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eJournal of Tax Research

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EDITORS' NOTE

The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation.

SUBMISSION OF ORIGINAL MATERIAL

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WEBPAGE

Current and past issues of the *eJournal of Tax Research* are available via the journal's website: <https://www.business.unsw.edu.au/research/publications/atax-journal>.

Editorial

There is a story from the 1990s involving a conversation with a Russian tax inspector. The Russian was incredulous at the high rate of voluntary tax compliance in Sweden. He was told that most Swedes paid their taxes for two reasons: because everyone else does and that the revenue will be honestly spent on purposes beneficial to society. The Russian replied that, by way of contrast, Russians avoided paying taxes because they believed few of their fellow citizens paid their taxes in full and that their money would be misappropriated through corruption.

This story is relayed in a 2005 book by Bo Rothstein called *Social Traps and the Problem of Trust*¹. At the heart of this story is a delineation between an insidious circle of distrust and a virtuous circle of trust. Rothstein refers to the former as a “social trap” where individual “rationality” of avoiding paying tax as far as possible has socially disastrous consequences for the revenue system.

While Government plays a major part in whether a society is experiencing the virtuous or the insidious, the critical institutional framework at the forefront of this divide is that of Tax Administration. This is a broad concept and includes not only the Tax Administrator *per se*, but the academics, legal practitioners and accountants that provide the setting.

The Hon Michael Kirby AC CMG, former justice of the High Court, has on several occasions² drawn a parallel between the histories of Australia and Argentina in the 20th Century. Both countries had very similar economic circumstances at the beginning of the century, but not at the end. Kirby attributes this in no small way to the way each country administered their tax system.

In short, tax administration is crucial to the well-being of our society. This significance is reflected in the substantial interest shown in the 12th International Conference on Tax Administration held on 31 March and 1 April 2016 in Sydney. The conference featured Commissioners’ Chris Jordan AO from Australia and Naomi Ferguson from New Zealand and Deputy Director Dr Puspita Wulandari from Indonesia. The program also included Mr Ali Noroozi, Inspector General of Taxation in Australia, Ms Nina Olson, Inland Revenue Service in USA, Mr Shinichi Nakabayashi from the Asian Development Bank Institute in Japan, Professor Duncan Bentley, Pro-Vice Chancellor of Swinburne University of Technology, Mr Jeremy Sherwood, the former head of the Office of Tax Simplification in the UK, and Dr Ian Taylor, Chair of Tax Practitioners Board in Australia. There were a wide variety of academics and administrators from Australia, Austria, Indonesia, New Zealand,

¹ Bo Rothstein, *Social Traps and the Problem of Trust*, Cambridge University Press, 2005 pp. 2-4 quoted in Geoffrey Hosking, *Trust: A History*, Oxford University Press, 2014, pp 2-3.

² Kirby, Michael --- "Of 'Sham' and Other Lessons for Australian Revenue Law" [2008] MelbULawRw 27; (2008) 32(3) Melbourne University Law Review 861

Turkey, the United Kingdom and the United States who delivered papers at the Conference.

This Special Edition of the eJTR features a selection of those papers.

We commence with the winner of the Cedric Sandford Medal for 2016, Michelle Lyon Drumbl for her work *Beyond polemics: Poverty, taxes and noncompliance*. This very insightful paper suggests practical solutions to a number of issues concerning the earned tax credit system in the United States. It is based on strong empirical research.

This is followed by Duncan Bentley, *Taxpayer Rights in Australia twenty years after the introduction of the Taxpayers' Charter* and Binh Tran-Nam and Michael Walpole, *Tax disputes, litigation costs and access to tax justice*. Both papers consider very different angles on the nature of disagreements between the taxpayer and the Revenue in the Australian context.

