

Tax Management Systems

Summary

Tax penalties, like all bottom line impacts, need to be managed effectively and economically. The purpose of this article is to show you cost effective ways to reduce the risk of ATO (“Australian Taxation Office”) penalties using the “reasonably arguable position” test. The other key test is the “reasonable care” test.

Both tests are contained in tax legislation covering tax penalties. The penalty laws of the self assessment regime were changed with effect from the 2001 financial year. However, the nature and scope of the “reasonably arguable position” test remain largely intact.

The “reasonably arguable position” test relates to taking positions on specific issues, while the “reasonable care” test relates to establishing a good tax management system.

The "reasonable arguable position" test requires that if there is a tax shortfall as a result of a false or misleading statement (eg, an incorrectly claimed deduction in a tax return) and the tax shortfall relates to an item worth more than \$10,000 or 1% of the return tax (ie, tax payable, not assessable income), then the taxpayer must satisfy the “reasonable arguable position” test to escape penalty. The quantum requirement for trusts and partnerships is \$20,000 or 2% of tax payable.

There are two types of tax “penalties” – criminal and financial. There are two types of financial “penalties” – culpability and interest. This article will focus on culpability penalty tax.

One of the key ways to reduce the risk of incurring culpability penalties is proving to the ATO that you have a “reasonably arguable position”. If you do, then the ATO will not charge a culpability penalty even if you are wrong. That is, there will be no culpability penalty even if the ATO decides the primary tax must be paid on an incorrect claim. The ATO will charge interest, however.

To satisfy the ATO that you have a “reasonable arguable position”, you need to ensure that any claims (particularly contentious or large dollar items) are about as likely as not to be correct when the claim is made. That is, your position must be defensible and strong enough to support a reasonable expectation that you could win in court. The price of failure is normally a tax penalty of 25% of the tax shortfall. There are higher penalties for more aggressive claims (see Table below).

Where ATO auditors disallow a claim during an audit, they will raise a penalty if they do not believe that the test has been satisfied. This is a matter of concern, because the ATO often reviews these decisions years after they are taken. Thus, taxpayers who do not document a “reasonably arguable position” run the risk that they will not be able to convince ATO auditors that the test was satisfied at the time of making the claim (in the relevant tax return).

The “reasonably arguable position” test is satisfied if you establish that it is "about as likely as not" that you are correct. The Explanatory Memorandum for relevant legislation states that this means "the strength of the taxpayer's argument should be sufficient to support a reasonable expectation that the taxpayer could win in court". The Explanatory Memorandum goes on to state:

"A taxpayer may have a reasonably arguable position for the tax treatment of an item despite the absence of authorities other than the law itself. What is required in such cases is that the taxpayer has a well-reasoned construction of the applicable statutory provision which it could be concluded was about as likely as not the correct interpretation. An opinion expressed by an accountant, lawyer or other advisor is not an authority. However, the authorities used to support or reach the view

expressed by the advisor, including a well-reasoned construction of the relevant statutory provisions, may support the position taken by a taxpayer.”

In fact, ATO auditors are more likely to find that an opinion by a tax professional will support a finding that a taxpayer meets the “reasonably arguable test”. The taxpayer has made a *bona fides* attempt at getting independent support for the claim. The additional advantages of getting supporting professional opinions include restrictions on access to the opinions themselves by the ATO.

There are two types of restricted access to opinions. Legal professional privilege applies to opinions of tax lawyers if the opinions have been brought into existence with the dominant purpose of getting or giving legal advice, or for use in existing or anticipated litigation. The privilege can be claimed by the client or the lawyer on behalf of the client. The other privilege is an administrative privilege granted by the Commissioner under the ATO's Access Guidelines, which restrict ATO access to opinions prepared by tax accountants.

Public practitioners and in-house advisers can minimise risk for themselves by getting second opinions to support their own advice. In the case of Public Practitioners, such a strategy would reduce the risk of being sued if a claim is disallowed by the ATO. There is no risk of losing the client to a competitor. However, many Public Practitioners find the cost of using tax professionals for second opinions prohibitive, particularly where the claim is not large. In this case, CPAs may find Tax Barristers a useful cost effective alternative.

CPAs can brief Tax Barristers directly themselves in many States (including Queensland, NSW and Victoria). This is not a substitute for seeing your solicitor, however, where you want a second opinion from a tax expert without going through your solicitor, then direct access briefs are a good alternative. The process is quite simple. Many States have their own Barristers’ Bar with Clerks who maintain lists of specialists, including tax counsel. Simply call one of the Clerks, and she/he will listen to your requirements and find the best person for your particular situation. If a Clerk does not have someone appropriate on her/his List, they will refer you to a Clerk who can help you.

TABLE - PENALTY SUMMARY

Reasonable care and reasonably arguable position	NIL
Lack of reasonable care	25%
Recklessness	50%
Intentional disregard of law	75%
Anti-avoidance	50%
Disregard of Private Ruling	25%
No Reasonably Arguable Position	25%

Source: CCH Federal Tax Reporter

The Need for a Good Tax Management System

Corporate taxpayers need a comprehensive and effective tax management system for two reasons:

- (1) to reduce the risk of tax penalties; and,
- (2) to produce information management can use in making strategic and tax related decisions.

An effective tax management system will also play an important part in minimising the tax expense and the risk of prosecution action being taken against officers of the corporate group.

What Should a Good tax Management System Look Like?

This article looks at a typical tax management system for a medium sized company and suggests possible improvements which may bring the system up to the standard required to achieve the objectives outlined above.

A Typical Tax Management System

In most corporation, information (generally accounting) is gathered and processed by accountants who code invoices, classify items and document their treatment. This is often done using Charts of Accounts. This information is recorded together in the General Ledger (GL). The tax manager or accountants use the GL to prepare the tax returns. They are also responsible, generally, for checking that items have been properly classified (eg, deductible or non-deductible expenses).

