



Performance Audit

98-99

Prescribed Payments System

Australian Taxation Office



T h e A u d i t o r - G e n e r a l

Audit Report No.14
Performance Audit

Prescribed Payments System

Australian Taxation Office

A u s t r a l i a n N a t i o n a l A u d i t O f f i c e

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Canberra ACT
12 November 1998

Dear Madam President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit of the Australian Taxation Office in accordance with the authority contained in the *Auditor-General Act 1997*. I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Prescribed Payments System*.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'P. J. Barrett', is positioned below the 'Yours sincerely' text.

P. J. Barrett
Auditor-General

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

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Abbreviations/Glossary

ANAO	Australian National Audit Office
ATO	Australian Taxation Office
ELS	Electronic Lodgment Service
IVR	Interactive Voice Recognition technology
OCR	Optical Character Recognition technology
Payees	Individuals, companies, partnerships or trusts who receive prescribed payments
Payers	Individuals, companies, partnerships or trusts who make prescribed payments
PPS	Prescribed Payments System
SBI	Small Business Income Business Line
TFN	Tax File Number
WHT	Withholding and Indirect Taxes Business Line

Summary and Recommendations

Summary

1. During 1997-98, the Australian Taxation Office (ATO) collected revenue totalling \$110.34 billion with \$2.57 billion of this amount collected through the Prescribed Payments System (PPS). Although PPS revenue collections represent only 2.3 per cent of the ATO's total revenue collections, the system was introduced because there is a high risk that taxpayers in PPS industries will not comply with their taxation obligations.

2. PPS was introduced in 1983 in an attempt to stem income tax evasion in a number of traditionally cash-based industries using deduction at source and third-party reporting of income to the ATO. It provides a mechanism for taxpayers in nine prescribed industries to meet their tax obligations as they earn income under contracts from those in the same industry.¹

3. Under the ATO's Business and Service Line organisational structure,² PPS is administered by both the Withholding & Indirect Taxes (WHT) and the Small Business Income (SBI) business lines in the ATO. WHT's responsibilities include the collection of PPS revenue and the issue of exemptions and variations while SBI manages the assessment of Income Tax Returns for PPS clients. Both business lines are responsible for coordinating and implementing PPS compliance strategies.

Audit objective and approach

4. The objective of the audit was to ascertain and report to the Parliament on the ATO's administration of PPS and to identify opportunities for improvement. To accomplish this objective, the Australian National Audit Office (ANAO) identified four key compliance issues for the administration of PPS:

- reporting PPS income;
- claiming PPS credits;
- remitting PPS deductions; and
- managing PPS exemptions and variations.

5. As the principal purpose of PPS is to ensure that taxpayers in high risk industries comply with their taxation obligations, effective

¹ Exceptions to the intra-industry criteria are discussed at paragraph 1.7. The legislation also provides for householder reporting of domestic construction projects in excess of \$10 000.

² This structure is outlined at Appendix 2.

administration of the system relies heavily upon the collection and matching of income and payment information from payers and payees. For this reason, the ANAO also examined the ATO's PPS information collection and matching practices.

6. In addition, we considered the following key aspects of the ATO's management of PPS:

- PPS risk assessments;
- coordination of PPS administration between the SBI and WHT business lines; and
- PPS compliance project performance information.

7. During the audit there was significant policy debate regarding reform of the Australian tax system. Outcomes of this debate are likely to impact on the administration of the tax system, including PPS. We consider the recommendations contained in this report can be readily transferred to alternative withholding and information reporting systems. The ATO has advised that the report will assist with the design and implementation of any future withholding or reporting systems.

Overall conclusion

8. The ANAO noted past administrative problems with the Prescribed Payments System. However, we consider the ATO has improved its administration of the system during the past eighteen months.

9. We concluded that administration of the system would benefit considerably from more effective use of the Payment Summary information currently provided by PPS payers and payees. Effective use of this information would enable the ATO to systematically improve taxpayer compliance with their PPS obligations and allow for ongoing review of the compliance risks associated with PPS such as unreported income, over-claimed credits and unremitted deductions. This, in turn, would enable the ATO to better assess the level of resources that should be applied to PPS administration.

10. ATO improvements in administration have included, in particular, the commencement of two significant PPS compliance projects. In addition, the ATO is now capturing and systematically using Payee Declarations information. These initiatives are likely to result in improved compliance.

Key Findings

Obtaining and using PPS information (Chapter 2)

11. The ANAO concluded that taxpayer compliance with PPS provisions would considerably improve if the ATO made more effective use of the information currently collected from PPS payers and payees. Although providing Payment Summary information imposes a compliance cost on payers, the ATO had not effectively used the Payment Summary information provided, with less than ten per cent of it captured on ATO business systems in the past two years.

12. The ATO has advised that the decision not to capture all Payment Summaries over the last two years has been taken on a risk management basis and that it is currently evaluating the costs and benefits of capturing and using Payment Summary data for future risk assessments.

13. However, based on our review, we consider that unreported PPS income, over-claimed PPS credits and unremitted PPS deductions represent significant compliance risks. Unless all Payment Summary information is captured on business systems, the ATO cannot systematically detect and rectify:

- unreported income by matching the PPS income declared by payees in Income Tax Returns with that reported by payers in Payment Summaries;
- over-claimed PPS credits by verifying the credit claims of payees (in Income Tax Returns); and
- unremitted PPS deductions by determining whether payers have reported all PPS deductions.

14. We noted the ATO commenced capture of all Payee Declaration information on its business systems in 1997 and has used this information for a number of compliance improvement purposes. We consider that there may also be benefit in using this information to identify payers who should be forwarding Payment Summaries and PPS remittances.

15. We also consider that using alternative data capture technology (such as Interactive Voice Recognition software) may reduce the costs to the ATO and taxpayers of collecting and providing required PPS information. The ATO has begun to evaluate this technology for PPS administration.

Reporting PPS income (Chapter 3)

16. The ANAO considers that unreported PPS income represents a significant risk to revenue and found that the ATO could considerably improve its strategies to address this risk. While we acknowledge there are difficulties associated with using external data, the ATO would be in a better position to identify and rectify instances of unreported income if it made more effective use of available external data sources, as well as the information provided on Payment Summaries. We support the ATO's development of industry benchmarks to assist with the detection of unreported income.

17. We also found that the ATO's administration of PPS householder reporting had been ineffective, partly as a result of the inherent difficulties with administering this aspect of the legislation. We consider that more structured analysis of possible strategies is necessary to improve compliance. The ATO has advised that it is currently exploring a number of alternatives in this regard.

18. In addition, we found that the ATO is now effectively using the information provided in payer and payee returns to identify unregistered payers.

Claiming PPS credits (Chapter 4)

19. ATO fraud statistics indicate that over-claimed PPS credits represent a significant compliance risk. The ANAO found that substantial improvement in the ATO's current controls is necessary to address this risk. We consider that controls put in place to ensure that high risk refunds are reviewed prior to issue will not necessarily ensure that high risk PPS credit claims will be reviewed prior to the issue of an ATO assessment. Early intervention in cases where credits have been over-claimed is important because it increases the likelihood of debts being recovered. We noted that the ATO has taken steps to reduce the risk of invalid credit claims being issued prior to review.

20. The ANAO also considers that Payment Summary information could be effectively used to identify high risk PPS credit claims where an ATO assessment has already been issued, by comparing the amounts claimed in payee Income Tax Returns to amounts reported in Payment Summaries. The ATO has advised that it is currently investigating the costs and benefits associated with this approach.

Remitting PPS deductions (Chapter 5)

21. Results of a number of ATO compliance projects have indicated that there is a high risk that PPS payers will not remit PPS deductions to the ATO. The ANAO noted that the ATO had taken steps to reduce this

risk by considerably increasing its focus on the routine follow-up of non-remittance during 1997-98. However, we also noted that the systematic use of Payment Summary information would further reduce the risk of unremitted deductions because it would enable the ATO to check the amounts reported and remitted by payers against the credits claimed by payees.

22. We also found that the ATO had not undertaken timely follow-up of annual PPS stationery³ non-lodgment. This stationery is important because the annual stationery forms the basis for credit and income matching activities. The ANAO noted that the implementation of alternative information collection technology may encourage more timely submission of PPS annual stationery and capturing all Payment Summaries would obviate the need for PPS payers to complete and forward Annual Reconciliation Statements.

Managing PPS exemptions and variations (Chapter 6)

23. The ANAO found that, despite little action being taken until late 1997, concerted efforts have been made by the ATO to address deficiencies in its administration of exemptions and variations during the past year. For example, the ATO has:

- taken action to ensure that exemptions and variations are issued in accordance with PPS legislation; and
- made more effective use of the information provided in Payee Declarations (including verifying exemptions and variation details quoted by payees).

24. The ANAO noted that additional information has been requested on 1998 Income Tax Returns to enable automated rate verification. However, the ANAO was unable to determine whether the implementation costs of automated verification would be outweighed by the benefits, based on the information available. We consider the ATO should further investigate the costs and benefits of introducing automated rate verification. The ATO has stated its intention to undertake this activity.

25. We also noted that increased review of exemption and variation holder compliance could provide substantial leverage for the ATO in obtaining outstanding returns or collecting outstanding tax debts. We suggested the ATO investigate the likely compliance impact of this activity. As a result of a risk analysis completed during 1998, the ATO has stated its intention to undertake this activity.

³ PPS stationery comprises Payee Declarations, Payment Summaries and Annual Reconciliation Statements, with the last two items being submitted annually.

PPS management issues (Chapter 7)

26. The ANAO found that, although the ATO has taken a number of years to address identified significant risks to PPS compliance, during the past eighteen months its risk assessment processes have been more focused. However, as previously noted, the ATO has not made effective use of the PPS information provided by taxpayers. The ANAO considers that the ATO should re-assess its use of this information to allow soundly-based decisions to be made regarding the best use of PPS resources.

27. Although there was significant scope to improve the ATO's coordination of PPS administration in past years, we found substantial improvements had been made during 1997-98. These measures should lead to better coordination and more efficient and effective use of PPS resources in the future.

28. We also found that the ATO's administration of PPS would benefit substantially from improvements in compliance project performance information. Such performance information is important because it allows the ATO to better identify areas where there is a high risk to revenue (as a result of non-compliance) and allocate resources accordingly for better outcomes.

Recommendations

Set out below are the ANAO's recommendations aimed at improving the ATO's administration of PPS. Report paragraph references and abbreviated ATO responses are also included. More detailed responses are shown in the body of the report. The ANAO considers the ATO should give priority to Recommendations 1, 3, 5, 6 and 7.

Recommendation No.1
Para. 2.30 The ANAO recommends the ATO, subject to the outcome of its current cost/benefit analysis, capture all PPS Payment Summary information provided by taxpayers on its computerised business systems.

ATO Response: Agreed

Recommendation No.2
Para. 2.45 The ANAO recommends the ATO investigate the costs and benefits of using Payee Declaration information to automatically identify payers who should be lodging Payment Summaries and remitting amounts deducted from prescribed payments.

ATO Response: Agreed

Recommendation No.3
Para. 2.60 The ANAO recommends the ATO investigate the costs and benefits of using alternative data capture technology, such as Interactive Voice Recognition software, to streamline current PPS processes.

ATO Response: Agreed

Recommendation No.4
Para. 3.13 The ANAO recommends the ATO:

- identify external holdings of data which can be cost-effectively used to identify unreported PPS income; and
- where possible, pursue agreements with the organisations that hold such data regarding the most effective format in which it will be provided.

ATO Response: Agreed

Recommendation No.5
Para. 3.32 The ANAO recommends the ATO:

- develop criteria to identify PPS income matching discrepancies that indicate a high risk to revenue from unreported income; and
- follow up potential instances of unreported PPS income identified using these criteria.

ATO Response: Agreed

- Recommendation No.6
Para. 4.18** The ANAO recommends the ATO:
- develop criteria to identify PPS credit matching discrepancies that indicate a high risk to revenue from over-claimed credits; and
 - follow up potential instances of over-claimed credits identified using these criteria.
- ATO Response:** Agreed
- Recommendation No.7
Para. 5.32** The ANAO recommends the ATO:
- develop criteria to identify PPS credit matching discrepancies that indicate a high risk to revenue from failure to remit; and
 - follow up potential instances of failure to remit identified using these criteria.
- ATO Response:** Agreed
- Recommendation No.8
Para. 6.11** The ANAO recommends the ATO ensure that, when complex aspects of tax legislation are introduced or altered, rulings are promulgated in a timely manner to clarify the ATO's interpretation of the legislation.
- ATO Response:** Agreed
- Recommendation No.9
Para. 6.32** The ANAO recommends the ATO investigate the costs and benefits of introducing automated rate review for exemption and variation holders.
- ATO Response:** Agreed
- Recommendation No.10
Para. 6.42** The ANAO recommends the ATO investigate the compliance impact if it were to revoke exemptions and variations where non-compliance is detected.
- ATO Response:** Agreed
- Recommendation No.11
Para. 7.26** The ANAO recommends the ATO improve its identification of significant compliance risks and subsequent targeting of resources by determining and recording the total costs and impact of PPS compliance activities.
- ATO Response:** Agreed

Audit Findings and Conclusions

1. Introduction

This chapter provides background on the PPS administrative environment and the broad features of PPS as well as setting out the objectives, criteria and methodology of the audit. It also outlines the structure of this report.

The PPS administrative environment

1.1 During 1997-98, the Australian Taxation Office (ATO) collected revenue totalling \$110.34 billion with \$2.57 billion of this amount being collected through the Prescribed Payments System (PPS). Although PPS revenue collections represent only 2.3 per cent of the ATO's total revenue collections, there is a high risk that taxpayers in PPS industries will not comply with their taxation obligations.

1.2 The Prescribed Payments System is one of several revenue collection systems put in place to assist with the collection of income tax. Other income tax collection systems include the Pay As You Earn and Reportable Payments systems.

1.3 In addition to the collection of taxes, the ATO has administrative responsibility for some superannuation legislation and, at the time of the audit, it had responsibility for child support. The ATO's organisational structure consists of a number of business and service lines which are described in Appendix 2.

Overview of PPS

1.4 PPS was introduced in 1983 in an attempt to stem income tax evasion in a number of traditionally cash-based industries using:

- deduction at source; and
- third-party reporting of income to the ATO.

1.5 PPS provides a mechanism for taxpayers in prescribed industries to meet their tax obligations as they earn income under contracts from those in the same industry. The industries are:

- architectural services;
- cleaning;
- engineering services;
- joinery and cabinet making services;
- motor vehicle repair;
- professional building and construction services;

- road transport; and
- surveying services.

1.6 These industries were chosen because there is a high risk that taxpayers in these industries will fail to report all income to the ATO and therefore not comply with their income tax obligations.

1.7 Contract payments between parties from different industries do not have obligations under PPS with the exception of:

- contract payments to an individual, partnership, company or trust for building and construction work where the total of all work is expected to cost more than \$10 000; and
- contract payments for the transportation of goods on a regular, daily and exclusive basis.

1.8 Approximately 70 per cent of PPS revenue is collected from prescribed industries in the building and construction sector⁴ with the road transport industry responsible for a further 14 per cent. The remainder was collected from the motor vehicle repair and cleaning industries.

1.9 In addition to commercial construction activity, construction contracts in excess of \$10 000 between householders and builders must be reported to the ATO (there is no requirement to deduct tax from these payments).

Payer, payee and householder responsibilities

1.10 For the purposes of PPS, those who make PPS-related contract payments (head contractors) are called *Payers* and those who received these payments (sub-contractors) are called *Payees*. PPS payers (head contractors) must register with the ATO and at 30 June 1998, there were approximately 200 000 active PPS payers registered with the ATO. The exact number of PPS payees is more difficult to determine because they are not required to register with the ATO. However, approximately 400 000 taxpayers declared PPS gross income or claimed PPS credits in their 1996-97 Income Tax Return.⁵

1.11 PPS payers are responsible for the deduction of tax from contract payments and the remittance of those deductions to the ATO. The legislated general deduction rate is 20 per cent. However, this rate can be varied if the payee (sub-contractor):

⁴ Building and construction sector consists of architectural services, engineering services, joinery and cabinet making services, professional building and construction services, and surveying services.

⁵ This figure may underestimate the actual number of PPS payees as some payees had not lodged 1996-97 Income Tax Returns when this report was prepared.

- has not quoted a Tax File Number (tax is deducted at the rate of 48.5 per cent and payments are reported);
- holds a Deduction Variation Certificate (tax is deducted at the specified (lower) rate and payments are reported);
- holds a Deduction Exemption Certificate (no tax is deducted from payments but payments are reported); and
- is granted a Reporting Exemption Number by the ATO (no tax is deducted and payments are not reported).

1.12 At the commencement of a contract, payees can complete and forward to the payer a Payee Declaration that sets out the payee's Tax File Number and any variation or exemption entitlements.⁶ The payer must forward to the ATO copies of any Payee Declarations provided by payees. If the payee chooses not to complete a Payee Declaration and they do not hold a Reporting Exemption Number, the payer must deduct tax at a rate of 48.5 per cent from payments.

1.13 The payer must raise a Payment Summary for each payee at the beginning of each financial year (unless the payee holds a Reporting Exemption Number) or when a new payee is paid. This form is used to record, for each payee, PPS payments and deductions made during the financial year.

