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Good governance and tax risk management

Speech by Michael D'Ascenzo, Commissioner of Taxation, at the Australian Risk Policy Institute & National Institute of Governance Inaugural Winter Seminar, University of Canberra
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Tax risk management is a core issue for both taxpayers and the community because tax impacts on all Australians, directly or indirectly.

On the ATO's part, we need to use our scarce resources in a way that optimises voluntary compliance. We do so by using a risk management approach, guided very much by our Compliance Model[1].

ATO's Compliance Model

The ATO's Compliance Model is a regulatory pyramid which seeks to encourage as many taxpayers as possible to the base of the pyramid where there is self regulation and high levels of voluntary compliance. This contrasts with the narrower apex which is characterised by a wilful minority who seek to abuse Australia's tax and superannuation systems.

The Commonwealth Ombudsman has observed that:
'In a self-assessment environment, voluntary compliance is a vital component. While this depends in part on the taxpaying community having confidence in the ATO, it also rests in large measure upon the taxpaying community being aware of its obligations, and deciding to engage in a lawful, ethical and compliant behaviour. In my view, education and deterrence by the ATO have significant roles in facilitating such outcomes.'[2]

These interactions are managed through the ATO's Compliance Model. In short the model requires us to understand the causes for non-compliance and to develop responses that are directed at remedying the causes, whether they are lack of information, practical difficulties in complying, or game-playing and wilful non-compliance.

In this way the Compliance Model is a key instrument in the ATO's approach to risk management. Recently the Joint Committee of Public Accounts and Audit (JCPAA) supported the model and considered that it would continue to play a major role in the ATO's work in future.[3]

As an Australian Government agency, we are also required to comply with various statutory obligations[4] and government guidelines which require sound risk management[5].

So both practical and legal requirements coalesce to ensure that risk management in the broader sense is ingrained in the culture of the ATO.

1 Compliance Model

2 Commonwealth Ombudsman submission to Joint Committee of Public Accounts and Audit (JCPAA) Report 410, p5.

3 JCPAA Report 410, p114

4 Examples include the Financial Management and Accountability Act 1997, the Occupational Health and Safety Act 1991 & the Safety, Rehabilitation and Compensation Act 1988.

5 Risk Management Standard (AS/NZS 4360:2004) & OECD Guidance Note on Compliance Risk Management.

Risk management at the ATO

In the ATO's view, good tax risk management requires a systematic and structured approach.

Not only do we follow the principles set out in the Australian and New Zealand Risk Management standard, but we also use a corporate environmental scan to identify emerging risks.

We undertake risk assessment of events and their causes, and then consider the effectiveness of our controls and mitigation strategies.

The ATO's key risks are captured in our risk and priority statements that form the basis of our corporate planning. Many of our activities are responses to risks that we are actively monitoring and reviewing through our corporate governance process.

We have a commitment to consult, collaborate and co-design with stakeholders throughout our risk management process.

Our Corporate Plan is a product of this risk management process. The 2008-09 plan sets out the parameters of the ATO for the current year and beyond[6].

The Corporate Plan and our business plans that stem from it, together with the visible and active involvement of our senior leaders in communicating the directions and areas of focus, are the key to getting a large workforce of 20,000 plus across 60 sites aligned with the corporate priorities. Our people give the plan life and the initiative and innovation that they apply to this mean that we can deliver for the community in ways that make us more efficient, effective and responsive.

This year and looking to our centenary in 2010, we will be:

- delivering the Government's agenda
- extending and enhancing our analytics and risk profiling techniques to hone our differentiation of taxpayers
- delivering the next stage of our ambitious Change Program
- continuing to focus on improving compliance with superannuation obligations, including employer obligations such as the superannuation guarantee
- continuing our debt collection focus
- optimising productivity improvements and measures of effectiveness, and
- strengthening our capabilities in policy implementation, taxpayer-centred design, and interpretive expertise.

The ATO is not resourced to chase every last tax dollar – and in any event this would be a very simplistic approach that would impose significant dead weight compliance costs on the Australian economy. Rather we adopt a more

6 Corporate Plan 2008-09

holistic approach that seeks to address the causes for non-compliance with appropriate responses. This requires us to ask the right questions, identify the entities and events that have a significant impact on the proper operation of the laws we administer and the reasons for that impact, and to tailor our responses accordingly.

