

The Auditor-General  
Audit Report No.57 2002-03  
Performance Audit

# **Administration of the Payment of Tax by Non-Residents**

**Australian Taxation Office**

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of Australia 2003

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Canberra ACT  
25 June 2003

Dear Mr President  
Dear Mr Speaker

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

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 'O. Winder', is positioned above the printed name.

Oliver Winder  
Acting Auditor-General

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

## AUDITING FOR AUSTRALIA

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

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# Abbreviations/Glossary

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ABN	Australian Business Number
ABR	Australian Business Register
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
BAS	Business Activity Statement
CFC	Controlled Foreign Company
CGT	Capital Gains Tax
CIDC	Client Identification Centre
CoE	Centres of Expertise
CRR	Client Risk Review
DIMIA	Department of Immigration and Multicultural and Indigenous Affairs
DTAs	Double Taxation Agreements
EM	Explanatory Memorandum
EoI	Exchange of Information
FIF	Foreign Investment Fund
FIRB	Foreign Investment Review Board
GST	Goods and Services Tax
IDF	International Design Forum
IPS	Independent Personal Services
IRW	Investment Royalties Withholding
ISC	International Steering Committee
ISO	International Strategy and Operations
ITAA	Income Tax Assessment Act
ITW	Income Tax Withholding
IWT	Interest Withholding Tax
JTO	Junket Tour Operators
K&IM	Knowledge and Information
KdNet	Knowledge Development Network
LB&I	Large Business and International

NRWT	Non-resident Withholding Tax
OECD	Organisation for Economic Co-operation and Development
PAYG	Pay-As-You-Go
PTax	Personal Tax
RITA	Review of International Taxation Arrangements
SB	Small Business
TAA	Taxation Administration Act
TFN	Tax File Number
TT	Transferor Trust
VSE	Visiting Sportspersons and Entertainers





# **Summary and Recommendation**



# Summary

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## Background

1. Australia's tax legislation requires that non-residents pay tax on any income they receive that originates in Australia. In broad terms, people, companies, trusts, and other entities not residing in Australia are referred to in tax legislation as non-residents.
2. In some cases the tax is paid as a final withholding tax instead of an income tax. In these cases, the person who pays the income to the non-resident pays the tax, not the non-resident. Nevertheless, the tax liability is on the non-resident. Examples include interest, dividend and royalties withholding taxes. The person making the payment (payer) deducts the withholding tax from the income that is to be paid to the non-resident and sends it directly to the Australian Taxation Office (ATO). In most cases the payer is a financial institution or other large corporate.
3. Non-residents are also liable to pay tax in the country in which they reside. Double Taxation Agreements (DTAs) assign taxing rights between countries and prevent a taxpayer from being taxed by more than one country on the same income. Australia has such agreements with 39 sovereign states. The DTAs are legal treaties that have international standing and are ratified by Australian law.

## Administration of non-resident taxation matters

4. The normal provisions of the *Income Tax Assessment Act 1936* and the *Taxation Administration Act 1953* about the imposition, collection, evasion and avoidance of taxation that apply to residents also apply to non-residents. The ATO's administration of the non-resident function takes place within the ATO's business lines as part of the ongoing practice of tax administration. There is no specific group that has responsibility for the administration (as distinct from co-ordination) of non-resident taxation affairs. It is a complex area involving a range of technical concepts and terminology, which are difficult to express simply.
5. The ATO's tax administration framework is based on a number of related components consisting of principles, models and operating concepts. These include self-assessment, the Taxpayers' Charter, the compliance model and risk management. The components interact at different levels and the interactions are critical to good tax administration. The general administration of non-resident matters, and use of compliance assurance strategies in relation to non-residents in particular, are undertaken within this administrative framework.

## Audit objective and scope

6. The objectives of the performance audit were to:
  - provide Parliament with assurance about how efficiently and effectively the ATO administers the payment of tax in respect of non-residents;
  - identify any scope for more effective and efficient administration of the function; and
  - identify any opportunities for the cost-effective collection of additional revenue.
7. The audit complemented reforms to the administration of the non-resident function proceeding at the time of the audit in two areas. These reforms relate to the strengthening of the legislative framework and improving the ATO's internal co-ordination of non-resident administration.
8. Reforms to the legislative framework culminated in the introduction of the *Tax Laws Amendment Bill (No.4) 2003* into Parliament on 13 February 2003. Initiatives to improve co-ordination resulted in the ATO's establishment of the International Strategy and Operations (ISO) Branch in the Large Business and International (LB&I) Business Line.

## Audit findings and overall conclusion

### Audit assurance about non-resident administration

#### *A sound framework*

9. Australian tax legislation generally provides a sound framework for non-residents to comply with their Australian tax obligations. For example:
  - non-resident business operations in Australia that are subject to Australian tax usually involve the non-resident having a physical presence in Australia;
  - thin capitalisation<sup>1</sup> and transfer pricing rules reduce the ability of non-residents to shift profits offshore; and
  - the Pay-As-You-Go (PAYG) withholding arrangements deal with the employment income of non-residents employed in the normal manner.

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<sup>1</sup> A thinly capitalised entity is one whose assets are funded by a high level of debt and relatively little equity. The thin capitalisation rules refer to the legislative requirement for multinational enterprises to be funded to a significant degree by equity (capital) rather than by debt to help ensure Australia receives an appropriate share of global business tax revenue. The new rules seek to limit the amount of debt used to fund Australian operations or investments.

10. Specific and general non-resident withholding obligations play a key role in collecting Australian tax on the forms of income to which they apply, particularly where the non-resident has little or no physical presence or few material assets in Australia.

11. In terms of risk management policies, procedures and practices, the ATO does not identify residency, as such, as a risk factor, except in four specific instances.<sup>2</sup> The Australian National Audit Office (ANAO) found that it is efficient to integrate the administration of residents and non-residents under strategies and activities undertaken at a business line or whole-of-market level for each market segment.

### *Compliance concerns*

12. In those cases where non-resident risks are business line specific, or a withholding obligation applies to a resident payer associated with the non-resident, or there are suitable links between a non-resident and a resident, the ANAO found that the ATO's risk management of non-resident tax matters is sound. However, the ANAO also found that there is a range of compliance concerns associated with non-resident issues without these features. The ATO's co-ordination of non-resident issues that cross business lines had not been well managed in the past. The ANAO considers that the successful establishment of the ISO Branch should largely overcome these co-ordination difficulties. There are also compliance concerns associated with non-resident transactions that fall outside the existing withholding framework.

### *The proposed Non-Resident Withholding Tax*

13. The ANAO noted that the Ralph Committee's recommendations addressed the compliance concerns associated with non-resident transactions that were outside the existing withholding framework.<sup>3</sup> The Government has acted on the Ralph Committee's recommendations and the reforms are part of the *Tax Laws Amendment Bill (No.4) 2003* introduced into Parliament on 13 February 2003.

14. Schedule 5 of the Bill introduces new withholding obligations to apply to certain payments to foreign residents. These will be prescribed progressively by regulation. As explained in the Explanatory Memorandum (EM) accompanying the *Tax Laws Amendment Bill (No.4) 2003*, the Government is

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<sup>2</sup> The ATO maintains dedicated teams to administer some categories of non-residents. These are Visiting Sports and Entertainers, Shipping Industry, Junket Tour Operators and Building and Construction (particularly in the mining and petroleum sector).

<sup>3</sup> J Ralph *Review of Business Taxation—A Tax System Redesigned*, released in July 1999, Recommendations 21.6, 21.7, 22.17 and 22.20.

proposing a phased approach to improved compliance. The Government has stated that the policy objective of the new measures is 'to improve the compliance of foreign residents with their Australian tax obligations through the use of withholding arrangements that can be tailored to address risks of non-compliance.'<sup>4</sup> The Government has further stated that this measure is the only feasible method of achieving compliance.<sup>5</sup>

15. The categories of non-resident activity for which there have been no specifically legislated withholding arrangements have been the subject of over a decade of ATO research. This research has identified eight categories of non-residents and transactions involving them with which a range of compliance problems has been associated. These categories are:

- independent personal services;
- capital gains on the sale of shares and other like assets;
- payments to non-resident contractors;
- non-resident entertainers and sportspersons;
- commissions to junket tour operators;
- rental and capital gain income of non-resident landlords;
- capital gains from the disposal of assets; and
- shipping.

16. The ANAO found that ATO research varied widely in terms of quality and sound methodology. The ATO has sufficient understanding of several categories to support the new regulatory arrangements under consideration. However, in some other categories, the ATO's understanding would require additional work to do so. The ANAO considers that the ATO needs to progress good quality research in several categories, including non-resident landlords and independent personal services. Amongst other things, this research would address issues such as improving the incidence of compliance of non-residents with their Australian tax obligations and the likelihood and amount of additional compliance cost to the community and administrative cost to the Government.

17. The ANAO has noted that, while the non-resident function as a whole does not present compliance risks of the same magnitude as some other compliance concerns facing the ATO, it does involve some areas with relatively high levels of non-compliance. The ATO has advised that annual revenue of at least \$320 million could be collected by tightening up compliance in several

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<sup>4</sup> *ibid.*, p. 73.

<sup>5</sup> *ibid.*, p. 74.

categories in ways that are contingent on the measures proposed in the new Non-resident Withholding Tax (NRWT) regime contained within the *Tax Laws Amendment Bill (No.4) 2003*, presently before Parliament. Such categories are where the known extent of non-compliance permits the calculation of sufficiently reliable and valid estimates of the collectable revenue.

### *Non-resident use of interposed entities in financial transactions*

18. The ANAO noted that non-residents' use of interposed entities has been a matter of concern to the ATO. The ANAO has been advised that it is a common exit strategy of large non-resident entities to hold their investments in Australia via a non-resident interposed entity. The ANAO considers that it would be beneficial for the ATO to continue to bring to government's attention the costs and benefits associated with options for addressing these arrangements, if action to address the arrangements requires a governmental decision. As part of its review of Australia's international tax arrangements, the Government recently announced that this matter would receive further consideration in consultation with the Australian community.<sup>6</sup>

### **Scope for more effective and efficient administration of the function**

19. The ANAO identified three areas of ATO's administration of non-resident taxation central to the sound administration of the function. These were the ATO's use of data about non-residents, the interface between the systems of the ATO and the Department of Immigration and Multicultural and Indigenous Affairs (DIMIA) that relate to the movement of non-residents into and out of Australia, and the transition from the Investment Royalties Withholding (IRW) to the PAYG Income Tax Withholding (ITW) administrative arrangements.

#### *ATO's use of relevant data*

20. Unlike resident taxpayers, data relevant to the administration of the taxation affairs of non-residents can be difficult to identify and obtain. This calls for an ATO wide, strategic approach to the collection of data relevant to the administration of the tax affairs of non-residents and the development of long-term partnerships with external organisations that can provide it. This approach would assist achieving higher levels of compliance by non-residents with their Australian tax obligations.

21. The ANAO found that the ATO would benefit from an integrated strategic framework for its access, collection and use of external data relevant to the

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<sup>6</sup> Press Release No.32: Review of International Taxation Arrangements, The Treasurer, 13 May 2003.

administration of the taxation of non-residents. Improvement to the quality of data recorded from the Schedule 25A forms about related party dealings is required. The quality of the data provided in relation to section 128F exemptions could be also improved.<sup>7</sup>

22. The ANAO found that the amount of collectable tax debt incurred by non-residents might be about \$29 million. The accuracy of this figure is dependent on the clarification of a range of data integrity and debt classification issues. The ANAO considers that it would be desirable for the ATO to address these matters. The incidence, amount and recovery of non-resident tax debt warrants the ATO's closer analysis. There may also be merit in the ATO examining the scope for the wider use of Article 27 of the 2003 Organisation for Economic Co-operation and Development (OECD) Model DTAs to recover the tax debts of non-residents.<sup>8</sup>

23. The recently established International Steering Committee (ISC), that has oversight of a wide range of international taxation administrative matters, could play a key role in developing an integrated strategic framework for access, collection and use of external data relating to non-residents and securing the requisite improvements to data quality.

### *ATO/DIMIA interface initiative*

24. There had been concerns raised in the Commonwealth Parliament about the tax treatment of temporary entrants into Australia, particularly in relation to harvest labour. The ANAO considers that the successful completion of the Individual Auto Registration Project<sup>9</sup> with the DIMIA will improve the ATO's ability to identify non-resident workers and introduce tighter controls for issuing non-residents with Tax File Numbers (TFN).

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<sup>7</sup> All taxpayers regardless of residency who have international dealings in excess of \$1 million with a related party have to lodge a Schedule 25A form. Schedule 25A provides the ATO with a range of data on how much a resident company has received in terms of sales or revenue and how much has been spent in terms of purchases or expenses for a range of categories. Taxpayers claiming exemption from paying Interest Withholding Tax under Section 128F (ITAA 1936) are required to complete the Section 128F label field on the company tax return.

<sup>8</sup> The OECD Model Tax Convention on Income and on Capital provides a standard framework that countries can use as a basis for negotiating bilateral DTAs with other countries. DTAs essentially provide certainty of taxation obligations for residents of both countries, in that they allocate taxing rights between the two countries (referred to as Contracting States in the Model). DTAs also provide a foundation for international co-operation between tax administrations. Article 27 of the Model is titled 'Assistance in the Collection of Taxes'. It is, however, an Article that to date has not generally been included by most OECD member countries in their concluded DTAs.

