

# SME audit strategies

## – The Art of War

**THE AUDIT ART OF WAR IS TO PREPARE THOROUGHLY... AND DON'T MISS THE MOMENT FOR SETTLING THE MATTER.**



Q: What do you give someone that has everything?

A: An audit!<sup>1</sup>

### INTRODUCTION

The Australian Taxation Office (ATO) undertakes extensive review and audit activities to ensure voluntary compliance under the self-assessment regime or to coerce compliance.<sup>2</sup>

The ATO audit segments are:

- individuals;
- micro enterprises (annual turnover under \$2m);
- small and medium enterprises (annual turnover \$2m - \$250m);
- large businesses (annual turnover over \$250m);
- non-profit organisations; and
- government organisations.

The relevant issues and approach by the ATO and advisers to reviews and audits may require modification depending on the audit segment.

This article discusses reviews and audits in respect of individuals, micro enterprises and small and medium enterprises (SME) (including high wealth individuals (HWI) and self-managed superannuation funds (SMSF)).

The ATO intends to undertake at least:<sup>3</sup>

- 500,000 individuals discrepancy explanation contacts;
- 100,000 individuals discrepancy explanation letters;

- 5,900 work-related income and expense audits and reviews;
- 3,000 SMSF compliance contacts;
- 2,000 new HWI and SME income tax and fringe benefits tax verifications;
- 370 audits and 650 reviews of SMEs;
- 120 audits and 420 reviews of HWIs;
- 300 new HWI and SME reviews;
- 175 audits and reviews of excise transactions; and
- 600 audits and reviews and 23 criminal inquiries for tax havens.<sup>4</sup>

The increasing incidence of review and audit activities means advisers and taxpayers are facing the complexity of taxation administration procedures with greater regularity.

Legislative references are to the *Income Tax Assessment Act 1936 (ITAA 1936)* and the *Taxation Administration Act 1953 (TAA 1953)*.

### AUDITS

#### Audit Strategies

The objective of the audit strategy is to (in no particular order):

- define clear and achievable outcomes, time frames and procedures;
- define clear lines of communication;
- promote objectivity, focus and relevance of the audit process;
- objectively, efficiently and effectively settle the matter with no or minimal tax adjustment;

- minimise time investment and resource utilisation in the audit process;
- proactively present relevant facts, tax analysis and policy considerations in a systematic manner to influence the audit outcomes; and
- extract from the ATO as much ATO intelligence on the matter before the matter becomes contentious.

An uncooperative approach will result in escalation of formality, contentious information exchange and costs while reducing settlement goodwill. However, a limited cooperative approach (exercise of all legal rights to their full limit) may be appropriate in circumstances where there is a real risk of criminal prosecution or allegations of fraud or evasion arising from the audit.

Information exchange can be undertaken on an expansive or minimalist basis. A minimalist approach (answer only the information and provide only the document requested) is usually adopted until the ATO audit issues are revealed and sufficiently developed to allow an assessment of the risk exposure of the client.

Once the ATO audit issues are sufficiently revealed and developed, a more expansive approach is usually adopted to positively influence the ATO to promote conclusion of the audit or settlement.

The issues the subject of the audit may be technical,<sup>5</sup> administrative<sup>6</sup> or policy<sup>7</sup> based. The nature of the issue may affect the approach adopted or the emphasis of correspondence. Generally, however, an approach that adopts a technical, administrative and policy based response will be more persuasive.

There is an art to audit management where reasonable and experienced practitioners can have diametrically opposed legitimate opinions. The audit Art of War<sup>8</sup> is to prepare thoroughly for likely contingencies by well-prepared strategies, ensure the ATO operates within its administrative parameters, identify and seek to exploit weaknesses in legislative and administrative policy, fight only those battles with real prospects of success, don't make mistakes and don't miss the moment for settling the matter.

The involvement of lawyers in the audit process may provide an opportunity for the accountant to maintain a continuing cooperative approach and rhetoric with the ATO while using the lawyer strategically as a shield.

The ATO's audit expectations and processes are widely published.<sup>9</sup>

### Audit Areas

Reviews and audits are authorised by the ATO's general power of administration.<sup>10</sup>

An audit is intended to gather intelligence, increase voluntary compliance and coerce compliance.

The *ATO Compliance Program 2009-10* relevantly identifies the following 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 withholding and personal services income;
- 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 rollover exemptions, profit making scheme reporting, goods and services tax 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 ITAA 1936;
- business activity statement and income tax return lodgment compliance; and
- tax haven arrangements and Project Wickenby project compliance.

