

ATO Submission to the Standing Committee on Tax and Revenue

8 August 2014



Commissioner's Foreword

I am pleased to present the Australian Taxation Office's second submission to the Standing Committee on Tax and Revenue.

As outlined in February, the ATO has commenced a program of reinvention to streamline and modernise its services. The aim is to transform the taxation and superannuation experience for all taxpayers, to deliver improved, high-quality customer service across the board.

While we remain committed to our main priority of revenue collection on behalf of the government, we are implementing major organisational change – building the workforce of the future, in the context of budgetary and staffing constraints.

Australia's taxation system is one of willing compliance. The vast majority of taxpayers willingly pay their fair share of tax simply because they believe it's the right thing to do. At the same time, we have better targeted and smarter compliance measures to detect and deter the small minority not willing to do the right thing.

The ATO's reinvention program aims to improve the client experience for all categories of taxpayers through tailored services, the right technology, less red tape and simpler compliance requirements.

This submission provides information sought by the Committee, including:

- An update on 'reinventing the ATO', including progress reports from the Australian Public Service Commission Capability Review and our action plan to implement its recommendations.
- A summary of improvements to public reporting of our performance information and how this information is integrated into ATO management decisions.
- Information on how the ATO benchmarks its performance against other agencies, both in Australia and overseas. This includes data comparing staffing levels with the amount of revenue collected in Australia and other Organisation for Economic Cooperation and Development (OECD) jurisdictions.
- An examination of the impacts of budget and staffing reductions, including their effect on revenue and service standards.
- An overview of the ATO's position on tax gap.
- An update on section 25-90 of the *Income Tax Assessment Act 1997*.
- Information on internal reviews of ATO decisions, including progress in making independent reviews available to more categories of taxpayers.

I trust that this submission contains the information sought and adds to your understanding of the ATO's business and our reinvention program.

I look forward to hearing your views and working with you to advance our shared interest in transforming the taxation experience in Australia.

Chris Jordan AO

Commissioner of Taxation

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PART 1 – REINVENTING THE ATO

The ATO Executive is delivering a broad program to ‘reinvent the ATO’ that will drive the change towards a more contemporary and service-oriented organisation. The reinvention is focused on our clients and supports the government’s vision that Australia is ‘open for business’.

These are challenging times – the ATO must continue to enhance our revenue collection capability while demonstrating efficiency improvements and reducing red tape across the board. The community expects a greater demand for personalised, accessible, reliable services using the latest technology and communication practices.

To meet this challenge we must reinvent the ATO and redefine how we operate, add value and deliver services to the Australian community. Reinventing the ATO is a long term journey that we have already begun. Over the past year several initiatives demonstrate our genuine commitment and capacity to change.

Our new leadership team and the recruitment of a new Chief Tax Counsel, Deputy Chief Tax Counsel and a number of tax and audit professionals, from outside the ATO, are bringing people from diverse backgrounds with a wealth of skills and different perspectives into the ATO.

In May we released the ATO’s *Strategic Intent* - outlining our goals, strategies and risks to achieving our vision, including how we will measure success. We are now developing a blueprint to describe the future experience for our clients and staff and outline the cultural transformation required to achieve these goals. As part of this process we will define and prioritise the key streams of work to realise our vision.

Delivering on our blueprint for change is a challenging task. Securing the capacity and funding to progress significant change is a key issue as our reform agenda emerges. To address this we are:

- taking steps to ensure we do not reinvent for the sake of it – our reinvention is about increasing willing participation and compliance, and enhancing community confidence in the system. We are taking a ‘whole of tax and superannuation system’ view and co-designing the services and systems with our clients and stakeholders to ensure we identify the right changes.
- implementing a new framework to ensure investment across the ATO is aligned with our strategic direction.

Identifying and initiating our change activities will only announce the start of our change process. Realising the outcomes and benefits will require us to embed the change and to get our clients and staff to adopt new ways of interacting and working with the tax and superannuation systems.

A challenge for us is to progress our change agenda in an environment already focused on enhancing efficiency and doing more with less. To combat this we have already embarked on a strategy for equipping all ATO staff with the skills required to manage and deal with change effectively.

Sustaining enthusiasm and commitment for such a significant and long-term change program requires careful management. For this reason we are committed to planning our change journey and communicating our progress to ensure we remain engaged with our stakeholders.

The reinvention has already delivered new products and services to our clients and changed the way we work in the ATO.

We have cut red tape across the board and made significant changes to the way we consult with the community. We have established independent reviews, increased our influence in law design and progressively introduced a number of improvements that make access to ATO services and information easier.

