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## CONTENTS

**182** Editorial  
**Margaret McKerchar, Michael Walpole and Binh Tran-Nam**

**184** Tax compliance costs for the small business sector in South Africa – establishing a baseline  
**Sharon Smulders, Madeleine Stiglingh, Riel Franzsen and Lizelle Fletcher**

**227** Australian business taxpayer rights to compensation for loss caused by tax official wrongs – a call for legislative clarification  
**John Bevacqua**

**250** Findings of tax compliance cost surveys in developing countries  
**Jacqueline Coolidge**

**288** Tax compliance costs for small and medium sized enterprises (SMEs): the case of the UK  
**Ann Hansford and John Hasseldine**

**304** FACTA and Schedule UTP: Are these unilateral US actions doomed unless accepted by other countries?  
**J. Richard (Dick) Harvey, Jr**

**329** Navigating a transition in US tax administration  
**Kristin Hickman**

**345** Behavioural economics and the risks of tax administration  
**Simon James**

**364** Improving tax compliance strategies: can the theory of planned behavior predict business compliance?  
**Jo'Anne Langham, Neil Paulsen and Charmine E. J. Härtel**

**403** Intervening to reduce risk: identifying sanction thresholds among SME tax debtors  
**Elisabeth Poppelwell, Gail Kelly and Xin Wang**

**436** Developing risk management strategies in tax administration: the evolution of the Australian Tax Office's compliance model  
**Robert Whait**

**465** Tax return simplification: risk key engagement, a return to risk?  
**Jason Kerr**

**483** New dimensions in regulatory compliance – building the bridge to better compliance  
**Stuart Hamilton**

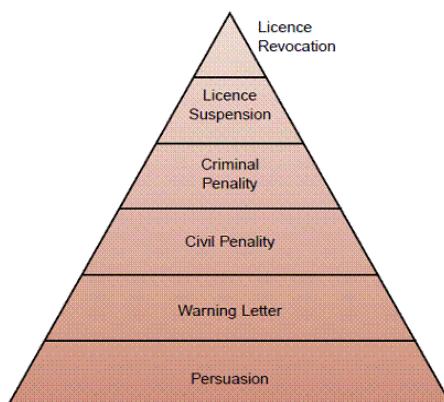
# New dimensions in regulatory compliance – building the bridge to better compliance

Stuart Hamilton<sup>1</sup>

## Abstract

This article examines the background of the risk differentiation framework now being used as an adjunct to Ayres-Braithwaite pyramid of compliance strategies by the Australian Taxation Office. The two aspects complement each other, one guiding 'who' the regulator should prioritise for review, the other guiding the appropriate choice of remedy if non-compliance is found.

Since it was laid out so cogently in the seminal Ayres and Braithwaite book<sup>2</sup>, the compliance pyramid has become the foundation 'compliance model' for a significant number of regulatory agencies<sup>3</sup>, including several tax administrations.



Source: Ayres and Braithwaite (1992).

Figure 1  
The Ayres and Braithwaite Compliance Pyramid

<sup>1</sup> Stuart Hamilton is the Assistant Deputy Commissioner of Risk Strategy with the Australian Taxation Office's Large Business Line. He has a Masters Degree in Business Administration and a degree in Economics from the University of Adelaide. He is currently undertaking his PhD at UNSW. The views expressed in this article are those of the author and do not necessarily reflect the considered views of any organisation mentioned.

<sup>2</sup> Ayres, I & Braithwaite, J 1992, *Responsive regulation: Transcending the deregulation debate*. Oxford University Press, New York, p 35. It was earlier described by John Braithwaite (1985) in *To punish or persuade*, State University of New York, p 142.

<sup>3</sup> See for example the sample in Annex 1.

While other regulators have also shifted towards more client<sup>4</sup> centric approaches<sup>5</sup>, it would be my view<sup>6</sup> that those that have adopted, either explicitly or implicitly, the escalatory approach ('responsive regulation') of the compliance pyramid<sup>7</sup> as a central paradigm or shared value set, have made the greatest strides forward in engaging with the diversity of compliance behaviours and causal factors that their client base inevitably presents.

However not every client can be reviewed and prioritization decisions have to be made about 'who' to review and on 'what' basis. The article describes the background to the risk differentiation approach being used by the ATO that addresses some of the conceptual and practical difficulties<sup>8</sup> that have arisen in trying to bring the Compliance model approach to 'life'.

## 1. THE IMPORTANCE OF VOLUNTARY COMPLIANCE IN REGULATORY SYSTEMS

It is probably clear to most observers that regulatory systems function in the real world because most clients do the right thing most of the time. In the case of taxes this is also generally true, as James Alm noted in 1996 "Most people pay most of their taxes most of the time".<sup>9</sup>

Much has been written on the factors influencing tax compliance. A small sample of salient articles are outlined in the footnotes for the interested reader.<sup>10</sup> As a working

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<sup>4</sup> While some may argue against identifying those being administered by a regulator as "clients", the use of such language, like the compliance model itself, is a subtle, but important part of engendering cultural change away from possible dualistic mentalities so easily slipped into by those undertaking regular enforcement activities ('you are what you repeatedly do' to paraphrase Aristotle). We should also note that clients in regulatory systems do have a choice – they can choose not to comply, and as most regulatory systems are premised on the basis of significant voluntary compliance, continuing 'client engagement' is a really critical frame of mind to maintain with staff.

<sup>5</sup> See for example Hamilton, S 2003, 'Putting the Client First: the Emerging Copernican Revolution of Tax Administration', *Tax Notes International*, Vol 29, Part 6, February 2003, pp 569-576.

<sup>6</sup> Other commentators offer a similar view, such as: Parliament of Australia 2008, *Joint Parliamentary Committee Report 410 Tax Administration*, Commonwealth of Australia, Canberra, p 114 at <http://www.aph.gov.au/house/committee/jcpaa/taxation06/report/fullreport.pdf>;

Hasseldine J (draft) 2007 *Tax implementation: Commentary*, p 4, <http://www.ifs.org.uk/mirrleesreview/commentaries/hasseldine.pdf>; Leviner, S 2008, 'An Overview: A New Era of Tax Enforcement - From 'Big Stick' to Responsive Regulation' in *Regulation and Governance*, Vol 2, State University New York, Buffalo. Available at SSRN: <http://ssrn.com/abstract=1082247>.

<sup>7</sup> The compliance pyramid's evolution is tracked in Braithwaite, J & Braithwaite, V 'An evolving compliance model for tax enforcement' in Shover, N & Wright, J P (ed) 2000, *Crimes of Privilege: Readings in White-collar Crime*, OUP, New York, pp1-19 @ <http://vab.anu.edu.au/pubs/1/anevolvingcompliance.pdf>.

<sup>8</sup> See for example the consistency of treatment aspects noted by Waller, V 2007, 'The Challenge of Institutional Integrity in Responsive Regulation: Field Inspections by the Australian Taxation Office, 29 Law & Policy, 67 – 69, and the comments of Burton, M 2007 in 'Responsive Regulation and Uncertainty of Tax Law – Time to reconsider the Commissioner's Model of cooperative compliance?' 5 eJournal of Tax Research, 71 – 73, where the application of the law to a set of facts and circumstances is unclear. Kornhauser, M, 2007, in 'Normative and Cognitive aspects of Tax Compliance: Literature Review and Recommendations for the IRS regarding individual Taxpayers', Taxpayer Advocate Service – 2007 Annual Report to Congress' at 157 – 158 also notes that tax morale models only work as well as the regulators understanding of client attitudes and behaviours.

<sup>9</sup> Pozo, S. (ed) 1996, *Exploring the underground economy*, Upjohn Institute, Michigan. Several other researchers, such as Henk Elffers have made similar comments. See Van Vugt, M et al 2000 'But taxpayers do cooperate' in *Cooperation in modern society: promoting the welfare of communities, states and organisations*, Routledge, London.

<sup>10</sup> For examples of the rich vein of academic research in this area see:

generalization for the purposes of this article, I will work on the basis that most people comply because it is the accepted thing to do, a societal or peer norm, rather than through deliberate calculation, compulsion or fear.

Without such a broad level of voluntary compliance any regulatory system would be swamped with cases that called for intervention - which would quickly outstrip the resources and remedies available.<sup>11</sup> That's not to say it is all smooth sailing. Norms can clearly change over time - sometimes rapidly - and from a tax compliance viewpoint, breakouts of mass marketed arrangements have at times severely strained the Australian system.<sup>12</sup>

The compliance framework or model that a regulatory authority adopts is like a 'lens' it uses to view its clients and it appears to become part of a shared value set that inevitably permeates its strategies, systems, and style of interactions with clients.<sup>13</sup>

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Allingham, M G & Sandmo, A 1972, 'Income tax evasion: a theoretical analysis', *Journal of Public Economics 1*, pp 323–338. While this was the initial ground breaking paper on the economics of tax evasion and the effect of penalties, it predicted a far higher rate of non compliance than was in fact observed given actual audit rates and penalties. [http://darp.lse.ac.uk/papersdb/allingham-sandmo\\_\(jpub72\).pdf](http://darp.lse.ac.uk/papersdb/allingham-sandmo_(jpub72).pdf); Sandmo, A 2006, 'The theory of tax evasion: A retrospective view', *National Tax Journal 58*, pp 643 – 663 at <http://old.nhh.no/sam/stabssem/2004/sandmo.pdf>; Fischer, C M, Wartick, M & Mark M 1992, 'Detection Probability and Taxpayer Compliance: A Review of the Literature', *Journal of Accounting Literature 11*, pp 1-46, brings a richer conceptual compliance framework taking into account: demographic factors (e.g. age, gender and education); non-compliance opportunity (e.g. income level, income source and occupation); attitudes and perceptions (e.g. fairness of the tax system and peer influence) and tax system/structure (e.g. complexity of the tax system, probability of detection, penalties and tax rates); Chau, G and Leung, P 2009, 'A critical review of Fischer tax compliance model: A research synthesis', *Journal of Accounting and Taxation Vol.1 (2), July*, pp.034-040 at <http://www.academicjournals.org/jat/PDF/Pdf2009/July/Chau%20and%20Leung.pdf>; Feld L, & Frey, B 2003, 'Deterrence and Tax Morale: How Tax Administrations and Taxpayers Interact', *European Review*, Vol 11 No3, pp 385-406 @ <http://www.oecd.org/dataoecd/9/51/2789923.pdf>; Feld, L, Torgler, B & Dong, B 2008, 'Coming Closer? Tax Morale, Deterrence and Social Learning after German Unification' *Discussion and Working Paper Series # 232*, QUT School of Economics and Finance at <http://external-apps.qut.edu.au/business/documents/discussionPapers/2008/232Torgler.pdf>; Wittberg, L 2005, *Right From The Start - Research and Strategies*, Swedish Tax Agency at [http://www.skatteverket.se/download/18.612143fd10702ea567b80002569/rapport200501\\_eng.pdf](http://www.skatteverket.se/download/18.612143fd10702ea567b80002569/rapport200501_eng.pdf); Gino, F, Ayal, S, & Ariely, D 2009, 'Contagion and Differentiation in Unethical Behavior - The Effect of One Bad Apple on the Barrel' *Journal of Psychological Science, Volume 20—Number 3*, pp 393 – 398 at <http://duke.edu/~dandan/Papers/contagion.pdf>.

<sup>11</sup> Though views of compliance, embodied in the legislation passed, are generally set by reference to what society regards as normal or broadly accepts as appropriate. Where this isn't the case, as with Prohibition in the US in the 1920s, non-compliance can be a norm.

<sup>12</sup> See for example the work of a former Australian Commissioner of Taxation: Boucher, T 2010, *Blatant, artificial and contrived: Tax schemes of the 70s and 80s*, ATO, Canberra at <http://www.ato.gov.au/content/downloads/cor00244226.pdf> and Xynas, L 2010 'Tax Planning, Avoidance and Evasion in Australia 1970-2010: The Regulatory Responses and Taxpayer Compliance' in *Revenue Law Journal, Vol. 20, Issue 1* @ <http://epublications.bond.edu.au/rlj/vol20/iss1/2>.

A robust debate regarding the role of 'literal' rather than 'substance' based interpretations by the Courts of anti-avoidance provisions (following in the 1936 Duke of Westminster case tradition) in fermenting a mutually assured process of escalating legislative complexity is perhaps overdue. This is particularly pertinent given some recent decisions that are perhaps somewhat reminiscent of the Barwick days. For a more expansive discussion of this aspect see: 'Experience and innovations in other countries' by Owens, J. and Hamilton, S. in the compilation by Aaron, H J & Slemrod, J 2004, *The crisis in tax administration*, Brookings Institute.

(“You are what you do” said Aristotle.) It becomes a key facet in shaping the compliance ‘culture’ of the organisation and can even influence its structure, since structure often follows strategy, as Alfred Chandler noted in 1962.<sup>14</sup>

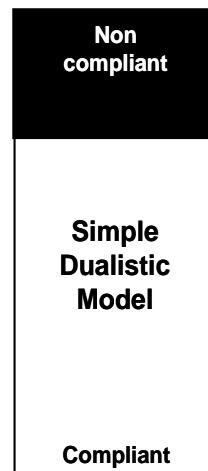
Such frameworks or models are more useful if they provide logical guidance or direction, allow for improvements on previous approaches, add insight by explaining apparent compliance relationships or better yet, make predictions as to outcomes.

Regulators use such frameworks because they provide a rationale or direction - as the French essayist Michel de Montaigne expressed it: “No wind favours he who has no destined port.”

## 2. BLACK AND WHITE

A regulator could, for example have a simple dualistic regulatory model that views a client’s behaviours as being either right or wrong. This is a black or white or ‘mousetrap’ view of compliance where, as they say in quality control circles: “you get what you ‘inspect’, not what you ‘expect’”, so the tendency of such a regulator is to try to inspect everything and everyone!

Clearly there are significant limits to the effectiveness of such an approach unless non-compliance is obvious, the causes simple, and the treatment straight forward.



**Figure 2**  
**A simple dualistic or binary compliance model**

For very simple regulatory systems (often those with ‘strict liability’ aspects) such a dualistic model may be enough for the regulator to work with. However it is a truism that ‘if the only tool you have in your bag is a hammer then the solution to every problem starts to look like a nail’.

<sup>13</sup> Raskolnikov, A 2009, ‘Revealing choices: using taxpayer choice to target tax enforcement’, *Columbia Law Review* Vol 109:689@ <http://www.columbialawreview.org/assets/pdfs/109/4/Raskolnikov.pdf>.

<sup>14</sup> Chandler, A 1962, *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*, MA: MIT, Cambridge.

Regulatory systems where the only answer is, for example, a prosecution, tend to view the solution set to a compliance issue as ‘prosecuting the right clients’ – even though a prosecution might not be the most effective treatment to engender long term compliant behaviour.<sup>15</sup>

It’s a rather limited tactical response for an increasingly complex regulatory world. Indeed a side effect of such a simple dualistic approach can be that an ‘enforcement culture’ permeates the organisation rather than a client service ethic that realises clients can get it ‘wrong’ for a wide variety of reasons that need to be addressed.

Means can start to become viewed as ends as employees strive to deliver what they perceive they are being ‘measured on’, such as ‘strike rates’ in audits and prosecutions rather than the desired outcome of improved long term voluntary compliance.

This can set the organisation up for claims of ‘unreasonableness’ or ‘over-zealousness’. The credibility of the organisation as a fair regulator can suffer and community and ministerial confidence in the regulator can decline as a result.

This is a real risk for a regulatory authority and one that can be easily overlooked, with dire consequences.<sup>16</sup> Alternatively, having only a few hardline regulatory responses can lead to them not being applied at all. Like nuclear weapons they become an arsenal that is effectively un-useable in most situations confronting a regulator.<sup>17</sup>

### 3. SHADES OF GREY

A straight forward enhancement to the simple dualistic compliance model is to introduce the view of a continuum, or spectrum, of compliance behaviours, ranging from deliberately non-compliant through to fully compliant – and ideally have a choice of several remedies that appropriately reflect an informed judgement of a client’s position within the compliance continuum.<sup>18</sup>

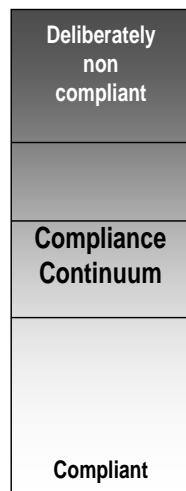
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<sup>15</sup> OECD FTA Information Note, 2010 ‘Understanding and Influencing Taxpayers’ Compliance Behaviour’, *Forum on Tax Administration: Small/Medium Enterprise Compliance Subgroup*, p 40 point 3 at <http://www.oecd.org/dataoecd/58/38/46274793.pdf>.

<sup>16</sup> See for example the Palmer Report into the detention of Cornelia Rau, July 2005 at <http://www.immi.gov.au/media/publications/pdf/palmer-report.pdf>.

<sup>17</sup> See for example Braithwaite V & Braithwaite J ‘An evolving compliance model for tax enforcement’ in Shover, N & Wright, J P (ed) 2000, *Crimes of Privilege: Readings in White-collar Crime*, OUP, New York, p1-19 at <http://vab.anu.edu.au/pubs/1/anevolvingcompliance.pdf>.

<sup>18</sup> See for example the Australian Customs ‘Compliance Continuum’ at [http://www.customs.gov.au/webdata/resources/files/FS\\_CustomsCompliance.pdf](http://www.customs.gov.au/webdata/resources/files/FS_CustomsCompliance.pdf).



**Figure 3**  
**A linear compliance continuum – introducing shades of grey**

This more nuanced view is one of the conclusions of the OECD Forum of Tax Administration (2010):

“Circumstances and drivers change and it is too simplistic to divide the taxpayer population into just compliers and non-compliers. Taxpayers can be found on a continuum from total compliance to total non-compliance. The individual’s position on this continuum is not fixed — it changes depending on both the individual and the situation or circumstances.”<sup>19</sup>

#### **4. BROADENING THE BASE – ADDING A HIERARCHY OF RESPONSES TO THE COMPLIANCE CONTINUUM**

Research on compliance approaches by Braithwaite and others<sup>20</sup> on regulatory systems suggests that a range of treatments should be available to engender long-term voluntary compliance.<sup>21</sup> An escalatory or responsive (‘if you do this then I’ll do that’) model was put forward to create an incentive for the client to move towards a more engaged and compliant behavioural set.