This article does not address the substantive tax law issues underlying these audit areas, but at the centre of all audit strategies is a clearly articulated position (and an understanding of relative strengths, weaknesses and risks) of the substantive tax law.

Further, the ATO will continue the HWI program, including:

- continuation with the four year program to risk assess all taxpayers with turnovers between \$100m and \$200m;
- examination of HWIs with net wealth between \$5m and \$30m;
- initiation of 300 new reviews; and
- undertaking at least 120 audits and 420 reviews.

The following administrative issues are worth noting:

- the ATO has extensive unfettered audit selection powers;<sup>11</sup> and
- audits are not generally susceptible to judicial review.<sup>12</sup>

Accordingly, the review and audit process is largely about managing the taxpayer's position rather than avoiding the review and audit.

The ATO will likely select a taxpayer for review and audit where:

- the taxpayer's financial or tax performance varies substantially from industry patterns;
- the taxpayer's amounts or patterns of tax payments vary substantially from previous periods, economic indicators or industry trends;
- the taxpayer's economic performance, productivity and tax performance are not aligned;

- the taxpayer has losses or a low effective tax rates that vary substantially from industry patterns;
- the taxpayer or the taxpayer's related entities, officers, executives or advisers have a history of aggressive tax planning; or
- the taxpayer has structural, procedural or governance weaknesses to their approaches to tax compliance.

These selection criteria should form the basis of any risk assessment by the taxpayer's advisers.

### Review and Audit Types

A review is a type of audit, but it will be identified separately in this article because a review as opposed to other forms of audit may be eligible for more generous remissions of penalty for voluntary disclosure.

Review and audit activity can be roughly categorised into the following types:

#### ■ data matching:

Information matching with BRW lists, AFR and media publications, Centrelink, State Revenue Office, Land Titles Office, AUSTRAC, ASIC, ASX, Department of Immigration records, Motor Vehicle, Marine and Aircraft Registries and other sources.

The ATO analyses the information and undertakes risk classification.

#### ■ research audits:

Industry or activity research enquiries are undertaken to gather intelligence, profile industries and trends in taxation compliance.

#### ■ desk audits:

ATO requests receipts, invoices and other documents to substantiate the return. The ATO may conduct interviews. The ATO analyses the information and undertakes risk classification. Desk audits can be subcategorised into:

- **substantiation review** – rental deductions or work-related expense claims verification; or
- **source deduction review** – PAYG withholding verification.

#### ■ risk reviews:

Risk reviews are becoming increasingly common and are commenced with

a questionnaire, followed by ATO analysis, detailed expert opinion and risk classification. After review, the matter is closed or escalated. Risk reviews can be subcategorised into:

- **preliminary risk review** – general questionnaire;
- **comprehensive risk review** – detailed issues questionnaire with informal or formal interviews and document access; and
- **specific review** – specific issues questionnaire with informal or formal interviews and document access.

■ **audits:**

Audits generally commence with an audit notification letter, including a request to make voluntary disclosure. The ATO generally undertakes informal or formal interviews and document access, analysis, expert opinion and risk classification under an information gathering process. Based on the risk classification, the ATO may proceed to an audit process that can be subcategorised into:

- **specific issues audit** – detailed specific issue or issues information and document exchange, interviews, taxpayer systems review and analysis, ATO analysis, expert opinion, position papers exchange, audit findings paper, closure or escalation;
- **comprehensive audit** – detailed issues information and document exchange, interviews, taxpayer systems review and analysis, ATO analysis, expert opinion, position papers exchange, audit findings paper, closure or escalation;
- **complex audits** – strategic and complex industries, international groups, tax issues; and
- **special audits** – serious non-compliance activities with a prosecution emphasis (such as Project Wickenby).

■ **continual monitoring:**

Specific taxpayers can be requested to provide expanded or special purpose tax returns. A common example is the HWI expanded tax returns.

The order of review and audit activity need not be sequential.

✓ **TIP: ATO AUDIT**

1. Consider the scope of the audit as expressed in the ATO audit letter as voluntary disclosures outside the audit scope or before commencement of audit proper may attract the 80% voluntary disclosure concession (MT 2008/3).
2. Note audit commencement date and schedules finalisation date to set period after which shortfall interest charge or general interest charge can be remitted (PSLA 2006/8).
3. Record ATO response due dates that are exceeded so that shortfall interest charge or general interest charge can be remitted for the period after the response due date (PSLA 2006/8).

