[9]: (1) administrative cost should decline by 30% over project period and (2) compliance cost should be reduced by 2% of tax revenue over project period. These numbers were based largely on a number of different and not always directly

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

The EU example is particularly noteworthy because point-values are established for several different components of each of 14 different aspects of tax administration with pass marks ('desired scores') set for each. In other words, not only are a large number

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

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

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

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

## 3.1. Strategic and Operational Practices

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

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

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

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

[17] For a full discussion of the notion of "congruence" in this context, see Gill (2000).

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

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

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

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

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

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

Similarly, the statute of limitations differs from country to country in terms of time limits and consequences. For example, in most developed countries there is no time limit in evasion cases where there is fraud. Even when there is no fraud, taxpayers may sometimes be audited up to 10 years later. In contrast, many developing

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

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

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

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

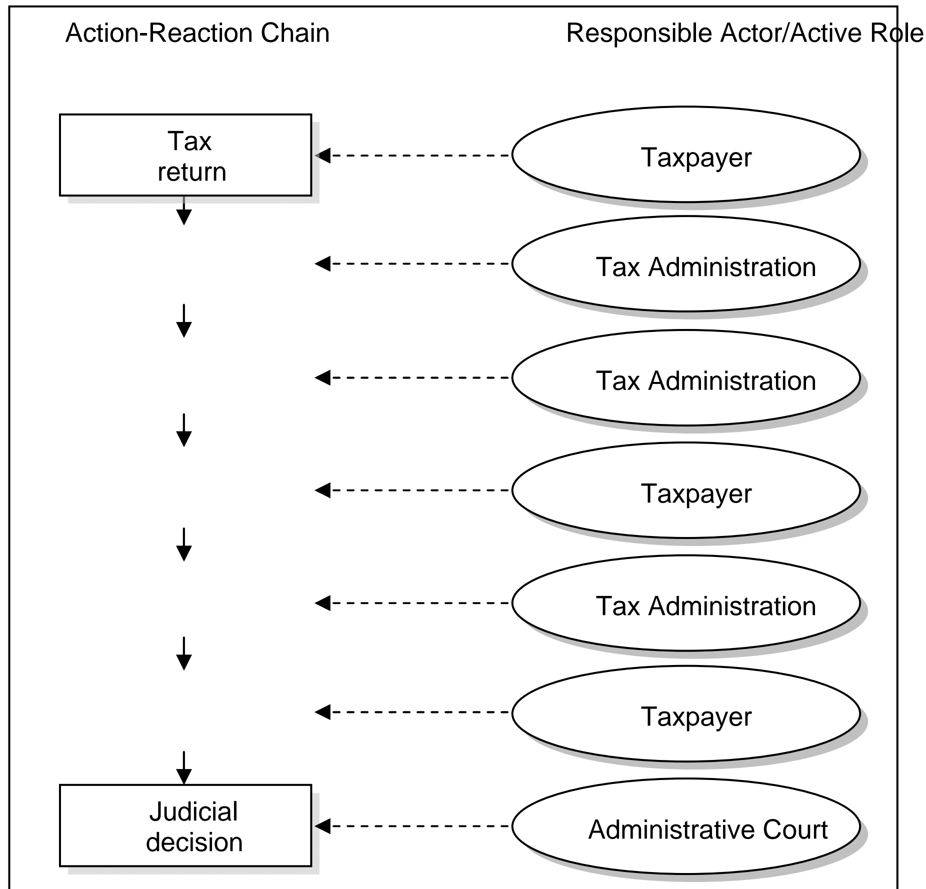
### 3.3. Good Practices and Best Practices

To identify the best strategic (implicit or explicit) practices that may provide a useful standard for assessing operational practices in any country is at least a four-stage

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

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

FIGURE 1: ADVERSARIAL MODEL OF ADMINISTRATION -TAXPAYER INTERACTIONS




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

## 4.2. The Cooperative Approach

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

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

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

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

## 5. IMPLEMENTING COOPERATIVE C

## 5.1. Risk Analysis

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

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

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

From the perspective of the tax administration, risks may be classified as relatively controllable or non-controllable. Non-controllable risks may or may not be insurable. Risks arising from the basic design and vulnerability of the law and its interpretation fall into the uninsurable non-controllable category from the perspective of the tax

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

Good risk analysis requires the administration to have a deep understanding of the taxpayer population. As noted earlier, good tax administrations have developed many

FIGURE

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

## 5.4. Consultation

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

## 5.5. The International Dimension

In recent years, a key aspect in protecting the tax base at the country level has

TABLE 1: STRATEGIC OBLIGATIONS IN M

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

TABLE 2: BENCHMARKING MANAGERIAL P4(.153ET q 1 i 531.4 6501.3274.0 60 TD 6re W n 1 T207.96 6531.

