META RISK MANAGEMENT AND TAX SYSTEM INTEGRITY

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THE CENTRE FOR TAX SYSTEM INTEGRITY
WORKING PAPERS

The Centre for Tax System Integrity (CTSI) is a specialized research unit set up as a partnership between the Australian National University (ANU) and the Australian Taxation Office (Tax Office) to extend our understanding of how and why cooperation and contestation occur within the tax system.

This series of working papers is designed to bring the research of the Centre for Tax System Integrity to as wide an audience as possible and to promote discussion among researchers, academics and practitioners both nationally and internationally on taxation compliance.

The working papers are selected with three criteria in mind: (1) to share knowledge, experience and preliminary findings from research projects; (2) to provide an outlet for policy focused research and discussion papers; and (3) to give ready access to previews of papers destined for publication in academic journals, edited collections, or research monographs.

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Tina Murphy

Meta risk management and tax system integrity

John Braithwaite and Rob Williams

The risk paradigm in compliance administration

Meta risk management means the risk management of risk management. The Australian Taxation Office (Tax Office) has an international reputation as an organisation that is sophisticated in risk management. The aim of this working paper is to understand how it is developing a capability in meta risk management and how it can extend that capability.

Drawing together a number of longstanding themes in the regulation literature with more recent writing on neo-liberal governmentality, Peter Grabosky (1995) developed the theme of meta regulation, which he called 'meta-monitoring' - government monitoring of self-monitoring. He elaborated further on these ideas with Neil Gunningham (1998) in *Smart Regulation: Designing Environmental Policy*. The most sustained development of this approach is in Christine Parker's forthcoming book *The Open Corporation: Self-Regulation and Corporate Citizenship*. The penultimate chapter of that book is entitled 'Meta-Regulation: The Regulation of Self-Regulation'. Parker jointly explores notions of meta-regulation and meta-evaluation - evaluation of corporations' self-evaluations of their compliance systems. In this working paper, we seek to give these ideas more of a risk-management orientation and one specifically attuned to tax administration.

According to Ulrich Beck's (1992) influential book *Risk Society: Towards a New Modernity*, societies have become more reflexive about risk. The Tax Office's Risk Management System can be seen as an example of tax administration reflexively remaking tax administration in a risk paradigm. To date, however, the Tax Office Risk Management System has been a rather conventional case of a regulatory organisation getting more analytic about the risks the organisation must confront. A further step toward a reflexive risk paradigm is for the Tax Office to monitor and seek to remake the risk management systems of the organisations it regulates. This is a move from the Tax Office developing its own Risk Management System to influencing the risk management systems of other important organisations in its risk environment.

The developing practice of meta risk management

One of the earliest shifts of this kind was with nuclear safety regulation after the Three Mile Island near-meltdown in 1979 (Rees 1994). One cause of the accident was that nuclear power plant operators had become rule-following automatons rather than strategic thinkers about risk management systems. When something went wrong that was not covered by a rule, operators lacked the systemic wisdom and the risk analysis intelligence to think systemically about what needed to be done. So the nuclear regulation paradigm changed to being less about government inspectors checking compliance with rules. An important part of the new paradigm became regulatory scrutiny of risk management systems and reintegrative shaming within the nuclear professional community of companies that failed to improve those systems. Within a decade SCRAMS (safety-related automatic shut-downs of nuclear plants) fell from seven per-unit-per-year to average less than one per year in the US, and then in the next decade fell to 0.1 per year (Braithwaite and Drahos, 2000: 302).

Another important shift of this type occurred following the Piper Alpha disaster when 165 lost their lives in 1988 on a North Sea offshore oil rig. Following the recommendations of Lord Cullen's Royal Commission on the disaster, regulation of offshore oil and gas production worldwide became based on the rig operator developing a ‘safety case’ or safety management system that it submitted to the regulator for analysis and approval (Cullen, 1990). Instead of government inspectors directly enforcing rules, they moved to checking that the operator was both self-enforcing its safety management system and continuously improving it. Ulrich Beck (1992: 232) discusses this kind of feature of risk society as ‘externally monitored self-coordination’.

