Title
Tax system integrity and director’s obligations under the Corporations Act. A tale of two systems.

Author Name¹
Kalmen Datt

Abstract
The level of risk, including tax risk, a company is prepared to take in achieving its goals is determined by its board of directors. The greater the tax risk appetite of a company, the greater the risk of the regulators consideration of its affairs. This increased attention is inter alia caused by regulators being the subject of increased political and public scrutiny on how they deal with corporations generally and multinational corporations (MNCs) in particular. As part of its administration of the tax system the Australian Taxation Office (ATO) makes significant demands on corporations to ensure they have adequate and functional corporate governance (including tax) processes in place. Actions from the regulator pursuant to a breach of the tax laws can result in penalties and possible criminal sanctions against both the company and its directors under the tax laws.

The obligations of directors are exacerbated by a multitude of external factors outside their control. These include: the quantum of tax paid by corporations and particularly MNCs has become a focus of the media that contend they must pay their ‘fair share’ of taxes; parliamentary enquiries into corporate tax avoidance; the introduction of country by country reporting obligations.

¹ Kalmen Hyman Datt, Senior Lecturer, UNSW Australia.
These remarks introduce the two-related topics considered in this article. First, can a breach of the tax laws by a corporation lead to personal liability of a director under the *Corporations Act* 2001 (Cth) (Corporations Act). This article deals only with the corporate law duties of care and diligence and good faith, which, for tax purposes, are arguably the most important duties imposed by the Corporations Act on directors. These are duties owed to the corporation. Second does the ability of the tax regulator to interrogate massive quantities of information almost instantaneously (something humans are incapable of doing) from sources throughout the world impact on the risk faced by directors of breaching both the tax laws and the Corporations Act. The author argues the answer to both is yes.
Tax system integrity and director’s obligations under the Corporations Act. A tale of two systems.

1 Introduction

The level of risk, including tax risk, a company is prepared to take in achieving its goals is determined by its board of directors. The greater the tax risk appetite of a company, the greater the risk of the regulators consideration of its affairs. This increased attention is inter alia caused by regulators being the subject of increased political and public scrutiny on how they deal with corporations generally and multinational corporations (MNCs) in particular. As part of its administration of the tax system the Australian Taxation Office (ATO) makes significant demands on corporations to ensure they have adequate and functional corporate governance (including tax) processes in place. The importance of this is illustrated by what was said by French J in *Chemeq* when considering the form of penalty to be imposed on a director.

The presence or absence of compliance systems is of importance… that the Court, in fixing penalty, is made aware of the reasons for the contravention. This may enable it to determine whether there were inadequate compliance systems or whether the contravention involved aberrant disregard by an individual of relevant policies and procedures. The seniority of those in the company who were involved in the contravention is also relevant because it goes to the risk of recurrence and the extent to

---

2 Risk is defined as the probability of an unfavourable event, multiplied by the severity of harm if the event occurs: Productivity Commission, Regulator Engagement with Small Business (September 2013) 272.

3 See for example PS LA 2009/4 When a proposal requires an exercise of the Commissioner's general powers of administration, 21 May 2009.
which their conduct is likely to be noticed by subordinates within the company and by others in the wider corporate community.\(^4\)

Actions from the regulator pursuant to a breach of the tax laws can result in penalties and possible criminal sanctions against both the company and its directors under the tax laws.

The obligations of directors are exacerbated by a multitude of external factors outside their control. These include: the quantum of tax paid by corporations and particularly MNCs has become a focus of the media that contend they must pay their ‘fair share’ of taxes; parliamentary enquiries into corporate tax avoidance; constantly changing legislation; treaties and legislation with a view to dealing with issues arising out of the Base Erosion and Profit Shifting (BEPS) process which for purposes of this article are those dealing with exchange of information (this article deals only with country by country reporting obligations (CbCR); and finally industry standards or voluntary codes of conduct that must be met including codes of practice put up by regulators regarding such issues as corporate governance.\(^5\) Hanrahan notes that in Australia there is an increasing tendency by regulators (she refers specifically to ASIC although her comments are of equal application to the ATO) to look on directors as gatekeepers of corporate compliance. This according to Hanrahan transforms the role of directors from a role of managers to being ‘embedded policemen.’\(^6\)

These remarks introduce the two-related topics considered in this article. First, can a breach of the tax laws by a corporation lead to personal liability of a director under the Corporations Act 2001 (Cth) (Corporations Act). This article deals only with the corporate law duties of care and diligence and good faith,\(^7\) which, for tax purposes, are arguably the most important duties


\(^5\) See for example Joan Loughrey, Breaching the Accountability Firewall: Market Norms and the Reasonable Director, 2014 Seattle University Law Review (37) 989.

\(^6\) Pamela Hanrahan, Corporate governance in these ‘exciting times,’ Paper presented to the Corporate Law Teachers’ Association annual conference, Griffith University, Gold Coast, Australia, February 2017.

\(^7\) Corporations Act s 180.
imposed by the Corporations Act on directors. These are duties owed to the corporation. Second does the ability of the tax regulator to interrogate massive quantities of information almost instantaneously (something humans are incapable of doing) from sources throughout the world impact on the risk faced by directors of breaching both the tax laws and the Corporations Act. The author argues the answer to both is yes.

Before continuing some assumptions and limitations to this article.

