

The Auditor-General
Audit Report No.44 2009–10
Performance Audit

Administration of the Tax Obligations of Non-Residents

Australian Taxation Office

Australian National Audit Office

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of Australia 2010

ISSN 1036-7632

ISBN 0 642 81138 5

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Canberra ACT
16 June 2010

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*. I present the report of this audit and the accompanying brochure. The report is titled *Administration of the Tax Obligations of Non-Residents*.

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', written over a horizontal line.

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 (ANAO). 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 Australian Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

| | |
|--------------|--|
| ABN | Australian Business Number |
| AIIR | Annual Investment Income Report |
| ATOSROC | Australian Tax Office and State Revenue Offices Compliance Committee |
| AUSTRAC | Australian Transaction Reports and Analysis Centre |
| CEM | Compliance Executive Meeting |
| DIAC | Department of Immigration and Citizenship |
| FIRB | Foreign Investment Review Board |
| FRW | Foreign Resident Withholding |
| GST | Goods and Services Tax |
| HOTSA | Health of the System Assessment |
| ISC | International Steering Committee |
| ISO | International Strategy and Operations |
| ITSC | Income Tax Steering Committee |
| JCPAA | Joint Committee of Public Accounts and Audit |
| LBI | Large Business and International Business Line |
| MEI | Micro Enterprises and Individuals Business Line |
| MOU | Memorandum of Understanding |
| Div 855 | Non-Resident Capital Gains Tax |
| NRIDRAR | Non-Resident Interest, Dividends and Royalties Annual Report |
| NRWT | Non-Resident Withholding Tax |
| PAYG | Pay As You Go |
| RAB | Revenue Analysis Branch |
| SME | Small and Medium Enterprises Business Line |
| Tax Office | Australian Taxation Office |
| TFN | Tax File Number |
| Commissioner | The Taxation Commissioner |
| TPCC | Tax Policy Coordination Committee |
| Treasury | The Department of the Treasury |

Summary and Recommendations

Summary

Introduction

1. Australia is part of a dynamic global economy that accommodates the free flow of capital and labour across national borders. In 2006–07, just over one million resident and non-resident taxpayers lodged returns that included some type of foreign-sourced income.
2. Australia’s system of tax administration is based on self-assessment by taxpayers, which requires them to declare all assessable income and only claim deductions and offsets to which they are entitled. The Australian tax system endeavours to treat non-resident taxpayers in an effective manner that promotes the integrity of the system.
3. A non-resident is usually connected with the Australian taxation system because they receive business, investment or employment income, and/or make capital gains or losses from within Australia. This may result in income tax, withholding tax and/or Goods and Services Tax (GST) obligations.
4. In 2007–08, the Tax Office collected some \$40.75 million in foreign resident withholding tax, \$236.99 million in Capital Gains Tax (CGT) from non-residents and some \$1.93 billion in non-resident withholding taxes.
5. Broadly, an Australian resident is subject to Australian tax on all income earned from Australian and foreign sources, while a non-resident is usually only subject to Australian tax on income derived from Australian sources.
6. There are three broad categories of non-residents that interact with the Australian tax system, namely:
 - i. offshore-based individuals and entities that have no physical presence in Australia but may, for example, invest in real property, shares, funds management or other income-producing activity;
 - ii. foreign workers and entities who are earning income in Australia, such as professionals on secondment from parent companies, and working holiday makers (e.g. backpackers); and
 - iii. expatriates/Australian citizens who move in and out of residency status, working overseas and who may return to Australia from time to time.

7. A taxpayer's residency status will determine the types and rate of tax they are liable to pay and the Australian Taxation Office (Tax Office) uses a number of tests to determine a taxpayer's residency status for tax purposes.

8. Generally, if a taxpayer resides in Australia, they are deemed to be a resident for tax purposes. In addition, if the taxpayer has been in Australia for at least 183 days of any financial year, or their permanent place of residence is in Australia, or they are a contributor to a Commonwealth Government superannuation scheme, they are deemed to be an Australian resident for tax purposes.¹ Similarly, the Tax Office applies a set of tests to determine if an entity is a resident for tax purposes.

9. The ANAO reviewed the tax administration relating to non-residents in Audit Report No.57 2002–03, *Administration of the Payment of Tax by Non-Residents* (Audit Report No.57 2002–03). Since that review the Tax Office has expanded the compliance activities covering this sector in response to changing economic, immigration and administrative circumstances.

Audit objective and scope

10. The audit objective was to assess the Tax Office's effectiveness in administering the tax obligations of non-residents.

11. The audit assessed the tax administration arrangements pertaining to non-residents by considering:

- the Tax Office's organisational and governance arrangements for the management of non-resident tax obligations;
- the effectiveness of the Tax Office's identification of risks and monitoring of compliance in relation to non-residents;
- the data the Tax Office collects on non-residents and its use of this data for risk identification and compliance activities;
- the effectiveness of non-resident educational programs; and
- progress in implementing the recommendation relating to the use of third party data from Audit Report No. 57 2002–03.

¹ section 6 (1) of the *Income Tax Assessment Act 1936*

12. The audit gave particular emphasis to the CGT administrative arrangements applying to non-residents because of recent legislative changes (2006) and because CGT is one of the small number of taxes paid by non-residents that is not a withholding tax. In this context, the changes to the foreign investment rules as they relate to residential real estate announced by the Government on 24 April 2010, have the potential to impact significantly on the Tax Office's administration of CGT for temporary residents and foreign non-residents.

13. International tax arrangements relating to the large business sector, issues relating to offshore tax havens, transfer pricing and other complex international tax issues administered by the Tax Office were outside the scope of this audit.

Conclusion

14. Overall, the Tax Office has implemented appropriate systems and processes to effectively manage the tax obligations of non-residents. The Tax Office has continued to improve the administration arrangements of the payment of tax by non-residents since Audit Report No.57 2002–03, particularly in respect of improved coordination of non-resident tax compliance activity, and increased and improved application of external data sources. Increased compliance has also resulted from the introduction of additional withholding arrangements applying to non-residents.

15. These initiatives have all contributed to improved risk mitigation and increased compliance by non-residents, although there remains the inherent difficulty and additional expense in identifying and contacting non-residents that may be unknown to the tax system.

16. The Tax Office could continue to build on the improvements it has made to non-resident tax administration since Audit Report No.57 2002–03, by investigating the expanded use of external data sources for risk identification and compliance activities as they relate to non-residents, and by providing additional, and more easily accessible and targeted, education materials for non-residents.

17. The ANAO's more detailed examination of the administration of CGT as it applies to non-residents identified certain areas of risk and potential non-compliance. Whilst aspects of CGT administration for non-residents could be improved, these matters do not significantly impact on the overall effectiveness of the Tax Office's administration of non-residents tax

obligations. Furthermore, changes announced by the Government on 24 April 2010 relating to foreign investment rules covering residential real estate have the potential to further mitigate potential risks of non-compliance in this area.

18. The ANAO made two recommendations aimed at improving the usefulness of third party data and non-resident taxpayer education.

Key findings by chapter

Progress on the implementation of the previous audit recommendation (Chapter 2)

19. ANAO Audit Report No 57 2002–03, was the ANAO’s first review of non-resident tax. That report found that overall, the Tax Office’s administration of the non-resident tax function was sound. The effectiveness and administration of the function was found to have been strengthened by administrative reforms implemented by the Tax Office during the period of that audit and was expected to be further strengthened by a proposed new withholding framework. The ANAO made one recommendation regarding the better use of data and improving the quality of Tax Office research into non-resident activity.

20. In evaluating the implementation of the recommendation from Audit Report No.57 2002–03, the ANAO also evaluated the progress in implementing other suggested improvements made in that report.

21. The focus of Audit Report No.57 2002–03 and the recommendation was that there was third party data in Australia, other than the data the Tax Office was already using, that could potentially be used to improve compliance among non-resident taxpayers.

22. The Tax Office agreed with the recommendation but had some concern regarding the cost-benefit of implementing the recommendation to both the Tax Office and third party data suppliers. The Tax Office commissioned a research consortium to investigate the acquisition and use of third party data sources to improve compliance among non-residents. The research consortium provided a series of recommended actions, and the Tax Office subsequently implemented the majority of those recommended actions. Whilst it did not pursue others due to cost-benefit considerations, overall those that were implemented helped the Tax Office achieve substantive implementation of the recommendation in Audit Report No.57 2002–03.

Administration and governance arrangements for non-resident compliance (Chapter 3)

23. The Tax Office uses a matrix management model to administer the tax system effectively through business planning, risk management and active compliance.

24. Operational responsibility for non-resident risk and active compliance is spread across various Tax Office business lines. The Tax Office coordinates and monitors non-resident risk mitigation strategies through key cross-business line steering committees, each focusing on a particular tax product. This cross-business line approach is consistent with the approach taken for resident taxpayers.

25. Much of the reporting reviewed by the ANAO is part of the Tax Office-wide reporting framework, and includes annual Health of the System Assessments (HOTSAs); at both the product level, such as the Non-Resident Withholding Tax HOTSAs, and taxpayer type, such as the International Taxpayers HOTSAs.

26. The ANAO observed that the Tax Office wide reporting structure for non-resident governance effectively supported the ongoing management of non-resident risk.

Use of data sources for risk identification and compliance (Chapter 4)

27. The Tax Office requires relevant, accurate and timely data sources to undertake effective risk identification, analysis, and compliance activities. The better the understanding of the nature and extent of the risk, the better the Tax Office can direct resources to appropriate compliance strategies.

28. The Tax Office has made progress in using internal and external data sources for non-resident compliance activities, but there is potential for further improvement. The Tax Office does not periodically collect or analyse data relating specifically to taxpayer groups such as non-residents. Rather, the Tax Office collects and analyses data based on tax type as a means to monitor and, where necessary, develop appropriate compliance risk mitigation strategies.

29. To better understand the level of risk pertaining to non-resident taxpayers, and to assist in developing more targeted risk mitigation and compliance measures, the ANAO considers there would be benefit in the Tax Office undertaking a more focused approach to the collection and analysis of

appropriate non-resident data. In particular recommendation 1 of this report suggests the Tax Office examine ways to improve the use of AUSTRAC data for non-resident compliance activities.

Voluntary Compliance in a Self-Assessment System (Chapter 5)

30. The Australian tax system is large and complex. For this reason, the Tax Office needs to effectively educate taxpayers about their responsibilities and obligations. This is also important for non-residents who may have had only limited exposure to Australia's self-assessment taxation system. Non-residents are more likely to be unaware of their legal obligations, due to greater familiarity with their 'home' jurisdiction's tax system, and are more likely to be uninformed as to the complexities of the Australian taxation system.

31. The Tax Office aims to maximise voluntary compliance by providing taxpayers with the information they need to comply with the law. A key component for the Tax Office's voluntary compliance program designed for non-residents is taxpayer education programs. These could be better targeted to increase voluntary compliance among non-residents.

32. In addition, the Tax Office should investigate further leveraging the existing information networks of other government agencies that interact with non-residents (for example DIAC and Customs), and the practicality of working with industry bodies that are closely connected with non-resident taxpayers (for example real estate bodies for real property transactions) as strategies to enhance educational and awareness communication with non-resident taxpayers. Accordingly the ANAO has recommended that the Tax Office investigate ways it could further improve its education program for non-residents.

Capital Gains Tax and non-residents (Chapter 6)

33. The ANAO reviewed in greater detail one area of taxable income that, unlike most other taxes applying to non-residents, is not subject to specific withholding arrangements – CGT. The ANAO reviewed CGT applying to non-residents in terms of the administration and governance arrangements, the use of data sources to identify and monitor risk, and the level of education to encourage voluntary compliance.

34. The review of CGT as it applies to non-residents highlighted the challenges arising due to, in some cases, the non-resident taxpayer not being known to the Tax Office. The risk of non-compliance related to CGT is increased where the payment on sale may have been transferred to an offshore

financial institution at the time of settlement on a real property sale. However, as noted at paragraph 17, the changes relating to the foreign investment rules covering residential real estate announced on 24 April 2010, have the potential to further mitigate risks of non-compliance.

Tax Office response

35. The Australian Taxation Office (ATO) welcomes the recommendations and findings of the report. The report reflects positively on the hard work the ATO has instigated since Report 57 in 2003. In particular it is encouraging that the ANAO found that:

"Overall, the Tax Office has implemented appropriate systems and processes to effectively manage the tax obligations of non-residents. The Tax Office has continued to improve the administration arrangements of the payment of tax by non-residents since Audit Report No.57 2002–03, particularly in respect of improved coordination of non-resident tax compliance activity, and increased and improved application of external data sources."

