

The Auditor-General
Audit Report No.16 2006–07
Performance Audit

**Administration of Capital Gains Tax
Compliance in the Individuals
Market Segment**

Australian Taxation Office

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of Australia 2006

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Canberra ACT
20 December 2006

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Taxation Office in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Administration of Capital Gains Tax Compliance in the Individuals Market Segment*.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee', is positioned above the typed name.

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

AIIR	Annual Investment Income Report
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
BAU	Business as Usual
CC	Compliance Challenges
CGT	Capital Gains Tax
ECMP	<i>Easier, cheaper and more personalised</i> change program
DM&I	Data Management and Integrity
MOU	Memorandum of Understanding
OECD	Organisation for Economic Co-operation and Development
PBR	Private Binding Ruling
PLAD	Pre-lodgement advisory determination letters
PTax	Personal Tax business line (now the Micro Enterprises and Individuals business line)
REI	Real Estate Institute
SCF	Strategic Compliance Forum
TFN	Tax File Number
TPG	Tax Practitioners Group

Summary and Recommendations

Summary

Background and Context (Chapter 1)

1. Capital gains tax (CGT) refers to the income tax payable on any net capital gain made and included in an annual tax return.¹ It is not a separate tax, but forms a component of income tax.

2. A CGT regime was introduced in Australia on 20 September 1985, through amendments to the *Income Tax Assessment Act 1936*. The Tax Law Improvement Project established in 1994 aimed to address the complexity of the original CGT provisions. Following this project, CGT law was rewritten to include events, each with its own provisions for identifying and calculating capital gains and losses.² These changes were incorporated into the *Income Tax Assessment Act 1997*. A key change from the 1999 Review of Business Taxation was the introduction of a discount in CGT payable for certain assets held for over a year.³ In addition, indexation was frozen at 30 September 1999.⁴ The Australian Taxation Office (ATO) has identified that the evolving and complex nature of CGT legislation, with its extensive record keeping requirements and calculations, means many individuals find compliance with their legislative obligations difficult.

Context: capital gains tax for individuals

3. In 2003–04, 813 755 individuals reporting net capital gains were classified as being taxable (that is, have net tax payable of more than \$0). This number of taxable individuals reporting net capital gains increased by 19 per cent from 2002–03, while the amount of net capital gains reported increased by 45 per cent over the same period. The trend for the number of taxable individuals reporting net capital gains, and the value of these gains is shown in Figure 1. The decline in the number of individuals reporting net

¹ A net capital gain is the difference between total capital gains for the year and total capital losses (including capital losses from prior years).

² There are currently 52 CGT events. The most common is disposal of an asset (e.g. sold or given away).

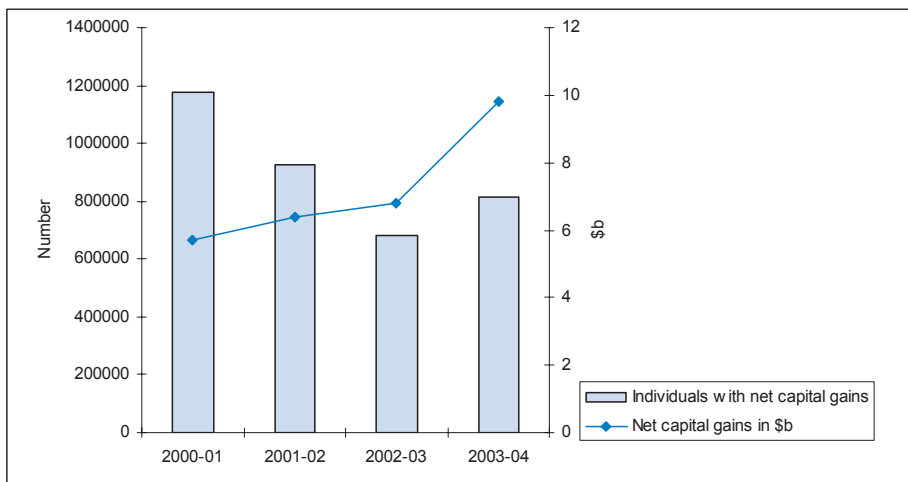
³ This is 50 per cent for individuals and trusts, 33.3 per cent for super funds and is not available to most companies.

⁴ There are three methods for calculating CGT. The indexation method is now only applicable for assets acquired pre-21 September 1999. It allows an increase to the assets' cost base by applying an indexation factor based on CPI up to September 1999; the discount method allows a discount on capital gains on assets held for over 12 months; and the other method involves subtracting the cost base from the capital proceeds.

capital gains from 2000–01 to 2002–03 shown in Figure 1 was identified by the ATO as a major risk to the CGT system, and was a key driver behind the introduction of the CGT Project, designed to improve the ATO’s administration of CGT compliance by individual taxpayers.⁵

Figure 1

Number of taxable individuals reporting net capital gains and value of net capital gains 2000-01 to 2003-04



Source: ANAO analysis of *Taxation Statistics 2003-04*, Table 9.12.

4. The Reserve Bank of Australia reports that Australia has a strong tradition of home ownership, with ownership of other residential property (primarily for investment) increasing over the past decade. In 2002, 17 per cent of Australian households owned residential property which was not their principal place of residence, and over half of these received rental income from the property.

5. As with almost all OECD countries, Australia experienced a significant increase in housing prices since the mid-1990s. In particular, the property boom in Australia peaked on the eastern seaboard around 2003, with what the Commonwealth Bank referred to as a ‘home buying frenzy in 2003’. At this time, approximately 30 per cent of all housing loans were for investment properties.

6. In addition, the Australian Stock Exchange has reported that in 2004, approximately eight million Australians (55 per cent of the adult population)

⁵ See paragraph 10 below.

owned shares. Share ownership is currently the highest it has been since 1999. This strong growth in both the real property and share markets has also increased the likelihood of large capital gains being made.

Audit objective

7. The objective of the audit was to assess the ATO's administration of CGT compliance in the individuals market segment. The focus of the audit was the ATO's administration of compliance by individuals with respect to the two most common CGT events: real property and share disposals. The Australian National Audit Office (ANAO) identified three key areas for review:

- *governance* – the corporate planning and reporting arrangements relevant to the administration of CGT compliance in the individuals market segment, including how these are integrated with the ATO's overall approach to managing CGT;
- *identifying and assessing compliance risks* – the mechanisms and strategies used to identify and assess CGT compliance risks in the individuals market segment; and
- *compliance activities* – the products and processes used to manage CGT compliance in the individuals market segment.

Governance Arrangements (Chapter 2)

Recent history of CGT administration for individual taxpayers

8. During the first 12 years of Australia's CGT regime, the ATO did not have a comprehensive approach to identifying and treating CGT compliance risks. Between 1997 and 2003 it made isolated attempts to better comprehend or quantify CGT compliance in geographical areas or for large events. These did not progress for reasons ranging from funding, resourcing, and skilling to prioritisation of perceived higher risks.

9. In 2003 the ATO sought additional funding, and in the 2004 Budget was allocated \$7.3 million to address its CGT *compliance challenges*. There was also a substantial increase in the business-as-usual funding made available to administer CGT compliance by individual taxpayers (from \$0.3 million in 2003–04 to approximately \$4.37 million over four years). A total of \$11.67 million has been allocated to improve the ATO's dedicated CGT capability for the individuals market segment (the CGT Project). At the time of

the audit (two years into the project) just over \$7 million of this funding had been spent by the ATO.

The CGT Project

10. The CGT Project commenced in July 2004 and is a four-year project focusing on capital gains arising from real property and share disposals. A key feature is the systematic use of external data to develop the ATO's understanding of the real property and share markets.

11. In addition to ensuring that the ATO meets its overall revenue and coverage commitments for CGT, the project intends to position the ATO to effectively measure levels of CGT compliance and make informed decisions about risk treatment strategies. A series of integrated strategies have been initiated to build capability across key areas and to embed improvements to the point that they are considered business-as-usual by the end of the project.

12. The ATO has established monitoring and reporting arrangements that support the ongoing management of the CGT Project. Although the comprehensiveness of, and links between, higher level strategic planning documentation was adequate, the ANAO concluded that there is a need to improve relevant planning documentation to provide assurance that the CGT Project is being undertaken in a coordinated and consistent way at the operational level. The ANAO also considers that there is scope for the ATO to introduce additional performance measures that enable the assessment of progress against the projects' intended outcomes.

13. The ANAO examined the relationship between the CGT Project and the ATO's Capital Gains Compliance Committee and found that the Project was integrated with the ATO's overall approach to managing CGT.

CGT Compliance Risks (Chapter 3)

14. During the initial stages of the CGT Project a CGT risk management framework was developed in line with the ATO's corporate requirements. As part of the audit, the ANAO examined progress made by the project to inform the ATO's understanding of the compliance risks relating to non-disclosure of real property and share capital gains by individual taxpayers.

Research and intelligence

15. The ATO has initiated research and intelligence activities designed to support systemic risk identification and assessment and inform its CGT

compliance strategies. The ANAO recognises the ongoing challenge faced by the ATO in balancing client costs with administrative requirements. However, in the absence of other information sources, the ANAO considers that the limited capital gains or losses information that an individual must report on their annual income tax return impedes the ATO's ability to obtain a good understanding of CGT compliance risks.

Data management

16. At the time of the audit, the ATO had sought external data relating to real property and share transactions. However, it had not yet finalised its acquisition of relevant share trading data from the Australian Stock Exchange and selected share registers.

17. Commencing in August 2004 the ATO approached state and territory Government Revenue and Land Titles offices to explore opportunities for acquiring bulk real property data. The data related to title transfers in all states and territories, from 1 July 1999 to 30 June 2004 (including available historical data required to establish a CGT liability). The ANAO noted that the acquisition process for this data satisfied the ATO's corporate requirements for external data matching, which includes ensuring that the Federal Privacy Commissioner's guidelines for data matching in Commonwealth administration have been met.

18. During 2004-05 the ATO employed manual techniques to identify real property disposals. The ATO began receiving bulk real property data in March 2005. Due to variations in the content, quality and formatting between agencies, significant time and effort was spent analysing the data structures and holdings. Using insights gained from this work, the ATO adopted a systematic approach to develop a data model to convert all real property data into a common format. The ATO advised that delays in acquiring external data meant that one State Revenue Office was the main source used to identify real property disposals for administrative action during 2005-06.

19. The ANAO noted that as each data set was progressively analysed quality shortcomings were identified. Where data has been acquired from an Office of State Revenue, a requirement of the Memorandum of Understanding is to notify the source agency as soon as practicable where possible errors or defects are identified. At the time of the audit limited feedback had been provided on identified shortcomings to Offices of State Revenue.

20. During 2005–06 approximately 70 per cent of individuals, within the data sample of those who disposed of property, had their identity partially matched with taxpayer information held by the ATO and were consequently available for analysis and case selection. Consistent with 2004–05, identity matching was only partial and considered to only be successful to a low or medium level of confidence. The major reason for these lower grade identity matching outcomes is that external real property data does not generally contain key identifiers relied on when using external data in other areas of tax administration.⁶

21. The ANAO noted that one of the original deliverables identified by the ATO for the CGT Project was to report on the feasibility of automated data matching and case actioning for CGT compliance in the individuals market segment. The ANAO considers that given the delays in acquiring and converting all relevant data, it is too early to make an overall assessment of the long-term feasibility of the data management activities initiated by the ATO.⁷ However, based on the outcomes of activities to date, it is clear the absence of key identification data significantly reduces the proportion of individuals disposing of real property that can be readily matched to the ATO taxpayer database.

22. The ANAO considers that given the project's focus on data management to enable it to better understand CGT compliance risks, it is important that the ATO assess, prior to the project's end date of 30 June 2008, whether automated data matching and case actioning is the most appropriate strategy for CGT compliance in the individuals market segment. This could include exploring other solutions with relevant state and territory Government Revenue and Land Titles offices that may support the quotation by individual taxpayers of key identifiers at the time of real property disposal or acquisition. Such enhanced data from source entities would enable an increased proportion of real property disposals to be readily identified and assessed for administrative action.

Assessing identified CGT compliance risks for active compliance activities

23. Once an individual's identity has been matched with taxpayer information held by the ATO, the ATO compares disposal details with

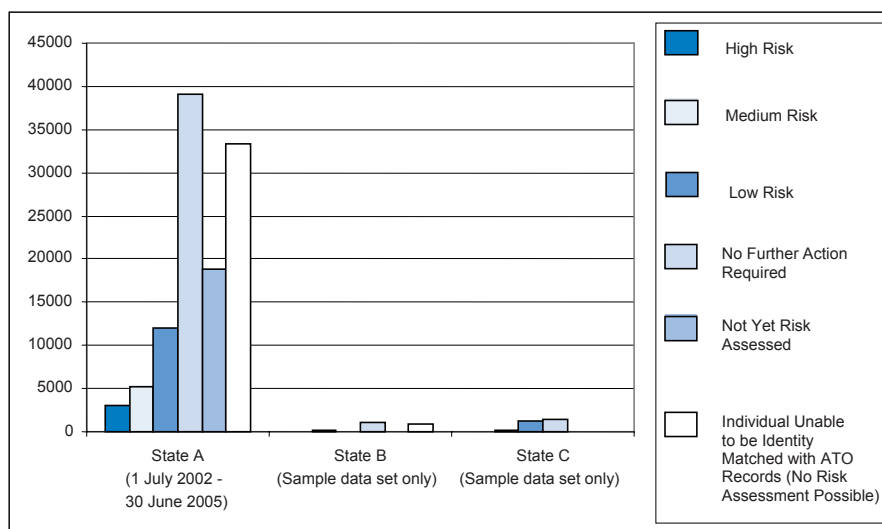
⁶ Key identifiers for the ATO are the individual's TFN and date of birth.

⁷ This is particularly so, given that the conversion of share trading data has yet to begin.

information reported in the individual's income tax return, to determine the risk of non-compliance with CGT obligations. As part of the CGT Project the ATO developed risk criteria to prioritise and plan treatment of identified real property disposals. Figure 2 summarises the real property disposal risk assessments undertaken during 2005–06.

Figure 2

Real property disposal risk assessments during 2005-06



Source: ANAO analysis of ATO data

24. The ATO conducted audits on high risk cases, and risk reviews on low/medium risk cases. The ATO advised that 'No Further Action Required' relates to individuals that may have been eliminated due to the main residence exemption, or sufficient CGT had been disclosed, or the transactions associated with the individual could not be verified.

25. During 2005–06, the ATO attempted to estimate a potential CGT population using aggregate real property sales data published by the Real Estate Institute of Australia. The ANAO recognises the effort by the ATO to provide assurance that it is reviewing an acceptable proportion of real property disposals as part of its active compliance interactions. In the absence of a complete set of useable data from its data management activities, it is appropriate to use industry data such as that published by the Real Estate Institute. However, there is scope to improve the transparency and calculation of any sales population used to support real property compliance interactions for the CGT Project.

26. To partly address compliance risks relating to the potential non-disclosure of share-related capital gains, the ATO initiated a pilot project in 2005–06 using dividend information from the Annual Investment Income Report (AIIR). This project was labour-intensive and produced limited returns. The ANAO identified opportunities for the ATO to improve its use of relevant AIIR data to assess CGT compliance risks associated with the capital gains paid to individuals by unit trusts.

Activities to Facilitate and Enforce Compliance with CGT Obligations (Chapter 4)

Compliance assistance

27. As part of the CGT Project, the ATO developed an investor pathway for real property and at the time of the audit was developing a shares investor pathway. The pathways are diagrammatic representations of taxpayers' interactions with the revenue system for specific CGT assets. The ANAO considers the development of the pathways to be innovative and effective mechanisms to improve the ATO's understanding of a taxpayers experience in relation to CGT, including the role of intermediaries.

28. The ANAO found that the ATO also used a range of compliance assistance products to treat identified CGT compliance risks in the individuals market segment. The ANAO observed that the numbers and types of products developed increased following receipt of *compliance challenges* funding and the inception of the CGT Project. At the time of the audit the focus had been on real property disposals.

Active compliance

29. The ATO's Active Compliance stream is responsible for managing, measuring and generally improving taxpayer compliance. The ATO identified obtaining staff and developing staff capability (particularly for Active Compliance) as key issues in the first year of the CGT Project. The ANAO noted that procedural guidance documentation supports active compliance activities, and some capability training has been provided. Staffing and staff capability are issues the ATO will need to closely monitor and address as the focus of its active compliance activities shifts to capital gains made on the disposal of shares by individuals. Embedding this capability is critical to the long-term success of the CGT Project.

