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Creating the right environment: transparency, cooperation and certainty in tax

(check against delivery)

Speech by Michael D'Ascenzo, Commissioner of Taxation
Financial Executives International of Australia
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The mission statement for the Treasury portfolio is about contributing to the economic and social well being of Australia.

While the Tax Office is an independent statutory agency within that portfolio, we have taken that mission as applicable to us.

So it is that we recently changed our Strategic Statement from 'optimising collections' to 'optimising voluntary compliance' with the range of laws we administer. These include important aspects of Australia's superannuation as well as revenue legislation.

The context of revenue legislation includes both obligations and rights. The tax laws serve a variety of social and economic policies, as well as funding public goods and services.

In relation to revenue collections, the contribution of the 'top end of town' is substantial.

Total large market revenue collections have increased from \$61.5 billion in 2003-04 to \$75.1 billion in 2005-06. The top 100 corporate enterprises contributed 67% of company tax collections.

These figures highlight the role of Australia's large corporates as major contributors to our society.¹ They reflect the hard work, investment, enterprise, and competitiveness of business, both in domestic and global terms.

This revenue provides essential services, infrastructure, a skilled workforce, our court system and the rule of law, the protection of property, copyright, trade and other agreements that connect Australia to the global marketplace and the broader economic framework, all of which allow corporates to be successful.

Notwithstanding the high level of voluntary compliance overall, there are significant risks that we are reviewing. The challenge now for large business and the Tax Office is to create certainty through transparency and cooperation.

Governance

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

Good governance helps an organisation get to or stay at the base of the compliance pyramid, and also helps them avoid or mitigate material risks including material tax risks.

¹ See also Business Council of Australia, Tax Nation: Business Taxes and the Federal-State Divide, April 2007

Promoting good governance therefore is an important building block in our compliance strategy for large business.

As chief financial officers, you, probably more than anyone in your organisation understand that material risks, including major tax risks can have a wide-ranging impact on a corporation, including in extreme instances, failure.

Conversely, well considered corporate governance makes your business more efficient and gives investors more confidence in your company.

Most large businesses have appropriate corporate governance processes in place. These processes ensure that there is appropriate oversight of systems to provide the correct level of integrity and risk assurance relative to the importance of the tax issues involved.

What are our expectations? Early in 2007 acting on recommendations from the Large Business Symposium², I issued a guide to CEOs and company boards recommending that:

- there is a sound framework in place for managing tax issues and complying with tax obligations
- there is a well resourced, skilled and experienced in-house capability in place to support the management of tax issues
- appropriate reporting systems are in place so that significant tax risks are escalated to the board or decision makers in a timely fashion
- the appropriate review and sign-off for material transactions are in place and that tax impacts are considered as part of this process
- the company has a clearly articulated approach to managing tax risk (for example, seeking rulings in relation to complex and novel transactions), and
- that these systems and processes are audited regularly to ensure that they are operating effectively.

We are seeing large companies run the ruler over their current governance processes to satisfy themselves that they have sufficient protection from major tax risks. For example, an Ernst & Young Survey³ of 14 major countries said that Australian companies reported the most well-established communication between the tax department and the boards of companies, compared to global and USA responses (77%, 70% and 62%, respectively).

We are also seeing an increase in private binding ruling requests by around 14% from large companies, as well as a heightened interest in Advanced Pricing Agreements, Forward Compliance Arrangements and in other ways to provide more certainty for business.

Consultation

² Held in Sydney on 30 August 2006. For a synopsis refer to our media release 'Large business and the Tax Office working together'

³ Tax Risk: External Change, Internal Challenge – The Australian Perspective, Global Tax Risk Survey 2006-2007

We are committed to supporting large business, and believe that this can best be achieved by developing close and constructive relationships.

The outcomes of last year's Large Business Symposium have increased my optimism about our relationship with large business. Discussion at the symposium was very constructive and has continued in that vein.

At the same time, we are very aware of the continuing need for improvement.

Consultation between the Tax Office and large business takes place via a number of forums. Major conduits are the regular meetings of the National Tax Liaison Group and the Corporate Consultative Committee and their subcommittees.