36. In addition, the ATO's governance frameworks such as reporting, project management and risk management were all found to support good governance and management of non-resident risk. This should provide reassurance to the community that it can have confidence in the ATO's administration of non-residents.

37. The Tax Office accepted both recommendations in full. The Tax Office's full response can be found in Appendix 1.

Recommendations

The ANAO's recommendations, aimed at improving Tax Office administration of non-residents' compliance with their taxation obligations, are presented below.

Recommendation No. 1
Para 4.28 The ANAO recommends that the Tax Office examines ways to improve its use of AUSTRAC data for non-resident compliance.

Tax Office Response: Agreed

Recommendation No. 2
Para 5.24 The ANAO recommends that the Tax Office investigate ways to improve direct communication with non-resident taxpayers to inform them of their rights and responsibilities under the Australian tax system.

Tax Office Response: Agreed

Audit Findings and Conclusions

1. Background

This chapter provides the context for the audit, including an overview of how non-residents can interact with the Australian taxation system, and outlines the audit approach.

1.1 The Australian Taxation Office (Tax Office) is Australia's principal revenue collection agency, collecting around 90 per cent of Commonwealth revenue. In 2008–09, the Tax Office collected \$264.5 billion in tax, superannuation and excise revenue, and had an operating expenditure of \$3 billion. As at 30 June 2009, it employed 22 429 employees.²

1.2 Under Australia's self-assessment system of taxation, the Tax Office seeks to maximise voluntary compliance in a way that maintains community confidence.

Non-residents

Non-resident interaction with Australia

1.3 Australia is part of a dynamic global economy that accommodates the free flow of capital and labour across national borders.

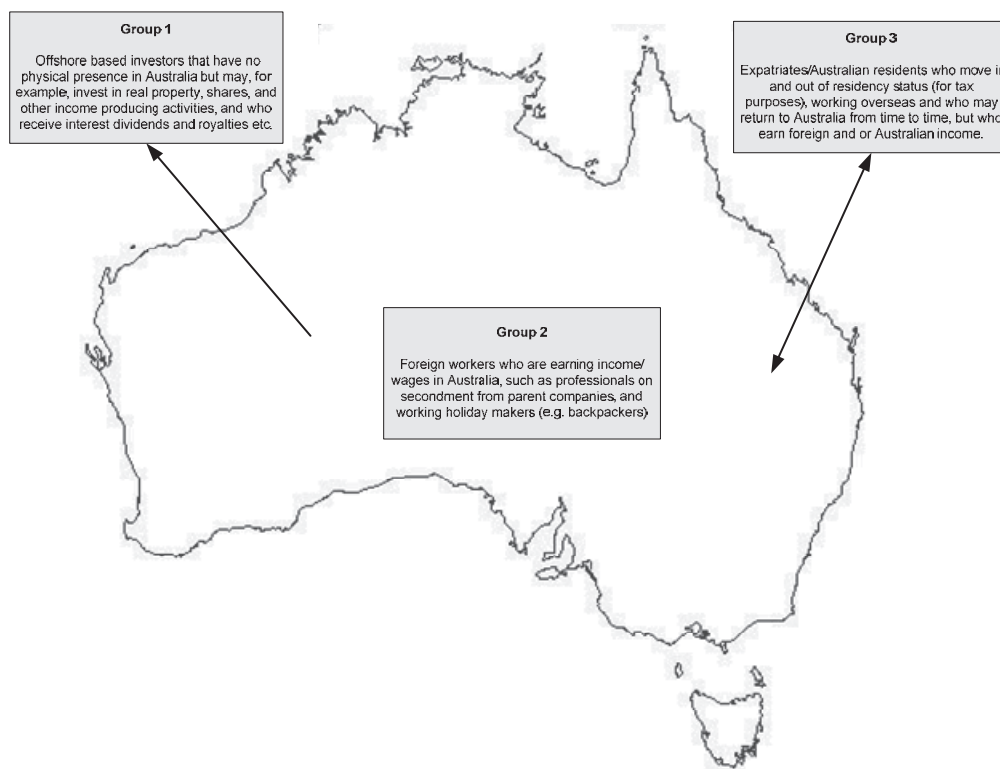
1.4 Broadly, an Australian resident is subject to Australian tax on all assessable income earned from Australian and foreign sources, while a non-resident is usually only subject to Australian tax on assessable income derived from Australian sources. For tax purposes a non-resident can be an individual or an entity.

1.5 There are three broad categories of non-residents that interact with the Australian tax system as depicted in Figure 1.1 below.

² Australian Taxation Office, *Annual Report 2008-09*, Canberra.

Figure 1.1

Non resident groups



Source: ANAO

Core concepts for non-resident taxation

1.6 Residency and source of income are the two core concepts in determining the taxable income of a taxpayer.

1.7 Residency for tax purposes is different from residency for immigration purposes. A foreign citizen could be classified as an Australian resident for tax purposes if they met the criteria outlined below, and conversely, an Australian citizen may not always be an Australian resident for tax purposes.

1.8 The Tax Office uses a number of tests when determining a taxpayer’s residency status for tax purposes. These are:

Residency Test – this is the primary, or ‘ordinary concepts’, test used by the Tax Office to determine residency. If a taxpayer resides in Australia according to the ordinary meaning of the word, the taxpayer is deemed

to be a resident for tax purposes and the statutory tests outlined below do not need to be applied.

Statutory Tests – failing the Residency Test, the Tax Office applies the tests listed below; satisfying any one of these tests will result in the taxpayer being classified as non-resident for tax purposes:

- 183 day test – if a taxpayer is present in Australia for more than half the income year, whether continuously or intermittently, they are deemed to be a resident for tax purposes.
- Domicile test – if a taxpayer’s permanent place of residence is in Australia, they are deemed to be a resident for tax purposes.
- Superannuation test—if a taxpayer is a member of a Commonwealth Government superannuation scheme, they are deemed to be a resident for tax purposes.

1.9 Similarly, the Tax Office applies a number of tests to determine if a company is a resident for tax purposes. Under section 6(1) of the *Income Tax Assessment Act 1936* (ITA Act), a company is deemed to be resident in Australia for tax purposes if it is:

- incorporated in Australia; or
- not incorporated in Australia but carries on business in Australia and:
 - central management and control is based in Australia; or
 - its voting power is controlled by Australian residents.

1.10 If a company does not satisfy at least one of these tests, it is deemed to be non-resident for tax purposes.

1.11 Source of income refers to the place where the income is earned. It is necessary to determine the source of income because non-residents are usually taxed on their Australian-sourced assessable income, but not their foreign-sourced income.

1.12 Section 6.5(3) of the ITA Act provides that non-residents are subject to tax on:

- the ordinary income derived directly or indirectly from all Australian sources during the income year; and
- other income that a provision includes in assessable income for the income year on some basis other than having an Australian source.

Taxes paid by non-residents

1.13 Non-residents may be liable for different taxes and may be subject to compliance measures. The main taxes pertinent to non-residents are briefly outlined below.

Pay-As-You-Go

1.14 Non-residents working in Australia have Pay-As-You-Go (PAYG) income tax withheld by their employer in a similar way to residents. The difference is that the rate of tax is higher for non-residents for annual taxable earnings up to \$35 000 and non-residents are not entitled to the tax free threshold. A non-resident earning \$35 000 in 2009–10 would have paid \$5800 more in PAYG than a resident earning the same income. That difference would be slightly reduced in the final tax assessment for a non-resident because non-residents are not liable for the 1.5 per cent Medicare surcharge.

Non-Resident Withholding Tax

1.15 Non-Resident Withholding Tax (NRWT) is a withholding tax applicable to a non-resident's earnings from Australian sourced interest, dividends and royalties.

1.16 Under NRWT, payments of interest, dividends and royalties made to non-residents are required to have amounts withheld by the resident payer. The general rates are 10 per cent for interest payments, 30 per cent for unfranked dividend payments and 30 per cent for royalty payments. However, the rate of withholding can vary where Australia has a Double Tax Agreement (DTA) in place.

1.17 Failure to withhold the correct amount of NRWT results in a penalty being imposed on the Australian payer (equal to the amount that would otherwise have been withheld).

1.18 In 2007–08, the Tax Office collected \$1.93 billion in NRWT.³

³ The Tax Office cannot accurately determine the amount of NRWT it collects because NRWT payments are included as part of PAYG collections. The amount quoted is in relation to payer reported amounts (reported to have been paid) and are not based on payment receipts.

Capital Gains Tax

1.19 The legislation applying to non-residents regarding Capital Gains Tax (CGT) received Royal Assent on 12 December 2006. Prior to that date, non-residents were liable for CGT on a broader range of assets with the necessary connection to Australia. Most recently, the Government announced proposed changes on 24 April 2010, relating to the foreign investment rules covering residential real estate.

1.20 Generally, non-residents are only liable to pay CGT on proceeds from the direct disposal of Australian real property, or from the indirect disposal of such property through disposal of interests in land rich entities (subject to certain tests). This differs from resident taxpayers who are generally liable to pay CGT on net gains from the occurrence of CGT events in relation to all CGT assets held in Australia or overseas.

1.21 The scope of CGT in respect of non-residents was changed to improve:

- (a) Australia's status as an attractive place for international business and investment; and
- (b) the integrity of Australia's capital gains tax base.⁴

1.22 CGT is not subject to any withholding arrangements for either non-residents or residents. A CGT liability forms part of a taxpayer's income tax liability, which is assessed at the end of the financial year via the established self-assessment regime.

1.23 In 2008–09, the Tax Office collected \$236.99 million in CGT from 13 273 non-resident taxpayers.

Foreign Resident Withholding obligation

1.24 Foreign Resident Withholding (FRW) is a withholding obligation targeted at specific non-resident taxpayers. It is part of the PAYG withholding regime.

1.25 Under changes introduced by Taxation Administration Amendment Regulations 2004 (No. 1), there are now targeted withholding arrangements in relation to income gained by non-residents engaged in particular activities, including:

⁴ *Income Tax Assessment Act 1997*, Division 855-5(1).

- entertainment or sports activities (where the withholding rate is 30 per cent for a foreign resident company, and at the non-resident marginal rate for foreign individuals);
- construction and related activities (where the withholding rate is 5 per cent); and
- casino gaming junket activities⁵ (where the withholding rate is three per cent).

1.26 Under FRW, Australian payers are obliged to withhold prescribed amounts from specific payments made to foreign-residents involved in the above activities. Failure to withhold FRW results in a penalty being imposed on the Australian payer (equal to the amount that would otherwise have been withheld.)

1.27 In 2007–08, the Tax Office collected \$40.75 million in FRW tax.

Administration of non-resident taxation

1.28 Non-resident taxation matters fall across all business lines in the Tax Office’s risk assessment and mitigation planning documentation, known as the Compliance Sub-Plan. While the Large Business and International business line (LBI) has overall Tax Office wide administrative responsibility for non-resident tax, each business line has compliance responsibility for specific non-resident tax matters that fall within their market segment.

1.29 The Tax Office has established a cross-business line committee structure to coordinate the key non-resident and international risk issues. The most relevant committees for non-residents are:

- Non-Resident Withholding Tax Steering Committee;
- Exchange of Information Advisory Committee;
- Tax Havens Steering Committee;
- Transfer Pricing Steering Committee;
- Capital Gains Tax Steering Committee (which includes a focus on non-residents); and
- Sport and Entertainers Steering Committee.

⁵ Casino gaming junket activities are arrangements where individuals or companies receive payments, incentives and non-cash benefits from casinos for bringing ‘high rollers’ to casinos to gamble. Junket operators may also provide other services including translation, transportation and concierge services.

1.30 These committees are attended by senior Tax Officers and report, either directly or indirectly, to the Income Tax Steering Committee (ITSC) chaired by a Deputy Commissioner. The ITSC covers all income tax obligations.

1.31 The Tax Office's International Strategy and Operations (ISO) business area is part of the Large Business and International business line (LBI). ISO is responsible for providing strategic leadership to the Tax Office on international tax risk, including non-resident tax issues that are not covered by the committees listed above, and liaising with the business lines which deal with non-resident matters.

Audit approach

Audit objective and scope

1.32 The audit objective was to assess the Tax Office's effectiveness in administering the tax obligations of non-residents.

1.33 The audit reviewed the tax administration arrangements pertaining to non-residents by considering:

- the Tax Office's organisational and governance arrangements for the management of non-resident tax obligations;
- the effectiveness of the Tax Office's identification of risks and monitoring of compliance in relation to non-residents;
- the data the Tax Office collects on non-residents and its use of this data for risk identification, monitoring and compliance activities;
- the effectiveness of non-resident educational programs; and
- the progress implementing the recommendation from Audit Report No.57 2002–03, *Administration of the Payment of Tax by Non-Residents* (Audit Report No.57 2002–03).

