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Performance Audit

Administration of the Taxation of Personal Services Income

Australian Taxation Office

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Canberra ACT
15 October 2013

Dear Mr President
Dear Madam Speaker

The Australian National Audit Office has undertaken an independent performance audit in the Australian Taxation Office in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit to the Parliament. The report is titled *Administration of the Taxation of Personal Services Income*.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee'.

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, financial statement audits and assurance reviews 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 and Glossary

ABN	Australian Business Number
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
Commissioner	the Commissioner of Taxation
KPI	key performance indicator
level playing field	the ATO's project addressing contractors who understate or omit income from their tax returns
ME&I	the Micro Enterprises and Individuals Business Line of the ATO, renamed in July 2013 to the Small Business/Individual Taxpayers Business Line
Part IVA	the general anti-avoidance law for income tax, contained in Part IVA of the <i>Income Tax Assessment Act 1936</i>
personal services business	a business (sole trader, company, partnership or trust) that earns income from personal services and meets the results test or at least one of the four personal services business tests, and/or has a determination from the ATO stating it is a personal services business
PSI	personal services income, income that is mainly a reward for an individual's personal efforts or skills
PSI regime	the combination of the personal services income rules and the administration of these by the ATO

PSI rules	alienation of PSI rules, introduced on 1 July 2000 by the <i>New Business Tax System (Alienation of Personal Services Income) Act 2000</i> inserting Part 2–42 into the <i>Income Tax Assessment Act 1997</i> . The PSI rules were introduced to prevent individuals reducing their tax by diverting income generated by their personal services to a company, partnership or trust and to limit work-related deductions available in those cases
PSI tests	a series of self-assessment tests designed to determine the business status of an entity, and therefore whether the PSI rules apply to the entity’s personal services income

Summary and Recommendation

Summary

Introduction

1. The personal services income (PSI) regime is one of many taxation measures administered by the Australian Taxation Office (ATO), Australia's principal revenue collection agency with responsibility for administering Australia's taxation and superannuation systems. In 2011–12, the ATO collected \$301 billion in net revenue from taxpayers, working within a departmental operating budget of \$3.4 billion and with over 24 700 staff.¹

2. PSI is defined by Part 2–42 of the *Income Tax Assessment Act 1997* as income gained mainly as a reward for the personal efforts or skills of an individual. This excludes income: earned as salary by employees; from supplying or selling goods; from income-producing assets; or generated by a business structure. PSI is most typically earned by contractors, consultants and sole practitioners, and in 2010–11, the majority (59 per cent) of these worked in administrative and support services; professional, scientific and technical services; and the construction industries.

3. The alienation of PSI legislation (PSI rules) was introduced on 1 July 2000², after the 1999 Review of Business Taxation (known as the Ralph Report) found that taxpayers 'alienating' PSI by interposing a company, partnership or trust between themselves and the person paying for the services presented a threat to the income tax base.³ These arrangements created opportunities to reduce taxation liabilities by splitting income with other individuals (such as a spouse), claiming work-related tax deductions not otherwise available to an individual, and/or tax deferral. It was estimated at the time that the new regime would raise \$1.4 billion in additional revenue in its first four years of operation⁴, mainly by reversing the trend of wage and salary earners accessing the business tax system to gain tax advantages. The

1 ATO, *Annual Report 2011–12*, Canberra, October 2012, page c. At the time of preparation of this report, 2011–12 was the latest year for which the ATO could provide these figures.

2 On 1 July 2000, the *New Business Tax System (Alienation of Personal Services Income) Act 2000* inserted Part 2–42 into the *Income Tax Assessment Act 1997*.

3 The number of owner-managers of incorporated enterprises increased from 110 700 in 1978 to 465 900 in 1997, although the Ralph Report acknowledged that not all of these entities would necessarily be providing services in an employee-like manner.

4 Explanatory Memorandum, *New Business Tax System (Alienation of Personal Service Income) Bill 2000*, p. 4.

revenue estimate was revised in 2001, calculating that the PSI regime would raise \$2.3 billion over the first six years of operation.⁵

4. The PSI rules are intended to tax income earned from personal services in a broadly similar way to the income of people who are employees, and to not impact on genuine business undertakings. The legislation introduced five tests⁶ to enable entities to self-assess whether the PSI rules apply to them before submitting their tax return. The tests are designed to determine the nature of the income-producing relationship and specifically if an entity is operating as a business (known as a 'personal services business'⁷), and therefore not subject to the PSI rules.⁸ Taxpayers can also apply to the ATO for a determination⁹ of their personal service business status.

5. Prior to the introduction of the PSI rules, the Commissioner of Taxation (the Commissioner) had to rely on the general anti-avoidance law for income tax (Part IVA¹⁰) to counter alienation of PSI. However, some taxpayers consider that the structure of the PSI rules has created complexity and uncertainty, particularly in how Part IVA now interacts with the PSI regime. Taxpayers who are assessed (through self-assessment or determination) as personal services businesses are not subject to the PSI rules and instead, standard taxation provisions apply (including potentially Part IVA). This situation is summarised in Figure S.1.

5 The estimate was revised to account for the introduction of pay as you go withholding tax, the PSI results test and certain exemptions for financial planners.

6 The five tests are sequential, and the assessment is completed if one is met. In broad terms, they involve an assessment of whether: (1) payments are for agreed outcomes rather than hours worked; (2) 80 per cent or more of the PSI comes from more than one client; and if so, (3) the income is from two or more unrelated clients; (4) employees or sub-contractors are engaged, or (5) a business premises is maintained.

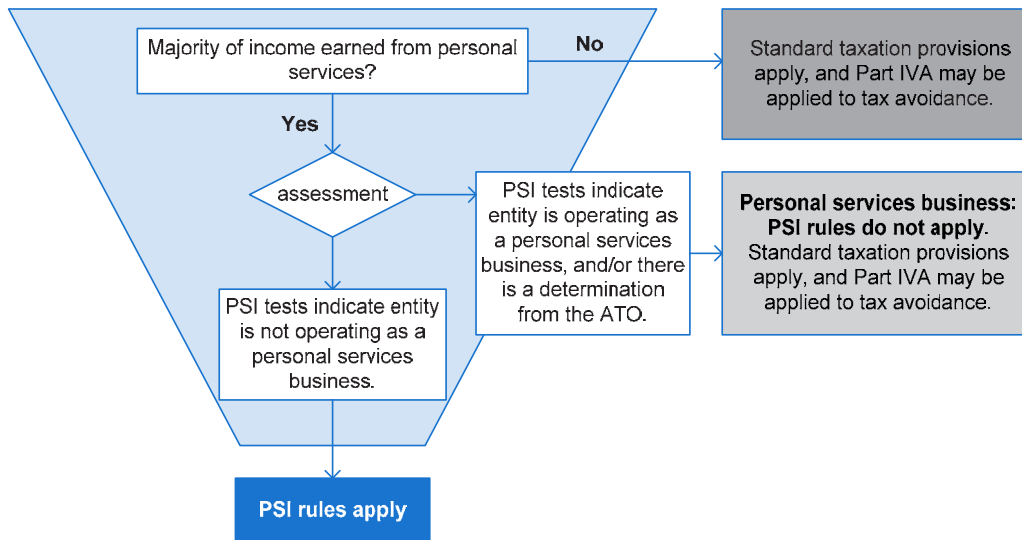
7 A 'personal services business' is a business (sole trader, company, partnership or trust) that earns income from personal services and meets the results test or at least one of the four personal services business tests, and/or has a determination from the ATO stating it is a personal services business.

8 For example, an individual providing information technology services, being paid according to hours worked, and failing the other PSI tests earns PSI and will be subject to the PSI rules. Alternatively, an individual receiving income on the basis of the agreed outcomes from providing these services would be classified as a personal services business, and subject to business taxation arrangements including deductions such as work-related travel.

9 A determination states the Commissioner of Taxation's opinion on the application of a tax law to specific circumstances.

10 Part IVA of the *Income Tax Assessment Act 1936* (Part IVA) has a broad application, and can apply to any circumstance where the Commissioner considers a scheme has been entered into for the sole or dominant purpose of obtaining a tax benefit.

Figure S.1: Interaction between the PSI rules and standard taxation provisions



Source: ANAO interpretation of information provided by the ATO.

6. Two external reviews of the PSI rules have been conducted. In 2009, the Board of Taxation suggested a range of legislative options for improving the integrity and simplicity of the PSI regime, as it noted: poor compliance by taxpayers with the PSI rules; the ATO's difficulty in monitoring compliance due to an absence of data on the taxpayers who should be reporting; and the level of uncertainty for taxpayers in applying the PSI rules to determine their personal services business status. This review was submitted to the *Australia's Future Tax System Review* (the Henry Review), and in 2010, the Henry Review agreed and further considered that the PSI rules were complex and uncertain, and recommended consideration be given to a revised regime. There has been no formal government response to this recommendation.

Administration of the personal services income regime

7. When introduced in July 2000, the administration of the PSI regime was managed by a project team of around 120 staff within the ATO. Over time, staff numbers reduced to around 10 in 2004–05, and the level of staffing has been relatively constant since transition to the Micro Enterprises and Individuals (ME&I) Business Line.¹¹ In 2012–13, there were approximately 6.1 full time

¹¹ In July 2013, this business line was renamed the Small Business/Individual Taxpayers Business Line. For the purpose of this audit it is referred to by its former name.

equivalent staff allocated to PSI activities, and the cost of administering the PSI regime was estimated by the ATO at just over \$784 000. The PSI regime is only a small proportion of the overall activity undertaken by the business line, which had 2273 full time equivalent staff and an operating budget of \$216.7 million as at June 2013.

8. Understanding taxpayer behaviour, and what motivates people to comply with their taxation obligations, is the basis of the ATO's approach to managing compliance. Compliance activities undertaken for the PSI regime follow the ATO's compliance model.¹² Initially the focus was on education and liaison with taxpayers and industry associations, but particularly with tax practitioners, as the ATO estimated that around 90 per cent of taxpayers who earned PSI used a tax practitioner to lodge their returns. Current activities include: educational information aimed at making compliance easier for taxpayers and tax practitioners; interpretive assistance on general or specific topics; targeted letter campaigns aimed at informing taxpayers and tax practitioners of their obligations; and compliance reviews and audits for investigating non-compliance.

Reporting personal services income taxation revenue

9. At the time of preparation of this report, the ATO's PSI data was limited to taxpayers who declare themselves subject to the PSI regime. In 2011–12, ATO data indicated that 462 824 taxpayers declared the receipt of PSI income and, of these, 328 261 were assessed as personal services businesses and therefore exempt from the PSI rules. The remaining 134 563 entities, for whom the PSI rules applied, reported \$3.1 billion in net PSI.

10. Recent changes to PSI reporting will provide the ATO with further data sources for detecting potential non-compliance, and improve the quality of the data reported. Mandatory annual reporting requirements for certain businesses that make taxable payments to contractors in the building and construction industry took effect on 1 July 2012.¹³ Further, from 1 July 2013, the PSI tax lodgement process for businesses was simplified by replacing the PSI

12 The ATO's compliance model is structured around four strategies: make it easy to comply; help to comply; deter non-compliance by detection; and use the full force of the law for significant fraud or tax evasion activity.

13 Known as the 'reporting of taxable payments to contractors in the building and construction industry', this information will provide a data source that can be matched against ATO PSI data holdings.

schedule with a smaller set of specific questions in the annual income tax return.

Audit objective, criteria and scope

11. The objective of the audit was to assess the effectiveness of the Australian Taxation Office's administration of the personal services income regime.

12. The audit examined whether the ATO's:

- governance arrangements for the PSI regime are appropriate and effective;
- systems and processes to identify and assess compliance risks are adequate and effective; and
- strategies to promote compliance and address non-compliance are appropriate and effective, and their impact is being measured.

13. The audit also examined the ATO's Part IVA program where it involved personal services businesses.

Overall conclusion

14. The PSI regime was introduced on 1 July 2000 as part of the *Income Tax Assessment Act 1997* to address the erosion of the tax base arising from taxpayers alienating PSI—that is, gaining taxation advantages such as claiming business deductions and splitting income earned from personal services when they were not genuinely conducting a business. The regime was subject to independent review by the Board of Taxation and the Henry Review in 2009 and 2010 respectively, which noted complexity and uncertainty of the PSI rules for taxpayers, and the potential for considerable non-compliance.

15. The PSI regime is a small proportion of the overall activity of the ATO but is important to the equity and integrity of the tax system. The ATO has effectively administered many of the key elements of the regime, including developing sound governance arrangements and appropriate business planning, risk management and reporting processes. There has also been an evolving program of compliance activities to promote voluntary compliance and to address non-compliance with PSI obligations.

16. The ATO last attempted to quantify the net revenue impact of the PSI rules (revised in 2001 to be \$2.3 billion over six years) and the population of

taxpayers that do not declare PSI in 2004–05, but was unable to do so with any reliability or accuracy; and there have been no subsequent attempts. The ATO has also yet to determine whether its compliance activities are effectively mitigating the ongoing alienation of PSI risk. Nevertheless, the ATO advised that it is endeavouring to better understand and estimate the population of non-compliant taxpayers as part of the PSI compliance effectiveness assessment¹⁴ currently underway and anticipated to be completed in late 2013. A methodology to estimate the magnitude of the potential revenue at risk from this non-compliance would contribute to establishing a baseline for comparison over time in future compliance effectiveness assessments.

17. There are, however, indications that the PSI regime has reversed the trend of wage and salary earners incorrectly accessing the business tax system when receiving PSI. From 2000–01 to 2011–12, the total number of individuals declaring PSI¹⁵ increased from around 184 000 to over 434 500, while the number of entities (such as partnerships, trusts and companies) decreased from around 32 000 to 28 000. Further, annual net PSI declared increased from \$1.0 billion in 2000–01 to \$3.1 billion in 2011–12.

18. The ATO's strategies to encourage voluntary compliance and to address non-compliance with PSI rules include educational material, general and specific advice as well as letter campaigns, reviews and audits.¹⁶ The ATO has calculated that compliance enforcement activities, which are based on an annual review of the alienation of PSI risk, have resulted in \$38 million in additional revenue being collected over the last 10 years.

19. The ATO has found that at risk PSI taxpayers have common links with other non-compliant contractors it manages.¹⁷ As a consequence, compliance activities being undertaken by other areas of the ATO will include PSI

14 The ATO's Compliance Effectiveness Methodology sets out its method for assessing the effectiveness of its compliance activities in treating the specified risk. It is based on two key elements: identifying measurable compliance objectives; and treating the risks to achieving them; and is undertaken across four phases of assessment.

15 That is, individuals declaring PSI on their income tax returns and either being subject to the PSI regime or being classified as personal services businesses and not being subject to the regime.

16 The ANAO's assessment of 221 PSI compliance reviews and audits showed general adherence to key ATO procedures, with 94 per cent of cases meeting planning requirements and 91 per cent meeting decision procedures.

17 Other contractor risks being managed by the ATO include: 'sham contractors', who receive income that should be classified as salary and wages; 'non-lodgers', taxpayers (including contractors) who receive income but fail to register or to submit tax returns; and 'level playing field', the project addressing contractors who understate or omit income from their tax returns.

taxpayers. The ATO acknowledges that currently, these interactions across the ATO are not well communicated or appropriately documented. Capturing this information and analysing the outcomes of these compliance activities would assist with the ongoing assessment and reporting of the range of risks associated with the contractor population.

20. Stakeholders interviewed by the ANAO held mixed views about the complexity of the PSI regime.¹⁸ Some considered the rules complex and difficult to comply with, while others thought the regime was now operating more smoothly. The ATO has acknowledged that further communication is required to raise awareness and to improve taxpayers' and tax practitioners' understanding of their PSI obligations.

21. The ANAO has made one recommendation aimed at strengthening the assessment of the PSI compliance risk and the effectiveness of PSI compliance activities, by estimating the population of non-compliant taxpayers and the magnitude of revenue at risk.

Key findings by chapter

Governance Arrangements (Chapter 2)

22. The governance arrangements within ME&I supporting the PSI regime are appropriate. Business plans include activities relating to PSI as well as relevant performance measures and targets. Given its relative scale, there is minimal external reporting of PSI activities, but internal reports monitor actual achievements against the PSI activities planned.

23. ME&I's risk management processes incorporate an annual review of risks, overseen by the business line's Risk Management Committee. The 'alienation of PSI' risk has been reviewed by the Committee at least annually. The December 2012 quarterly review noted that the PSI risk assessment, risk summary and treatment plan had been finalised and approved by the risk owner. Planned PSI activities draw upon annual PSI risk treatment plans and include compliance case coverage, case volumes, and anticipated revenue figures. However, the business plan performance measure relating to measuring compliance effectiveness, introduced in 2010–11, has not been

18 Stakeholders interviewed included CPA Australia; the Association of Professional Engineers, Scientists and Managers Australia; the Civil Contractors Federation; the Housing Industry Association; Independent Contractors Australia; Master Builders Australia; and Taxpayers Australia.

reported against for PSI. Nevertheless, work is underway to address this gap and is expected to be completed later this year.

Managing Compliance Risks (Chapter 3)

24. PSI is considered by the ATO to be an ‘endemic risk’, as it continues to be identified through compliance and data matching activities. Comprehensive PSI risk assessments were conducted in 2008 and 2011, and show very little change in the risk profile.¹⁹ In particular, the percentage of taxpayers that reported earning most of their taxable income from personal services, as opposed to earning other forms of income as well as PSI, was around 30 per cent (26 400 taxpayers) in 2005–06 and 29 per cent (30 000 taxpayers) in 2009–10. However, there have been no attempts to estimate the size of the non-compliant PSI population since 2004–05.

25. The introduction of the taxable payments reporting system from 1 July 2012 and replacing the PSI schedule of business tax returns with a set of specific questions will provide additional information for use in the ATO’s next comprehensive PSI risk assessment, currently scheduled for 2014. As part of this process, it would be beneficial to include an updated estimate of the number of taxpayers not declaring PSI, in light of findings from a 2012–13 PSI risk assessment exercise. This ‘risk summary’ identified that ATO data matching exercises had found that 81.5 per cent of entities in the selected sample may have incorrectly classified their income by not declaring their personal services business status.²⁰

26. As it is difficult for the ATO to identify non-compliant taxpayers using only the PSI information from tax returns, data matching programs were undertaken using labour hire firm data in 2007, 2009, and 2011. The use of data matching for compliance case selection has contributed to the improved ‘strike rate’²¹ (the percentage of compliance cases that have an outcome) of active compliance cases, from 60.2 per cent in 2010–11 to 78.9 per cent in 2012–13.

27. Annual PSI risk treatment plans cover a range of compliance activities to educate taxpayers about PSI, increase understanding and test for

19 Annual risk summaries are also developed, containing more recent information than the comprehensive risk assessment.

20 The significance of this non-compliance may be low, as prior compliance case results have shown that many taxpayers who satisfy one of the personal services business tests do not complete the appropriate questions on their tax returns due to the complexity and cost of compliance with PSI obligations.

21 The strike rate has a performance benchmark of 55 per cent.

non-compliance. The treatment strategies align with the risk behaviours documented in the PSI risk assessment, but not all strategies can be implemented because of resource constraints. Past compliance results are used in planning future compliance strategies. More recently, data matching activities have been repeated and greater emphasis has been placed on letter campaigns as an efficient method of interacting with a greater number of taxpayers.

28. In developing PSI risk treatment strategies, the ATO acknowledges that it does not currently coordinate the interaction of all contractor risk treatments, such as the inclusion of PSI in other streams' plans and compliance mitigation strategies. An estimate of the non-compliant population would also assist in the development of future PSI risk treatments.

Promoting Voluntary Compliance (Chapter 4)

29. The ATO's strategies for promoting voluntary compliance with the PSI regime are generally appropriate. Marketing and education activities include online information, presentations to external stakeholder groups (including tax practitioners) using media such as webinars and webcasts, and all primary PSI-related information has been recently updated. Although measuring the effectiveness of communication activities is difficult, the reach of communication is being measured by the ATO. The ATO's risk assessments acknowledge that further communication is required to raise awareness of PSI obligations to those new to business, and to improve tax practitioners' understanding of PSI. In this regard, there would be benefit in the ATO developing online decision tools to assist taxpayers to self-assess and apply the PSI tests, and to incorporate PSI information into the existing employee/contractor decision tool.²²

30. Interpretive assistance staff provide general advice to taxpayers and practitioners, as well as managing determinations, rulings and objections. Reports of the activities undertaken have been compromised in the past, following changes to recording and management systems in 2009–10. The ATO advised that poor record-keeping during this period and in 2010–11, resulted in the number and outcome of some activities being unreliable. ATO data shows that the number of determinations has decreased significantly over time

22 This online decision tool, available on the ATO's website, assists employers to determine whether their workers are employees or contractors.

(from over 1800 in 2000–01 to 155 in 2012–13), despite the stated complexity of the legislation and the entry of new taxpayers into the system every year. However, the relatively high proportion of unfavourable outcomes (32 per cent, or 49 of 152 in 2011–12 and 21 per cent, or 33 of 155 in 2012–13) for determinations would suggest a need for greater communication and education. Adverse determinations were also to be considered in compliance case selection but this has not yet occurred.

31. The ATO does not currently analyse the basis for trends in taxpayer PSI queries or requests for determinations, private rulings and objections. This analysis would assist the ATO to better tailor the education material and advice provided to taxpayers and tax practitioners, as well as provide information on the effectiveness of these activities. In addition, the ATO undertakes a wide range of stakeholder consultation and research to assist with its understanding of taxpayers' views and behaviours in relation to taxation topics. It may be of benefit for the ATO to explore this issue further in its research and client surveys, in order to determine whether current PSI-related communication material and advice are the most effective for the PSI audience.

32. Stakeholders have expressed confusion about the interaction between the PSI rules and Part IVA. A Part IVA test case program began in March 2003 and has continued as a limited compliance program since 2009. Both programs were intended to provide clarity around the application of Part IVA to personal services businesses. However, the program still has not resulted in a clear outcome or a case being tested before the courts. As a result, taxpayer uncertainty in organising their personal services businesses to comply with the regime remains and was raised as a concern by some stakeholders. Given the lack of success of the Part IVA program in clarifying the application of Part IVA to personal services businesses over the past 10 years, the ATO may wish to review whether there is merit in continuing the program.

