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Auditor-General for Australia



2 October 2024

Senator Jess Walsh
Chair
Senate Standing Committees on Economics
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Senator Walsh

ANAO submission for the inquiry into Australia's taxation system

The Australian National Audit Office (ANAO) presented the following performance audits to the Parliament that the Committee may find relevant to the above inquiry:

- Auditor-General Report No.20 2022–23, [Identifying and Reducing the Tax Gap for Individuals Not in Business](#); and
- Auditor-General Report No.22 2023–24, [Management of Taxpayers' Use of Transfer Pricing for Related Party Debt](#).

Information about what the audits assessed, concluded, and recommended is attached. The audit reports are available online at www.anao.gov.au.

The ANAO also has two audits on the Australian Taxation Office underway ([Australian Taxation Office's adoption of artificial intelligence](#) and [Management of complaints by the Australian Taxation Office](#)) that are expected to be tabled in the Parliament in the first quarter of 2025.

Should the Committee require further information in relation to these matters, my office would be pleased to provide you with a briefing at a time convenient to you or appear as a witness at a hearing. To arrange a briefing, please contact our External Relations team at [REDACTED]

Yours sincerely



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**Identifying and Reducing the Tax Gap for Individuals Not in Business
No.20 2022–23
Australian Taxation Office**

Background

1. The Australian Taxation Office (ATO) is responsible for the effective management of Australia's taxation and superannuation systems. This includes responsibility for achieving confidence in these systems by 'helping people understand their rights and obligations, improving ease of compliance and access to benefits, and managing non-compliance with the law.'¹
2. The ATO's purpose is to contribute to the economic and social wellbeing of Australians by fostering willing participation in the tax, superannuation and registry systems. The ATO's Corporate Plan 2022–23 identifies the tax gap as part of a strategic objective: 'We build community confidence by sustainably reducing the tax gap and providing assurance across the tax, superannuation and registry systems.'²

Rationale for undertaking the audit

3. In its 2021–22 annual report, the ATO estimated that the overall net tax gap³ for the Australian tax and superannuation system was \$33.4 billion for 2019–20. Within this total, the estimated net tax gap for the taxpayer population of 'individuals not in business' was the second largest gap in dollar terms — \$9 billion for 2019–20⁴ meaning that for this gap, the ATO collected around 94.4 per cent of the tax revenue it would have collected if all taxpayers were fully compliant with tax law. This audit will provide Parliament with assurance that the ATO is appropriately managing the tax gap for individuals not in business.

Audit objective and criteria

4. The objective of the audit was to assess the effectiveness of the Australian Taxation Office's arrangements for identifying and reducing the income tax gap for individuals not in business.
5. To form a conclusion against the objective, the following criteria were adopted.
 - Does the ATO use appropriate methods for identifying the tax gap?
 - Has the ATO implemented risk-based compliance strategies for reducing the tax gap?
 - Does the ATO assess the effectiveness of its compliance strategies for reducing the tax gap?

1 Department of the Treasury, Portfolio Budget Statements 2022–23, Budget Relation Paper No. 1.13: Treasury Portfolio [Internet], Department of the Treasury, 2022, pp. 173 and 180, available from https://treasury.gov.au/sites/default/files/2022-03/pbs_2022-23_08_ato.pdf [accessed 7 September 2022].

2 Australian Taxation Office, *Corporate Plan 2022-23*, available from https://www.ato.gov.au/uploadedFiles/Content/CR/downloads/ATO_Corporate_Plan_2022-23.pdf [accessed 12 January 2023].

3 The tax gap is an estimate of the difference between the amount of tax the ATO collected and what the ATO would have collected if every taxpayer was fully compliant with tax law.

4 The largest estimated net tax gap is for Small Business at \$11.9 billion in 2019–20.

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Conclusion

6. The ATO is largely effective at identifying and reducing the tax gap for individuals not in business.

7. The ATO is largely effective at developing, implementing, and communicating the tax gap methodology for individuals not in business. The ATO undertook an appropriate process to develop a fit-for-purpose methodology, though it did not fully integrate expert advice on sample size and does not have a mechanism to review whether the sample size remains sufficient over time. The ATO has effectively implemented its methodology. The ATO communicates information on its tax gap methodology through its website, though transparency on the methodology could be improved. The ATO publishes a reliability assessment along with the tax gap estimate, though it does not document the process undertaken to develop this assessment. Doing this will help to drive continuous improvement.

