

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

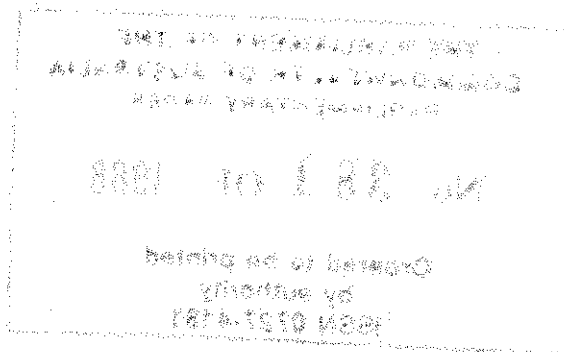
SHIFTING THE TAX BURDEN

AN INTERIM REPORT ON AN EFFICIENCY AUDIT OF THE AUSTRALIAN
TAXATION OFFICE:

INTERNATIONAL PROFIT SHIFTING

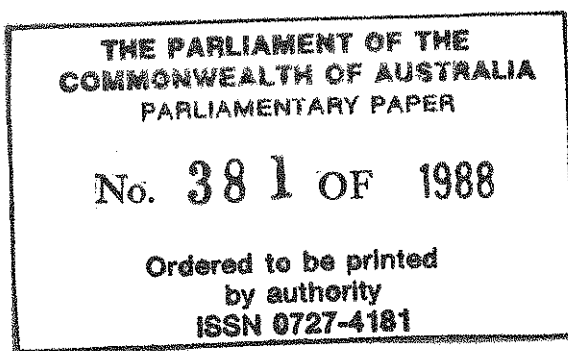
THE HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON
FINANCE AND PUBLIC ADMINISTRATION

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FOREWORD

The Committee decided to present this interim report to provide its views on a number of the issues which have arisen and to express its disappointment at the response of the private sector to the inquiry. It is to be hoped that this report will promote discussion and encourage those with an interest in the inquiry to put forward their suggestions and comments to the Committee.

The Committee's interest in and awareness of taxation issues is unchallenged within the Parliament. This is the 13th efficiency audit report into the Taxation Office to be reviewed by the Committee or its predecessor. The three reports, A Taxing Problem presented in November 1986, A Taxing Review presented in May 1988 and A Tale of Three Cities presented in November 1988 are each testimony to the Committee's expertise. During the course of the inquiry the subcommittee had visited tax offices in Perth and Melbourne and questioned taxation officers at the three separate public hearings.

The Audit Report is a most significant document. It considered 13 cases which involved adjustments to taxation income of over \$230m. Another two cases in the oil industry involved adjustments to taxable income of \$34m in one instance and \$28m in another. In respect of the banking industry it was suggested there were increased assessments of more than \$120m as a result of adjustments to claims for deductions.

The inquiry was advertised in two metropolitan newspapers and some 40 organisations were invited to make submissions.

The response was not overwhelming, in terms of the quality of the submissions received or the number of submissions received. Exceptions to this were the Taxation Institute of Australia, The Australian Bankers Association and Arthur Andersen & Co. who are to be commended for their public interest. The Committee still awaits a submission from the Business Council of Australia while the submission from the Confederation of Australian Industry was received on 17 November. The Institute of Chartered Accountants said it would respond to any specific matters while the Australian Society of Accountants made a two page submission on one the 35 recommendations in the report.

I would hope that the Committee is in a position to present a comprehensive report early in the Autumn Session of 1989. But this will in part depend on the response from the private sector.



STEPHEN MARTIN, MP
CHAIRMAN

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MEMBERSHIP OF THE COMMITTEE

Chairman: Mr S.P. Martin, MP

Deputy Chairman: Hon. I.B.C. Wilson, MP

Members:

- Mr R.A. Braithwaite, MP
- Dr R.I. Charlesworth, MP
- Mr M.R. Cobb, MP
- Mr B.W. Courtice, MP
- Mr G. Gear, MP
- Dr J.R. Hewson, MP (up to 20 October 1988)
- Mr H.A. Jenkins, MP
- Mr F.S. McArthur, MP
- Mr J. Saunderson, MP
- Mr R.F. Shipton, MP (from 20 October 1988)
- Mr D.W. Simmons, MP

Secretary: Mr P.F. Bergin

MEMBERSHIP OF THE SUB-COMMITTEE

The following Members served on the subcommittee during the course of the inquiry

Chairman: Mr S.P. Martin, MP

Members:

- Mr R.A. Braithwaite
- Mr G. Gear, MP
- Mr F.S. McArthur, MP
- Mr D.W. Simmons, MP
- Hon. I.B.C. Wilson, MP

Secretary: Mr P.F. Bergin

Inquiry Staff:

- Mr C.R. Hodges
- Ms K.E. Buckley
- Ms S.L. Fisher

TERMS OF REFERENCE OF THE COMMITTEE

The Standing Committee on Finance and Public Administration is empowered to inquire into and report on any matters referred to it by either the House or a Minister including any pre-legislation proposal, bill, motion, petition, vote or expenditure, other financial matter, report or paper.

The Auditor-General's efficiency audit report of the Australian Taxation Office: *International Profit Shifting* was tabled in the House on 26 November 1987 and referred to the Committee.

On 10 December 1987 the Committee appointed a subcommittee to review the efficiency audit report by the Auditor-General on the Australian Taxation Office, entitled *International Profit Shifting*.

ABBREVIATIONS AND DEFINITIONS

AA	Arthur Andersen and Company, Chartered Accountants
AAO	Australian Audit Office
ABA	Australian Bankers' Association
ANZ	Australia and New Zealand Banking Group Ltd
APNGBCC	Australia-Papua New Guinea Business Co-operation Committee
ATA	Australian Taxpayers Association
ATO	Australian Taxation Office
CAI	Confederation of Australian Industry
CIE	Centre for International Economics
CWITS	Companies with International Transactions System
EA	Efficiency Audit
IPS	International Profit Shifting
IRS	Internal Revenue Service of the United States of America
ITAA	<i>Income Tax Assessment Act 1936</i>
OECD	Organisation for Economic Co-operation and Development
RBA	Reserve Bank of Australia
TAC	Taxation Advisory Committee
TIA	Taxation Institute of Australia
TIPS	Taxpayer Information Profile System
TCC	Taxation Clearance Certificate

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

CHAPTER 2 : CONDUCT OF THE EFFICIENCY AUDIT

The efficiency audit was a worthwhile exercise in focusing upon an important and current issue. It has provided a catalyst for the ATO to question its own priorities. (para 2.2)

The Committee also acknowledges that the ATO itself had, prior to the commencement of the efficiency audit, recognised deficiencies within its own system and had commenced corrective action. The efficiency audit was useful in that it provided both a review and support mechanism for the initiatives undertaken by the ATO. (para 2.2)

The Committee recommends that (1) in appropriate cases, the AAO retains a consultant to advise on areas of technical complexity and provide objective input into the audit. (para 2.6)

The Committee welcomes the professional relationship which continues to develop between the AAO and the ATO. (para 2.7)

The Committee recommends that (2) the AAO continue the practice of indicating the priorities which it sees as attaching to its recommendations. (para 2.8)

CHAPTER 3 : MEASURES TO COUNTER INTERNATIONAL PROFIT SHIFTING

The Committee supports the ATO's move to the large case program. The strategy of auditing the 'top end of the market' has resulted in substantial improvements in procedures, as well as significant increases in taxation revenue. (para 3.5.1)

The evidence before the Committee is that for the ATO's new large case program to be effective, ATO must get to the frontiers of tax avoidance practice in Australia. The methods of tax avoidance, particularly those relating to international profit shifting, change very rapidly to take advantage of new opportunities. That the ATO is already headed to counter these activities is indicated by the existence of the Intelligence Units and the recent establishment of the Strategic Response Unit with the capacity to respond rapidly and positively to tax avoidance issues. The Committee endorses these initiatives. (para 3.5.6)

In the Committee's opinion, the ATO should continue to draw upon the experience of overseas tax administrations such as the United Kingdom Internal Revenue and the United States Internal Revenue Service to counter IPS practices. In the United States, the Committee understands that there is an annual variation to the tax law to deal with problems that have arisen during the year. (pg. 299). The ATO's adoption of such a practice may enable it to respond quickly to tax avoidance practices which have currency. The ATO should keep the adequacy and effectiveness of Division 13 and other legislative measures under active review in order to combat international profit shifting practices. (para 3.3)

To enable the ATO to more effectively counter IPS practices, the Committee recommends that (3) the Government should introduce into the taxation law a provision similar to IRS Code Section 982 relating to the admissibility of documents maintained in foreign countries. (para 3.8.4)

The Committee considers that the ATO should keep under review the policy of integrating international audits within the large case program to ensure that audit focus on international transactions where appropriate is not jeopardised. (para 3.5.5)

The Committee recommends that (4) the ATO should, where appropriate, maintain and strengthen its focus on international audit issues within its Complex Audit program. Project officers with international audit skills should be dedicated to examining international issues within the limited entity and large case programs. (para 3.5.7)

The Committee recommends that (5) the ATO issue an income tax ruling dealing with the operation of Division 13. (para 3.3.7)

The Committee recommends that (6) the ATO issue an income tax ruling on the operation of the large case program, to enable taxpayers and their advisers to better understand the Office's approach to the areas and add certainty to the operation and administration of the taxation laws. (para 3.6.9)

CHAPTER 4 : QUANTIFICATION OF INTERNATIONAL PROFIT SHIFTING

The Committee accepts the AAO's view that, while quantification is still a primary goal, it is 'large scale, long way down the track type recommendation'. (pg. 86) Because of the acknowledged difficulty in quantifying the loss to revenue caused by IPS, it is perhaps disappointing that AAO did not indicate possible methodologies by which that exercise could be carried out. (para 4.6.1)

The Committee recommends that (7) the ATO should continue liaison with the IRS on the quantification issue in order to learn from their experience. (para 4.5.8)

The Committee recommends that (8) the ATO should retain a consultant with experience in international taxation issues to assist it in the quantification exercise. (para 4.2.3)

The Committee recommends that (9) aggregate results of international audit adjustments carried out within the Complex Audit program should be separately identified for revenue collection purposes. (para 4.3)

CHAPTER 5 : RESOURCES DEVOTED TO COUNTERING IPS ACTIVITIES

That the ATO has recognised the importance of its human resource management is evident from the evidence given by the Commissioner of Taxation. Mr Boucher identified particular training activities for auditors including communication, negotiation, conflict resolution, interpretation and research, supervisory skills, investigation procedures, knowledge of tax law, computer literacy, and knowledge of general law and taxation office procedures. Whilst recognising that the ATO is not in a state of perfection, the Commissioner indicated that he realised the Office has to do more to enhance the skills and aptitudes which its officers already possess. (para 5.6)

The Committee commends the Commissioner for his positive approach to human resource management and notes that in the ATO's 1988-89 Corporate Plan there is a planned commitment for the Audit Group to devote 6 per cent of its approved staffing level time to training. (para 5.6)

The Committee recommends that (10) the ATO should include in its training programs for auditors packages dealing with strategic planning techniques for audits, risk assessment training, use of functional analysis techniques, cross cultural awareness skills and training in appropriate assertion skills. As well as enhancing technical competence, such skills should improve ATO officers' sensitivity and appreciation of the problems facing taxpayers. (para 5.7)

The Committee recommends that (11) the ATO should undertake a program of interchange of senior staff with the private sector. (para 5.5.12)

The Committee recommends that (12) the Commissioner should be given the opportunity to employ top experts from various areas of interest at rates of pay comparable with the market. This should enable the ATO to make quantum leaps in acquiring expertise in technically complex areas. The ATO should rely more on contract employment of experts in particular fields. The ATO should be able to 'go out and buy in high priced help'. (pg. 345) (para 5.6.10)

The Committee recommends that (13) the ATO continue its participation in informal practitioners discussion groups and the Tax Liaison Group, as forums for positive exchanges of views. (para 5.6.7)

The Committee is satisfied that the ATO is addressing the important issues of the quality and quantity of its resources. (para 5.6)

The Committee recommends that (14) the ATO continue its training programs, addressing the areas of both technical competence and human relations skills. This should enable a greater quantity of skilled and competent auditors who are sensitive to the demands placed upon the private sector to be released into the ATO's Complex Audit and International program. (para 5.7.6)

CHAPTER 6 : ATO'S MANAGEMENT OF INTERNATIONAL PROFIT SHIFTING CASES

The ATO has recognised the specific deficiencies identified by the AAO in the administration of certain IPS cases. With the large scale restructuring of the audit group, combined with ATO initiatives in that area, the Committee is confident that the ATO's management of its international profit shifting cases, now within the Complex Audit and International Branch, will be substantially improved. However the Committee recommends that the ATO remain vigilant and keep abreast of current commercial developments and practices to ensure that its audits are effective in protecting the revenue. (para 6.4)

The ATO's administrative measures to counter international profit shifting practices have improved and continue to improve. Taxation officers indicated that the specific deficiencies in cases identified by the AAO have been taken into account in the design of the large case program. To that extent, the ATO is confident that those deficiencies should not reoccur. (para 6.4)

The Committee recommends that (15) the ATO should consider using external specialist audit teams drawn from the private sector to assist it in auditing areas of technical complexity where it does not have sufficient knowledge or expertise. (para 6.6.3)

The Committee recommends that (16) the Government should consider an amendment to the income tax law to allow as a deduction to the auditee company the costs directly incurred by it in relation to an ATO audit. (para 6.6.7)

The Committee recommends that (17) a formal register of completed and settled cases should be developed to provide precedents and ensure consistency of approach in the large case program. (para 6.6.5)

CHAPTER 7 : TAX SCREENING ARRANGEMENTS

The Committee recognises that tax screening plays an important part in the fight against IPS practices. (para 7.2)

The Committee recommends that (18) there should be legislative amendment to bring responsibility for tax screening under the ATO's aegis. (para 7.4.4)

The Banking (Foreign Exchange) Regulations are an inadequate and inappropriate basis for tax screening. (para 7.4.2)

The Committee recommends that (19) the Reserve Bank no longer be involved in tax screening. (para 7.4.4)

If tax screening is to be retained at all, then the Government should consider correcting a deficiency on both the tax clearance certificates and declaration forms to make them more useful: the deficiency is that there does not appear to be any sort of identification required when transferring funds overseas. (pg. 330) The Committee therefore recommends that (20) both those documents should contain the remitter's tax file number. (para 7.6.5)

CHAPTER 1

INTRODUCTION

1.1 Background

1.1.1 This Interim Report examines an efficiency audit (EA) of the Australian Audit Office (AAO) on the Australian Taxation Office (ATO): International Profit Shifting (IPS). It is the ninth audit report to be reviewed by the House of Representatives Standing Committee on Finance and Public Administration (F&PA).

