Extend Tax Compliance Evaluation Report

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December 2014

Executive Summary

This report is an evaluation of the 2013/14 outcomes related to the Extend Tax Compliance initiative proposed to the Expenditure Review Committee of Cabinet (ERC) in March 2013 by the NSW Office of State Revenue (OSR).

This report evaluates the outcomes of this initiative against the targets and key outcomes for 2013/14 based on the Cabinet Minute submitted to the ERC.

This evaluation assesses:

- how effectively the initiative is delivering against the revenue targets and operational efficiency set out in the ERC proposal, in terms of net benefits to Crown revenue and costs incurred
- the establishment of new and expanded staffing and technology required to achieve these outcomes
- the approach taken to review selected legislation as part of this initiative.

Overall findings

This initiative is effectively delivering the outcomes sought in the proposal to the ERC. This can be summarised in, and evidenced by, the following points:

- Overall Crown compliance revenue targets have been exceeded for 2013/14 by just over 12%, with $358.5m against a target of $320m. This demonstrates that OSR is identifying liable tax clients and ensuring they meet their financial obligations and contribute to funding the schools, hospitals, infrastructure and services provided to the community by the NSW Government.
- OSR compliance operations were undertaken within the budget allocated for this initiative, providing a baseline indication of the efficiency of service provision of the proposal endorsed by ERC.
- Additional technology and staffing are in place to augment and enhance OSR's ability to identify liable clients, improve the efficiency of audits conducted on clients and increase the volume of audits conducted in a given period.
- The key legislative review proposed has been undertaken to the satisfaction of the responsible Executive Sponsor (Anthony Johnston, Commissioner of State Revenue and Director, Technical and Advisory Services (TAS)). There were no major deficiencies identified and a plan has been established for further amendments to landholder duty provisions.

Further developments related to this review

It has been noted while undertaking this review that, based on the interim findings and success of this initiative, a further proposal was put to the ERC in May 2014 seeking to expand and extend the increase in revenue compliance activity undertaken to 30 June 2018.

Performance to the end of November 2014 demonstrated that OSR was already on track to exceed the revised and expanded target in 2014/15 of $366m. Revenue identified was 40% above the apportioned year-to-date target as at 30 November 2014 ($257m against a target of $183m).

The author of this review would like to thank the OSR staff members that provided input, data and information required for this evaluation for their time, assistance and expertise.

The evaluation

Scope of the program

In March 2013 OSR submitted a Cabinet Minute to the Expenditure Review Committee of Cabinet (ERC) seeking additional funding from 1 July 2013 to 30 June 2017 to expand OSR's compliance program. This would enable OSR to:

- Conduct more investigations and field audits in high risk revenue streams;
- Identify, analyse and evaluate more complex taxation and business structures to ensure State tax liabilities are not being evaded;
- Adopt more sophisticated taxpayer record verification techniques through the better use of data mining and matching against external data sources; and
- Engage a specialist practitioner to quality assure the landholder provisions in the *Duties Act 1977*.

This expansion of capacity would allow OSR to identify an additional $203m in compliance revenue over the 4 year program from the $20.36m in funding. These targets are in addition to the existing budget and compliance targets provided to OSR as part of the budget process over the forward estimates. The additional targets are summarised by financial year impacts in Table 1 below:

Table 1 Revenue and Costs of Extend Tax Compliance by Financial Year

Financial Year	2013/14	2014/15	2015/16	2016/17	TOTAL
Revenue ($m) (1)	37.00	49.00	55.00	62.00	203.00
Costs ($m) (2)	4.34	5.13	5.33	5.56	20.36
Budget Result	**32.66**	**43.87**	**49.67**	**56.64**	**182.64**

Notes to Table 1:

(1) Revenue is comprised of compliance outcomes for landholder duty, payroll tax, land tax, health levy and insurance duty from additional audit activity.

(2) Costs are comprised of labour costs (including salaries, superannuation and other staff on-costs), ICT costs (including amortisation and depreciation) and legal advisory costs.