8. The ATO has sound processes for identifying and developing compliance strategies to address risks to the individuals not in business tax gap, though inconsistent application of ATO guidance undermines the effective implementation of these strategies. The tax gap measurement process and estimate inform business and enterprise level risks to the individuals not in business tax gap. Performance of the tax system for individuals not in business is monitored, and compliance strategies are developed if necessary. ATO guidance to implement compliance strategies is applied inconsistently, and as compliance strategies do not contain specific targets, the ATO is unable to determine the extent to which compliance strategies contribute to reducing the tax gap for individuals not in business.

9. The ATO is largely effective in assessing compliance strategies for reducing the tax gap. Data and intelligence used to assess effectiveness is relevant, and the use of data for review purposes is embedded during compliance strategy planning via the use of randomised control trials. ATO guidelines encourage timelines for assessment to be developed. While this generally occurs, testing of selected compliance strategies indicates that the ATO has been inconsistent in meeting the timelines set. The ATO internally reports on the effectiveness of individual compliance strategies through Evaluation and Review reports and provides overviews of these meetings upwards. Actionable insights are shared within the ATO.

Supporting findings

Identifying and measuring the tax gap

10. In designing its methodology, the ATO took into account best practice and the methodologies of other jurisdictions, and sought and incorporated expert advice across all areas except sample size. The methodology was assessed and endorsed by an Expert Panel. Procedures to monitor developments in the field of tax gap estimation for individuals not in business are in place. (See paragraphs 2.3 to 2.30)

11. The ATO has implemented its methodology to measure the tax gap for individuals not in business as set out in its guidance. Review and quality assurance processes are fit-for-purpose, and the tax gap estimate for individuals not in business is appropriately endorsed. (See paragraphs 2.31 to 2.68)

12. The tax gap methodology is generally well communicated. A summarised version of the methodology for the individuals not in business tax gap is published on the ATO website, though the ATO could improve transparency by publishing its Technical Guide in full. The ATO publishes an assessment of the reliability of the tax gap estimate for individuals not in business to indicate the ATO's level of confidence in the accuracy of the estimate. The ATO has not recorded the processes or

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outcomes of meetings held to establish reliability assessments since estimation of the tax gap for individuals not in business commenced. (See paragraphs 2.69 to 2.88)

Implementing risk-based compliance strategies to reduce the tax gap

13. The ATO has sound processes for identifying and prioritising risks to the individuals not in business tax gap at the business and enterprise level. Procedures governing the operation of the ATO's risk management framework are comprehensive and well-articulated. The findings from the tax gap measurement process and the estimate inform the risks that relate to the tax gap for individuals not in business. (See paragraphs 3.2 to 3.22)

14. The ATO develops compliance strategies that target specific groups of taxpayers to address business and enterprise level risks to the tax gap for individuals not in business. Data from lodged tax returns are assessed against established tolerances, and when performance moves out of tolerance, the ATO is prompted to consider whether a compliance strategy is required. (See paragraphs 3.23 to 3.31)

15. If a compliance strategy is required, the ATO develops a program logic which identifies the key elements of the compliance strategy. Guidance to prepare a compliance strategy is comprehensive, and they are largely developed in accordance with ATO guidance. (See paragraphs 3.32 to 3.47)

16. While the ATO has guidance to implement compliance strategies, this guidance is applied inconsistently. ATO guidance also requires the intended outcomes of a program logic to be reflected in a compliance strategy's Measurement and Evaluation Plan. An examination of selected compliance strategies found that this occurred inconsistently. While the ATO is able to assess the results of a compliance strategy, it is unable to determine the extent to which a compliance strategy is successful. Targets and benchmarks are not articulated in Measurement and Evaluation Plans. (See paragraphs 3.48 to 3.77)

Assessing compliance strategies for reducing the tax gap

17. The ATO conducts randomised control trials to analyse the effectiveness of compliance strategies where appropriate. These are supported by a range of relevant data and intelligence sources to allow for comparison of target populations and control groups. (See paragraphs 4.4 to 4.11)

18. ATO guidance does not mandate specific timeframes for the assessment of individual compliance strategies for individuals not in business, but staff are encouraged to consider how often an assessment will need to be conducted when designing a Measurement and Evaluation Plan. An examination of selected compliance strategies indicated that where a Measurement and Evaluation Plan had been developed, timeframes for assessment had been established, but were inconsistently met. (See paragraphs 4.12 to 4.31)

19. The ATO monitors the performance of compliance strategies via a dashboard, reporting, and fortnightly meetings. The outcomes of fortnightly meetings are not documented, meaning the ATO may not be able to monitor the progress of agenda items outlined in reporting. (See paragraphs 4.32 to 4.43)