30. The ATO's key active compliance activities for CGT are letters,⁸ risk reviews and audits. Table 1 details active compliance activities from 2002–03 to 2005–06. The ANAO noted that inconsistent reporting of active compliance activity types over time and across types of reports, makes analysis of performance difficult. In particular, the classification of risk identification/data matching reviews, risk reviews and audits was not constant.

Table 1

Coverage: planned and actual CGT active compliance activities in the individuals market segment 2002–03 to 2005–06

Active compliance activities	2002–03		2003–04		2004–05 ¹			2005–06 ¹		
	Planned	Actual	Planned	Actual	Planned		Actual	Planned		Actual
					BAU	CC	Both	BAU	CC	Both
PLAD letters	–	–	–	–	500	–	519	5000	–	5463
Risk reviews	1100	1658	8000	7997	–	–	–	2000	4000	6126
Audits		196		501	1080	1500	3354	1000	2000	3380

Note 1: From 2004–05 the ATO received additional funding to undertake CGT active compliance activities in the individuals market segment. These planned activities are identified as business-as-usual (BAU) or *compliance challenges* (CC) funding.

Source: ANAO analysis of ATO information.

31. Table 1 indicates that the ATO met or exceeded the active compliance coverage commitments made under *compliance challenges* and the *Output Pricing Agreement 2002–05* during the last four years. The ANAO observed that the 2005–06 target for liabilities raised by active compliance activities was adjusted twice during the financial year. The target directly impacts the level and nature of activities the CGT active compliance team undertakes. The Improving Active Compliance Reporting project is reviewing calculation of collection rates, and their consistent application to liabilities raised. The ANAO notes that to meet cash collection commitments made under *compliance challenges*, the ATO will need to monitor the collection rates throughout the CGT Project. A consistent and documented methodology for applying collection rates is essential to inform compliance planning and for accurate reporting of active compliance activities.

Compliance evaluation

32. During the audit the ATO was in the process of evaluating the effectiveness of compliance assistance activities initiated as part of the CGT

⁸ The ATO issues two types of letters; education and pre-lodgement advisory determinations (PLADs).

Project. The ATO undertakes analysis of active compliance activities to inform risk identification and future compliance planning.

Overall Conclusion

33. An increasing proportion of Australians have invested in potential CGT assets such as real property and shares during the last decade. Prior to 2003, there were limited resources allocated to support the ATO's administration of CGT compliance in the individuals market segment. With the benefit of additional budget funding, the ATO initiated a four-year CGT Project with a particular focus on assessing the levels of compliance relating to gains arising from real property and share disposals.

34. The governance arrangements established as part of the CGT Project support the administration of CGT compliance in the individuals market segment. However, there is a need to improve relevant planning documentation to provide assurance that the project is being undertaken in a consistent and coordinated way at the operational level.

35. A CGT risk management framework has been implemented, focusing on the use of data from a range of external sources to better identify the compliance risks associated with the non-disclosure of capital gains. The ANAO recognises the ongoing challenge faced by the ATO in balancing client costs with administrative requirements. However, the ANAO considers that in the absence of other information sources, the ATO's understanding of CGT compliance risks would be enhanced by increasing the disclosure requirements for asset disposals reported by individual taxpayers in their income tax returns.

36. The current lack of key identifiers for external real property data also significantly reduces the proportion of individuals, who have disposed of real property, that can be readily identified and risk assessed for compliance by the ATO. In addition, there have been delays in the ATO acquiring the external data, which has resulted in it not yet being in a position to effectively measure levels of CGT compliance across the total taxpayer population. This has also impacted on the ATO's ability to make informed decisions about risk treatment strategies for the individuals market segment.

37. The ANAO considers it important that the ATO assess, prior to the project's end, whether of the options available, automated data matching and case actioning is the most appropriate strategy to achieve CGT compliance in the individuals market segment. There are also opportunities for the ATO to

improve its use of measures that provide assurance that its active compliance activities are covering an acceptable proportion of real property disposals across Australia.

38. Similarly, there are opportunities for expanding the use of relevant AIIR data to assess CGT compliance risks associated with the capital gain components paid to individuals by unit trusts.

39. The ANAO observed that the ATO used a range of compliance assistance and active compliance activities to treat CGT compliance risks in the individuals market segment. The ATO met or exceeded the active compliance coverage and revenue commitments made under *compliance challenges*, the *Output Pricing Agreement 2002–05* and in the last four *Compliance Programs*. To date, the main focus of compliance activities has been on real property disposals.

Recommendations

40. The ANAO made seven recommendations aimed at improving the ATO's administration of CGT compliance in the individuals market segment. These recommendations are intended to complement the ATO's aim, as part of its CGT Project, of embedding CGT capability improvements into its business-as-usual practices.

Summary of ATO's Response

41. The Tax Office welcomes the ANAO's recommendations in relation to the administration of Capital Gains Tax compliance in the individuals' market segment. It is encouraging to note that although the ANAO identified areas for improvement, it was broadly supportive of the approach adopted and the achievements the Tax Office has made since the Capital Gains Tax project began in July 2004.

42. Results of the project to date include:

- 32 new educational products for investors;
- in the year ended 30 June 2006, the Tax Office reviewed or audited 9 500 returns where taxpayers had failed to fully disclose capital gains tax liabilities, resulting in revenue adjustments of \$40 million;
- the translation of key educational products into six languages; and

- in the year ended 30 June 2006, the Tax Office wrote to over 23 000 taxpayers who had purchased investment properties to help them better understand their future Capital Gains Tax obligations.
43. Capital Gains Tax continues to be a focus area for the Tax Office. The Tax Office will adopt in full, the seven recommendations made by the ANAO.
44. The Tax office will continue to work with the community to optimise voluntary compliance with Capital Gains Tax laws through a range of integrated strategies including:
- improving the understanding of taxpayers' and intermediaries' experiences interacting with the Capital Gains Tax system;
 - supporting systemic risk assessment and identification strategies;
 - making more efficient use of external data to better identify Capital Gains Tax risks;
 - delivering a range of Capital Gains Tax educational products to better educate and inform the community; and
 - expanding Tax Office active compliance activities to address non-compliance.
45. The ATO's full response is at Appendix 1.

Recommendations

Recommendation No.1

Para 2.19

The ANAO recommends that CGT Project planning be improved at the operational level by:

- preparing a CGT Project Delivery Plan annually with clear links to relevant priorities, outcomes and risks identified in strategic level plans and performance measures that enable assessment of progress against the project's intended outcomes; and
- linking the planning documents for the ATO's various operational streams to the CGT Project Delivery Plan in accordance with relevant ATO practice statements.

ATO Response: The Tax Office **agrees** with this Recommendation.

The Personal Tax business line developed a Business Line Plan that included all activities for 2005–06. For 2006–07 the Micro Enterprises and Individuals business line will bring together the relevant outputs to form a Capital Gains Tax Project Plan.

The integrated Capital Gains Tax Project Plan will highlight key outputs at the overall Project level and at the business line and stream level. It will be modelled on the 2004–05 plan, providing clear linkages between Project deliverables and business line stream deliverables.

**Recommendation
No.2**

Para 3.10

The ANAO recommends that the ATO, based on the outcomes of the data management activities initiated as part of the CGT Project, assess the need to implement changes or additions to the level of information disclosure required in respect of the capital gain and loss components in the individual income tax return, having regard to the cost of compliance.

ATO Response: The Tax Office **agrees** with this recommendation.

To date, the Tax Office has focused compliance activities on those who do not include any capital gains tax amounts on their income tax returns. The Tax Office will consider return form changes as it broadens its' compliance focus.

**Recommendation
No.3**

Para 3.30

The ANAO recommends that the ATO regularly report back any significant errors or defects identified in the real property data provided by an Office of State Revenue.

ATO Response: The Tax Office **agrees** with this recommendation.

This is an important feedback mechanism, and the Tax Office has already provided both the Offices of State Revenue and the Land Titles Office with reports regarding the initial data. In the 2006–07 Capital Gains Tax Project Plan, one of the outputs is regular feedback reports on data received.

**Recommendation
No.4
Para 3.38**

The ANAO recommends that the ATO, based on the outcomes of the data management activities undertaken for the CGT Project:

- assess whether, of the options available, automated data matching and case actioning is the most appropriate strategy to achieve capital gains tax compliance in the individuals market segment; and
- review the need to explore other solutions with relevant state and territory Government Revenue and Land Titles offices that support the quotation of key identifiers at the time of real property disposal or acquisition.

ATO Response: The Tax Office **agrees** with this recommendation.

It is part of the overall strategy to determine the feasibility of automated data matching and case actioning for Capital Gains Tax compliance in the individuals' market segment at the completion of the project. The Tax Office is involved in regular discussions with state and territory Government Revenue Offices. The Tax Office will continue to explore options for solutions via these discussions, including expanded data capture or the use of a unique identifier for real property transactions.

**Recommendation
No.5**

Para 3.51

The ANAO recommends that to provide assurance that real property active compliance interactions planned for the CGT Project achieve an acceptable risk based level of national coverage, future plans should demonstrate suitable linkages to the real property sales population being reviewed and consistency in the period being analysed.

ATO Response: The Tax Office **agrees** with this recommendation.

The intent of the Tax Office's strategy is to take a national approach, acquiring real property transaction data from all states and territories.

Research and intelligence will inform the Tax Office understanding of the market in real property and case selection will be based on risk.

**Recommendation
No.6**

Para 3.61

The ANAO recommends that to assist with the assessment and treatment of CGT compliance risks identified in respect of Annual Investment Income Report (AIIR) data, the ATO:

- analyse relevant data, in the related period of review, reported by unit trusts on capital gains distributed to individuals; and
- subject to a risk assessment, incorporate unit trust distributions as part of the active compliance interactions planned for the remainder of the CGT Project.

ATO Response: The Tax Office **agrees** that Capital Gains Tax compliance risks identified in Annual Investment Income Report data will be risk assessed along with all other risks. The cases rated as higher risk will be addressed.

**Recommendation
No.7****Para 4.38**

The ANAO recommends that the ATO, to inform future compliance planning, determine and document its methodology for setting the CGT Project liabilities and cash collection targets, and consistently apply the cash collection rate to liabilities raised. This documented methodology should address business-as-usual and *compliance challenges* targets.

ATO Response: The Tax Office **agrees** with this recommendation.

A document outlining the methodology to establish project and cash collection targets will be compiled.

Audit Findings and Conclusions

1. Background and Context

This Chapter provides an overview of capital gains tax in Australia, and the Australian Taxation Office's administration of capital gains tax compliance for individuals. It also outlines the audit objective and methodology.

The Australian Taxation Office

1.1 The Australian Taxation Office (ATO) is responsible for effectively managing and shaping the systems that support and fund services for Australians, and for giving effect to social and economic policy through the tax system. It is the Australian Government's principal revenue management agency. In 2005–06, the ATO collected \$232.6 billion in tax, superannuation and excise revenue, and received an appropriation of \$2 459 million. As at 30 June 2006 it employed 21 511 staff.

Capital gains tax in Australia

1.2 Capital gains tax (CGT) refers to the income tax payable on any net capital gain made and included in an annual tax return.^{9, 10} It is not a separate tax, but forms a component of income tax. Further explanation of the application of CGT for individual taxpayers is provided in Figure 1.1.

Introduction in 1985

1.3 A CGT regime was introduced in Australia on 20 September 1985, through amendments to the *Income Tax Assessment Act 1936*. At this time:

- CGT was levied on ordinary rates of income tax (e.g. at an individuals' marginal tax rate, determined by averaging);
- CGT was calculated by indexing the assets' cost base;
- a taxpayers' principal place of residence was exempt from CGT; and
- assets acquired pre-20 September 1985 were exempt from CGT.

⁹ A net capital gain is the difference between total capital gains for the year and total capital losses (including capital losses from prior years).

¹⁰ Australian Taxation Office, 2005, *Guide to Capital Gains Tax*. See: <www.ato.gov.au>.

Figure 1.1

The application of capital gains tax for individual taxpayers

Individuals	Acquisition of CGT Asset	Ownership: Improvements and Cost Base Elements	CGT Events: Disposals	Calculations and Income Declaration
<p>In 2003–04, 813 755 taxable individuals reported \$9 827 million in net capital gains subject to tax.</p>	<p>CGT assets include shares, collectables (e.g. jewellery), assets for personal use (e.g. boat) and other assets (e.g. investment property).</p> <p>Individuals may acquire CGT assets through direct purchase, inheritance, receiving a gift, or transfer upon divorce.</p> <p>Assets exempt from CGT include:</p> <ul style="list-style-type: none"> • assets acquired pre-1985; and • main residence. 	<p>The cost base of an asset is what it costs the taxpayer. It comprises:</p> <ul style="list-style-type: none"> • money paid for the asset; • incidental costs; • non-capital ownership costs; • costs associated with increasing its value; and • costs to preserve or defend title or rights to it. 	<p>A CGT event is an event or transaction that may result in a capital gain or loss. The most common CGT event is the disposal of a CGT asset.</p> <p>Total current year capital gains for individuals arise from:</p> <ul style="list-style-type: none"> • property (54%); • shares and units (29%); and • other assets (17%). 	<p>A capital gain or loss is worked out by reference to provisions for each particular CGT event. For asset disposals:</p> <ul style="list-style-type: none"> • Capital proceeds from disposal of asset - Cost base of asset = Capital gain; and • Reduced cost base of asset - Capital proceeds from disposal = Capital loss. <p>The three methods of calculating CGT are:</p> <ul style="list-style-type: none"> • indexation; • discount; and • other.



ATO

Intermediaries Approximately 88 per cent of individual taxpayers with CGT liabilities use tax practitioners to prepare their return.

In 2005–06, through its CGT active compliance activities in the individuals market segment, the ATO raised an additional \$30.3 million in CGT liabilities and generated \$9.8 million in interest and penalties.

Source: ANAO analysis of ATO information – Taxation Statistics 2003–04 published in May 2006.

Legislative amendments in 1998 and 1999

The Tax Law Improvement Project

1.4 The Tax Law Improvement Project established in 1994 aimed to address the complexity of the original CGT provisions. Following this project, CGT law was rewritten to include events, each with its own provisions for identifying and calculating capital gains and losses.¹¹ These changes were incorporated into the *Income Tax Assessment Act 1997*, effective from 1 July 1998.

Review of Business Taxation

1.5 A key change arising from the 1999 Review of Business Taxation (the Ralph Review) was the introduction of a discount in CGT payable for certain assets held for over a year.¹² In addition, indexation was frozen at 30 September 1999. CGT is now calculated using the 'indexation', 'discount', or 'other' methods, depending on the taxpayers' circumstances.¹³ Further, the averaging mechanism was abolished and small business CGT concessions were rationalised and extended. Current CGT provisions are contained in parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*.

Legislative complexity and compliance costs

1.6 The ATO has identified that the evolving and complex nature of CGT legislation, with its extensive record keeping requirements and calculations, means many individual taxpayers find compliance with their legislative obligations difficult. Professor Chris Evans found that tax practitioners also consider the CGT legislation to be complex. This, in addition to factors such as CGT record keeping requirements, contributes to high compliance costs for CGT.¹⁴ It is likely that the data matching activities recently initiated by the ATO (see Chapter 3) will further impact overall CGT compliance costs. While these activities incur costs for the ATO and external organisations that supply data, effective data matching processes are less costly and intrusive for individuals when compared to compliance interventions such as audits.

¹¹ There are currently 52 CGT events. The most common is disposal of an asset (e.g. sold or given away).

¹² This is 50 per cent for individuals and trusts, 33.3 per cent for super funds and is not available to most companies.

¹³ There are three methods for calculating CGT. The indexation method is only applicable for assets acquired pre-21 September 1999. It allows an increase to the assets' cost base by applying an indexation factor based on CPI up to September 1999; the discount method allows a discount on capital gains on assets held for over 12 months; and the other method involves subtracting the cost base from the capital proceeds.

