The Tax Summit

Session 15.3: Are you audit ready?

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Jane Harris, CTA
Brown Wright Stein Lawyers

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1. Introduction

In the 2022-2023 financial year, the ATO conducted nearly 1.3 million client engagement activities. It is estimated that the ATO's audit actions and measures to prevent incorrect claims contributed $7.7 billion to the total revenue effects.[1]

Recent data indicate that the ATO is intensifying its audit activities. The Federal budget for 2024-25 extended the ATO Personal Income Tax Compliance Program for one year from 1 July 2027. This program is intended to "deliver a combination of proactive, preventative and corrective activities in key areas of non-compliance, including overclaiming of deductions, incorrect reporting of income and inappropriate tax agent influence".[2]

The ATO's small business random enquiry program revealed common issues such as poor record-keeping, undeclared business income, and improper claiming of private expenses as business expenses. These practices contribute to a substantial tax gap, with shadow economy activities accounting for approximately 64% of the gross small business income tax gap, estimated to be around $10.4 billion annually.[3]

This paper is intended to share some essential strategies to ensure clients are well-prepared for an ATO review or audit.

The discussion begins by exploring the likelihood of an audit, providing an overview of the ATO's audit and review programme, and highlighting key triggers for audits, including the role of data matching. Understanding these triggers is crucial for advising clients effectively.

Next, the paper discusses what auditors typically ask for, including recent guidance on governance, the importance of maintaining accurate group diagrams, and the documentation required for recent transactions. This section offers best practices for record-keeping and compliance.

The focus then shifts to readiness strategies, emphasising the importance of organised filing systems, maintaining evidence for earlier years, and ensuring all crucial documents, such as trust deeds and share registers, are on file and up-to-date.

Specific information requirements for R&D claims, tax consolidation, and common mistakes that can lead to audits are also covered. Lastly, the paper examines the risks associated with audits going wrong, highlighting the consequences of poor preparation and the lessons learned.

Overall this paper aims to provide tax professionals with practical tools and insights to better support their clients in navigating ATO reviews and audits successfully.

[1] Commissioner of Taxation Annual Report 2022-23, p.91, https://www.ato.gov.au/api/public/content/eba65257d7b04994bb5be907cb8add40 [Accessed 27 July 2024].
[2] Department of Treasury, *Budget 2024-25: Budget Measures Budget Paper 2*, (14 May 2024), p.15.
[3] https://www.ato.gov.au/about-ato/learn-about-tax-and-the-ato/tax-and-small-business/in-detail/small-business-random-enquiry-program-findings [Accessed 27 July 2024]

2. What triggers an audit?

For tax professionals, the prospect of an ATO audit is a critical concern, requiring a nuanced understanding of the factors that trigger audits and the sophisticated data matching techniques employed by the ATO. This knowledge is essential for advising clients effectively and mitigating their audit risk.

2.1 Audit and Review Programme Overview

The ATO's audit and review programme is a cornerstone of its compliance strategy, aimed at ensuring adherence to tax laws across the board. The ATO employs a risk-based approach to select audit targets, focusing on entities that exhibit behaviours or characteristics indicative of potential non-compliance. Understanding this approach is crucial for tax professionals advising clients on compliance and risk management.

2.2 Audit vs Review

An ATO review is a preliminary assessment of a taxpayer's compliance, focused on identifying potential risks. It typically involves gathering information and understanding the taxpayer's business context. If concerns are identified during the review, it may lead to a more in-depth investigation. An ATO audit, on the other hand, is a thorough examination of a taxpayer's financial records and transactions, aimed at ensuring compliance with tax laws. Audits are generally more detailed than reviews and involve gathering evidence to verify the accuracy of tax assessed. They are typically initiated if significant risks are identified during the review process or if there are ongoing compliance concerns.

2.3 Key Triggers for Audits and Reviews

Several factors can increase the likelihood of an ATO audit. Significant discrepancies between reported income and data held by the ATO often raise red flags. Large or unusual claims for deductions or offsets can also draw scrutiny. Repeated errors or adjustments in previous tax returns suggest potential ongoing non-compliance, making clients more likely targets. Participation in high-risk industries or transactions, such as cash-intensive businesses or international dealings, is another common trigger. Additionally, specific issues flagged by industry or tax advisers may lead to further investigation.

2.4 ATO Data Matching

Several factors can increase the likelihood of an ATO audit, each serving as a potential indicator of non-compliance. One of the primary triggers is significant discrepancies between reported income and data held by the ATO. When the income declared on a client's tax return does not match information from financial institutions, employers, or other third-party sources, it raises immediate red flags for the ATO. Such inconsistencies suggest possible underreporting or errors that necessitate further investigation.