We have special liaison arrangements with the Australian Bankers' Association, the International Banking and Securities Association, the Investment and Financial Services Association and the Insurance Council of Australia.

The Tax Office supplements these consultations with senior executives and technical leaders with surveys and our Client Feedback Questionnaires to track perceptions and experiences of a broader range of corporates.

We undertake specific consultations with particular sectors and large-business representative organisations including the Corporate Tax Association. Other consultations with corporates include our program of visits to the top 100 companies each year.

The difficulty lies in effectively communicating the outcomes of these meetings which would go a long way to dispelling a range of misunderstandings and myths.

Similarly all this consultation, collaboration and co-design should nurture greater trust. But there's still a way to go. One blocker is a misunderstanding of roles. Business often confuses the ATO's role as the 'administrator' with the government's role as 'policy maker', and Parliament's role as 'law maker'. So where a policy is disliked or the law produces unintended consequences- for example double taxation and resentment is (somewhat unfairly) directed at the Tax Office.

Perhaps one of our roles is to bear the brunt of that, even though this may ignore what may be going on behind the scenes. For example, the Tax Office may have been advising Treasury and/or Government of these views and outcomes, giving Government the opportunity to consider a legislative fix.

Implementing improvements after the Burges Review

Implementing the improvement measures stemming from a review of interactions between the Tax office and some of our largest corporate groups, the 2005 Burges Report has been a major focus for us over the last two years.

The improvements underway include process improvements aimed at providing greater clarity to our risk review and audit processes, better engagement between large business and the Tax Office, and enhancing our understanding of large business.

What have we delivered?

Better engagement between large business and the Tax Office

We launched the *Large business and tax compliance* booklet at the large market symposium in 2006⁴. Both the booklet and the symposium were clear and practical examples of our commitment to consultation, collaboration and co-design. The governance guide which I issued in January this year was a direct result of feedback provided at the symposium.⁵ The Tax Office is continuing to work with the Corporate Tax Association on issues raised at the symposium – such as on how to more clearly articulate our policy on the use of formal powers for information gathering.

I have already talked about our consultative processes which is improving our dialogue with the large business segment. We are now in the second round of our visits program with the top 100 corporate taxpayers.

The focus for the visits includes our view of the company's risk profile, emerging trends and issues, corporate governance, the overall revenue (economic and tax) performance of the company, and feedback to us on our interactions and any engagement we have had over the past 12 months. This feedback is essential in improving our relationship with large business.

Improving our processes

One of the main issues raised with Burges Review was that the Tax Office was seen by some as disengaged from the corporate group when undertaking a risk review or an audit or providing a ruling. We have put in place a requirement for the case leader to hold regular discussion with the group about plans for the risk review or audit, and to explain our information needs.

We are holding workshops, early in the process, with technical specialists to ensure that the issues we are identifying are critical. We are also clarifying what extra information we may require from the taxpayer for the right conclusions at law to be reached about risk or liabilities.

The Tax Office now provides the opportunity for the large business taxpayer concerned to comment on the conclusions of a risk review before they are finalised. This is followed up by a discussion on the implications of outcomes for example, whether or not we will be proceeding to audit.

The process improvements are also aimed at ensuring audits are concluded in an appropriate timeframe. We have therefore introduced a general policy

⁴ *Large business and tax compliance*, http://www.ato.gov.au/content/downloads/77898_N8675-08-2006_w.pdf

⁵ *Large business and tax compliance 2006: governance guide for boards and directors*, <http://www.ato.gov.au/large/content.asp?doc=/content/82560.htm>

on the remission (back to the base rate) of the General Interest Charge for audits which exceed two years.⁶

Given the complexity inherent in business dealings, it is essential that corporates know how to access the Tax Office's view of the law. Drawing on what we have learnt from the priority ruling program and other initiatives aimed at improving our overall capabilities, we have made considerable progress in improving cycle times for private binding rulings⁷ over the past eighteen months.

The earlier the engagement with us, the more fulsome the supply of relevant information, and the fewer the material changes to a proposal, the sooner we can provide you with the high level of certainty you require of us.

