

Chapter 10

Tax Compliance by the Very Wealthy: Red Flags of Risk

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The issue of detection of tax evasion and avoidance is no small challenge for tax authorities. Oftentimes detection depends on extensive auditing. The ambiguity and difficulty of the task has led tax authorities to devise risk management strategies so that they can dedicate their limited resources to detection exercises that are likely to uncover instances of evasion or aggressive avoidance. The process of identifying a set of red flags that alerts tax officers to aggressive tax planning is the focus of attention in this chapter. We illustrate how a statistical methodology can be deployed with subjective estimates of risk made by expert analysts and more objective data in the form of dollars at risk.¹

The High Wealth Individuals (HWI) Taskforce

In 1996, the Australian Taxation Office (ATO) established a High Wealth Individuals (HWI) Taskforce to enhance compliance management for HWIs. It did this in a way no other tax authority in the world has done before to our knowledge. Traditionally, tax authorities treat individual persons and corporate entities (partnerships, trusts, corporations) as separate taxpayers in their case management. The innovation of the HWI Taskforce was to treat the individual return of a HWI and the entities they control as a single case. In the first year of operation, 180 HWIs received a questionnaire about the groups of entities they controlled, or from which they received income. These were formalised in subsequent years into expanded returns, called Current Year Data Collection (CYDC) returns. In 1997 and 1998, 285 HWIs (142 rated as medium overall risk and 143 high overall risk) were required to complete expanded returns for their 2371 and 2599 associated companies, trusts, partnerships, or individuals. The level of these individuals' wealth, and the amount of tax they paid, to qualify for this level of scrutiny is confidential. However, all those completing expanded returns are extremely wealthy.

The HWI program seems to have increased the amount of tax paid by HWIs. In 1994 and 1995, the two years before the program was set up, private companies controlled by individuals in the program paid 17 per cent and 12 per cent less tax than non-HWI companies respectively. Afterward, HWI companies paid 23 per cent more than non-HWI companies in 1996 and 20 per cent more in 1997

(Braithwaite, 2001, p. 13). It is believed that this is because HWIs are generally more cautious with their tax affairs when they are under the microscope of the HWI program:

It's the constant surveillance of being on the program that causes compliance...Part IVA is of indeterminate width. It might be applied more aggressively in future. So I advise clients to be careful.

Asking the question and getting them to focus their mind on where everything is had an impact.

(HWI advisers quoted in Braithwaite, 2001, p. 10.)

Another adviser suggested that 'the more information he's [the Commissioner] got, the less aggressive they will be in their tax planning'. What was meant by this comment was that through notifying the Commissioner of 'X' in 1998, taxpayers reduced their degrees of freedom to re-configure their 1999 affairs in such a way that not-X appeared to be the case in 1999. Changes from year to year will be noticed, so HWIs must keep their affairs consistent with the underlying truths of earlier declarations. Also the more holistic approach of HWI program surveillance means there is a need to work harder at keeping the story about one HWI entity's tax affairs consistent with that of another (Braithwaite, 2001, p. 11).

The Risk Ratings

The data in this report are based on risk ratings of 207 potential risk issues identified from 1997 and/or 1998 tax returns for 235 individual HWIs and the entities they control.

ATO analysts might examine as many as 100 expanded returns from all the entities controlled by a HWI, and then in theory rate each of the 207 potential risk issues from 0 to 10. These ratings are estimates of indications of risk; that is, there is no guarantee that there really is a high risk. Usually an audit would be needed, sometimes even litigation, to establish if the risk was a reality.

As with all risk ratings, the rating estimates used as the basis for this report were checked by a supervisor who may have revised them. For the highest risks, senior taskforce staff would also meet to discuss the analyst's assessment.

Most of the potential risk issues were not recorded or rated for each HWI. In fact more than half the HWIs in the database had less than ten rated issues. The maximum was fifty-one, and the minimum was one.

This report is concerned with high risk ratings. A rating of 1-3 was defined by the taskforce as a low risk, 4-7 as medium, and 8-10 as high. The defining features of a score of more than 7 in the instructions to analysts are indications of aggressive tax planning 'like significant loss creation', followed by a list of other types of aggressive tax planning or 'further information desirable and would suggest audit action'. Judgments about what is aggressive tax planning are controversial and subjective² and there are many reasons to suspect risk ratings as

unreliable.³ In the first part of this report we accept these subjective judgments at face value and use them to predict several criteria of overall risk of the HWI and the entities they control. We then test if the ‘objective’ criterion of dollars at risk adds any additional information to the more ‘subjective’ assessment of risk.

The list of 207 potential risk issues used in this analysis has been until now highly protected. While not all issues are identified specifically, it is now possible to release results that reveal at least the issues that turned out to be important in these analyses. The collection of risk ratings, which are the basis of these analyses, has now been suspended and superseded, so the definition of issues discussed in this chapter does not provide useful information to tax advisers. Even at a more conceptual level, some of the issues, which we find to be serious risks for 1997-98, are no longer risks as a result of tax reform.

Our objective with this research is not to revise a list of 207 risk issues that have already been revised, but rather to seize the unique opportunity the data provides and to explore the kinds of risk factors that predict the existence of the highest levels of overall risk. That is, what are the issues which, when rated as an indication of high risk, are a red flag for the existence of many other high risks to the revenue?

What are the Most Common High Risks for HWIs?

Analysts rated risks in comparison with other HWIs, not general taxpayers. If this were not the case, virtually all HWIs would have attracted a large number of high risk ratings based simply on their wealth, income levels, and the complexity of their business dealings. This outcome would have been unproductive for determining where the greatest risks lay. As a result, and because not many issues were rated by analysts, it is rare for a HWI to be given a risk rating over 7 on one of the 207 issues.

Table 10.1 shows the 13 issues most commonly given a rating greater than 7. In addition, the ratings of the 235 HWIs on each risk have been averaged and appear in the second column alongside the number of HWIs scoring in the extreme categories. While these statistics suggest a somewhat different ordering of risk, priority tends to be given to use of extreme categories rather than average rating. Tax authorities are more interested in the extreme risks than in average risks, as they only have the resources to deploy audits and other strategies against the highest risks.

The most common risk issue, rated over 7 in only 12 cases, was the utilisation of revenue losses (as opposed to capital losses) through transfers within the HWI’s group of entities – moving losses to a taxable entity to save tax for that entity (Issue 1, Table 10.1). The second most common high risk was the use of an offshore entity (company, trust, partnership) in an unlisted (that is, low taxed)⁴ country (Issue 2, Table 10.1).