1.34 The audit gave particular emphasis to the CGT administrative arrangements applying to non-residents because of recent legislative changes (2006) and because CGT is one of the small number of taxes paid by non-residents that is not a withholding tax. In this context, the changes to the foreign investment rules as they relate to residential real estate announced by the Government on 24 April 2010, have the potential to impact significantly on the Tax Office's administration of CGT for temporary residents and foreign non-residents.

1.35 International tax arrangements relating to the large business sector, issues relating to offshore tax havens, transfer pricing and other complex international tax issues administered by the Tax Office were outside the scope of this audit.

Audit methodology

1.36 The ANAO conducted fieldwork in a number of Tax Office areas and interviewed Tax Office representatives from a number of areas including, Large Business and International (LBI), Micro Enterprises and Individuals (MEI), Small and Medium Enterprises (SME), The Office of the Chief Knowledge Officer, Revenue Analysis Branch, Governance and Government Relations, Operations, and People and Places. The ANAO also examined relevant Tax Office program and project files, and relevant strategic documents and business plans.

1.37 A range of stakeholders were consulted, including: the Department of the Treasury; the Foreign Investment Review Board (FIRB); the Australian Transaction Reports and Analysis Centre (AUSTRAC), and the Department of Immigration and Citizenship (DIAC); and key industry bodies.

1.38 The audit was conducted in accordance with ANAO auditing standards at a cost to the ANAO of approximately \$465 700.

Audit report structure

1.39 The structure of the report is outlined below and addresses the following matters:

- the progress in implementing the recommendation from Audit Report No.57 2002–03 (Chapter 2);
- governance and administration, including staff skilling and knowledge transfer, relating to non-resident tax matters (Chapter 3);
- risk identification and compliance assessment through the acquisition and utilisation of additional data sources (Chapter 4);
- education activities aimed at increasing voluntary compliance by non-resident taxpayers (Chapter 5); and
- an examination of the administration of CGT as it applies to non-residents (Chapter 6).

2. Progress on the implementation of the previous audit recommendation

This chapter discusses the progress made in implementing the recommendation of ANAO Audit Report No.57 2002-03, Administration of the Payment of Tax by Non-Residents.

2.1 The ANAO first reviewed the Tax Office's administration of non-residents in Audit Report No.57 2002–03. The report concluded that overall the Tax Office's administration of the non-resident function was sound. The effectiveness of the function was considered to have been strengthened by administrative reforms implemented by the Tax Office during the period of that audit, and by a proposed new withholding regulatory framework. The ANAO made one recommendation (see Figure 2.1) regarding the better use of data and improving the quality of Tax Office research into non-resident activity.

2.2 The major finding in Audit Report No.57 2002–03 was that there were databases available in Australia, other than those that the Tax Office was using at that time, which could potentially be used to improve compliance among non-resident taxpayers.

2.3 In evaluating the progress made in implementing the recommendation from Audit Report No.57 2002–03, the ANAO also evaluated the progress made in implementing other suggestions that were made in the original report.

2.4 Audit Report No.57 2002–03 resulted in the Tax Office reviewing its administration of non-residents, including the commissioning of an independent review. Audit Report No.57 2002–03 and the independent review recommended improvements in the following areas:

- the management and administration of non-residents;
- the acquisition of additional, and more effective use of, data sources for risk identification; and
- education and marketing aimed specifically at non-residents.

2.5 This report looks at the current status of each of these issues in further detail in Chapters 3 to 5.

Table 2.1

Audit Report No.57 2002–03, recommendation

| Recommendation | Tax Office Response |
|---|---|
| <p>The ANAO recommends that, in order to assist the ATO's more effective and efficient administration of the payment of tax by non-residents:</p> <p>(a) the ATO's International Steering Committee commission the development of an integrated strategic framework for the ATO's access, collection and use of external data relevant to the administration of the taxation of non-residents; and</p> <p>(b) the ATO continue the improvement of the quality and integrity of all data used in the administration of the non-resident function, especially Schedule 25A, section 128F exemptions and tax debt.</p> | <p>The ATO agrees with this recommendation, but with the qualification that the type of external data referred to in part (a) of the recommendation that will be most relevant for ATO purposes is expected to be that at the micro or individual transaction level. Initiatives to acquire such data have the potential to be very expensive for the external suppliers and the ATO. The ATO has undertaken to do scoping and sampling investigations, consistent with overall compliance strategies, to evaluate the costs and benefits of different data sources. These investigations may also help the ATO to adopt the most streamlined methodologies for obtaining data and integrating its use with other data sources.</p> |

Source: Audit Report No.57 2002–03.

2.6 As noted, the Tax Office agreed with the recommendation but had some qualifications in regard to implementing the recommended changes in relation to the cost for both the external suppliers of the data and the Tax Office. The Tax Office proposed to undertake scoping and sampling investigations to evaluate the costs and benefits of using additional data sources for identity matching for non-resident tax.

External consultancy report

2.7 Following Audit Report No.57 2002–03, the Tax Office commissioned SIRCA (Securities Industry Research Centre of the Asia-Pacific)⁶ to investigate the potential use of additional databases by the Tax Office to increase compliance among non-residents.

⁶ SIRCA is an independent not-for-profit organisation comprising collaboration between 26 universities across Australia and New Zealand. SIRCA's mission is: "To enhance the integrity and efficiency of financial markets, systems and services."

2.8 The aim of SIRCA's review was to

'...identify and assess Non-Resident income generated (with a view to facilitating recovery of outstanding tax revenue by the ATO), either in single or multiple databases currently external to the ATO, or when acquired by the ATO in conjunction with the current ATO in-house databases.'

2.9 The Tax Office accepted six of SIRCA's recommendations. These recommendations broadly related to the acquisition of additional data sources, and more effective data matching using those data sources, to increase non-resident compliance. One of these recommendations related to Non-resident specific education and marketing.

2.10 The Tax Office did not accept four recommendations mainly because of cost constraints related broadly to the development of internal databases.

2.11 The SIRCA report concluded that:

'...by acquiring new identified data sets or data matching ATO databases with identified new databases and using currently procured ATO databases more effectively and efficiently, more non-resident obligations should be able to be determined.'

Progress in implementing the recommendation

2.12 Evaluation of the Tax Office's progress in implementing the ANAO recommendation was assessed in two parts:

- introduction of a strategic framework to better utilise data relating to non-residents; and
- use of additional data sources.

2.13 In addition, other findings which were mentioned in Audit Report No.57 2002–03, are discussed in this chapter.

Introduction of a strategic framework

2.14 The Tax Office has pursued the development of a strategic framework to better utilise data relating to non-residents. It has progressively liaised with the organisations identified by SIRCA to gain access to relevant data that supports compliance activity. The Tax Office arranges periodic data downloads from these organisations and uploads this data to the Tax System, where identity matching is attempted.

2.15 Data is requested within a strategic framework which includes continuous improvement initiatives pursued through the respective Tax Office/State Revenue Office forums. The framework involves:

- a coordinated data request being made to each external organisation on behalf of all Tax Office compliance business lines; and
- identity matching being undertaken for all received data before being made available on the Tax Office data warehouse for use by the respective business lines.

2.16 While the focus of the recommendation in Audit Report No.57 2002–03, and this audit, is on non-resident tax administration, the Tax Office initiatives in developing the integrated framework benefit both resident and non-resident compliance activity.

Use of additional data sources

2.17 The key thrust of the ANAO recommendation in Audit Report No.57 2002–03, and the subsequent SIRCA recommendations, was that the Tax Office could potentially use additional data sources and better use existing data sources to improve non-resident compliance.

2.18 Some of the most promising data sources included data from:

- The Foreign Investment Review Board;
- State and Territory Land Titles and State Revenue Offices;
- Annual Investment Income Reports (AIIR); and
- State and Territory Rental Bond Boards.

2.19 Each of these data sources is discussed in Chapter 4: *Use of data sources for risk analysis and compliance*.

Other findings

2.20 Other findings from Audit Report No.57 2002–03 were revisited during this audit. There were also projects and issues that were in their infancy when Audit Report No.57 2002–03 was tabled. For completeness, the ANAO has reviewed these matters and provides the following comments on those that are most relevant to the current environment.

Double Taxation Agreements

2.21 Double Taxation Agreements (DTAs) have an important role in determining non-resident administration arrangements. DTAs are negotiated bilaterally and define how Australia's and the respective treaty partner's tax systems treat each other's citizens regarding taxation. Some DTAs also include a provision, Article 27, which allows the foreign taxation authority to pursue tax debts on behalf of the Australian Tax Office.

2.22 In 2002-03, Australia was a partner in 39 DTAs; by 2009 this number had increased to 42. The increase in the number of DTAs facilitates tax compliance for non-residents.

Individual auto registration project

2.23 The individual auto registration project was developed to enable the issue of Tax File Numbers (TFN) to permanent immigrants and work visa holders upon application for the visa or residency.

2.24 The system that has been instituted allows individuals to apply for a TFN (through the Tax Office website) when they arrive in Australia and requires the entry of personal details, including visa information. The Tax Office then matches the passport details with DIAC details and, upon a successful match, issues a TFN.

2.25 The system has been fully operational since 2004. In 2008-09, 461 054 TFN applications were lodged in this way by non-residents.

2.26 By encouraging the issue of TFN to non-residents via this system, the Tax Office is better placed to successfully undertake identity matching of non-residents and thereby to reduce the compliance risk.

Foreign Resident Withholding

2.27 Foreign Resident Withholding (FRW) arrangements came into effect on 1 July 2004. FRW introduced withholding obligations in relation to income gained by non-residents from:

- entertainment or sports activities;
- construction and related activities; and
- casino gaming junket activities.

2.28 Under FRW, resident payers are required to withhold prescribed amounts from specific payments made to non-resident payees involved in the above activities.

2.29 This is a specific compliance measure aimed at non-residents engaged in particular activities, and was introduced after Audit Report No. 57 2002–03 was tabled.

2.30 As a tax withholding measure, the ANAO considers that compliance risks have been reduced following the introduction of the FRW arrangements.

Governance and administration

2.31 The Tax Office’s governance and administration of non-resident tax have changed since the original audit report. At that time, non-resident issues fell mainly in the domain of the International Steering Committee (ISC). The ISC, which was chaired by a Deputy Commissioner, had responsibility for setting the strategic direction for international issues within the Tax Office. In 2007, the ISC was disbanded and was replaced by a number of non-resident/international specific committees which are considered in Chapter 3: *Administration and governance arrangements for non-resident compliance*. The current committees are listed at paragraph 3.9.

2.32 These committees are attended by senior Tax Officers and report, either directly or indirectly, to the Income Tax Steering Committee, which covers all income tax ‘products’ and is chaired by a Deputy Commissioner.

2.33 The establishment of this series of focused senior committees has resulted in increased coordination and monitoring of non-resident tax matters.

2.34 As noted in Chapter 4: *Use of data sources for risk analysis and compliance*, the Tax Office has acquired additional data sources and better utilises its existing data sources which has increased the effectiveness of its identity matching activities which include addressing non-resident issues. As a result the ANAO considers that the recommendation of Audit Report No.57 2002–03, has been substantially implemented.

3. Administration and governance arrangements for non-resident compliance

This chapter discusses the Tax Office's administration and governance arrangements, including staffing and knowledge transfer issues, supporting the management of non-resident tax compliance risk.

3.1 The ANAO Better Practice Guide, *Public Sector Governance*, July 2003, defines corporate governance as:

'... 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.'

3.2 Consistent with this definition, the Tax Office describes its governance framework as:

'... the means by which the Tax Office assures itself that it is managing in an efficient, effective and ethical manner, as a whole, in all respects. The framework is designed to ensure that [we] apply and practice the principles of good governance, particularly as they apply to the Public Sector, in [our] administration.'⁷

3.3 Overall coordination and administrative responsibility for non-residents tax matters rests within LBI. Operational issues, including active compliance, are spread across various business lines within the Tax Office.

3.4 The ANAO examined six key areas to assess the effectiveness of the Tax Office's governance arrangements supporting the administration of non-resident tax, namely:

- relevant business units and committees;
- interaction with external stakeholders;
- internal coordination;
- risk management process;
- performance monitoring and reporting; and

⁷ Tax Office Practice Statement PS CM 2003/03, para. 2.