Many of the changes are in the ATO action plan, which aim to address findings from the Australian Public Service Commission (APSC) capability review. We have provided three quarterly reports for December 2013, March 2014 and June 2014 to the Public Service Commissioner on our progress. Copies of these reports were also provided to the committee secretariat on 25 July 2014.

Delivery of the ATO action plan is a key component of our new pathway as we work towards 2020 and the reinvention of the ATO. We are pleased to report that implementation of the plan is progressing well and we are on track against each of the five priority areas identified in the APSC capability review. The plan contains 52 milestone deliverables and 35 of these were completed as at 30 June 2014.

The activities and deliverables in the ATO action plan support the achievement of our outcomes, which include:

- A clear statement of strategic intent that covers the 2020 vision and mission and the enterprise strategies to achieve that intent.
- ICT investment driven by our strategic intent and enterprise strategies and our plans maximise our ability to keep pace with contemporary service expectations.
- Our workforce is equipped, ready, willing and able to deliver our ongoing and future business needs.
- An efficient, streamlined governance system that supports accountability, quality decision-making and effective risk management.
- Our connections and relationships across government and the community are purposeful and effective and provide benefits to the tax and superannuation systems and our administration.

Implementation of the ATO action plan will continue over the next 12-18 months as we strengthen and build organisational capability. Some areas of focus are:

- Implementing our new governance framework incrementally over the next 6-12 months. Our new framework will shape the development of our new governance practices and arrangements, ensuring that the direction we have set is supported by strong, sustainable and accountable performance monitoring and reporting to achieve our expected outcomes. We recognise that over time, our governance arrangements will need to respond to changes such as emerging risks, community and government needs, our reform agenda and the global environment. We will

regularly evaluate and review our governance approach to ensure it remains fit-for-purpose.

- A post implementation review of our new consultation arrangements. The Consultation Steering Group (whose members include key external and internal stakeholders and Treasury) agreed that while they are seeing improvements in the effectiveness of our new consultation arrangements, an assessment of how the model is operating in practice would be most appropriate during the first quarter of 2015. The outcomes of this review will be used to improve the operating model in line with external stakeholder expectations.
- Quantifying the cost of internal governance. An agreed costing framework has been developed and we plan to implement this framework with the current financial year's strategic costing framework and draw reports on our cost of governance around late August 2014. These reports will feed into the Resource Forum to inform decision-making.

The next quarterly report to the Public Service Commissioner is due in early October 2014, and in 2015 the APSC is scheduled to undertake a follow-up 'health-check' review of the ATO, with a focus on clear evidence of organisational capability lift.

Contemporary services

A key feature of the reinvention program is the drive to provide more contemporary services for the community, with a similar experience that an individual would expect when transacting with an institution such as a bank. Since the last committee hearing, we have implemented a number of service delivery initiatives that improve the individual's experience.

In May this year, the ATO joined *myGov* enabling individuals to create a single online account that can be linked to Centrelink, Medicare, Child Support, e-health record, Veterans' Affairs, National Disability Insurance Scheme and now ATO to access online services.

To date, over 1.5 million *myGov* accounts have been linked to ATO's online services. This is expected to increase to approximately 3 million by the end of October 2014. The introduction of *myGov* authentication has resulted in a substantial increase in the use of our existing online services such as tracking the progress of tax returns, updating details and keeping track of superannuation.

Tax Time for 2014 has seen the launch of our new *myTax* product, an online service available on desktop, tablet and mobile devices, enabling individual taxpayers with simple affairs to lodge their tax return in 10 screens. *myTax* uses the new *myGov* authentication to prefill and lodge returns. More than 400,000 tax returns have already been lodged through the new *myTax* and there has been an overwhelmingly positive response to the new service.

To support individuals with the new *myGov* and *myTax* features, we have extended our call centre opening hours to 10pm during weeknights and from 10am to 5pm on weekends.

Recent additions to ATO's online services include the ability to notify a non-lodgment advice, view account balances for Higher Education Loan Program and Student Financial Supplement Scheme accounts and a 'Pay now' option for debts.

This month, the ATO launched the Small business newsroom - a new online channel for small businesses with news and information. The newsroom gives small businesses access

to a modern online facility that will save them time and effort. Small business can subscribe to the latest news, watch videos, rate and share articles and add tax dates and reminders to their own calendars.

One of the key features is that businesses can opt out of receiving general ATO letters in the mail and instead read an article in the newsroom. The newsroom was co-designed with small business for small business and we will continue to work with small business to enhance the newsroom functionality. Subscribers can choose their topic preferences and will receive email notification when there are updates. There are three types of notifications, quarterly news, information updates and alerts.