There are seven instances of revenue loss creation via research and development (R&D) deductions (Issue 5, Table 10.1). R&D investment receives a concessional tax treatment and has traditionally been used in tax minimisation

arrangements (Issue 6, Table 10.1). There are seven instances of ‘taxable distributions to a loss entity’, which is the inverse of transferring a loss to a taxable entity. The term ‘distribution’ means it is limited to trusts in this instance.⁵ If used unscrupulously a loss can be transferred a number of times and can be used in each entity it passes through. This is known as ‘loss cascading’ and has been considered a serious risk to the revenue.

There are eight cases of ‘debt forgiveness/bad debts’ (Issues 3, Table 10.1). This technique can be used to create a revenue loss within a group of companies. If one company fails to repay a loan, the company that made that loan can claim it as a bad debt for tax purposes. A bad debt is tax deductible, and, when deductions exceed income, a loss is created. An ‘asset disposal’ can create a capital loss if the asset is sold for less than the purchase price. Purchase price can be manipulated when the same person ultimately owns the company that is selling the asset and the company that is buying the asset. In this way an artificial, and tax deductible, capital loss will be created within the group with no corresponding economic loss to the taxpayer. There are also eight instances of ‘other significant deduction issues’ (Issue 4, Table 10.1). These ‘other issues’ will be discussed later in this chapter.

Table 10.1 also shows the recorded mean dollars at risk (e.g., the dollars transferred within the HWI group) for each of the common high risk issues. The dollars at risk are the maximum dollars at risk in either 1997 or 1998. Note this is not the dollars at risk when the risk was rated over 7; this would be a higher number. The mean dollars at risk number is the mean dollars at risk for this risk across all ratings of risk from 1 to 10 (regardless of whether it was high or low). Note also that the mean dollars at risk will include zero entries if they are recorded. However the value of zero may mean no dollars were at risk or that the analyst did not know the dollar amount for some HWIs or the entities they control. The high value of \$46 million for those placed in the miscellaneous ‘other’ category is significant and will be interpreted later in this chapter.

Table 10.2 shows the issues with the highest mean dollars at risk across all 207 issues (as opposed to just the highest risk issues). Transfer of trading stock has an average of \$379 million at risk. This could be indicative of a transfer pricing issue, but there are only three HWIs with recorded dollars at risk for this issue. In general, the estimates of the mean dollars at risk should be treated with caution. For example, if an entity is only partially controlled by a HWI there is a possibility that the analyst has included only a portion of the actual risk.

Table 10.1 Most common high risk issues

Issue	No. HWIs with risk rating > 7	Mean risk rating	Mean dollars at risk (\$AUS)
Revenue loss utilisation via intra group transfer (1)	12	4.12	\$4 328 670
Use of offshore entity in an unlisted country (2)	8	4.40	-
Revenue loss creation via debt forgiveness/bad debts (3)	8	4.21	\$5 416 922
Miscellaneous income and deduction items – other significant deduction issues (4)	8	4.04	\$4 540 784
Revenue loss creation via research and development deduction claims (5)	7	5.76	\$3 332 722
Trust distributions – taxable distributions to a loss entity (6)	7	4.14	\$5 492 180
Other miscellaneous items – disposal of significant capital item in review period (non-assessable profit) (7)	7	3.93	\$15 843 564
Evidence of value shifting or unusual transactions – means of minimising income tax in group (8)	6	5.22	-
Other miscellaneous items – other (9)	6	4.27	\$46 153 472
Evidence of value shifting or unusual transactions – means of minimising capital gains tax in group (10)	5	5.62	-
Group restructure due to significant new ventures (11)	5	4.24	-
Trust distributions – distributions from capital profits reserve (12)	5	4.63	\$3 315 175
Trust distributions – capital distribution in cash (to the HWI) (13)	5	4.73	\$1 196 229

Table 10.2 Issues with highest mean dollars at risk

Issue	No. HWIs with risk rating > 7	Mean risk rating	Mean dollars at risk (\$AUS)
Related party transactions with an entity in an unlisted country – transfer of trading stock	0	7.00	\$379 333 333
Other miscellaneous items – other	6	4.27	\$46 153 472
Other miscellaneous items – finance/treasury issues	2	6.25	\$34 848 766
Capital loss creation via cost base manipulation	0	5.33	\$22 782 914
Related party transactions with an entity in an unlisted country – transfer of assets/property	1	4.20	\$21 222 264
Evidence of dividend streaming within group companies	0	3.67	\$17 485 377
Related party transactions with an entity in a listed country – granting of guarantees	0	1.00	\$17 382 600
Trusts – use of beneficiary loan accounts (loan source unknown)	3	4.28	\$16 152 070
Other miscellaneous items – disposal of significant capital items (non-assessable profit)	7	3.93	\$15 843 564
Companies – use of shareholder loan accounts (loan source is HWI)	4	3.19	\$10 579 077
Capital loss creation via property development/industry	1	3.26	\$10 318 261
Significant franking credit surplus in group	0	3.33	\$9 464 742
Related party transactions with an entity in an unlisted country – interest income	1	2.57	\$9 186 641

Predicting High Overall Risk

The initial objective was to use a cluster analytic procedure on the HWI risk factors to show which risks went together, in hope of revealing systemic risk factors that

were underpinning a variety of seemingly unrelated risks. It was thought that risk clusters might be particularly useful in targeting types of specific purpose audits. For example, risk cluster A should get audit product X; risk cluster B, product Y; and so on.

Unfortunately, it eventuated that cluster analysis was inappropriate because, as described above, high-risk ratings are rare events with joint occurrence of any two specific high risks being even lower. In fact there are only two pairs of issues on which four HWIs are both rated as a high risk; all the other pairwise combinations have fewer HWIs sharing a high risk on both issues.

Thus, cluster analysis and other pattern finding methodologies are inappropriate for this data set where the emphasis is on high risk. Empirically this suggests that if a 'risky' taxation strategy is measured as a combination of issues assessed as high risk, then these strategies tend to be unique to each HWI or rather shared by very few HWIs.

Due to this finding, the analysis shifted to identifying specific risks that are the best red flags for high overall risk. A 'high' overall risk assessment is defined with a clear action orientation. It means the analyst and their supervisor agree that, all things considered, the application of some kind of audit product is justified. Being placed in the high overall risk category is still a rare event. This characterised only thirty-three HWIs (14%). There were six HWIs who were not assessed as being in either a high, medium or low risk category. They were treated as not a high risk and included with medium and low risk HWIs for the purpose of the following analysis.

