

SME tax risk management



A ROBUST RISK MANAGEMENT PROCESS IS ESSENTIAL TO DEAL WITH THE ATO.

Send lawyers, guns and money...¹

INTRODUCTION

The Australian Taxation Office (ATO) *Compliance Program 2009-10*² and experience suggests that the ATO is increasing its review and audit activities for small and medium enterprise (SME) taxpayers.³

Increasing review and audit activities means taxpayers and advisers are facing complex taxation administration and dispute resolution procedures with greater regularity. An error in risk management during any step can have serious consequences for defending a tax position.

Risk management primarily concerns identifying and quantifying risk, communicating risk amongst stakeholders, accepting or reducing that risk, and monitoring risk outcomes in a structured and continual process.

Tax risk management should be part of normal business and investment risk management and not only during year-end tax compliance.

Large organisations with formalised business and investment risk management processes include tax risk management. However, SME taxpayers (including high wealth individuals (HWI) and self managed superannuation funds (SMSF)) have relied extensively on their advisers to manage tax risk on an *ad hoc* and reactionary basis.

This reliance by SME taxpayers on their advisers places a greater tax risk management role and potential liability on the advisers. More formalised and strategic tax risk management processes for SME taxpayers will assist in identifying

and reducing tax risk for SME taxpayers. It will also reduce the potential liability on advisers as SME taxpayers better appreciate and self manage their risk profiles. The tax risk management process must reflect the SME status of the taxpayer and not be overly burdensome.

This article is the first in a series that will discuss a selection of tax controversy technical, practical and strategic issues during the pre-audit, audit, assessment, objection, review and appeal stages with a focus on SME taxpayers.

CLIENT TAX RISK MANAGEMENT

Introduction

The objective of tax risk management is to:

- determine the taxpayer's risk profile;
- establish and embed risk management processes;
- systematically monitor, adapt and apply risk management processes; and
- systematically maintain effective communication of tax risk within the stakeholder group.

Risk is traditionally categorised as:⁴

- strategic risks – specific legal, technical and administrative issues;
- operational risks – implementation of tax policies and laws to day-to-day business operations issues;
- compliance risks – implementation of systems, registrations, accounting, lodgment and compliance issues; and
- reporting risks – implementation of accounting and financial standards and statutory reporting issues.

There are also:

- reputation risks – business, industry and personal reputation risks; and
- detection risks – review or audit risk.

SME taxpayers are often greatly concerned with the adverse consequences arising from the publication by the media and the courts of a taxpayer's taxation activities regardless of the ultimate outcome on the merits of the activities.

Detection risk is often associated with the presumption that there has not been full and proper disclosure of a tax position. However, detection risk analysis is legitimate where the taxpayer had adopted a reasonably arguable position (RAP) and made full and proper disclosure in accordance with the RAP.

The degree of tax risk should be aligned with the taxpayer's degree of business, corporate, industry and financial risk and should be commensurate with the benefit of assuming that risk.

A robust tax risk management process will assist in reducing tax risk generally and because it may evidence the exercise of reasonable care by the taxpayer reducing tax shortfall and administrative penalties.

Good tax risk management processes combine risk management theories and procedures and tax law, tax policy and tax administration with a detailed understanding of the taxpayer and the taxpayer's business and investments. Accordingly, tax risk management protocols distil complex issues and apply them practically to the taxpayer's circumstances.

A robust tax risk management process can greatly assist a taxpayer to take a more organised, informed, proactive

and responsive position in a review, audit or dispute with the ATO.

The tax risk management process is shaped by the ATO's attitude to the taxpayer, the industry in which the taxpayer operates and the particular tax at issue. Accordingly, a detailed understanding of risk areas from the ATO's perspective is required.

Risk areas

The ATO *Compliance Program 2009-10* relevantly identifies the following SME audit areas:

- remuneration of public and private executives and directors, sales and marketing managers and representatives, share and option plans, income splitting and international activities;
- voluntary and compulsory superannuation contributions and early release arrangements, pay-as-you-go (PAYG) withholding and personal services income (PSI);
- retail investment products not validly implemented or abandoned, tax exploitation schemes and phoenix arrangements;
- investments and capital gains tax reporting, small business concession claims, capital gains tax (CGT) rollover exemptions, profit-making scheme reporting, goods and services tax (GST) registration, margin scheme claims and new residential reporting on property transactions;
- partnership and trust distributions reporting consistency, and hybrid trust reporting issues;
- private company wealth extraction including Div 7A ITAA36;
- business activity statement (BAS) and income tax return (ITR) lodgment compliance; and
- tax haven arrangements and Project Wickenby investigations.

