Deloitte.

16 July 2019

Australia 2019/20

Tax Insights

The ATO's expectations to obtain assurance

Snapshot

The Australian Taxation Office (ATO) has recently shared the 'Top 1,000 Tax Performance Program (Income tax) Findings Report' (the ATO Report) which highlights their key findings from over 280 streamlined assurance reviews (SARs) conducted to March 2019 on large public and multinational taxpayers, as part of the *Justified Trust* program.

Deloitte has been actively assisting clients to respond to SARs and to develop, document and implement tax control frameworks (TCF).

This article includes key findings from the ATO Report as well as practical insights into what information the ATO requires in order to obtain assurance that the right amount of taxes are accounted for and paid.

Well before the commencement of the *Justified Trust* program, the ATO had publicised their heightened expectations in relation to the level of tax governance large corporate taxpayers should be implementing. Since the initial publication of the ATO's *Tax Risk Management and Governance Review Guide* (the Guide) in 2017 and subsequently through the Top 1,000 SAR program, the ATO has been assessing the extent to which corporate Australia has listened to the tax governance message.

The findings in the ATO Report indicate that, while the ATO's drive to establish higher levels of tax governance has been acted upon by large taxpayers, there is still room for improvement.

It is important to appreciate that although the Guide was developed for large and complex organisations, the ATO has indicated that the principles outlined in the Guide can be applied to a corporation of any size, and may be tailored if appropriate.

The ATO has recently extended the *Justified Trust* program to include reviews of privately held groups under their *Top 320 Tax Performance Program* as well as superannuation funds and investment trusts. We have also seen a number of GST focused reviews that are performed in parallel with the Top 1,000 reviews and we understand that the ATO is planning on integrating these reviews in the near future.

Deloitte can assist you to navigate the elevated tax governance expectations of the ATO, and to prepare for a SAR in the most efficient and effective way.

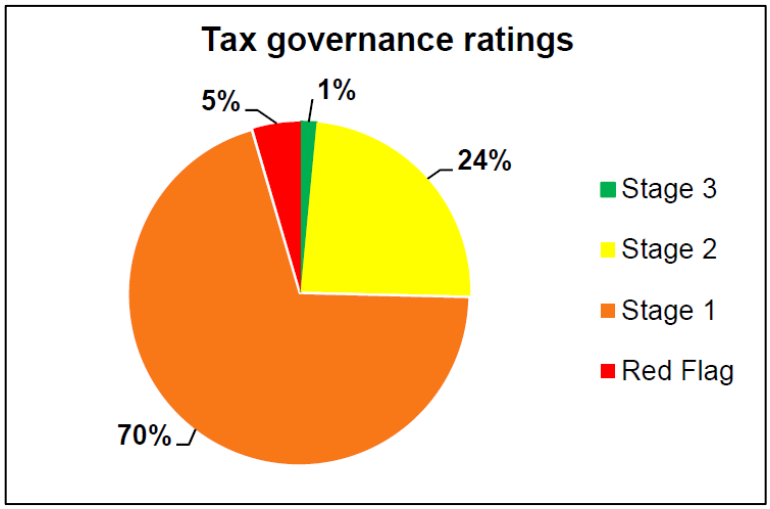
Top 1,000 Findings Report

The ATO Report shares the key findings from over 280 SARs to assist taxpayers to understand how to apply the ATO Justified Trust methodology. These findings shed light on the way in which the ATO is expecting to obtain greater assurance that taxpayers are paying the right amount of tax, and the key areas of tax risk being identified for further action. The ATO Report findings focus on the four key areas underpinning Justified Trust:

- The tax governance framework,
- Identifying tax risks flagged to the market by the ATO,
- Understanding new and significant transactions, and
- The alignment of tax and accounting results.

Tax governance

In respect of tax governance, the ATO issued the following ratings for the reviews completed up to the end of January 2019:



Tax control framework (TCF)

Red flag	No TCF or significant concerns regarding TCF
Stage 1	Evidence that a TCF exists
Stage 2	Evidence that a TCF exists and is designed effectively
Stage 3	Evidence that TCF exists, and is designed and operating effectively

Deloitte's observations on the ATO tax governance ratings are set out below:

Red Flag

The ATO has confirmed that a red flag rating is only issued after careful consideration where they have significant concerns with the taxpayer's TCF, as evidenced by a high level of errors identified and / or fundamental concerns about the robustness of existing tax processes. Of the taxpayers that have been subject to a SAR, **5% have obtained a Red Flag rating from the ATO**.