Addressing Non-Compliance (Chapter 5)

33. The ATO has a range of strategies for addressing non-compliance with the PSI regime. Letter campaigns are increasingly being used as a less resource-intensive method for interacting with a larger number of the potential PSI population, with over 10 700 letters being sent between January 2012 and June 2013. These campaigns are also the only recent compliance activities directed at potential non-declarers of PSI. The ATO assessed that the three letter campaigns in 2012 resulted in disclosure by some 10–15 per cent of

targeted taxpayers, with voluntary disclosures providing approximately \$1.1 million in additional revenue as at June 2013.²³

34. Although the number of compliance reviews and audits has declined significantly (from over 800 cases in 2003–04 to 441 cases finalised in 2012–13), additional revenue collected has been relatively steady and the average revenue per case has increased over time. ATO data indicates that the average collected per case in 2005–06 was \$5778 (450 cases raised \$2.6 million) whereas in 2012–13, each case collected an average of \$7482 (441 cases raised \$3.3 million). The ANAO's analysis of a sample²⁴ of review and audit cases showed that key active compliance procedures were generally adhered to, including 94 per cent of cases meeting the planning requirements and 91 per cent of cases meeting decision procedures and requirements.

35. The ATO has an 80 per cent internal performance benchmark for compliance cases being finalised within prescribed time periods. For comprehensive audits it is 360 days and for comprehensive reviews it is 240 days. ATO records show that only 62 per cent of PSI cases met this performance standard in 2010–11; increasing to 75 per cent of cases in 2011–12; and 98 per cent of cases in 2012–13. Cases generally escalate from a review to an audit, however the ANAO found that 23 per cent of comprehensive review cases (completed from 1 July 2009 to 31 March 2013) exceeded the maximum allowable cycle time before escalation to an audit. The ATO may wish to reconsider when cases are escalated to audit and how the timeframes for these reviews/audits are recorded.

36. Work is being undertaken to measure the effectiveness of compliance activities in addressing the alienation of PSI risk, using the ATO's Compliance Effectiveness Methodology. The methodology involves four phases: articulating the risk; defining successful outcomes and developing compliance strategies to achieve those; identifying and testing success indicators; and using those indicators to measure the effectiveness of the compliance strategies. The ATO undertook a PSI compliance effectiveness assessment during 2011–12, and the results of the assessment were put to the Risk Management Committee in October 2012. However, the assessment was

23 As results for campaigns update over time, the June 2013 campaign results were not available at the time of preparing this report.

24 The ANAO assessed a sample of 221 closed cases against ME&I Active Compliance procedures, representing 62 per cent of the 359 completed cases from the period 1 July 2009 to 28 March 2013.

withdrawn as the ME&I Executive asked for further work on the success indicators. At the time of this audit the assessment had not been completed.

37. The ATO has not attempted to quantify the level of non-compliance in the PSI population since 2004–05, or developed a methodology to assess the magnitude of the related revenue at risk. These estimates are an important element in any assessment of the effectiveness of PSI compliance activities and would establish a baseline for comparison with future PSI risk and compliance effectiveness assessments.

Summary of agency response

38. The ATO provided the following summary comment to the audit report:

The ATO welcomes this performance audit and considers the report supportive of our overall approach to administering the personal services income (PSI) regime. The audit recognises that the ATO has effectively administered key elements of the PSI regime including the development of sound governance arrangements, appropriate business planning, risk management and reporting processes.

The ATO agrees with the report's recommendation that the assessment of the alienation of PSI risk and the effectiveness of PSI compliance activities can be further informed by estimating the number of non-compliant PSI taxpayers, and developing a methodology to assess the potential magnitude of the revenue at risk from the estimated non-compliance.

39. The ATO's full response is included at Appendix 1.

Recommendation

Recommendation No. 1

Para 5.37

To better inform its assessment of the alienation of personal services income (PSI) risk and the effectiveness of PSI compliance activities, the ANAO recommends that the Australian Taxation Office:

- (a) estimates the number of non-compliant PSI taxpayers; and
- (b) develops a methodology to assess the potential magnitude of the revenue at risk from this non-compliance.

ATO response: *Agreed.*

Audit Findings

1. Background and Context

This chapter provides the background and context for the audit, including an overview of the establishment of the personal services income measure, and the Australian Taxation Office's administration of the personal services income regime. The audit objective is also outlined.

Introduction

1.1 The Australian Taxation Office (ATO) is Australia's principal revenue collection agency, with responsibility for administering Australia's taxation and superannuation systems. In 2011–12, the ATO collected \$301 billion in net revenue from taxpayers, working within a departmental operating budget of \$3.4 billion and with over 24 700 staff.²⁵ Personal services income (PSI) is one of many taxation measures administered by the ATO. In the same year, 462 824 taxpayers declared the receipt of PSI income and, of these, 328 261 were assessed as personal services businesses and therefore exempt from the PSI rules.²⁶ The remaining 134 563 entities, for whom the PSI rules applied, reported \$3.1 billion in net PSI in 2011–12.

Personal services income

1.2 PSI is defined by Part 2–42 of the *Income Tax Assessment Act 1997* as income that is gained mainly as a reward for the personal efforts or skills of an individual. PSI is generally paid to the individual who provides the services, or to a company, partnership or trust through which the services are provided by the individual. This definition excludes income that is:

- earned as an employee in the form of salary or wages;
- earned from supplying or selling goods (for example, from retailing, wholesaling or manufacturing);
- generated by an income-producing asset (such as a bulldozer);
- gained by granting a right to use property (for example, the copyright to a computer program); or

25 ATO, *Annual Report 2011–12*, Canberra, October 2012, page c. At the time of preparing this report, 2011–12 was the latest year for which the ATO could provide these figures.

26 The PSI rules do not apply to personal services businesses (explained in paragraph 1.14).

- generated by a business structure (for example, an accountant working for a large accounting firm).

1.3 The ATO provides examples of taxpayers who earn this kind of ‘employee-like’ income as being: medical or legal practitioners in a sole practice; professional sports people or entertainers; consulting engineers, computer consultants or other expert consultants; or someone working under a contract wholly or principally for labour or services. PSI is most typically earned by contractors, consultants and sole practitioners, and in 2010–11, the majority (59 per cent) of these worked in administrative and support services; professional, scientific and technical services; and the construction industries.

1.4 PSI is taxed at the individual’s marginal personal tax rate.²⁷ Even if a company, partnership or trust obtains the income rather than the person directly, it is still included in the assessable income of the individual taxpayer²⁸, unless the entity is assessed as a personal services business (discussed in paragraph 1.14).

Alienation of personal services income

1.5 Personal services income can be ‘alienated’ when an entity (a company, trust or partnership) is interposed between the individual providing the services and the person paying for the services, so that the entity derives the income rather than the individual. By this arrangement, taxation liabilities may be reduced or deferred through:

- income splitting, where income is diverted to other individuals (such as a spouse) on lower individual tax rates;
- claiming work-related deductions that would not otherwise be available to the individual, such as the cost of travelling between home and work; or
- the retention of income in the entity, allowing a lower rate of tax to be paid on that income.

27 Individual income tax rates are imposed on a progressive scale, dependant on the taxable income earned. For example, in 2012–13 an individual earning between \$37 001 and \$80 000 a year would pay \$3572 in tax plus 32.5 cents for each \$1 over \$37 000, excluding levies, offsets and other tax considerations. Company income is taxed at a flat rate of 30 per cent.

28 ATO website, *Definitions*, available from <<http://www.ato.gov.au/General/Gen/Definitions/#P802-67701>> [accessed 2 August 2013].

1.6 In addition, alienation can result in individuals reducing their taxable income to a level where they and their families become eligible for a range of income-tested government payments, or become exempt from obligations such as the Medicare levy surcharge.

Establishing the personal services income regime

1.7 In July 2000, new rules around the income tax treatment of certain PSI were introduced as part of 'A New Business Tax System'.²⁹ The then Treasurer stated that the bill, known as the 'PSI rules', was introduced:

...to prevent individuals reducing their tax by diverting income generated by their personal services to a company, partnership or trust and to limit work related deductions available in those cases.³⁰

1.8 Prior to the introduction of the PSI regime, the Commissioner of Taxation (the Commissioner) had to rely on the general anti-avoidance law for income tax, contained in Part IVA of the *Income Tax Assessment Act 1936* (Part IVA). Part IVA could only be applied on a case-by-case basis and required the ATO to demonstrate that the dominant purpose of entering into the arrangement was to gain a tax benefit. This requirement was resource intensive and only partly successful in developing clear principles that could subsequently be applied in similar cases.³¹

1.9 The new rules for PSI came out of the recommendations of the July 1999 Review of Business Taxation (known as the Ralph Report). This review found that the alienation of PSI not only posed a threat to the income tax base, but was inequitable because some taxpayers paid a lower rate of tax compared to others in the same situation, and claimed deductions that were unavailable to personal taxpayers. The use of interposed entities to alienate

29 On 1 July 2000, the *New Business Tax System (Alienation of Personal Services Income) Act 2000* inserted Part 2–42 into the *Income Tax Assessment Act 1997*.

30 The Hon. P Costello MP, Treasurer, Media Release No. 23, *Alienation of Personal Services Income*, 13 April 2000.

31 S Pennicott, *Resolving the Personal Services Income Dilemma in Australia: an Evaluation of Alternative Anti-Avoidance Measures*, *Journal of Australian Taxation* 10(1), 2007, pp. 53-103, available from <<http://www.buseco.monash.edu.au/blt/jat/vol10-issue1-07-pennicott.pdf>> [accessed 3 April 2013].

payments in respect of personal services was increasing, along with the engagement of contractors rather than employees in some industries.³²

1.10 The Ralph Report concluded that people who provide personal services should be taxed in a broadly similar way to people who are employees of the entity that requires the services. Three recommendations were made for an approach designed to attribute such income to the individual service provider³³, and to not impact on genuine business undertakings.³⁴ These recommendations formed the basis for the legislative changes that took effect from 1 July 2000³⁵ and remain in force today, with amendments.³⁶

PSI self assessment

1.11 The PSI legislation introduced five self-assessment tests designed to determine the nature of the income-producing relationship and specifically if an entity is operating as a business (known as a ‘personal services business’) and therefore not subject to the PSI rules. The self-assessment process is illustrated in Figure 1.1, and is divided into two stages, first determining if the income meets the definition of PSI, and then using the tests to determine if the PSI rules apply to that income.

32 The number of owner-managers of incorporated enterprises increased from 110 700 in 1978 to 465 900 in 1997, although the Ralph Report acknowledged that not all of these entities would necessarily be providing services in an employee-like manner. *Review of Business Taxation, a Tax System Redesigned*, Chapter 7—Specific Equity Concerns, July 1999, pp. 286–293, available from <<http://www.rbt.treasury.gov.au/publications/paper4/download/Section7.pdf>> [accessed 3 April 2013]. The Australian Bureau of Statistics *Labour Mobility* figures (publication number 6209.0) as at February 2012 reports the number of these entities as 790 000. This represents a much lower annual rate of growth of these entities since 1997 (around 3.4 per cent), than the period examined in the Ralph Report (around 7.4 per cent from 1978 to 1997).

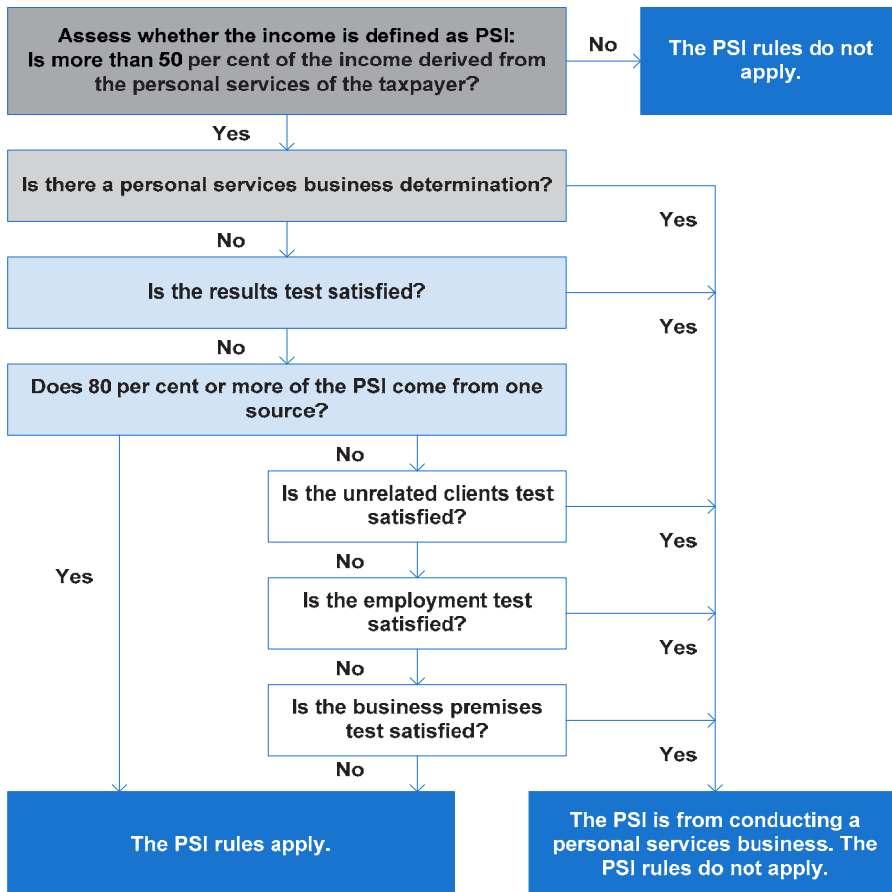
33 *Review of Business Taxation, a Tax System Redesigned*, recommendations 7.2, 7.3 and 7.4.

34 Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000, p. 7.

35 With the exception of transitional arrangements for certain taxpayers in the prescribed payments system (a system for deducting tax from payments for certain work or services that was replaced by the pay as you go withholding tax) for whom the PSI rules came into effect on 1 July 2001.

36 Amendments include the ‘results test’ (explained in paragraph 1.13) and allowing agents whose income is primarily derived from commission-based payments (for example, financial planners) to treat that income as if it was received directly from customers. These were incorporated into the PSI rules in the *Taxation Laws Amendment Act (No.6) 2001*—Schedule 6.

Figure 1.1: Taxpayer self-assessment steps for the application of PSI rules



Source: Adapted from the *Income Tax Assessment Act 1997*, part 2–42, s 87–5.

1.12 In the first stage, taxpayers need to calculate (for each contract for delivering services) the percentage of their income that is derived from:

- labour—that is the skills, knowledge, expertise or efforts of the person who performed the services; and
- material supplied and/or tools and equipment used to complete the job.

Where the majority of the income (more than 50 per cent) for the contract is from labour, the income from that contract is defined as PSI.

1.13 For income defined as PSI (the second stage), an individual or a personal services entity can apply for a determination from the ATO on their personal services business status.³⁷ If no determination is in force, the taxpayer must self-assess whether or not the PSI rules apply to that income using the tests. Briefly, these tests are the:

- results test—for at least 75 per cent of the PSI, the income was received in respect of the work completed, that is, for producing the contracted result; and
- four personal services business tests, the:
 - 80 per cent rule—to determine if 80 per cent or more of the PSI comes from one client; and if not, any one of the
 - three remaining personal services business tests (the unrelated clients test, the employment test and the business premises test).³⁸

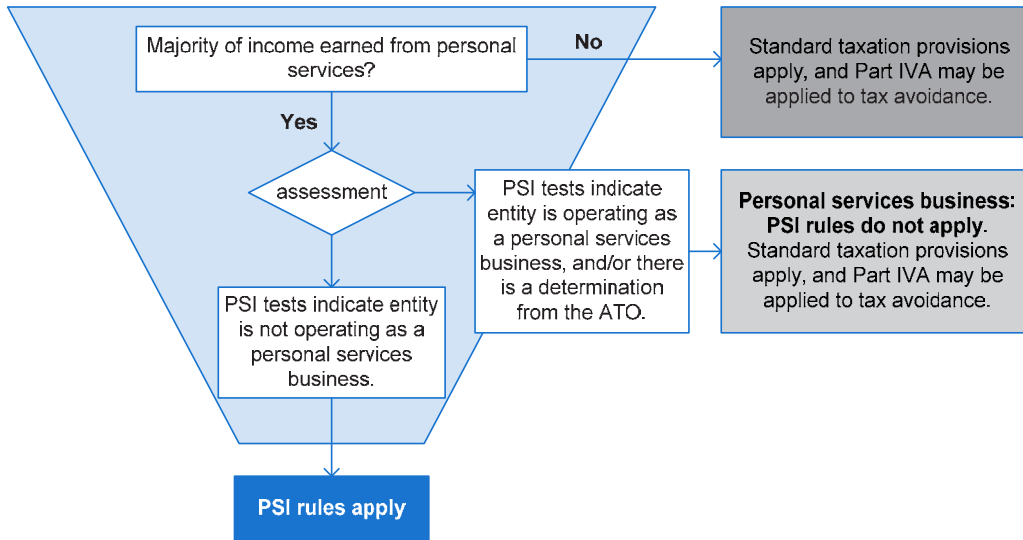
1.14 If, through the application of these tests, the income is classified as income from conducting a personal services business, the PSI rules do not apply.³⁹ Some taxpayers consider that the structure of the PSI legislation has created complexity and uncertainty, particularly in how Part IVA interacts with the PSI regime. Taxpayers who are assessed (through self-assessment and/or determination) as personal services businesses are not subject to the PSI rules and instead, standard taxation provisions apply (including potentially Part IVA). Part IVA has a broad application, and can apply to any circumstance where the Commissioner considers a scheme has been entered into for the dominant purpose of securing a tax benefit. This situation is summarised in Figure 1.2.

37 A determination states the Commissioner's opinion on the application of a tax law to specific circumstances. The 'in force' status of a personal services determination can change, dependent on the entity's circumstances in a given year.

38 These three tests relate to the income coming from two or more unrelated clients, employees or sub-contractors being engaged, or a business premises being maintained. More detail on all five tests is included in Appendix 2.

39 For example, an individual providing information technology services, being paid according to hours worked, and failing the other PSI tests earns PSI and will be subject to the PSI rules. Alternatively, an individual receiving income on the basis of the agreed outcomes from providing these services would be classified as a personal services business, and subject to business taxation arrangements including deductions such as work-related travel.

Figure 1.2: Interaction between the PSI rules and standard taxation provisions



Source: ANAO interpretation of information provided by the ATO.

1.15 Having assessed their income and confirmed that they received PSI, taxpayers declare their PSI at the relevant question in their tax returns, according to whether they are lodging a sole trader/individual tax return or a company, partnership or trust tax return. They further declare whether they are conducting a legitimate personal services business and so consider the PSI rules do not apply.

1.16 While the PSI tests are detailed, very few taxpayers need to work through all of the tests as ATO data shows that, in 2010–11, the majority of taxpayers who self-assessed as personal services businesses used the results test (89.1 per cent of the 302 000 entities) and need not consider the remaining tests. The second most frequently used test was the unrelated clients test (8.8 per cent), with the employment test (0.5 per cent) and the business premises test (0.9 per cent) being least used. Only 0.7 per cent of PSI declarants had a personal services business determination in 2010–11.

Reporting PSI taxation revenue

1.17 The Explanatory Memorandum to the Alienation of PSI Bill estimated that the new regime would raise \$1.4 billion in additional revenue in its first four years of operation. These estimates were revised in 2001, calculating that the PSI regime would raise \$2.3 billion over the first six years of operation, to

account for the introduction of pay as you go withholding tax, the PSI results test and certain exemptions for financial planners.

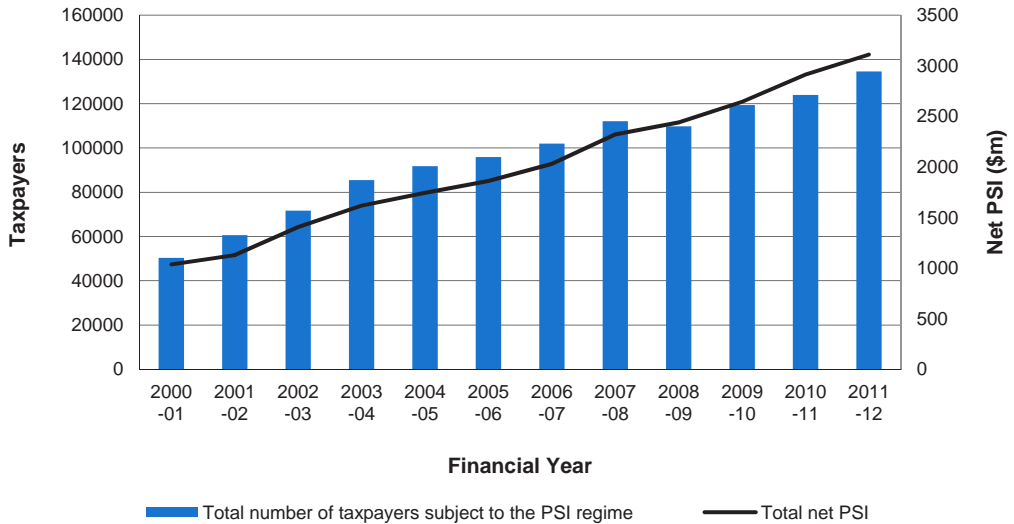
1.18 The ATO has not estimated the revenue collections attributable to the PSI regime, but the ATO does report some PSI data in its annual Taxation Statistics. From 2000–01 to 2009–10, Taxation Statistics reported the number of taxpayers who disclose in their tax returns that they are subject to the PSI regime (that is, they are not a personal services business), and the amount of net⁴⁰ PSI they declare. For 2010–11, this reporting format changed, and only included net PSI for individuals, with 121 727 individuals reporting \$2527 million in net PSI. PSI withheld by taxpayers for withholding tax⁴¹ purposes was also reported, with 51 674 individuals reporting \$305 million as PSI withholding.