First it is assumed that if a breach of the tax laws brings into play the Corporations Act both the ATO and the corporations law regulator, the Australian Securities & Investments Commission (ASIC) would consult with each other with a view to seeking the most appropriate penalty. Unfortunately to date this type of liaison appears to have been limited. The author has found only one case, Bolton, where discussions between the two may have occurred. In Bolton a breach of the tax laws caused ASIC to issue a disqualification notice to a director. It is assumed ASIC acted in consultation with the ATO, but it is possible that ASIC may have acted on its own volition. ASIC accepts that it may act on the referral to it of possible breaches of the Corporations Act by other regulators, but it says it will only act if, in its view, this is an appropriate action. In making this determination it considers: the seriousness of the alleged misconduct and particularly its market impact, what regulatory benefits can be obtained in pursuing misconduct; is there sufficient evidence available; and is the issue better addressed by the other agency or by private dispute resolution between those involved. It seems in the

---

8 ASIC v Maxwell (2006) 24 ACLC 1,308 [102].
9 According to Welsh the duties of ASIC are to:

utilise the enforcement mechanisms at its disposal for the purpose of altering the behaviour of directors who may be inclined towards non-compliance with the statutory directors’ duties. Applying Haines’ definition, ASIC should target its enforcement efforts at contraventions of the directors’ duty provisions, with the specific goal of achieving a reduction in the type of behaviour of directors that may lead to a contravention of these provisions.


11 ASIC, Information Sheet 151: ASIC’s Approach to Enforcement (September 2013).
current climate alluded to above it seems tax is an important factor that must be considered on an ongoing basis by directors. A failure on their part to do so and to properly perform their obligations justifies the attention of ASIC.

Next the breaches of the tax laws referred to are those that carry substantial penalties, both monetary and reputational, for corporations. Data protection, taxpayer confidentiality, and the vexed question whether the use of data mining and data analysis software by the tax regulator breach the privacy or human rights or tax laws are the subject matter of other research by the author. An example of a possible breach of the tax laws is a case in the UK that suggests there may be problems with computer generated assessments or determinations depending on the wording of the legislation. In *Khan* 12 the court held that a penalty imposed automatically by a computer was not valid as the legislation required an officer of HMRC to impose the penalty. This decision is on appeal. Finally, the references to CbCR refer only to what are stated to be significant global entities. These entities are essentially a corporation that is a global parent entity with annual global income of $1 billion or more, or a member of a group of entities that has a global parent entity and the annual global income of the group is $1 billion or more.

The scheme of the article is as follows. Part two considers the duties of care and diligence and good faith owed by a director to the corporations and whether a breach of the tax laws could constitute a breach of these duties. Part three looks at some of the risks faced by corporations and directors by the introduction of CbCR and the use by the ATO of data analysis software to interrogate this mass of information. Part four summarises the author’s conclusions.

12 *Khan Properties Ltd v HMRC* [2017] UKFTT 830 (TC).
The next part first considers the duty of care and diligence and then turns to that of good faith. Once the criteria for a breach of the duties has been reviewed the article determines whether a breach of the tax laws can constitute a breach of these duties.

2. Duty of Good faith, care and diligence

2.1 Duty of care and diligence

This duty, referred to in section 180 (1) of the Corporations Act provides that directors must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they were a director or officer of a corporation in the corporation's circumstances; and occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

Ipp J, who delivered the majority judgment in *Vrisakis*, said that for a breach of this duty to occur it must be reasonably foreseeable that harm to the interests of the company might be caused as a result. This duty is not intended to penalise legitimate but unsuccessful entrepreneurial activity. The learned judge continued:

> The question whether a director has exercised a reasonable degree of care and diligence can only be answered by balancing the foreseeable risk of harm against the potential benefits that could reasonably have been expected to accrue to the company from the conduct in question.

Edelman J in *Cassimatis*, conducted a far-ranging review of the history and cases dealing with this section and after citing *Vrisakis* with approval clarified and explained some important matters arising from this duty. These were:

---

14 *Australian Securities and Investments Commission v Cassimatis (No 8)* [2016] FCA 1023.
1. The foreseeable risk of harm to the corporation includes harm to all the interests of the corporation including its reputation and its interests which relate to compliance with the law. The case of Starbucks in the UK is an example of this reputational damage. Starbucks was the subject of a concerted media campaign about the quantum of tax paid by it in the UK. The result of this campaign was detrimental to the reputation of the Starbucks with the result that in an attempt to minimise the damage the company publicised the fact that it would not claim deductions to which it was entitled to in law with a view to increasing the amount of tax paid. A spokesperson of Starbucks is reported as saying:

We listened to our customers in December and so decided to forgo certain deductions which would make us liable to pay £10m in corporation tax this year and a further £10m in 2014. We have now paid £5m and will pay the remaining £5m later this year.\(^\text{15}\)

2. The factors to be considered are not to be balanced or weighed as though by a common metric. An example given by Edelman J of this was that ‘the director might not avoid liability merely because he or she proved that a balancing exercise showed that the likely financial cost of a penalty was exceeded by the likely profit from a serious contravention of the law.\(^\text{16}\) The enquiry is ‘forward looking’ to what a reasonable person would have done, not backward looking at what would have avoided the injury.\(^\text{17}\)

3. The conduct in question, must take place from the perspective of the corporation’s circumstances and the office and responsibilities of the director.\(^\text{18}\)

\(^\text{15}\) Terry Macallister, ‘Starbucks pays corporation tax in UK for first time in five years’ The Guardian (online) 24 June 2013 <http://www.theguardian.com/business/2013/jun/23/starbucks-pays-corporation-tax>. See also House of Lords, above n 47, [68].

\(^\text{16}\) Australian Securities and Investments Commission v Cassimatis (No 8) [2016] FCA 1023 [485].

\(^\text{17}\) Ibid [487].

