

## Dealing with a Tax Office Audit<sup>1</sup>

### They mean business

The Tax Office has selected you for an audit. What do you do?

First of all, don't be distracted from your core business or your life by a process that is lengthy and unpleasant. It isn't going to be easy, but it's important from day one to understand that an audit is part of a dispute between you and the Tax Office. That means that most audits will deal with a specific issue rather than involve a general review of your compliance.

In other words, the Tax Office already believes that you may have underpaid some tax or done something wrong when they first approach you for an audit. The Tax Office only puts resources towards an audit where it perceives a risk to the revenue.

In our experience, the auditors from the beginning tend to take an adversarial role rather than a merely investigative one. This reflects the basic premise of the tax law: it is necessary for the *taxpayer* to show that any assessment of tax made by the Tax Office is excessive.

### Get a tax lawyer

As soon as you find out you are going to be audited, call a tax lawyer - not the usual solicitor who handles wills or conveyancing, but one who is experienced in tax audits (as well as the things that can come after an audit).

Most people turn to their accountant when the Tax Office come calling. That is fine for minor enquiries. However, in an audit there are several reasons why you, and your accountant, would be well advised to allow the matter to be managed by a specialist tax lawyer:

1. Your accountant probably has a good knowledge of tax legislation as far as compliance is concerned, but not much experience in managing disputes with the Tax Office. In an audit it is important that your adviser should understand the rules of evidence and court procedure. To persuade the auditors that your view of the law is correct, you must be able to show them why any contrary view would fail before a court or tribunal
2. The audit will often turn upon advice provided or action taken by your accountant. This may put the accountant in an invidious position and lead to a possible conflict of interest if there is not a third party to manage your interaction with the Tax Office during the audit. Your accountant could also be a witness in your case, and may need to remain at some distance from the dispute with the Tax Office so as to maintain the integrity of any evidence that he or she may give

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<sup>1</sup> Nothing in this article should be construed as advice without first consulting your legal practitioner  
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3. If you need to negotiate a settlement with the Tax Office, a solicitor can do this on a 'without prejudice' basis. This means that the content of such negotiations cannot be raised by the Tax Office in any subsequent court case, and
4. The communications between a lawyer and client can be subject to legal professional privilege (LPP). The Tax Office cannot compel a lawyer or client to divulge the contents of communications (including documents) that are subject to LPP. The Tax Office has the discretion to extend a form of LPP to communications between clients and their accountant, but in our experience this discretion is not often exercised.

Of course it is always necessary to keep your accountant as part of the team dealing with the Tax Office, primarily for the supply of information and for technical support. We often advise clients to use another Partner in the accounting firm as the member of the audit team (and as the client's day-to-day accountant) for the duration of the audit rather than the accountant with whom the client usually deals. This ensures the independence of the original accountant if he or she needs to be called as a witness.

It is always wise to ensure that your lawyer is the first point of contact with the Tax Office during an audit. This ensures that you always have time to consider the answer to any questions put by the Tax Office. It can also take some of the heat out of your dealings with the Tax Office.

### **What if the Tax Office is right?**

If you know (or suspect) that the Tax Office is right about the issue to be audited, be candid with your solicitor about this. It is much easier for your solicitor to negotiate a reduction in penalties and a favourable settlement if a taxpayer makes an admission as early as possible. Recently, we had two cases on the one issue where one client admitted first up that he had done the wrong thing. He got a very favourable settlement and the penalties were reduced to a very low amount. The other taxpayer only (finally) admitted after a year that he had underpaid tax. The Tax Office did not provide such favourable terms to the second taxpayer because of the length of time he took to ask for a settlement.

Even if you believe that your view of the law is correct, you can always negotiate a settlement with the auditors. Generally this will mean that you will pay some tax and some penalty, but the Tax Office has some discretion to reduce the payment so that it would be a lot less than it would be if you were unsuccessful in a court challenge. As noted above, if you conduct settlement negotiations through your solicitor, then such negotiations can be on a 'without prejudice' basis.

### **Tax Office methods of gathering information**

Usually the first step in an audit is a request for information to be supplied voluntarily. This gives the taxpayer a chance to make a voluntary disclosure of any underpayments and to reduce substantially any penalties that may be payable.