We are using your feedback from our Client Feedback Questionnaires as well as findings from the regular case callover processes in monitoring the performance of our staff in delivering these improvements.

Enhancing our understanding of large business

We are engaging external experts in complex areas such as market valuations work, transfer pricing cases and corporate financing issues. This is expanding our understanding of business practices and corporate strategies drivers. We are also conducting workshops to enhance the technical capability of staff engaged in active compliance work.

This complements our use of external counsel on disputes and the increasing number of senior tax officers recruited from the private sector.

Toward real time compliance and certainty for large business

In the fair administration and effective management of the tax system, it is essential that we make the tax system as easy as possible to deal with by reducing uncertainty and minimising compliance costs.

Last year, we signed two forward compliance arrangements (FCAs) with the ANZ⁸ and BP⁹. They promote governance arrangements that reduce the company's risk of audits, tax litigation, penalties and interest, and also streamline access to support and advice.¹⁰

We are working with the Corporate Tax Association to develop less rigorous approaches that provide more graduated levels of certainty for large business – options that are matched to your appetite for risk.

⁶ Our practice statement ([LAPS 2006/8](#)) on the remission of Shortfall Interest Charge and General Interest Charge provides our staff with guidance on applying them. [insert link to practice statement]

⁷ We have reduced the average time it takes us to provide written advice from five months (at end June 2005) down to three months.

⁸ On GST

⁹ On GST and Excise

¹⁰ FCAs are designed to reduce uncertainty and compliance costs. However, they are a premium product, requiring high standards of self examination and continuous disclosure and will not be suitable for everyone

These might include proposals based on full and true disclosure of the elements of a proposed transaction, or they could be based on disclosure of any reasonably arguable or contentious position adopted by the company. In these cases the discussions could protect the company from culpability penalty. This is at an early stage of development and if any of your companies are interested in participating, we would be happy to work with you on a pilot basis.

We are seeking outcomes that will provide you with certainty, trust and ultimately less compliance cost. These initiatives will complement Australia's system of binding and reviewable private rulings. We are also looking at models based around more current or real-time risk reviews. This supports a theme of supporting business rather than being a blocker to economic growth.

International cooperation

With the growth in globalisation, compliance issues are increasingly associated with that international market.

When 35 tax commissioners met at the OECD's Forum on Tax Administration in Seoul in September 2006, the main focus was on how to improve international tax compliance. The final communiqué stated that:

Our discussions in Seoul confirmed that international non-compliance is a significant and growing problem. Cross-border non-compliance can take many forms, up to and including outright tax fraud. Individuals have, for example, used offshore accounts, offshore trusts or shell companies in offshore financial centers or other countries to conceal taxable assets or income, as well as credit cards held in offshore jurisdictions to provide access to concealed assets; businesses of all sizes have created shell companies offshore to shift profits abroad often taking recourse to over or undervaluation of traded goods and services for related party transactions and some multinational enterprises (including financial institutions) have used more sophisticated cross-border schemes and/or investment structures involving misuse of tax treaties, the manipulation of transfer pricing to artificially shift income into low tax jurisdictions and expenses into high tax jurisdictions which go beyond legitimate tax minimization arrangements.¹¹

Australia has developed strong global tax information sharing through international tax forums and bilateral agreements. This has resulted in productive and positive discussions that have helped resolve corporation-specific bilateral or multilateral tax issues. For example, through the mutual assistance provisions of our tax treaties, we have been able to avoid double taxation for some Australian enterprises.

JITSIC and other forums

International cooperation is also critical to countering abusive attempts to obfuscate tax obligations. In this time which has been called 'banking without borders', offshore tax evasion is more pernicious than just the lost revenue of

¹¹ Final Seoul Declaration, Third Meeting of the OECD Forum on Tax Administration, 14-15 September 2006

the tax evaded¹². This tax evasion alters the public's perceived fairness of the integrity of the tax system, and as we know public confidence in the fairness of the tax system is an essential part of maintaining a healthy "voluntary" tax system.