The ATO mobile app released in July 2013 continues to be updated to provide further information and tools for taxpayers. Since May, we have added functionality that makes it easier for individuals to identify if they have lost superannuation and allows them to lodge their *myTax* return on their smart phone. Small businesses can work out their super guarantee responsibilities and calculate their fuel tax credits. In addition, information and resources for self-managed superannuation funds are also available through the app. As at the end of July 2014, the app had been downloaded more than 340,000 times and is available on Apple, Android and Windows devices.

PART 2 - PUBLIC REPORTING OF PERFORMANCE INFORMATION

Performance measurement and reporting of information is an integral component of the ATO's governance arrangements. Performance information supports our decision-making on how to best design programs and strategies, allocate scarce resources to mitigate risks and provide assurance that key requirements are met.

Our planned performance is outlined each year in the Portfolio Budget Statements (PBS) and our corporate plan. With the introduction of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act), our new four year corporate plan is the foundation document for the measurement and assessment of our performance.

We regularly monitor and report on our performance measures through internal committees and publicly report our performance in our annual report, through our website and through contribution to surveys and benchmarking with international and Australian agencies.

Continuous improvement of performance information

The ATO works to continuously improve our performance information. Like other Government agencies, the ATO is good at measuring efficiency and not as good at evaluating our effectiveness. In recent years we have developed and published effectiveness measures across our four pillars of compliance, but further work is required to evaluate effectiveness for all aspects of our administration.

During 2012–13, the ATO participated in the Australian National Audit Office pilot project on developing and implementing key performance indicators to support the Outcomes and Program Framework. Combined with other work undertaken, this has resulted in further improvements to our key performance indicators in the PBS.

Following a major review of our service standards in 2012–13, the ATO commenced its transition to service commitments from 1 July 2013. The service standards were developed from a community perspective. Our public commitments to service state the level of performance the community can expect when dealing with us under normal circumstances. We set performance targets that are intended to be challenging, attainable with effort, affordable and meaningful to the community.

This year, as part of the new direction set out in the *ATO Strategic Intent*, we identified twelve key measures that indicate the overall health of the system and our performance in delivering on our outcome and strategic goals:

1. Community and key stakeholders engagement and satisfaction with ATO performance
2. Number of customer service interactions delivered through our multi-channel environment
3. Proportion of businesses and individuals registered in the system
4. Proportion of businesses and individuals that lodge on time
5. Proportion of liabilities paid on time by value for each of the major tax revenue types
6. Adjusted average cost to individual taxpayers of managing their tax affairs

7. Net cost to collect \$100
8. Earlier resolution of disputed cases
9. Ratio of collectable debt to net tax collections
10. GST gap as a proportion of GST revenue
11. Operating within budget
12. Employee engagement compared to APSC state of service.

Building on these twelve measures - the majority of which are included in the PBS - our broader suite of corporate measures was refreshed this year and is published in the *ATO Corporate Plan 2014–18*. On initial review of the measures we reduced the number being reported against from over 500 measures to fewer than 250. These measures cover the deliverables we produce, their impacts on the community, and our commitments to service.

Integration of performance information into ATO management decisions

Internally, we integrate performance information into our key corporate committees to facilitate decision-making. Ongoing performance monitoring and reporting provides a view of performance against planned outcomes as well as our conformance to obligations.

We use information gathered from both internal and external sources to identify areas for improvement. This is achieved through monthly, quarterly and annual reporting of performance.

Monthly reporting

Our Executive Committee meets monthly to consider both financial and non-financial performance against planned outcomes. We publish information monthly about our performance against commitments to service on our website to meet our commitment for transparent management, accountability for results and client-centred service delivery.

Quarterly reporting

Each quarter, our executive committee considers a more detailed assessment of our performance. This includes commissioned research, stakeholder views, financial and workforce data, performance against commitments to government and progress towards our reinvention. Aspects of financial and non-financial performance and conformance are also considered by our Audit and Risk Committee, which includes external representatives.

Annual reporting

The ATO's *Commissioner of Taxation Annual Report* is tabled in Parliament by 31 October each year. The report includes information about performance against the deliverables and key performance indicators as outlined in the PBS for the Treasury. In recent years the report has been awarded by the Institute for Public Administration Australian and at the Australasian Reporting Awards for a high standard of reporting.

We also publish a selection of effectiveness stories on our website to provide further insight into our performance. Over recent years we have increased the publication of case studies and results based on compliance effectiveness evaluations in annual reports and

compliance program publications. We have also published improved performance information aggregated by tax product, market segment and key compliance obligations. We will continue to build a comprehensive picture of our effectiveness in our performance reporting to the Parliament and the community.

PART 3 – BENCHMARKING PERFORMANCE

BENCHMARKING PERFORMANCE

We recognise that regularly comparing our performance with other jurisdictions enables us to benchmark our position against other tax authorities. It is equally important to gauge how key stakeholders rate our performance as a tax authority and large public sector service provider.