1.14 At the end of each financial year, payers must forward copies of completed Payment Summaries to both the ATO and the payee. Payers must also complete and forward to the ATO an annual Payer Reconciliation Statement that summarises all prescribed payments and amounts deducted for all payees during the year. Payees, in annual Income Tax Returns, then claim credits for the amounts deducted from their contract payments during the financial year (similar to the Pay As You Earn system).

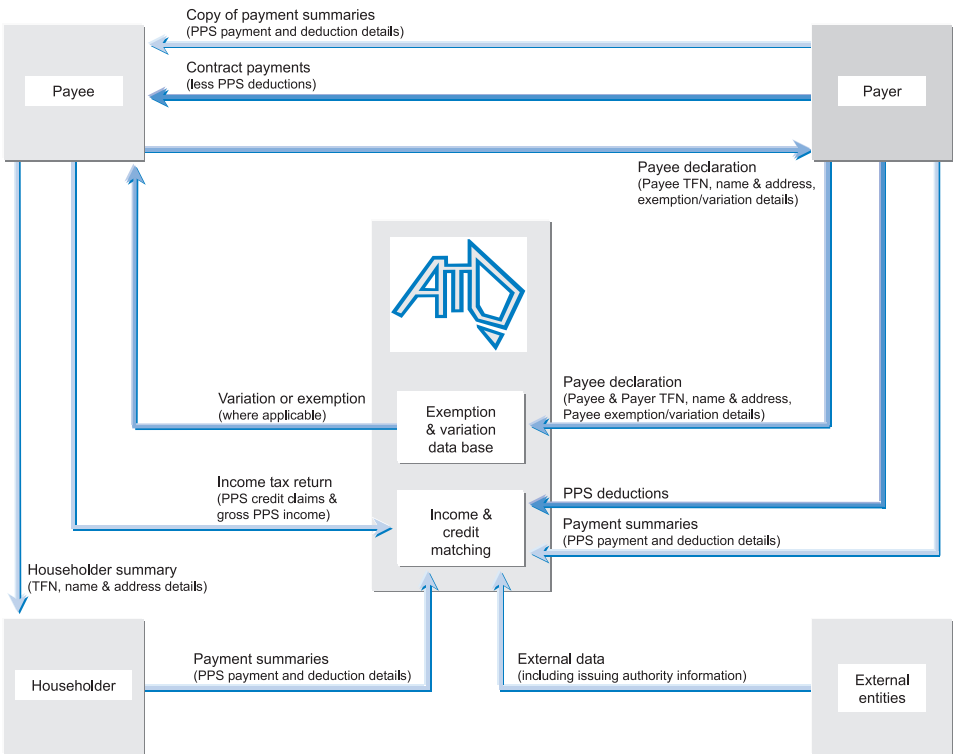
1.15 For householder projects, the payee is required to provide the householder with a Householder Summary on commencement of the project. When the project is completed, the householder must forward a completed Householder Summary (which sets out payments made to the payee during the project) to the ATO.

1.16 Prescribed payments legislation also stipulates that information regarding building approvals issued each month must be forwarded to the ATO by local issuing authorities.

⁶ Details of the frequency with which Payee Declarations are completed are provided at paragraph 2.32.

1.17 Figure 1 provides an overview of these payer, payee and householder responsibilities.

Figure 1.
Overview of Payee, Payer and Householder responsibilities



1.18 Current PPS legislation requires payers and payees to provide a substantial amount of information to the ATO. When PPS was introduced in 1983, the Parliament considered that this information was necessary to effectively address the high risk that taxpayers in PPS industries would not comply with their obligations.

Administration and resources overview

1.19 PPS is administered by both the Withholding & Indirect Taxes (WHT) and the Small Business Income (SBI) business lines in the ATO. WHT's responsibilities include the collection of PPS revenue and the issue of exemptions and variations while SBI manages the assessment of Income Tax Returns for PPS clients. Both business lines are jointly responsible for coordinating and implementing PPS compliance strategies.

1.20 The ATO estimates that PPS administration costs totalled approximately \$33.4 million during 1997-98.

Audit objective, criteria and methodology

1.21 The objective of the audit was to ascertain and report to the Parliament on the ATO's administration of PPS and to identify opportunities for improvement. To accomplish this objective, the Australian National Audit Office (ANAO) identified four key compliance issues for the administration of PPS:

- reporting PPS income;
- claiming PPS credits;
- remitting PPS deductions; and
- managing PPS exemptions and variations.

1.22 Our findings regarding the ATO's managements of these compliance risks can be found at Chapters 3 to 6.

1.23 The principal purpose of PPS is to ensure that taxpayers in high risk industries comply with their taxation obligations. Effective administration of the system relies heavily upon the collection and matching of income and payment information from payers and payees. For this reason, the ANAO also examined the ATO's PPS information collection and matching practices and the results of our review of this area can be found in Chapter 2.

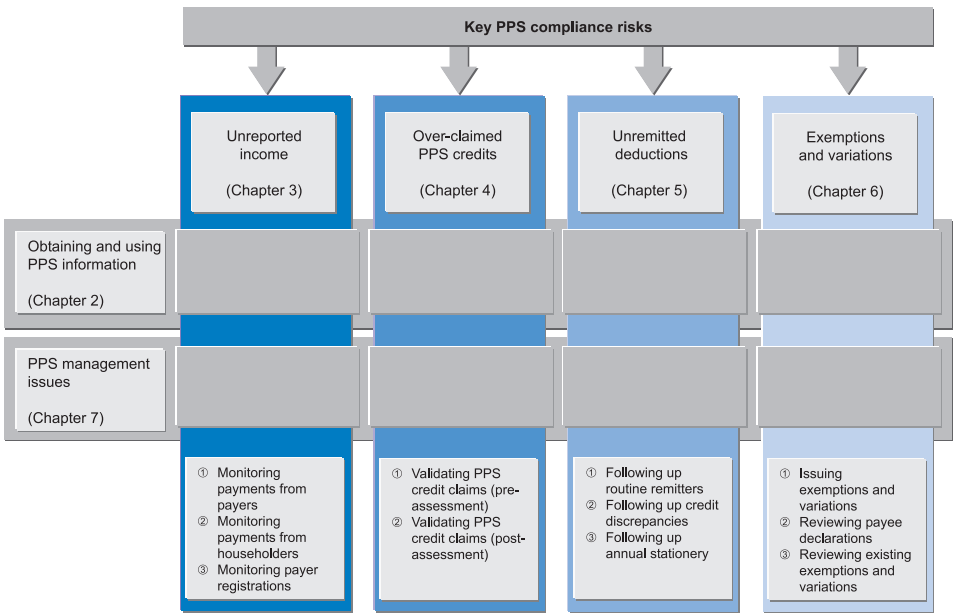
1.24 In addition, we considered the following key aspects of the ATO's management of PPS:

- PPS risk assessments;
- coordination of PPS administration between the SBI and WHT business lines; and
- PPS compliance project performance information.

1.25 Chapter 7 sets out our findings in relation to these issues.

1.26 Figure 2 provides an overview of the structure of this report which mirrors the framework used by the ANAO to analyse the ATO's administration of PPS.

Figure 2.
Report structure



1.27 Fieldwork was conducted in six ATO branch offices as well as the National Office in Canberra over a period of six months and the total cost of the audit was approximately \$282 000. The audit was conducted in accordance with ANAO Auditing Standards.

Current taxation environment

1.28 Outcomes of the current debate regarding tax policy alternatives have the potential to impact significantly on the administration of the tax system, including PPS. We consider that the recommendations contained in this report can be readily transferred to alternative withholding systems. More specifically, the recommendations regarding collection and effective use of taxpayer information can be readily transferred to any alternative information reporting system for high risk areas.

Overview of significant recent PPS compliance activity

1.29 The ANAO’s estimate of revenue foregone as a result of undeclared income (based on academic estimates of the extent of the cash economy⁷)

⁷ Academic studies estimate the cash economy to be between 3.5 per cent and 13.4 per cent of GDP or between \$17.8 and \$68.3 billion for 1996-97.

ranges from \$6 to \$23 billion or between 6 and 24 per cent of total income tax revenue collected by the ATO during 1996-97.⁸

1.30 The Commissioner of Taxation established a Cash Economy Task Force in November 1996 to investigate and recommend strategies to discourage tax evasion in cash-based industries. As well as senior executives from the ATO, membership of this task force included representatives from a number of key stakeholder organisations.

1.31 The Cash Economy Task Force has produced two reports — one in May 1997 and one in April 1998 — that provide an overview of the ATO's current strategies and recommend further strategies to address tax evasion in the cash economy. The Task Force recognised that PPS is a key element in addressing tax evasion in some traditionally cash-based industries.

1.32 Substantial work has been carried out by the ATO as a result of the Task Force's reports, including the development of a new compliance model which the ATO plans to use to improve compliance with tax laws.

1.33 The new compliance model promotes an hierarchical approach to tax administration where the ATO's treatment of taxpayers takes into account individual circumstances such as a previous good compliance record. A key element of the ATO's approach is developing a comprehensive understanding of the issues affecting taxpayer compliance behaviour.

1.34 In terms of its potential to improve tax administration, the ANAO supports the proposed compliance approach but notes that in order to gain a comprehensive understanding of taxpayer compliance, the ATO must ensure it is effectively using the information provided by taxpayers. The ATO's capture and use of information provided by PPS payers and payees are discussed in Chapter 2.

The Building and Construction Project

1.35 Building and construction industries represent a significant proportion of PPS revenue collections and clients (approximately 70 per cent of PPS revenue collections and 80 per cent of registered PPS payers).

1.36 As part of its focus on the cash economy, in 1997 the ATO commenced a significant compliance project in the building and construction industry. The anticipated life of the project was three years.

1.37 Key objectives of the project were to increase the ATO's visibility in the industry through a range of strategies and seek to influence taxpayer

⁸ These estimates are based on an assumed income tax rate of 33 cents in the dollar.

behaviour so that compliance with all taxation laws improves. PPS compliance was a specific focus of the project.

Road Transport Project

1.38 Approximately fourteen per cent of the ATO's PPS collections and six per cent of PPS payers are from the road transport industry. The ATO commenced a PPS project in the road transport industry in late 1996 following a comprehensive 1995 review of PPS administration.

1.39 Key objectives of this project included:

- confirmation of identified gaps in the administration of PPS;
- identification of any further gaps in the administration of PPS;
- the pilot implementation of more effective administration of PPS; and
- improvement of PPS compliance by people in the industry.

1.40 Outcomes of both the Building and Construction and the Road Transport projects are discussed in relevant sections of following Chapters.

Previous ANAO audits

1.41 In 1986, three years after the introduction of PPS, the ANAO conducted an audit of PPS focusing on implementation of the System which included consideration of operational and administrative aspects of the System. The report on that audit was tabled in September 1986.⁹

1.42 An ANAO follow-up audit in 1992 focused on the extent to which the recommendations of the 1986 audit report had been implemented, and identified further opportunities for improvement.¹⁰

1.43 The original PPS legislation has been altered and substantial organisational change has taken place in the ATO since those audits were carried out. However, both audit reports stressed the importance of capturing and effectively using the PPS payment and income information provided by payers and payees to improve compliance and ensure that the revenue properly payable is collected.

Acknowledgments

1.44 The ANAO wishes to express its appreciation of the time, effort and expertise contributed by ATO officers during the audit and with the preparation of this report.

⁹ Auditor-General Efficiency Audit Report, *Australian Taxation Office, Prescribed Payments System*, September 1986.

¹⁰ Auditor-General Report No. 28, 1991-92, *Australian Taxation Office: Prescribed Payments System*.

2. Obtaining and using PPS information

This chapter discusses the ATO's capture and use of the PPS information provided by taxpayers and the information available from other external sources to improve compliance. It also discusses alternative information collection processes.

Introduction

2.1 This Chapter sets out our findings in relation to the ATO's PPS information collection processes. It examines the ATO's current information collection processes and then discusses possible use of alternative capture methods. Detailed discussion about using this information to address those PPS compliance risks that were a focus of this audit are set out in subsequent chapters.

2.2 PPS was introduced to stem tax evasion in industries where there is a high risk of non-compliance. Consequently, effective administration of the system relies heavily on the reporting and matching of income to detect non-compliance.

2.3 In 1997 the United States General Accounting Office noted (with respect to United States tax administration) that relevant and reliable information is critical in identifying compliance problems because it enables estimation of the extent of non-compliance and detection of variations in taxpayer behaviour.

2.4 In October 1994, an ATO Second Commissioner noted that:

...income reporting and matching is a widely used means of achieving high levels of compliance by tax administrations around the world for the collection of income taxes. Where accompanied by 'tax deduction at source' arrangements [as is the case with PPS], it can usually be demonstrated that it is possible to achieve very high levels of compliance with tax laws. Even where arrangements do not include deductions at source as a standard feature, it is nevertheless possible to achieve higher compliance levels than would otherwise be the case (between 85-95 per cent has been demonstrated by various ATO and overseas research)...

2.5 He went on to note that:

...the imposition of reporting requirements [such as PPS] (and associated costs) on payers carries with it an implicit obligation that we will optimise use of the information so provided...¹¹

¹¹ Minute on Future Directions for Income Reporting and Matching from the Second Commissioner to the National Business Managers (INB, SBI, LBI and WHT) and the Chief Financial Officer.

2.6 The ANAO supports this view and a major focus of our audit was the ATO's capture and use of information to detect PPS non-compliance.

2.7 The ATO receives a substantial amount of information from PPS payers and payees each financial year. Stationery forwarded to the ATO by payers and payees includes:

- Payee Declarations (payers);
- Payment Summaries (payers);
- Householder Summaries (householders);
- Annual Reconciliation Statements (payers); and
- Income Tax Returns (payees).

2.8 The ATO has recognised that the full potential of PPS as a compliance improvement system depends upon its ability to reconcile Payee Declarations and Payment Summaries with tax return and other data. The ATO's capture and use of Payment Summary and Payee Declaration information are discussed below from paragraph 2.16.

2.9 Eighty per cent of small business Income Tax Returns are captured through the ATO's electronic lodgment system rather than on paper. Where paper returns are submitted, they are captured on ATO business systems by operator keying. The capture and use of Householder Summary information and Annual Reconciliation Statement information are discussed in detail in Chapters 3 and 5 respectively.

2.10 Appendix 1 describes procedures relating to PPS forms and Income Tax Returns, including their frequency, the information they must contain and how that information might be used to detect non-compliance.

Current information collection processes

2.11 At the time of the audit, the ATO's PPS returns process was as follows:

- (a) Payees may choose to quote their TFN by providing their payer with a Payee Declaration at the commencement of, or at any time during a contract where prescribed payments apply.¹²
- (b) Payers forward to the ATO Payee Declarations provided by payees.

¹² Payees are not required to quote their TFN by completing a Payee Declaration but failure to do so results in deductions at the rate of 48.5 per cent, unless they hold a Reporting Exemption Number.

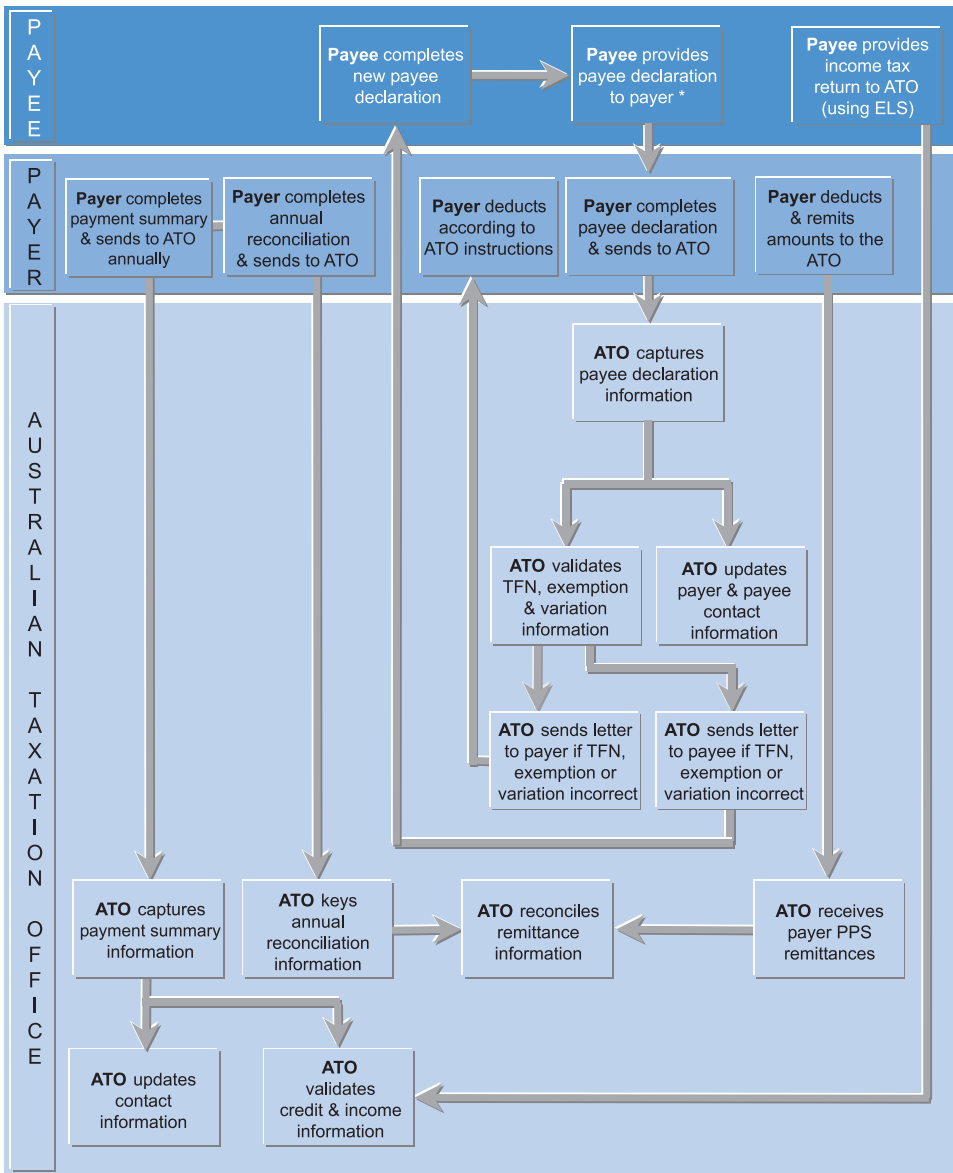
- (c) The ATO captures Payee Declarations provided using Optical Character Recognition (OCR) technology or operator keying (90 and 10 per cent respectively in 1997).¹³
- (d) The ATO can verify TFN and exemption or variation details provided on Payee Declarations. If discrepancies are found, the ATO can send a letter to payers advising them to make deductions at the appropriate rate and also send a letter to payees advising them to complete a new Declaration where appropriate.
- (e) Payers forward to the ATO Payment Summaries for each of their payees at the end of each financial year.
- (f) The ATO can capture Payment Summaries using OCR technology or operator keying (73 and 27 per cent respectively in 1997) and use this information to verify income declared and credits claimed in payee Income Tax Returns.¹⁴
- (g) Payers forward to the ATO Annual Reconciliation Statements at the end of each financial year.
- (h) The ATO keys some information provided on payer annual reconciliations to check that the PPS amounts deducted for the year (as reported by payers on annual reconciliations) match the amounts remitted by payers for that year.