Large or unusual claims for deductions or offsets also attract the ATO's attention. Clients who claim substantial deductions, particularly those that deviate markedly from industry norms, are at higher risk of being audited. This is especially true for claims that lack sufficient supporting documentation or appear excessive relative to the income reported. The ATO scrutinises these claims to ensure they are legitimate and substantiated.

Repeated errors or adjustments in previous tax returns can be another strong indicator of potential ongoing non-compliance. Clients who consistently submit returns requiring corrections or who frequently amend their returns may be flagged for closer examination. Such patterns suggest either a lack of proper record-keeping or a deliberate attempt to evade taxes, prompting the ATO to delve deeper into their tax affairs.

Participation in high-risk industries or transactions is another common trigger for audits. Businesses operating in cash-intensive industries, such as hospitality or retail, are inherently more challenging to monitor for accurate income reporting. Similarly, clients engaged in international dealings, such as cross-border transactions or holding offshore accounts, are subject to heightened scrutiny due to the complexity and potential for tax avoidance associated with these activities

Additionally, specific issues flagged by industry or tax advisers can lead to further investigation. For example, if an industry is known for certain non-compliance issues or if a tax adviser's clients frequently encounter tax disputes, the ATO may prioritise audits in these contexts. Advisers must stay abreast of industry trends and regulatory changes to pre-emptively address areas of concern

Understanding these triggers allows tax professionals to better advise their clients on maintaining compliance and mitigating audit risks. By addressing potential red flags proactively and ensuring accurate, well-documented tax disclosures, clients can significantly reduce the likelihood of an ATO audit.

3. Audit insurance

Audit insurance is a valuable safeguard for high-wealth taxpayers and those likely to be audited by the ATO. It covers the costs associated with professional fees incurred during an audit or review, ensuring that taxpayers have access to expert representation without the financial burden. This type of insurance is intended to provide peace of mind, allowing taxpayers to focus on their business and personal affairs while their tax affairs are reviewed by professionals. Given the increasing scrutiny on high-wealth individuals and complex tax arrangements, having audit insurance can be a prudent measure to manage potential risks and avoid unexpected expenses.

However, it is crucial to check the exclusions in the insurance policy to understand what is and is not covered. Regularly reviewing any thresholds is also important, especially if the business has grown and has not updated its cover. Ensuring that the insurance coverage aligns with the current size and complexity of the business can prevent gaps in protection and ensure that all potential risks are adequately managed.

4. Be RFI ready

4.1 Governance documents

Over the past decade, the ATO has significantly revised its approach to taxpayer governance, with a stronger emphasis on transparency, accountability, and self-regulation, particularly among large businesses and high-wealth individuals. This change reflects a broader global trend towards enhancing tax compliance through cooperative compliance frameworks.

4.1.1 Key developments in the ATO's approach

The ATO has increasingly focused on the role of corporate governance in ensuring tax compliance. This approach involves a thorough evaluation of a taxpayer's governance frameworks and their effectiveness in supporting the integrity of tax outcomes. Central to this is the introduction of the "Justified Trust" concept, where the ATO assesses whether a taxpayer has justified the trust placed in their tax compliance. This assessment is heavily reliant on the effectiveness of the taxpayer’s governance practices and risk management.

Over time, the ATO has transitioned from a reactive enforcement model to one that emphasises prevention. This shift is evident in the ATO's encouragement of taxpayers to proactively manage their tax risks and seek certainty through advance rulings and agreements. The ATO now conducts reviews of the Top 100 and Top 1000 taxpayers, focusing on the largest and most complex entities, with a particular emphasis on the quality of their tax governance.

Transparency has become a cornerstone of the ATO’s expectations. Large corporations, in particular, are expected to be open about their tax affairs, which includes making voluntary disclosures and providing tax governance documents during reviews or audits. The introduction of the Reportable Tax Position (RTP) schedule for large businesses underscores this expectation, requiring them to disclose their most contestable and material tax positions.

Over recent years, the ATO has expanded its focus on governance and risk management to include a broader range of taxpayers through the introduction of the Top 500 and Next 5000 programs. The Top 500 program targets Australia’s largest privately owned groups, assessing their tax governance, risk management, and compliance activities. The Next 5000 program, on the other hand, focuses on high-wealth individuals and the private groups they control. Both programs aim to ensure that these taxpayers have effective tax governance and risk management frameworks in place. The ATO's scrutiny under these programs is rigorous, with a strong emphasis on ensuring that tax obligations are met with transparency and integrity. Taxpayers within these programs are expected to have detailed and robust documentation of their tax governance procedures, aligning with the ATO’s broader expectations for corporate governance. The inclusion of these programs demonstrates the ATO’s commitment to broadening its oversight beyond the largest corporations to include significant private entities, ensuring a comprehensive approach to tax compliance across the board.