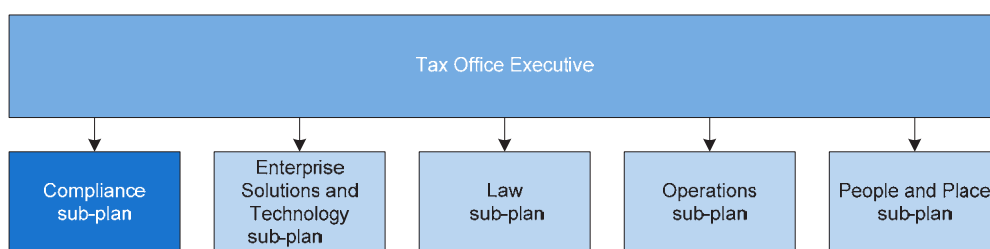
- staffing.

Relevant business units and committees

3.5 A sound organisational planning framework is an essential element for effective governance. The Tax Office is organised around five organisational sub-plans, which represent the highest level of strategic management and together establish overall organisational accountabilities, as represented in Figure 3.1 below.

Figure 3.1

Tax Office sub-plans



Source: Tax Office

3.6 Business lines within each sub-plan deliver the outputs and outcomes for their respective sub-plan. Non-resident tax risk is administered under the Compliance sub-plan, with support from the other sub-plans.

3.7 The Tax Office classifies market segments, represented by the following Compliance business lines:

- Large Business and International (LBI);
- Small and Medium Enterprises (SME); and
- Micro Enterprises and Individuals (MEI).

3.8 Risks associated with particular tax obligations or specific issues that are common to the three compliance business lines are managed by cross-business line committees, or projects where appropriate; for example, NRWT has a steering committee to manage the associated risk while activities supporting compliance by businesses operating as franchises are classified as a project.

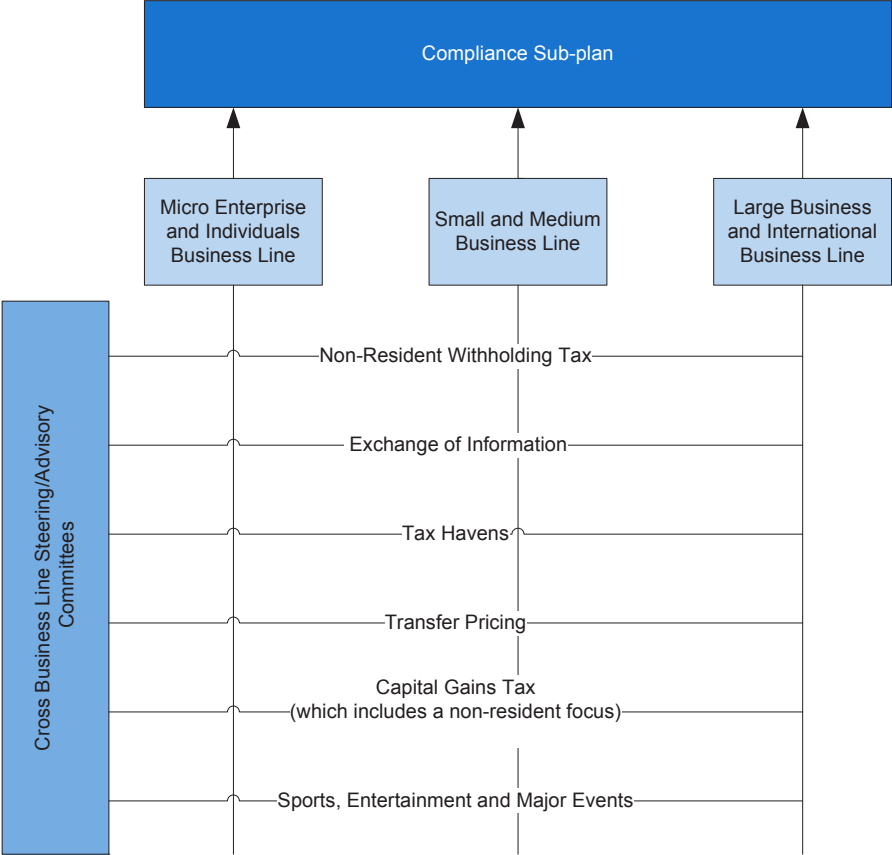
3.9 These committees, which consist of senior representation from relevant business lines, and from other areas of the Tax Office as appropriate, are:

- Capital Gains Tax Steering Committee (includes focus on non-residents);
- Transfer Pricing Steering Committee;
- Sport and Entertainer Steering Committee;
- Exchange of Information Advisory Committee;
- Non-Resident Withholding Tax Steering Committee; and
- Tax Havens Steering Committee.

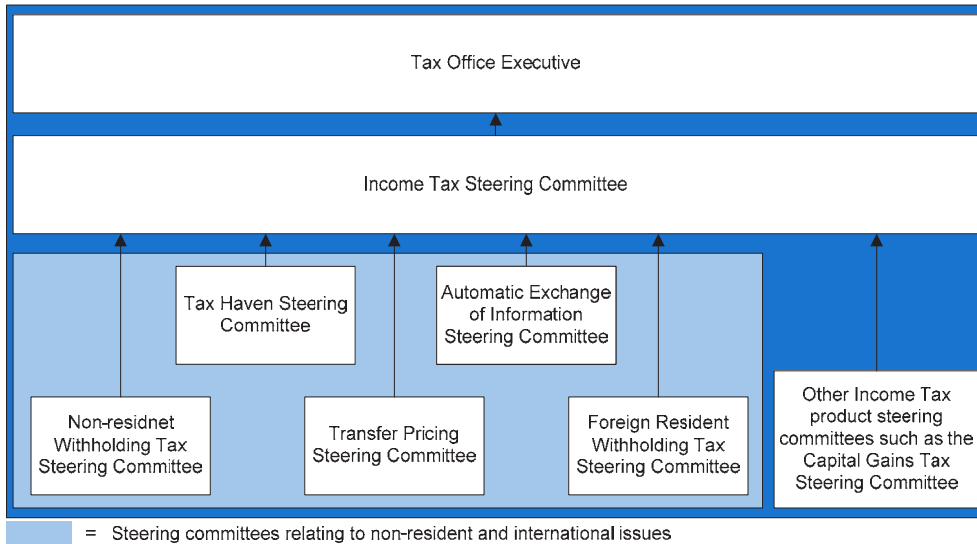
3.10 The Tax Office has a matrix management model to administer business planning, risk identification and mitigation, and active compliance. The above mentioned committees report, either directly or indirectly, to the Income Tax Steering Committee which, in turn, reports to the Compliance Executive Meeting (refer to Figures 3.2 and 3.3).

Figure 3.2

Tax Office matrix management model



Source: ANAO analysis of Tax Office information.

Figure 3.3**Reporting structure for non-resident taxes**

Source: ANAO

Income Tax Steering Committee

3.11 The Income Tax Steering Committee (ITSC) provides high level oversight for all income tax products, including those pertaining specifically to non-residents. The ITSC is attended by senior Tax Office executives responsible for individual tax products and meets around 12 times per year. The ITSC considers high level key risks and coordinates cross-business line responses to identified risks.

Committee structure

3.12 The Tax Office replaced the former International Steering Committee in 2007 with the cross-business line committee structure as depicted in Figure 3.3 in order to provide more effective management of international issues. The committees, which usually meet four times per year, and by teleconference as required, provide leadership for the respective risk area and coordinate cross-business line risk mitigation strategies.

3.13 The committees are governed by the Tax Office Corporate Management Practice Statements. These practice statements outline the structure and practice of the steering committees, and provide guidance on the key responsibilities of committee members. They also prescribe the record-keeping requirements for the committees.

3.14 The ANAO reviewed the agendas and minutes for the Non-Resident Withholding Tax Steering Committee and found that they conformed to the requirements prescribed in the practice statements.

International Strategy and Operations

3.15 The International Strategy and Operations (ISO) business area is part of LBI. ISO is responsible for providing risk management and capability support to other areas of the Tax Office on international issues, including non-resident issues that are outside the responsibilities of the above mentioned committees.

3.16 ISO performs an important role in providing cross-business line coordination of non-resident issues, including responding to emerging risks, monitoring progress on risk mitigation initiatives, and ensuring the effective operation of the monitoring and reporting for the various committees.

3.17 The ANAO considers the ISO is providing effective and useful cross-business line coordination and capability support for non-resident tax issues.

Interaction with external stakeholders

3.18 The Tax Office interacts with a number of Commonwealth and state government agencies for the effective management of non-resident compliance risk. The ANAO reviewed the governance arrangements with the main agencies whose information relates to non-resident issues, namely:

- i. State and Territory Land Titles and Revenue Offices;
- ii. Australian Transaction Reports and Analysis Centre;
- iii. Foreign Investment Review Board;
- iv. Department of Immigration and Citizenship; and
- v. Department of the Treasury.

3.19 Chapter 4: *Use of data sources for risk analysis and compliance* discusses governance arrangements in place with organisations (i) to (iii). Discussion of governance arrangements for organisations (iv) and (v) follow.

Department of Immigration and Citizenship (DIAC)

3.20 The Tax Office and DIAC have convened a high level committee that meets on a regular basis to discuss matters of interest to each organisation. For example, DIAC may be able to assist the Tax Office with information to

identify non-residents that are unknown to the tax system, and the Tax Office may be able to assist DIAC with information on the last known address for visa 'over stayers'.

3.21 Tax Office compliance officers in specific roles have desktop access to a DIAC database to view DIAC's information on particular visa holders. The Tax Office and DIAC have a Memorandum of Understanding (MOU) governing this arrangement.

3.22 The ANAO found that this arrangement was working effectively in relation to non-residents and is a good example of the Tax Office using external data sources to administer non-resident tax risk.

Department of the Treasury

3.23 The Tax Office and Treasury have an agreed protocol to formally support their relationship. The Tax Policy Coordination Committee (TPCC), which is attended by senior leadership from both agencies, meets on a regular basis to consult on proposed new policy and legislation changes, and to discuss problems facing the Tax Office in administering the law.

3.24 The TPCC is supported by the Treasury and Tax Office Liaison Committee which monitors work flows between the agencies.

3.25 Within the Tax Office, responsibility for the internal coordination and dissemination of information regarding matters arising from these two committees rests with the Governance and Government Relations, and New Measures areas.

3.26 The ANAO reviewed the agendas and minutes for the TPCC and found that it was operating in accordance with the agreed protocol.

Internal coordination

3.27 The Tax Office's workforce (22 429 personnel as at 30 June 2009) is organised into business lines and branches spread across some 70 sites in capital cities and regional centres. Individual work units at a particular location can be as small as three or four personnel. An organisation of this size and geographic spread needs effective internal information dissemination policies and practices to ensure all personnel, regardless of location or business unit, receive quality guidance and consistent, relevant and timely information to assist in the performance of duties. In addition, business line management

needs to receive relevant information to monitor progress effectively and coordinate national programs.

3.28 The Tax Office has a project management practice statement that provides the policy for managing, governing and assuring project and program work⁸. Generally, the ANAO found close adherence to this practice statement in the non-resident program and project activities.

3.29 In addition, the Tax Office has heavily invested in and extensively embraced the use of technology to overcome 'the tyranny of distance'. The Tax Office continues to have a large decentralised physical presence but with a 'virtual' organisational structure. As well as providing personnel with the technology for performing their tasks, the Tax Office's deployment of technology has had the positive effect of enabling it to retain and access specialist skills at their 'home' location.

3.30 The ANAO noted two important considerations adopted by the Tax Office for overcoming the challenges of organisational size and geographic dispersion, namely:

- i. a wide geographic dispersion of personnel requires increased management effort to ensure that the work of multiple local teams of personnel is coordinated and consistent with respective national program objectives; and
- ii. office-wide liaison personnel are designated as responsible for coordinating agency-wide communication with particular external stakeholders. This may mean that one person or a team, depending on the resourcing requirement of the issue, is responsible for liaising with an external stakeholder and communicating relevant information throughout the Tax Office.

3.31 Consequently by having personnel who are working in different compliance business units in different geographic locations provide coordinated contributions to form an agency-wide response to issues helps the Tax Office ensure consistency. For example, a coordinated response by the Tax Office was required for its submission to the Treasury regarding challenges in administering Division 855 of the *Income Tax Assessment Act 1997* since its enactment in 2006.

⁸ Project Management Practice Statement Corporate Management (PS CM 2003/05).

3.32 The ANAO reviewed the submission made to the Treasury and found that it presented a Tax Office wide perspective of the issue.