Using measures that identify how we are actually performing, and how we are seen to be performing, ensures the ATO Executive is better informed of organisational strengths and weaknesses, and able to identify areas for improvement.

The ATO uses a range of sources, including independent international comparative studies and internal measures, to benchmark our performance in relation to other tax administrations. This includes the Forum of Tax Administrations (FTA) biennial survey of tax administrations, Commissioner of Taxation annual performance reporting, the Australian Public Service Commission state of the service annual report, ATO Commitments to Service and a range of perception studies and market research.

Forum of Tax Administrations biennial international benchmarking study

Every two years the ATO participates in a major international study undertaken by the FTA that compares performance information provided by revenue authorities across the Organisation for Economic Cooperation and Development (OECD) and other advanced and emerging economies. We benchmark our position in relation to other tax authorities by examining the results of the FTA's independent comparative study.

Directly comparing data and information across jurisdictions is challenging as each tax authority operates differently. It should also be noted that international studies of tax administrations such as the FTA survey are not prescriptive, but rather indicative of performance.

Trend ratios are useful to examine and benchmark performance. The three tables below compare performance data from 2005 with the most recent [FTA study](#), relative to five other jurisdictions, namely the United Kingdom, New Zealand, the Republic of Ireland, Denmark and Norway. We have included our own 2013 data (not yet published by the FTA) to indicate our continued improved performance.

The tables illustrate an overall downward trend in the cost of collecting tax in Australia. It is important to note, however, that a number of other factors may influence trend analysis¹.

- Table 1 compares the 'cost of collection' relative to **gross revenue**². For Australia, this ratio means to collect \$100 in (gross) tax cost the ATO 84c in 2005, down to 71c in 2013.

¹ Downward trends may be indicative of revenue authorities that have improved the efficiency and/or effectiveness of their revenue collection. However, changes in the macro-economy, tax rates, scope of taxes collected or large scale investment in reporting jurisdictions may also influence trend ratios.

² Gross revenue is defined as total tax revenue collected.

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- Table 2 compares the 'cost of collection' relative to **net revenue**³. For Australia, this ratio means to collect \$100 in (net) tax cost the ATO \$1.04 in 2005, down to 93c in 2013.
- Table 3 compares tax administration expenditure relative to **gross domestic product**. For Australia this ratio means that in 2013 we spent 0.18% of GDP on collecting taxes compared to 0.23% in 2005.

Table 1: Comparative trends: Cost of gross collection ratio Total tax administration expenditure/gross revenue collected				
Country	Ratio (2005)	Ratio (2011)	Ratio (2013)	Trend
Australia	0.84%	0.75%	0.71%	↓
United Kingdom	0.96%	0.68%	not yet available	↓
Ireland	0.71%	0.81%	not yet available	↑
New Zealand	0.64%	0.71%	not yet available	↑
Denmark	0.68%	0.45%	not yet available	↓
Norway	0.63% ⁴	0.59%	not yet available	↓
OECD Average	0.82%	0.81%	not yet available	

Table 2: Comparative trends: 'Cost of net collection' ratio (Total tax administration expenditure/net revenue collected)				
Country	Ratio (2005)	Ratio (2011)	Ratio (2013)	Trend
Australia ⁵	1.04%	0.99%	0.93%	↓
United Kingdom	1.10%	0.83%	not yet available	↓
Ireland ⁶	0.82%	1.14%	not yet available	↑
New Zealand ⁷	0.76%	0.89%	not yet available	↑
Denmark	0.69%	0.46%	not yet available	↓
Norway	unavailable	unavailable	unavailable	N/A
OECD average	1.05%	0.99%	not yet available	

³ Net revenue is defined as the amount of tax revenue collected after refunds are paid.

⁴ 2007 ratio - data for 2005 and 2006 unavailable

⁵ There was a low of 0.93% in 2007 and a high of 1.05% in 2010.

⁶ Figures include customs related data, affecting comparability.

⁷ Figures do not include excise related data, affecting comparability.

Country	Ratio (2005)	Ratio (2011)	Ratio (2013)	Trend
Australia	0.229%	0.182%	0.183%	↓
United Kingdom	0.341%	0.237%	not yet available	↓
Ireland ^b	0.238%	0.247%	not yet available	↑
New Zealand	0.202%	0.204%	not yet available	→
Denmark	0.367%	0.202%	not yet available	↓
Norway	0.188%	0.162%	not yet available	↓
OECD Average	0.195%	0.191%	not yet available	

'Tax Administration 2013' reports that "a consistent downward trend in relative administrative costs can be observed for only a small number of countries: Australia, UK, Norway and Denmark (as well as France, Lithuania, Malaysia, Mexico, the Netherlands and Russia)".