Tamer Budak, Simon James and Adrian Sawyer, embrace the ubiquitous problem of complexity in *International experiences of tax simplification and distinguishing between necessary and unnecessary complexity*. Thought on this theme is extended in a later paper by Tamer Budak and Simon James, *The applicability of the OTS Complexity Index to comparative analysis between countries: Australia, New Zealand, Turkey and the UK*.

There is a deeply analytical piece by Ann Kayis-Kumar titled *What's BEPS got to do with it? Exploring the effectiveness of thin capitalisation rules*. Simon James and Andrew Maples explore *The relationship between principles and policy in tax administration*. The paper carries a subtitle: *Lessons from the United Kingdom capital gains tax regime with particular reference to a proposal for a capital gains tax for New Zealand*.

One of the most important issues going forward will be how developing country tax administrations, bring taxpayers “into the fold”. Setting a framework for this issue, is a paper by Arifin Rosid, Chris Evans and Binh Tran-Nam, *Do perceptions of corruption influence personal income taxpayer reporting behaviour? Evidence from Indonesia*.

Kalmen Datt enters the difficult area of reputational risk with Hamletian aplomb in his paper *To shame or not to shame: That is the question*.

Finally we return to the practical day to day administration with a paper by Agung Darono and Danny Ardianto, *The use of CAATTs in tax audits-lessons from some international practices*.

We hope you enjoy this Special Edition as much as we have enjoyed our role as Guest Editors.

Grant Wardell-Johnson

Robin Woellner

Beyond polemics: Poverty, taxes, and noncompliance

Michelle Lyon Drumbl¹

Abstract

The earned income tax credit (EITC) is perhaps the most significant refundable credit in the U.S. tax system. Designed as an anti-poverty program, it is a social benefit administered by the Internal Revenue Service (IRS). Studies show it has a positive impact upon the children whose families receive it. Despite its many positives, however, the EITC is a program that for years has been plagued by taxpayer noncompliance. Though it is believed that the majority of EITC noncompliance may be unintentional, public reports of misconduct and fraud hurt the program's image and fuel political rhetoric.

This article unpacks the rhetoric. It describes why the term 'improper payments' is not synonymous with fraud. It places EITC noncompliance within the broader context of the US 'tax gap,' explores motivations for intentional EITC noncompliance, and examines the role of inadvertent error in the overpayment rate.

Building upon theories of taxpayer noncompliance, the article concludes that increasing the amount of information required from all taxpayers (whether self-prepared or using a preparer) at the time of filing will reduce both intentional and unintentional EITC errors. Increasing these requirements, coupled with slowing down the refund process generally, is a reasonable way to improve administration of the EITC program without unduly burdening low-income taxpayers.

Keywords: earned income tax credit, tax compliance, poverty law, tax policy

¹ Clinical Professor of Law and Director, Tax Clinic, Washington and Lee University School of Law. The author drew inspiration from, and thanks, the participants of the 2014 Washington and Lee University School of Law Tax Roundtable and the 2014 University of Washington Graduate Program in Taxation Symposium. She is grateful to Abby Mulugeta, Laura Dallago, and Maureen Edobor for research assistance and the Frances Lewis Law Center for support of the project. All errors and omissions remain the author's own.

1. INTRODUCTION

The earned income tax credit (EITC) suffers an image problem. Introduced in 1975, today the EITC reaches more than 27 million households annually and is the most significant earnings-based refundable credit in the Internal Revenue Code.² While the EITC has long enjoyed bipartisan support and is lauded as a successful anti-poverty program, it is also criticised for its complexity and its difficulty to administer and enforce.³ Despite the high audit selection rate for EITC returns⁴ and a myriad of approaches aimed at improving accuracy and educating taxpayers, the Internal Revenue Service (IRS or ‘Service’) has been unsuccessful at reducing the rate of EITC overclaims in the last decade.⁵ Since 2003, the estimated rate of improper payments on EITC claims has exceeded 20% and ranged as high as 30%.⁶ The annual dollar amounts of improper EITC payments have ranged between an estimated minimum of \$8.6 billion (in 2004) to an estimated maximum of \$18.4 billion (in 2010). These figures long have drawn the attention of the Treasury Inspector General for Tax Administration (TIGTA) and the Government Accountability Office (GAO).⁷ These overpayment figures add fuel to the political rhetoric about a tax system in which nearly half of Americans pay no federal income tax.⁸