\(^\text{18}\) Ibid [495].
4. A breach of the duty can give rise to pecuniary penalties and disqualification from acting as a director. Only ASIC may apply to the court for a civil penalty.\textsuperscript{19} To impose a civil penalty, a declaration of contravention must be made by the court. To use a criminal law analogy, this is the equivalent of a finding of guilt and shows the civil penalty provision that was contravened, who contravened it and the conduct that constituted the contravention. Such a declaration has serious reputational consequences for directors. For example, in \textit{Healey}, where a breach of the duty was found to have occurred, the court said:

The acts and omissions of the directors, as recorded in the liability judgment, have already been the subject of widespread public dissemination. Against such a backdrop of widespread public analysis and associated embarrassment and reputational damage for each of the directors, the need for the imposition of a disqualification order or pecuniary penalty for reasons of general deterrence is much less than it would otherwise be.\textsuperscript{20}

A civil penalty of up to $200,000 can be imposed on a director, or $1 million on a company, if the contravention of sections 180 or 181 is serious or materially prejudices the interests of the corporation.\textsuperscript{21}

5. It is not possible to ratify a statutory breach.

6. An actual breach of some statutory duty is not necessary. In this regard the learned judge said:

---

\textsuperscript{19} Cases where ASIC successfully sought a civil penalty include: \textit{Australian Securities and Investments Commission, in the matter of Sino Australia Oil and Gas Limited (in liq) v Sino Australia Oil and Gas Limited (in liq)} [2016] FCA 934, \textit{Australian Securities and Investments Commission v Cassimatis (No 8)} [2016] FCA 1023, \textit{ASIC v Flugge (No 2)} [2017] VSC 117, \textit{Australian Securities and Investments Commission v Ostrava Equities Pty Ltd} [2016] FCA 1064.

\textsuperscript{20} \textit{ASIC v Healey (No 2)} [2011] FCA 1003 (31 August 2011) [177].

\textsuperscript{21} \textit{Corporations Act s 1317E and 1317G}. Serious is not defined.
For instance, suppose a director unreasonably (within the terms of s 180(1)) and intentionally commits acts which are extremely likely to involve a serious breach of the *Corporations Act* perhaps even threatening the very existence of the corporation…it might be seriously doubted whether the director could escape liability simply because, by some good fortune, no actual breach eventuates. *Loss is not a required element of an action for contravention of s 180(1) of the Corporations Act* (My emphasis).  

Not every breach by a corporation of the Corporations Act or the tax laws gives rise to a breach of this duty. The steps to be taken depend on all the corporation’s circumstances. It depends what a reasonable person who is a director of a corporation in the same circumstances and with the same responsibilities as the director would have done. The duty does not require the director to take every possible step to avoid a foreseeable risk of contravention of legislation. For a breach to occur one must:

[D]etermine what a reasonable man would do by way of response to the risk. The perception of the reasonable man's response calls for a consideration of the magnitude of the risk and the degree of the probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action and any other conflicting responsibilities which the defendant may have. It is only when these matters are balanced out that the tribunal of fact can confidently assert what is the standard of response to be ascribed to the reasonable man placed in the defendant's position.

Risk taking is not a breach of these duties, although risks must be weighed against potential reward for the corporation. Simply making a mistake is not a breach of this duty-compliance does not require perfection. However, as noted in *Daniels*, Justices Clarke and Sheller

---

22 *Australian Securities and Investments Commission v Cassimatis* (No 8) [2016] FCA 1023 [4-5].
23 *Australian Securities and Investments Commission v Warrenmang Limited* [2007] FCA 973 (29 June 2007)[22].
24 *Australian Securities and Investments Commission v Cassimatis* (No 8) [2016] FCA 1023 [530].
25 *Australian Securities and Investments Commission v Cassimatis* (No 8) [2016] FCA 1023 [529].
27 *Australian Securities and Investments Commission v Healey* [2011] FCA 717 [180].
emphasise that lack of experience or knowledge of what is required by directors is not a
defence when a breach of this duty is alleged.\textsuperscript{28} Directors must be aware of the financial
status of the company (this includes tax) through a regular review of the financial statements
and must ensure that there is nothing amiss.\textsuperscript{29} They must ensure that the board has the means
to audit the management of the company, to satisfy themselves that the company is being
properly run.\textsuperscript{30} Directors must be familiar with the fundamentals of the business in which the
corporation is engaged (including tax risk management) and must keep themselves informed
about the activities of the corporation.\textsuperscript{31} They must conduct general monitoring of corporate
affairs and policies by ensuring their regular attendance at board meetings.\textsuperscript{32}

There is a core, irreducible requirement that directors be involved in the management of the
comp\cellcolor{black}\cellcolor{black}any and take all reasonable steps to be able to guide and monitor the company, including
tax issues. Directors must take a diligent and intelligent interest in the information available to
them, as well as in the information that they can request from other employees of the
company.\textsuperscript{33} An objective standard of care is applied.\textsuperscript{34} If anything is found to be amiss or the
directors are put on enquiry, a proper investigation must be undertaken. If directors fail to do
so, this is a breach of their duty of care and diligence.\textsuperscript{35}

\textsuperscript{29} Ibid.
\textsuperscript{30} Ibid 662.
\textsuperscript{31} In Re Caremark Int’l, 698 A.2d 959, 970 (Delaware Chancery, 1996), Chancellor Allen states:
I note the elementary fact that relevant and timely \textit{information} is an essential predicate for satisfaction
of the board’s supervisory and monitoring role.
Without reliable information, directors are unable to meet their obligations. It is because of this that being put on
enquiry and failing to do anything can be an important element of directorial liability.
\textsuperscript{32} ASIC v Adler (2002) 20 ACLC 576, 652.
\textsuperscript{33} ASIC v Healey [2011] FCA 717 (27 June 2011); Statewide Tobacco Services Ltd v Morley (1990) 2 ACSR
405; Commonwealth Bank of Australia v Friedrich (1991) 5 ACSR 115; Deputy Commissioner of Taxation v
Clark [2003] NSWCA 91 (1 May 2003).
\textsuperscript{34} ASIC v Healey [2011] FCA 717 (27 June 2011) [172].
\textsuperscript{35} The duty of care is far reaching. See, for example, ASIC v Hellicar (2012) 286 ALR 501; ASIC v Healey
Breaches of section 180 have been found where: the director’s conduct involved a substantial departure from normal industry practice; and failing to take an active role in the supervision of the company’s affairs.

2.2 The duty of good faith

Under section 181 of the Corporations Act directors must exercise their powers and discharge their duties in good faith in the best interests of the corporation and for a proper purpose. Many of the obligations under this duty overlap with the duty of care and diligence considered above and are not repeated.

