

Audit Report No. 55, 2002–03

Goods and Services Tax Fraud Prevention and Control

Introduction

Background

- 4.1 Fraud against the Commonwealth is a major concern to the Government. Agencies must ensure that fraud is minimised and, where fraud does occur, is rapidly detected, effectively investigated, appropriately prosecuted, and losses minimised.¹
- 4.2 The Commonwealth Fraud Control Guidelines (Fraud Control Guidelines) require Commonwealth agencies to put in place a comprehensive fraud control program that includes prevention, detection, investigation and reporting strategies. The Guidelines, which define fraud as *dishonestly obtaining a benefit by deception or other means*—include both tangible and intangible benefits and apply to all agencies covered by the *Financial Management and Accountability Act 1997* (the FMA Act) and bodies covered by the *Commonwealth Authorities and Companies Act 1997* that receive at least 50% of their funding for operating costs from the Commonwealth.

1 Attorney-General's Department (AGD), *Commonwealth Fraud Control Guidelines*, p. iii.

- 4.3 The Attorney-General's Department (AGD), the Australian Federal Police (AFP) and the Commonwealth Director of Public Prosecutions (DPP) are the Commonwealth agencies with cross-government responsibilities in relation to fraud control. In short AGD advises, AFP investigates and DPP prosecutes.
- 4.4 The Australian Taxation Office (ATO) function is to manage and shape the revenue systems that give effect to social and economic policy, and fund government services for Australians. Its response to fraud complies with the FMA Act.
- 4.5 Introduced from 1 July 2000, the Goods and Services Tax (GST) is a broad-based indirect tax, imposed on goods and services at each point in the distribution chain, including at importation. GST replaced the existing wholesale sales tax and a number of indirect state taxes. The GST rate is 10 per cent.

The Audit

- 4.6 The audit by Australian National Audit Office (ANAO) assessed whether ATO has implemented administratively effective GST fraud control arrangements, consistent with the Commonwealth Fraud Control Guidelines.
- 4.7 The audit addressed the following key elements of fraud control:
- fraud control arrangements integrated within ATO's corporate governance framework;
 - ⇒ all GST business areas included in the ATO Compliance sub-plan;
 - ⇒ fraud prevention and detection focussed on GST General Compliance only (the highest risk area);
 - ⇒ detection strategies and management of fraud investigations were assessed;
 - strategies, systems and processes used to prevent and detect GST fraud;
 - management of GST fraud investigations;
 - reporting of GST fraud; and
 - key Risk Rating Engine (RRE) controls.

Audit Findings

- 4.8 ATO has systems and processes in place to prevent, detect, investigate and report GST fraud. These activities are undertaken and implemented across

business lines. However, ANAO considers that these activities need to be better integrated and coordinated if they are to underpin an effective GST fraud control framework.

4.9 ATO is currently revising its GST fraud control plan. This will allow ATO to undertake a comprehensive assessment of all GST fraud risks. The plan should also integrate GST fraud prevention, detection and mitigation strategies across ATO. ANAO has identified a number of areas where improvements could be made. These include:

- articulating ATO's overall fraud control strategy to staff and how the Commonwealth's definition of fraud is to be interpreted and implemented;
- recognising that external fraud should be treated as a separate component of ATO's compliance continuum;
- reviewing data collection requirements and the integrity of data to be included in fraud reports; and
- enhancing the effectiveness of the RRE as a fraud detection tool.

4.10 ANAO made eight recommendations, all of which were agreed to by ATO. In summary, ANAO recommended that ATO:

- articulate how the Commonwealth's definition of fraud is to be interpreted across the ATO;
- undertake an agency-wide co-ordinated assessment of GST fraud risks;
- review and report on its data integrity and collection requirements;
- undertake on-going evaluation of RRE fraud tests and business rules;
- reference fraud case notes to maximise the potential of the Registration Information Matching System (RIMS);
- record fraud cases in the Fraud Investigation Reporting and Management (FIRM) System;
- supply investigation guidelines to officers preparing briefs for the DPP; and
- evaluate and analyse fraud outcomes and trends routinely, to support agency fraud control planning and development.

The Committee's Review

- 4.11 On 13 October 2003 the Committee held a public hearing to review ATO's progress against the audit's recommendations. The public hearing was attended by:
- Australian Taxation Office; and
 - Australian National Audit Office
- 4.12 The Committee took evidence on the following issues:
- definition of fraud;
 - international comparison of Australia's fraud control systems;
 - serious non-compliance capability;
 - cash economy;
 - recording and reporting; and
 - Risk Rating Engine (RRE).