¹⁴ Evans, 2003, *Taxing Personal Capital Gains: Operating Cost Implications*. pp. 153, 163

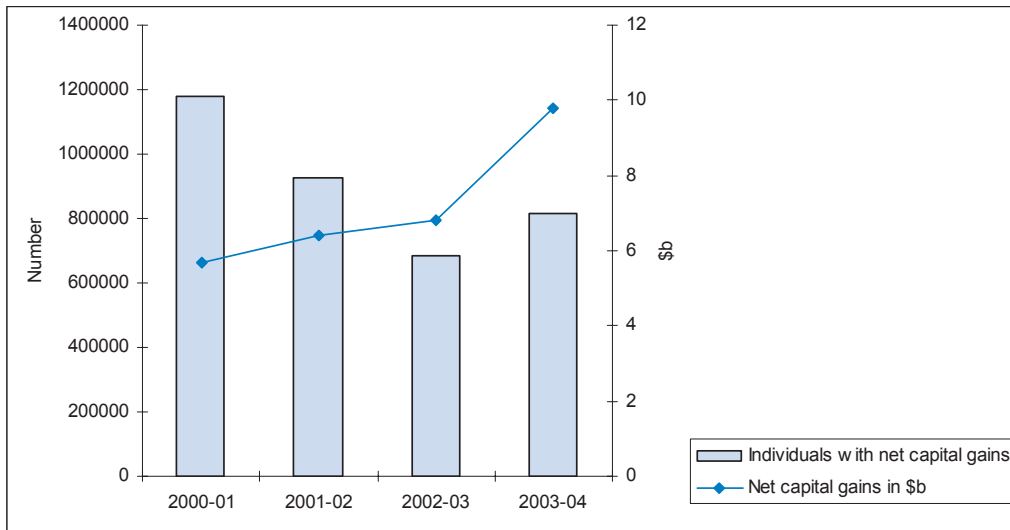
Additionally, they are a deterrent against non-compliance with CGT obligations. The ATO has also recently increased its marketing and education activities (see Chapter 4) in an effort to reduce CGT compliance costs for the community.

Context: capital gains tax for individuals

1.7 In 2003–04 the majority of income reported by individuals was derived from salary or wages; income from net capital gains represented 2.5 per cent of total income (\$10 230 million). For this period, 813 755 individuals reporting net capital gains were classified as taxable (that is, have net tax payable of more than \$0). Taxable individuals accounted for 92 per cent of all taxpayers with a net capital gain, and reported 62 per cent of the total value of net capital gains.¹⁵ In this same year, the number of taxable individuals reporting net capital gains increased by 19 per cent from 2002–03, while the amount of net capital gains reported increased by 45 per cent over the same period. The trend for the number of taxable individuals reporting net capital gains, and the value of these gains is shown in Figure 1.2. The decline in the number of individuals reporting net capital gains from 2000–01 to 2002–03 shown in Figure 1.2 was identified by the ATO as a major risk to the CGT system, and was a key driver behind the introduction of the CGT Project.¹⁶

¹⁵ Other types of taxpayers with net capital gains were companies and taxable funds.

¹⁶ The CGT Project is discussed from paragraph 2.11 of chapter 2.

Figure 1.2**Number of taxable individuals reporting net capital gains and value of net capital gains 2000–01 to 2003–04**

Source: ANAO analysis of *Taxation Statistics 2003–04*, Table 9.12.

1.8 *Taxation Statistics 2003–04* reports that for individual CGT taxpayers, 54 per cent of total current year capital gains arose from real property while 29 per cent arose from shares and units (in unit trusts). These statistics are drawn from the CGT schedule; only individuals who report capital gains or losses exceeding \$10 000 are required to complete a CGT schedule, which identifies the source of capital gains and losses.¹⁷

Australian investments: residential property and the share market

1.9 The Reserve Bank of Australia reports that Australia has a strong tradition of home ownership, with ownership of other residential property (primarily for investment) increasing over the past decade. In 2002, 17 per cent of Australian households owned residential property which was not their principal place of residence, and over half of these received rental income from the property.¹⁸ As with almost all OECD countries, Australia experienced a

¹⁷ Individual taxpayers who completed a schedule comprised approximately 30 per cent of all individuals with total capital gains, representing 90 per cent of the dollar value of total capital gains. This data is derived from individual returns lodged between 1 July 2003 and 31 October 2004 and relate to the 2003–04 income year.

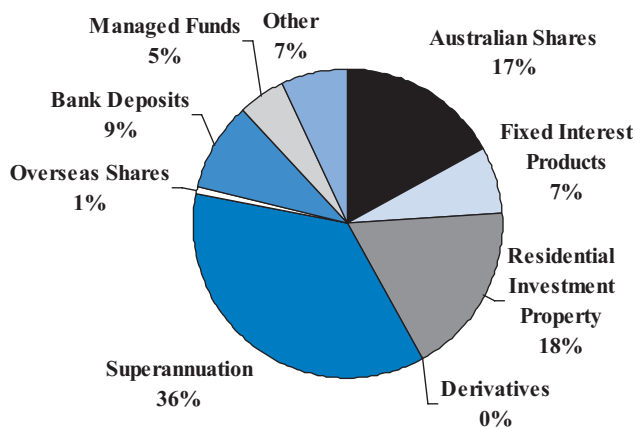
¹⁸ Reserve Bank of Australia, 2005. *Property Owners in Australia: A Snapshot*. p. 1 and Reserve Bank of Australia, 2004. *Investment Properties in Australia*. p. 1.

significant increase in housing prices since the mid-1990s.¹⁹ In particular, the property boom in Australia peaked on the eastern seaboard around 2003, with what the Commonwealth Bank referred to as a ‘home buying frenzy in 2003’.²⁰ At this time, approximately 30 per cent of all housing loans were for investment properties.²¹ The factors driving the boom included low interest rates, the availability of innovative financing methods, and the perception of housing as a safer investment than shares.

1.10 The Australian Stock Exchange has reported that in 2004, approximately eight million Australians (55 per cent of the adult population) owned shares.²² Share ownership has been increasing and is currently the highest it has been since 1999. In 2004 approximately 5 per cent of Australian adults invested in managed funds.²³ Figure 1.3 shows the portfolio components of Australian investors in 2004.

Figure 1.3

Australian investors: portfolio components



Source: ANAO depiction of information in *Australia’s Share Owners: An ASX study of share investors in 2004*

¹⁹ Organisation for Economic Cooperation and Development, 2005, *OECD Economic Outlook No. 78 Recent House Price Developments: The Role of Fundamentals*.

²⁰ Commonwealth Research, January 2006, *Economic Update, Housing Finance*.

²¹ Reserve Bank of Australia, 2003. *Do Australian Households Borrow Too Much?* p. 8.

²² Share Ownership In Australia. See <www.asx.com.au>.

²³ Managed Funds are investment funds where an individual purchases unit trusts in the fund. The fund invests in assets such as cash, shares and property. Investors receive an income stream (a unit trust distribution (UTD)) consisting of income and capital gains. The ATO collects information about these different income components under legislated reporting (e.g. the Annual Investment Income Reports).

The ATO's administration of CGT compliance for individuals

1.11 Australia's revenue system relies on self-assessment; taxpayers are required to assess their tax liabilities under the law, and pay the correct amount of tax. This system of self-assessment has inherent risks, which the ATO aims to manage through its compliance activities. The ATO's compliance work is guided by the *Taxpayers' Charter* and the *Compliance Model*. The ATO's overall approach to compliance is depicted in Table 1.1.

1.12 The ATO publishes its *Compliance Program* annually. This program describes the ATO's overall approach to managing compliance, discusses the risks associated with Australia's revenue system, and how the ATO proposes to treat those risks. Within this program, the ATO has identified six market segments for which it identifies specific compliance risks and develops a general compliance approach.²⁴ In the last four *Compliance Programs* the ATO has identified capital gains tax compliance in the individuals' market segment as a key focus area warranting increased compliance verification activities.

Table 1.1

ATO's overall approach to compliance

Taxpayer		ATO	
Obligations	Attitude to Compliance with Obligations	Approach to Compliance	Compliance Activities
<ul style="list-style-type: none"> Register in the System. Timely lodgement (of forms/returns). Report information (completely and accurately). Make payments. 	<ul style="list-style-type: none"> Willing to do the right thing. Try, but don't always succeed. 	Maximise the number of taxpayers who choose to voluntarily comply by making it as easy as possible for them to understand and meet their obligations.	Compliance assistance: <ul style="list-style-type: none"> marketing and education; and provision of advice.
	<ul style="list-style-type: none"> Don't want to comply. Have decided not to comply. 	Deter, detect, and address non-compliance.	Active compliance: <ul style="list-style-type: none"> risk reviews; audits; and prosecutions.

Source: ANAO analysis of information in the ATO's *Compliance Program 2005–06*.

²⁴ The ATO's market segments are: individuals, micro-businesses, small to medium enterprises, large businesses, non-profit organisations and government organisations.

Key developments potentially affecting the ATO's administration of CGT compliance in the individuals market segment

Review of income tax self assessment

1.13 In 2004 Treasury conducted a review of aspects of income tax self assessment. The *Report on Aspects of Income Tax Self Assessment* included recommendations on rulings and other ATO advice, review and amendment of assessments, penalties and the general interest charge. The review recommended that the standard period allowed for the ATO to amend an individuals' assessment (currently four years), be reduced to two years.

1.14 The ATO advised that due to the legislative complexities associated with CGT (e.g. the AMP takeover of GIO, where retrospectively compensation payments were included in taxable income, several years after the payments were made to shareholders) the proposed shortening of review timeframes could have significant implications for CGT administration. The administrative impact of the shortened period of review is also relevant in the context of the ATO's recent data management activities.

The Easier, cheaper and more personalised change program

1.15 The ATO is currently undertaking a major program of work, called the *Easier, cheaper and more personalised* (ECMP) change program. As part of this program, the ATO will replace multiple computer systems with a single integrated ATO-wide system for all tax types. The new system will include functionality for client relationship management, case management, core processing, document and content management and analytics. The system is being released in a staged approach. The ATO advised that implementation of the new system could have implications for CGT administration. For example, in the interim there are reduced resources for non-ECMP change program information technology initiatives (such as those being developed to support the CGT data matching capability).

Information management and data quality in the ATO

1.16 In July 2004 the ATO Executive endorsed an *Information Management Strategic Framework*. The purpose of this framework is to realise the strategic value of ATO information through corporate discipline, governance and accountability mechanisms for information resources. The ATO recognises that data is a key component of information management, and has developed a *Data and Information Standards* and a *Data Quality Strategy*. These are likely to impact on the longer term approach of the CGT data management activities recently initiated by the ATO. For example, the lower grade identity matches

currently obtained for external real property data (due to a lack of key identifiers such as a date of birth or tax file number (TFN)) means that the continued use of this data may need to be evaluated against any ‘fitness for purpose’ standards introduced for acquiring third party data.

The audit

Audit objective

1.17 The objective of the audit was to assess the ATO’s administration of CGT compliance in the individuals market segment. The focus of the audit was the ATO’s administration of compliance by individuals with respect to the two most common CGT events: real property and share disposals.

1.18 The ANAO identified three key areas for review:

- *governance* – the corporate planning and reporting arrangements relevant to the administration of CGT compliance in the individuals market segment, including how these are integrated with the ATO’s overall approach to managing CGT;
- *identifying and assessing compliance risks* – the mechanisms and strategies used to identify and assess CGT compliance risks in the individuals market segment; and
- *compliance activities* – the products and processes used to manage CGT compliance in the individuals market segment.

These areas are examined in the following three Chapters.

Audit methodology

1.19 The ANAO conducted fieldwork in the ATO’s Canberra, Melbourne, Sydney and Brisbane offices between February and April 2006. This included a review of relevant CGT documentation and interviews with ATO staff from the Operations, Information Communications and Technology, Large Business and International, and Personal Tax (PTax) business lines.²⁵

1.20 The ANAO also consulted with a range of stakeholders including:

- government agencies – the Commonwealth Ombudsman, various State Revenue Offices and Land Titles Offices;

²⁵ Subsequent to audit fieldwork the PTax business line was restructured, and renamed ‘Micro Enterprises and Individuals’.

- an academic – Professor Chris Evans;
- tax agent representative bodies and professional associations – Taxpayers Australia, the National Institute of Accountants (including a tax agent focus group), the Institute of Chartered Accountants in Australia and CPA Australia;
- the Australian Stock Exchange; and
- various Real Estate Institutes.

1.21 This audit was undertaken in conformance with ANAO auditing standards and cost \$335 000.

Acknowledgements

1.22 The ANAO would like to thank ATO management and staff for their assistance in the conduct of the audit. In particular, we would like to thank our contact officers for their considerable time, effort and expertise contributed during the audit. The ANAO would also like to express appreciation to the stakeholders consulted for their contribution to the audit.

2. Governance Arrangements

This Chapter examines the governance arrangements that support the Australian Taxation Office’s administration of capital gains tax compliance in the individuals market segment.

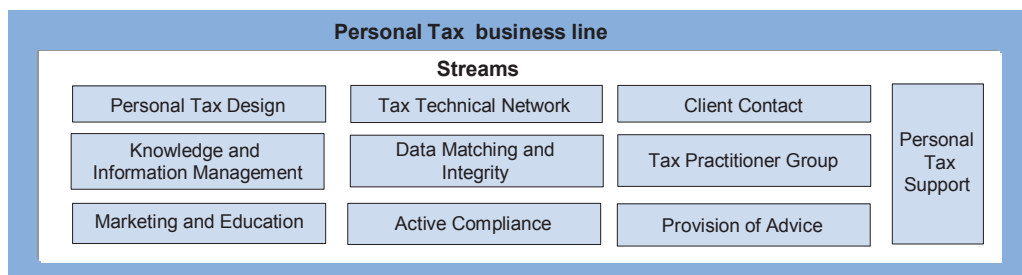
Introduction

2.1 Governance refers to the processes by which organisations are directed, controlled and held to account. It encompasses authority, accountability, stewardship, leadership, direction and control exercised in the organisation. Public sector governance is explained in the ANAO’s Better Practice Guide, *Public Sector Governance, Volumes 1 & 2*.²⁶

2.2 The PTax business line has primary responsibility for managing the income tax affairs (including CGT) of taxpayers in the individuals market segment. PTax is organised into ten streams. A high-level view of PTax’s functional structure at the time of audit fieldwork is shown in Figure 2.1.²⁷

Figure 2.1

Personal Tax business line organisational structure



Source: ANAO analysis of ATO information

2.3 The ANAO’s examination of the governance arrangements relevant to administration of CGT compliance in the individuals market segment focused on:

- the recent history of CGT administration in the PTax business line; and
- the governance framework established by PTax for its CGT Project.

²⁶ This Better Practice Guide is available at <www.anao.gov.au>.

²⁷ Subsequent to audit fieldwork the PTax business line was restructured. This included the transfer of its Tax Practitioner Group to the ATO’s Lodgement Compliance business line and additional responsibility for managing the income tax affairs of taxpayers in the micro business market segment.

Recent history of CGT administration in Personal Tax

2.4 As noted in Chapter 1, Australia's CGT regime has been in effect since 1985. However, during the first 12 years of its operation, the ATO did not have a comprehensive approach to identifying and treating CGT compliance risks. Dedicated CGT coverage for individual taxpayers was limited to a small number of staff in what is now the Active Compliance stream. The ATO advised that CGT compliance activities were confined to ad hoc audits or checks when auditors questioned taxpayers on other matters. Between 1997 and 2003 the ATO made isolated attempts to better comprehend or quantify CGT compliance by individuals in geographical areas (e.g. property sales in Queensland) or for large events (e.g. Telstra and AMP demutualisations). These did not progress for reasons ranging from funding, resourcing, and skilling to prioritisation of perceived higher risks.

Compliance challenges funding

2.5 During 2002 the ATO completed an Output Pricing Review to reassess its baseline funding for 2002–03 to 2004–05. The focus of the review was to ensure the sustainability of the ATO's forward revenue estimates. The Output Pricing Review also highlighted areas where the ATO had gained a greater understanding of existing and emerging risks it needed to manage. The ATO noted that these risks did not, at the time, threaten its forward revenue estimates. They did, however, pose a threat to the overall integrity of the revenue system and offered an opportunity to improve revenue collection.

2.6 The Output Pricing Review identified CGT compliance in the individuals market segment as one of the ATO's *compliance challenges*. In 2003 the ATO sought additional funding. In the 2004 Budget, the ATO subsequently received an additional \$216.4 million over four years to better educate taxpayers, raise voluntary compliance with taxation obligations and undertake additional compliance activities which would result in increased revenue.

2.7 PTax was allocated \$26.4 million to address its key risk areas of CGT, rental deductions, high risk income tax refunds and work related expenses. CGT accounted for approximately \$7.3 million (28 per cent) of this additional funding. In addition, there was also a substantial increase in the business-as-usual funding made available to administer CGT compliance by individual taxpayers (from \$0.3 million in 2003–04 to approximately \$4.37 million over

four years). Table 2.1 summarises the funding for PTax's CGT Project²⁸ following the allocation of additional funding.

Table 2.1

CGT Project funding and actual costs 2004–05 to 2007–08

	2004–05	2005-06	2006-07	2007-08	Total
Budget \$m	3.75	3.64	2.48	1.80	11.67
Actual \$m	3.30	3.83	N/A	N/A	7.13

Source: ATO records

2.8 ATO records indicate that just over \$7 million (approximately 60 per cent) of funding for the CGT Project had been spent by the end of 2005–06, which is halfway through the project's timeframe. As part of its external reporting requirements for the *compliance challenges* funding (see below), the ATO indicated that problems in obtaining sufficient quality data from external sources had caused it to delay some strategies originally outlined to government.²⁹ However, it was largely on track to deliver its *compliance challenges* revenue and coverage commitments for CGT.