¹³ OCR technology can read and electronically store on ATO business systems the information provided on paper returns. However, some forms provided by taxpayers are not able to be read using OCR and need to be manually keyed into ATO systems.

¹⁴ Less than ten per cent of Payment Summaries have been captured on ATO business systems during the past two years.

2.12 This process is set out in Figure 3.

Figure 3.
Current PPS information collection processes



* Details of the frequency with which Payee Declarations are currently completed are set out in paragraph 2.32.

2.13 The ATO has estimated that approximately 700 000 Payee Declarations are forwarded each year and ANAO analysis of ATO data indicates that approximately 1.7 million Payment Summaries are forwarded

to the ATO each year. As discussed further in Chapters 3, 4 and 5, the information provided in these returns can be used by the ATO to determine compliance levels and initiate compliance improvement activity where necessary.

2.14 The volume of information forwarded by payers and payees suggests that, unless this information is captured on the ATO's computerised business systems to enable electronic matching, the ATO will not be able to make effective use of it. Consequently, the information will be collected for no purpose.

2.15 In 1995, the information provided on 1993-94 and 1994-95 Payment Summaries was manually keyed into ATO business systems. During 1997, the ATO began capturing PPS information by using Optical Character Recognition (OCR) technology where possible.¹⁵ This technology can read and electronically store the information provided on taxpayer stationery and its introduction has provided an opportunity to significantly improve the efficiency of capturing return information.¹⁶

Capture and use of Payment Summary information

2.16 Payers are obliged under PPS legislation to complete a Payment Summary at the end of the financial year for each payee they make prescribed payments to (unless the payee holds a Reporting Exemption Number). Information provided on Payment Summaries includes payer and payee Tax File Numbers (TFNs) and contact details as well as the total value of prescribed payments made to the payee and the total value of amounts deducted from those payments.

2.17 The ANAO noted that full capture of Payment Summary information last occurred for 1995 Payment Summaries. We found the majority of 1996 and 1997 Payment Summaries forwarded to the ATO have not been captured on ATO business systems. ANAO analysis of ATO data indicated that 1996 Payment Summaries captured as part of the Road Transport project constituted approximately ten per cent of all Payment Summaries received by the ATO that year. Our analysis also indicated that 1997 Payment Summaries captured (from payers in South Australia and the Northern Territory) represent approximately seven per cent of all Payment Summaries received by the ATO for 1997.

¹⁵ Although most forms submitted by taxpayers are of sufficient quality to read using OCR, some must be manually keyed into business systems.

¹⁶ Auditor-General Report No.1 1995-96, *Income Matching System: Australian Taxation Office*, explains in some detail the technology used by the ATO to capture and match income and credit information.

2.18 In the ANAO's view, as discussed below, there is a strong case for the capture of all Payment Summary information on the ATO's business systems.

2.19 First, PPS was introduced in an effort to address a significant form of tax evasion in prescribed industries because there was a high risk that those taxpayers would not comply with their obligations under taxation law.

2.20 Second, complete and accessible Payment Summary information enables the ATO to perform credit and income matching which are key strategies in addressing significant PPS compliance risks. Unless Payment Summary information is captured on business systems and matched against Income Tax Return information, the ATO cannot effectively verify that:

- the prescribed payments made by payers to payees are declared as income (and therefore subjected to full assessment) in payee Income Tax Returns (see Chapter 3);
- the PPS credits claimed by payees in Income Tax Returns have, in fact, been deducted by payers (see Chapter 4); and
- the amounts that have been deducted by payers from prescribed payments (and claimed as PPS credits in payee Income Tax Returns) have been reported and remitted to the ATO (see Chapter 5).

2.21 Chapters 3, 4 and 5 contain a number of recommendations that we consider will enable the ATO to effectively address these compliance risks by using Payment Summary information. These recommendations cover the infrastructure necessary for the ATO to effectively use Payment Summary information to detect and follow up income and credit discrepancies.

2.22 However, these recommendations cannot be implemented effectively unless the ATO captures all Payment Summary information on its business systems and uses computerised systems to match Payment Summary and Income Tax Return information. The volume of information is too large for manual matching to be feasible.¹⁷

2.23 Third, the ATO has a responsibility to make the best use of the information taxpayers are required by law to provide, particularly when this information is provided at considerable expense. Research undertaken by the University of NSW found that PPS imposes the highest compliance burden (in terms of the revenue it collects) of all revenue collection systems

¹⁷ Over one million Payment Summaries are received by the ATO each year and Payment Summaries for one payee can be stored at a number of different ATO offices.

for businesses.¹⁸ The ANAO considers that the obligation on taxpayers to provide Payment Summary information is difficult to justify if less than ten per cent of the information provided is effectively used by the ATO.

2.24 Fourth, the full capture of Payment Summary information would nullify the need for payers to complete an Annual Reconciliation Statement each year. This would also save the cost to the ATO of keying information from these statements.

2.25 Finally, the integrity of the ATO's PPS data holdings would be improved because payee and payer contact information can be confirmed or updated each time a Payment Summary is lodged.

2.26 During the audit, the ANAO also noted that, when a refund is reviewed prior to issue (as discussed in Chapter 4), one of the reviewing officer's tasks is to verify credit claims in the return. Evidence reviewed by the ANAO suggests that, where PPS credit claims are involved, it is often necessary for the reviewing officer to request Payment Summary information from payees to support their PPS credit claim, despite the fact that this information may have already been provided by payers.

These requests:

- impose an unnecessary compliance burden on taxpayers;
- present an unprofessional image of the ATO and may therefore encourage avoidance behaviour; and
- delay the refund review process, thereby increasing the time taken to issue what may be justified refunds.

2.27 Comprehensive capture of Payment Summaries on ATO business systems would alleviate these problems to a large extent.

2.28 The ANAO concluded that the ATO has not adequately addressed the risks to compliance arising from its decision not to comprehensively capture Payment Summary information. For the reasons outlined above, it is our view that the full capture of Payment Summaries on ATO business systems would improve the ATO's administration of the Prescribed Payments System.

2.29 The ATO has stated that it plans to identify and evaluate potential uses for the Payment Summaries captured from the Northern Territory and South Australia and that, if the project were successful, consideration would be given to complete capture of Payment Summaries. However, the results of this exercise were not available at the time of the audit.

¹⁸ Evans, C., Ritchie, K., Tran-Nam, B., Walpole, M., *A Report into Taxpayer Costs of Compliance*, November 1997, p. 56.

Recommendation No.1

2.30 The ANAO recommends the ATO, subject to the outcome of its current cost/benefit analysis, capture all PPS Payment Summary information provided by taxpayers on its computerised business systems.

ATO Response

2.31 The ATO agrees with this recommendation. It is the ATO's intention to complete the capture of the 1997 financial year South Australian and Northern Territory Payment Summaries and to use this project to provide the cost/benefit analysis and to assist the development of strategies required for successful data matching.

Capture and use of Payee Declaration information

2.32 Payee Declarations can be provided by payees to payers at the commencement of, or during, a contract that involves prescribed payments.¹⁹ These Declarations remain in force until:

- the ATO informs the payee or payer that details provided on the completed Payee Declaration are incorrect;
- the ATO announces publicly that the Payee Declaration is no longer in force;
- a payee completes a new Declaration;
- entitlements to exemptions or variations described on the Declaration are extinguished (that is, the payee's certificate is revoked by the Commissioner); or
- a prescribed payment is not made by the payer to the payee within a twelve month period.

2.33 Payees are not obliged to complete Payee Declarations. However, if a payee provides a Payee Declaration, the payer must forward the Declaration to the ATO for processing.

2.34 Despite ATO recognition that a strong business case existed for capture of Payee Declarations in 1995, this information was not captured on ATO business systems until 1997. A 1995 ATO review of PPS noted that, since Payee Declaration provisions came into force on 1 January 1993, an estimated three million Payee Declarations had been received but not processed by the ATO.

¹⁹ Payees who elect not to provide a Payee Declaration will have amounts deducted from prescribed payments at the rate of 48.5 per cent (unless they hold a Reporting Exemption Number).

2.35 Findings from the Road Transport project indicated the integrity of data captured for income and credit matching was poor and that, among other things, this could be attributed to the ATO's failure to capture and process Declarations in the past. During this project, a significant amount of work was undertaken to prepare the ATO's existing data capture technology for the capture of PPS stationery and the format of forms to be captured was improved.

2.36 The ATO also asked Road Transport payees to lodge new Payee Declarations during the project. The ANAO notes that this requirement imposed a compliance burden on both payees and payers who are required to process the new Declarations (particularly companies with multiple payees). All refreshed Payee Declarations were captured during the project but we found no evidence to indicate that this information had been used to test compliance.

2.37 We noted the ATO was capturing on business systems all PPS Payee Declarations forwarded on or after 1 October 1997.

2.38 Information provided on Declarations includes Tax File Numbers (TFNs) and contact details for both the payee and the payer, as well as any deduction exemption or variation details quoted by the payee. TFNs enable the ATO to link different types of returns for individual taxpayers so they provide the basis for income and credit matching activities.

2.39 A significant obstacle in information matching processes is the large number of incorrect TFNs provided on Payment Summaries. For example, payees may quote their individual TFN rather than their partnership TFN on Payee Declarations and the payer may then transfer this information to the Payment Summary. Incorrect TFN quotation on Payment Summaries can result in significant, though explainable, matching discrepancies. If the ATO ensures that incorrect TFN information provided on Payee Declarations is corrected, it could reduce the number of discrepancies identified in matching processes and the associated costs of following up these discrepancies.

2.40 The ANAO considers that capture and use of Payee Declaration information can systematically improve PPS compliance because it provides the following benefits:

- the integrity of PPS data can be improved because, as Declarations are lodged, they confirm or provide updated payer and payee contact details. This promotes more cost-effective and timely follow-up action;
- Declaration information can be used by other agencies, such as the Child Support Agency and Centrelink, to trace their clients;

- exemption or variation details quoted by payees can be validated by the ATO. This minimises the risk of incorrect amounts being deducted by payers because invalid exemption and variation quotations can be detected and corrected early in the payee/payer relationship (this issue is discussed further in Chapter 6);
- the ATO can establish which payees and/or payers should be forwarding Income Tax Returns, Payment Summaries and remittances; and
- if the ATO follows up on Payee Declaration discrepancies, it increases its visibility in the community. This is a desirable outcome for the ATO because increased community visibility is generally acknowledged to be a key factor in influencing compliance.

2.41 During the audit we noted the ATO now captures all Payee Declarations. We also noted that the ATO had begun to use Payee Declaration information to:

- improve PPS data integrity;
- reduce the incorrect quotation of payee TFNs on Payment Summaries (by sending letters to payers and payees where incorrect details are provided); and
- identify payees who should be lodging Income Tax Returns.

2.42 However, we found the ATO had not used Payee Declaration information to automatically identify payers who should be lodging Payment Summaries and remitting amounts deducted from prescribed payments. Using Payee Declaration information for this purpose may help the ATO to address the risks of unreported income, over-claimed credits and unremitted deductions as Payment Summaries play a key role in reducing these risks. This information may also enable timely identification of unremitted PPS deductions, thereby increasing the likelihood of collecting outstanding amounts.

2.43 A recommendation regarding the ATO's use of Payee Declaration information to validate exemption and variations information can be found in Chapter 6.

2.44 The ANAO concluded that the ATO's decision not to capture and use Payee Declaration information prior to 1997 had hindered the ATO's ability to effectively administer PPS. However, we support the ATO's recent efforts to use Payee Declaration information to systematically improve PPS compliance.

Recommendation No.2

2.45 The ANAO recommends the ATO investigate the costs and benefits of using Payee Declaration information to automatically identify payers who should be lodging Payment Summaries and remitting amounts deducted from prescribed payments.

ATO Response

2.46 The ATO agrees with this recommendation.

Alternative information collection processes

2.47 As discussed in paragraph 2.15, the ATO currently uses Optical Character Recognition (OCR) technology to capture the information on PPS stationery on its business systems where possible. However, there is a number of factors, such as literacy problems in segments of the PPS client population, that make it difficult to capture PPS stationery using OCR technology.

2.48 For example, Australian Bureau of Statistics research reviewed by the ANAO during the audit suggests that some 55 per cent of construction workers had poor, or very poor, literacy skills²⁰ (approximately 80 per cent of PPS payers are from building and construction industries). Poor literacy skills lead to incorrect completion and processing of ATO forms by taxpayers and can significantly impact on the costs associated with capturing and matching PPS data using Optical Character Recognition technology. This suggests that methods of capturing PPS information, which rely less on the ability of payers and payees to adequately complete forms, should at least be considered.

2.49 The ATO provided an alternative to paper stationery from 1 July 1997 by allowing for the electronic lodgment of PPS stationery. However, at the time of the audit, less than one per cent of payers were taking advantage of this technology.²¹ Those who had chosen to submit stationery electronically were generally technologically advanced businesses.

2.50 The ANAO supports the ATO's introduction of electronic lodgment for PPS stationery. However, we note that electronic submission does not solve the problems arising from illiteracy. It would be reasonable to suppose that few PPS payers have taken up electronic lodgment of PPS stationery because many of them are not computer literate. The nature of the PPS client base suggests that this will continue to be the case for some time.

²⁰ Australian Bureau of Statistics, Labour Force, 6203.0, December 1997, p. 5.

²¹ ANAO analysis of ATO data indicates that in excess of 99 per cent of PPS payers registered at 30 June 1998 forwarded PPS returns to the ATO on paper.

2.51 The ANAO considers that viable alternatives to paper-based stationery exist and noted that, during the audit, a review of PPS processes was carried out which considered these issues. This review provided a number of recommendations for the ATO to consider, such as use of appropriate alternative data capture technologies.

Use of Interactive Voice Recognition technology

2.52 Among other things, the PPS process review considered the use of Interactive Voice Recognition (IVR) technology to capture and verify PPS information. This technology is used by most major banks, allowing customers to check account balances, transfer funds and pay bills by telephone. It includes pre-recorded messages and requires users to enter information through the telephone key pad.

2.53 There are several possible benefits to the ATO of using IVR technology for PPS administrative processes, including:

- compliance with PPS reporting obligations may improve because it provides PPS payers with greater flexibility regarding the method of providing information to the ATO;
- payer and payee compliance costs could be reduced;
- the number of completion errors by payers and payees on PPS stationery could be substantially reduced (thereby reducing the costs of capturing the information, the number of matching discrepancies and the costs of actioning discrepancies); and
- costs to the ATO of capturing PPS information could be reduced because Payee Declaration and Payment Summary information provided through IVR will not need to be captured on business systems from paper records.²²

2.54 We noted that IVR technology is already being used by the ATO in its administration of Sales Tax and that the use of IVR for PPS administration has been canvassed in the ATO's recent PPS process review.

2.55 The ANAO has developed the following example of how PPS processes could be streamlined by using IVR technology:²³

- (a) Payees provide the payer with a Payee Declaration at the commencement of a contract where prescribed payments apply or as required (see paragraph 2.32).

²² The exact cost of using IVR technology for PPS is unknown. However, it would be reasonable to assume that the number of large organisations which have recently introduced this technology have done so for reasons of efficiency.

²³ This example is not intended to be comprehensive or prescriptive.