The pyramid shape of the Braithwaite model effectively adds another dimension to the simple linear compliance continuum, allowing for a somewhat richer and more

<sup>19</sup> OECD Forum of Tax Administration, 2010, *Small/Medium Enterprises Compliance Subgroup, Information Note. Understanding and Influencing Taxpayers’ Compliance Behaviour*, November 2010.

<sup>20</sup> See for example the useful state of play summary in *Law & Policy, Volume 29, Issue 1, January 2007*.

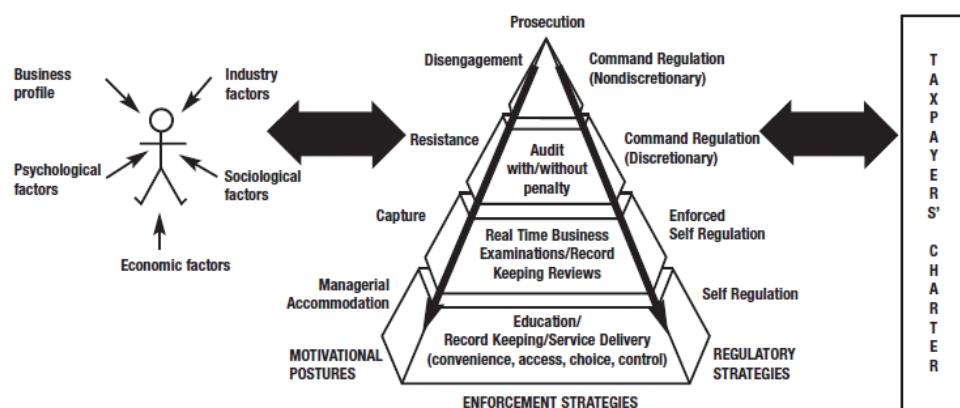
<sup>21</sup> See for example the range of escalatory sanctions contained in the UK “Regulatory Enforcement and Sanctions Act” 2008 @ <http://www.lbro.org.uk/docs/regulatory-enforcement-and-sanctions-act-2008.pdf>.

informed view and discussion of compliance behaviours and the appropriate regulatory responses.

The shape roughly indicates the number of clients that might be found at each 'level', the hierarchical and escalatory nature of the engagement, and the increasing focus on the minority who appear to deliberately seek to abuse the system and undermine its integrity.

The choice of remedy imposed (and the model is conceptually a 'choice of remedy' framework – what you do after you determine that non compliance has occurred) becomes increasingly severe the higher up the pyramid you go - with the view of creating an incentive for clients to move towards more compliant behaviours. "Create pressure down" is the terminology used by both the Australian and New Zealand tax authorities in this regard.

The regulatory compliance pyramid was developed further during work with the Australian Taxation Office's (ATO) Cash Economy Project in the mid-to-late 1990s where the client's perceived broad motivational posture was explicitly coupled with a suggested regulatory response:



**Figure 4**  
**Integrating the Braithwaite compliance model into ATO operations**<sup>22</sup>

In this version of the compliance model, a series of simplistic client 'archetypes'<sup>23</sup> were defined by their implied motivational posture:<sup>24</sup>

<sup>22</sup> See ATO Cash Economy Task Force 1998, *Improving Tax Compliance in the Cash Economy Second Report*, p 58 <http://www.ato.gov.au/content/downloads/SB39073.pdf>.

<sup>23</sup> In my view the use of client 'archetypes' in a compliance setting can be dangerous for a regulator undertaking case selection as it explicitly leads to labelling of the client rather than of the apparent behaviour. Given the rate of false positives in case selection systems such mislabelling would be of real concern – eg being labelled as a 'resistant client' before compliance contact sets up the wrong tone for the interaction. For example with a 90% compliant population a non compliance test with a 90% accuracy will still only lead to a 50% strike rate. (Why: 90% of the 10% non-compliers are correctly identified, but the 10% error rate will identify the same number of false positives in the 90% compliant part of the population giving an overall strike rate of just 50%. This inevitable outcome is often not considered when judging compliance effectiveness.) Archetype labeling might be seen as prejudging

- The disengaged clients who have decided not to comply,
- The resistant clients who don't want to comply,
- The captured clients who try to comply, but don't always succeed, and
- The accommodating clients who are willing to do the right thing.

To work the Braithwaite model requires compliance staff to make reliably informed and accurate judgments not merely about whether non-compliance has occurred but also in respect of the 'motivation' for that non-compliance – a challenging ask as it goes beyond observed behaviours to making inferences about a client's state of mind. There is a real risk that staff focus on the perceived client attitude rather than on the actual client behaviour.

It should also be noted that some commentators<sup>25</sup> have raised questions regarding the applicability of the compliance pyramid in situations where the determination of compliance itself is uncertain – where legitimate differences of views exist regarding what compliant behaviour is. This situation, not uncommon with large complex transactions, magnifies the danger of asking staff to reliably form views as to the apparent motivation for perceived non-compliance. 'Difficult' tax minimisers may be inappropriately viewed as 'aggressive' tax avoiders. This aspect is discussed further later in this article.

As noted earlier, the compliance pyramid posits an escalating choice of remedy matched to observed client behaviours and the perceived motivation. For example:

- For those perceived as doing the "right thing" – the majority of clients – compliance is made as simple as possible. Information reporting requirements are reduced and interactions are made as cheap and easy as is practical.<sup>26</sup>
- For those perceived as trying, but not succeeding, in doing the right thing, education and advice is provided to enable compliance. This can be general, or aimed at a specific client segment – an industry or occupation group or some other discernable client grouping.<sup>27</sup>
- Some clients may be selected for a review where the output is advice on how to comply in the future, rather than an adjustment that punishes the past. For example, 'record keeping reviews' where the output is often advice on how to better record transactions. These interventions are generally relatively quick,

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the client rather than indicating a level of concern (a view of risk) at that point in time that suggests follow up action to ascertain the relevant salient facts and circumstances. A more appropriate regulatory approach therefore is to describe the level of 'risk' or 'concern' associated with evidenced behaviours.

<sup>24</sup> Braithwaite, V 2003, 'Dancing with Tax Authorities: Motivational Postures and Non-compliant Actions' in Braithwaite, V (ed) *Taxing Democracy: understanding tax avoidance and evasion*, Ashgate, Aldershot. 5 postures suggested: Commitment, Capitulation, Resistance, Disengagement, Game-playing: at [http://demgov.anu.edu.au/papers/Braithwaite2003TD\(2\).pdf](http://demgov.anu.edu.au/papers/Braithwaite2003TD(2).pdf).

<sup>25</sup> Burton, M 2007, 'Responsive Regulation and the Uncertainty of Tax Law – Time to Reconsider the Commissioner's Model of Cooperative Compliance?' *eJournal of Tax Research, Volume 5, VI*, at [http://www.atax.unsw.edu.au/ejtr/content/issues/previous/paper4\\_v5n1.pdf](http://www.atax.unsw.edu.au/ejtr/content/issues/previous/paper4_v5n1.pdf).

<sup>26</sup> See for example the direction of the ATO 'Easier, Cheaper, More Personalised Change Program' at [http://www.ato.gov.au/content/downloads/Making\\_it\\_easier\\_to\\_comply\\_2005\\_06.pdf](http://www.ato.gov.au/content/downloads/Making_it_easier_to_comply_2005_06.pdf).

<sup>27</sup> See <http://ato.gov.au/corporate/content.asp?doc=/content/42628.htm> on marketing aspects to particular groupings.

lower cost mechanisms for enhancing voluntary compliance for the majority of clients who are trying to comply.

- A smaller number of clients will usually exist who, for a variety of reasons, appear to have carelessly, negligently or deliberately not complied. For these clients in the tax system the common response is an administrative one – an audit to determine the amount of non-compliance and the reasons for it and, if appropriate, apply penalties for the non-compliance. The audit may be targeted at a specific issue (eg work related expenditure claims) or be a comprehensive review of the client's tax affairs.
- For those few clients considered to be 'aggressively' non-compliant, the treatment may be to investigate, with a view to prosecution (civil for abuse or criminal for fraud). Due to the legal evidence-gathering nature of these cases they tend to be adversarial, resource intensive, time consuming and costly for all sides.

All of these variations in regulatory response maintain the essential aspect that the choice of remedy should be appropriate and take into account the facts and circumstances of the client's situation so as to treat the client in an appropriate and proportionate way:

- For example recidivist clients (those who repeatedly offend after treatment) would generally warrant a different treatment than a client detected making an error for the first time.
- Similarly those who knowingly promote non-compliance by others generally warrant different treatment to those who don't.
- Those in special positions of knowledge, trust and influence in the regulatory system (eg key intermediaries, agency staff, lawyers, judges, police and accountants) generally warrant different treatment to those who aren't in such positions.
- Those involved in avoidance arrangements aren't all the same. Clients with relatively low knowledge of the regulatory system who enter arrangements on the advice of their trusted advisor should not be treated the same as those who would be reasonably expected to have sound knowledge.

The correct translation of the perceived motivational postures from observed behaviours and into the subsequent choice of remedies is critical, as the effectiveness of the Braithwaite compliance model is posited on applying the right remedy to the right situation.<sup>28</sup>

It is naturally quite important that the compliance strategy or 'choice of remedy' always be appropriate and defensible – and that the mechanism to get to a decision on the remedy is evidence based and repeatable.

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<sup>28</sup> Black, Dr J 2008, 'Chancer', 'Failure' or 'Trier'? Regulatory Conversations and the Construction of Identities' July 2008, *Crime Narratives in Context Seminar Papers* at <http://www.cardiff.ac.uk/chri/research/cnic/J%20Black%20CNIC%20Paper.doc>.

There is also a broadly accepted order – persuasion before punishment, education before enforcement. Fair warning and firm, but fair, treatment. A common-sense approach to compliance activities.

Both the Australian Tax Office and the New Zealand Inland Revenue documents suggest the use of a broad analysis approach to create an understanding of the client's motivational stance based on: Business and Industry factors, Social and Economic aspects, as well as Psychological influences - a 'BISEP' analysis.<sup>29</sup>

In practice both the capacity and capability to do this kind of analysis 'in depth' for large numbers of clients in a regulatory system is significantly constrained by real resource and competence limitations. A way of prioritising in whom and how much you invest is inevitably required.

The causal factors (a view of the motivational posture) involved in the non-compliance should clearly factor into the appropriateness of the choice of remedy with the Braithwaite approach. For example the causal factors<sup>30</sup> for non-compliance could be as a result of:

- deliberate intent,
- negligence,
- carelessness or recklessness,
- ignorance, (ie a lack of knowledge of the regulators view of compliance)
- honest mistake,
- not being in a position to comply,
- or a difference of views as to what compliance is. This can range from reasonably arguable positions (differences of view as to where the 'line' is) to positions that are more clearly aggressive or 'hard' avoidance.

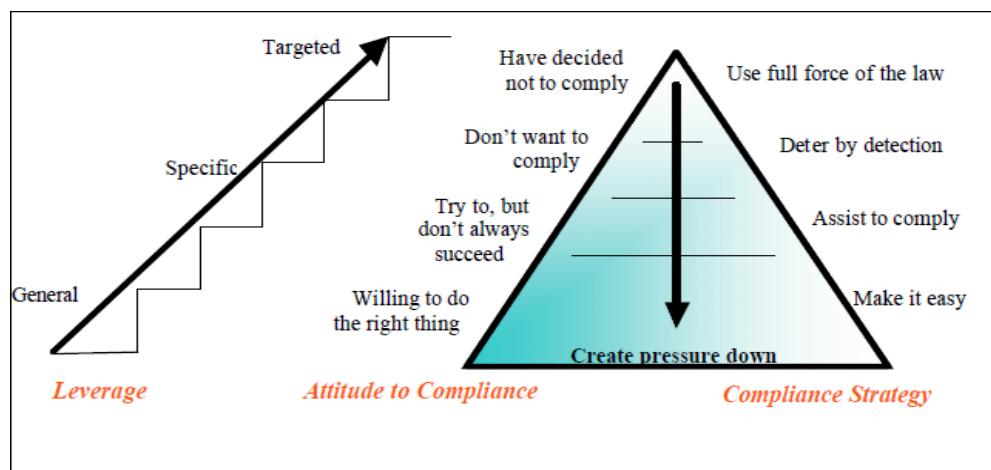
In the Australian Tax System these aspects factor into penalty imposition considerations and towards the end of this article I'll bring these into a broader risk management approach. A New Zealand variation of the compliance pyramid approach highlights different leverage effects possible, in that:

- Some treatments will apply to many clients at once and be rather general in nature – such as education materials available to the public.
- Other treatments will be client group specific, advice aimed at a particular industry or occupation or segment.
- Finally, some treatments are targeted at clients considered to have been deliberately non compliant.

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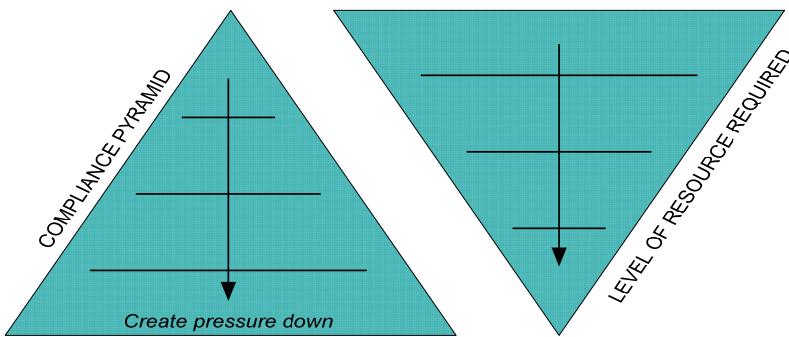
<sup>29</sup> Shover, N, Job, J & Carroll, A 2003 'The ATO Compliance Model in Action: A Case Study of Building and Construction' in Braithwaite, V (ed) *Taxing Democracy: understanding tax avoidance and evasion*, Ashgate, Aldershot at [http://demgov.anu.edu.au/papers/ShoverEtal2003TD\(8\).pdf](http://demgov.anu.edu.au/papers/ShoverEtal2003TD(8).pdf).

<sup>30</sup> OECD Regulatory Management and Reform Group 2000, *Reducing the risk of policy failure: challenges for regulatory compliance* @ <http://www.oecd.org/dataoecd/48/54/1910833.pdf>.



**Figure 5**  
**Compliance Pyramid - Types of Leverage**<sup>31</sup>

A further NZ variation in presentation also uses an inverted pyramid to show the relative resource intensity per client generally increases as we move up the compliance pyramid:



**Figure 6**  
**Relative resource intensity per client.**  
**New Zealand Inland Revenue, Internal Document**

The 'Law & Policy' special edition<sup>32</sup> in January 2007 brought together a compilation of papers exploring and commenting upon the implementation of 'responsive regulation' and was a useful summary of the overall state of play with the regulatory compliance pyramid at that time.

The approach has garnered wide acceptance by regulatory agencies in Australia, though in my discussions with their staff it is more rhetoric than reality. Dig deeper and there isn't much more than a triangle on a corporate document.

<sup>31</sup> Morris, T & Lonsdale, M 2005, 'Translating the compliance model into practical reality', New Zealand Inland Revenue, February 2005 @ <http://www.irs.gov/pub/irs-soi/04moori.pdf>.

<sup>32</sup> *Law and Policy* Vol 29 January 2007, John Wiley & Sons / University of Denver available at <http://onlinelibrary.wiley.com/doi/10.1111/lapo.2007.29.issue-1/issuetoc>.

## 5. EXPLICITLY BRINGING RISK INTO THE PICTURE

As noted earlier, before a regulator can determine whether a client is compliant or not decisions have to generally be made about ‘who’ to review. Aspects concerning likelihood of non-compliance, the potential consequences of that non-compliance and the degree of certainty of these need to be guided by risk based case selection (who the regulator reviews to determine whether or not they are, in the regulators view, compliant) and client engagement approaches in a practical sense, where it is both evidence based, repeatable and scalable across markets. Making it reality rather than mere organizational rhetoric.

At their most basic level, risks are simply things that can threaten our success in achieving our intent or vision. Risk events have both a likelihood of occurrence and a consequence of occurrence and it is critically important to understand the difference between these two aspects, ‘how likely’ and ‘how much’, in order to consciously manage and treat risk.

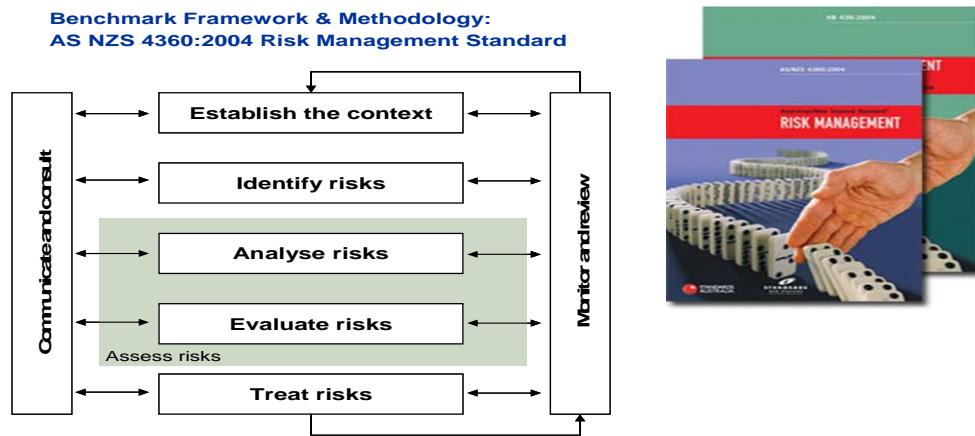
My experience is that it isn’t uncommon for people to talk about risk just in terms of likelihood and not calculate the relative and absolute consequence aspects. That tends to fuel ‘one size fits all’ approaches that may work well when all are of one size – but most aren’t (eg A hundred dollar consequence is ten thousand times smaller than a million dollar consequence and ten million times smaller than a billion dollars... if you just use likelihoods you effectively loose the significance of the dimension of consequence.)