The most recent debate about this regulatory paradigm shift occurred after the Asian financial meltdown of 1997-98. The twentieth century approach to assuring that banks did not collapse was to insist that banks had a certain ratio of loans to gold in their vaults - enough capital to withstand a run on the bank and non-repayment of loans. Over time the required capital ratios became more complex. Bonds of an Organisation for Economic Cooperation and Development (OECD) government counted for more than bonds in a private company. But in a crisis these capital adequacy ratios did not always make sense. For example, in the midst of the Asian meltdown, were General Electric or Microsoft bonds really less secure than bonds with the South Korean government (an OECD member)?

Many experts began to believe it would be better to require banks to disclose to national and international regulators their risk management systems and their risk assessments of their portfolio of reserves according to those systems. Moreover, they should test these systems by seeking proof that they could cope with major shocks. For example, the regulator might ask: 'Run your risk-management software and show me what will happen if there is a forty per cent fall in the value of the yen at midnight tonight'. While the complexity and volatility of financial risk in a world of derivatives and rapidly fluctuating currency markets would seem to make this regulatory paradigm shift vital, in practice regulators are finding it difficult to design a reflexive system for evaluating the assessment of financial risk that will work with both sophisticated global banks and banks with lesser risk analysis capabilities. Nevertheless, there seems little doubt that this is the direction prudential regulation will move (Mayes, 2001).

We think it is the case that globalisation and the new financial engineering of purpose-built financial products renders risk to tax authorities more complex and volatile (Tanzi, 2001). Yet we think it is also true that new information technologies make possible more sophisticated monitoring of such risks than have been possible in the past. It follows that a shift is needed in tax compliance strategy to risk analysis of the risk management systems of taxpayers and tax agents.

Our objective in this working paper is to help understand how the Tax Office can move from an organisation with a comparatively sophisticated approach to shaping its own risk management system, to an organisation which is also sophisticated in shaping the risk management systems of other organisations in the taxpaying environment. The first step toward achieving this objective is to discover where a shift to Meta Risk Management is already occurring in the Tax Office. By publicising such shifts and interpreting them as Meta Risk Management, we can help others to grasp the possibilities of the paradigm shift. We will do this by describing two innovative Tax Office projects as examples of Meta Risk Management – the Registered Software Project and the Transfer Pricing Record Review and Improvement Project.

The Registered Software Project

Business tax returns and many individual returns are based on computations undertaken by accounting software. This has become much more widely the case in Australia with the introduction of the goods and services tax (GST) and the Business Activity Statement (BAS). Such software can be designed to minimise error, make anomalies visible and assure the correct computation of tax liability. The idea of the Registered Software Project is to develop specifications that software would have to meet to be registered by the Tax Office as approved for calculating tax obligations such as GST and capital gains tax. Not only is it hoped that this will directly improve compliance and reduce the cost of compliance, it is also hoped it will reduce the cost of auditing compliance. When a software product is registered, Tax Office auditors will only have to check inputs and outcomes from the program (assuming that the computer has got all other stages right between input and outcome, and assuming all transactions were input in the first instance).

The Tax Office has put these specifications onto a website (http://202.174.232.41/home.asp), together with a number of test scenarios that provide detailed financial data on real world tax situations. To get registration, the software manufacturer must run the required test scenarios through their software. If they come up with the same answers as the Tax Office and meet all the specifications, they certify themselves as meeting the registration requirements. They then post their self-certification to a Tax Office website. After a twenty four hour delay that allows the Tax Office to check or question the self-certification, the software product is registered as Tax Office approved for this or that kind of tax, or for several on a matrix of approved taxes.