- (b) The payer telephones the ATO and enters (using the telephone key pad) his/her payer number, the payee's TFN, and any exemption or variation details quoted by the payee. If any details entered by the payer do not match the ATO's data (for example, an invalid TFN, variation or exemption number is quoted) the payer is advised to take the appropriate action.
- (c) At the commencement of each financial year, the payer telephones the ATO and enters the TFN for each payee where there is no change from the previous year.
- (d) When a valid Payee Declaration is entered or confirmed by the payer, the payer is notified of any exemption or variation entitlements for the payee. The IVR system then notifies another ATO business system which prints the following details on Payment Summaries (for each payee reported by the payer):
 - a unique number for each Payment Summary;
 - payee TFN;
 - payee name and address;
 - payer TFN; and
 - payer name and address.

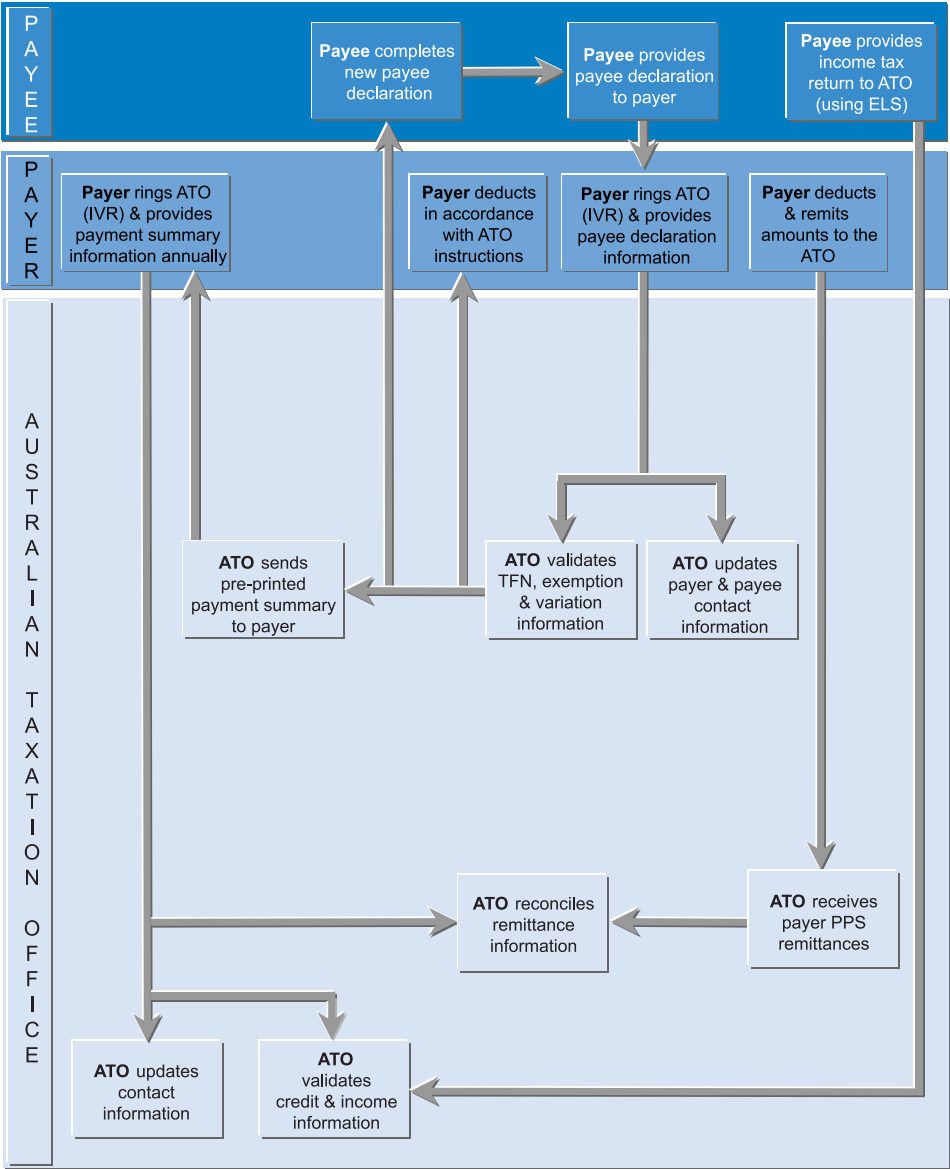
These Payment Summaries are then sent to the payer.

- (e) The payer telephones the ATO at the end of the financial year and enters (using IVR technology) the following information for each Payment Summary:
 - Payment Summary number;
 - total amount of prescribed payments made; and
 - total amount of PPS deductions made.
- (f) ATO business systems store the Payment Summary information which can then be used to automatically:
 - match credits and income reported against payee Income Tax Returns as they are received; and
 - match the PPS deductions reported by payers against the amounts remitted throughout the year.

2.56 Figure 4 sets out this process and demonstrates that implementation of IVR technology could make the following processes obsolete:

- completion by payers of Annual Reconciliation Statements;
- keying by the ATO of Annual Reconciliation Statement information; and
- the ATO sending letters to payers to advise of discrepancies in Payee Declarations.

Figure 4.
Example of PPS information collection processes using IVR



* Details of the frequency with which Payee Declarations are completed are set out in paragraph 2.55.

2.57 A comparison of this diagram with the diagram setting out current processes (provided at paragraph 2.12) shows that using IVR technology can substantially reduce the number of processes required.

2.58 Although IVR technology could represent a viable alternative for some PPS clients, it is not likely to be a preferred option for those

organisations who are required to provide a high volume of Payee Declarations and Payment Summaries. As these organisations are more likely to prefer electronic lodgment of this stationery, the ANAO does not consider that IVR lodgment should replace existing magnetic media arrangements.

2.59 The ANAO also acknowledges that the Payee Declaration and Payment Summary forms used by the ATO for its administration of PPS are set down in current PPS legislation. As a result, the introduction of technology that would eliminate the need for payers and payees to complete these forms may require legislative amendments. However, for the reasons outlined above, we consider that there is merit in further investigating the use of such technology for PPS administration.

Recommendation No.3

2.60 The ANAO recommends the ATO investigate the costs and benefits of using alternative data capture technology, such as Interactive Voice Recognition software, to streamline current PPS processes.

ATO Response

2.61 The ATO agrees with this recommendation.

Conclusion

2.62 The ANAO found taxpayer compliance with PPS provisions would considerably improve if the ATO made more effective use of the information collected from PPS payers and payees. This is particularly the case for Payment Summary information. We consider, subject to the ATO's current cost/benefit analysis, the ATO should comprehensively capture this information on its business systems and systematically use the information to improve compliance.

2.63 We noted the ATO commenced capture of all Payee Declaration information on its business systems in 1997 and has used this information for a number of compliance improvement purposes. However, we consider that there may be benefit in using this information to identify payers who should be forwarding Payment Summaries and PPS remittances.

2.64 We also noted that using alternative data capture technology (such as Interactive Voice Recognition software) may reduce the costs to the ATO and taxpayers of collecting and providing required PPS information. We consider that the ATO should investigate the costs and benefits of using alternative information collection technologies.

3. Reporting PPS income

This chapter discusses the ATO's management of the risk to compliance from payers and payees failing to report PPS income. It reviews, in particular, the ATO's monitoring of payments from payers, payments from householders and payer registrations.

Introduction

3.1 The extent of unreported income in prescribed industries is unknown. However, because PPS was introduced to address tax evasion in what are considered to be predominantly cash-based industries, there is a high risk that some or all of the PPS-related income received by payees will not be reported to the ATO. Preliminary results from the ATO's Building and Construction project, which found that non-lodgment of Income Tax Returns is a problem in the industry, support this perception.²⁴ The ATO is responsible for devising and implementing compliance strategies to address the risk that payees will fail to declare some or all of their PPS income.

3.2 During the audit, the ANAO identified failure to report PPS income as one of the key PPS compliance risks. This is supported by ATO analysis. Consequently, we reviewed the success of the ATO's compliance strategies in detecting and rectifying unreported PPS income. We focused on strategies aimed at detecting and rectifying:

- unreported PPS income in Income Tax Returns, including payee income from householder construction contracts;²⁵ and
- unregistered payers.

3.3 Our findings regarding these issues are set out below.

Monitoring payments from payers

3.4 To form a view of how the ATO addressed unreported PPS income from payees, the ANAO examined the ATO's use of the information available to identify taxpayers who either did not submit returns or understated their income in returns. The ATO has numerous information

²⁴ Report of the Cash Economy Task Force, *Improving Tax Compliance in the Cash Economy*, April 1998, p. 3.

²⁵ Contract payments for private building and construction projects where the total of all work is expected to cost more than \$10 000 must be reported by householders.

sources at its disposal that can be used to detect unreported PPS income in payee Income Tax Returns. These sources include:

- external data;
- Payment Summaries lodged by payers;
- other ATO PPS data (including recent Payee Declarations and the exemption and variation database); and
- industry benchmarks.

3.5 During the audit the ANAO reviewed whether the ATO had made effective use of these sources.

Using external data to detect unreported income

3.6 There is a risk that PPS payers and payees will either collude to reduce the amount of income reported to the ATO or be unaware of their responsibilities to report PPS income. The ATO can address this risk by comparing external data to its own data.

3.7 Relevant external data for PPS administration may include building approval information, vehicle licence information and Australian Transaction Reports and Analysis Centre²⁶ data. It can be used by the ATO to:

- determine whether information provided in Income Tax Returns is commensurate with the size of construction projects being undertaken and financial transactions being reported; and
- identify entities in PPS industries who have not lodged Income Tax Returns but may be obliged to do so.

3.8 Matching ATO data with external data is a sensitive issue. However, matching with external data can provide significant benefits in terms of compliance leverage for the ATO in collecting the tax duly payable by taxpayers. The collection, handling and use by Commonwealth agencies of information about individuals is regulated by the *Privacy Act 1988*. This Act gives the Privacy Commissioner special responsibilities for safeguarding privacy. Any matching of ATO and external data would have to take place within this framework and the ATO would need to ensure it complies with arrangements established by the Parliament and the Government for safeguarding privacy.

²⁶ The Australian Transaction Reports and Analysis Centre has been set up to encourage and monitor reporting of suspect transactions, significant cash transactions and international currency transfers under the Financial Transaction Reports Act. These reports can be used to detect tax avoidance and cash transactions linked to criminals and organised crime.

3.9 The ATO has used external data to identify small business taxpayers who have never lodged Income Tax Returns. However, specific results of this activity for PPS payees were not available at the time this report was completed so the ANAO was unable to form an opinion regarding the success of this initiative.

3.10 We concluded that, although the ATO has used external data to detect unreported income in the past, this has been undertaken on an ad-hoc rather than systematic basis. The ANAO supports the ATO's use of external data to detect unreported income but we consider that external data should be used by the ATO for this purpose as part of its day-to-day compliance activities. This will necessitate the identification of key external data sources that can be effectively and routinely used by the ATO to identify under-reporting of PPS income.

3.11 During the audit we noted the format of the external data used in matching processes can considerably impact on the cost-effectiveness of this activity. Much of the external data used to date by the ATO has required a substantial amount of manual manipulation to convert it to a useful format for matching, which reduces the cost-effectiveness of undertaking such action.

3.12 The ANAO considers that establishing alliances with holders of key external information could improve the cost-effectiveness of the ATO's external matching processes, particularly if agreements are put in place regarding the format of the data to be provided. These agreements could ensure that the format of external data allows for efficient importation into ATO business systems and efficient matching against ATO data.

Recommendation No.4

3.13 The ANAO recommends the ATO:

- identify external holdings of data which can be cost-effectively used to identify unreported PPS income; and
- where possible, pursue agreements with the organisations which hold such data regarding the most effective format in which it will be provided.

ATO Response

3.14 The ATO agrees with this recommendation and notes that this is under way.

Using Payment Summaries to detect unreported income

3.15 The ATO can also target under-reported PPS income by comparing:

- gross PPS income reported in Payment Summaries with payee Income Tax Returns; and
- PPS Payment Summaries with Income Tax Return lodgments to identify payees who have not lodged Income Tax Returns;

3.16 In 1994, an ATO Second Commissioner noted that:

- comprehensive systems of income reporting and matching are an integral part of the self-assessment framework for income tax;
- the ATO can readily demonstrate the significant role that income reporting and matching plays in achieving high levels of compliance; and
- the value of income reporting and matching is multi-dimensional because it provides a capability for mass surveillance of the targeted population (including the ability to detect non-compliance on a very wide scale) and provides a major deterrent to evasion.

3.17 The ANAO supports this view and notes the ATO's ability to detect wide scale non-compliance is particularly important for PPS industries where there is a high risk of non-compliance.

3.18 The ANAO's 1986 audit of PPS noted the considerable amount of payment data flowing continuously into the ATO from payers, local authorities and householders was not fully utilised at the time of the audit.²⁷ As a result of recommendations contained in that report, the ATO developed business systems' capacity to enable automated matching of PPS income declared with payments reported by PPS payers.

3.19 Our 1986 audit also noted that manual matching of PPS income information is impractical. This is still the case as the volume is too large and much of the relevant information is dispersed throughout the ATO (in different offices). As discussed in Chapter 2, it is the ANAO's opinion that comprehensive automated matching is an efficient process to ensure the ATO's compliance strategies are effective. However, comprehensive automated matching is possible only if all the Payment Summary information is effectively captured on the ATO's computerised business systems.

²⁷ Auditor-General Efficiency Audit Report, September 1986, *Australian Taxation Office, Prescribed Payments System*, September 1986, pp. 2, 19.

3.20 In Chapter 2 we also noted the full capture of Payment Summaries last took place in 1995. This meant the ATO could investigate 1995 discrepancies to determine the number of taxpayers who had not lodged returns, understated their PPS income or overstated their PPS credits. As a consequence, the ATO was in a good position to recover outstanding tax resulting from unreported PPS income for that year.

3.21 However, as discussed in Chapter 2, some 90 per cent of Payment Summaries for 1996 and 1997 have not been captured. This means that Payment Summaries for these years cannot be comprehensively used to determine whether the income declared by payees in Income Tax Returns matches that reported by payers on the Payment Summaries.

3.22 The ANAO concluded the ATO's ability to ensure that payees are reporting all PPS income is compromised by not capturing PPS Payment Summary information on its business systems. Capture of Payment Summary information is discussed in Chapter 2.

Follow-up of income discrepancies

3.23 PPS income matching will identify discrepancies between payments reported by payers and income declared by payees. However, matching activity will have a negligible impact on compliance if the ATO does not investigate discrepancies identified during the matching process.

3.24 ATO estimates of the amount of income disclosed on Payment Summaries but not included on Income Tax Returns for 1995 ranged from \$180 million to \$800 million.²⁸

3.25 The ANAO noted that the Road Transport project investigated a small number of 1995 income discrepancies for that industry.²⁹ We also noted that potential PPS non-lodgment cases, identified as discrepancies during the 1995 income matching process, were being investigated during the audit. Other 1995 income matching discrepancies were still being followed up by the ATO when this report was prepared. The ANAO was therefore unable to review the results of this activity.

3.26 We also noted that, although a number of potentially non-compliant payees were identified during the Road Transport project, most of these cases were not followed up. We consider that the lack of follow-up activity on suspect cases could have a negative impact on compliance as it

²⁸ These estimates have not been tested by ATO field activity which would provide a substantially more accurate picture of the amounts at risk.

²⁹ The ANAO was unable to establish the exact proportion of discrepancies investigated or the reasons particular discrepancies were investigated due to insufficient project information.

encourages a perception that the ATO does not follow up identified non-compliance.

3.27 The ANAO accepts that discrepancies can arise for a number of reasons other than payees under-reporting income on returns and that comprehensive follow-up for this purpose may not be effective. However, we consider that criteria could be developed which enable the ATO to identify PPS income discrepancies representing the highest risk of non-compliance. For example, the ATO could investigate discrepancies which:

- exceed a specified limit;
- involve payees with a poor compliance history; and
- involve Income Tax Returns with a high proportion of credits claimed relative to gross PPS income declared.

3.28 The ATO has criteria in place that are used, to some extent, to determine what follow-up action will be taken on discrepancies. However, these criteria are substantially based on the quality of the match between return information and existing ATO data. For example:

- if *invalid* TFNs are provided on Payment Summaries, the ATO attempts to manually correct the TFN information by using its existing data; and
- if *valid* TFNs are provided on Payment Summaries, these are subsequently compared to Income Tax Returns. If an Income Tax Return *has not* been forwarded for the period, the case is referred for non-lodgment follow up. If an Income Tax Return *has* been lodged, but a discrepancy is identified between the Payment Summary and the income tax return, the case is flagged as a potential audit case.

3.29 However, income discrepancies identified in the past have not been followed up in a timely manner. Also, if the ATO captures only minimal Payment Summary information (as discussed in Chapter 2), it will be unable to detect effectively unreported income using Payment Summaries.

3.30 The ANAO concluded that the ATO could considerably improve its strategies to detect and rectify instances of unreported PPS income by using the information provided on Payment Summaries more effectively.

3.31 We consider the criteria suggested in paragraph 3.27 could be used to determine which income discrepancies should be subjected to follow-up activity. In the ANAO's opinion, as well as considerably reducing the risk to revenue from unreported PPS income, use of risk-based criteria would enable the ATO to effectively target its follow up activity by maximising the impact on compliance for the resources invested.

Recommendation No.5

3.32 The ANAO recommends the ATO:

- develop criteria to identify PPS income matching discrepancies that indicate a high risk to revenue from unreported income; and
- follow up potential instances of unreported PPS income identified using these criteria.