A risk with a lower likelihood, but higher consequence is generally a very different thing to a risk with a higher likelihood, but lower consequence – even though the risk event and overall risk rating may be the same, you usually need to approach them very differently to be effective.<sup>33</sup>

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<sup>33</sup> The standard 4 ‘Ts’ of risk management (ie Tolerate, Treat, Transfer, or Terminate the risk) play out differently by the combination of likelihood and consequence. See for example HM Treasury 2004, *The Orange Book - Management of Risk - Principles and Concepts* at [http://www.hm-treasury.gov.uk/d/orange\\_book.pdf](http://www.hm-treasury.gov.uk/d/orange_book.pdf) (Eg ‘Tolerate’ is appropriate for Lower risk, Terminate the process for Higher risk etc.).

In its approach to risk management the ATO follows the standard for risk management – ISO31000<sup>34</sup> - derived from AS/NZS 4360.



**Figure 7**  
**The AS/NZS 4360 Risk Management Steps**

We should note that risk management frameworks bring with them relatively mature and robust approaches to the prioritisation of very different risks for treatment – a key facet in considering compliance interventions.

Like most organisations, the ATO has utilised a risk matrix as a conceptual aid for displaying and considering relative risk levels of various, and often very different, risks.

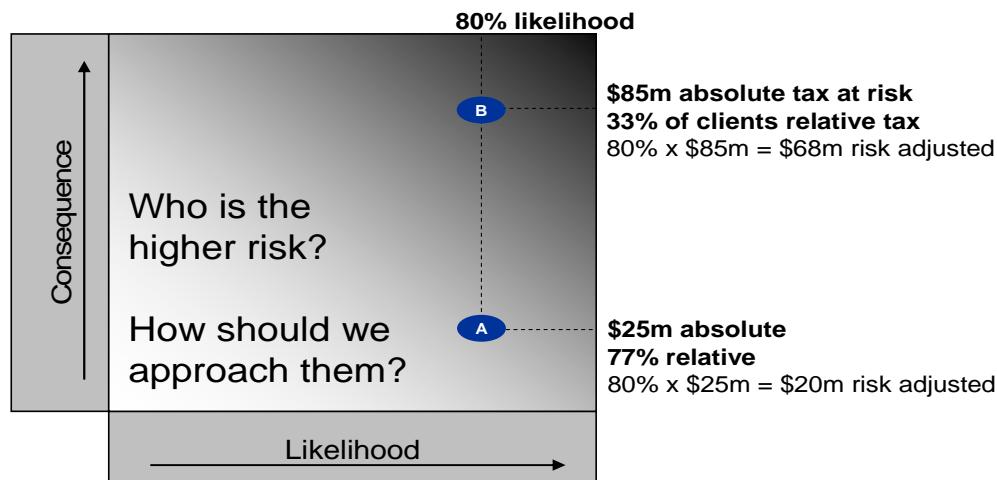
Severity	Extreme	High	High	Severe	Severe	Severe
	Very High	High	High	High	Severe	Severe
	High	Significant	Significant	High	High	High
	Medium	Moderate	Moderate	Significant	Significant	Significant
	Low	Negligible	Negligible	Moderate	Moderate	Significant
	Likelihood					

**Example Risk Matrix**

**Figure 8**  
**Example Risk Matrix**

<sup>34</sup> Available at <http://www.riskmanagement.com.au/>.

An issue was how compliance 'view' of risk might best fit with these broader risk management approaches. For example, if we had two clients with the same likelihood of potential non-compliance, but significantly different relative and absolute consequences of non-compliance, who should we prioritise for review and how should we map<sup>35</sup> them onto a risk matrix?



**Figure 9**  
**Differing absolute (\$) or relative (%) risk positions**<sup>36</sup>

- How should we best combine or take into account in our risk prioritisation, concepts such as relative non-compliance (eg client A evaded 77% of their tax – a view of severity of offence) and absolute non-compliance (eg client B evaded \$85 million of tax)?
- How should leverage aspects, such as the influence or impact over clusters of clients that a market leader or an advisor might have, come into the picture?
- Can we find features associated with 'attitude' towards compliance (however that might be effectively and consistently estimated beforehand) or are we in practice largely limited to identifying potential non-compliance before client contact is made?

A further, and very important, consideration for a tax administration is how should possible avoidance<sup>37</sup> (bending the rules or having a tax position the Commissioner regards as contentious) figure relative to possible evasion (breaking the rules)?

<sup>35</sup> The scaling of the likelihood and consequence dimensions of a risk matrix is an 'informed judgment' by the organisation. Eg Logarithmic scales (eg by factors of ten) may be used for plots of absolute consequence and likelihood. The choice between say linear or logarithmic scales depends on the nature of the risks being plotted, what the tolerance for risk is and how many risk levels it wants to identify. A risk matrix is essentially a prioritisation tool for sorting risks, and hence scales that best suit the organisations decision-making on risk should be used.

<sup>36</sup> See Hamilton, S 2006, *Optimising Compliance – the role of analytic techniques* available at <http://www.itsweb.org/documents/Optimising%20Compliance%20-%20Role%20of%20Analytic%20Techniques.pdf> for a deeper discussion.

As previously noted, we need to be able to effectively approach the compliance pyramid, with its responsive regulation concepts, in situations where *compliance itself is uncertain*, for example where the law's application to a set of facts and circumstances may be unclear and a reasonable contention exists.

This 'zone of uncertainty' in the operation of the law may range from facts and circumstances that appear to be legitimate tax minimisation, through to arrangements that appear to have little commercial purpose other than to obtain a tax benefit<sup>38</sup> not otherwise available.

It should be noted that, for large corporate clients involved in complex transactions this uncertainty of 'what is compliant' is associated with most of the risk of being viewed by the regulator as being *potentially* non compliant.<sup>39</sup>

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<sup>37</sup> See the discussion in Chapter 1 "Tax Avoidance" of Pagone, G. T. "Tax Avoidance in Australia", The Federation Press, 2010.

Stripped to its basics avoidance generally works towards seeking a tax advantage in altering:

- who incurs the tax (alienation),
- when they incur it (timing),
- where they incur it (profit shifting),
- what is taxed (characterisation) and/or
- how the tax is calculated (eg changing valuation methodologies).

Another view of this is:

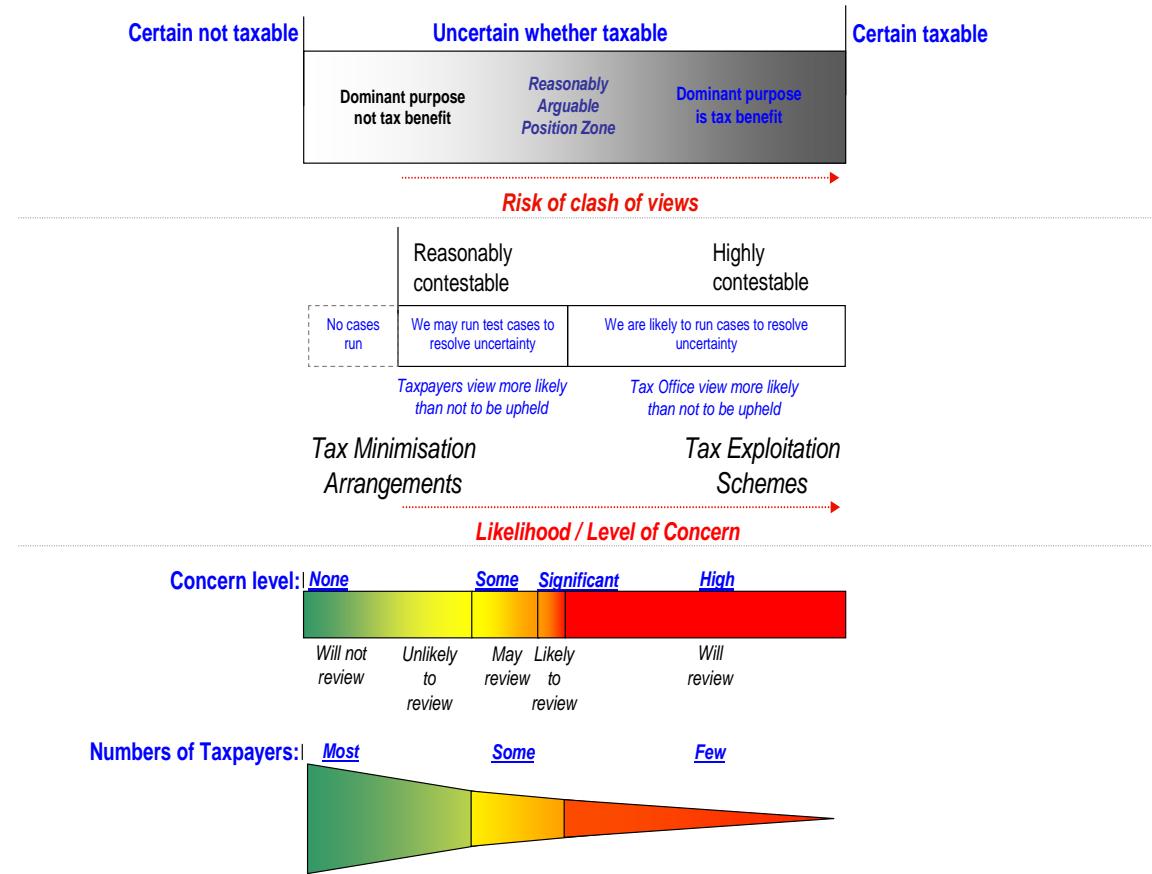
- Person (who),
- Period (when),
- Place (where),
- Product (what),
- Process (how) as a mnemonic for these basic avoidance or tax minimization strategies.

<sup>38</sup> See for example the discussion in Chapter 4 "Tax Benefit" of Pagone, G. T. "Tax Avoidance in Australia", The Federation Press, 2010.

<sup>39</sup> See for example the discussion by Freedman, J. Loomer, G. and Vella, J at Section 2 "The Continuing Importance of the 'Boundary of the Law'" in "Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC, Report of a preliminary survey", June 2007 at <http://denning.law.ox.ac.uk/tax/documents/Movingbeyondavoidance.pdf>.

## Certainty level re application of the law to facts and circumstances

Shades of Grey → Informed Judgment necessary



**Figure 10**  
**Contentious tax positions - Tax Minimisation and Avoidance - The zone of uncertainty**

Potentially contentious arrangements - it is where advisors<sup>40</sup> really earn their money in the face of appropriate, but perhaps not always appreciated, professional scepticism<sup>41</sup> and judgment<sup>42</sup> by the regulators compliance staff.

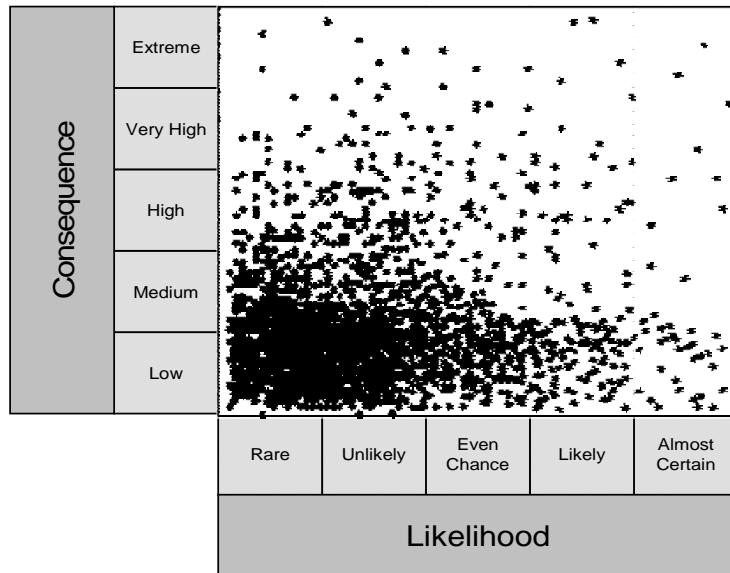
From a regulator's perspective we need to be able to factor this aspect of the likelihood and consequence of potential non-compliance, both absolute and relative, and our degree of confidence in these aspects, into our view of risk in a consistent, logical, repeatable and defensible manner.

<sup>40</sup> See for example the discussion in Chapter 10 'Advising on Tax Avoidance' of Pagone, G. T 2010, *Tax Avoidance in Australia*, The Federation Press, Sydney.

<sup>41</sup> As defined in Australian Auditing Standard ASA 200 requirement paragraph 15 and A18 – A22 <http://www.comlaw.gov.au/Details/F2009L04064>.

<sup>42</sup> As defined in Australian Auditing Standard ASA 200 requirement paragraph 16 and A23 – A27.

Represented as a scatter plot of compliance risk we are likely to have something like:



**Figure 11**

**Most clients have a lower consequence and lower likelihood of non-compliance – most clients are compliant most of the time**

There is a natural logic to this. In both cases the probability distribution of clients would generally follow a scale invariant<sup>43</sup> inverse power distribution<sup>44</sup>, such as Pareto, of a few large consequence or higher likelihood clients and many lower likelihood/consequence ones. It is the way nature and regulatory systems generally work.

The reason for this in living systems is both obvious and subtle: viable systems adapt to reduce the impact and/or the likelihood of severe events, making them relatively ‘rarer’ over time. If they didn’t the system wouldn’t ‘survive’ long term (eg prohibition in the USA). This result will hold true whether our view of risk is event based or whole of client. A whole of client risk view is essentially a summation of the client’s risk events.

<sup>43</sup> Essentially the shape of the distribution looks similar at all scales: eg the shape of cumulative tax paid by a hundred clients, a thousand, or a million etc.

<sup>44</sup> Eg one over  $x$  to the  $n$ th power ( $1/x^n$ ) so small values of  $x$  are more probable than large values. In nature (many creeks few continent draining rivers) and in human systems (many towns few mega cities, many small taxpayers few billion paying taxpayers). See for example: Newman, M 2006 *Power laws, Pareto distributions and Zipf’s law* at [http://aps.arxiv.org/PS\\_cache/cond-mat/pdf/0412/0412004v3.pdf](http://aps.arxiv.org/PS_cache/cond-mat/pdf/0412/0412004v3.pdf).

It is not a simple ‘add and average’ since probabilities are involved, but the mathematics of forming a whole of client view is not really that complicated.<sup>45</sup> On the other hand how you form a view on the probabilities themselves can be quite complex; using either ‘decision rules’ from subject matter experts or, if sufficient data exists, from predictive data mining approaches – eg logistic regression, neural networks, decision trees etc.<sup>46</sup>

Having formed a risk based view of where a client sits relative to other clients we can then consider who we may want to, or can focus on – those who appear to present a higher relative risk. One way of thinking about this is to imagine that we are essentially zooming in on ‘who’ we might have compliance ‘concerns’ about and therefore may want to review.

We do this by considering the potential consequences of possible non-compliance as well as our view of the likelihood of non-compliance. (Eg A larger client generally warrants a different level of interaction and investment to a smaller client.) Clearly, from a risk management perspective, we will have a more significant interest in, and need for assurance with, higher consequence clients or events than lower consequence ones.

Equally we will be more interested in reviewing those clients or events that have a higher likelihood of being non-compliant (having a contestable position – one that we have concerns with) than those with lower likelihoods.<sup>47</sup>

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<sup>45</sup> Overall likelihood for ‘n’ mutually exclusive ‘i’ risk events:  $L_n = \sum(L_i \times C_i) / \sum(C_i)$ . [Note this is not the average likelihood ‘ $\sum(L_i)/n$ ’ unless all risks have the same the consequence.] The overall consequence is:  $C_n = \sum(C_i)$  and the overall risk is:  $R_n = L_n \times C_n = \sum(L_i \times C_i)$ .

For example say we have a taxpayer with:

- a late lodgement likelihood of 50% and a consequence of lodging late of \$200,
- a likelihood of reporting incorrectly on the return of 10% with a consequence of \$1,000, and
- a likelihood of late payment of 20% with a consequence of \$500.

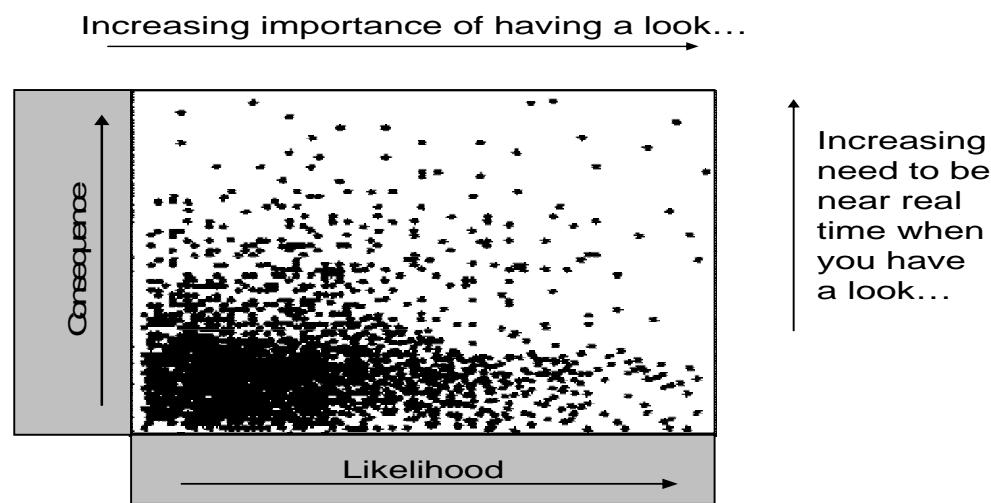
Then:

- Overall consequence =  $\$200 + \$1,000 + \$500 = \$1,700$
- Overall likelihood =  $[(50\% \times \$200) + (10\% \times \$1,000) + (20\% \times \$500)] / \$1,700 = 17.64\%$ , and
- The overall taxpayer risk =  $(50\% \times \$200) + (10\% \times \$1,000) + (20\% \times \$500) = \$300 = 17.64\% \times \$1,700$ .