The elements of this holistic approach include:

- providing help and assistance
- treating people fairly and professionally
- making it as easy as possible to comply
- having appropriate deterrence strategies, and
- building community confidence and trust.

Risk management and compliance

The importance of an effective deterrence was recently commented upon by the Joint Committee of Public Accounts and Audit in its Report 410:

'However, the prevention of aggressive tax planning in the future is less likely to depend on legislation. As the history of these investments show, the legislative response takes a number of years. Rather, it is more likely to depend on the ATO's data collection, analysis, risk management, initiative and the quality of staff. Although such preventative work is unlikely to attract much public recognition, it is an important factor in the integrity of the tax system.'[7]

Risk management for the ATO requires appropriate choices to be made as to how we use our scarce resources – and we adopt a risk management approach to do this is relation to our compliance activities. Generally, we direct resources to areas of highest risk identified through monitoring developments across market segments and the use of analysis techniques such as risk profiling.

For example verification of large business compliance is relatively intensive, reflecting the size and complexity of large business transactions. Increasingly we are trying to be more real time in our activities, preferably in collaboration with the companies themselves.

Using a range of both financial and tax-specific indicators, we profile large business comparing their business performance with their tax outcomes. Quantitative indicators for each group are compared with their market peers, along with other issues identified through intelligence and analysis.

Profiling involves the use of risk engine analysis that examines taxpayer-reported information, data from other agencies, our own intelligence and

7 JCPAA Report No 410, June 2008, p18. The JCPAA also referred to the ANAO's 'The Australian Taxation Office's use of Data Matching and Analytics in Tax Administration', Audit Report No 30 2007-08, 24 April 2008, for an update on the ATO's use of data matching.

publicly available information against risk filters to identify potential compliance risks.

The risk filters are periodically reviewed for their effectiveness and changed as necessary to reflect the lessons from our compliance activities.

Tax risk management

Last year I had the opportunity of discussing tax risk management with the Chairman of a large overseas based multinational. His initial thought was that tax was a 'black box' and better delegated to the company's tax area, rather than a consideration for the board. He was then asked why the difference for matters on other specialised areas such as IT, industrial processes, labour management, and environmental issues which are escalated to board or audit committee level when they are material. The Chairman replied: "We drill where the geologist tells us to – we don't second guess the experts." "What if then there was a chance that drilling in that spot could trigger an earthquake that could affect a nearby town – would you want to know that?" he was asked. "Of course," was the immediate reply. After a little thought he said: "I'll have to rethink my views on tax!"

The point is that risk management applies to all material risks.

Australian boards have made relatively good progress in managing tax risk in the same way as they manage other material risks to their organisation[8]. This has come to be accepted as best practice in a risk management framework[9]. This increasingly involves integrating tax risk management work into an enterprise wide approach to risk, implementing systematic processes and controls to prevent or detect potential risks[10]. For example, Australian companies reported good communication between their tax function and their boards compared to global and USA responses (77%, 70%, and 62% respectively).[11]

Tax risk management and governance

Tax risk management is important to taxpayers who are required to take reasonable care in their tax affairs. Risk management is being seen as a

8 'This is due to the old walls between tax and the rest of the business being eroded by outside influence, rather than being dismantled systematically by internal action. External developments such as the Sarbanes – Oxley Act of 2002 in the US, new compliance programs in Australia and elsewhere and growing public scrutiny of tax, are forcing the issue': KPMG, 2004, 'Tax in the Boardroom›. Measures designed to improve corporate reporting and audit regulation will facilitate a more effective integration between an entity's tax function and its business activities: Mroczkowski P., 'Regulating Framework' in 'Tax Risk Management', 2007, Lexis Nexis / Butterworths.

9 Dobson C., 'Managing tax risk – A framework approach›: in 'Tax Risk Management', 2007, Lexis Nexis / Butterworths.

10 Ernst & Young, Tax Risk: External Change, Internal Challenge – The Australian Perspective, Global Tax Risk Survey 2006-7

11 Ernst & Young, Tax Risk: External Change, Internal Challenge – The Australian Perspective, Global Tax Risk Survey 2006-7

global corporate governance issue and as including tax risk management conceived widely to cover not only technical and financial impact but also corporate reputation and accountability[12].