Benchmarking staffing levels

Table 4 shows relative staffing levels for tax administration functions based on full time equivalent data compared to the amount of gross revenue collected. For continuity we have compared the same five tax administrations as in Tables 1-3 above.

We have used 2011 financial year data, included in the most recent FTA study (Tax Administration 2013) in this comparison. For Australia, this table indicates that our performance is above UK, Ireland and New Zealand, and close to par with Norway and Denmark.

Country	Staffing level (FTE) ⁹	Gross revenue collected in local currency (billions)	Gross revenue per FTE in local currency (millions)	Approx. Gross revenue per FTE in US\$ (millions) ¹⁰
Norway	5,943	NK 753.4	NK126.8	\$22.6
Denmark	6,871	DK 805.1	DK117.1	\$21.9
Australia	18,196	A\$361.3	A\$19.9	\$20.5
UK	66,466	GB£532.8	GB£8.0	\$12.8
New Zealand	3,789	NZ\$58.5	NZ\$15.4	\$12.2
Ireland	5,962	€48.4	€8.1	\$11.3

⁸ These figures include Customs related data, affecting comparability.

⁹ These figures are total staff usage in 2011 on tax administration functions (in full time equivalents), for Australia this figure excludes staff working in non-tax roles such as superannuation.

¹⁰ These approximate figures are based on the average monthly exchange rate in 2011

Other benchmarking studies

From time to time, the ATO participates in one-off international benchmarking studies of tax administrations commissioned by other jurisdictions. These studies have provided valuable information about areas of good performance and areas for improvement.

For example, in 2011 the ATO participated in Her Majesty's Revenue and Customs United Kingdom commissioned [benchmarking study](#) with the tax administrations of: Canada, France, the Netherlands, New Zealand, Ireland, Poland, Spain and South Africa. The results included:

- Australia was observed to have low processing cost per return for personal tax returns;
- Australia was observed to be the most cost efficient of the tax administrations which carry out all GST/VAT registration activities in-house;
- the UK, Australia, Ireland and Canada were observed to have much lower opening and closing debt balances as a percentage of total tax revenues than the other countries;
- Australia needed to continue its improvement program to resolve large business disputes more quickly in line with the efforts of other jurisdictions.

The ATO has commissioned independent benchmarking studies of non-financial performance measures. Such studies enable us to ascertain where we stand in relation to other high performing organisations and inform areas for ongoing improvement.

In 2011 we commissioned a study to compare our service standards with other international taxation agencies, local government and large private sector organisations. As a result of this study, we have developed our 'commitment to service' framework and adopted key performance measures based on community expectations that centre on ease, quality and timeliness in our service offering.

Community Perception

The ATO has for some time been surveying taxpayers and tax professionals about their perceptions of the ATO's fairness. Some recent surveys have sought taxpayer or practitioner responses to statements such as: "The ATO is fair and professional in how it administers the tax and superannuation system" or "Over the last 12 months, do you agree or disagree that you have found the ATO to be fair?"

The ATO also adapts our research agenda to assist with priority information needs. For example, for work on tax disputes the ATO will now conduct a new quarterly survey, based on a sample of taxpayers who have had their matter in dispute finalised. It will focus on a representative sample of taxpayers across markets and taxes. We currently propose to ask the questions:

- Did the ATO treat you fairly during the dispute process? and
- Was the outcome of the dispute process fair?

Where taxpayers consider they were treated unfairly or the dispute outcome was unfair, we will ask additional questions to understand how we can improve our performance and perceptions.

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This survey will be conducted independently of our compliance and dispute resolution areas and will be facilitated by our corporate research centre.

Given we need to establish this new survey process with an approved provider, we aim to have the first set of dispute survey insights available in February 2015.

PART 4 – IMPACTS OF BUDGET AND STAFFING REDUCTIONS

The 2014 Federal Budget required the ATO to bring forward staffing reductions expected over the forward estimates to 2015-16. Specifically this was a reduction of 500 relating to 2014-15 year, and a further 1,600 in 2015-16. Together with an existing target reduction of 900 in 2013-14 this required a total reduction of 3,000 staff.

The ATO commitment to self-fund this reduction and maintain a balanced operating budget meant that we needed to achieve the reduction by 31 October 2014 to meet associated costs within our available budget. The ATO conducted an initial round of expressions of interest in voluntary redundancy (VR) in the 2013-14 year. This saw 908 staff leave the organisation through the first VR process at 30 June 2014. A further 436 will exit through this initial process. A second round of voluntary redundancies saw 2366 staff express interest. An initial 1316 offers of VR have been made as part of this second process. As a result the ATO expects to achieve the required staffing reduction through voluntary redundancies, natural attrition and other exits in the period to 31 October.