1.19 At the time of preparation of this report, the ATO was able to provide information from the commencement of the PSI regime to 2011–12. For this period, the total number of taxpayers declaring they were subject to the PSI regime (that is, not personal services businesses), and the amount of net PSI declared, is provided in Figure 1.3.

40 The ATO defines net PSI as the PSI amount remaining after subtracting from the gross amount: non-assessable components such as goods and services tax; salary and wages promptly paid to the individual; allowable deductions; and entity maintenance deductions.

41 Withholding tax is an amount withheld by a payer that is paid to the ATO in the name of the payee.

Figure 1.3: Number of taxpayers declaring they were subject to the PSI regime and net PSI declared, 2000–01 to 2011–12

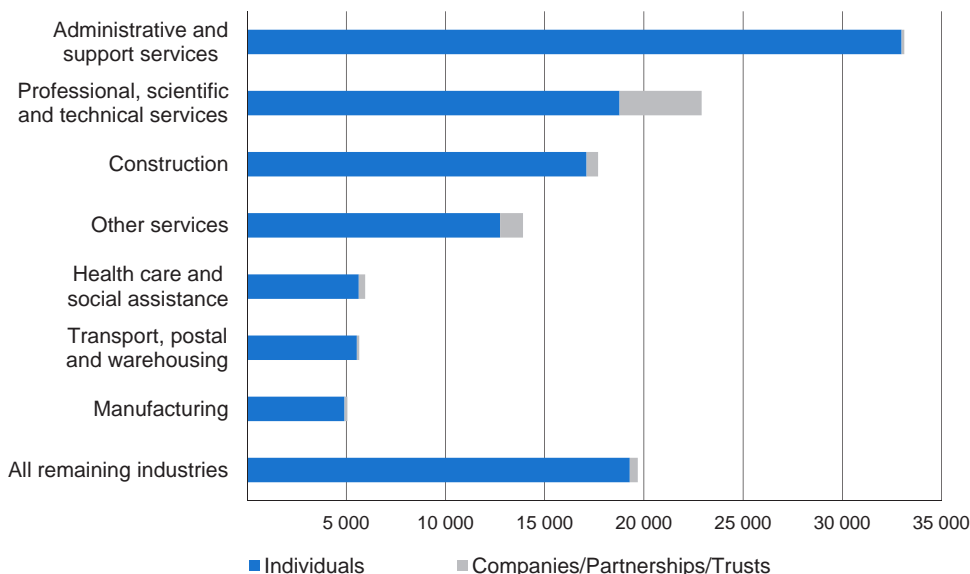


Source: Information provided by the ATO.

1.20 The ATO has estimated that around 90 per cent of taxpayers who declare PSI use a tax practitioner to lodge their return. The ATO also determined the industries that these entities primarily operate within. Figure 1.4 provides the number of taxpayers subject to the PSI regime (that is, they are not personal services businesses), their industry and the number of individuals as distinct from companies, partnerships or trusts for 2010–11.⁴² There are a number of professional associations, industry bodies, contractor associations and employee unions that represent these workers.

⁴² The industries are Australian and New Zealand Industrial Classification descriptions, jointly developed by the Australian Bureau of Statistics and Statistics New Zealand.

Figure 1.4: Number of taxpayers subject to the PSI regime by industry and type, 2010–11



Source: Information provided by the ATO.

Note: The category 'All remaining industries' was used by the ANAO to combine industries with less than 5000 participants each.

External reviews of the PSI regime

1.21 In 2009, at the request of the then Assistant Treasurer, the Board of Taxation⁴³ conducted a post-implementation review of the alienation of PSI rules. The report, delivered on 16 December 2009 raised issues including:

- poor compliance by taxpayers with the rules;
- confusion over the interaction of the PSI regime with Part IVA and the need for the Commissioner to have to continue to rely on the application of Part IVA because of the large number of taxpayers who self-assess as personal services businesses; and
- the difficulty in applying the rules that determine whether or not the taxpayer is a personal services business, resulting in a degree of uncertainty.⁴⁴

⁴³ The Board of Taxation is a non-statutory advisory body that provides the Government with a perspective on improving the design of taxation laws and their operation. The Board also provides advisory services to the Treasurer on improvements to the general functionality of the taxation system.

1.22 The report also noted that the rules had gone some way to achieving the improved integrity and equity of the tax system, but the extent of improvement was inadequate. The ATO's monitoring of compliance was made difficult by the absence of data on the taxpayers who should be reporting, and its compliance focus on high-risk taxpayers may have contributed to complacency amongst lower risk taxpayers and tax advisors. The Board of Taxation suggested a range of possible legislative options for improving the integrity and simplicity of the PSI regime, such as introducing a reporting obligation to provide some third party information to the ATO, extending certain rules to cover personal services businesses and clarifying and simplifying the rules around who is affected.

1.23 The terms of reference for the Board of Taxation review included producing a report that could be considered by the *Australia's Future Tax System Review* (the Henry Review).⁴⁵ In 2010, the Henry Review agreed with the Board of Taxation review, that the current PSI rules limit, but do not eliminate, the scope for the alienation of an individual's earned income to other people or legal entities. Further, the Henry Review considered that the rules were complex and uncertain, and recommended that:

Consideration should be given to a revised regime to prevent the alienation of personal services income that would extend to all entities earning a significant proportion of their business income from the personal services of their owner-managers, whether in employee-like or non-employee-like cases. This regime may also apply an arm's length rule to deductions arising from payments to associates to ensure deductions reflect the value of services provided.⁴⁶

1.24 There has been no formal government response to the recommendations from the Board of Taxation or the Henry Review recommendations.

44 Board of Taxation, *Post Implementation Review into the Alienation of Personal Services Income Rules*, Australia, 2009.

45 The Government established the Henry Review in May 2008 to examine Australia's tax and transfer system, including state taxes, and make recommendations to position Australia to deal with the demographic, social, economic and environmental challenges of the 21st century.

46 Recommendation 10, *Australia's Future Tax System*, Chapter A: Personal Taxation (A1. Personal Income Tax, A1-2 Income Tax from Work and Deductions), Australia, 2010, available from http://www.taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/Publications/Papers/Final_Report_Part_2/chapter_a1-2.htm [accessed 22 March 2012].

Administration of the PSI regime

1.25 When the legislation was introduced in July 2000, the administration of the PSI regime was managed by a project team of around 120 staff within the ATO. Over time, staff numbers reduced to around 10 in 2004–05 and 2005–06 and, with transition to business-as-usual on 1 July 2006, the level of staffing has been relatively constant since. The project undertook much of the early education and liaison with taxpayers and associations, but also set the compliance focus for the transition to the Micro Enterprises and Individuals (ME&I) Business Line.⁴⁷ ME&I is one of nine business lines within the ATO's Compliance Sub-plan⁴⁸ and has primary responsibility for the administration of the PSI regime, with inputs from other areas of the ATO. The ATO classifies micro enterprises as businesses with an annual turnover of less than \$2 million or superannuation funds with less than \$2 million in assets.

1.26 ME&I is a large and geographically dispersed business line. As at June 2013, it had 2273 full time equivalent staff located in 34 sites across Australia and an operating budget of \$216.7 million. The PSI regime is only a small proportion of overall activity undertaken by the business line. In 2012–13 there were approximately 6.1 full time equivalent staff allocated to PSI regime activities, primarily located in Brisbane, the Gold Coast and Albury. The cost of administering the PSI regime was estimated by the ATO at just over \$784 000 for the same period.

1.27 Understanding taxpayer behaviour, and what motivates people to comply with their taxation obligations, is the basis for the ATO's approach to ensuring compliance. The ATO's compliance model is structured around four strategies:

- make it easy—provide information and guidance to stakeholders to facilitate lodgement of returns;
- help to comply—clarify taxation laws;
- deter by detection—interact with taxpayers through letter campaigns, reviews and audits; and

47 In July 2013, this business line was renamed the Small Business/Individual Taxpayers Business Line. For the purpose of this audit it is referred to by its former name.

48 The ATO's Annual Plan is managed through four sub-plans, the: Compliance Sub-plan; Corporate Service and Law Sub-plan; Enterprise Solutions and Technology Sub-plan; and the Operations Sub-plan. Business and Service Lines provide the operational delivery vehicles for the relevant sub-plan.

- use the full force of the law—prosecute significant fraud or serious tax evasion activity.

1.28 Compliance activities undertaken for the PSI regime follow this model, and initially the focus was on education and liaison with taxpayers and industry associations, but particularly with tax practitioners because of the important role they play for PSI taxpayers. Current activities include: educational information aimed at making compliance easier for taxpayers and tax practitioners; interpretive assistance on general or specific topics; targeted letter campaigns aimed at informing taxpayers and tax practitioners of their obligations; and compliance reviews and audits for investigating non-compliance.

Developments relating to PSI

1.29 Two recent developments are of relevance to the ATO's administration of the PSI regime: new reporting requirements for payments made to contractors in the building and construction industry; and changes to the PSI schedule in business tax returns.

Reporting requirements—building and construction industry

1.30 Following the identification of significant levels of non-compliance by contractors in the building industry and consultation by the Department of the Treasury in 2011⁴⁹, the Government introduced the requirement that certain businesses that make payments to contractors in the building and construction industry are to report those payments to the ATO annually.⁵⁰ The new reporting requirements took effect from 1 July 2012 and are expected to improve voluntary compliance, and assist the ATO to target non-compliance.⁵¹ While this measure was not specifically introduced for PSI purposes, it will benefit the ATO by providing another data source for detecting potential non-compliance with the PSI regime.

49 Senator the Hon. Bill Shorten, Assistant Treasurer, Media release No. 85, *Consultation on Reporting of Taxable Payments Made to Contractors in the Building and Construction Industry*, 30 May 2011.

50 Taxation Administration Amendment Regulation 2012 (No. 1) amended the Taxation Administration Regulations 1976 to include this reporting requirement.

51 Australian Government, Budget 2011–12, *Budget Paper No. 2, Part 1: Revenue Measures: Treasury*, p. 47.

Deleting the personal services income schedule

1.31 In November 2012, the Joint Committee of Public Accounts and Audit tabled its report on the annual hearing with the Commissioner. The Commissioner reported that one of the avenues for simplifying tax lodgement processes for businesses was deleting the PSI income schedule from business annual tax returns.⁵² From 1 July 2013, the PSI schedule will be removed and a smaller set of questions introduced on the annual income tax return.

1.32 The ATO estimated that this will benefit 27 000 business taxpayers by reducing the reporting burden. While this does not mean a change to taxpayers' PSI obligations, it is expected that moving key questions from the PSI schedule to the annual income tax return will make it easier and quicker for business taxpayers to complete PSI questions, and improve the quality of data reported.

Audit objective, criteria and scope

1.33 The objective of the audit was to assess the effectiveness of the Australian Taxation Office's administration of the personal services income regime.

1.34 The audit examined whether the ATO's:

- governance arrangements for the PSI regime are appropriate and effective;
- systems and processes to identify and assess compliance risks are adequate and effective; and
- strategies to promote compliance and address non-compliance are appropriate and effective, and their impact is being measured.

1.35 The audit also examined the Part IVA program where it involved personal services businesses.

Audit methodology

1.36 The Australian National Audit Office (ANAO) examined documentation and interviewed key ATO staff and representatives of the various tax professional associations, industry bodies, contractor associations

⁵² Joint Committee for Public Accounts and Audit, *Report 424: Annual Public Hearing with the Commissioner of Taxation—2012*, Canberra, 2012, p. 18.

and employee unions. A detailed examination of a sample of compliance reviews and audits was also undertaken.

1.37 The audit has been conducted in accordance with the ANAO's auditing standards at a cost of approximately \$473 000.

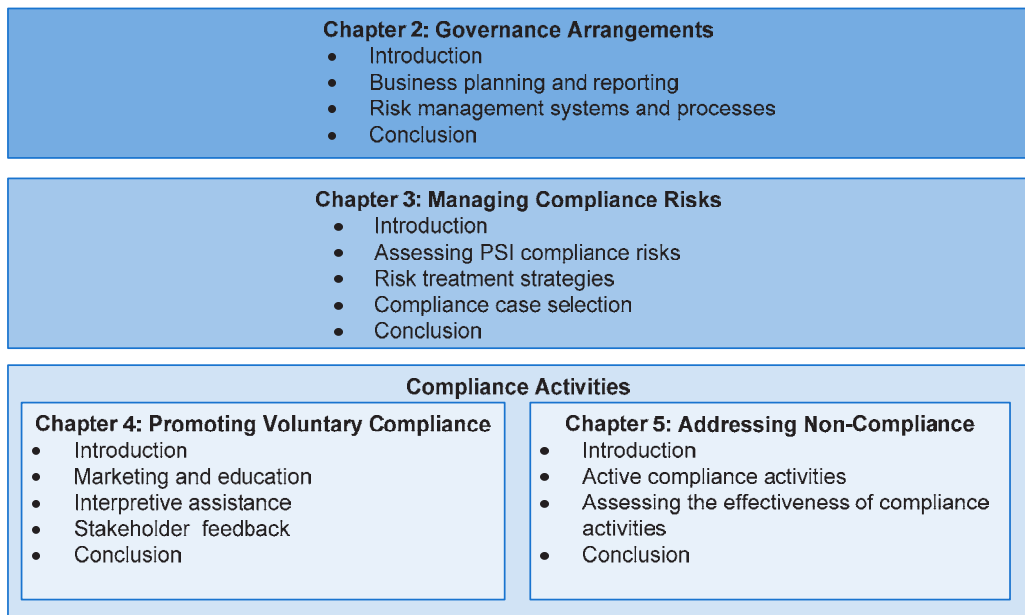
Acknowledgements

1.38 The ANAO appreciates the contribution of ATO staff, and external stakeholders who provided information and feedback during the conduct of the audit.

Structure of the report

1.39 The structure of the report reflects the high-level audit criteria. Accordingly there are a further four chapters, outlined in Figure 1.5.

Figure 1.5: Structure of the report



2. Governance Arrangements

This chapter examines the governance arrangements supporting the ATO's administration of the PSI regime.

Introduction

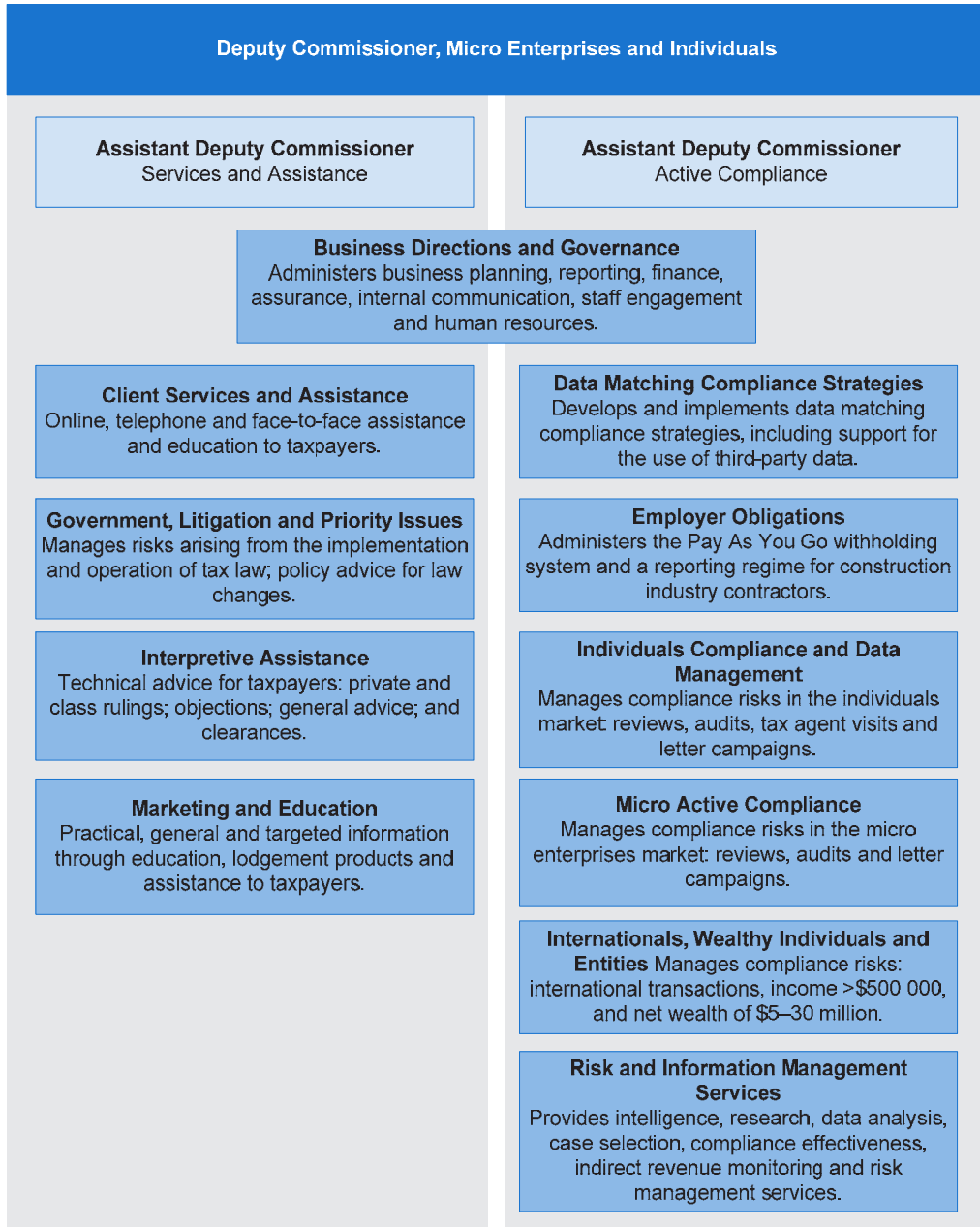
2.1 Prior to the introduction of the PSI legislation in July 2000, the ATO established a PSI project team in the former Small Business Line.⁵³ The administration of the PSI regime was managed by this team until July 2006, when the transition to business-as-usual saw the transfer of responsibilities to the Micro Enterprises and Individuals Business Line (ME&I). The governance arrangements for the PSI regime have changed considerably since then, reflecting the work undertaken by the former project team, changes to the ATO's governance processes, and a better understanding of the PSI risk.

Current management arrangements

2.2 ME&I comprises 11 'streams', organised in two groups. The business line's structure and a summary of each stream's responsibilities are provided in Figure 2.1. Primary responsibility for the PSI regime lies with the Micro Active Compliance stream, although three other streams also have a direct involvement in the administration of PSI: Interpretive Assistance; Marketing and Education; and Risk and Information Management Services. A fifth stream (Government, Litigation and Priority Issues) is involved in the Part IVA program for personal services businesses (discussed in Chapter 4).

53 An organisational restructure in 2006–07 separated the Small Business Line into the Small and Medium Enterprise Business Line (administering those enterprises with an annual turnover between \$2 million and \$250 million) and the Micro Enterprises and Individuals Business Line.

Figure 2.1: Structure of the Micro Enterprises and Individuals Business Line, 2012–13



Source: ANAO interpretation of information provided by the ATO.

2.3 As discussed in Chapter 1, the PSI regime is a small proportion of the overall activity undertaken by ME&I. There is no annual budget set for PSI activities, as staff allocated to PSI may also work on other projects throughout

the year. The ATO can however monitor the cost of those activities. The split of staff across the five streams, and the ATO’s estimate of the cost of administering the regime for 2010–11 to 2012–13 is provided in Table 2.1.

Table 2.1: Number of staff and estimated cost of administering the PSI regime, 2010–11 to 2012–13

ME&I Business Line stream	Full time equivalent staff		
	2010–11	2011–12	2012–13
Micro Active Compliance	5.0	5.0	3.0 ⁽¹⁾
Interpretive Assistance	1.6	2.3	1.7
Government, Litigation and Priority Issues	0.1	0.1	0.1
Marketing and Education	0.7	0.7	0.7
Risk and Information Management Services	0.6	0.6	0.6
Total staff	8.0	8.7	6.1
ATO’s estimated cost of PSI administration	\$907 421	\$1 030 779	\$784 011

Source: Information provided by the ATO.

Note 1: In 2012–13, an average of two staff were redirected to following up non-lodgement of tax returns by taxpayers identified through PSI data matching exercises (discussed in Chapter 3). These staff were not directly allocated to PSI activities, but were undertaking activities relating to the PSI population.

2.4 The ANAO examined the ATO’s approach to administering the PSI regime by assessing whether there were appropriate and effective governance arrangements for the PSI regime, including:

- business planning and reporting; and
- risk management systems and processes.

Business planning and reporting

2.5 The ATO Executive Committee and supporting committees are accountable through the ATO’s senior executive reporting structure for managing a number of business and service lines, including ME&I. Business planning, performance measurement and reporting are linked through a suite of corporate documents, which include the Annual Plan, various supporting business line plans and the Annual Report.

Business planning

2.6 The ATO's planning documents, particularly the Strategic Statement and Annual Plan, set the overall direction for the organisation.⁵⁴ Planning processes cascade from these documents through the relevant business line, branch and stream plans, and finally to team plans and individual performance and development agreements.

2.7 The ME&I Business Line Plan provides the overall framework for the work of the business line, and is directly integrated with the ATO Annual Plan. The plan assigns to streams, either jointly or individually, responsibility for tactics⁵⁵ to enable the business line to achieve each deliverable. The ME&I Business Line Plan summarises information and the PSI regime generally rates minimal mention as an example of a Micro Active Compliance responsibility. Micro Active Compliance stream plans contain more detail.

2.8 During the period 2009–10 to 2011–12, work relating to the PSI regime was a separate section within the Micro Active Compliance stream plan for the upcoming year. In 2012–13, PSI-related work was grouped together with other projects that were going to deliver similar tactics.⁵⁶ Micro Active Compliance has a supplementary planning tool that breaks this work down by project and activity, so PSI activities are separately identified. Planned PSI work in the stream plan draws upon the corresponding PSI risk treatment plan (discussed in Chapter 3) and includes planned PSI compliance case volumes and anticipated revenue figures. Other streams do not include specific PSI-related work in their annual plans.