The technical challenge is designing risk filters using limited, often highly summarised, data to provide useful and robust views of likelihood and consequence that can then be scaled and brought together in this fashion. This view of a taxpayer’s risk then needs to be considered relative to other taxpayers to decide on an appropriate prioritisation.

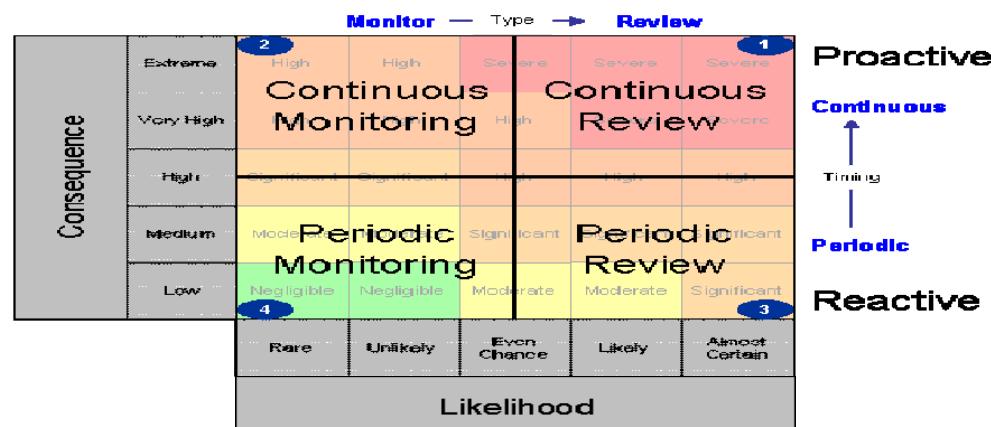
<sup>46</sup> Tools such as SAS JMP (<http://www.jmp.com/>) have made simple data mining, both descriptive and predictive, easier to access and use, though there is still considerable science and ‘art’ involved in both getting the data in a state to mine and in what tool to use to best mine it. Open source software, such as the r based “RATTLE” system (<http://rattle.togaware.com/>) is also available.

<sup>47</sup> This is effectively the same as the requirements in the Australian Auditing Standard ASA 200 where the ‘nature, timing and extent’ of audit testing is associated with professional judgments regarding the likelihood and consequences of a material misstatement.



**Figure 12**  
**Timing and importance of detection efforts**

If we then map a client engagement approach based on timing and frequency of the suggested detection effort - periodic to continuous (ie ~near real time) and the type and intensity of detection effort - passive monitoring to active review, the following risk differentiation framework emerges for the large market:<sup>48</sup>

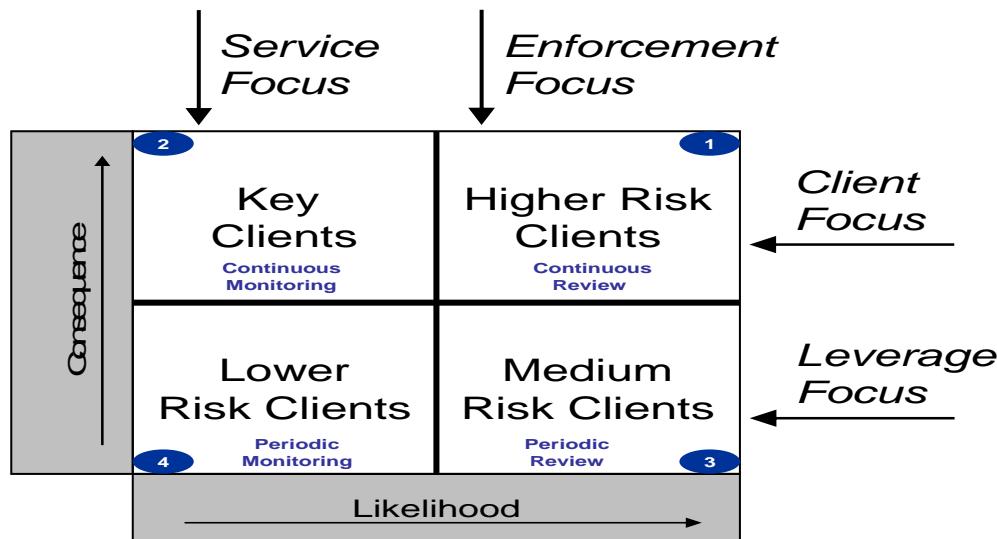


**Figure 13**  
**Detection strategies/investment laid over a risk matrix**

This framework is the basis of a risk differentiation framework now being used by the Australian Tax Office for its large corporate clients. Similar approaches are being used for advisors and intermediaries.

<sup>48</sup> For areas with much larger client numbers the engagement stances associated with the risk categorisations clearly need to be modified to match capability and cost effectiveness. The engagement stance should always be an appropriate and proportionate response to the risk posed.

Giving the quadrants broadly representative names<sup>49</sup> we derive the following:



**Figure 14**  
Service, enforcement, leverage and client focus

This isn't really a radical change to the way the Australian Tax Office has been dealing with its clients in the large market in the past – it is very much a logical framework within which to set and guide what they have been doing day to day.

By taking into account consequence, it makes it explicit that there is a set of clients in whom we may need to make an extra investment to keep them from moving 'up' the compliance model.

These are the 'Key clients', where the precautionary principle of risk management is of increased importance – where you don't want to wait for things to go wrong if they can be reasonably prevented and where it is important to be able to demonstrate to the broader community that the largest players are being appropriately monitored by a prudent regulator.

<sup>49</sup> Note that one of the areas of concern regarding the framework is the terminology used for quadrant 1 (higher risk). Some consider this a pejorative term that may cause unnecessary dispute. Perhaps 'higher concern' or 'higher interest' may be considered less inflammatory terms for this quadrant.

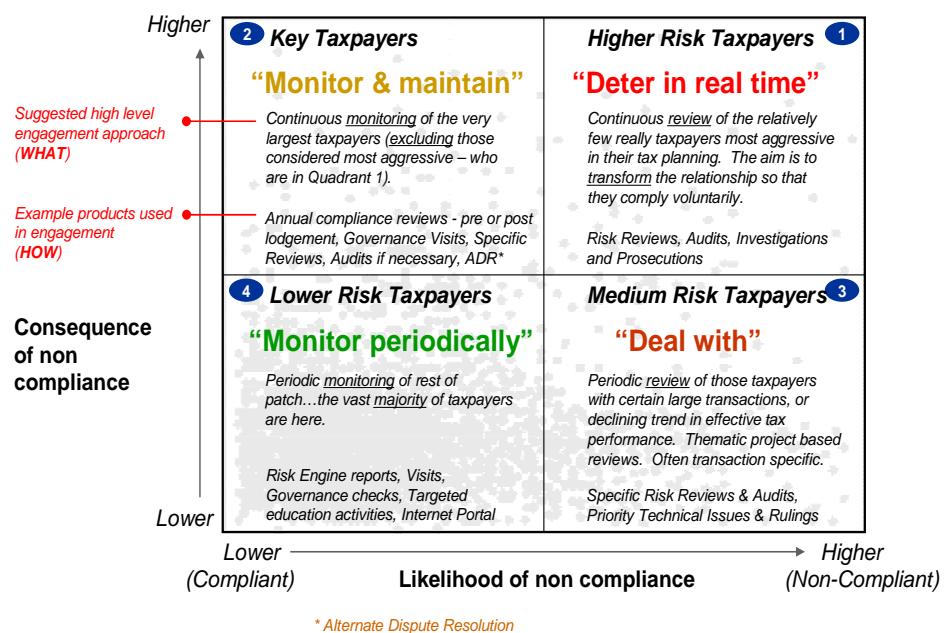
Another aspect is that the risk descriptions are relative – quadrant 1 clients are higher risk relative to key and lower risk clients. It is not high and low and not an absolute threshold set in stone, but a relative one.

We are not dealing with certainties but with risk, so categorising a client as 'higher risk' is not the same as saying that they actually have made an error – we don't know that until we have reviewed law as it applies to the facts and circumstances. Instead a higher risk client is perceived by us, based on the information and intelligence we have at that point in time, to have a higher relative likelihood of having a potentially contentious tax position than a key or a lower risk client – so more time and effort is expended in checking whether this is the case. The efficacy of the risk differentiation approach should not turn on the descriptive labels used and the most practical and appropriate set should be used.

In one sense this is a level of recursion of how the broader market segmentation approach effectively operates within the Australian Tax Office. For example, if we use turnover as a proxy for consequence<sup>50</sup> the following picture broadly emerges:

- Large business (Higher coverage rates)
- Quasi evasion behaviours (Higher coverage rates)
- Small & medium enterprise (Moderate coverage rates)
- Micro enterprises and individuals (Lower coverage rates)

It can be seen that such a framework effectively makes clearer many of the risk based approaches that people have implicitly been using within tax administrations for years. The approach makes the decision process on risk prioritisation more coherent, consistent, explicit and transparent. Drawing these threads together we can obtain an overarching strategic framework for differentiated approaches to compliance risk management for large corporate clients:



**Figure 15**  
**The quadrant risk differentiation framework for large business compliance engagement**

In broad conceptual terms, this risk differentiation framework<sup>51</sup> suggests a different high level engagement approach for clients in each quadrant:

<sup>50</sup>Turnover has proved to be a useful proxy. An analysis of adjustments made over several years showed that most adjustments of business returns were for less than 10% of turnover and it is rare for an adjustment to be greater than turnover (eg as with a large CGT event). Most adjustments were thus relatively small compared to turnover and both smaller and larger business adjustments were usually 'small' when compared to the largest adjustments. As would be expected, the relatively rarer large adjustments are associated with the largest businesses.

- For those clients with relatively higher consequences (often the largest clients or those with significant influence in the tax system) the logical strategy is that the regulator would invest more time and effort in trying to reduce the likelihood of non-compliance – of the client having a contentious tax arrangement.
- For those clients with lower consequences of non-compliance if deterrence efforts failed the regulator would look for more efficient leverage approaches to detect and deal with potential non-compliance.

Reflecting the underlying Pareto nature of risk, the risk differentiation framework suggests that relatively few clients would be treated as ‘higher risk’ – perhaps 2% or fewer.<sup>52</sup> This is how it has played out in practice as well. Correctly identifying these relatively few higher risk clients or transactions is clearly critical for overall compliance effectiveness.

The framework suggests a relatively intense focus on clients considered as ‘higher risk’ even though these may not produce the greatest immediate result since compliance activities with higher risk clients can be drawn out, litigious affairs often involving entrenched positions. The activities of higher risk clients tend to set the bar of acceptability in the market, particularly if their activities go unchallenged for a period of time.

For the long term success of the regulatory system, higher risk clients need to be effectively engaged with credible compliance approaches – and this needs to have a degree of visibility in the market.

If a regulator is slower than ‘market time’,<sup>53</sup> to be ‘seen’ to deal with aggressive avoidance behaviours then ‘breakouts’ of such arrangements occur as more risk-neutral clients begin to take up the scheme.

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<sup>51</sup> While in strict risk terms the Key Client quadrant might also be seen as “medium risk” (eg  $80\% \times \$200 = 20\% \times \$800$ ), the two quadrants (2 and 3) can be clearly distinguished on the basis of the dominant part of the likelihood and consequence calculation. The Key Client quadrant has clients with a relatively lower likelihood and higher consequence, whereas the Medium Risk Client quadrant has clients with a relatively higher likelihood and lower consequence. They are likely to be behaviourally different and impact the system differently.

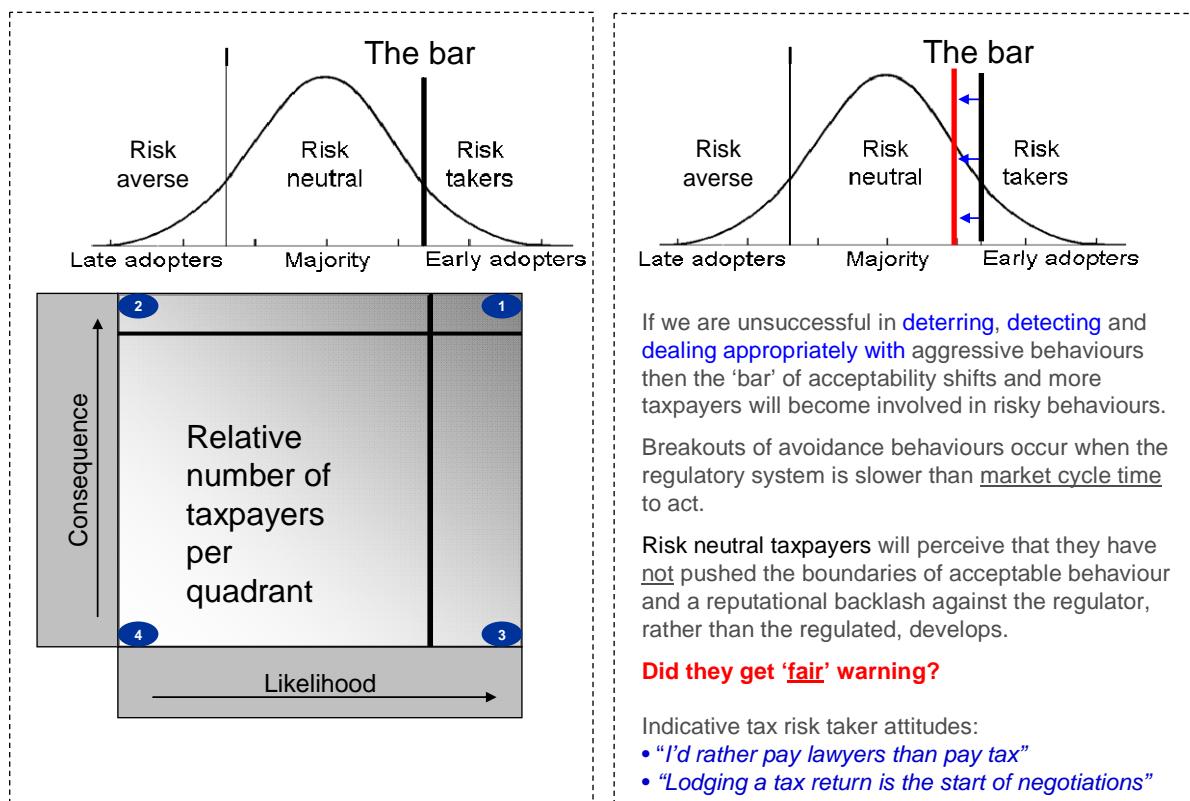
<sup>52</sup> For example a 90:10 Consequence and 80:20 Likelihood split gives  $10\% \times 20\% = 2\%$  as ‘Higher Risk’,  $10\% \times 80\% = 8\%$  as ‘Key clients’,  $90\% \times 20\% = 18\%$  as ‘Medium risk’ and  $90\% \times 80\% = 72\%$  as ‘Lower risk’. Note these are indicative figures only and in practice additional taxpayers have been categorised as medium risk for assurance (checking relatively large claims) and scoping purposes (checking an unusual or novel arrangement) than would be otherwise selected as medium risk on simple likelihood of non compliance grounds.

<sup>53</sup> In the highly concentrated and interconnected large business market arrangements tend to spread rapidly. One recent financial arrangement with significant alleged tax benefits spread between the major players within a year, highlighting the need to be ‘real time’ in detecting and dealing with such arrangements. In markets with much larger numbers of clients the take-up time is longer, typically in the order of several years.

The generally long lead times of legal processes don't help in this regard and it highlights the importance of explicit signalling of the regulator's views in a timely manner. Accusations of 'U-turns' by the regulator regarding process or interpretation can follow as it switches gear to focus on the break-out of non compliance. Perhaps<sup>54</sup> understandably, risk neutral clients may perceive that they did not receive 'fair' warning in such circumstances.

## 6. THAT 'DAM' WALL

One experienced tax auditor said to me that a number of large clients appear to 'sit just behind the dam wall'. We can usefully think of that dam wall as the bar or line where acceptable tax planning becomes unacceptable tax avoidance, where tax positions transit to become more 'highly contestable'. Clients, advisors and the regulator may have very different views on where that line is and it is important for the parties to consult to get a robust view into the market.



**Figure 16**  
**Risk positioning and behaviours (Concept adapted from: *Diffusion of Innovations* by E. M. Rogers, 1962, Free Press, New York)**

<sup>54</sup> Though a well-informed and advised large taxpayer with good tax governance should generally have a reasonable feel for when it is playing in the grey, and if wanting certainty, can always request a ruling.

Successfully addressing clients in ‘market time’ who breach the ‘dam wall’ is clearly a priority for any effective compliance strategy otherwise more risk-neutral clients<sup>55</sup> will become involved.

Such breaches can be opportunistic constructs of advisors, devised for a particular business situations faced by a large client. The advisors or others associated with the transaction then may use the template of the approach and promote<sup>56</sup> its use with other clients, facilitating a break-out of avoidance activity that exhibits the classic “S” innovation growth curve.<sup>57</sup>

The risk differentiation framework provides for the needed higher level of focus on clients that are, based on past experience and current market intelligence, perceived as being more likely to be involved in such contentious approaches.

A key caveat with all of this is that frameworks are broad guides rather than absolutes and they do not mandate, nor sanction, the use of an inappropriate approach, given an understanding of a client’s facts and circumstances. The framework should provide guidelines for engagement - rather than tramlines for action.

The framework does not suggest that a higher risk client has made an error or is non compliant. In the large market it is about coming to an informed professional judgement, using the limited amount of information available, of who is relatively more likely to have a significant contentious arrangement. Identifying and resolving those contentions, whether by agreement or by going to the Courts, is key to providing increased certainty of tax outcomes to the market.

In the framework, tax attitudes and behavioural indicators would be expected to differ between the left and right hand sides. However there is no sharp divide between the two sides, rather a spectrum of behaviours that change from left (lower likelihood) to right (higher likelihood).