20. The ATO reports on the effectiveness of individual compliance strategies to reduce or maintain the individuals tax gap through evaluation and review reports. While endorsement of these documents is required, evidence of endorsement is not always included in or attached to the reports. The findings of evaluation and review reports are communicated through a risk call-over process, and the outcomes of this are then transmitted internally. The ATO also includes corporate revenue measures in its Annual Report. (See paragraphs 4.44 to 4.60)

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Recommendations

**Recommendation no. 1
Paragraph 2.76** The Australian Taxation Office publish the *Individuals Not In Business Tax Gap Technical Guide* in full to enable transparency as to how the tax gap for individuals not in business is estimated.

ATO response: Agreed

**Recommendation no. 2
Paragraph 2.85** The Australian Taxation Office document the process of assessing reliability of the tax gap estimate for individuals not in business to support transparency and confidence in the accuracy of the estimate.

ATO response: Agreed

**Recommendation no. 3
Paragraph 3.77** The Australian Taxation Office set specific measurable targets and develop benchmarks for use in Measurement and Evaluation Plans. Associated guidance should reflect the need to set targets and use benchmarks to enhance the ATO's understanding of the effects of compliance strategies intended to reduce the tax gap for individuals not in business.

ATO response: Agreed

Summary of entity response

21. The proposed audit report was provided to the ATO. The summary response is reproduced below.

We are extremely proud of our individuals not in business tax gap methodology and random enquiry program, which is recognised internationally as best practice. The estimate is published in the Commissioner's Annual Report, and our experience shared through the OECD Tax Gap Community of Practice. Our methodology has been effectively applied to administered programs including JobKeeper. We believe there is significant value in other agencies adopting a similar approach, particularly if performance metrics are based on compliance yield which is a good proxy for short term activity, but not necessarily for sustained system health. By contrast, 'gap' style methodologies attempt to estimate system health and support a longer-term stewardship approach.

The individuals not in business market is a focus for us given its size and complexity. Tax gap analysis is an evidence-based measure of the risk behaviours driving the gap. Understanding those drivers is an important input to strategy development, as are other measures such as total revenue effects, and evaluation of preventative actions.

As we move beyond tax gap thinking, our focus is shifting to preventative activities that support compliance upfront. Our new evaluation framework provides better measures of these strategies and their sustained effect on future willing participation.

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**Management of Taxpayers' Use of Transfer Pricing for Related Party Debt
No.22 2023–24
Australian Taxation Office**

Summary and recommendations

Background

1. The Australian Taxation Office (ATO) is the principal revenue agency responsible for administering the tax system and aspects of the superannuation system. As part of its duties, the ATO conducts compliance activities to ensure taxpayers are complying with tax requirements. The ATO's stated purpose is to contribute to the economic and social wellbeing of Australians by fostering willing participation in the tax, superannuation, and registry systems.
2. The ATO's Corporate Plan 2023–24 identifies multinational tax performance as a key focus area, with a number of deliverables, including:
 - address key risks to the corporate tax base and close tax loopholes so that the community has confidence that public and multinational businesses are paying the right amount of tax in Australia; and
 - support the integrity of the tax system by boosting tax transparency through better public reporting of large business tax information.

Rationale for undertaking the audit

3. The latest publicly reported figures indicate that in 2020–21 inbound international related party borrowings in Australia totalled \$520 billion, with \$13.2 billion in interest expenses paid. The ATO monitors entities belonging to the Top 100 and Top 1,000 populations. Approximately 33 per cent of these inbound related party borrowings were attributed to the Top 100 entities and an additional 40 per cent were reported by the Top 1,000 entities.
4. The ATO has identified inbound related party borrowings as a key risk. In the ATO's 2022 assurance activities for the Top 100 entities, related party financing represented the highest proportion of unassured items receiving a red flag rating to indicate likely non-compliance with income tax laws. Similarly, amongst the Top 1,000 entities, financing assurance activities resulted in a higher amount of low assurance and red flag ratings (22 per cent) than other areas reviewed. Interest bearing loans were the largest category of financing risks reviewed.
6. This audit will provide assurance to the Parliament that the ATO effectively manages transfer pricing for related party debt, using sound strategies and processes to address risks and to ensure related party debt is appropriately priced. This audit was identified as a priority by the Parliament's Joint Committee of Public Accounts and Audit in the context of the ANAO's 2022–23 and 2023–24 Annual Audit Work Program.