ATO Response

3.33 The ATO agrees with this recommendation and notes that this is under way.

Using other ATO PPS data

3.34 In addition to Payment Summaries, the ATO can examine its existing PPS data holdings to detect unreported PPS income by identifying payees who have not lodged Income Tax Returns but may have an obligation to do so. For example, the ATO can:

- use the information provided on Payee Declarations to detect payers and payees who have not lodged Income Tax Returns; and
- verify that exemption and variation holders are lodging Income Tax Returns as required.

3.35 The ANAO noted at paragraph 2.41 that the ATO is now using Payee Declarations to identify potential non-lodgers of Income Tax Returns.

3.36 The ATO's use of the exemption and variation holder data base to identify non-lodgers is discussed in detail at paragraph 6.38.

Using industry benchmarks to detect unreported income

3.37 A financial ratio represents the relationship between two financial outcomes (such as gross profit and turnover) and can be used as an analytical measure to compare different entities. Industry benchmarks can be developed that represent the expected value of specified financial ratios for particular industry groups and can be used by the ATO to test the reasonableness of income declared by such entities in individual Income Tax Returns.

3.38 The second Cash Economy Task Force report noted that industry benchmarks can also be used to:

- identify opportunities for improvement in management practices by business operators and their advisers; and

- improve the ATO's understanding of industry characteristics leading to more effective risk management, education and compliance activities.³⁰

3.39 As part of its recent cash economy work, the ATO has developed a number of industry benchmarks. These benchmarks specify, for selected segments of the building and construction industry, expected ranges for key financial ratios, including:

- gross profit to turnover;
- net profit to turnover; and
- wages to turnover.

3.40 The ATO has undertaken considerable consultation with industry and relevant professional bodies in order to develop benchmarks that will be acceptable to taxpayers.

3.41 Although the benchmarks reviewed by the ANAO were still being refined at the time of writing, we consider they could prove to be valuable case selection criteria for detecting unreported income. We noted that the ATO plans, subject to the success of present ratios, to extend the development and use of such ratios to other PPS industries.

Monitoring payments from householders

3.42 When PPS was introduced in 1983, the then Minister for Finance's Second Reading Speech made specific mention of the PPS householder reporting provisions that require construction projects in excess of \$10 000 to be reported to the ATO. The Minister noted there was substantial risk that income from this source would not be reported to the ATO. To address this risk, the prescribed payments legislation includes a requirement that local issuers of building approvals forward to the ATO information regarding building approvals granted each month. The ATO has stated that, among other things, this information will include, for building approvals granted each month:

- the name of the approved builder; and
- the estimated value of the project.

3.43 The legislation requires payees to provide householders with a Householder Summary at the commencement of the contract. At the completion of the contract the householder must forward to the ATO the

³⁰ Report of the Cash Economy Task Force, *Improving Tax Compliance in the Cash Economy*, April 1998, p.40.

completed Summary (which includes a record of payments made throughout the contract).

3.44 The ANAO found the ATO has placed little emphasis on administering this aspect of the prescribed payments legislation. However, we noted that some efforts have been made to review compliance with this part of the legislation during the Building and Construction project which has focused on the sub-segments of the industry that are likely to perform construction work for householders.

3.45 We recognise the ATO faces significant obstacles in enforcing this aspect of the legislation. For example, because householders are irregular users of the system, they are often not aware of their obligations under PPS. We accept the ATO's opinion that the costs of regularly educating all householders regarding their PPS obligations are very high and any attempt to do so is likely to provide a poor return on investment.

3.46 The ANAO also noted the timing of information provided by householders on Summaries does not necessarily relate to the fiscal year in which income is reported on payee Income Tax Returns. Therefore, matching of the information provided by householders to payee Income Tax Returns can result in significant, though explainable, discrepancies.

3.47 Finally, as with all attempts to match external data, the format and completeness of external information can have a significant impact on the costs of using the information. We noted that:

- several local authorities continue to submit building approval information in paper format (as they are entitled to do);
- the level of detail provided is not consistent across authorities; and
- the ATO has encountered difficulties in obtaining information, particularly where building approval processes have been outsourced by state or local governments.

3.48 The ANAO also noted that the legislated dollar limit of \$10 000 for householder construction projects has not changed since the inception of PPS in 1983.³¹ This means that more and more householder construction projects are being caught up in the PPS net each year.

3.49 However, the principal intention of this aspect of the prescribed payments legislation is to ensure those householder payments to payees for contracts in excess of \$10 000 are declared in payee Income Tax Returns and therefore subject to taxation. Australian Bureau of Statistics figures reveal that the value of householder construction work (for projects in

³¹ \$10 000 in 1983-84 is equivalent to \$5 405 in 1997-98.

excess of \$10 000) during 1996-97 was approximately \$2.6 billion dollars. As there is a significant risk that a substantial part of this income will not be declared,³² the ANAO considers that a more structured analysis of measures is necessary to ensure greater compliance.

3.50 For example, based on the assumption that many householders will take out loans for major construction activity, the ATO could review the benefits and costs of using financial institutions to provide educational material to householders who enter into loans for this purpose.

3.51 We suggest the ATO develop strategies that are likely to improve householder reporting and investigate the costs and benefits of these strategies, with a view to introducing more effective compliance measures in this area.

Monitoring payer registrations

3.52 Taxpayers are required to register with the ATO when they become obliged to make prescribed payments to payees.

3.53 Unregistered payers represent a significant risk to PPS compliance because payers who are not registered are unlikely to deduct and remit amounts where required and report prescribed payments to the ATO.

3.54 The ATO can identify unregistered payers by:

- interrogating external data to determine whether payers who should be registered for PPS are, in fact, registered;
- examining Income Tax Returns to determine whether those under PPS-related industry codes who claim external labour costs should be registered as Payers; and
- reviewing Payment Summaries and Payee Declarations upon receipt to ascertain whether payers identified are registered.

3.55 The ATO's Road Transport project involved the matching of ATO data with vehicle registration information from New South Wales and Victoria to identify unregistered payers. The results of this exercise indicate that a substantial majority of payers identified through external data were, in fact, registered with the ATO for PPS.

3.56 However, the ANAO noted that payers investigated during this project were from only one PPS industry (road transport) and represented only six per cent of the registered PPS payer population. It is the ANAO's

³² The ATO is unable to determine the proportion of this income that is declared because Householder Summaries are not captured on business systems.

opinion that further research is necessary before the ATO can determine whether matching external data for this purpose is worthwhile.

3.57 The ANAO noted that a compliance project under way at the time this report was completed was investigating whether Income Tax Returns with PPS-related industry codes and claims for external labour costs would provide an effective means of identifying unregistered payers.

3.58 Recently, the ATO also commenced a major external data source project as part of the Building and Construction Project (discussed at paragraphs 1.35 to 1.37). The data source project involved the development of a business system which captures Australian Transaction Reporting and Analysis Centre (AUSTRAC) and local issuing authority building approval data and matches this to the ATO's existing data. This activity will enhance the ATO's ability to identify unregistered payers.

3.59 The ATO had not used Payment Summaries to identify unregistered payers because the likelihood of unregistered payers providing Payment Summaries is low (particularly as Payment Summary forms need to be obtained from the ATO). However, we noted that, during the audit, the ATO began to use Payee Declaration information for this purpose. We also noted that the revised PPS processes, discussed in Chapter 2, may enable the ATO to automatically generate payer registration if unregistered payers provide Payee Declaration information.

3.60 The ANAO concluded that, although the ATO had not systematically used the information provided by taxpayers to identify unregistered payers until recently, it was now making adequate use of the information. We also concluded that, while the ATO has made some use of external information to identify unregistered payers, this information has not been routinely used by the ATO until recently. We suggest the ATO further investigate the costs and benefits of systematically using external information to identify unregistered payers.

Conclusion

3.61 The ANAO considers that unreported PPS income represents a significant risk to revenue and found that the ATO could considerably improve its strategies to address this risk. In particular, the ATO would be in a better position to identify and rectify instances of unreported income if it made more effective use of available external data sources and the information provided on Payment Summaries. However, we support the ATO's development of industry benchmarks to assist with the detection of unreported income.

3.62 We also found that the ATO's administration of the PPS householder provisions had been ineffective, partly as a result of the inherent difficulties with administering this aspect of the legislation. We consider that more structured analysis of possible strategies is necessary to improve compliance.

3.63 In addition, we found that the ATO is now effectively using the information provided in *payer and payee stationery* to identify unregistered payers. However, we suggested the ATO investigate the costs and benefits of systematically using *external information* for this purpose.

4. Claiming PPS credits

This chapter discusses the ATO's management of the risk to compliance from payees over-claiming PPS credits in their Income Tax Returns. It reviews, in particular, the ATO's pre-assessment and post-assessment validation of payee credits claims.

Introduction

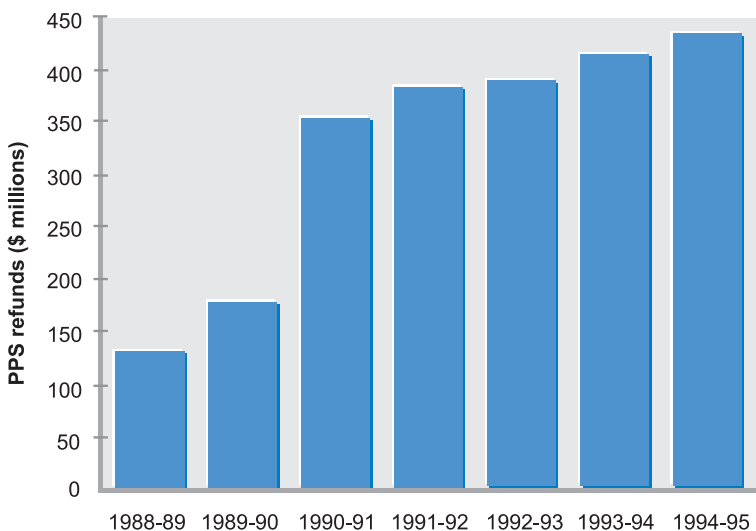
4.1 Payees who earn PPS income are entitled to claim credits in their annual Income Tax Return for PPS amounts deducted by payers. PPS credits are offset against the payee's total tax liability in much the same way as credit is allowed for Pay As You Earn deductions. If credits and expenses claimed as deductions on Income Tax Returns exceed the taxpayer's tax liability, then the ATO is obliged to refund the difference to the taxpayer.

4.2 ATO compliance activity results indicate there is a high risk of PPS credits being over-claimed. For example, in excess of \$47 million in PPS fraud has been detected during the past seven years, the majority of which is attributed to the over-claiming of PPS credits. Also, during 1996-97, PPS credit fraud constituted approximately 70 per cent in value of all detected ATO fraud. These results underline the importance of implementing effective controls aimed at validating PPS credit claims.

4.3 Figure 5 sets out PPS refund claims from 1988-89 to 1994-95.³³

Figure 5.

PPS refunds, 1988-89 to 1994-95



³³ The ATO has not reported the total value of PPS refunds for 1995-96, 1996-97 and 1997-98.

4.4 The ATO can validate payee claims for PPS credits either before or after an income tax assessment is issued. Although self-assessment provisions necessitate a greater reliance on post-assessment validation, the ATO is able to review assessments prior to issue if it considers that there is a high risk of inaccuracies. During the audit, the ANAO examined the effectiveness of the ATO's post-assessment and pre-assessment validation processes in detecting PPS credit over-claims. Our findings are set out below.

Validating PPS credit claims (post-assessment)

4.5 The ATO can verify PPS credits claimed by matching the deduction information provided by payers in Payment Summaries to the credits claimed by payees in Income Tax Returns.

4.6 In October 1994, an ATO Second Commissioner recommended that the ATO introduce income matching arrangements that include systematic validation of credits claimed in payee Income Tax Returns. The ANAO supports this approach, particularly in light of the high proportion of ATO fraud attributable to PPS (discussed in paragraph 4.2).

4.7 The ANAO found the decision to capture minimal Payment Summary information on its business systems has significantly impeded the ATO's ability to use Payment Summaries as a source of information to validate payee credit claims. Chapter 2 discusses in greater detail the ANAO's findings in relation to data capture and matching. The same comments apply in this context as the capture of all Payment Summary information would allow the ATO to carry out systematic and comprehensive validation of credit claims.

4.8 Previous ANAO audits of PPS conducted in 1986 and 1992 raised concerns about the level of action taken by the ATO to resolve prescribed payment credit discrepancies.³⁴ Although discrepancies were identified by the ATO as a result of credit matching activity using 1994 and 1995 Payment Summaries, we found no evidence during our recent audit to suggest that these discrepancies have been systematically followed up.

4.9 The ANAO acknowledges that credit discrepancies can arise for reasons other than payees over-claiming credits. For example, as discussed in Chapter 2, payees may use valid but incorrect TFNs on returns.

³⁴ Auditor-General Efficiency Audit Report, *Australian Taxation Office, Prescribed Payments System*, September 1986, p. 3 and Auditor-General Report No. 28, 1991-92, *Australian Taxation Office: Prescribed Payments System*, p. 21.

4.10 However, it is our opinion that the significant proportion of detected fraud arising from PPS credit over-claims during recent years justifies activity to detect and resolve credit discrepancies.

4.11 The ANAO considers that criteria could be developed enabling the ATO to identify those PPS credit discrepancies with the highest risk of over-claimed credits. For example, the ATO could examine discrepancies that:

- exceed a specified limit;
- involve payees with a poor compliance history; and
- involve Income Tax Returns with a high proportion of credits claimed relative to gross PPS income declared.

4.12 As noted at paragraph 3.28, the ATO has criteria in place that determine, to some extent, what action to take on discrepancies. We also noted in Chapter 3 that ATO procedures include the identification of discrepancy cases for potential audit. However, these criteria are based on the degree of the match only. They do not include consideration of other factors that may impact on the likelihood of non-compliance (such as those discussed above).

4.13 Also, as discussed in paragraph 4.8, we found no evidence during the audit to suggest that credit discrepancies found in the past have been systematically followed up.

4.14 The ATO has stated that it plans to use the 1997 Payment Summary information from South Australia and the Northern Territory to verify payee credits claims. However, the ANAO was unable to review the results of this exercise as they were not available when this report was completed.

4.15 The ANAO concluded the ATO could considerably improve its post-assessment validation of PPS credit claims by using the information provided on Payment Summaries more effectively. In particular, the ANAO suggests that the ATO match the information provided in Payment Summaries to that provided by payees in Income Tax Returns.

4.16 We also concluded that the ATO had not adequately followed up cases where post-assessment checks had identified discrepancies in the past.

4.17 We do not suggest that follow-up of all credit discrepancies would be cost-effective. However, we consider that criteria developed along the lines suggested in paragraph 4.11 could be cost-effectively used to determine which credit discrepancies are most likely to represent a high risk to revenue from over-claimed PPS credits. As well as considerably reducing the risk to revenue of fraudulent credit claims, it is the ANAO's opinion that this would enable the ATO to effectively target its follow-up activity and therefore maximise the effect on compliance for the resources invested.

Recommendation No.6

4.18 The ANAO recommends the ATO:

- develop criteria to identify PPS credit matching discrepancies that indicate a high risk to revenue from over-claimed credits; and
- follow up potential instances of over-claimed credits identified using these criteria.

ATO Response

4.19 The ATO agrees with this recommendation and notes that this is under way.

Validating PPS credit claims (pre-assessment)

4.20 Implementation of the above ANAO recommendation will help the ATO to identify over-claimed PPS credits. However, as the matching process often takes place several months after returns have been received by the ATO, it does not assist with timely identification of PPS credit over-claims. Untimely identification of PPS credit over-claims can substantially reduce the probability of collecting outstanding debts or retrieving amounts inappropriately refunded.³⁵

4.21 We noted the ATO has introduced controls that involve testing all small business income tax refunds to determine whether there is a high risk that the claim is illegitimate based on established criteria. However, these controls only affect assessments that result in a refund to the taxpayer. They do not address large PPS credit claims that do not result in a refund.

4.22 The aim of these controls is to determine whether review of a refund is warranted prior to issue. If a refund does not fail any of the 'high risk' criteria, it is automatically issued. However, if a refund fails one or more of these criteria, ATO policy requires it to be reviewed prior to issue. One of the existing criteria includes a specified limit³⁶ and all refunds exceeding this limit are to be reviewed prior to issue.

4.23 The ANAO noted that high risk refund activity resulted in *total refund adjustments* of \$25.3 million during 1997-98 and that approximately 47 per cent of adjusted cases involved PPS payees. The ANAO was unable to establish the value of *PPS refund adjustments* during this period because the ATO was not able to disaggregate this information. This is due to

³⁵ This was established in the ATO's recent audit report on debt collection in the ATO, Auditor-General Report No. 13 1996-97, *Tax Debt Collection*, p. 21.

³⁶ As part of its fraud prevention strategy, the ATO varies the specified limit regularly to ensure that it does not become public knowledge.

limitations of the business systems in place at the time of the audit which did not enable the ATO to identify which particular high risk criterion adjusted refunds had failed.

4.24 Improvements to existing systems, which will enable the ATO to rank the effect of individual criterion on the value of adjustments are planned for 1998-99. The ANAO notes that this initiative will allow the ATO to review the effectiveness of individual high risk criteria.

