

August 1994

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### Recommended Citation

Wickerson, John (1994) "The Changing Roles of Taxpayer Audit Programs: Some Recent Developments in the Australian Taxation Office," *Revenue Law Journal*: Vol. 4 : Iss. 2 , Article 2.

Available at: <http://epublications.bond.edu.au/rlj/vol4/iss2/2>

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# The Changing Roles of Taxpayer Audit Programs: Some Recent Developments in the Australian Taxation Office

## **Abstract**

This paper reviews some of the concerns raised in the recent report by the Joint Committee of Public Accounts in respect of the Australian Taxation Office's Taxpayer Audit Group. It examines the audit-based risk management strategy being applied to two particular categories of business taxpayers and queries the validity of the concerns raised.

## **Keywords**

audits, taxation, risk management, Australian Taxation Office

## THE CHANGING ROLES OF TAXPAYER AUDIT PROGRAMS: SOME RECENT DEVELOPMENTS IN THE AUSTRALIAN TAXATION OFFICE

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This paper reviews some of the concerns raised in the recent report by the Joint Committee of Public Accounts in respect of the Australian Taxation Office's Taxpayer Audit Group. It examines the audit-based risk management strategy being applied to two particular categories of business taxpayers and queries the validity of the concerns raised.

### Introduction

In November 1993, Mr Les Scott MP, Chairman of the Commonwealth Parliament's Joint Committee of Public Accounts ("JCPA"), tabled Report No 326: *An Assessment Of Tax*.<sup>1</sup> This report contained the findings and recommendations resulting from the Committee's two-year inquiry into the operations of the Australian Taxation Office ("ATO").

Mr Scott noted that this broadly-based inquiry had been the first of its kind in 80 years. He observed that "The Committee's Report provides a comprehensive assessment of the Tax Office and may be seen as providing a blueprint for the future - a future with benefits for

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\* The author works in the Taxpayer Audit Group of the Australian Taxation Office (ATO). This paper was written whilst he was on study leave from his position as Director, Compliance and Industry Research (CIR) Unit. The views expressed are his own and do not necessarily reflect official ATO views. The latter part of the paper is based largely on one presented previously by the author at the 1992 Internal Revenue Service Research Conference, Washington, DC. Thanks are due to Nyree Goss for assistance in updating the data required for Figure 2.

<sup>1</sup> JCPA, Joint Committee of Public Accounts, Report No 326, *An Assessment of Tax: A Report on an Inquiry into the Australian Taxation Office* (1993) AGPS, Canberra.

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taxpayers, the Tax Office and the Parliament".<sup>2</sup> In his subsequent circular to the ATO's some 18,000 staff<sup>3</sup> the Commissioner for Taxation, Mr Michael Carmody, commented that "While the Committee has made many suggestions for improvement, there is no doubt that we are headed in the right direction. Indeed, many of the Committee's recommendations are premised on the maintenance of the directions that we have set in place".<sup>4</sup>

One of these directions has involved the development and implementation of various compliance-based strategies for managing the "risks to the Revenue". Each of these strategies is based on three main considerations. The first consideration is that different, broadly-defined groups of taxpayers (or "market segments") are likely to have quite different problems in complying with their tax obligations.<sup>5</sup> The second consideration is that, within each of these market segments, there are likely to be significant variations in the extent to which particular groups of taxpayers actually meet their tax obligations. The third consideration is that each of these market segments also varies considerably in terms of numbers of taxpayers, and with respect to their total amounts and composition of taxable income.

Thus the ATO needs to strike an appropriate balance for each market segment when resourcing its "education", "service", "law improvement", "revenue collection systems" and "enforcement" programs. The ATO has encapsulated the nature of this challenge as follows:<sup>6</sup>

In order to achieve maximum compliance at lowest cost, the ATO's efforts must be focussed in ways that are most appropriate for each client segment. The resources allocated to specific functions and segments will need to be flexible and change over time in order to deal most

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<sup>2</sup> Ibid at 1.

<sup>3</sup> Carmody, "An Assessment of Tax" *Initial Response to Staff*, 17 November 1993.

<sup>4</sup> Ibid at 1.

<sup>5</sup> The principal market segments the ATO has defined for purposes of managing the "risks to the Revenue" are as follows: large businesses with annual turnover in excess of \$50 million; medium businesses with annual turnover between \$5 million and \$50 million; small businesses with annual turnover less than \$5 million; non-business individuals, comprising taxpayers who do not have business income. For further details and an overview of the ATO's market segmentation strategies see Bird S, "Market Based Strategies to Improve Taxpayer Compliance: The ATO's Approach and Experience to Date," paper presented at the (United States) Internal Revenue Service 1992 Research Conference, 12-13 November, Washington DC.

<sup>6</sup> Australian Taxation Office, *Risk Management in the ATO* (1992) 8.

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appropriately with any particular identified risk.

A plausible scenario is one where, across all market segments, the proportion of resources devoted to risk assessment increases as we work to improve our understanding of client behaviour and how it responds to various compliance strategies. A greater proportion of effort may also need to be devoted to service initiatives and identifying possible changes to the administrative framework, to the extent that these are seen as more cost efficient ways of promoting compliance.