The ATO *Compliance Program 2009-10* identifies the areas of audit risk which advisers can use to focus tax risk management analysis for taxpayers and in their professional practices.

Structured approach

The formalisation of risk management processes assists in proactively managing interactions with the ATO.

Tax risk management is widely used by large companies. Modified tax risk management processes are becoming more relevant and popular for SME taxpayers and advisers.

The most common risk management models include:

- Committee of Sponsoring Organisations of Treadway Commission (COSCO), *Enterprise Risk Management – Integrated Framework*; and
- Australian & New Zealand Standard AS/NZ 31000:2009 *Risk Management – Principles and Guidelines*.⁵

The COSCO framework is generally used by entities with USA direct or indirect reporting requirements.⁶

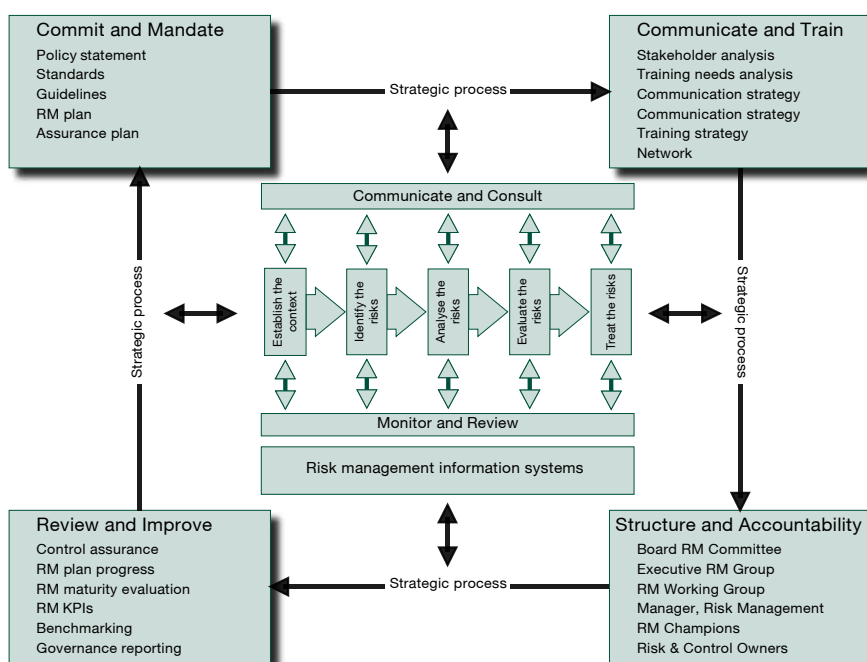
The COSCO framework focuses on the organisational adoption of strategic, operational, reporting and compliance risk management processes and measuring risk management capability on a progressive scale: (0) Non existent, (1) Initial/*ad hoc*, (2) Repeatable but intuitive, (3) Defined, (4) Managed & measurable and (5) Optimised.

AS/NZ 31000:2009 is an Australian standard providing principles of risk management, assessment attributes and a guide to establishing and implementing an effective risk management process at the strategic, tactical and operational level and for specific projects.

AS/NZ 31000:2009 identifies the risk management process as:

- communicate and consult with internal and external stakeholders;
- establish the internal, external and risk management context and criteria;
- identify the risks;
- analyse risks and likely consequences of the risk occurring;
- evaluate risks against risk criteria and balance potential benefits and adverse outcomes;
- treat risks by cost-effective strategies and action plans; and
- monitor and review to ensure continuous improvement and appropriateness for changing circumstances and priorities.

Risk management framework



AS/NZ 31000:2009 was published on 27 October 2009 and includes various changes to the former standard. In particular, AS/NZ 31000:2009 provides greater focus on the likelihood of the consequences of events rather than the occurrence of the events. A number of associated handbooks and publications are to be published in 2010.

The COSCO framework and AS/NZ 31000:2009 are designed for large organisations and require adaptation so they can apply to SME taxpayers and not be burdensome.

Determine taxpayer's risk profile

Tax risk management focuses on appreciating risk, accepting the degree of risk or implementing processes to reduce risk. Tax risk management assesses the degree of exposure to uncertainty and variance from the intended outcome. It includes a process of determining the taxpayer's appetite for review, audit, objection and litigation.

Tax liability management assesses the range of potential adverse consequences arising from the risk management assessment. It is a process of determining the range of unintended outcomes and the taxpayer's appetite in respect of underpaid tax, shortfall or administrative penalties, shortfall or general interest charge, loss of registrations and civil or criminal prosecutions.

Tax risk management and tax liability management are generally combined to provide a tax risk profile.

Establishing a commonly accepted risk profile for diverse stakeholders may also reduce management disputes and inconsistencies amongst the stakeholders and key staff.