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

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

3. It is important to gather information also on such critical 'soft' elements of organisational 'culture' as management philosophy, behaviors and style, the degree of participative management, communication and recognition, empowerment, and 'ownership.'[44]

4. Even those in international agencies or elsewhere who may be unable (or unwilling) to go very far along the path suggested in the last point need to understand clearly that to be meaningful benchmarking must at a minimum be clearly linked to the overall strategic plan or strategy of the administration. As Casanegra and Bird (1992) noted some years ago, when there is no such strategy attempts to reform tax administration, with or without benchmarking exercises, are almost inevitably a waste of time.

Of course, it is also essential that those who are politically and managerially responsible for tax administration both understand and support any benchmarking exercise if it is to have any useful effects. To illustrate this point, the country study in the course of which much of the argument above was originally developed turned out to be not particularly productive. The reason is simple. The objectives of the client country's operational team were different and focused within a different management paradigm. They did not want to hear that to be able to implement 'best practices'

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

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

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

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

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

Kalmen Datt and Adrian Sawyer

## Abstract

The requirements for listed corporations to disclose material tax-related information has been in the spotlight over the last few years in Australasia, especially in regard to the large banks that have a major presence on both sides of the Tasman. In this paper we examine how listed companies have made disclosures in their financial statements in relation to material tax disputes with the respective revenue authorities.

forward. For the analysis we draw some common themes from the companies reviewed, including that companies will tend to make disclosures only after their tax positions have been challenged by the revenue authorities and they intend to dispute the revenue authority's approach.

## 1. INTRODUCTION

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

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

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Kalmen Datt is a Senior Lecturer in Atax in the Australian School of Taxation and Business Law at the University of New South Wales, Sydney, Australia. Adrian Sawyer is Professor of Taxation in the

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

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

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

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

## 2. DISCLOSURE REQUIREMENTS IN AUSTRALIA

### 2.1 Continuous disclosure – The Corporations Act 2001 (Cth)

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

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

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

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

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

Fortesque was successful before Justice Gilmour in the court of first instance. However, the Full Bench of the Federal Court unanimously found in favour of ASIC.[14]

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

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

In the final paragraph Keane CJ states:[17]

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

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

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

In Flavel v Roget,[20] a case in which criminal charges were laid as a result of an alleged

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

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

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

## 2.2 Continuous disclosure – the ASX Listing Rules

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

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

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[21] Id, at page 243.
[22] ASX Listing Rule 3.1.
[23] ASX Listing Rule 3.1A. Other exceptions are also mentioned in this rule.
[24] ASX Listing Rule 19.2.
[25]

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

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

Companies listed on the ASX must also have regard to the ASX Corporate Governance Principles and Recommendations. These recommendations, as their name suggests, do not purport to lay down hard and faTc Tc 8and fatich-5.8(ororco)-7aT

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

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

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

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

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

[34] Australia follows the recommendations of the IASB if the recommendations are implemented as policy.
[35] IASB, ED 2009/2, at paragraph 26 (our emphasis).
[36] Id, at paragraph BC 63.

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

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

## 2.4 Auditor independence

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

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

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

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

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

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

## 2.5 Cooperative compliance agreements

A cooperative approach between a revenue authority (in this context either the ATO[42] or IRD) with large enterprises involves the sharing of some responsibilities to ensure that effective compliance management systems are in place. A cooperative compliance approach has several benefits for both the revenue authority and the corporate taxpayers, namely:

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

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

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

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

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

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

[44] See ATO, Forward Compliance Arrangements (2008) available at http://www.ato.gov.au/content/00100436.htm (accessed 1 May 2011.)