Stage 1

In order to achieve a Stage 1 rating, the ATO generally expects clients to undertake a gap analysis comparing the client's current state TCF to the ATO Guidelines, and to have some documentation in place that demonstrates the existence of the TCF. Where gaps are identified in the gap analysis, the ATO expects a clear timeline to be documented, indicating when improvements will be made to tax governance frameworks. **The vast majority of taxpayers that have been subject to a SAR (70%) have achieved a Stage 1 rating for governance.**

Stage 2

To achieve a Stage 2 rating, documentation evidencing the TCF needs to be provided to the ATO. For an income tax SAR, this should include:

- A Board approved tax governance policy (typical content would include tax governance responsibilities of the Board, tax risk tolerance and acceptable transactions, tax risk identification and assessment processes and how tax is incorporated into the business governance framework)
- Evidence of regular reporting of tax issues, risks and significant transactions to the Board
- Procedures regarding the identification, review and approval of significant transactions including when to seek external advice
- Documentation of tax related roles and responsibilities for direct and indirect tax matters
- Documentation of income tax return and tax effect accounting processes (this may involve process maps or checklists) and the associated key tax controls

To date, 24% of taxpayers subject to a SAR have achieved a Stage 2 rating.

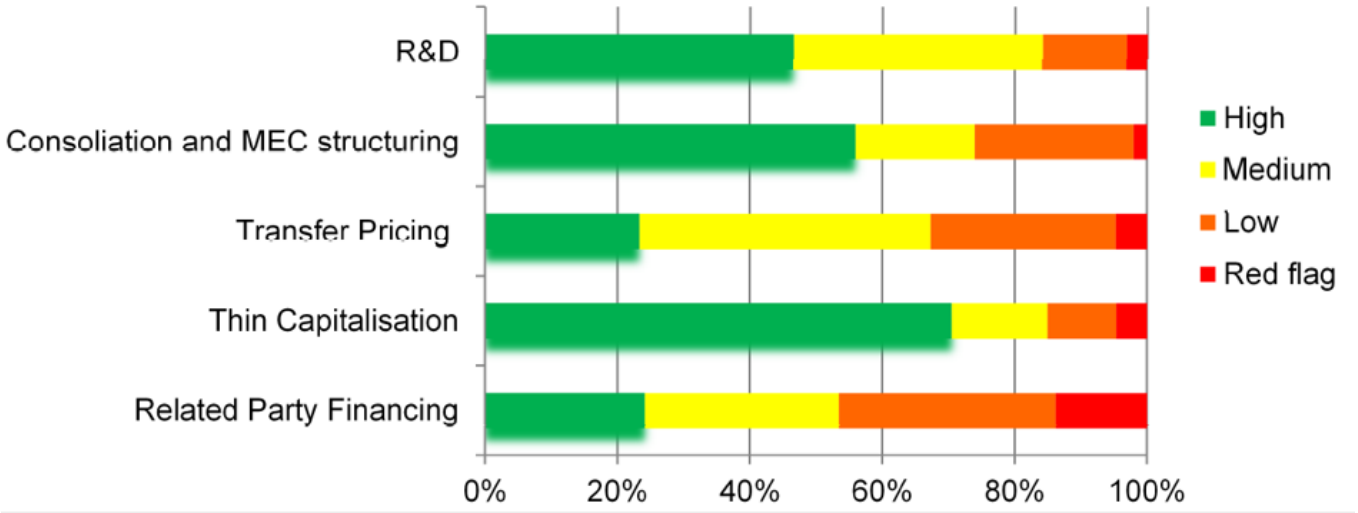
Stage 3

To achieve a Stage 3 rating, a Stage 2 level TCF must be evidenced and, in addition, support must be provided that key tax controls are tested as part of a periodic testing program and operating effectively.

Best practice dictates any testing program should be as independent as possible (e.g. internal audit, external audit, external advisers, or where these options are not possible, review by finance team members who do not play a role in the tax processes under review). The results (including remediation measures) of the control testing should be reported to the Board. **To date, only 1% of the taxpayers subject to the SAR program have achieved a Stage 3 rating.**

Tax risks flagged to the market and significant transactions

The assurance ratings for some of the common areas arising in reviews completed to the end of January 2019 are shown below:



Transfer pricing and related party financing

In terms of tax risks flagged to the market and significant and new transactions, **transfer pricing was singled out**, with more than 70% of the Top 1,000 taxpayers disclosing related party dealings.

