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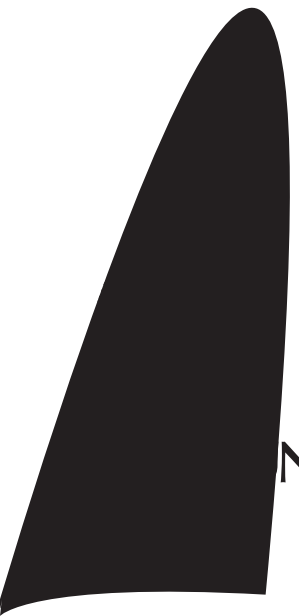
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# Developing risk management strategies in tax administration: the evolution of the Australian Taxation Office's compliance model

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## ***Abstract***

The cooperative compliance model was introduced by the Australian Taxation Office (ATO) toward the end of the last century as a means of improving voluntary compliance with Australia's taxation system. In some circles, the model is regarded as a new and innovative approach to tax enforcement for administrations that had apparently hitherto relied upon deterrence strategies to enforce compliance. Since its introduction in Australia many other jurisdictions, including New Zealand and the United Kingdom, have also adopted the model.

The purpose of this study, from a historical perspective, is to reveal the reasons why the compliance model was adopted. It aims to uncover the nature of the transition from the previous deterrence approach to a cooperative approach and to determine the influences that shaped the emergence of the model as it was officially adopted. It also aims to discover the key precursors that created the environment that encouraged the paradigm shift from deterring non-compliance to encouraging compliance. The study employs a traditional historiographical methodology involving the assembly, organisation and analysis of written and oral historical data using content analysis and historical narrative analysis. An historical study of the compliance model offers insights into risk management approaches in tax administrations through its determination and consideration of the factors that led to the development and introduction of the compliance model within their historical context.

This article argues that administrative equity and administrative efficiency were two factors that influenced the development and adoption of the cooperative compliance model by the ATO. Here, administrative equity refers to the taking into account of the taxpayer's circumstances that led to non-compliance while administrative efficiency refers to the cost-effectiveness of the ATO in targeting non-compliers and carrying out audit and other activities aimed toward improving compliance. Based on this historical study, it is recommended that the ATO consider new techniques to assess risk in large businesses due to the ever-increasing amount of resources these businesses will require as they continue to grow and expand their operations. While the compliance model was adopted in part to improve administrative equity and administrative efficiency, these two goals may be in conflict and the compliance model may exacerbate any such conflict since both utilise the same types of information as their input. Where administrative efficiency dominates over administrative equity, the ATO may respond inappropriately. While automated risk based audit selection techniques may be efficient, such techniques tend to give priority



## **2. LITERATURE REVIEW**

The literature contains only the briefest glimpses as to how the compliance model developed and why it was adopted by the ATO. A detailed



### **3. METHODOLOGY**

In broad terms, the methodology for this

was adopted rather than a pure narrative approach (Tosh 1984, 2010; Previts, Parker & Coffman 1990a; Neumann 2006). Since the history was analysed thematically into codes as mentioned directly above, it is also presented herein thematically. Overall, the sources were utilised to construct the best interpretation for how and why the model was implemented from the available evidence (Tosh 1984, 2010; Gaffikin 1998; Neumann 2006).

Interview methodology raises the question as to how many interviews are sufficient. In addition to the written data obtained, this study is based on 12 interviews. The details of the types of sources used are provided below. With.





(Woellner et al 2012, p. 26). Vertical equity is more concerned with a taxpayer's capacity to pay and refers to people in different financial positions paying different amounts of tax in correspondence to that capacity (Lewis 1982, p. 10; Woellner et al 2012, p. 26). These two definitions are concerned with the normative view that all taxpayers should pay their fair share of tax. Whether this occurs is considered to be one of the main drivers of voluntary compliance (Wallschutzky 1985). When a taxpayer perceives that others are not paying oer

his judgements about whether tax avoidance had taken place no longer appropriate. Instead the Commissioner could only “check whether the letter of the law had been obeyed.” (Sutton n.d., p. 4). This gave an open invitation to certain taxpayers to keep pushing the boundaries of tax avoidance further and develop more daring schemes. The lack of success by the ATO in addressing tax avoidance through the courts due to the literal interpretation of the general anti-avoidance rule that existed at that time by the High Court is evident in the following comment:

*The Tax Office lost everything in the 70s. The other big case is Westraders. If you look at that it's a very blatant 'find the loophole' kind of scheme and that was really Barwick's [former Chief Justice of the High Court] approach (Academic).*

But the courts cannot be, and were not, held solely accountable for the widespread tax avoidance and evasion of the 1970s. There were administrative causes for the inequity during this period in addition to the typical form of inequity created by the law itself. Some have interpreted the ATO's actions as legitimising evasion and avoidance through it being seen as a representative of oppression (Bright 1980, p. 168). But there was worse to come. The Costigan Royal Commission was established to investigate the activities of the Federated Ship Painters and Dockers Union and the diligence of Mr Costigan exposed the ‘bottom of the harbour’ schemes. In the wake of this discovery, the ATO came in for stinging criticism. The performances of the ATO and the Commonwealth Crown Solicitor's office were described as ‘demoralised’ and ‘inept’ with both offices

On the same day that Peter Costello made the above announcement, the ATO issued a press release in response to the Task Force's first report (Australian Taxation Office

developed for this purpose and was included as part of the Cash Economy Task Force's compliance model in its second report.