Program logic

The program logic diagram in Figure 1 helps to visually communicate the objectives and assess the extent of implementation. This forms the basis of evaluative arguments about the overall effectiveness of the Extend Tax Compliance initiative. The program logic relates directly to OSR's Results Logic that forms part of the OSR 2021 Strategic Plan and maps the ultimate outcomes of OSR's operations.

The program logic shows how the Extend Tax Compliance initiative is based on the successful delivery of audits to targeted clients (the vertical dimension) to achieve the intermediate outcomes of increased compliance through audits undertaken and revenue identified.

Increased audits lead to an increased capability to identify aggressive tax planning, improved understanding of complex company structures and commercial transactions and a more highly skilled and experienced workforce through greater exposure to these risk areas. This will ultimately lead to the direct revenue identified positively contributing to consolidated revenue and the State budget position, improving the efficiency and equity of the NSW tax system and promoting the OSR Operations Business Model of upfront compliance based on automated revenue collection.

Figure 1 Program Logic of the Extend Tax Compliance initiative

Ultimate outcomes

- All revenue is collected and contributed to consolidated funding for schools, hospitals and services
- Clients pay their taxes; they know what to pay, how to pay and their options
- Clients are integrated into the automated revenue collection OSR Operations Business Model
- Revenue legislation is robust, reduces red tape and costs to the community and business

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Intermediate outcomes

- New risks to compliance are recognised, documented and shared to increase capabilities
- Fewer liable clients remain outstanding as they are progressively brought into the tax net
- Recommendations are made to improve the effectiveness of legislation

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Immediate outcomes

- Increased number of audits and investigations are conducted
- Liabilities for state revenue are identified, assessments are issued where revenue is identified from unpaid liabilities (including multi-year liabilities) and payments are received

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Activities and outputs

- Cases are selected and an increased number of audits are scheduled based on new staffing level
- Review of *Duties Act 1977* undertaken with a report provided to the Director, Technical and Advisory Services (TAS) and Commissioner of State Revenue on areas for improvement
- New approaches and techniques for data management and analysis are applied and trialled

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Design

- Recruit staff, increase the number of audits and investigations using a risk-based approach
- Conduct analysis and application of new data approaches and techniques (Grouped Entity Management System (GEMS), Computer Assisted Verification (CAV))
- Retain specialist resources to review and make recommendations on potential legislative concerns
- Set new revenue targets and incorporate into existing revenue compliance targets to focus on the overall outcome

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Need identified

- New business structures and transactions identified as emerging compliance risks that impact on the equity and efficiency of the tax system through evasion
- Liable clients are not meeting their obligations
- Potential legislative weakness and complex valuation issues for landholder duty
- Pressure on the NSW state budget from rising costs and falling GST revenue, with the objective to return to a sustainable surplus from 2015/16 from a deficit of $283m in 2014/15 (Budget Speech 2014/15 by the Hon. Andrew Constance MP,17 June 2014, p4)