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

The IRD embarked on a similar initiative after investigating developments in this area internationally in 2009. In the IRD's view[45] the relationship will be one that is guided by a written agreement, reviewed annually, between a company's board of directors and the Commissioner of Inland Revenue (Commissioner). This agreement will set out the responsibilities of both parties and provide a framework for the progression and resolution of issues. The expectation of such an agreement is that it brings with it a whole-of-organization commitment and is thus at the Commissioner/Board of Directors level. The IRD suggests that there are four ke45c). Th.251a07 Tc .1154

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

## 3.0 NEW ZEALAND DISCLOSURE REQUIREMENTS

In comparison to Australia, New Zealand takes a lighter regulatory hand to disclosure requirements in that it is less prescriptive in what companies need to disclose in their financial statements and to the NZX. For New Zealand listed companies (that is, those on NZX or the smaller sub-exchanges) companies and other entities which issue securities have obligations under the NZX Listing Rules[47] to keep the market constantly informed on matters that may affect the price of their securities; that is, listed issuers are required to disclose material information immediately. Continuous disclosure is the requirement for listed companies to provide timely advice to the market of information required to keep the market informed of events and developments as they occur.

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

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

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

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

The 2010 annual financial report noted the following:[61]

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

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

Futuris lost the appeal in the High Court under the Judiciary Act but was able to prosecute its appeal under Part IVC TAA. In 2010 the matter relating to the sale of the building products division was heard by the Federal Court on the merits and Futuris was successful.[65] The Commissioner has appealed

The 2008 annual financial report of BHP noted the following.[70] The ATO had issued assessments against subsidiary companies, primarily BHP Billiton Finance Ltd, in respect of the financial years 1999 to 2002. The assessments related to the deductibility of bad debts in respect of funding subsidiaries that undertook certain projects. BHP Billiton Finance Ltd lodged appeals on 17 July 2006. The amount in dispute at 30 June 2008 for the bad debts disallowance was approximately US$1,162 million (A$1,224 million) (net of tax), being primary tax US$656 million (A$691

> BHP Billiton was again successful on all counts. The ATO sought special leave to appeal to the High Court only in relation to the Beenup bad debt disallowance and the denial of the capital allowance claims on the Boodarie Iron project. The High Court has granted special leave only in relation to the denial of the capital allowance claims on the Boodarie Iron project. A date for the appeal has not yet been set. As a result of the ATO not seeking to challenge the Boodarie Iron bad debt disallowance, the ATO refunded US$552 million to BHP Billiton including interest. BHP Billiton also expects that as a result of the High Court not granting special leave for the Beenup bad debt disallowance, the ATO will refund the amount paid in relation to this dispute of US$62 million plus interest. BHP Billiton settled the Hartley matter with the ATO in September 2009.
>
> The amount remaining in dispute following the decision of the High Court for the denial of capital allowance claims on the Boodarie Iron project is approximately US$435 million, being primary tax of US$328 million and US$107 million of interest (after tax).

The matter was heard by the High Court in late 2010 but at the time of writing a

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

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

However, when one looks at the rules (such as the ASX Listing Rules and NZX Listing Rules and associated statutory reporting obligations) relating to financial statements and the notes to such accounts, it may well be necessary to disclose all material disputes[74] with the revenue authorities as the financial statements must be prepared in compliance with international financial reporting standards, and must reflect a true and fair view of the company's affairs.[75] These requirements, read in conjunction with each other, suggest that all material disputes must be disclosed. The questions is when is a dispute 'material' such that it has reached the point that disclosure is required – is this when an amended assessment is issued and it is disputed by the company, or at some earlier stage? We would suggest that once there is a clear difference in view between the revenue authority and the taxpayer, and this difference can be quantified, and sum is material, then disclosure should be made. The fact and the basis for a dispute, albeit the amount is small in numerical terms, could well have a disproportionate impact on the views of investors and other

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# VAT on Intra-Community Trade and Bilateral

## 1. INTRODUCTION

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

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

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reason, such a transitional VAT system was then implemented by the Directives 91/680/EEC and 92/77/EEC. Yet the origin principle applies to the direct imports of households, although for some specific cases (including household purchase of cars) the destination principle still prevails. In addition an EU-wide minimum VAT standard rate of 15% was introduced.