Table 10.3 shows the summary from a logistic regression analysis predicting high overall risk. The independent variables in the model are the 207 issues coded as 1 for a high risk (that is a rating greater than 7) and zero (that is a rating of 1 to 7). Issues coded like this are referred to as flags to differentiate them from rated issues. Because of the interest in choosing a minimum set of 'flags' we chose a stepwise algorithm, which selects the best predictor of likelihood from amongst the 207 flags, then the second-best after the first-best has been included, and so on. The stopping criterion is when the addition of further flags does not sufficiently increase predictability of membership into the correct risk group to warrant the added complexity. A scree slope test based on the percentage correctly predicted was used to define this stopping point. Thus we attempted to balance statistical and practical significance.

The first predictor of high overall risk is being rated over 7 in the 'other miscellaneous items – other' category (Issue 9, Table 10.1): The potential meaning of this finding is discussed in the next section.⁶ The issue rated over 7 with the next most predictive value in this model is 'use of an offshore entity in an unlisted country' (Issue 2, Table 10.1). We might assume that ratings over 7 will mostly be incurred when there is concern that the unlisted country is a tax haven. The third most useful predictor is 'trust distributions – capital distributions in cash (to the HWI)'⁷ (Issue 13, Table 10.1). Various other analyses were undertaken to confirm the stability of these results, and this flag also turned out to be important in these supplementary analysis. For example, 'trust distributions – capital distributions in cash (to the HWI)' is the top predictor in a model predicting the sum of all risk

ratings (0-10) across all 207 issues. Indeed all three flags in Table 10.3 are recurrently useful and statistically significant predictors across different types of analyses. Column two in Table 10.3 shows the Likelihood Chi-square statistic for the inclusion of the flag at each step of the model building process. Beyond this set of flags, the increase in correctly predicted high risk HWIs was small (even though other flags subsequently entered into the model were statistically significant).

The percentage in the fifth column of Table 10.3 shows that with information about whether or not each of these three issues is rated over 7 (and with no other information about the case), we can correctly classify the case as High or not-High 91.9 per cent of the time. Of the 202 HWIs in the low to medium risk group, 201 were correctly predicted. Of the 33 HWIs in the high risk group, 15 were correctly classified into the high risk group.

Table 10.3 Predicting high overall risk with flags* using logistic regression analysis

Step	Chi-square	df	Sig.	% Correctly Classified	Flags
1	24.557	1	0.000	88.5%	Other miscellaneous items – other
2	21.402	1	0.000	90.6%	Other miscellaneous items – other Use of an offshore entity in an unlisted country
3	14.894	1	0.000	91.9%	Other miscellaneous items – other Use of an offshore entity in an unlisted country Trust distributions – capital distribution in cash (to the HWI)

* A flag is a risk from a list of 207 possible risks that an analyst rates over 7 on a risk scale from 1 to 10.

While it may seem obvious that these would be crucial issues, there may be any number of sets of completely different issues that would generate the same reaction. The question is which of the 207 risk issues we really would have selected as the top three predictors of overall risk. In our experience, auditors have hunches about red flags of risk that are in no way confirmed by these data. Some auditors believe that the use of a company controlled by a wealthy person to own a luxury yacht, a holiday home, or a racehorse is a red flag. Although there is some support for this view from the data, knowledge of risk on any of these items classifies only two HWIs in the high risk group. Given the time it takes to get on top of the complexity of cases such as these groups of HWI entities, even very senior analysts may have a remarkably narrow scope of experience. While their supervisors might have greater breadth of experience built by approving the analyses of others, they lack the depth of experience of the analyst who has pored

over the case. Hence a method that takes at face value that depth of experience, but aggregates it over the breadth of (235) cases, is valuable. Although less obvious, use of statistical reasoning can also produce results which are important though less intuitive.

Proxy Analyses for High Overall Risk

Although the three flags shown in Table 10.3 are statistically significant and useful in correctly predicting about half the HWIs in the high risk group, it is important to test if alternative sets of flags work equally well. There are many methods of looking for subsets. The method employed here is to remove the most significant from the potential set of flags used to predict high risk and to repeat the analysis. Then the most significant flag from this analysis is removed from the potential pool of flags as well, and so on. This iterated method also identifies the best predictors of high risk when used on their own as the first step in the analysis. Further, there is the advantage of excluding the ‘other miscellaneous items – other’ issue (Issue 9, Table 10.1) from the potential pool of flags, since having a miscellaneous ‘catch-all’ issue as the best predictor of high risk can be difficult to interpret.

When ‘other miscellaneous items – other’ was excluded from the potential pool of flags, ‘use of an offshore entity in an unlisted country’ (Issue 2, Table 10.1) became the top predictor, followed by ‘other significant deduction issues’, a subheading of ‘miscellaneous income and deduction items’ (Issue 4, Table 10.1). Interestingly, a slightly more specific catch-all issue has been substituted for another category of catch-all issues. ‘Trust distributions – capital distributions in cash (to the HWI)’ (Issue 13, Table 10.1) remained the third most significant predictor once these other flags were included (see Table 10.4). When ‘other miscellaneous items – other’ and ‘use of an offshore entity in an unlisted country’ were excluded from the pool of potential flags, ‘trust distributions – capital distributions in cash (to the HWI)’ became the top predictor, followed by ‘miscellaneous income and deduction items – other significant deduction issues’ (again) and another issue that looks like a proxy for ‘use of an offshore entity in an unlisted country’, that is, ‘evidence of funds coming onshore irregularly’ (as opposed to ‘regularly’). This is not one of the most common high risk issues and therefore does not appear in Table 10.1.

When ‘trust distributions – capital distributions in cash (to the HWI)’ was removed from the pool of potential flags the ‘utilisation of revenue losses via intra group transfers’ (within the group of HWI entities) (Issue 1, Table 10.1) became the top predictor.⁸ This means moving losses from one entity controlled by the HWI to wipe out or reduce the profits recorded in another entity that it controls (or vice versa), so that tax does not have to be paid on these profits.

Three new ‘other’ issues became the next best predictors of high risk: ‘group structures – use of multiple entities (other)’, ‘group structures – evidence of value shifting/unusual transactions in group (other)’ and ‘other miscellaneous items – disposal of significant capital items (non-assessable profit)’. In our first proxy

analysis an ‘other’ variable is replaced by a different ‘other’ variable. When this second ‘other’ is deleted from the analysis, two different kinds of ‘other’ variables are prominent in alternative sets 2 and 3. In short, as we delete one ‘other’ variable, another keeps popping up across all the proxy analyses. There is a stable ‘other’ effect.