To test for a breach of this duty the same objective test is applied. This provision is breached even if the director subjectively believes that his purpose is proper. Sackville AJA delivering the judgment of the court of appeal in Coope noted that the function or responsibility of directors is a question of fact. The test for a breach is to be determined from the standpoint of the objective observer with knowledge of all relevant facts and circumstances (references omitted).

If all necessary reporting and information systems and controls are not implemented, or if the directors consciously fail to monitor or oversee the corporation’s operations and are thus disabled from being informed of risks or problems requiring their attention, liability follows.

---

36 Circle Petroleum (Qld) Pty Ltd v Greenslade (1998) 16 ACLC 1,577.
37 Daniels v Anderson (1995) 13 ACLC 614
38 Asic v Adler and 4 Ors [2002] NSWSC 171 (14 March 2002) [738] per Santow J.
39 Coope v LCM Litigation Fund Pty Ltd [2016] NSWCA 37 [108-109]. See also Australian Growth Resources Corp Pty Ltd v van Reesema & Ors (1988) 6 ACLC 529, 538; In the matter of FAL Healthy Beverages Pty Ltd and FAL Retail Pty Ltd [2017] NSWSC 476 (27 April 2017 [57-59].
This oversight function includes establishing a system to prevent, detect and correct any wrongdoing with reference to tax.41

In Disney, the following examples of conduct were identified as establishing a failure to act in good faith:

Where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.42

2.3 Can a breach of the tax laws constitute a breach of these duties?

Considering the all the forgoing it seems clear that a breach of the tax laws can constitute a breach of sections 180 and 181 of the Corporations Act and the consequential issues for directors. This is because:

• The taxation of corporations and the quantum of tax paid is the subject of intense debate in the media and has captured the interest of the public;
• The courts, the ATO and ASIC have put directors on notice that proper tax governance processes are essential. This includes processes to prevent, and if necessary detect and correct any wrongdoing;
• Directors must be aware of any transactions that may be at the boundaries of what is and is not acceptable from a tax point of view. If in doubt caution should prevail;
• They must make detailed enquiries on an ongoing basis on any complex or unusual transactions which could attract the attention of the regulator or which could be found to be a breach of the tax laws. General oversight of all tax issues should be maintained;
• A breach of the tax laws can result in significant harm (monetary or reputational or both) for a corporation;

42 Re Walt Disney Co. Deriv Litig, 906 A 2d 27, 67 (Delaware, 2006).
• Any reasonable director would take all reasonable steps to ensure compliance with the
tax laws; and
• The expense, difficulty or inconvenience of taking remedial action is relatively minor
in relation to the magnitude of the risk assumed.

It seems that in these circumstances it appears that where there is a breach of the tax laws this
can bring the operation of the Corporations Act into play.

The article now turns to whether the introduction of CbCR and the use of data analytic
software by the ATO increase the risk of a breach of the tax and corporations law.

3 The risks of the digital age

The ATO and all other tax regulators suffer from a lack of resources (monetary and human).
To enable them to properly perform their function of ensuring taxpayers comply with the tax
laws they have adopted risk assessment policies to identify risks to the revenue. In the past
the ATO would assess risk in accordance with its risk differentiation framework (this is still
operative). Since the BEPS project and the advent of CbCR (the information furnished under
this is said to be on a confidential basis), exchange of information articles in double tax
agreements, the common reporting standard and the enactment of Foreign Account Tax
Compliance Act in the USA (FATCA) the quantity and quality of information now available
has increased to such an extent that humans are incapable of assimilating and dealing with
same. To enable them to properly perform their function of ensuring taxpayers comply with
the tax laws they have adopted risk assessment policies to identify risks to the revenue.  

The result is that regulators now resort to computers to analyse this data and to predict if there
is a potential risk to the revenue based on anomalies or outliers in the information received
concerning taxpayers. The function of the data analysis software is to make these types of

43 Geoff Leeper, Second Commissioner, People, Systems and Services, Tax administration transformation: Reinventing the AT, Address on behalf of Mr Leeper by First Assistant Commissioner Steve Hamilton to the National Tax Practitioner Conference Sydney, Wednesday, 18 June 2014.
predictions. Data analysis software makes use of what are described as algorithms. A report furnished to the Obama White House in May 2014 described an algorithm as follows:

In simple terms, an algorithm is defined by a sequence of steps and instructions that can be applied to data. Algorithms generate categories for filtering information, operate on data, look for patterns and relationships, or generally assist in the analysis of information. The steps taken by an algorithm are informed by the author’s knowledge, motives, biases, and desired outcomes. The output of an algorithm may not reveal any of those elements, nor may it reveal the probability of a mistaken outcome, arbitrary choice, or the degree of uncertainty in the judgment it produces. So-called “learning algorithms” which underpin everything from recommendation engines to content filters evolve with the datasets that run through them, assigning different weights to each variable. The final computer-generated product or decision—used for everything from predicting behavior to denying opportunity—can mask prejudices while maintaining a patina of scientific objectivity.44

This definition suggests some of the problems considered later in this article concerning the use of data analysis software. Rainey et al describe some of the advances made in the development of these analytic tools as follows:

With recent advances in natural language processing, computers can now read and extract meaningful information from unstructured data…in a cognitive solution, we teach the tool the area of interest, or “domain.” Once the base domain knowledge is established within the software, the cognitive solution typically continues to learn and solve problems within that domain, generally all on its own. The real power of cognitive computing is its ability to ingest massive amounts of data about which to formulate hypotheses. The human brain cannot handle this volume of data and does not have the time to absorb it, let alone process it.45

---

44Executive office of the President of the United States, Big Data: Seizing Opportunities, Preserving Values, May 2014.
The OECD advocates the use of this type of software on the information received as a result of the CbCR process and describes 19 risks that may be highlighted through its use. These include risks such as: how the results in various jurisdictions differ from each other; the nature and extent of the activities in each jurisdiction; whether the results in a jurisdiction do not reflect market trends; how many employees each member of the group has; and whether there are jurisdictions with substantial profits but little substantial activity. The OECD was acutely aware of regulators potentially using the information obtained for purposes other than that for which the process was designed. The OECD accordingly stressed that:

Under the Action 13 minimum standard, CbC Reports may be used by tax authorities for the purposes of high level transfer pricing risk assessment, the assessment of other BEPS-related risks, and economic and statistical analysis, where appropriate. CbCR information should not be used as a substitute for a detailed transfer pricing analysis of individual transactions and prices based on a full functional analysis and a full comparability analysis. It should also not be used by tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income. The requirement that CbCR information is used appropriately is a condition that must be met in order for a tax authority to obtain and use CbC Reports.