4.25 We support the ATO's implementation of pre-assessment validation to prevent the issue of refunds where there is a high risk that the refund is not legitimate. However, the ANAO notes that significant over-claims of PPS credits may not be detected because pre-assessment validation is not carried out for:

- assessments which do not result in a refund to the taxpayer; and
- refunds under the specified limit.

4.26 The ANAO considers the substantial amount of PPS fraud detected during recent years suggests PPS credit claims are a significant compliance risk. We concluded that current ATO pre-assessment controls, which focus on refunds, do not adequately address this risk because a large refund claim will not necessarily occur if taxpayers reduce their tax liability by fraudulently claiming PPS credits.

4.27 The ATO has stated its intention to introduce automated checks on electronically submitted Income Tax Returns to ensure that:

- if PPS credits are claimed, PPS gross income is declared; and
- the amount of PPS credit claimed is not greater than a specified percentage of gross PPS income declared.

4.28 The ANAO supports this initiative as we consider it will reduce the risk of PPS credits being over-claimed. We suggest that the ATO introduce these automated checks as soon as possible.

4.29 We also noted that a number of sampling exercises had been undertaken by the ATO to determine the risk associated with PPS credits claims that will generally not be reviewed as part of the ATO's high risk refund activity.

4.30 The ANAO supports these initiatives. If the results of these exercises indicate there is a high risk to revenue from over-claimed PPS credits, we suggest the ATO:

- develop criteria to identify high risk PPS credit claims; and
- validate these claims before an assessment is issued.

Conclusion

4.31 ATO fraud statistics indicate that over-claimed PPS credits represent a significant compliance risk and the ANAO concluded that substantial improvement in the ATO's current controls is necessary to address this risk. We consider that controls which have been put in place to prevent the issue of high risk refunds will not necessarily prevent the issue of assessments with high risk PPS credit claims. However, we noted that the ATO has taken steps to reduce the risk of assessments being issued, prior to review, which represent a high risk of over-claimed credits.

4.32 The ANAO also concluded that Payment Summary information could be effectively used to identify high risk PPS credit claims. We consider the ATO needs to make more effective use of the information provided in Payment Summaries to target high risk PPS credit claims.

5. Remitting PPS deductions

This chapter discusses the ATO's management of the risk to compliance from payers under-remitting PPS amounts deducted on behalf of payees. It reviews, in particular, the ATO's follow up of routine remittances, credit discrepancies and annual stationery lodgment.

Introduction

5.1 Under current PPS legislation, PPS payers must remit deductions from prescribed payments to the ATO within specified periods. One of the compliance risks associated with PPS is the failure of PPS payers to remit amounts deducted from prescribed payments. Failure to remit is also problematic because payers who do not remit amounts they deduct from prescribed payments hold a competitive advantage over those payers in the industry who comply with their remittance obligations.

5.2 In addition to its obligations under tax law, the ATO has an obligation to payees to ensure that amounts deducted from their prescribed payments are remitted and not used to supplement the cash flows of payers.

5.3 The ATO's 1995 review of PPS found that failure to remit was a major problem compliance problem for PPS. Subsequent ATO projects have supported this finding.

5.4 For example, in 1997 the ATO identified PPS payers from 1996 external building approval data in Toowoomba and the surrounding shires. Of 245 builders identified, 55 were subsequently selected for audit.³⁷ Audit activity included a review of payers' compliance with their obligation to remit PPS amounts deducted to the ATO. These audits found a total of \$1.2 million that had been deducted from prescribed payments by payers but not remitted to the ATO.

5.5 Audits carried out during the Building and Construction project also examined payer compliance with their obligation to remit. The 1997-98 results of the project indicate that remittances for payers visited during the project increased by approximately 25 per cent from \$51 to \$63 million.

³⁷ The 55 payers selected for audit were selected on the basis that there did not appear to be a PPS registration, the builder's remittance pattern was not commensurate with the size of projects undertaken or the builder had a poor compliance history.

5.6 The ATO has employed a number of strategies to detect and rectify instances of failure to remit, including:

- routine follow-up of payers (who the ATO considers to be regular remitters) if a payment is not received when it is expected;
- matching of credits claimed by payees in Income Tax Returns with amounts reported and remitted by payers (although as discussed in Chapters 2, 3 and 4 recent activity in this area has not been comprehensive); and
- follow-up of payers who do not lodge end of year stationery (Annual Reconciliation Statements and/or Payment Summaries) or who have discrepancies between the amount of deductions reported and amounts remitted.

5.7 During the audit, the ANAO reviewed whether these strategies had been successful in treating the risk of payers failing to remit amounts deducted from prescribed payments. Our findings are outlined below.

Following up routine remittances

5.8 Routine, timely follow-up of cases where PPS deductions have not been remitted is an important element in an overall PPS compliance strategy. In particular, it raises the visibility of the ATO and helps payers to rectify problems before they become too large.

5.9 Current PPS legislation requires payers to remit PPS amounts to the ATO on a weekly, monthly or quarterly basis, based on their expected combined annual total liability for PPS, the Pay As You Earn System and the Reportable Payments System. The following table sets out the legislated liability criteria used to determine when remittances are due from PPS payers and provides the number of payers in each category as at 1 July 1998.

Table 1.
Number of payers by remittance cycle

Estimated annual liability	Remittances due	Number of payers
Less than \$25 000	Quarterly	179 975
\$25 000 to \$1 000 000	Monthly	21 476
More than \$1 000 000	Weekly	124

5.10 The estimated value of expected remittances for each period (week, month or quarter) is calculated using the estimated annual liability amount of the payer. To determine the amount expected each period, the ATO divides the annual estimated liability by:

- four, if the payer is a quarterly remitter;
- twelve, if the payer is a monthly remitter; or
- fifty-two, if the payer is a weekly remitter.

5.11 The criteria set out in the above table took effect from 1 July 1998. Prior to this, all PPS payers were obliged to remit PPS deductions on a monthly basis.

Routine follow-up arrangements prior to 1 July 1998

5.12 In March 1997 the ATO changed its procedures to improve the effectiveness of routine remitter follow-up activity by reducing the estimated annual liability criterion from \$30 000 to \$10 000, thereby increasing the number of payers subjected to routine follow up.

5.13 The ATO also increased its focus on routine follow-up activity in an effort to reduce outstanding remittances and, as a result, the total estimated value of remittances outstanding reduced by 61 per cent during 1997-98 from approximately \$820 million to approximately \$320 million.³⁸

5.14 The ANAO noted the ATO had developed business systems capacity to monitor PPS remittances. Prior to 1 July 1998, this system automatically flagged remitters who had an estimated annual liability of \$10 000 or greater if a payment was not received for any given month. Flagged cases were then allocated to ATO staff for follow up.

Routine follow-up arrangements post 1 July 1998

5.15 From 1 July 1998, PPS remitters who have an estimated annual liability of less than \$25 000 will no longer be automatically flagged for follow up if a remittance is not received in any given quarter. However, additional systems capacity has been developed which enables the ATO to run ad hoc queries to identify quarterly payers for follow-up action. We noted that the ATO's principal purpose in developing this system was to ensure that the current focus on remitters was maintained.

5.16 The ANAO concluded that the ATO has made substantial efforts to improve its routine follow-up of PPS non-remitters during the past eighteen months. We consider that the initiatives implemented have led to a reduction in the risk of payers not remitting PPS deductions.

Following up credit discrepancies

5.17 Credit matching involves the matching of PPS credits claimed in payee Income Tax Returns to the amounts reported in Payment Summaries

³⁸ These figures include all payers, not just those with an annual estimated liability of \$10 000 or more.

by PPS payers. As well as enabling the identification of PPS credit over-claims (as discussed in the previous Chapter), this activity allows the ATO to identify instances where payers have failed to remit and subsequently not reported amounts deducted from prescribed payments.

5.18 Routine, timely follow-up of PPS payers can assist the ATO in addressing instances of failure to remit before they amount to considerable taxpayer debts. This is not always the case with credit matching activity which usually takes place several months after the end of the financial year.

5.19 However, the ATO's *routine* follow-up activity relies on estimates and remittances provided by payers, whereas credit matching activity enables the ATO to match the information provided by payers against that provided by payees.

5.20 Credit matching and subsequent follow-up activities enable the ATO to determine precisely amounts that have been deducted by payers (according to payees) and check whether these amounts have been remitted to the ATO.

5.21 We note in Chapter 4 that during the audit the ATO was not in a position to undertake systematic credit matching activity because some 90 per cent of 1996 and 1997 Payment Summaries were not captured on business systems.

5.22 However, 1994 and 1995 Payment Summaries were captured on business systems and were matched to Income Tax Returns in an effort to identify credit discrepancies. The ANAO examined two ATO projects that involved investigation of these discrepancies.

5.23 The first of these projects was carried out in Queensland and involved the follow-up of credit discrepancies for the 1993-94 financial year. The cases selected for review came from ATO offices in Brisbane, Chermside, Townsville and Upper Mount Gravatt. They consisted of discrepancies from individual and company returns in excess of \$2 000. The total value of under remittance found during this project was \$5.3 million.

5.24 The second project also involved credit discrepancies from the 1993-94 financial year and was carried out in the ATO's Cannington office. A random sample of 200 cases was selected for further investigation from 1 750 identified discrepancies and 40 payers were subsequently audited. This activity identified 25 payers who had not remitted amounts provided as credits to payees. The total value of non-remittance identified was \$1.5 million. The project also found that 84 per cent of the payers who had failed to remit deductions had not lodged PPS end of year stationery.

5.25 The ANAO noted that these projects, which investigated 1993-94 credit discrepancies from five of the ATO's 25 branches, identified a total of \$6.8 million that had not been remitted to the ATO. The ANAO calculated that the Queensland project raised approximately \$28 in debt for each dollar of direct salary invested in the project due to failure to remit.³⁹ This significant return on investment suggests that credit matching and subsequent audit activity can be effectively used to identify and rectify instances of failure to remit.

5.26 We noted that the ATO's routine remittance follow-up activity was substantially less comprehensive during 1993-94 than it was during our recent audit. As a result, an increased focus on routine follow up may have reduced the return on investment for the above projects. However, we also noted that the recent project undertaken by the ATO in Toowoomba (discussed on paragraph 5.4), which identified \$1.2 million that had been deducted but not remitted to the ATO, was undertaken when there was a significantly higher focus on routine follow-up activity.

5.27 As discussed in Chapters 3 and 4, credit discrepancies can arise for reasons other than payers failing to remit PPS deductions so not all credit discrepancies will be a result of failure to report and remit PPS deductions.

5.28 However, the ANAO considers that the ATO could develop criteria to identify those PPS credit discrepancies that indicate a high risk of failure to report and remit PPS deductions. Similar to proposals discussed in previous Chapters, the ATO could follow up discrepancies which:

- exceed a specified threshold; and
- involve payers with a poor remittance history.

5.29 During the audit we noted ATO plans to develop failure to remit credit matching criteria as a result of its capture and use of 1997 South Australia and Northern Territory Payment Summary information. However, the ATO cannot make effective use of these criteria unless it captures Payment Summary information on its business systems. As noted in Chapter 2, the ATO has captured less than ten per cent of Payment Summary information on its business systems over the past two years.

5.30 Because some 90 per cent of Payment Summaries have not been captured on ATO business systems over the past two years, the ANAO concluded that the ATO had not used credit discrepancies to systematically detect and follow up instances of failure remit. This is despite evidence

³⁹ An average staffing level of 3.7 was invested into the project. The ANAO used a direct salary cost of \$50 000 which is commensurate with the top of the ASO 6 salary band.

suggesting that credit discrepancies would be an effective means of identifying failure to remit.

5.31 We do not suggest that all credit discrepancies should be followed up in an effort to rectify failure to remit. However, it is our view that the incidence of and risk to revenue from failure to remit could be considerably reduced if the ATO:

- identifies all credit discrepancies; and
- uses criteria which enable cost-effective identification and follow-up of discrepancies where there is a high risk to revenue from deductions that have not been remitted by payers.

Recommendation No.7

5.32 The ANAO recommends the ATO:

- develop criteria to identify PPS credit matching discrepancies that indicate a high risk to revenue from failure to remit; and
- follow up potential instances of failure to remit identified using these criteria.

ATO Response

5.33 The ATO agrees with this recommendation and notes that this is under way.

Following up annual stationery

5.34 At the end of each financial year, each payer is required to lodge an Annual Reconciliation Statement that provides a summary of the prescribed payments made and the amounts deducted from these payments for all payees during the year. At the same time, payers are required to lodge Payment Summaries for each payee they made prescribed payments to (unless the payee holds a Reporting Exemption Number). These documents must be lodged by 14 August each year.

5.35 When the ATO receives an Annual Reconciliation Statement it checks that the total deductions reported match the amounts remitted by the payer throughout the year. If these amounts do not match, the ATO commences action to recover outstanding remittances.

5.36 Timely follow-up of PPS annual stationery non-lodgment is important because:

- this stationery provides the information needed for income and credit matching, which the ANAO considers to be essential for the effective management of the compliance risks associated with PPS; and

- it provides another avenue for the ATO to raise its visibility in the community.

5.37 Although past ATO projects have found a high correlation between submission of this stationery and remittance compliance, preliminary findings of the ATO's annual stationery compliance project (discussed in paragraph 5.42) do not appear to support this. The final results of this project were not available at the time this report was prepared so the ANAO was unable to confirm whether non-submission of annual stationery is correlated with non-remittance.

5.38 In the ANAO's view it is important that the ATO has a program of routine, timely follow up where annual stationery has not been submitted by payers.

5.39 Existing ATO policy for follow-up of annual stationery non-lodgment includes the issue of letters to payers who have not lodged end of year stationery. If payers do not respond to these letters, their accounts are automatically flagged by ATO business systems and allocated to an ATO staff member for follow up.

5.40 However, although the due date for annual stationery is 14 August each year, ATO figures show that in November 1997:

- 41 per cent of 1996-97 annual stationery had not been lodged; and
- 27 per cent of 1995-96 annual stationery had not been lodged.

5.41 ATO data also revealed that 24 per cent of 1996-97 stationery was still outstanding in May 1998.

5.42 In February 1998, the ATO commenced a national compliance project to sample the risk that non-lodgment of 1995-96 and 1996-97 annual stationery represents as well as to ascertain the reasons for non-lodgment. Results were not available at the time of writing so the ANAO was unable to review the project's outcomes.

5.43 Although the ANAO supports this activity, which is likely to lead to a reduction in the amount of outstanding PPS annual stationery, we consider that the ATO should have addressed this issue in a more timely manner, particularly for 1995-96 stationery. Generally, the longer it takes the ATO to establish a debt, the less likely it is that the debt will be collected.⁴⁰

⁴⁰ This was demonstrated in the our recent audit report on Debt Collection in the ATO, Auditor-General Report No. 13 1996-97, *ATO Debt Collection*, p. 21.

5.44 The ANAO concluded the ATO's follow-up of PPS annual stationery non-lodgment during recent years has not been timely and this has increased the risk that unremitted amounts will not be collected.

Alternative annual reconciliation processes

5.45 In 1996, the Government set up the Small Business Deregulation Task Force to examine the compliance burden placed on small business by Commonwealth regulations. The November 1996 report of the Task Force recommended, among other things, that an annual compliance statement be introduced to incorporate all ATO annual returns for small business taxpayers.⁴¹

5.46 In its response to this report, the Government asked the ATO to investigate the possibility of developing a single annual compliance statement for all *withholding* annual reporting obligations for small business.

5.47 The ATO has developed a set of proposals to implement this recommendation and plans to introduce an annual compliance statement in 1999 that incorporates end of year reporting for the Pay As You Earn system and the annual compliance statement for the Prescribed Payments System. Rather than asking taxpayers to complete a blank annual reconciliation, the form is to be prepared by the ATO (including the amounts remitted throughout the year) and sent to taxpayers for confirmation.

5.48 The ANAO supports ATO efforts to reduce the compliance burden of taxpayers. However, we noted that the proposed statement does not incorporate annual Payment Summary reporting for PPS though payers will still need to submit this information. We acknowledge that the incorporation of Payment Summary reporting on this statement would not be practical for the ATO or payers as some PPS payers are required to complete a substantial number of Payment Summaries for their payees.

5.49 However, we note that full capture on its business systems of all PPS Payment Summary information would enable the ATO to perform automated annual reconciliation of payer accounts to detect non-remittance of deductions. This would make PPS Annual Reconciliation Statements unnecessary and is supported by the ATO's 1998 risk assessment of PPS that noted that the full capture of Payment Summaries would obviate the need for payer reconciliations.

⁴¹ Report of the Small Business Deregulation Task Force, *Time for Business*, November 1996, p. 39.

5.50 The ANAO also notes that use of interactive voice recognition technology (as suggested in Chapter 2) can potentially encourage more timely lodgment of PPS annual stationery as some payers may prefer to use this method of providing information to the ATO.

Conclusion

5.51 Results of a number of ATO compliance projects have indicated that there is a high risk that PPS payers will not remit PPS deductions to the ATO. The ANAO noted that the ATO had considerably increased its focus on the routine follow-up of non-remittance during 1997-98. However, we noted that the systematic use of Payment Summary information would further reduce the risk of unremitted deductions because it enables the ATO to check the amounts reported and remitted by payers against the credits claimed by payees.

5.52 We also found that the ATO had not undertaken timely follow up of annual PPS stationery non-lodgment. This stationery is important because the stationery forms the basis for credit and income matching activities. The ANAO noted that the implementation of alternative information collection technology may encourage more timely submission of PPS annual stationery and capturing all Payment Summaries would obviate the need for PPS payers to complete and forward Annual Reconciliation Statements.