<sup>9</sup> Under the proposed Individual Auto Registration system, when the non-resident applies for a work visa to work in Australia, DIMIA will exchange the visa data with the ATO. The non-resident will need to apply for a TFN through a web-based system upon arrival in Australia to work. The non-resident will need to supply their personal details including the visa number. The visa number will be matched with that supplied by DIMIA. If a match is successful, the applicant will be issued with a TFN.



## **Transition from the Investment Royalties Withholding regime to the PAYG Income Tax Withholding regime**

25. As part of *A New Tax System*, the Government has consolidated all withholding tax arrangements into the PAYG framework. A key feature of PAYG is to have one administrative regime for all ITW payment events, with a single set of rules that cover all withholding events listed in the legislation. The ATO needed to terminate some old stand-alone administrative regimes as a result. The IRW regime was one of these. However, the new processes will result in less timely data and, therefore, may limit the ATO's ability to monitor and act on potential risks in a more timely manner. Because of this possibility, the ANAO considers that the ATO will need to closely monitor the performance of the new arrangements.

## **Overall conclusion**

26. Overall, the ANAO concluded that the ATO's administration of the non-resident function is sound. The administration of the function has been strengthened by administrative reforms implemented by the ATO during the period of the audit. The new withholding regulatory framework has the potential to tighten compliance and provide opportunities for additional revenue, if implemented effectively.

27. There is scope for more effective and efficient administration of the non-resident function through the better use of data and by improving the quality of ATO research into non-resident activity, particularly in categories relating to non-resident landlords and independent personal services.

# Recommendation

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*The ANAO has made one recommendation aimed at improving the ATO's administration of the payment of tax by non-residents. This recommendation complements the administrative reforms recently implemented by the ATO.*

**Recommendation  
No.1  
Para 2.90**

The ANAO recommends that, in order to assist the ATO's more effective and efficient administration of the payment of tax by non-residents:

- a) the ATO's International Steering Committee commission the development of an integrated strategic framework for the ATO's access, collection and use of external data relevant to the administration of the taxation of non-residents; and
- b) the ATO continue the improvement of the quality and integrity of all data used in the administration of the non-resident function, especially Schedule 25A, section 128F exemptions and tax debt.

***ATO response:***

The ATO agrees with this recommendation, but with the qualification that the type of external data referred to in part (a) of the recommendation that would be most relevant for ATO purposes would be that at the micro or individual transaction level. Initiatives to acquire such data have the potential to be very expensive for the external suppliers and the ATO. The ATO has undertaken to do scoping and sampling investigations, consistent with overall compliance strategies, to evaluate the costs and benefits of different data sources. These investigations may also help the ATO to adopt the most streamlined methodologies for obtaining data and integrating its use with other data sources.

# **Audit Findings and Conclusions**



# 1. Background and Context

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## Introduction

**1.1** Australia's tax legislation requires that non-residents pay tax on any income they receive that originates in Australia. Non-residents are defined in Australia's taxation legislation. In broad terms, they include people, companies, trusts, and other entities not residing in Australia.

**1.2** In some cases the tax is paid as a final withholding tax instead of an income tax. In these cases the person who pays the income to the non-resident pays the tax, not the non-resident. Nevertheless, the tax liability is on the non-resident. Examples include interest, dividend and royalties withholding taxes. The person making the payment (payer) deducts the withholding tax from the income that is to be paid to the non-resident and sends it directly to the Australian Taxation Office (ATO). In most cases the payer is a financial institution or other large corporate.

**1.3** Non-residents may also be liable to pay tax in the country in which they reside. Double Taxation Agreements (DTAs) assign taxing rights between countries and prevent a taxpayer from being taxed by more than one country on the same income. Australia has such agreements with over 39 sovereign states. The DTAs are legal treaties that have international standing and are ratified by Australian law.

## The Australian Taxation Office

**1.4** The ATO is the Federal Government's principal revenue collection agency. Its aim is to optimise collections and make payments under the law in a way that instils community confidence that the system is operating effectively. The ATO's efficiency and effectiveness in the administration of non-resident taxation is important to the ATO's achievement of this aim.

**1.5** The ATO employs more than 19 000 officers located in 46 offices throughout Australia. The Office is structured into business and service lines,<sup>10</sup> which are organised around market segments, revenue products and services.

**1.6** The ATO does not have responsibility for tax policy and legislative change. Those responsibilities rest with the Treasury.

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<sup>10</sup> Business lines have an external client focus and are organised around either market segments or revenue categories (e.g. Small Business, GST). Service lines have an internal client focus and provide goods and services (ie outputs) only for internal ATO use (e.g. information technology, payroll management).

## Legislative framework

### Non-residents liability to Australian tax

**1.7** Non-residents are defined in the *Income Tax Assessment Act 1936* (ITAA 1936) as an entity that is not a resident.<sup>11</sup> This definition interacts with those for other entities: trusts at section 95(2); and companies, mutual companies and superannuation funds at section 6(1).

**1.8** The normal provisions of ITAA 1936 and the *Taxation Administration Act (1953)* (TAA 1953) about the imposition, collection, evasion and avoidance of taxation that apply to residents also apply to non-residents. The system of self-assessment that applies generally in Australia applies to non-residents.<sup>12</sup>

**1.9** Non-resident taxpayers may be classified into the same categories as resident taxpayers: individuals, partnerships, trusts, companies, superannuation funds and government entities. Non-resident taxpayers' income may include:

- salary and wages;
- pensions and annuities;
- personal services income;
- dividends, interest, royalties;
- rent from assets;
- gains and other proceeds of the disposal of assets; and
- business income.

**1.10** Non-residents may choose to do business in Australia in a number of ways, for example by using an Australian resident company, operating through the permanent establishment of a non-resident company or operating without a permanent establishment, or a fixed presence, in Australia. Thus, the tax treatment of non-resident activity will be caught under measures dealing with residents as well as non-residents. It is also relevant that, under Australia's DTAs, business profits derived by non-residents operating without a fixed base in Australia will generally not be taxed in Australia.

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<sup>11</sup> There are three statutory tests for determining residency status of individuals in ITAA 1936 section 6(1). These are:

- domicile/permanent place of abode;
- the 183 day test; and
- Commonwealth Superannuation Fund test.

<sup>12</sup> Exceptions are the non-resident withholding taxes.

**1.11** There is also a range of other provisions in tax legislation that regulate specific aspects of non-resident arrangements and activities. The main ones are:

- the thin capitalisation rules (Div 820 of *Income Tax Assessment Act 1997* (ITAA 1997)). The thin capitalisation rules contain several specific provisions dealing with the capitalisation of the Australian elements of a non-resident's business;
- the taxation of Foreign Bank Branches rules (Part IIIB of ITAA 1936). Part IIIB deals exclusively with issues relating to taxation of non-resident banks, including special rules for interest withholding tax;
- the transfer pricing rules contained in Division 13 of Part III of ITAA 1936 and various DTA rules, including Business Profits Article and Associated Enterprises Article;
- attribution regimes for Australian controlled non-resident entities. These are the Controlled Foreign Companies (CFC) rules at Part X, the Foreign Investment Fund (FIF) rules at Part XI, and the Transferor Trust (TT) rules at Division 6AAA of Part III, of ITAA 1936;
- certain specialised industries involving non-residents are dealt with via specific legislative regimes including Division 12 concerning shipping and Division 15 concerning insurance and reinsurance of Part III of ITAA 1936; and
- general and specific and withholding provisions applicable to a range of transactions according to which there may be a requirement on residents or non-residents to withhold moneys in certain circumstances and in relation to certain transactions from payments that would be made to non-residents that would otherwise attract a taxation liability.

**1.12** There is a range of provisions in tax legislation that applies generally without regard to the residency of the entity. These include the general anti-avoidance provisions contained in Part IVA of ITAA 1936, the Australian Business Number (ABN) and the related Australian Business Register (ABR) requirements of the *A New Tax System (Australian Business Number) Act 1999*. The Goods and Services Tax (GST) legislation and input credit availability apply to non-residents intending to participate legitimately in the Australian economy.

**1.13** A non-resident is generally liable to Australian tax on income that is sourced in Australia and is not generally subject to tax on foreign sourced income.<sup>13</sup> If the residency status of the taxpayer or the source of the income is not clear, a non-resident taxpayer may be subject to double taxation on their

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<sup>13</sup> ITAA 1997 section 6-5(3), and section 6-10(5); and ITAA 1936 section 23(r).

income.

**1.14** DTAs regulate the taxation affairs of non-residents with Australian sourced income.<sup>14</sup> DTAs are bi-lateral treaties between the Australian Government and that of another country and are the legislative means for allocating the taxing rights of each country. They provide a framework for the taxation of non-residents who earn income from Australian sources. DTAs are designed to help avoid non-residents being taxed twice; to assist in preventing tax evasion by non-residents; and to foster cooperation between Australia and other international tax agencies in enforcing their respective tax laws.<sup>15</sup>

**1.15** DTAs distribute taxation rights between sovereign states within the framework of international law. In accordance with subsection 4(2) of the *International Tax Agreements Act 1953* the provisions of a DTA have effect in preference to a domestic provision to the extent of any inconsistency.<sup>16</sup> Therefore the obligations of the DTA override domestic legislation if the latter conflicts with the former. Each DTA is incorporated into Australian domestic law as a Schedule to the *International Tax Agreements Act 1953*.

## **Specific non-resident withholding arrangements**

**1.16** Some sources of non-resident income are subject to Pay-As-You-Go (PAYG) withholding requirements. These include salary and wages, payments to labour hire workers, director's fees, annuities and eligible termination payments, dividends, interest and royalties.

**1.17** Salary and wages received by individual non-residents are subject to PAYG withholding arrangements and are generally taxed on the same basis as income for residents. Taxable income is calculated by determining assessable income less allowable deductions. The taxable income is then subjected to special tax rates. Non-resident individual taxpayers are required to pay tax on every dollar of income they earn in Australia.<sup>17</sup> Non-resident individual taxpayers are exempt from the Medicare Levy and cannot claim any concessional rebates. Legislation requires that the employer of the non-resident remit PAYG tax to the ATO. The

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<sup>14</sup> Australia has entered into 39 DTAs with sovereign states. There are other agreements in the process of being negotiated, e.g. with Mexico and Turkey. (*Australian Master Tax Guide 2002*, page 1071.) A protocol amending the existing Australia-USA Treaty entered into force on 13 May 2003.

<sup>15</sup> In cases where a non-resident originates from a country that does not have a DTA with Australia, the normal provisions of ITAA (1936 and 1997) and TAA 1953 about the imposition, collection, evasions and avoidance of taxation will apply.

<sup>16</sup> There are two exemptions: the general Part IVA anti-avoidance rules and the maximum foreign tax credit provisions.

<sup>17</sup> ATO Fact Sheet: Visiting Australia. <[www.ato.gov.au](http://www.ato.gov.au)>.



terms of any relevant DTA need to be considered in this context as well.

**1.18** Dividends, interest and royalties are a component of the ATO's PAYG withholding system. All dividends, interest and royalties are subject to a withholding tax unless excluded by legislation.<sup>18</sup> Withholding tax on dividend, interest and royalties is imposed as a final tax and is paid by the entity that pays the dividends, interest and royalties to the non-resident. This means that income subject to Non-Resident Withholding Tax (NRWT) and amounts exempt from withholding tax are excluded from assessable income.<sup>19</sup>

**1.19** Where the correct amount of withholding tax is not withheld and paid, the payer of the dividend, interest and royalty is liable to pay the tax that should have been paid, including any general interest charge on the unpaid amount. The area of non-resident withholding exemptions for dividends, interest and royalties is complex and there may be a risk of tax evasion/avoidance or misunderstanding. Consequently, the Government has extended the anti-avoidance provisions of Part IVA to include schemes that have the sole or dominant purpose of avoiding the payment of tax for non-resident income derived from dividends, interest and royalties.

## **Transactions outside the specific withholding arrangements**

**1.20** There are several sources of non-resident income that are not subject to any withholding arrangements. Examples include business income, income from real estate (eg rentals and capital gains), and capital gains from the disposal of assets. Legislation currently before the Parliament (and discussed in paragraphs 1.38 to 1.43 and 2.26 to 2.62) would enable the extension of withholding arrangements in these areas.

## **General withholding obligation**

**1.21** Section 254 (ITAA 1936) empowers the Commissioner to collect taxes owing by taxpayers, including non-residents, from an agent or trustee.<sup>20</sup> Section 255 (ITAA 1936) provides, in general terms, that a person (the payer) who has receipt, control or disposal of any money that belongs to a non-resident who derives income, or profits or gains of a capital nature, from an Australian source is authorised to withhold sufficient money to pay the tax due or that will become due by the non-resident. Section 255 makes the payer personally liable to pay

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<sup>18</sup> The rules governing the exclusions are specified in Division 11A of Part III of ITAA 1936.

<sup>19</sup> Section 128D ITAA 1936.

<sup>20</sup> In relation to section 254, an agent is any person who has control or holds money that belongs to a non-resident. More specifically, ITAA defines a non-resident's agent as including any person who, in Australia, holds or has the control, receipt, or disposal of any money belonging to a non-resident.

the tax.<sup>21</sup> Subsection 255(1) (ITAA 1936), person in receipt or control of money from a non-resident, states:

**1.22** The Commissioner has outlined in *Taxation Ruling IT 2544 Income Tax: Application of Section 254 and 255 (IT 2544)* that the ATO will not require the non-resident's agent to retain sufficient moneys for the payment of a non-resident's tax liability unless notified by the ATO to do so.<sup>22</sup> For example, the Commissioner has advised the Real Estate Institute of Australia that where a real estate agent has receipt, control or disposal of moneys belonging to a non-resident land owner, the ATO will not generally require the agent to retain an amount from those moneys to pay tax owing by the non-resident. However, the ruling notes that the legal scope of the power may require money to be retained for payment of the tax before the ATO notifies the agent.