54 The Strategic Statement provides direction and a framework for the ATO's activities over a five-year period, currently from 2010–15. The Annual Plan provides a consolidated view of all the sub-plans' annual work to support corporate priorities.

55 A tactic contributes to delivering a strategy, as set out in the Annual Plan.

56 For example, activity 1.3.4.14 'provide tailored advice' was associated with the tactic—campaigns prompting outstanding lodgment or voluntary disclosures will be undertaken as an activity within the treatment strategy for the following risks: contractors level playing field; contractors PSI; and high risk referrals. Collectively 15 300 letters were planned to address these three risks.

2.9 For the period 2010–11 to 2012–13 other performance measures and targets were:

- improving quality assurance results; achieving an 80 per cent benchmark for case cycle time and a 55 per cent benchmark for ‘strike rate’ of cases⁵⁷;
- issuing compliance case finalisation letters within the seven day ATO service standard; and
- compliance strategy evaluations demonstrate improved taxpayer behaviour over time and result in indirect revenue outcomes.⁵⁸

2.10 Mid-year reviews of business plans also occur, and any changes to stream business plans, for example a change in the planned number of compliance cases, planned revenue or resource requirements, go to the ME&I Executive for endorsement.

Performance management and reporting

2.11 At the highest level, the ATO reports its performance against one Portfolio Budget Statement objective, Program 1.1:

The objective of the ATO is to administer aspects of Australia’s taxation and superannuation systems fairly by helping people do the right thing, by making it as easy as possible for taxpayers to comply, ensuring effective strategies are in place to deter, detect and deal with non-compliance, and developing and supporting the capability of its people and of others in the system.⁵⁹

2.12 Four deliverables contribute to achieving Program 1.1. Work conducted on the PSI regime primarily relates to Program Component 1.1.3: ‘We support and protect people by dealing with those not willing to comply’, and delivery is measured using four key performance indicators (KPIs).⁶⁰

57 The case cycle time is the elapsed time from the commencement date until the completion date, and cycle times differ for types of compliance cases. The strike rate is the number of compliance activities that have an outcome, expressed as a percentage of the total number of activities completed.

58 This is being measured through the Compliance Effectiveness Methodology, discussed in Chapter 5.

59 Australian Government, *Portfolio Budget Statements 2012–13, Budget Related Paper No. 1.19, Treasury Portfolio*, Commonwealth of Australia, Canberra, 2012, p. 190. The ATO is also responsible for other Programs such as the Australian Valuation Office and the Australian Business Register.

60 The four KPIs are: products, services and tools are available to help people meet their obligations; issue advice and practical guidance that assists people to meet their obligations; reduce non-compliant behaviours through deterring, detecting and dealing with taxpayers not willing to comply; and establish the nature and extent of non-compliant behaviour and, where appropriate, apply penalties and prosecute.

2.13 Agencies are required to report against Portfolio Budget Statement KPIs in their annual report. Specific mention of activities undertaken in the PSI regime is not included in the ATO's annual reports, apart from the occasional mention of litigation cases involving PSI. The number of PSI-related activities does however contribute to the total number of activities that are reported for the whole of the ATO. Some PSI-related activities do appear in the ATO's annual Compliance Program (discussed in Chapter 5).

Internal reporting of performance

2.14 Within ME&I, there is a monthly coordination telephone conference between streams involved in PSI administration. These meetings are minuted and provide a record of PSI administration, including work requested by Micro Active Compliance of the other streams, resourcing, monitoring and forward planning. Micro Active Compliance also maintains a weekly 'Dashboard' report that allows managers to monitor the number of compliance cases (including PSI-related cases) on-hand and results.

2.15 Formal monitoring of PSI administration occurs through the 'heartbeat' report produced fortnightly for the ME&I Executive. The Micro Active Compliance reports contain updates of planned versus actual compliance cases and taxpayer liabilities raised and collected, and PSI is one of the topics included. These reports contribute to a monthly ME&I heartbeat report that is part of the ATO's corporate reporting regime. Reports include information on the activities of all ME&I streams and projects against those planned. Other compliance performance measures such as strike rates (the percentage of cases that have an outcome), cycle times (cases being finalised within prescribed time periods) and the service standard are also reported (results are discussed in Chapter 5). The last heartbeat report of the financial year reports against the business plan.

2.16 The performance measure 'compliance strategy evaluations demonstrate improved taxpayer behaviour over time and result in indirect revenue outcomes' has not been reported on for PSI. This issue is discussed in the compliance effectiveness section of Chapter 5.

Risk management systems and processes

2.17 The ATO manages the risks associated with taxpayers through its Risk Management Framework.⁶¹ The framework identifies three levels of risk: enterprise, operational and tactical, as defined in Table 2.2, with each level rated through a different risk matrix. Management arrangements are applied for the identified level of risk.

Table 2.2: The three levels of risk in the ATO’s Risk Management Framework

Level	Characteristics of the risk	Management arrangements
Enterprise	Risks that cut across the ATO or that are rated high or severe when assessed on a corporate scale.	Risks are normally managed at the sub-plan or ATO Executive level.
Operational	Risks are usually limited to one or two business and service lines, and are not rated high or severe on a corporate scale.	Risks are normally managed by business and service lines and capability areas.
Tactical	Risks are usually associated with specific events or activities such as financial transactions and audits.	Risks are managed by individuals or teams as part of their day-to-day management.

Source: ATO, *ATO Risk Matrices*, Corporate Management Procedures and Instructions 2003/02/02.

2.18 Within this framework, ME&I is responsible for the analysis and treatment of risks in relation to PSI. The ‘alienation of PSI’ is an operational level risk, and accordingly the operational risk owner responsible for ensuring appropriate management is the Assistant Commissioner of Micro Active Compliance. PSI forms part of the overarching enterprise risk ‘tax and superannuation compliance’⁶², for which the enterprise risk owner is the Deputy Commissioner of the Large Business and International Business Line. ME&I’s business planning cycle incorporates an annual review of risks. This is overseen by the business line’s Risk Management Committee, which meets monthly and reports to the ME&I Deputy Commissioner. The Committee is responsible for the identification, prioritisation and oversight of all risks managed by the business line.

61 The ATO’s Risk Management Framework is based on the AS/NZS ISO 31000:2009 standard (*Risk Management—Principles and Guidelines*). The framework consists of: a corporate risk register; an issues management database that records information on new and emerging risks, as well as the status of treatment strategies for existing risks; risk matrices that define how each level of risk is to be managed; and instructions for staff.

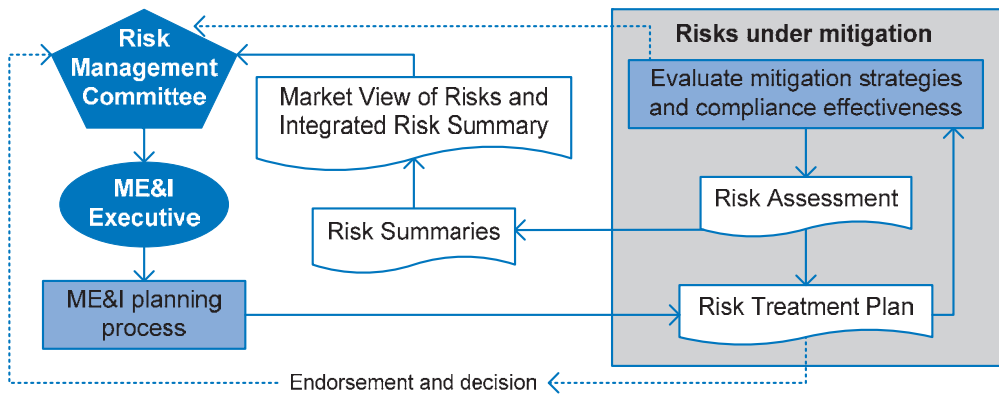
62 The tax and superannuation compliance risk is described as the failure of the ATO to ensure taxpayers and other clients can understand and meet their tax, superannuation and related obligations and receive appropriate concessions associated with these obligations.

2.19 The ANAO examined the ATO’s approach to identifying and prioritising the risk of taxpayers not complying with PSI taxation obligations, and oversight by the Risk Management Committee.

Risk Management Committee

2.20 ME&I’s ‘risks under mitigation’ (as distinct from new and emerging risks) are recorded on the ATO’s risk register. The annual planning and approval process for these risks incorporates risk assessment, development of risk treatment plans, endorsement by the Risk Management Committee, incorporation into business plans and evaluation of the effectiveness of compliance activities. Figure 2.2 illustrates this process.

Figure 2.2: Annual planning and approval process for risks



Source: Adapted from information provided by the ATO.

2.21 The Risk Management Committee first met in October 2009, and in March 2010 the committee considered a summary of all ME&I compliance risks for the 2010–11 planning process. The PSI risk was described as ‘taxpayers impacted by Part 2–42 incorrectly income splitting, retaining profits and claiming specified deductions. This leads to reduced revenue collected and reduced community confidence in the tax system’. PSI was rated as a high risk using the operational risk matrix, and was one of the 13 high-rated risks for the business line in 2010–11. Of the remaining risks, three were rated moderate and one was rated low.

2.22 In 2011–12, ME&I continued using the operational risk matrix but began using the enterprise risk matrix as well, as the enterprise risk matrix allows for a greater differentiation between the ratings of risks, making prioritisation and resource allocation easier across the business line. PSI was downgraded to a moderate risk using the operational risk matrix, but also

rated as significant using the enterprise risk matrix.⁶³ The required management action for both of those ratings is similar, and the PSI risk has an executive level risk owner.

2.23 In 2012–13, PSI was one of 20 risks under mitigation in the business line.⁶⁴ The risk description was: ‘Failure of taxpayers to understand and voluntarily comply with their tax obligations in regards to PSI’. In September 2012, following an ATO-wide request from the Office of the Chief Knowledge Officer (the corporate owner of the risk management framework), the ATO risk register was updated to include a rating for PSI using both the enterprise and operational risk matrices. The rating using the operational risk matrix remained moderate, and the rating remained significant using the enterprise risk matrix.

2.24 In September 2012, the Risk Management Committee began a quarterly review of risk treatment plans to gain assurance that risk treatment plans are being reviewed by risk owners on a quarterly basis⁶⁵, and that all other risk documentation (risk assessments and risk summaries⁶⁶) had been prepared and subsequently approved by risk owners. The PSI risk assessment, risk summary and treatment plan were approved in December 2012, and the March 2013 quarterly review (presented to the Risk Management Committee in June 2013) noted that the PSI treatment plan had been reviewed.

2.25 Although the PSI regime is a small proportion of the work undertaken by ME&I, there has been Risk Management Committee focus on the PSI risk, and meeting minutes show that this has been reviewed at least annually. The question of whether PSI should continue to be a standalone risk topic has also been discussed. In October 2011, an agenda item on potentially combining the PSI risk, and three ‘omitted income’ risks (contractors, government stimulus payments and taxable government grants) was discussed. The decision was to make no change so that focus could be maintained on each separate risk.

63 PSI was one of 15 risks under mitigation by the business line.

64 The change to the number of risks reflects decisions to combine or reduce the risk rating of certain risks. Of the 20 risks, two were severe, nine were high, five were significant, two were moderate, and two were low.

65 In accordance with responsibilities outlined in the ATO’s *Risk and Issues Management, Corporate Management Practice Statement, PS CM 2003/02*.

66 A risk summary is a summary of a more detailed risk assessment document containing more recent information.

2.26 Another process used by the ATO is annual Health of the System Assessment (HOTSA) reports to assist with the identification of risk priorities and subsequent resource allocation. These reports feed information into the ATO planning process by informing the ATO's Compliance Program and other risk mitigation strategies. In 2010 and 2011, ME&I produced an income tax HOTSA for the Micro Enterprises Market. In 2012, the HOTSA assessment was broadened to cover the whole market, not just the income tax aspects. In all three years, PSI rates a minor mention in relation to taxpayers omitting income from their tax returns, and is linked in discussion regarding contractors.

Conclusion

2.27 The governance arrangements within ME&I supporting the PSI regime are appropriate. Business plans include activities relating to PSI as well as relevant performance measures and targets. Given its relative scale, there is minimal external reporting of PSI activities, but internal reports monitor actual achievements against the PSI activities planned.

2.28 ME&I's risk management processes incorporate an annual review of risks, overseen by the business line's Risk Management Committee. The 'alienation of PSI' risk has been reviewed by the Committee at least annually. Planned PSI activities draw upon annual PSI risk treatment plans and include compliance case coverage, case volumes, and anticipated revenue figures. However, the business plan performance measure relating to measuring compliance effectiveness, introduced in 2010–11, has not been reported against for PSI. Nevertheless, work is underway to address this gap and is expected to be completed later this year.

3. Managing Compliance Risks

This chapter examines the identification, assessment and treatment of risks associated with taxpayers who do not comply with their PSI regime obligations.

Introduction

3.1 The Risk and Information Management Services⁶⁷ stream of ME&I identifies and assesses the risk of non-compliance with PSI obligations, determines treatment strategies and selects cases for compliance intervention by Micro Active Compliance.⁶⁸ PSI risk assessments are overseen by the PSI risk manager (an executive level staff member of Micro Active Compliance), the risk owner (the Assistant Commissioner of Micro Active Compliance) and the Risk Management Committee.

3.2 The ANAO examined the ATO's processes for assessing PSI compliance risks, determining appropriate treatment strategies and selecting cases for active compliance (primarily between 2009–10 and 2012–13).

Assessing PSI compliance risks

3.3 PSI risk assessments are conducted periodically, typically every three years, to help to ensure that knowledge of all aspects of the 'alienation of PSI' risk is current and there is appropriate oversight. These periodic assessments incorporate the major components of the risk management process including reviewing existing controls, and the implementation and continuing relevance of treatment plans. The output from each risk assessment has been an extensive document outlining the results of the analysis—the nature of the risk, its impact, causes and sources, and a description of the population. Since PSI administration became business-as-usual, two risk assessments have been conducted, in 2008⁶⁹ and 2011.

67 For 2012–13, Risk and Information Management Services had a budget of \$7.3 million and 66 full time equivalent staff members.

68 For PSI, this work is conducted primarily by one officer, and around 70 per cent of his time is spent on PSI-related work. This officer has been involved in PSI activities since the inception of the regime in 2000, providing expertise and continuity.

69 The 2008 document profiles the risk population without rating the risk. The format of risk-related documents changed after this date, with profiling information now being included in risk assessments.

3.4 A one-page summary of the risk assessment is also prepared annually, and these documents provide the ME&I Executive and the Risk Management Committee with an integrated view of compliance risks across the business line for planning purposes. There are PSI risk summaries for 2010–11 and 2012–13.⁷⁰ The 2012–13 risk summary was based on the 2011 risk assessment, and this summary has been endorsed by the risk owner, although it gives the risk treatment strategies for the previous year, and not those planned for 2012–13. To ensure currency of PSI risk-related documents, there would be benefit in the risk manager and the risk owner reviewing the documentation and, where necessary, its endorsement by the risk owner.

Analysing the risk

3.5 PSI is considered by the ATO to be an endemic risk, as it continues to be identified through active compliance activities and data matching with external data sets. There are common links between at risk PSI taxpayers and other non-compliant contractors being managed by the ATO. The 2011 risk assessment documents these links, and the projects or areas of the ATO that should be mitigating the risk. The ATO acknowledges that while the connection between risks is known, documentation of the interaction of these ‘like’ risks could be improved as there was little recognition of the PSI risk in documents other than the PSI risk assessments. Table 3.1 summarises the December 2011 risk assessment—PSI risk, population, participants in the risk, behavioural drivers for non-compliance, and common links with other contractors risks.

70 A 2011–12 version of the risk summary was created retrospectively from the 2012–13 version. It contains the same information as the 2012–13 risk summary, has the same version number and date of Risk Management Committee endorsement (14 March 2012).

Table 3.1: Summary of 2011 PSI risk assessment

Risk description	
Failure of taxpayers to understand and voluntarily comply with their tax obligations in regard to PSI. This reduces community confidence in the tax system and leads to wider non-compliance in the community.	
Risk population	
Micro taxpayers who are registered in the system (that is, have a tax file number), lodge tax returns and declare all income, and:	
<ul style="list-style-type: none"> • mainly earn income from labour, stream income through an interposed entity (a company, partnership or trust) and split income with an associate in a lower tax bracket, retain profits or claim specified deductions; or • self-assess that they conduct a personal services business and either split or retain income (these taxpayers are of interest for the Part IVA program). 	
Participants and behavioural drivers for non-compliance	
<ul style="list-style-type: none"> • Taxpayers affected by Part 2–42 of the <i>Income Tax Assessment Act 1997</i> • Personal services businesses • New entrants • Intermediaries (tax practitioners, financial planners, artificial tax scheme promoters) 	<p>Gaining financial advantage from a reduction in tax liability; perceived low risk of detection; lack of awareness or understanding of the PSI rules; misinformation; cost of compliance is too high; belief that the business is genuine and should not be caught by the legislation; and lack of clarity in the law for personal services businesses (Part IVA).</p>
Participants not involved in the PSI risk	
<ul style="list-style-type: none"> • Sham contractors who receive income that should be classified as salary and wages (risk mitigated by the Employer Obligations stream of ME&I). • Contractors who receive income from service acquirers but fail to register in the system or lodge tax returns (risk mitigated by the Tax Practitioners and Lodgement Business Line). • Contractors who understate or omit income in their tax returns (the 'level playing field' project managed by Micro Active Compliance). 	

Source: ANAO analysis of information provided by the ATO.

Population analysis

3.6 No attempt has been made to accurately determine the size of the population likely to be the target of the PSI legislation since 2004–05.⁷¹ However, reference to the potential size of the non-compliant population has been made:

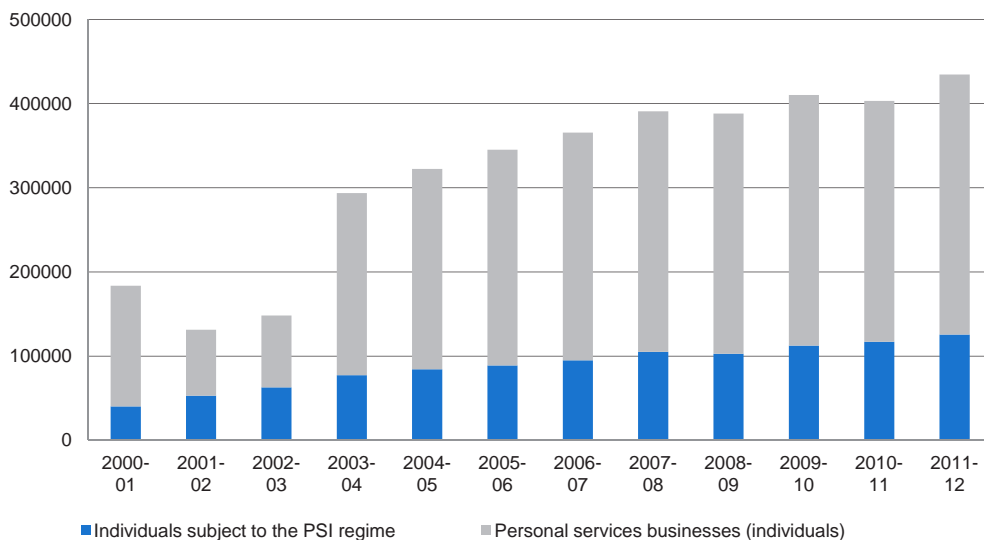
- the 2008 PSI risk assessment used an assumption that only a third of all taxpayers in receipt of PSI declared this situation in their tax returns;
- the 2011 risk assessment did not estimate the total size of the non-compliant population, stating that the lack of good quality data to enable monitoring of the entire population meant that the confidence level of this information was low. The number of taxpayers at high-risk of non-compliance was estimated to be around 2000 to 4000, although no defined quantitative methodology was used to arrive at this figure.⁷² It was also stated that the PSI non-declarers were managed through compliance activities for other risks being undertaken by other areas of the ATO (however, as discussed in paragraph 3.5, the ATO has acknowledged that the interaction of these like risks could be better communicated and documented).

3.7 Population analysis has formed part of the 2008 and 2011 risk assessments, but this analysis is based on the known population, that is, the taxpayers that declare PSI. As outlined above, this may represent a relatively small proportion of taxpayers in receipt of PSI (such as one third). To enable analysis of trends in the known PSI population, a comparison is made of tax return lodgement information by financial year. The numbers of taxpayers declaring PSI each year from commencement of the program in 2001, together with the proportion of personal services businesses to taxpayers subject to the PSI regime is shown for individuals in Figure 3.1, and for entities in Figure 3.2.

⁷¹ The estimate of population size was done as part of an attempt to calculate the revenue attributable to the PSI regime. This is discussed in Chapter 5, paragraphs 5.32 to 5.34).

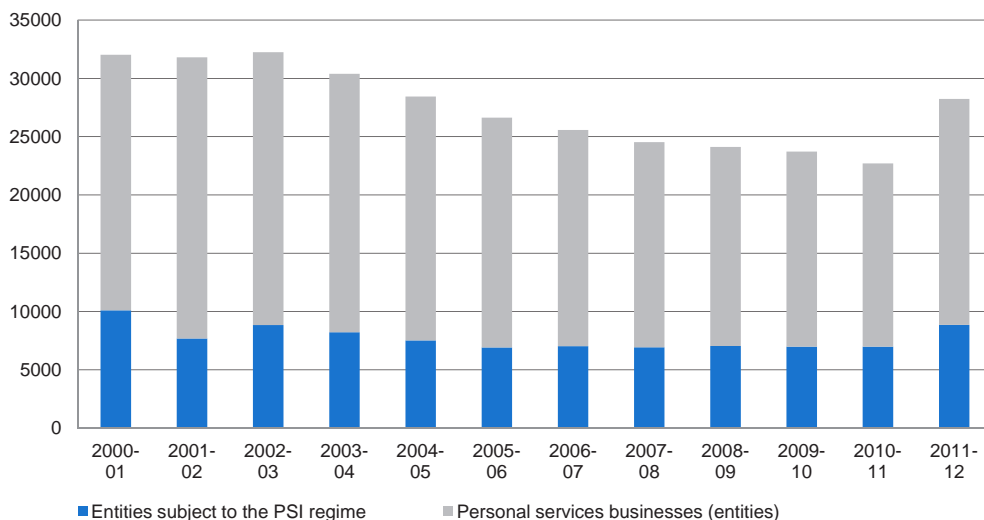
⁷² The ATO advised this figure was arrived at by workshopping the views of staff involved with PSI-related activities.