This is a salutary warning to all regulators that even if an anomaly is discovered or some other factor induces an adverse risk rating to be made by the machine, this is not determinative of whether the taxpayer has breached the tax laws. Something more needs to be done by the regulator to make this determination. This could be a range of actions from a please explain letter to an audit. It is conceivable that the outcome of these actions by the regulator may result in a settlement of the issue or even litigation. If matters that concern the ATO are remedied pre-audit or even pre-litigation this must be advantageous for all parties concerned.

The ATO have expanded on the approach suggested by the OECD in regard to risk factors that can be identified by CbCR. Jeremy Hirschhorn, Deputy Commissioner at the ATO has stated that:

---

In Australia, for CbCR we have set up a structured schema that makes the data more searchable. *In terms of the risk factors, there are the 19 put out by the OECD, but we actually have more than 100 that we apply to international dealings.* Our plan is to progressively make those transparent to the taxpaying community, so that people know where we stand and can consciously decide whether they want to have a high or a low risk position. We sometimes call this the “setting out the flags at the beach” strategy, which means that if you put out the flags, you hope that people will swim in between the flags and be safe. For those who swim outside the flags, they should not complain too much if they get caught by a rip and get taken out to sea, because they’ve chosen the position of being at risk.\(^48\) (My emphasis).

These additional markers referred to by Hirschhorn would presumably include the tax risk appetite of a corporation, where revenue and profits are sourced, which member/s of the group generate profits, and how much tax is paid in each jurisdiction. Compliance with VAT/GST requirements further enhances the ability of the regulator to obtain information about the business affairs of corporations and can be utilised for income tax purposes. All this information enhances the regulators knowledge of the taxpayer both locally and internationally. In addition to direct information about taxpayers the regulator has access to social media and all public posts on these and other sites which constitute part of the data available to it. Data from social media can inform both business and governmental decisions. Much social media data is ‘publicly’ available, and it can be analysed to profile both corporations and individuals and predict behaviours.\(^49\) Information posted on these sites by executives and senior managers and even other staff concerning the corporation or that persons affairs could conceivably insights as to how the corporation does

---


business. Details of job descriptions also give information about what a corporation is doing and would enhance the regulators knowledge of the taxpayer. House and Sanders note that the IRS:

Uses big data analytics to mine commercial and public data pools including social media sites (e.g., Facebook, Instagram, and Twitter). This data is then added to its proprietary data bases, and pattern recognition algorithms are run to identify potential noncompliant taxpayers. The author has no empirical data on this but would suggest all act in this way.

An example of how some of these flags referred to by Hirschhorn above may be made available to taxpayers can be seen from a recent practical compliance guideline issued in relation to related party financing arrangements. The document sets out in broad general terms areas of concern to the ATO, but no detail is given as to the precise markers used to determine risk. To date very little, if anything is known about the markers that have been used to identify risk in areas of international taxation or the sources or accuracy of the information accessed under CbCR.

The use of these flags by the ATO suggests it has adopted a strategy designed to anticipate issues before audit and to resolve them as expeditiously as possible. This of course does not preclude litigation if necessary. As KPMG note:

Despite this new approach, taxpayers can still expect significant and extensive reviews of taxation positions, particularly where there is a difference in opinion on critical tax issues. To the extent disputation occurs, the ATO continues to welcome alternative dispute resolution (ADR) and settlement as potential pathways to resolution.

House and Sanders comment that:

50 Kimberly A. House and Debra Sanders, The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It? (2017) 19 Vand. J. Ent and Tech. L 817.

51 ATO, PCG 2017/4 ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions, 5 February 2018.

52 KPMG, Tax insights 2018.
In addition to the secrecy surrounding IRS data mining, they are also keeping the algorithms themselves secret. The reason is to prevent taxpayers from gaming the system by understanding the nature of the audit selection and working around it.53

Details of the algorithms used by the ATO are also not known. In a presentation on 14 March 2018 Anthony Siouclis, an Assistant Commissioner in the ATO was asked by the author as to what these 100 plus markers were and whether they were publicly available. The effect of his response was that they were not, but he suggested if one had regard to various statements of various senior members of staff of the ATO (and possibly ATO publications) one could determine what were the ATO’s areas of concern. The suggestion that these markers can be identified from these sources seems easier to articulate than put into operation. MNCs are aware of public statements made by the ATO of matters that are the subject of concern or reviews by the ATO but that is different to an identification of the actual markers used by the data software analytic programs. This view is supported if one has regard to the statement by Mr. Siouclis that he was aware of what these markers were but declined to divulge either all or part of them to the audience. It seems the ATO will keep the precise nature of these markers confidential to it.54

The reluctance to divulge these markers is both reasonable and logical. Potential gaming of the system is clearly a problem for the regulator and one can understand why its markers are kept confidential. If these markers were known unscrupulous taxpayers could adjust their affairs to ensure they do not activate any of the markers but continue breaching the tax laws. There may also be laws such as privacy or the secrecy provisions of the tax laws themselves or that the data used is confidential to one or more third parties precludes the regulator divulging this information.55 Kroll et al furnish an example of gaming as follows:

53 Kimberly A. House and Debra Sanders, The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It? (2017) 19 Vand. J. Ent and Tech. L 817.
For example, the IRS may look for signs in tax returns that are highly correlated with tax evasion based on returns previously audited. But if the public knows exactly which things on a tax return are treated as telltale signs of fraud, tax cheats may adjust their behavior and the signs may lose their predictive value for the agency…in many contexts, an automated decision may use as inputs, or will create as an output, sensitive or private data that should not be broadly shared to protect business interests, privacy, or the integrity of law enforcement or investigative methods.⁵⁶

Notwithstanding this reluctance on the part of regulators the author suggests no MNC (there may be the rare exception) actively seeks to breach the tax laws. It is conceded they may inadvertently do so. They expend significant sums of money to the tax profession and others to ensure they comply with the tax laws in all the countries in which they operate. The refusal to indicate the factors that the data analysis software targets suggest a conflict with what Hirschhorn is reported to have promised taxpayers and mentioned above. From the ATO perspective, however, no matter how well intentioned MNCs may be it is possible one or more MNCs may attempt to game the system if this information is made public. A further reason supporting the ATO approach is that these markers are not directed at MNCs only but to the general body of taxpayers. The goal of the ATO is ensure compliance with the tax laws by all not just MNCs although the Commissioner is reported as saying:

Closer to our core topic, we’ve got ongoing insatiable interest in multinationals and large corporates’ tax behaviour, policy debates about tax rates, data leaks like the Paradise Papers, renewed attention on the Black Economy, estimates of tax gaps with the release of the large market tax and superannuation guarantee estimates last year, a program of random enquiries for other markets, and the ongoing work of the Tax Avoidance Taskforce.⁵⁷

⁵⁶ Ibid at 658.
Taxpayers may also suffer from what is usually described as overreaching by the regulator. For example, in collecting, interrogating and using the information received the regulator may act in a way that is not permitted under the tax or other laws. The Khan case cited earlier is an example of this. Because so little known about the internal data analytic processes at the ATO (or other regulators) it may not be possible to determine that such a breach has occurred other than in the most obvious cases.

The accuracy and source of the data is also an aspect that needs to be considered. As House and Sanders note:58

The IRS is less forthcoming about its use of data analytics in deciding whom to audit; the decision is based on private, highly detailed profiles of each US taxpayer, created from sources other than the taxpayer's returns and third party reports. Also, the question remains as to whether the data upon which algorithms rely is accurate and if the algorithms themselves may result in discrimination. Overall, the collection and use of this data without proper oversight and the increasing reliance on machine generated decisions may result in harm... Thus, verification of the accuracy of the database is critical for developing useful algorithms predicting behaviour. By keeping the data collected proprietary, the IRS is effectively preventing people from viewing and correcting information about themselves that the IRS may be using in its predictive analytics.59

The forgoing applies to all tax regulators that use data analytics. Taxpayers do not know the source or accuracy of the information furnished to a regulator. They have no basis of checking it for accuracy or advising the regulator of the error if such an error exists.60 The erroneous information may be the factor that triggers a prediction of a breach of the tax laws. Siouclis stressed that the ATO goes to some lengths to ensure the accuracy of the data used by

58 Kimberly A. House and Debra Sanders, The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It? (2017) 19 Vand. J. Ent and Tech. L 817.

59 Kimberly A. House and Debra Sanders, The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It? (2017) 19 Vand. J. Ent and Tech. L 817.

60 See for example Kimberly A. House and Debra Sanders, The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It? (2017) 19 Vand. J. Ent and Tech. L 817.
it but of course it is unable to do this with data supplied by third parties especially if they are overseas.\textsuperscript{61} In addition The ATO accepts that:

We have seen a huge shift around individuals and indirect taxes, which are both far more based on verifiable data. And that’s an important point - I think that ultimately, the long-term shift is towards moving tax systems towards verifiable data.\textsuperscript{62}

This is important as it gives taxpayers some comfort that the analysis effected by the software is based on legitimate data.

Another potential problem arises because of the actual knowledge the regulator has about the taxpayer and taxpayer’s assumption or inferences about the perceived quantum of knowledge concerning them held by the regulator. These two do not necessarily coincide. Thus, the regulator may suggest (it is put no higher than this) that it has information concerning a taxpayer’s affairs that impacts on an assessment but does not divulge the true extent of this information to induce the taxpayer to concede some tax shortfall. It is stressed the regulator would not make any untrue statement to the taxpayer but in effect leave it to the taxpayer to assume the regulator knew more than it did resulting in the taxpayer potentially acting in a way not supported by what the regulator inferred.

In the past a problem encountered by many regulators, including the ATO, was the apparent inability of legislatures to enact comprehensive and effective tax laws that targeted the income sought to be taxed. This resulted in many MNCs legitimately paying less tax than the government of the day or regulator believed should have been paid due to the source of the income derived by that MNC. This has changed dramatically in Australia with the enactment of the Multinational Anti Avoidance Law (MAAL) and the Diverted Profits Tax (DPT) both being part of the general anti-avoidance rules that take them outside the ambit of DTAs. Further legislation will shortly be presented to parliament on a range of issue arising from the BEPS project. An example is the recent exposure draft legislation on the hybrid mismatch


\textsuperscript{62} Ernst and Young \textit{Tax Administration Goes Digital}, 2017 citing Jeremy Hirschhorn, Deputy Commissioner at the ATO.
rules. This legislation has significantly increased the ability of Australia to tax the income of an MNC derived because of economic activity in Australia. The MAAL is designed to counter the erosion of the Australian tax base by multinational entities using artificial and contrived arrangements to avoid the attribution of profits to a permanent establishment in Australia. The DPT aims to ensure that the tax paid by significant global entities properly reflects the economic substance of their activities in Australia. It aims to prevent the diversion of profits offshore through contrived arrangements. As the Commissioner recently noted:

The Multinational Anti-Avoidance Law (MAAL) is having a positive impact on the behaviours of multinationals operating in Australia. Since the introduction of the MAAL in January 2016, we have identified 221 taxpayers within its scope and as at 31 December 2017, we have assured 179 taxpayers and have 42 ongoing MAAL engagements; 38 multinationals have brought, or are in the process of bringing, their Australian sourced sales back onshore. As a result of the restructures, we estimate $7 billion of additional income per annum will be returned to the Australian tax base.\(^{63}\)

There can be no doubt, in the author’s opinion, that the use of data analytics by the ATO significantly increases the risk of a breach of the tax laws generally and more specifically a breach of these anti avoidance measures. Other potential issues with the introduction of CbCR and the use of data analytics are mentioned below.