² Refundable Tax Credits, Cong Budget Off Rep No 43767, at 10 (Feb 2013). The Premium Tax Credit, also refundable, is projected to surpass the earned income credit in size. In contrast to the earned income credit, the Premium Tax Credit is an expenditure based, rather than earnings based, credit.

³ For an overview of the political history of the EITC, including examples of both bipartisan support and criticisms, see Jason Furman, ‘Poverty and the Tax Code’ (2014) 32 *Democracy* 8.

⁴ EITC returns are twice as likely to be audited as the average individual income tax return. National Taxpayer Advocate, *2011 Annual Report to Congress* (2011) 300; US Government Accountability Office, GAO-16-92T, *Fiscal Outlook: Addressing Improper Payments and the Tax Gap Would Improve the Government’s Fiscal Position* 14–15 (Oct 1, 2015) (Statement of Gene L Dodaro also noting that ‘about 45 percent of correspondence audits (audits done by mail) that closed in fiscal year 2013 focused on EITC issues.’)

⁵ See generally ‘Compliance Estimates for the Earned Income Tax Credit Claimed on 2006–2008 Returns’, IRS Pub 5162 (Aug 2014). This report updates a similar compliance study released in 1999 that had been considered to be ‘the authoritative source on the nature of EITC compliance’: at 1.

⁶ Treas Inspector Gen Tax Admin, ‘The Internal Revenue Service Fiscal Year 2013 Improper Payment Reporting Continues to Not Comply With the Improper Payments Elimination and Recovery Act’ 2014-40-027 (Mar 31, 2014), figure 2, 5. Section 2, below, defines ‘improper payment’ and explains why this measure is controversial.

⁷ See, eg, Treas Inspector Gen Tax Admin, ‘Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments’ 2014-40-093 (Sept 29, 2014); GAO-16-92T, ‘Fiscal Outlook: Addressing Improper Payments and the Tax Gap Would Improve the Government’s Fiscal Position’ 15 (Oct 1, 2015).

⁸ According to Tax Policy Center estimates published in 2013, 50% of all households paid no federal income tax in 2009. ‘Tax Units with Zero or Negative Income Tax Liability Under Current Law, 2004–2024’ Tax Policy Center, <<http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0228.pdf>>, accessed 21 October 2016. This percentage was estimated to decline over time, but not by more than a few percentage points; See ‘Table T15-0138: Tax Units with Zero or Negative Income Tax Under Current Law, 2011–2025’ Tax Policy Center, <<http://www.taxpolicycenter.org/numbers/Content/PDF/T15-0138.pdf>> accessed 21 October 2016. For a detailed consideration of why EITC noncompliance attracts so much political attention, see Lawrence Zelenak, ‘Tax or Welfare? The Administration of the Earned Income Tax Credit’ (2005) 52 *University of California Los Angeles Law Review* 1867 (in which Zelenak attempts to answer his own question: ‘Why does tolerance for errors that leave individuals with too much money and the government with too little vary according to the tax, transfer, or hybrid nature of the program in which the errors occur?’)

Certainly, the rate of improper payments is troubling; the IRS must continue in its efforts to reduce overpayments. It is important, however, to frame these figures within a larger context of taxpayer noncompliance in the United States. As dollar amounts, the EITC overclaim figures pale in comparison to the estimated annual \$122 billion underreporting tax gap attributable to business income on individual returns,⁹ or to the \$40 to \$70 billion dollars that are estimated to be lost annually to evasion through the use of offshore tax havens and tax shelter abuses.¹⁰ As a percentage of the gross tax gap, improper EITC claims comprise perhaps only 3.5% of the total.¹¹

This article explores the nature and nuances of EITC noncompliance, identifies ways in which it is both different than and similar to other types of taxpayer noncompliance, critiques certain of the Service's EITC enforcement efforts, and discusses ways in which the IRS might improve upon its EITC audit selection and enforcement mechanisms in the future. It concludes by proposing a program that would allow first-time EITC claimants the option to submit substantiating documentation with the return in order to receive an expedited refund.