Exchanging information in real-time is making a big difference to the complex task of tracking tax avoidance and abusive cross-border transactions.

The Joint International Tax Shelter Information Centre (JITSIC) was established in 2004 by the tax administrations of Australia, Canada, the United Kingdom and the United States, to supplement their continuing work in identifying and curbing abusive tax avoidance transactions.

Australian, Canadian, UK and US tax administrations will open a second JITSIC office in London UK, in Spring 2007. Japan has also accepted an invitation to join JITSIC, and a representative of their National Tax Agency will join the London office.

JITSIC members have identified and challenged highly artificial arrangements including:

- a scheme marketed cross-border, involving hundreds of taxpayers and tens of millions of dollars in improper deductions and unreported income from retirement account withdrawals
- financial institutions creating financing structures selling the benefit of foreign tax credits separate from the economic benefit of the underlying income, and
- brokers providing made to order losses on futures and options transactions for individuals in other JITSIC jurisdictions, leading to a tax loss of over one hundred million dollars.

There are also plans for the future development of JITSIC, along with measured expansion to cover Asia in addition to North America and Europe.

Mergers, acquisitions and divestments

Many of the corporate tax issues that are of concern to tax administrations relate to the global growth in mergers and acquisitions. Record Australian activity is reflected in the latest direct investment statistics and has attracted our attention.

In the nine months to September 2006, foreign direct investment inflow to Australia totalled \$29.7 billion – the biggest nine-month inflow in our history. In the same nine months Australian businesses invested \$29.8 billion abroad.

12 Without vigorous and coordinated action by governments to ensure that the right legislative framework is in place, that tax administrations have the necessary information, tools and resources to address the problem, and without greater bilateral and multilateral co-operation, offshore tax evasion will continue to grow and undermine the integrity of national tax systems.

No one country by itself can meet this challenge. The next year will be crucial to see how far offshore centres are prepared to move away from financial services based on concealment to legitimate financial services (Jeffrey Owens, 3 May 2007, US Senate Finance Committee on Offshore Tax Evasion)

The flows for this period continued a trend increasingly apparent over the last decade.

Overall announced merger and acquisition activity in Australia in 2006 showed a 56.4% upsurge from US\$104.8 billion worth of transactions in 2005 to US\$163.9 billion in 2006. The total number of deals increased by 12.1% from 2371 in 2005 to 2657 in 2006.¹³ The dollar value and volume of deals is significant.

As tax administrators, we need ongoing assurance that the tax outcomes of these significant deals are appropriate. We are increasingly working with business to understand the structuring of the deals and the tax consequences at the point of divestment and at the point where new tax entities are formed.

We also seek to understand the role played by investment banks and other advisors in developing and implementing the tax structuring, calculations and tax assumptions underpinning these deals.

As part of our review of the tax risks, we check that capital gains tax outcomes on divestment are appropriate and reflect the economic gains made.

Second, post-acquisition, we ensure there is compliance with our thin capitalisation rules so that interest deduction claims comply with those rules. Another focus is ensuring that increased capital allowance deductions due to the increased tax value of assets on acquisition, are not excessive.

We check whether the use of carry forward losses comply with the loss rules. We also seek to ensure that the payment of new international related party fees are not excessive and appropriately characterised for tax purposes and are in line with the OECD's arm's length principle, and where hybrid securities are issued, and the distinction between debt and equity becomes less clear, that the tax treatment of those securities is appropriate.

The Tax Office has established a project to identify high-risk hybrid financing arrangements, in particular the potential for:

- corporate financing instruments to be misclassified as debt rather than equity
- circumvention of debt/equity provisions by the use of unit trusts, and
- tax planning involving stapled instruments, tax deferred distributions and CGT deferrals in relation to un-stapling of hybrid instruments.

We have also started a risk assessment project in relation to domestic hybrid capital raisings and their compliance with the debt-equity rules in Division 974 of the ITAA 1997. High-risk cases have been identified for further detailed risk assessment (for example, specific reviews or as part of a client risk review) or audit treatment if warranted.