Despite the establishment of the Cash Economy Task Force in 1996, perceptions of administrative inequity still dogged the ATO into the late 90s. These perceptions were influenced by the Nine Network's *Sunday* television program which alleged that organised crime had infiltrated the ATO and that the ATO "treats small taxpayers

may be named administrative efficiency. Included within its ambit is the process of selecting taxpayers for audit and the how the audit is conducted. The ATO's approach to audit in the 70s and early 80s has been already discussed above with respect to administrative equity, but there were also administrative efficiency issues associated with audits. While it was easy to audit many smaller taxpayers and create lots of

different form with post assessment audit now becoming a more important strategy. However, voluntary compliance was not the main focus at this early stage.

Self-assessment, coupled with post assessment audit, necessitated a determination of who was compliant and who was not. When self-assessment was introduced, the ATO was ill equipped to identify non-compliant taxpayers since it did not have the resources in terms of technical know-how to select cases for audit (Australian Taxation

advocated by the Joint Committee of Public Accounts report ‘*An Assessment of Tax*’ (see recommendations 20 and 28-43). By this time, education and service had been combined with audit as part of an overall risk management strategy (D’Ascenzo 1993, Australian Taxation Office 1999). The ATO realised that audits did not achieve compliance ‘lock-in’ (Australian Taxation Office 1999) and it became clear that if improvements in compliance were to be achieved, a method other than audit would have to be developed. Wickerson (1995, p. 226-231) describes how the role of audit shifted from one of enforcement and recovery to one that tries to improve future compliance primarily to achieve compliance ‘lock-in’. This was in part sparked by the aforementioned Joint Committee of Public Accounts report which recommended that auditors be briefed on the reasons why an audit had been selected and that these briefings should stress the need to improve future voluntary compliance (Commonwealth of Australia 1993, p. 251 and recommendation 92). The aforementioned focus on audits for enforcement and information gathering had given way to a new goal of finding a copxommnd ihould2D(a)-2(n)11ldinn1c1dtc304 0 Td 5hould1 d2(



Market Segmented Basis' was published in a volume on business regulation edited by Peter Grabosky and John Braithwaite, two pioneers of responsive regulation theory which underpins the compliance model. Boucher first presented this paper at the Australian Institute of Criminology in March 1992 (Wickerson 1994, p. 128 at footnote 11). This similarity raises the question as to how the ATO became exposed to responsive regulation techniques. It has been suggested by one interviewee (Academic) that knowledge of responsive regulation was dispersed by students and influenced thinking in the workplaces that they entered into, including the ATO. The ATO was also possibly influenced by the Organisation for Economic Cooperation and Development through its publication *'Administrative Responses and the Taxpayer'* (OECD 1988). However, it is also possible that the ATO began using techniques advocated by responsive regulation of its own volition and had come to see the usefulness of those techniques independently, through its own realisation that audit and service ought to be combined together.

*...the Taxpayer's Service Group was set up to complement the Taxpayer's Audit Group. They didn't really talk to each other, so it was really when the market segments came together that the notion of service and audit really began to gel together. And you really can't make a distinction between audit and service... They are not separate concepts... It's ridiculous to say that you can have an audit program that is conceptually separate from service. Even the auditors who are in "gotcha" mode would admit that often they ended up, as, part of their audit, actually helping the taxpayer anyway, because in the process of auditor saying, "Your records don't support this deduction." That's a learning thing, so it was really when all the market segments came together that, in my view, deterrence and the support notions began to coalesce a bit and the project based audit program certainly was in that mode (former ATO employee).*

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equity and administrative efficiency for risk management in general. While there may be many implications of the history presented herein, the implications discussed in this section concern future ATO resourcing issues, administrative equity issues surrounding self-assessment, potential incompatibility between risk management and the responsive regulation, and taxpayer responses to risk management and compliance. Each of these areas will be discussed in turn.

## 6.1 Future ATO resourcing issues

Given that post self-assessment audit was introduced as a risk management and resource allocation process in the mid-late 80s and early 90s, examining where audits were undertaken at a particular time provides a picture as to where the ATO saw the risks at that time. Wickerson (1995, p. 224) tabulates the audits conducted over the period of 1988 to 1993. There was a sharp drop in the overall number of audits from 1988 to 1989 and then a slow rise to 1993. The trend shows a continual increase in the proportion of companies audited out of the total from 12.3% in 1988 to 30.5% in 1993 (Wickerson 1995, p. 224). Wickerson (1995, p. 229) also observes an increasing emphasis in the auditing of larger business from the period 1988 to 1993, and especially companies. After 1993, Boucher (1993, p. 237-238) explained that a key group of high-risk large corporates would be under continual observation with other less risky companies being subject to less scrutiny.