1.1.2 The audit was begun on 13 November 1985 and was carried out in the ATO National Office (Canberra) as well as in the Sydney, Melbourne and Brisbane branch offices of the ATO. It was decided by the AAO to extend the time devoted to the audit to ensure that the report reflected the contemporary situation and provide a balanced view of the perceived historical lack of action and the ATO's recent drive for improvement.

1.1.3 The efficiency audit report was tabled in both Houses on 26 November 1987 and referred to the Committee.

1.2 Aim of the Report

1.2.1 The objective of the efficiency audit conducted by the AAO was to assess the effectiveness and the efficiency of the Australian Taxation Office's coverage of International Profit Shifting. The audit was confined to an examination of ATO's administrative procedures and

did not attempt to assess the validity of particular taxpayer assessments or industry compliance with the law. The aim of the review by the F&PA Committee was to:

- . assess the substantive content of the audit exercise and the quality of the efficiency audit report;
- . examine the response of interested parties to the efficiency audit report; and
- . examine the response of the ATO to the efficiency audit.

1.3 The Committee's Review of the Efficiency Audit Report

- 1.3.1 In accordance with established practice the Committee appointed a Sub-Committee to conduct the inquiry.
- 1.3.2 To date 13 submissions have been received. Nine of those who have made submissions have appeared at public hearings. In addition, two witnesses appeared at public hearings but did not lodge submissions. ATO officers have appeared on three occasions while AAO officers have appeared twice. There are over 400 pages of transcript.
- 1.3.3 Public hearings have been held in Canberra (25 February 1988, 15 and 16 August 1988), Sydney (4 May 1988) and Melbourne (5 May 1988).
- 1.3.4 Lists of the submissions authorised for publication and details of witnesses who appeared at public hearings are included at Appendixes I and II respectively.

1.3.5 The transcript of the evidence given at public hearings and submissions and incorporated documents authorised for publication have been incorporated in separate volumes. Copies are available for inspection in the Committee Secretariat and the Parliamentary Library. References to evidence in the text of this interim report relate to page numbers in those volumes. References to paragraph numbers refer to paragraph numbers in the efficiency audit report. The F&PA Committee had access to the evidence and records of the former Expenditure Committee which had conducted earlier inquiries into the AAO's efficiency audits of the ATO, pursuant to Sessional Order 28B.

CHAPTER 2

CONDUCT OF THE EFFICIENCY AUDIT

2.1 Introduction

2.1.1 In this audit the AAO did not attempt to identify particular instances of profit shifting through examination of taxpayers' income tax returns. Rather, the AAO sought to form an opinion of the efficiency of the procedures of the Australian Taxation Office and its efforts to administer the anti-profit shifting provisions of the Income Tax Assessment Act 1936. AAO officers indicated that they sought to ascertain:

- (a) what the likely revenue potential was;
- (b) what avenues there were for escaping tax in this area;
- (c) what complimentary controls operated (such as tax screening of foreign exchange transactions and withholding tax); and
- (d) what the achievements of the Taxation Office were in this area. (pg. 65)

2.2 Overview of the Efficiency Audit

2.2.1 The efficiency audit found that international profit shifting had a major impact on taxation revenue collections. It was suggested that while there may be

more than 40,000 corporations able to shift profits, only 251 international audits had been undertaken by the Taxation Office during 1985-86. In AAO's view there was little doubt that transfer pricing associated with intra-corporate trade resulted in very significant losses of taxation revenue. (para 2.16 of EA Report)

2.2.2 However, the report noted that:

'since this audit was begun at the end of 1985, the ATO has initiated a number of administrative reviews and major system developments which are expected to achieve substantial improvements in procedures and result in significant increases in taxation revenue.' (para 1.12 of EA Report)

2.2.3 Section 13 of the efficiency audit report (pgs. 71-84) sets out the AAO's recommendations and the responses of the ATO. There are 35 recommendations, some which have more than one part. In general, the ATO has agreed with those recommendations, or has indicated that steps are already in progress to meet the concerns expressed by the Australian Audit Office.

2.3 **ATO's Response**

2.3.1 The Commissioner of Taxation responded that:

'the reason the problems of IPS had not been addressed more vigorously was not a lack of corporate will by ATO but rather could be traced directly to the explosion in mass marketed artificial tax avoidance schemes during the period under review.' (para 1.14 of EA Report)

2.3.2 The Committee heard evidence that cases reviewed by the AAO related to taxation audits undertaken in the late 1970's. The Taxation Office gave evidence that in the context of that time and considering the prevailing issues and the resources available to it, the largest and most significant issue facing the tax administration was the explosion of artificial tax avoidance activity:

'Given that, it was incumbent on us to devote our resources to countering that activity. That is a decision we took consciously and I believe it is a correct one. The amount of revenue that was at stake at that time was enormous.' (pg. 9)

2.3.3 The ATO suggested that given the large number and availability of artificial tax avoidance schemes at that time, there was probably little incentive for companies to enter into the much more complex area of international profit shifting if they were committed to tax avoidance.

2.4 Other Responses to the Efficiency Audit

2.4.1 The responses of other witnesses to the report were generally positive, with the central premise being that constructive review by the AAO should assist in better administration by the ATO.

2.5 Cost of the Efficiency Audit

2.5.1 In his Annual Reports, the Auditor-General lists the cost of each efficiency audit undertaken by his Office. The Committee was advised that the cost of the audit was \$177,307, including consultant's fees.

2.5.2 In recognising the complex issues of taxation law reviewed in their efficiency audit, the AAO employed specialist consultancy assistance to advise on technical issues. The cost of the consultant was \$2,200.

2.6 **The Use of Consultants by the Australian Audit Office**

2.6.1 The Audit Office representatives advised that a consultant would be a useful resource in their audit. The consultant was used to provide an 'objective input into the audit to examine our recommendations' and ensure that the AAO had correctly interpreted some areas that might be open to different views. Appointment of the consultant was made under the Audit Act. (pg. 74)

2.6.2 The consultant retained by the AAO reviewed the report at the draft preparation stage. The consultant was not attached to the audit for the duration and at no stage approached the Taxation Office or reviewed taxation files. (pg. 74)

2.6.3 The Committee endorses the approach of the Australian Audit Office in retaining a consultant to advise on areas of technical complexity. The Committee sees merit in the Audit Office obtaining an outside opinion at the draft stage of its efficiency audit report. The use of a consultant provides an objective input into the audit. In this way the drive towards better administration of efficiency audits is enhanced.

2.7 Review by the Auditee of the Draft Efficiency Audit Report

2.7.1 The efficiency audit team indicated its appreciation for the co-operation of taxation officers in the International Operations Branch (as it then was):

'Throughout this task the audit team was appreciative of the co-operation of Taxation Office officers in the International Operations Division of the National Office of the Tax Office and those in other related sections to which our inquiries led us.' (pg. 65)

2.7.2 The ATO also welcomed the opportunity that it had been given, during the course of the IPS efficiency audit, for its officers to have full discussions with the Audit Office, to have an input into the efficiency audit and to have that input recorded.

2.7.3 The Australian Audit Office auditing standards basically call for one closing interview with the auditee and a written exchange of comments on the draft efficiency audit report. However the progression of discussions with senior taxation officers in this case was more elaborate than usual. The Committee heard evidence that the method adopted in the international profit shifting report, although lengthening the elapsed time for the audit, was necessary to provide an adequate reflection in the report of the extent and current development of the initiatives introduced by the Taxation Office during the closing stages of the audit. (pg. 66)

2.7.4 Audit officers indicated that this process:

'... proved its worth in that the main thrust of the audit report and of the recommendations made by the Australian Audit Office has been generally accepted by the Taxation Office'. (pg. 66)

2.8 Priorities for AAO's Recommendations

2.8.1 In its report 'A Taxing Problem', the former Expenditure Committee recommended that:

The Australian Audit Office follow a more positive approach in its reporting by providing, in particular, detailed constructive recommendations and advice to audited agencies in cases where serious deficiencies within an agency's activities are observed. (para 2.9)

2.8.2 The AAO's 35 recommendations and the responses of the ATO are set out in Section 13 of the efficiency audit report. (pgs. 71-84)

2.8.3 The AAO has also indicated the priorities to be attached to its audit recommendations (pgs. 67-69 of the efficiency audit report). It was suggested that it is of primary importance for the ATO to commence a quantification exercise to determine to the maximum extent possible the loss to revenue caused by international profit shifting. The next priority was the need to minimise as far as possible the degree to which otherwise assessable income escapes Australian taxation through being held offshore indefinitely in tax havens. (paras 12.2 and 12.3 of EA Report)

2.8.4 In some cases the ability to comply with the AAO's priorities may be outside the power of the ATO. For example, the AAO suggested that high priority be given to 'developing legislation to expose to domestic tax any income of domestically controlled companies and trusts sheltered in tax havens'. However the ATO has noted that it is a matter for Government policy whether such legislation should be developed and if so, the timing of that legislation. The Committee nevertheless sees merit in the AAO continuing to indicate to auditees the priorities which it sees as attaching to its recommendations.

2.9 Conclusion

- 2.9.1 The efficiency audit was a worthwhile exercise in focusing upon an important and current issue. It has provided a catalyst for the ATO to question its own priorities. (para 2.2)
- 2.9.2 The Committee also acknowledges that the ATO itself had, prior to the commencement of the efficiency audit, recognised deficiencies within its own system and had commenced corrective action. The efficiency audit was useful in that it provided both a review and support mechanism for the initiatives undertaken by the ATO. (para 2.2)
- 2.9.3 The Committee recommends that (1) in appropriate cases, the AAO retains a consultant to advise on areas of technical complexity and provide objective input into the audit. (para 2.6)
- 2.9.4 The Committee welcomes the professional relationship which continues to develop between the AAO and the ATO. (para 2.7)
- 2.9.5 The Committee recommends that (2) the AAO continue the practice of indicating the priorities which it sees as attaching to its recommendations. (para 2.8)

CHAPTER 3

MEASURES TO COUNTER INTERNATIONAL PROFIT SHIFTING

3.1 Introduction

3.1.1 The Taxation Office has made significant progress in developing and refining its audit activity. In its submission, the ATO indicated that in 1985-86 it had increased its workload under the International Enforcement Program to some 250 audits. In 1986-87 that moved to in excess of 400. There has also been a large increase in experienced staff and training devoted to audit activities. This reflects that as an organisation the ATO is generally improving the way it is operating, not only in the international area in particular but in audit activity generally.

3.1.2 The ATO has indicated that as part of its restructuring, international audits will be integrated into the broad Complex Audit program. It will conduct a range of projects that will focus on transaction based industries, industry types and entities that trade with related companies in tax havens.

3.2 The Extent of the IPS Problem

3.2.1 In its efficiency audit report, the AAO indicated that statistics used by the Australian Bureau of Statistics for 1984-85 revealed that approximately 30 percent of total Australian import and export trade, valued at \$17.6m in that year, was conducted between Australian

branches and subsidiaries of foreign companies on the one hand and their foreign parent and related companies abroad (para 2.15). The report indicated that these statistics did not reflect the volume of trade conducted between Australian owned enterprises and their subsidiaries and related companies abroad. Nor did they include transactions in the banking sector. The report suggested that the inclusion of such data would undoubtedly establish that an even greater proportion of total Australian imports and exports of goods and services (estimated by the AAO to be in excess of \$20,000m annually), is conducted through intra-corporate trade). Accordingly, Audit concluded that there was:

'little doubt that transfer pricing associated with such trade results in very significant losses of taxation revenue'. (para 2.16)

The AAO also commented that there was a substantial and increasing use of tax havens to remove a significant amount of Australian income from Australian tax. (para 3.7.1 of EA Report)

3.2.2 On the other hand, Arthur Andersen & Company, Chartered Accountants, submitted that the AAO's conclusion that international profit shifting is a substantial problem is not necessarily valid. It had been their experience that large corporate taxpayers are exceedingly careful to comply with the law: the larger the corporation and the more public its profile, the more concerned it is to preserve its public image. Such corporations it was submitted try to 'avoid the taint of being seen to be involved in abusive tax arrangements'. Accordingly, Arthur Andersens concluded that most multinational corporations have (at least) defensible pricing

arrangements for all cross border transactions. Arthur Andersen believed that these companies are sufficiently sophisticated, intelligent and respectful not to flagrantly abuse the taxation systems of their host countries. (pg. S12) Arthur Andersen concluded that:

'the specific attention that is being given to the multinationals or the large corporations that are subject to statutory audit is misdirected because they are the very ones who seek to comply with the law'. (pg. 93)

- 3.2.3 In commenting on Arthur Andersen's submission, the AAO representatives suggested that they would have preferred a more balanced presentation. They indicated that Arthur Andersens were probably working to a certain brief whereas the AAO had looked at a different brief. Arthur Andersen's officers responded that they believed their submission was balanced. In their experience, large corporate taxpayers were careful to comply with the law.
- 3.2.4 Whilst acknowledging the views expressed in the submissions and by witnesses, the Committee cannot ignore the AAO's analysis of the 13 cases for which S.136/Division 13 determinations were made between 1 July 1982 and 31 December 1986. Division 13 adjustments of \$350.5m were made after the audits were completed. (Table pg. 43 of EA Report). In two of those cases the adjustments were in excess of \$100m each. In addition, the Commissioner of Taxation, Mr Boucher, has indicated that the ATO's recent concentration on the 'top end of the market' (which now includes international audits) has been very lucrative for the revenue. In these circumstances the Committee considers that IPS remains a threat to the revenue.