**1.23** In the Federal Court Decision of 14 June 2002 the Court provided the first judicial consideration of s 255.<sup>23</sup> The Court held that a notice under s 255(1)(a) is the 'trigger' to activate the operative provisions of s 255(1). The Court noted that a notice under s 255 might require the recipient to pay not only tax that is already due and payable, but also tax that may become due and payable in the future. Therefore, the recipient would be required to retain amounts from future amounts of the non-resident's money over which they obtain the receipt, control or disposal thereof.

**1.24** The ATO has accepted the Federal Court decision as applying to the exceptional circumstances of the case. The ATO advised that the decision has confirmed its general administrative practice, described at paragraph 13 of IT

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<sup>21</sup> Subsection 255(1) (ITAA 1936), person in receipt or control of money from a non-resident, states:

With respect to every person having the receipt, control or disposal of money belonging to a non-resident, who derives income, or profits or gains of a capital nature, from a source in Australia or who is a shareholder, debenture holder, or depositor in a company deriving income, or profits or gains of a capital nature, from a source in Australia, the following provisions shall, subject to this Act, apply:

- (a) he shall when required by the Commissioner pay the tax due and payable by the non-resident;
- (b) he is hereby authorised and required to retain from time to time out of any money which comes to him on behalf of the non-resident so much as is sufficient to pay the tax which is or will become due by the non-resident;
- (c) he is hereby made personally liable for the tax payable by him on behalf of the non-resident to the extent of any amount that he has retained, or should have retained, under paragraph (b); but he shall not be otherwise personally liable for the tax;
- (d) he is hereby indemnified for all payments which he makes in pursuance of this Act or of any requirement of the Commissioner.

Subsection 255(2) (ITAA 1936), person deemed to have control, states:

Every person who is liable to pay money to a non-resident shall be deemed to be a person having the control of money belonging to the non-resident, and, subject to subsection (2A), all money due by him to the non-resident shall be deemed to be money which comes to him on behalf of the non-resident.

<sup>22</sup> This Ruling was issued on 29 June 1989 in response to the Auditor-General Efficiency Audit Report *Australian Taxation Office: International Profit Sharing* November 1987, and the House of Representative Standing Committee on Finance and Public Administration report of 31 May 1989.

<sup>23</sup> *CoT v Wong*: [2002] FCA 756.

2544, under which the ATO will not regard a person as being required to retain funds to pay a non-resident's tax unless a notice under s 255 has been issued.

## Other legislation

**1.25** There is a range of legislation administered by other Commonwealth departments that is relevant to the ATO's administration of the non-resident function. The legislation includes the *Foreign Acquisitions and Takeovers Act 1975* administered by the Treasury, immigration legislation administered by the Department of Immigration and Multicultural and Indigenous Affairs (DIMIA), and the *Shipping Registration Act 1981* administered by the Department of Transport and Regional Services.

## ATO's general administrative framework and non-residents

**1.26** The general administration of non-resident matters, and use of compliance assurance strategies in relation to non-residents in particular, occurs within the ATO's general administrative framework. It is therefore necessary to understand the essential features of that framework. The ATO's approach to tax administration is based on a number of related components consisting of principles, models and operating concepts. The key components are as follows.

### *Self-assessment*

**1.27** Australia's tax system functions on the basis of self-assessment, which is designed to provide taxpayers with greater equity and fairness, and increased certainty and simplicity. It applies to both residents and non-residents with Australian tax obligations.

### *The Taxpayers' Charter*

**1.28** The Charter outlines the rights and obligations taxpayers have as participants in the Australian tax system and relevant service and other standards that the community can expect from the ATO. In doing so, it explains overarching philosophies and principles about the way the ATO undertakes to do business with its clients.

### *The Compliance Model*

**1.29** The Compliance Model provides a knowledge-based framework for determining the most appropriate strategy to take in relation to a compliance matter, given what is known about taxpayers, their situation, circumstances and lines of business. It provides for a hierarchy of strategies and responses, the severity of which is intended to be commensurate with the taxpayer's compliance behaviour.

## *Market segmentation*

**1.30** The ATO is structurally organised into business lines that reflect a broad segmentation of the market. The business lines that have most to do with non-resident income tax matters are:

- Large Business and International (LB&I);
- Small Business (SB);
- Personal Tax (PTax); and
- Operations.

**1.31** The ATO International Strategy and Operations (ISO) Branch is part of the Large Business and International (LB&I) business line, and is headed by a Senior Assistant Commissioner. This Branch provides technical interpretation and other international related strategic leadership within the ATO; manages the ATO's international forum participation; and works with other business line areas that focus on international matters.

**1.32** The ATO has a corporate level International Steering Committee (ISC) with cross-market representation providing strategic direction on international matters. A recently formed cross market International Research and Intelligence Forum focuses on research and intelligence activities with an emphasis on identifying and assessing international related risks. An International Design Forum (IDF) has also been established to develop strategies to deal with international risks.

**1.33** The ATO does not have a market segment focusing exclusively on 'non-residents'. Non-resident issues are dealt with under the business line structure according to risks identified on a market segment basis. However, during the audit, the ATO established a non-resident unit within the ISO Branch with the role of overseeing the development of compliance strategies relevant to non-residents. The ATO also has a cross business line Non-Resident Withholding Tax Forum that provides a whole-of-ATO approach to the integrity of the NRWT system.

## *Risk management*

**1.34** The ATO's Corporate Management Practice Statement on Governance sets out the ATO's risk management policies, procedures and practices.<sup>24</sup> The ATO considers that risk management is an integral aspect of corporate governance and intrinsic to all ATO activity. The ANAO agrees.

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<sup>24</sup> PS CM 2003/02(G) 11 February 2003. The Statement is based on the Australian/New Zealand Risk Management Standard—AS/NZS 4360:1999, modified for the ATO.

**1.35** The Statement sets out the highest categories of risk that require escalation to the ATO Executive and inclusion in the Compliance Plan and other high level plans. It also sets out requirements for the involvement of senior officers in the planning and management of risks.<sup>25</sup>

### *Interaction of the components*

**1.36** The five components summarised above interact at different levels. Self-assessment places responsibilities on taxpayers to voluntarily comply with their tax obligations. In support of self-assessment, the ATO adopts a compliance program consisting of a range of education and other compliance strategies to enable and encourage taxpayers to comply. The Taxpayers' Charter builds on this concept by explaining that the ATO will treat its clients as being honest in their tax affairs unless the ATO determines that they are not acting honestly. The Compliance Model shapes the compliance actions and strategies that the ATO takes in response to non-compliance. The ATO relies upon risk management approaches and the integrity features built into the tax system to identify instances where taxpayers fail to comply.

**1.37** At this higher strategic level, the ATO does not differentiate between residents and non-residents in relation to compliance with their Australian tax obligations. Non-residents with Australian tax obligations would be the subject of administrative action of the relevant business line using the interconnected principles, models and operating concepts outlined above.

## **Recent developments relating to non-resident taxation issues**

**1.38** Non-resident taxation issues have been the focus of several recent government decisions and therefore have been afforded a certain level of priority. This is evidenced by in-principle agreements to several recommendations in the Review of Business Taxation that focus on taxation of non-residents,<sup>26</sup> recommendations from a Parliamentary Committee,<sup>27</sup> government decisions on non-residents and the current consultation paper on the *Review of International Taxation Arrangements*.

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<sup>25</sup> The ATO's Compliance Plan is set out in the ATO booklet publication titled '*Compliance Program 2002-03*', which can also be viewed electronically at <<http://atoassist/content.asp?doc=/content/corporate/complan.htm>>.

<sup>26</sup> J Ralph, *Review of Business Taxation—A Tax System Redesigned*, released in July 1999, Recommendations 21.6, 21.7, 22.17 and 22.20.

<sup>27</sup> Report of the House of Representatives Standing Committee on Economics, Finance and Public Administration, *Numbers on the Run*, tabled in August 2000. Recommendations 14 to 17.

**1.39** The Review of Business Taxation recommended the introduction of a uniform withholding tax regime on taxable Australian-source income and gains derived by non-residents. On 11 November 1999, the Government announced agreement in-principle to this recommendation, with the new arrangements to commence from July 2002. On 14 May 2002, the Government announced that, from July 2003, it would proceed with a modified approach to the implementation of this measure, with obligations to withhold to be developed, as required, for specific industries, and supported by the existing PAYG withholding system.

**1.40** On 13 February 2003, the Government introduced *Tax Laws Amendment Bill (No.4) 2003* into Parliament. Included in the Bill is Schedule 5 that introduces new withholding obligations to apply to certain payments to foreign residents. The Government has stated that these new obligations are part of the next stage of business tax reform measures and will improve the compliance of foreign residents with their Australian tax obligations.<sup>28</sup>

**1.41** The new withholding obligations will apply to certain payments made to foreign residents, to be prescribed by regulation. Amounts withheld will be available as a credit against an assessment of income tax.<sup>29</sup> The Government has stated that the policy objective of the new measures is 'to improve the compliance of foreign residents with their Australian tax obligations through the use of withholding arrangements that can be tailored to address risks of non-compliance'.<sup>30</sup> The Government has further stated that 'this measure is considered to be the only feasible method of achieving the objective of collecting tax from foreign residents in receipt of certain payments and ensuring that they comply with their obligations under Australian tax law'.<sup>31</sup>

**1.42** An additional consideration is that, as globalisation increases, the movement of people, capital and companies may become less restricted and the identification of non-resident activities in Australia may become more difficult. Therefore, it is important for the ATO to have the ability to deal now with these increasing international risks. The NRWT arrangements are intended to be a positive step in this direction.

**1.43** On 2 May 2002, the Government announced details of a review by the Board of Taxation of Australia's international tax arrangements. This was followed by the release of a Treasury Consultation Paper, *Review of International Taxation Arrangements*, on 22 August 2002. The Board's report to the Government and the Government's decisions were released as part of the 2003–2004

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<sup>28</sup> *Tax Laws Amendment Bill (No.4) 2003*. The Second Reading Speech, House of Representatives Hansard p.798, 13 February 2003.

<sup>29</sup> *Tax Laws Amendment Bill (No.4) 2003*, Explanatory Memorandum p. 61, 13 February 2003.

<sup>30</sup> *ibid.*, p. 73.

<sup>31</sup> *ibid.*, p. 74.

Budget.<sup>32</sup> The Government's decisions have implications for the taxation of non-residents, particularly in the areas of capital gains and their investments in Australian managed funds. The ANAO notes that the ATO has provided input into the review on possible implementation and integrity issues.

## Audit objectives and scope

**1.44** The objectives of the performance audit were to:

- provide Parliament with assurance about how efficiently and effectively the ATO administers the payment of tax in respect of non-residents;
- identify any scope for more effective and efficient administration of the function; and
- identify opportunities for the cost-effective collection of additional revenue.

**1.45** The audit applied these criteria, as appropriate, to the examination of the three broad areas of administrative activity. These are: the ATO's current administrative arrangements for the function; ATO's work in response to the Government's decisions to introduce new withholding obligations to apply to certain payments to foreign residents;<sup>33</sup> and ATO initiatives to align two significant aspects of the administration of the taxation of non-residents to other key reforms. The two reforms are the transition from the former stand-alone Investments, Royalties and Withholding (IRW) system to a system of administration based on the Business Activity Statement (BAS), and introduction of exemptions to the NRWT in support of economic policy objectives.

**1.46** The scope of the audit covered the administration of tax law generally, including the DTAs, as applied to non-residents. The audit reviewed the relevant aspects of the administration of non-resident taxation within LB&I, (SB), (PTax) and the Operations business lines. We also interviewed ATO staff from the Knowledge Development Network (KdNet); Client Identification Centre (CIDC); Internal Assurance; Centres of Expertise (CoE) on Capital Gains and International; Operations, Policy and Practice; and the Non-Resident Withholding Tax Core Design Team. As well, the ANAO held discussions with staff in the International Tax and Treaties Division in the Department of the Treasury.

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<sup>32</sup> *International Taxation: A Report to the Treasurer*, The Board of Taxation, 28 February 2003 and Press Release No.32: *Review of International Taxation Arrangements*, The Treasurer, 13 May 2003.

<sup>33</sup> The Government's decisions referred to are those made in response to recommendations 21.6, 21.7, 22.17 and 22.20 in the Ralph Report.

**1.47** The Superannuation and GST business lines were not reviewed because these areas did not pose any significant risks to the ATO's administration of the payment of tax by non-residents.

**1.48** The next Chapter outlines the ATO's corporate planning and governance processes, the risk management practices within each business line and the activities of the recently established ISO Branch, as these relate to the payment of tax by non-residents. The ATO's work in relation to the main compliance risks that the proposed NRWT is designed to address are reviewed, as is the ATO's use of data relevant to the administration of the non-resident function. The Chapter concludes with a discussion of three issues important to achieving improved administration; that is, non-resident use of interposed entities in financial transactions; the ATO/DIMIA interface initiative; and the transition from the IRW regime to the PAYG Income Tax Withholding regime.