Audit objective and criteria

5. The objective of the audit was to assess the effectiveness of the ATO's management of transfer pricing for related party debt.
6. To form a conclusion against the objective, the following criteria were adopted.
 - Are the risks relating to transfer pricing for related party debt appropriately managed?
 - Does the ATO have a sound strategic framework to manage the use of transfer pricing for related party debt?
 - Does the ATO effectively manage transfer pricing for related party debt?

Conclusion

7. The ATO is largely effective at managing taxpayers' use of transfer pricing for related party debt. Effectiveness is reduced by not assessing, meeting and reporting on assurance targets.
8. The ATO is largely effective in identifying and prioritising risks to transfer pricing for related party debt. Its processes operate at the ATO business line level and are sound. The risk is primarily managed through use of the Top 100 Justified Trust Program and Top 1,000 Combined Assurance Program. However, management of risk is undermined by the ATO not meeting its stated taxpayer review targets to gain its desired level of assurance. Annually, the ATO seeks to review the entire Top 100 population, and 250 taxpayers within the Top 1,000 economic groups. This has not occurred during the audit period and the ATO has not conducted a process to determine whether an annual review of 250 Top 1,000 taxpayers provides sufficient oversight. There is no reporting to the Strategic Management Committee (SMC) on progress against targets for completed Pre-lodgment Compliance Reviews (PCRs) or Combined Assurance Reviews (CARs). The ATO does not conduct analysis on the reasons taxpayers may not be required to complete Country-by-Country local file reporting. Risk reporting occurs on a quarterly basis at the business level. As the risk has been rated as in tolerance, reporting has not been escalated to the enterprise level.
9. The ATO has established a largely effective strategic framework to manage the use of transfer pricing for related party debt. The principles outlined in Organisation for Economic Co-operation and Development (OECD) transfer pricing guidance are reflected in the ATO's guidelines for staff and taxpayers. The ATO has a sound strategy to engage with taxpayers with related party debt, primarily through the application of Practical Compliance Guideline 2017/4 (PCG 2017/4), though training for staff is not mandatory and records of staff training are not kept. Further, while the ATO aims to review all taxpayers using related party debt that do not apply PCG 2017/4, this does not occur in the majority of cases. The ATO effectively supports engagement with taxpayers through the completion of assurance reviews, though a lack of IT quality controls means it cannot be determined with certainty that the Top 1,000 population is complete and accurate.
10. The ATO is largely effective at managing transfer pricing for related party debt. Data and intelligence are gathered to monitor taxpayer behaviour. The ATO largely applies its framework to analyse related party finance, though there are some variations in how the Top 100 and Top 1,000 teams verify taxpayer application of PCG 2017/4, and record analysis of taxpayer financing and capital structures.

Supporting findings

Managing risks related to transfer pricing for related party debt

11. The ATO has sound processes for identifying and prioritising risks to transfer pricing for related party debt at the business level. Procedures governing the operation of the ATO's risk management framework are comprehensive and well-articulated. Data obtained through the Reportable Tax Position Schedule disclosures and the International Dealings Schedule is used along with self-assessments via PCG 2017/4 to monitor trends and detect risks. While Country-by-Country local file reporting provides further data, the ATO was unable to quantify the total number of taxpayers with a reporting obligation that had not complied with lodgment requirements. (See paragraphs 2.4 to 2.32)

12. The ATO uses the Top 100 Justified Trust Program and Top 1,000 Combined Assurance Program to engage with Top 100 and Top 1,000 taxpayers to manage transfer pricing risk. To gain assurance each year, the ATO aims to review all Top 100 taxpayers, and 250 Top 1,000 taxpayers. These targets have not been met over the last four years, and the ATO was unable to determine whether the Top 1,000 target provided sufficient oversight over the population. (See paragraphs 2.33 to 2.58)

13. As the business level risk relating to transfer pricing for related party debt has remained in tolerance, it has not been escalated for enterprise level consideration. At the business level the risk is monitored by the Public Groups SMC. The SMC receives quarterly reporting on the transfer pricing risk, but has not been provided with reporting on progress against targets for completed PCRs or CARs, meaning that the SMC cannot properly monitor the level of assurance the ATO has over the Top 100 and Top 1,000 populations' use of transfer pricing for related party debt. Until October 2023, the SMC was required to 'provide regular reports' to the Public Groups Executive. This did not occur. (See paragraphs 2.59 to 2.63)