Overall outcomes and achievements

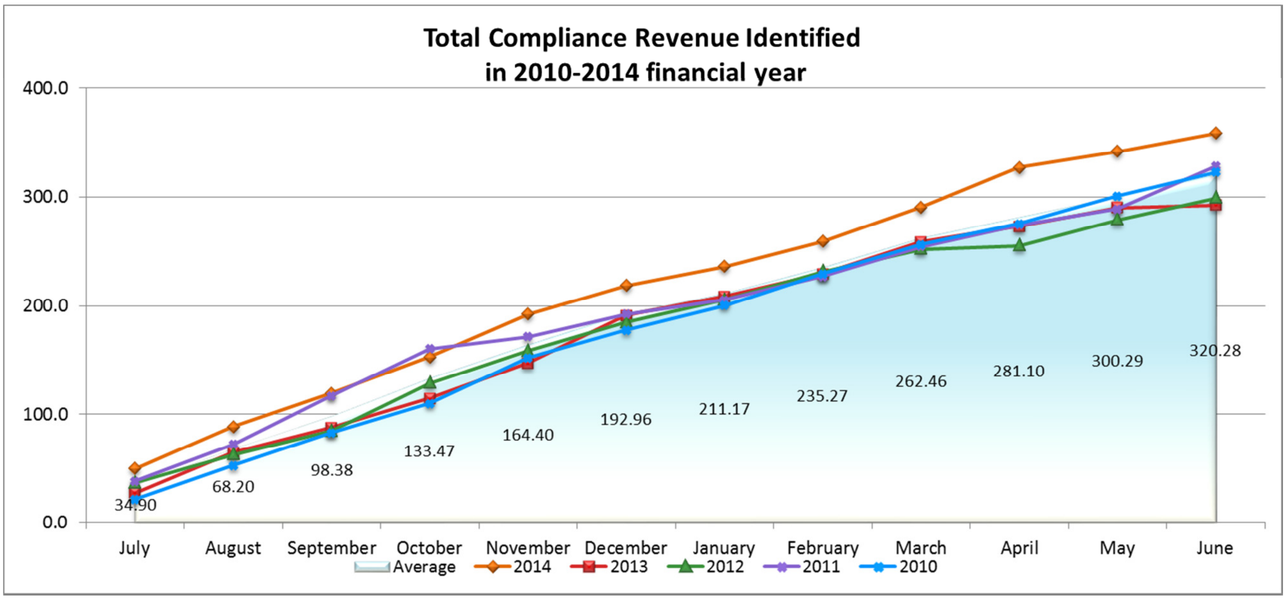
1. OSR exceeded the total compliance revenue identified target of $320m for 2013/14, with $358.5m in compliance revenue identified. This was accomplished within the agreed budget and Net Cost of Services (NCOS)

Overall, OSR exceeded the 2013/14 target for compliance revenue identified. The total target was $320m, including the $37m added to the pre-enhancement target of $283m. This is the key result for the Extend Tax Compliance initiative as this outcome indicates:

- that the return-on-investment (ROI) sought by the ERC in supporting this proposal was realised
- efficiency in operations was achieved based on cost-to-collect ratios set as part of this proposal
- revenue leakage has been arrested at a rate surpassing prior years from additional effort expended.

This compliance result by month is shown diagrammatically in Graph 1 with the results compared against prior years.

Graph 1 Total Compliance Revenue Identified by Financial Year



Graph 1 demonstrates that every month in 2013/14 had a revenue identified result that was higher than the average over the preceding 4 years, with only 1 month in a previous year having more compliance revenue identified over that period.

The proportion of compliance revenue collected (now due) was 93.7% of revenue identified in 2013/14, comparable to the previous year's result of 93.5%. This would suggest that the capacity and propensity to pay for these newly identified clients is not markedly different to those identified in prior year audits.

OSR was able to deliver this compliance result within the augmented funding provided by the ERC. The overall funding position was monitored by OSR's Finance Branch and Enterprise Project Management Office, providing independent oversight of expenditure and attributable costs to ensure ERC obligations were met within the parameters set.

OSR has ongoing reporting to Treasury on compliance revenue through monthly analytics and compliance revenue is considered as part of quarterly Revenue Forecasting Rounds.

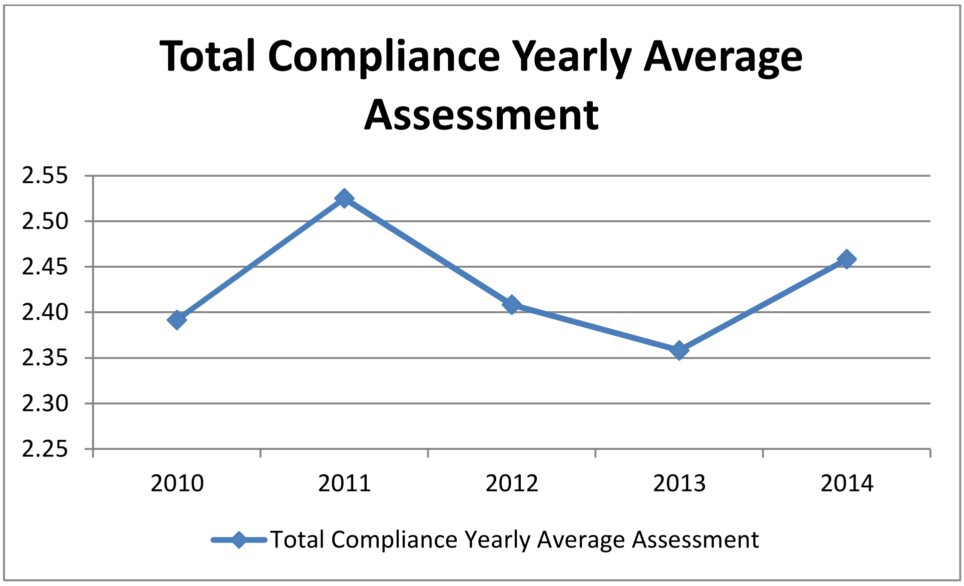
2. OSR has used the additional staff and technology provided under the Extend Tax Compliance initiative to identify more liable clients and move them to lower cost compliance groups (upfront automated and voluntary)