3.33 During fieldwork, the ANAO observed two instances where the Tax Office's due process was not followed. These were in relation to coordination of information from FIRB. As a result of the ANAO having advised of this breakdown in coordination of FIRB information flows to the Tax Office, the Tax Office instituted an internal review of these arrangements.

Risk management process

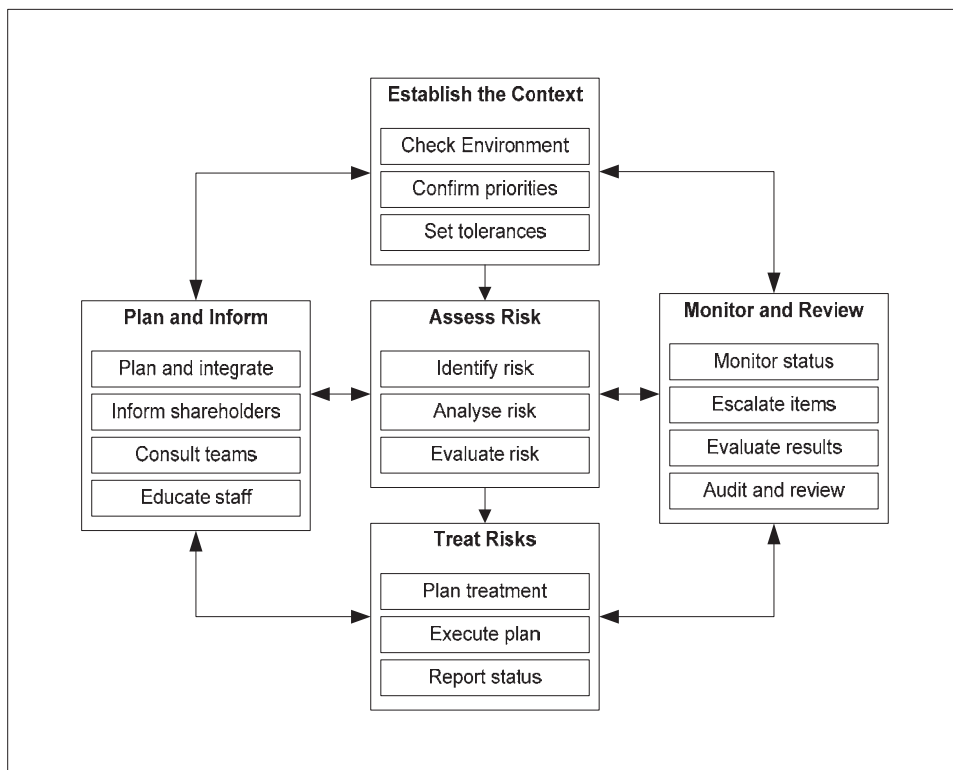
3.34 Decisions pertaining to compliance planning, priority setting and resource allocation are based on an assessment of the following risks:

- program delivery to government;
- minimisation of compliance costs and improvements to client experience;
- reputation as an efficient and adaptive organisation; and
- maintaining community confidence.

3.35 The Tax Office integrates its risk management process into its management framework (see Figure 3.4) and assigns risk levels to revenue obligations, market segments and special focus areas. This process is consistent with the Australian/New Zealand standard 4360:2004 on Risk Management.

Figure 3.4

Tax Office risk management process



Source: Tax Office, Risk and Issues Management PS CM 2003/02.

3.36 In support of the risk management process, the Tax Office undertakes annual Health of the System Assessments (HOTSAs) on key revenue products and taxpayer groups. HOTSAs provide strategic assessments of key revenue products and other risk areas, and offer an annual checkpoint for the risk management cycle.

3.37 The HOTSAs process identifies emerging risks and monitors key strategic risks. The annual HOTSAs are considered by the ITSC: risks are assessed and, depending on severity, may be included on the Tax Office’s Strategic Risk Register. In addition, compliance risk management is complemented by the escalation of any issues for ITSC attention at any time, if required.

3.38 The severity of an identified risk is assessed on two dimensions:

- likelihood of its occurrence; and
- consequence should it occur.

3.39 These two assessments result in the assignment of a series of escalating risk ratings from 'rare' through to 'severe', which attract increasingly intensive management attention and action.

3.40 The Strategic Risk Register is designed to inform the Tax Office's executive and respective risk owners, regarding '...the current status of the risk and risk mitigation plans as well as informing review processes, planning and resourcing in the Tax Office.'⁹

3.41 Strategic risks are reviewed monthly by senior Tax Office personnel. As at October 2009, there were 45 risks registered on the Strategic Risk Register.

3.42 The Tax Office's process for managing risk identification and mitigation, using the identification and escalation of NRWT risk as an example, is reflected in the stages outlined below:

- NRWT was identified as a compliance risk through the annual Health of the System Assessment (HOTSAs) process;
- the risk was analysed and, following consideration by the Income Tax Steering Committee, was accorded strategic risk status (#69 on the Tax Office's Strategic Risk Register), which meant mitigation effort received increased executive oversight, including resource consideration, and monitoring of the status of progress on the Strategic Risk Register was reported monthly; and
- the identification and escalation of the NRWT risk led to related projects such as the Integrity Improvement project (and 12 sub-projects), and development of other focus areas such as the AUSTRAC Royalties project, and a project which increased the focus on franchising.

3.43 The Tax Office also produces a monthly 'Heartbeat' report which is designed as a risk management communication tool within the Tax Office to quickly identify and, where necessary, notify and escalate issues that may require more immediate attention than is applied through the annual HOTSAs process. The 'Heartbeat' report is considered at Compliance Executive Meetings.

⁹ Risk and Issues Corporate Management Practice Statement (PS CM 2003/02).

Performance monitoring and reporting

3.44 Regular monitoring and reporting of performance supports agencies in managing programs, and provides external accountability and transparency. To be effective it requires the timely collection and analysis of relevant performance information.

Internal reporting

3.45 Non-resident issues are reported and monitored internally at several levels. Consistent with the Tax Office's integrated approach to the management of non-resident risk, there is no reporting at a whole-of-non-resident level. Much of the reporting reviewed by the ANAO is part of the Tax Office-wide reporting framework. This includes HOTSAs; at both the tax obligation level, such as the Non-Resident Withholding Tax HOTSAs; and taxpayer market segment, such as the LBI HOTSAs. The ANAO also reviewed monthly Heartbeat reports and monthly project progress reports.

3.46 The ANAO observed that internal reporting generally aligned with the Tax Office-wide reporting structure and effectively supported the ongoing management of non-resident risk.

External reporting

3.47 External reporting is important to ensure public accountability and transparency. The Tax Office does not report specific non-resident performance indicators in its Annual Report. This reflects the integrated compliance approach adopted by the Tax Office when dealing with non-residents. For example, external reporting of Income Tax does not differentiate between residents and non-residents unless there is a specific focus or issue.

3.48 In November 2009, the Tax Office advised the ANAO that it was establishing a new International Steering Committee (ISC); a different entity from the former ISC that existed in 2003 at the time of Audit Report No.57 2002–03. The ANAO notes the significance of this initiative as it is likely, given the mandate of the committee as detailed in its Charter, that it will strengthen agency-wide coordination of non-resident compliance risk. The ANAO suggests that the new ISC also include in its responsibilities the establishment of performance measures for non-resident compliance risk, and their reporting externally.

Staffing

Staffing Issues

3.49 An ageing workforce is a challenge for most government agencies. The Australian Public Service Commission's *State of the Service Report 2009* reports that 26.9 per cent of Australian public servants are over 50 years of age. The Tax Office's workforce demographic suggests that the Tax Office will face the challenge of retaining 'corporate memory' as experienced staff retire from the workforce.

3.50 Non-resident taxpayer interactions with the tax system can be complex and challenging, and Tax Office personnel require formal and on-the-job training to become fully competent. In the context of the growing number of non-residents involved in the Australian tax system, and the complexity of their involvement, the retention of appropriately skilled personnel in this area is a significant risk to the Tax Office. As noted in the International HOTSAs 2009, 'Staff capability represents the most significant risk to our ability to deliver, both in terms of international tax and forensic investigative abilities necessary to deal with key strategic risks.'

3.51 This section considers the Tax Office's policies and practices for engaging and maintaining a technically competent workforce to assist non-resident taxpayers and undertake non-resident compliance activities.

Staff training

3.52 The ANAO reviewed the Tax Office's training modules for all international tax personnel. The training program consists of three modules:

- i. Foundations – half-day and multi-day courses designed for personnel who are new to international tax. These training courses are delivered internally and are undertaken by all personnel involved with international tax issues.
- ii. Intermediate – a mixture of short (2-3 hour) and longer (1-2 days) modules undertaken by 60 per cent of personnel involved with international tax issues.
- iii. Advanced – a number of short courses provided by external providers and undertaken by 10 per cent of personnel involved with international tax issues.

3.53 The Tax Office continually reviews the content of these modules to maintain their relevance to contemporary international tax issues.

Technical knowledge

3.54 The Tax Office has various support mechanisms to assist personnel with technical case-based skilling, namely:

- i. The Client contact, work management, case management system (CWC);
- ii. technical networks;
- iii. risk manager/owner support; and
- iv. training products.

3.55 CWC is the Tax Office's case management system, and was introduced as part of the Tax Office's 'Easier, Cheaper and more Personalised change program'. CWC provides Tax Office personnel with a template to assist with their compliance activity. CWC provides links to related data sources based on actions entered into the system. Links to relevant case law, technical determinations or provide options for further action.

3.56 Technical networks exist to contribute to managing complex parts of the tax system, such as CGT and transfer pricing. These networks are forums that enable senior and more experienced personnel to share their expertise with and assist less experienced personnel with technical and case-based application of the law. Technical networks are a useful means to transfer knowledge from senior personnel to staff with less experience, and are one way the Tax Office is seeking to protect its "corporate memory".

3.57 Technical networks are established in response to situations where the Tax Office has identified a potential risk to the tax system. For example, the International Technical Network was established during 2007–08 with the purpose of building Tax Office capability to identify and address international tax risks. (In November 2009, this network was renamed International Network and assumed a revised focus with broad attendance.)

3.58 The ANAO reviewed the minutes from the CGT technical network and found that meetings were held regularly and were well-attended.

3.59 The Tax Office appoints Risk Managers and, in turn, Risk Owners for particular compliance matters. For example, the CGT Risk Manager is responsible for coordinating all CGT-related risk activities across the Tax Office, and is assisted in this activity by Risk Owners for aspects of CGT. The

CGT Risk Manager chairs the CGT Steering Committee and is responsible for both resident and non-resident CGT matters.

3.60 Together, these mechanisms, risk managers/owners and other support from other sub-plans provide personnel with on-the-job training, support and guidance, and provide the link between formal training, delivered through the three training modules (refer to paragraph 3.52), and the practical application by personnel engaged in active compliance.

Succession planning

3.61 The Tax Office undertakes an annual staff survey of all middle level and senior personnel to seek their career intentions over the next two years. The information gained from this survey is used by the Tax Office to design programs to train personnel with adequate lead-time for subject areas where there may be an indication of significant attrition and/or risk of specialist staff loss.

3.62 The Tax Office also uses CWC to retain corporate knowledge, including by recoding technical decisions, compliance issues, risk methods and identification to mitigate the risk of specialist staff loss.

Personnel rotation policy

3.63 The Tax Office has a policy of rotating personnel though different areas of the Tax Office so that they gain a broad understanding of the tax system. Industry feedback received by the ANAO during fieldwork noted some dissatisfaction with the external impact of this policy, namely:

- taxpayers and practitioners often speak to a different tax officer each time they call on a particular matter and have to explain the details of their inquiry from the start again; and
- Tax Office enquiry personnel lack in-depth technical knowledge of the subject matter, with taxpayers and practitioners being transferred between numerous tax officers before their inquiry is answered.

CWC is designed to capture taxpayer interactions with the Tax Office which should enable Tax Office staff to more effectively manage subsequent contacts with a client. This is done by accessing information previously provided by the client that has been recorded in CWC. The Tax Office expects that over time, CWC will alleviate some of the dissatisfaction expressed to the ANAO by taxpayers and practitioners during fieldwork.

4. Use of data sources for risk analysis and compliance

This chapter discusses the data sources and methods used by the Tax Office to assist with non-resident risk identification and how these assist to monitor compliance.

4.1 An understanding of the nature, size and extent of non-resident tax risks is important in devising measures and directing appropriate resources to effectively mitigate those risks. Data sources play a major role in understanding those risks.