External reporting requirements for the compliance challenges funding

2.9 The ATO is required to report annually to the Government's Expenditure Review Committee regarding performance of its specifically funded compliance activities. The ATO advised that, in the context of PTax, the *compliance challenges'* focus was to increase compliance coverage rather than to achieve large revenue gains. PTax's CGT revenue commitments were relatively small in the context of other *compliance challenges*.

2.10 The ANAO noted that the Expenditure Review Committee reporting requirement for CGT is combined with rental deductions and high risk income tax refunds. At the time of the audit, the ATO had met its 2004–05 obligations, reporting to the Committee that it had successfully met its revenue and coverage commitments.³⁰

²⁸ A key feature of the CGT Project is to increase the cross-stream CGT involvement within PTax. The project is discussed in detail from paragraph 2.11.

²⁹ The impact of this is examined further from paragraph 3.13.

³⁰ Chapter 4 discusses the compliance activities underpinning the revenue and coverage commitments, including reporting these to Government. See also *Review of the Tax Office's performance reporting processes to the Compliance Program* for discussion on the effectiveness of ATO compliance reporting.

The CGT Project

2.11 The CGT Project is a four-year project that commenced in July 2004. The project is aligned with *compliance challenges* funding and is bringing together PTax's overall CGT capability, while focusing on capital gains arising from real property and share disposals. A key feature is the systematic use of external data to develop PTax's understanding of the real property and share markets.

2.12 In addition to ensuring that PTax meets its overall revenue and coverage commitments for CGT, the project intends to position the ATO to undertake effective measurement of levels of CGT compliance and make informed decisions about risk treatment strategies. To support this, a series of integrated strategies have been initiated to build capability across key areas and to:

- improve the ATO's understanding of a taxpayer's experience in interacting with CGT requirements, including the role of intermediaries;
- support systemic risk identification and assessment to inform compliance strategies;
- improve and automate the ATO's data matching capability through the efficient use of external data to better identify CGT risks;
- establish a robust risk assessment framework including risk and case selection criteria and analytical tools;
- identify and deliver CGT products to better educate and inform the community and tax agents and raise voluntary compliance levels; and
- expand the program of active compliance activities, including case reviews and audits, to address non-compliance.

2.13 PTax aims to embed improvements in each area to the point that they are business-as-usual by the end of the project. In reviewing the CGT Project governance framework the ANAO focused on project planning, performance monitoring and reporting and the projects integration with the work of the Capital Gains Compliance Committee.

CGT Project planning

2.14 Effective planning processes are essential for the CGT Project given its cross-stream approach and to best use its resources (see Table 2.1) to achieve the intended outcomes. The ATO uses a cascading model to support strategic

and business planning at several levels within the organisation.³¹ CGT Project planning is required to satisfy the requirements of the overall corporate planning framework.

2.15 The CGT Project operates under the ATO's Compliance Sub-Plan. To determine if the project established an integrated and cohesive approach to planning, the ANAO examined the content of and linkages between the *Compliance Sub-Plan*, the *PTax Delivery Plan*, the *CGT Delivery Plan* and the delivery plans prepared by teams from the key streams. The projects' high-level strategic planning documentation was found to be integrated with the ATO's broader planning framework and clearly linked to the ATO's outputs and outcomes.

2.16 Planning at the operational level was supported in 2004–05 through a detailed *CGT Delivery Plan* that clearly articulated cross-stream linkages, resource requirements and deliverables. It also documented how the integrated strategies supporting each key capability contributed to the project's intended outcomes and aligned these with the strategic risks identified as relevant to administering CGT compliance in the individuals market segment.

2.17 The comprehensiveness of, and the links between, higher level strategic planning documentation was adequate. However, the ANAO found that planning at the operational level could be improved. In particular:

- while stream delivery plans were completed, and the *PTax Delivery Plan* identified some CGT deliverables for the streams within the project, an overall *CGT Delivery Plan* was not prepared for 2005–06. The ANAO considers the *CGT Delivery Plan* the most important planning document for the project. It enables priorities and risks identified in strategic planning documentation to be translated into operational requirements and goals to guide the project team. It should also include performance measures³² that can be updated and reported against in line with changes made during the ATO's annual planning cycle and, more importantly, enable management to assess progress against the project's intended outcomes (see paragraph 2.11 to 2.12); and
- the development and comprehensiveness of stream delivery plans was inconsistent, and in some cases risks and priorities did not align with

³¹ These arrangements are outlined in the ATO's corporate planning practice statement, PS CM 2004/06.

³² For example, this could include measures of the time taken to acquire relevant external data sources and the proportion of acquired data that is actually used for administrative purposes.

higher level plans. Consequently they did not comply with requirements of the ATO's corporate planning framework.³³

2.18 The ANAO concluded that there is a need to improve relevant planning documentation to provide assurance that the CGT Project is being undertaken in a coordinated and consistent way at the operational stream level (see Figure 2.1).

Recommendation No.1

2.19 The ANAO recommends that CGT Project planning be improved at the operational level by:

- preparing a CGT Project Delivery Plan annually with clear links to relevant priorities, outcomes and risks identified in strategic level plans and performance measures that enable assessment of progress against the project's intended outcomes; and
- linking the planning documents for the ATO's various operational streams to the CGT Project Delivery Plan in accordance with relevant ATO practice statements.

ATO Response

2.20 The Tax Office agrees with this Recommendation.

2.21 The Personal Tax business line developed a Business Line Plan that included all activities for 2005–06. For 2006–07 the Micro Enterprises and Individuals business line will bring together the relevant outputs to form a Capital Gains Tax Project Plan. The integrated Capital Gains Tax Project Plan will highlight key outputs at the overall Project level and at the business line and stream level. It will be modelled on the 2004–05 plan, providing clear linkages between Project deliverables and business line stream deliverables.

Monitoring and reporting CGT Project performance

2.22 Performance monitoring and reporting are important aspects of the governance framework established for the CGT Project. However, without the timely collection, and regular analysis and reporting of relevant performance information, fully informed decisions about the impact of the project on CGT compliance cannot be made.

³³ PS CM 2004/06 indicates that business lines are to ensure linkages are clearly demonstrated between their delivery plans, branch plans (in this instance the *CGT Delivery Plan*) and team plans.

2.23 The Strategic Compliance Forum (SCF) is the management committee responsible for overseeing and monitoring the performance of the CGT Project; its role is to provide compliance leadership. This includes, amongst other functions, ensuring that compliance activities are aligned with the ATO's Compliance Sub-Plan and measuring the effectiveness of compliance and risk management activities.

2.24 The ANAO noted that the SCF was actively involved at the start of the CGT Project, approving the original CGT Delivery Plan and receiving a detailed half-yearly progress report. The ATO advised that subsequently, monitoring and reporting of the project was incorporated into the corporate reporting framework, with exception reporting to the SCF where activities funded by *compliance challenges* were not progressing as planned.

2.25 The ANAO concluded that PTax had established monitoring and reporting that support the ongoing administration of the CGT Project. However, as noted in paragraph 2.19, there is scope to introduce performance measures that enable the assessment of progress against the projects intended outcomes. The ANAO considers it important that any performance measures developed for the *CGT Delivery Plan* are also monitored and reported on a regular basis during the remaining two years of the project.

CGT Project integration with the Capital Gains Compliance Committee

2.26 The ANAO examined the relationship between the CGT Project and the Capital Gains Compliance Committee given its relevance to administration of CGT compliance in the individuals market segment. The Capital Gains Compliance Committee (a sub-committee of the Income Tax Steering Committee) was established in March 2004 and is responsible for providing a single ATO-wide risk perspective on capital gains. It includes representatives from all ATO market segments and co-ordinates the preparation of an ATO-wide *CGT Strategic Compliance Plan* and an annual *CGT Health of the System Assessment Report* (used by the ATO Executive as a key input for CGT planning at the whole-of compliance level).

2.27 The ANAO found that work undertaken as part of the CGT Project was generally reflected in the *CGT Health of the System Assessment Report* and updates made to the *CGT Strategic Compliance Plan*. As noted above, there are opportunities for the CGT Project to improve planning at the operational level and to establish performance measures that enable assessment of the project's progress in delivering its intended outcomes. The ANAO considers that this

should take account of PTax's risk mitigation responsibilities and measures of success for the individuals market segment identified in the *CGT Strategic Compliance Plan*.

3. CGT Compliance Risks

This Chapter examines the mechanisms and strategies the Australian Taxation Office uses to identify and assess capital gains tax compliance risks in the individuals market segment.

Introduction

3.1 As noted in Chapter 1, the ATO's Business Model is based on a risk management approach to verifying tax compliance; individuals self-assess their tax liabilities. The ATO seeks to optimise revenue collections by allocating its compliance resources to areas identified as having the highest risk. An individual's ability to meet their compliance obligations (see Table 1.1) for CGT is influenced by the complexity of CGT legislation and the recordkeeping requirements associated with the application of CGT.

3.2 The CGT Project intends to position the ATO to effectively measure levels of CGT compliance and make informed decisions about risk treatment strategies. An important first step is to have a risk management framework in place.

Establishing a CGT risk management framework in Personal Tax

3.3 During the initial stages of the CGT Project a CGT risk management framework was developed in line with the ATO's corporate requirements. The strategic compliance risks identified as most significant to the individuals market at the start of the CGT Project were:

- non-disclosure of capital gains on real property and share disposals; and
- low levels of understanding and a lack of community awareness of CGT obligations.³⁴

3.4 The ANAO noted that although it was considered significant at the time, understanding of the risks associated with non-disclosure of capital gains on real property and share disposals was largely based on the limited results of sampling work undertaken before *compliance challenges*. The ATO recognised there was a need to better understand and quantify the nature of this risk.

³⁴ Active compliance and compliance assistance activities used to treat risks are discussed in Chapter 4.

3.5 This chapter considers progress made by the project to inform the ATO's understanding of the compliance risks relating to non-disclosure of real property and share capital gains in the individuals market segment. In particular, the ANAO examined:

- the research and intelligence activities supporting the project;
- the data management activities initiated as part of the project; and
- how identified CGT compliance risks were assessed for treatment by PTax's active compliance activities at the time of the audit.

Research and intelligence

3.6 The research and intelligence activities supporting the CGT Project aim to support systemic risk identification and assessment and inform compliance strategies. The initial research focus was real property, concentrating on high value/high growth areas and off-the-plan sales.³⁵ However, the usefulness of this research was constrained by the number of CGT exempt properties in many of these areas and the inability to identify 'on-selling'³⁶ of properties purchased off-the-plan.

3.7 The ATO's understanding of real property compliance risks has been enhanced by analysing outcomes from the active compliance activities undertaken during the first year of the project (for further detail see paragraph 4.45). During 2005–06 efforts were also underway to strengthen PTax's CGT research and intelligence capability, including increasing the range of internal and external information sources accessed to inform its understanding of CGT compliance risks.

3.8 The ATO's understanding of CGT compliance risks is also informed by the data that individuals report when lodging their annual income tax returns. In this context:

- unless an individual completes the CGT schedule,³⁷ the ATO does not capture data that enables it to determine the asset type that a reported gain or loss relates to, or whether any capital loss applied relates to the current year or was carried forward from a previous year; and

³⁵ Buying off-the-plan is defined as paying a deposit and exchanging contracts for the purchase of a property that is only an architect's plan or not fully built. Payment occurs when it is completed.

³⁶ On-selling occurs when a property bought off-the-plan is resold for a profit prior to completion.

³⁷ Only individuals lodging electronically and reporting a capital gain or loss exceeding \$10 000 are required to complete a Capital Gains Tax schedule.

- even where the CGT schedule has been completed, the ATO does not capture sufficient information to enable it to distinguish between major asset types. In particular, gains relating to disposal of shares (in both public and private companies) as well as the capital gain components from unit trust distributions are all captured in the same field.

3.9 The quality and completeness of the ATO's internal information directly impacts the outcomes of its data matching activities. While recognising the ongoing challenge in balancing client costs with administrative requirements, the ANAO considers that the lack of information relevant to net capital gains and losses required to be disclosed in annual income tax return impedes the ATO's ability to obtain an overall understanding of CGT compliance risks for individual taxpayers.³⁸

Recommendation No.2

3.10 The ANAO recommends that the ATO, based on the outcomes of the data management activities initiated as part of the CGT Project, assess the need to implement changes or additions to the level of information disclosure required in respect of the capital gain and loss components in the individual income tax return, having regard to the cost of compliance.

ATO Response

3.11 The Tax Office agrees with this recommendation.

3.12 To date, the Tax Office has focused compliance activities on those who do not include any capital gains tax amounts on their income tax returns. The Tax Office will consider return form changes as it broadens its' compliance focus.

Data management

3.13 A major thrust of the CGT Project is the efficient use of external data to strengthen and quantify the ATO's understanding of the non-disclosure compliance risks associated with capital gains made on property and share disposals. During the course of the audit the ANAO reviewed key aspects of the data management activities initiated as part of the project, including:

- acquisition of data from a range of external sources; and

³⁸ This is particularly relevant to any current or potential data matching that seeks to compare information an individual has reported in their income tax return with an external data source.

- work undertaken to convert acquired data into a useable format.³⁹

Acquisition of external data

3.14 Commencing in August 2004, the CGT Project's data management team approached state and territory Government Revenue and Land Titles offices to explore opportunities for acquiring bulk real property data to help administer Australian taxation law.⁴⁰ The data related to title transfers in all states and territories, from 1 July 1999 to 30 June 2004 (including available historic data required to establish a CGT liability). The ANAO noted that the acquisition process for this data satisfied the ATO's corporate requirements for external data matching. This included ensuring the Federal Privacy Commissioner's guidelines for the use of data matching in Commonwealth administration have been met, through preparation of a data matching program protocol.

3.15 External real property data the ATO currently acquires is not covered by legislation.⁴¹ The real property data matching program protocol contains important information on external data matching activities, including a description of the program and an explanation of the reasons for deciding to conduct it. The ANAO noted that in relation to the protocol:

- it was anticipated that any data acquired would be of a high quality, as it is obtained and maintained under obligations imposed by state law, and it is relied upon by a number of external bodies (e.g. banks and local councils);
- it was envisaged that the information obtained would provide a clear statistical picture of individuals' compliance with their CGT obligations and enable PTax to identify high-risk taxpayers for administrative action;⁴²

³⁹ A useable format is one that enables PTax to confirm the identity of an individual by matching external data to taxpayer information held by the ATO. Once an individual's identity has been matched to an acceptable level, PTax compares the relevant disposal with information reported in the individual's income tax return (the analysis and criteria supporting this process are discussed from paragraph 3.41).

⁴⁰ While the immediate focus was CGT compliance by individual taxpayers, the real property data was acquired on behalf of the ATO, and has been made available to other business lines within the ATO for tax administration purposes.

⁴¹ The Commissioner's formal powers are established by s. 264 of the *Income Tax Assessment Act 1936*, enabling information to be requested from third parties to enable assessment of compliance with taxation obligations. Failure to comply with a s. 264 notice carries a penalty of between \$2 200 and \$27 500 depending on number of offences and/or imprisonment not exceeding 12 months for a third or subsequent offence.

⁴² As outlined on page 8 of the 2005–06 *Compliance Program*, bulk real property data matching activities undertaken as part of the project were intended to **nationally identify** transactions against which the ATO could check for undeclared income and thereby re-balance its compliance activities.

- PTax has no alternative method to identify an individual's failure to meet their CGT obligations in relation to real property; and
- subject to the outcomes of its initial activities, it was intended to acquire real property data on an ongoing basis.

3.16 Despite initial expectations that it could obtain the required data in a prescribed format, the ATO was unable to negotiate this outcome as the various state and territory agencies did not have the resources to meet such a request. Instead, given the time pressures to meet its additional *compliance challenges* revenue and coverage commitments as well as the need to identify undeclared gains within the ATO's standard period of review (see paragraph 1.13), the ATO decided to obtain database extracts. This decision had major implications for the time needed to properly analyse the acquired data and to convert it into a useable format that could be matched with the ATO's internal records. It also meant that the ATO had to rely on alternative data sources to identify sufficient cases to meet its active compliance targets for 2004–05.