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

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

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

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

## 2. Revenue Clearing in Different European VAT Systems

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

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

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

FIGURE 1: INTRA-EU TRADE AND DESTINATION PRINCIPLE

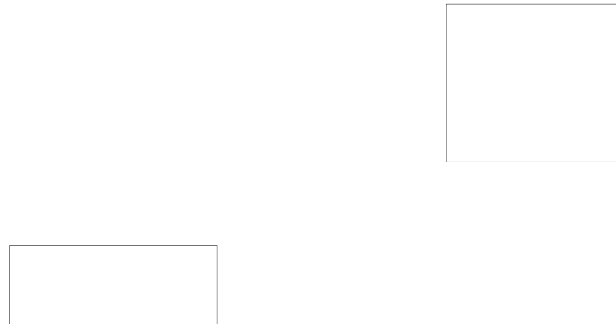
As illustrated in Figure 1, the B2B cross-border supplies are tax free in the present transitional regime. Moreover, in country A the final consumption of the imported goods from country B ($X_B$) bears the VAT burden with an own tax rate of A ($t_A$).

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

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

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

FIGURE 2: INTRA-EU TRADE AND PURE ORIGIN PRINCIPLE



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

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

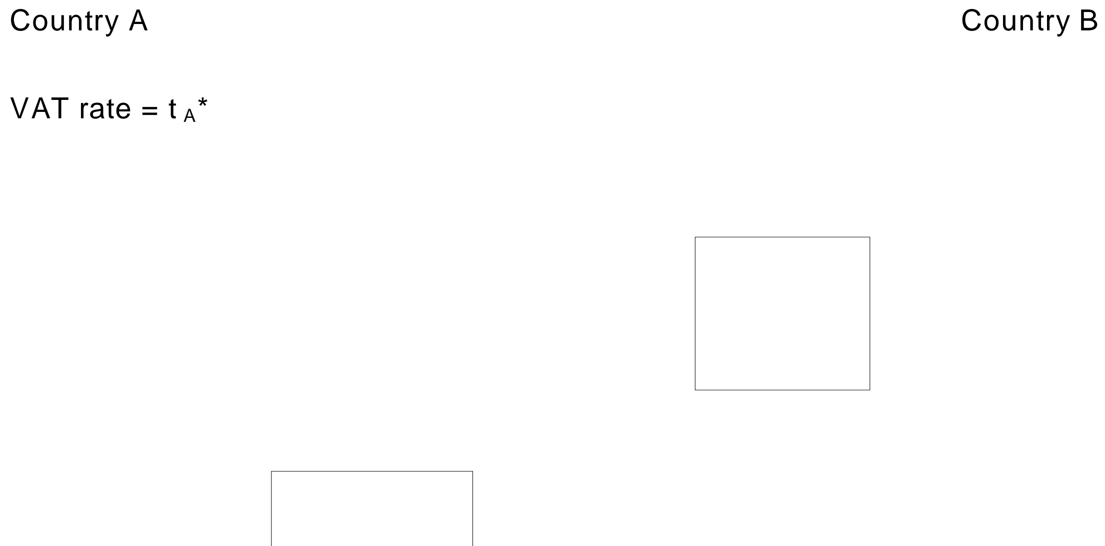
$$T_{A,INT} = t_A \cdot X_B + t^* \cdot (X_A - X_B) = T_{A,DES} + t^* \cdot (X_A - X_B) \qquad (5)$$

while for government *B* the following applies:

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

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

FIGURE 3: INTRA-EU TRADE AND VIVAT




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

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

$$t_A > t_B > t^* \text{ where } t^* > 0 \qquad (7)$$

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

The purchasing company is now entitled to deduct the VAT it has paid to its supplier and the VAT it has accounted for because of the rate difference via the VAT return and according to the right-of-deduction rules of the country of arrival ("internal clearing"). As a consequence, company A can deduct $tA \cdot XB$ $(= t^*XB + (tA - t^*) \cdot XB)$, while for company B the sum amounts to $tB \cdot XA$ (

In order to justify the effectiveness and superiority of the VAT reform recommendation the European Commission should thoroughly evaluate benefits and costs related to its introduction.[8] In particular the Commission should make it clear whether the potential to combat VAT fraud is worth the additional administrative costs and complications raised by the need for revenue clearing. The answer to this question will partly depend on the current extent of VAT fraud and on the extent to which this fraud can be eliminated by the proposal. In this context, it should be borne in mind that the recent Commission's VAT reform model primarily targets the prevention of carousel fraud. Yet there are other types of VAT fraud including (1) shadow economy fraud, (2) suppression fraud, (3) insolvency fraud and (4) bogus traders (Cnossen 2008a).[9]