Upfront compliance is a more efficient way to ensure the potential revenue base is accessed and tax liabilities are met, but often requires clients to first be identified. OSR has used the number of years assessed when undertaking audits as a measure of upfront compliance and the effectiveness of client training, communication and engagement. Liable clients ideally pay when they first become liable.

The more years of liability assessed as outstanding during an audit (that is, the more years where a client has an outstanding liability due that has not been paid), the less effective OSR has been in making clients aware of their obligations and enabling them to meet them with minimal intervention.

Graph 2 shows the average number of years of revenue assessed under audits over the last 5 years.

Graph 2 Total Compliance Revenue Yearly Average Assessments



Graph 2 demonstrates that the number of assessment years had been falling prior to the 2013/14 audit year. While some level of back-end active compliance will always be required, the most cost effective use of resource allocation is in upfront compliance to improve voluntary compliance levels. This can only be achieved for a proportion of clients through active compliance to transition their behaviour and practices.

The increase in average assessment years indicates that OSR is contacting new clients that may not have been targeted in prior active compliance and audit activities. This includes clients that may not have been aware they were liable for a form of state revenue (land tax, payroll tax and so on) due to increased employment, the acquisition of more properties or other factors or variables that determine tax liabilities.

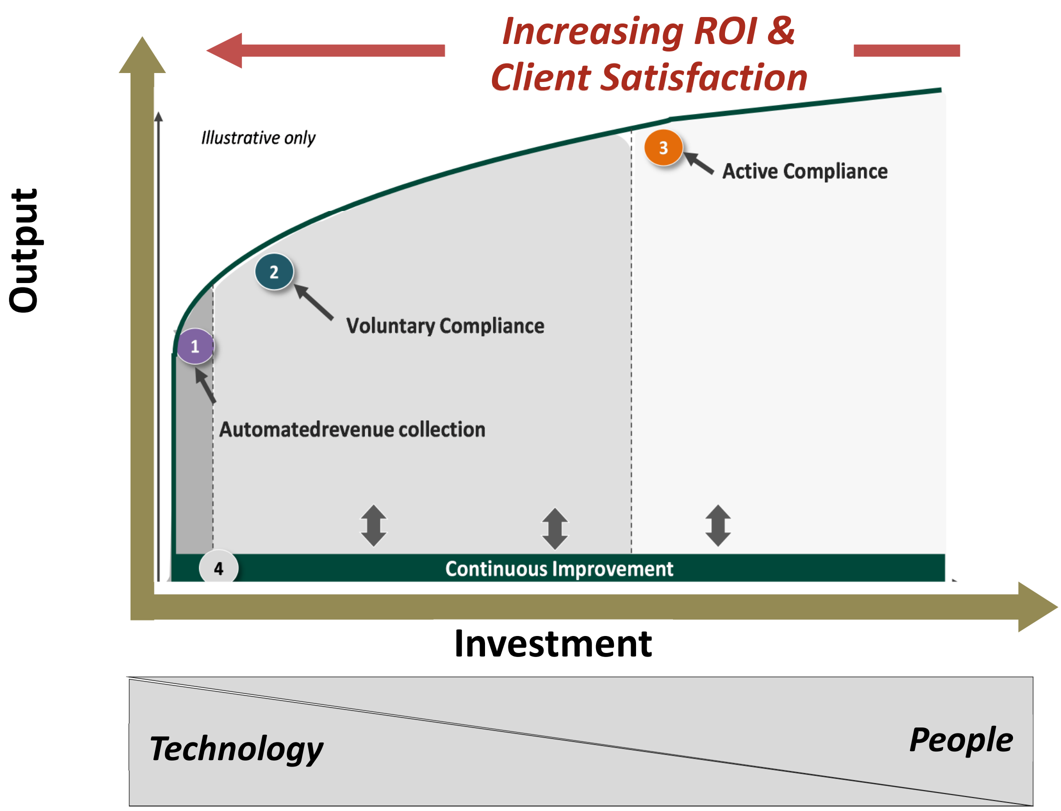
The active compliance method, denoted as (3) in Figure 2, is the approach endorsed by the ERC for the Extend Tax Compliance initiative. Audit and active compliance activities are typically highly resource intensive compared to automated revenue collection or voluntary compliance, and are facilitated through staffing and applying data insight and analysis. OSR has pursued this improved analysis and increased activity by investing in technology and people to apply to this initiative including:

- Recruiting 40 additional staff in 2013/14 (including 2 Computer Assisted Verification (CAV) technical analysts noted below), with a further 4 positions funded in 2014/15. These staff include senior auditors, compliance managers, intelligence analysts, a debt collection officer and a technical expert for advice on landholder matters and to manage reviews and objections.

- Expanding the use of CAV, a means of analysing electronic client data to assist in the profiling of clients and in the planning and undertaking of subsequent complex audits. CAV allows OSR staff to work with clients to deliver the secure and accurate extraction and storage of data from client computer systems. OSR was able to recruit an additional 2 CAV technical analysts as part of the staffing expansion, allowing further time saving specifically in payroll tax audits.
- Upgrading and deploying the Visual Grouped Entity Management System (GEMS), a means of data visualisation that enables quicker assessment of grouping risk for payroll tax clients by auditors and analysts to ensure correct liabilities are identified, relevant thresholds and rates are applied and exemptions are verified and permitted. Over $168m in business tax revenue was identified in 2013/14, mostly relating to payroll tax.

With the new approach to data matching and case selection through the deployment of the Visual GEMS and CAV technologies, and the increased capacity to audit more clients (and potential clients) from more staff, OSR is identifying clients that may previously have missed upfront and voluntary compliance messages. The OSR Operations Business Model that underpins the approach to identifying and transitioning clients to lower compliance cost behaviours is shown in Figure 2.

Figure 2 OSR Operations Business Model



The resource investment in active compliance is comparatively high, with a cost of $9.50 for every $100 identified compared to an overarching cost to collect for every $100 of all tax revenue of $0.48 in 2013/14. This compliance cost is based on approximately $37.7m for 2013/14 in total costs (based on existing controllable allocated operating expenditure and the additional ERC funding) compared to the revenue generated from all active compliance activities of $358.5m.

Active compliance activities are reviewed for effectiveness and efficiency to maximise ROI, with a benchmark figure of 9:1 pursued from historical compliance activities and accepted marginal rates of return.

There are several key points to note from the active approach to compliance:

- **Absolute benefit** - the return-on-investment from this initiative when measured in absolute terms for Crown revenue is almost 10:1, a rate of return that is unsurpassed in other government agencies. The net result that this contributes to Crown revenue is material to the NSW Government being able to achieve a budget surplus in the current economic environment.
- **Relative cost** - in relation to overall OSR operations as a component of total tax revenue, over $21.4 billion in 2013/14, active compliance and associated costs are a relatively small proportion of total revenue managed by OSR (1.7% of OSR revenue costing 0.17% of overall revenue managed). To provide a point of comparison, the total NSW State Budget in 2013/14 was $62.6 billion (Budget Statement 2014/15 p4-3).
- **Volume of activity** - OSR conducted increased audits in 2013/14 against 2012/13 as outlined in Table 2. This data is provided in absolute terms without context as a high level summary of the compliance program undertaken by OSR. It should be noted that the data in Table 2:
    - does not account for the client base for revenue types (for example, in 2014 there were approximately 40,000 liable payroll tax clients compared to 158,000 liable land tax clients)
    - does not consider the complexity or average time taken for each audit (for example, an EDR transaction investigation is less time consuming than a land tax audit)
    - does not provide a comparison of the volume of the revenue base for each type (for example, in 2013/14 OSR collected $8,504m in payroll tax for 40,000 clients compared to $894m in insurance duty revenue with only 1% of the number of payroll tax clients)
    - does not consider the risk profiling, client segmentation and data mining used to determine those clients identified for audits and investigations. OSR publishes an annual compliance program factsheet on its website to provide clients with an overview of activities and work practices being targeted, information and contact options and prior year audit results.