This scenario might seem to indicate a reduced proportion of effort being devoted to enforcement.

However, enforcement activities **need not** decline. This is because of the growing emphasis being placed on less intrusive and less labour intensive "leverage" compliance activities...Modernisation...(of the ATO's computer-based systems)...will also permit staff to be re-allocated from narrow processing jobs to work on broader roles including the enforcement programs. Thus overall, enforcement activities could well increase rather than decrease under the above scenario.

Interestingly, the JCPA did not comment directly on the strategic issues associated with the allocation of resources by the ATO **between** its various programs. However, a number of the JCPA's recommendations do relate generally to these important resource allocation issues. The following three recommendations are especially pertinent in these respects:

- The Australian Taxation Office be established by statute under its own Charter as the Australian Taxation Commission.<sup>7</sup>
- The Australian Tax Commission be established with a **one line** budget appropriation.<sup>8</sup>
- The Australian Tax Commission report on its resources to the Parliament in accordance with the **current practice** of the Australian Taxation Office and be fully available for on-going scrutiny by the Parliament.<sup>9</sup>

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<sup>7</sup> Recommendation 1.

<sup>8</sup> Recommendation 3: emphasis added.

<sup>9</sup> Recommendation 5: emphasis added.

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One inference that could be reasonably drawn from these particular recommendations is that the JCPA regarded the current allocation of ATO resources across programs as being generally appropriate and therefore no significant changes to the existing reporting and oversighting arrangements were warranted. A further inference would be that the JCPA was broadly supportive of the risk management strategies and procedures adopted by the ATO in making these resource allocation decisions.

Likewise, the JCPA did not focus to any significant extent on the ATO's strategies and procedures for allocating resources *within* particular programs. Again, however, it would be reasonable to infer that the JCPA generally supported the ATO's approach to making intra-program resource allocation decisions.<sup>10</sup> As noted above, these decisions are based largely on the ATO's evaluation of the extent and nature of the "risks to the Revenue" associated with different categories of taxpayers.<sup>11</sup> In particular, the JCPA considered the "Targeting of audits through the use of risk management principles represents...an appropriate response to the economic realities of a self assessment system".<sup>12</sup> Again, the JCPA did not address in any depth the criteria utilised by the ATO when targeting particular populations of taxpayers or individuals for audit. However, it clearly endorsed the general approach of "targeting" in preference to the alternative of selecting taxpayers for audit simply on a random basis.

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<sup>10</sup> Tacit support for this assessment can be found elsewhere in the JCPA's Report. For example, the JCPA noted that "(e)vidence from taxpayer representatives suggested the ATO's mix of **enforcement** strategies, while correct in theory, was inappropriately balanced and skewed too heavily in favour of penalty and prosecution. Such a claim, if **correct**, would represent a fundamental imbalance in the taxation system..." (JCPA, above n 1 at 293; emphases added). However, having made this important observation the JCPA did not proceed to make its own judgment as to whether the ATO had generally struck the right balance in allocating its resources. Rather, it was clearly much more concerned with the role played by auditors and the nature of the audit process, and of the penalty regime in a self-assessment environment. In relation to the above quotation, it should also be noted that the JCPA used the term "enforcement" to include education of taxpayers, improvements to the law, the development of systematic collection systems, as well as administrative penalties and prosecutions (ibid at 292). Such a usage is much broader than typically used in the literature and by tax administrations.

<sup>11</sup> For an overview of the ATO's general approach to managing the "risks to the Revenue" see ATO, above n 6, and Boucher, "Risk Management on a Market Segmented Basis", Address given to the Australian Institute of Criminology, March 1992, Sydney.

<sup>12</sup> JCPA, above n 1 at 255.

For example, in relation to PAYE taxpayers the JCPA noted that the application of risk management practices meant "Intrusive auditing involving face to face desk audits or other alternatives are only necessary for taxpayers whose returns demonstrate a circumstance which might be considered unusual".<sup>13</sup> Likewise, in the case of small and medium-sized business taxpayers, the JCPA noted that "Through the use of research and historical data the ATO...has begun developing extensive profiles for 370 occupations and industry groups. The groups are ranked according to their perceived risks to the Revenue and behavioural thresholds have been established which act as a first indicator to the ATO of possible non-compliance".<sup>14</sup>

By contrast, the JCPA expressed some major concerns with the stated objectives of the ATO's Taxpayer Audit Group, as presented in evidence to the JCPA<sup>15</sup> and in previous public documents.<sup>16</sup> Section 2 of this paper briefly discusses these stated objectives, and the JCPA's interpretation of them.

Section 2 provides the policy background for the subsequent discussion in Section 3, which forms the main part of this paper. In Section 3 the focus will be on a particular audit-based risk management strategy being applied by the ATO to two particular categories of business taxpayers. These categories or "market segments" cover, respectively, Small Businesses with annual turnover less than \$5 million and Medium Businesses with annual turnover between \$5 million and \$50 million. These two market segments were selected because the JCPA's general concerns with the ATO's stated audit program objectives are most readily apparent and assessed in this context. The particular risk management strategy to be discussed, termed the Project-based Audit ("PBA") Approach, was selected because it is typical of much of the ATO's current approach to fostering taxpayer compliance.