The ATO Report highlights the following common issues in relation to their analysis of transfer pricing:

- Limited information (documentation) on the global value chain and/or functional analysis of the entities to the arrangement
- Overreliance on the whole-of-entity Transactional Net Margin Method. In their view, there are circumstances where other methods, including transactional approaches, may be more appropriate
- Lack of comparability analysis in applying the transfer pricing methodology
- Changes in transfer pricing policy / methodologies without an underlying change to taxpayer functional analysis
- In relation to financing transactions, the commercial purpose / arm's length nature of terms and conditions is not well documented or evidenced (e.g. subordination, security), and other options realistically available may not be clearly considered
- In relation to services transactions, the beneficial nature of services and appropriateness of allocation keys may not be well documented / evidenced
- In relation to royalty / licensing / intellectual property arrangements, the beneficial nature and development, enhancement, maintenance, protection and exploitation activities may not be not well documented / evidenced.

Other areas

The ATO also highlighted the following areas that commonly arise that attract their attention:

Thin capitalisation: Increasing use of alternative methods, revaluations, and valuation of debt capital

Consolidation: Asset recognition, valuation, MEC Groups, consolidation and re-domiciling

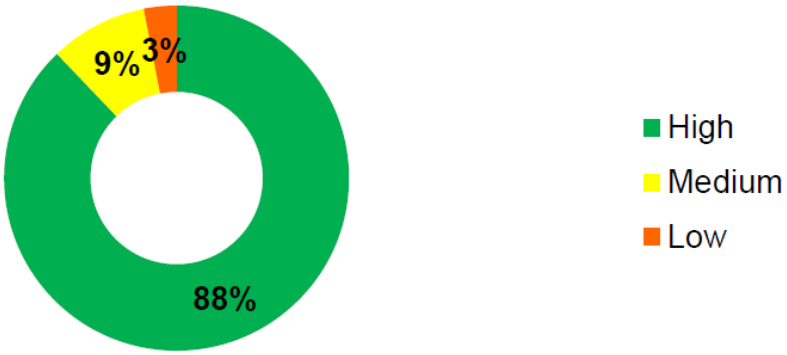
R&D: Taxpayer alerts, and allocation of expenditure

Tax losses: Generation, carry forward, and transfer and utilisation

Inbound and outbound holding structures: Various issues

Alignment between tax and accounting outcomes

The review completed up the end of January 2019, resulted in the following assurance rating:



The ATO indicated that they generally obtain high assurance over reported income and expenses, as most taxpayers have audited financial statements and they are able to review the reconciliation between financial statements with the starting profit and loss disclosed in the relevant tax return. This is more challenging for MEC groups, foreign bank branches and stapled groups. They are also generally seeing good procedures for calculating taxable income from accounting results.

What is the ATO looking for to obtain assurance?

As part of the Justified Trust program, the ATO seeks objective evidence that would lead a reasonable person to positively conclude that a taxpayer has paid the right amount of taxes.

On 30 May 2019, the ATO published guidelines on what they look for to obtain assurance over business and economic activities connected or linked to Australia.

The ATO obtains assurance if the following information can be provided to them:

Financial information and tax reconciliation	Supporting working papers to the tax return and schedules	Information on tax losses
• A detailed statement of taxable income with supporting working papers which indicate the nature of adjustments made to accounting profit to determine taxable income. • Explanation around the nature of adjustments where income tax adjustments are specific to your industry, business or a particular transaction. • An explanation of: – The differences between accounting and tax groups – Why the starting profit in the tax return differs from the audited financial statements.	• Tax return working papers which show how disclosures were prepared and any supporting calculations. Supporting work papers include those that are internally produced or calculation work papers created using tax return preparation software. • International dealings schedule working papers which breakdown all related party transactions into their respective types, the relevant offshore counterparty, the actual value of the transactions and how they are priced. • Thin capitalisation calculations which include a balance sheet for the tax consolidated group or MEC group which shows how average assets, non-debt liabilities and average adjusted debt is calculated. Working papers that show how debt deductions were calculated. • A summary of the fixed asset register and any relevant policies and procedures, including: – How effective lives are determined and reviewed for each major class of asset – A reconciliation between the tax and accounting fixed asset register.	• A detailed summary of any available and / or utilised tax losses showing year of incurrence / utilisation and whether these are group losses or transferred losses. • Where losses are utilised during the period of review, but those tax losses arose in respect of income years which have not previously been reviewed by the ATO, an explanation to support the validity of those losses. • Detailed work papers to support the satisfaction of either the continuity of ownership test (COT) or same business test (SBT). • Where losses have been transferred in during the review period, an analysis supporting the transfer of the tax losses and any calculation of the available fraction, including: – How underlying market valuations were calculated or – Valuation reports.