The very fact of being identified as a possible risk may build an inherent bias in the auditor examining the affairs of the taxpayer and possibly makes it difficult to persuade him/her that nothing is amiss. Veale et al conducted a survey of twenty-seven public sector employees in 2016 with a view to assess fairness and accountability in algorithmically-informed public decisions.\(^{64}\) Some of their results indicated that some tax officials were concerned that if by

---

releasing details of the inputs variables and their weightings in a model could make their own auditors investigate according to their perception of the model structure, rather than the actual model outputs. Although not directly in point I this implicitly gives some credence to the view expressed by the author.

Another finding by Veale et al was that:

Similar sentiments were also echoed by individuals in national tax offices, particularly around the ‘trading’ of models by large vendors. One tax analytics lead [X2] in a European country expressed concerns that another less resourced European country was being sold models pre-trained in other jurisdictions by a large predictive analytics supplier, and that they would not only transpose badly onto unique national problems, but that the country interested in purchasing this model seemed unprepared to invest in the in-house modelling capacity needed to understand the model or to change or augment it for appropriate use.

This gives some support for the view that not all jurisdictions have the same requirements or the same training and ability to fully take advantage of the software and may get biased results as a consequence.

A basic problem faced by all taxpayers is the provision in most tax laws that in the event of a challenge to an assessment by the regulator the onus is on the taxpayer to show that the assessment is either incorrect or excessive. With CbCR in operation the regulator must accept as correct the information received from third parties and amend assessments accordingly if appropriate to do so. The onus is then shifted to the taxpayer to show that the amendment should not have been made. On occasion no corresponding taxpayer can be found that matches information received and the issue that the regulator then faces is does it ignore the information or does it assess a taxpayer with a similar identity. The author suggests the latter is the case. Where the amended assessment is issued due to faulty information the taxpayer must often

expend significant time and resources in persuading the ATO of the error in the assessment. These disputes may be such that it may be uneconomical for the corporation to challenge a decision of the regulator as the costs may outweigh any potential benefit.66

KPMG raise the problem that:

Multinationals are also struggling to understand the appropriate narrative to provide in annual country-by-country reports, which will be shared with each of the jurisdictions where they operate, as well as in new transfer pricing master files that are required in many jurisdictions. Confidentiality is the question at hand. How much information will tax officials in foreign countries share, and with whom? Many tax leaders want to control their sensitive data and seek to reveal as little as possible while still achieving compliance.67

Notwithstanding the appeal by the OECD that CbCR information be kept confidential in many countries around the world this is not necessarily the case. MNCs do not know if and to whom or what information will be disclosed. The laws of all countries are not the same. This could include confidential or even secret information about the affairs of the MNC. Further support for this view comes from McCracken who states:

It is therefore crucial to ensure that adequate safeguards are in place to protect taxpayer information; it is also necessary to prevent overly broad or unnecessary information exchanges. In this sense, national authorities should not engage in exchange of information without first satisfying themselves that the requested information will not be used for improper purposes.

Accordingly, as national authorities experiment with new means of gathering and sharing information, they must take care to protect taxpayers’ affairs from misuse both at home and abroad. In this respect, greater access to information should be coupled with greater government transparency. It is hoped that such transparency will lead to increased government accountability.68

66 Ibid.
67 Ibid.
Further not all jurisdictions have the same requirements as to the documentation that must be furnished or the same information to be filed which increases exponentially the risk faced by corporations. Fact A may have a meaning or consequences in Australia but a different one in some other jurisdiction. There are also differences as to timing as to when and what must be reported; the format of such information; and the tests used to establish the validity of the information received. This makes it increasingly difficult for MNCs or members of the group to ensure information supplied in one jurisdiction is compatible and comparable with data supplied in another. A failure of the part of the regulator to appreciate and take this into account in setting their search parameters could lead to an incorrect or biased prediction. The result, the author suggests, is that MNCs and members of the group must: amend their systems and process to ensure it can meet and comply with the most stringent CbCR requirements; and have methodologies available to deal with interactions (both litigious and other) with the regulator.

It seems that MNCs hit by the CbCR will need to try and create some bank of tests to enable businesses to try and understand and if possible anticipate what these regulators may do. Of course, they will not be able to duplicate the algorithm/s used by the regulator but any insights as to the way the regulator operates will be helpful. They would also have to employ data specialists who can advise on the best ways of communicating with a regulator if assessed as being a risk. Ernst and Young note that:

> It also means verifying that they fully understand what is being sourced from the financial systems, how (and why) data transformation is applied and what processes exist to remediate issues — ideally before they occur, through pre-filing analytics testing. When issues do arise, these resources must be ready to act without delay.⁶⁹

Companies must be ready to respond to queries at any time of the income year and not just after a return is submitted to the regulator. This may also be an important aspect on how the

---

tax function in corporations are to be conducted in the future. Dialogue with the regulator should at least at the early stages of an intervention by the regulator be non-adversarial. With all the information currently available to the regulator it seems an adversarial approach would be counterproductive.