**1.48** The audit was undertaken in conformance with ANAO auditing standards and cost \$355 000.



## 2. ATO Administration of Non-residents

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### Introduction

**2.1** Australian tax legislation generally provides a sound framework for non-residents to comply with their Australian tax obligations. For example:

- non-resident business operations in Australia that are subject to Australian tax usually involve the non-resident having a physical presence in Australia;
- thin capitalisation and transfer pricing rules reduce the ability of non-residents to shift profits offshore; and
- the PAYG withholding arrangements deal with the employment income of non-residents employed in the normal manner, subject to PAYG withholding arrangements.

**2.2** The specific and general and non-resident withholding obligations play a key role in ensuring that Australian tax is levied and collected on other forms of income to which they apply, particularly where the non-resident has little or no physical presence or material assets in Australia.

**2.3** The ATO's administration of the non-resident function takes place within the ATO's business lines as part of the ongoing practice of tax administration. As there is no specific unit that has responsibility for the whole administration (as distinct from co-ordination) of non-resident taxation affairs, it is important to establish the extent to which the ATO's corporate planning and governance processes enable the ATO to be assured (and thereby assure Parliament) that the ATO administers the payment of tax in respect of non-residents effectively. Any scope for improvement in the administration of the function will depend to a large extent on the soundness of these processes. The ANAO therefore reviewed the ATO's corporate planning and governance processes specifically in terms of the administration of the non-resident function in relation to the objectives of the audit.

### Corporate planning and governance processes

**2.4** The ATO's Strategic Statement of intent is 'to optimise collections and make payments under the law in a way that instils community confidence that the system is operating effectively'.<sup>34</sup> The ATO's corporate planning and governance processes, which are designed to enable the ATO to achieve this

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<sup>34</sup> *ATO Strategic Statement 2003–2005*, Australian Tax Office, 16 December 2002.

goal, amongst other things, are organised around four plans.<sup>35</sup> These plans determine the strategic priorities for the ATO and guide resource allocation. It is the responsibility of business and service lines to implement the four corporate level plans. The ANAO reviewed the ATO's business line specific risk management plans in relation to the payment of tax by non-residents. An overview of the four plans and the supporting plans of the business lines in relation to the administration of the non-resident function can be found in Appendix 1.

**2.5** Good governance includes the capacity to coordinate issues and treatment of risks that cross business lines and coordinate administration in relation to such issues and risks. Accordingly, the ANAO reviewed ATO initiatives in this area, specifically the recently established ISO Branch of LB&I. A discussion of the ATO's business line specific risk management plans in relation to the payment of tax by non-residents follows this discussion.

## **International strategy and operations**

**2.6** In June 2001, the ATO commissioned a review of the performance of the International Branch of LB&I. This had been in response to concerns within the ATO that the function being performed by the Branch may need to be redefined and that the Branch's overall performance could be improved. During the second half of 2002, the ATO acted on the review's findings and recommendations and proceeded to implement them.

**2.7** The ISO Branch was established in October 2002, replacing the International Branch. The objective of the redesigned ISO is to focus better on ATO-wide international activities. Within the ISO, the ATO has appointed the Non-resident Unit that has responsibility for a number of non-resident issues, especially those that cross the ATO's business line structure.

### ***Role of the Non-resident Unit***

**2.8** This Unit is designed to have the lead role within the ATO for interpretive advice and strategic direction setting about a range of non-resident tax issues. The Unit specifically deals with the following specialist areas:

- the NRWT regime for dividends, interest and royalties;
- the offshore banking unit concession; and
- obligations and tax treatment of non-resident beneficiaries of Australian trusts, especially those operated by the managed fund industry.

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<sup>35</sup> These plans are: Compliance; Information Technology; Operations; and People and Places. Each of these plans sets out the highest level risks to the achievement of ATO outcomes.

**2.9** The Unit also has the interpretive responsibility for other non-resident issues not specifically managed elsewhere in the ATO. One example is the finalisation of general interpretative advice concerning income derivation by the Australian permanent establishments (branches) of non-residents carrying on business in Australia.

**2.10** As part of the interpretive role, the Non-resident Unit develops and finalises taxation rulings and other interpretative advice. The Unit will provide policy implementation and administration advice to Treasury. It will also provide technical assistance to the LB&I specialist segments and to the other ATO business lines on casework. The Unit has a lead role in the overall ATO monitoring and identification of emerging compliance risks and in developing and implementing compliance risk strategies in respect of the taxation of non-residents.

**2.11** In undertaking these roles, the Unit is to work closely with all other relevant areas of the ATO including the ISO's International Strategic Intelligence Unit and the Treaties Unit. This latter Unit deals with specific interpretation of Australia's DTAs regarding non-residents from particular treaty partner countries. The Non-resident Unit's scope includes liaison with the financial regulatory and promotional arms of government<sup>36</sup> and with industry and peak bodies representatives.<sup>37</sup>

### *Role of the Non-resident Withholding Tax Market Focus Group*

**2.12** This is a cross-business line group formed in August 2002 that meets each six weeks and is chaired by the head of the Non-resident Unit. Its responsibilities are to monitor the health of the NRWT regime across the ATO. In particular, it is to assess compliance risks, assess the processes that record and monitor the NRWT process, and coordinate the development of resultant compliance strategies. Further, the group identifies deficiencies and suggests improvements within that process. It does so by establishing better practice for the particular operation or component of NRWT administration. It uses a combination of the practical experience of its members and research undertaken within ISO and the wider ATO environment. The Group then communicates that outcome to the relevant business line personnel responsible for actual delivery.

**2.13** The Market Focus Group will fill a similar role for the new and extended NRWT measures currently before Parliament. High level and strategic issues

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<sup>36</sup> These include the Australian Prudential and Regulatory Authority, the Reserve Bank of Australia, the Australian Securities and Investment Commission and Axiss Australia (a Division of the Department of the Treasury that has a mandate to position Australia as a global financial services centre in the Asian time zone).

<sup>37</sup> This includes the Australian Bankers Association, the International Banks and Securities Association of Australia and Investment and Financial Services Association.

raised by the Group are referred to either the IDF or the ISC. More specific or tactical issues are generally referred to the ISO Executive.

**2.14** The ANAO considers that the formation of the Non-resident Unit in ISO is a major improvement in the ATO's existing structure for administration of the non-resident function. However, at the time of the audit, the ATO had yet to fully implement and set up the appropriate structures needed to have the ISO Branch fully functioning. The ANAO supports full implementation of the ISO Branch for more effective administration of the function.

## **Large Business and International Business Line arrangements**

**2.15** LB&I non-resident clients of the ATO that may have Australian tax obligations are invariably associated with a resident taxpayer. For example, they will most probably have a subsidiary (or subsidiaries) in Australia. The subsidiary is then subject to the scanning and review processes referred to in Appendix 1. If not associated with a resident taxpayer, non-resident activity in Australia would be identified and assessed particularly through the processes outlined in Appendix 1. Client Risk Reviews (also described in Appendix 1) may be used especially where there is a permanent establishment. The ANAO notes that the interaction of the provisions of tax legislation discussed in the previous Chapter is quite prominent in relation to the tax affairs of LB&I clients. This decreases the risk that LB&I might not detect non-residents with tax obligations.

**2.16** The ANAO found that the risk management processes within LB&I can incorporate all relevant issues that may arise when assessing a corporate group (which can include non-resident parent companies, subsidiaries or associated entities). Consequently, the ANAO found that LB&I's processes are sufficient to identify the taxation affairs of non-residents with Australian taxation obligations.

## **Small Business Business Line arrangements**

**2.17** The SB Integrity of the System Committee is the major decision-making body in the process of risk determination and management. For issues and risks referred to it by the SB National Risk Network (see Appendix 1), the Integrity of the System Committee makes decisions on whether the risk needs further research; allocates resources for an SB segment to undertake a compliance project; keeps a watching brief; closely monitors a situation; or forms some other compliance strategy to manage or mitigate the identified risk.

**2.18** The ANAO considers that the new ISO will assist the SB Business Line mitigate non-resident risks, particularly those that cross business lines or that lack a clear link with a resident taxpayer or that may not have the withholding

arrangements applied as would be permitted by *Tax Laws Amendment Bill (No.4) 2003* now before the Parliament.

## Personal Tax Business Line arrangements

**2.19** As described in Appendix 1, one of the compliance assurance strategies of the PTax Business Line is the analysis of data linked to tax return labels. However, the effectiveness of this analysis clearly depends on high levels of lodgement. The ANAO identified a range of ATO internal research that suggested significant and high levels of non-lodgement for non-residents. This risk is mitigated by the fact that for the significant majority of known non-residents operating within PTax's market segment, almost all of the income earned falls within the PAYG withholding framework. Because of this, there are overarching integrity measures built into the design of the tax system.

**2.20** These integrity measures are structured to reduce the risk of non-resident individuals not complying with Australian tax obligations. The PAYG framework, for example, ensures that third parties withhold the tax at source on a range of payment events. In such cases there is little opportunity for non-residents to structure their affairs to escape paying tax. The ANAO notes that these arrangements do not affect compliance risks associated with non-resident persons whose tax liable transactions are not subject to withholding arrangements. Some of these may be addressed by regulation, if Parliament passes the *Tax Laws Amendment Bill (No.4) 2003*.

**2.21** The ANAO found that ATO research identified high levels of non-compliance amongst non-resident landlords and non-residents in the category of Independent Personal Services (IPS). The income of these non-residents falls outside of the PAYG withholding framework. PTax and SB together administer these non-residents and may need to investigate the extent of non-lodgement and its consequences. The ANAO considers that, based on the research reviewed, the ATO needs to better understand the compliance risks associated with these categories of non-residents in order to present decision-makers with better advice about the range of suitable options and their implications.

## Conclusion

**2.22** Residency status, as such, is not an identifiable risk factor for the ATO except in four specific instances.<sup>38</sup> The general administration of non-resident matters, and use of compliance assurance strategies in relation to non-residents

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<sup>38</sup> The ATO maintains dedicated teams to administer some classes of non-residents. These are Visiting Sports and Entertainers in the SB Business Line; and Shipping Industry, Junket Tour Operators and Building and Construction (particularly in the mining and petroleum sector), in the LB&I Business Line.

in particular, are performed within the administrative framework previously described. This is done as an integral element of tax administration practice of the particular business line appropriate for the non-resident. The ANAO considers that there are considerable benefits and efficiencies in having residents and non-residents covered together under strategies and activities undertaken at a business line, or whole-of-market level, for each segment. For example, there is a high degree of interaction and dealing between residents and non-residents in the international environment. The ANAO found it both necessary, and effective, to cover both groups together.

**2.23** In those cases where non-resident risks are business line specific, or a withholding obligation applies to a resident payer associated with the non-resident, or there are suitable links between a non-resident and a resident, the ANAO found that the ATO's risk management of non-resident tax matters is sound. In this respect, the ANAO considers that the tax legislation framework, which provides built-in risk minimisation safeguards, and the ATO's administrative framework, with a market segment focus balanced with interconnected approaches, generally provides a sound basis for dealing with compliance assurance issues relating to the taxation of non-residents.

**2.24** The ATO's co-ordination of non-resident issues that cross business lines had not been well managed in the past. However, the ANAO considers that the successful establishment of the ISO Branch should overcome the co-ordination difficulties. Nevertheless, there are compliance concerns associated with non-resident transactions that fall outside the existing withholding framework.

## Scope for improved administration

**2.25** Arising from ATO's initiative to bring to the attention of the Ralph Committee the range of compliance risks associated with non-resident taxation matters and the Government's favourable response to that Committee's recommendations on those matters, the ATO established a special team to progress the further consideration of the matters. As there is scope for the improved administration of the function, the ANAO examined in greater depth five areas central to achieving improvements. These areas are:

- the proposed NRWT;
- the ATO's use of relevant data;
- non-resident use of interposed entities in financial transactions;
- the ATO/DIMIA interface initiative; and
- the transition from the IRW regime to the PAYG Income Tax Withholding regime.

## The Proposed Non-resident Withholding Tax

**2.26** The *Review of Business Taxation: A Tax System Redesigned* (the Ralph Review), published on 30 July 1999, found that ‘in the absence of effective collection mechanisms, it can be difficult to ensure that the Australian tax liability of non-residents is met if they do not have a permanent presence or assets in Australia... The most effective way to collect tax is through withholding systems.’<sup>39</sup>

**2.27** The Ralph Review recommended the introduction of a uniform withholding tax regime on taxable Australian-source income and gains derived by non-residents.<sup>40</sup> On 11 November 1999, the Government announced agreement in-principle to this recommendation, with the new arrangements to commence from July 2002.

**2.28** The ATO advised that, as work proceeded to implement the new withholding arrangements, concerns were raised about the appropriateness of a comprehensive ‘all in’ withholding regime for all payments to non-residents by Australian residents. These concerns included the potential significant compliance costs for large numbers of Australian payers, as well as the potential compliance costs for payees and ATO administration costs in dealing with large scale requests to vary the rate of withholding to take into account individual circumstances. Some of these concerns came out of learnings from the experience in implementing the general PAYG withholding arrangements. This began as an ‘all in’ regime but required significant exemptions and other changes in the light of practical experience within the first couple of years of the regime’s operation.