3.3 The Adequacy of the Income Tax Assessment Act to Counter IPS Activities

3.3.1 Division 13 of the ITAA was enacted with effect from 27 May 1981 to deal comprehensively with arrangements under which profits were shifted out of Australia whether by transfer pricing or other means. It replaced an original provision - the former Section 136 - which had proved inadequate to deal with these practices. In commenting upon the effectiveness of new Division 13 to counter IPS activities, an the ATO officer stated:

'We now have legislation that is of international standard, relying on arm's length principles, and we see that as appropriate legislation'. (pg. 22)

3.3.2 The Commissioner of Taxation stated that even with the implementation of other legislation, such as the Foreign Tax Credits System, companies will still be able to indefinitely defer the tax on income directed to or accumulated in a tax haven company and not remitted to Australia. The AAO's findings also indicate that there is an increasing use of tax havens.

3.3.3 As a result the report recommended that:

'a high priority should be allocated to the necessary work on developing legislation to expose to domestic tax any income of domestically controlled companies and trusts sheltered in tax havens.' (para 3.7.1 of EA Report)

3.3.4 In evidence the Commissioner considered that the law is effective in dealing with the assessment of tax liability of taxpayers with international connections.

Mr Boucher said he was mindful of the legislative proposals in the May mini budget for an accruals basis for taxation of foreign income. In addition, he referred to the use made of the Foreign Tax Credits System, the Division 13 measures specifically directed against profit shifting and the general anti-avoidance provision, Part IVA of the Income Tax Assessment Act.

3.3.5 The terms of Part IVA are very wide and would seem to cover most transfer pricing situations. When introducing the Part IVA legislation, the Treasurer indicated that it was directed at 'blatant, artificial or contrived arrangements'. Part IVA is not limited by other provisions in the Income Tax Assessment Act or the Income Tax (International Agreements) Act. It applies whether the scheme is carried on inside or outside Australia.

3.3.6 There needs to be clarity and certainty in the application of the tax laws as they affect companies with international dealings. Mr Boucher indicated that there was already a level of certainty but that: 'certainty can always be improved.' (pg. 347) An issue which arose was whether there is sufficient certainty in the way in which the transfer price to be brought into account to determine tax liability is established. In response, Mr Boucher indicated that the rules which the ATO has in Division 13 and the double taxation agreements with major trading partners are exactly the same as with other countries. Therefore there is as much certainty in Australia as tax administrators and taxpayers have in those other countries. (pg. 347) Mr Boucher acknowledged however, that some practitioners may not agree that there is sufficient certainty in the way in which the transfer price for Division 13 purposes is established.

- 3.3.7 To enhance the clarity and certainty in the application of the transfer pricing rules, the Committee sees merit in the ATO issuing, as a matter of priority, an income tax ruling which details the Office's view of the law and how it administers the provisions of Division 13. Included in the exercise could be details as to the way in which the transfer price to be brought into account to determine tax liability is formulated.
- 3.3.8 In its submission, the Taxation Institute of Australia, considered that Division 13 (transfer pricing), Part IVA (anti-avoidance) and foreign tax credits are adequate legislative deterrents to prevent international profit shifting. The Institute submitted that the ATO should direct its resources to all members of the Australian community evading taxation in any form, including international profit shifting. The Institute emphasised that the law is in place to do this and supported the implementation of administrative measures to further this goal. (pg. S55) The Confederation of Australian Industry submitted that Division 13 and Part IVA are as comprehensive as any legislation in the world to enable the ATO to investigate and punish IPS, and that the penalties provided in the law acted as a strong disincentive to engage in IPS.
- 3.3.9 Although the anti-profit shifting provisions of Division 13 are supplementary to the general anti-avoidance provisions contained in Part IVA, they are not limited in scope to arrangements that have a dominant tax avoidance purpose. There is therefore scope for overlap between the operation of Division 13 and Part IVA. In some cases the Commissioner may find it easier to establish the criteria necessary to apply Division 13 rather than Part IVA. Accordingly, to add

clarity and certainty to the law, the income tax ruling on the operation of Division 13 should specify, as far as practicable, the conditions under which the Commissioner will apply Division 13 rather than Part IVA.

3.3.10 During the course of the hearings, examples were given which may disclose inadequacies of the income tax law in combating international profit shifting. These involve entities which have arranged their affairs so as to overcome the provision of the Income Tax Assessment Act and where Division 13 would not apply. Typically, this occurs through the non-arm's length behaviour of related parties in circumstances which themselves are apparently arm's length.

3.3.11 Evidence was given (pg. 285) that it is very hard to know the actual nature of the international transaction when there are techniques such as back-to-back transactions, side deals as well as put and call options which are not revealed to the ATO. Critical to the examination of international profit shifting is the definition of 'profit' in the case of companies operating in the international arena. In the view of one witness (pg. 285) the taxation law has not adequately defined 'profit'. An example was given of a leading multinational company operating in Australia which was alleged to use as its unit of account the Japanese yen. Because all of its imports were denominated in Japanese yen, in the past two years the company needed to do nothing in order to have a substantial deterioration in its Australian 'profit'. Examples were also given of how a domestic partner can be compensated in a side deal, for example, a corresponding 'sweet deal' in some other overseas country. The difficulty identified for the ATO in that context is that it would be very difficult to have evidence on the back-to-back transactions and side deals involved. (pg. 286)

3.3.12 In the foreign exchange context, it was suggested that financial institutions operating subsidiaries offshore can exercise considerable discretion as to where foreign exchange profits and losses are booked. This is especially the case when large numbers of foreign exchange trades are executed in the course of a day. (pg. 290)

3.3.13 Further evidence was given (pg. 292) of the difficulty which can arise where differential tax rates are involved. Thus where a company bears the corporate rate of tax of 39 percent (formerly 49 percent) on one form of income, and a 10 percent tax rate on another form of income (interest income), there is scope for an arbitrage deal. It follows that it is a simple matter for companies to rearrange their affairs so as to minimise their taxation liabilities. In that context a witness suggested that there should be a uniform rate of tax applied to all sources of income overseas. (pg. 292)

3.3.14 In their paper entitled, 'Overseas Aspects of the Australian Company Tax System' Mr D. Dixon and Professor R. Vann address methods of reducing effective rates of tax levied by both the country of residence and the country of source of income. They identify that the avenues for reducing Australian tax liability are of two broad types:

(i) using transfer pricing techniques, and

(ii) a choice of company structure which limits liability to company tax in Australia.

- 3.3.15 In relation to Australians investing overseas, Dixon and Vann explain that by paying attention to corporate structures, several methods can be utilised to avoid the Foreign Tax Credits System as it impacts on their need to repatriate foreign profits to Australia.
- 3.3.16 The most significant conclusion arising from their paper is the variety of methods available to Australian companies to avoid the full impact of the Foreign Tax Credits System. That is despite widespread criticism of the new system by many companies with significant overseas sourced income.
- 3.3.17 Although the Foreign Tax Credits System reduces the scope for avoidance of Australian tax by residents, Dixon and Vann demonstrate that there are still avenues available to do so by appropriate structuring of overseas transactions.
- 3.3.18 Reaction to this paper appears to have been minimal (pg. 287). The Committee notes that the Government has moved to amend the Foreign Tax Credits System and the Singaporean Double Taxation Treaty to prevent losses to the revenue.

3.4 Double Taxation Treaties

- 3.4.1 Australia has 23 comprehensive taxation agreements with other countries. Over 70 percent of Australia's trade is with treaty partners. The comprehensive taxation agreements are bilateral international treaties which are given domestic legislative effect in Australia by the Income Tax (International Agreements) Act 1953. The agreements are schedules to that Act and as such have legislative force. Australia is a 'dualist' country in that its international agreements acquire force of law only if implemented by domestic legislation.

- 3.4.2 The Income Tax Assessment Act and International Agreements Act are to be read as one, with the provisions of the International Agreements Act having priority over any inconsistent provisions in the Assessment Act (except for Part IVA and Section 160A0 which deals with credits for foreign tax paid on certain dividends.) There will generally be no inconsistency between the provisions of Division 13 and the provisions of the treaties as they both seek to apply the same arm's length principles.
- 3.4.3 All of Australia's comprehensive taxation agreements have provisions dealing with transfer pricing and profit shifting as well as other activities which have relevance to international audits. While all the agreements have articles designed to deal with common subject matters, the articles are not identical in text and therefore not identical in operation.
- 3.4.4 In 1963 the OECD published its first draft Double Tax Convention. Several revisions resulted in an updated version in 1977. This is informally referred to as the OECD model double taxation convention. The OECD model aims to provide taxpayers with protection against the possibility of double taxation and to facilitate the task of national tax administrations in combating tax avoidance and evasion.
- 3.4.5 One of the most important ways in which DTTs counter international profit shifting practices is by the use of the exchange of information article (OECD model article 26). This article provides for the exchange of information necessary for the carrying out of the provisions of the convention or for the domestic laws of the states concerning taxes covered by the convention.

3.4.6 The main rule concerning exchange of information is contained in the first sentence of paragraph 1:

'the competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning the taxes covered by the Convention insofar as the taxation hereunder is not contrary to the Convention.'

3.4.7 As exchange of information is not restricted by article 1, it may include information about non-residents. A limitation to the exchange of information power is that information should only be given insofar as the national tax in question is covered by the Convention. This means that a request relating to the imposition of a sales tax need not be complied with as it is not a tax covered by the Convention.

3.4.8 Information needed for the proper allocation of taxable profits between associated companies in different countries, or the adjustment of the profits shown in the accounts of a permanent establishment in one state and in the accounts of the head office in another state, could be exchanged pursuant to paragraph 1 of the OECD model article.

3.4.9 The Commissioner of Taxation gave evidence (pg. 365) that there is a very high level of co-operation between the ATO and overseas tax administrations in addressing international profit shifting cases. This is particularly so concerning New Zealand, America, Canada and the United Kingdom.

3.4.10 Exchange of information under DTT's is also relevant for the determination of arm's length prices. At paragraph 9.1.6 of the efficiency audit report, AAO stated that the determination of arm's length prices was inherently difficult for a number of reasons including:

'(5) the ATO's access to an entity's books and records, particularly when such information is held overseas, is very limited and is dependent upon specific articles in the various DTT's.'

3.4.11 In that context, an academic has been reported discussing the difficulty for national governments to monitor their corporations in the international economy. In particular it was suggested that Australia should:

'open our information, our tax records, so that they can be matched and that they can be compared, in order to see who is actually paying what amount, to which particular government.'

3.4.12 It was also suggested that:

'part of the problem for governments to trace companies' earnings around the world is that there is no clear access to the original tax records.'

3.4.13 Similar problems faced by the United States tax administration, the Internal Revenue Service, are dealt with by the use of IRS Code Section 982. That section relates to the admissibility documents maintained in foreign countries. It provides, in general terms, that where a taxpayer fails to substantially comply with a formal request for documents, a court shall prohibit the

introduction by the taxpayer of the foreign based documents covered by the request. Sub-section 982(a) provides:

(a) GENERAL RULE - If the taxpayer fails to substantially comply with any formal document request arising out of the examination of the tax treatment of any item (hereinafter in this section referred to as the 'examined item') before the 90th day after the date of the mailing of such request on motion by the Secretary, any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue shall prohibit the introduction by the taxpayer of any foreign-based documentation covered by such request.

Section 982 is reproduced in full at Appendix III.

- 3.4.14 The Commissioner of Taxation indicated (pg. 367) indicated that a provision similar to IRS Code Section 982 would be of interest to the ATO as one of the problems in this area is obtaining information that is outside the ATO's jurisdiction.
- 3.4.15 The introduction into the Income Tax Assessment Act of a provision similar to IRS Code Section 982 relating to the admissability of documents maintained in foreign countries should assist the ATO in its access to foreign documents and enable it to more effectively counter IPS practices.

3.5 ATO's Large Case Program

3.5.1 In its efficiency audit report, the AAO stated that:

'since this audit was begun at the end of 1985, the ATO has initiated a number of administrative reviews and major system developments which are expected to achieve substantial improvements in procedures and result in significant increases in taxation revenue.' (para 1.1.2)

3.5.2 Foremost amongst these was the move to self assessment in 1986. That strategic move has freed up a large amount of resources which enables the ATO to tackle its audits generally and international audits in particular in a more effective way. The Committee also received evidence that the ATO has moved from a fairly low audit base to a substantial audit base where approximately one quarter of ATO staff are now directly or indirectly involved in audit activities.

3.5.3 The ATO has also undertaken a comprehensive review of the structure and operations of its audit areas. The most significant response to that review has been the development of a Complex Audit and International Program, encompassing both limited entity and new comprehensive large corporate audit program. This reflects the experience of taxation administrations in the United States, Canada and elsewhere in developing specific large corporate strategies. Traditionally, ATO has conducted audits by having individual auditors. Under the large corporate audit program these will now be conducted by teams of auditors. The purpose of the program is to undertake comprehensive audits of

corporate groups as a whole - not merely individual large companies within groups. The Committee was told that these teams will focus on international aspects, so that as the ATO moves into this large corporate audit program, an integral part will be examining international operations. This is planned to give the ATO a much wider breadth of coverage in that area. In the audits of the large corporate groups there will automatically be a close emphasis on international operations. (pg. 7)

3.5.4 As teams of tax auditors will be examining the total corporate group, it is expected that those audits will extend over some time; they may continue on a rolling basis. The ATO has assured the Committee that these audits will be well planned and well managed. (pg. 40) The development of the large corporate audit program and the integration of a large range of projects into ATO's general audit activities reflect the organisation's pro-active mode at this time. (pg. 22)

3.5.5 With the integration of international audits into the ATO's broader Complex Audit program, it may be that the focus on international aspects of an audit could be blurred, with a consequent deterioration in international audit skills. In that regard the Committee notes that the 1987 Annual Report of the US Internal Revenue Service (IRS) comments at page 24 that they anticipate a 25 per cent increase in international staffing this year to support the growing significance placed on international issues. The IRS indicates that this is a first step towards a substantial increase in international examiner resources.