2. WHAT WE KNOW (AND DON'T) ABOUT THE EXTENT OF TAXPAYER NONCOMPLIANCE

This section provides a general overview of taxpayer noncompliance, the US tax gap, and the nature of EITC noncompliance. It is believed that the majority of EITC errors are inadvertent, and this is an important consideration to bear in mind when crafting policy solutions.¹² That said, a significant portion of improper EITC claims are

⁹ The most recent tax gap figures show that, as of the 2006 data, 56% of business income that should have been reported on individual tax returns went unreported. Robert Greenstein, John Wanchuck and Chuck Marr, 'Reducing Overpayments in the Earned Income Tax Credit' at 5 (Dec 1, 2015). The \$122 billion in estimated underreported business income is 'about ten times the estimated EITC overpayments that year.' See also IRS, *Tax Gap for Tax Year 2006*, IRS Pub 2012-4, <http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf> accessed 21 October 2016.

¹⁰ The 2006 Tax Gap study doesn't pull this out separately in its data, and TIGTA has criticised the IRS for that. See *How Much Tax Cheating is Really Going On?*, FORBES.COM (Sept 16, 2013 at 3:23 pm). The TIGTA report mentions the \$40 to \$70 billion figure and cites to Jane G Gravelle, Cong Research Serv, *Tax Havens: International Tax Avoidance and Evasion* (July 9 2009). See also Dave Rifkin, 'An Overview of the "Tax Gap"' (2008) Scholarship @ Georgetown Law at <http://scholarship.law.georgetown.edu/fwps_papers/77> accessed 21 October 2016. This article, which used the 2001 data available at the time: 'An estimated \$50 to \$100 billion (15 to 30 percent) of the \$345 billion tax gap is due to offshore tax haven and tax shelter abuses.' The IRS's most recent net tax gap estimate (defined by the IRS as 'the amount of true tax liability that is not paid on time' less 'account receipts from enforcement activities and late payments'), provided using 2006 data, is \$385 billion. See 'IRS Releases 2006 Tax Gap Estimates', FS-2012-6, Jan 2012. Of the \$385 billion, \$28 billion is attributable to credits on individual income tax returns, while \$122 billion is attributable to underreporting of business income on individual income tax returns. IRS, *Tax Gap 'Map' Tax Year 2006*, see <http://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf> accessed 21 October 2016.

¹¹ Rifkin (above n 10) notes later 'The IRS estimates that approximately \$32 billion [ie, approximately 10%] of the tax gap is due to errors in claiming tax credits and deductions.' This overstates the portion attributable to the EITC in that includes all credits and deductions (again, this is 2001 data). My figure of 3.5% is based on the most recent EITC improper payment estimates (using the 'maximum' figure of 15.6 billion) as compared to the most recent gross tax gap estimate of \$450 billion.

¹² Robert Greenstein, John Wanchuck and Chuck Marr, 'Reducing Overpayments in the Earned Income Tax Credit', Center on Budget and Policy Priorities (CBPP), (Apr 7, 2014) (citing two older studies on this point: Janet Holtzblatt & Janet McCubbin, 'Issues Affecting Low-Income Filers' in Henry Aaron & Joel Slemrod (eds), *The Crisis in Tax Administration* (Brookings Institution Press, 2004); and Jeffrey Liebman, *Noncompliance and the EITC: Taxpayer Error or Taxpayer Fraud* (Harvard University, 1995). See also Leslie Book, 'The Poor and Tax Compliance: One Size Does Not Fit All' (2003) 51

intentional and/or fraudulent, just as taxpayers intentionally underreport or hide income in other contexts.¹³ Notably, it is important to understand and appreciate this distinction, because the two ends of the spectrum present different enforcement challenges and should be addressed by different policy prescriptions.