**2.29** The ATO advised that there were also concerns about the capacity of large numbers of Australian payers and their tax agents to deal with further significant changes at this time. Had Parliament legislated an ‘all in’ withholding regime, the changes would have occurred whilst large numbers of Australian payers and their tax agents had been bringing to the Government’s and Parliament’s attention that they were having difficulties in dealing with the large number of changes to the tax law that had already been implemented as part of tax reform.

**2.30** The ANAO understands that the Government wished to balance the range of concerns against the revenue at risk from non-residents not declaring Australian source income. After considering these matters, the Government announced, on 14 May 2002, that it would proceed with a modified approach to the implementation of the proposed NRWT. Under the modified approach, obligations to withhold would be developed, as required, for specific industries or identified risk areas and be supported by the existing PAYG withholding

<sup>39</sup> J Ralph *Review of Business Taxation: A Tax System Redesigned*, p. 651.

<sup>40</sup> *ibid.*, Recommendation 21.6, p. 650.



system. The Government announced that, following further consultations, any new obligations would be introduced progressively by regulations from 1 July 2003, with enabling legislation to be introduced prior to 1 July 2003.

**2.31** The Government introduced legislation into Parliament on 13 February 2003 that allows for withholding from specified payments.<sup>41</sup> The Explanatory Memorandum (EM) states that payments will be prescribed by regulation progressively after consultation with affected groups as they are identified as presenting a compliance risk.<sup>42</sup> The EM states that the measure is designed to address non-compliance by foreign residents in a manner that is proportionate to the specific areas of non-compliance and that recognises the need to minimise the impact of those measures on Australian and foreign resident taxpayers who do meet their obligations.<sup>43</sup> The EM further states that the new withholding framework is considered to be the only feasible method of achieving the objective of collecting tax from foreign residents in receipt of certain payments and ensuring that they comply with their obligations under Australian tax law.<sup>44</sup>

**2.32** In response to the Government's decisions in relation to the Ralph Report's recommendations about non-resident taxation, the ATO has carried out detailed research into a range of non-resident transactions that could be subject to a NRWT. This analysis identified a range of tax relevant transactions involving non-residents where non-compliance by non-residents is high. These transactions involve no specifically legislated withholding arrangements.

**2.33** ATO research analysed the following factors in considering a range of categories of non-residents and transactions involving them:

- the nature and extent of the risks of non-compliance, including the extent of non-compliance;
- the impact on the integrity of the tax system including estimates of any additional revenue that might be collected as a result of the non-compliance; and
- the administrative cost of a range of possible initiatives and the compliance cost to the community of such initiatives.<sup>45</sup>

**2.34** The adequacy of the ATO's evaluation of these three matters is crucial to the adoption of cost-effective measures that might be under consideration. For such measures to be cost-effective, they would need to be able to meet concerns

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<sup>41</sup> *Taxation Laws Amendment Bill (No. 4) 2003*, HoR Hansard 13 February 2003, p. 787.

<sup>42</sup> *Taxation Laws Amendment Bill (No. 4)*, Explanatory Memorandum para 5.23.

<sup>43</sup> *ibid.*, para 5.77.

<sup>44</sup> *ibid.*, para 5.79.

<sup>45</sup> For simplicity these will be referred to as 'non-resident categories' throughout the text.



identified by the evaluation about compliance, the integrity of the tax system and the collection of any additional revenue identified.

**2.35** The following is a brief overview of some main features of the following non-resident categories:

- independent personal services;
- capital gains on the sale of shares and other like assets;
- payments to non-resident contractors;
- non-resident entertainers and sportspersons;
- commissions to junket tour operators;
- rental and capital gain income of non-resident landlords;
- capital gains from the disposal of assets; and
- shipping.

### *Independent personal services*

**2.36** This category of non-residents consists of those who are independent contractors as opposed to dependent employees. IPS consists of non-resident professionals with expertise in a given field who are working in Australia for a time. IPS is a diverse group and includes individuals such as accountants, lawyers, business consultants, architects, information technology professionals, lecturers, professional speakers, engineers, authors, specialist medical practitioners, physicians, dentists, scientists, psychiatrists, mathematicians and physicists.

**2.37** From the identified incidence of non-compliance, the ATO estimates that the revenue collectable in relation to this category is in the order of \$143 million per annum. The ATO advised that the SB Business Line continues to undertake risk analyses of this area concentrating on specific industries or professions.

### *Capital gains on the sale of shares and other like assets*

**2.38** This category refers to the disposal of shares and other assets that have the necessary connection with Australia by non-residents. The 'other assets' include units in Australian unit trusts, other trust interests together with rights and options to these asset types.

**2.39** In general terms, a non-resident owning or having owned 10 per cent or more of the shares in an Australian public company or unit trust or owning any shares in a private company or in a trust (other than a unit trust) at any time during the last five years is assessable on any capital gain arising from the sale of these shares or units. The Government recently announced some changes to these rules as a result of the review of Australia's international tax arrangements.

**2.40** The parties making the payments in relation to these transactions include those holding a purchase consideration due to non-resident vendors, such as share brokers, solicitors, unit trust managers and purchasing companies. The ATO advises that the estimated number of transactions within this category is about 4000 per annum.

### *Payments to non-resident contractors*

**2.41** This category refers to non-resident contractors providing services, equipment or plant in connection with construction projects in Australia. Examples of payments covered by this category include design, engineering, fabrication, installation, management, repair and maintenance, and technical services. There are an estimated 800 non-resident contractors involved in current construction projects of which approximately 160 have potential Australian tax liabilities.

**2.42** Future growth in this industry translates to an ongoing and significant revenue risk. The ANAO found that collection action under sections 254 and 255 (ITAA 1936) has not been effective because of the short-term presence of the contractor in Australia and difficulties in the calculation of tax liability.

### *Non-resident entertainers and sportspersons*

**2.43** In 1998, the ATO established the Visiting Sportspersons and Entertainers (VSE) team in readiness for the 2000 Sydney Olympic Games. This team is responsible for identifying, calculating and collecting the tax due from earnings of non-resident sportspersons, entertainers and other high profile visitors.

**2.44** The category would include those persons/entities entering Australia to carry out activities within the sporting, athletic, entertainment and performing arts segments. These include entertainers (such as theatrical, motion picture, radio or television artistes and musicians) and sportspersons as identified in DTAs and the persons/entities associated with these fields, which are excluded from the VSEs group such as television commentators and other media staff; directors and producers of theatre and movie productions; film crews; professional speakers; and coaches.

**2.45** In 2002, the VSE team raised \$29.1 million. The ANAO found that the ATO has established sound processes to manage the payment of tax from visiting non-resident sports persons and entertainers.

**2.46** The ATO has advised that there may be up to 31 000 persons in any given year in this category. The ATO estimates that the number of transactions in the category is likely to be 45 000 per annum.

### *Commissions to junket tour operators*

**2.47** Junket tour operators (JTOs) organise gambling tours for overseas high rollers.<sup>46</sup> They organise the necessary flights and accommodation; assist in the groups' gambling activities; and provide other assistance as necessary (such as translating services). Australian casinos pay JTOs a commission for choosing their casino in which the gambling occurs. The ATO considers that the fees and commissions paid by the Australian casinos to the JTOs are Australian sourced income and therefore subject to Australian tax.

**2.48** To address this area of risk, the ATO has entered into administrative arrangements with the casinos to withhold amounts from commission payments made to non-resident JTOs. Since 1998, the ATO has collected \$19.2 million from JTOs. The ATO advised that there are approximately 300 non-resident JTOs.

### *Rental and capital gain income of non-resident landlords*

**2.49** Non-residents may own real property in Australia (subject in certain instances to consideration by the Foreign Investment Review Board (FIRB)) from which they may derive taxable rental income and taxable capital gains income. This category refers to these non-residents. ATO research indicates a high level of non-compliance by non-resident landlords in the lodgement of tax returns for income received from the rental of property, whether for residential or commercial purposes. The ATO has undertaken several small-scale research projects in order to gauge the nature of compliance problems and estimate the total revenue at risk from non-compliance. The research has been conducted in several States and for different financial years, between 1994 to 2002.

**2.50** The ANAO found that the research into the lodgement behaviour of non-resident landlords deriving income from properties rented for domestic purposes did not conform to established standards of statistical design for the making of general inferences from samples of data and included a number of arbitrary assumptions.

**2.51** The ATO has endeavoured to estimate the total revenue at risk from the incidence of non-compliance detected. In order to calculate estimates of any additional revenue collectable, it is necessary to estimate the net tax payable, after allowable deductions. The ATO advised that the work in progress which analyses the pattern of deductions reported on Rental Property Schedules, together with data that the ATO is currently obtaining from other sources, is expected to improve the ATO's understanding of compliance risks, including the likelihood of any additional revenue collectable. The ANAO considers that the ATO's research in this area requires more work before reliable and valid estimates can be determined.

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<sup>46</sup> High rollers are gamblers who gamble large sums of monies in casinos.

**2.52** The ANAO found that ATO research about non-residents investing in real property in Australia that has a commercial use has been of a higher quality. The ATO estimates that the total number of non-residents in this category is in the order of 6000.

**2.53** The ATO has been unable to produce reliable and valid estimates of the revenue loss arising from the non-reporting of capital gains from non-residents' disposal of domestic and commercial properties. However, the ATO has established a compliance team to remedy this. A recently commenced project with the FIRB,<sup>47</sup> initiatives with relevant State and Local Government agencies and new techniques of data analysis may improve the ATO's compliance initiatives in this area. The ANAO considers that this work could enable the ATO to better assist decision-makers' consideration of various compliance strategies.

**2.54** The ANAO notes that several Organisation for Economic Co-operation and Development (OECD) member states, including Canada, the United Kingdom (UK) and the United States (US), have legislated to impose non-resident withholding tax obligations in relation to the rental income of non-resident landlords. A summary of the arrangements in these countries is at Appendix 2.

## *Shipping*

**2.55** The taxable income of ship owners and charters is governed by section 129 of ITAA 1936. This section states that where a ship belongs to a non-resident and carries goods shipped in Australia, then five per cent of the amount paid to the non-resident in respect of the carriage is derived in Australia and is therefore taxable.

**2.56** The ATO has developed alliances, and liaises with several external entities, that enable the ATO to identify non-residents involved in the shipping industry. These arrangements are:

- liaising with the Australian shipping industry's peak body, Shipping Australia Limited, to provide 'tip-off' information;
- obtaining shipping permits from the Department of Transport and Regional Services that allows the ATO to have advance notice of non-resident owned shipping vessels arriving in Australia; and
- receiving data from the Australian Customs Service that identifies the national agent of every ship which arrives in Australia. This information can be used to ensure that the agent has lodged a tax return on the non-resident's behalf.

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<sup>47</sup> Discussed in paragraphs 2.85 to 2.87.

**2.57** The ANAO considers that the development of effective alliances with these external bodies to access relevant information on non-residents, allows the ATO to better identify and collect the payment of tax by non-residents in the shipping industry.

### *Phased implementation of NRWT*

**2.58** The application of the new arrangements is not a straightforward process in all of the categories to which the new regulations could apply. Measures of this type may result in additional compliance costs to the community and additional administrative costs to government.

**2.59** As explained in the EM accompanying the *Tax Laws Amendment Bill (No.4) 2003*, the Government is proposing a phased approach to improved compliance. The ANAO understands that the ATO will continue to monitor non-resident activity and provide advice about compliance risks in relation to the new regulatory framework. In this context, the ANAO considers that continued good quality research in the relevant categories would contribute to decision makers' understanding of the incidence of non-compliance of non-residents with their Australian tax obligations, as well as possible additional compliance and administrative costs. The ANAO considers that two important categories for such research are those of non-resident landlords and independent personal services.

## Conclusion

**2.60** The ANAO concluded that there is a range of tax relevant transactions involving non-residents where ATO research indicates that non-compliance by non-residents is high. The ATO has administrative units responsible for four of these categories. The ANAO notes that the replacement of a number of these administrative arrangements with the new non-resident withholding arrangements set out in the *Tax Laws Amendment Bill (No.4) 2003* currently before the Parliament could be a consequence of the new legislation.

**2.61** The ANAO also concluded that ATO research varied widely in terms of quality and sound methodology. Nevertheless, the ANAO considers that the ATO has sufficient understanding of several categories to support the new regulatory arrangements under consideration. In some other categories, the ATO's understanding would require additional work to be fully effective.

**2.62** The ANAO notes that the non-resident function as a whole does not present compliance risks of the same magnitude as some other compliance concerns facing the ATO. It does, however, involve some areas with high levels of non-compliance. The evidence of a decade of ATO research supports this. As

the data in Appendix 3 shows, the ATO has estimated that annual revenue of at least \$320 million could be collected if compliance risks were fully addressed. The ATO further advised that the additional revenue collectable is contingent on the measures proposed in the new non-resident withholding tax regime contained within the *Tax Laws Amendment Bill (No.4) 2003*, presently before Parliament. This estimate relates to the known extent of non-compliance in which estimates of collectable revenue may be calculated with sufficient reliability and validity.<sup>48</sup> It includes revenue already collected in the categories of non-resident entertainers and sportspersons and commissions paid to JTOs.

## **ATO's use of relevant data**

**2.63** The transactions that result in a non-resident's tax obligation may cross more than one national jurisdiction. Unlike resident taxpayers, where the ATO has access to large amounts of data to perform risk analysis and monitor taxpayer behaviour, data about non-residents can be difficult to obtain.