4.1.2 ATO expectations for documenting tax governance procedures

The ATO expects that taxpayers, particularly those within the Top 1000 and large private groups, maintain documented tax governance procedures that align with their corporate governance frameworks. Tax governance should be an integral part of the broader corporate governance structure, reflecting a commitment from the board and senior management to tax compliance. This documentation should clearly demonstrate how tax risks are identified, assessed, and managed within the organisation.

The ATO expects these documents to detail the processes for managing and mitigating tax risks, including the procedures for handling significant transactions, tax planning strategies, and potentially contentious positions. The roles and responsibilities of those involved in tax governance, along with how decisions are escalated to senior management or the board, should be clearly outlined.

Furthermore, effective tax governance requires ongoing monitoring and regular reviews of tax positions, controls, and processes. The ATO expects documentation to describe how tax governance is reviewed, how issues are identified and resolved, and how the effectiveness of tax controls is tested. Evidence of board and executive oversight is also crucial. The ATO expects to see that the board and executive management are actively engaged in overseeing tax governance. This includes documentation showing that tax is a regular agenda item at board meetings, that the board is informed of significant tax risks, and that there is a clear policy on the organisation's tax risk appetite.

Finally, the ATO expects taxpayers to be prepared for engagement by maintaining up-to-date and accurate documentation of their tax governance processes. This preparedness is essential when the ATO conducts reviews or audits.

4.2 Source documents

When conducting an audit or review, the ATO is likely to request various source documents that are essential for substantiating financial and tax positions. These documents may include trust deeds, unit registers, share registers, copies of resolutions and copies of loan and transaction documents from recent or ongoing transactions.

The ATO may also seek records from previous years, such as cost base documentation for assets, evidence of elections or roll-overs that have been applied, and substantiation for any carried forward losses. While the requirement to keep records for five years is standard, this is not the end of the story—records from much earlier may be required to substantiate gains or losses down the track. Therefore, maintaining comprehensive and well-organised records beyond the five-year mark is crucial for ensuring compliance and supporting the accuracy of tax lodgments during an ATO audit or review.

It is prudent for the taxpayer to have a single repository for such documents that can be easily accessed and shared with the relevant advisers in the event of an ATO audit or review. This also facilitates prompt responses to initial information requests once the audit or review commences.

4.3 Group diagrams

In the context of tax compliance and preparation for ATO reviews or audits, maintaining an up-to-date group diagram is essential. A group diagram and / or list of group entities is a common request in the context of ATO audits and reviews.

4.3.1 Key features of an effective group diagram

One page

The group diagram should be concise and fit on a single page to ensure clarity and ease of understanding. Where possible, a single-page diagram facilitates quick reference and minimises the risk of overlooking important details.

Show Beneficial Ownership

Clearly display the beneficial ownership of entities within the group. This includes both direct and indirect ownership, making it easier to identify who ultimately controls each entity.

Key – what do the lines mean?

Include a key that explains the meaning of different lines and symbols used in the diagram. This helps avoid confusion and ensures that all users can accurately interpret the relationships and structures depicted.

Errors in ASIC records

It is important to note any discrepancies between the group diagram and the official records held by the Australian Securities and Investments Commission (ASIC). Highlighting these differences can prompt timely updates to ASIC records, ensuring legal compliance and accuracy.

4.3.2 Essential elements

- **Beneficial owners including unit holders:** Clearly identify all beneficial owners, including unit holders in trusts. This transparency helps in understanding the true control and financial interests within the group.
- **Number of shares/units and class:** Specify the number and class of shares or units held by each owner. This detail is crucial for understanding voting rights, profit distribution, and control dynamics within the group.
- **Timeframe or date the diagram covers:** Indicate the specific timeframe or date that the diagram represents. This helps in tracking changes over time and ensuring that the diagram remains current and relevant.

4.3.3 "Nice to have" elements

- **Directors:** Including the names of directors provides additional context about the governance structure and key decision-makers within the group.
- **Incorporation dates:** The dates when each entity was incorporated can offer insights into the group's history and development.
- **ABN or ACN:** Including the Australian Business Number (ABN) or Australian Company Number (ACN) for each entity facilitates quick identification and verification.
- **Classes of key assets or income:** Highlighting major assets or sources of income can help in assessing the financial health and risk exposure of the group.
- **Family Trust Election (FTE) or TOFA elections:** Indicating whether a Family Trust Election has been made is crucial for understanding the tax implications and compliance requirements related to family trusts. Highlighting TOFA elections on the group diagram can assist taxpayers and their advisers with correctly reporting gains and losses on financial arrangements.