While the Tax Office will occasionally check that false self-registrations are not being made, it is hoped that the scheme will be largely self-enforcing. That is, competitors will dob in software manufacturers who claim that their product meets the specifications and gets the right answers on the test scenarios when in fact it does not. Effective sanctions are available to the Tax Office for non-compliance with the self-registration arrangements. Replacing an ‘approved’ entry on the website with ‘under review’ would cost software manufacturers business. Emblazoning ‘approval suspended’ or ‘approval revoked’ across a posting to the website could do serious damage to the confidence of accounting firms in not only that product, but in the manufacturer.

The Registered Software Project satisfies the four key components of the Australian Taxation Office Compliance Model (ATO Compliance Model).

1. *Understanding Taxpayer Behaviour*. The strategy is based on the understanding that most small business and all large business taxpayers use software to calculate their various tax liabilities, that over ninety per cent of businesses choose that software on the advice of their accountants or tax agents, and that accountants and tax agents desire some quality assurance for software products.

2. *Building Community Partnerships*. The strategy was developed collaboratively with the Australian Information Industry Association and has been received positively by tax advisers. Future brainstorming meetings with software experts are planned to see if they can come up with ideas for designing specifications so that financial manipulations to avoid tax liabilities become more visible, so that what once might have been concealed becomes transparent, and so that transactions are channelled into playing the accounting game with a straight bat.

3. *Increasing Flexibility in Tax Office Operations to Encourage and Support Compliance*. This Meta Risk Management approach is more flexible than Tax Office production of approved software. Self-registration with periodic checks is more flexible than the British approach of government accreditation of software products.

4. *More and Escalating Regulatory Options to Enforce Compliance*. No software manufacturer is forced to participate in the registration scheme, so at the base of the regulatory pyramid is a free market of highly informed accountants and advisers who know how to check the registration web site and are likely to desert unregistered products. Then there is escalation to an ‘under review’, ‘approval suspended’ and ‘approval revoked’ entry on the website. Then there is the fear of private tort litigation against software manufacturers who misrepresent the facts about their registration. This risk is signalled by a Tax Office disclaimer on the web site that the manufacturer who posts the registration to the website is responsible for the veracity of the claims made about the software. At the peak of the enforcement pyramid is prosecution under the criminal law of fraud.

The Transfer Pricing Record Review and Improvement Project

About half of world trade is between subsidiaries of the same multinational enterprise group. This increases opportunities for shifting profits from one part of the group to another. Transfer pricing arises, for example, when a subsidiary of a multinational company in country A sells something to another in country B. If country A has high taxes and B low taxes, then it is rational to sell at a low price from the A to the B subsidiary. This means that less profit will be recorded in country A (which has high taxes) and more profit will be made in country B (which will tax it less). The global profitability of the multinational company will thereby be increased at the expense of country A.

Australia, like most nations, seeks to combat this profit shifting with transfer pricing rules to enforce an arm's length principle. The arm's length principle uses the behaviour of independent parties as a guide or benchmark to determine the allocation of income and expenses in international dealings between associated enterprises.

In 1997 and 1998 new Tax Office Transfer Pricing Rulings were introduced, TR 97/20 and TR 98/11. These rulings tell taxpayers what they must do to set arms length prices, and what methodologies and documentation they must have in place to assure the Tax Office that they are not shifting profits out of Australia. TR 98/11 also explains how the Tax Office will assess whether profits recorded by the Australian enterprise are 'commercially realistic' or 'less than commercially realistic'. A matrix (Figure 1) defines the risk of audit in terms of the intersection between the assessment of the quality of transfer pricing processes and documentation and the commercial realism of the taxpayer's outcomes. TR 97/20 details a number of acceptable methodologies for setting or reviewing the international dealings with associated enterprises. This ruling endorses all of the OECD methodologies, which are comparable uncontrolled price method, resale price method, cost plus method, profit split method and transactional net margin method are defined. Tax Office analysts rate from 1 to 5 on a number of criteria the quality of a taxpayer's processes and documentation.