Table 2 Comparison of audit volumes and revenue identified 2012/13 and 2013/14

Revenue stream/transaction type	Number of audits and investigations		Revenue identified ($m)	
	2012/13	2013/14	2012/13	2013/14
Duties and electronic duties returns (EDR)	4,841	5,078	3.1	2.5
Landtax	15,200	18,100	114.0	140.0
Landholder and land rich duty	118	269	38.9	36.3
Payroll tax - registered clients	2,439	2,650	89.2	112.0
Payroll tax - unregistered clients	1,834	1,874	39.4	52.7
Insurance duty	-	6	-	2.9
First home benefits (1)	541	432	3.9	3.2

Notes to Table 2:

1) First home benefit audits result in the cancellation of exemptions and concessions that result in a repayment of grants and other payments as well as the assessment of duty owed.

The volume of audits and investigations conducted directly impacts on the accuracy of payments by existing clients and in identifying those clients that are liable but not paying their tax.

Given the different factors, variables and methods available to clients that impact on a tax liabilities and payment approaches, audits and investigations provide a means to verify that clients meet their obligations.

For example, payroll tax is self-assessed on a monthly basis across the year, with the annual reconciliation providing the opportunity for clients to ensure their liability is fully understood and paid. By undertaking audits, OSR can confirm that clients have applied the correct taxation treatment to new and emerging areas of risk, such as the engagement of contractors and the impact of fringe benefits on payroll tax liabilities. OSR can then educate clients and secure payment. Audit activity for existing payroll clients was worth $112m in 2013/14.

At the other end of the spectrum are those clients that may not realise they are now liable, for example a company that has exceeded the payroll tax threshold for the first time. As elaborated in the next point, audits often provide a first means of contact based for this client segment on related information available to OSR that leads us to engage with potentially unregistered clients. Based on the information above, this activity for potential payroll tax clients was worth almost $53m in 2013/14.

- **Enables future low-cost compliance** - a key objective of OSR undertaking compliance is to move clients categorised under active compliance to the left of the curve in Figure 2. By actively engaging with non-complying clients through audits and investigations, OSR is able to provide all future contact through lower-cost methods. For example, providing payroll tax clients with annual electronic notices of assessment and allowing monthly self-assessment with lodgement enforcement reminders prior to an annual reconciliation process. This approach ensures revenue and minimise costs.

The revenue collected through automated or client-initiated methods denoted as (1) in Figure 2 provides a high return for the investment made. Technology plays a significant role in realising these returns, and a higher proportion of investment in this activity relates to technology (and staff who build and maintain that technology) relative to the other activity areas. This forms part of OSR's ongoing operational investment approach overseen by the Portfolio Governance Board and Finance Committee. OSR seeks to protect and maximise the revenue collected in this category once clients are identified through active compliance.

Voluntary compliance activities, denoted as (2) in Figure 2, also represent a favourable ROI through direct revenue. Once clients have been engaged through active compliance, OSR provides them with the opportunity to voluntarily comply in future by providing them with the information

Continuous improvement (Ci) initiatives, denoted as (3) in Figure 2, aim to ensure that emerging opportunities for increased effectiveness and ROI are actively addressed and managed. Ci initiatives should inform and be informed by activities and outcomes in the automatic, voluntary and active compliance categories. This is reflected in the inclusion of specific areas of concern identified from previous audits on future analysis and case selection.