In our experience, it is usually wise for a client to provide the information requested. However, this should be done with care. In several cases, a client has decided that it is not necessary to take much

advice before providing information and making statements to the Tax Office early in the audit process. This led to complications later on, because the client didn't understand the terms used by the Tax Office or because the Tax Office misunderstood what the client said. Clients are well advised to seek their lawyer's advice before providing *any* information or explanation to the auditors.

In some cases, if enough care is taken with the answers to these first informal requests for information, it can result in the Tax Office calling off any further action.

The Tax Office has extensive formal information gathering powers. They can issue a notice to anyone they believe has information that is pertinent, calling for documents and evidence. Not obeying these notices is an offence that carries heavy penalties.

In some cases the Tax Office will visit your business premises (or those of your accountant) without notice. You should always ask to see the auditor's authority, and a copy of the notice under which the site visit is being made. If you or your accountant is formally requested to provide documents then it is compulsory to supply those documents. The only exception will be documents that are subject to LPP or to accountant's privilege. However, whether accountant's privilege applies is at the Tax Office's discretion. Even where the auditors attend your premises at a pre-arranged time, it is a good idea to have your lawyer present.

In our experience, the Tax Office will often undertake a site visit more than once during the course of an audit. In later visits, the Tax Office will often wish to see documents relating to a client's discussion with advisers about the audit. If your adviser is a solicitor, then LPP will apply to prevent the Tax Office obtaining such documents. Such LPP might also extend to communications between the lawyer and the accountant.

The Tax Office can require you to attend interviews at their office and answer questions under oath or affirmation. In these interviews, you must answer all questions put to you and have no right to avoid self-incrimination. We strongly advise that you have a lawyer present in these interviews to ensure that you do not do anything more than answer the questions put to you. For example, in many interviews we have attended with clients, the tax officer has made a lengthy statement which is really an assertion of fact and not a question. The officer will then leave a pause, in an attempt to get the taxpayer to make a statement in response to the assertion. At this stage either the client or the solicitor should point out that the assertion put forward by the officer is not a question. The client is not required to make any response to a statement, only to a question. Pointing this out gives the client time to consider the issue whilst the tax officer reframes the assertion as a question.

In fact we would argue that in all discussions with tax officers during an audit, taxpayers should try as hard as they can to answer questions only and not respond to assertions of fact.

The Tax Office has sophisticated data matching tools to detect fraud. This data matches data including bank interest, property rentals, share transactions, real property transfers and money transfers. In one

of our recent cases, a senior auditor in the Tax Office mentioned in a phone call that the Tax Office was aware that the client had put his house on the market a few days before. The Tax Office also uses industry benchmarks to help detect variances in some tax returns compared to others in the same industry. The powers and skill of the Tax Office to detect tax shortfalls should not be underestimated.

### **Once the information is gathered**

After the Tax Office has gathered the information it has sought, it will generally take some time to interpret it and reach a view on the application of the law. If the Tax Office's conclusion from the information gathered is that you owe additional tax, then it will usually send you a 'Position Paper' which sets out the facts, the reasons why tax has been underpaid, the amount of tax owing, the penalty that will be imposed and the interest due.

You are then given a period between 2 - 4 weeks to respond to the Position Paper if you wish to do so. Whether you respond to the Position Paper depends upon the circumstances, but taxpayers should take into account that it is wiser *not* to provide information or even arguments to the auditors unless there is a real opportunity to persuade them to change their position. Alternatively, it may serve your purposes better if you and your lawyer discuss the issues with the auditors in a meeting or a telephone call. In this way you can concentrate on the main issues more effectively without having to provide a complete answer to every assertion set out in the Position Paper.

After further submissions, in some cases the Tax Office will accept that the taxpayer's arguments are correct and will take no further action.

Alternatively, the Tax Office may raise amended assessments based on the Position Paper. In that case, the taxpayer has to consider whether an objection should be lodged with the Tax Office against the amended assessments. This process can take some time.

### **The main message**

Call a lawyer, one who specialises in tax matters. Let them do what they do best: speak on your behalf and be the first point of contact for enquiries on the Tax Office audit. By using the appropriate adviser, you may find that the whole audit process is nowhere near as lengthy, unpleasant and costly as it might be otherwise.