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

## 4. CONCLUSION

This study examines the EU's ongoing efforts aimed at searching for an efficient European VAT system that fits its single market concept. Unfortunately the previous attempts have been unable to achieve a satisfactory solution, which calls for a reopening of public discussions and policy actions on this matter in the EU. The European Commission's recent VAT reform model, applying the exporter pricing to the intra-EU supplies with a common EU minimum rate (15%), would compensate for the weakness of the deferred payment system which breaks the VAT chain and causes

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

The failure of VAT coordination in the EU mainly originates from the failure of a correct measurement of the volume of intra-EU exports and imports on the national level. For example, a smooth movement from destination to origin principle would be feasible if high quality intra-EU trade data were available in the EU. CertaIT63.9o2bMEisty

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

Kalmen Datt and Mark Keating

## Abstract

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

## 1. INTRODUCTION

This article deals with the vexing question of the characterisation of supplies. In doing so it looks at two recent Australian cases on this issue and then compares the

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

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

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

## 2 THE CASES

### 2.1 Travelex

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

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

#### 2.1.1 The Majority View

On the issue whether the supply of foreign

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

Catterall[5] noted in his commentary on the case that:

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

### 2.1.2 The Minority View

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

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

As such the right must be transmissible by the supplier. They concluded that the holder or owner of bank notes has certain rights that are the incidents of ownership of the corporeal item – the bank notes or coins. A supplier of such corporeal items will not necessarily know what incidents of ownership an acquirer will exercise. Rights that are the incidents of ownership of a thing are not themselv0011 Tbf085 T3ea[(not w the(m)8.2e(anins of )55( the)7 GST Ac,t whic

### 2.1.3 Decision impact statement

The Commissioner has issued a decision impact statement[6] on this judgment. The Commissioner states the effect of the High Court judgment is that the expression 'a supply that is made in relation to rights' covers the supply of a thing (other than goods or real property) such as foreign currency where the thing supplied only has value because of rights that attach to it and those rights are transferred.

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

### 2.1.4 Intention of the purchaser relevant for GST supplies?

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

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

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

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

This approach is significant because the c

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

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

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

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

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

It was common cause between the parties that the supply of credit cards involves a right to credit, as a cardholder may elect to pay less than the entire balance on the card assi64 T

the system.' The majority held (at paragr

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

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

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

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

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

## 3. New Zealand Treatment of Financial Supplies that Incorporate Financial Services

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

### 3.1 Travelex

As under the Australian regime, the New Zealand *Goods and Services Tax Act* 1985 ("NZ GST Act") also stipulates that where a supply is both an exempt financial service and a zero-rated supply, then the zero-rating provisions should prevail.[24] Accordingly, the general issue in the *Travelex* case (whether an indisputably financial service[25] should nevertheless be zero-rated) could potentially arise.

Like Australia, the supply of certain rights for use outside of NZ can also be zero-rated. However, unlike the equivalent Australian provision, the nature of those 'rights' is much more narrowly defined under

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

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

Interestingly, the Australian High Court appears to have ignored the distinction

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

Nevertheless, *American Express* is interesting from a New Zealand-perspective for its consideration of the extent to which the nomenclature given by the parties in their contracts to various supplies governs its GST treatment. In particular, Amex was careful to specify in its contract with customers that the Late Payment Fees were not

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

In economic terms the investment constituted a fixed term loan that was repayable with interest upon maturity – but the specific contractual terms conformed in all respects to definition of a life insurance po

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

Likewise, in *Wilson & Horton Ltd v CIR*[48] the Court of Appeal rejected as impractical any interpretation of the Act that required a supplier's GST treatment to depend upon having to determine the direct or indirect purpose of each customer. There a newspaper publisher had treated as zero-rated all advertising placed by non-residents, even if that advertisement may also have provided an ancillary benefit to New Zealand residents. IRD contested that zero-rate treatment on the grounds the publisher should have determined whether and to what extent each advertisement would benefit

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

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

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

## 2.3 Changing role of tax departments

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

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

## 3. Research and Conduct

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

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

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

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

[20] Ibid 89

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

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

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

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

Due to the small scale of this research the results are not held out to be representative of all large Australian corporations. The participants were selected from a variety of

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

PricewaterhouseCoopers in their publication, 'Tax Risk Management' outline seven broad categories of risk associated with taxes[27] including transactional, operational, compliance, financial accounting, portfolio, management and reputational risk.