Definition of fraud

- 4.13 The Committee expressed concern that the definition of fraud was "too loose" for the purposes of ATO assessment of the veracity of many taxpayer GST-related records. It noted that ATO appeared to be hampered in achieving effective containment and successful prosecution of suspected fraud due to definitional vagueness. ANAO recommended in its audit report, and ATO agreed to articulate how fraud would be interpreted and implemented across ATO.
- 4.14 In response to the Committee's questions, ATO conceded that the existing definition of fraud was "...an extremely wide definition. It basically covers just about anything that we come across in a tax environment".² From the definition and the DPP guidelines there is no formula that determines "all of these add up to fraud".³ ATO said that it is pessimistic about "ever getting an absolutely clear definition".⁴

2 Australian Taxation Office (ATO), *Transcript, 13 October 2003*, p. 3.

3 ATO, *Transcript, 13 October 2004*, p. 2.

4 ATO, *Transcript, 13 October 2004*, p. 2.

4.15 ATO emphasised that for fraud to occur, it has to be seen that there has been *intent* to defraud, or some deception⁵. This matter is quite problematic for ATO. If someone has claimed a deduction they are not entitled to, ATO does not know whether they did it with intent, or if it was an innocent error.⁶ The process and cost implications of ATO's response options are variable.

The area where we have difficulty is the borderline of where you make the decision about what you deal with administratively and what you refer to prosecution.⁷

4.16 ATO advised that the two most prevalent types of fraud were:

- where a taxpayer improperly claims a GST credit, and;
- invoice veracity, where non-arms length parties have concocted a transaction value. For example, there is a potential for fraud if one party to a transaction uses the accruals basis of accounting and the other party uses the cash basis and there is a non-arms-length valuation.

4.17 ATO emphasised that even where it harboured suspicions about a taxpayer;

Fraud is a very difficult offence to prove⁸

4.18 In the GST context, where a taxpayer claims an input tax credit but does not hold a valid tax invoice, ATO normally regards this as a compliance issue. If a taxpayer manufactures false documents to support such claims, then this is a fraud.

4.19 Other factors for ATO to consider in deciding the course of action on compliance, include materiality and past compliance history.

4.20 ATO advised that, in the context of the difficulties it experiences in proving fraud, rather than rely on a strict definition of fraud, it preferred to rely on on-the-ground referral guidelines and a bridging statement, as well as judgement on when to use a range of administrative solutions, rather than prosecution. ATO advised that its guidelines were in the process of refinement and were expected to be in place by early 2004.⁹

5 ATO, *Transcript, 13 October 2003*, p. 3.

6 ATO, *Transcript, 13 October 2003*, p. 4.

7 ATO, *Transcript, 13 October 2003*, p. 2.

8 ATO, *Transcript, 13 October 2003*, p. 7.

9 ATO, *Transcript, 13 October 2003*, p. 8.

Committee comment

- 4.21 The Committee is adamant that prevention of fraud is at the core of the integrity of a good GST system.
- 4.22 Evidence presented to the Committee shows that the Commonwealth's vague definition of fraud appears to allow some GST fraud to slip ATO's net and it is dismayed that ATO is pessimistic about tightening the definition of fraud.
- 4.23 The Committee endorses the risk management approach adopted by ATO, including consideration of taxpayer evasion history, financial materiality and evidence gathering as inputs to its decision whether to prosecute suspected GST fraud or not. ATO's undertaking to articulate the existing definitions of fraud, intent to defraud and the many examples cited in the Commonwealth Fraud Control Guidelines is seen as a step in the right direction.
- 4.24 ATO appears, however, to be constrained by the provisions in existing legislation in successfully prosecuting some suspected GST fraud and, instead, is forced to deal administratively with certain suspected breaches of a borderline nature. A more rigorous prosecution policy should be available to ATO to contain the incidence of GST fraud. Existing legislation that may form the basis for prosecution of suspected GST fraud should be reviewed to see if it can be tightened to enhance the ease of proof of fraud. The Committee recommends accordingly.

Recommendation 4

- 4.25 **The Attorney-General's Department, in liaison with the Australian Taxation Office and the Commonwealth Director of Public Prosecutions, draft amendments to legislation, for the Attorney-General's consideration, that enhance the ease of proof in the prosecution of suspected Goods and Services Tax fraud.**

International comparison of Australia's fraud control systems

- 4.26 The Committee questioned ATO as to how well the overall Australian GST data collection management regime, accountability and transparency compared with overseas counterparts.