Strategic framework to manage the use of transfer pricing for related party debt

14. The principles outlined in OECD transfer pricing guidance are reflected in legislation and ATO guidance for both its staff and taxpayers. The ATO has taken action to incorporate recent updates to the OECD guidance into Australian law. The ATO's approach to Country-by-Country reporting is largely consistent with its international obligations. (See paragraphs 3.3 to 3.27)

15. The ATO has developed a sound strategy to engage with taxpayers who use transfer pricing for related party debt. PCG 2017/4 forms the basis of the strategy. The ATO verifies taxpayer application of PCG 2017/4 through PCRs for the Top 100 population and CARs for the Top 1,000 population. Experts in the ATO's Economist Practice are consulted to determine that transfer pricing has occurred appropriately. Staff have access to training to analyse transfer pricing, though training is not mandatory. Support is available to assist taxpayers in applying PCG 2017/4. While the ATO aims to review taxpayers who do not apply PCG 2017/4 this does not occur for the majority of cases. (See paragraphs 3.28 to 3.67)

16. The ATO has a framework to support engagement with taxpayers using related party debt. The Action Differentiation Framework categorises taxpayers by size and applies a risk-based 'engagement experience'. These two factors determine the regularity and intensity of the ATO's review processes to gain assurance over taxpayers' income tax, including their use of related party debt. Case teams undertaking assurance reviews are supported by other ATO business lines when engaging taxpayers and finalising assurance outcomes. (See paragraphs 3.68 to 3.107)

Does the ATO effectively manage transfer pricing for related party debt?

17. The ATO has documented processes to gather data and intelligence on Top 100 and Top 1,000 taxpayers using related party debt. Profiling of taxpayers occurs early in the review process via internal and publicly available information. Data and intelligence are sourced from information disclosed by taxpayers as part of their responsibilities under Australian income tax law or from information requested by the ATO during the review process. (See paragraphs 4.3 to 4.13)

18. The ATO manages transfer pricing for related party debt largely as intended. There are some variations in how the Top 100 and Top 1,000 teams verify taxpayers' application of PCG 2017/4, and record analysis of taxpayers' financing and capital structures. (See paragraphs 4.14 to 4.32)

Recommendations

Recommendation no. 1
Paragraph 2.29 The Australian Taxation Office conduct further analysis to determine and monitor why taxpayers may not lodge Country-by-Country local file reporting.

Australian Taxation Office response: *Agreed.*

Recommendation no. 2
Paragraph 2.54 The Australian Taxation Office take action to:

- (a) determine the number of completed Tax Assurance Reports considered sufficient to gain assurance that Top 100 taxpayers are appropriately using transfer pricing for related party debt; and
- (b) determine how to gain sufficient assurance over the Top 1,000 population through the use of Combined Assurance Reviews and gap analysis, while also formalising how gap analysis should be conducted.

Australian Taxation Office response: *Agreed.*

Recommendation no. 3
Paragraph 3.43 The Australian Taxation Office take action to ensure all taxpayers with related party debt that do not apply Practical Compliance Guideline 2017/4 are reviewed in accordance with the Australian Taxation Office's goals.

Australian Taxation Office response: *Agreed in principle.*

Recommendation no. 4
Paragraph 3.60 The Australian Taxation Office:

- (a) make training in related party financing mandatory for new case officers where related party financing is likely to be relevant to their role; and
- (b) develop and maintain a register to ensure all staff are trained consistently and remain up to date in developments around transfer pricing for related party debt.

Australian Taxation Office response: *Agreed in principle with (a); agreed with (b).*

Summary of entity response

The ATO welcomes this review and is pleased the report acknowledges the ATO has sound strategies and processes to address transfer pricing risk for related party debt.

Since the Tax Avoidance Taskforce commenced, we have transformed our approach to profit shifting related risks, including related party debt. We are very proud of the outcomes achieved and strive to continue this success. We continually look to evolve and improve our approach and welcome the input from the ANAO.

The ATO was one of the first tax administrations globally to release detailed guidance on our compliance approach. Further supported by litigation success, we have removed more than \$45 billion of interest deductions for past and future years from the system. Through our compliance programs we have coverage of over \$341 billion or 80% of all inbound interest bearing related party debt and this continues to increase.

Our range of programs are designed to encourage voluntary compliance by large businesses. Our increased guidance, detection of incorrect tax positions, litigation successes, and 'locking in' behavioural changes as part of settlements is driving permanent changes in taxpayers risk profiles. These programs also provide the Australian community with confidence that all large businesses are regularly reviewed to assure that they pay the right amount of tax.