Importantly the ATO remains committed to revenue collection and service to the community. The achievement of this reduction in the short term has provided greater certainty for staff and allows us to focus on stabilising our workforce and building capability.

The ATO must rebalance the remaining work force to continue to meet priorities. In the first half of the 2014-15 year the ATO will ensure that, as staff leave the organisation through the VR processes, we have made adjustments to ensure continuity of service and delivery of revenue commitments.

We are refining the way we work - we are delayering management structures and reviewing internal enabling functions to maximise resources to meet government and community priorities.

Revenue and service impacts are minimised by focussing on:

- The introduction of new contemporary technologies that better meet expectations, such as *myTax*.
- Building the capability of our staff to improve efficiency and effectiveness.
- Clearer communication with customers, with fewer objections and disputes that are frustrating to our customers and costly to administer.
- Early resolution of disputes through negotiation and the use of independent review.
- Systemic improvements that realise efficiencies such as automating repetitive work processes.
- Improved use of small business benchmarks, analytics, case selection engines and community information to ensure we focus on the areas of identified risk.
- More direct interaction with taxpayers, increased case management and senior leader oversight to ensure cases progress to completion.

- Improvements to risk assessment processes, such as tax return fraud models, to ensure the majority of the community who do the right thing do not experience unnecessary delays when they interact with the tax system.

PART 5 - MEASURING THE TAX GAP

The 'tax gap' is the difference between the amount of tax legally payable (assuming full compliance by all taxpayers) and the amount of tax actually collected. A number of tax administrations around the world develop gap estimates for some or all of the taxes they administer. Since 2012, the ATO has released estimates of the size of the goods and services tax (GST) gap and the luxury car tax gap.

Following extensive consultation with tax gap experts and representatives from jurisdictions already publishing estimates, the ATO executive endorsed extending our tax gap estimation program to cover all taxes administered. Extending our tax gap estimates is a priority in our corporate plan for 2014-18 and part of a broader strategy to use our data to improve decisions, services and compliance.

Tax gap estimation will complement our broader suite of effectiveness measures, providing additional insights into our performance as an administrator of the tax system. It will also:

- promote community conversation about compliance gaps and what might be done to address them
- show which areas of the tax system are working well and those which can be improved, allowing us over time to shift our efforts to the highest priorities and provide better evidence-based advice to Treasury and government, and
- provide an opportunity to analyse and understand the significant quantum of operational data and knowledge of tax administration in the organisation.

Noting the inherent uncertainty associated with tax gap estimates, it is possible that as we develop estimate trends, we may also gain some insights into changes in compliance levels as a result of variables such as the prevailing economic environment.

Consultation

Our decision to extend tax gap estimation was informed by consultation with recognised experts in the field and representatives from revenue authorities already publishing tax gap estimates. This includes Her Majesty's Revenue and Customs (United Kingdom) and the Internal Revenue Service (the United States). We also consulted with representatives from Treasury, the Department of Human Services, the Australian Bureau of Statistics and the Office of the Inspector-General of Taxation regarding the possible whole-of-government impacts. Some key themes emerged from our consultation:

- There was strong emphasis on the value and benefits of tax gap research and importance of advancing tax gap work as there is a void in our knowledge about how well the tax system works. The benefit was not just for ATO purposes, but for Australia as a nation.
- The estimation of tax gap is complex, with inherent uncertainty. Tax gap, in effect, is about measuring what is not visible – what taxpayers have not disclosed about their compliance.
- Due to the inherent level of uncertainty, estimates should be published as a range. Given this, measuring movements through pattern and trend analysis can be challenging, particularly in the early stages of a program.

- Tax gap estimates should not be used in isolation as a performance measure; they should be placed with a broader suite of effectiveness indicators, noting that tax gap estimates reflect more than just the ATO's administration of the tax system.
- The 'compliance' tax gap needs to be distinguished from the 'policy gap', which refers to revenue foregone due to concessions built into the law, and revenue related to legal tax planning arrangements. For example, some base erosion/profit shifting arrangements (BEPS) will be examples of the policy gap (where the law allows the arrangement), however other components of BEPS will form part of the compliance gap (i.e. contestable avoidance).
- Any tax gap estimate needs to be disaggregated (i.e. publish separate estimates for each tax administered) to better understand and communicate the value and insight of gap analysis.
- An estimate should only be published when the methodology and the estimate itself are credible. Publishing should not be driven by a specific date.
- Once methodologies are sufficiently robust, estimates should be released every two years. This gives sufficient time to understand insights, refine methodologies, conduct quality assurance and work with stakeholders. Trends are less evident on a year-to-year basis.
- We were advised that credible tax gap estimates could not be produced for individuals and small business without a random audit program, due to the size of these populations and the relatively small coverage of operational audit data.