*Trevor Boucher's initial plans was that he decided that he would audit the top 100 companies, and that he would place an auditor in those top 100 companies (former ATO employee).*

The ATO created the role of a key account manager to act as a contact point between a large corporate entity and the ATO (Boucher 1993). Specifically, the manager's role was to ensure that the ATO's information about the business was up to date, to take note of major developments and to identify whether action was necessary. One person was charged with these tasks.

Various high wealth individual and large corporate audit programs have been undertaken by the ATO in recent decades. Resourcing issues similar to those that existed prior to the introduction of self-assessment are likely to resurface in the future as the ATO is unlikely to be able to keep up with the growth, complexity and detail of these companies and their increasing globalisation. The key account manager's role will ultimately become too large for one person to fulfil. Therefore the ATO will have to find newer and more resource efficient methods of auditing or observing large businesses.

Perhaps in recognition of the resourcing difficulties associated with auditing large business, the ATO has recently introduced the Reportable Tax Position framework as



overpayment of tax. Since the burden of taxes is one factor that influences voluntary compliance, the ATO could make a greater effort to reduce over-compliance. For example, under responsive regulation, salary and wage earners who have claimed a higher level of deductions compared to others in their occupational group will be sent a letter advising them to be careful when claiming their deductions. This strategy is a form of responsive regulation (Stata, 2003).



that the response of the ATO as determined by the 'BISEP' analysis becomes commensurate with the compliance strategy advocated by the risk assessment. This is because risk assessment is designed to identify taxpayers who are not compliant and naturally categorises taxpayers as either low risk or high risk or somewhere in between. Since the 'BISEP' approach is designed to also inform the response of the regulator to a taxpayer's circumstances as well as the risk management assessment, the response from the regulator effectively becomes aligned with the risk assessment. Such alignment means that there is a danger that the 'BISEP' analysis that is supposed to take into account the taxpayer's circumstances and administrative equity ends up becoming more focused on administrative efficiency instead. The diametrically opposed views expressed by some participants in this study concerning whether the compliance model is a risk management strategy or otherwise indicates there is potential for conflict where the same model is trying to achieve two different objectives. In some cases, risk management strategies can lead directly into deterrence strategies in response.

*...in a lot of work there is a simple minded assumption that [if] the red flag for fraud is there you would want an investigation and if there is culpability [then] a prosecution (Academic).*

If risk management results in an automatic fine, prosecution or a similar tough stance by the ATO, then the tax system is not being regulated in the way that responsive regulation intended and in the way that the ATO communicates to the taxpayer through its compliance program. This is because such compliance measures would not be taking into account the circumstances of the taxpayer, a key element that was desirable to members of the Cash Economy Task Force and the basis of the responsive regulation methods that underpin the model.

#### **6.4 Taxpayer responses to risk management and compliance**

As discussed above, the literal interpretations of the High Court were one reason for tax avoidance being allowed to flourish in the 70s and early 80s. As more and more cases were decided, the schemes became more daring.

*...it was a frustrating time because the Tax Office were, from a Tax Office perspective, were just losing cases and I thought that the cases were more egregious as time went on, but maybe that was just my perspective of being involved (former ATO employee).*

The ATO fought these schemes by trying to stay one step ahead of taxpayers by advocating for new legislation to deal with specific cases. One of the eventual legislative changes was the introduction of a new general anti





unusual or seemingly irrelevant data using flexible, non-automated risk assessment methods combined with a willingness to follow a lead to its conclusion may yield fruitful results.

## **7. CONCLUSION**

This article has argued how the two factors of administrative efficiency and administrative equity were influential in the development and adoption of the ATO's cooperative compliance model. Based on the evidence and analysis presented herein, this article suggests that in addition to equity and efficiency having an economic dimension, these concepts also have an administrative dimension. For those involved in developing the compliance model, equity not only means that all taxpayers shoulder the burden of tax fairly, but also that the administrator should use different means to achieve equity where appropriate. Administrative equity also influences voluntary compliance such that if a taxpayer is of the view that they unfairly shoulder the burden of taxes they are more likely to engage in non-compliant behaviour. Furthermore, if the ATO is perceived to be wasteful in how it administers the tax system, taxpayers will evaluate it like any other government agency and reduce their compliance activity accordingly (Bowler & Donovan 1995).

In order to achieve administrative efficiency, the ATO has adopted risk management techniques that have evolved over time. However these techniques potentially come at the expense of equity, in both a traditional economic and administrative sense. Limited resources will affect the ATO's ability to audit large businesses as these businesses continue to grow and expand globally; therefore administratively efficient and equitable risk management techniques that do not place undue burden on com (6.7bI4y)2( an)2I4y

The focus of risk management and managing the risks to the revenue appears to not

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