Figure 3.1: PSI lodgements—individuals, 2001–02 to 2011–12



Source: Information provided by the ATO.

Figure 3.2: PSI lodgements—entities, 2001–02 to 2011–12



Source: Information provided by the ATO.

3.8 The ATO advised that the large increase in lodgements by individuals in 2003–04 was due to an education campaign and subsequent compulsory PSI question included in individual tax returns. The main effect of these initiatives was on personal services businesses and the ATO attributes this to their prior

lack of awareness of the need to answer a PSI question in their tax return. The ATO considers that the decrease in lodgements by entities from 2003–04 can be seen as evidence that the alienation of PSI measure has arrested the growth in taxpayers switching from salary and wages to a personal services entity structure, which was considered one of the key objectives of the legislation. However, while around 4000 fewer entities declared PSI in 2011–12 compared to 2000–01, there were over 165 500 additional individuals declared as personal services businesses over the same period.

3.9 The 2008 and 2011 risk assessments also contained information on the percentage of individuals, personal services businesses, and taxpayers declaring they were subject to the PSI regime. A comparison of this population data (given in Table 3.2) for 2005–06, 2008–09 (the data available at the time the risk assessments were conducted) and 2010–11 (the most recent data available at the time of preparation of this report) shows little change in the known PSI population profile.

Table 3.2: Comparison of known PSI population, 2005–06, 2008–09 and 2010–11

Taxpayers	2005–06	2008–09	2010–11
Total number that declared PSI	345 792	393 913	426 007
Percentage that self assessed as personal services businesses/(number)	75% (257 720)	73% (289 439)	71% (302 036)
Percentage that the PSI regime applied to/(number)	25% (88 072)	27% (104 474)	29% (123 971)
Percentage of individual sole traders/(number)	92% (319 655)	94% (370 477)	95% (403 296)
Percentage of entities (companies, partnerships, and trusts)/(number)	8% (26 137)	6% (23 436)	5% (22 711)

Source: Information provided by the ATO.

3.10 Of relevance to determining the likely population size of PSI taxpayers, the 2008 risk assessment found that the taxable income of most taxpayers (around 70 per cent) had a small proportion of net PSI while a larger proportion of their taxable income came from salary and wages. That is:

- 70 per cent of taxpayers earned a small proportion of net PSI and could best be described as salary and wage earners (who also earn a small amount of PSI); and

- 30 per cent of taxpayers who earned most of their taxable income from net PSI could more confidently be classified as contractors.

3.11 The risk assessment concluded that the contractor population that is the target of the PSI legislation is likely to be quite small. In this regard, the ANAO notes that PSI is determined for each contract entered into by the taxpayer, and not on annual income. Accordingly, it is possible that the PSI contractor population could be large, although individual taxpayers may only have a small amount of PSI.

3.12 The most up-to-date population information is contained in the 2012–13 PSI risk summary. This indicated very little change in the percentage of taxpayers earning most of their taxable income from PSI, as of the 104 474 taxpayers that the PSI regime applied to, only 29 per cent (just over 30 000 taxpayers) earned most of their taxable income from net PSI.⁷³ The risk summary also states:

- that some taxpayers incorrectly classify their income as business income, as only 18.5 per cent of entity taxpayers identified through third party data matching classified their income as subject to the PSI regime; and
- that while this implies that 81.5 per cent of entities may have incorrectly classified their income, prior compliance case results show that many taxpayers who satisfy one of the personal services business tests do not complete the appropriate questions on their tax returns due to the complexity and cost of compliance.

3.13 In September 2012, a PSI operational intelligence scan documented an observation that there may be growth in the number of sole traders wrongly self-assessing as personal services businesses, and incorrectly splitting income through pay as you go withholding salary and wage payments to associates for non-principal work. The number of individual personal services businesses has been increasing (as shown in Figure 3.1) and the trend in salary and wage expenses and payments to associates has also been increasing. Further analysis was recommended and the March 2013 quarterly review of the risk treatment plan (put to the Risk Management Committee in June 2013) notes this possible

⁷³ While this analysis focuses on net PSI, the alienation of PSI risk includes the taxpayer incorrectly claiming deductions they are not entitled to, which may enable them to reduce their net PSI below this threshold. Separate reports on deductions inform the risk analysis and are also used in certain compliance case selection parameters.

change to the risk environment but considers that the current risk rating and treatment controls are appropriate. A further review of the risk management strategy was recommended for later in 2013–14.

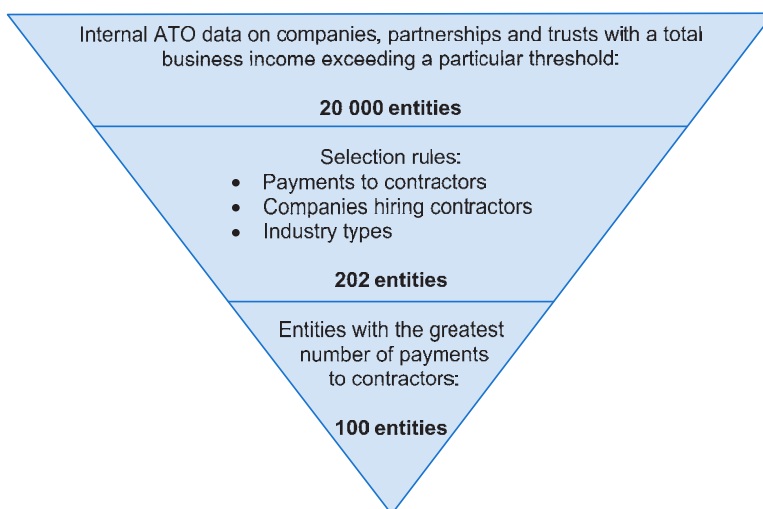
Data sources for risk analysis

3.14 It is difficult for the ATO to identify non-compliant taxpayers using only the PSI information from tax returns, and the ATO recognises that it needs to use other relevant information. In 2003, during the project phase of PSI administration, data matching was conducted using information obtained from third parties as well as the ATO's data. Results indicated that compliance case selection could be improved through the use of labour hire firm data⁷⁴, as this enabled the ATO to identify taxpayers who had received payments but had not reported these payments accurately in their tax returns. Since this time, data matching programs were run in 2007, 2009 and 2011. A data acquisition strategy covering acquisition of further labour hire firm data was approved in December 2012 and the ATO advised this is planned for late 2013.

3.15 The key objective for PSI data matching is to identify higher risk taxpayers who fail to voluntarily comply with their PSI tax obligations. Data matching is used to identify cases for active compliance work. In particular, it identifies taxpayers that: operate through a company or trust; have not declared PSI correctly; are actually subject to the PSI regime as distinct from being personal services businesses; are income splitting; and are claiming deductions that are not allowable. The most recent exercise in 2011 illustrates the process as it has been refined over time (Figure 3.3).

74 Labour hire firms were selected as some businesses were hiring contractors through labour hire firms, but the arrangement was more like an employee-employer relationship.

Figure 3.3: Process for identifying external data sources



Source: ANAO interpretation of ATO processes.

Note: The ATO advised that obtaining data from entities with small numbers of payment records does not justify the resources needed to obtain and analyse the data.

3.16 Data is sourced from entities such as labour hire firms, placement agencies and computing and technical consultancies as these tend to be the industries with the most contractor payments. For example, from the group of 202 entities identified by the ATO’s selection rules, 92 per cent (186 entities) were from four industries: Employment Services; Architectural, Engineering and Technical Services; Computer Systems Design and Related Services; and Management and Other Consulting Services.

3.17 When entities are selected for data matching, the ATO documents a data matching protocol, and then requests data from the entities.⁷⁵ Data obtained from third parties includes the source organisation’s Australian Business Number (ABN), the ABN of the entity receiving the payments, and the amounts paid.

3.18 PSI data matching has the potential to identify taxpayers who have not lodged tax returns or are non-compliant with other obligations.⁷⁶ In 2009, there were 125 records referred to the ‘level playing field’ project⁷⁷ and 1381 records

⁷⁵ The ATO can reimburse entities for the costs of providing the data in certain circumstances.

⁷⁶ The ATO did not record this information during the 2007 data matching exercise.

⁷⁷ The ‘level playing field’ is the ATO’s project addressing contractors who understate or omit income from their tax returns.

to the Tax Practitioner and Lodgements Business Line. No information is available about what action (if any) was taken. In 2011, rather than referring cases to the Tax Practitioner and Lodgements Business Line, Micro Active Compliance issued 658 letters to prompt those taxpayers to lodge their tax returns. More formal and documented linkages between areas responsible for PSI risks and other contractor risks would assist with the ongoing assessment and reporting of PSI risks, as well as other risks relevant to the contractor population.

3.19 Agencies conducting data matching that involves the use of tax file numbers are subject to the *Data-matching Program (Assistance and Tax) Act 1990*. For data matching that does not involve tax file numbers, the Office of the Australian Information Commissioner has issued a voluntary guideline for programs that involve information about more than 5000 individuals.⁷⁸ Although PSI data matching relates to data on entities, not individuals, each exercise complied with the guidelines, had an approved concept brief and was advertised in the government gazette.

3.20 An evaluation of the 2009 exercise was conducted, recommending expansion of the program in 2011, and finding that:

- 81 per cent of selected audits resulted in a revenue adjustment (positive or negative); and
- 71 per cent of selected review cases resulted in a voluntary disclosure.

The use of data matching for compliance case selection has also improved the strike rate (the percentage of cases that have an outcome) of cases, which was 60.2 per cent in 2010–11 and increased to 78.9 per cent in 2012–13. An evaluation of the 2011 data matching exercise was being conducted at the time of preparation of this report.

Future risk assessment

3.21 Given the minimal changes to the known PSI population since 2005–06, at which time the regime became more stabilised, the frequency of comprehensive PSI risk assessments has been appropriate. The introduction of the taxable payments reporting system from 1 July 2012⁷⁹ will provide another

78 Office of the Australian Information Commissioner, *The Use of Data-Matching in Commonwealth Administration—Guidelines*, February 1998, available at <http://www.oaic.gov.au/privacy/privacy-act/government-data-matching> [accessed 6 June 2013].

79 Discussed in paragraph 1.30 of Chapter 1.

data source for detecting potential non-compliance with the PSI regime for use in the next comprehensive risk assessment, currently scheduled for 2014. The impact of deleting the PSI schedule of business tax returns and whether this changes the risk of non-declaration, could also be assessed, as could the results of recent compliance activities given the greater emphasis on letter campaigns in the last few years (discussed in paragraph 3.25 and Chapter 5).

3.22 There have been no attempts to estimate the size of the PSI population since 2004–05. In light of the findings from the 2012 PSI intelligence scan suggesting potentially high non-compliance risks (reported in paragraph 3.13) it would be beneficial if the next comprehensive PSI risk assessment included an updated estimate of the number of taxpayers not declaring PSI. An estimate of this non-compliant population would also provide a baseline for use in measuring the effectiveness of PSI compliance activities (discussed in Chapter 5), and subsequently these results could be used to assist in the planning of future compliance activities.

Risk treatment strategies

3.23 Annual risk treatment plans are used in determining compliance strategies. The plans:

- describe the intended approach to treating the risk, and provide a summary of information from the risk assessment (descriptions of taxpayer behaviours, drivers for that behaviour, and the characteristics of participants posing the risk);
- define the intended outcomes, success goals, indicators of success and proposed treatments; and
- document responsibilities and the rationale for selecting the target population.

3.24 The ANAO examined the PSI risk treatment plans from 2009–10 to 2012–13. Treatment strategies contained in these plans covered a range of compliance activities: from those that might encourage increased understanding and compliance amongst taxpayers (marketing and education); assist with clarifying the law (interpretive assistance and the Part IVA limited compliance program); to those that enable intelligence gathering, understanding of risk behaviours, and focus on non-compliance interventions (reviews and audits). The treatment strategies suggested for PSI match the risk

behaviours documented in risk assessments. However, not all suggested treatment strategies can be implemented because of resource constraints.

3.25 The emphasis of some strategies has changed with time. For example, greater emphasis has been placed on letter campaigns, as an efficient method of interacting with more taxpayers.⁸⁰ Specific letter campaigns have also been designed to interact with lower PSI-earning taxpayers, who may not pose the same revenue risk as higher PSI-earning taxpayers, who can instead be subjected to reviews and audits. Not all of the planned letter campaigns were incorporated into business plans, and of those that were, not all have been completed (discussed in Chapter 5). Other treatment strategies remain the same from year to year, such as many marketing and education activities. Regularly repeated strategies include maintenance of ATO website material and targeting messages to tax practitioners using ATO newsletters.

3.26 To document interaction with other areas of the ATO undertaking work with contractors, the 2011–12 and 2012–13 PSI treatment plans have activities relating to Employer Obligations and the level playing field project, both within ME&I. In both years, a suggested strategy was to use data from the Employer Obligations contractor database to select cases for PSI letter campaigns, reviews and audits. This suggested strategy was carried through to the corresponding Micro Active Compliance business plan for 2011–12, but not for 2012–13. The ATO has advised that the Employer Obligations contractor database has not been used for PSI purposes.

Compliance case selection

3.27 The annual treatment plan provides for examination of cases that may not comply with the legislation and indicates the various sources of data for selecting cases. The ATO's general automated profiling tools⁸¹ are not used for PSI as the population is small, although the business line's use of these tools has been under development for several years. Instead, target selection criteria are documented that define case selection parameters for particular purposes. These selection criteria are designed to identify taxpayers potentially at a

80 For 2009–10, no letter campaigns were suggested; for 2010–11, one campaign of 1000 letters was suggested; for 2011–12, four campaigns totaling 2500 letters were suggested; and for 2012–13, three campaigns were suggested although no numbers of letters were indicated.

81 Some other areas of the ATO use risk engines (computer programs that assess multiple data sets and criteria to determine a relative risk of non-compliance), or the Risk Differentiation Framework (a modelling tool that gives a risk profile of a specified population) to assist in compliance case selection.

high-risk of not complying with their PSI obligations, and typically include: amounts paid per contract; total income; number of payees; industry type; and the amount of retained earnings. These criteria apply to the taxpayer's gross income and as such capture the income before deductions are applied.

3.28 The case selection criteria are applied when needed (at least annually), allowing the selection of cases for Micro Active Compliance reviews and audits, or specific letter campaigns. Refreshing the case pool from time to time identifies new potentially high-risk cases, as taxpayers may not have lodged at the time of the previous case selection, or they may be new to the PSI population. For existing potential cases that are already identified as high-risk, running the case selection criteria will identify any new tax returns that were not previously lodged.

3.29 Other sources of information for potential compliance case selection include: personal services business determination requests that have non-favourable outcomes; ATO internal referrals⁸²; and media commentary. The results of the case selection process are discussed in Chapter 5.

Planning future compliance activities using compliance outcomes

3.30 As discussed in Chapter 2, the outcomes of PSI compliance activities are monitored and reported in ME&I's fortnightly heartbeat reports. The ATO's understanding of the PSI risk is well established, and the treatment strategies (such as marketing and education, letter campaigns, reviews and audits) have largely remained the same since the regime was introduced, although with a change in emphasis on targeting these activities.

3.31 Results from compliance activities are used to plan and improve future risk management activities. The results of letter campaigns are monitored, and the rate of voluntary disclosures used as a measure of the success of this strategy. The success of these campaigns has meant that more of these types of activities are being conducted. In the same vein, the strike rates of review and audit cases have improved following the selection of cases through matching information obtained from labour hire firms with the ATO's own data.

82 The number of referrals made to PSI from other areas of the ATO increased from five in 2008–09 to 20 in 2011–12.

Conclusion

3.32 PSI is considered by the ATO to be an 'endemic risk', as it continues to be identified through compliance and data matching activities. There are common links with the non-compliant behaviours of PSI risk participants and other contractor risks being managed by the ATO, such as PSI taxpayers not lodging tax returns or contractors who receive income that should be classified as salary and wages. The PSI risk assessment documents the risks, specific taxpayers, and the projects or areas within the ATO that have responsibility for mitigating these risks. The ATO acknowledges that it does not currently coordinate the interaction of all risk treatments, such as the inclusion of PSI participants in other streams' plans and compliance mitigation strategies. Capturing this information and analysing the outcomes of compliance activities would assist with the ongoing assessment and reporting of PSI risks as well as other risks relevant to the contractor population.

3.33 Comprehensive PSI risk assessments were conducted in 2008 and 2011, and show very little change in the risk profile. The introduction of the taxable payments reporting system from 1 July 2012 and replacing the PSI schedule of business tax returns with a set of specific questions will provide additional information for use in the ATO's next comprehensive PSI risk assessment, currently scheduled for 2014. As part of this process, it would be beneficial to include an updated estimate of the number of taxpayers not declaring PSI, in light of findings from the 2012–13 PSI risk summary (that 81.5 per cent of entities in a selected sample may have incorrectly classified their income by not declaring their personal services business status).

3.34 As it is difficult for the ATO to identify non-compliant taxpayers using only the PSI information from tax returns, data matching programs were undertaken using labour hire firm data in 2007, 2009, and 2011. Protocols and criteria for these programs were documented, and the results used to select potential compliance cases for letter campaigns, reviews and audits. Case selection criteria were applied to the taxpayer's gross income particularly to capture income before deductions were applied. The use of data matching for compliance case selection has contributed to the improved strike rate (the percentage of compliance cases that have an outcome) of active compliance cases, from 60.2 per cent in 2010–11 to 78.9 per cent in 2012–13.

3.35 Annual PSI risk treatment plans cover a range of compliance activities to educate taxpayers about PSI, increase understanding and test for non-compliance. The treatment strategies align with the risk behaviours

documented in the PSI risk assessment, but not all strategies can be implemented because of resource constraints. Past compliance results are used in planning future compliance strategies. More recently, data matching activities have been repeated and greater emphasis has been placed on letter campaigns, as an efficient method of interacting with a greater number of taxpayers. An estimate of the non-compliant population would also assist in the development of future PSI risk treatment plans.

4. Promoting Voluntary Compliance

This chapter examines the ATO's strategies for promoting compliance with the requirements of the PSI regime. Stakeholder's views on the PSI regime are also discussed.

Introduction

4.1 The ATO's approach to compliance is based on a model that helps it to understand what motivates people to comply or not comply with their taxation obligations. The compliance model assists the ATO to plan interventions that are proportionate and appropriate to the underlying cause of non-compliance. The model is structured around the following four strategies:

- make it easy—marketing and education provides information and guidance, facilitates lodgement of returns and engages stakeholders;
- help to comply—interpretive assistance helps taxpayers by clarifying taxation laws through public and private rulings, factsheets and practice statements, and responding to objections;
- deter by detection—active compliance intervention through letter campaigns, reviews and audits; and
- use the full force of the law—the prosecution of significant fraud or serious tax evasion activity.⁸³

4.2 As discussed in Chapter 3, the number and type of PSI compliance activities are determined following an assessment of compliance risks. The ANAO examined the ATO's approach (primarily between 2009–10 and 2012–13) to promote voluntary compliance with the PSI regime through its marketing and education and interpretive assistance strategies.

83 ATO, *Compliance in Focus 2013–14*, July 2013, pp. 3–4.

Marketing and education

4.3 During 2007 and 2008, the ME&I communications team produced a plan to review the existing 37 PSI publications.⁸⁴ The plan stated that: the publications contained duplication; essential information was split across publications; and some legislative changes were not incorporated. In addition, taxpayers and tax practitioners had difficulty identifying the publications they needed.

4.4 The plan used the January 2008 PSI population profile as a basis for the review. Relevant sub-risks included: a lack of knowledge and understanding of the PSI legislation; the complexity of the legislation; and the high reliance by taxpayers on tax practitioners to determine PSI compliance. The plan acknowledged that a large number of PSI taxpayers potentially enter and exit the PSI system each year due to the 'churn' of small businesses. For these reasons, reviewing the existing publications was seen as a risk treatment strategy.

4.5 During 2008, the 37 print and online publications were consolidated into 13 online publications (Appendix 3 lists the 15 primary publications by topic as at June 2013).⁸⁵ PSI-user product testing conducted during 2006 assisted with rewriting, simplifying and updating the content, removing duplication and improving the consistency of information. The PSI webpage on the ATO website was also restructured to improve accessibility.

84 These publications included paper and online guides on: an introduction to PSI; the personal services business tests; obtaining a personal services business determination; self assessment checklists; industry-specific fact sheets; and instructions and schedules for PSI in tax returns in different years. Online-only guides included PSI deductions, definitions of PSI and PSI businesses, frequently asked questions and a checklist for completing a tax return.

85 These publications differentiate between sole traders, companies, partnerships and trusts and included guides on: completing tax returns; personal services business determinations and application instructions; Part IVA general anti-avoidance rules; avoiding common mistakes; and industry specific guides for financial planners, engineers, building and construction workers and road transport workers.

Current marketing and communications activities

4.6 At the time of the audit, the Compliance—Strategic Communications team (part of the Marketing and Education stream) was responsible for PSI-related marketing and education activities.⁸⁶ The monthly teleconference between PSI teams was the primary method for reviewing strategies and revising plans in relation to PSI marketing and communications activities.

4.7 The Compliance—Strategic Communications team has produced annual PSI Communication Strategy Plans since 2010–11. The 2010–11 and 2011–12 plans were comprehensive documents that incorporated up-to-date risk and population information and a summary of media coverage and existing ATO treatment strategies for PSI. Related yet distinct marketing and communications activities for other projects⁸⁷ were acknowledged as there was the potential for the same taxpayers or tax practitioners to be contacted by the ATO more than once, albeit on different topics. In 2012–13 a shorter one page summary of the communications strategy was developed, after a decision at the monthly PSI coordination teleconference between streams involved in PSI administration.