3.5.6 Evidence before the Committee suggests (pg. 298) that the ATO needs to get to the frontiers of tax avoidance in this country. The development of Intelligence Units and the Strategic Response Unit represents a positive move in that area. It was suggested that international transactions, particularly those involving tax effective financial arrangements and intangibles offer potential for tax avoidance in Australia. Accordingly, they should provide an area for the ATO to realise large gains to the taxation revenue. In that regard the Committee notes that statistics given by the Commissioner at the recent ACT Bicentennial Accounting Conference from auditing the 'top end of the market'. In 1986-87 audits on companies with turnovers in excess of \$100m pa yielded \$272m in taxable income. In 1987-88 another 40 companies produced extra revenue of \$197.2m, resulting in additional tax and penalty of \$100.9m. There are currently in progress 33 large case program audits. By July 1991 the Commissioner expects to have started 100 such cases.

3.5.7 The ATO should, where appropriate, maintain and strengthen its focus on international audit issues within its Complex Audit program. This could be done by having project officers with international audit skills dedicated to examining international matters within the limited entity and large case programs.

3.6 Publicity

3.6.1 In its efficiency audit report, the AAO stated that:

'foreign owned corporations are prepared to pay a price to avoid involvement in disputes with tax authorities ... The foregoing comments should not be interpreted as meaning that Audit is exhorting

the ATO to exploit its advantages unduly but rather that ATO should employ its bargaining strength to obtain adequate outcomes in the public interest'.
(para 6.4.13 of the EA Report)

3.6.2 In evidence, the AAO witnesses said that publicity should not be used as a bargaining tool in a direct way. They suggested that there is a view that if a company gets into trouble with overseas tax authorities, it immediately becomes subject to detailed investigation in its home country. (pg. 83) They added that in at least one of the cases examined by them the ATO did not make sufficient use of publicity where it had a good case, and that proper weight had not been given to that factor.

3.6.3 The importance of the publicity aspect was also emphasised by witnesses from Arthur Andersens (pg. 93) and the Taxation Institute of Australia (pg. 118): they indicated that multinational corporations seek to comply with the law and because of their concern about their image and perception in the marketplace, do tend to use competent legal and tax advisers. The Confederation of Australian Industry submitted that companies are acutely sensitive to the impact which accusations of IPS would have on their operations. It added that assertions that companies engage in IPS to improve the 'bottom line' fail to recognise the high priority which they place on achieving good corporate citizenship.

3.6.4 Earlier in the efficiency audit report, the AAO noted that the practice of naming and listing taxpayers in the Commissioner's Annual Report for breaches and evasions ceased from the year ended 30 June 1985 (para 6.4.12).

3.6.5 On the other hand, the Committee heard evidence that the AAO's suggested use of publicity as a tool for the ATO, was not the way to run a tax system. (pg. 290) The reason cited for this view was that it takes about ten years to have a case go through the legal system. The witness went on to suggest that a better way would be to have simplicity and certainty for the tax system. (pg. 290) Whilst agreeing that the tax system should be as certain and as simple as possible, the Committee notes from the evidence that in the field of taxation audits in general and international transaction audits in particular, there are 'very difficult and complex issues at work'. (pg. 297)

3.6.6 The Committee endorses the position of the ATO when it was said in evidence:

'what we are about is getting the correct amount of tax, and not trying to get more because we are threatening people with publicity'. (pg. 50)

The Committee urges such caution upon the ATO: it should not use the threat of publicity as a bargaining tool.

3.6.7 The provision of high standards of public information should assist taxpayers in understanding what their rights and obligations are under the tax laws. Clear and unambiguous forms and publications for taxpayers should minimise uncertainty and provide impetus in the move towards increased voluntary compliance.

3.6.8 With the ATO's move to self assessment and an increased emphasis on voluntary compliance, the Committee sees merit in the ATO publicising information concerning the actions it is taking as to both targeting of its cases and increased taxation revenue collections. This may have a significant impact on voluntary compliance.

3.6.9 Accordingly, the Committee considers that the ATO should give priority to the issue of an income tax ruling on its administration of the large corporate audit program. This form of publicity should enable taxpayers to have greater certainty in organising their affairs, add simplicity to the income tax law and enable corporate taxpayers to have a better view of how ATO's revised audit procedures will affect them and their operations.

3.7 **Legislation Subsequent to the Efficiency Audit Report**

3.7.1 The Committee also notes that there has been an ensemble of recent legislative measures designed to reduce the attractiveness of international tax avoidance activities. These may also supplement the purpose for which tax screening was designed: that is to detect and prevent tax avoidance or evasion effected through foreign exchange transactions. These legislative measures include:

- . the foreign tax credits system;
- . thin capitalisation rules;
- . high integrity tax file number system;
- . cash transactions reports legislation; and
- . accruals tax legislation (formerly controlled foreign corporations legislation).

3.8 **Conclusion**

3.8.1 The Committee supports the ATO's move to the large case program. The strategy of auditing the 'top end of the market' has resulted in substantial improvements in procedures, as well as significant increases in taxation revenue. (para 3.5.1)

- 3.8.2 The evidence before the Committee is that for the ATO's new large case program to remain effective, ATO must get to the frontiers of tax avoidance practice in Australia. The methods of tax avoidance, particularly those relating to international profit shifting, change very rapidly to take advantage of new opportunities. That the ATO is already headed to counter these activities is indicated by the existence of the Intelligence Units and the recent establishment of the Strategic Response Unit with the capacity to respond rapidly and positively to tax avoidance issues. The Committee endorses these initiatives. (para 3.5.6)
- 3.8.3 In the Committee's opinion, the ATO should continue to draw upon the experience of overseas tax administrations such as the United Kingdom Internal Revenue and the United States Internal Revenue Service to counter IPS practices. In the United States, the Committee understands that there is an annual variation to the tax law to deal with problems that have arisen during the year. (pg. 299). The ATO's adoption of such a practice may enable it to respond quickly to tax avoidance practices which have currency. The ATO should keep the adequacy and effectiveness of Division 13 and other legislative measures under active review in order to combat international profit shifting practices. (para 3.3)
- 3.8.4 To enable the ATO to more effectively counter IPS practices, the Committee recommends that (3) the Government should introduce into the taxation law a provision similar to IRS Code Section 982 relating to the admissibility of documents maintained in foreign countries. (para 3.4.15)
- 3.8.5 The Committee considers that the ATO should keep under review the policy of integrating international audits within the large case program to ensure that audit focus on international transactions where appropriate is not jeopardised. (para 3.5.5)

- 3.8.6 The Committee recommends that (4) the ATO should, where appropriate, maintain and strengthen its focus on international audit issues within its Complex Audit program. Project officers with international audit skills should be dedicated to examining international issues within the limited entity and large case programs. (para 3.5.7)
- 3.8.7 The Committee recommends that (5) the ATO issue an income tax ruling dealing with the operation of Division 13. (para 3.3.7)
- 3.8.8 The Committee recommends that (6) the ATO issue an income tax ruling on the operation of the large case program, to enable taxpayers and their advisers to better understand the Office's approach to the areas and add certainty to the operation and administration of the taxation laws. (para 3.6.9)

CHAPTER 4

QUANTIFICATION OF INTERNATIONAL PROFIT SHIFTING

4.1 Introduction

- 4.1.1 In its efficiency audit report, the AAO concluded that the ATO has not conducted a comprehensive analysis and assessment of the cost to Australia of tax evasion and avoidance associated with IPS. The AAO considered that quantification of the amount of tax evasion and avoidance associated with IPS was essential if the ATO (and in turn the legislature) was to be assured that its resources were deployed to the optimal advantage. (para 1.4. of EA Report)

4.2 Recommendations of the Audit Office

4.2.1 Accordingly, the AAO recommended that:

- (a) a rigorous analysis of all forms of tax evasion, including profit shifting, should be completed in order to assist effective determination and allocation of resources and program priorities, and
- (b) this analysis attempt to quantify the effort required to collect that revenue represented by measure of tax evaded and the proposed timetable. (Recommendation 16)

- 4.2.2 The audit report indicated that it is of primary importance to commence the quantification exercise to

the maximum extent possible to determine the loss to the revenue caused by IPS: that would provide a basis for establishing greater priority for the allocation of resources. (para 12.2 of the EA Report)

4.2.3 ATO's response to AAO's recommendation was that research is to be undertaken to measure tax evasion and establish initial broad estimates. It would be necessary to refine and enhance those estimates to identify specific components of the gap. The ATO continued that the quantification recommendation assumed a level of precision that is unlikely to prove achievable.

4.3 Elements in the Quantification Exercise

4.3.1 The first element of the quantification exercise relates to the number of corporations which may be in a position to transfer profits. The second element deals with the estimate of the amount of profits which that number of companies may be able to shift overseas.

4.3.2 The Audit Report stated that in 1986 the ATO had estimated that there may be more than 40,000 corporations in Australia which are in a position to shift profits. (para 1.7 of the EA Report)

4.3.3 However the ATO suggested that caution needs to be exercised in drawing implications from some of the specific indicators used in the report. The target group of 40,000 potential profit shifters was derived from work done in 1986 to determine the printing requirements for the schedule 25A which applies to companies with transactions with overseas entities. Evidence before the Committee suggests that, at best, it was a 'guesstimate'

of the number involved. (pg. 12) The ATO went on to note that, irrespective of its accuracy, the figure gives no real indication of the extent to which companies are likely to be engaged in profit shifting practices. (pg. S29) At the public hearing on 25 February 1988, the ATO witnesses suggested that the 40,000 figure 'is not far removed from the level that every taxpayer is in the potential field for avoidance. There are a lot of factors that have to be reduced from that potential field before you get to specific numbers of companies that you really are confident, from a case selection point of view, that there is some chance of international avoidance'. (pg. 13)

- 4.3.4 Later in evidence, the ATO officers referred to discussions with the Australian Bureau of Statistics which indicated a range of between 12,000 and 18,000 companies conducting international transactions with associates. However there were stated to be many qualifications on these figures and the ATO would 'not put any faith on them at this time.' (pg. 19)
- 4.3.5 The efficiency audit report itself does indicate that quantification is a difficult exercise. Others have also recognised the difficulty: in an article in the Australian Business magazine of 20 January 1988 quoted by the Second Commissioner in evidence it was stated that the quantification exercise 'sounds a bit like asking someone to work out how many fish they did not catch'. (pg. 14)
- 4.3.6 The rough estimate of initially 40,000 companies, subsequently reduced to between 12,000 and 18,000 companies, provides merely an indicator as to the number

of companies which have the potential to conduct international profit shifting. Merely because a company has an overseas subsidiary or affiliate, that should not of itself lead to the implication that the company is engaged in profit shifting activities. There are a great many companies with overseas subsidiaries or affiliates which comply with the income tax law. Accordingly, the figure of companies with overseas transactions merely provides an indication of the maximum potential number of profit shifters: the worst case scenario. It should not be taken to imply that all companies with overseas subsidiaries or affiliates undertake profit shifting activities.

4.4 Priority for Quantification

4.4.1 In evidence, AAO representatives indicated that the quantification of the extent of IPS was still a primary goal for the ATO. (pg. 85) However, in recognising the difficulties of the exercise, they went on to say that quantification is: 'one of those that is a large-scale, long way down the track type recommendation ... it is something that is an iterative process: the more work they do the better idea they will have of the total target population.' (pg. 86)

4.4.2 AAO representatives however indicated that they did not think anybody would be able to come up with the assessment of the potential loss caused in the past by international profit shifting. (pg. 73)

4.4.3 The issue of quantification of the revenue at risk because of IPS practices is not new. In the House of Representatives Estimates Committee D of

8 September 1980 (Hansard pg. 385) the Committee discussed the High Court decision involving the former Section 136. The question was asked: 'Is any estimate available of the degree to which tax might be avoided through the process of transfer pricing.' In response the ATO indicated that they did not have a figure for the estimate involved. It is perhaps disappointing that despite the difficulties, the ATO has not done more work over the years on the quantification issue.

4.5 Other Evidence

- 4.5.1 The Committee also heard from Arthur Andersen & Co. concerning quantification. It was stated that the quantification approach 'puts the cart before the horse' and that the quantification exercise was not practical. The witnesses said that:

'Until you start getting experience in actually undertaking the audits and seeing what the results are, we do not believe it is possible to attempt to examine the quantification issues'. (pg. 92)

The Arthur Andersen officer went on to indicate that the focus on quantification was misdirected until the ATO has had the experience of undertaking large scale audits and determined what the results are. (pg. 92) However he added that:

'there is inevitably tax lost to the Australian revenue as a result of international profit shifting and/or international tax evasion. That is unquestionable'. (pg. 93)

4.5.2 Evidence given by Mr Risstrom, Secretary of the Australian Taxpayers Association, also related to the quantification issue. Mr Risstrom was reported in a newspaper article on 9 January 1983 as stating that 'the Melbourne branch alone of the Australian Tax Office losses over \$2,000 million each year from transfer pricing'. However when questioned on this aspect, the evidence was that the estimate was a gut reaction; it was nevertheless 'quite a big figure'. (pg. 152)

4.5.3 In its submission, the Centre for International Economics suggested that:

'the instruction to the ATO that it quantify profit shifting really begs the question', (pg. S73)

and further that:

'quantification would justify the allocation of more administrative resources on the grounds that big problems need big resources to overcome them'. (pg. S74)

4.5.4 In evidence the CIE's representative also referred to the difficulty quantifying the extent of the IPS problem.

4.5.5 Representatives of the Taxation Institute of Australia indicated that when the Taxation Office has looked at the pricing policies of certain multinationals, invariably adjustments are not made. In their view very few adjustments have been made in this area over the last six to eight years. (pg. 120) They went on to indicate that they did not believe the problem of IPS is as all pervasive as the audit report suggests. It was

their experience that adjustments in this area are fairly rare. They indicated however that, if adjustments were made, the amount of tax collected could be substantial. (pg. 137)

- 4.5.6 The Institute's representatives also considered there to be a high level of compliance. They believed that there is a mistaken notion that there is a lot of tax minimisation or tax avoidance or evasion among companies with international connections. (pg. 138) They added that one of the problems in terms of tax evasion is that the tax evaders will not provide certain information on international transactions:

'I do not believe tax evaders would check the necessary box (in Schedule 25A) because they are people who do not attempt to comply with the system in the first place'. (pg. 138)

- 4.5.7 Representatives of the Australia-Papua New Guinea Business Co-operation Committee gave evidence that the issue of IPS does run a definite risk of being overstated. (pg. 205) They went on to criticise the efficiency audit report on the basis that the 40,000 companies referred to as being in a position to shift profits, makes the assumption that all such companies may shift profits or at least are in a position to do so. They were not convinced that was the case. (pg. 206) Neither were they convinced that all activity with tax haven countries involved profit shifting. (pg. 206)

- 4.5.8 The USA experience may provide some indication in this area: the IRS employs random sampling audits on their international companies to provide a rough guide on the extent of IPS activities.