The review letter, audit commencement letter and finalisation letter require close consideration because they affect rights (such as voluntary disclosure remission entitlements).<sup>13</sup>

**Assessment of Audit Processes**

The Burges Report analysed the ATO audit performance for large businesses.<sup>14</sup> Where appropriate, these initiatives were to be applied to other segments.<sup>15</sup> The Burges Report recommended and the ATO accepted 13 initiatives, including:

- Initiative 1:** the early engagement of technical specialists in reviews and audits;
- Initiative 4:** internal ATO technical workshops for high and contentious risks prior to finalisation;
- Initiative 5:** provision of preliminary review findings and an opportunity for the taxpayer to respond;
- Initiative 6:** greater communications with taxpayer stakeholders on procedures when proceeding from review to audit including communication of audit plans which clearly explain the stages of audit and scope of the audit; and
- Initiative 7:** requests for information will include the reasons for seeking the information.

The ATO has also published other audit procedure standards, including:<sup>16</sup>

- issuing taxpayers with review and audit notification letters;
- giving taxpayers reasonable time to consult with financial and legal representatives;

- completing audits within the shortest possible time depending on the quality of records, availability of information, complexity of issues and level of taxpayer cooperation;
- undertaking an initial interview to introduce the audit, outline the audit processes, and provide taxpayers with an opportunity to make voluntary disclosures;
- arrange interviews or meetings at mutually convenient times during normal business hours;
- advise taxpayers in advance whether the tax officer will have a legal adviser present during an interview;
- allow taxpayers to tape record interviews with prior notice, provided a copy of the audio tape is given to the ATO at the conclusion of the audit; and
- arrange for an interpreter to be present at interviews and meetings.

The ATO regularly reports against these audit processes.<sup>17</sup>

Understanding these rights can assist to progress the review or audit efficiently and with a clear exchange of information and of audit procedures.

**High Wealth Individuals (HWI) Taskforce**

In March 2009, 1,000 letters were sent to HWIs. And a further 1,000 to 2,000 letters were to be sent in the 2009/10 financial year.

HWI classification has decreased from net wealth of at least \$30m to \$5m, resulting in a far greater number of traditional SME clients being affected by review and audit activities. Audits are conducted over approximately two years, unless entered

into a subsequent category of review and audit activity.

A detailed working knowledge of the HWI program as detailed in *Wealthy and Wise: A tax guide for Australia's wealthiest people* and the HWI questionnaire is invaluable. Particular review and audit processes are discussed in the chapters on Audit Process, Comprehensive Risk Review Process and Preliminary Review Process.

The HWI questionnaire is primarily concerned with gathering information on:

- tax residency;
- family and business relationships;
- direct and indirect ownership or control of assets;
- direct and indirect access to wealth in related entities;
- business and industry environment, statistics and performance; and
- business and industry tax compliance history, sociology and psychology.

The HWI questionnaire is wide ranging and is, therefore, difficult to answer in a concise manner. Particular issues about the scope of the questionnaire include:

- the HWI's ability to disclose information about siblings, adult children, grandchildren and their spouses or any 'person named' in a response in the questionnaire;
- the relevance of the HWI's office as a settlor or appointor of a private trust for third parties (eg accountants that act as settlor or independent appointor for their clients);
- the extent of the legal analysis of trust law and the trust deed required to provide disclosure in respect of private trusts in which the HWI, family or named persons have 'a power of appointment over the assets of the trust';
- the potential requirement to consider third party documents, such as powers of attorney, unit holders agreements etc, to provide disclosure of private trusts in which the HWI, family or named person have power to appoint an office or any power in respect of a private trust;
- the potential requirement to consider third party documents, such as put

and call options, first rights of refusal, shareholders agreements etc, in determining whether the HWI, family or named person controls the allotment of shares or capital of a trust;

- the difficulty in determining whether the HWI, family or named person has provided any 'financial accommodation' having regard to the current debate over the scope of the undefined term;<sup>18</sup>
- the difficulty of providing assets and liabilities financial information for estranged spouses; and
- the difficulty in preparing a structure diagram for the group in a manner that is clear and precise.

The questions refer to 'knowledge' so there appears no expected obligation to make enquiries regarding siblings, adult children, grandchildren and their spouses or any person named in a response in the questionnaire.

The art in answering the questionnaire is clearly stating the scope and limiting factors in preparing the answers.

#### Risk Assessment

A robust risk management approach to an audit is essential because an error in risk management during the audit phase can have serious consequences for defending a tax position in objection and appeal stages.

During audit, a detailed risk management process should be conducted which includes identification, analysis and management of:

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

A robust tax risk management process can greatly assist a taxpayer to take a more organised, informed, proactive and responsive position in a review or an audit with the ATO.