Specific personal services income publications

4.8 The 15 primary PSI publications include online factsheets that are accessed through the '*Personal services income essentials*' webpage on <www.ato.gov.au/Business/Personal-services-income>. This webpage presents all information relating to PSI and personal services businesses in one place and provides logical paths to navigate the material. This page is also the first 'hit' referenced by the ATO's internet search function.

4.9 For businesses unsure whether individual workers are employees or contractors, the ATO has developed two online decision tools.⁸⁸ One is specifically for the building and construction industry, and the second is for all other workers. The ATO's website states that these tools can also be used by individuals to determine their status, although the tools are not designed for use where intermediaries such as labour hire firms are involved. If the results

86 There were two staff members equating to 0.7 full time equivalent staff working on PSI.

87 Other projects acknowledged included the Level Playing Field project, and ME&I's Employer Obligations stream.

88 Available at <<http://ato.gov.au/General/Contractors/Employee-or-contractor/Employee-contractor-online-decision-tool/>> [accessed 2 July 2013].

conclude that the individual is a contractor, advice is provided to the employer on obligations such as Pay As You Go Withholding and superannuation.

4.10 No such tool exists to assist taxpayers or tax practitioners to work through the self-assessment steps of the PSI rules. Given the complexity of the PSI legislation is acknowledged as contributing to non-compliance, and the recent removal of the PSI schedule in tax returns, there would be value in strengthening the support for PSI self-assessment through developing an online decision tool(s) to assist individuals and personal services businesses in applying the PSI tests. There would also be merit in revising the advice given by the employee/contractor decision tools to include mention of the PSI rules and when the rules may or may not apply. Such advice could also be incorporated into some of the questions in the employee/contractor decision tools, which have similar decision points to some of the PSI tests.⁸⁹ At the time of the audit, the ATO advised that options for a PSI decision tool were being considered.

PSI communications

4.11 The Compliance—Strategic Communications team contributes to staff training material, the content of letters for compliance campaigns and the scripting for call centre staff to use during campaigns. From 2011–12, the team has also provided support for communicating with specific PSI interest groups. This includes presentations at external stakeholder seminars, content in broader ATO publications, ‘webinars’ and ‘webcasts’.⁹⁰ In August 2012, the team reported the results of these activities for 2011–12, stating that ‘reporting the effectiveness of communication activities can be challenging in relation to a complex topic such as PSI’. Nevertheless, the report gives estimates of the reach (the estimated audience of the communication), and concluded that further communication was required to raise awareness of PSI to those new to business, and to continue to improve tax practitioners’ understanding of PSI. Table 4.1 summarises these activities and their estimated audience reach for 2012–13.

89 For example, if answering yes to labour hire firm involvement, the user could be reminded of the PSI rules.

90 A webinar is an online seminar that allows interactive communication between the participants. A webcast is a recorded presentation that can be viewed at any time using online media tools.

Table 4.1: PSI communications and audience reach, 2012–13

Activity undertaken	Audience reach
<i>PSI for sole traders</i> —online publication	77 100 web visits
<i>PSI for companies, partnerships and trusts</i> —online publication	65 858 web visits
Personal services business web content (revised September 2012)	5448 web visits
September 2012 email to subscribers of ‘What’s New’ for tax professionals—included updates on PSI topics	20 409 subscribers
September 2012 <i>eLink</i> , an email bulletin for tax professionals—reporting of PSI and business income	26 449 subscribers
<i>PSI—completing your tax return</i> —online publication (revised October 2012)	9333 web visits
<i>PSI—avoiding common mistakes</i> —online publication (revised January 2013)	16 771 web visits
<i>Tax basics for small business—issues for contractors</i> webinar (PSI was one topic covered)	75 webinars 686 attendees
April–May 2013 <i>Tax practitioner update</i> webinar—PSI was one topic included, focusing on the results test and 80 per cent rule	67 webinars 3677 attendees

Source: Information provided by the ATO.

4.12 The Aggressive Tax Planning Business Line also advises taxpayers how to comply with their PSI obligations. Taxpayer Alerts (available at <<http://law.ato.gov.au/atolaw/browse.htm?toc=02:TPA>>) are intended to be ‘early warnings’ of ATO concerns about tax planning issues. One of five alerts issued in 2011 related to PSI: *TA 2011/2—Certain labour hire arrangements utilising a discretionary trust to split income*.⁹¹ The only other PSI related alert was in 2002: *TA 2002/4—Personal Services—Partnership Arrangement*.⁹²

Interpretive assistance

4.13 The Interpretive Assistance stream of ME&I provides general advice to taxpayers and tax practitioners, as well as:

- personal services business determinations—notices stating whether the taxpayer conducts a personal services business;

⁹¹ This alert describes an arrangement where a labour hire firm makes a discretionary trust structure available to individual taxpayers for the purpose of alienating PSI and splitting the income.

⁹² This alert describes an arrangement where a taxpayer who earns PSI enters into a partnership with other unrelated taxpayers who also earn PSI, for the purpose of alienating PSI and splitting the income.

- public rulings—publicly available advice on interpretation of the laws administered by the Commissioner;
- private rulings—taxpayers who have specific circumstances for which they consider that the general guidance provided by the ATO does not give sufficient clarity may seek a private ruling;
- objections—taxpayers can object against some decisions the ATO makes about their tax affairs; and
- assistance with the Part IVA program.⁹³

4.14 Monthly accountability reports are submitted to the ME&I executive and include year-to-date total deliverables against planned activity levels and service standards, providing a ‘traffic light’ snapshot of progress. PSI is rarely mentioned in these reports.

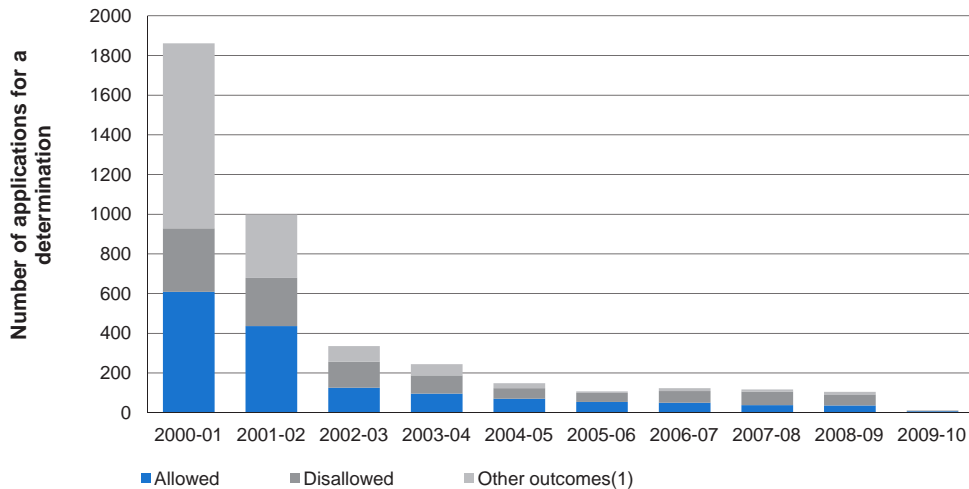
Personal services business determinations

4.15 Personal services business determination applications are available online, and can be submitted electronically. Determinations can: be for specified periods; have conditions applied depending on the applicant’s circumstances; and be revoked if the ATO is no longer satisfied the conditions are still met. Recording methods changed during 2009–10, when Interpretive Assistance began using the Client Contact-Work Management-Case Management (CWC) system for managing work items.⁹⁴ The ATO advised that, because of this change, there is no reliable record of PSI determinations (and some other data) for 2009–10.⁹⁵ Figure 4.1 shows the number of determinations allowed and disallowed from 2000–01 to 2009–10.

93 In 2012–13, there were 1.7 full time equivalent Interpretive Assistance staff working on PSI-related matters, and 0.1 full time equivalent staff assisting with the Part IVA program.

94 CWC is an ATO enterprise case management system used to record all contact with clients, including compliance cases. Prior to this, records were kept in the Technical Decision Making System, and during this changeover both systems were used concurrently for a number of months.

95 A number of records are unreliable for this period as procedural documents for staff needed improvement, and staff were inexperienced with the new system.

Figure 4.1: Personal services business determinations, 2000–01 to 2009–10

Source: Information provided by the ATO.

Note 1: Includes: no further action; refusal to rule; unable to rule; unknown decision; and withdrawn.

4.16 The ATO advised that the initial peak in applications was due to taxpayers being uncertain of their status under the PSI legislation. Minor peaks, such as those in 2011–12 and 2012–13 (shown in Table 4.2) may be caused by letter campaigns prompting PSI taxpayers to seek determinations, although specific reasons have not been recorded. The ATO advised that the high number of ‘no outcome recorded’ in 2010–11 was due to poor record keeping, and that the data is more reliable in 2011–12, after an emphasis on staff following data entry procedures.

Table 4.2: Personal services business determinations, 2010–11 to 2012–13

Determination by outcome	2010–11	2011–12	2012–13
Favourable	22	76	55
Partly favourable	-	1	3
Unfavourable	10	49	33
Withdrawn	7	4	25
No outcome recorded	85	12	17
Other	6	10	22
Total	130	152	155

Source: Information provided by the ATO.

4.17 In 2012–13, 37.4 per cent of determinations were in the applicant’s favour or partly favourable, 21.3 per cent were unfavourable and 41.3 per cent had no outcome recorded, other outcome, or were withdrawn. Overall, there is a reasonably high number of unfavourable or other outcomes which suggests there would be benefit in the ATO improving its recording practices⁹⁶, but also in determining the reasons for the unfavourable outcomes and using this information to better communicate the basis for applying for a determination.

4.18 The Micro Active Compliance stream plans for 2009–10 to 2012–13 state that some compliance cases will be selected from entities that had a determination refused, and for whom it appeared were still not correctly applying the legislation. To date, none of these cases have been followed up.

Public rulings

4.19 Public rulings are for external and internal reference, and all current PSI public rulings are on the ATO website (listed in Table 4.3). In discussion with the ANAO, stakeholders did raise concerns about the complexity of the PSI regime, but they did not specifically mention public rulings. The lack of recent public rulings is likely to reflect the maturity of the PSI regime.

Table 4.3: Public rulings for PSI as at 30 June 2013

Current PSI public rulings
TR 2001/7 Income tax: the meaning of personal services income.
TR 2001/8 Income tax: what is a personal services business.
TR 2003/6 Income tax: attribution of personal services income.
TR 2003/10 Income tax: deductions that relate to personal services income.
TR 2005/3 Income tax: attributed personal services income that is foreign income—allowance of a foreign tax credit to an individual where foreign tax paid by a personal services entity.

Source: ATO legal database available at <<http://law.ato.gov.au/atolaw/index.htm>>, [accessed 30 June 2013].

Private rulings

4.20 A private ruling sets out the ATO’s opinion about the way a tax law applies, or would apply, to a taxpayer in relation to a specific circumstance. Table 4.4 provides a summary of outcomes of private rulings for PSI from

96 The ANAO examined the 85 determination records labelled ‘no outcome’ from 2010–11, and found that 28 of them had information in the activity description field that indicated they were favourable or unfavourable, but this was not recorded against the determination.

2000–01 to 2012–13, excluding 2009–10 as reliable data was not available. The ATO could not readily provide an explanation for the 2008–09 peak of 26 unfavourable private rulings.⁹⁷

Table 4.4: Private rulings for PSI, 2000–01 to 2012–13

Private rulings by outcome	00–01	01–02	02–03	03–04	04–05	05–06	06–07	07–08	08–09 ⁽¹⁾	10–11	11–12	12–13
Favourable	0	6	16	9	6	3	7	7	17	8	6	7
Partly favourable	0	2	7	8	0	5	0	0	0	0	2	1
Refusal to rule	0	0	1	4	4	1	2	3	1	0	1	1
Unfavourable	0	5	6	3	3	0	5	7	26	0	2	2
Withdrawn	0	2	6	4	2	5	4	5	5	3	3	10
Invalid	0	1	7	1	1	3	0	1	0	0	1	1
No outcome recorded	0	0	0	0	0	0	0	0	0	15	0	0
Total	0	16	43	29	16	17	18	23	49	26	15	22

Source: Information provided by the ATO.

Note 1: The ATO advised that there is no reliable record of private rulings for 2009–10 as reporting methods changed part-way through that year with the move to the CWC system.

4.21 The ATO advised that no assessments are issued without appropriate levels of review, including quality checkpoints and authorisation guidelines. Private rulings are also subject to quality assurance review, using the ATO-wide Integrated Quality Framework (IQF).⁹⁸ Table 4.5 provides a summary of the IQF assessments on PSI private rulings for 2009–10 to 2012–13.

97 This data is held on the legacy system, which requires manual searching of each record, as opposed to running a standard report.

98 The IQF uses a corporate sampling methodology, and is applied to both interpretive assistance and active compliance cases. The assessment involves rating nine quality measures (integrity, transparency, consistency, administrative soundness, timeliness, effectiveness, efficiency, correctness, and appropriateness to taxpayers' requirements and circumstances) against five assessment grades (very high, high, meets standard, aligned, and not aligned); as well as two risk-based quality ratings (critical and important).

Table 4.5: IQF assessments on PSI private rulings, 2009–10 to 2012–13

Period	Number of assessments	Outcomes
2009–10	1	1 Aligned
2010–11	9	9 Aligned
2011–12	1	1 Meets Standard
2012–13	3	1 Aligned; 2 Meets Standard

Source: Information provided by ATO.

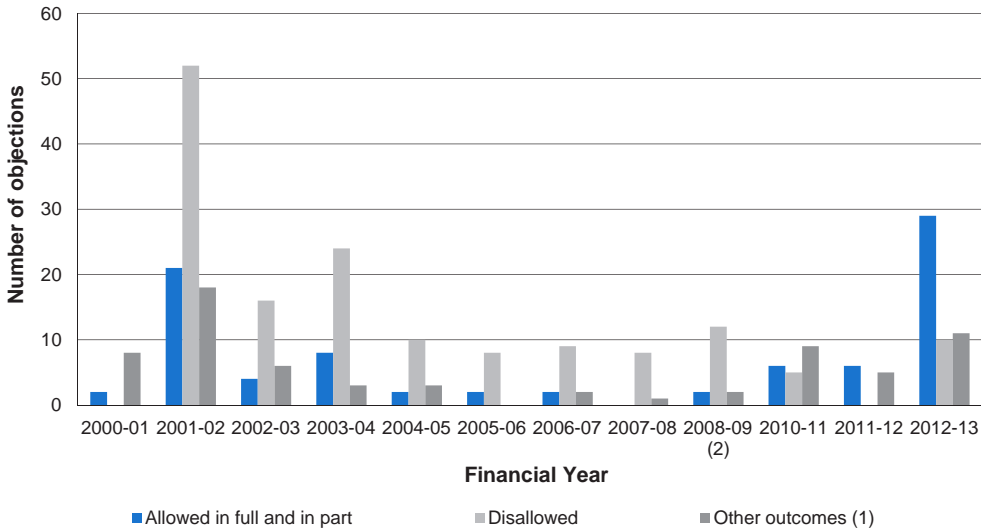
4.22 The positive IQF results indicate good processes for the management of private rulings. For additional assurance of the quality of PSI-related rulings (amongst other low-volume rulings), a separate review is planned for the first half of 2013–14. This was initially due to be completed by the end of October 2012, but the ATO advised there was a delay due to competing priorities.

Objections

4.23 Prior to July 2013, when a taxpayer objected to a PSI decision made by the ATO (including the results of determinations, private rulings or compliance reviews or audits) the objection was determined by Interpretive Assistance.⁹⁹ The number of objections relating to PSI and their outcomes from 2000–01 to 2012–13, excluding 2009–10 is provided in Figure 4.2.¹⁰⁰ This is a small proportion of the total objections received by ME&I each year, with 25 146 being received in 2011–12.

99 The determination of objections was undertaken independently through: objections to PSI work undertaken by Micro Active Compliance (such as reviews and audits) are reviewed by Interpretive Assistance staff; and objections to PSI work undertaken by Interpretive Assistance staff (such as determinations and rulings) are reviewed by Interpretive Assistance staff in a separate team and location. Objections and other dispute resolution processes were changed in July 2013.

100 Objections for 2009–10 are not reported as the ATO has no reliable record of these due to recording methods changing with the commencement of using the CWC system.

Figure 4.2: Objections relating to PSI, 2000–01 to 2012–13

Source: Information provided by the ATO.

Note 1: Other outcomes include: no further action; no outcome recorded; invalid; and withdrawn.

Note 2: There is no reliable record of private rulings for 2009–10 as reporting methods changed part-way through that year with the move to the CWC system.

4.24 Objections relating to PSI in 2010–11 represented 10 per cent of PSI decisions in that year (20 objections from 199 decisions), and five per cent in 2011–12 (11 objections from 233 decisions).¹⁰¹ In 2012–13, 29 of the 50 objections were allowed in full or in part. The ATO advised that the recent peak in objection numbers in 2012–13 was related to some taxpayers seeking to self amend multiple related entities (involving combinations of their personal, company, trust, and /or spouse’s tax returns).¹⁰² This approach could be related to taxpayers targeted during a PSI letter campaign, but this information was not analysed or recorded.

4.25 There were no formal complaints relating to PSI in 2009–10 or 2010–11, two complaints in 2011–12 and one complaint in 2012–13. These figures would suggest little dissatisfaction with PSI processes and practices. Knowledge of the most common types of PSI questions from taxpayers may help with

¹⁰¹ The total of PSI decisions was calculated from determinations, private rulings and active compliance cases, but excluding voluntary disclosures.

¹⁰² In accordance with the ATO document *Practice Statement Law Administration 2008/16, request for amendment of income tax assessments*, a taxpayer can use an amendment to correct a mistake or omission. In contrast, an objection is a formal avenue of dispute resolution, and requires full consideration of the facts and the application of the law to them.

targeting assistance to taxpayers, but Interpretive Assistance does not record this information. Anecdotally, most telephone calls are requests for determinations and ATO staff consider that most people contacting them understand the PSI regime. The poor data quality in relation to the recording of the outcome of some cases¹⁰³ in CWC also makes it difficult to analyse any trends.

4.26 Currently, the ATO does not measure whether Interpretive Assistance activities assist taxpayers to better understand and comply with their PSI obligations. In November 2011, the Risk Management Committee discussed including interpretative assistance information within risk reporting, as it would increase the understanding of risks under mitigation. At the time of this audit no action had been taken in this regard.

Clarifying Part IVA

4.27 The Government, Litigation and Priority Issues stream manages the Part IVA program, which is intended to provide clear legal authority around the application of Part IVA to income splitting and income retention in personal services businesses.¹⁰⁴ Early in the implementation of the PSI regime, tax practitioners raised concerns at the ATO Tax Practitioner Forum regarding the potential application of this law. The ATO decided to clarify this matter through a test case litigation program.¹⁰⁵

4.28 The program was first announced in March 2003, in relation to arrangements involving the splitting of PSI by personal services businesses¹⁰⁶, and the ATO worked in consultation with tax and legal practitioners to identify 10 potential test cases. In November 2004, the Commissioner asked for a review of the program, and in December 2005, the program was refocused to concentrate on more artificial or contrived arrangements.¹⁰⁷ As a result, the number of potential test cases was reduced to two.

103 For example, in 2010–11, 85 of the 130 applications for a personal services business determination had no outcome recorded (discussed in paragraph 4.17).

104 As discussed in Chapter 1, Part IVA of the *Income Tax Assessment Act 1936* may apply to personal services businesses where the Commissioner considers that a scheme has been entered into for the dominant purpose of securing a tax benefit.

105 This is part of a broader program that provides financial assistance to taxpayers who are litigating matters that will clarify the law that the ATO administers.

106 ATO, Media Release Nat 03/29, *Tax Office to Test Some Income Splitting Arrangements by Personal Services Businesses in Courts*, 14 March 2003.

107 ATO, Media Release Nat 2005/70, *Practical Guide to Part IVA*, 13 December 2005.

4.29 In November 2008, the ATO announced that it would not proceed with those two cases, as Senior Counsel had advised neither was likely to result in a clarification of the law. Instead, a limited compliance program would be undertaken that could potentially clarify the law in respect of the application of Part IVA to personal services businesses; and there would be a review of existing ATO public rulings, in consultation with a newly formed National Tax Liaison Group working group.¹⁰⁸

Limited compliance program

4.30 Risk and Information Management Services and Micro Active Compliance conducted a data mining exercise to identify potential cases using data from the 2005 to 2007 income tax years. The parameters were agreed in consultation with a panel from ME&I, the Tax Counsel Network and Legal Services Branch of the Law and Practice Sub-plan.¹⁰⁹ In November 2008, the panel identified 25 potential cases, and letters and questionnaires were sent to these taxpayers asking for information relating to the 2005 to 2008 tax years in December 2008. In June 2009 the panel recommended that five of the cases be escalated to audit.¹¹⁰

4.31 Commencement of the audits awaited the impending Board of Taxation's post implementation review of the PSI legislation and the Henry Review of Australia's future tax system, as reforms of the law arising from these reviews may have meant that reliance on Part IVA would no longer be needed. No such reforms occurred, and in December 2010 the panel decided to commence the five audits, notifying these taxpayers by letter. Despite the ATO's efforts to ascertain that these cases did relate to personal services businesses, one taxpayer disclosed that they were not a personal services business. This was accepted; however the taxpayer was required to substantiate claims for income tax deductions.

108 ATO, *National Tax Liaison Group Minutes*, Agenda Item 16.2, November 2008.

109 The criteria included that: the entity must be a declared personal services business; there must be minimal amounts of non-PSI (sale of goods, investment income, income from a business structure, income from the use of an asset); and there must be income-splitting, or retained profits.

110 Seventeen of the cases were referred to Micro Active Compliance as it appeared that they were not personal services businesses. The three remaining cases were closed with no further action.