### Objectives of the ATO's Taxpayer Audit Group

In its report, the JCPA noted that the principal objectives of the Taxpayer Audit Group had been identified by the ATO as follows:<sup>17</sup>

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<sup>13</sup> Ibid at 247.

<sup>14</sup> Ibid at 249.

<sup>15</sup> Australian Taxation Office, Submission to the Joint Committee of Public Accounts, April 1992.

<sup>16</sup> For example, see Australian Taxation Office, *Towards a World Class Tax Administration: Commissioner of Taxation, Annual Report 1991/92* (1992) and Australian Taxation Office, *Taxpayer Audit Group: Business Plan 1992/93* (1992).

<sup>17</sup> Above n 1 at 242.

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to progressively build relative and absolute measures of taxpayer behaviour by taxpayer group;

identify the causes of non-compliance detected, and with other Groups, identify strategies to improve compliance; and

where appropriate, take part in the implementation and carrying out of those strategies.

The JCPA commented that, despite the ATO's emphasis on managing the "risks to the Revenue", these objectives "do not expressively include the raising of revenue or even the protection of the revenue from tax strategies. Nevertheless, from the weight of the evidence received, the JCPA concluded it was these latter two factors which taxpayers perceived formed the critical objectives of this Group".<sup>18</sup>

Importantly, the JCPA further commented that the latter revenue protection role "does not approximate to the more community focussed objective of ensuring "compliance" with the law".<sup>19</sup> It would appear, however, that the JCPA is confusing here three distinct but interdependent roles of taxpayer audit programs. Indeed, analysis of these three roles and their relationships constitutes a significant part of the now extensive literature on taxpayer compliance behaviour.<sup>20</sup> In this literature, taxpayer audit programs are identified as playing not only two types of deterrence role but also a third, wider compliance enhancing role. Bearing in mind the preceding observations of the JCPA, this wider role may be termed the community compliance role.

The first of the two deterrence roles referred to above is usually termed the specific deterrence role. It involves detecting and bringing to account those taxpayers who deliberately seek to evade tax. In the process it is hoped that the detection of tax cheats will have a general deterrence or "ripple" effect<sup>21</sup> on other potential tax evaders. Both the

<sup>18</sup> Ibid.

<sup>19</sup> Ibid at 243.

<sup>20</sup> For recent reviews of much of the deterrence literature relating to taxpayer compliance behaviour and taxpayer audit programs refer Roth J A and Scholtz J T (eds), *Taxpayer Compliance: Vol 2: Social Science Perspectives* (1989 University of Pennsylvania Press); Roth J A, Scholtz J T and Witte A D (eds), *Taxpayer Compliance: An Agenda for Research* (1989 University of Pennsylvania Press); Long S B and Swingen J A, "Taxpayer Compliance: Setting New Agendas for Research" (1991) 25 *Law and Society Review* 901; Wallschutzky I, "Achieving Compliance" April 1992 *APTIRC Bulletin* 143; and Hasseldine J, "How Do Revenue Audits Affect Taxpayer Compliance?" July/August 1993, *International Bureau of Fiscal Documentation* 424.

<sup>21</sup> Malanga F, "The Relationship Between IRS Enforcement and Tax Yield" (1986) 39 *National Tax Journal* 333.



specific and general deterrence roles of taxpayer audit programs have often been analysed, typically following the seminal economic framework developed by Allingham and Sandmo,<sup>22</sup> by assuming that taxpayers regard tax evasion as little more than an amoral game of chance to be played against the tax administration.

In this game a "win" occurs where the taxpayer is not selected for audit. Correspondingly, a "loss" occurs where the reverse applies, and financial or other penalties are incurred by the taxpayer. Recently, researchers utilising this type of economic analysis have also sought to capture other motivations underpinning taxpayer compliance behaviour, such as feelings of guilt about cheating and perceptions of the degree of fairness of the tax regime (defined to include the provision of public goods) and the way it is administered. As a result, very few of the latest analyses of taxpayer audit programs focus solely on the narrower (but still important) deterrence roles of taxpayer audit programs.<sup>23</sup>

In effect, this more recent literature has sought to integrate the different traditional interests of the various social science disciplines.<sup>24</sup> One result is that the taxpayer compliance literature is now focussing much more on the wider role that taxpayer audit programs can play in fostering a climate wherein the community is willing to comply voluntarily with the tax laws. Typically, this climate is seen as being one where most taxpayers feel that other taxpayers are also complying and that, importantly, they themselves have been treated fairly by the tax administration. Levi<sup>25</sup> in particular has emphasised this latter point. Furthermore, it can be argued that such a climate is more likely to be achieved where tax administrations take appropriate steps to assist taxpayers to meet their tax obligations. This function is especially important where a significant proportion of noncompliance is inadvertent and arises because of (say) complexity or ambiguity in the

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<sup>22</sup> Allingham M G and Sandmo A, "Income Tax Evasion: A Theoretical Analysis" (1972) 1 *Journal of Public Economics* 323.