4.6 Conclusion

- 4.6.1 The Committee accepts the AAO's view that, while quantification is still a primary goal, it is 'large scale, long way down the track type recommendation'. (pg. 86) The Committee considers that the quantification exercise should be undertaken progressively as the ATO gains experience from its large case audits. Because of the acknowledged difficulty in quantifying the loss to revenue caused by IPS, it is perhaps disappointing that AAO did not indicate possible methodologies by which that exercise could be carried out. (para 4.4.1)
- 4.6.2 The Committee recommends that (7) the ATO should continue liaison with the IRS on the quantification issue in order to learn from their experience. (para 4.5.8)
- 4.6.3 The Committee recommends that (8) the ATO should retain a consultant with experience in international taxation issues to assist it in the quantification exercise. (para 4.2.3)
- 4.6.4 The Committee recommends that (9) aggregate results of international audit adjustments carried out within the Complex Audit program should be separately identified for revenue collection purposes. (para 4.3)

CHAPTER 5

RESOURCES DEVOTED TO COUNTERING IPS ACTIVITIES

5.1 Introduction

5.1.1 Given the currency and the importance of the international profit shifting issue, the Committee wanted to investigate how well ATO had managed its resources to counter IPS activities. It was apparent, that with the ATO's restructuring of the Audit Group, the internal reporting systems commented on by AAO were no longer relevant. The Committee sought to obtain evidence as to the effectiveness of the new systems to be employed by ATO in the context of its Complex Audit and International program.

5.1.2 The issue of the adequacy of resources devoted to countering IPS activities needs to be considered from two perspectives:

- (a) the number of people involved, and
- (b) the technical competence of those people.

5.2 AAO's Recommendations

5.2.1 The AAO was critical that the ATO's monthly Division 13 report, entitled 'Profit Shifting Cases Report', did not compare actual cases completed and revenue raised with estimates and revised estimates. Nor did it provide explanations for variances or make reference to other

cases. National Office was often not made aware of other cases which were very old and remained uncompleted. Accordingly, the report recommended that:

- (a) ATO develop existing performance criteria to facilitate resource management and to provide effective measurement of performance against plans and budgets, and
- (b) the emphasis currently placed on the importance of meeting annual revenue estimates should also be tempered by reference to the possible longer-term costs to revenue. (AAO's recommendation 33)

5.2.2 In response, the ATO said that it recognised the need to develop existing performance criteria to facilitate its resource management and provide effective performance management. It indicated that it is developing a three year strategy for its audit programs to facilitate better management and monitoring. In relation to the large case program, all cases will be subject to mandatory planning which provides for staged assessments and resource specifications.

5.3 AAO's Evidence on Resources

5.3.1 Audit office representatives indicated that:

'There is no doubt that the Australian Taxation Office was, beginning in about late 1983, increasing the proportion of its resources devoted to tax matters in the international field'.

(pg. 66)

5.3.2 Whilst AAO witnesses agreed that the ATO has expanded the numbers of staff involved in international audits, they were unsure as to whether the ATO now had sufficient resources to counter IPS. They indicated that there was a need for identification of the total area that international profit shifting might encompass. Until that was done in broad terms, they indicated that it was difficult to determine the optimum number of resources for the ATO to put into that area. To make an objective allocation of resources, the AAO officers said that the ATO should really have some idea of the extent of the IPS issue. (pg. 85)

5.4 ATO's Evidence on Resource Management

5.4.1 The introduction of self assessment from July 1986 enabled the release of in excess of 800 staff for taxpayer audit work to add to the additional resources already provided by Government. The number of staff available to the former International Operations Branch increased from 30 nationally in 1983 to 161 in 1986-87.

5.4.2 The Committee was told that the ATO's review of its audit structures was designed to ensure that the ATO was making the best use of its available resources. The recommendations of that review included, among other things, the new comprehensive large corporate audit program which gave further attention to international profit shifting. The review also addressed issues of case planning and management.

5.4.3 Given the explosion of artificial tax avoidance schemes in the mid to late 1970's, with the consequent risk to revenue, in ATO's submission it was incumbent upon the Office to devote its resources to countering that

activity: 'we had to make a judgment as to where our resources were best utilised. Clearly that was in countering artificial tax avoidance schemes of the kind prevalent at that time. Failure to do that would have had enormous revenue consequences.' (pg. S28)

5.4.4 One implication of that decision was that the ATO had to make choices about resources. That meant that other areas of the Office, including examinations of international transactions, did not receive the resources or attention which they otherwise would have received.

5.4.5 The ATO's resources devoted to countering IPS activities increased significantly over the period to the point where in 1986-87, the ATO devoted 161 staff directly to IPS issues. However, with the movement to the ATO's new audit structure and operations, a large proportion of auditors will embrace international transactions into their audit of companies. (pg. 22) The number of company audits increased from 251 in 1985-86 to 410 in 1986-87. The ATO anticipates an equivalent number of company audits for 1987-88. The point emerged during the ATO's evidence that the Office has to concentrate its resources on the 'tax implications of minimisation'. (pg. 39)

5.5 Comments by Other Witnesses

5.5.1 Whilst not wishing to express an expert opinion on the matter, the representative from the Australian Taxpayers Association indicated that in one branch office there could be 11 or 12 taxation officers dealing with the complex tax affairs of just one company. In that

situation the figure of 161 staff nationally was not seen as necessarily a large or even an adequate figure. (pg. 149)

- 5.5.2 In its submission, the Australia-Papua New Guinea Business Co-operation Committee (APNGBCC) indicated that additional expenditure of resources by the ATO was unlikely to be balanced by additional revenues. The conclusion was therefore drawn that other priorities should prevail over the problem of IPS. (pg. S5)
- 5.5.3 In evidence, representatives of the APNGBCC saw the issue of resources in the context of the ATO's concentration on the audits of large corporate groups. They indicated that the more organised and rigorous training program on the part of the Tax Office should mean more efficient ATO audits in the future. More efficient audits should also provide benefits for the auditee companies because the conduct of an audit is for a company, a very costly exercise in terms of the disruption caused to its normal work patterns, whether or not audit adjustments are made.
- 5.5.4 Better trained ATO audit staff would bring about more efficient and better managed audits. The ATO should however be sympathetic to the concerns of auditee companies about disruptions to their work flows and the indirect costs which they bear during a tax audit.
- 5.5.5 In their submission, Arthur Andersen & Co. suggest that probably the most important area for the Taxation Office to consider is the training of its personnel particularly in view of the expansion of audit coverage

and increasingly complex legislation. They suggest that the training should cover audit techniques, international taxation law and interpersonal skills. They go on to say that other solutions identified by the AAO (engagement of consultants, assessing professional journals), represent short-cut solutions and, whilst not harmful, would be of little practical value. (pg. S19)

- 5.5.6 In evidence, Arthur Andersens considered that the Tax Office had its biggest problem in the area of developing technical competence through training. As with other institutions dealing with the complex areas of taxation law, so too the ATO should seek to maintain and strengthen the technical competence of its staff. The AA's view was that the ATO:

'can throw 500 people at the problem ... but if those people do not have the technical competence to deal with the issue then the numbers do not matter much. In fact they become counterproductive and frustrating. All they tend to do is to lead to an increasing level of dispute and litigation.'
(pg. 109)

- 5.5.7 In evidence, representatives of the Taxation Institute of Australia indicated that in dealing with taxation officers on audits, when reviewing a transfer price, they have felt that the ATO expertise was not as high as it could be. In addition, they have not noticed a marked improvement in resources devoted to international areas within the Taxation Office. (pg 120) Neither have the Institute's constituent organisations been able to suggest that improvements have been made in the resourcing area and therefore the ability of the Tax Office to tackle problems in the international sphere. (pg. 121) However the representatives accounted for this

position by indicating that 'any one tax adviser will take a fair amount of time to come into contact with the people from the Tax Office'. (pg. 120)

5.5.8 In a radio interview in June 1988, Mr D. Dixon suggested that originally the Taxation Office had only less than 100 people auditing the accounts of large companies. Even if that figure was now closer to 300-500 people, he said it was still a very small number of resources compared with what the private sector itself would have in putting together its tax accounts.

5.5.9 In evidence Mr Dixon indicated that the issue is really one of quality not quantity:

'you do not really need many resources at all; you actually need the right people to do it'. (pg. 281)

However in dealing with a large multinational corporation the number of people required to do the audit could be quite substantial. He also recognised that the operations of the company must necessarily be interferred with where there is a large number of tax auditors involved.

5.5.10 He identified that one of the difficulties with a career public service is simply that the material which is available and their horizons, are in many cases narrow. He went on to indicate that in the Tax Office one would find:

'very few people who are specialised or knowledgeable about the workings of the corporate sector in this country, whether it be international or domestic'. (pg. 282)

However, Mr Dixon acknowledged that the Tax Office had made great strides under the present Commissioner and added that the ATO has 'upped its game recently'. (pg. 300)

- 5.5.11 Mr Dixon went on to say that retaining experts from outside the public sector may also be difficult because of the need to determine why outsiders would want to come and work for the Tax Office. He indicated that it was important to build up a career Tax Office together with flexibility both in rules and the method of operation. (pg. 283)
- 5.5.12 However the Commissioner indicated that the ATO had employed the head of the restructured Audit Group from the commercial sector. This proved to be a successful exercise. Rather than the private sector viewing the ATO as being a cheap training ground for accountants, lawyers and other specialist staff which it might later poach, it seems that both the private and government sectors would benefit from increased interchange of senior staff. Issues of access to confidential commercial information and secrecy would of course have to be addressed, but the resulting increased liaison, skills base and appreciation if the difficulties facing the other party should make it a worthwhile exercise.

5.6 Initiatives within the ATO

- 5.6.1 With the changes to the Audit Group structure, the ATO has had to reconsider its approach to resource allocation. For the large corporate audit program the ATO has between 300 and 400 auditors. For the business audit program, which covers the market referred to as middle business, the ATO has in the order of 800 to

1,000 tax auditors. In the lower end of the audit market - the ATO's desk audit activity - ATO estimates that it has of the order of 300 staff. There are between 500 and 600 officers involved in internal income matching activities where the ATO matches dividend and interest income declared on tax returns. The ATO also has between 600 and 700 inspectors who are primarily concerned with enforcing employer and payroll obligations under the PAYE System. Nationally the Audit Group has some 3,900 staff.

- 5.6.2 Within the next twelve months the ATO expects to expand its large corporate audit program by an additional 200 staff. For 1989-90 it is anticipated that there will be a further 200 staff and an additional 100 to 200 officers in 1990-91. These will be staff either promoted from within the ATO, replaced from elsewhere within the ATO or, recruited into the ATO. Given the greater emphasis on the large corporate audit program, the ATO has indicated that it will be employing industry specialists to carry out some of the work.
- 5.6.3 This reflects the fact that the ATO finds it very hard to recruit quality auditors. In evidence given before the Senate Estimates Committee C on 18 October 1988 (pg. C151) the Commissioner indicated that good taxation officers can double their remuneration by moving outside the Public Service. He indicated if the ATO was able to offer more pay than is presently the case, the Office would tend to lose fewer people to the private sector.
- 5.6.4 Arthur Andersen representatives also identified income levels paid to officers in the Tax Office as a matter of

concern. The salaries which the ATO can offer its auditors were said to be below the market:

'the Tax Office is, of course, suffering from that problem because clearly there are people in it who are highly skilled and who are very competent, and they are being attracted to the professions and to industry by the substantially higher salaries that these are able to offer. That is a major problem for the Tax Office'. (pg. 110)

- 5.6.5 Mr Boucher also indicated that in the most recent budget, the Government allocated additional funding which includes lifting the salary profile of people in the audit area and bringing in 11 Senior Executive Service positions as case managers of large audits.
- 5.6.6 This seems to be following the US pattern where the IRS reported a 25 per cent increase in international staffing in 1987 to support the growing significance placed on international issues.
- 5.6.7 ATO auditors recognise that they must keep up to date with current commercial practices and participate in informal practitioners discussion groups. This is an extremely useful method for the ATO's auditors to not only maintain and expand their technical competence but also to increase their sensitivity and appreciation of the problems facing the corporate sector. However Mr Boucher expressed reservations as to the responsiveness of such groups when ATO participates in them:

'those groups are not too comfortable with the notion of having a tax officer as part of their ordinary discussion process - we might learn to much.' (pg. 342-343)

By such regular participation in practitioners discussion groups, ATO auditors can also be in a position to learn about the latest international tax planning techniques and acquire market intelligence. Meetings with such bodies as the Tax Liaison Group provide a forum for industry and professional bodies to be advised of development, changes and problems within the ATO.

5.6.8 To improve the technical competence of its officers in theand complex audit and international areas, the ATO conducts training courses at three levels:

- . basic level - occupying two and half to three days;
- . intermediate modules - ten modules of three hours each, and
- . the advanced modules - not yet completed and in some cases superceded by industry wide workshop programs.

These training courses are conducted in most branch offices as an on-going exercise as resources permit and as the need is perceived. They are continuously revised and expanded to meet the auditors' needs in both the international and complex audit areas. Although the advanced course has not been completed, there is an increasing involvement in industry wide workshops, covering such areas as alumina, grain, insurance and pharmaceuticals. Quite often outside experts are retained by the ATO to assist in the presentation of the information.

5.6.9 One aspect which has been brought to the Committee's attention concerning the use of consultants is a certain reluctance by experts to assist the ATO. This was explained on the basis that the independence of an expert is perceived by his or her peers to be jeopardised when he or she works with the ATO. In addition the expert's sources of information were said to sometimes dry up when the market learns that the expert has been assisting the ATO. On the other hand, besides providing expertise to the ATO, experts also gain from experience and knowledge in working with the ATO system and its officers. It is a two way street in which both experts and the ATO can benefit.