¹³ [Thomson Financial, Mergers and Acquisitions, 4th Quarter 2006](#)

As part of our 2006/07 Compliance Program, we tried to ensure that:

- tax deductions related to financing arrangements are appropriate
- payment of international related-party fees are appropriately characterised for tax purposes and the level of these payments accords with the OECD's arm's length principle
- following the takeover, Australian entities with offshore operations or foreign-controlled Australian entities do not allocate an excessive amount of debt to their Australian operations (and so meet the legislative limits in the thin capitalisation rules)
- security distributions are taxed appropriately, and withholding tax payments are made
- the tax values of assets, post-restructure, are appropriately assigned, especially where divestments are made; and
- there is appropriate disclosure of capital gains on any disposals by the investors and the target entities.

Private equity

Our approach is to work with private equity firms to help them carry on business in accordance with Australian law rather than the industry operating with a level of uncertainty and with potential after-the-fact disputes.

This strong growth of private equity in Australia follows a boom elsewhere over a number of years.¹⁴ Approximately 80% to 90% of the growth in private equity buyout activity that happened in the calendar year 2006 occurred in only a small number of significant transactions (five deals).

We recognise that this trend towards private equity is underpinned by a huge pool of capital available from superannuation funds and offshore financiers looking for strong rates of return. A concern for us is where publicly listed companies are taken into private hands they become less transparent in their current operations.

As it is possible for a tax regime to influence the structure of transactions, the Tax Office has been working with some of the businesses where private equity takeovers have been completed or announced in 2006. Our aim is to understand the tax outcomes of private equity deals at the earliest possible point, particularly given the complexity of some of the larger arrangements.

We have been also talking with some of the leaders in the private equity field to educate ourselves about the industry. What we have learnt is that there is a need to differentiate between private equity deals.

For example, the small domestic deals do not usually have the risks associated with substantial off-shore debt gearing, arbitrage using synthetic debt/equity instruments and significant use of havens. Even for those that do, that is not to say that there is anything wrong with these deals, but their increasing incidence and size require some vigilance on our part.

¹⁴ Reserve Bank of Australia, Financial Stability Review, March 2007

What then is the criteria we use to identify tax risks?

Business and financial analysis modelling

We try to understand corporate group's cash flow generation and management through corporate structures to see jurisdictional impacts where relevant (e.g. when the issue involves the correct allocation of global profit).

We have also been developing trend analysis by exploring profit and cost drivers and identifying correlations (for example, between cost of goods sold and net sales; exploring relativities between Australian dollar and foreign currencies and their impacts on profit and cost structure outcomes).

Another key aspect is examining cash flow projections and instances where earnings are not being returned on a straight line basis.

Cross-border activities and foreign bank branches in Australia

The Tax Office is also examining compliance with transfer pricing rules, thin capitalisation, consolidation rules (including multiple entry consolidated groups) with a specific focus on cross-border activities.

Corporate financing and capital management generally (including treasury operations, asset and project financing, repatriation arrangements and cross-border arbitrage on debt and equity classifications) continue to be on our radar.

We also have concerns regarding the performance of some foreign bank branches in the Australian market, where we are seeing some long term loss patterns in investment banking and wholesale financing activities, and where effective tax rates are low relative to their Australian counterparts.

In conjunction with the OECD, the role of investment banks at the boundaries of tax planning is also under consideration.¹⁵

Conclusion

As corporate leaders in the Australian community, how your tax behaviour is perceived, rightly or wrongly, strongly influences general community confidence in Australia's tax system.

It's your tax system, and so you have a fundamental interest in its health and integrity. As for the Tax Office, we are committed to supporting business to ensure that it is as easy as possible for you to comply with Australian tax law, and promoting a more level playing field.

Our approach is based on transparency and cooperation, which will make your taxable profits more certain.

¹⁵ An OECD project is currently underway to examine the role of tax intermediaries (e.g. law and accounting firms, other tax advisers and financial institutions) within tax systems, including in relation to unacceptable tax minimization arrangements,
http://www.oecd.org/document/50/0,3343,en_2649_34897_37930802_1_1_1_1.00.html