2.1 Estimating taxpayer noncompliance: The ‘tax gap’

The US revenue collection system is largely dependent on voluntary compliance. The voluntary nature of the compliance is bolstered by such mechanisms as withholdings, third-party reporting, and the deterrent effect of selective audit procedures. As a means of evaluating the effectiveness of the system, the Service has developed statistical methods to periodically estimate the ‘voluntary compliance rate’ (VCR) and specific types of noncompliance.¹⁴ These estimates, known as the ‘tax gap’, are compiled and released every several years. There is a significant time-lag between the statistics and the reporting. The most recent tax gap report was issued in 2012 (using data from tax year 2006) as an update to the estimates released in 2006 (using data from tax year 2001).

The Service provides estimated figures for the ‘gross tax gap’ and the ‘net tax gap.’ The former is defined as ‘the amount of true tax liability faced by taxpayers that is not paid on time’, while the latter is the amount of tax liability that is not paid or subsequently collected through Service enforcement.¹⁵ The estimated VCR for tax year 2006, calculated on the gross tax gap, was 83.1%; the IRS concluded this to be ‘statistically unchanged’ from the 2001 estimates.¹⁶

In its 2006 estimate, the IRS reported a gross tax gap of \$420 billion and a net tax gap of \$365 billion—representing a noncompliance rate of 14.5 percent.¹⁷ Commentators

Kansas Law Review 1145, 1165. (‘Somewhat surprisingly, there is little data relating to how much EITC noncompliance is intentional, although there is strong anecdotal evidence that a significant amount of EITC noncompliance is caused by taxpayer ignorance or mistake.’) In his July 17, 2003 testimony to Congress, Leonard Burman framed EITC noncompliance within the context of all taxpayer noncompliance: ‘while the noncompliance among EITC recipients is troubling, there is no reason to think that it is any worse than exists among the taxpaying public generally, and is probably lower than the noncompliance rate for certain classes of individuals and businesses.’ ‘Waste, Fraud, and Abuse: Hearing Before the Comm On Ways and Means’ 108th Cong, 1 (2003) (statement of Leonard Burman).

¹³ See generally Michelle L Drumbl, ‘Those Who Know, Those Who Don’t, and Those Who Know Better: Balancing Complexity, Sophistication, and Accuracy on Tax Returns’ (2013) 11 *Pittsburgh Tax Review* 113.

¹⁴ See generally Internal Revenue Serv, Off of Research, *Overview of the Tax Gap for Tax Year 2006* (Jan 6, 2012), <http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf> accessed 9 September 2014) (hereinafter ‘IRS Overview 2006’); Treas Inspector Gen for Tax Admin, ‘The Internal Revenue Service Needs to Improve the Comprehensiveness, Accuracy, Reliability, and Timeliness of the Tax Gap Estimate’ 2013-IE-R008 (Aug 21, 2013) (hereinafter TIGTA, ‘Tax Gap’).

¹⁵ IRS Overview 2006, above n 14, at 1.

¹⁶ Ibid. Notably, an 83.1% compliance rate is high compared to many European nations. See, eg, JD Tuccille, ‘Globally Speaking, American Taxpayers Are Pushovers’, *reason.com*, Apr 17, 2012 12:33 pm (reporting rates from a number of countries, including: the United Kingdom (77.97%); Switzerland (77.70%); France (75.38%); Austria (74.80%); Netherlands (72.84%); Belgium (70.15%); Portugal (68.09%); Germany (67.72%); and Italy (62.49%)).