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

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

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

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

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[26] Ernst and Young above at n 12, 12

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

## 6. Key Tax Risk Decision Makers

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

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

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

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

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

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

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

[28] Ernst and Young above at n 12, 9

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

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

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

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

Interestingly the participant's concerns expressed for the negative impact on reputation of a tax aggressive or non-compliant position was not demonstrated in a Pilot Study of large corporations in the UK.[32] Few of the respondents in the Pilot Study of large UK corporations were concerned with the public's perceptions of their tax policy and planning behaviour. The authors of the Pilot study suggest that the lack of concern for negative publicity concerning tax compliance behaviour could be du A

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

## 7.8 Views of a Big 4 Tax Partner

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

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

## 8. Factors that Affect the Level of Tax Risk

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

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

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

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

- Demand for franking credits
- Change in ATO interpretation /approach to a tax issue
- Level of concern for reputation
- Size of the transaction
-

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

## 8.2 Staffing

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

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

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

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

By way of comparison the third party tax preparer participant's view was that the extent and quality of tax risk management systems can at times be limited because of the lack of technical qualifications of the in-house tax person as their skills remain static and are quite often not up to date. The

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

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

## 8.4 Other factors

Other factors that affect the level of tax risk include change in ATO interpretation of the tax laws, concern for reputation, size

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

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

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

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

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

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

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

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

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

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

A number of participants felt that although they had adopted a low tax risk profile the ATO was still regularly reviewing, contacting and requesting information from them. All participants who made this observation said that they had a good relationship with

potential tax risks as well as the corporation's tax risk profile. Directors did not want surprises in relation to tax and participants felt that the impact of a tax risk management system was primarily in relation to significant improvements in documentation in relation to

## ATTACHMENT 1

Interviewer : Catriona Lavermicocca
PhD student UNSW

Project description: In-depth interviews

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

Proposed questions for in-depth interviews concerning tax risk management

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

13. What influence have the ATO announcements on your organisation's tax risk management practices?

14. Have you received any correspondence from or entered into discussions with the ATO concerning tax risk management and tax decision making practices?

15. Who (not by name but by title) are the key tax decision makers in your organisation? Is there any board/director involvement in tax decision making and if any, what is the level of that involvement?

16. What are the performance measures in respect of the key tax decision makers in your organisation?

17. What do you consider to be the impact of tax risk management systems on the determination of the acceptable level of tax risk?

18. Is the organisation more or less tax risk averse (or has there been no change) after the introduction of a tax risk management system?

19. To what extent does the organisation consider corporate social responsibility issues and if so does that include a consideration of the organisation's tax compliance profile?

ATTACHMENT 2

Approval No 092098

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

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

Participant selection and purpose of study

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

Description of study and risks

If you decide to participate, we will contact you to organise an appropriate time and place to conduct an interview. It is envisaged that the interview will be either face to face or via telephone depending on what is most appropriate determined by your preference and location. A copy of the questions that will be asked can be provided prior to the interview if requested. The interview will run for a maximum of two hours and will not be recordedlth au4 Tw [o1omnnun

THE UNIVERSITY OF NEW SOUTH WALES

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

Ying Yang, Esther Ge, Ross Barns

## Abstract

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

## 1. INTRODUCTION

Individual income tax is a major revenue source for the Australian government. Over

A definitive solution to tax agent compliance risk identification is to check every single tax return lodged by every single tax agent and then reach a conclusive statement. However such a solution is neither practical nor sustainable due to resource

## 2. HOW TO CREATE PEERS FOR A TAX AGENT

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

### 2.1 Definition of a peer

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

(a)

(3)

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

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

### 3.1 The normal distribution

Since T A's peers are created by random sampling with replacement and with stratification according to T A's rental properties' postcodes, all the peers are equal-size random samples from the same population.