4.2 A strategy to improve non-resident tax compliance and resident compliance is data matching. This involves gaining tax-related information about taxpayers from both internal and external sources and comparing this additional information with the information disclosed by the taxpayer in their tax return, for example the amount of interest paid by financial institutions. The Tax Office has sophisticated identity matching processes to successfully match data from a number of sources.

4.3 The ANAO reviewed the identity matching activities undertaken by the Tax Office to inform their understanding of the compliance risk associated with non-residents, and the appropriateness of the external data sources. In particular, the ANAO examined the main external data sources used for non-resident taxes, namely:

- State and Territory Land Titles and Revenue Offices;
- State and Territory Rental Bond Boards;
- Australian Transaction Reports and Analysis Centre (AUSTRAC);
- Foreign Investment Review Board (FIRB); and
- Department of Immigration and Citizenship (DIAC).

4.4 In large part, the use of these data sources as part of non-resident compliance strategies has resulted from the continuing data matching program arising from the Tax Office's implementation of the recommendation from Audit Report No.57 2002–03 (discussed in Chapter 2: *Progress on the implantation of the previous audit recommendation*).

4.5 The ANAO also reviewed the Tax Office's use of data sources, such as reports required to be submitted to the Tax Office by investment bodies regarding income payments made to non-residents. These reports include the:

- Annual Investment and Income report (AIIR); and
- Non-Resident Interest Dividend and Royalty Annual Report (NRIDRAR).

4.6 Non-residents' taxation debt represents another area of compliance risk. The ANAO reviewed the Tax Office's use of non-resident debt data and its use as a risk mitigation tool.

External data sources

State and Territory Land Titles and Revenue Offices

4.7 All Australian States and Territories have a Land Titles Office and a Revenue Office. Land Titles Offices have an important role as the authoritative source of information on the current ownership of a land title.

4.8 When a land title is transferred, usually when a property is sold (which may be vacant land or include an improvement to the land – such as a building), the Land Title Office records:

- name and address of the seller and buyer; and
- other information required by the respective jurisdiction.

4.9 State and Territory Revenue Offices collect and record information about payments for taxpayers' state liabilities such as stamp duty. This includes the stamp duty paid at the time of purchase, and the price paid (for calculating the stamp duty liability).

4.10 State and Territory Land Titles and Revenue Offices provide useful data to the Tax Office to assist in compliance work relating to real property sales. The Tax Office seeks to cross-match this data with information provided by taxpayers to identify taxpayers whom may have had a CGT liability. State and Territory Land Titles and Revenue Offices are not legally entitled to collect TFNs, and so the Tax Office can only 'soft match'¹⁰ the state data for individuals. However, some states and territories may capture the ABN for business transactions, and these are used to assist in the identity matching process for tax payers registered with an ABN when provided to the Tax Office.

¹⁰ Soft match refers to a match which cannot be made exactly using a unique record identifier (e.g. a TFN) but has one or more non-unique matching values (e.g. name, address, date of birth).

4.11 Residency status (whether or not the buyer or seller is an Australian resident for tax purposes) is not specifically recorded by the relevant state and territory authorities. This reduces the usefulness of the data for undertaking non-resident CGT compliance projects in respect of non-residents.

4.12 Reasons why the Tax Office may be unable to effectively identify non-residents include that the non-resident may:

- not have a TFN and thus may not be 'known' to the Tax Office. When the data is identity matched, the Tax Office may identify a seller's name and address whose details are unknown to the tax system; and
- legitimately use the address of an agent (lawyer, accountant) to sell the property, thereby reducing the effectiveness of identity matching.

4.13 In 2008, the Tax Office and the respective State and Territory Revenue Offices formed the ATO and State Revenue Offices Compliance Committee (ATOSROC) as a sub-committee of the pre-existing ATO/State Revenue Office Forum. One of the roles of the ATOSROC is to coordinate and improve information exchanges to assist the Tax Office and State Revenue Offices in treating real property risks. State and Territory Revenue Office representatives coordinate their respective Land Titles Office representation.

4.14 ATOSROC is in the early stages of considering ways to improve the information collected at the state and territory level. Progressively, ATOSROC's activities should enable the Tax Office to better identify property buyers and sellers, including residents and non-residents.

4.15 Where appropriate, the Tax Office seeks the Privacy Commissioner's approval for its intended use and retention of acquired data, such as the real property data provided by the states and territories. The Privacy Commissioner previously agreed with the Tax Office's proposal to retain State and Territory Land Titles and Revenue Offices data for 4 years. For CGT calculation purposes, the Tax Office now plans to extend the retention period indefinitely as historical information is essential for effectively administering CGT and other legislation.

4.16 The Privacy Commissioner has expressed concern regarding indefinite retention of acquired data. The matter is currently being discussed between the Tax Office and the Privacy Commissioner. While the Privacy Commissioner's position is non-binding, the Tax Office always seeks to adopt an agreed position.

State and Territory Rental Bond Boards

4.17 Most state and territory jurisdictions have a Rental Bond Board whose role is to act as trustee of rental bonds deposited by tenants.

4.18 Rental Bond Board data has the potential to be an important compliance data source for the Tax Office because it allows the Tax Office to identify investment properties. This is important for two reasons:

- it alerts the Tax Office to potential rental income for income tax compliance; and
- it assists in identifying where a property may not be a primary place of residence for CGT compliance.

4.19 A taxpayer's (including non-residents) primary place of residence is exempt from CGT. Rental bond board data helps confirm if the property was rented and is actually an investment property.

4.20 In 2006, the Tax Office commenced a project using Rental Bond Board data from Victoria, New South Wales and Queensland and sought to identity-match it with taxpayer returns to identify potential non-compliance in reporting by taxpayers, including non-resident taxpayers. The Tax Office plans to extend this project nationally.

Australian Transaction Reports and Analysis Centre (AUSTRAC)

4.21 AUSTRAC is Australia's financial intelligence regulator for monitoring anti-money laundering and the financial services industry for flows of funds that enter and leave Australia. AUSTRAC collects and compiles data on all electronic financial transactions using information collected from financial institutions, and on cash transactions over \$10,000 using information collected by the Australian Customs Service (regarding large amounts of currency being carried by international travellers). Most financial institutions require a description of the transaction to be completed to enable the transaction to be processed.

4.22 AUSTRAC data is already used extensively by the Tax Office. In 2008–09, AUSTRAC reported that information supplied to the Tax Office had contributed to 1193 active compliance cases during the year, leading to tax assessments worth \$131.18 million.

4.23 AUSTRAC data has the potential to be more effectively utilised by the Tax Office in increasing non-resident compliance. The Tax Office's compliance

business lines are at varying stages of investigating the use of AUSTRAC data for non-resident compliance.

4.24 During 2009, the Tax Office undertook a project to identity-match AUSTRAC data categorised as royalty payments with its own records to ascertain the level of compliance with Non-Resident Withholding Tax (which includes royalty payments). This project was a relatively simple and effective use of AUSTRAC data and provided the Tax Office with valuable insights into taxpayer behaviour regarding royalty payments to non-residents.

4.25 While the use of AUSTRAC data has significant potential for the Tax Office, its full use is limited due to the difficulty in achieving high levels of confidence for identity matching. A high confidence match requires a unique identifier, such as a TFN. AUSTRAC, however, does not require TFNs to be recorded and the Tax Office is only able to achieve soft matches – that is matching names and/or addresses, which can potentially result in a transaction not being uniquely matched to a single taxpayer.

4.26 A difficulty of using AUSTRAC data is that the descriptive field required by financial institutions is small and may provide insufficient space for longer descriptions. For example a transaction for multiple purposes, such as royalties and personal use, could be described as personal use only which would reduce the usefulness of the information for compliance projects like the AUSTRAC Royalties project mentioned above in paragraph 4.24.

4.27 At present there is no standard description/classification applying to financial transactions emanating from Australia. The value of AUSTRAC data for the Tax Office would be enhanced if the categorisation of financial transactions were to be standardised across financial institutions when describing transaction type. However, notwithstanding these difficulties, the Tax Office could better utilise the existing AUSTRAC data available for non-resident compliance.

Recommendation No.1

4.28 The ANAO recommends that the Tax Office examines ways to improve its use of AUSTRAC data for non-resident compliance.

Tax Office response

4.29 Agreed. The ATO continually seeks to improve its compliance processes to ensure that they remain appropriate, efficient and effective. As part of its ongoing risk management the ATO continually examines ways to

improve its use of AUSTRAC data for non-resident compliance, as per the AUSTRAC royalty payments project identified in the report and expanding to a capital gains scoping project on non-resident real property transactions. Any further expansion is subject to a cost benefit analysis and to the legal framework within which the ATO can operate.

Foreign Investment Review Board

4.30 FIRB was established in 1976 to advise the Treasurer on the Government's foreign investment policy and its administration. The Board examines proposals by foreign interests to undertake direct investment in Australia and recommends to the Government whether those proposals are suitable for approval under the Government's foreign investment policy.

4.31 Prior to March 2009, all foreign residents, with a few exceptions, required FIRB approval to buy Australian real property of any value. If FIRB approval was granted, the non-resident owner was obliged to inform FIRB when the property was subsequently sold. The Tax Office could then use this information, referred by FIRB, to identify a potential non-resident CGT liability.

4.32 Since March 2009, most foreign residents have not been required to gain FIRB approval to buy Australian real property. Since May 2009, foreign residents have only been obliged to notify FIRB when they purchase Australian property but have not been required to first seek FIRB's approval.

4.33 These obligations for non-residents to advise FIRB after the event are unreliable for tax compliance purpose, since the onus is now on the non-resident to inform FIRB. Without the cooperation of the non-resident FIRB is unlikely to know about any property purchases made by non-residents.

4.34 Due to these changes to FIRB policies, the volume and quality of data available to the Tax Office for compliance activities has been reduced.

4.35 On 24 April 2010 the Government announced proposed changes relating to the foreign investment rules covering residential real estate. These changes will expand the existing FIRB notification, screening and approval process. These new changes, in essence, reverse the changes made in May 2009 and, once implemented, will reinstate a useful intelligence source for non-resident CGT compliance activities.

Department of Immigration and Citizenship

4.36 Work visas have the potential to be a useful intelligence tool for the Tax Office. A responsibility of DIAC is the administration of Australia's visa system. Visas are issued for a range of reasons including: work, study, migration and recreational purposes.

4.37 The Tax Office's FRW team obtains on a weekly basis DIAC information on work visa subclasses 421 and 420, issued to sportspeople and entertainers respectively. In this way, the Tax Office is alerted to forthcoming visits to Australia of non-residents in this FRW class to assist in compliance with FRW arrangements.

Submitted data sources

Investment income reports

4.38 The Tax Office uses two reports to collect data on non-resident interest, dividend and royalty income, namely:

- Annual Investment Income Report (AIIR) – 1.9 million transactional reports received in 2008; and
- Non-Resident Interest, Dividends and Royalties Annual Report (NRIDRAR) – reported 65,000 transactional reports relating to non-residents received in 2008.

4.39 The AIIR was a significant feature of the Tax File Number legislation introduced by the government in 1988 and, among other things, was designed to improve the efficiency of the Tax Office's income matching system. The AIIR is prescribed by legislation and is used by the Tax Office to validate certain classes of investment income that are required to be included on income tax returns. The AIIR is now used as one of the major information sources supporting the Tax Office's expanded pre-filing program¹¹.

4.40 Since 1992, investment bodies have been providing the Tax Office with an AIIR containing the details of dividend and interest income paid to all resident and non-resident investors in each financial year.

¹¹ Pre-filing involves the inclusion or correction of certain taxpayer information in a tax return without being divulged by or incorrectly advised by, the taxpayer on the tax return.

4.41 NRIDRAR is used by non-investment bodies to report interest, dividend and royalty payments made to non-residents, and by financial institutions to report royalty payments.

4.42 A current Tax Office project aims to integrate the NRIDRAR and the AIIR with the objective of standardising and streamlining reporting. This would also allow the payer (of any interest, dividend or royalty payments) to lodge reports online more effectively. (Currently, NRIDRAR can only be submitted electronically in spreadsheet form.)

4.43 Constraints resulting from higher priority activities as part of the Tax Office's IT Change Program have delayed the Tax Office's implementation of the AIIR-NRIDRAR integration project. When implemented the improvements will allow collection of more timely and useful data on NRWT, and make reporting requirements easier to comply with through a single, integrated, online form.

Internal data sources

4.44 A tax liability for a non-resident taxpayer, particularly if the taxpayer resides overseas, presents a greater compliance risk than for a resident taxpayer due to the problematic logistics and costs of collecting outstanding tax from overseas.