<sup>23</sup> See Pinney N and Scholz J T, "Can Cognitive Consistency Cure Collective Dilemmas? Self Interest Versus Duty to Pay Taxes" (1992) Working Paper 28, Russell Sage Foundation, New York, for a good example of a recent extension of the basic deterrence-based approach to modelling taxpayer compliance behaviour.

<sup>24</sup> See McGraw K M and Scholz J T, "Appeals to Civic Virtue Versus Attention to Self-Interest: Effects on Tax Compliance" (1991) 25 *Law and Society Review* 472, for a succinct statement of the main challenges involved here.

<sup>25</sup> Levi M, *Of Rule and Revenue* (1988 University of California Press).

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law.<sup>26</sup>

One of the major challenges facing tax administrations, therefore, is the design, resourcing and implementation of taxpayer audit programs which are both (i) efficient and effective in performing their specific and general deterrence roles, and are at the same time (ii) widely perceived by the community-at-large to be fair and reasonable.

By contrast, in places the JCPA would appear to be suggesting that roles (i) and (ii) are best viewed separately. Indeed, a strong interpretation of the JCPA's comments in this respect would be that the JCPA considers roles (i) and (ii) to be essentially incompatible. However, this latter interpretation would most probably be incorrect. For example, the JCPA particularly expressed concern that ATO audit "case selection procedures were contributing to the development of a belief amongst auditors that cases chosen by case selection staff should automatically return revenue to the Commonwealth"<sup>27</sup>. The JCPA therefore recommended that "auditors in the Australian Taxation Office be briefed on the reasons for a case being selected for audit, the briefings to stress the need to improve voluntary compliance."<sup>28</sup>

Unfortunately the JCPA did not make it clear whether it was referring here to the need to improve the voluntary compliance of just auditees or amongst the wider community. In general, their Report gives the impression that the JCPA was somewhat unclear about the interplay of the various functions taxpayer audit programs are increasingly being expected to perform in support of the corporate goals tax administrations set themselves. This is perhaps unsurprising since, as indicated above, it is only recently that this interplay has been focussed on in the taxpayer compliance literature. Reaching such an holistic view of the roles played by the ATO's taxpayer audit programs was also undoubtedly made all the more difficult for the JCPA in that the particular kinds of initiatives implemented by the ATO have yet to be commented upon in the taxpayer compliance literature.

The objective set for the remainder of this article is therefore deliberately modest. It is simply to describe the rationale and approach of the "Project-based Audit", ("PBA") approach to managing the "risks

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<sup>26</sup> For some preliminary evidence of the relative incidence of inadvertent and deliberate noncompliance in the Business Audit domain see Wickerson J, "Measuring Taxpayer Compliance: Issues and Challenges Facing Tax Administrations", paper presented at the 1993 Australian Taxation Office Conference, 2 and 3 December 1993, Canberra.

<sup>27</sup> Above n 1 at 250.

<sup>28</sup> Ibid at 251; emphasis added.

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to the Revenue" in the small and medium sized business market segments. Hopefully, this description will serve to clarify the wide nature of the roles increasingly being expected of taxpayer audit programs.

### **The Project-based Audit approach**

In early 1989, the ATO's Taxpayer Audit Group commenced a rolling program of nationally-coordinated projects designed to measure and, where necessary, facilitate improved compliance amongst populations of small and medium-sized businesses in those industries and occupations considered to represent a high "risk to the Revenue". Collectively, these projects constitute what has become known in the ATO as the PBA approach. After surmounting a number of early implementation problems, PBA projects are now an integral part of the ATO's Business Audit Program. This program covers taxable income reportable by sole traders, partnerships, trusts and companies with annual turnover less than \$50 million.

To give some idea of the scale of the resources that have been allocated so far to the PBA Approach in the Business Audit Program, of the 45,000 or so business audits conducted over the 4-year period 1989-90 to 1992-93, some 4,000 (9%) were conducted as part of PBA projects. The PBA Approach also has been extended into the Source Deduction Audit Program, which seeks to promote compliance by those businesses responsible for deducting income tax "at source" from employees and also from those taxpayers subject to the Prescribed Payments System.

The PBA Approach was designed to address compliance problems amongst those "high risk" taxpayer populations where either (i) the present "audit trail" is relatively weak, or (ii) a significant increase in "audit coverage" using established case selection and audit techniques is neither a viable nor an appropriate compliance improvement option. Correspondingly, the two key objectives set initially for individual PBA projects were:

- (i) to improve "audit trails" by making better ATO-wide use of the available information ("signals") about taxpayer noncompliance;

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- (ii) to identify ways of achieving greater compliance "leverage"<sup>29</sup> from existing ATO resources.