3.17 Variations between each state and territory, in terms of different organisations holding the data needed to identify a potential CGT liability,⁴³ also impacted how data was acquired. The ATO was able to access data from Offices of State Revenue using its existing Memorandum of Understanding (MOU) governing exchange of confidential information. Where the data required was held by another state or territory organisation, the ATO either negotiated a licensing agreement or compulsorily acquired the data using the Commissioner's formal powers. Table 3.1 summarises the CGT Projects' data acquisitions.

3.18 The ANAO noted that during the course of negotiations, questions were raised about the ATO's willingness to pay for access to information after it had issued a formal notice to acquire the data.⁴⁴ At the time of the audit, the ATO was in the process of determining its position on this matter, including giving consideration to the voluntary payment for expenses incurred in meeting a formal request under s. 264 in certain circumstances.

3.19 At the time of the audit, the ATO had not acquired real property data from all relevant states and territories. The ATO advised that it intends to

⁴³ For example, some State Revenue Offices held sufficient data (i.e. property title history, name and address details as well as land tax and duties paid) whereas others only held some of this information, requiring the ATO to acquire the remaining data from the relevant Land Titles Office or its equivalent.

⁴⁴ In many cases a s. 264 notice was requested to protect a private sector organisation's confidentiality obligations, or for a government body to avoid breaching its privacy or secrecy obligations.

acquire outstanding data once higher priority acquisitions have been finalised (including share trading data). The ANAO considers the acquisition of data from all states and territories would ensure that, in line with paragraph 3.15, the ATO is ultimately able to identify compliance risks associated with the non-disclosure of real property capital gains, on a national basis.

Table 3.1

Summary of real property data acquired as part of the CGT Project

Data Origin	Agency	Authority to Acquire	Data Received	Volume of Records Received
State A	Office of State Revenue	MOU	19/5/2005	50 353 469
		MOU	3/4/2006	51 210 795 (Data refresh)
	Other Agency	s.264	30/1/2006	830 300
State B	Office of State Revenue	MOU	16/3/2005	11 463 529
	Other Agency	Licence for Sample Data	14/11/2005	30 000
		s.264	14/3/2006	1 110 060
State C	Office of State Revenue	MOU	21/04/2005	49 522 834
	Other Agency 1	Licence	15/6/2005	24 189 440
	Other Agency 2	s.264	18/05/2006	1 241 360
State D	Office of State Revenue	MOU	11/3/2005	43 758 546
State E	Office of State Revenue	MOU	19/8/2005	35 165 310
	Other Agency	Licence	23/8/2005	19 125 428
State F	Office of State Revenue	MOU	3/1/2006	8 628 412
Territory A	Other Agency	-	10/6/2005	140 529
	Other Agency	s.264	20/12/2005	435 284

Source: ANAO analysis of ATO information

The acquisition of share trading data

3.20 The ATO is in the early stages of acquiring relevant share trading data. Sample data has been received from the Australian Stock Exchange and was being analysed at the time of the audit. The ANAO notes that the ATO’s position on voluntarily paying for data acquired through a formal s.264 notice, when finalised, may also increase the effectiveness of data matching that can

occur using the share trading data currently acquired from the Australian Stock Exchange.⁴⁵

3.21 The ANAO also noted that during the early stages of the project PTax indicated that it may explore opportunities to obtain information from State Revenue Offices pertaining to private company or off market public company share transactions as part of its current MOU arrangements. The ANAO supports initiatives in this area that enable the ATO to better understand compliance risks relating to capital gains made on the sale of shares held in a private company.

Converting external data into a useable format

3.22 Conversion of data into a useable format at the time of the audit was restricted to real property transactions and can be separated into:

- initial use of alternative data sources during 2004–05; and
- work undertaken to develop a real property data model and convert data acquired as part of the project.

The initial use of alternative data sources

3.23 During 2004–05 the ATO employed transitional techniques to identify real property disposals using data from a commercial data provider, and data previously acquired by the ATO's Goods and Services Tax business line, from a state revenue office. This work was largely manual, and focused on property disposals in one state, with some disposals identified in two other states.

3.24 The useability of external data is dependant on the outcomes achieved by the ATO's corporate identity matching engines.⁴⁶ During 2004–05, the ATO noted that approximately 68 000 individuals made 71 000 real property disposals between 1 July 2002 and 30 June 2004. Of these, 35 per cent subsequently had their identity matched (but only partially which was

⁴⁵ This is because, while the Australian Stock Exchange data includes share transaction data for all 'sponsored' clients, share registry data is also needed to enable the ATO to match an individual's TFN with the holder identification number retained by the Australian Stock Exchange. (As discussed further in footnote 47, the TFN is a key identifier the ATO uses to convert external data into a useable format.) At the time of audit fieldwork, negotiations were ongoing with share registries, regarding the supply of supplementary data.

⁴⁶ An overview of the identity matching engines the ATO uses can be found from paragraph 4.4 of *The Australian Taxation Offices Management and Use of Annual Investment Income Reports*, The Auditor-General Report No. 48 2003–04. The ATO's identity matching engines use special purpose phonetic scoring software to grade identity matching outcomes. This enables the ATO to determine whether or not an outcome is at an acceptable confidence level to inform its administrative activities. There are four grades of identity match; high, medium, low or unmatched. Only AIIR data that achieves a high-grade identity match is used for administrative activities.

considered to only be successful to a low or medium level of confidence) and were made available for analysis and case selection.⁴⁷

3.25 The ATO stated in late 2005 that the transitional arrangements implemented for data matching in a manual environment were inefficient and not sustainable. During 2005–06, in line with its receipt of data under the real property protocol, work commenced to analyse and convert external data into a standard form.

Development of a real property data model

3.26 The ATO began receiving bulk real property data in March 2005. Due to variations in the content, quality and formatting between agencies, a significant amount of time and effort was spent analysing the data structures and data holdings. Using insights gained from this work, the ATO developed a real property data model (the model) to convert all real property data into a common format.⁴⁸ During 2005–06 the project team used data acquired from one State Revenue Office to prototype the requirements of the model. A systematic approach was used to develop the model, in accordance with the ATO's Integrated Systems Development Methodology. This included development of:

- a real property data dictionary;
- detailed functional specifications;
- specific processing rules to map each agency's data to the model; and
- testing plans and procedures to verify application of these rules.

3.27 Appropriate data security arrangements have been established to ensure access to external real property data is restricted to relevant members of the project team. Following the initial conversion of each data set, the ATO anticipates that minimal additional work will be needed to convert any subsequent data received from an agency.

⁴⁷ The ANAO noted that the major reason for such low grade identity matching outcomes is that the external data does not contain the key identifiers used in other areas of tax compliance activity (such as the AIIR). The key identifiers the ATO generally relies on include an individual's TFN or date of birth. Where these are absent the identity matching engines use less reliable identifiers such as an individual's name or address in an effort to achieve a matching outcome. Where this information has not been captured in full, or is absent from an external data source, there is an increased likelihood that any effort to identify match the data will produce low grade outcomes.

⁴⁸ The model is essentially a set of standard 'flat files' that once populated with a given agency's data resides on the ATO's Data Warehouse.

3.28 At the time of the audit, data for six agencies had been fully converted using the model. Conversion of the remaining data is planned for 2006–07. The ANAO considers that the conversion of acquired data is important to enable the ATO to identify CGT compliance risks associated with the non-disclosure of real property capital gains, on a national basis.⁴⁹

3.29 As each data set was progressively analysed, data quality shortcomings were identified. Where data has been acquired from an Office of State Revenue, a requirement of the Memorandum of Understanding is to notify the source agency as soon as practicable where possible errors or defects are identified in the data provided.⁵⁰ At the time of the audit fieldwork limited feedback had been provided on identified shortcomings to Offices of State Revenue.

Recommendation No.3

3.30 The ANAO recommends that the ATO regularly report back any significant errors or defects identified in the real property data provided by an Office of State Revenue.

ATO Response

3.31 The Tax Office agrees with this recommendation.

3.32 This is an important feedback mechanism, and the Tax Office has already provided both the Offices of State Revenue and the Land Titles Office with reports regarding the initial data. In the 2006–07 Capital Gains Tax Project Plan, one of the outputs is regular feedback reports on data received.

Use of interim solutions to convert data into a useable format during 2005–06

3.33 The ATO advised that delays in acquiring real property data meant that one State agency was the main source used to identify real property disposals for administrative action during 2005–06. Project staff from the Knowledge and Information Management stream analysed this data using ‘interim solutions’ to make sense of the data and convert it into a useable format. In addition,

⁴⁹ The ANAO considers that, given the commitments originally made by PTax when acquiring data, there is a need to ensure that if possible all relevant data is converted during the remaining 2 years of the CGT Project and that identified compliance risks are assessed for administrative action.

⁵⁰ The ANAO notes that in some instances the absence of key identifiers, such as an individual’s date of birth, or optional fields such as the property contract date has been fully acknowledged by the source agency. The ANAO considers that relevant errors or omissions that may warrant reporting under the MOU would include the absence of mandatory information such as the property settlement date, ownership details, duplicate or multiple entries or where data has failed referential integrity tests.

limited amounts of data acquired from two other States and a commercial data provider were used to identify disposals for analysis and case selection.⁵¹

3.34 The ANAO noted that as the ATO's understanding of the limitations of the available real property data has improved in line with its development of the model, efforts have been made to enhance identity matching outcomes given the absence of key identifiers (e.g. a Tax File Number or a date of birth).⁵² The ANAO also noted that one of the original deliverables identified in the 2004–05 CGT Delivery Plan was to report on the feasibility of automated data matching and case actioning for CGT compliance in the individuals market segment.

3.35 The ANAO considers that given the delays in acquiring and converting all relevant data, it is too early to make an overall assessment of the long-term feasibility of the data management activities initiated by the ATO as part of the CGT Project.⁵³ However, based on the outcomes of the activities undertaken to date, it is clear the absence of a key identifier significantly reduces the proportion of real property transactions that can be converted into a useable format. The ANAO also considers that while this continues to be the case it is unlikely that the real property data acquired will satisfy any 'fitness for purpose' requirement for acquiring third party data as part of the planned introduction of ATO data quality standards.⁵⁴

3.36 The Data Matching Steering Committee (DMSC) is responsible for ensuring that matching external data to ATO data enhances compliance outcomes. It is also responsible for ensuring that internal processes are effectively managed, meet governance requirements and that evaluation processes exist to assess the value of external data to the ATO. The ANAO considers it important that, based on the quality and effectiveness of the data management activities completed as part of the CGT Project, the DMSC assess whether automated data matching and case actioning is the most appropriate strategy to achieve CGT compliance in the individuals market segment.

⁵¹ Further information on the real property disposals identified during 2005–06, including how these were assessed for administrative action can be found in Figure 3.1. As indicated in paragraph 3.28, additional data sets were also converted using the model during 2005–06. However, these were not analysed to select cases for actioning during 2005–06 (as the CGT Project had already achieved its active compliance commitments for this period).

⁵² This has included loading postal and historical residential address information to increase the likelihood of obtaining an acceptable identity match.

⁵³ This is particularly so given that the conversion of share trading data has yet to begin.

⁵⁴ See paragraph 1.16 of Chapter 1.

3.37 The DMSC could explore different strategies, including other solutions with relevant state and territory Government Revenue and Land Titles offices that may support the quotation by individual taxpayers of key identifiers at the time of real property disposal or acquisition. Such enhanced data from source entities would enable an increased proportion of real property disposals to be readily identified and assessed for administrative action.

Recommendation No.4

3.38 The ANAO recommends that the ATO, based on the outcomes of the data management activities undertaken for the CGT Project:

- assess whether, of the options available, automated data matching and case actioning is the most appropriate strategy to achieve capital gains tax compliance in the individuals market segment; and
- review the need to explore other solutions with relevant state and territory Government Revenue and Land Titles offices that support the quotation of key identifiers at the time of real property disposal or acquisition.

ATO Response

3.39 The Tax Office agrees with this recommendation.

3.40 It is part of the overall strategy to determine the feasibility of automated data matching and case actioning for Capital Gains Tax compliance in the individuals' market segment at the completion of the project. The Tax Office is involved in regular discussions with state and territory Government Revenue Offices. The Tax Office will continue to explore options for solutions via these discussions, including expanded data capture or the use of a unique identifier for real property transactions.

Identifying CGT compliance risks for active compliance activities

3.41 The CGT Project's data management activities are intended to provide PTax with a statistical picture of CGT compliance to enable national identification and targeting of high risk individuals for administrative action. However, unanticipated delays in acquiring and converting external data into a useable format, and the absence of key identifiers, have restricted the pool of disposals available for analysis during 2004–05 and 2005–06.

3.42 The ANAO examined the approach used to assess CGT compliance risks using data management activities being undertaken at the time of audit fieldwork. The ANAO also examined the CGT Project's use of relevant Annual Investment Income Report (AIIR) data.

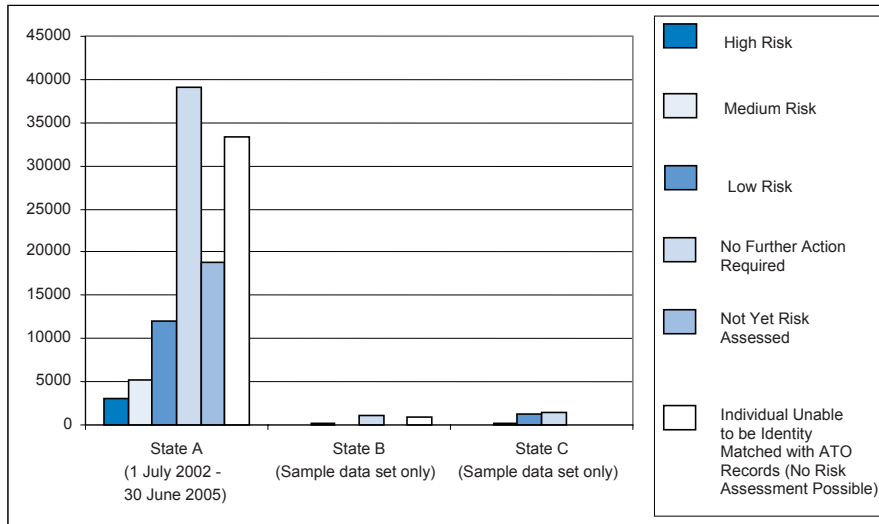
Real property compliance risks assessed in 2004–05 and 2005–06

3.43 Once an individual undertaking a property transaction has been matched with taxpayer information held by the ATO, the ATO compares disposal details with information that has been reported in the individual's income tax return. This analysis is performed on the ATO's Data Warehouse. The ATO developed risk criteria as part of the CGT Project to prioritise and plan treatment of identified real property disposals.

3.44 During 2004–05, of the approximately 24 000 individuals available for analysis, 36 per cent were allocated to a risk review pool. Due to the low grade identity matches associated with these disposals, active compliance staff either telephoned the individual or used the ATO's Transaction Search Facility to reduce the possibility that the disposal may relate to a main residence. Following this, approximately 7 000 individuals were risk reviewed, with 40 per cent deemed low risk (either receiving an advisory letter or no further action) and the remaining 60 per cent being classified as high risk.⁵⁵

3.45 Figure 3.1 summarises the real property disposal risk assessments during 2005–06.

⁵⁵ Information on the active compliance products applied during 2004–05 can be found in paragraph 4.21.

Figure 3.1**Real property disposal risk assessments during 2005-06**

Source: ANAO analysis of ATO data

3.46 Figure 3.1 indicates that during 2005–06, approximately 70 per cent of individuals with real property disposals, in the data sample used, had their identities partially matched with ATO records and were subsequently available to be risk assessed for administrative action (although, consistent with 2004–05, these individuals were only matched to a low or medium level of confidence). Of these, a significant proportion (approximately 74 per cent) did not warrant further action⁵⁶ or had not been risk assessed at the time of the audit.

3.47 For the remaining individuals, the ATO undertook audits on cases identified as high risk, and risk reviews on medium and low risk cases.⁵⁷ The ATO's processes and treatments relating to its assessment of the various CGT compliance risks for real property disposals are depicted in Appendix 2.

3.48 During 2005–06, the ATO attempted to estimate a potential CGT population using aggregate property sales data published by the Real Estate Institute of Australia.⁵⁸ The CGT population was estimated to be

⁵⁶ The ATO advised that these individuals may have been eliminated due to the main residence exemption, or sufficient CGT had been disclosed, or the transactions associated with the individual could not be verified.

⁵⁷ The ATO advised that a risk review may also be escalated to an audit once additional information has been sought from a taxpayer.

⁵⁸ See the Real Estate Institute of Australia *Profile: Australian Real Estate Industry Review 2004–05*.

approximately 1.1 million disposals for the period 1 July 2002 to 30 June 2004.⁵⁹ The ATO planned to interact with 3 per cent of this population during 2005–06 (approximately 33 000 individuals) through its active compliance activities initiated as part of the CGT Project.