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<sup>55</sup> “Saints, Swingers, and Sinners” is a simplistic, but useful, mnemonic of some broad groupings of a regulated population to be kept in mind. One can think of the 15% to 20% or so risk averse as being “Saints”- who won’t cheat or bend the rules even when highly unlikely to be caught or punished, “Sinners” as the 15% to 20% or so risk takers who are more likely to defy the system and gamble on not being detected or on coming out ahead even after penalties, and “Swingers” as the 70% to 60% or so more risk neutral, who will tend to *swing one way or the other* depending on what they perceive the majority as doing/getting away with – the ‘norm’. One can easily see how ‘tipping points’ come into this picture. In a somewhat similar vein Valerie Braithwaite in her book *Defiance in Taxation and Governance: Resisting and Dismissing Authority in a Democracy* (2009) identifies ‘resistant defiance’ involving about half the population and ‘dismissive defiance’ about 20%. A less emotive terminology, using a traffic light analogy, has ‘green’, ‘amber’ and ‘red’ taxpayers in terms of broad groupings by likelihood of concern.

<sup>56</sup> The introduction of Promoter Penalty Legislation has had an influence on the explicit marketing of such arrangements within Australia.

<sup>57</sup> See for example Boucher, T 2010, *Blatant, artificial and contrived: Tax schemes of the 70s and 80s*, ATO, Canberra at <http://www.ato.gov.au/content/downloads/cor00244226.pdf> on the regular cycle of breakouts of tax avoidance.

For example, broadly speaking, higher and medium risk clients might be expected to have some aspects of the following behaviours,<sup>58</sup> none of which is definitive:

- Relatively low effective tax rates over time (compared to peers, partners, or the past) that often appears to be at odds with the economic outcomes being achieved.
- A history of relatively aggressive tax positions that the regulator has concerns about.
- Relied on non disclosure or limited disclosure of significant, potentially controversial tax positions. (For example not seeking rulings or seeking rulings only on parts of a transaction without disclosing the more contentious aspects of the arrangement.)
- Used concealment or obfuscation as part of process, playing the audit lottery approach.
- Utilised complex tax driven structures that appear make little sense other than to obtain a tax benefit or inserted otherwise unnecessary steps into a transaction that would objectively appear to be for the dominant purpose of obtaining a tax benefit.
- Tax risk is not appropriately factored into corporate governance process, such as rewarding the attainment of effective tax rates significantly below that of competitors.
- Used ‘game playing’ in negotiations, trickle feeding information (and sometimes misinformation) rather than ‘full and true’ disclosure of the facts. This includes non bona-fide behaviours in negotiations - ‘deny, delay, deflect, defeat’ activity by a few.
- Sought out and used advisors, intermediaries or associates with history of aggressive tax planning for their tax arrangements. (‘Where there is smoke, there may be fire’...)

Key and lower risk clients on the other hand might be expected to have more of the following behaviours:

- Relatively higher effective tax rates that accord with the economic outcomes achieved.
- Generally no significant history of adjustments, though that is not to say that they don’t have disputes or differences of opinion on the tax outcomes intended by law. The key difference compared to higher risk clients is that they let the regulator know and do not seek to conceal relevant facts, so that the regulator can choose to disagree and negotiate or go to the umpire (the courts) for a decision.
- Upfront full and true disclosure of significant, potentially controversial tax positions via rulings process. They seek the regulator’s opinion regarding controversial or contentious issues and keep them informed of decisions and actions.

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<sup>58</sup> See also the indicators of possible non compliance in paragraph A13 in Australian Auditing Standard ASA 250.

- Tax risk as an explicit considered part of a robust corporate governance process where independent advice is generally sought on potentially contentious matters.
- Business driven transactions, structures and approaches.
- Use of advisors, intermediaries or associates noted for advice and arrangements that doesn't push the boundaries of aggressiveness.

*Consequence Factors:*

Key and higher risk taxpayers might be expected to have one or more of the following consequence features:

- Significant potential revenue impact (this may be reflected by relatively high turnover as most adjustments are for less than 10% of turnover and that it is rare for an adjustment to be more than turnover)
- Control or influence over a relatively large amount of assets
- Occupy perceived positions of trust in the community or in the market
- Directly or indirectly influence significant numbers of other taxpayers
- Significant linkages and influence regarding advisors and intermediaries.

These taxpayers are material leverage points in the system – the regulator needs to invest in knowing what they are doing now – ‘real time’ compliance.

Broadly speaking, lower and medium risk taxpayers might be expected to have the following features:

- Relatively lower revenue impact per taxpayer
- Not in positions of significant trust in the community or market
- Relatively lower influence over other taxpayers or advisors and intermediaries.

These taxpayers are not, by themselves, material leverage points in the compliance market, though in total they may be.

The ATO risk differentiation framework is thus based on the very simple premise that the risk management stance should differ based on an informed perception of a taxpayer’s relative:

- Likelihood of non compliance (that is having a tax outcome that the regulator doesn’t agree with and may want to contest), and the
- Consequences (dollars, relativities, reputation, precedent) of that potential non compliance.

The design challenge then was how to meld these various views and concepts of quantitative and qualitative intelligence, risk, engagement and enforcement strategies into a coherent, consistent and considered framework for risk differentiation of the taxpayer base. Doing this effectively integrated the risk differentiation framework within the corporate approaches and directions, such as the Strategic Statement and Enterprise Risk Framework, and operationalised them.

One thing to keep in mind is the significant information asymmetries involved here:

- The taxpayer will generally have a deep, detailed knowledge of themselves, the transactions they have entered into, and probably a reasonable degree of awareness about those of their immediate competitors, but little about their claims relative to the distribution for the entire business population.
- The tax regulator, on the other hand, has a wide but very limited set of information about all taxpayers, primarily that which is on the tax returns and activity statements, but little specific information about the businesses transactions that go to make up the high level summary detail in those returns and statements.

The regulator's view of a client's risk, determined by the evidence and information they have about all clients at a point in time may well differ from a client's view of their risk. This is not unexpected given the significant information asymmetries that exist.

While in the majority of cases the regulators view of client risk and the client's view will in fact coincide, as most clients are viewed as lower risk or key, it is not surprising that views of relative risk for the much smaller number of 'higher risk' and "medium risk" clients may differ.

Understanding the reasons behind those different views requires openness and transparency and is critical to resolving possible contentions of view. Part of being fair and professional, open and accountable is being prepared to communicate to the client the regulator's view of the client's risk of non compliance to enable a more informed view of self assessment to take place.

Such communication is in fact an important part of the regulator explaining and educating the client about concerns about the perceived risk of non compliance, so that the client has the chance to explain or self correct matters in the future - should they wish or choose to. It is an opportunity to discuss behaviours and the regulator's view of them in an open and frank way.

That some clients dispute the regulator's view of the perceived risk of non compliance should not be a blocker to the implementation of risk categorisations and risk based differentiation frameworks. That will always be the case. It is always open to the client to show why the regulator's view of them is incorrect, thus updating the regulator's intelligence picture.

## 7. USING THE RISK DIFFERENTIATION APPROACH IN PRACTICE

In practice the ATO's Compliance Risk Differentiation Framework<sup>59</sup> serves several purposes:

- It provides an overarching framework for differentiating engagement stances with taxpayers according to an informed 'professional judgment'<sup>60</sup> of their likelihood and potential consequences of non-compliance.
- It enables a coherent, consistent and considered approach to form a view of a taxpayer's relative risk of non compliance, taking into account the multiple factors associated with likelihood and consequence, and the intensity of the response to that risk.
- It allows the communication of the approach, and view of a taxpayer's risk categorisation, to the taxpayer in an open and transparent manner so as to enable an informed discussion about their perceived risk of non-compliance.
- It facilitates resource and capability discussions and decisions regarding quite diverse compliance risks<sup>61</sup> (eg Transfer Pricing, Thin Capitalisation, Capital Gains Tax Reduction, Inappropriate use of losses etc) all within a consistent framework.

Using a range of risk filters and factors,<sup>62</sup> the ATO formally profiles large businesses twice a year (when enough comparative data from Tax Returns exists and the timing allows for substituted accounting period taxpayers, late lodgers, self amendments to be appropriately considered) against previous results and data from other businesses, both domestic and international.

This 'past and peers' quantitative analysis is then supplemented with qualitative intelligence from other sources (media, external databases, observations by field staff, other tax administrations etc) regarding potential problem areas, to place large market taxpayers into one of the four risk categories of each tax type (Income Tax, GST etc):<sup>63</sup>

- Higher risk, (relatively higher likelihood and consequence)
- Key Taxpayer, (relatively lower likelihood and higher consequence)
- Medium risk, (relatively higher likelihood and lower consequence) and
- Lower risk, (relatively lower likelihood and consequence).

<sup>59</sup> The Risk Differentiation Framework is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00246010.htm>.

<sup>60</sup> See the requirements of Australian Auditing Standard ASA 200 regarding "Professional Judgment" at paragraphs A23 to A27.

<sup>61</sup> These compliance concerns are largely identified in the annual compliance program and are incorporated into the quantitative risk filters. The Compliance Program is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00248103.htm&mnu=47063&mfp=001>.

<sup>62</sup> Roughly one hundred tests are applied in total, grouped around concerns that are largely identified in the Compliance Program such as Capital Gains Tax, Loss Utilisation, Profit Shifting (eg Transfer Pricing, Cross border Financial Arbitrage, and Thin Capitalisation), R&D and other Concessions, Capital/Revenue distinctions, Source & Residence aspects, Royalty Withholding Tax, Consolidation, etc. The broad description of these filters is now available on the ATO website.

<sup>63</sup> The Commissioner's speech on the risk differentiation framework is "Do you see what I see?" available at: <http://www.ato.gov.au/corporate/content.asp?doc=/content/00228656.htm>.

The risk categorisation in the large market is thus an informed professional judgement, using intelligence available at a point in time, rather than something produced at the push of a button. As the information set changes or is enhanced, the categorisation of a client's relative risk may change.

Importantly, the risk categorisation of a taxpayer does not in any way influence the outcome of a possible risk review of a client nor the choice of remedy – that of course depends on the facts and circumstances found regarding their compliance obligations. However it does influence the initial likelihood and initial intensity of a review.

The numbers of taxpayers placed in each category is informed by analysis of the Pareto-like distribution of taxpayers and their risk and the ability to resource responses to that risk:

- Relatively few taxpayers, about 2%, are considered higher risk,
- about 8% are considered key taxpayers and these account for the majority of income and other taxes paid,
- roughly 25% of large market taxpayers are categorised as medium risk (selected for a variety of risk themes such as compliance assurance of large claims, risk scoping of new arrangements, and some for potential enforcement), and
- the majority, about 65%, are considered relatively lower risk.

(These are indicative percentages only and may vary from year to year as risk themes change.)

## 8. ENGAGEMENT STANCE

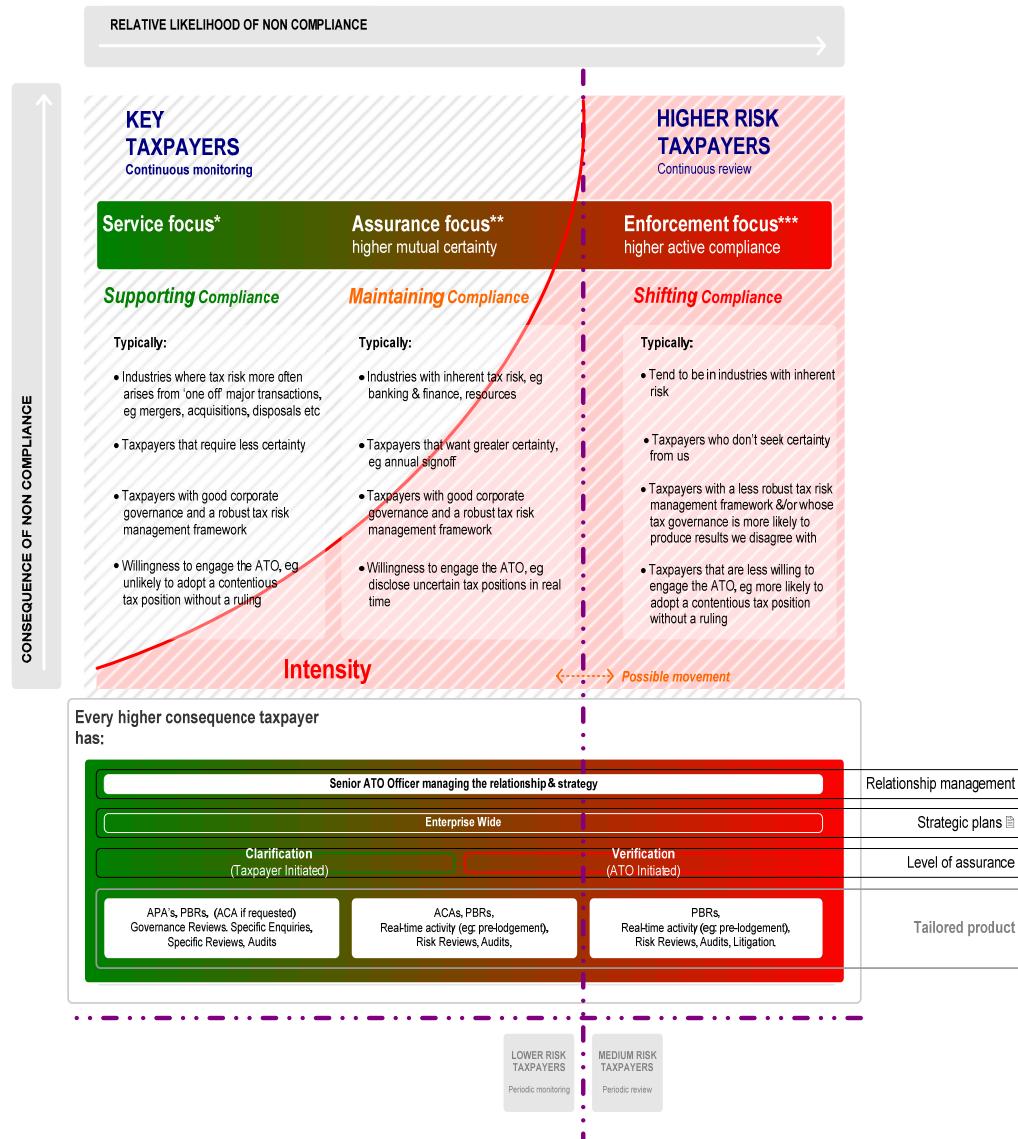
For higher risk taxpayers, the suggested engagement stance is a real time/continuous risk review. These taxpayers matter a lot and often set the tone for the market. Accordingly, the ATO assigns sufficient resources to enable it to identify, review and understand any material transactions that have the potential for tax planning so that it can quickly form a view as to their appropriate treatment, ideally before that tax return has been lodged.

For key taxpayers, the framework is suggestive of a continuous monitoring stance. Most of Australia's largest businesses fall into this category, they pay most of the taxes and they have significant influence on the tax system.

As major 'payers and players' the actions of key taxpayers matter a great deal to the overall health of the tax system. Hence the ATO has a particularly keen interest in appropriately verifying that the key taxpayer's risk management and governance frameworks adequately identify and mitigate tax compliance risks.

Most taxpayers categorised as key taxpayers will engage with the tax office to seek or understand the Commissioner's view on a potentially contentious matter, whereas our experience has been that higher risk taxpayers largely 'default to detection' by the Tax Office – hence the larger investment in detection effort by the Tax Office with these taxpayers.

Obviously perceptions of truth and transparency engender greater trust by a regulator while apparent non disclosure, obfuscation and concealment generate mistrust ie if we can't see in and understand something of apparent concern to us then we are more likely to come searching to get the data to provide that understanding – as any prudent regulator would do.

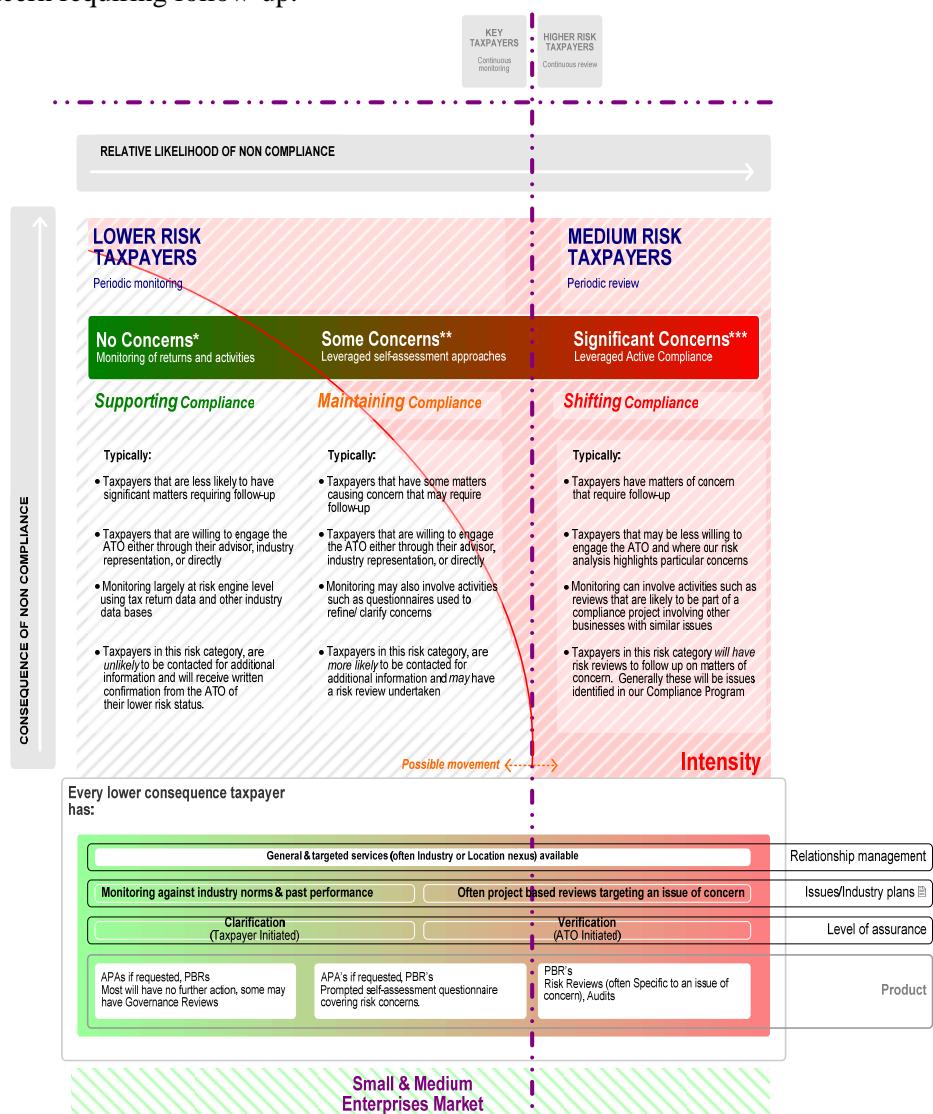


**Figure 17**  
**ATO Large Market engagement model for Higher consequence taxpayers (Higher risk and Key Large Market Taxpayers)**

For medium risk taxpayers, the framework suggests a more periodic review stance. From time to time the ATO may involve the business in specific risk reviews, where matters of concern relating to specific issues are followed up. These are generally issues identified in the annual Compliance Program. These reviews are likely to be part of a compliance project involving other businesses with similar issues.