¹⁷ Billy Hamilton, ‘How Big a Problem Is the Underground Economy?’ (2014) 73 *State Tax Notes* 847, 848). (‘no one knows precisely how large the underground economy is.’)

note, however, that the IRS figure is ‘at best a sophisticated guess’, in part because no one knows the extent of the underground economy.¹⁸

The Service divides the tax gap into three categories: (1) the non-filing gap; (2) the underreporting gap; and (3) the underpayment gap.¹⁹ The underreporting gap is by far the largest of these three categories, accounting for \$376 billion of the tax gap, while non-filing and underpayment account for \$28 billion and \$46 billion, respectively.²⁰ The individual income tax accounts for the largest segment of the gross tax gap (an estimated \$296 billion) as compared to corporate income taxes, employment taxes, estate taxes, and excise taxes.²¹ EITC noncompliance is categorised as underreporting of individual income tax, specifically, an overstated offset of tax due.²²

Unsurprisingly, the Service finds that ‘compliance is far higher when reported amounts are subject to information reporting and, more so, when subject to withholding’.²³ Thus, noncompliance is more prevalent with regard to amounts subject to little or no information reporting, such as sole proprietor income and rents. For example, the Service estimates that \$179 billion (comprising nearly 40% of the gross tax gap) is lost due to misreporting of individual business income and related self-employment taxes.²⁴

The Service estimates that the portion of the underreporting gap attributable to credits is \$28 billion, which is 6% of the overall gross tax gap.²⁵ This figure includes all credits, not just EITC. Combining the tax gap estimates with other available data on EITC overclaims, I estimate that EITC overclaims account for approximately 3.5% of the gross tax gap.²⁶

As discussed in the next section, the Service is required to collect and report detailed information annually on EITC overclaims as part of the federal government’s program to reduce improper payments. A primary source of this EITC data is the IRS’s National Research Program (NRP).²⁷ NRP estimates are based upon audit data, including audits in which the taxpayer did not participate or in which the taxpayer

¹⁸ Ibid. Hamilton cites two academic studies, one estimating the underground economy may be as much as \$2 trillion annually, and the other estimating a \$1 trillion shadow economy. The former study also estimated the federal tax gap is higher than what the IRS estimates: somewhere between \$450 and \$500 billion, with noncompliance rates of 18 to 19 percent.

¹⁹ IRS Overview 2006, above n 14, at 1. The underpayment gap is based on actual amounts, while the other categories are estimated amounts.

²⁰ Ibid table 1.

²¹ Ibid.

²² TIGTA, ‘Tax Gap’ above n 14 at n 9. On the ‘Tax Gap Map’, EITC noncompliance presumably is reflected in the subcategory of ‘credits’. See IRS, above n 10.

²³ IRS Overview 2006, above n 13 at 1. The IRS reports that amounts subject to substantial information reporting and withholding, such as wages reported on W2s, are accurately reported by taxpayers on individual returns nearly 99% of the time; US Govt Accountability Office, GAO 12-651T, Tax Gap: Sources of Noncompliance and Strategies to Reduce It (2012), 5.

²⁴ US Govt Accountability Office, GAO 12-651T, Tax Gap: Sources of Noncompliance and Strategies to Reduce It (2012). See also IRS, above n 10.

²⁵ IRS, above n 10.

²⁶ My figure of 3.5% is based on the most recent EITC improper payment estimates (using the ‘maximum’ figure of 15.6 billion) as compared to the most recent gross tax gap estimate of \$450 billion.

²⁷ Treas Inspector Gen for Tax Admin, ‘The Internal Revenue Service Is Not in Compliance With Executive Order 13520 to Reduce Improper Payments’ 2013-40-084 (Aug 28, 2013), 8-9 (hereinafter TIGTA, ‘Not in Compliance’.)

prevailed after the initial audit had been closed.²⁸ These studies furthermore present imperfect information insofar as they do not capture cases of undetected EITC overclaims (those that were not detected by audit). Despite these shortcomings, the NRP study nonetheless provides concrete data as to the types of errors that the IRS discovers and identifies. While this is helpful in comprehending the types of overclaims, unfortunately the reports do not shed light on whether these overclaims are intentional or unintentional.