Phased approach

We will take a phased approach to developing separate estimate calculations for each administered tax. Work has already commenced on developing estimates for excise, large business and Pay As You Go (PAYG) withholding. Work is underway to determine the feasibility of estimating the tax gap in the high wealth individuals and wealthy Australians market (individuals controlling more than \$5 million in wealth), noting that other jurisdictions combine this market with the individual/company tax gap.

Our schedule for developing estimates is:

In 2014

- Announce broader tax gap program of work
- Luxury car tax gap refreshed
- GST gap refreshed.

In 2015

Assuming credible estimates and quality assurance:

- PAYG withholding and fringe benefits tax gap estimated
- Excise tax gap estimated
- Large business income tax gap estimated
- High wealth individuals including wealthy Australians tax gap estimated
- Random audit program co-designed
- ATO Executive consideration of design and implementation impacts of the random audit program.

In 2016

Assuming credible estimates and quality assurance:

- Individual income tax gap estimated
- Small business income tax gap estimated
- Once all elements of a broader tax gap are known, they will be consolidated into a broader tax gap range
- Subject to ATO Executive approval, random audit program commences.

Given the complexity and scale of the calculations, all tax gap estimates have an irreducible level of uncertainty. As a result, we will be expressing our tax gap estimates as ranges which have a fairly wide confidence interval (depending on the head of revenue).

Once the estimates are developed, we will consider their relative certainty levels and credibility before making a decision on whether the estimates should be made public and how they should be included in our broader suite of effectiveness measures.

Credibility is based on a number of factors such as the chosen methodology, sample sizes and the quality or completeness of data. We continue to engage with international experts in tax gap estimation and our counterparts in other tax administrations and Australian government agencies to support our ability to develop a credible methodology and estimates.

The ATO's proposed methodology

In practice, overall estimates are made using an ensemble of top-down approaches, bottom-up extrapolation from random audits and bottom-up extrapolation from operational data. As part of our feasibility study, we examined a number of different methodologies:

- **Top-down methodologies** use independent aggregated data (e.g. the National Accounts) to estimate the amount of tax that should have been paid. For example, data such as the level of vehicle sales is used to inform luxury car tax estimates. These methods are most suited to taxes where there is relevant, independent data available.
- **Bottom-up methodologies (constructed estimates using operational compliance data)** adjust operational audit results to make them more representative of the overall population, which then informs the tax gap estimate. They have the advantage of being relatively low cost and use the significant amount of operational compliance information we already hold. Due to risk-based case selection processes affecting operational audit data, we need to attempt to control for selection bias. Where selection bias cannot be completely removed, this will increase the range of the tax gap estimates.
- **Bottom-up methodologies (random audit data).** Where operational audit data does not provide a representative sample of the population, a random audit process can be used to provide estimates of the tax gap. This approach has the benefit of mitigating selection bias.

We intend to continue the use of top-down approaches for GST tax and luxury car tax, and extend this approach to excise and PAYG withholding.

A combination of top-down and bottom-up methodologies, including the extrapolation of available operational data and our significant knowledge of the system, will be used to produce tax gap estimates for large, medium and small business, individuals and fringe benefits tax.

In developing these estimates we acknowledge that due to selection bias, the confidence level associated with the measures may be low for the small business and individual populations. To overcome this, we will give consideration to introducing an individuals and small business random audit program with a possible commencement date in 2016.

Random audits

The use of random audits as part of bottom-up methodologies is a consistent feature of tax gap measurement approaches used by OECD jurisdictions where they are recognised as international best practice – particularly for the individual and small business components of the gap.

We have extensively discussed the use of random audits with recognised experts in the tax gap field and representatives from Her Majesty's Revenue and Customs (United Kingdom) and the Internal Revenue Service (the United States). Through this consultation, it is apparent that for the individuals and small business markets:

- an estimation approach which does not include a random audit program is unlikely to be seen as credible
- an estimate which does not include a random audit program, particularly for the small business and individual segments, would be drastically different from the methodology used by Her Majesty's Revenue and Customs (United Kingdom) and the Internal Revenue Service (the United States)
- our external scrutineers have indicated that based on international best practice, the ATO would need to defend a decision not to undertake random audits.

The decision on the nature of the random audit program will be made after giving consideration to the outcome of the initial estimates based on operational data for small business and individuals. Any decision to proceed with the program will be contingent on our ability to develop an approach which minimises the administrative and opportunity costs for the ATO, as well as any regulatory burden for taxpayers.