3.49 The ANAO recognises the ATO’s efforts to review an acceptable proportion of real property disposals as part of its active compliance interactions.⁶⁰ In the absence of a complete set of useable data gathered from data management activities, it is appropriate to use industry data such as that published by the Real Estate Institute of Australia. However, the ANAO found there is potential to improve the scope and method of calculating the sales population used to support real property compliance interactions for the CGT Project. This includes:

- ensuring the real property sales population covers the same period as the disposals being analysed. E.g. during 2005–06 disposals for 1 July 2002 to 30 June 2005 were examined, but the real property sales population ended 30 June 2004;
- including land sales in the real property sales population; and
- clearly indicating the proportion of interactions planned for a particular state or territory. E.g. more than 95 per cent of the 2005–06 interactions were determined using data from one State (as this was the main data source converted at the time), however sales in this State during this period accounted for only 28 per cent of sales Australia wide.

3.50 Making these adjustments, the ANAO estimates that planned interactions for 2005–06 accounted for about 1.8 per cent of the potential CGT population. Until the data from its real property data management activities is sufficient to inform PTax’s understanding of non-disclosure compliance risks across Australia, the ANAO considers that continued use of a real property sales population is appropriate (with the necessary adjustments detailed in paragraph 3.49).

⁵⁹ This figure was determined by adding the total number of dwelling sales across Australia for this period.

⁶⁰ The ANAO noted that planned interactions for 2005 were tabled with the SCF in December 2005. Acknowledging the ATO’s compliance approach and application of the *Compliance Model*, the ANAO considers it appropriate for the SCF to formally approve the level of CGT active compliance interactions.

Recommendation No.5

3.51 The ANAO recommends that to provide assurance that real property active compliance interactions planned for the CGT Project achieve an acceptable risk based level of national coverage, future plans should demonstrate suitable linkages to the real property sales population being reviewed and consistency in the period being analysed.

ATO Response

3.52 The Tax Office agrees with this recommendation.

3.53 The intent of the Tax Office's strategy is to take a national approach, acquiring real property transaction data from all states and territories. Research and intelligence will inform the Tax Office understanding of the market in real property and case selection will be based on risk.

Use of relevant data from the Annual Investment Income Report

3.54 At the time of the audit the ATO was in the early stages of analysing relevant share trading data as part of the CGT Project. To partly address compliance risks relating to the potential non-disclosure of share-related capital gains, the ATO initiated a pilot project during 2005-06 using dividend information from the AIIR.⁶¹

3.55 Project staff selected a recently listed company and examined situations where a dividend had been reported for an individual in one year but not the next. This analysis identified approximately 5 000 individuals. Of these 68 per cent had disclosed a capital gain (which could be assumed to relate to the share disposal), 20 per cent had not lodged an income tax return, and the remaining 12 per cent had lodged an income tax return but had not disclosed any CGT. The ATO reviewed the latter of these categories only, with approximately 500 individuals assessed as a medium risk.

3.56 The ATO advised that the pilot project was a labour-intensive exercise that produced limited returns. It was always intended to be an interim measure and has now been discontinued given the subsequent receipt of Australian Stock Exchange data. While AIIR data was never intended to be used for CGT purposes, the ANAO considers there is potential for better use of specific capital gains data reported to the ATO as part of the AIIR.

⁶¹ Further information on the investment income types reported to the ATO on the AIIR can be found in The Auditor-General Report No. 48 2003-04 op. cit.

Potential for better use of capital gains data reported by unit trusts

3.57 Since 1992 it has been a legislative requirement that unit trusts report annually to the ATO on income and capital gains distributions paid to unit holders.⁶² The ANAO has previously recommended that the ATO evaluate enhancement of its automated income matching system to cater for income distributed to an individual by a unit trust.⁶³ In its response to this recommendation, the ATO indicated that consideration would be given to making the necessary enhancements and that the DMSC was responsible for managing the ATO's strategic approach to using AIIR data. This included annual assessment of any gap between aggregate investment income reported by investment bodies and taxpayers, and assessing any potential revenue risk, taking into account broader data matching considerations and compliance priorities.

3.58 In its March 2006 report, the DMSC advised that a project had commenced in 2005 to enhance the functionality of the automated income matching system. However, the project was discontinued in December 2005 due to complexities associated with checking a number of different labels⁶⁴, anticipated budget overruns and, at the time, new functionality was planned for inclusion in Release 3 of the ECMP change program.⁶⁵ The ANAO noted the decision to discontinue the project was taken despite analysis of 2002–03 AIIR data providing estimates of some \$190 million in potential revenue from approximately 230 000 discrepant cases. A sample from this population indicated that this equated to an average potential revenue gain of \$826 per case. The ATO advised that significant additional resources would be required to action the identified cases (approximately 56 FTE). During the course of the audit, the ATO further advised that this analysis was restricted to ordinary income only; i.e. it excluded capital gain components for these distributions.

3.59 As noted in Chapter 2, the matching of capital gains data reported by unit trusts was included in the business-as-usual scope of the *CGT Delivery Plan* for 2004–05. At the time of audit fieldwork, this work had not begun. The ANAO requested analysis by the Data Management & Integrity (DM&I) team

⁶² *ibid.*

⁶³ Refer to Recommendation 7 of The Auditor-General Report No. 48 2003–04 *op. cit.*

⁶⁴ This is because information may be wrongly declared in one of 14 labels. The ANAO considers that paragraph 3.8 is relevant to the complexities involved in comparing AIIR data with income tax returns.

⁶⁵ The March 2006 DMSC report notes that it is unclear whether the necessary enhancements would still be included in Release 3, as it is restricted to functionality that is in production as at January 2006.

of the capital gain components of unit trust distribution reported in the AIIR for 2003–04. This analysis, which was restricted to individuals with a high-grade identity match, indicated that approximately 617 000 individuals received \$552 million⁶⁶ of Australian capital gains. Of these, approximately;

- 67 000 individuals receiving \$38 million in gains had not lodged, or had an indicator that they were not required to lodge, an income tax return;
- 27 000 individuals failed to fully declare \$26 million of relevant gains where the amount received was above \$100;
- 97 000 individuals received \$34 million of these gains and had not disclosed any amount at any of the CGT labels; and
- \$1 000 million in carried forward capital losses was claimed.

3.60 As a result of this analysis, the ATO advised that it plans to evaluate the above categories, and action these where required, as part of the active compliance interactions for the CGT Project in 2006–07. Based on the likely average gain per case,⁶⁷ the ATO anticipates that the number of high-value cases may be limited. In this respect, the ANAO considers it unlikely that the ATO will be able to apply similar taxable income thresholds to those used for real property when assessing the compliance risks for share transactions that this analysis identified.⁶⁸ The ANAO also considers that given the high-grade identity matches, and the level of PTax’s DM&I stream AIIR subject matter experts, assessment of the compliance risks associated with the capital gain distributions to an individual by a unit trust is likely to include all relevant data available for actioning in the ATO’s current period of review.⁶⁹ Given its responsibilities to manage the ATO’s strategic approach and use of AIIR data, the DMSC is best placed to oversee this process.

⁶⁶ PTax also advised that analysis of 2004–05 AIIR data indicated that this had increased to \$1 621 million.

⁶⁷ Which are similar to those found for the ordinary income-only components of unit trust distributions analysed in December 2005.

⁶⁸ Unlike real property cases that may have been selected using high dollar/low volume thresholds (indicative of gains made during the recent property boom), as the ATO turns its attention to unit trust distributions (and to undisclosed share trading gains) an alternative selection strategy may be needed for these relatively high volume/low dollar gain transactions.

⁶⁹ As noted in Chapter 1, this is 4 years following the date that an individual lodges their income tax return. Given this data has not been analysed recently, the analysis should include AIIR data reported for 2001–02 and 2002–03. This will enable multi-year assessment of compliance risks for these gains.

Recommendation No.6

3.61 The ANAO recommends that to assist with the assessment and treatment of CGT compliance risks identified in respect of Annual Investment Income Report (AIIR) data, the ATO:

- analyse relevant data, in the related period of review, reported by unit trusts on capital gains distributed to individuals; and
- subject to a risk assessment, incorporate unit trust distributions as part of the active compliance interactions planned for the remainder of the CGT Project.

ATO Response

3.62 The Tax Office agrees that Capital Gains Tax compliance risks identified in Annual Investment Income Report data will be risk assessed along with all other risks.

3.63 The cases rated as higher risk will be addressed.

4. Activities to Facilitate and Enforce Compliance with CGT Obligations

This Chapter details the compliance assistance (e.g. marketing and education) and active compliance (e.g. audit) activities undertaken by the Australian Taxation Office to facilitate and enforce compliance with capital gains tax obligations by individuals.

Introduction

4.1 The ATO's overall approach to compliance is detailed in Chapter 1. This Chapter discusses the compliance assistance and active compliance activities the ATO uses to administer CGT compliance in the individuals market segment, as conducted through the CGT Project. In particular, the ANAO considered whether the ATO:

- uses a range of compliance products and processes to treat identified CGT compliance risks in the individuals market segment;⁷⁰
- supports active compliance activities with procedural guidance and capability training for staff;
- met the active compliance coverage and revenue commitments made with respect to *compliance challenges* in the *Output Pricing Agreement 2002-05*, and as published in the ATO's *Compliance Programs*;
- analyses compliance activity outcomes to inform risk identification and future compliance planning; and
- is positioned to meet the CGT Project compliance aims and strategies (listed in paragraph 2.12) by the end of the project.

Investor pathways

4.2 Using a cross-stream approach, the ATO developed a real property investor pathway and at the time of the audit was developing a shares investor pathway. The pathways are diagrammatic representations of taxpayers' interactions and experiences with the revenue system for specific CGT assets. They provide the context for compliance assistance activities (by identifying key intermediaries and interaction points between taxpayers and the ATO) and

⁷⁰ The ATO's *Compliance Program 2005–06* explains that compliance activities are undertaken to treat identified risks. Chapter 3 details how the ATO has sought to better identify CGT risks associated with disposal of real property and shares.

facilitate the ATO's understanding of taxpayers' experiences with active compliance activities. The ATO advised that the pathways have been particularly useful for guiding the compliance assistance approach during the CGT Project.

Compliance assistance

4.3 The Marketing and Education stream designs and provides products and services to help individual taxpayers meet their taxation obligations. Prior to the *compliance challenges* funding, no staff were specifically allocated to undertaking CGT marketing and education activities for the individuals market segment. The Provision of Advice stream helps taxpayers correctly self assess by providing written interpretive advice. The Tax Practitioner Group (TPG) manages the relationship between the ATO and tax practitioners.⁷¹ No *compliance challenges* funding was provided for Provision of Advice or TPG activities; this work is completed as business-as-usual.

Marketing and education

4.4 A major component of the ATO's *Marketing and Communications Strategy* for CGT in the individuals market segment is the leverage of messages through key intermediaries. In January 2005 an *Intermediaries Strategy for Capital Gains Tax* was developed. This identifies the State and Territory Real Estate Institutes (REIs) and the New South Wales Estate Agents Cooperative as key intermediaries for disseminating CGT real property information. During the audit the ANAO sought stakeholder feedback about the ATO's management of the relationship, and the costs and benefits received from participating in the ATO's CGT strategy. Feedback from the REIs was positive; they had been contacted through a variety of channels, and considered the ATO to be professional in their dealings. The REIs did not consider the ATO's requests to disseminate information to be cumbersome, and believed the relationship to be mutually beneficial as they received reliable and accurate CGT information to distribute in newsletters, bulletins and on their websites.

4.5 The ANAO discussed use of intermediaries (e.g. REIs or Financial Planning Associations) to distribute CGT information to taxpayers with tax agent representatives and professional associations. These stakeholders strongly supported provision of generic CGT information at the point of asset

⁷¹ Subsequent to audit fieldwork the Tax Practitioner Group was transferred to the ATO's Lodgement Compliance business line.

acquisition. This support was qualified by the proviso that no specific tax advice is provided to taxpayers, unless through registered tax practitioners.

Marketing and education products

4.6 Compliance assistance products are classified into four categories, as detailed in Table 4.1.

Table 4.1

The four layers of compliance assistance products

Layers	Description and Examples
1. Awareness	These are simple, high-level introductory products, referring taxpayers to additional information. E.g. Editorials, media articles, speeches and flyers.
2. Applicability	These provide more detail than Layer 1 products, help individuals identify their tax obligations, and reference additional information. E.g. Editorials, fact sheets (printed and electronic), and the <i>Personal Record Keeping Tool</i> .
3. Meet Obligations	Layer 3 products help taxpayers meet their obligations with respect to specific areas of CGT law. E.g. E-tax modules.
4. Rules	These products provide detailed technical information to help taxpayers meet their obligations with respect to specific areas of CGT law. E.g. <i>Guide to Capital Gains Tax</i> and <i>CGT Property Exemption Tool</i> .

Source: ATO

4.7 Feedback to the ANAO during stakeholder consultation revealed that tax practitioners were aware of an increase in CGT products over the last 2 years, and were generally positive about the products. However, a continued lack of taxpayers' awareness was repeatedly raised as a challenge for the ATO. Despite the existence of marketing and education products, if people (*incorrectly*) do not think they have a CGT liability (e.g. when selling a second property that was not rented), they will not look for CGT information.

4.8 The ATO's focus on marketing and education activities significantly increased following the receipt of *compliance challenges* funding. There has been an increase in the number and types of CGT compliance assistance products the ATO has produced; in particular, Layer 1 and 2 products for property. The ANAO noted that the compliance assistance products produced to date have been developed in accordance with plans. The ATO has transferred its marketing and education focus to shares, while continuing to refine and maintain the property products. It has also developed an investor pathway for shares and has increased its focus on risk and active compliance activities. The ATO is yet to assess the effectiveness of many of its compliance assistance products (evaluation is discussed from paragraph 4.44).

4.9 The ANAO considers it important that the ATO continues to maintain its focus and momentum on developing and delivering CGT compliance assistance products and activities. This focus should continue until an evaluation indicates that the desired changes in knowledge and behaviour towards CGT within the community have been effected to a level where CGT is no longer considered to be a 'significant/high' risk area.⁷² This is consistent with the ATO's objective of embedding a CGT capability within PTax.

Provision of advice

4.10 A key element of the ATO's administration of taxation law is the provision of interpretative advice on taxation issues. This advice is particularly important due to Australia's self-assessment taxation system, which relies upon taxpayers having an understanding of taxation law in order to fulfil their obligations. A private binding ruling (PBR) is an expression of the Tax Commissioner's opinion of the way a relevant provision applies, or would apply, to a taxpayer in relation to a specified scheme. The PTax Provision of Advice stream issued 1 419 PBRs on CGT topics in 2005–06 (1 276 in 2004–05). The areas covered were: main residence – 32 per cent (33 in 2004–05); deceased estates – 17 per cent (32 in 2004–05); and shares and unit trusts – 19 per cent (26 in 2004–05). The ATO advises that in 2005–06, 69 per cent of PBRs were issued within the ATO's service charter timeframes (87 per cent in 2004–05).

Objections

4.11 In 2004–05 there were 316 CGT related disputes. Of these, 52 resulted from CGT audits. In 2005–06 there were 573 CGT related disputes, with 376 from CGT audits. Approximately 61 per cent of the CGT audit disputes were allowed in full, and 21 per cent were allowed in part. Fifteen per cent were disallowed in full, and in 4 per cent of the cases the taxpayer withdrew the objection. The ANAO considers the increased number of CGT audit disputes reflects the significant increase in the number of active compliance activities undertaken.⁷³ The high incidence of audit disputes allowed in full is an issue the ATO will need to continue to monitor and address, particularly when evaluating the effectiveness of its active compliance activities. The ANAO

⁷² The ATO's assessment of the CGT risk in the individuals market segment was made in March 2005. This status was current at the time of undertaking audit fieldwork.

When conducting an informal analysis of a sample of 2004–05 productive audit cases the ATO determined that 66 per cent of taxpayers were 'Willing to do the right thing' but made an honest mistake determining their CGT liability. This reinforces the importance of compliance assistance activities.