**2.64** Higher levels of compliance by non-residents with their Australian tax obligations would be achieved by the ATO's better use of relevant data. An improved ATO wide, strategic approach and the development of long-term partnerships with external organisations for the collection of data relevant to the administration of the tax affairs of non-residents would assist in this regard. In order to gauge the scope for improvement, the ANAO reviewed both internal and external data available to (and used by) the ATO to administer this function.

### *Internal ATO data sources*

**2.65** The ANAO identified three internal data sets that relate to the taxation of non-residents. These are:

- Related Party Dealings (Schedule 25A);
- Exchange of Information in DTAs; and
- Non-Resident Tax Exemption—the Section 128F label field on the company tax return.

**2.66** The ANAO reviewed how the ATO used these data sets to assist administering the payment of tax by non-residents. In order to obtain information about the compliance behaviour of non-residents, the ANAO also initiated an analysis of the taxation debts of non-residents.

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<sup>48</sup> The details of this estimate may be found at Appendix 3. The quantitative data in this audit has been drawn from the ATO. Unless otherwise shown, the data has been examined for reasonableness, but not audited.

## *Related Party Dealings—Schedule 25A*

**2.67** The ATO considers that transfer pricing is a major risk area relating to non-residents. The risk is that profits may be transferred out of Australia to a non-resident. In many instances the non-resident to which the profit is shifted is not the entity that is operating in Australia either directly or via an Australian company. Where the non-resident is operating through a permanent establishment in Australia or as an Australian company, the payment of tax in respect of a non-resident is achieved indirectly through the taxation of a resident company.

**2.68** All taxpayers regardless of residency who have international dealings in excess of \$1 million with a related party have to lodge a Schedule 25A form. Schedule 25A provides the ATO with a range of data on how much a resident company has received in terms of sales or revenue and how much has been spent in terms of purchases or expenses for a range of categories.<sup>49</sup>

**2.69** The ATO has advised that the completed Schedule 25A forms are an important source of information for identifying cases where a non-resident is engaged in profit shifting or illegal transfer pricing.<sup>50</sup> Consequently, the ATO performs regular analysis of the Schedule 25A data. The analysis has highlighted a range of problems affecting data quality including data entry shortcomings by the ATO, failure of relevant taxpayers to lodge the Schedule, and taxpayer difficulties in understanding the requirements of the Schedule. The ATO analysis indicates that these problems arise from taxpayers in the small to medium enterprise, not the large enterprise, market. The ATO further advises that initiatives now underway are expected to improve compliance.

**2.70** The ANAO found that Schedule 25A data is of critical importance to the ATO's management of risk processes and supports its ongoing work to monitor and address data quality problems.

## *Exchange of information*

**2.71** All DTAs contain a provision that allows the ATO to exchange information with overseas revenue agencies. The Exchange of Information (EoI) provisions provide for the correct application of the provisions of DTAs, or of the domestic laws of contracting states, to taxpayers with international dealings, and through

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<sup>49</sup> These categories include tangible property (stock in trade and materials and all other tangible property), royalties, rent and intangible property, services (management, financial, administrative, marketing, training, technical, construction, research and development), interest, discounts, insurance, interest bearing loans (amount borrowed and amount lent) and interest free loans (amounts borrowed and amounts lent).

<sup>50</sup> This includes attribution regimes such as Controlled Foreign Companies, Foreign Investment Funds and Transferor Trust.



this enhance the compliance initiatives of the signatories to the treaties. EoIs can be classified into three broad categories: specific, spontaneous and automatic.

**2.72** Specific and spontaneous information exchange occurs when the ATO receives or provides information on a specific case or taxpayer. Automatic exchange of information is data the ATO receives or provides on a recurring basis. Currently, the ATO receives electronic data relating to dividends, interest, royalties, capital gains and pensions from nine DTA countries. Another 10 countries provide paper-based records. The electronic data is processed by the CIDC in PTax and matched with ATO records when this can be achieved.

**2.73** The primary purpose of automatic EoI matching is to determine whether or not a resident has earned foreign sourced income but has not declared it to the ATO. Consequently, almost all of the automatic EoI information currently provided by overseas revenue agencies to the ATO is not relevant to the ATO's identification of non-residents with Australian tax obligations. However, specific and spontaneous exchanges with overseas revenue agencies frequently brings to light cases of non-residents avoiding Australian taxes.

**2.74** The ANAO found that the data provided to the ATO under the EoI provisions of DTAs contributes to the improved compliance of non-residents with their Australian taxation obligations. However, there may be scope to obtain further data.

### *Non-Resident Tax Exemptions—Section 128F*

**2.75** Interest Withholding Tax (IWT) is a tax applied to non-residents who earn income through Australian sourced interest. Division 11A of the ITAA 1936 imposes IWT on interest paid to a non-resident by a resident of Australia. The tax is a final and flat rate of 10 percent on the gross amount paid or credited. In 2000–01, the ATO collected \$705 million in IWT.<sup>51</sup>

**2.76** Section 128F (ITAA 1936) is a tax concession that allows non-resident taxpayers to become exempt from paying IWT that would normally apply. The section exempts from tax the interest non-residents receive from publicly offered debentures, provided certain conditions are met. The exemptions reduce the cost to Australian businesses of borrowing from offshore lenders and over time have been redesigned to position Australia as a regional financial centre and 'encourage the deepening and greater liquidity of the domestic corporate debt market'.<sup>52</sup>

**2.77** The Treasury's estimates of the financial impact of section 128F is

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<sup>51</sup> *Commissioner of Taxation, Annual Report 2000-01*, p. 27.

<sup>52</sup> *Investing for Growth*, 8 December 1997, p. 62.



\$580 million for the 1999–2000 financial year<sup>53</sup> with projections running flat and constant at \$570 million per annum for the next five years.<sup>54</sup> The ANAO reviewed ATO research about the actual amounts of the exemptions obtained by non-residents. The ANAO found that the quality of the data used by the ATO was not sufficient to calculate the amounts of the exemptions received each year since the measures were introduced. This may be a result of lodgement irregularities. Nevertheless, the ATO's indicative research reviewed by the ANAO suggests that the financial impact might be increasing non-linearly, rather than continuing in the constant manner projected by the Treasury. The ATO advises that there are both strategic and tactical processes underway to further assess the current impact of the exemption. The ATO further advises that given the poor quality of the return label data on this item, it doubts that it is possible at this stage to draw any confident conclusions about the pattern of growth until that further work has been completed.

2.78 The ANAO considers that if the ATO were to address the data quality problems associated with the section 128F exemption, the actual amounts of tax forgone could be accurately calculated. The ANAO understands that fewer than 80 taxpayers claimed exemption under section 128F in 1999–2000. Given the relatively small numbers of taxpayers, it may be feasible to obtain a precise amount of the tax expenditure cost of the section 128F exemption. This would enable the comparison between actuals and the amounts originally projected. It would also enable the rate of increase in the take up of the exemption to be determined. When changes to the exemption provisions were introduced in 1999,<sup>55</sup> the EM indicated that Treasury and the ATO would monitor the performance of the measures in relation to the objectives set for them.<sup>56</sup>

### *Non-resident taxation debt*

2.79 In order to obtain further information about the compliance behaviour of non-residents who have lodged tax returns, the ANAO initiated a brief analysis of the taxation debts of non-residents with tax records on the ATO's mainframe databases. The initial analysis indicated that, at 30 August 2002, approximately 8 500 non-residents with an ATO lodgement history may have an assessed tax debt of approximately \$71 million. However, further analysis indicated that there could be problems of data integrity and debt classification.

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<sup>53</sup> Department of the Treasury, *Taxation Expenditure Statement 2002*, p. 5044.

<sup>54</sup> Department of the Treasury, *Taxation Expenditure Statement 2002*, p. 5044.

<sup>55</sup> The 128F exemption regime was first introduced in 1971. The regime was completely reformed in 1997. There were subsequent refinements in 1998 and 1999.

<sup>56</sup> *Taxation Laws Amendment Bill (No 2) 1999, Explanatory Memorandum* p. 3.

**2.80** Further analysis also indicated that a large proportion might be associated with non-resident companies that have an Australian presence, in which case any tax debts would be recovered in the normal manner. A proportion of the identifiable debt was found to be in dispute, and until disputes are settled, the debt cannot be classified as collectable. The amount of collectable debt incurred by non-residents might be about \$29 million. The accuracy of this figure would depend on the clarification of a range of data integrity and debt classification issues. The ANAO considers that it would be desirable for the ATO to address these matters. The incidence, amount and recovery of non-resident tax debt warrants the ATO's closer analysis.

**2.81** The ATO's normal collection processes depend ultimately on enforcement action sanctioned by Australian courts. Such remedies might not be available to the ATO for the recovery of tax debt incurred by non-residents without an Australian presence who do not visit Australia again. Article 27 of the 2003 OECD Model Double Taxation Convention provides rules under which contracting states may agree to provide each other assistance in the collection of taxes, including the recovery of tax debts.<sup>57</sup> The ANAO considers that there may be merit in the Treasury and the ATO examining the scope for the inclusion of such a provision in future treaties so as to assist in the recovery the tax debts of non-residents.

### *External data sources*

**2.82** The ANAO noted several instances where the ATO uses external data sources to help it identify and collect payment of tax from non-residents. These range from:

- collecting data from publicly available information;
- using relevant databases maintained by external bodies such as Commonwealth authorities, State government agencies, private sector entities;
- developing liaison and partnerships with external bodies; and
- using the ATO's information gathering powers under sections 264(1) and 264A of ITAA 1936.

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<sup>57</sup> The OECD Model Tax Convention on Income and on Capital provides a standard framework that countries can use as a basis for negotiating bilateral DTAs with other countries. DTAs essentially provide certainty of taxation obligations for residents of both countries, in that they allocate taxing rights between the two countries (referred to as Contracting States in the Model). DTAs also provide a foundation for international co-operation between tax administrations. Article 27 of the Model is titled 'Assistance in the Collection of Taxes'. It is, however, an Article that to date has not generally been included by most OECD member countries in their concluded DTAs.

**2.83** These initiatives are examples of the positive steps the ATO can take in terms of liaising more closely with the relevant bodies to collect information about non-residents. Nevertheless, the ANAO considers that there is scope for the ATO to take a more strategic and comprehensive approach.

**2.84** For example, although the ATO has Memoranda of Understanding covering data exchange with a number of authorities, its use of relevant data maintained by State authorities has been sporadic. It appears to the ANAO that it is not guided by a strategic approach that aims to maximise the value of data to the ATO as a whole.<sup>58</sup> Furthermore, data relevant to the identification of transactions with non-residents indicating tax obligations might also be valuable for other tax administration purposes. The converse would apply in some instances as well.

**2.85** The FIRB examines proposals by foreign interests to undertake direct investment in Australia and makes recommendations to the Government on whether those proposals are suitable for approval under the Government's policy.<sup>59</sup> As a result, the FIRB maintains data about the property holdings of a number of non-residents who may have Australian tax obligations. The FIRB provides data to the ATO on a regular basis. The ANAO noted that the ATO uses this data to assist the identification of non-residents who may have Australian tax obligations, particularly those arising from the acquisition of property. The ATO regularly receives from the FIRB data about approaches by overseas investors who may wish to purchase or dispose of assets in Australia.

**2.86** The FIRB has the power to direct non-residents to dispose of real property held in Australia where the non-resident has breached the legislation administered by the FIRB. The ANAO noted that the ATO investigates all such cases in order to ensure that any capital gains liabilities that result from the disposal of real property in Australia are met.

**2.87** The ANAO found that FIRB data is relevant to the ATO's administration of the non-resident function and that it is being used to good effect by the ATO.

## Conclusion

**2.88** There may be merit in the ATO's use of a strategic framework to guide the collection, access and use of relevant data from external sources. Such a framework could provide cost efficiencies by using, for example, a consolidated approach to obtain information from external agencies rather than ATO officers

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<sup>58</sup> Data held by State Registrars-General, property titles offices, rental boards and State Revenue agencies are examples.

<sup>59</sup> FIRB website: <[http://www.firb.gov.au/aboutus/about\\_us.htm](http://www.firb.gov.au/aboutus/about_us.htm)>.

pursuing individual inquiries. The ANAO notes that in the areas where the ATO has liaised with the relevant external agencies and collects regular data about non-residents, generally there is a higher level of compliance and tax revenue collected. Accordingly, ANAO concluded that, although the ATO has some positive initiatives, it would benefit from an integrated strategic framework for its access, collection or use of external data relevant to the administration of the taxation of non-residents.

**2.89** The recently established ISC that has oversight of a wide range of international taxation administrative matters could play a key role in ensuring that an integrated strategic framework is developed for access, collection and use of external data relating to non-residents. There may be merit in the ISC commissioning the new ISO Branch to prepare a submission, in consultation with the relevant ATO business lines, on this matter for the ISC's consideration.

## Recommendation

**2.90** The ANAO recommends that, in order to assist the ATO's more effective and efficient administration of the payment of tax by non-residents:

- a) the ATO's International Steering Committee commission the development of an integrated strategic framework for the ATO's access, collection and use of external data relevant to the administration of the taxation of non-residents; and
- b) the ATO continue the improvement of the quality and integrity of all data used in the administration of the non-resident function, especially Schedule 25A, section 128F exemptions and tax debt.

### *ATO response*

**2.91** The ATO agrees with this recommendation, but with the qualification that the type of external data referred to in part (a) of the recommendation that will be most relevant for ATO purposes is expected to be that at the micro or individual transaction level. Initiatives to acquire such data have the potential to be very expensive for the external suppliers and the ATO. The ATO has undertaken to do scoping and sampling investigations, consistent with overall compliance strategies, to evaluate the costs and benefits of different data sources. These investigations may also help the ATO to adopt the most streamlined methodologies for obtaining data and integrating its use with other data sources.