5.6.10 In the interests in countering tax evasion in general and international profit shifting in particular, it is necessary that the ATO be at the forefront of knowledge in the tax planning area. The use of specialist consultants is a way of achieving that result. It is not in the long term interest of the market that barriers should be erected to frustrate the ATO's efforts.

5.7 Attitudes of Taxation Officers

5.7.1 A recent Senate Estimates Committee inquiry (Senate Estimates Committee C, 18 October 1988, pg. 147) into taxation administration, raised the issue of confrontation tactics used by ATO's auditors. The problem related to the psychological and human relations training to ensure that auditors operate in a

non-confrontationist manner. Similarly, in evidence before this Committee, the issue of ATO's attitudes arose: in a press article entitled 'How to get harmony with the Tax Office' the introduction stated:

'No one is ever going to love the tax man but does he have to be quite to hateful? Daryl Dixon writes that overseas models show the Tax Office could win more dollars with less aggression'.

Mr Dixon suggests that 'unless there are big changes in the way the Tax Office operates, poor strategy and defects in tax legislation will mean that small taxpayers will still get tangled in needless rows with the taxman'. In Mr Dixon's view the search for dollars on the tax audits is the wrong way to go. (pg. 296) He expressed fear that the ATO would target the person who was weak and not able to respond. However he indicated that before the ATO did any audits it should be aggressive in the courts to ensure that the law is adequate.

5.7.2 In discussing the powers exercised by the Commissioner the AAO commented that:

'A common observation ... was the ATO's gingerly approach to use of the broad powers vested in the Commissioner to determine various factors affecting the calculation of tax payable'. (para 6.6.1)

They went on to conclude that:

'... more frequent and/or earlier use of the Commissioner's powers could well obtain more co-operative responses from reluctant taxpayers and quicker settlement of cases'. (para 6.6.1)

5.7.3 On the other hand in its submission the Centre for International Economics stated:

'In our view officials should be "gingerly" as they press their arbitrary calculations upon firms ... Indeed it seems likely that there would be a body of opinion which would have it that it is a lack of a "gingerly approach" which is the problem'. (pg. S71)

The CIE's conclusion was that:

'... we would argue that this power of the ATO is a power which should be used gingerly'. (pg. S77)

5.7.4 The CIE suggested that training of taxation officials to be appropriately cautious would be one way of overcoming the difficulties envisaged as to whether or not a heavy handed or a more gentle approach was appropriate.

5.7.5 In its submission Arthur Andersen & Co. also emphasised that training of taxation officers should include interpersonal skills. In evidence, their officer indicated that there has been, over recent years, an unfortunate development between the profession and the Tax Office in the sense that there has been almost a siege mentality developing. In order to improve the relations between the accounting and legal professions on the one hand and the Taxation Office on the other, Arthur Andersen's witness suggested that the Taxation Office should improve its interpersonal skills. (pg. 109). He indicated that whilst there are reasonable and competent people in the ATO, at the extreme end of the spectrum there are some ATO officers who perceive 'anybody in business as a crook and a tax cheat, and that is not a desirable sort of position to be in'. (pg. 110)

5.8 Conclusion

- 5.8.1 That the ATO has recognised the importance of its human resource management is evident from the evidence given by the Commissioner of Taxation. Mr Boucher identified particular training activities for auditors including communication, negotiation, conflict resolution, interpretation and research, supervisory skills, investigation procedures, knowledge of tax law, computer literacy, and knowledge of general law and taxation office procedures. Whilst recognising that the ATO is not in a state of perfection, the Commissioner indicated that he realised the Office has to do more to enhance the skills and aptitudes which its officers already possess. (para 5.6)
- 5.8.2 The Committee commends the Commissioner for his positive approach to human resource management and notes that in the ATO's 1988-89 Corporate Plan there is a planned commitment for the Audit Group to devote 6 per cent of its approved staffing level time to training. (para 5.6)
- 5.8.3 The Committee recommends that (10) the ATO should include in its training programs for auditors packages dealing with strategic planning techniques for audits, risk assessment training, use of functional analysis techniques, cross cultural awareness skills and training in appropriate assertion skills. As well as enhancing technical competence, such skills should improve ATO officers' sensitivity and appreciation of the problems facing taxpayers. (para 5.7)

- 5.8.4 The Committee recommends that (11) the ATO should undertake a program of interchange of senior staff with the private sector. (para 5.5.12)
- 5.8.5 The Committee recommends that (12) the Commissioner should be given the opportunity to employ top experts from various areas of interest at rates of pay comparable with the market. This should enable the ATO to make quantum leaps in acquiring expertise in technically complex areas. The ATO should rely more on contract employment of experts in particular fields. The ATO should be able to 'go out and buy in high priced help'. (pg. 345) (para 5.6.10)
- 5.8.6 The Committee recommends that (13) the ATO continue its participation in informal practitioners discussion groups and the Tax Liaison Group, as forums for positive exchanges of views. (para 5.6.7)
- 5.8.7 The Committee is satisfied that the ATO is addressing the important issues of the quality and quantity of its resources. (para 5.6)
- 5.8.8 The Committee recommends that (14) the ATO continue its training programs, addressing the areas of both technical competence and human relations skills. This should enable a greater quantity of skilled and competent auditors who are sensitive to the demands placed upon the private sector to be released into the ATO's Complex Audit and International program. (para 5.7.6)

CHAPTER 6

ATO'S MANAGEMENT OF INTERNATIONAL PROFIT SHIFTING CASES

6.1 Introduction

6.1.1 The files examined by the AAO indicated that, in general terms, ATO's audits involving Division 13 determinations had been inadequate as regards research, planning, monitoring and review. In particular the AAO identified six matters of concern:

- (1) insufficient detail recorded to explain significant reductions to determinations previously made;
- (2) minimal use by the ATO of industry experts during investigations and negotiations;
- (3) a tendency to rush the assessments through by 30 June;
- (4) a lack of quality control procedures for the conduct of audits;
- (5) processing delays in branch offices as well as National Office; and
- (6) excessive time to determine objections.
(para. 6.4.3 of the EA Report)

The Committee sought evidence concerning these areas to discover whether the ATO's management of its IPS cases had improved.

- 6.1.2 In evidence before the Committee, AAO witnesses stated that the six matters of concern related to the ATO's audits carried out in 13 cases in which determinations were issued under Division 13. The table at pg. 43 of the efficiency audit report provides details of these cases. Their findings were not related to more general audits of domestic issues. As most of those audits were carried out in the Melbourne branch of the ATO, their remarks are particularly pertinent to that Office.
- 6.2 **ATO's New Audit Regime**
- 6.2.1 The Committee's review of the AAO's criticisms and the ATO's responses to those criticisms must be taken in the context of the comprehensive changes introduced by the ATO in its audit function. When the AAO conducted its efficiency audit, cases involving Division 13 determinations were dealt with by the International Operations Branch (IOB) of the ATO. As part of its audit reorganisation, the former International Operations Branch has been absorbed within the Complex Audit and International Branch. The Committee nevertheless wanted to satisfy itself that the perceived deficiencies identified by the AAO were being adequately addressed by the ATO under its new audit regime.
- 6.2.2 The Complex Audit and International Branch of the Audit Group in National Office is responsible at a national level for the new large case program and for international matters, including transfer pricing, international avoidance and prevention and competent authority matters under Australia's various double taxation treaties.

6.3 AAO's Suggested Priorities

6.3.1 Asked to indicate the priority of their concerns, the AAO officers indicated that the first priority would be action to correct the lack of quality control procedures for the conduct of ATO's audits. (pg. 75)

6.3.2 Beyond that, the evidence indicated that priority becomes much more subjective and there would be various factors affecting each of the AAO's concerns. For example, as against the criticism of 'excessive time to determine objectives', the ATO subsequently made considerable changes to its objection procedures and the review of its cases. The significantly reduced backlog of cases awaiting review is likely to have reduced the significance of that point.

6.4 Background to the IPS Cases

6.4.1 The ATO officers made the point that while there were criticisms in the efficiency audit report of ATO's past activities it was important to consider the context that was then prevailing. ATO's evidence was that these 13 cases related to audits undertaken in the late 1970's. In looking back at the then prevailing issues and the resources that the ATO had available to it, ATO officers said that the most significant issue facing the tax administration in Australia at that time was the explosion of mass marketed artificial tax avoidance schemes.

6.4.2 The Committee was told that 'the amount of revenue that was at stake at that time was enormous'. (pg. 9) Given the then existing structure of the ATO and the extent of

reliance upon assessment and audit activity, the ATO had to concentrate its resources in combating such schemes. That had a number of implications. The ATO had to make choices about deployment of its resources: that meant that other areas of the Office, including the analysis of international transactions, suffered.

6.4.3 Accordingly there were criticisms of delays, as evidenced in the audit report. A further possible factor was that while international transactions are a large issue at the moment, in the past they were considered by companies to be less important because of the availability of artificial tax avoidance schemes.

6.4.4 Notwithstanding the priorities at that time, the AAO's criticisms of the ATO's past management of its IPS cases appear to have been well based. However, the Committee is confident that the move to self-assessment in Australia since 1986, together with increased concentration on lifting the quality of its audits, should ensure the ATO will substantially improve its management of international profit shifting cases.

6.5 ATO's Corporate Plan

6.5.1 The Committee notes from the ATO's 1988-89 Corporate Plan that the purpose of the Taxpayer Audit Group is to promote voluntary compliance in the community through a program which is seen to detect and bring to account those who do not pay the correct amount of tax. The action strategy for the Complex Audit and International Branch in dealing with audit methodologies and packages is to review practices for major activities and codify 'agreed best practice' for the major high volume activities in each business area. In addition it will

develop and review manuals and packages for these areas and incorporate them into training. The application of preferred practice is expected to result in improved audit efficiency.

6.6 Views of Witnesses on ATO's IPS Case Management

6.6.1 A number of witnesses before the Committee also commented upon the AAO's identified areas of concern. In commenting upon the criticism that there was 'minimal use by the ATO of industry experts during investigations and negotiations' the Centre for International Economics (CIE) submitted that 'it would be tempting for potential industry experts in the private sector to endorse this approach' but that such employment would not provide an 'easy solution'. (pg. S75) The submission went on to state that the use of industry experts would be an unnecessarily expensive way of establishing that prices can indeed vary over a wide range. In evidence, the witness from the CIE stated that because transfer prices can vary, a cautious approach to using experts should be adopted. (pg. 271)

6.6.2 The ATO has agreed that industry experts should be used in appropriate cases and has stated that consultants were engaged in several cases. (Response to AAO's Recommendation 20) A related aspect raised by the Committee's was the use which the ATO could make of external specialist audit teams. With the changed emphasis to corporate audits and evidence that the frontiers of international profit shifting now involve tax effective financial arrangements and the use of intangibles, it is apparent that the ATO's auditors will encounter increasingly complex and novel international issues. Those officers may not have the skills and expertise, at least in the short term, to effectively deal with them.

6.6.3 To overcome this potential problem in auditing specialised areas, the ATO should have recourse to external audit teams with specialist knowledge in the particular area. Whereas the ATO auditor could undergo a training program of possibly some months duration in order to acquire the relevant technical expertise, the Committee sees merit in the ATO sub-contracting those technical and specialist audit areas to private sector accounting firms. Of course commercial secrecy and conflict of interest issues would need to be overcome. Nevertheless this approach should enable the ATO to bridge its knowledge gap and strike while the audit trail is still fresh. ATO officers could also acquire knowledge and expertise from working with the external auditor. Such an approach should also lessen the chances of the audit being delayed whilst technically complex issues are identified, examined and resolved.

6.6.4 In evidence, representatives of the Taxation Institute of Australia agreed that the concerns by the AAO have caused some problems within the accounting profession. The major problem arising was that with 'insufficient detail being recorded to explain significant reductions in determinations previously made', a precedent then exists. However other ATO officers cannot access it due to lack of documentation. That may prejudice other taxpayers in similar situations. It would not be equitable if a particular taxpayer were able to reach a settlement with Tax Office in one state on a particular matter and a taxpayer in a different state could not reach the same settlement on the same facts because of lack of documentation on the precedent. (pg. 134) The issue of an income tax ruling on the ATO's administration of Division 13 should help to overcome this type of problem. (As recommended at para 3.8.7 of this report).

6.6.5 The Committee recommends that the liaison between branch offices and National Office, particularly regarding interpretation of the law and factual precedents should also be strengthened. Whilst meetings of case managers and internal ATO newsletters go some way to redress this problem, the Committee sees a need for a more formal process of information dissemination to be undertaken. As part of the Complex Audit and International program, a register of completed and settled cases should be developed. Such a register could include details of the relevant facts, the appropriate law and the application of the law to those facts. Such a case register should be available on a national computerised basis to all branch offices and should be updated regularly. It should enable auditors to become aware of both difficulties which they might encounter in their own audits and of precedents already set by other branch offices. It could become a valuable training tool, a basis for ensuring consistent treatment of similar cases as well as provide precedent in novel or complex fact/law situations in order to assist field auditors.

6.6.6 With the establishment of the Complex Audit and International Branch, there has been a devolution of audit responsibility onto case managers. The ATO should ensure that its case managers undertake adequate strategic planning of their cases. Situations could arise where, with limited time available for the audit, case managers would prefer to deal with the more familiar audit items with which they feel comfortable, rather than tackling complex or novel areas. Without adequate strategic planning, the risk is that the large case program might not be as revenue productive as the Commissioner would wish.

6.6.7 A further matter raised was the disruption caused to auditee companies during the course of an ATO audit. Quite apart from the indirect costs associated with disrupted work flows, auditees may also bear direct costs of retaining professionals to assist the company comply with the audit. Such direct costs are not incurred in earning assessable income and are not tax deductible. As the revenue benefits from adjustments to an auditee's claim for deductions or income, likewise the revenue should share the burden of the costs directly incurred by an auditee in complying with an audit.