- **Tax residency status:** If applicable, including this information assists with drawing attention to potential cross-border compliance obligations, such as withholding tax, thin capitalisation, controlled-foreign-company regimes and transfer pricing.
- **Substituted Accounting Period (SAP):** If relevant, note any Substituted Accounting Periods that entities are using, as this can influence financial reporting and tax obligations.

4.3.4 Issues a group diagram can highlight

Legal and beneficial ownership

A well-structured group diagram clarifies both legal and beneficial ownership, revealing any discrepancies or complexities in ownership structures that might require attention. Preparing the diagram provides a good opportunity to review share and unit registers and reconcile them to the ASIC record. This allows pro-active updates or rectification where required.

It is beneficial in an ATO review or audit to have group diagrams, source documents and ASIC records that are reconciled and up to date. Coherent records assist both the taxpayers and ATO audit team to understand the relationships between parties and provide evidence of good tax governance.

Changes in ownership

The process of preparing or updating the group diagram can illustrate historical or recent changes in the ownership of group entities, such as share issues or transfers. This can assist tax advisers and taxpayers to ensure that the transactions have been properly accounted for and that any tax implications have been appropriately recorded.

Whether Family Trust Elections or Taxation of Financial Arrangements elections in place or required

By indicating Family Trust Elections and TOFA elections, the diagram can help tax advisers to identify whether these elections are in place or if they may be required for tax planning purposes.

Connected entities

The visual representation of entities in the taxpayer's group can assist when considering which entities might be connected entities. This is relevant for many areas of tax law, including determining aggregated turnover of for the purposes of identifying 'base rate entities', small business capital gains tax concessions, and availability Early Stage Innovation Company concessions.

Operational and structural insights

Once the diagram has been prepared or updated, it can be helpful for tax advisers to use the diagram to understand the key assets and activities of each entity represented, including any large or recurring intragroup transactions. The diagram can provide insights into the operational and structural aspects of the group, highlighting potential issues such as complex inter-company relationships or compliance risks.

5. Specific record-keeping requirements

5.1 R&D

The ATO has specific requirements for Research and Development (R&D) claims to ensure that businesses accurately and thoroughly document their R&D activities. Businesses often face challenges in maintaining comprehensive and accurate records, which can lead to disputes with the ATO. Common pitfalls include insufficient documentation of experimental processes, poor record-keeping of financial expenditures, and inadequate evidence linking R&D activities to the claimed outcomes.

To avoid these issues, businesses should establish robust internal systems for documenting R&D activities. This includes maintaining real-time records, ensuring that all team members are trained in proper documentation practices, and conducting regular internal audits to verify the accuracy and completeness of R&D records.

5.1.1 Overview of R&D Claim Requirements

R&D tax incentives are designed to encourage companies to engage in innovative activities by providing tax offsets for eligible R&D expenditures. To qualify, businesses must demonstrate that their activities meet the legislative definition of R&D, which includes both core R&D activities and supporting R&D activities. Core activities must involve experimental processes aimed at generating new knowledge, while supporting activities are those that directly relate to the core activities.

5.1.2 Documentation and Evidence Necessary for R&D Claims

Project plans and records should include detailed outlines of the hypotheses, objectives, and experimental methods used, as well as records of project timelines, milestones, and progress reports. Technical documentation needs to describe the technical challenges faced and the processes undertaken to overcome them, along with data from experiments, including test results, analyses, and iterations.

Accurate financial records are crucial, showing expenditures on R&D activities, such as staff costs, contractor fees, and the costs of materials and equipment, as well as the allocation of overhead costs related to these activities. Staff and contractor documentation should encompass timesheets and work logs for employees and contractors involved in R&D, along with statements of work and contracts detailing the R&D tasks performed by external parties.

Finally, intellectual property (IP) records must include documentation of any IP generated from the R&D activities, such as patents, designs, or trade secrets, and evidence showing how the R&D activities contributed to the creation of IP.

Accurate documentation and thorough evidence are paramount to successfully claiming R&D tax incentives. By adhering to the ATO's specific information requirements and avoiding common pitfalls, businesses can maximise their R&D tax benefits and support their innovation efforts. This proactive approach not only ensures compliance but also strengthens the overall management and reporting of R&D activities.

5.2 Tax Consolidation

Tax consolidation allows a group of entities to be treated as a single entity for income tax purposes, simplifying compliance but requiring meticulous documentation and accurate calculations. The ATO's expectations during an audit or review focus on several key areas, including Allocable Cost Amount (ACA) calculations, transferred losses calculations, and workpapers used to prepare consolidated accounts and tax returns, including intragroup transactions.