Where the accountants have prepared the tax returns, the draft returns are then forward to the tax manager for review. Contentious or uncertain items are generally identified and resolved at all three levels by the accountants and tax manager. Where the accountants are responsible for preparing the returns, review items are referred back to them by the tax manager for further necessary action.

Where the tax manager has prepared the tax returns, most taxpayers use external consultants to double check them before lodgement. The tax manager is also responsible for supporting the accountants with tax return preparation, coding and issue identification/resolution. This should be done with annually updated tax manuals, newsletters, direct advices, ongoing training and communication. However, many companies have a poor record in this respect. The intention is there, but many companies are inconsistent in maintaining the necessary level of commitment.

The responsibility for preparation and maintenance of proper records is generally that of all levels of the organisation, including senior management. Records that are not required are destroyed, provided this accords with the law. Systems are normally established for storage and retrieval of records.

Finally, the information that has been gathered, classified, recorded and stored may be used in special or major projects at a later date (eg, sale of business). These usually have tax consequences. Therefore, the tax manager is properly involved in the major decisions of these projects. This requires special advice and support, which is subsequently documented and stored.

The above system is unlikely to reduce significantly the risk of tax penalties or provide management with the most reliable and useful information.

Problems with Most Tax Management Systems

- The main weakness with many systems is checking input data at the stage of allocating items for tax purposes (eg, deductible or non-deductible). There should be a system of "checks and balances" that ensures the risk of errors is acceptably low and a system of contentious/uncertain issues identified.
- Current and proposed systems, procedures and controls need to be properly documented. This includes the Tax Manual, as well as other manuals (eg, Accounting).
- The next main weakness pertains to the integration of the various systems. This will require the Tax Manual to link with other Manuals and for Job Descriptions to be linked into the new system. Also, the system must ensure that contentious/uncertain issues that have been identified are resolved and documented properly (to meet the two penalty tests). Accountants should be made responsible for their tax input (eg, coding, tax return preparation) and for maintaining a satisfactory level of skills to identify, process and resolve tax issues.
- Record keeping systems need to be integrated and tightened. This is to be done by reviewing current procedures and documentation, ensuring the correct records are properly maintained and stored. This includes systems for retrieval and checking before destruction.
- While most training and information dissemination is good, in order to form part of the tax management system they need to be integrated with the above systems and documented. For example, a technical update session could be conducted for tax return preparers each year before they start to prepare returns. There should be regular meetings of participants with the tax manager to monitor and control the process. The level of communication and advice to the senior managers should be maintained and documented.

Establishing a Good Tax Management System

In addition to the suggestions discussed above, taxpayers should consider the following.

- Accountants should be trained and supported (eg, a Tax Manual and access to the tax manager) to correctly code simple and uncontentious items. Where an item is contentious and requires "reasonably arguable position" test procedures to be implemented, the system should ensure accountants refer to the tax manager. Therefore, the system should have in place provision for double checking these items. For example, 100% checks by the tax manager and sampling by questionnaires.
- The next stage of the process is return preparation and workpapers. The accountants who prepare the draft returns and supporting workpapers are also responsible for the correctness of the source information. They should also be responsible for maintaining the procedures to be implemented for the penalty tests. The proper creation and maintenance of workpapers (records) is an integral part of these new procedures. Therefore, their responsibilities need to be clarified and documented (eg, job descriptions). Quite often field accountants do tax work, but there is no mention of tax in their job description. They need to be accountable. Job descriptions are critical in this process.
- The tax manager should review draft returns for correctness and ensure workpapers have been properly created and retained. Once again, contentious issues should be identified and resolved, using external advisors if necessary. These procedures should be documented in detail. The tax manager should also be involved in ongoing training and updating of accountants and decision-makers (as well as themselves). This too should be fully documented and recorded.

- Accountants and others should be fully briefed on documentation, workpapers and retention requirements on an ongoing basis. There should be training and updates on this, in addition to appropriate commentaries in the Tax and other manuals. Particularly the Records Management Manual. There should be regular meetings between the tax accountant/manager and controllers to monitor the system. Internal tax seminars are very useful here.
- In relation to major projects, the requirements of the “reasonably arguable position” test should be met. This ensures all decision-makers are made aware and reminded of the need to advise the tax accountant/manager. Generally, it will be the tax accountant/manager that will establish, document and create a file proving a RAP position.
- A good tax management system will have procedures in place to handle an ATO audit. The best tax audit strategy is to have a “reasonable care” system in place. This would include ATO audit procedures.

Record Keeping

Proper record keeping is vital. Procedures should be in place that ensure transactions and their classification are properly documented. Documentation would include analysis of the issues, advice of external consultants and authorities relied upon.

Records must be properly maintained and stored. Retrieval and destruction procedures need to satisfy legal requirements in addition to the two tax penalty tests.

The system should ensure the proper treatment of documents subject to legal professional privilege (the ATO has issued guidelines on this) and the ATO's Access Guidelines (which grant a form of privilege to taxpayers on their accountant's tax advice). The Access Guidelines restrict ATO access to advices prepared by external advisors on structuring an arrangement. The privilege does not extend to source documents. These include ledgers, working papers and contracts.

Conclusion

Failure to implement a good tax management system could result in tax penalties. A good tax management system will provide senior management with high quality and timely information it can utilise in the decision making and risk management process. The suggestions and recommendations contained in this paper will provide such a tax management system once implemented and maintained. However, a detailed review is required to adapt the principles in this paper to the particular circumstances and systems of the company group. This paper provides a framework for discussion to achieve the optimum outcome.

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