Thus, although PBA projects are the responsibility of the Taxpayer Audit Group, the initiatives arising from them have not necessarily been restricted to improving the efficiency and effectiveness of "conventional" audit program activities. The opportunities for achieving greater compliance "leverage" through the use of taxpayer audit program resources are more broadly-based than this and can take numerous forms, including improved taxpayer education and other services, changes to administrative arrangements, and changes to the tax legislation.

In brief, the PBA Approach acknowledges that taxpayer audit program resources can be used in more than just a deterrence mode. As already noted, until recently this point had seemingly been missed by most researchers concerned with modelling "optimal audit strategies" (Welch<sup>30</sup> and Wertz<sup>31</sup> perhaps remain the most significant exceptions). It is reasonable to suggest this omission has been sustained largely because of the lack of a strong focus in the taxpayer compliance literature on those taxpayers who inadvertently make errors on their tax returns. Instead, as indicated above, the research focus has been largely on supposedly fully-informed game-playing taxpayers who are presumed to maximise their "expected utility" by making a deliberate decision whether to evade tax, and if so by how much.

By contrast, the structure of the penalty regime in Australia, as elsewhere, acknowledges that some noncompliance by taxpayers is inadvertent. Since auditors largely determine which penalty rate(s) shall apply, they are obliged to form views about the nature of the detected noncompliance. There is no in-principle reason why the information they obtain in performing this role cannot be utilised subsequently as part of (say) a corporate-wide taxpayer service strategy. The challenge is in designing and implementing organisational structures and procedures which will achieve this transference of information.

The next part of this article will focus mainly on the experience the ATO had gained, prior to the publication of the JCPA's report, in

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<sup>29</sup> The term "leverage" has been popularised by Senge P, *The Fifth Discipline: The Art and Practice of the Learning Organisation* (1990 Doubleday Currency), writing in a broader corporate planning context.

<sup>30</sup> Welch R B, "Measuring the Optimum Size of a Field Audit Staff" (1954) 7 *National Tax Journal* 201.

<sup>31</sup> Wertz K L, "Allocation by, and Output of, a Tax-Administering Agency" (1979) 32 *National Tax Journal* 143.

applying the PBA Approach to the ATO's Business Audit Program. First, there is an explanation of the origins of the PBA Approach. This is followed by a description of its objectives and recent implementation.

## Origins

Because policy evolves over time and cannot be observed in any specific legislative act or administrative action, the true spirit of community corrections can be inferred only through an examination of the history of its development.<sup>32</sup>

The PBA Approach reflects many of the recent changes in the ATO's strategy towards meeting its principal corporate objective - "collecting at the lowest possible overall cost to the community the Revenue properly payable". The history of the PBA Approach's development and implementation therefore provides general insights into the ATO's resource allocation and decision-making processes and the roles played by external "stakeholders" and advisors in what has been a period of rapid and substantial changes for the organisation.<sup>33</sup> The following historical perspective is necessarily selective and only illustrative of the wide range of factors which have influenced the development of the PBA Approach.

The first important influence was the 1985 Draft White Paper *Reform Of The Australian Taxation System*.<sup>34</sup> In contributing to the *Draft White Paper*, the ATO was required for the first time to produce economy-wide estimates of the extent of taxpayer noncompliance. Of the estimated loss to the Revenue in 1984/85 of "at least \$3 billion",<sup>35</sup> \$1 billion was attributed to unincorporated enterprises and a further \$500 million to companies. These estimates of business sector noncompliance, it should be noted, excluded the loss to the Revenue through tax avoidance. They also excluded the attribution to businesses of some proportion of the other \$1500 million or so of the estimated noncompliance associated with the receipt of unreported wage and salary income, fringe benefits, dividend, interest and rental income and overclaimed employee expenses.

<sup>32</sup> Palumbo D, Maynard-Moody S and Wright P, "Measuring Degrees of Successful Implementation: Achieving Policy Versus Statutory Goals" (1984) 8 *Evaluation Review* 45.

<sup>33</sup> For an overview of these changes see ATO, above n 15.

<sup>34</sup> Australian Treasury, *Reform of the Australian Tax System: Draft White Paper* (1985) AGPS.

<sup>35</sup> This estimate excludes some \$220 million recouped through enforcement activities.

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The above estimates of noncompliance were not based on systematic audit-based research but instead were derived from comparisons between "...business income aggregates, as reported in the Australian National Accounts and taxation returns...supplemented by knowledge of the level of evasion coming to light as a result of audit and investigation activities ..."36 The resulting estimates37 implied an understatement of net business income of some 30%, although this particular figure was not included in the *Draft White Paper*. Since then, these estimates have been regularly used by the Australian Bureau of Statistics (for National Income Accounting purposes), academic researchers, the media and politicians (as benchmarks when making "guestimates" of the current overall level of noncompliance in the so-called "cash-economy").