5.2.1 Allocable Cost Amount (ACA) Calculations

The ACA calculation is fundamental in determining the tax cost setting amounts for the assets of entities joining or leaving a consolidated group. The ATO expects detailed and precise ACA calculations to be provided during an audit. These calculations must include:

- **Entry ACA calculations:** Documentation detailing the cost base of membership interests in the joining entity, including acquisition costs and any adjustments for liabilities or distributions.
- **Exit ACA calculations:** For entities leaving the group, the ACA should reflect the fair value of assets and liabilities at the time of exit, adjusted for any distributions or changes in ownership during the consolidation period.
- **Supporting documentation:** Evidence of how each component of the ACA was determined, including asset valuations, debt balances, and other relevant financial data.

5.2.2 Transferred losses calculations

When entities join a consolidated group, any pre-existing tax losses can be transferred to the group under certain conditions. The ATO requires comprehensive documentation of these transferred losses, including:

- **Quantification of losses:** Detailed calculations showing the amount of tax losses available for transfer at the joining time, including any adjustments required under tax law.
- **Utilisation records:** Documentation demonstrating how these losses have been utilised within the consolidated group, including any limitations or restrictions on their use.
- **Compliance with legislation:** Evidence that the losses meet all legislative requirements for transfer, including continuity of ownership and business tests.

5.2.3 Workpapers for consolidated accounts and tax returns

The ATO expects comprehensive workpapers that support the preparation of consolidated accounts and tax returns, with a particular focus on intragroup transactions. These workpapers should include:

- **Preparation of consolidated accounts:** Detailed records of how individual financial statements of group entities are consolidated, ensuring all intragroup transactions are properly eliminated to avoid double-counting.
- **Intragroup transactions:** Workpapers documenting all intragroup transactions, such as sales, loans, and services. This includes:

   - **Elimination entries:** Documentation of entries made to eliminate intragroup sales, expenses, and balances.
   - **Allocation of adjustments:** Workpapers showing how adjustments are allocated to the tax cost setting amounts of the assets involved in intragroup transactions.
- **Tax return workpapers:** Comprehensive records that explain the tax implications of the consolidated accounts, including adjustments made for intragroup transactions and reconciliations to the tax return figures.
- **Compliance records:** Evidence that all calculations and adjustments comply with relevant tax consolidation legislation and ATO guidelines.

5.2.4 Tax sharing agreements

A tax consolidated group is not legally required to have a Tax Sharing Agreement (**TSA**). However, if such an agreement is executed, the ATO expects that TSAs within a consolidated group comply with specific requirements to ensure their validity and availability upon request. According to section 721-25 of the *Income Tax Assessment Act 1997* (**ITAA 1997**), a TSA must exist immediately before the head company's due time, determining how the relevant group liability is apportioned among the contributing members.

The ATO stipulates that a TSA must be in writing, executed by or on behalf of the head company and each contributing member, and must include the date of execution, the names of the head company and contributing members, and a specification of the group liabilities covered by the agreement. Additionally, if the Commissioner issues a formal notice requesting a copy of the TSA, subsection 721-25(3) of the ITAA 1997 mandates that the head company must provide the TSA in the 'approved form' within 14 days. Failure to do so may result in the TSA being considered non-existent, thus rendering all contributing members jointly and severally liable for the group liability.

The ATO emphasises the importance of retaining a TSA in a form that meets these criteria and being able to produce it promptly upon request to avoid severe consequences, including the imposition of joint and several liability on contributing members.[4]

5.3 Transfer pricing

The ATO places significant emphasis on thorough and accurate record-keeping for transfer pricing to ensure compliance with the arm's length principle and relevant tax laws. When the ATO conducts a transfer pricing review, it expects taxpayers to provide detailed documentation supporting their transfer pricing practices.

Although transfer pricing rules are typically associated with cross-border transactions, the ATO recognises that they can also apply to domestic transactions within Australia. This can occur in cases where there are different tax rates, concessions, or loss-making entities within the group.

[4] Australian Taxation Office, *Consolidation Reference Manual*, (15 July 2011), C9-7-110, https://www.ato.gov.au/law/view/document?docid=CON/C9-7-110 [Accessed 18 August 2024].

5.3.1 Comprehensive Documentation

The ATO has published *Taxation Ruling TR 98/11* (**TR 98/11**), which sets out the ATO's expectations regarding the documentation and processes required to demonstrate compliance with the arm's length principle in transfer pricing, particularly in preparation for an ATO review or audit.