Establish and embed risk management processes

Assessment of taxation risk is essential to its proper management. Tax risk management processes includes establishing and embedding:

- a well-defined tax risk management team of the taxpayer's stakeholders and advisers;
- well-defined risk management team responsibilities and reporting channels;

- regular information exchange meetings between the tax risk management team;
- well-defined risk management protocols; and
- regular training of the tax risk management team, key staff and the adviser's staff to ensure compliance with the tax risk management processes.

The ATO's view on tax risk management for large business and corporate governance was published in the ATO *Large business and tax compliance 2006 guide*.⁷ The ATO's key governance questions may be of assistance for SME taxpayers in assessing the quality of their tax governance and in questioning their advisers to determine the risk arising from advice and transactions.

Corporate governance for SMEs often becomes less well-defined and more complex over time as a result of business succession and the delegation of business or investment management to senior employees. As a result, the importance of written corporate governance protocols will increase.

A corporate governance protocol which better defines the ownership and decision making structure will assist in risk management. Further, consistent decision making will reduce the incident of change in tax treatment over time which is a significant cause of tax reviews and audits.

A good corporate governance protocol can demonstrate the exercise of reasonable care and assist in minimising shortfall and administrative penalties.⁸

Greater disclosure and transparency are goals of adopting a risk management process. However, with greater disclosure and circulation of tax-sensitive information comes an increased risk of loss of client legal privilege and client accounting privilege, because the ATO is arguably entitled to access corporate board documents⁹ and accountant documents.¹⁰

Tax information management protocols that may be implemented include:

- client's identification, storage and circulation procedures to maintain confidentiality;

- adviser's identification, storage and circulation procedures to maintain confidentiality;
- client's premises and documents access procedures for ATO access at business and private premises; and
- adviser's premises and documents access procedures for ATO access at business and private premises.

With the increased incident of reviews and audits, clearly defined protocols to manage the ATO coercive access powers to premises, information and documents are a priority. Some advisers do not appreciate the scope and restrictions on the ATO's powers¹¹ which may result in inadvertent disclosure of privileged information and documents. An unannounced ATO visit can cause great stress to SME taxpayers unless they understand their fundamental rights and obligations.

Tax information management protocols should concentrate on:

- maintaining complete documentation of the taxpayer's group ownership and control structure;¹²
- maintaining a complete summary of the taxpayer's milestones, events and major transactions to ensure information transfer on death and incapacity of the key stakeholders or resignation, death or incapacity of the taxpayer's key staff or the adviser's staff;
- retention of significant original and copy documents on a central and comprehensive permanent file;
- identification, segregation and circulation procedures for sensitive and privileged documents to ensure privilege is maintained;
- ATO retention requirements;¹³
- document custody and transportation procedures;
- document storage and technology redundancy protections; and
- document archiving and destruction procedures.

The taxpayer bears the onus of proof in tax matters.¹⁴ The requirement to keep documents for five years after completion of the transaction is often insufficient.

Taxpayers often misunderstand that the five year period is five-years after the taxing event and not from acquisition of the document. For example, specific classes of documents such as purchase contracts, working papers and minutes may be required to be kept for five years after disposal of the asset.

The loss of documents is surprisingly common and can have a significant impact on the success of any dispute with the ATO. The transportation of documents to and from banks, between advisers, between private residences, between offices and upon death are common times when documents are lost.

The adviser's protocol will vary for the taxpayer's accountants, lawyers, financial planners, stock brokers and other advisers so the tax risk management team will need to understand the differences in compliance issues for different classes of advisers.

Common tax control procedures include providing second review and sign-off for all final tax positions and high risk transaction such as large transactions, related party transactions and change from historic treatment.

Monitor and apply risk management processes

A structured approach is required to monitor:

- tax-compliant software and upgrades;
- changes and developments in tax law and administrative procedures;
- milestones and completion of transactions and projects; and
- changes in stakeholders and key employees.

Regular continual monitoring of risk is usually delegated to the risk management team.

Advisers often provide an informal tax law and administrative procedures monitoring system for their premium

clients. The delegation of roles within the tax management team may require the formalisation and structuring of this service and possibly a fee retainer that recognises the value this adds to the taxpayer's risk management process.

How an identified material tax risk will be managed depends on the taxpayer's risk profile. A voluntary disclosure before or during audit may reduce shortfall penalties and administrative penalties.¹⁵

Where the tax position is not at least reasonably arguable and there is an appreciable risk of fraud or evasion or of criminal prosecution, it is inappropriate and possibly a criminal offence to advise a taxpayer not to make disclosure and to rely upon non-detection.

However, where the tax position is at least reasonably arguable and there is no risk or a low risk of fraud or evasion or of criminal prosecution, a taxpayer may elect not to make disclosure where there is a low risk that the matter will be detected by the ATO.