6. Managing exemptions and variations

This chapter discusses the ATO's management of PPS exemptions and variations. It reviews, in particular, the issue of exemptions and variations, the review of Payee Declarations and the review of existing exemptions and variations.

Introduction

6.1 Exemptions and variations are issued by the ATO to allow a reduction in the amount of tax deducted from prescribed payments. They are given in circumstances where the ATO judges that the ordinary deduction rate of twenty per cent does not fairly represent the taxpayer's taxation liability or where taxpayers have established a sound record of compliance. These instruments can have one or both of two effects. They can reduce the amount of tax to be deducted by the payer from twenty per cent to some other level (from zero to nineteen per cent) and/or reduce PPS reporting obligations.

6.2 There are three different instruments as follows:

- **Deduction Variation Certificates.** These certificates authorise the payer to deduct PPS amounts from prescribed payments at a level lower than twenty per cent. They can authorise deductions ranging from zero to nineteen per cent. They have no effect upon reporting arrangements as Payee Declarations and Payment Summaries must still be forwarded for these payees. Once issued, these certificates are valid until they are revoked by the ATO or by the client upon request, so they may have an unlimited life.
- **Deduction Exemption Certificates.** These certificates authorise the payer not to deduct amounts from prescribed payments. Similar to Deduction Variation Certificates, they have no effect upon reporting arrangements and once issued, do not expire unless they are revoked by the ATO or by the client upon request.
- **Reporting Exemption Numbers.** The primary effect of these numbers is to exempt payers and payees from PPS reporting obligations. Payee Declarations and Payment Summaries are not required for payees who hold Reporting Exemption Numbers. They also authorise the payer not to deduct amounts from prescribed payments. Unlike Deduction Exemption and Variation Certificates, Reporting Exemption Numbers are only valid for up to three years.

6.3 To qualify for any of these instruments payees must apply to the ATO and satisfy certain legislated criteria. The ATO requires that the applications for all three instruments be supported by an estimated profit and loss statement for the two years following the application date. Applications for exemption instruments must be accompanied by a statement from a registered tax agent which confirms that the applicant's last Income Tax Return accurately reflects assessable income and allowable deductions for that year.

6.4 The ANAO noted that zero per cent Deduction Variation Certificates provide similar benefits to Deduction Exemption Certificates. Both certificates entitle payees to a zero per cent deduction rate for an unlimited duration (unless revoked by the Commissioner). However, applications for Deduction Exemption Certificates are subject to more stringent financial criteria under PPS legislation.

6.5 ANAO analysis of ATO data shows that approximately 330 000 exemption and variation instruments were in force at 30 June 1998. Figure 6 summarises the characteristics of the three different instruments and indicates the number of each type issued as at 30 June 1998.

Figure 6.
Variation and exemption instruments

	Duration	Deduction rate	Payment summaries	Number issued *
Deduction Variation Certificate	Unlimited	0 - 19%	Required	299,946
Deduction Exemption Certificate	Unlimited	0%	Required	20,060
Reporting Exemption Number	Up to three years	0%	Not required	10,708

* Number of each type of instrument in force as at 30 June 1998

6.6 The ATO has three main responsibilities in relation to exemptions and variations. These are:

- issuing exemptions and variations;
- reviewing Payee Declarations; and

- reviewing existing exemptions and variations.

6.7 During the audit, the ANAO reviewed the ATO's performance in these areas and our findings are discussed below.

Issuing exemptions and variations

Exemption and variation rulings

6.8 Taxation rulings enable the ATO to publicly clarify its position on granting and maintaining exemptions and variations. On 1 January 1993 simplified PPS legislation was introduced which rendered existing exemption and variation rulings obsolete. Documents reviewed by the ANAO during the audit indicate the ATO intended to clarify its position on exemptions and variations by the end of the 1995-96 financial year. However, the ATO did not issue draft variation and exemption rulings⁴² for public comment until August 1997. Final versions of these rulings are not expected to be released until November 1998.

6.9 This means definitive clarification of the ATO's position on the 1993 exemption and variation legislation changes has not been available for payees and payers for more than five years.

6.10 The ANAO considers it is important that exemption and variation rulings remain up to date because they:

- clarify the ATO's interpretation of a complex aspect of the prescribed payments legislation for taxpayers;
- set out the ATO's official position regarding exemption and variation legislation for ATO staff; and
- set out for taxpayers ATO exemption and variation policy and procedures that are not provided in tax legislation (for example, they specify in detail what information is required by the ATO to determine whether an application meets legislated criteria).

Recommendation No.8

6.11 The ANAO recommends the ATO ensure that, when complex aspects of tax legislation are introduced or altered, rulings are promulgated in a timely manner to clarify the ATO's interpretation of the legislation.

ATO Response

6.12 The ATO agrees with this recommendation.

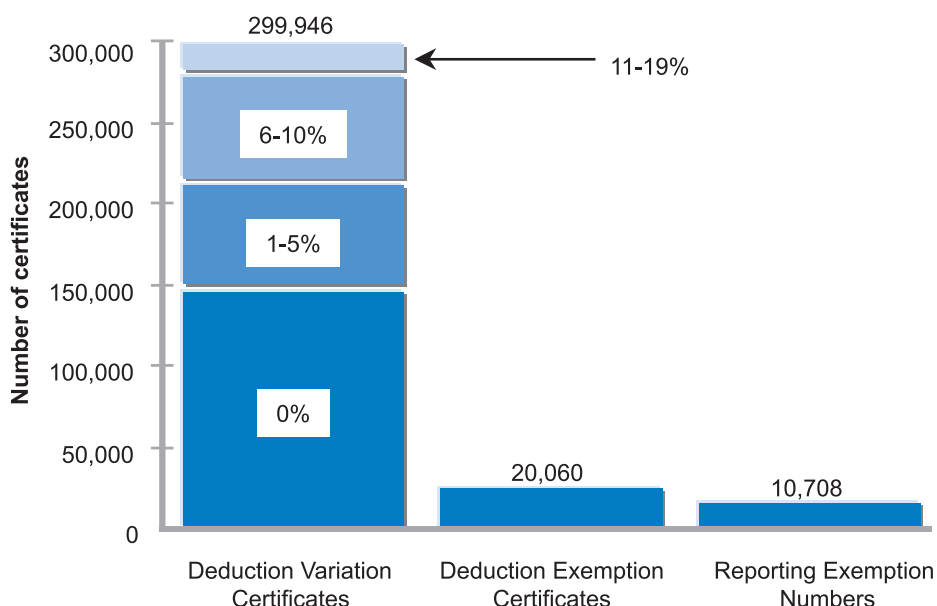
⁴² Draft taxation ruling TR 97/D13 covers PPS Deduction Variation Certificates and draft taxation ruling TR 97/D12 covers PPS Deduction Exemption Certificates and Reporting Exemption Numbers.

Issuing procedures

6.13 Figure 7 sets out the number of exemptions and variations issued at 30 June 1998 and includes the number of Deduction Variation Certificates issued by selected percentage ranges.

Figure 7.

Number of exemptions and variations issued at 30 June 1998



6.14 Previous ANAO reports tabled in 1986 and 1992 raised concerns about the low level of scrutiny applied to applications for exemptions and variations prior to issue.⁴³ During our recent audit, we noted that, according to a 1995 ATO review of PPS, some ATO staff were issuing Deduction Variation Certificates to payees with little or no evidence to substantiate their claim for a reduced deduction rate. Subsequently, a 1998 ATO risk assessment for exemptions and variations noted that Reporting Exemption Numbers were renewed with insufficient review of the payee's financial situation or compliance record at the time of renewal.

6.15 As indicated by the above diagram, approximately 50 per cent of Deduction Variation Certificates in force at 30 June 1998 were issued with

⁴³ Auditor-General Efficiency Audit Report, *Australian Taxation Office, Prescribed Payments System*, September 1986, p. 2 and Auditor General Report No. 28, 1991-92, *Australian Taxation Office: Prescribed Payments System*, p. 28-29.

a zero per cent deduction rate. The large number of PPS payees with zero per cent deduction rate entitlements could be a result of the weaknesses in issuing practices identified by the ATO.

6.16 We also noted that the large proportion (50 per cent) of zero per cent Deduction Variation Certificate holders does not appear to be consistent with ATO policy set out in its draft tax ruling on Deduction Variation Certificates. This ruling states that:

...A nil rate of deduction (0 per cent) is reasonable only in exceptional cases.

6.17 We noted that the ATO has recognised these problems and during the audit it took the following steps to ensure that exemptions and variations are issued in accordance with legislated criteria:

- application forms for variations and exemptions were revised to ensure that sufficient information is obtained on applications to determine whether the applicant meets legislated criteria;
- exemption and variation issuing procedures were revised to ensure that exemptions and variations are issued only to applicants who meet legislated criteria; and
- ATO staff who issue exemptions and variations are being provided with training regarding the new issuing procedures for exemptions and variations.

6.18 The ANAO supports these initiatives and considers that they will reduce the risk of exemptions and variations being issued in inappropriate circumstances.

Reviewing Payee Declarations

6.19 Payees who hold a Deduction Exemption or Deduction Variation Certificate must lodge a Payee Declaration with the payer for their entitlements to take effect.⁴⁴ The payer then forwards a copy of the Declaration to the ATO. If a completed Payee Declaration is provided, unless exemption or variation entitlements are quoted, the payer deducts amounts from prescribed payments at the rate of twenty per cent.⁴⁵

6.20 Payee Declarations were introduced as part of the simplified PPS legislation on 1 January 1993. They provide the ATO with the following information:

⁴⁴ Reporting Exemption Number holders are not required to complete Payee Declarations.

⁴⁵ If a payee does not complete a Declaration, the payer is obliged to deduct tax from payee prescribed payments at the maximum rate of 48.5 per cent.

- payee TFN and contact details;
- payer TFN and contact details; and
- deduction exemption and variation details, including the variation or exemption number and variation rate, where applicable.

6.21 Although this allowed the ATO to determine whether valid exemption and variation details are being quoted by payees,⁴⁶ prior to 1997, the ATO did not capture Payee Declaration information on its business systems and was unable to automate validation processes. As discussed in Chapter 2, manual matching of this data is impractical so the ATO was unable to effectively verify the exemption and variation details provided on Payee Declarations prior to 1997.

6.22 The validation of exemption and variation details provided by payees to payers is important because if the payee quotes Deduction Exemption or Deduction Variation Certificate details to which they are not entitled, the payer deducts amounts from prescribed payments at the level quoted (which may be 0 per cent). This effectively reduces the tax deducted and remitted to the ATO through PPS. The ANAO considers that if a payee deliberately quotes invalid exemption or variation details, there is a high risk that they will not report all their income in Income Tax Returns so they will pay less tax than is duly payable.

6.23 Validation is also important because it reduces the risk of payees gaining a competitive advantage over others in the industry by having access to funds to which they are not entitled.

6.24 The ATO has stated that it is developing systems capacity that would automatically validate the exemption and variation details quoted on Payee Declarations. For the reasons noted above, the ANAO supports this activity and suggests that the ATO introduce as soon as possible automated validation of the exemption and variation details provided on Payee Declarations.

Reviewing existing exemptions and variations

6.25 Systematic review of existing exemption and variation instruments is needed to ensure that exemption and variation holders continue to satisfy legislated criteria. Review of Deduction Variation and Deduction Exemption Certificate holders is particularly important because these certificates do not expire.

⁴⁶ Except for Reporting Exemption Numbers.

6.26 The current draft taxation rulings on exemptions and variations stipulate that exemption and variation holders must continue to satisfy specified criteria. These criteria state that:

- exemption or variation entitlements must be reasonable, based on the payee's current circumstances; and
- payees must maintain satisfactory compliance with all laws administered by the Commissioner.

Reasonableness of existing entitlements

6.27 The ANAO found no evidence, prior to 1997, of systematic ATO review activity aimed at determining the reasonableness of existing exemption and variation entitlements. However, during 1997, as part of a comprehensive data analysis exercise, and during 1998, as part of the Building and Construction project, the ATO reviewed the reasonableness of existing Deduction Variation Certificate rates. This activity had not been completed at the time of writing so the ANAO unable was unable to review the outcomes.

6.28 The ANAO also noted the ATO could introduce automated verification of existing deduction rate entitlements, based on information provided by taxpayers in their income tax return. The ATO has included a net PPS income field on the 1998 Income Tax Return that would allow the automatic calculation of an appropriate deduction rate. This calculated rate could then be compared with existing entitlements.

6.29 Because there were approximately 320 000 Deduction Exemption and Deduction Variation Certificate holders at 30 June 1998, automated verification of deduction rate entitlements would enable the ATO to effectively review a much larger proportion of the exemption and variation population than manual review.

6.30 However, automated verification of entitlements would involve substantial changes to existing business systems as the information required is currently stored in two different systems. Also, a significant number of taxpayers may not complete the Net PPS income field added to Income Tax Returns as it is contained in the statistical information block. Although the ATO has commenced a number of initiatives to encourage taxpayers to complete these fields, unless a substantial majority of payees complete this information, automatic verification of entitlements may not be cost-effective.

6.31 The ANAO considers further investigation is necessary of the costs and benefits associated with automated verification of exemption and variation rate entitlements.

Recommendation No.9

6.32 The ANAO recommends the ATO investigate the costs and benefits of introducing automated rate review for exemption and variation holders.

ATO Response

6.33 The ATO agrees with this recommendation and notes that this is under way.

Maintaining a good compliance record

6.34 PPS legislation states that the Commissioner may revoke a variation or exemption at any time. The current draft Income Tax rulings indicate that exemptions and variations will be revoked if a payee fails to comply with any laws administered by the Commissioner of Taxation. For example, if the payee has outstanding tax debts or fails to lodge required returns, under criteria set out in the draft rulings, the ATO has grounds to revoke the exemption or variation.

6.35 Given the benefits provided by variations and exemptions, the ANAO considers that the threat of revocation could provide payees with a powerful incentive to pay outstanding debts or lodge outstanding returns. However, prior to 1997, we found no evidence of systematic ATO activity aimed at reviewing the compliance records of existing exemption and variation holders. The ATO has stated that the implementation of data warehousing technology in 1996 has enabled them to cost-effectively address this issue over the past eighteen months.

6.36 We noted that in 1997 the ATO conducted two pilot projects specifically aimed at reviewing exemption and variation holder compliance with income tax legislation.

6.37 The first project involved a sample of exemption and variation holders from Penrith. However, a number of inaccuracies were discovered in the case selection data used and this prevented the ATO from drawing any definitive conclusions from the project.

6.38 The second project focused on variation and exemption holders from Western Australia and sought to identify those who had failed to lodge Income Tax Returns. Preliminary results from this project indicate that PPS payees were motivated to lodge outstanding Income Tax Returns when threatened with revocation. The project also found that new certificates had been issued when ATO data indicated the payee was not complying with his/her tax obligations.

6.39 We also noted that the ATO recently performed significant analysis of its existing data to investigate the compliance records of exemption and variation holders. Although the results of this data analysis were still being

tested through field work during our audit, ATO data indicated that 45 per cent of exemption and variation holders had not lodged returns as required, had not lodged remittances as required or had outstanding taxation debts.

6.40 ANAO analysis of ATO data indicates that six per cent of exemption and variation holders had outstanding tax debts at 30 June 1997. The total sum of these debts was \$322 million. The substantial number of exemption and variation holders with outstanding tax debts and the quantum of outstanding debt suggest there is potential to use the threat of revocation as a significant compliance lever.

6.41 Although the ANAO noted the ATO's intention to follow up potential non-compliance identified as a result of its recent review (discussed in paragraph 6.39), we concluded that the ATO had undertaken very little activity aimed at detecting poor compliance by exemption and variation holders until recently. As a result, the ATO was not in a position to perform systematic follow-up of poor compliance by exemption and variation holders. We noted that increased review activity could provide substantial leverage for the ATO in obtaining outstanding returns or collecting outstanding tax debts. However, we consider the ATO should investigate the costs and benefits of using revocation as a compliance lever.

Recommendation No.10

6.42 The ANAO recommends the ATO investigate the compliance impact if it were to revoke exemptions and variations where non-compliance is detected.

ATO Response

6.43 The ATO agrees with this recommendation and notes that this is under way.

Conclusion

6.44 The ANAO concluded that although little action was taken until late 1997, concerted efforts have been made by the ATO to address deficiencies in its administration of exemptions and variations during the past year. For example the ATO has:

- taken action to ensure that exemptions and variations are issued in accordance with PPS legislation; and
- made more effective use of the information provided in Payee Declarations (including verifying exemptions and variation details quoted by payees).

6.45 The ANAO noted that additional information has been requested on 1998 Income Tax Returns to enable automated rate verification. However, the ANAO was unable to determine whether the implementation costs of automated verification would be outweighed by the benefits, based on the information available. We consider the ATO should further investigate the costs and benefits of introducing automated rate verification.

6.46 The ANAO noted that increased review of exemption and variation holder compliance could provide substantial leverage for the ATO in obtaining outstanding returns or collecting outstanding tax debts. We suggested the ATO investigate the likely compliance impact of this activity.

7. PPS management issues

This chapter discusses several important PPS management issues including the ATO's PPS risk assessments, coordination of PPS compliance activities in the ATO and PPS project performance information.