6.7 ATO's Auditing and Future Directions in Compliance

6.7.1 As part of its restructured audit activity, the ATO has identified four broad themes for its auditing and future direction in compliance activities. Those themes are:

- (1) promotion of voluntary compliance;
- (2) a shift in emphasis to larger cases;
- (3) continuing refinement of strategies for different sectors of the market; and
- (4) enhanced support for auditors in achieving their objective of a highly professional standard of audit.

Witnesses appearing before the Committee supported these broad themes. These themes should enhance the ATO's management of its audits in general and its

international profit shifting cases in particular and reduce the chances of the AAO's matters of concern being repeated in the future.

6.8 Conclusion

6.8.1 The ATO has recognised the specific deficiencies identified by the AAO in the administration of certain IPS cases. With the large scale restructuring of the audit group, combined with ATO initiatives in that area, the Committee is confident that the ATO's management of its international profit shifting cases, now within the Complex Audit and International Branch, will be substantially improved. However the Committee recommends that the ATO remain vigilant and keep abreast of current commercial developments and practices to ensure that its audits are effective in protecting the revenue.
(para 6.4)

6.8.2 The ATO's administrative measures to counter international profit shifting practices have improved and continue to improve. Taxation officers indicated that the specific deficiencies in cases identified by the AAO have been taken into account in the design of the large case program. To that extent, the ATO is confident that those deficiencies should not reoccur.
(para 6.4)

6.8.3 The Committee recommends that (15) the ATO should consider using external specialist audit teams drawn from the private sector to assist it in auditing areas of technical complexity where it does not have sufficient knowledge or expertise. (para 6.6.3)

6.8.4 The Committee recommends that (16) the Government should consider an amendment to the income tax law to allow as a deduction to the auditee company the costs directly incurred by it in relation to an ATO audit. (para 6.6.7)

6.8.5 The Committee recommends that (17) a formal register of completed and settled cases should be developed to provide precedents and ensure consistency of approach in the large case program. (para 6.6.5)

CHAPTER 7

TAX SCREENING ARRANGEMENTS

7.1 Introduction

7.1.1 The efficiency audit report notes that: 'there are recognised deficiencies of foreign exchange controls/tax screening arrangements' and 'the ATO is unable to monitor effectively the performance of foreign exchange dealers'. (para 7.7.1) The AAO goes on to make eight recommendations specifically directed at tax screening. During the conduct of the efficiency audit and in the course of the Committees hearings, it was revealed that the ATO was undertaking a major internal review of all operating procedures relevant to the tax screening arrangements. This review has not yet been finalised.

7.1.2 The Committee considered it important to review the perceived deficiencies identified by the AAO and to assess the ATO's proposed corrective actions. If, as a result of its review, the ATO decides to maintain its involvement with tax screening arrangements, then the evidence and views elicited by the Committee may provide a basis for the ATO to institute improvements.

7.1.3 The AAO's efficiency audit reviewed the operations of the tax screening arrangements as they currently exist. It did not however review the requirement for tax screening per se. As acknowledged in the response to the AAO by the Department of the Treasury, there is a more

fundamental question of whether tax screening arrangements are the appropriate way of preventing international tax avoidance and evasion. The Treasury's role is to establish foreign exchange control policy.

7.2 Background

7.2.1 Tax screening measures were first introduced in 1973 to combat tax avoidance by Australian residents seeking to use tax havens. The measures related to both in-flows and out-flows of funds to and from Australia. Exchange control restrictions were substantially lifted with the floating of the Australian dollar in December 1983. From that time tax screening reviewed only out-flows of funds overseas for certain categories of transactions.

7.2.2 Tax screening measures now in place have two elements. The first element requires foreign exchange ('forex') dealers to physically sight a tax clearance certificate ('TCC') before effecting certain transactions with listed tax haven countries. Emigrants wishing to transfer funds overseas also require a TCC. Where there are no perceived adverse consequences for the Australian revenue, a TCC would be issued by the ATO. The second element involves a post-transaction reporting system by which declarations are completed by the remitter of funds for certain transactions in excess of \$50,000. Declarations are referred by the forex dealers to the ATO.

7.2.3 TCCs are issued pursuant to the Taxation Administration Act 1953, under the control of the ATO. On the other hand, declarations are issued under the Banking (Foreign Exchange) Regulations which are administered by the Reserve Bank of Australia ('RBA'). The RBA also

administers the authorities which authorise foreign exchange dealers and the public to undertake foreign exchange transactions.

- 7.2.4 In recognising the ATO's internal review of tax screening arrangements, the AAO recommended that if it was intended that the RBA should not be involved in the administration of tax screening arrangements, consideration should be given to amendment of the Taxation Administration Act 1953 to provide the ATO with the responsibility and effective powers to police the tax screening requirements. (Recommendation 24) In response to the efficiency audit, the Treasury considered that the most practical solution to improve the operation of the tax screening arrangements would be to place them within the ambit of taxation legislation, rather than continuing the impediment of continued reliance for legislative backing on the Banking (Foreign Exchange) Regulations.
- 7.2.5 Prior to deregulation in 1984, the tax screening exchange control system meant that all transactions with tax havens specified in the Gazette, required the Reserve Bank to physically sight a tax clearance certificate from the Taxation Office before those transactions could proceed. In addition there was the provision by the Reserve Bank to the Tax Office of declarations by persons or companies dealing with tax havens listed in the Gazette. The second part of that relationship became the responsibility of authorised dealers after deregulation.

7.3 Evidence Received on Tax Screening

7.3.1 In its submission the Taxation Institute of Australia indicated that the deregulation of the Australian financial system over the past five years has seen the number of foreign exchange dealings rise significantly. The Reserve Bank of Australia it was said has not reacted well to this increase: the RBA does not have the resources to successfully carry out this task. The Institute submitted that the monitoring of foreign exchange dealings would be more successful under the aegis of the ATO. However the Institute recognised that this would put a strain on ATO's resources. The Institute further submitted that the current screening of foreign exchange dealings should be replaced by a notification system based on mandatory taxpayer compliance.

7.3.2 In evidence representatives of the Institute indicated that the current exchange control screening mechanism is totally inadequate and should be reviewed as a matter of urgency. They reiterated that the appropriate domain for that mechanism was with the ATO on the basis that they are involved in the prevention of tax evasion practices using foreign exchange transactions. To ensure that Australian residents were not disadvantaged in terms of international business, the Institute's representatives considered that it was preferable if the screening mechanism would be by way of post-transaction notification rather than prior approval in order avoid delays. (pg. 140)

7.3.3 In its submission, Arthur Andersen & Co suggested that restrictive banking controls in the finance industry, such as those imposed by the Reserve Bank, provide an

inducement to set up operations in tax havens. (pg. S14) Arthur Andersen's witness considered that delays in the tax screening processes operate as an irritant to business. He indicated that often the need to move funds is instantaneous and decisions have to be made quickly, particularly by corporate raiders or foreign exchange investors. (pg. 103) Delays within the ATO in issuing tax clearance certificates were seen as an example of frustration created by the bureaucracy. To overcome that problem it was suggested that the reporting function be changed to an after-the transaction event. The current measures require having a tax clearance certificate as a prerequisite to a person undertaking the transaction. On this basis it was suggested that the Tax Office could still deal with tax evasion issues whilst not frustrating business by delays in issuing certificates. (pg. 103)

7.3.4 The Arthur Andersen's representative did not advocate removal of the tax clearance certificate system. He preferred the mechanism of reporting after the event so that either through the banking system or by the reporting requirements by taxpayers, the ATO would be informed of funds transfers.

7.3.5 An area of concern noted by the Committee was the relative ease with which the tax clearance certificate system can be circumvented. It was stated in evidence that if persons wanted to shift a large amount of funds to a tax haven, they would not transact directly with that tax haven. Rather, they would go a country where there are no TCC requirements, move funds there, and subsequently from that country to the tax haven. By

using such conduit countries, the realities are that the tax screening arrangements were not achieving their objectives. It was said that they are:

'causing obstacles for the honest person and ... being completely ignored by the dishonest.'
(pg. 106)

7.3.6 The Australian Bankers Association claimed in its submission that:

'the complexity of modern financial transactions and market practices has left taxation legislation outmoded in some instances'. (pg. S36)

Reference was made to the changes in the operation of foreign exchange markets in Australia which, in the ABA's view:

'make adherence to the guidelines virtually impossible if the market is to operate in an efficient and orderly manner'. (pg. S42)

The example was given of dealers in the professional market executing foreign exchange transactions, with the Association indicating that the requirement for prior inquiry as to the purpose of the funds not being 'realistic in the current foreign exchange market'. (pg. S43) The ABA notes that there is not exemption from the tax screening requirements where one authorised dealer undertakes a foreign exchange transaction with another authorised dealer. A major proportion of foreign exchange transactions are not trade or transaction related but, according to the ABA, are dealings in the professional market between dealers, dealers and their corporate clients or dealers dealing on their own

account. Due to the nature of these transactions and the basis on which they are conducted, tax screening is in the ABA's opinion, 'not applicable and physically impossible to achieve without a significant change in the market'. (pg. S43)

- 7.3.7 The ABA submitted that trade related transactions were being effectively screened and accordingly only minor changes were considered necessary. These were:
- . to clarify the time of transaction as being a time prior to the dispatch of payment instructions; and
 - . to make the client responsible for declaring whether the transaction is subject to tax screening. For those transactions where the customer declares in the affirmative, dealers would undertake to sight the certificate or obtain a declaration. (pg. S43)
- 7.3.8 The ABA indicated that it and the Australian Merchant Bankers Association ('AMBA') had also lodged submissions with the ATO concerning these matters.
- 7.3.9 In evidence the ABA representative indicated that the view of the Association is that tax screening works reasonably well for trade related transactions but for financial transactions, particularly screen trading, it is fairly ineffective. (pg. 172) It would be quite impractical in terms of the volume of the short term money markets and foreign exchange markets to monitor each transaction.
- 7.3.10 The ANZ Banking Group representative also stated that given modern electronic banking practices and

techniques, the provisions of the Taxation Act and tax administration cannot accommodate the very large amount of foreign exchange dealings which are transacted by use of dealers' screens. (pg. 188)

7.4 The Position of the Reserve Bank of Australia

7.4.1 The efficiency audit report states that the Reserve Bank of Australia ('RBA') and the ATO each have an important role to play in the implementation of foreign exchange controls.

7.4.2 However, in its submission, the RBA stated:

'... the Bank does not see a role for itself in the administration of tax screening arrangements. We have always found something of a dilemma in using the Banking (Foreign Exchange) Regulations for tax purposes; this has been particularly so since suspension of most aspects of exchange control'.
(pg. S78)

This was also noted in the audit report: 'the RBA has relinquished any effective role in the administration of foreign exchange controls as they relate to tax screening arrangements'. (para 7.2.3 (1)) In evidence the RBA representatives indicated that they saw the Bank as having an important role in administering the foreign exchange regulations, but that taxation matters played a subsidiary role. The Bank's preferred position is that administration of tax screening should be the sole responsibility of the ATO as the only efficient method of administration. (pg. 317) The RBA officers also indicated identified that a danger arose for the RBA being involved in tax administration if people in the market place 'think that you are at least partly the

tax man, it will mean it will be much harder to get market information - to get the information that we need to operate effectively in the foreign exchange market.' (pg. 318) Such information was said by the Bank to be essential to it to carrying out its prudential functions and supervisory responsibilities as a central bank.

7.4.3 One of the tax screening problems identified by the AAO was that breaches of the Banking Act were not brought to the attention of the Reserve Bank via Treasury due to the secrecy provisions of Section 16 of the taxation legislation. Up to 1985, the Commissioner published in his Annual Report the names of taxpayers who had been found guilty of breaches of the law. Rather than an amendment to Section 16, the RBA officers indicated that their preference was for the matter to be dealt with solely under taxation legislation, without reference to the RBA. They indicated that they had no expertise in taxation matters and whilst the Bank would be happy to provide expertise on foreign exchange transaction, breaches by authorised dealers should be dealt with by the ATO. (pg. 324)

7.4.4 In its submission to the Committee the Reserve Bank made a number of points concerning tax screening:

- . the Bank does not see a role for itself in the administration of tax screening arrangements;
- . the Bank does not have administration of tax matters as part of its legislative responsibilities nor does it have expertise in the area;

- . the Bank's strong view is that the tax authorities should have adequate entree to overseas transactions and that this should be based on appropriate tax legislation;
- . the Bank believes there is little mileage in renovations to the present tax screening system; and
- . adjusting the secrecy provisions of the taxation laws to enable the ATO to advise the Bank of irregularities committed by authorised foreign exchange dealers is, in the Bank's view, inferior to the alternative of legislation to put the matter clearly in the hands of the tax authorities.

7.5 Declaration Forms

- 7.5.1 The efficiency audit report noted that a signed declaration form issued pursuant to the Banking (Foreign Exchange) Regulations was required for certain remittances offshore which are in excess of \$50,000. The Audit Office also identified examples of funds transfer splitting which entailed transfers of two separate amounts of \$49,000 overseas without a declaration form, when an amount of \$50,000 or more would have required that form. Declaration forms are referred to the ATO by authorised forex dealers. No declaration forms are lodged with the Reserve Bank. This is another anomaly in that a document that is prescribed by the banking regulations is neither lodged with nor used by the RBA.
- 7.5.2 The ATO officers advised that they had outlined to the Reserve Bank in general terms that they believed the secrecy provisions of the income tax law prevented them

from advising the Bank on specific breaches of the provisions in the Bank's regulations and which were detected through ATO's activities. The ATO advised the Department of the Treasury in similar terms. The ATO has also had discussions with the Australian Bankers' Association, the Australian Merchant Bankers' Association, the Australian Customs Service and the Director of Public Prosecutions. The ATO officers said that the tax screening options paper will take the views of such organisations into account.

7.6 Checking of Documents

7.6.1 The AAO was critical that there was insufficient checking of the documents and little use made of the information which they contained. In particular 'little, if any, use was made of information held in the exchange control sections (within International Units) by the withholding tax section'. (para 7.4.3) Even if information was provided to the withholding tax section, the AAO considered that there would be little if any chance of any concerted follow-up action.