- 4.27 ATO assured the Committee that it had designed its GST compliance program by considering a number of overseas regimes, at the time. These included Singapore which had implemented the most modern technological system; the United Kingdom's system which exhibited maturity; the Canadian system which showed a demographic fit; and New Zealand's system which possessed a credible GST policy model. Organisation of Economic and Cultural Development (OECD) papers and European Union arrangements were also reviewed.¹⁰
- 4.28 ATO had also perused the GST models of Australia's major trading partners, specifically Japan and China, but found that the systems in those jurisdictions were not comparable to Australia's. Japan had a different type of Value Added Tax (VAT) and China's tax administration was not as developed as other overseas regimes. The Committee noted in passing that another of Australia's major trading partners, the USA, has no GST.
- 4.29 Based on its research, ATO concluded that its international benchmarking had been made more robust through reference to systems in a number of countries which it believed were comparable to the Australian context, particularly the OECD, rather than countries solely with strong trade links to Australia.¹¹

Committee comment

- 4.30 The Committee is satisfied that ATO's benchmarking with overseas regimes has been thorough.

Serious non-compliance capability

- 4.31 ATO advised the Committee that it had up-graded its serious non-compliance capability since the ANAO audit. Under the new structure, introduced in July 2003, its three former non-compliance functions – investigation, serious non-compliance and excise compliance – had been merged into a corporatised compliance program. The intent was to capture the benefits of critical mass as well as to allow practices, tools, resourcing and management of the program to be monitored and controlled. ATO reminded the Committee that it could only use tax powers for civil purposes and that for fraud only criminal investigation procedures could be used, necessitating the separation of the two

10 ATO, *Transcript, 13 October 2003*, p. 4.

11 ATO, *Transcript, 13 October 2003*, p. 5.

functions. Notwithstanding, ATO advised it was seeking to merge its capability “because we need to be able to choose between those different strategies and use the most appropriate one for the circumstances”.¹²

4.32 Although it is early days, ATO advised that it was confident that the new arrangements were superior to the system they replaced. Two areas - albeit non-GST - were already being investigated.

Committee comment

4.33 The Committee is satisfied that ATO has undertaken the appropriate upgrade of its serious non-compliance capability, in line with ANAO recommendations.

Cash economy

4.34 Of concern to the Committee was the level of GST revenue lost through the operations of the cash economy, and questions were directed to ATO as to the methods used by ATO to estimate the magnitude of the cash economy.

4.35 ATO advised that:

there is not any agreed methodology to estimate the size of that cash economy.¹³

4.36 ATO indicated that it monitored academic, international and Australian Bureau of Statistics (ABS) research, but was unable to offer a firmer estimate of the magnitude of non-declared income other than equivalent to costing “billions of dollars of tax revenue” (including income taxes of sole traders and company taxes).

4.37 ATO’s administrative approach to making in-roads into non-declared income used:

- Australian Business Number (ABN);
- requirement for businesses to withhold at the top marginal tax rate for businesses not quoting an ABN;
- monitoring audit trails between parties using GST; and

12 ATO, *Transcript, 13 October 2003*, p. 10.

13 ATO, *Transcript, 13 October 2003*, p. 6.

- verifying business records and business transactions with suppliers and customers.
- 4.38 ATO advised that, using the above methods, it was successful in bringing to account revenue that otherwise would be missing.
- 4.39 The Committee was advised by ATO that the introduction of the ABN system had resulted in the collection “at this stage, ... around \$60 million in back taxes from those businesses”¹⁴ that had never been in the system. A far greater number of businesses were found by ATO than had been expected.

Committee comment

- 4.40 The Committee, whilst appreciating that the size of the cash economy probably runs to billions of dollars and that the task of estimating the extent of the cash economy is enormous, recognises that not all tax revenue evaded results from GST fraud. It therefore concurs that ATO resources are better spent identifying non-declared income using the administrative tools mentioned above, and seeking appropriate penalties.
- 4.41 The Committee urges ATO to encourage ABS to intensify its research into methodologies to determine the extent of non-declared income in Australia.

Recording and reporting

- 4.42 ANAO identified problems in recording and reporting by ATO with respect to the incidence of GST fraud and subsequent ATO action. Records on data bases were permitted to fall out of date as investigations proceeded.
- 4.43 The Committee asked ATO whether reporting and recording had been improved since the audit. ATO advised that a new case management system was scheduled for introduction in January 2004.¹⁵ This system will envelope all areas that deal with fraud. Statistics will be collected and reports produced based on definitions devised in consultation with AGD. Manual monitoring will continue and will run in parallel with the new system until it is operating satisfactorily.