## Non-resident use of interposed entities in financial transactions

**2.92** A Capital Gains Tax (CGT) liability arises where a non-resident makes a profit from the disposal of an asset that has a necessary connection with Australia. It may be possible to avoid this liability where there is a non-resident entity interposed between an Australian asset and a non-resident owner. If the non-resident entity is sold by the non-resident owner rather than the Australian asset itself, Australian tax may not be payable.

**2.93** Over a number of years the ATO has undertaken activities to ensure that tax is being paid by non-residents in respect of profits arising from the sale of interests in Australian assets. In this regard, it has taken appropriate action including litigation before the Full Federal Court. It has also brought the matter and the possible need for a legislative response to the attention of the Government. The ANAO considered that the ATO has followed due process in identifying risks associated with the arrangements and bringing those risks to the attention of the Government.

**2.94** In 1998 the Government announced that the *International Tax Agreements Act 1953* would be amended to clarify the interpretation of the alienation of property articles in Australia's DTAs. This amendment was designed to overcome the 1997 Full Federal Court decision in *Commissioner of Taxation v. Lamesa Holdings BV*. The amendment, which is effective from 27 April 1998, ensures that Australia is able to maintain its taxing rights, afforded under some DTAs, over alienations of Australian real property in situations where it is owned by non-residents either directly or through a chain of interposed entities and it is one of these entities which is alienated, rather than the real property itself.

**2.95** The ATO has advised that the amendments to the *International Tax Agreements Act 1953* have certain restrictions. The ANAO understands that changes to Australia's tax laws relating to capital gains would need to be made before the ATO can consistently apply CGT to these arrangements at the domestic level.

**2.96** The Review of Business Taxation canvassed these arrangements outside of the DTA context and recommended that legislation deal with the avoidance.<sup>60</sup> In a press release issued on 11 November 1999, the Government announced that a measure would be introduced to counter the avoidance by non-residents of Australian CGT by disposing of an interposed entity holding Australian assets rather than the assets themselves.<sup>61</sup> It further stated that it would limit this

<sup>60</sup> J Ralph *Review of Business Taxation—A Tax System Redesigned*, released in July 1999, Recommendation 21.7.

<sup>61</sup> Press Release No.74: *The New Business Tax System: Stage 2 Response*, the Treasurer, 11 November 1999

measure to tax avoidance rather than commercial transactions.<sup>62</sup> At the time of the announcement, the fiscal impact of the measure was estimated to be \$40 million in 2002–03, \$50 million in 2003–04 and \$50 million in 2004–05.<sup>63</sup>

**2.97** In August 2002, the Department of the Treasury released a consultation paper entitled *Review of International Taxation Arrangements* (RITA). An option raised in the RITA paper is to consider whether or not to proceed with the Review of Business Taxation proposal to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets (Option 3.6 of RITA). As part of the review, the Board of Taxation has undertaken an extensive public consultation process and recommended that the Government not proceed with this proposal. The ATO has provided input to the Board on administration and integrity issues raised during the consultation process. The Government recently announced that this proposal would receive further consideration in consultation with the business community.<sup>64</sup>

**2.98** The ATO has advised that it is a common exit strategy of large non-resident entities to hold their investments in Australia via a non-resident interposed entity. During 2001–2002, ATO research identified that there were at least a dozen other transactions similar to the *Lamesa* transaction.

## Conclusion

**2.99** The ANAO concluded that it would be beneficial for the ATO to continue to bring to Government's attention the costs and benefits associated with options for addressing these arrangements, if action to address the arrangements requires a governmental decision.

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<sup>62</sup> *ibid*, Attachment I.

<sup>63</sup> *ibid*, Attachment O.

<sup>64</sup> The relevant extract from the *Treasurer's Press Release No.32 of 2003*, dated 13 May 2003, states: 'A non-resident holding Australian assets through a non-resident company can dispose of that company, avoiding Australian tax on any capital gain—even though the gain relates to Australian assets. The Review of Business Taxation recommended addressing this issue but its implementation was deferred pending a review of tax treaty policy by this review. As the Board proposed giving up relevant capital gains taxing rights (Recommendation 3.11(2)) in tax treaty negotiations, it did not support this measure proceeding. It also noted the possible adverse effect upon foreign investors' perception of Australia as a place to invest, and perceived administration concerns. However, as the Government has decided to continue taxing these capital gains, it may be appropriate to reinforce Australia's ability to tax non-residents disposing of Australian assets. Accordingly, in consultation with the business community, the Government will give further consideration to the Review of Business Taxation recommendation, recognising that any proposal will need to address concerns regarding a possible adverse effect upon foreign investors' perception of Australia as a place to invest, administration and compliance issues.'

## ATO/DIMIA interface initiative

**2.100** In August 2000, the House of Representative Standing Committee on Economics, Finance and Public Administration (the Committee) tabled a report titled *Numbers on the Run: Review of ANAO Report No.37 1998–99 on Management of Tax File Numbers*. Part of the report looked at the tax treatment of non-residents and found that harvest labour<sup>65</sup> is a ‘particularly problematic area for ensuring correct tax treatment of temporary entrants’.<sup>66</sup> This was due to the large number of non-residents holding working holiday visas and the short period of work in each location.

**2.101** The report noted that the then Department of Immigration and Multicultural Affairs collects visa data that identifies work rights granted to individuals and duration of stay for people entering Australia. The report found that this information was not being systematically used by the ATO. There would be benefit in exchanging visa data to match the information with individual income records. This would assist in the identification of illegal workers and put stronger controls on ATO’s recording of visa numbers.

**2.102** At the time of the audit, the ATO had begun work on a High Level Design for the Individual Auto Registration Project.<sup>67</sup> One of the objectives of the project is to ‘facilitate, upon application, the automatic allocation of a Tax File Number (TFN) to permanent immigrants and visitors with a visa that contains conditions allowing the application the right to seek work in Australia’.<sup>68</sup> The diagram below represents the high level overview of the Individual Auto Registration Project.

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<sup>65</sup> ‘Harvest labour’ refers to the largely itinerant workforce employed in the fruit picking industry.

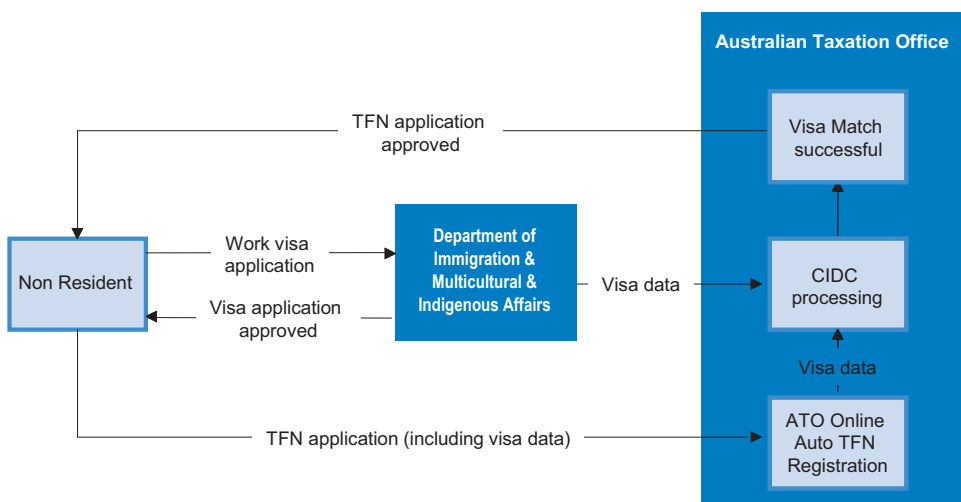
<sup>66</sup> *Numbers on the Run*, House of Representative Standing Committee on Economics, Finance and Public Administration, August 2000, p. 55.

<sup>67</sup> *Individual Auto Registration Project: High Level Design (Version 1.2)*, 8 May 2002.

<sup>68</sup> *ibid.*, p. 9.

**Figure 1**

## **ATO Auto Tax File Number Registration System**



Source: Individual Auto Registration Project

**2.103** Under this system, when the non-resident applies for a work visa to work in Australia, DIMIA will exchange the visa data with the ATO. When the non-resident arrives in Australia to work, they will need to apply for a TFN through a web-based system. The non-resident will need to supply their personal details including the visa number. The visa number will be matched with that supplied by DIMIA. If a match is successful, the applicant will be issued with a TFN. At the time of fieldwork, the ATO was refining the system so that it would also gather arrival and departure information from Australian Customs Service. This data would allow the ATO to ‘switch off’ a TFN once the non-resident leaves Australia. This will limit the opportunities for TFNs to be used for fraud or other illegal activities.

## **Conclusion**

**2.104** The ANAO concluded that the successful completion of the Individual Auto Registration Project will improve the ATO’s ability to identify non-resident workers and introduce tighter controls for issuing non-residents with TFNs.

## **Transition from the Investment Royalties Withholding regime to the PAYG Income Tax Withholding regime**

**2.105** As part of *A New Tax System*, the Government has consolidated all withholding tax arrangements into the PAYG framework. A key feature of PAYG is to have one administrative regime for all income tax withholding (ITW)



payment events, with a single set of rules that cover all withholding events listed in the legislation. On 1 July 2000, the management of all ITW payment events (with the exception of those dealing with withholding tax on interest, dividends, royalties and mining payments to non-residents) were consolidated into the general Activity Statement and related processes. On 1 July 2001, the payments events dealing with withholding tax on interest, dividends, royalties and mining payments to non-residents, were aligned with the general PAYG ITW processes.

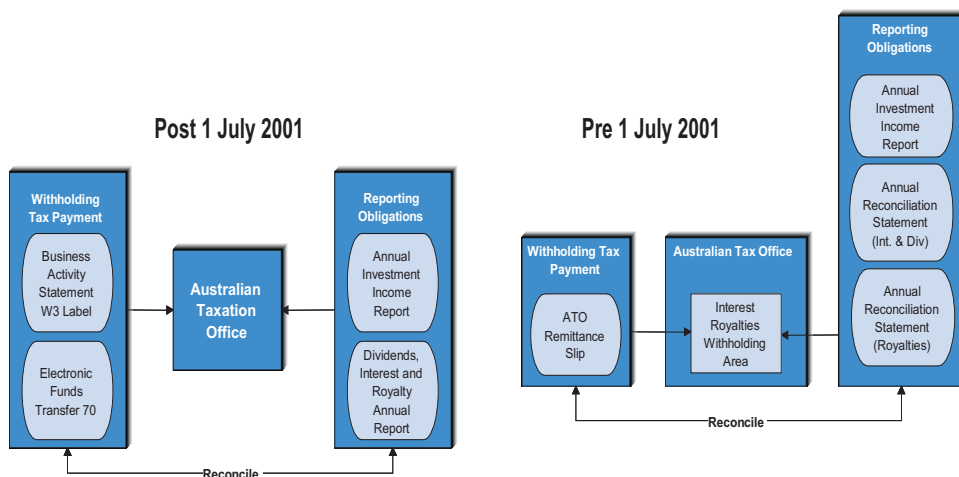
**2.106** The transition to the PAYG arrangements required some changes to the processes previously in place. These included the periodic notification of PAYG ITW liabilities via a composite label (label W3) on the activity statement. The end of year obligation to provide an annual report to the payee level of transaction, remained the same, but in a slightly different reporting format.

**2.107** The main difference between the two regimes, relates to the timing of the provision of certain data. Under the previous IRW system, clients worked on a monthly cycle for the notification and payment of liabilities, including a breakdown of the monthly amounts relating to dividends, interest and royalties. They then provided an annual reconciliation report of those monthly remittances. Under the PAYG regime, the client provides the total of the liability for a reporting period (weekly, monthly or quarterly) across all ITW payment events on the relevant activity statement. They then provide an annual report, breaking down the totals in individual payee amounts for interest, dividends or royalties. This means that the periodic aggregate data now provided via the relevant activity statement, under the PAYG system, cannot be disaggregated until after the end of year reporting processes have occurred.

**2.108** The figure below presents a high level overview of the payment and reporting obligations for dividends, interest and royalties under the old IRW system (pre 1 July 2001) and the new Annual Reporting regime (Post 1 July 2001).

**Figure 2**

**Annual Reporting and Reconciliation Arrangements**



Source: ANAO (based on ATO reports)

**2.109** The ATO had planned to receive the Annual Report for non-resident dividends, interest and royalties on 31 October 2002. However, this date was extended to 31 January 2003 to allow payers more time to adjust to the new reporting system. Since the reconciliation of reported payments with actual payments for dividends, interest and royalties did not occur before the completion of this audit, the ANAO cannot assess how effectively the ATO has managed this process, nor comment on data integrity or the scale of any mismatch.

## Conclusion

**2.110** We concluded that the new processes will result in less timely data and therefore may limit the ATO's ability to monitor and act on potential risks in a more timely manner. The ANAO suggests that the ATO closely monitor the performance of the new arrangements in order to establish whether the abovementioned concerns warrant remediation.

Canberra ACT  
25 June 2003

Oliver Winder  
Acting Auditor-General

# **Appendices**



## Appendix 1

### Corporate planning and governance processes

Each of the four plans that support the ATO's corporate planning and governance processes set out the broad strategic directions for addressing the highest level risks to the achievement of the ATO's outcomes.