TR 98/11 clearly outlines the types of documentation that the ATO expects taxpayers to produce during a transfer pricing audit. This includes:

- **Functional and comparability analysis:** Detailed documentation of the functions performed, risks assumed, and assets employed by the entities involved. The comparability analysis should include data interpretation, adjustments for comparability, and the rationale behind selecting specific data points or comparables.
- **Application of transfer pricing methodologies:** Documentation explaining the choice of transfer pricing method, how it was applied, and why it was deemed the most appropriate for the given circumstances. This should also include performance reports used to verify the arm’s length nature of the pricing.
- **Monitoring and review documentation**: Records of ongoing monitoring activities, including the identification of material changes in the business environment and the resulting adjustments to the transfer pricing method. This also includes documentation of the review process and any decisions made to revise the methodology.
- **Documentation for small businesses**: While less extensive, small businesses are still expected to maintain records that justify their transfer pricing outcomes. This includes basic functional analyses, comparisons with external data (where applicable), and any internal benchmarks used.
- **Adjustments and revisions**: Where changes in the business or economic environment require a revision of the transfer pricing methodology, the taxpayer must document the reasons for the change, the process undertaken to review the methodology, and the basis for any adjustments made.

The ATO requires that all relevant transfer pricing documentation be prepared contemporaneously and be readily accessible during a review. This means that documentation should be prepared by the time the relevant tax return is lodged and should be updated regularly to reflect any significant changes in the business or its transfer pricing practices.

6. Common mistakes

6.1 Small and medium businesses

The ATO identifies several common mistakes made by small business taxpayers during audits. These issues can lead to significant tax adjustments, penalties, and increased scrutiny. According to the ATO's Tax gap program summary findings for 2020-21 (the most recently published at the time of writing), the key areas where errors frequently occur include those set out below.[5]

Undeclared or omitted income

According to the tax gap program summary findings, one of the most significant challenges identified by the ATO during audits is the failure of small businesses to declare all income. This issue often arises when businesses do not report cash transactions, income deposited into private accounts, or income received from associated entities. Whether intentional or inadvertent, undeclared income remains a focal point in compliance activities.

Over-claimed deductions

Another common mistake involves the overclaiming of deductions. Small businesses frequently claim expenses that are not wholly and exclusively related to business activities. This includes personal expenses such as rent, travel, and home office costs being claimed as business deductions. Additionally, excessive claims for assets used for both personal and business purposes, like vehicles, are also prevalent.

Poor record keeping

Inadequate record keeping is a recurring issue that often leads to incorrect tax reporting. Common problems include failing to maintain proper documentation, manual recording errors, and not distinguishing between personal and business transactions. These shortcomings make it difficult for businesses to accurately report their income and expenses, increasing the risk of errors during audits.

Misunderstanding tax obligations

Many small businesses struggle with understanding their tax obligations, particularly when dealing with complex business structures or transactions. This lack of understanding can result in incorrect claims and reporting, often leading to significant tax adjustments and penalties during audits.

Shadow economy activities

A significant portion of the tax gap is attributed to deliberate tax avoidance activities within the shadow economy. This includes underreporting income, overclaiming deductions, and paying cash wages without proper reporting. These activities are of particular concern to the ATO, as they represent intentional efforts to evade tax obligations.

[5] https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/tax-gap/australian-tax-gaps-overview/tax-gap-program-summary-findings, [Accessed 18 August 2024].

6.2 Large businesses

For large businesses, the ATO has identified the following common errors.[6] Addressing these issues requires strong internal controls, regular audits of systems and processes, and a thorough understanding of current tax laws. Tax advisers are essential in guiding large businesses through these complexities to ensure compliance and reduce the risk of errors during audits.

GST reporting errors

Large businesses frequently face challenges with their GST reporting. Common issues arise from incorrect transaction classifications, such as claiming GST on items not fully subject to GST, and errors in communication between related entities that result in duplicate claims for the same expense. These problems are often exacerbated by outdated or improperly configured systems, especially during periods of business growth or restructuring.[7]

Errors in system integration and business changes

Significant changes, such as mergers or the implementation of new accounting systems, often result in errors. These can include coding mistakes during system integration or failing to adjust for changes in the business structure, leading to incorrect tax reporting.

Profit shifting and related party debt

Large corporate groups often engage in complex international arrangements that can result in profit shifting. This includes excessive allocation of debt to Australian entities, which can reduce tax liabilities through transfer pricing and thin capitalisation schemes.

Offshore service hubs and inbound supply chains

The use of centralised hubs and complex supply chains may lead to inappropriate tax treatments, where profits are not adequately recognised in Australia. This can result in significant compliance risks, particularly when goods or services are transferred at non-arm's length prices.

Intangible assets and non-arm's length arrangements

The migration or artificial allocation of intangible assets, such as intellectual property, to offshore entities presents a high risk of tax avoidance. These arrangements often involve non-arm's length dealings, leading to underreporting of income in Australia.

[6] https://www.ato.gov.au/about-ato/learn-about-tax-and-the-ato/tax-and-corporate-australia/in-detail/key-compliance-risks-for-large-corporate-groups, [Accessed 18 August 2024].
[7] https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/large-business/in-detail/compliance-and-governance/gst-and-business-systems-large-business, [Accessed 18 August 2024].