The experience gained in contributing to the *Draft White Paper* heightened the ATO's awareness that because it did not have "sufficient data on the extent and nature of noncompliance with the income tax laws...it is not possible to measure or predict the impact of the various compliance activities on voluntary compliance", and that the lack of such data inhibited "decision making on how resources might best be allocated across the various audit programs".38 As acknowledged subsequently by the ATO in its submission to the JCPA, prior to the *Draft White Paper*, "Audit activity was largely reactive with case selection being based on return information only, rather than data from external sources. Few activities focussed on promoting voluntary compliance".39

To put these observations in a wider institutional context, it is important to recall that prior to 1 July 1986 tax returns were "assessed" by the ATO at the point of lodgement. This compliance strategy was pursued as a second-best option because, "In the past we considered that we had neither the appropriate case selection techniques nor the competence and experience to conduct audits on the scale necessary to

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36 Australian Taxation Office, "Compliance Strategy - 1986", Background Paper, July 1986.

37 Subsequent work on comparing ATO with Australian National Accounts (ANA) data has demonstrated that observed differences for key income aggregates cannot be simply equated with noncompliance. In some cases the ANA data themselves are based on taxation statistics, thus obviating useful results. In most other cases significant conceptual differences between the two data sets cannot be fully reconciled.

38 Above n 36.

39 Above n 15.

support self-assessment".<sup>40</sup>

Partly in response to the experience gained from the *Draft White Paper* exercise and partly because of the introduction of self-assessment, the ATO undertook in 1986 a major in-house review of its enforcement activities. That review, entitled *Compliance Strategy - 1986*<sup>41</sup> extended beyond the unincorporated business sector and provided the basis for *inter alia* an immediate but modest expansion of taxpayer compliance measurement research. However, as had been the case previously, that research was somewhat narrowly focussed in that it comprised only a few, essentially *ad hoc* projects aimed at measuring the overall level of compliance with respect to particular sources of business and non-business income. More generally, these research projects and other compliance-related initiatives flowing from *Compliance Strategy - 1986* were not conceived of as part of a broader strategy to systematically promote taxpayer compliance in a self-assessment environment. Instead, the main purpose of these initiatives was to increase the efficiency and effectiveness with which audit resources could be used to raise revenue directly from noncompliant auditees, rather than to achieve a sustained increase in the level of compliance across the general taxpaying population. By contrast, at the same time a broader view was taken of the type of compliance research program that was required. The intent here was to "Examine the various measurement approaches that could be adopted...(and to)...develop a comprehensive plan of measurement research".<sup>42</sup>

Next, May 1987 saw the publication of a review by the ATO of all the strategic initiatives then underway within the organisation. This review<sup>43</sup> was undertaken in response to a recommendation by the House of Representatives' Standing Committee On Expenditure that such a review should be conducted.<sup>44</sup> A further internal review<sup>45</sup> then focussed on the organisational structure of the ATO's taxpayer audit activities. Both reviews found that these activities needed to be more strategically directed and that they should be grouped around

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<sup>40</sup> Australian Taxation Office, "ATO Developments: Self-assessment", Australian Position Paper Presented at the Executives Meeting, Pacific Association of Tax Administrators (PATA) (1987).

<sup>41</sup> Above n 36.

<sup>42</sup> Ibid.

<sup>43</sup> Australian Taxation Office, *A Taxing Solution, Report of Program Management Performance Review (The Cullen Report)* (1987 AGPS).

<sup>44</sup> House of Representatives, *A Taxing Problem, Report of the House of Representatives Standing Committee on Expenditure* (1986 AGPS).

<sup>45</sup> Australian Taxation Office, *Pappas, Carter, Evans and Koop Pty Ltd Review of Organisation for Taxpayer Audit Programs* (1987).

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distinct taxpayer market segments. The result was that the ATO's previously largely generic audit activities were restructured into three business areas: Complex Audit, Business Audit and Primary Audit. This segmentation largely equates with one which distinguishes between "large corporations", "small and medium businesses" and "nonbusiness individuals".

In its submission to the JCPA, the ATO stated that "Until we had arranged our audit business in this way, our enforcement activities lacked ..."system"...(Previously)...the clear but limited main objective was to raise revenue from the cases audited. To this objective was added, almost as an afterthought, the hope of somehow achieving a general deterrent effect. In more recent years...we have put strategic priorities into enforcement activities to give us better information about where the major compliance problems exists and how to deal with them more effectively".<sup>46</sup>

A 1987 report of the Australian Audit Office (AAO) further stimulated the development of a more strategic approach for both compliance research and the allocation of ATO audit resources across the unincorporated business sector. Of particular importance was the recommendation that the ATO needed to "specify the techniques to be used to research, evaluate and document productive areas of evasion".<sup>47</sup> This recommendation helped further promote the already emerging practice within the ATO of conducting "controlled projects and provid(ing) feedback for evaluation and distribution to other branch offices".<sup>48</sup> The following AAO recommendations did likewise: the ATO should "ensure its industry and group study projects are adequately coordinated, monitored, controlled and documented to increase the accuracy and comprehensiveness of its views of taxpayer behaviour", and the ATO should "ensure its industry and group study projects make optimum use of information available from sources independent of existing taxpayer records".<sup>49</sup> The ATO agreed with these recommendations and in giving effect to them laid the foundations of the PBA Approach.

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<sup>46</sup> Above n 15.