7.6.2 In response, ATO representatives indicated that they recognised the need to pay more attention to the development of a national withholding tax audit program. They added that, given scarce resources, other aspects or areas of the ATO would suffer if resources were diverted to withholding tax areas. They also referred to the effect which the recently introduced imputation legislation would have upon withholding tax.

7.6.3 Since the efficiency audit was finalised, the ATO has taken steps to make more use of the information

contained on the declaration forms. Since late 1987 the ATO has used declaration forms as one input medium to its Taxpayer Information Profile (TIP) System. The declaration information, along with intelligence information, building application information obtained from local councils, Maritime Service Board information on luxury boat registration etc is now fed into the TIP System and is used as a case selection and targeting tool by auditors.

7.6.4 However, the position concerning the use of information contained in tax clearance certificates does not appear to have changed since the efficiency audit report. Whilst there is scope to use the TCCs as case selection tool on a ad hoc basis, they are not automatically referred to auditors. There are plans to later introduce the information contained on the TCC's into the TIP System. However the question of allocating resources to undertake that work remains a problem for the ATO.

7.6.5 An additional factor hindering the use of the declarations and TCCs is that neither document contains a tax file number or other identifying number. This makes the forms labour intensive for matching purposes and not immediately suitable for computer matching.

7.7 Licencing of Foreign Exchange Dealers

7.7.1 After 1 January 1985 the Reserve Bank relinquished effective control in the administration of foreign exchange controls as it relates to tax screening. However the Bank retained responsibility for granting licences to authorised foreign exchange dealers.

7.7.2 The Bank's officers advised that in 1984, when the Treasurer invited finance institutions to apply to deal in foreign currency, there were two minimum criteria specified: \$10m in capital and a demonstrated capacity and expertise to deal in foreign currencies. Institutions apply to the Reserve Bank for authorisation. They seek to demonstrate that they are institutions of substance and that they can offer a service transacting in foreign currency in Australia. If the Bank is satisfied an authority will be issued under the Banking (Foreign Exchange) Regulations for the institution to deal in foreign exchange. That authority has four conditions:

- . the institution shall maintain capital of \$10m at all times;
- . the institution shall meet a limit on the foreign currency risks which it carries at the end of the day;
- . the institution shall provide the RBA with regular statistical information; and
- . the institution shall co-operate with the Government in tax screening arrangements.

The RBA officers advised that their responsibility was to maintain prudential supervision on the operations of those institutions. (pg. 318)

7.7.3 Where a dealer fails to meet the conditions of the authority the Bank endeavours to ensure that corrective action is taken. If a dealer was in a position that a

condition was at risk the Bank advised that the penalties provided in the regulations could be brought into effect: as a last resort the Bank could either revoke or vary the authority.

- 7.7.4 However the Bank's officers advised that in the last five years no dealers have lost their licences for failing to meet the criteria set out in a licence. Licences have been revoked on other grounds, however, such as in the case of amalgamations and departures from Australia. (pg. 312)
- 7.7.5 As regards the condition concerning co-operation being provided in the tax screening process, the Bank's officers advised that the licenced dealers provide information direct to the Taxation Office under the present arrangements. Hence, the Bank is not aware of irregularities unless it is advised by the ATO. The secrecy provisions of the taxation legislation preclude such liaison.
- 7.7.6 The anomaly perceived by Committee was that on the one hand a condition for a licenced foreign exchange dealer related to co-operation in tax screening. However, the Bank is unaware whether any breaches have occurred in those tax screening arrangements because the secrecy provisions prevent the ATO bringing breaches to the attention of the Bank. The question put was how can the Bank justify maintaining such a condition in the licencing of foreign exchange dealers when the Bank had indicated that it did not want to be involved in tax screening any longer. The Bank's representatives responded that the tax screening arrangements have been a growing feature over the years. As a matter of administrative convenience foreign exchange transactions

were dealt with by the Reserve Bank. The Bank's officers indicated that having tax arrangements under the regulations was not their preferred way of dealing with the matter. However there was now no administrative convenience remaining in the arrangement.

7.7.7 The officers also indicated that they thought it was important that the tax authorities should continue to have adequate entree to overseas transactions. They indicated that the authorised dealers are the main source of information and that the Tax Office could seek from them particulars concerning transactions.

7.8 Conclusion

7.8.1 The Committee recognises that tax screening plays an important part in the fight against IPS practices. (para 7.2)

7.8.2 The Committee recommends that (18) there should be legislative amendment to bring responsibility for tax screening under the ATO's aegis. (para 7.4.4)

7.8.3 The Banking (Foreign Exchange) Regulations are an inadequate and inappropriate basis for tax screening. (para 7.4.2)

7.8.4 The Committee recommends that (19) the Reserve Bank no longer be involved in tax screening. (paa 7.4.4)

7.8.5 If tax screening is to be retained at all, then the Government should consider correcting a deficiency on both the tax clearance certificates and declaration forms to make them more useful: the deficiency is that there does not appear to be any sort of identification required when transferring funds overseas. (pg. 330) The Committee therefore recommends that (20) both those documents should contain the remitter's tax file number. (para 7.6.5)

CHAPTER 8

NOT THE FINAL WORD

8.1 Not the Final Word

- 8.1.1 In presenting this interim report, the Committee wishes to draw to the attention of the Parliament the lack of response by the private sector to the AAO's efficiency audit report. The findings of the audit report are a cause for concern. The interim report deals with subject matter upon which the evidence is reasonably complete.
- 8.1.2 The Committee has reached a number of conclusions and made recommendations which should lead to improvements in the taxation system. In particular it deals with the resources and professionalism of the ATO.
- 8.1.3 However, the Committee considers that the efficiency and certainty of the taxation system and the law on which it is based can be improved. It has been suggested, in the area of taxation the subject of the inquiry, that too often it is taxation by negotiation rather than taxation by the application of a law which is clear to taxpayer and tax collector alike.
- 8.1.4 The Committee perceives that there is a fear in the community, particularly in the business community, that taxation is sometimes levied by administrative discretion.

8.1.5 Where the law lacks clarity and certainty it is incumbent upon the Commissioner to suggest appropriate amendments to the law to overcome legislative inadequacies, rather than seeking to resolve them by administrative means.

8.1.6 There are a number of other issues which the subcommittee proposes to deal with in the final report which should be tabled early in the autumn session of next year. Those matters include an analysis of the responses concerning specific industries, particularly the oil and banking industries, and recommendations to overcome the loss to Australian revenue as a result of tax havens.

8.1.7 The determination of arm's length prices is another matter which will receive consideration as will other measures to counter international profit shifting activities. A more positive response from the private sector on these matters and on changes necessary in the taxation administration of the nation would be most welcome.



STEPHEN MARTIN, MP
CHAIRMAN

*Appendix I***List of Submissions**

Submission No.	Organisation/Date	Page No.
1	Australian Audit Office, dated 23 December 1987	S2
2	Australia-Papua New Guinea Business Co-operation Committee, dated 19 February 1988	S4
3	Australian Society of Accountants, dated 18 February 1988	S6
4	Arthur Andersen & Co., dated 23 February 1988	S8
5	Australian Taxation Office, dated 19 February 1988	S27
6	Australia and New Zealand Banking Group Limited, dated 29 February 1988	S30
7	Australian Bankers Association, dated 14 March 1988	S36
8	Australian Taxation Office, dated 7 March 1988	S48
9	Australian Petroleum Exploration Association Limited, dated 22 April 1988	S52
10	The Taxation Institute of Australia, dated 27 April 1988	S54
11	Centre for International Economics, dated 30 April 1988	S66
12	Reserve Bank of Australia, dated 17 May 1988	S78
13	Confederation of Australian Industry, dated 16 November 1988	S83

Appendix II

List of Witnesses

Witness	Date(s) of Appearance before Committee at Public Hearings
Mr Michael Joseph CARMODY, Second Commissioner of Taxation, Australian Taxation Office, Canberra, Australian Capital Territory	25.2.1988 15.8.1988
Mr John Joseph CROTTY, Senior Assistant Deputy Commissioner, Australian Taxation Office, 350 Collins Street, Melbourne, Victoria	25.2.1988 15.8.1988
Mr Michael D'Ascenzo, Assistant Commissioner, International Operations, Australian Taxation Office, Canberra, Australian Capital Territory	25.2.1988 15.8.1988
Mr Andrew William Winch GODFREY, Chief of Audit Group, Australian Taxation Office, Canberra, Australian Capital Territory	25.2.1988
Mr David John GRECIAN, Executive Officer, International Operations, Australian Taxation Office, Canberra, Australian Capital Territory	25.2.1988 15.8.1988
Mr John Arthur BOWDEN, Assistant Auditor-General, Australian Audit Office, Canberra, Australian Capital Territory	17.3.1988 15.8.1988
Mr Gregory Malcolm WILLIAMS, Acting First Assistant Auditor-General, Australian Audit Office, Canberra, Australian Capital Territory	17.3.1988 15.8.1988

Mr Grantley Giles ABBOTT, Research Officer, Taxation Institute of Australia, 64 Castlereagh Street, Sydney, New South Wales	4.5.1988
Mr Peter Heins GUTWEIN, Tax Partner, Arthur Andersen & Co., 141 Walker Street, North Sydney, New South Wales	4.5.1988
Mr Michael WACHTEL, Member of Technical and Legislation Committee, Taxation Institute of Australia, 64 Castlereagh Street, Sydney, New South Wales	4.5.1988
Mr Alan Charles CULLEN, Executive Director, Australian Bankers Association, 55 Collins Street, Melbourne, Victoria	5.5.1988
Ms Melda Kay DONNELLY, Group Controller - Taxation, ANZ Banking Group Ltd, 55 Collins Street, Melbourne, Victoria	5.5.1988
Mr Eric Richard RISSTROM, National Director, Australian Taxpayers Association, 343 Little Collins Street, Melbourne, Victoria	5.5.1988
Mr Peter Scott ROBINSON, Representative, Australia-Papua New Guinea Business Co-operation Committee, Industry House, Queen Victoria Terrace, Canberra, Australian Capital Territory	5.5.1988
Mr Donald Clayton VERNON, Patron and Executive Member, Australia-Papua New Guinea Business Co-operation Committee, Industry House, Queen Victoria Terrace, Canberra, Australian Capital Territory	5.5.1988

Mr Trevor Percy Winston BOUCHER,
Commissioner of Taxation,
Australian Taxation Office,
2 Constitution Avenue,
Canberra, Australian Capital Territory 16.8.1988

Mr Andrew Gordon CUTHBERTSON,
Managing Director,
Centre for International Economics
PO Box 2203,
Canberra, Australian Capital Territory 16.8.1988

Mr Daryl Albert DIXON,
Freelance Writer and Consultant,
PO Box 42,
Charnwood, Australian Capital Territory 16.8.1988

Dr John Francis LAKER,
Deputy Chief Manager,
International Department,
Reserve Bank of Australia,
65 Martin Place,
Sydney, New South Wales 16.8.1988

Mr James Stuart MALLYON,
Chief Administration Officer,
Reserve Bank of Australia,
65 Martin Place,
Sydney, New South Wales 16.8.1988

Mr William Edwin NORTON,
Head,
Financial Markets Group,
Reserve Bank of Australia
65 Martin Place,
Sydney, New South Wales 16.8.1988

IRS Code Section 982

United States of America - Internal Revenue Code 1954
 Subtitle A, Ch. IN, Part IVA

SEC. 982 ADMISSIBILITY OF DOCUMENTATION MAINTAINED IN FOREIGN COUNTRIES

(a) **GENERAL RULE** - If the taxpayer fails to substantially comply with any formal document request arising out of the examination of the tax treatment of any item (hereinafter in this section referred to as the 'examined item') before the 90th day after the date of the mailing of such request on motion by the Secretary, any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue shall prohibit the introduction by the taxpayer of any foreign-based documentation covered by such request.

(b) **REASONABLE CAUSE EXCEPTION** -

(1) **In General.** -Subsection (a) shall not apply with respect to any documentation if the taxpayer establishes that the failure to provide the documentation as requested by the Secretary is due to reasonable cause.

(2) **Foreign Nondisclosure Law Not Reasonable Cause.** -For purposes of paragraph (1), the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the requested documentation is not reasonable cause.

(c) **FORMAL DOCUMENT REQUEST** - For purposes of this section-

(1) **Formal Document Request.** -The term 'formal document request' means any request (made after the normal request procedures have failed to produce the requested documentation) for the production of foreign-based documentation which is mailed by registered or certified mail to the taxpayer at his last known address and which sets forth-

- (A) the time and place for the production of the documentation,
- (B) a statement of the reason the documentation previously produced (if any) is not sufficient,

- (C) a description of the documentation being sought, and
- (D) the consequences to the taxpayer of the failure to produce the documentation described in subparagraph (C).

(2) Proceeding to Quash. -

(A) IN GENERAL. -Notwithstanding any other law or rule of law, any person to whom a formal document request is mailed shall have the right to being a proceeding to quash such request not later than the 90th day after the day such request was mailed. In any such proceeding, the Secretary may seek to compel compliance with such request.

(B) JURISDICTION. -The United States district court for the district in which the person (to whom the formal document request is mailed) resides or is found shall have jurisdiction to hear any proceeding brought under subparagraph (A). An order denying the petition shall be deemed a final order which may be appealed.

(C) SUSPENSION OF 90-DAY PERIOD. -The running of the 90-day period referred to in subsection (a) shall be suspended during any period during which a proceeding brought under subparagraph (A) is pending.

(d) DEFINITIONS AND SPECIAL RULES. -For purposes of this Section-

(1) Foreign Based Documentation. -The term 'foreign-based documentation' means any documentation which is outside the United States and which may be relevant or material to the tax treatment of the examined item.

(2) Documentation. -The term 'documentation' includes books and records.

(3) Authority to Extend 90-Day Period. -The Secretary, and any court having jurisdiction over a proceeding under subsection (c)(2), may extend the 90-day period referred to in subsection (a).

(e) SUSPENSION OF STATUTE OF LIMITATIONS. -If any person takes any action as provided in subsection (c)(2), the running of any period of limitations under section 6501 (relating to the assessment and collection of tax) or under section 6531 (relating to criminal prosecutions) with respect to such person shall be suspended for the period during which the proceeding under such subsection, and appeals therein, are pending.