⁷³ There is a lag between when an audit is undertaken and the objection process. Between 2003–04 and 2005–06 the ATO increased the number of CGT audits conducted annually sixfold.

notes that ATO has agreed with the Improving Compliance Reporting project recommendation to:

Review the definition of liabilities and collections with particular regard to the impact of objections and disputes and consider implementing a reporting regime that provides greater transparency around the extent to which liabilities and/or collections are impacted by objections and disputes.⁷⁴

4.12 No CGT cases have been raised with the Ombudsman in the past 5 years.⁷⁵

CGT Property Exemption Tool

4.13 While PBRs are an effective mechanism for taxpayers and tax practitioners to overcome complexity and gain certainty in their tax affairs, it may take up to 2 months to receive a response, and the ATO may be required to respond to requests on the same topic from multiple taxpayers. The ANAO found that the ATO developed an online 'CGT Property Exemption Tool', as a proactive response to receiving a large number of requests on the main residence exemption.⁷⁶ Following its introduction on 1 July 2005, the ATO's preliminary investigations indicated a reduction in PBR applications on main residence topics towards the end of 2005–06. Feedback to the ANAO from stakeholders on the tool was positive. The ATO advised that it will commence work on a CGT decision tool for shares in 2006-07.

Tax Practitioner Group

4.14 In 2003–04 approximately 88 per cent of taxable individuals who reported a net capital gain lodged through tax practitioners; these individuals represented approximately 94 per cent of the value of net capital gains reported.⁷⁷ The ATO considers tax practitioners to be a key leverage point for delivery of CGT marketing and education, due to their role in influencing and assisting individuals comply with CGT obligations. In 2004–05 TPG published a *CGT Checklist* for tax practitioners, updated the *Compliance Toolkit* CGT section, and included CGT information in *eLink* and at *Satellite Seminars*.

⁷⁴ ATO, February 2006, *Review of the Tax Office's performance reporting processes to the Compliance Program*, p.18

⁷⁵ Some cases included CGT components, however it was not considered to be a key issue in any case.

⁷⁶ It provides an immediate determination for a taxpayer regarding the proportion of their capital gain that is exempt from capital gains tax, and is available on the ATO website at <www.ato.gov.au>.

⁷⁷ For the total population of individual taxpayers who lodged in 2003–04, approximately 74 per cent of tax returns were submitted by tax practitioners.

Active compliance

4.15 The ATO's Active Compliance stream is responsible for managing, measuring and generally improving taxpayer compliance. *Compliance challenges* funding has provided a substantial increase in the number of staff undertaking active compliance activities. Information on the ATO's assessment of CGT compliance risks in the individuals market segment is outlined in paragraph 3.41. The ATO's key active compliance activities to treat these risks are letters, risk reviews and audits, and are discussed below.⁷⁸

Letters: education and pre-lodgement advisory determinations

4.16 The active compliance stream issues two types of letters; education and pre-lodgement advisory determinations (PLADs). PTax considers PLADs to be compliance interventions as the 'notional' revenue attributed to these is identified and monitored.⁷⁹ While the issuing of education letters is undertaken by active compliance staff, and monitored and reported with their activities, the ANAO considers these to be compliance assistance products.

Real Property

4.17 An education letter is sent to taxpayers the ATO has identified as new to ownership of a property that may be subject to CGT.⁸⁰ Education letters advise taxpayers that they may have a future CGT liability, and include the *Tax-smart investing – Property investors, home buyers and sellers* pamphlet. The 3 875 and 22 000 education letters sent in 2004–05 and 2005–06 respectively provided coverage across Australia. During the audit the ANAO received feedback from tax agent and tax practitioner representative bodies that they considered education letters to be beneficial as they:

- reinforce the importance of keeping records;
- are a timely and proactive reminder of a taxpayers' CGT obligations – they are issued at the point of acquisition of a CGT asset; and
- encourage taxpayers to discuss potential CGT events with their tax agent.

⁷⁸ The ANAO notes that all reviews and audits were desk-based (i.e. not field visits).

⁷⁹ Notional revenue refers to the CGT liability reported by taxpayers that the ATO considers would not have been reported if it were not for a compliance intervention. Notional revenue is also referred to as 'protected revenue'. It is not counted as a liability raised through active compliance activity.

⁸⁰ For example, taxpayers declare rental income for the first time in their tax return, or information obtained from state government agencies indicates that a potential investment property purchase was made.

4.18 PLADs are sent to taxpayers in selected cases where information obtained from state government agencies indicates that a property was disposed of, and the taxpayer has not yet filed a tax return for the income year. PLADs sent in 2004–05 and 2005–06 were primarily for property disposals in one State that met certain risk criteria. This limited coverage reflected the ATO's data matching ability at the time, as only one State's data had been obtained and converted into the format required for automated case selection. The ATO intends to expand PLAD coverage when additional data becomes available.

4.19 Tax practitioners receive a summary letter when the ATO sends an education or PLAD letter to one of their clients. The summary letter outlines who has received the correspondence and the nature of the correspondence. The decision to adopt this approach was made in consultation with the Tax Agent Advisory Group. The ANAO received feedback that tax practitioners appreciate the co-communication process.

Shares and units (in unit trusts)

4.20 At the time of the audit, the CGT Project had not issued education or PLAD letters for share disposals or unit trust capital gains.

Risk reviews

Real Property

4.21 Risk reviews are conducted on low and medium risk cases as a mechanism for clarifying information held by the ATO. As part of a risk review, taxpayers are required to complete a questionnaire. Taxpayers who make voluntary disclosures during a risk review are eligible for a penalty reduction. Risk reviews may subsequently be escalated to audits.

4.22 The ANAO found that in 2002–03 and 2003–04 the ATO conducted risk reviews on property disposals across Australia.⁸¹ Cases were selected by matching internal ATO rental information with property disposal data sourced from an external commercial provider and state government agencies.⁸² In addition, sales in high-growth regions (e.g. the Gold Coast) were targeted. The ATO did not conduct risk reviews in 2004–05. In 2005–06 reviews were primarily conducted on disposals in one State (due to data availability), with some cases undertaken using sample data from additional states.

⁸¹ See Chapter 2 for commentary on the ATO's compliance activities prior to the CGT Project.

⁸² This data was obtained on a case-by-case basis.

Shares and units (in unit trusts)

4.23 In 2001–02, a risk assessment project involving reviews on an Initial Public Offering and a demutualisation were undertaken, and in 2002–03 risk reviews were conducted on a small sample of Australian Stock Exchange share sales. In 2003–04 no risk reviews were conducted on share disposals or capital gains from unit trusts, due to a lack of resources. In 2004–05 and 2005–06 a pilot project was conducted to undertake risk reviews on an Initial Public Offering using AIIR data. The ATO advised that it expects to significantly increase the number of risk reviews and audits of share disposals during the second half of the CGT Project; the receipt of bulk data from share registries is planned for 2006–07.⁸³ The ATO also advised that it will undertake a pilot project consisting of education letters, risk reviews and audits of the capital gains component of unit trust distributions in 2006–07.

Audits

Real Property

4.24 The audits conducted in 2002–03 and 2003–04 occurred as part of the rental and high growth area projects (as noted in the *Risk review* section above). The ATO considered the rental audits to be a labour intensive manual process, due to the poor availability of data at the time.⁸⁴ Of the high growth region audits, only a small percentage were productive due to the main residence exemption, or the gains already being accounted for in a trust or partnership return. For the productive cases, average adjustments were approximately \$100 000 (residential sales) and \$50 000 (land sales).

4.25 The *Compliance Program 2004–05* stated that ‘Capital gains tax is a strong focus for us this year’. In 2004–05 audits were undertaken on property disposals in one State with limited audits in two other States also conducted. In addition, a small number of audits on non-residents, originating from recommendations by the Foreign Investment Review Board, were conducted in 2003–04 and 2004–05. CGT for individuals was also identified as a strong focus area in the *Compliance Program 2005–06*. In this financial year, audit activity was primarily conducted on property disposals in one State, with some cases

⁸³ This data includes all sales with purchase history from 1 July 2002 onwards. As noted in Chapter 1, the standard period allowed for the ATO to amend an individual’s tax assessment is 4 years. This means that by the time the data is converted and analysed for case selection, share disposals pre-2002 will be outside the review period.

⁸⁴ Online searching of complete data sets was only available for one state, and for some state government agencies, data was only available on microfiche.

undertaken from two other States. Again, this limited coverage was due to data availability.

Shares and units (in unit trusts)

4.26 In 2001–02, audits on an Initial Public Offering and a demutualisation were undertaken as part of the previously mentioned risk assessment project. In 2002–03 a small number of audits on capital gains from unit trust distributions were completed. In 2003–04 no audits were conducted on share disposals or capital gains from unit trusts, due to a lack of resources. At the time of the audit, the CGT Project had not conducted audits on share disposals or unit trust capital gains.

Prosecutions

4.27 In 2004–05 and 2005–06 no CGT active compliance cases in the individuals market segment were referred to the Office of the Director of Public Prosecutions.

Those outside the system and non-lodgers

4.28 One of the aims of the CGT Project is to identify and bring to account those outside the system (e.g. individuals who have never lodged a tax return) and non-lodgers (e.g. taxpayers within the system, who have not lodged in the recent past). The ATO has identified these groups as at risk for the omission of capital gains. For example, those outside the system may derive income from capital gains rather than from salary. Alternatively, individuals may omit a tax return for a year when they receive a capital gain, as they consider it too hard to complete, or believe that failing to lodge is not the same as lodging a false return. In some cases, they lodge the following year as normal.

4.29 Non-lodgers identified by the CGT Project are dealt with in conjunction with the Lodgement Compliance business line. In 2004–05, 89 demands to lodge were issued, with 271 demands issued in 2005–06. The ATO expects its ability to identify those outside the system and non-lodgers to increase in line with its use of data converted by the real property data model: ‘we know little about [those outside the system] due to a lack of data matching capability. This is expected to be addressed in 2005–06 as bulk data from State Revenue and [Land Titles Offices] comes on line’.⁸⁵

⁸⁵ Australian Taxation Office, March 2005, *PTax Risk and Strategy Evaluation Report*, p. 14.

Staff capability and procedural guidance

4.30 The ATO identified obtaining staff and developing staff capability (particularly for active compliance) as key issues in the first year of the CGT Project. In 2004 the ATO developed a *CGT PTax Skilling Strategy* as well as an ATO-wide *CGT Skilling Strategy*. Under these strategies some staff capability training for CGT has been provided. In addition, procedure manuals for CGT audits and risk reviews have been developed and are regularly updated.⁸⁶ The ANAO found that at the time of undertaking fieldwork, the ATO was relatively stable and satisfied with its capabilities and escalation points for technical assistance. However, the recent conversion of real property data from multiple state government agencies (see paragraph 3.28), and the ATO's change in focus from real property to shares and unit trusts, may require different technical skills in addition to the capacity to manage an increased workload. The ANAO considers that staffing and staff capability are issues the ATO will need to continue to monitor closely during the second half of the CGT Project. Planning for post 2007–08 will be critical for the ATO to achieve its aim of embedding the CGT capability into business-as-usual. The importance of robust planning for the final two years of the CGT Project is discussed in Chapter 2. In particular, see *Recommendation No.1*.

CGT coverage and revenue commitments

4.31 The ATO committed to delivering 10 000 audits for CGT and Rental in 2004–05 (6 000 business-as-usual, and 4 000 *compliance challenges*).⁸⁷ The ANAO found that 11 158 audits were conducted, exceeding the target by 12 per cent. In the end of year performance report to the Expenditure Review Committee, the ATO stated that it had conducted 7 615 *compliance challenge* audits (against the target of 4 000). This implies that the CGT and Rental coverage target was exceeded by 90 per cent. The ATO advised that with respect to CGT, its system for recording audit casework was not updated to differentiate business-as-usual and *compliance challenges*, and some activities were incorrectly reported as *compliance challenges*. This discrepancy was not explained in the reporting to the Expenditure Review Committee. The ATO advised that corrective action has been taken with respect to recording *compliance challenges* and business-as-usual audits in its system, and this situation will be remedied for 2005–06. The ANAO considers that the ATO needs to ensure that the business

⁸⁶ The ANAO did not review adherence with the procedure manuals by active compliance case officers.

⁸⁷ Chapter 2 notes the combination of CGT and Rental targets in *compliance challenges*.

rules for recording CGT and Rental results for active compliance activities are consistent, and that future reporting to the Expenditure Review Committee accurately reflects performance against targets.

4.32 The ANAO found that with respect to *Compliance Programs* 2002–03 through 2005–06 the ATO consistently met or exceeded its CGT coverage commitments for the individuals market segment. Table 4.2 details active compliance activities from 2002–03 to 2005–06.

Table 4.2

Coverage: planned and actual CGT active compliance activities in the individuals market segment 2002–03 to 2005–06

Active compliance activities	2002–03		2003–04		2004–05 ¹			2005–06 ¹		
	Planned	Actual	Planned	Actual	Planned		Actual	Planned		Actual
					BAU	CC	Both	BAU	CC	Both
PLAD letters	–	–	–		500	–	519	5000	–	5463
Risk reviews	1100	1658	8000	7997	–	–	–	2000	4000	6126
Audits		196		501	1080	1500	3354	1000	2000	3380

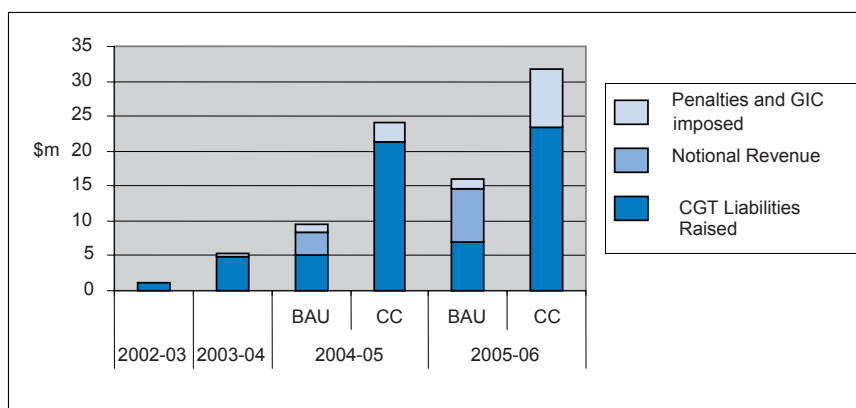
Note 1: From 2004–05 the ATO received additional funding to undertake CGT active compliance activities in the individuals market segment. Planned activities are identified as business-as-usual (BAU) or *compliance challenges* (CC) funding.

Source: ANAO analysis of ATO management reporting information (*Heartbeat* reporting).

4.33 The ANAO found that in 2004–05 and 2005–06 the ATO significantly exceeded its revenue target for liabilities raised. Liabilities of \$30.4 million (including penalties and general interest charges, but excluding notional revenue of \$3.2 million) were raised for 2004–05, compared to a target of \$11.7 million. In 2005–06 the target was \$23 million, with liabilities raised of \$40.1 million (including penalties and general interest charges, but excluding \$7.6 million in notional revenue). Figure 4.1 depicts liabilities raised from CGT active compliance activities in the individuals market segment.

Figure 4.1

Revenue: liabilities raised from CGT active compliance activities in the individuals market segment 2002–03 to 2005–06



Note 1: From 2004–05 liabilities are identified as arising from business-as-usual (BAU) or *compliance challenges* (CC) activities.

Source: Source: ANAO analysis of ATO management reporting information (Heartbeat reporting).

4.34 From Table 4.2, it appears that at the inception of the CGT Project there was a drop in the number of business-as-usual audit and risk review activities. However, Figure 4.1 shows that the value of liabilities raised remained reasonably constant for business-as-usual active compliance activities. In part, this may be attributed to more effective case targeting (e.g. high value cases are undertaken). However, the ANAO noted that inconsistent reporting of active compliance activity types over time, and across types of reports makes analysis of active compliance performance difficult. In particular, classification of risk identification/data matching reviews, risk reviews and audits was not consistent.

4.35 The cash collection rate for payment of liabilities raised in 2004–05 by CGT audits in the individuals market segment is estimated to be 50.9 per cent. The Revenue Analysis Branch determined this collection rate after analysing a sample of payments made by taxpayers with a CGT liability resulting from active compliance activity.⁸⁸ The *compliance challenges* target for 2004–05 cash collections was \$4.7 million. Using the Revenue Analysis Branch collection rate estimate, the ATO significantly exceeded this target, collecting \$15.5 million. The collection of 2004–05 liabilities in 2005–06 is estimated to be 20 per cent.

⁸⁸ CGT collections fall within the non-Income Matching System (IMS) category (e.g. verification is not automated through the IMS). Only payments made in the financial year in which the liability was raised are counted towards the collection rate. In addition the ATO is not able to match payments to a specific debt. The Australian Bureau of Statistics has peer reviewed the collection rate calculation methodology.