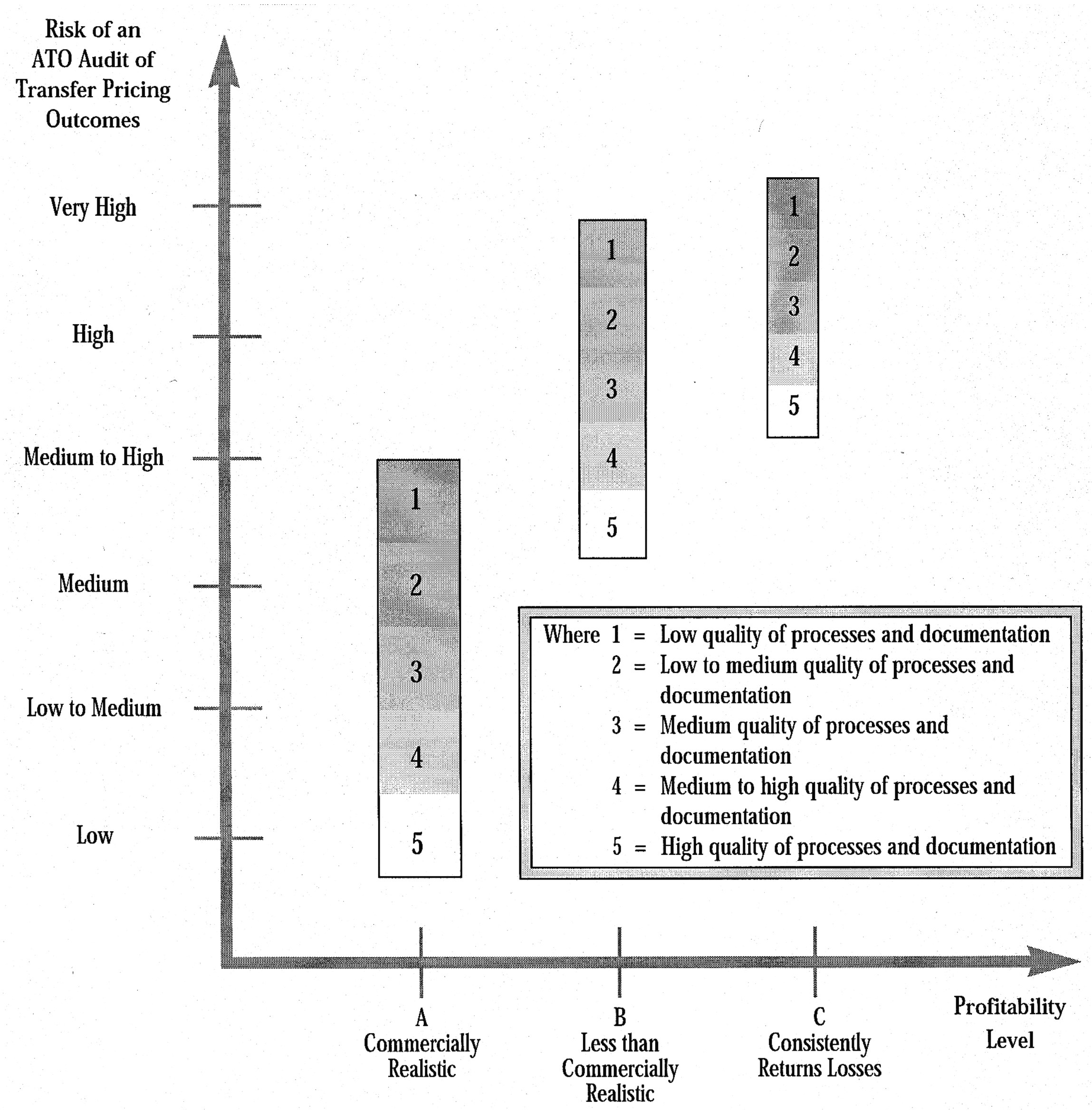

Figure 1: The risk of an ATO audit for transfer pricing as defined in TR 98/11

This new approach to profit shifting is a case of meta risk management because the Tax Office risk manages the risk management methodologies taxpayers use to ensure that they do not engage in profit shifting. We will see that the Transfer Pricing Record Review and Improvement Project is the most striking element of this new meta risk management. The interesting thing about TR 98/11 is that it is unusually transparent about just how the Tax Office will assess the taxpayer's risk management. This feature reinforces the reflexive quality of meta risk management. The Tax Office shows business that if corporations manage their risks of breaching the arm's length principle in ways the Tax Office specifies or through some other persuasive methodology of their own, then they will be left alone. We will risk manage you benignly if you manage your risk in the image of our standards of risk management. Conversely, the Tax Office leaves itself open to absorbing new risk management approaches from business into its risk management paradigms. Tax Office risk management constitutes corporate risk management and corporate risk management constitutes Tax Office risk management. It is a clear case of the risk management of risk management.

In one respect TR98/11 involves meta-meta risk management. Steps 1-3 as outlined in Chapter 5 of TR98/11 involve the implementation of a process for setting or reviewing their international dealings with associated enterprises in accordance with the arm's length principle. Step 4 involves the risk management of this risk management insofar as it strongly recommends that the company install a review process to ensure that adjustments are made when the environment changes. Then the Tax Office comes in with its risk management of the company's internal risk management of its transfer pricing risk management.

Soon after the release of TR 98/11, the Tax Office distributed three booklets on the new approach, sent letters to relevant companies, and conducted a number of public and private seminars for the clients of major accounting firms. There were also consultation meetings with the transfer pricing partners of the Big 5 accounting firms. At these seminars and meetings, the Transfer Pricing Record Review and Improvement Project was foreshadowed.

One hundred and ninety companies, mostly with total income between $50 million and $500 million and at least $30 million in international related party transactions, were selected for the Transfer Pricing Record Review and Improvement Project. A new audit product was developed for trial– the Transfer Pricing Record Review –to roll out the risk management approach revealed in TR 98/11. Program staff visited the selected companies to conduct the review. At the end of the review, each of the companies received a letter advising them of whether their transfer pricing processes and documentation were assessed as of high, medium or low quality, and whether their profits were commercially realistic or less than commercially realistic.

Depending on the risks assessed by the Tax Office, a hierarchy of risk management responses was deployed as detailed in Figure 2. At the base of this enforcement pyramid were cases assessed as such low risks that they did not require direct ongoing contact from the Tax Office. When they had finished in the program they simply received a letter advising them that their risk had been assessed as low.