Given also that Tables 10.1 and 10.2 show that the amount of money at risk in these ‘other’ issues is high, there is too much evidence to ignore this ‘other’ effect in an analysis of high risk and we need to consider whether there is some potentially explanatory meaning behind their significance. The four best predictors of overall high risk on their own (without entering other flags into the analysis) are ‘other miscellaneous items – other’, ‘use of an offshore entity in an unlisted country’, ‘trust distributions – capital distributions in cash (to the HWI)’, and the ‘utilisation of revenue losses via intra group transfers’.

Table 10.4 Predicting high overall risk with flags* using proxy analyses

Alternative set 1 with 91.1% correctly predicted	Alternative set 2 with 90.6% correctly predicted	Alternative set 3 with 89.4% correctly predicted
Use of an offshore entity in an unlisted country (Issue 2)	Trust distribution – capital distribution in cash (to the HWI) (Issue 13)	Revenue loss utilisation via intra group transfers (Issue 1)
Miscellaneous income and deduction items – other significant deduction issues (Issue 4)	Miscellaneous income and deduction items – other significant deduction issues (Issue 4)	Other miscellaneous items – disposal of significant capital items in review period (non-assessable profit) (Issue 7)
Trust distribution – capital distribution in cash (to the HWI) (Issue 13)	Evidence of funds coming onshore – irregularly	Group structure – use of multiple entities (other)

* A flag is a risk from a list of 207 possible risks that an analyst rates over 7 on a risk scale from 1 to 10.

Other Risks and the Evolutionary Ecology of Tax Planning

As would be expected with more than 200 possible risk labels, the number of HWIs rated above 7 in the ‘other miscellaneous items – other’ category is very small – only six HWIs. But all six have been assigned to the high risk group. This is very high when the probability of being in the high risk group for the whole data set is only 0.14. The Chi-square test of independence has a significance of less than five in a million that this result would have occurred by chance. One source of

error in this calculation is that two HWIs who were related were both rated high for seemingly the same issue and thus independence is questionable. However, the test would still remain very significant with the removal of either one of the relatives. Examination of the data also showed that the two HWIs who had the highest number of 'other miscellaneous items – other' type issues rated as a high risk were the two HWIs who also had the two greatest numbers of high risks. Overall 8 per cent of the 207 issues were labelled as 'other' type issues and they were rated as a high risk 11 per cent of the time.

It is surprising that when more than 200 issues have been created to define the most important risks, some of the most worrying fall outside that list. This could be due to limitations in the type of risks included on the original risk identification form, or to the way analysts complete the form. For instance, they may have been confused by the way that their instructions conjoin 'further information desirable' with 'and would suggest audit action'. If insufficient information were available to properly assess an unusual issue they would be obliged to rate it as a high risk. Yet perhaps this unexpected outcome is not so surprising given the very nature of aggressive tax planning. Tax planning at its most aggressive is also at its most creative and entrepreneurial. The strategies that everyone, particularly the ATO, knows about will not be the most lucrative. When everyone is into the same aggressive tax planning strategy, the strategy will be highly visible and will draw the fire of the ATO. This will cause the smart money to move into more boutique strategies, and is a similar effect to the evolutionary ecology of predation in nature. While there are certain strategies of predation that can each inhabit a strong niche for predation, if all predators jumped into the same niche some would perish. It is thought that a new predation strategy is more likely to persist if it is different from that already used by other predators competing for the same resource (Cohen and Machalek, 1988). That is, under this scenario, the most successful strategies are the most idiosyncratic. Similarly with tax planning, the best tax planners are game players who are always coming up with new angles or games.

There is no single best strategy that all the smart money gravitates towards. ATO analysts commonly identify a set of strategies, which could be conceived in an evolutionary ecology of tax planning as standard niches, each of which support a lot of players. In Australia in recent years these have included: (a) redefining income as capital by the use of multiple trust structures that conceal a common controlling mind; (b) creating artificial losses (e.g., by acquiring companies or trusts with accumulated losses); (c) disguising distributions to HWIs and family members as loans and other non-taxable benefits; (d) using off-shore trusts; (e) converting activities undertaken for private pleasure into tax losses (e.g., pleasure craft, horse breeding and racing); and (f) using charitable trusts to disguise benefits to HWIs and their families. Aggressive tax planning is to a degree recurrent and patterned into the above standard forms.

However, it is also true that its leading edge is about finding new niches that are maximally lucrative because no one else is exploiting them and no law enforcers are watching them. At its most sophisticated, this leading edge involves engineering completely new financial products, mutations that are not covered by existing tax law (Tanzi, 2000). Faced with this evolution of tax planning, the belief

that most aggressive tax planning in Australia is patterned into such stable and predictable niches could lead analysts to miss tax planning niches which pose the highest risk to the revenue. This could explain why a high risk under ‘other miscellaneous items – other’ would be both predictive of high risk overall and associated with maximum dollar amounts.

Is there evidence from the case files to support the notion that the ‘other miscellaneous items – other’ category, when rated as a high risk, indicates an innovative strategy, or was it rather that the analyst ‘sensed’ a risk not adequately covered by the predefined issues? Two cases were picked up by Penny Gilson of the HWI Taskforce with narratives identifying risks that could have (perhaps should have) been classified under one of the 207 risk categories. Without going back to the analysts and asking them to reconstruct their reasoning it is hard to be sure that they did not see an important additional risk that was not adequately captured by the pre-defined risk issues. One case narrative has, on the face of it, a jumble of concerns that seem over-rated and that suggest a lack of information more than systemic risk. Examples are:

Overseas borrowing – group entity claimed deduction of \$218 000 for interest paid to a Swiss financier.

Share trading – a group trust received substantial number of company X shares in float. Media reports indicate HWI made substantial profits through the sale of company X shares. Trust accounts do not reflect this amount.

While the first example involves a small amount of money we do not know whether the analyst knows something about this financier that causes the high risk rating. Perhaps the second example represents a kind of turning over of a seemingly inoffensive rock where something dangerous lurks. Perhaps the whole list of ten ‘other’ concerns conceals a detective’s intuition about an inchoate underlying pattern of risk. We cannot be sure either way.⁹ For example, the HWI Taskforce staff suggested that in trying to make sense of losses, analysts might well say: ‘There’s a big loss but I’m not sure of the source. I’ll put losses down as a risk. There is something else going on so I’ll record it in the ‘other’ risk category. The case looks like a high risk overall. I’ll get to the bottom of it when I audit them’. At the very least, we should read the strong predictive power of ‘other miscellaneous items – other’ as a caution about relying wholly on pre-defined risk issues for identifying aggressive tax planning. Rather, it encourages intuitive detective work to follow risks that fall between the cracks.