<sup>47</sup> Australian Audit Office, *Report of the Auditor-General on an Efficiency Audit: Australian Taxation Office: Taxpayers in Unincorporated Businesses* (1987).

<sup>48</sup> Ibid.

<sup>49</sup> Ibid.



## Objectives and early implementation

The prototype of the PBA Approach was developed by ATO Branch Office audit case selection managers in 1988. The initial focus was on improving audit case selection techniques. However, by the time the first wave of projects was selected in early 1989 the objectives had widened to include obtaining industry-specific measures of taxpayer compliance and the fostering of voluntary compliance in those industries. The key steps of an individual PBA project are captured in Figure 1.

The Compliance and Industry Research Unit (CIRU) in the ATO's National Office has the task of ranking annually some 370 separate industries and occupations on the basis of their perceived economy-wide "risks to the Revenue". After the ranking has been reviewed by senior Branch Office representatives, a number of projects are conducted in the highest-ranked industries and occupations.

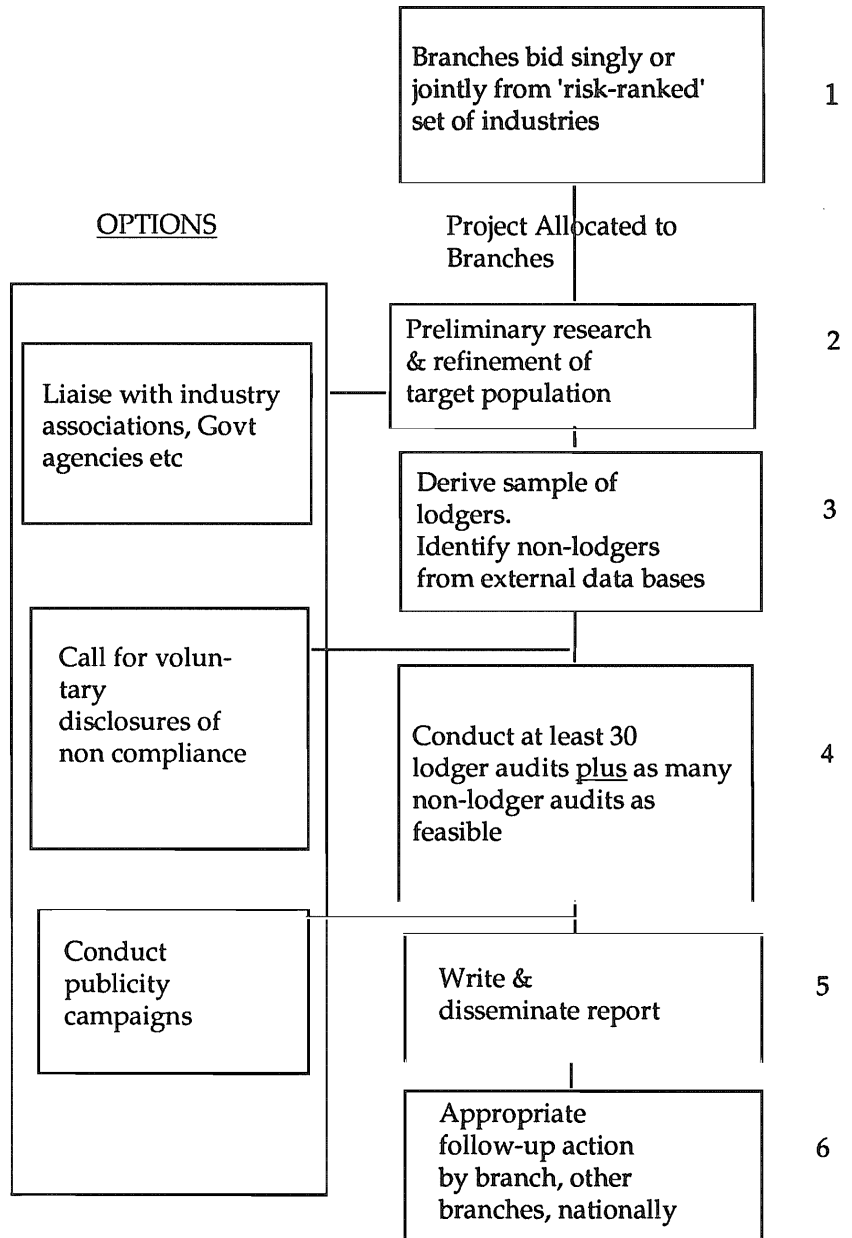
Once commenced, normally all projects proceed to Stage 5, as indicated in Figure 1. The term "Scoping Project" is applied to a project covering Stages 1 to 5. No formal revenue targets are set for audits conducted as part of Scoping Projects, only for any audits arising from them.

Previous Business Audit Program experience suggests that the "compliance profile" for a particular regional taxpayer population usually will be very similar to that observed for the corresponding populations elsewhere in Australia. For example, business practices and the opportunities and propensities for noncompliance (whether deliberate or otherwise) by (say) a urologist or plumber in Western Australia will not be markedly different from those applicable to his or her counterpart in North Queensland. Thus in most cases it is expected that the key results of a particular Scoping Project conducted by one ATO Branch will be generally applicable to the corresponding taxpayer populations in other ATO Branches.