Debt analysis

4.45 A taxation debt arises when a liability falls due for payment and it remains unpaid beyond the due date. The Tax Office has a number of options available to collect tax-related liabilities from taxpayers located outside Australia, including:

- i. Require a payment under section 255 of the *Income Tax Assessment Act 1936*. This section of the Act requires a person or company in control of money owed to a non-resident to pay the non-resident's tax liability.
- ii. Issue a notice under section 260-5(2) in Schedule 1 of the *Taxation Administration Act 1953*. Such a notice is akin to a 'garnishee' and requires a third party that owes money to a taxpayer to pay that money directly to the Tax Office.

- iii. Rely on provisions of the Foreign Judgment Act 1991. This allows a ruling made in Australian courts to be enforced in certain foreign jurisdictions, namely Papua New Guinea and New Zealand.
- iv. Where insolvency proceedings have been commenced against the taxpayer, the Tax Office can rely on the powers conferred on trustees and liquidators for the recovery of assets located outside Australia in the taxpayer's name.
- v. Rely on an Article in specific Tax Treaties between Australia and other countries for mutual assistance in the collection of tax debts. During 2008–09, the Tax Office invoked the mutual assistance in collection provision with one of Australia's bilateral tax treaty partners for the first time.

4.46 The Tax Office does not periodically collect data or analyse debt relating specifically to non-residents. Non-resident tax debt and the associated breakdown were specifically prepared by the Tax Office for the purpose of this audit (see Table 4.1). Results of the data request show that the level of collectible debt relating to non-residents represents less than 1% of total debt.

4.47 The Tax Office collects and analyses data at a whole-of-taxpayer level. Given that the Tax Office utilises reporting on taxpayer debt as a means to monitor and, where necessary, develop appropriate compliance risk mitigation strategies, there may be benefit in the Tax Office investigating the appropriateness of regularly monitoring and reporting aggregate non-resident debt.

4.48 The reporting of non-resident debt may assist in identifying deficiencies in the Tax Office's education programs for non-residents; for example, if debts are predominantly raised with a particular type of tax, it could suggest that non-residents are unaware of that tax obligation. Analysis of non-resident debt could also highlight particular countries of concern which could also result in the Tax Office seeking to influence Treasury's priorities for undertaking future Treaty negotiations, or could alert the Tax Office in advance of possible suspect transactions emanating from that jurisdiction. In turn, this could involve seeking information from AUSTRAC.

Table 4.1**Total debt owed by non-residents as at September 2009**

| Entity Type | Total (Disputed and Collectible) | | Disputed | | Collectible | |
|----------------------|-------------------------------------|----------|-------------------------------------|----------|-------------------------------------|---------|
| | Number of Taxpayers (based on TFNs) | \$m | Number of Taxpayers (based on TFNs) | \$m | Number of Taxpayers (based on TFNs) | \$m |
| Individuals | 11524 | \$111.18 | 90 | \$65.14 | 11434 | \$45.05 |
| Companies | 451 | \$109.16 | 3 | \$86.24 | 448 | \$22.91 |
| Superannuation funds | 40 | \$4.22 | 1 | \$4.09 | 39 | \$0.14 |
| Partnerships | 19 | \$0.07 | 0 | \$0.00 | 19 | \$0.07 |
| Trusts | 37 | \$1.44 | 1 | \$0.42 | 37 | \$1.02 |
| Totals | 12071 | \$225.08 | 95 | \$155.88 | 11977 | \$69.19 |

Source: Tax Office

4.49 A critical component of risk identification and mitigation is the collection and analysis of appropriate data. The Tax Office recognises that it can improve in this area of non-resident tax administration, as highlighted in the most recent Health of The System Assessment (HOTSAs) for Internationals:

'Data sufficient to permit an accurate estimate of income, expenditure or profit attributable to all international dealings is not collected, nor is it able to be reliably separated out of total dealings for analysis.'

5. Voluntary compliance in a self-assessment system

This chapter discusses the compliance activities undertaken by the Tax Office to address risks to the collection of non-resident taxes, namely education programs.

5.1 The Tax Office aims to maximise voluntary compliance by providing taxpayers with the information they need to comply with the law. The Tax Office also aims to reduce the compliance burden for taxpayers by reducing the time it takes to comply with the law.

5.2 The Tax Office's compliance approach, as illustrated by the compliance triangle in Figure 5.1, consists of four key principles:

- making compliance as easy as possible for those seeking to comply;
- helping those who try to comply but don't always succeed, by reducing 'red tape' and educating taxpayers through targeted education programs;
- providing a deterrence by detecting those who do not want to comply, by using tools such as risk profiling and analytics; and
- using the full force of the law to ensure compliance by those who have decided not to comply.

Figure 5.1**Tax Office compliance pyramid**

Source: ANAO analysis of Tax Office information

5.3 The ANAO reviewed taxpayer education programs as the key component that supports voluntary compliance for the collection of tax on non-residents.

5.4 The education component of compliance activities should provide non-resident taxpayers with the requisite level of access to appropriate information resources to support their understanding of their tax obligations.

Taxpayer education programs

5.5 The Tax Office seeks to provide taxpayers with the information and advice needed to assist them to meet their tax obligations. This strategy is important for non-residents who may have had only limited exposure to the Australian tax system and may be unaware of their legal obligations. This approach complements the role played by professional advisors and tax agents.

5.6 Taxpayer education is an important element of the Tax Office's compliance strategy. Taxpayer education aims to support and encourage the bottom two categories of taxpayers reflected in the compliance pyramid, as shown in Figure 5.1, namely those taxpayers that:

- are willing to do the right thing; and
- try to do the right thing but don't always succeed.

Policy and practices

5.7 The Tax Office has well developed policy and structured practices for developing taxpayer education products. The policy and practices aim to provide Tax Office products with consistency in language, quality and corporate branding.

5.8 The corporate Marketing and Communications (M&C) capability area and the individual compliance business line M&C areas collaborate to ensure all facets of education product development are consistent in message content and quality, and to ensure the best use of available resources; for example, in some circumstances, a single product covering multiple compliance lines may be preferred to multiple similar products issued by each compliance business line.

5.9 All Tax Office education products, including internet products, booklets and direct mail-outs are subject to coordination by the Education and Marketing business line.

5.10 The ANAO reviewed the communication program developed for NRWT and found that it had adhered to Tax Office policies and procedures.

Industry feedback

5.11 During fieldwork, the ANAO met with industry bodies that represent taxpayers and tax professionals, including tax professionals that represent non-resident taxpayers.

5.12 General feedback from these stakeholders was that a significant factor in non-resident taxpayers failing to fully comply with their Australian tax obligations was that they were unaware of their Australian tax obligations.

5.13 One tax practitioner informed the ANAO that their company produces monthly newsletters that are distributed to their clients. These newsletters include articles on Australian tax obligations; for example, that capital gains tax may be incurred on the sale of Australian property. These newsletters can

result in non-resident taxpayers contacting the company and inquiring further about their Australian tax obligation. Without these newsletters, those non-resident taxpayers may have remained unaware of their Australian tax obligations and thereby be inadvertently non-compliant.

Targeted education projects

5.14 Compliance activity undertaken by the Tax Office includes targeted education and communication campaigns, such as direct mail outs. In 2007–08, the Tax Office contacted 2034 Australian taxpayers by phone and/or letter regarding NRWT obligations. The survey found that 60 percent of payers had used an incorrect label field on either their tax return or Business Activity Statement (BAS) and consequently did not actually have a NRWT obligation.

5.15 In 2008–09, the Tax Office follow-up sampling of those payers contacted in 2007–08 indicated that they had complied with their NRWT obligations. However, continued testing of new taxpayers revealed error rates similar to 2007–08. The Tax Office has responded by developing a targeted education campaign for tax agents, as 90 per cent of Australian payers involved in NRWT employ a tax agent.

5.16 The high level of incorrect reporting received by the Tax Office on the NRIDRAR and the results from the NRWT Franchising project currently being undertaken by the Tax Office also suggest that non-residents are not fully informed about their Australian tax obligations (see Chapter 3: *Administration and governance arrangements for non-resident compliance*).

5.17 The NRWT Franchising project commenced in early 2009 and is scheduled to finish in mid 2010. The primary objective of this project is to ‘... find and inform franchisees about their RWT [Royalties Withholding Tax] and IWT [Interest Withholding Tax] obligations.’¹² As a second stage, the project involved undertaking selected compliance activities to test general compliance obligations and evaluate the effectiveness of the education strategy.

5.18 Another targeted education project was the NRWT Top 100 Questionnaire, where the top 100 organisations (based on tax paid) and a specific subsidiary of the selected organisations were provided with a questionnaire regarding their internal NRWT governance. Preliminary results from this project found that most large businesses had some issue with their

¹² Australian Tax Office, *NRWT Franchisees Project Outline*.

NRWT obligations, ranging from minor to significant. Some of the survey responses indicating poor NRWT compliance included:

- overlooking the transaction;
- incorrectly dealing with the tax in their internal accounting system; or
- incorrectly accounting for the amount in previous years and carrying the error forward.

5.19 The Tax Office could undertake further targeted approaches when dealing with non-residents; for example, in relation to casual visitors and temporary workers. The Tax Office could target these potential non-resident taxpayers through closer collaboration with DIAC and with industry bodies that heavily represent or interact with these potential non-resident taxpayers.

5.20 For example, the Tax Office could work with DIAC to produce an information booklet, or something similar, aimed to raise non-resident awareness of the Australian tax system, non-residents' rights and responsibilities, and to inform non-residents where they could gain additional assistance. The booklet could be included when DIAC issues visas to non-residents and could also be made available via the internet.

5.21 During fieldwork, the ANAO accessed DIAC's website to review information accessible by potential non-resident taxpayers to inform them about their rights and responsibilities relating to Australian taxation. The ANAO was able to locate some information on DIAC's website pertaining to non-resident tax obligations but locating the information was not straightforward. For example, the ANAO's review of the Professionals and Skilled Migrants webpage on the DIAC website found no direct link to the Tax Office website, nor any mention of the Tax Office or the Australian tax system.

5.22 Similarly, a targeted strategy could be deployed with key industry groups, such as state/territory real estate institutes which represent real estate agents. During real property transactions, real estate agents could act as an information conduit to non-resident property buyers and sellers. The Franchising Council of Australia could perform a similar role, with franchisees accounting for a significant portion of royalty payments. The effective execution of this strategy could require the production of targeted information materials.

5.23 The Tax Office is working with the Franchise Council of Australia and could similarly investigate the viability of similar action for state/territory real estate institutes.

Recommendation No.2

5.24 The ANAO recommends that the Tax Office investigate ways to improve direct communication with non-resident taxpayers to inform them of their rights and responsibilities under the Australian tax system.

Tax Office response

5.25 Agreed. The report notes that the ATO seeks to provide taxpayers with the information and advice needed to assist them to meet their tax obligations and that taxpayer education is an important element of the ATO's compliance strategy. The report also states that the ATO has well developed policy and structured practices for developing taxpayer education products and that the ATO currently has a number of strategically targeted education and communication projects. The report additionally acknowledges the inherent difficulty and additional expense in identifying and contacting non-residents that may be unknown to the tax system.

As part of its ongoing risk management the ATO will investigate ways to improve direct communication with non-resident taxpayers, subject to a cost-benefit analysis. This could involve targeted education materials (in paper or electronic form) as well as encouraging the insertion of ATO web site links on various non-ATO web sites used by non-residents to make tax information more readily accessible.

The ATO will build on its relationship with the Department of Immigration and Citizenship to leverage off their products and appropriate communication channels, and to incorporate further strategic hyperlinks from their web-site.

The ATO will also continue to explore the value of working further with various industry peak bodies to improve awareness and voluntary compliance by non residents with their taxation obligations.

6. Capital Gains Tax and non-residents

This chapter reviews in greater detail the administration of non-resident Capital Gains Tax.

6.1 Prior to December 2006, non-residents were subject to a similar CGT regime as resident taxpayers. That is, non-residents were liable to pay CGT on most capital gains. The implications of these changes, which occurred subsequent to Audit Report No. 57 2002–03 are examined in detail below.

6.2 The Review of International Taxation Arrangements presented a report to the Treasurer in 2003 recommending changes to Australia's treatment of capital gains made by non-residents. On 12 December 2006, Division 855 of the *Income Tax Assessment Act 1997* received Royal Assent. The changes were made to improve:

- Australia's status as an attractive place for business and investment; and
- the integrity of Australia's capital gains tax base.

6.3 Broadly speaking, Division 855 reduced a non-resident's CGT liability to only include net gains from the direct disposal of Australian real property, or from the indirect disposal of such property through disposal of interests in land rich entities (subject to certain tests).