### 3.3 The risk score

The risk score combines both the risk of underreporting rental gross income (z-score(income)) and the risk of overclaiming rental gross expense (z-score(expense)). Because a z-score is a standardised value that calculates how many counts of standard deviations the actual value of a tax agent falls away from the average value of its peers, z-score(income) and z-score(expense) are commensurate and hence we can apply mathematical operations on them to calculate the risk score. For T A we can calculate its z-score of rental gross income, z-score(income), as well as its z-score of rental expense, z-score(expense). The lower the value of z-score(income), the less the rental gross income declared by T A than its peers, and hence the higher the possible

- Peers' maximum $ value per property: the biggest mean rental gross income or expense value among all the peers.
- Peers' standard deviation: the standard deviation of the peers' mean rental gross income or expense values.
- z-score: the standardised difference between the tax agent's actual rental value and its expected value drawn from its peers.
- Risk score = z-score(gross expense)

(a) Rental gross income

(b) Rental gross income

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

Thus, Tax Agent X underreports its rental income but overclaims its rental expense. Overall it incurs a risk score of 22.99 ( = 21.21 – (- 1.78)), which is the highest among

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

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

### 4.3 Effciency

Our proposed stratified random sampling algorithm is very efficient. Given the rental

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

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

Alternatively one can use behaviours more detailed than gross income and gross expense. For instance, gross expense can be further divided into expenses of bank loan interest, capital works and other expenses.

Risk score =
– z(gross income) (3)

Note that $(gross expense) = $(bank loan interest) + $(capital works) + $(other expenses). However, z(gross expense) ≠ z(bank loan interest) + z(captial works) + z(other expenses) because a z-score is a standardised value. Instead 3xz(gross expense)§z(rental interest) + z(captial works) + z(other expenses).

5.2 The central limit theorem

According to Moore [5], the central limit theorem says that the distribution of a sum or average of many small random quantities is

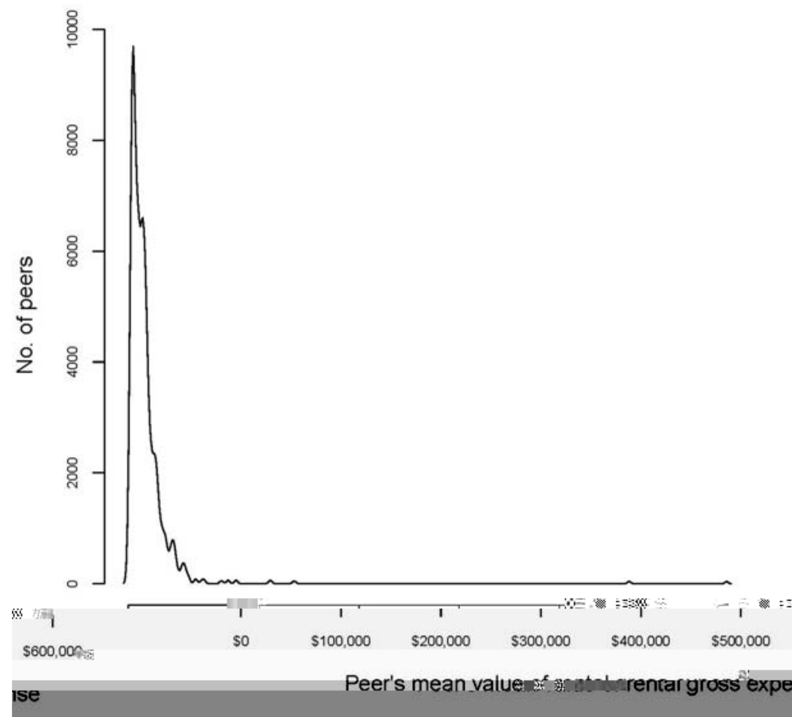


FIGURE 8: A small tax agent has only one rental property. Its peer means does not follow a normal distribution.

5.3 Median vs. mean

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

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

(b) For Tax Agent Y, the peers' median values of rental net income do follow a normal distribution. Hence a z-score is applicable.

FIGURE 9: The central limit theorem does not cover the median statistic. If using median instead of mean to measure tax agent behaviour, one should always check whether peer median values follows a normal distribution before adopting the z-score to quantify a tax agent's potential compliance risk.