For this reason, a Scoping Project for a particular industry or occupation is normally conducted either by just one ATO Branch or jointly by adjacent Branches. In 1992/93 each ATO Branch (then numbering 22, now 25) was given the responsibility for taking the lead role on at least one Scoping Project. In addition, each ATO Branch was required to conduct a number of follow-up audits in industries which had already been covered by Scoping Projects and where an audit response was considered appropriate.

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FIGURE 1: STAGES IN A PBA PROJECT



## John Wickerson    Taxpayer Audit Programs

Refining the definition of the population to be covered by a Scoping Project (Stage 2) is seen as an especially important aspect of the research phase. It is usually the one that creates the most difficulties, given the heterogeneous nature of most taxpayer populations as identifiable from tax return and other data.

For Quality Control reasons, all audit samples are selected by the CIRU, although the Branches can determine, within limits, the basis of any stratification required to take into account local circumstances (Stage 3). There has been considerable debate within the ATO's Taxpayer Audit Group over the appropriate audit sample size for a Scoping Project. To date, the minimum sample size has been held at 30 audits. The statistical limitations inherent for such a small sample are well understood within the ATO, and for other types of compliance research projects much larger samples are used (up to and sometimes beyond 600 cases). However, with Scoping Projects there are competing research and wider program considerations. Nevertheless, from an "audit trail" or case selection perspective, working with 30 audits has usually proved quite sufficient for identifying the range of compliance issues that might warrant further attention in a particular taxpayer population. In effect, Scoping Project audit samples are case studies and, as with many other types of economic and other social science research, 30 proves to be more than a sufficient number to identify the key issues.

"Full audits" are required of all sampled taxpayers. The auditors and their supervisors are required to use their professional judgement in determining what audit techniques are required to ensure this objective is achieved.<sup>50</sup> Since the use of indirect audit techniques (such as "asset betterment") is often required, it will not always be possible to identify the precise source of any detected noncompliance. Thus, in order to achieve comparability between the data obtained from different Scoping Project audits, the level of analysis is conducted principally at the level of Net Business Income (= Total Business Receipts *less* Business Expenses). Also for comparison purposes, all audits constituting a particular Scoping Project have to focus on one common financial year. Finally, all primary compliance analysis is conducted in terms of "omitted income" rather than "tax evaded". This approach is required to avoid the unnecessary complications that would arise

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<sup>50</sup> Scoping audits can therefore be expected to have much the same impact on auditees as other "full audits" conducted as part of the general Business Audit program. This is likely to be a major benefit for subsequent program evaluation purposes. This point was made by Dr Kent Smith (American Bar Association).

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because, for example, partners and trust beneficiaries can be subject to quite different effective marginal tax rates, and that a reduction upon audit of a "loss carried forward" does not have any immediate revenue implications.

From a compliance measurement perspective, the ATO's main priority has been to determine whether the overall dollar "risks to the Revenue" associated with a particular industry or tax issue is above or below some threshold level of concern. Fine compliance-based ranking of industries and tax issues are only of secondary concern. Thus, before increasing the audit sample size for Scoping Projects, the ATO would need to be sure this was warranted on strategic grounds. To date it has not been.

Moreover, 30 audits per industry (stratum) is definitely a sufficient number for obtaining reasonably reliable global estimates of (detectable) noncompliance for that part of the Business Audit domain covered by Scoping Projects. To date, the ATO has completed over 4000 stratified random audits across 139 fine-level industries. Since, in effect, individual Scoping Projects are allocated more or less randomly between ATO Branches, there should be little or no geographical bias in the industry-wide estimates of compliance obtained from the above audits. A risk management perspective on the Scoping projects completed to date indicates that these projects had covered industries which in total account for nearly 50 per cent of the total business turnover in the Business Audit domain.

Scoping Projects usually will not be warranted in the smallest industries because, individually, they do not represent major "risks to the Revenue". However, they are not being neglected and the ATO is currently developing other "leverage" audit-based techniques to enhance compliance here.

Finally, it is intended to repeat Scoping Projects previously conducted in particular "high risk" industries to determine whether compliance has improved as a result of specific action taken by the ATO.

## **Conclusion**

Increasingly, the utilisation of Scoping Project results is being seen as an integral part of the case selection process in the ATO's Business Audit program. Also, Scoping Projects are now beginning to demonstrate they have the capacity to provide the kind of information required to better allocate not only audit but also other ATO resources to "high risk" areas, improve taxpayer service, improve administrative

procedures and possibly lead to changes to the tax laws.

As the ATO's PBA Approach illustrates, modern taxpayer audit programs have a wider role than simply seeking to deter deliberate noncompliance by individual taxpayers. Instead, the emphasis is increasingly on the need to better manage the "risks to the Revenue", by targeting resources at those populations of taxpayers or market segments which, for one reason or another, represent the greatest risks. In the process, such targeting will hopefully be seen by most taxpayers as fair and reasonable and, in turn, help produce a climate generally more conducive for voluntary compliance.