If we decide to proceed with a random audit program we will also focus on the program's ability to deliver a range of other benefits to the tax system and the individuals audited. For example:

- Random audit programs capture pertinent information that can be used to develop risk profiles, ultimately leading to improved risk identification. As a result we may be able to identify populations of taxpayers to exclude from our compliance audit program.
- The audits could include an education focus – informing good record-keeping practices, and highlighting initiatives such as *myGov* or Standard Business Reporting (which will ultimately save taxpayers time).
- If a mistake or issue is found in a random audit, we could consider encouraging self-correction (with assistance around payment arrangements if needed). We could also

inform and educate the community on common mistakes we have found and how they can avoid these mistakes.

PART 6 – UPDATE ON SECTION 25-90 ITAA 1997

Section 25-90 of the *Income Tax Assessment Act 1997* allows Australian companies to claim interest deductions on investments in their overseas businesses which produce foreign non-assessable non-exempt income. The deduction is subject to limitations imposed on interest deductions by the Thin Capitalisation measures.

The provision was established in 2001 and was designed to reduce compliance costs for Australian companies with overseas investments. It came in together with the 2001 Thin Capitalisation measures.

Before section 25-90 was introduced, companies were required to determine (by tracing and matching) their interest expenses incurred in earning exempt foreign source income, and those incurred in earning assessable income. The *Review of Business Taxation* (1999) recommended allowing deductions for interest incurred in deriving exempt foreign income in conjunction with implementing Thin Capitalisation rules.

The ATO had expressed concerns relating to tax structures that seek to shift profits through debt loading into Australian entities. These structures may employ interactions between Thin Capitalisation measures, exempt foreign income measures and the benefits of s25-90. Earlier this year, Treasury conducted consultations on a targeted integrity measure.

This was a subject of the government announcement of 6 November 2013 on un-enacted measures and remains a matter for government.

PART 7 – INTERNAL REVIEW OF ATO DECISIONS

The ATO has introduced 'independent review' recognising that the existing internal review process did not go far enough and that the ATO needed to do more to demonstrate its willingness to question its decisions in an open, transparent and independent manner.

The service was developed in consultation with members of the Dispute Resolution Working Group, the Large Business Advisory Group and others. It commenced on 1 July 2013 and was available for large business income tax audits. From 1 July 2014, the service was extended to all large market audits, including GST, Excise and Petroleum Resource Rent Tax audits.

Overview

An independent review is conducted by a senior technical officer from the Review and Dispute Resolution (RDR) business line. Any public group taxpayer with a turnover of \$250 million or greater who disagrees with some or all of a 'Statement of Audit Position' may request an independent review.

A review is completed within 12 weeks and results in recommendations to the taxpayer and the audit team. Recommendations provide an understanding and interpretation of the facts and the application of the law to those facts.

A key aspect of the service is a case conference which brings the taxpayer, their representatives, the audit team and the independent reviewer together. The case conference has been well received both externally and internally.

There are limited exclusions to the service. The main exclusions are:

- Provision of new facts, evidence or arguments that have not been provided to the audit team. If this occurs the independent review is finalised and the material provided to the audit team for their consideration.
- The specific areas of disagreement have or will be considered by or subject to recommendations of the General Anti-Avoidance Rules Panel.
- The request relates to issues that have been considered under another review process, for example an objection, litigation or formal alternative dispute resolution.

Since 1 July 2013, seventeen cases have been completed with a further five on hand. Of these, 62 per cent have been in favour of the ATO, while 38 per cent have favoured the taxpayer. Of the reviews where the ATO view was favoured, only one case has progressed to objection.

Post Implementation Review

A review of the service was completed in January 2014 and focused on obtaining both external and internal feedback on what had and had not worked well, areas for enhancement, and how the service might be extended.

The feedback was generally positive, with the case conference identified as a highlight in the process. The two main areas where feedback differed both externally and internally related to the escalation process and the provision of further information.

In February 2014, the ATO executive endorsed recommendations which took account of the views of all participants in the post implementation review. These recommendations provided a balanced approach to addressing the feedback and resulted in:

- Inclusion of an escalation process (at the instigation of RDR) directly to the Chief Tax Counsel where there is a disagreement related to the interpretation of a critical question of law.
- Retention of the current exclusion related to the introduction of new facts, evidence or arguments, but flexibility to accept further clarifying information, particularly if it is helpful in resolving the dispute.
- Expansion of the service to include Indirect Tax and Petroleum Resource Rent Tax audits (limited to the \$250 million turnover threshold)

Opportunities for improvement

At the conclusion of each review, feedback is sought from the taxpayer, their representatives and the audit team. This feedback is used to identify possible improvements to both the independent review service and to our audit processes and procedures.