The final collection rate for 2005–06 will not be determined until after the end of the financial year; in the interim, the ATO works to the previous year’s collection rate when determining the active compliance activities needed to meet its cash collection commitments to government.⁸⁹

4.36 The ANAO observed that the 2005–06 targets for liabilities raised by business-as-usual and *compliance challenges* active compliance activities was adjusted twice during the year, due to uncertainties in the application of cash collection rates. For example, issues such as how liabilities raised in prior years were to be accounted for in collections, at what point the Revenue Analysis Branch collection rates are applied, and how potentially revised targets would be reported were not clear. As the liabilities target directly impacts the level and nature of compliance activities that the CGT active compliance team undertakes, its continual revision makes planning, monitoring and analysis of performance difficult.

4.37 The Improving Active Compliance Reporting project is reviewing calculation of collection rates, and their consistent application to liabilities raised.⁹⁰ The ANAO notes that this project recommended the ATO reconsider setting cash collections as a performance target. The ANAO further notes that the ATO must report cash collections made under *compliance challenges* to the Expenditure Review Committee. A consistent and documented methodology for applying collection rates to liabilities raised is essential to inform compliance planning for accurate performance reporting.

Recommendation No.7

4.38 The ANAO recommends that the ATO, to inform future compliance planning, determine and document its methodology for setting the CGT Project liabilities and cash collection targets, and consistently apply the cash collection rate to liabilities raised. This documented methodology should address business-as-usual and *compliance challenges* targets.

ATO Response

4.39 The Tax Office agrees with this recommendation.

⁸⁹ There are a number of reasons for variations in collection rates, including changed focus of ATO resources, timing of when liabilities are raised, or outliers (e.g. a large case skews the collection rate).

⁹⁰ ATO, February 2006, *Review of the Tax Office’s performance reporting processes to the Compliance Program*, p. 12.

4.40 A document outlining the methodology to establish project and cash collection targets will be compiled.

Ensuring compliance activities treat compliance risks

4.41 The ANAO considers that recording and analysing active compliance outcomes and the outcomes of non-audit compliance activities is important to inform future planning and targeting of compliance risks.

Performance reporting

4.42 The ANAO found that performance reporting for the streams in the CGT Project was conducted through the ATO's corporate reporting framework; weekly *Heartbeat* reports. Compliance assistance *Heartbeat* reports monitor progress against targets in developing products. For active compliance, *Heartbeat* reports monitor year-to-date planned and actual progress against liabilities, cash collections and coverage targets. Performance indicators that are reported against also include coverage, revenue, strike rates, and audit cycle times. Resource usage by stream is monitored through the workforce planning process, and exception reporting to the SCF by the streams is also conducted on a monthly basis.

4.43 As each stream produces a separate *Heartbeat* report, including CGT resource usage, the ANAO considers there is scope for improving performance reporting through a consolidated CGT Project report. This would consolidate performance reports for each stream in the CGT Project, include any consultancy or contractor costs, include costs associated with acquiring external data, and would have differentiated reporting for business-as-usual and *compliance challenges* activities. This would assist in evaluating the effectiveness of the CGT Project as a whole (e.g. against the CGT project outcomes detailed in paragraph 2.12) and the ATO's progress in mitigating the CGT risks identified for the individuals market segment. The consolidated report could be prepared annually against the *CGT Delivery Plan* (see Recommendation 1).

Evaluation

4.44 The ATO engaged an external research firm to examine the delivery of marketing and education activities for existing, likely and potential CGT clients. The cost of the study, as reported in the ATO's *Annual Report 2004–05*, was \$253 676. The objectives were to understand taxpayer's use of CGT products, and identify gaps in the ATO's product range. In addition, the study

explored taxpayer preferences for products, services and intermediaries, and validated the ATO's investor pathways. At the time of audit fieldwork, the ATO had released a tender for the conduct of a survey to measure the effectiveness of CGT marketing and education activities. The intended outcome is a comprehensive range of benchmarks to measure the effectiveness of marketing and education activities, and inform future compliance assistance activities. The ANAO considers this to be a significant step towards ensuring compliance activities effectively treat compliance risks.

4.45 The ATO conducted internal focus groups to discuss lessons learnt from active compliance cases. The ATO also produces *CGT Case Analysis Reports* to document the drivers of non-compliance and patterns and trends in the audits undertaken. An example of the information identified in the *CGT Case Analysis Reports* is that for 2004–05 over 35 per cent of the productive audit cases sampled revealed main residence issues; from not moving in as soon as practicable, to first using a main residence to produce income, to breaches of the 6-year rule. A case study is provided below.

Incorrect use of the settlement date to calculate capital gains from a property disposal.

A taxpayer purchased a property on 7 July 2002. The property was sold under a contract entered into on 30 June 2003, with settlement occurring on 30 July 2003. The property was rented for the entire period of ownership.

The taxpayer did not declare a capital gain in the 2003 income year; they claimed they intended to report the gain in the 2004 income year. The taxpayer incorrectly believed the capital gain was calculated at the date of settlement, as opposed to the contract date. Further, as the property was purchased and sold within a 12-month period (contract to contract date) the taxpayer was unable to apply the 50 per cent discount when calculating their gain.

Source: ATO, CGT Case Analysis Report

4.46 The ANAO considers the conduct of auditor debriefs and the production of case analysis intelligence reports to be key elements of the ATO's risk and intelligence gathering capability for CGT. The outcomes of this analysis are an important input into planning and targeting compliance risks for compliance assistance and active compliance activities.

4.47 The March 2005 *PTax Risk and Strategy Evaluation Report* provided a comprehensive description of the operational CGT risk, risk status, risk owners, and compliance assistance and active compliance treatment strategies. At the time of the audit, this report had not been updated. The ANAO considers that it is important that the ATO update this report in order to document the current risk of non-compliance with CGT, outline information on the effectiveness of compliance assistance and active compliance activities undertaken to date, and update the *PTax Risk Register*.

4.48 In addition to ensuring that CGT revenue and coverage commitments are met, the CGT Project intends to position the ATO to effectively measure CGT compliance levels and make informed decisions about risk treatment strategies. The ANAO found that at the time of the audit the ATO had not yet commenced measurement of CGT compliance, or determined the impact of its compliance activities on reducing the risk of non-compliance with CGT obligations.

Quality assurance

4.49 The Marketing and Education, Provision of Advice and TPG streams provide input into each others' products through co-design and review mechanisms. In addition, drafts are subject to clearance processes prior to publication, including editorial clearance and approval by technical experts, advisory groups, and external user test groups. In the absence of a formal program, the ANAO considers this an appropriate quality assurance approach.

4.50 Quality assurance for the CGT Project's active compliance activities is conducted through the ATO's corporate quality assurance process: the Technical Quality Review. Due to the small number of cases selected, the Active Compliance stream also conducts internal quality assurance, to make meaningful judgements about the quality of their work, and improve performance. The ANAO considers the combined corporate and stream reviews to be a comprehensive approach to quality assurance.

CGT Project compliance aims and strategies

4.51 The ANAO considers the development of the investor pathways to be an innovative and effective mechanism used to address the desired outcome of '[improving] the ATO's understanding of a taxpayers experience in relation to CGT, including the role of intermediaries'. A heightened marketing and education focus with dedicated resources is enabling the ATO to 'identify and deliver CGT Products to better educate and inform the community and tax agents'. The forthcoming evaluation will provide a sound basis for determining whether these compliance assistance activities have '[raised] the level of voluntary compliance' in the community. For the disposal of real property, the CGT Project has '[expanded] the program of active compliance activities, including case reviews and audits, to address non-compliance'. The ATO is commencing its active compliance activities for share disposals and unit trust capital gains.



Ian McPhee
Auditor-General

Canberra ACT
20 December 2006

Appendices

Appendix 1: ATO response

PO Box 9990
Canberra ACT 2601

Mr David Crossley
ANAO Performance Audit Executive Director
Australian National Audit Office
GPO Box 707
CANBERRA ACT 2601

Contact Officer: Judy O'Connell
Telephone: (03) 9275 2716
Facsimile: (03) 9275 2032
Issue Date: 14 November 2006

Dear Mr Crossley,

Re: AUSTRALIAN NATIONAL AUDIT OFFICE AUDIT OF THE ADMINISTRATION OF CAPITAL GAINS TAX BY THE AUSTRALIAN TAXATION OFFICE (TAX OFFICE)

On the 18th October 2006, the Australian National Audit Office (ANAO) provided the Tax Office with the proposed audit report on the administration of Capital Gains Tax compliance in the Individuals Market Segment.

I am writing to you to provide comments on the report, pursuant to section 19 of the *Auditor-General Act 1997*.

I would like to thank the ANAO audit team for the cooperative and professional manner in which the audit was undertaken and I look forward to continuing the good working relationship developed in this performance audit.

The Tax Office has provided responses to each of the recommendations at 'Annex 1'. Attached at 'Annex 2' is a summary of our comments to be used in the report brochure, and at 'Annex 3', suggested edit changes to the report.

If you require further information on this matter, please contact Judy O'Connell, Assistant Commissioner, Micro Enterprises and Individuals business line, on phone (03) 9275 2716.

Yours Sincerely



Erin Holland
Deputy Commissioner
Micro Enterprises and Individuals
Australian Taxation Office

Cc: Ben Sladic Australian National Audit Office
Kirsty Stuart Australian National Audit Office

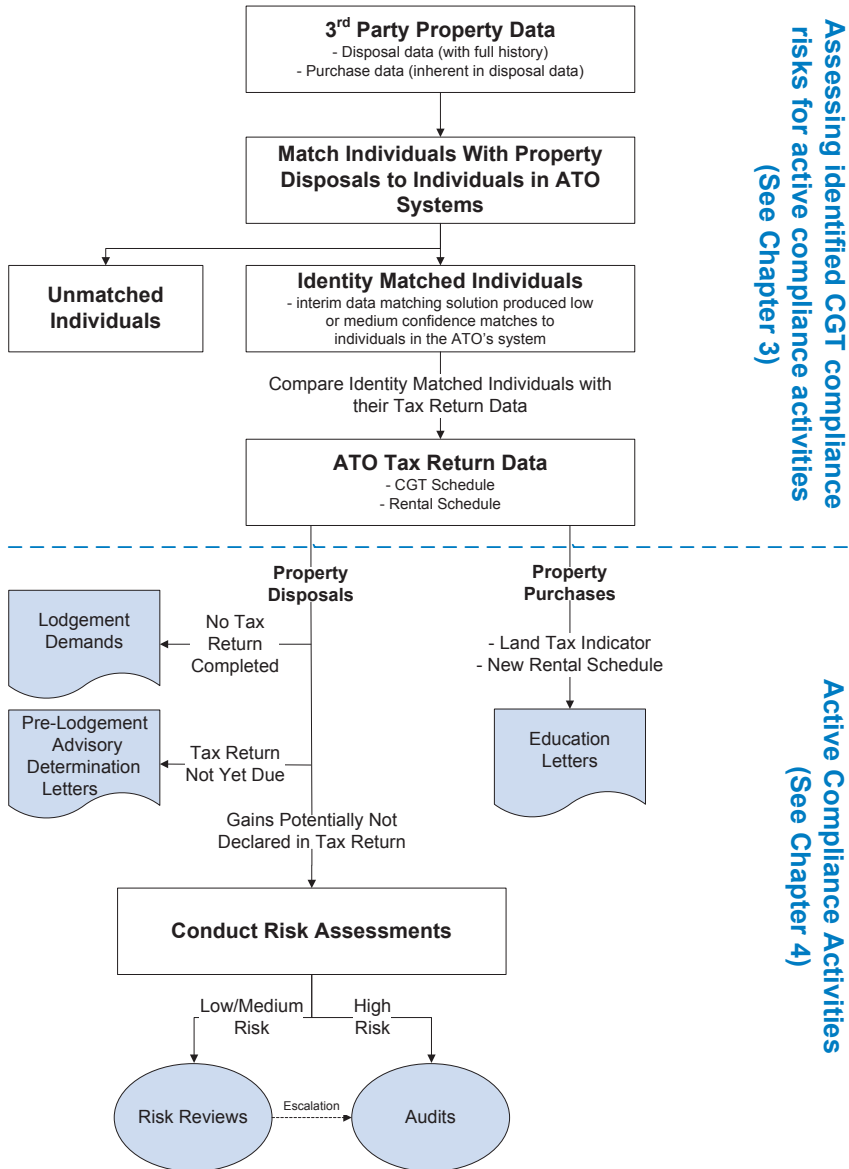
ANNEX 1

	Recommendation	ATO Response
1 2.19	<p>The ANAO recommends that CGT Project planning be improved at the operational level by:</p> <ul style="list-style-type: none"> • preparing a CGT project Delivery Plan annually with clear links to relevant priorities, outcomes and risks identified in strategic level plans and performance measures that enable assessment of progress against the project's intended outcomes; and • linking the planning documents for the ATO's various operational streams to the CGT Project Delivery Plan in accordance with relevant ATO practice statements. 	<p>The Tax Office agrees with this Recommendation.</p> <p>The Personal Tax business line developed a Business Line Plan that included all activities for 2005-06. For 2006-07 the Micro Enterprises and Individuals business line will bring together the relevant outputs to form a Capital Gains Tax Project Plan.</p> <p>The integrated Capital Gains Tax Project Plan will highlight key outputs at the overall Project level and at the business line and stream level. It will be modeled on the 2004-05 plan, providing clear linkages between Project deliverables and business line stream deliverables.</p>
2 3.10	<p>The ANAO recommends that the ATO, based on the outcomes of the data management activities initiated as part of the CGT Project, assess the need to implement changes or additions to the level of information disclosure required in respect of capital gain and loss components in the individual income tax return, having regard to the cost of compliance.</p>	<p>The Tax Office agrees with this recommendation. To date, the Tax Office has focused compliance activities on those who do not include any capital gains tax amounts on their income tax returns. The Tax Office will consider return form changes as it broadens its' compliance focus.</p>
3 3.30	<p>The ANAO recommends that the ATO regularly report back any significant errors or defects identified in the real property data provided by an Office of State Revenue.</p>	<p>The Tax Office agrees with this recommendation.</p> <p>This is an important feedback mechanism, and the Tax Office has already provided both the Offices of State Revenue and the Land Titles Office with reports regarding the initial data.</p> <p>In the 2006-07 Capital Gains Tax Project Plan, one of the outputs</p>

		is regular feedback reports on data received.
4 3.38	<p>The ANAO recommends that the ATO, based on the outcomes of the data management activities undertaken for the CGT project:</p> <ul style="list-style-type: none"> • assess whether, of the options available automated data matching and case actioning is the most appropriate strategy to achieve capital gains tax compliance in the individuals market segment: and • review the need to explore other solutions with relevant state and territory Government Revenue and Land Titles offices that support the quotation of key identifiers at the time of real property disposal or acquisition. 	<p>The Tax Office agrees with this recommendation.</p> <p>It is part of the overall strategy to determine the feasibility of automated data matching and case actioning for Capital Gains Tax compliance in the individuals' market segment at the completion of the project.</p> <p>The Tax Office is involved in regular discussions with state and territory Government Revenue Offices. The Tax Office will continue to explore options for solutions via these discussions, including expanded data capture or the use of a unique identifier for real property transactions.</p>
5 3.51	<p>The ANAO recommends that to provide assurance that real property active compliance interactions planned for the CGT Project achieve an acceptable risk based level of national coverage, future plans should demonstrate suitable linkages to the real property sales population being reviewed and consistency in the period being analysed.</p>	<p>The Tax Office agrees with this recommendation.</p> <p>The intent of the Tax Office's strategy is to take a national approach, acquiring real property transaction data from all states and territories.</p> <p>Research and intelligence will inform the Tax Office understanding of the market in real property and case selection will be based on risk.</p>
6 3.61	<p>The ANAO recommends that to assist with the assessment and treatment of CGT compliance risks identified in respect of the Annual Investment Income Report (AIIR) data, the ATO:</p> <ul style="list-style-type: none"> • analyse relevant data, in the related period review, reported 	<p>The Tax Office agrees that Capital Gains Tax compliance risks identified in Annual Investment Income Report data will be risk assessed along with all other risks. The cases rated as higher risk will be addressed.</p>

	<p>by unit trusts on capital gains distributed to individuals; and</p> <ul style="list-style-type: none"> subject to a risk assessment, incorporate unit trust distributions as part of the active compliance interactions planned for the remainder of the CGT Project. 	
7 4.38	<p>The ANAO recommends that to inform future compliance planning, determine and document its methodology for setting the CGT Project liabilities and cash collection targets, and consistently apply the cash collection rate to the liabilities raised. This documented methodology should address <i>business-as-usual</i> and <i>compliance challenges</i> targets.</p>	<p>The Tax Office agrees with this recommendation.</p> <p>A document outlining the methodology to establish project and cash collection targets will be compiled.</p>

Appendix 2: Real property – process flow for data matching, case selection and treatment activities



Source: ANAO analysis of ATO information

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