Re-characterisation of income

There is a risk when business trading income is re-characterised as passive income, often to benefit from lower tax rates. This may involve complex group structuring or the use of stapled structures, posing significant compliance concerns.

Research and development claims

Incorrect claims for the R&D tax incentive, particularly those that misattribute regular business expenses to eligible R&D activities, are a key risk. This is especially prevalent in industries like construction, agriculture, and software development.

Property and construction activities

The property and construction sectors have low tax performance and higher rates of insolvency, leading to a heightened focus on compliance in this area. This includes ensuring proper tax treatment of capital gains and asset transfers during significant business events.

6.3 How tax advisers can help

To help clients avoid common tax pitfalls identified by the ATO, tax advisers should adopt a proactive and tailored approach. Regularly updating clients on their tax obligations and ensuring they understand the nuances of declaring income and legitimate deductions is essential. Staying abreast of changes in tax laws and ATO focus areas allows advisers to provide accurate and relevant advice. Implementing robust record-keeping practices and using reliable accounting software can prevent errors, particularly in distinguishing between personal and business transactions. Periodic compliance reviews are crucial, especially for businesses undergoing changes such as mergers or system upgrades. Advisers should assist clients to strengthen and document internal controls, especially for large businesses dealing with profit shifting, intangible assets, and related party transactions. Ongoing support is vital, monitoring any changes in business activities that might impact tax obligations. By maintaining a continuous relationship and providing tailored advice, tax advisers can effectively assist clients in navigating complex tax laws and ensuring compliance with ATO requirements.

7. The art of a well-timed voluntary disclosure

A voluntary disclosure to the ATO involves a taxpayer proactively informing the ATO about errors, omissions, or discrepancies in their tax returns or other statements before the ATO identifies these issues through an audit or other compliance activities. It is not uncommon for errors to be uncovered when the taxpayer and their advisers begin reviewing the taxpayer's affairs following notification of an ATO audit or review.

7.1 Benefits of voluntary disclosures

Making a voluntary disclosure helps taxpayers avoid further penalties that might be imposed if the ATO discovers the error independently during an audit or investigation. Furthermore, a voluntary disclosure demonstrates good faith and cooperation, which can contribute to a more favourable relationship with the ATO and potentially influence the ATO's approach to future compliance activities involving the taxpayer.

If the disclosure is made before the ATO notifies the taxpayer of an examination, the base penalty amount can be reduced by 80 per cent. In cases where the shortfall amount is less than $1,000, or where the error does not result in a shortfall, the penalty may be reduced to nil. If the disclosure is made after the taxpayer has been informed of an examination, but it is determined that the disclosure has saved the ATO significant time or resources, the penalty can be reduced by 20 per cent. Additionally, the ATO has the discretion to treat a disclosure made after notification of an examination as if it had been made before the notification, allowing the taxpayer to receive the higher penalty reduction. The specific requirements are discussed further below.

7.2 Timing

The timing of the disclosure is critical to maximising its benefits. To gain the most advantage, it is best to make the disclosure before any ATO audit or review begins. The specific circumstances of the disclosure, including whether it is made before or after the taxpayer has been informed of an ATO examination, will determine the extent of the penalty reduction.

7.2.1 Availability of 80% reduction

Section 284-225 of Schedule 1 to the *Taxation Administration Act 1953* (**TAA**) provides for a tiered system of penalty reductions depending on the timing and nature of the voluntary disclosure. Specifically, an 80% reduction in penalties is available when a taxpayer voluntarily discloses a shortfall amount or a scheme shortfall amount before the Commissioner notifies the taxpayer that an examination of their affairs will be conducted or before a public statement is issued by the Commissioner requesting such disclosures.

Under this section, if the taxpayer makes a voluntary disclosure before being notified of an examination or before a public deadline set by the Commissioner, the base penalty amount is reduced more substantially. Specifically, an 80% reduction applies to shortfall amounts or scheme shortfall amounts of $1,000 or more. Where the shortfall amount is less than $1,000, or the false or misleading statement does not result in a shortfall amount, the base penalty amount is reduced to nil.

Furthermore, the Commissioner has discretion under section 284-225 of the TAA to apply the 80% reduction, or a reduction to nil in certain cases, even when the disclosure is made after notification of an examination. This discretionary power is exercised if the Commissioner considers it appropriate based on the circumstances of the case.