This approach allows the ATO to more consistently address the issue across the market and reduce compliance costs for the business. These medium risk reviews may have an assurance -like focus (eg check compliance with Section 40.880), a scoping like focus (eg understand the nature of the 23AJ/25.90 arrangements) or an enforcement- like focus (eg gather information to determine whether to proceed to a transfer pricing audit).

The majority of large businesses have a lower risk categorisation. For lower risk taxpayers the framework suggests a periodic monitoring stance. This can involve activities such as the provision of targeted information about specific issues identified in the market, visits and normal internal risk analysis involving the monitoring tax activities and outcomes. If a business is in this risk category, they are unlikely to be contacted for additional information and are less likely to have significant matters of concern requiring follow-up.

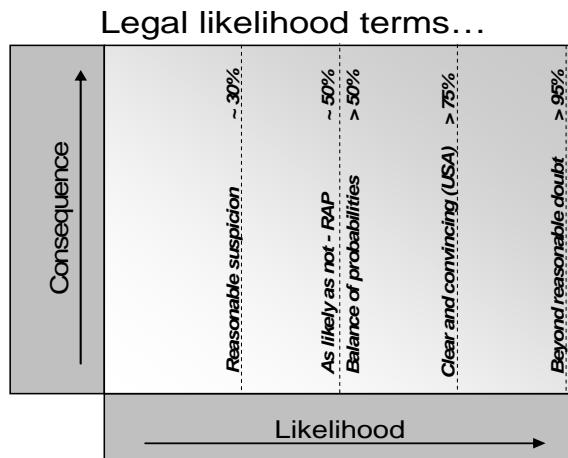


**Figure 18**  
**ATO Large Market engagement model for Lower consequence taxpayers (Medium risk and lower risk Large Market taxpayers)**

The underlying tone or nature of the approach thus changes from a service to assurance to more of an enforcement orientation as the perception of the relative likelihood of non compliance changes. The frequency and intensity of monitoring or review activity also changes from a periodic and leveraged one to a more real time and intense one as the consequences of potential non compliance changes.

These changes should generally be reflected in the compliance product set applied: Lighter touch Governance Workshops and Assurance Reviews for Key Taxpayers and more resource intensive Pre-lodgement Compliance Reviews for Higher Risk Taxpayers. Project based Assurance Reviews and Risk Reviews for medium risk taxpayers, high level monitoring, generally without field contact, for lower risk taxpayers. (Whether a Taxpayer Audit is subsequently undertaken depends on what is found in the review.)

It can also be seen that risk likelihood can be roughly, though usefully, linked to legal concepts such as the evidentiary requirements to support ‘reasonable suspicion’, ‘reasonably arguable position’ and ‘balance of probabilities’. This view can be useful in scaling different compliance risks appropriately.



**Figure 19**  
**Legal likelihood**

Forming views of a client's likelihood of non compliance is inherent in a regulatory system and the administrator is required to both appropriately form and make reasonable evidence based decisions regarding these views. In many regulatory systems this isn't easy.

Detecting non compliance in a largely compliant population is often quite difficult as they often share most of the same attributes. For example low effective tax rates can have a variety of causes. As has been noted the signal to noise ratio, how discriminant features of the potential non compliance stand out, is often fairly low, generating significant numbers of false positives.

Moreover, if the regulator can prioritise clients by risk, as caseload increases the conversion or strike rate decreases, producing an explicit compliance/coverage trade-off.

There is also the ‘prosecutor’s fallacy’ to keep in mind when using a test, even a good one, to examine a largely compliant population – many false positives are likely to be generated.<sup>64</sup>

We also need to remember that regulators treat compliance within certain resource constraints<sup>65</sup> allocated by Government and by their Executive. Most regulators are not resourced to do every possible compliance case and it is inevitable that action on risk in practice will be more influenced by a bias towards higher likelihood than higher consequence in the prioritisation process. (You tend to focus on what is happening rather than what may happen.)

As the regulator’s ability to resource risk alters, the number of clients in each quadrant of the framework can be varied by changing their thresholds. The ‘bars’ are not static and moving the threshold bars for treatment does not change the relative prioritisation of a client’s risk, only the suggested engagement stance and resource intensity that might be initially assigned.

For example, if more staff were allocated to discretionary risk work the likelihood cut-off point could be lowered – increasing client numbers for quadrants one (higher risk) and three (medium risk) or the cut-off point for consequence could be lowered, increasing client numbers for quadrants one (higher risk) and two (key clients).

Equally, as the regulator experiences non discretionary resource constraints it can raise the threshold for likelihood or consequence, thus reducing the relative client numbers in those quadrants. The risk differentiation approach thus provides guidance for a considered and consistent response to resource changes and constraints in a dynamic risk environment.

Another way of saying this is: what is the appropriate risk treatment isoquant that can be resourced at a point in time?

For example, while the regulator should treat<sup>66</sup> a lower consequence client that it is ‘confident’ did not comply, where should it draw the line regarding a higher

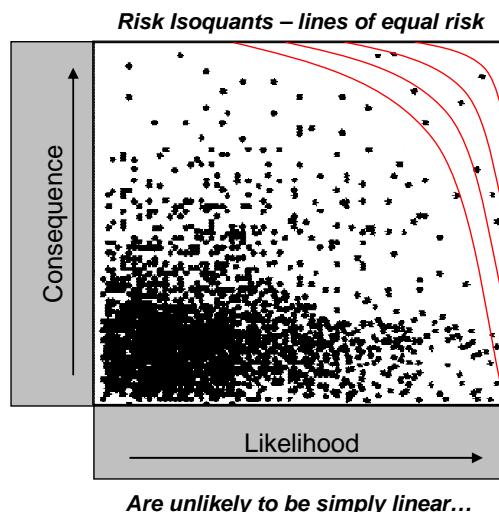
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<sup>64</sup> For example if our case selection sensitivity (ability to detect true positives) is 70% and the population is 90% compliant then our false positive rate will be  $30\% \times 90\% = 27\%$  while true positives will be  $70\% \times 10\% = 7\%$  giving a strike rate of 7% ( $27\% + 7\% = 21\%$ ).

<sup>65</sup> For example see the conceptual framework of Hamilton, S 2006, *Optimising Compliance – the role of analytic techniques*, p 5 at <http://www.itdweb.org/documents/Optimising%20Compliance%20-%20Role%20of%20Analytic%20Techniques.pdf>.

<sup>66</sup> Naturally this treatment should always be in a proportionate and appropriate manner based on the facts and circumstances found.

consequence client where there is merely a ‘reasonable suspicion’ of potential non compliance?



**Figure 20**  
**Risk isoquants – lines of equal risk**

## 9. COMMUNICATION

The approach is explained to taxpayers in the co-designed ‘Large Business and Tax Compliance’<sup>67</sup> booklet which sets out in relatively plain language how the ATO considers:

- the roles of the parties involved
- the approach to the market including the Taxpayers Charter setting out broad rights and obligations
- the end-to-end compliance program approach of deterring, detecting, and dealing with compliance risk
- the products that enable this such as our speeches, media releases, guides, advice, public and private rulings through to risk reviews, audits, investigations and regulatory system changes
- the expectations regarding corporate governance and its role in managing tax risks
- ways in which the parties can work together to provide certainty to the market
- differentiation and management of tax compliance risks (Chapter 7 of the booklet)
- the conduct of risk reviews, audits and disputes.

The Large Business and Tax Compliance booklet is supplemented on an annual basis with the Compliance Program<sup>68</sup> where it is set out, again in relatively plain language,

<sup>67</sup> The Large Business and Tax Compliance booklet is available at:  
<http://www.ato.gov.au/corporate/content.asp?doc=/content/33802.htm>.

<sup>68</sup> The Compliance Program is available at:  
<http://www.ato.gov.au/corporate/content.asp?doc=/content/00248103.htm&mnu=47063&mfp=001>

what compliance concerns exist for each market segment. For each of the compliance concerns identified, the ATO appoints a risk owner who is responsible for the overall end-to-end management of that risk, ensuring that appropriate strategies exist to deal with the compliance constraints encountered.

The ATO Strategic Statement<sup>69</sup> explains its vision, strategic themes, values and approaches, such as the Compliance Model<sup>70</sup> and the Enterprise Risk Management Framework<sup>71</sup> which form the corporate foundation of work on compliance risk differentiation. This integration is important.

An annual assessment of the efficiency and effectiveness of processes, opportunities and vulnerabilities, and the sustainability of the various systems is carried out. The outcomes from the ATO's compliance activities are reported in its Annual Report<sup>72</sup>, which also includes compliance effectiveness<sup>73</sup> indicators as well as revenue outcomes.

## 10. BRINGING THE COMPLIANCE IMPROVEMENT STRATEGIES TOGETHER – THE REGULATORY RISK BOW-TIE

The ultimate aim is to have taxpayers who are ready, willing and able<sup>74</sup> to participate in their tax and superannuation system:

<u>Aspect</u>	Compliance <u>Constraint</u>	Compliance <u>Strategy</u>
Ready	> Knowledge (I know how to comply)	> Educate and Exemplify
Willing	> Attitude (I want to comply)	> Engage, Encourage, Enforce
Able	> Capability (I can comply)	> Enable and Empower

These broad strategies and the risk differentiation framework can be brought together in a regulatory risk 'bow-tie' <sup>75</sup> that neatly maps the causes, consequences and controls

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The compliance concerns identified in the program are incorporated into the quantitative risk filters. (eg Thin Capitalisation, Transfer Pricing, Capital Gains Tax, Loss Utilisation, etc).

<sup>69</sup> The Strategic Statement is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00243384.htm>.

<sup>70</sup> The Compliance Model is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>.

<sup>71</sup> The Enterprise Risk Management Framework frequently asked questions is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00246438.htm>.

<sup>72</sup> The Annual Report is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00216293.htm>.

<sup>73</sup> The Compliance Effectiveness methodology is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00149070.htm>.

<sup>74</sup> See Box 2 page 12 in "Reducing the Risk to Policy Failure: Challenges for Regulatory Compliance," OECD, 2000 at <http://www.oecd.org/dataoecd/48/54/1910833.pdf>.

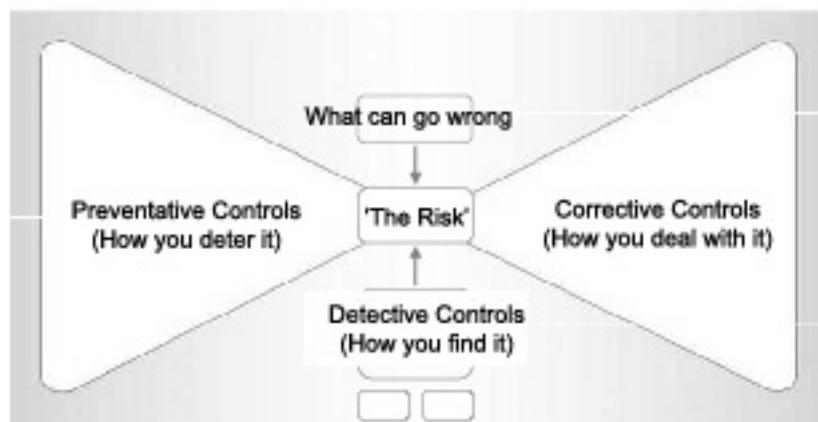
<sup>75</sup> Originally conceived of in the late 1970s by the University of Queensland and then brought to the fore by Royal Dutch Shell after the Piper Alpha disaster. Now a widespread risk management approach, the 'bow-tie', a cause, consequence and control map, usefully shows the 'paths' by which a risk event can

and then ties together these end-to-end strategies to address the compliance constraints encountered.

Using the bow-tie approach it becomes immediately apparent that there is a series of proactive and reactive compliance enhancement strategies that can be utilised to assist in achieving and maintaining higher rates of compliance.

Laid out as a risk ‘bow-tie’ these compliance enhancement strategies fit into standard regulatory deter, detect and deal with approach:

*Deter* (the things you do to prevent or lessen the likelihood of a problem);  
*Detect* (the things you do to detect when a problem may have occurred); and  
*Deal with* (the things you do to deal with /lessen the consequences of a problem.)



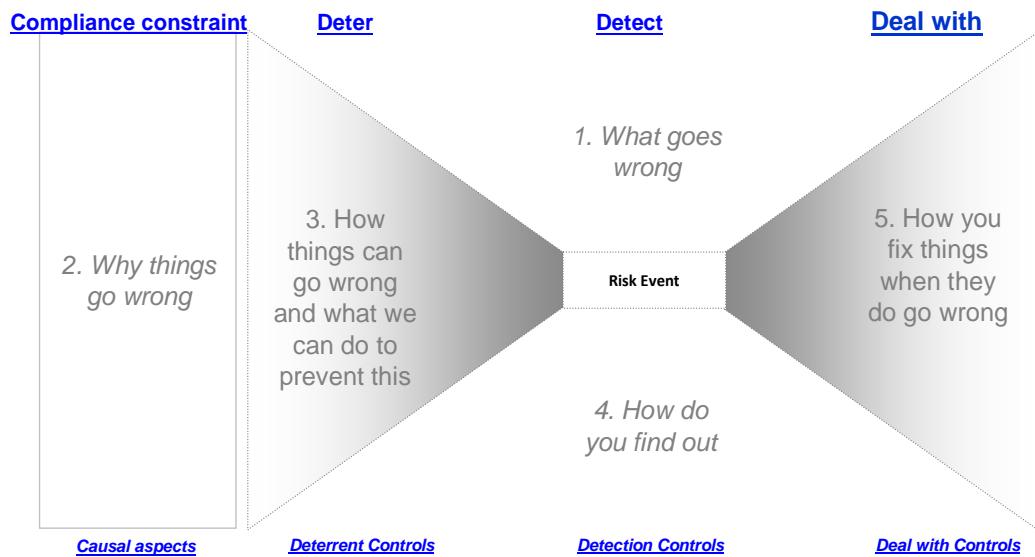
**Figure 21**  
**The Risk bow-tie approach**

Risk bow-ties are an intuitive way of graphically representing:

1. the risk event (what goes wrong – the ‘knot’ of the bowtie),
2. the causal factors associated with a risk (why things go wrong – on the left of the bowtie),
3. the different pathways that lead up to the risk event and the controls you have to prevent or deter the risk event (how things go wrong and what you do to prevent this),
4. the ways you detect the risk event occurring (intelligence), and finally,
5. the different ways you deal with the consequences of the risk event (your choice of remedy to fix things on the right hand side of the bowtie).

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occur, where preventative or deterrent controls are used, the event itself and detective controls and the consequence paths and restorative controls. [http://www.bowtiepro.com/bowtie\\_history.asp](http://www.bowtiepro.com/bowtie_history.asp).



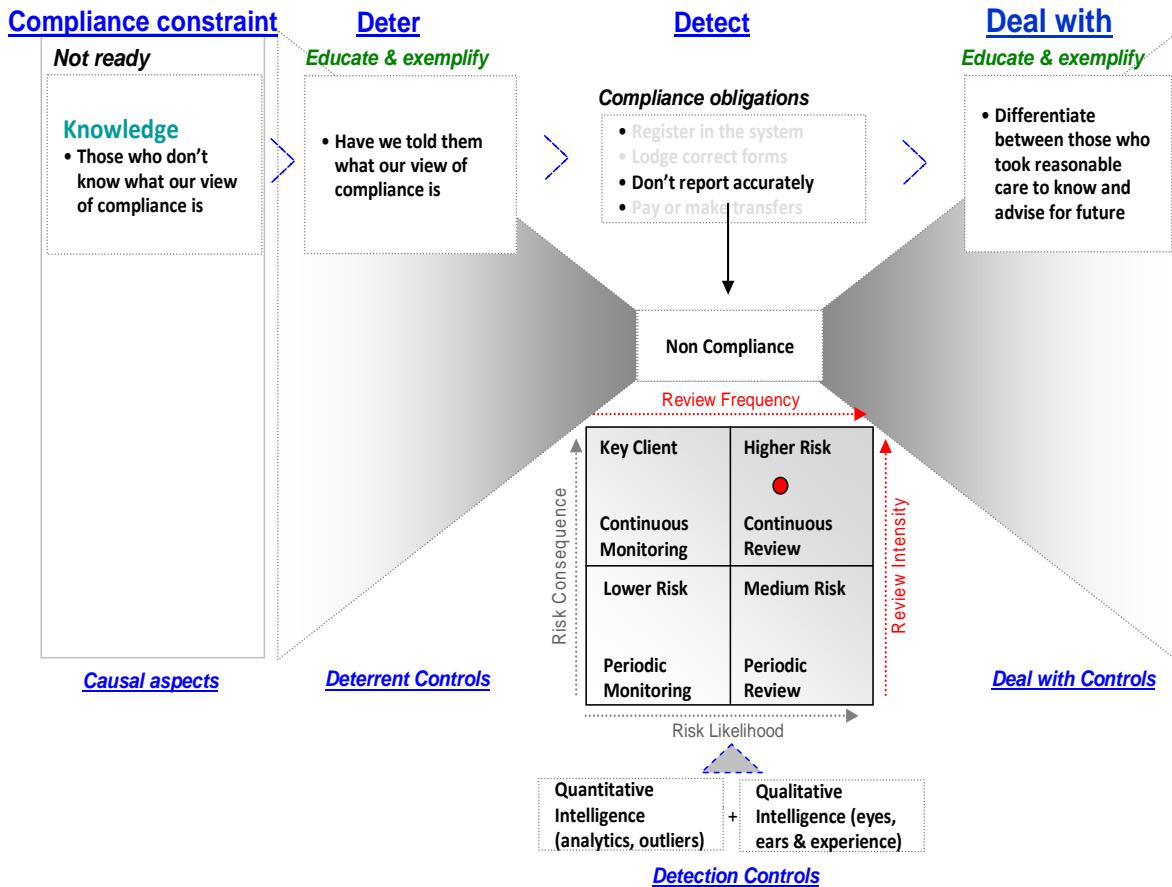
**Figure 22**  
**Risk bow-tie concepts**

Now if we begin to populate a regulatory risk bow-tie with the compliance constraints:

- (why things go wrong – knowing what compliance is, wanting to comply, and, being able to comply), and the
- compliance strategies (eg for the knowledge deficiency compliance constraint, what we do to address that deficiency by use of targeted or marketing campaign education programmes, and by ensuring that we have appropriate and influential exemplars of what ‘good’ compliance is, etc),

we start to flesh out a much more complete and nuanced ‘end to end’ deter, detect and deal with risk management narrative.