## 5.4 Ratio

In general, we discourage using ratio values as behaviour, such as . It is because a small denominator value will blow up the ratio and distort the behaviour. The extreme is when denominator is 0 and the ratio becomes infinitely big. Even if we replace 0 with some positive value to solve the infinity problem, the distortion problem still exists. Table 3 shows a true story. Tax Agent Z has 18 rental properties, whose rental gross income and gross expense are listed in Table 3. 10 out of the 18 properties have $0 gross income. In order to

- Risk rank = 1.

Thus Tax Agent Z incurs a very high risk score of 979.81 and is ranked as top risk, whereas the second highest risk score among tax agents is only 33.33. We suggest that Tax Agent Z's risk is largely exaggerated and ratio is the reason to the distortion. Hence one needs to be very cautious when using ratio.

## 6. RELATED WORK

Our concept of "notional peers" is inspired by Bloomquist, Albert and Edgerton's bootstrap approach to evaluating preparation accuracy of tax agents [1]. In Bloomquist etc.'s study the tax agent behaviour is AUR discrepancy rate, which equals to the number of tax returns lodged by a tax agent with potential misreported values divided by the total number of tax returns lodged by that tax agent. The misreported errors of tax returns are identified by the Automated Underreporter (AUR) program of the US Internal Revenue Service. Assume a tax agent T A lodges 12 tax returns of Postcode 20134 and 45 tax returns of Postcode 20143. The bootstrap approach creates T A's notional peers and evaluate T A's compliance risk by the following steps.

Step 1: Randomly pick 12 and 45 tax returns from all the tax returns of Postcode 20134 and Postcode 20143 respectively. The resulting 57 (= 12 + 45) picked tax returns will contribute to create a notional peer Peer1 for T A as in Step 2.

Step 2: For each of the above 57 tax returns, a uniform random number $u$ ($0 < u < 1$) is generated. If the value of u is less than or equal to the AUR discrepancy rate of the tax return's corresponding Postcode, a value 1 is added into Peer1's base; otherwise, a value 0 is added into Peer1's base.

Step 3: Compute Peer1's AUR discrepancy rate as where {0, 1}.

Step 4: Repeat Steps 1-3 for 1000 times, creating 1000 notional peers for T A. The expected AUR discrepancy rate for T A equals to the average value of the 1000 notional peers' AUR discrepancy rates: .

Step 5: Obtain the one-tailed 95% confidence interval by sorting the 1000 peer AUR discrepancy rates in ascending order and selecting the cutoff as the 950th value.

Step 6: If T A's AUR discrepancy rate exceeds the 95% confidence interval (the 950th value), it is identified as being a potential risk.

We respectfully suggest that the bootstrap approach does not quantify tax agent compliance risk. Consequently, it does not compare risk degrees across different tax agents to offer a risk ranking among multiple tax agents. However a proper risk ranking is highly desired in tax administration organisations such as the Australian Taxation Office because it enhances the effectiveness and efficiency of tax audit under resource constraints. Hence we have instead proposed a stratified random sampling approach where we have proved via the central limit theorem that one can use the z-score to quantify potential tax agent risk regarding a behaviour. Meanwhile, since z-

scores are commensurate across different behaviours, we can apply mathematical operations on them to calculate a collective risk score for each tax agent. Multiple agents can be ranked according to their risk scores. These scores together with our proposed descriptive illustrations can provide important insight into the integrity an compliance level of a single tax agent as well as of the whole tax agent industry. Hsu etc. reported to use supervised learning to improve the audit selection procedure at the Minnesota Department of Revenue [3]. In the machine learning and data mining fields of computer science, there exist supervised learning versus unsupervised learning approaches [4, 6]. Supervised learning needs training data, that is, an unbiased and representative sample of the whole population where each of the sample returns has a known outcome (compliance or noncompliance). From the training data supervised learning infers a classifier to differentiate between compliance and non-compliance tax returns. This classifier is then used to classify other unlabelled tax returns. In their particular work, Hsu etc. had access to tax returns with auditing results and trained a naive Bayes classifier therefrom. In contrast, we lack the luxury of having good training data of agent compliance risk due to the fact that tax agent client bases are immensely diversified. Thus our proposed approach is unsupervised learning that does not demand a supply of labelled agents. As a result, our approach is of very low cost and can be easily made operational. A traditional risk identification approach in the Australian Taxation Offce is to use business expert rules. A rule system often first specifies non-compliance patterns according to domain experts' previous experience,

normal distribution. Therefore one can use th

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