Paragraph [60] of *Miscellaneous Taxation Ruling 2012/3 Administrative penalties: voluntary disclosures* (**MT 2012/3**) which states:

> *Because the phrase 'examination ... of your affairs' is so broad it may result in circumstances where it is harsh to not allow the higher reduction in penalty, for example where the Commissioner is merely identifying and/or assessing risks. In these cases, the Commissioner will generally exercise the discretion under subsection 284-225(5) (see paragraph 133 in Appendix 1 of this Ruling), the effect of which is to provide the entity with an 80% or full reduction in the penalty otherwise attracted.*

Paragraph [133] of MT 2012/3 states:

> *As a general rule, the Commissioner's discretion will be exercised in the following circumstances:*
>
> *(i) where the Commissioner is merely identifying and/or assessing risks, for example a risk review, notwithstanding that this is considered to be an examination;*
>
> *…*

If the Commissioner follows this guidance, where the taxpayer is subject to a general risk review the Commissioner should exercise the discretion to apply the 80% for voluntary disclosures, notwithstanding the fact that the ATO review is underway.

7.2.2 Disclosures after audit commenced

After the Commissioner has informed the taxpayer that an examination of their affairs will be conducted, a 20% reduction in the base penalty amount applies when a taxpayer voluntarily discloses a shortfall or a false or misleading nature of a statement. This reduction is contingent upon the disclosure being made in the approved form and being reasonably estimated to have saved the Commissioner significant time or resources during the examination.

8. What causes audits to go awry

8.1 "if you just ignore it, it will go away"

Failing to cooperate with an ATO audit poses several key risks for the taxpayer:

1. **Penalties and interest**: Non-compliance with information requests or notices can lead to significant financial penalties. The ATO can impose fines for failing to provide required information or documentation. Any unpaid tax liabilities identified during the audit will likely accrue interest. Delays caused by non-cooperation can increase the amount of interest owed.
2. **Escalation and litigation**: Persistent non-cooperation can result in the ATO escalating a review to an audit or seeking legal remedies, including court orders compelling compliance. This can lead to additional legal costs and potential contempt of court charges.
3. **Default assessments**: The ATO may issue default assessments based on the information available, which could result in higher tax liabilities than if full cooperation had been provided.
4. **Increased scrutiny**: Non-cooperation can trigger heightened scrutiny from the ATO. This might result in more extensive audits, additional investigations, and a greater likelihood of identifying discrepancies or tax evasion.
5. **Reputational damage**: Businesses and individuals found to be non-cooperative with tax authorities risk damaging their reputation, which can affect relationships with customers, suppliers, and financial institutions.

8.2 "we'll just say we can't find the information or it will take too long to compile"

The ATO has extensive formal information-gathering powers to ensure compliance with tax laws. Under section 353-10 of the TAA, the ATO can issue a notice requiring a person or entity to provide information, produce documents, or attend and give evidence under oath. These powers are designed to facilitate thorough audits and investigations, enabling the ATO to access necessary data to verify tax liabilities, assess compliance, and detect potential tax evasion.

If a taxpayer does not cooperate in a timely manner during an audit, the ATO may use these powers to compel cooperation. This could include issuing notices, escalating the matter to higher authorities within the ATO, and potentially seeking legal enforcement of compliance through the courts. Non-compliance with these notices can result in substantial penalties, including fines and, in some cases, criminal charges.

8.3 Missed deadlines

The ATO generally sets timeframes for the taxpayer to respond to information requests. If there is any reason why the timeframe cannot be met, it is best practice to communicate with the relevant ATO contact as soon as possible, and negotiate an extension of time where required. If a large number of documents have been requested, it may be possible to provide some documents as and when they become available and request further time to compile other items.

If deadlines are missed without proactive communication, it may be viewed as a lack of cooperation by the taxpayer and could cause the ATO to escalate its review, issue default assessments or turn to its formal information gathering powers.

9. Conclusion

9.1 Be prepared

In conclusion, navigating ATO audits and reviews requires thorough preparation, meticulous record-keeping, and a proactive approach to compliance. Tax professionals must understand the triggers that could lead to an audit and ensure their clients are well-prepared to address any concerns raised by the ATO. This involves maintaining accurate and up-to-date documentation, implementing effective governance practices, and following record-keeping best practice in areas such as R&D claims, tax consolidation, and transfer pricing.

9.2 Minimising costs of audit

Audit insurance, while a helpful safeguard, should be complemented by robust internal controls and regular internal compliance reviews to minimise the risk of costly errors and penalties. The strategic use of voluntary disclosures can significantly reduce penalties and foster a cooperative relationship with the ATO.

9.3 Communication is key

Tax professionals should, with their client's authorisation, communicate proactively with the ATO from the outset of any review or investigation and work cooperatively with the ATO where possible.

Hopefully this paper has provided some helpful strategies for tax professionals to assist clients to obtain the best possible outcome from ATO audits and reviews.