4.32 Of the remaining four cases, three were considered by the General Anti-Avoidance Rules¹¹¹ panel in February 2012 and finalised as follows:

- Part IVA determinations were made, assessments amended and compensating adjustments made for two years. The audit case was closed in September 2012. The taxpayer objected to the penalty decision only, so the matter will not proceed to litigation;
- Part IVA did not apply in the second case—the taxpayer was provided with education in respect of some other issues identified at audit. The audit case was closed on 12 September 2012; and
- at the taxpayer’s request, the matter was considered by the General Anti-Avoidance Rules Panel a second time in July 2012. At this meeting, Part IVA determinations were made and assessments amended for four years. The audit case was closed in October 2012. The taxpayer objected to the decisions for all four years. This taxpayer has been granted test case funding.

At the time of the audit, the fourth matter was still being decided.

National Tax Liaison Group working group

4.33 From December 2008, feedback was requested from the National Tax Liaison Group working group on issues relating to the alienation of PSI and Part IVA.¹¹² In July 2009, a discussion paper was provided to members, with possible content for a new public ruling. In September 2009 it was agreed that the ATO would use the feedback provided by members to develop a ruling, and that the working group had completed the task for which it was set up.

4.34 The ATO added the topic to the public rulings program in March 2011, but delisted the process in September 2011. As with the limited compliance program, events which led to this decision included the Board of Taxation and the Henry Reviews in 2009 and 2010. Additionally, late in 2009 a private ruling application to the ATO provided an opportunity to clarify the law regarding the application of Part IVA to the retention of profits—one of the aspects to be clarified by the program. However, the taxpayer advised in March 2012 that

111 The General Anti-Avoidance Rules panel was established by the Commissioner to advise the ATO on the application of the general anti-avoidance rules (of which Part IVA is one). The Panel’s membership is drawn from expert business and professional people, and senior ATO officers.

112 Minutes of the Alienation Working Group of the National Tax Liaison Group are available at <http://ato.gov.au/taxprofessionals/content.aspx?menuid=0&doc=/content/00192307.htm&page=2&H2> [accessed 14 August 2013].

they were withdrawing the ruling application. The ATO's focus reverted to the five audits (discussed in paragraph 4.31) being undertaken at the time as part of the limited compliance program.¹¹³

4.35 The delay in clarifying Part IVA for personal services businesses highlights the difficulty in identifying appropriate test cases. In discussion with the ANAO, stakeholders also raised concerns about the delay, as it has caused uncertainty for taxpayers in organising their personal services businesses to comply with the regime (discussed in paragraph 4.40). A review of the circumstances surrounding the PSI private rulings, objections and compliance cases could assist the ATO to determine if there is still a need for continuing with the PSI Part IVA limited compliance program.

Stakeholder feedback

4.36 Prior to the October 2009 report on the *Post Implementation Review into the Alienation of Personal Services Income Rules*, the Board of Taxation called for submissions from interested parties. In response to five broad issues raised by the Board, 13 submissions were received from a variety of professional bodies representing: industry bodies, a contractor and contractor associations (seven); tax advisers and accountants (four); and employee unions (two). The ANAO's analysis of these submissions is provided in Appendix 4 and the submissions generally expressed the view that the PSI legislation was complex, inappropriate to industry circumstances and unnecessary.

4.37 The ANAO contacted those stakeholders who had made a submission to the 2009 Board of Taxation review, and several others, interviewing eight.¹¹⁴ The seven that had made previous submissions stated that their comments were still relevant and remained the same, although one added that while PSI had been a contentious topic prior to the Board of Taxation review, it had now stabilised.

4.38 The ANAO asked stakeholders about taxpayers' and tax practitioners' knowledge of the PSI regime. Responses were mixed, with three stakeholders

113 The proposed draft ruling was not continued, as several matters that could clarify the situation were likely to proceed to litigation, and the ATO considered it preferable to get court guidance rather than continue to develop the ruling.

114 Interviews were held with CPA Australia; the Association of Professional Engineers, Scientists and Managers Australia; the Civil Contractors Federation; the Housing Industry Association; Independent Contractors Australia; Master Builders Australia; and Taxpayers Australia. The ANAO also interviewed an individual engineer who had made a submission to the Board of Taxation review.

stating that there was high awareness, and the rules and the regime were working. Five stakeholders considered the legislation to be complex and confusing, with the rules poorly understood. Of the two tax agent associations, one stated that it received no concerns from members, whereas the other said the PSI rules, especially the results test, were the second most common topic on their free assistance telephone call line (the most common being capital gains tax).

4.39 All eight stakeholders described the PSI rules as difficult and costly to comply with or inappropriate for the nature of changes in industry working relationships. Examples were given of individuals who maintain a mobile workshop rather than physical premises (meaning the business premises test cannot be met), and seek custom by word of mouth rather than advertising (making the unrelated clients test hard to satisfy).

4.40 Additional comments made in relation to the operation of, and the ATO's administration of, the PSI regime included:

- two stakeholders said that the ATO's education and guidance material was very good;
- three stakeholders felt that levels of compliance with the PSI rules were reasonable, and that the ATO had struck a balance between compliance activities in this area and the far larger problem of the cash economy¹¹⁵;
- two stakeholders believed there was inconsistency in the way the ATO applied the regime, depending on which officer handled the case;
- two stakeholders raised the lack of certainty around Part IVA as problematic, particularly as there was a widespread perception that if your business operated properly and you passed the PSI tests then the entity was clearly compliant and Part IVA should not apply; and
- two stakeholders mentioned the cost of compliance with the PSI rules. One of these, a tax agent association, stated that working through the PSI tests means that tax agent fees may be higher than they would be for a standard tax return. In addition, whether or not clients meet the rules needs to be monitored between years, as taxpayer's circumstances can change.

¹¹⁵ The ATO uses the term cash economy to describe people in business deliberately using cash transactions to hide income and evade tax obligations.

4.41 The ATO undertakes a wide range of consultation and research to assist with understanding client's views and behaviours in relation to taxation topics. These include consultative forums such as the ATO's Tax Practitioner Forum, and surveys on different topics with different segments of the taxpayer/tax practitioner population. No PSI-specific topics or questions have been included in any of the ATO's surveys of community members, businesses or tax practitioners. The only mention of PSI appears in tax agents' responses to the *State of the Industry Survey 2010–Tax Agents Final Report* as one area found to be complex. Of 335 respondents, 19 per cent (64 respondents) found it a complex area 'hard to keep on top of', while two per cent (seven respondents) found it the most complex area of tax legislation.¹¹⁶ In the same survey, 79 per cent (265 respondents) of tax agents stated that they deal with PSI and 28 per cent (94 respondents) of agents stated that they specialise in it.

4.42 As previously mentioned, around 90 per cent of taxpayers affected by the PSI rules use a tax agent. The two tax agent associations that the ANAO interviewed had different perceptions of tax agent's understanding of the PSI regime, and the ATO has not included any detailed PSI questions in its surveys. It may be of benefit for the ATO to explore this topic further in its research, to determine whether current PSI-related marketing and education activities are most effectively tailored to the intended audience.

Conclusion

4.43 The ATO's strategies for promoting voluntary compliance with the PSI regime are generally appropriate. Marketing and education activities include online information, presentations to external stakeholder groups (including tax practitioners) using media such as webinars and webcasts, and all primary PSI-related information has been recently updated. Although measuring the effectiveness of communication activities is difficult, the reach of communication is being measured by the ATO. The ATO's risk assessments acknowledge that further communication is required to raise awareness of PSI obligations to those new to business, and to improve tax practitioners' understanding of PSI. In this regard, there would be benefit in the ATO

¹¹⁶ Respondents were asked to select between nine areas of tax legislation, and PSI was selected by the least respondents (superannuation was rated the hardest to keep on top of by 66 per cent of respondents). Respondents were then asked to select the most complex area out of the same nine topics and PSI was again selected by the least respondents (superannuation was selected by 31 per cent of respondents).

developing online decision tools to assist taxpayers to self-assess and apply the PSI tests, and to incorporate PSI information into the existing employee/contractor decision tool.

4.44 Interpretive assistance staff provide general advice to taxpayers and practitioners, as well as managing determinations, rulings and objections. Reports of the activities undertaken have been compromised in the past, following changes to recording and management systems in 2009–10. The ATO advised that poor record-keeping during this period and in 2010–11, resulted in the number and outcome of some activities being unreliable. ATO data shows that the number of determinations has decreased significantly over time (from over 1800 in 2000–01 to 155 in 2012–13), despite the stated complexity of the legislation and the entry of new taxpayers into the system every year. However, the relatively high proportion of unfavourable outcomes (32 per cent, or 49 of 152 in 2011–12 and 21 per cent, or 33 of 155 in 2012–13) for determinations would suggest a need for greater communication and education. Adverse determinations were also to be considered in compliance case selection but this has not yet occurred.

4.45 The ATO does not currently analyse the basis for trends in taxpayer PSI queries or requests for determinations, private rulings and objections. This analysis would assist the ATO to better tailor the education material and advice provided to taxpayers and tax practitioners, as well as provide information on the effectiveness of these activities.

4.46 Stakeholders have expressed confusion about the interaction between the PSI rules and Part IVA. A Part IVA test case program began in March 2003 and has continued as a limited compliance program since 2009. Both programs were intended to provide clarity around the application of Part IVA to personal services businesses. However, the program still has not resulted in a clear outcome or a case being tested before the courts. As a result, taxpayer uncertainty in organising their personal services businesses to comply with the regime remains and was raised as a concern by some stakeholders. Given the lack of success of the Part IVA program in clarifying the application of Part IVA to personal services businesses over the past 10 years, the ATO may wish to review whether there is merit in continuing the program.

4.47 Stakeholders interviewed by the ANAO held mixed views about the PSI regime. Some described the PSI rules as difficult to comply with or inappropriate for the nature of changes in industry working relationships whereas others said the regime had matured and was operating more

smoothly. The ATO undertakes a wide range of consultation and research to assist with its understanding of taxpayers' views and behaviours in relation to taxation topics. It may be of benefit for the ATO to explore this issue further in its research and client surveys, in order to determine whether current PSI-related communication material and advice are the most effective for the PSI audience.

5. Addressing Non-Compliance

This chapter discusses the ATO's strategies for addressing taxpayer's non-compliance with their PSI obligations, and for assessing the effectiveness of compliance activities.

Introduction

5.1 The ATO's compliance model¹¹⁷ incorporates two strategies intended to address non-compliance: deter by detection (active compliance); and use the full force of the law (prosecution). Each year, the ATO publishes its Compliance Program, which highlights the compliance topics it will focus on in that year, and the activities it will undertake to address them. PSI has been mentioned briefly in most annual compliance programs from 2002–03 onwards.¹¹⁸

5.2 The active compliance activities undertaken for PSI include letter campaigns, reviews and audits. No prosecutions have been pursued by the ATO in relation to PSI. The ANAO examined the ATO's approach to:

- addressing non-compliance (primarily between 2009–10 and 2012–13) by the Micro Active Compliance stream; and
- assessing the effectiveness of compliance activities.

Active compliance activities

5.3 The PSI team, part of the Micro Active Compliance stream, are responsible for conducting active compliance activities to target non-compliance with the PSI rules.

Letter campaigns

5.4 As previously mentioned, the ATO uses PSI letter campaigns¹¹⁹ to collect intelligence, raise awareness of the need for taxpayers and tax agents to review income using the PSI rules, and also to inform taxpayers that the ATO is aware of discrepancies in their tax returns and is taking an interest in their

117 The compliance model is described in Chapter 4, paragraph 4.1.

118 In 2013–14, the Compliance Program was renamed Compliance in Focus.

119 The ATO considers letter campaigns to be an element of active compliance because they actively target potential non-compliance with tax obligations.

tax affairs. This is less resource-intensive than reviews and audits, and provides the opportunity to interact with a larger number of taxpayers.

5.5 Letter campaigns target a specific population, for example: companies and trusts that identify as personal services businesses, and declare income within a certain range. Risk and Information Management Services select the taxpayers for the campaign, and Compliance—Strategic Communications assist Micro Active Compliance to develop the letters and scripting for call centre staff to use if taxpayers have questions during the campaigns. Letters are prepared both for taxpayers and their tax agents, and all letters go through a process of corporate review and clearance and are recorded in a corporate correspondence register. Non-responses are not followed up by the ATO, although these could be subject to a compliance review to determine whether non-compliance had occurred.

5.6 Micro Active Compliance stream plans specify the number of letters to be issued, and the topics they will target, with four ‘prompter’ letter campaigns¹²⁰ being conducted between January 2012 and June 2013¹²¹:

- 2000 letters were planned for three campaigns in 2011–12. Two campaigns were conducted with 2631 letters sent to taxpayers; and
- 1493 letters were planned for three campaigns in 2012–13. A campaign of 835 letters was conducted in September 2012 and a second campaign of 5000 letters was conducted in May and 2264 letters in June 2013.

5.7 Table 5.1 summarises the results of recent letter campaigns as at 30 June 2013. Voluntary disclosures¹²² are recorded when taxpayers request a change to a previously lodged tax return. These can relate both to the amount earned and simple amendments, for example, where the taxpayer discloses that their income includes PSI but this does not alter the tax payable.

120 A prompter campaign is a letter that prompts the taxpayer to submit certain details, or in this case, check their compliance with the PSI rules.

121 One thousand letters were planned for one campaign in 2010–11, but none were sent due to resource limitations.

122 A voluntary disclosure is recorded when a taxpayer informs the ATO of a false or misleading statement or a change that increases their tax or reduces their credits, and they are not prompted or persuaded.

Table 5.1: Results of PSI letter campaigns

	Jan 2012	Jun 2012	Sep 2012	May/June 2013
Rationale	Taxpayers who report PSI and may incorrectly self-assess as a personal services business.	Taxpayers who indicate they receive business income when it may, in full or in part, be PSI.	Taxpayers who report PSI and may incorrectly self-assess as a personal services business.	Taxpayers who indicate they receive business income when it may, in full or in part, be PSI.
Letters to taxpayers	663	1968	835	7264
Voluntary disclosures ⁽¹⁾	80	294	87	176
Success rate	12%	15%	10%	Not yet reported
Additional tax identified	\$245 206	\$730 839	\$161 933	Not yet reported

Source: Information provided by the ATO.

Note 1: The results of these campaigns update over time, as taxpayers lodge their returns. Results for the May/June 2013 campaign were not available at the time of preparing this report.

5.8 The ATO has advised that increasingly, letter campaigns are taking the place of comprehensive reviews and audits to enable a greater coverage of the PSI population at a considerably smaller resource cost, although they do not have as high a success rate as matching data from labour hire firms. The June 2012 and May–June 2013 letter campaigns are the only recent compliance activities directed at potential non-declarers of PSI, estimated in 2008 to be twice as many in number as those that declare PSI. The ATO assessed that the results from the campaigns have been positive, with the three letter campaigns in 2012 having a success rate of between 10 and 15 per cent, and voluntary disclosures providing approximately \$1.1 million in additional revenue as at June 2013.

5.9 The 2012–13 Micro Active Compliance stream plan includes a performance measure for letter campaigns: ‘achieve a lodgement and/or amendment request response rate of 5 per cent for each prompter campaign’.

Reviews and audits

5.10 Compliance reviews and audits are typically undertaken to target non-compliance by specific taxpayers. Reviews provide the ATO with the opportunity to assess the risk concerning selected taxpayers, and issues detected may be escalated to an audit. Audits are a more intrusive and

resource intensive examination of the affairs of a taxpayer. The ATO uses the CWC system to record and manage active compliance cases.¹²³

5.11 The manager of the PSI team selects potential cases from the case pool (as discussed in Chapter 3, cases are selected by Risk and Information Management Services) and conducts a preliminary profile against the taxpayer's previous tax returns and any previous compliance actions. Cases considered appropriate to proceed are allocated to a staff member, entered into CWC, and a more detailed profiling exercise is conducted. Cases that are deemed not appropriate to progress are not documented on the system. The taxpayer is contacted once a decision has been made to proceed with a review or audit, and their tax practitioner should also be informed. Information is generally requested using a questionnaire.

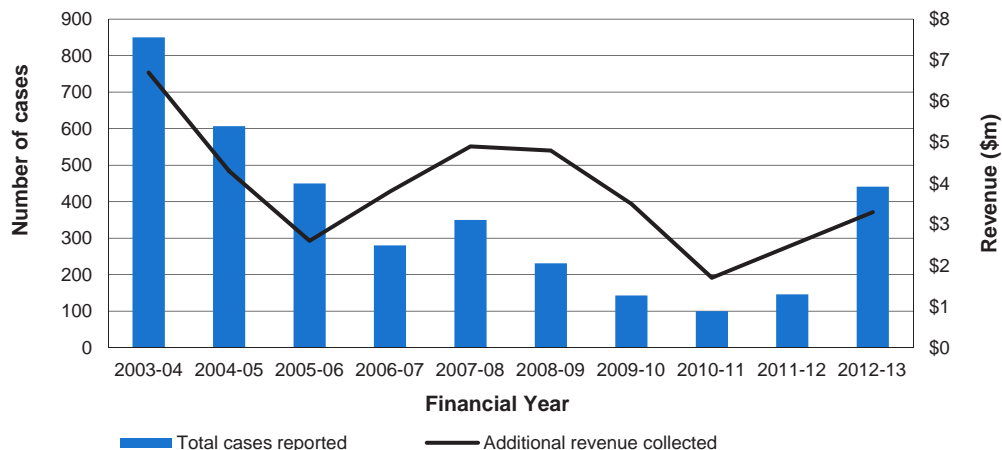
Reporting on active compliance cases

5.12 Active compliance activities for PSI began in 2003–04, and reporting of these cases generally combines reviews, audits, and amendments resulting from letters to taxpayers (as a specific compliance case type is opened in order to record the voluntary disclosure, and amend the tax return). Figure 5.1 outlines the number of cases conducted and the additional revenue collected in 2003–04 to 2012–13.

5.13 The number of active compliance cases has declined significantly since 2003–04 (from over 800 cases in 2003–04 to 441 cases finalised in 2012–13). The ATO advised that this is because of the reduced focus on PSI when it transitioned to business-as-usual in July 2006. In addition, from 1 July 2010 ME&I aligned with other business lines by adopting the use of a single case for multiple related entities. Prior to this date ME&I recorded a single case for each entity. As each review or audit affects at least two entities (the individual and the entity) and often three (an associate), fewer cases are now reported.

¹²³ CWC is an ATO enterprise system, and as such there are whole-of-ATO business processes and procedures for the management of these cases. These include procedures for active compliance case products with hyperlinks to instructions for staff, guidance, policy and legislation references.

Figure 5.1: Active compliance cases and additional revenue, 2003–04 to 2012–13



Source: ANAO analysis of ATO response to Senate Standing Committee on Economics Question on Notice 23–24 February 2011, and information provided by the ATO.

5.14 Although the number of cases has declined¹²⁴, additional revenue collected has been relatively steady and the average revenue per case has increased over time. For example, the average collected per case in 2005–06 was \$5778 (450 cases raised \$2.6 million) whereas in 2012–13, each case collected an average of \$7482 (441 cases raised \$3.3 million). PSI active compliance activities have raised just over \$38 million in additional revenue in the 10 years since their inception.

5.15 The ATO’s main approach to reporting compliance activities involves fortnightly Micro Active Compliance heartbeat reports that detail the planned and actual cases and revenue amounts for that year (Table 5.2 provides these figures for 2009–10 to 2012–13). Revenue targets were met or exceeded, but the ATO’s addition of voluntary disclosure numbers to the total of cases reported is not a reflection of the work undertaken. The majority of voluntary disclosures arise from letter campaigns and these are less resource intensive than reviews and audits.

¹²⁴ Until the increase in 2012–13 which was caused by letter campaigns prompting 378 voluntary disclosures (as shown in Table 5.2).

Table 5.2: Active compliance cases, 2003–04 to 2012–13

Year	Planned cases	Actual cases	Voluntary disclosures	Total cases reported	Planned revenue (\$m)	Actual revenue (\$m)
2009–10	119	53	90	143	\$3.0	\$3.5
2010–11	80	43	57	100	\$1.7	\$1.7
2011–12	43	66	80	146	\$2.3	\$2.5
2012–13	40	63	378	441	\$2.0	\$3.3

Source: Information provided by the ATO.

5.16 Table 5.3 outlines reporting against active compliance performance measures (discussed in Chapter 2) for 2009–10 to 2012–13. Over this period, PSI cases have met or exceeded the strike rate and service standard goal (rounded strike rate result in 2010–11). Performance against the cycle time did not meet the goal until 2012–13, and case completion timeliness is discussed later in this chapter.

Table 5.3: Performance against cycle time, strike rate and seven-day service standard, 2009–10 to 2012–13

Performance measure	2009–10 ⁽¹⁾	2010–11	2011–12	2012–13
Cycle time (benchmark: 80% of cases completed within the cycle time)	n/a	62.1	74.4	97.7
Strike rate (benchmark: 55% of cases have an outcome)	n/a	60.2	54.8	78.9
Notification letter service standard (benchmark: 99% within seven days)	99.3	99.2	99.0	100.0

Source: Information provided by the ATO.

Note 1: Cycle time and strike rate were not performance measures for 2009–10.

ANAO review of active compliance cases

5.17 To assess whether the PSI cases are complying with legal and internal procedures, the ANAO tested a sample of 221 closed cases, representing 62 per cent of the 359 completed review and audit cases for the period 1 July 2009 to 31 March 2013, as shown in Table 5.4.

Table 5.4: ANAO compliance case testing, 2009–10 to 31 March 2013

Type	Number completed	Number tested	Percentage tested
Reviews	287	149	52
Audits	72	72	100
Total	359	221	62

Source: ANAO extraction of sample cases from the ATO's CWC system.

5.18 The cases were assessed against ME&I Active Compliance procedures with a focus on the following three major areas:

- profiling and planning, which is to be completed in the early stages of every audit and review, and should demonstrate an understanding of key risks and the relevant operational issues to be addressed;
- case decision reports, which are prepared for each case and explain the issues being addressed, outline the key evidence collected and provide arguments supporting reasons for decisions reached; and
- whether case documentation (profile, plan, decision report, instructions and evidence) was saved on the CWC system. This assists with staff changes, access to key information in objections or legal proceedings, and IQF assessment.