3. The review of the *Duties Act 1977* was successfully completed, with no material deficiencies in the legislation identified

OSR wanted to obtain an unbiased and expert assessment of the current landholder duty provisions as it is considered to be a complicated and growing area of compliance, with new transactions and ownership structures emerging to add complexity to assessments.

OSR retained the services of a retired solicitor, recognised as an expert in landholder duty matters, as a consultant to critically evaluate this legislation in an impartial and structured manner. The objective of an impartial review was achieved without raising concerns of a self-interest threat from this engagement as the consultant no longer actively practiced in this area of law, and therefore would not benefit from exploiting any identified deficiencies or concerns. This approach was undertaken to ensure the legislation was reviewed independently and assessed as being effective and delivered its intended outcomes. In discussion it was noted that the consultant viewed the engagement as an intellectual exercise and an opportunity to test his skills in critiquing legislation to promote improvements.

By way of background to the legislation under review, landholder duty is paid on the acquisition, by a person, of a significant interest in a landholder. A landholder is a unit trust scheme, a private company or a listed company that has land holdings in NSW with a threshold value of $2m or more.

A landholder can be either private (private unit trust scheme or private company) or public (public unit trust scheme or listed company). Acquiring interests in landholders applies to acquisitions in private landholders made on or after 1 July 2009 and in public landholders on or after 1 October 2009. The legislative complexities raised by the various ownership forms and types of holdings reflects the need to ensure the operation of the act does not raise uncertainty

The consultant met with key OSR stakeholders on numerous occasions during the engagement to provide progress updates and interim findings.

The consultant's report was completed in June 2014, with a number of recommendations made that varied in complexity. Overall it was noted in the review that the landholder legislative provisions are strong, with the quality assurance service sought under this engagement considered to have been exceeded by the sponsor for this review, Anthony Johnston, Commissioner of State Revenue and Director TAS.

Policy changes emanating from this review are under consideration, with straightforward changes included in the draft Cabinet Minute submitted in the November 2014 Parliamentary session. Opportunities for improvement, including simplification of land valuations and self-executing rules, will be subject to consideration for future years, with plans for future reviews and legislative proposals in place.

4. Future results and further success will be dependent on maintaining and strengthening access to information from other government departments

Based on the success of the 2013/14 Extend Tax Compliance initiative, a further submission was made to the ERC in May 2014 to identify an additional $247.3m in compliance revenue between 1 July 2014 and 30 June 2018. OSR compliance management noted that this result is dependent on information to assist audits.

OSR makes extensive use of information from other parties to undertake effective compliance activities. OSR has well established relationships with other NSW Government agencies, such as Land and Property Information (LPI), the Office of Liquor, Gaming and Racing (OLGR) and the Office of Fair Trading (OFT), to collaborate and obtain information that is relevant for revenue assessment, such as the notice of sale of a property from LPI for duties and land tax compliance.

OSR works closely with the Australian Taxation Office (ATO) and other revenue offices across Australia to share best practice and experiences in compliance audits and investigations. OSR participates in several forums to maximise the benefit from these relationships, including regular strategic meetings including Commissioners' Conferences, the Australian Tax and Revenue Offices' Compliance Committee (ATRO CC) and the Revenue Offices' Compliance Committee (ROCC).

There are operational forums in place to augment these strategic discussions for specific areas of shared interest such as the Business Practices Committee, the Employment Taxes Working Group and the Property Working Group. Experts and specialists from each jurisdiction are able to explore emerging trends and case studies, augmenting their own experiences.

These NSW and interjurisdictional relationships and related data exchange agreements are vital to the ongoing effectiveness of compliance activities for current and future revenue types. Occasionally OSR has new revenue types transferred for it to administer, such as gaming and racing taxes that have been coordinated with OLGR since 2001.

The collection, financial compliance and debt management of mineral royalties payable in NSW was transferred from the Department of Trade and Investment, Regional Infrastructure and Services (DTIRIS) to OSR from the 2014/15 financial year. The additional revenue targets to 2017/18 include compliance revenue from mineral royalties. OSR looks forward to working with DTIRIS to ensure a robust and effective relationship is established and maintained to deliver the outcomes sought by the NSW Government from this transition.