Another response to CbCR is to advocate for an enforceable charter of taxpayer rights. Taxpayers generally have limited rights to challenge acts or omissions of the ATO and with the advent of CbCR and the use of data analytic software the risks these entities face of an unlawful use of these tools increases (even unintentionally). To challenge this type of conduct successfully would be difficult.  As Dabner noted context:

Increasing conflicts and fears of overreaching by tax administrators have seen some countries generate taxpayer- specific bills of rights and, indeed, a growth in litigation concerning the exercise of power by tax authorities. Australia has been no exception, but its experience illustrates the limitations of both a taxpayers' charter, unsupported by legislative mandate, and the traditional legal remedies.

The risks faced by directors and corporations increase even further due to increased scrutiny from authorities with reduced response times. In the future the return submitted by taxpayers will still be useful for an original assessment but the increased reliance on third party data and CbCR interacting with data analytic software will play an increasingly important role in identifying taxpayers that require the attention of the regulator. This is irrespective of whether that attention is low key or an audit. On this point Hirschhorn said:

The (Australian) tax office is trying very hard to be more transparent around some of the risk engines and risk factors that it drives around that data and the hope is that companies will be able to self-apply those risk settings so that they can either avoid a dispute or consciously take on a dispute. So coming back to the beginning, I think there’s a whole lot of work to be done, both from a data perspective but probably also

---

70 See for example Inspector General of Taxation, Appendix 2—UNSW report on taxpayer rights in Review into the Taxpayers’ Charter and taxpayer protections, 12 December 2016.


just a fundamental tax-setting perspective before the idea of a push return for large companies can exist. But I do see more and more reliance on natural data and less and less on this bespoke dataset that we call the tax return.73

4 Conclusion

Tax is at subject of much debate and discussion in the public arena. In addition to this the courts and regulators (ASIC and the ATO are but examples) stress how important it is to have adequate and functional corporate (including tax) governance processes in place. A failure to properly have oversight of the tax function and make enquiries when the circumstance require is a breach of a director’s duties under the Corporations Act. A Corporation may be subjected to significant harm if it breaches the tax laws. This harm could be both monetary or reputational or both.

In the circumstances described above a breach of the tax laws would constitute a breach of the duties of good faith, care and diligence under the Corporations Act. This is so especially because the expense, difficulty or inconvenience of taking remedial action to ensure no breach of the tax laws is relatively minor in relation to the magnitude of the risk assumed. If there were a breach of the Corporations Act provisions this would enable ASIC to seek to apply civil penalties or a disqualification order against the recalcitrant director.

The effect of all the forgoing is that MNCs and their directors face increased risks arising from a breach of the tax laws.

These risks are exacerbated with the advent of CbCR and the use of analytics to interrogate the information received so as to furnish an indication of risk. These risks include the following problems: the sources of information available to the regulator include not only CbCR reports but sources such as twitter, linked in Facebook and other public or semi-public

data bases; the increased inability of MNCs to challenge or correct the source or accuracy of information received from via CbCR and other sources; the confidentiality of information; bias either in the manner in which the analytics are programmed or in their use, there is no basis to control the purposes for which this information may be used; and depending on which jurisdiction the information is shared there may be significant security issues around the confidentiality and safeguards around disseminating this information to unauthorised entities.

The consequence of all of the forgoing is that the risks of a corporation breaching the tax laws has increased significantly if they fail in the performance of their duties. This would result in the corporation’s directors becoming liable for action being taken against them under the Corporations Act.
Bibliography

ASIC, Information Sheet 151: ASIC’s Approach to Enforcement (September 2013).


ASIC v Flugge (No 2) [2017] VSC 117.

ASIC v Healey (No 2) [2011] FCA 1003 (31 August 2011).


ASIC v Maxwell (2006) 24 ACLC 1,308.

ATO, PCG 2017/4 ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions, 5 February 2018.


Australian Growth Resources Corp Pty Ltd v van Reesema & Ors (1988) 6 ACLC 529.

Australian Securities and Investments Commission v Cassimatis (No 8) [2016] FCA 1023.


Australian Securities and Investments Commission, in the matter of Sino Australia Oil and Gas Limited (in liq) v Sino Australia Oil and Gas Limited (in liq) [2016] FCA 934.


Circle Petroleum (Qld) Pty Ltd v Greenslade (1998) 16 ACLC 1,577.


Coope v LCM Litigation Fund Pty Ltd [2016] NSWCA 37.

Corporations Act 2001 (Cth) sections 180, 81, 1317E and 1317G.


Deputy Commissioner of Taxation v Clark [2003] NSWCA 91 (1 May 2003).


Executive office of the President of the United States, Big Data: Seizing Opportunities, Preserving Values, May 2014.

FAL Healthy Beverages Pty Ltd and FAL Retail Pty Ltd [2017] NSWSC 476 (27 April 2017).


Hanrahan, Pamela Corporate governance in these ‘exciting times,’ Paper presented to the Corporate Law Teachers’ Association annual conference, Griffith University, Gold Coast, Australia, February 2017.

House, Kimberly A. and Debra Sanders, The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It? (2017) 19 Vand. J. Ent and Tech. L 817.


Khan Properties Ltd v HMRC [2017] UKFTT 830 (TC).


KPMG, Tax insights 2018.


Leeper, Geoff Second Commissioner, People, Systems and Services, Tax administration transformation: Reinventing the AT, Address on behalf of Mr Leeper by First Assistant Commissioner Steve Hamilton to the National Tax Practitioner Conference Sydney, Wednesday, 18 June 2014.

Loughrey, Joan Breaching the Accountability Firewall: Market Norms and the Reasonable Director, 2014 Seattle University Law Review (37) 989.


Productivity Commission, Regulator Engagement with Small Business (September 2013) 272.

Re Caremark Int’l, 698 A.2d 959, 970 (Delaware Chancery, 1996).
Re Walt Disney Co. Deriv Litig, 906 A 2d 27, 67 (Delaware, 2006).


*Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405.

*Stone v Ritter*, 911 A.2d 362 (Delaware Chancery, 26 September 2005).