Tax governance and risk management	Group structure	New businesses and transactions
• Responses that have considered ATO guidance and have undertaken a gap analysis of current policies and procedures against the ATO guidelines. • Analysis which explains why policies and procedures differ from the ATO guidance. • Evidence that controls have been designed and were operating effectively during the review period. This could be shown by internal or external reviews testing the controls, provided the reviews are conducted by a party independent of the tax team.	A diagram or written explanation showing: • All related entities operating in Australia even if outside of the tax consolidated or MEC group • Overseas subsidiaries or permanent establishments of the Australian group • All intermediary holding companies of the Australian group • Other offshore related entities who transact with the Australian group.	Responses which explain the nature of any new business or transactions and the treatment of any income or expenses arising from the new activities.
Restructures	**Acquisition of an interest in another entity**	**Asset disposal**
An explanation of: • The nature of any restructures (whether they are domestic or cross border) • The treatment of any income, or expenses / losses arising from the restructure itself (if any) • Changes in underlying income and expenditure as a result of the restructure.	• Where an acquisition results in an entity joining a TCG or MEC group, provide sufficient information which demonstrates how tax values of assets owned by joining entities have been determined. • Where the acquisition is part of a global acquisition, provide evidence which shows the relative market value of the Australian entity or business acquired.	• Provide evidence of both the proceeds and how the cost base was determined. • Where there is a disparity between the accounting gain or loss on disposal and the tax gain or loss on disposal, provide an explanation of why there is a differential.
Funding	**Taxation of financial arrangements (TOFA)**	**Tax effect accounting**
• Where funding is vanilla (e.g. loans with third party banks or ordinary equity), provide a very brief response confirming these facts. • Where the funding involves more complicated or unusual financial arrangements or related parties, a more detailed response is required, which includes a summary of: – The relevant term – The accounting and tax treatments and – The legal documentation.	• A table listing the different types/categories of financial arrangements in place in each review year, and the associated gains and losses recognised each financial year for each type / category. • Where the TOFA treatment is different from the accounting treatment, provide an explanation of how the gains and losses are identified or calculated.	• Tax effect accounting working papers. • An explanation of why deferred tax balances have been recognised and any reconciliation of tax effect working papers to the tax effect disclosures made in the financial statements.

Controlled foreign companies (CFCs)	Offshore branches or permanent establishments (PE's)	Transfer pricing (TP) documents
• Working papers which support the attribution of income, or explaining why no attribution is necessary, in respect of each CFC. • Sufficient information about the type and source of income of the CFC to allow confirmation that such income is not eligible designated concession income (EDCI) (listed country CFC's) or that the active income test is passed (or not) and whether such income is passive or is tainted.	• An explanation of why a PE exists (e.g. there is a fixed place of business overseas etc.). • Transfer pricing documentation in respect of PE's. • Advising whether any of the arrangements of the type described in Taxpayer Alert 2016/7 exist in dealings with the PE.	• Unless covered by country by country reporting, contemporaneous TP documentation for each year of review. This documentation should cover all offshore-related party transactions including financing transactions and dealings with offshore permanent establishments.

How Deloitte can help

A way to govern and to manage tax risks

How can companies demonstrate to key stakeholder that their tax affairs are managed in a responsible manner and that the right amount of taxes are paid?

Consider our **Tax Governance** offerings

Gap analysis
We can facilitate a gap analysis workshop to compare your current state Tax Governance Framework (TGF) with the ATO Guide, and to agree strategies to close these gaps. The output of this workshop is a gap analysis report including a plan to enhance the TGF.

Design or enhance the tax governance framework
Depending on the current TGF, we can either work with you to develop a TGF or to enhance the existing TGF by drafting tax policies, charters or manuals in accordance with your determined content. The TGF should be practical, fit for purpose and in line with your broader business governance framework.

Documenting and mapping key tax processes
A key part of tax governance is ensuring processes are accurately mapped and key controls are documented. We can assist you to document your processes and controls.

Preparing or reviewing ATO 'Request for Information' (RFI) responses
The RFI document usually includes around 30-40 questions, including tax governance questions. We can prepare or review responses to the RFI in order for you to sign off on the content prior to submission to the ATO.

Independent control testing
We can advise on tax control testing in conjunction with our Audit or Risk Advisory teams. This involves testing the design and operating effectiveness of your tax controls.

Contacts

Anita Paddock
Partner
Tel: +61 4 0420 4222
apaddock@deloitte.com.au

Steve O'Connor
Director
Tel: +61 419 047 680
soconnor@deloitte.com.au

Abs Osseiran
Partner
Tel: +61 409 456 006
aosseiran@deloitte.com.au

Rian Cloete
Senior Manager
Tel: +61 4 2097 7403
rcloete@deloitte.com.au

Patrick Grob
Partner
Tel: +61 4 1523 9147
pgrob@deloitte.com.au