Predicting the Total Number of High Risk Issues

An alternative definition of high risk is the number of issues where the 1 to 10 risk score exceeds 7 for a HWI. The question then becomes: if a particular risk issue is rated over 7, how many risk issues in total will be rated over 7? This is just another way of testing whether the existence of one kind of risk is a red flag for many different risks. We use a similar algorithm to that used for predicting high risk. The

estimation procedure is ordinary least squares, and residual analysis was carried out to test the validity of assumptions important in this situation. Since the dependent variable in the model is a composite of all the potential independent variables (the flags) there is no attempt to use the statistical tests commonly associated with this type of modelling. The issue which when rated greater than 7 accounts for the most variance in this alternative definition of risk is included in the model first. Then the flag that accounts for the greatest proportion of the remaining variance is included, and so on until the amount of additional variance explained does not increase much relative to that already explained. The size of this change is determined by a scree slope test using R^2 .

The top predictor with this flag analysis is 'capital loss creation via by asset sales' (see Table 10.5). The second predictor is 'trust distributions – taxable distributions to a loss entity' (Issue 6, Table 10.1), another trust distributions issue. One of these issues is about creating losses and the other about shifting losses. This is the game of creating or buying losses and then avoiding tax by shifting value that would otherwise be taxed into an entity that has losses, thereby cancelling out their value. The number three predictor of the model in Table 10.5 is 'group restructures – significant new ventures' (Issue 11, Table 10.1). This will often be rated as a risk because when new ventures are undertaken new entities are created that may be significant in terms of scale or in terms of moving offshore, or new in terms of being a new type of business for this group. Analysts may see reasons to worry that they may be connected to an aggressive tax planning scheme in the particular case.

Table 10.5 Predicting the total number of high risks with flags* using ordinary least squares regression analysis

Model	R^2	Flags
1	0.38	Capital loss creation via asset sales
2	0.55	Capital loss creation via asset sales Trust distributions – taxable distributions to a loss entity (Issue 6)
3	0.67	Capital loss creation via asset sales Trust distributions – taxable distributions to a loss entity (Issue 6) Group restructures – significant new ventures (Issue 11)

* A flag is a risk from a list of 207 possible risks that an analyst rates over 7 on a risk scale from 1 to 10.

When proxy analyses are used with this alternative definition of risk, the conclusion is that little additional insight is afforded. 'Investments held off-shore in a listed country' is the top predictor if 'capital loss creation via asset sales' is removed from the potential flags. Unfortunately it may not be of practical significance as a red flag since only one HWI was rated a risk (greater than 7) on

this issue. However not only was this HWI rated a high risk, they had the highest number of high risks (31); just over one and a half times their nearest competitor (19) in terms of the number of high risks!

The three best predictors when used on their own are ‘capital loss creation via asset sales’, ‘bank accounts and investments held in a listed country’ and ‘trust distributions – taxable distributions to a loss entity’, each accounting for approximately the same proportion of variance in the dependent variable.

Using Dollars at Risk on a Specific Issue to Predict High Overall Risk

A comparison of Tables 10.1 and 10.2 shows that the most common high risks are not the most costly high risks necessarily. Consequently, instead of using flags, the next set of analyses use dollars at risk (see Table 10.2) on each of the 207 specific issues to predict high overall risk and number of high risks. Table 10.6 shows the significant issues included in a model using dollars at risk to predict the probability of an overall high risk. As before, a forward stepwise logistic regression algorithm is used. However, issues were added to the predictive set until the likelihood ratio test for their inclusion was not significant. The analysis includes the implicit assumption that no dollars are at risk if a value is not recorded. This may not always be correct. The logistic model including the dollars at risk for the issues in Table 10.6 correctly predicts approximately 95 per cent of the HWIs into their overall risk group. If we used a scree test slope as was done earlier, only three issues would have been shown and the percentage correctly predicted would have been 90.2.

Most of the issues that make it into the final model at the conclusion of this chapter (see Table 10.8), based on the subjective risk ratings, do get some support from the more objective risk ratings data in Table 10.6. Having involvements in an offshore-unlisted country has multiple entries in Table 10.6. Trust distributions also feature in Table 10.6. ‘Trust distributions – capital distributions in cash (to the HWI)’ is the second highest objective predictor.¹¹ ‘Utilisation of revenue losses via intra group transfers’ is also present. Capital loss creation does not appear nor does ‘other miscellaneous items – other’. Dollars at risk recorded in ‘capital loss creation by asset sales’ and ‘other miscellaneous items – other’ are actually significant predictors of high overall risk, but they are not as important as some of the others, nor are they as important in adding additional predictive information once some of the other issues are included in the model. All the HWIs who were given a *high* risk rating on ‘other miscellaneous items – other’ had zero or no dollars recorded, so it is not surprising this issue is not amongst the best.

There is interest also in issues from the list of 207 that crop up in the dollar-based analysis that are not in the top predictive sets for the subjective rating analyses. The number three predictor in Table 10.6, ‘property held offshore in a listed country – real estate’, is an interesting one. It was also one of the best independent (stand-alone) predictors of high risk when measured as the number of risks greater than 7, but it did not outweigh the other predictors in Table 10.7.

Table 10.6 Predicting high overall risk with dollars at risk using logistic regression analysis

Step	Chi-square	df	Sig.	% correctly classified	Dollars at risk for issues
1	15.622	1	0.000	87.7%	Trust beneficiary loan accounts – credit balance and no draw-downs ¹⁰
2	12.540	1	0.000	88.5%	+Trust distributions – capital distributions in cash (to the HWI) (Issue 13)
3	9.977	1	0.002	90.2%	+Property held offshore in listed country – real estate
4	9.408	1	0.002	90.6%	+Trust distributions to charitable trust
5	7.790	1	0.005	90.2%	+Utilisation of revenue losses via trading activities
6	5.348	1	0.021	90.6%	+Related party transactions with an entity in an unlisted country – royalty/ license income
7	5.037	1	0.025	91.1%	+Use of company shareholder loan account – repayments by HWI
8	4.909	1	0.027	91.5%	+Related party transactions with an entity in an unlisted country – provision of finance
9	9.422	1	0.002	93.2%	+Revenue loss creation via debt forgiveness/bad debts (Issue 3)
10	5.262	1	0.022	93.2%	+Trust distributions – capital distribution in cash (to group entity)
11	11.708	1	0.001	94.9%	+Utilisation of revenue losses via intra group transfers (Issue 1)