Further details on risk assessment and management have been discussed in this series.<sup>20</sup>

#### Exchange of Information

The ATO often uses the ATO's coercive access to information and documents for gathering information during audit:

- by entering premises;<sup>21</sup>
- by demanding provision of information in writing or by interview;<sup>22</sup>
- by demanding provision of documents;<sup>23</sup> and
- offshore information exchange demand for documents affecting admissibility of documents not produced.<sup>24</sup>

The ATO has similar (but differently worded) exchange of information and access powers for other taxes.

It may be an offence for the occupier to:

- make false or misleading statements;<sup>25</sup>
- fail to provide the ATO reasonable facilities and assistance to exercise the access;<sup>26</sup>
- fail to produce books or attend on the ATO;<sup>27</sup>
- refuse to answer questions or provide documents;<sup>28</sup> or
- hinder or obstruct the access.<sup>29</sup>

The audit strategy should not expose the taxpayer to offences.

An important consideration during audit and access is to ensure that client legal

#### WARNING: OFFENCE

It is an offence to provide false or misleading information and intention is not an element of this absolute liability offence.<sup>19</sup> Care is, therefore, required in preparing the response.

privilege or client accounting privilege is not inadvertently waived.

### Culpable Behaviour & Voluntary Disclosures

The uniform penalty provisions apply to statements made, returns lodged and schemes entered into from 1 July 2000.<sup>30</sup> The extent of the penalty is determined by the behaviour of the taxpayer and the taxpayer's advisers. Culpable behaviour may increase the penalty by 20%.

A taxpayer that makes a voluntary disclosure in the approved form to the ATO may have tax shortfall penalties and scheme shortfall penalties reduced<sup>31</sup> or administrative penalties reduced by 80% if made or deemed to be made before audit or 20% if made during audit.

The base penalty amount may be increased by 20% for culpable behaviour, including:<sup>32</sup>

- taking steps to prevent or obstruct the ATO from finding out about the tax shortfall;
- failing to correct a statement made to the ATO about a shortfall amount within a reasonable time; or
- having a previous shortfall amount.

The audit strategy should not expose the taxpayer to increased penalties.

The ATO has a general discretion to further remit penalties for assistance.<sup>33</sup>

Further details on voluntary disclosure have been discussed in this series.<sup>34</sup>

### CONCLUSION

One cannot absolutely avoid a risk review or audit, but one can manage the process optimally.

A collaborative approach between the client stakeholders, the accountant, the lawyer and the other advisers represents the best strategy to manage the review and audit, to settle or otherwise resolve any dispute at an early stage, and to ensure that any court proceedings are not inadvertently compromised.

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### ✓ TIP: DOS AND DON'TS

1. Do identify clients at appreciable risk of review or audit activity.
2. Do take a proactive role in preparing for review or audit.
3. Do take a proactive role in directing and managing the review and audit processes.
4. Do make voluntary disclosure in appropriate circumstances to reduce penalties and interest.
5. Do prepare submissions and disclosures in a manner that makes it easy for the ATO officers to see the course of action required and their power to give effect to the request.
6. Don't panic under access, document exchange, review or audit, and carry out the tax risk management strategy.
7. Don't make disclosure that is not substantiated by corroborating documents so as to avoid any unintended false or misleading statements or sending the ATO down the wrong line of enquiry.
8. Don't exceed deadlines to avoid unnecessary GIC or SIC accruing.
9. Don't be reactive; ensure every interaction with the ATO clearly states the policy and legal reasons showing that the taxpayer is correct.

#### Reference notes

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- 23 Section 264(1)(b) ITAA 1936.
- 24 Section 264A ITAA 1936.
- 25 Section 136.1 Criminal Code Act 1995.
- 26 Section 263(3) ITAA 1936 (\$3,300 (30 penalty units)).
- 27 Section 8C TAA 1953 (\$3,300 (30 penalty units)).
- 28 Section 8D TAA 1953.
- 29 Section 149.1 Criminal Code Act 1995 (penalty: two years imprisonment).
- 30 Pt. 4-25 TAA 1953.
- 31 Section 284-225 TAA 1953; MT 2008/3 (formerly TR 94/6).
- 32 Section 284-220 TAA 1953.
- 33 Section 298-20 TAA 1953; PSLA 2006/2 at [150]; MT 2008/3 at [27].
- 34 R. Jorgensen, 'Voluntary Disclosures', (2010) 44/9 Taxation in Australia, 519.