6.4 The Explanatory Memorandum for the legislation introducing Division 855 required the Tax Office to conduct a review of Division 855 two years after its introduction. The review was completed in May 2009, and the Treasury and the Tax Office are progressing the matters that were identified.

6.5 The Government announced on 24 April 2010, changes to the foreign investment rules as they relate to residential real estate that, as noted in paragraph 4.35, will impact on the application of CGT for temporary residents and foreign non-residents by providing the Tax Office with an expanded intelligence source.¹³

¹³ Assistant Treasurer Senator The Hon Nick Sherry, *Government Tightens Foreign Investment Rules for Residential Housing (Press Release)*, 24 April 2010.

Administrative arrangements affecting CGT

6.6 As noted earlier at paragraph 3.23, the Tax Policy Coordination Committee (TPCC) is a senior Treasury–Tax Office leadership forum that meets on a regular basis to consult on the policy and legislation program.

6.7 The ANAO reviewed the TPCC minutes relating to Division 855. Since May 2009, when the Tax Office provided the two year monitoring brief to the Treasury, Division 855 has been included in the Tax Office’s technical issues agenda item for all TPCC meetings and the technical issues raised are being considered by the Treasury and the Tax Office.

6.8 Of relevance to the Tax Office’s administration of Division 855 is the Tax Office’s interaction with the Foreign Investment Review Board (FIRB). FIRB had been providing the Tax Office with details of non-residents that had sold Australian real property. In March 2009, FIRB’s reporting requirements changed and FIRB ceased providing this category of details to the Tax Office.

6.9 The Tax Office was initially unaware of these changes to FIRB policies, and relevant business lines did not question why that category of FIRB referrals ceased abruptly. Against this background, the better monitoring of issues arising out of the Tax Office’s relationship with FIRB could be improved.

6.10 This will be of increased importance for identifying potential CGT obligations following the recent changes to the foreign investment rules for residential housing announced by the Government on 24 April 2010.

Use of data sources for identifying potential CGT liabilities

6.11 The Tax Office uses identity matching of third party data for its non-resident CGT compliance activities, namely, State and Territory Land Titles and Revenue Offices, AUSTRAC and FIRB data. These data sources, which are used by the Tax Office to varying degrees in areas of tax compliance, are at different stages of development in respect of identity matching.

6.12 State and Territory Land Titles and Revenue Offices data is used extensively in the Tax Office for CGT compliance activities for residents and non-residents.

6.13 While AUSTRAC data is used extensively in the Tax Office, it has not yet been used for Division 855 compliance activities. However, the Tax Office is beginning to investigate the use of AUSTRAC as a Division 855 compliance

source. AUSTRAC data has the potential to alert the Tax Office to financial flows in and out of Australia that are categorised as relating to real property ownership transactions.

6.14 The usefulness of AUSTRAC data for identifying real estate transactions has been recognised by the Tax Office as being limited due to issues inherent to AUSTRAC transactions. The information pertaining to these transactions is not aimed at tax compliance and does not include confident identifiers for matching (e.g. TFN, ABN). The Tax Office recently investigated using AUSTRAC in a similar way to identify royalty payments (see Chapter 4: *Use of data sources for risk analysis and compliance*).

6.15 The Tax Office proposes to continue to investigate the use of AUSTRAC data for Division 855 compliance involving real property transactions.

Approach to non-resident CGT compliance

6.16 In 2008, 13 373 non-residents paid \$236.99 million in CGT.

6.17 The nature of Division 855 made enforcing CGT compliance by non-residents a challenge for the Tax Office. Non-resident investors could purchase and sell Australian real property without entering Australia and with minimal interaction with the Australian tax system. For example, investors did not require a tax file number to buy or sell Australian real property. Without a tax file number the investor would not be recorded in the Tax Office system.

6.18 In the two years since the introduction of Division 855, the Tax Office sought to provide community education at various levels, including for both taxpayers and tax agents.

6.19 The Tax Office's compliance strategy for Division 855 varied between taxpayer market segments and involved different treatments.

6.20 As noted above, the Government announced on 24 April 2010 that the foreign investment rules as they relate to residential real estate would be changed. The changes would include a range of civil penalties, as well as various compliance, monitoring and enforcement measures.¹⁴ The proposed new measures will include a special penalty to recapture any capital gain made through the purchase and sale of property which does not comply with the legal requirements and FIRB processes.

¹⁴ *ibid.*

6.21 The Micro Enterprises and Individuals (MEI) market segment includes individuals and entities with turn-over up to \$2 million. Some 90 per cent (13 223) of the Division 855 transactions were in the MEI segment, which accounted for 88 per cent of all Division 855 revenue. Between December 2006, when Division 855 was introduced, and May 2009 the Tax Office had finalised 160 reviews and audits and, as at May 2009, had 35 reviews or audits in progress for individuals.¹⁵

6.22 The Small and Medium Enterprises business line (SME) is responsible for businesses with turn-over of between \$2 million and \$250 million. In 2008, 31 non-resident SME enterprises reported a capital gain, resulting in CGT of \$24.02 million.

6.23 The main compliance approach followed by both MEI and SME involved identity matching State and Territory Land Titles and Revenue Offices data with taxpayer returns. The major limitation with this approach is that its effectiveness is largely reliant on the non-resident already being known to the tax system, namely having a TFN or ABN.

6.24 The ANAO's analysis of Tax Office data against State and Territory Land Titles and Revenue Offices data revealed that there is a relatively small number of individuals that could not be identified possibly because they were not registered on the Tax Office system. The Tax Office believes that the relatively small number of non-resident real property sales that were unable to be identity matched are likely to have minimal impact on the overall integrity of the non-resident CGT liabilities.

6.25 Under the new arrangements announced by the Government on 24 April 2010, temporary residents seeking to purchase an existing property in Australia will be brought within the FIRB notification, screening and approval process.

6.26 The LBI business line is responsible for CGT compliance of all entities with turnover greater than \$250 million. In 2008, 19 non-resident large businesses paid \$3.89 million in Division 855 tax.

6.27 Compliance activities for large business is complicated by the sophisticated nature of business operations. Large business Division 855 cases are much more likely than those in other market segments to include complex

¹⁵ Tax Office, *An analysis of foreign residents and CGT*, May 2009.

aspects of the legislation, such as indirect holdings and valuing a proportion of assets in real property.

6.28 Division 855 is only applicable on the sale of real property or indirect disposal of such property through disposal of interests in land rich entities (subject to certain tests, including a requirement that a business has 50 per cent or more of its assets in real Australian property in order to trigger application of the law. Entities that have a 10 per cent or greater interest in a company that has the majority of its assets in Australian real property are subject to Division 855). These provisions of the law increase the difficulty of enforcing compliance because they can often require a formal valuation of the underlying real property assets. The Tax Office uses the Australian Valuation Office for these valuations, but this involves some cost and time.

6.29 Sophisticated investors, such as large businesses, could seek to minimise their Division 855 liability by:

- diluting the percentage of real Australian property as a percentage of total assets by restructuring;
- staggering the sale of the taxable entity by selling the first portion (attracting Division 855) so that less than 10 per cent of the entity is held after the initial sale, then selling the remaining portion (not attracting Division 855); and
- diluting the percentage of real Australian property as a percentage of total assets by using different valuation methods at the time of purchase and time of sale.

6.30 The Tax Office has issued two Taxpayer Alerts on these matters, namely TA 2008/19 (Foreign Residents attempting to avoid Australian Capital Gains Tax by certain staggered sell down “arrangements”) and TA 2008/20 (Foreign Residents exploiting asset valuations to avoid CGT), to publicise its concern with such arrangements.

6.31 The Tax Office’s compliance approach towards large business differs from that deployed in other market segments. The Tax Office constantly monitors major media outlets for news of the occurrence of potential Division 855 events flowing from sales by large non-resident business. This approach is complemented by the Tax Office accessing publically available information and analysing relevant FIRB applications.

Taxpayer education

6.32 The Tax Office website offers limited information about Division 855 issues (see paragraph 6.30 regarding recent Tax Alerts). However, the Tax Office produces a number of educational products relating to CGT compliance more generally. As a similar regime applies to both residents and non-residents for capital gains on real property sales, there are a number of relevant educational products available for non-residents.

6.33 During fieldwork, the ANAO received feedback that some tax agents find that their non-resident clients are ignorant of their tax obligations. This is an area where with minimal resources, the Tax Office could potentially make a positive impact by better educating and informing non-resident investors in Australian real property of their tax obligations. For example, Chapter 4: *Use of data sources for risk analysis and compliance* discusses working with DIAC to improve the Tax Office's ability to better inform non-residents of potential Australian tax obligations.

6.34 The Tax Office has previously worked successfully with industry bodies to promote compliance. The vast majority of non-residents purchase their Australian property through real estate agents, and recommendation 2 proposes further work in this area.

6.35 The Government's proposed changes to the foreign investment rules for residential housing include a national data-matching compliance monitoring program and a new 1-800 community hotline. These measures, together with the steps taken by the Tax Office since the introduction of Division 855, are designed to improve the compliance of non-residents in respect of CGT.



Ian McPhee
Auditor-General

Canberra ACT
16 June 2010

Appendices

Appendix 1: The Tax Office Response to the Audit



Australian Government
Australian Taxation Office

SECOND COMMISSIONER OF TAXATION

Mr David Crossley
Executive Director
Performance Audit Services Group
GPO Box 707
CANBERRA ACT 2601


Dear Mr Crossley

Australian National Audit Office (ANAO) Performance Audit:

The Tax Office's Administration of the tax obligations of Non-Residents

Thank you for the opportunity to comment on the ANAO's proposed report on the *Tax Office's Administration of the tax obligations of Non-Residents*.

The Australian Taxation Office (ATO) welcomes the recommendations and findings of the report. The report reflects positively on the hard work the ATO has instigated since Report 57 in 2003. In particular it is encouraging that the ANAO found that:

"Overall, the Tax Office has implemented appropriate systems and processes to effectively manage the tax obligations of non-residents. The Tax Office has continued to improve the administration arrangements of the payment of tax by non-residents since Audit Report No. 57 2002-03, particularly in respect of improved coordination of non-resident tax compliance activity, and increased and improved application of external data sources."

In addition, the ATO's governance frameworks such as reporting, project management and risk management were all found to support good governance and management of non-resident risk. This should provide reassurance to the community that it can have confidence in the ATO's administration of non-residents.

The Tax Office accepts the two recommendations made in the report and provides the following comments.

Recommendation No 1 Para 4.29

The ANAO recommends that the Tax Office examines ways to improve its use of AUSTRAC data for non-resident compliance.

Agreed

Comment: The ATO continually seeks to improve its compliance processes to ensure that they remain appropriate, efficient and effective. As part of its ongoing risk management the ATO continually examines ways to improve its use of AUSTRAC data for non-resident compliance, as per the AUSTRAC royalty payments project identified in the

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report and expanding to a capital gains scoping project on non-resident real property transactions. Any further expansion is subject to a cost benefit analysis and to the legal framework within which the ATO can operate.

Recommendation No 2
Para 5.24

The ANAO recommends that the Tax Office investigate ways to improve direct communication with non-resident taxpayers to inform them of their rights and responsibilities under the Australian tax system.

Agreed

Comment: The report notes that the ATO seeks to provide taxpayers with the information and advice needed to assist them to meet their tax obligations and that taxpayer education is an important element of the ATO's compliance strategy. The report also states that the ATO has well developed policy and structured practices for developing taxpayer education products and that the ATO currently has a number of strategically targeted education and communication projects. The report additionally acknowledges the inherent difficulty and additional expense in identifying and contacting non-residents that may be unknown to the tax system.

As part of its ongoing risk management the ATO will investigate ways to improve direct communication with non-resident taxpayers, subject to a cost-benefit analysis. This could involve targeted education materials (in paper or electronic form) as well as encouraging the insertion of ATO web site links on various non-ATO web sites used by non-residents to make tax information more readily accessible.

The ATO will build on its relationship with the Department of Immigration and Citizenship to leverage off their products and appropriate communication channels, and to incorporate further strategic hyperlinks from their web-site.

The ATO will also continue to explore the value of working further with various industry peak bodies to improve awareness and voluntary compliance by non residents with their taxation obligations.

Finally, the ATO will seek to implement the various improvements that are suggested throughout the ANAO's report.

If there are any questions concerning our response, please contact Ms Cheryl-Lea Field, Deputy Commissioner, Large Business and International on 02 62162376.

Yours sincerely



Bruce Quigley
Second Commissioner of Taxation

/ June 2010

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