Why would the dollar value of offshore real estate investment not in a tax haven in a listed country help to predict overall risk? Firstly we need to consider the data. There are only two HWIs with dollar amounts ever recorded for offshore real estate investment in an *unlisted* country (a tax haven), so it is not surprising that this issue was not an important predictor. There were not enough cases to pick up any effects. Real estate in tax havens might have. However, there are thirteen non-zero recorded dollar amounts for the issue ‘property held offshore in a listed country – real estate’ (twenty-eight HWIs were rated on this issue with two being rated as a high risk). The two largest dollar amounts were both HWIs where overall they were rated a high risk. This issue then, manages to capture just a few more of

the high risk group over and above the first two issues in Table 10.6. On its own, or as is sometimes said, as a direct effect, it is only marginally significant with fifty other issues being more useful. Therefore, although the dollars at risk for this issue adds additional predictive power to the model after the first two issues are included, it is not particularly useful in the predictive sense on its own. How far to speculate an explanation of the predictor is not a simple question. Usually, if the purpose of modelling is explanatory, then theoretical considerations would be used in defining a model rather than an algorithmic approach as used here. That said, it may be reasonable to hypothesise a relationship of some sort between the finding that large real estate investment in a listed country is a high risk, and the earlier finding that a high risk rating for bank accounts and investments held in a listed country were two of the four best independent predictors of the total number of high risk issues. Christopher Skase, the major Australian corporate criminal who fled to Spain, is not included in these analyses. But he is a well known case with large real estate investments and bank accounts in a listed country.

The fourth predictor shown in Table 10.6, 'trust distributions to charitable trust', is also not included in Tables 10.3 or 10.4. In Table 10.7, where we use dollars at risk to predict the total number of high risk issues, another issue – neither in Table 10.3 nor 10.4 – crops up, that is, 'revenue loss creation explained by negative gearing'. The HWI with the largest dollars on this issue, approximately \$50 million, was also rated overall a high risk, had the second largest number of high risk issues, and was rated high on 'other miscellaneous items – other'. Taking all this data together, although interesting, is likely to be indicative of the boutique strategies mentioned earlier, rather than useful for identifying red flags of more general predictive value.

When we spoke to HWI Taskforce staff about these issues, their reaction was the same as ours: 'Analysts would not think this was a risk in itself'. However, there is the interesting question of whether tax planners exploit this reasonable kind of expectation. It may be that if you want to move an amount of money that is too large to hide, it is best to make it visible through a vehicle that makes it appear unexceptionable. Hence, it could be that having offshore real estate is not a risk factor, but placing huge amounts of money into these vehicles should put analysts on the alert. While negative gearing is a perfectly legitimate and normal commercial practice, extraordinarily large losses created by negative gearing may give reason to be watchful, though one would expect even aggressive players to exhaust legitimate deductions like negative gearing before moving on to more doubtful techniques.

Table 10.7 reports the predictor issues whose dollars at risk predict the number of high risk issues. One reason for these analyses is to see how well the dollars at risk for the different issues predict high risk, and which ones are the best predictors. Another reason is to provide a possible corrective for the subjective nature of the assessment of the ratings used in the first part of the paper. There is concern that there may be consistent analyst bias in the ratings data since both the aggregate estimates of risk (overall risk rating and number of high risk issues), and the estimate of risk on the issues, are a subjective assessment carried out by the same assessor and may be prone to the same bias. As a hypothetical example,

consider the analyst who rates businessman X incorrectly high on certain issues because of bias or error; the same bias or error may result in the businessman being rated as a high risk overall. The role of the supervisor in these cases will eliminate some of the more obvious errors, but not all.

Table 10.7 Predicting the total number of high risks with dollars at risk for each issue using ordinary least squares regression analysis

Model	R^2	Adj. R^2	Flags
1	0.503	0.501	Revenue loss utilisation via intra group transfers (Issue 1)
2	0.612	0.609	Revenue loss utilisation via intra group transfers (Issue 1) Revenue loss creation via negative gearing
3	0.677	0.673	Revenue loss utilisation via intra group transfers (Issue 1) Revenue loss creation via negative gearing Trust distribution – capital distributions in non-cash (to the HWI)
4	0.712	0.707	Revenue loss utilisation via intra group transfers (Issue 1) Revenue loss creation via negative gearing Trust distribution – capital distributions in non-cash (to the HWI) Use of shareholder loan account – repayments by HWI
5	0.732	0.726	Revenue loss utilisation via intra group transfers (Issue 1) Revenue loss creation via negative gearing Trust distribution – capital distributions in non-cash (to the HWI) Use of shareholder loan account – repayments by HWI Trust distribution – capital distributions in cash (to the HWI family member)

It is difficult to know where to draw the line in our interpretations since often the number of cases is low, both in the number of issues where dollars at risk are recorded and the number of HWIs who are assessed as being a high risk. However the sparsity observed in this data set is very characteristic of rare events data. If the

notion of an evolutionary ecology of tax planning with the occurrence of stable and new niches is apt, then the prediction of a small number of rare events is important to keep abreast of new strategies.

The only issue that is consistently listed in Table 10.6 and 10.7 and the earlier tables where risk ratings were used is 'utilisation of revenue losses via intra group transfers'. This is actually the top predictor for the total number of high risk issues (see Table 10.7). Since this is also recurrently predictive in the subjective analyses, 'utilisation of revenue losses via intra group transfers' was considered a definite contender for being a red flag issue. Of the 207 issues, it is also the one that most commonly has a high risk rating (see Table 10.1). This makes it a decidedly useful red flag for our final models.

Choosing Between Subjective and Dollar Risk

In practice it appears that the two types of analyses described, those using the estimates of risk rating and those using the dollars at risk estimates, are capturing different aspects of the risk prediction process.

Focusing on issues from the preceding tables, we examined the relationship between risk rating and dollar ratings. Although there is some evidence that the higher risks had higher dollars associated with them, it was by no means universal nor unambiguous as many issues had zero or low dollars associated with high risk and vice versa. Thus, we need to interpret the dollars knowing that low dollars at risk do not necessarily signify low risk in the view of the assessor. Dollars at risk for 'revenue loss creation via negative gearing' is also a good example of the disjuncture: Assessors rarely considered the issue a high risk but unusually large dollar amounts recorded for this heading was predictive of high risk.

This chapter focuses on the subjective ratings and their use in predicting high risk. It is therefore of interest to ask if the dollars at risk for any issue adds significantly to the prediction after the flags from Table 10.3 have been included. This was analysed several ways and the dollars at risk for 'property held in a listed (non-tax-haven) country – real estate' consistently added to the prediction of high overall risk after subjective ratings were included. From our analyses it would appear that the subjective, informed assessment of the analyst is a useful approach to detecting risk, with the quantitative data providing further clues to follow. This is contrary to the notion that the dollars at risk, being a more objective measure, would have superior predictive capacity to predict: Better to analyse subjective risk assessments first, then add some value with a diagnosis of unusually large dollar amounts.