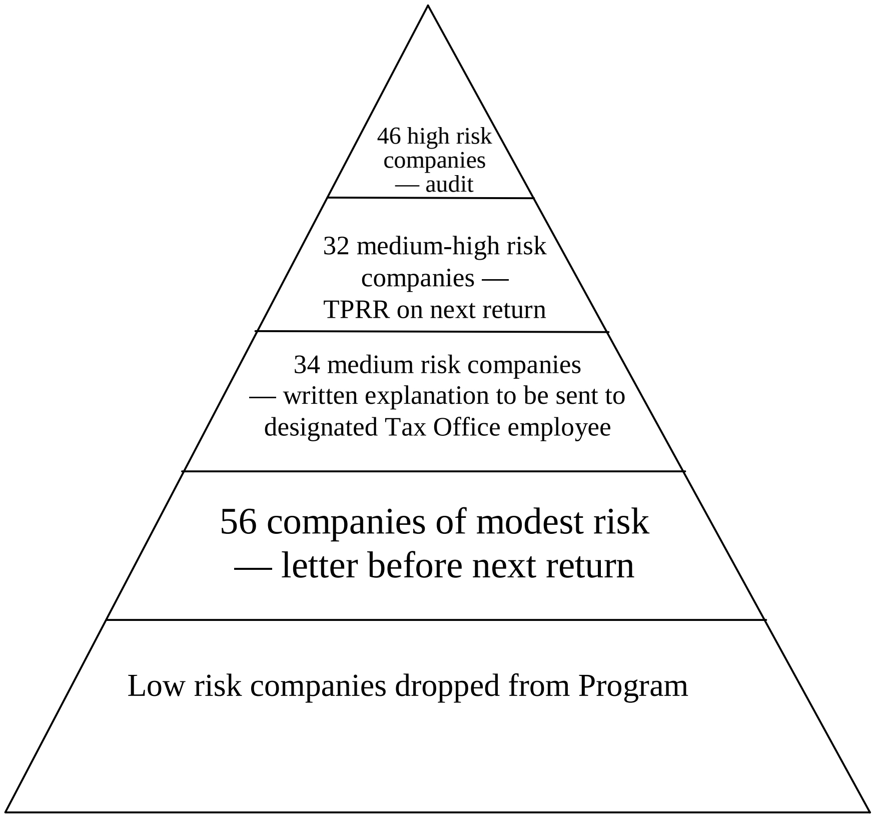

Figure 2: Enforcement pyramid: Transfer pricing record review project

Fifty six cases on the next rung of the pyramid were also of sufficiently low risk as to warrant no more than a letter before the following year's return urging them to continue to observe arm's length pricing. Thirty four cases with somewhat higher risk were asked to send their next tax return and Schedule 25A as well as a 'letter of explanation advising how your company's **current** transfer pricing practices and documentation comply with the arm's length principle'. This material was to be sent to a named Tax Office employee (a signal of more focused scrutiny).

Thirty two cases of still higher assessed risk were told that they clearly had a problem and would be subjected to another Transfer Pricing Record Review for their next return. This happened in all cases and was a last chance signal. The forty six highest risk cases from the 190 reviewed were sent a letter notifying them of intention to audit.

All companies on the top three rungs of the pyramid were given the option of de-escalating down to an Advance Pricing Arrangement (APA). The APA is an arrangement negotiated between the company and the Tax Office (and, in some cases involving the company's associated enterprises in other countries and the relevant revenue administrations in those countries) on the methodologies that will be used to calculate transfer prices on the company's future international dealings with associated enterprises. It is a risk management arrangement on profit shifting tailored to the goods and services to be traded in the future by a particular company.

The APA puts the onus on the firm to conduct the Tax Office's risk management, while providing the firm with certainty, relief from Tax Office scrutiny, and freedom from having to pay large fees, which can approach a million dollars, to accounting firms for transfer pricing work. Twelve of the audit cases applied for APAs. This had been an objective of the Project – to get more high risk firms into APAs. Consistent with the meta risk management strategy the resource investment in the Transfer Pricing Record Review Program was quite modest. The idea was to get the firm to do most of the risk management work. Three to five days at the company's premises by two officers was all that was required for the initial review. Transfer Pricing Record Reviews (TPRR) on the 190 companies were completed in less than six months, which was significantly less than previous transfer pricing risk assessment products.

The amount of tax paid in the year of the review increased by 26% (from $69 million in 1996 to $87 million in 1997 – the year under examination in most cases) even though the income for these companies actually fell by 5% in this year. Seemingly $18 million in extra tax for less than half a million in Tax Office resources. Table 1 shows that the tax paid by companies in the program jumped much more sharply in 1998 and fell back from that peak in 1999 (income for the companies also fell slightly in 1999). The average tax paid for the two fully post-intervention years (1998, 1999) was more than double that paid in the pre-intervention year of 1996. Not surprisingly therefore, the biggest benefit of the program seemed to be less in the year where returns were subject to direct Tax Office scrutiny and much greater in the subsequent two years when the firms had subjected themselves to intensified self-scrutiny through improved risk-assessment methodologies.