Linking the compliance constraints to the relevant deter > detect > deal-with risk management approach we have (read across left to right):



**Figure 23**  
**Risk bow-tie concepts**  
**Showing knowledge constraint and deter and deal with mitigation**

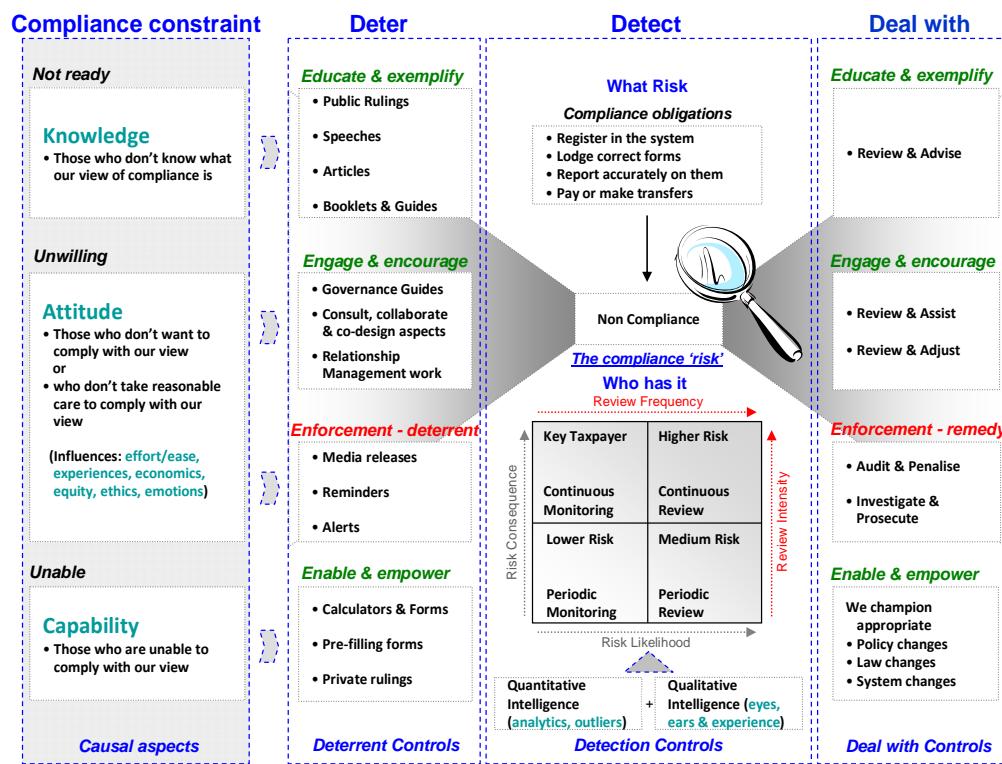
The risk being highlighted in Figure 23 is the one that in the tax system generates the most contention: the obligation to report accurately on the forms.

In this diagram the compliance constraint being illustrated is: "Clients not knowing what the regulator's view of compliance is". (The client may have their own view of what compliance is, but if this differs materially from the regulator's view then it may be considered as contestable by the regulator and ultimately the Court could be asked to decide.)

This risk can be deterred by the regulator providing both general and/or targeted education processes such as guides, speeches, articles, mail-outs, marketing and other media. In prioritising the investment and delivery mode (message and media) of this,

the regulator should consider 'who' needs this knowledge and 'how' important are they in the system. To detect potential non compliance the regulator uses both qualitative and quantitative intelligence to form a view of who is more likely to have not reported accurately and what the potential consequences of this might be. This provides an initial risk based view of the potential non-compliance, allowing for a prioritisation of resources and responses.

To appropriately deal with instances of non compliance associated with the knowledge compliance constraint, it is important for the regulator to then distinguish between those that took reasonable care to know, and those that didn't. The regulator then needs to choose an appropriate remedy for each client's facts and circumstances: eg advise for the future, or correct without penalty, or if warranted impose an administrative penalise, or seek to prosecute. If we put in the other constraints and strategies, the following generic regulatory risk bow-tie emerges:



**Figure 24**  
**Generic Regulatory Compliance Risk Bow-Tie**  
**Author 2010**

This generic framework neatly ties together the compliance constraint with the appropriate deterrent strategies, the detection and engagement approach and the 'deal with' strategies (choice of remedy).

Importantly, it explicitly includes other options from a risk management perspective, such as changing the system itself, that were not part of the compliance model.

Both the risk differentiation framework and the compliance model are explicitly encapsulated in this more holistic risk management approach to regulatory compliance:

- Input from intelligence sources is used to form a view of where taxpayers sit in the risk differentiation framework – which guides engagement and detection efforts – so the risk categorisation of a taxpayer is a key output of the ‘discovery and detection’ effort.
- The compliance model is embedded as the choice of remedy taken in response to the reasons for non compliance and how these are escalated, where necessary over time, on the ‘deal with’ side.

The use of the differentiation framework and risk bow-tie processes maintains the ATO’s position at or near the leading edge of compliance risk management internationally<sup>76</sup>, most significantly through the peak tax administration body, the OECD Forum of Tax Administration<sup>77</sup> and it is changing the nature of the compliance dynamic with large taxpayers.<sup>78</sup>

That said the ATO is very conscious of the challenges associated with the use of risk frameworks. The five design reflections regarding risk frameworks discussed in Dr Julia Black’s 2004 paper “The Development of Risk Based Regulation in Financial Services: Canada, the UK and Australia”<sup>79</sup> have been considered. The five reflections by Dr Black were:

- the danger of focusing more on diagnosis than cure;
- the importance of organizational culture in implementing risk based regulation;
- risk based frameworks can create risks; (eg ‘process induced myopia’)
- the danger of inappropriate reliance on firms’ internal controls is reduced, but not removed in risk based approaches;
- in making it clear what issues are not regulatory priorities, risk based regulation can have a potentially contentious political message.

She goes on to note:

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<sup>76</sup> See for example the discussion in Ernst & Young 2011-12 *Tax risk and controversy survey*, pp 30, 36 & 53 at [http://www.ey.com/Publication/vwLUAssets/2011-2012\\_Tax\\_risk\\_and\\_controversy\\_survey/\\$FILE/2011-2012\\_Tax\\_risk\\_and\\_controversy\\_survey.pdf](http://www.ey.com/Publication/vwLUAssets/2011-2012_Tax_risk_and_controversy_survey/$FILE/2011-2012_Tax_risk_and_controversy_survey.pdf).

<sup>77</sup> The OECD FTA guidance and information publications are listed on the report available at: <http://www.oecd.org/dataoecd/28/12/39965074.pdf> & [http://www.oecd.org/findDocument/0,3354,en\\_2649\\_33749\\_1\\_119666\\_1\\_1\\_1,00.html](http://www.oecd.org/findDocument/0,3354,en_2649_33749_1_119666_1_1_1,00.html).

<sup>78</sup> ‘Risk differentiation hardly sounds exciting but it’s one of the hottest issues in tax space.’ KPMG Tax Partner David Drummond indicated it was ‘probably the biggest development in tax administration [risk management] in the past 30 years’ in Nassim Khadem, ‘Who’s who on the ATO hit list’, *BRW*, 31 August 2011.

[http://afr.com/p/sections/professions/who\\_who\\_on\\_the\\_ato\\_hit\\_list\\_R6JrLtISntHQI47y4kVimL](http://afr.com/p/sections/professions/who_who_on_the_ato_hit_list_R6JrLtISntHQI47y4kVimL).

<sup>79</sup> Back, Dr J 2004, *The Development of Risk Based Regulation in Financial Services* is well worth a read and is available at <http://www.lse.ac.uk/collections/law/staff%20publications%20full%20text/black/risk%20based%20regulation%20in%20financial%20services.pdf>

“Any risk based framework is only as good as those who implement it, and risk based frameworks may not be implemented in such a way as to deliver on their promise of producing dynamic, risk sensitive regulation.

Whilst senior management in each regulatory agency are clearly committed to the principles of risk based regulation, in any organisation, bridging the gap between senior management and those at the front line is a core challenge, and regulators are no exception. Re-skilling is always hard to achieve. It is particularly hard in the case of risk based approaches because, as senior officials in each regulatory agency recognised, the frameworks are requiring officials to operate ‘outside their comfort zones’.

Ensuring that front line officials move from a compliance or comparatively passive supervisory mentality to the more reflective and dynamic approach that risk based regulation is meant to introduce will take time, and some organisations and some parts of an organisation will move faster than others.”

It is a difficult cultural change to progress and refine over time and there is a danger of an undue initial focus on the risk process activities and outputs rather than on the broader systemic, longer term outcomes. In particular those few categorised as higher risk are likely to strongly disagree with the regulators viewpoint and complain about the approach to the regulator, the media and ministers.

There is no getting around the fact that using any risk management approach to verify compliance requires the regulator to have a process to form a reasonably robust view of a client’s risk of non compliance and how that risk sits relative to other clients – their priority for action. This risk prioritisation process is quite fundamental to risk management and will exist for any regulatory risk assessment system. (For example the Australian Prudential Regulatory Authority’s “Probability and Impact Rating System” and “Supervisory Oversight and Response System”<sup>80</sup> shows a very similar coupling of risk and regulatory response.)

## 11. DEVELOPMENTS IN THE UK REGARDING REGULATORY APPROACHES

Looking further a field, an analysis of other countries regulatory best practices indicates that in some ways the UK has moved past Australia in modernising its approach to risk based regulatory guidance, enforcement and sanctioning.

For example, the UK Hampton Review “Reducing administrative burdens – effective inspection and enforcement”<sup>81</sup> which culminated in the UK Statutory Code of Practice for Regulators<sup>82</sup>, set the scene for a more holistic and whole of government approach

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<sup>80</sup> APRA’s PAIRS and SOARS documents are available at [http://www.apra.gov.au/PAIRS/upload/PAIRS\\_Final\\_May\\_2008\\_External\\_Version.pdf](http://www.apra.gov.au/PAIRS/upload/PAIRS_Final_May_2008_External_Version.pdf) & [http://www.apra.gov.au/PAIRS/upload/SOARS\\_Final\\_May\\_2008\\_External\\_Version.pdf](http://www.apra.gov.au/PAIRS/upload/SOARS_Final_May_2008_External_Version.pdf).

<sup>81</sup> Hampton, P 2005, *Reducing administrative burdens – effective inspection and enforcement (The Hampton Report)*, HM Treasury is available at: <http://www.berr.gov.uk/files/file22988.pdf>.

<sup>82</sup> The UK Statutory Code of Practice for Regulators is available at: <http://www.berr.gov.uk/files/file45019.pdf>.

to regulatory work that, crucially, included explicit consideration of the likelihood and consequence of non compliance:

“4.1 Regulators should ensure that the allocation of their regulatory efforts and resources is targeted where they would be most effective by assessing the risks to their regulatory outcomes. They should also ensure that risk assessment precedes and informs all aspects of their approaches to regulatory activity, including:

- data collection and other information requirements;
- inspection programmes;
- advice and support programmes; and
- enforcement and sanctions.

4.2 Risk assessment should be based on all available relevant and good-quality data. It should include explicit consideration of the combined effect of:

- the *potential impact* of non-compliance on regulatory outcomes; and
- the *likelihood* of non-compliance.

4.3 In evaluating the likelihood of non-compliance, regulators should give consideration to all relevant factors, including:

- past compliance records and potential future risks;
- the existence of good systems for managing risks, in particular within regulated entities or sites;
- evidence of recognised external accreditation; and
- management competence and willingness to comply.

4.4 Regulators should consult and involve regulated entities and other interested parties in designing their risk methodologies, and publish details of the methodologies.

4.5 Regulators should regularly review and, where appropriate, improve their risk methodologies. In doing so, they should take into account feedback and other information from regulated entities and other interested parties.” (Emphasis added)

The subsequent UK Macrory Review “Regulatory Justice – making sanctions effective”<sup>83</sup> led to the UK Regulatory Enforcement and Sanctions Act<sup>84</sup> that basically codifies the Ayres and Braithwaite compliance model<sup>85</sup> for UK regulators, thus modernising the regulatory choice of remedies available.

On the guidance side, the UK Anderson Review produced the “The Good Guidance Guide”<sup>86</sup> leading to a code of practice for guidance on regulation.

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<sup>83</sup> The Macrory Review 2006, *Regulatory Justice – making sanctions effective* is available at: <http://www.bis.gov.uk/files/file44593.pdf>.

<sup>84</sup> The UK Regulatory Enforcement and Sanctions Act 2008 is available at: [http://www.legislation.gov.uk/ukpga/2008/13/pdfs/ukpga\\_20080013\\_en.pdf](http://www.legislation.gov.uk/ukpga/2008/13/pdfs/ukpga_20080013_en.pdf).

<sup>85</sup> The Ayres and Braithwaite compliance model was first articulated in their 1992 publication *Responsive Regulation: Transcending the deregulation debate* and an outline is available at: [http://en.wikipedia.org/wiki/File:Ayres\\_Braithwaite\\_Compliance\\_Pyramid.jpg](http://en.wikipedia.org/wiki/File:Ayres_Braithwaite_Compliance_Pyramid.jpg).

<sup>86</sup> The Anderson Review 2009, *Good Guidance Guide: taking the uncertainty out of regulation*, UK, is available at: <http://www.bis.gov.uk/files/file49881.pdf>.

These UK reports effectively took forward the earlier good work contained in the Australian Law Reform Commission's 2003 report "Principled Regulation: Federal Civil and Administrative Penalties in Australia".<sup>87</sup>

In my view there are real and significant opportunities for Australia to learn from the UK experience in setting up a consistent code of conduct for regulators as well as bringing non criminal regulatory compliance sanctions within a single coherent framework.

Rather than being faced with a large and bewildering array of differing regulatory sanctions and approaches, a consistent code like the UK Regulatory Enforcement and Sanctions Act could be created for use across regulatory agencies whose choice of remedy reflected the best practices of the Braithwaite compliance model.

This would both modernise the choice of remedies available to regulators and simplify the array of different administrative sanctions into a single coherent set. At present the use of responsive regulation in Australia appears somewhat 'grafted on' by the regulator rather than being explicitly built into the law.

Interestingly, and appropriately, to access the UK Regulatory Enforcement and Sanctions Act the regulator needs to show that they are following the UK Statutory Code of Practice for Regulators. Independent reviews, whose outcomes are published, are held to check that this is the case.

## 12. CONCLUSION

Sun Tzu, the Chinese military philosopher, has been attributed<sup>88</sup> as saying: "Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat."

Strategies are very much the game plans for how an organisation proposes to achieve its intent, taking into account the opportunities and threats that are in the environment, and the organisation's particular strengths and weaknesses.

Strategy in many ways is both the science and art of resource allocation between contending claims on scarce resources in order to achieve the best results at the least cost – the matching of ambition and capability.

For a regulator, a risk differentiation framework provides logic for the allocation of resources to specific client risk initiatives on a clearly differentiated basis.

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<sup>87</sup> The Australian Law Reform Commission Report 2003 *Principled Regulation: Federal Civil and Administrative Penalties in Australia* (ALRC 95) is available at:

<http://www.austlii.edu.au/au/other/alrc/publications/reports/95/>.

<sup>88</sup> The saying is in fact not in his famous work of military strategy and tactics "The Art of War".

Those administering regulatory compliance systems need to have a clear strategy that sets out how they intend to encourage voluntary compliance - with a key risk to that intent being that clients don't voluntarily comply for a variety of reasons.

The Ayres and Braithwaite regulatory pyramid sets out a model for a choice of compliance remedy for administrators - and it is by differentiating our regulatory strategies by likelihood and consequences of non-compliance that we can more appropriately position ourselves to bring that model to life.

Bringing this more holistic view of compliance and risk mitigation together effectively adds another dimension to regulatory compliance approaches and enables a richer and more nuanced discussion to take place regarding compliance strategies and their targeting and timing.