Introduction

7.1 Effective planning, coordination and review of PPS compliance activities can significantly improve PPS compliance because it enables the ATO to identify and target areas where there are substantial compliance risks and engage in more effective planning and strategy formulation.

7.2 Although this audit did not include an extensive review of the ATO's overall planning and review activities, these areas have been addressed in a number of recent ANAO reports.⁴⁷

7.3 During this audit we reviewed annual risk assessments for the relevant ATO business lines and the ATO's PPS risk assessments. We also examined the following two aspects of the ATO's administration of PPS:

- coordination of PPS administration within the ATO; and
- performance information from PPS compliance projects.

7.4 Findings in relation to these issues are set out below.

PPS risk assessments

7.5 The ATO has stated that decisions regarding the resources applied to PPS and, consequently, the administrative effort applied to identified high risk aspects of PPS, are made in the context of a comprehensive risk management framework where competing priorities within the ATO need to be balanced.

7.6 The ANAO noted that, over the past four years, relevant business line risk assessments have rated PPS administration as a significant risk. For example:

- in December 1994, the ATO noted that it had concerns about the health of PPS;

⁴⁷ These reports include:

- Auditor-General Report No. 37 1996-97, *Risk Management: Australian Taxation Office*.
- Auditor-General Report No. 19 1997-98, *Risk Management in ATO Small Business Income: Australian Taxation Office*.
- Auditor-General Report No. 20 1997-98, *Sales Tax: Australian Taxation Office*.

- in April 1995, the ATO noted that it was exposed to a major risk of non-compliance and PPS-related fraud;
- in April 1996, the ATO stated an intention to arrest the decay of PPS;
- in March 1997, the ATO noted that the integrity of the PPS system has been compromised as a result of a loss of focus on system controls and the lack of effective review mechanisms; and
- in March 1998, the ATO noted that its commitment to PPS appears to have eroded over time.

7.7 We recognise that PPS is one of many revenue collection systems administered by the ATO. However, we noted that despite mounting evidence of non-compliance with PPS provisions and system weaknesses, a number of years passed before the ATO took action to address these risks. Also, as previously noted, the ATO has not made effective use of the PPS information provided by taxpayers. As a consequence, the ANAO considers that the ATO has not been in a sound position to make objective decisions regarding the best use of PPS resources.

Coordination of PPS compliance activities

7.8 Responsibility for the administration of the Prescribed Payments System lies with two business lines in the ATO namely:

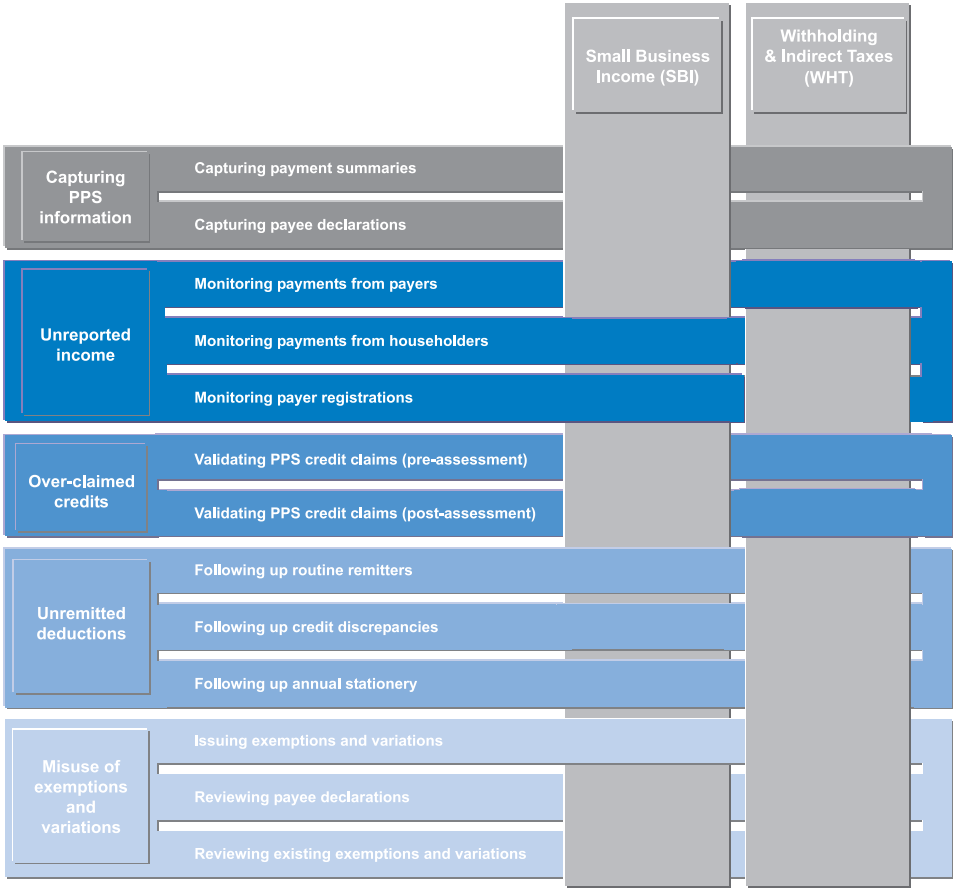
- the Withholding and Indirect Tax business line (WHT) — responsible for managing the collection of PPS revenue; and
- the Small Business Income business line (SBI) — responsible for ensuring that relevant businesses declare all income (including PPS related income) in the tax returns.

7.9 The four key PPS compliance risks identified by the ANAO and addressed during this audit are:

- unreported PPS income;
- over-claimed PPS credits;
- unremitted PPS deductions; and
- misuse of exemptions and variations.

7.10 Figure 8 sets out the responsibilities of SBI and WHT in relation to these risk areas.

Figure 8.
PPS administration responsibility matrix



Note: Where a risk area is covered by a business line block, this indicates the business line has responsibility for that aspect of PPS. For example, SBI is responsible for capturing Payment Summaries and Payee Declarations.

7.11 We noted that prior to 1998 compliance information had generally not been shared between the business lines in an effective and timely manner that compliance activities were not adequately coordinated between the business lines.

7.12 For example, when Payee Declarations were introduced in 1993, WHT decided not to capture this information on business systems.⁴⁸ As a consequence, SBI could not use this information to establish which payees should be forwarding income tax returns. This decision also impacted on

⁴⁸ Prior to 1998, the WHT business line was responsible for the capture of PPS Payment Summaries and Payee Declarations. SBI is now responsible for this task. The ATO did not begin capturing Payee Declarations on its business systems until October 1997.

the quality of PPS data used in credit and income matching activities. The ANAO considers that these consequences were not adequately addressed by WHT when it decided not to capture this information.

7.13 The ANAO also noted that in 1995 two reviews of PPS administration were carried out by the ATO, one in SBI and one in WHT. We found no evidence that there was significant input from either business line into the other's review. We noted that compliance strategies implemented as a result of these reviews were developed together by representatives from both business lines. However, we consider that it would have been more efficient to carry out one review with the involvement from both business lines.

7.14 In addition, the ANAO found that the initial PPS integrity review (carried out by WHT in 1997) did not include sufficient consideration of SBI's PPS compliance activities. Consequently, the compliance strategies recommended by the review team for the 1997-98 year did not adequately address some areas where SBI had primary responsibility (for example, non-lodgment of Income Tax Returns). However, we noted that one of the recommendations of this review was that each year a joint integrity review be undertaken in preparation for PPS Health of the System Assessments. This recommendation was implemented in 1998.

7.15 The ANAO noted that during the past eighteen months the ATO has taken steps to improve the coordination of PPS administration between SBI and WHT. Initiatives have included:

- combining SBI and WHT resources for all ATO activities in South Australia and Western Australia;
- establishing joint SBI/WHT field teams for taxpayer visits during the Building and Construction project;
- ensuring that substantial input was received from both business lines for the 1998 PPS integrity review;
- transferring responsibility for the capture of Payment Summaries and Payee Declarations from WHT to SBI. As a consequence, the business line which benefits most from this information is responsible for its capture on ATO business systems;
- establishing a cross-line PPS steering committee, responsible for the strategic direction of PPS management, and a cross-line PPS management committee, responsible for implementing the directions of the committee; and
- implementing formal communication channels to promote regular and timely discussion of PPS compliance activity plans and outcomes.

7.16 The ANAO supports these initiatives. We also support the ATO's stated intention to seek further opportunities for improvement in its coordination of PPS compliance activities. If successfully implemented, the revised arrangements discussed above will improve the coordination of the ATO's administration of PPS.

7.17 The ANAO concluded that, although there was substantial scope for improvement in the coordination of PPS compliance activities in past years, the ATO had significantly improved this aspect of its administration during the past year. A number of initiatives have been implemented to improve the coordination of the ATO's PPS administration and these will lead to more efficient and effective administration of the system.

PPS project performance information

7.18 Effective project performance information enables the ATO to make objective comparisons of the costs and benefits of various compliance projects. This, in turn, enables the ATO to better identify areas where there is a high risk to revenue as a result of non-compliance and allocate resources accordingly. Information structured around identified compliance risks is important if the ATO is to allocate its resources rationally. This is particularly relevant in an environment of diminishing resources.

7.19 The ATO also requires defensible estimates of the total costs and compliance impact of specific compliance improvement initiatives to compare the costs and benefits of compliance activities.

7.20 None of the project performance information examined by the ANAO (including several projects carried out during the past three years) included estimates of the total costs of the project. In addition, although project reports included the impact on revenue from some individual project activities, the information provided was not sufficient to determine the overall benefits arising from each project.

7.21 For example, the Road Transport project was intended by the ATO to be a significant PPS compliance initiative. The project commenced in March 1997, was completed in December 1997 and a draft report on the project was completed in April 1998. The report was not finalised until August 1998.

7.22 The ANAO noted the project report did not include estimates of the total cost of the project and, although the outcomes of individual activities for this project were reported, the information provided did not always include estimates of additional revenue generated. More specifically, although reported results included the *number* of demands issued for lodgment of Income Tax Returns and the *number* of cases where

returns were subsequently lodged, it did not indicate the amount of revenue associated with these returns. Inclusion of revenue information for this aspect of the project would enable the ATO to obtain a more accurate picture of the amount of revenue at risk as a result of Income Tax Return non-lodgment for PPS payees.

7.23 We were unable to determine the effectiveness of the income and credit matching activity carried out during the project as discrepancies identified from 1996 road transport Payment Summaries were not followed-up by the ATO. However, the project investigated some discrepancies from the industry that had been identified as a result of matching 1995 Payment Summaries to Income Tax Returns. Insufficient information was provided in the final report to determine what proportion of mismatched cases were investigated and why these cases were selected.

7.24 While the performance information provided for the 1997-98 activities of the Building and Construction project was substantially more comprehensive than that provided for the Road Transport Project, the report did not note the costs of particular activities and it did not enable easy determination of significant compliance risks. However, the ANAO notes that the report reviewed was in draft form and is only an interim report for the Project.

7.25 We concluded that the ATO could substantially improve the performance information provided in PPS compliance project reports by including information regarding the total costs and benefits of projects. This will enable the ATO to identify areas where there is a high risk to revenue or a high risk to the integrity of the tax system and allocate resources accordingly.

Recommendation No.11

7.26 The ANAO recommends the ATO improve its identification of significant compliance risks and subsequent targeting of resources by determining and recording the total costs and impact of PPS compliance activities.

ATO Response

7.27 The ATO agrees with this recommendation.

Conclusion

7.28 The ANAO found that the ATO has taken a number of years to address identified significant risks to PPS compliance. Also, as previously noted, the ATO has not made effective use of the PPS information provided by taxpayers. The ANAO considers that the ATO should re-assess its use

of this information to allow soundly-based decisions to be made regarding the best use of PPS resources.

7.29 We noted that, although there was substantial scope for improvement in the ATO's coordination of PPS administration in past years, substantial improvements had been made during 1997-98. We consider that these measures should lead to better coordination and more efficient and effective use of PPS resources in the future.






7.30 We also found that the ATO's administration of PPS would benefit substantially from improvements in compliance project performance information. Performance information is important because it allows the ATO to better identify areas where there is a high risk to revenue (as a result of non-compliance) and allocate resources accordingly.








Appendices

Appendix 1

Overview of PPS stationery

1. The following table sets out the frequency, information provided and the possible uses for the information provided in each form or return. Possible uses are colour coded to indicate which of the major PPS risk areas (as set out in our framework for analysis) are affected by use of the information, where:

-  represents 'Unreported income';
-  represents 'Over-claimed PPS credits';
-  represents 'Unremitted deductions';
-  represents 'Misuse of exemptions and variations'; and
-  represents all risks.

Return type	Frequency of return	PPS information provided	Possible uses
Payee Declaration	At the commencement of a PPS-related, contract-for-work relationship between a payee and payer or during the contract. ¹	<ul style="list-style-type: none">Payee TFN, name and addressPayer TFN, name and addressPayee exemption or variation number (where appropriate)Payee deduction rate (where appropriate)	<ul style="list-style-type: none"> Identify payees who may be liable to lodge income tax returns for the current year Identify payers who may not be registered Identify payers who should be forwarding PPS Payment Summaries during the current year Identify payers who should be remitting PPS-related deductions during the current year Determine whether payee quotes correct TFN Determine whether payee quotes valid exemption or variation certificate (where relevant) Determine whether payee quotes correct deduction rate (where relevant) Update ATO business systems contact information for payers and payees

⁴⁹ See paragraph 2.32 for details of when Payee Declarations are provided during a contract.

Return type	Frequency of return	PPS information provided	Possible uses
Payment Summary	At the end of each financial year from each payer for each of their payees.	<ul style="list-style-type: none"> Payee TFN, name and address Payer TFN, name and address Total gross prescribed payments made by the payer to the payee during the year Total PPS deductions from PPS-related payments for the payee during the year 	<ul style="list-style-type: none"> Determine total PPS-related payments made to each payee during the year Identify payers who may not be registered Determine total deductions made for each payee (total credits due to each payee) Determine whether payers have remitted all amounts deducted from payments Determine whether amounts have been deducted at the appropriate rate Update ATO business systems contact information for payers and payees
Annual Reconciliation Statement	At the end of each financial year from each payer.	<ul style="list-style-type: none"> Payer TFN and name Total amount of gross prescribed payments made by the payer to all payees during the year Total amount of PPS deductions on all Payment Summaries during the year Number of Payment Summaries issued by the payer during the year Total PPS amounts deducted & forwarded to the ATO during the year Monthly breakdown of the amounts deducted and the amounts remitted during the year² 	<ul style="list-style-type: none"> Determine whether remittances forwarded to the ATO match deductions reported by payers Determine whether deductions forwarded to the ATO match deductions reported by payers Update ATO business systems contact information for payers

⁵⁰ This is only required if the total annual amount deducted does not agree with the total amount remitted to the ATO

Return type	Frequency of return	PPS information provided	Possible uses
Householder Payment Summary	Within six weeks of a PPS-related building project's completion	<ul style="list-style-type: none">Householder name and addressPayee TFN, name and addressDate and amount of all PPS-related payments made by the householder to the payee	<div><div></div><div>Determine total PPS-related payments made to the payee during the project</div></div> <div><div></div><div>Update ATO business systems contact information for payees</div></div>
Income Tax Return	At the end of each financial year for each taxpayer (payee)	<ul style="list-style-type: none">Payee TFN, name and addressPPS credits claimedPPS gross incomePPS net income³External labour costs claimedVarious other sources of income declared and expenses claimed	<div><div></div><div>Determine whether PPS gross income declared matches payments reported on Payment Summaries for each payee</div></div> <div><div></div><div>Determine whether credits claimed are appropriate based on deductions reported on Payment Summaries for each payee</div></div> <div><div></div><div>Determine whether PPS remittances should have been reported and received from a payer for the payee (through claims for credit)</div></div> <div><div></div><div>Determine whether variation rate is appropriate</div></div> <div><div></div><div>Update ATO business systems contact information for payees</div></div>

⁵¹ This label has been included on income tax returns for the first time in 1998

Appendix 2

ATO Business and Service Line structure

1. The ATO has based its organisational structure around particular client groups. In addition, it has established a specialist tax law program and created specialist functional groups to assist the client group programs.

2. At the time of the audit, the ATO's client group programs, around which the organisation focused its program delivery, were as follows:

- *Individuals Non Business*: has responsibility for salary and wage earners as well as investors;
- *Small Business Income*: has responsibility for businesses with annual turnovers of less than \$10 million; also deals with fringe benefits tax matters for all taxpayers;
- *Large Business and International*: has responsibility for large corporate groups with annual turnovers in excess of \$10 million as well as international tax matters;
- *Withholding and Indirect Taxes*: has responsibility for prescribed payments, sales tax and Pay As You Earn collections;
- *Superannuation*: has responsibility for relevant superannuation policy and administration of Superannuation Guarantee and Reasonable Benefit Limit; and
- *Child Support Agency*.

3. The ATO has set up the following separate support programs to take responsibility for the tax technical service delivery:

- Legislative Services Group;
- Tax Counsel Network;
- Practice Management and Development Group.

4. The corporate, financial and information technology needs for the client group programs are provided by the following support programs:

- Financial Services;
- Corporate Services; and
- Information Technology Service.

5. The ATO considers that this organisational structure enhances output and places greater emphasis on taxpayer compliance strategies, taxpayer education, and accountability for outcomes.

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