The potential for increased penalties or prosecution for failing to disclose an otherwise honest or inadvertent mistake needs careful consideration and must be balanced against the reputational risks of non-disclosure.

Some tax risks are susceptible to adopting a "reasonably arguable position" which will reduce or eliminate shortfall and administrative penalties.¹⁶ While the ATO encourages taxpayers to obtain certainty through private rulings, the taxpayer may choose to adopt a reasonably arguable position in combination with an appropriate risk detection position.

Although the private ruling procedure provides greater certainty, the appeal right limitations from adverse private rulings effectively discourages the use of rulings as a risk management tool in all but the most uncontroversial and clear factual circumstances and tax treatments.

Arguably, the greater focus of AS/NZ 31000:2009 on the likelihood of the consequences of events rather than the occurrence of the events now requires a detection risk analysis as part of the risk management process.

Tax audit insurance may also be a cost effective means to hedge against the costs of complying with any review and audit activities, particularly where the taxpayer otherwise considers their risk of adverse assessments is low.

Maintain effective communication of tax risk

Establishing common risk classifications language will assist in tax risk management. For example, common risk continuums used by advisers include:

- no risk – low risk – medium risk – high risk; or
- beyond reasonable doubt – better view – reasonably arguable – arguable – not arguable.

The no risk to high risk classification reflects commercial risk assessment and is generally easier for SME taxpayers to understand. The beyond reasonable doubt to not arguable classification reflects the legal and tax risk thresholds and standards but are more difficult to explain to SME taxpayers.

A risk matrix supported by risk definitions may assist to explain both concepts (see diagram below).

The classification of risk should refer to each category of tax risk, so distinguishing clearly between categories is important.

A written taxpayer risk profile protocol addressing the above will assist all stakeholders and advisers to appreciate the taxpayer's risk profile and to communicate and assess risks in a common and consistent manner.

Strategic risk	No risk	Low risk	Medium risk	High risk	Fraud or evasion
Beyond reasonable doubt					
Better view					
Reasonably arguable position					
Arguable					
Not arguable					

CONCLUSION

The increasing incident of review and audit activities means there is greater value in implementing appropriately tailored risk management procedures for SME taxpayers.

The more robust the tax risk management process the more organised, informed, responsive and proactive the position that can be adopted by the taxpayer in a review, audit or dispute with the ATO.

Accountants and other advisers should adopt their own clearly defined protocols to manage the ATO coercive access powers to premises, information and documents to protect their clients but also their professional practices.

Subsequent articles in this series will discuss technical, practical and strategic issues during the pre-audit, audit, assessments, objection, review and appeal stages with a focus on SME taxpayers and managing tax risk.

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Reference notes

- 1 Warren Zevon, *Lawyers, Guns and Money, Excitable Boy* (Asylum Records, 1978).
- 2 ATO Compliance Program 2009-10 (NAT 7769-08.2009).
- 3 *The State and Territory revenue authorities have similar programs. This article does not address these issues, but similar tax risk management theory applies.*
- 4 Committee of Sponsoring Organisations of Treadway Commission, *Enterprise Risk Management – Integrated Framework*.
- 5 Published 27 October 2009 and supersedes Australian & New Zealand Standard AS/NZ 4360:2004 Risk Management
- 6 *Intended to provide risk management processes for US reporting entities under the Sarbanes Oxley Act 2002 (USA).*
- 7 ATO Large business and tax compliance 2006 guide (NAT 8675-08.06).
- 8 MT 2008/1.
- 9 PSLA 2004/14.
- 10 ATO Guidelines to Accessing Professional Accounting Advisors' Papers.
- 11 ATO Access and Information Gathering Manual.
- 12 TD 93/222 considers these documents may not be subject to client accounting privilege.
- 13 TR 96/7, TR 2005/9 and TD 2002/16.
- 14 Sections 14ZZK and 14ZZO Taxation Administration Act 1953 (Cth).
- 15 MT 2008/3.
- 16 MT 2008/2.

✓ TIP: TAX RISK MANAGEMENT PROCESS

Consider the following tax risk management issues:

- Taxpayer risk profile;
- Taxpayer corporate governance protocol;
- Taxpayer risk protocol – risk definitions, strategic risk, operational risk, compliance risk, reporting risk, reputational risk and detection risk;
- Taxpayer information and document management protocol;
- Taxpayer premises access protocol;
- Accountant information and document management protocol;
- Accountant premises access protocol;
- Lawyer information and document management protocol;
- Lawyer premises access protocol;
- Financial planner information and document management protocol;
- Financial planner premises access protocol; and
- Audit insurance.