Our experience of the regulatory craft (Sparrow, 2000) leads us to suspect that analysts need both the skills of a detective and those of an accountant. Nuance of judgment is needed; things have to pass the smell test. When the good analyst smells a rat, they are more likely to chase it down a hole than to further analyse numbers. While quantitative analysis provides clues, systemic wisdom must then be applied to the specific case. That case should be looked at through many different lenses, of which the quantitative lens is only one.

These data suggest to us that there might be a case for a two-step process with aggressive tax planning analysis. Step 1 is a qualitative diagnosis of returns and other intelligence surrounding the case that is informed by knowledge of red flags of systemic risk. Step 2 is a re-examination of objectively unusually large amounts of money that occur under labels that are not viewed as red flags, but that might become red flags when the dollars in them are extraordinary. Step 2 does not mean further interrogation of all extraordinary amounts. It means a harder look only when exceptionally large amounts occur under non-red-flag issues that the kind of analysis in Tables 10.6 and 10.7 reveal to be significant predictors of overall risk.

The analyses reported in this chapter only take us as far as making some practical suggestions for the identification of red flags for Step 1. Step 2 would only make sense to become a standard methodology after complementing the quantitative analyses in Tables 10.6 and 10.7 with qualitative intelligence on the operations of aggressive tax planners.

Final Red Flags Models

Having carried out the above analyses, our final task is to convert the results shown in Tables 10.3 to 10.7 into a more useful form for discussion and practical application. It is clear that most of our potential red flags were consistent with what we referred to as standard niches. Other issues appeared to be indicative of more boutique niches. It has further been demonstrated that the number of HWIs rated as high on any one issue was small, which means that single high risk issues are a narrow basis for selecting cases for audit.

Could the results be made more useful for auditors by aggregating some of the issues that rarely occur as high risks? Consider ‘capital loss creation via asset sales’. When the risk under this issue is rated high, the number of other high risk issues (that is, the number rated over 7) averages 16 (compared to a mean of 0.86 when ‘capital loss creation via asset sales’ is not high). But there were only four HWIs with a rating over 7 on ‘capital loss creation via asset sales’, so the level of risk on this particular issue is sufficiently rare that it will be of limited value in audit practice.

Consequently, we created an aggregated issue of wider scope. This issue was ‘capital loss creation’ instead of the narrower (but more powerfully predictive) issue ‘capital loss creation via asset sales’. The broader issue was a composite of nine different kinds of capital loss creation. Hence, if there was a rating of more than 7 for any single capital loss creation issue, the red flag was put up – whether the loss was created by asset sales, property development, debt forgiveness, bad debts, takeover/acquisition/merger, cost base manipulation, artificial loss duplication, related party transactions or some other explanation, or even if the capital loss creation was unexplained. Note, however, that it is not so broad as to include revenue loss creation; it is a capital loss creation variable only.

The second recurrently predictive red flag that we broadened was trust distributions. While ‘trust distributions – capital distributions in cash (to the HWI)’ was the most predictive red flag here, twenty different kinds of distributions from

trusts were combined in the composite red flag. This included distributions in cash and non-cash to the HWIs themselves, to HWI family members, to group entities, to charitable trusts, to a loss entity, and from probate/deceased estates, related entities, and so on. There were *from* as well as *to* distributions. Finally we broadened ‘other’ to include all sixteen ‘other’ issues including ‘other significant deduction issues’.

Table 10.8 shows the summary results from a logistic regression predicting high overall risk and an ordinary least squares regression predicting the total number of high risk issues (i.e., with a rating over 7) with our set of red flags which now include the broadened issues. What we are doing in Table 10.8 is a re-run of the analyses in Tables 10.3 and 10.5, but with ‘other’, ‘capital loss creation’ and ‘group trust distributions’ as broader red flags with many more high risk cases.

Table 10.8 Summary results of the final models predicting risk using original and aggregated red flags

Final red flags

Other categories (aggregated flag)
 Capital loss creation (aggregated flag)
 Group trust distributions (aggregated flag)
 Use of an offshore entity in an unlisted country (original flag)
 Utilization of revenue losses via intra group transfers (original flag)

Overall high risk based on logistic regression

92.8% correctly classified with 196 out of 202 HWIs in the low to medium risk group and 22 out of 33 HWIs in the high risk group correctly classified

Number of high risk issues based on ordinary least squares regression

An $R^2 = 0.90$ and an adjusted $R^2 = 0.82$

The adjusted R^2 for the final red flags regression model predicting number of high risks is an impressive 0.82.¹² Also these red flags, when used to predict overall high risk, yielded a slightly higher classification rate of 92.8 per cent (compared with the three predictors in Table 10.3). It is of note, however, that the final red flags model actually correctly predicts more HWIs into the high risk group but at the expense of incorrectly predicting some of the other HWIs as being high risk.

Nonetheless, we can conclude from these analyses that the final aggregated red flags, which are arguably better for auditing purposes, do as well or better than our previous sets of red flags. Therefore, there appears to be value for auditors in aggregating some of the issues that rarely occur as high risks.

Of the original set of red flags, two make a contribution in these final analyses, ‘utilisation of revenue losses via intra group transfers’ and ‘use of an offshore entity in an unlisted country’. The former, although significant, is not particularly useful in predicting the high overall risk group, but it does significantly increase the amount of variance explained when predicting the total number of high risk issues for a HWI. Hence we have identified five final red flags for overall risk: (a) trust distributions; (b) capital loss creation; (c) use of an offshore entity in a country that may be a tax haven; (d) utilisation of revenue losses via intra group transfers; and (e) extraordinary risks that fall between the cracks of the other risks.

Further analyses showed that the five subjective red flags were of more importance in predicting high overall risk than any of the dollar amounts associated with the red flags. The only red flag where the associated dollars at risk added significant extra predictive information above that of the subjective ratings greater than 7 was ‘utilisation of revenue losses via intra group transfers’. This was only the case for the model predicting number of risks greater than 7.

Conclusion

The five red flag issues are consistent with what many would regard as the fundamentals of aggressive tax planning. Fundamentals here is used in opposition to the idea that the best red flags would be telling symptoms of deeper problems (e.g., converting private pleasure activities into tax deductions – pleasure craft, horse breeding, racing deductions, for instance). The verified red flag issues are: (a) trust distributions (especially capital distributions in cash to the HWI); (b) capital loss creation (especially through asset sales, but not revenue loss creation); (c) use of an offshore entity in a country that may be a tax haven; (d) utilisation of revenue losses via intra group transfers (that is, within the group of entities controlled by the HWI); and (e) ‘other’ extraordinary risks that fall between the cracks.