This was also the pattern for results in the second row of Table 1, which relates to the second tranche of 74 companies that went into the TPRR in 1999-2000. Here the return subject to review was generally 1998. From 1997 to 1999 net tax increased 52% (compared to a 16% increase in income for this period), but the increase was twice as great between 1998 and 1999 as it was between 1997 and 1998. Again this is consistent with the main effect of the program being a meta risk leveraging effect on 1999 more than a direct monitoring effect of the review in the 1998 year.

Table 1: Total income and net tax of companies in the Transfer Pricing Record Review and Improvement Project for 1998-99 (1997 generally the return first reviewed) and 1999-2000 (1998 generally the return first reviewed)

	1996 $mil	**1997 $mil**	**1998 $mil**	**1999 $mil**
1998–1999 TPRR n = 190 Total income All companies	34 326	32 612	32 827	31 683
1998–1999 TPRR Net tax All companies	69	87	166	123
1999–2000 TPRR n = 74 Total income All companies	27 563	29 264	32 547	33 891
1999–2000 TPRR Net tax All companies	647	628	730	953

In addition to the increase in tax collected, the program was part of a strategy to improve the level of compliance across all firms that trade internationally by getting the message out to apply the transfer pricing rulings TR 97/20 and TR 98/11. It was also part of a meta risk management strategy to reduce compliance costs. The project also had an intelligence function in showing that the quality of transfer pricing documentation was very poor and poorer than expected. In a second round of the program in 1999-2000, the level of Tax Office-assessed quality of documentation and processes did improve, with 35% of companies assessed as having documentation of high or medium-high quality, compared to 16% in the previous year. There was also a modest fall in the Tax Office-assessed audit risk rating. Overall the program got the message out that the Tax Office was willing to get more serious about profit shifting than it had been in the past.

The Transfer Pricing Record Review and Improvement Project satisfies the four key components of the ATO Compliance Model.

1. *Understanding Taxpayer Behaviour*. Under TR 98/11, Step 1 of the method for selecting an appropriate transfer pricing methodology is for the taxpayer to 'Accurately characterise the international dealings between the associated enterprises in the context of the taxpayer's business, and document that characterisation'. When the taxpayer does this well, simply by reading this documentation the Tax Office will acquire a much enhanced understanding of taxpayer behaviour. On the third rung of Figure 2, the required written explanation of the relationship between the company's transfer pricing and the commercial realities of its business has also helped understanding of complex forms of taxpayer behaviour. This proffered understanding also changes the nature of audit. One senior Large Business and International (LB&I) manager described the written explanation as a 'thesis on the relationship between what's really happening and the accounts. An audit then becomes more directed as a test of that thesis'.

2.Building Community Partnerships. The Transfer Pricing Record Review and Improvement Project is a collaboration with major accounting firms and corporate clients. It was seen in the words of one LB&I manager as a move from 'policing to partnership'. The objective of shifting resources from transfer pricing audits to APAs was seen as a shift from 'the angst of audit to the better tone of APA negotiations'. Profit shifting enforcement in the past had been 'crafted on a canvas of suspicion'. The remarkable transparency of the TR 98/11 approach was crafted to build trust. Meta risk management means a risk management partnership here. The project succeeded in enrolling some of the major accounting firms to persuading their clients that indeed the partnership offered in the project was superior to audit. In the words of one LB&I officer they saw their interest in ‘sending the message that unless you employ us to get your methodology in order you’ll be audited eventually’. Wisdom in selecting targets is also important in this area. Selling the idea of an APA to one lead multinational from a particular country may bring to the negotiating table many other companies from that country that are in the first country’s network. Other networks are based on industry sector such that when a leading corporate player from that sector signs up to an APA, others in that sector are given confidence to do likewise.