The approach that has been outlined in this article provides a way of looking at the risk end to end, answering:

- the strategic question of *what* risks are important (credible threat agents intersecting with critical system vulnerabilities),
- the operational question of *who* may have or exhibit those risks, and
- the tactical question one of *how* to best deter, detect and deal with the instance:



**Figure 25 Bringing it together – End to end risk management**

It provides a way of looking at managing a risk from *discovery* of a '*matter of interest*' through to ongoing activities to systemically deter, detect and deal with '*matters of concern*' - an approach for appropriately considering and dealing with both emerging

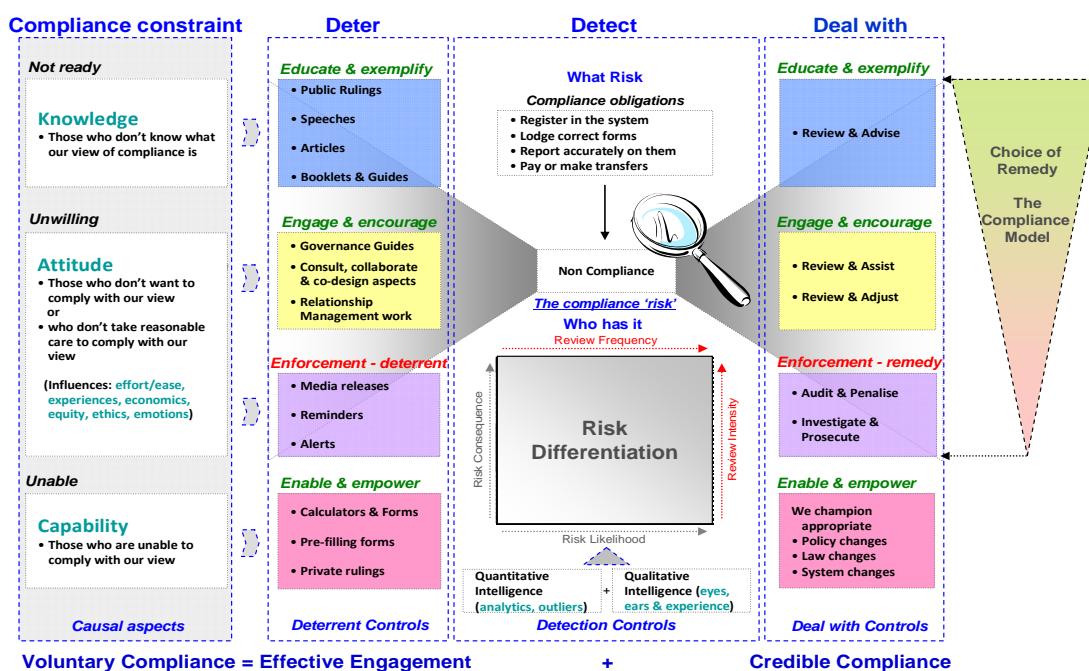
risks (such as a new tax effective financial arrangement) and those more endemic (such as transfer pricing) in the system.

In 2000 Professor Malcolm Sparrow in his book “The Regulatory Craft”<sup>89</sup> aptly noted the regulators ongoing dilemma:

“Regulators, under unprecedeted pressure, face a range of demands, often contradictory in nature:

- be less intrusive - but be more effective;
- be kinder and gentler - but don't let the bastards get away with anything;
- focus your efforts - but be consistent; process things quicker - and be more careful next time;
- deal with important issues - but do not stray outside your statutory authority;
- be more responsive to the regulated community - but do not get captured by industry.”

The implementation of risk bow-tie approaches, with a risk differentiation framework for engagement and detection, is part of an improved overall risk management strategy for regulators to deal with these apparently conflicting demands in a practical, logical and considered way. A way that links the strategic to the operational and tactical - and moves the ‘choice of remedy’ Braithwaite compliance model into ‘place’ in a more holistic end to end regulatory risk management framework.

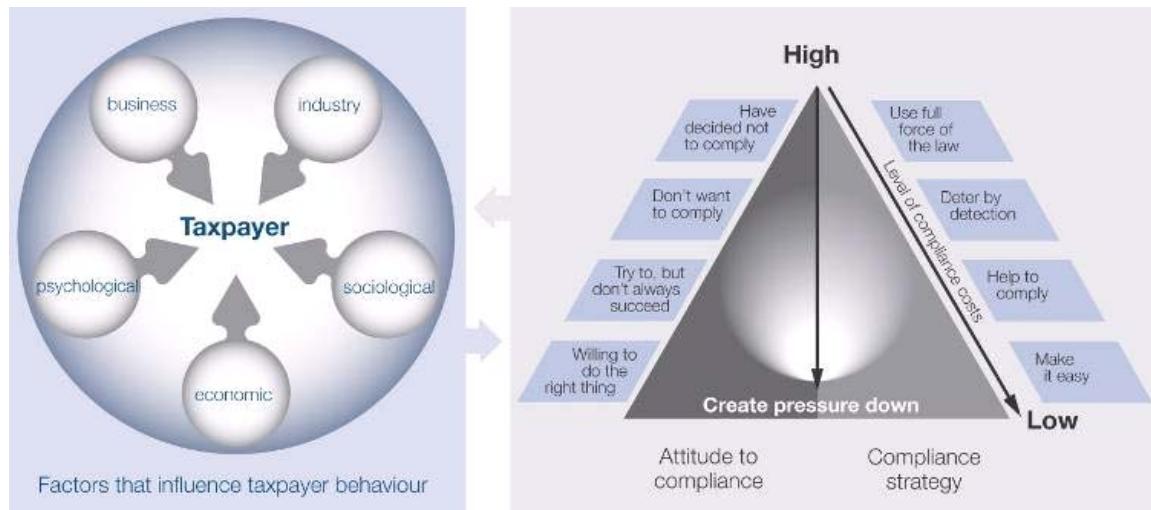


**Figure 26** The compliance model position as part of the ‘deal with’ choice of remedy in a generic regulatory risk bow-tie

<sup>89</sup> Sparrow, M, 2000, *The Regulatory Craft*, The Brookings Institution, Washington, DC.

## ANNEX 1: VARIATIONS ON THE COMPLIANCE PYRAMID THEME

The concept of the compliance pyramid has been taken up by others and, though remaining broadly consistent to the Ayres and Braithwaite model, there are some subtle variations:



**Figure 27 A more recent representation of the compliance pyramid at the Australian Taxation Office**

<http://atogovau/corporate/content.asp?doc=/content/5704.htm>

Australian Taxation Office, Australia



**Figure 28 The 2004 UK's Inland Revenue version**

[http://www.hm-treasury.gov.uk/media/2/0/odonnell\\_ch2\\_497.pdf](http://www.hm-treasury.gov.uk/media/2/0/odonnell_ch2_497.pdf)

Chapter 2, page 31, in *Financing Britain's Future, Review of the Revenue Departments by Gus O'Donnell, March 2004, HM Treasury, United Kingdom*

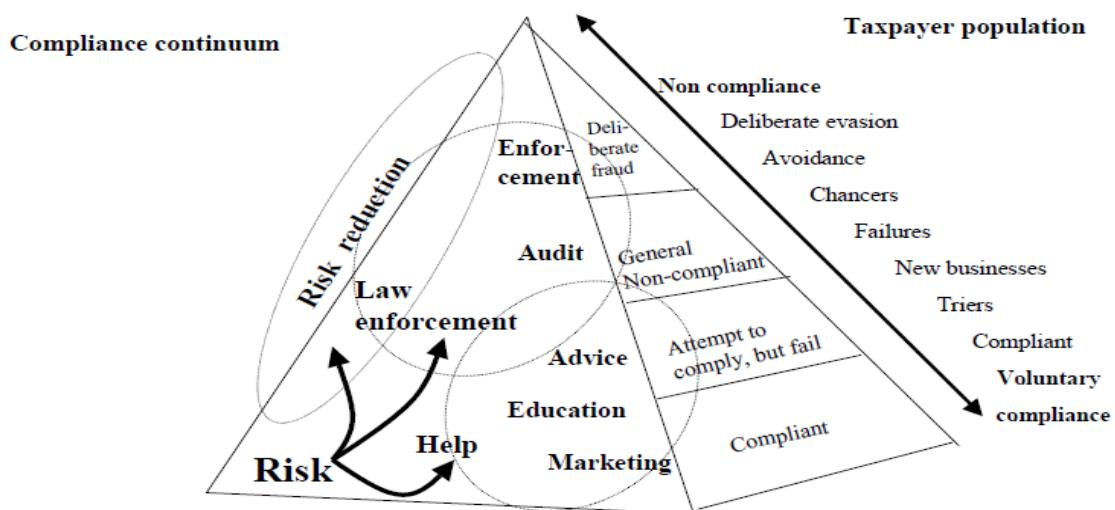


Figure 29

The 2006 European Union Fiscalis Risk Analysis Project

[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/tax\\_cooperation/gen\\_overview/Risk\\_Management\\_Guide\\_for\\_tax\\_administrations\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/gen_overview/Risk_Management_Guide_for_tax_administrations_en.pdf)

Risk Management Guide for Tax Administrations, Fiscalis Risk Analysis Project Group, FINANCIAL CODE: FPG/11, Version 1.02, February 2006, Page 33

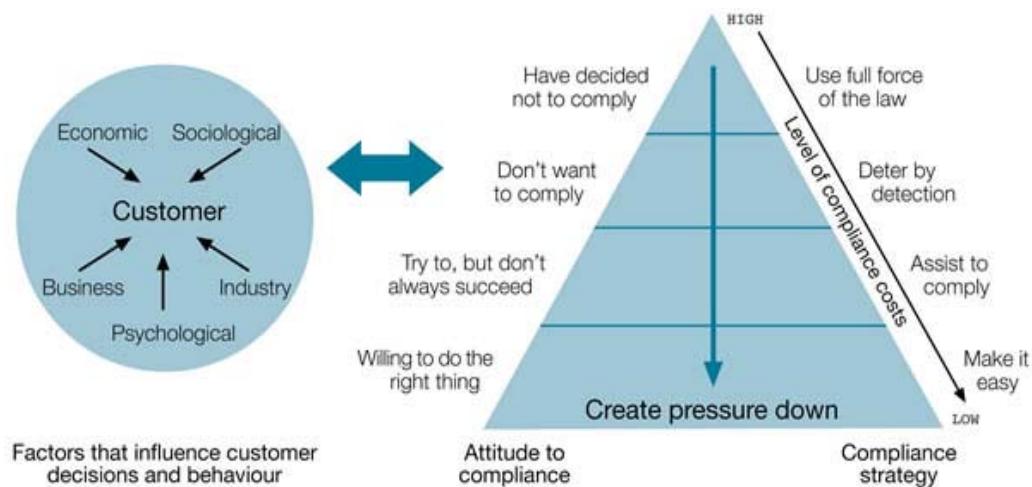


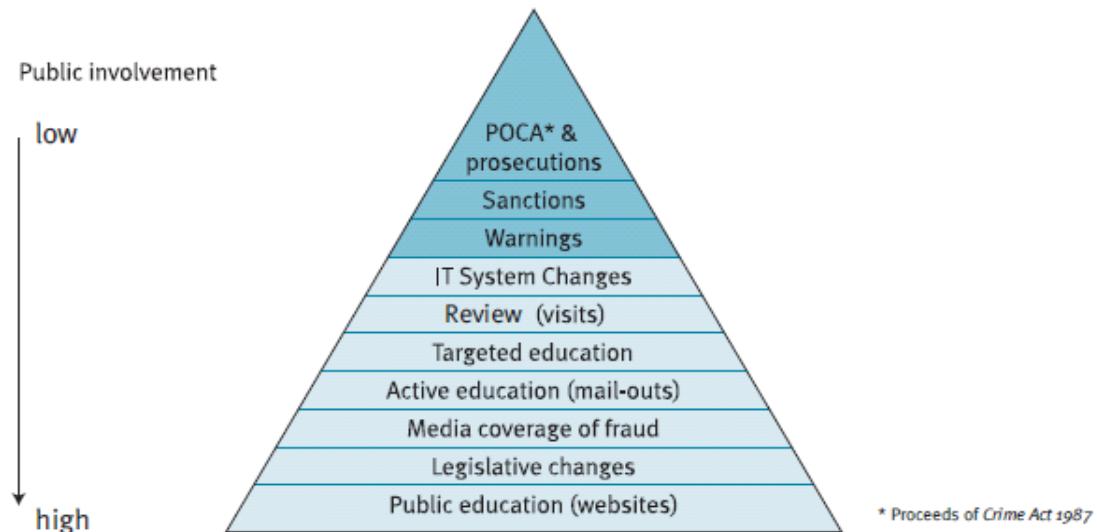
Figure 30

The New Zealand Inland Revenue Compliance Pyramid

<http://www.ird.govt.nz/aboutir/reports/annual-report/annual-report-2004/part3/annual-report-2004-part03-02.html>

New Zealand Inland Revenue, 2004

An example of a balanced and targeted child care payment compliance program.



**Figure 31**

**The 2007 Australian Child Support Compliance Pyramid**

[http://www.facsia.gov.au/internet/facsinternet.nsf/vIA/cc\\_benefit\\_compliance/\\$File/CC\\_Comp\\_v4.pdf](http://www.facsia.gov.au/internet/facsinternet.nsf/vIA/cc_benefit_compliance/$File/CC_Comp_v4.pdf) Child Care Payment Compliance Framework, Department of Families, Community Services and Indigenous Affairs (FaCSIA), Australia, 2007

and



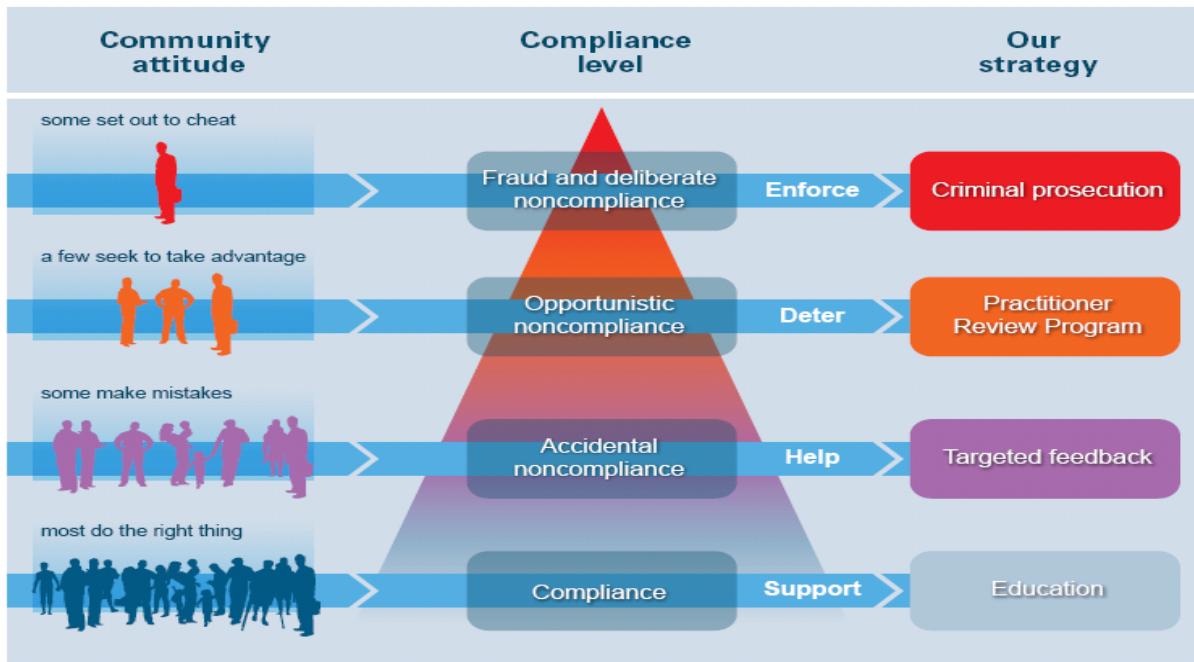
CSA: SUPPORTING PARENTS TO MEET THEIR CHILD SUPPORT RESPONSIBILITIES | 2008-2010

21

**Figure 32**

Child Support Agency "Supporting parents to meet their child support responsibilities 2008-2010" <http://www.csa.gov.au/publications/pdf/4073.pdf>

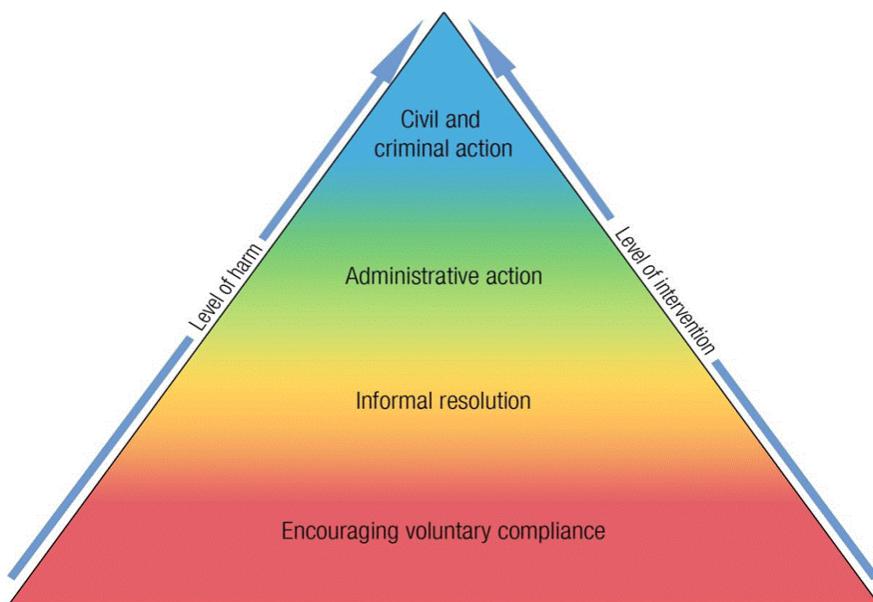
### Our compliance model



**Figure 33**

Australian Medicare Compliance

[http://www.medicareaustralia.gov.au/resources/national\\_compliance/national\\_compliance\\_program\\_2007-08.pdf](http://www.medicareaustralia.gov.au/resources/national_compliance/national_compliance_program_2007-08.pdf) National Compliance Program, 2007–08, Medicare Australia



**Figure 34**

Australian Communications and Media Authority

[http://www.acma.gov.au/WEB/STANDARD/pc=PC\\_312247](http://www.acma.gov.au/WEB/STANDARD/pc=PC_312247)

ACMA compliance and enforcement policy, August 2010, Page 3