The surprisingly robust results on the ‘other’ measures may suggest that we do not always know what the emerging fundamentals of the future may be. These results are not interpreted as anomalous, but rather as suggesting an evolutionary ecology of tax planning. Tax planning strategies that everyone, particularly the ATO, knows about will not be the most lucrative. While there will be recurrent predation strategies, the best new strategies will be those that are not crowded out by others who use a similar strategy. Minority strategies flourish. We therefore caution against the idea that we can settle in advance all risk categories for aggressive tax planning. We also highlight the importance of intuitive detective work to follow risks that fall between the cracks. This advice follows not only from the importance of the ‘other’ category, but also the result that the estimated ‘objective’ dollars at risk added little explanatory power to the ability to predict high risk above and beyond that provided by subjective risk ratings by ATO analysts.

An evolutionary ecology of tax planning implies that some successful players will seek new niches. Financial engineering of new derivatives never conceived

before by tax law and global capital mobility make this more possible than in the past (Department of the Treasury, 1999). As the law adapts to close off new niches the change in the tax law environment may also create new niches for other tax strategies. Law makers are less and less able to control these unintended effects as tax law changes in other countries create new niches available to local aggressive tax planners. The aggressive tax planner benefits from both an expanding range of niches globally, and expanding technical capabilities for local financial engineering. The first four red flags listed here may cover the standard niches while the last one covers the new niches.

The analyses also suggest a subset of cases that should be examined closely to see if there is evidence of new and previously unseen strategies or niches. These are cases where extraordinary dollar amounts are seen under issues that are not normally red flags, especially in those instances where other red flags suggest systemic risk.

Some aspects of the red flags we have identified should cease being indicators of risk to the revenue in future as Australian tax reforms have been undertaken to specifically deal with some of these problems. To this extent, the findings suggest that tax reform was well directed. For instance, the new loss integrity measures should prevent the ‘cascading’ of losses and will address some, but not all loss creation issues. Corporate consolidation measures are intended to limit the ‘trafficking’ of losses from outside the company (but they will not affect the genuine transfer of losses as this is accepted as part of normal business practice).

The proposed entity taxation regime, if adopted, will tax non-fixed trusts as companies and treat trust distributions as dividends, which would remove much of the tax effectiveness of trusts. This regime, however, has been put on hold at the time of writing. While not such a recent development, the controlled foreign corporations law was introduced to deal with tax haven use. Initially payments to these countries decreased, but in its annual report, the ATO notes that transfers to tax havens have increased significantly since 1996 (Commissioner of Taxation, 2000). Perhaps some aggressive tax planners have found a way of circumventing this legislation. In any case it appears that tax haven use remains a high risk area (Tanzi, 2000).

In a dynamic ecology of aggressive tax planning enforcement, tax administrators must adapt to cut out old risk factors just as they must prepare for mutations into new ones. Some of the most recurrent forms of aggressive tax planning are variations on fundamental themes that have been with us for many decades. Yet many of the mutations that seem so new retain the character of those fundamental strategies. A clever new piece of financial engineering may be clever and new at the same time as it is just another way of shifting losses, even if it cannot be recognised at first as loss shifting.

Notes

- 1 The ATO acknowledges the comments made in this paper and notes that the conclusions reached are based on aged data. The practices employed by the HWI

Taskforce have significantly changed and the conclusion reached may not be the same if this analysis were undertaken today.

- 2 For instance, the ATO conceives of aggressive tax planning as techniques which: (a) undermine the policy intent of the law; (b) impact on the integrity of the tax system; and (c) erode community confidence in the fairness and the equity of the tax system. Characteristics which mark aggressive tax planning in the ATO's view include arrangements which: (a) are contrived and artificial in their method of execution; (b) are uncommercial from a business or economic perspective; (c) are not implemented as specified in contractual and other legal documentation; (d) involve round robin finance or circular movement of funds and loans paid off by future earnings; (e) involve fraud on the revenue; (f) involve permanent tax advantage as distinct from a timing advantage; (g) abuse a specific concessional or anti-avoidance provision contrary to the policy underlying the law; and/or (h) attempt to reduce the amount of tax properly payable and thus create a revenue risk.
- 3 For example, in some instances analysts have included a risk more than once simply because it is feasible that the risk could fall under more than one category.
- 4 The Income Tax Regulations include a 'list' of countries which are considered to have tax systems broadly similar to the Australian system. There are fifty-eight of these 'listed' countries. 'Unlisted' countries are all those that do not appear on the list. They have taxation systems that range from almost comparable to full blown tax havens. Hence 'use of an entity in an unlisted country' would imply that profits were somehow derived in a low taxed country, and that a reduced amount of tax would be paid on them.
- 5 Income from trusts comes in the form of a distribution: From companies it is a dividend.
- 6 The individual risks named in the data are loosely grouped under five broader risk categories. The broad risk categories are International, Losses, Group Structure, Miscellaneous Income and Deduction Items, and Other Miscellaneous Items. The broad categories in turn contain more specific risk categories. Each of the specific risk categories contains a catch-all variable named 'other' to accommodate the less common or less understood risks of that type. As the broad category 'other miscellaneous items' has itself the flavour of a catch-all category, one would expect the least common or least understood risks to appear under the label 'other miscellaneous items – other'. Oddly, this has turned out to be the most highly predictive variable.
- 7 In this sense 'capital' is the money contributed to set-up a business or keep it running. Unlike profit, it is not taxable when it is returned to the contributor (because it is assumed to have been taxed previously). There are obvious tax benefits to the HWI if they can re-characterise profit as capital.
- 8 It is also a top predictor when we predict the sum of all risk rankings (0 to 10) or the number of issues where the risk score exceeds 7.
- 9 One risk that was classified as 'other' that was more or less systemic was property developers treating building costs as deductible on the revenue account while treating income from sales as capital. This practice gives the advantage of immediate deductions for expenses but a concessional treatment of income. It is not allowed by the legislation, but it appears that taxpayers 'try it on' in the hope the ATO will not detect it. It has since emerged that it is widespread among property developers.
- 10 Loan accounts are often used by HWIs as a tax free source of cash to maintain their lifestyles. A credit balance in a loan account would suggest that there was another source of income and analysts could find this a cause for concern.
- 11 Note also the predictive power of the dollar amounts of 'trust distributions – capital distributions in non-cash (to the HWI)' in Table 10.7.
- 12 An R^2 of 0.82 means that 82 per cent of the statistical variance is explained.

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