3. *Increasing Flexibility in Tax Office Operations to Encourage and Support Compliance*. TR 97/20 endorses a number of different pricing methodologies. The APA is a highly flexible approach, tailoring compliance requirements to the activities of the specific company. In fact, it is an enforced self-regulation (Ayres and Braithwaite, 1992: Chapter 4) strategy of meta regulation.

4. *More and Escalating Regulatory Options to Enforce Compliance*. Figure 2 shows that a regulatory pyramid the Tax Office can escalate up and down is very much in play here. One criticism of APAs that may have merit is that they divert resources to cooperative corporations and away from corporates who use aggressive tax planning. While this might be a generally valid criticism, it is not a valid criticism of the deployment of APAs in the context of the Transfer Pricing Record Review and Improvement Project. This is because in this project, the most aggressive companies who spurn the APA all get a transfer pricing audit, a more intensive intervention than the APA. Hence there is fidelity to the principle of the compliance model that cooperation must be associated with movement down the enforcement pyramid and combative tax planning with movement up.

Conclusion

The Tax Office has experienced a considerable shift from a culture of checking returns to find breaches of the law followed by consistent enforcement. This change has been to a culture of risk analysis, where the Tax Office scans its environment for the greatest risks and moves resources to where those risks can be managed. This is the shift from reactive law enforcement to proactive risk management (where law enforcement provides just some of the tools in a regulatory pyramid). Meta risk management is a further stage in this strategic change process. It is the move to the risk management of risk management. While proactive risk management can be more strategic than reactive enforcement, even more strategic leverage might be achieved by asking how the Tax Office can lever others to do fruitful risk management.

Self-assessment captures the above basic intuition. Instead of using Tax Office staff time to check the arithmetic of taxpayers, trust taxpayers to do the arithmetic. However, trust and verify by developing strategies for educating taxpayers how to check themselves and by educating agents to check their checking. Tax Office resources can then shift from direct checking to meta-monitoring (Grabosky, 1995), as by shifting enforcement resources to the clients of agents who are risk takers rather than risk checkers.

The registered software project illustrates how to move this core intuition up a conceptual notch and up from individual taxpayers to a strategy of relevance mainly to small business. The Transfer Pricing Record Review and Improvement Project moves the intuition up to a sophisticated application of meta risk management, even meta meta risk management, that is relevant only to businesses with international dealings with associated enterprises.

For any given risk to the revenue, being sensitised to the meta risk management option means asking the following questions:

1. Is there someone who has under their control better levers of that risk than the Tax Office?
2. Can the fact that the other party is successfully leveraging the risk be made transparent to the Tax Office?
3. Can the Tax Office work with them to persuade them to pull those levers?

4. Are there levers the Tax Office can pull to get the other party to pull their risk leveraging levers?
5. Can the Tax Office organise its levers into a pyramid that escalates up from trust and persuasion at the base of the pyramid?
6. Does Tax Office leveraging of the other party's leveraging reduce risk at lower cost than direct monitoring and enforcement?

The other party can be the taxpayer themselves, as in self-assessment; they can be third parties like software manufacturers as in the Registered Software Project; they can be tax agents or internal corporate compliance systems as in the Transfer Pricing Record Review and Improvement Project. Or they could be a parish priest who a persistent non-lodger nominates as their supporter in honouring their commitment to get their tax return lodged in future as part of a lodgement prosecution settlement. Meta risk management is about encouraging creativity in finding the best levers for the hardest cases and the most effectively automatic levers for the routine cases. Creative self-enforcement where entrenched resistance to compliance is found, automatic self-enforcement where routine compliance can be expected (for example, where third party deductions at source are possible).

Often we will find that the answer to question 6 above is that there is no cost-effective meta risk management strategy. Because regulators are only beginning to learn how to ask Questions 1 to 5, we will more often find meta risk management strategies are waiting to be discovered if only we can become creative enough to craft them. This is why it is an exciting time in an area like Excise within the Tax Office where the above questions are being asked about moving to self-assessment, smart cards and registered software for calculating excise liability.

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