An Executive Group, chaired by a Second Commissioner, which includes the relevant Deputy Commissioners, is responsible for each sub plan. The Executive Group of each sub plan is responsible for making decisions about corporate priorities and resource allocation. The Executive Groups are informed by several monitoring and reporting processes such as plenary governance, risk escalation and exception reporting arrangements. The figure below is a high level overview of the four plans.

## ATO's Strategic Statement and Four Supporting Plans

ATO Executive			
ATO Strategic Statement: To optimise collections and make payments in a way that instils community confidence that the system is operating effectively			
Compliance Executive	Operations Executive	Info. Technology Executive	People and Places Executive
Compliance	Operations	Info. Technology	People & Places
<p>Design and deliver the Tax Office's compliance program</p> <p>Administer income tax (including benefit distribution), fringe benefits tax and superannuation, GST, excise collection and distribution system.</p> <p>Develop and implement a range of services covering help and education, including a frontline advice and interpretation service for taxpayers and their advisers to help them meet their obligations.</p> <p>Maintain the integrity of the tax system with appropriate verification, audit and enforcement activities.</p>	<p>Design and deliver the Tax Office's operation program.</p> <p>Manage client account from registration through to their lodgement and payment obligations.</p> <p>Design and manage the Tax Office's accounting and registration systems, manage payment and product processing and debt lodgement.</p>	<p>Design, build and maintain the Tax Office's corporate business systems to support operations and compliance activities.</p> <p>Plan and manage the provision of information technology and telecommunications services.</p>	<p>Support the delivery of compliance, operations and IT sub-plans through communication and relationship strategies. This includes planning for the workforce required to deliver today and for the future through recruitment skilling and performance management programs.</p>
ATO business and service lines: plan and manage delivery of sub plans within lines, reflecting decisions and directions from executive bodies			

Source: ATO Strategic Statement 2003–2005

Each of these four plans are further supported by business line specific sub plans. Whilst the higher level plans address 'severe' and 'high' level risks, the business line sub plans address lower level risks (as well as the 'severe' and 'high' level risks). In addition, the business line sub plans outline specific strategies and detail resource limits. The business line sub plans are themselves supported by team level plans that make the higher level plans operational. All plans are subject to monitoring through a range of management structures, accountability processes, regular reporting and risk escalation arrangements.

## Risk management within business lines

### Large Business and International

Large Business and International (LB&I) is structured around industry segments. These industry segments are Financial Services Industry Group, Energy and Resources, Multi Media and Information Technology and National Client Group.

At the business line level, LB&I has several areas that provide it with information. These are as follows:

- *Corporate Consultative Committee*: an external consultative body consisting of representatives of major industry groups and key large business personnel. One of the purposes of this committee is to understand the high level patterns and trends in industry from an external perspective.
- *Intelligence and Strategic Research*: the objective of this group is to analyse information from external and internal environments and distribute this information to the relevant areas in LB&I for informed decision making.
- *Strategic Intelligence and Analysis*: the objective of this group is to detect emerging risks. It is responsible for real time intelligence gathering and analysing information for patterns and trends that impact on the tax system.

All these processes assist LB&I to identify risks in the large business market. In addition to these sources of risk information, the industry segments also examine risks within their market group. An important tool to assist them in doing this is the risk engine. This is a research method that provides comparative data across the whole of the market, within industries and in relation to corporate groups. LB&I uses this analysis as the basis to select industries or cases for further analysis. Other risk assessment activities includes performing environmental scanning, understanding the market and its members, industry liaison, risk reviews, audit activity, key client management, provision of advice and dispute resolution. Industry segments are required to report on major changes within the segment through a monthly accountability report. LB&I also has a bi-annual governance reporting process where each segment provides the Deputy Commissioner with an environmental scan and an indication of key risk areas.

An important tool the industry segments use to assess risks at the client level is a process called the Client Risk Review (CRR). CRR is a risk assessment tool designed to compliment the industry segment's risk management strategies in LB&I. CRR is a continual review of the past and latest information concerning a corporate group. The ATO has designed the CRR to identify risk and develop

strategies to manage risks within the LB&I market segments. The CRR consists of five broad phases which are:

- know the client;
- identify and assess material tax risks;
- visit the client to test identified risks;
- recommend treatment strategy to mitigate risks; and
- complete risk report (Health Card).

The focus of the CRR is on a corporate group. This review will cover all entities in this group including non-resident parent companies, subsidiaries or associated entities. A current focus area in the CRR includes international issues. The ATO has an international checklist that case officers have to address in performing a CRR. This checklist includes reviewing:

- resident parent company with worldwide related entities;
- resident entities with activities offshore;
- non-resident parent company with Australian related entities;
- non-resident entity with activities in Australia; and
- dual residents.

## **Small Business**

Small Business (SB) is structured into groups based on market segments and capabilities. A responsibility of these groups is to identify potential and emerging risks within their area. This can arise from current projects, intelligence or trends and movements in the SB market.

Another source of information about risks are SB forums and committees in which Deputy Commissioners, Assistant Commissioners, team leaders and operatives participate. These forums can identify risks through several mechanisms including external stakeholder discussions, newspaper articles, private binding rulings, audits or telephone enquiries.

The main device SB has to record and register the risks identified by the groups within SB is the Emerging Risk Register. This is where all emerging and potential risks are initially recorded. The risk register is maintained by an area in SB called the Knowledge Development Network (KdNet) who records the risk data it receives from the various sources within SB. From the collection of risks on the Emerging Risk Register, KdNet has a role in grouping similar intelligence and sorting similar risks together.



From the collection of risks on the Emerging Risk Register, an area called the SB National Risk Network performs preliminary analysis. The preliminary risk analysis is designed to ensure that emerging risks are sufficiently described and that there is an appropriate risk rating attached to each risk. The purpose of performing the preliminary risk analysis is to make recommendations to the SB Integrity of the System Committee on the highest areas of risk within the SB market.

## Personal Tax

There are three main compliance strategies in use in Personal Tax (PTax). These are:

- the provision of advice and public assistance to persons who may have Australian tax obligations;
- a range of governance and monitoring of compliance monitoring activities; and
- the activities of the Active Compliance Group of PTax. These involve the analysis of labels on income tax returns, front-line intelligence gathering and analysis, and statistical, trend and intelligence analysis produced by the PTax Knowledge and Information (K&IM) area.

PTax states that one of the major risks to compliance by individuals is failing to understand their obligations or entitlements. Such compliance concerns can be readily addressed by the provision of advice and public assistance. The ATO makes available several publications that help non-residents comply with their tax obligations. For example, the ATO provides basic information to non-residents on working in Australia, earning interest, lodging a tax return and superannuation. The ATO also publishes fact sheets that outlines the Australian taxation of dividend, interest<sup>69</sup> and royalty<sup>70</sup> income received by non-residents.

The main elements of the governance and monitoring of compliance activities of PTax are:

- 'Heartbeat process': consisting of a weekly phone hook-up of the PTax Executive to discuss a weekly report that focuses on emerging risks, hot issues and follow-up action;

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<sup>69</sup> Non-resident interest, dividend and royalty withholding taxes—interest and dividend payments to non-residents—Fact Sheet No. 7, ATO, 12 November 2001. This Fact Sheet was produced by the Operations Business Line, with technical clearance provided by SB.

<sup>70</sup> Non-resident interest dividend and royalty withholding taxes—royalty payments to non-residents—Fact Sheet No.5, ATO, 15 November 2001. This Fact Sheet was produced by the Operations Business Line, with technical clearance provided by SB.

- monthly accountability reporting which includes identification of emerging risks and steps PTax is taking or proposing to take to manage them;
- risk review panel focussing on Active Compliance risks. These are the risks that have been escalated through the Heartbeat and accountability reporting processes;
- monthly health of the system snapshot covering significant activities for discussion by the Executive; and
- biannual accountability reviews.<sup>71</sup>

An example of where PTax has identified a non-resident issue through this process and taken action to redress the compliance risk is backpackers and working holiday makers incorrectly claiming residency status on their tax returns. The latter action allowed these non-residents to obtain a tax-free threshold when they were not entitled and therefore reduce the amount of tax they were paying. PTax has shifted resources to examine working holidaymakers tax returns. To date, PTax has reviewed 28 000 tax returns of working holiday makers and stopped \$16.95 million in incorrect payments. PTax has also begun an education campaign and expects that in 2003–2004, compliance will be significantly higher. Another initiative that should strengthen compliance in this area is the Auto Registration of Tax File Numbers (discussed in paragraphs 2.100 to 2.104).

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<sup>71</sup> This occurs with the PTax Deputy Commissioner, Deputy Commissioner, SES and nominated Directors on a stream-by-stream basis which include year to date performance and associated risks.

## Appendix 2

### Current treatment of rental income derived by non-residents under the UK, Canadian, US and New Zealand tax systems

#### United Kingdom<sup>72</sup>

- The Non-resident Landlords (NRL) Scheme applies to UK rental income paid from 6 April 1996.
- A 22% withholding tax is deducted at source of rental income from UK property. In the case of non-UK companies this is a final tax liability (although a refund may be claimed in respect of interest and capital allowances relative to rents received).
- Non-resident landlords can apply to the Inland Revenue to have no tax deducted from the rental income and in return the Inland Revenue will usually ask the landlord to complete a Self Assessment Tax Return once a year to work out whether he/she has any liability to UK tax.
- Agents or tenants can reduce the rental amount from which they withhold by taking account of deductible expenditure.
- Tenants do not have to withhold if they pay £100 or less a week in rent or if they pay the rent to a letting agent in the UK.
- The Tenant or Letting Agent has to calculate tax for each quarter and pay the tax due within 30 days after each quarter. A return of information has to be lodged by 5 July every year for the year ended 31 March.

#### Canada<sup>73</sup>

- A 25% final withholding tax is deducted at source as per the Part XIII of the Canadian Income Tax Act.
- Payer or agent is responsible for withholding and remitting Part XIII tax at the correct rate.

<sup>72</sup> Source: <[www.inlandrevenue.gov.uk/leaflets/c9.html](http://www.inlandrevenue.gov.uk/leaflets/c9.html)> IR 140-Non-Resident Landlords, their Agents and Tenants, October 2002.

<sup>73</sup> Source: <[www.ccra-adrc.gc.ca/E/pub/tg/t4061/README.html](http://www.ccra-adrc.gc.ca/E/pub/tg/t4061/README.html)> Non-Resident Withholding Tax Guide, updated 20 December 2002.

- A non-resident who receives rental income from real property in Canada can ask that payers or agents be allowed to deduct withholding tax on the net amount instead of the gross amount.
- A prescribed form has to be filed on or before January 1 of the tax year for which the request applies, or on or before the date the first rental payment is due. In the case of corporations, estates and trusts with substituted accounting periods, the form has to be filed before the 1st day of their fiscal year. Although the forms are accepted throughout the year, the effective date for withholding on the net amount will be the 1st day of the month in which the form was received. Tax has to be withheld on the gross rental income paid or credited to a non-resident before that date.
- In all situations the gross amount of rental income for the entire year has to be reported by the payer or agent.

## **United States.<sup>74</sup>**

- A 30% final withholding tax is deducted at the source on gross rental income from US property as per section 1441, 1442 and 1443 of the Internal Revenue Code.
- Payer is responsible for withholding tax and filing annual return.
- If a non-resident has income from real property located in the US that he owns or has interest in and holds for the production of income, he/she can choose to treat all income from that property as income effectively connected with a trade or business in the US. He/she can make this choice only for real property income that is not otherwise effectively connected with his US trade or business.
- If the choice is made then, the non-resident files a return on net income basis. The net income is taxed at graduated rates.
- The choice is made by attaching a statement, containing specific details, to the non-resident's return. The choice can be revoked without IRS approval by filing the appropriate form for the year he/she made the choice and for later tax years.

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<sup>74</sup> Source: Publication 519—U.S. Tax Guide for Aliens for use in preparing 2002 Returns, updated 20 February 2003.

**New Zealand<sup>75</sup>**

- Withholding tax is not deducted at source from rental income.
- Non-resident must file a return for any rental income received from New Zealand.
- Non-resident is required to prepare his/her own summary of the details for each rental property or provide details on an appropriate form (IR 3R).

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<sup>75</sup> Source: <[www.ird.govt.nz/othertaxes/peopleoverseas.html](http://www.ird.govt.nz/othertaxes/peopleoverseas.html)> Non-resident income tax return guide 2002.

## Appendix 3

### Summary of ATO's estimates of collectable revenue associated with some categories of non-residents

Category of non-resident	Description of related activity	Estimate of collectable revenue (per annum)
Independent Personal Services	Non-resident independent contractors and professionals with expertise in a given field such as architects engineers, scientists and film directors.	\$143 million
Capital gains	Non-residents making a profit from the disposal of non portfolio shares and other like assets with the necessary connection with Australia	\$60 million
Payments to non resident contractors	Non-residents receiving payments under short term contracts in connection with construction projects in Australia.	\$60 million
Entertainers and sportspersons	Non-residents entering Australia to carry out in activities of a sporting, athletic, entertainment or performing nature.	\$25 million
Commissions paid to Junket Tour Operators	Non-resident Junket Tour Operators receiving commission payments from Australian casinos.	\$22.5 million
Commercial Rent	Any entity type that invests in real property in Australia that has a commercial use.	\$10 million

These categories are described in paragraphs 2.36 to 2.54.

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