14 ATO, *Transcript, 13 October 2003*, p. 16.

15 ATO, *Submission No. 5*, p. 2.

- 4.44 ATO advised that the reports produced will detail cases actually being investigated at the time.
- 4.45 In the case of interceptions of fraudulent or incorrect refunds, overseas experience and ATO's own risk assessments indicate that the most effective response by ATO is to intercept fraud prior to the refund being paid.
- 4.46 Compliance checks of businesses after GST refunds have actually been paid to tax payers, are carried out by a team of around 3 000 field officers which targets 10 per cent of the registered business population. These checks complement the interception activity noted above. Some 660 ATO field officers target the cash economy, of which 180 officers are specifically dedicated to the high risk building and construction industry. Techniques used include assessments of businesses for over-statement of expenses, visits to construction sites, checks to ensure sub-contractors are properly registered for GST and that they have reasonable arrangements in place to collect GST.
- 4.47 ATO advised the Committee that several entities had been prosecuted successfully, involving sums in the range \$6 million to \$13 million.
- 4.48 GST fraud investigations are generally selected on the basis of the significance of the suspected breaches, which was "not at the consumer end".¹⁶ ATO confirmed, however, that it used other mechanisms to follow up GST evasion at "the lower end", including an evasion hot line.

Committee comment

- 4.49 The Committee endorses ATO's attempts to identify and contain potential incidents of GST fraud before it happens.
- 4.50 The Committee is, however, concerned that ATO appears not to be able to quantify the tax gap – the difference between what is believed to be owed and what is actually collected.¹⁷
- 4.51 ATO's responses when questioned on their methods of measuring the extent of GST fraud appear to be indirect and vague, amounting to estimation by extrapolation. The Committee's view is that the basis of ATO's best estimate – "well over 80 percent,... close to 90 percent"¹⁸ of the detection of fraud-based revenue before it is actually lost - is not sufficiently rigorous to stand as a credible performance measure. The

16 ATO, *Transcript, 13 October 2003*, p. 14.

17 ANAO, *Audit Report No. 55, Goods and Services Tax Fraud Prevention and Control*, p. 51.

18 ATO, *Transcript, 13 October 2003*, p. 15.

Committee believes that ATO should establish and maintain a dynamic mechanism to determine an estimate of the tax gap using appropriate Australian Bureau of Statistics economy-wide business indicators.

- 4.52 Alternatively, the Committee believes that ATO's examination of a random sample of taxpayers to determine the level of compliance (and non-compliance) with GST obligations, which it performs as part of its performance agreement with the states and territories,¹⁹ could be expanded to provide an estimate of the tax gap.
- 4.53 ATO should be able to report against a target performance measure of, say, 95 per cent collection of the theoretical maximum amount of GST owed, and the Committee recommends accordingly.

Recommendation 5

- 4.54 **The Australian Taxation Office report to the Joint Committee of Public Accounts and Audit within six months, on a mechanism to estimate the tax gap, that would serve as the basis for reporting the overall efficacy of the range of measures being adopted to prevent and control Goods and Services Tax fraud.**

Risk Rating Engine (RRE)

- 4.55 Given the crucial role that ATO's RRE plays in detecting fraudulent and non-compliant behaviour in the processing of activity statements, ANAO reviewed a number of the RRE's key controls. To put the importance of the RRE in context, ATO advised the Committee that a very robust pre-issue (of refunds) checking mechanism was necessary because of the huge number of forms handled annually by the GST system – 9.7 million Business Activity Statements and 2.4 million refunds.²⁰
- 4.56 ATO advised the Committee that it has two automated checking mechanisms operating in tandem to detect compliance risk:
- Registration Information Matching System (RIMS) which checks registration consistency; and
 - RRE which checks activity statements automatically for consistency of current claims with the history of related business activity.

19 ANAO, Audit Report No. 55, *Goods and Services Tax Fraud Prevention and Control*, p. 50.

20 ATO, *Transcript*, 13 October 2003, p. 17.

- 4.57 File data are matched with current records and tests (some of which are dedicated fraud tests) are applied relating to various thresholds. If these checks show up high risk, the cases are immediately referred to the fraud intelligence area²¹.
- 4.58 The Committee questioned ATO whether there were any discernible trends relating to the level of fraud relating to those businesses using a tax agent to submit and those that did not. ATO advised that it had built in to its RRE the criterion of “not using a tax agent” as a higher risk. However it had found that there is not a discernible difference in what generates fraudulent compliance issues, whether a tax agent was used or not.

Committee comment

- 4.59 The Committee is satisfied that the dual systems – RIMS and RRE- that ATO has in place for risk assessment of activity statements and tax payer profiles, are sufficiently robust to screen out high risk GST respondents. The automated systems are coping adequately with the huge volume of GST-related records processed annually.

Bob Charles MP
Chairman
March 2004

21 ATO, *Transcript, 13 October 2003*, p. 18.