5.19 A summary of the results of the ANAO's testing is provided in Table 5.5. It shows a generally good performance in adhering to the key active compliance procedures tested, including 94 per cent of cases meeting the planning procedures and 91 per cent meeting the case decision procedures and requirements.

5.20 There were, however, a small number of cases that did not have relevant documentation:

- 26 of the cases (13 per cent) did not have a profiling document that provided sufficient information for case planning; and
- four audits did not have a case decision report attached, although related cases did.

5.21 The main reason for the lack of case documents was the presence of related cases that already had the documents, although some of these cases did not reference the related cases. There was improvement in case documentation for cases completed after 1 July 2010, when a single case was used for multiple related entities.

Table 5.5: Results of ANAO testing of PSI audits and reviews

Criteria	Case type	Met criteria (number)	Failed criteria (number)	Not applicable ⁽¹⁾	Met criteria (%) ⁽²⁾
Profile document exists and provides sufficient appropriate information.	Audit	63	8	1	89
	Review	116	18	15	87
Total		179	26	16	87
Planning document exists and outlines methods, sets milestones and time frames and considers stakeholder impacts.	Audit	67	4	1	94
	Review	136	8	5	94
Total		203	12	6	94
Case decision report exists and describes the evidence gathered and links this to key decisions, relevant legislation or ATO views. Reasoning was clearly set out.	Audit	66	4	2	94
	Review	128	16	5	89
Total		194	20	7	91

Source: ANAO analysis of completed audits and reviews.

Note 1: Not applicable can apply in circumstances such as the case not proceeding further.

Note 2: The not applicable cases were excluded in the percentage calculation for 'met criteria'.

5.22 The ANAO also assessed the timeliness of case completion. Prescribed cycle times for case types vary and are based on the expected case complexity. Table 5.6 outlines the recent cycle times of the main PSI active compliance case types and the average, maximum and minimum case completion times.

Table 5.6: Cases meeting cycle times, 2009–10 to 31 March 2013

Case type ⁽¹⁾	Cycle time (days)	Number of cases	Within time (no.) (%)	Average	Maximum	Minimum
Comprehensive audit	360	62	49 (79%)	262	832	44
Comprehensive review	240	237	182 (77%)	200	761	0
Specific audit	180	9	6 (67%)	287	575	5
Voluntary disclosure	40	48	19 (40%)	82	402	2
Income tax internal review	10	2	2 (100%)	4	4	4
Total		358	258 (72%)			

Source: ANAO analysis of ATO data.

Note 1: For the purpose of this analysis, the ANAO combined case types that had the same cycle time. One lodgement enforcement case (not a PSI case, but calculated by PSI staff) was included in the total for specific audits.

5.23 Case delays can have a negative impact for both the taxpayer and the ATO. The reasons for these delays included: waiting for replies from taxpayers/tax agents; staff changes or reallocation; and review by a technical panel (Part IVA program cases). While any delays due to ATO inaction are taken into account when calculating penalties such as general interest charge¹²⁵, it is important that the ATO minimises the impact of delays on taxpayers.

5.24 The average cycle time for audits was 262 days, which was substantially less than the 360 day benchmark. However, 13 cases exceeded this internal target, with one case reaching 832 days (over 2 years 3 months). The ATO advised that these delays were due to: Part IVA cases requiring further interpretation and decisions (four cases); one involved a personal services business determination application by the taxpayer taking longer than anticipated; and technical arguments and delays in obtaining information from taxpayers and their agents (eight cases). Six of these cases were linked, and would now be recorded as three cases, each involving two related entities.

5.25 Cases may escalate from a review to audit. The ATO advised the ANAO that one reason for escalation to audit is if there are disagreements over the application of PSI rules. Some cases will begin with an audit if there is

¹²⁵ The general interest charge applies when an income tax assessment is amended and, as a result, there is an increased tax liability.

enough information available to suggest serious issues. A reasonably significant proportion of the comprehensive review cases tested exceeded the maximum cycle time (23 per cent), and the ATO may wish to consider whether certain review cases should be escalated to audit sooner.

Integrated Quality Framework

5.26 Randomly selected active compliance cases are periodically reviewed against the ATO's Integrated Quality Framework (IQF). For the period 2009–10 to 2012–13, 69 PSI compliance cases (out of a total of 830) were reviewed. The reviews identified issues similar to those found by the ANAO, with eight cases (12 per cent of the sample) failing the timeliness criteria. Table 5.7 summarises the results of the IQF assessments. The performance measure 'improving quality assurance results' was not met because of the two ratings of 'not aligned' for 2011–12 and 2012–13.¹²⁶

Table 5.7: IQF assessments of PSI active compliance cases, 2009–10 to 2012–13

Period	Number of assessments	Outcomes
2009–10	25	10 Aligned, 15 Meets Standard
2010–11	18	5 Aligned, 13 Meets standard
2011–12	8	7 Meets Standard, 1 Not Aligned
2012–13	18	2 Aligned; 15 Meets Standard, 1 Not Aligned

Source: Information provided by the ATO.

Assessing the effectiveness of compliance activities

5.27 The ATO's method for assessing the effectiveness of its compliance activities in treating a specified risk is set out in its 2008 Compliance Effectiveness Methodology.¹²⁷ The methodology is based on two key elements: the identification of measurable compliance objectives; and the articulation and treatment of the risks to achieving the objectives.

¹²⁶ The rating of 'not aligned' is the lowest rating allocated to an IQF assessment and means the case failed the assessment.

¹²⁷ ATO, *Measuring Compliance Effectiveness—our methodology*, August 2008, available at <<http://www.ato.gov.au/Print-publications/Measuring-compliance-effectiveness---our-methodology/>> [accessed 1 July 2013].

5.28 The methodology is undertaken in four phases that:

- describe the risk and align it to the ATO's business intent.¹²⁸ This step is commenced after normal risk assessment processes have been completed;
- define successful outcomes and develop compliance strategies to achieve these outcomes. Strategies include help and education, verification and enforcement;
- identify and test indicators of success to be used during the compliance strategies; and
- use these indicators to evaluate and report the effectiveness of the compliance strategies in the short, medium and long term.

An ongoing annual review is conducted after phase four is completed.

5.29 In October 2011, the Risk Management Committee discussed a compliance effectiveness forward work program, as all four phases had been completed for very few risks, and some, like PSI, had not been considered. The need to integrate compliance effectiveness into risk management processes was recognised. By November 2011, the forward work program had been updated and included all ME&I risks from the Enterprise Risk Register (including PSI).

5.30 Work was undertaken on a PSI Compliance Effectiveness Case Study during 2011–12, and a phase four assessment was put to the Risk Management Committee in October 2012. However, the assessment was withdrawn as the ME&I Executive asked for further work on the success indicators. At the time of this audit the new case study had not been completed.

5.31 As of June 2013, no objective benchmarks have been set against which the effectiveness of the PSI regime can be determined. There are indications that the number of taxpayers declaring that their PSI income is subject to the regime, and the amounts declared, has increased¹²⁹, and that the trend of wage and salary earners incorrectly accessing the business tax system has

128 The Compliance Effectiveness Methodology (p. 10) describes the ATO's business intent as 'to optimise voluntary compliance and make payments under the law in a way that builds community confidence'.

129 Figure 1.3 in Chapter 1 shows that around 50 000 taxpayers subject to the PSI rules declared \$1.0 billion in PSI in 2000–01, compared with around 124 000 taxpayers declaring \$2.9 billion in 2010–11.

reversed.¹³⁰ However, while around 9000 fewer entities declared PSI in 2010–11 compared to 2000–01, over 143 000 additional individuals have declared as personal services businesses over the same period. These trends could be partly or wholly influenced by other factors, such as labour market trends, but without an estimate or a baseline of the non-compliant population and the potential revenue at risk, it will be difficult to determine the effectiveness of the PSI regime.

Estimating revenue attributed to the PSI regime

5.32 The expected additional revenue to be raised by the regime was stated in the Explanatory Memorandum to the Alienation of PSI Bill.¹³¹ It was estimated at the time that the new regime would raise \$1.4 billion in additional revenue in its first four years of operation. These estimates were revised in 2001, calculating that the PSI regime would raise \$2.3 billion over the first six years of operation to account for the introduction of pay as you go withholding tax, the PSI results test and certain exemptions for financial planners. Both the original and revised estimates are provided in Table 5.8.¹³²

Table 5.8: Revenue estimates for alienation of PSI measure

Revenue estimate by year (\$m)						
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06
Original	190	290	435	515	-	-
Revised	80	266	477	480	493	517

Sources: Original estimates from Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000, p. 4. Revised estimates provided by the ATO.

5.33 The ATO has not publicly released any further estimates of the revenue attributable to the PSI regime, although early attempts were made to quantify the net revenue impact of the PSI rules. In 2001, the ATO engaged an external

130 Figures 3.1 and 3.2 in Chapter 3 show the total number of individuals declaring PSI from 2000–01 to 2010–11 increased from 184 000 to 403 000, while the number of entities (such as partnerships, trusts and companies) decreased from 32 000 to 23 000.

131 As part of the Ralph Review, the ATO's Revenue Analysis Branch calculated the revenue amounts used in the Explanatory Memorandum. These figures were based on an estimate of the number of taxpayers that would be earning PSI, and the amount of additional revenue expected.

132 The ATO advised that the introduction of pay as you go withholding tax was expected to defer \$75 million in revenue from 2000–01 to future years, and increase estimated revenue by \$15 million in 2001–02 and \$75 million in 2002–03. In addition, the *Mid-year Economic and Fiscal Outlook 2001–02* (part III, Fiscal Outlook, p. 25) documented the results test reducing expected revenue by \$1 million per annum, and the exemptions for financial planners reducing expected revenue by \$35 million per annum (from 2001–02).

consultant to develop a methodology for estimating the additional revenue. Two methodologies were suggested, but the ATO's Revenue Analysis Branch concluded:

- the first—based on developing employment baselines in relevant industries—had too many factors likely to influence the taxable income of this group of taxpayers to be able to isolate the effects of the PSI rules; and
- the second—an analysis of tax return and pay as you go withholding tax data—relied on taxpayers accurately completing their tax returns.

5.34 In 2004, the ATO's PSI project team used some aspects of the consultant's methodology to develop a proposal for measuring the population earning PSI and the revenue attributable to the PSI rules. This was provided to the Revenue Analysis Branch for endorsement. In June 2005, the Revenue Analysis Branch concluded that the full impact of the PSI measure could not be accurately or reliably quantified, as it could not identify taxpayers that:

- had changed behaviour as a result of the measure (for example, had previously declared PSI but subsequently reported wage and salary income);
- no longer entered into arrangements that would be subject to the measure; or
- earned PSI but did not declare this on their tax returns.

Consequently, the ATO does not know whether the original estimates (provided in Table 5.8) were achieved, or if the PSI regime has effectively addressed the threat to the income tax base through the alienation of PSI. The ATO has advised the ANAO that its view continues to be that the revenue attributed to the PSI regime cannot be accurately or reliably quantified.¹³³

5.35 Even if it was possible to estimate the net revenue impact of the PSI regime, the exercise would be resource intensive, and the results would largely report performance against the estimates provided at the outset of the regime, rather than provide benefits to the ongoing administration of the PSI regime. However, estimating the revenue associated with the non-compliant

133 In the absence of data to identify those taxpayers that receive PSI and do not declare this, the ATO has begun to focus more on data matching and reporting systems (the building and construction industry taxable payments reporting) to obtain information about non-compliant PSI taxpayers.

population is likely to provide administrative benefits as it could be used in the assessment of the effectiveness of current PSI compliance activities and to inform future compliance strategies. As discussed in paragraph 5.31, it will be difficult to determine the effectiveness of PSI compliance activities without an estimate of the number of non-compliant PSI taxpayers and the magnitude of the potential taxation revenue at risk arising from this non-compliance.

5.36 The ATO advised that it is endeavouring to better understand and estimate the population of non-compliant taxpayers as part of the compliance effectiveness assessment currently underway but is yet to develop a methodology to estimate the potential taxation revenue at risk from this non-compliant population.

Recommendation No.1

5.37 To better inform its assessment of the alienation of personal services income (PSI) risk and the effectiveness of PSI compliance activities, the ANAO recommends that the Australian Taxation Office:

- (a) estimates the number of non-compliant PSI taxpayers; and
- (b) develops a methodology to assess the potential magnitude of the revenue at risk from this non-compliance.

ATO response: *Agreed.*

Conclusion

5.38 The ATO has a range of strategies for addressing non-compliance with the PSI regime. Letter campaigns are increasingly being used as a less resource-intensive method for interacting with a larger number of the potential PSI population. These campaigns are the only recent compliance activities directed at potential non-declarers of PSI. The ATO assessed that the three letter campaigns in 2012 resulted in disclosure by some 10–15 per cent of targeted taxpayers, with voluntary disclosures providing approximately \$1.1 million in additional revenue as at June 2013.

5.39 Although the number of compliance reviews and audits has declined significantly (from over 800 cases in 2003–04 to 441 cases finalised in 2012–13), additional revenue collected has been relatively steady and the average revenue per case has increased over time. ATO data indicates that PSI active compliance activities have raised just over \$38 million in additional revenue in the 10 years since their inception in 2003–04. The ANAO's assessment of a

sample of review and audit cases against ME&I Active Compliance procedures found those procedures were generally adhered to—including 94 per cent of cases meeting the planning requirements and 91 per cent of cases meeting decision procedures and requirements.

5.40 The ATO has an 80 per cent internal performance benchmark for compliance cases being finalised within prescribed time periods. PSI cases did not meet this performance standard until 2012–13. The ANAO also assessed the timeliness of cases, as delays can have a negative impact for both the taxpayer and the ATO. While the average cycle time of comprehensive audits was well within the 360 day benchmark, 13 cases exceeded this internal target, with cases ranging from between 395 and 832 days. Cases generally escalate from a review to an audit, however the ANAO found that 23 per cent of comprehensive review cases exceeded the maximum allowable cycle time before escalation to an audit. The ATO may wish to reconsider when cases are escalated to audit and how the timeframes for these reviews/audits are recorded.

5.41 Work is being undertaken to measure the effectiveness of compliance activities in addressing the alienation of PSI risk, using the ATO’s Compliance Effectiveness Methodology. The ATO undertook a PSI compliance effectiveness assessment during 2011–12, and the results of the assessment were put to the Risk Management Committee in October 2012. However, the assessment was withdrawn as the ME&I Executive asked for further work on the success indicators. At the time of this audit the assessment had not been completed.

5.42 Although it is possible to note trends in the number of taxpayers reporting PSI over time, it is difficult for the ATO to identify non-compliant taxpayers using only the PSI information from tax returns, particularly when taxpayers do not correctly classify their income. The ATO has not attempted to quantify the net revenue impact of the PSI regime nor estimate the level of non-compliance in the PSI population since 2004–05. These estimates would contribute to establishing a baseline for comparison in any assessment of the PSI risk and the effectiveness of PSI compliance activities.



Ian McPhee
Auditor-General

Canberra ACT
15 October 2013

Appendices

Appendix 1: Agency's response to the proposed report



Australian Government
Australian Taxation Office

SECOND COMMISSIONER OF TAXATION

Ms Barbara Cass
Group Executive Director
Performance Audit Services Group
Australian National Audit Office
GPO Box 707
CANBERRA ACT 2601

A handwritten signature in cursive script that reads 'Barbara'.

Dear Ms Cass

Thank you for your letter of 29 August 2013 and for the opportunity to provide comments on your proposed report on the *Administration of the Taxation of Personal Services Income*.

The ATO agrees with your recommendation regarding estimating the level of non-compliance with the Personal Services Income regime and its potential revenue impact.

Attached is the ATO response to the recommendation (Annexure 1) and the summary of our comments to be included in the final report (Annexure 2).

I would like to thank the Australian National Audit Office audit team for the cooperative and professional manner they have adopted in working with us on this matter. I look forward to continuing the good working relationship developed in this performance audit.

If you require further information on this matter, please contact Steve Vesperman, Deputy Commissioner, Small Business and Individual Taxpayers.

Yours sincerely

A handwritten signature in cursive script that reads 'Bruce'.

Bruce Quigley
Second Commissioner of Taxation

24 September 2013

Appendix 2: The results test and the personal services business tests

1. The personal services income (PSI) rules apply regardless of whether the income is generated directly by an individual, or channelled through a company, partnership or trust. Any reference to an individual in the following rules should be taken as also referring to such interposed entities.
2. The *results test* is satisfied if, for at least 75 per cent of the PSI during the year:
 - the income under the contract or arrangement is paid for producing a specified result or outcome;
 - the individual is required to supply any necessary tools or equipment (if any); and
 - the individual is liable for rectifying any defects in the work.

If the *results test* is satisfied, the PSI will be taken to be earned in conducting a personal services business and the PSI rules will not apply. However, Part IVA anti-avoidance provisions may still apply to schemes to reduce tax by income splitting.

3. If the taxpayer does not pass the *results test*, and 80 per cent or more of the PSI in the year (the *80 per cent rule*) comes from one client, he or she cannot continue to self-assess and will need to apply for a personal services business determination from the ATO to work out whether the PSI rules apply (see below). If the taxpayer does not obtain a determination, the PSI rules will automatically apply.
4. If each of the taxpayer's clients provided less than 80 per cent of the total PSI, the income will be exempt from the PSI regime if the taxpayer satisfies any one of the following three personal services business tests:
 - the *unrelated clients test*—satisfied if the individual gains income from two or more clients who are not associated with each other or with the individual; and the services are provided as a direct result of offers or advertising to the general public (excluding work obtained through a labour hire firm, placement agency or similar organisation);

- the *employment test*—satisfied if at least 20 per cent of the individual’s principal work¹³⁴ (by market value) is performed by an employee of or sub-contractor engaged by the individual, or apprentices are employed for at least half the income year; or
- the *business premises test*—passed if the taxpayer’s business premises are, at all times in the year, owned or leased by the taxpayer; mainly used to conduct the work (that is, more than 50 per cent of the use) from which the PSI is gained or produced; used exclusively by the taxpayer; physically separate from the private residence of the individual doing the personal services work, or their associates; and physically separate from the business address of the taxpayer’s clients or their associates.

134 Principal work is the main work that generates the personal services income and does not usually include support work such as secretarial duties. A spouse or family member who does principal work can be counted, but not associated companies, partnerships or trusts. If the taxpayer operates through a personal services entity, he or she is not counted as an employee.

Appendix 3: PSI publications, by topic and date modified

Introduction to PSI	Date modified
Personal services business self assessment checklist	Mar 2013
PSI—basic information you need to know	Oct 2008
PSI—completing your tax return	Sep 2009
PSI terms explained	Aug 2010
Information for sole traders	
PSI for sole traders	Nov 2011
Information for companies, partnerships and trusts (entities)	
General anti-avoidance rules and how they may apply to a personal services business	Oct 2008
PSI—avoiding common mistakes	Jan 2013
PSI—companies, partnerships and trusts	Dec 2011
PSI—what is income from a business	Jan 2012
PSI income and Pay As You Go Withholding	Jul 2012
Advanced topics	
PSI for engineers	Sep 2008
PSI for financial planners	Sep 2008
PSI for road transport workers	Sep 2008
PSI for the building and construction industry	May 2013
Personal services business determination application and instructions	Oct 2008

Source: ANAO analysis of publications available from www.ato.gov.au/Business/Personal-services-income [accessed 1 July 2013].

Appendix 4: Summary of submissions to the 2009 Board of Taxation review

Issue	ANAO analysis
Are the objectives of the rules clear?	One tax professional body felt that the PSI concept needed to be reviewed, given changing ways of work and contractual arrangements. Another felt that common law should determine whether arrangements were legitimate contracts or employee situations—PSI rules should not impose a different result. One industry representative felt the rules fully addressed the Government's concerns. Similarly, one union supported the policy intent behind the alienation of PSI rules.
Are the rules expressed in a clear, simple, comprehensible and workable manner?	Three tax professional bodies felt that the PSI rules were uncertain. Despite tax practitioners having used ATO guidance, many ATO audits and reviews resulted in a different view. Two industry representatives felt that the rules were complex and unclear, and private PSI tax rulings incoherent. One felt that basing the rules on common law would provide certainty—although one felt that it was best to leave the rules 'to settle'. A third industry representative thought that the rules were complex, but were well understood.
Do the rules take account of actual taxpayers' circumstances and commercial practices?	Two tax professional bodies felt that the rules failed to take into account the particular circumstances of taxpayers and industries, for example disadvantaging knowledge workers and those that received payments primarily from one source. Three industry representatives also expressed this view. Independent contractors should be recognised as a legitimate form of business activity, bearing commercial risk and providing efficiencies in volatile industries. The tests were considered inappropriate in many industries.
Does the legislation give effect to the Government's policy intent?	One tax professional body stated that the whole area of PSI has become a 'problem'. Another felt that levels of income to which PSI applies are generally below significant marginal tax rates. One industry representative claimed that the alienation of PSI was never the problem it was claimed to be. Another criticised the 'narrow and discretionary interpretation' of personal service business status by the ATO. A third industry representative, however, felt that the regime was very successful in achieving the announced policy intent. Both employee unions felt that the legislation failed to give effect to policy intent, with the legislated rules failing to adequately distinguish those workers who genuinely carry out their own business from those working in a dependent and controlled way. It was impossible to determine whether projected revenue gains were achieved.
What is the extent of compliance with the rules?	One tax professional body felt that entity structures were motivated by business considerations, not tax avoidance. One industry representative felt that there was little or no dissatisfaction in the community that independent contractors were avoiding tax, or workers falsely claiming contractor status to minimise tax. Another commented that there was little evidence that tests were adversely affecting its members. Another commented that the clarification process provided by test cases was very slow. Both employee unions commented that there was evidence of taxpayer non-compliance.

Source: ANAO analysis of the 13 submissions received by the Board of Taxation, 2009, available from <http://www.taxboard.gov.au/content/Content.aspx?doc=reviews_and_consultations/alienation_of_personal_services_income_rules/submissions/default.htm&pageid=007> [accessed 31 May 2013].

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