For example, in recent times there has been a changing of the tide in the way that corporate governance, compliance, and business ethics are approached. There is a worldwide trend towards greater transparency in financial reporting and improved accountability, facilitated by a greater emphasis on broader corporate compliance and social responsibility. This accountability extends to having a more rigorous approach to risk management within the broader focus on corporate governance.

Large organisations in particular have to manage risks to their performance and reputation. Better management of risks can lead to more certainty around the achievement of business objectives, which in turn can increase returns for the organisation's stakeholders. In contrast, lack of a corporate policy setting out the tax risk level acceptable to the board or audit committee may result in potential financial loss or missed opportunities.[13] Moreover, unanticipated tax risks may derail the enterprise's strategic goals and objectives.[14]

For example, the ATO continues to make large adjustments through our audit work, indicating an ongoing need for vigilance on our part and care on the part of taxpayers and their advisers.

It is in everyone's interest for there to be no surprises.

Good governance helps an organisation get to or stay at the base of the compliance pyramid and also helps to avoid or mitigate material risks including material tax risks. That is why promoting good governance is an important building block in our compliance strategies, particularly for large business.

Moreover, the market recognises good corporate governance. According to Goldman Sachs JB Were, 'investors who bought stocks with good corporate governance and sold those rated poorly could have improved their returns by 11%.'[15]

Similarly a survey conducted by McKinsey (2002) indicated that three quarters of institutional investors surveyed were willing to pay a premium for shares that adopted good governance.[16]

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12 Mills A., 2007 'Introduction to tax risk Management' in 'Tax Risk Management', Lexis Nexis / Butterworths.

13 Mason S., and MacPherson S., 2007, 'Consequences of not dealing with tax risk' in 'Tax Risk Management', Lexis Nexis / Butterworths.

14 Hiou E., 2007, Management of tax risks – Practical application in the real world' in 'Tax Risk Management', Lexis Nexis / Butterworths.

15 *The Australian Financial Review*, 19 June 2008

16 McKinsey & Company, June 2002, Global Investors Opinion Survey: Key findings

Firms that grasp the initiative on good governance and have effective processes to manage risk gain a competitive advantage:
'In sum, competitive advantage will be conferred on those institutions best able to adapt to new governance and control systems, which blend efficiency and effectiveness with accountability and alignment, thus optimising capital.'[17]

Tax risk appetite

In terms of corporate governance, the executives and boards of companies may want to ask the following questions:

1. Does my company have a sound framework for managing tax risk and complying with its tax and superannuation obligations (including access to credits)?
2. What are the reporting requirements to escalate significant tax risks to the board or one of its sub-committees?
3. What are the criteria used to escalate material tax risks, and how do they compare with those suggested by the ATO in its Large Business and Tax Compliance site.[18]

Whether a company has a broad or narrow appetite for risk, the ATO provides a wide menu to manage tax risks. For example we are now issuing some 300 private binding rulings a year to large companies that provide them with certainty about the tax outcomes of a proposed or completed transaction. We also offer product rulings, class rulings and advanced pricing agreements that also provide that certainty[19]. We also have Forward Compliance Agreements and Annual Compliance Arrangements for large companies that deliver what corporates tell us they want most – more certainty and fewer surprises.[20]

These approaches and similar strategies in other market segments help taxpayers stay at the base of our Compliance Model. For those that adopt more aggressive strategies there are firmer responses including audits and litigation.

Conclusion

The ATO's business model relies on risk management. We put our efforts into helping taxpayers operate at the base of our Compliance Model. We do this by identifying risks and developing appropriately tailored responses. What this means for taxpayers who try to do the right thing is that their compliance costs are minimised. Our focus on high risk areas and high risk taxpayers provides a more level playing field for all[21].

17 Deloitte, 2008, "In Control, Gaining Competitive Advantage through Governance, Risk and Control Best Practice."

18 Large business and tax compliance 2006

19 Subject to the arrangement being implemented as disclosed in the request for advice.

20 Forward compliance Arrangements

21 The OECD 2008 'Study in to the role of Tax Intermediaries› found that it is in the interests of the large majority of taxpayers to help tax authorities become better at risk management, better at recognising lower and higher risks, and better at not imposing extra compliance costs on lower risk taxpayers.

Similarly taxpayers sometimes make choices about the level of tax risk they adopt. Naturally, for their own benefit and for the benefit of their community we encourage them to take reasonable care in what they do.

All in all better risk assessment and management by all parties can improve certainty and minimise compliance costs. This can give Australia a competitive edge.