2.2 Improper payments and EITC noncompliance

The Improper Payments Information Act of 2002 (IPIA) requires federal agencies to annually review and identify those programs that are ‘susceptible to significant improper payments.’²⁹ The US Office of Management and Budget has declared the EITC to be a ‘high-risk’ program. As a result of this designation, the Service is required to undertake detailed studies to identify and reduce the level of erroneous EITC payments and has been doing so since fiscal year 2003.

Two important caveats must be noted regarding the improper payment rate calculations. First, ‘improper payment’ estimates are not intended to be estimates of fraud.³⁰ The estimates encompass both intentional and unintentional overclaims. However, this nuance is sometimes overlooked or misunderstood by critics who conflate improper payments with fraud.³¹ Second, improper payment rate estimates

²⁸ [National Taxpayer Advocate] Nina Olson has reported that in over 40% of the cases where the IRS examiners classified an EITC claim as invalid but the filer later received assistance from the Taxpayer Advocate Service (a component of the IRS that the National Taxpayer Advocate oversees) in appealing the ruling, the ruling was reversed.’ Greenstein, Wancheck, and Marr, above n 12 at 4. See also Book, ‘One Size Does Not Fit All’, above n 12, 1170, noting that taxpayer non-response to IRS examination requests make it hard to determine the extent of overclaims and EITC noncompliance.

²⁹ Improper Payments Information Act of 2002 (IPIA), Pub L No 107-300, 116 Stat 2350. IPIA has been amended and expanded by two subsequent acts of legislation and a recent executive order: Improper Payments Elimination and Recovery Act of 2010 (IPERA), Pub L No 111-204, 124 Stat 2224; Improper Payments Elimination and Recovery Act of 2012, Pub L No 112-248, 126 Stat 2390; and Reducing Improper Payments and Eliminating Waste in Federal Programs, Executive Order 13520 (November 20, 2009).

³⁰ US Govt Accountability Office, ‘Improper Payments: Recent Efforts to Address Improper Payments and Remaining Challenges’, GAO-11-575T (2011), 5: ‘Fraud consists of intentional acts of deception with knowledge that the action or representation could result in an inappropriate gain.’
<<http://www.gao.gov/new.items/d11575t.pdf>> accessed 21 October 2016.

³¹ As one example, US Senator Ron Johnson of Wisconsin was quoted as saying in a January 2014 speech: ‘Do you realize the average rate of fraud, whether it’s in the Earned Income Tax Credit or Medicare or Medicaid, across the board, food stamps — the average rate of fraud in those programs is 20 to 25 percent?’ When the *Milwaukee Journal Sentinel* asked for numbers to substantiate the claim, his policy advisor clarified that the senator ‘meant error rates in the various programs, not actual fraud.’ Senator Johnson then followed with a statement to the newspaper that ‘when he made his claim, he was ‘primarily referencing fraud’ in the Earned Income Tax Credit program.’ His statement continued: ‘I made too broad a generalization to other mandatory spending programs based on reports in the press and from colleagues that are not supported by other inspector general reports. I strive hard to convey accurate information that is fully supportable, and I was mistaken in making this overly broad generalization.’ Tom Kertscher, ‘PolitiFact: Testing Ron Johnson claim of 20% to 25% fraud in public assistance programs’, *Milwaukee Journal Sentinel Online*, Jan 20, 2014 at 5 am, <<http://www.politifact.com/wisconsin/statements/2014/jan/20/ron-johnson/fraud-claims-20-25-cents-every-1-spent-four-govern/>> accessed 21 October 2016. More recently, Rand Paul conflated ‘improper payment’ with fraud and also overstated the dollar amounts: ‘When you look at the earned income tax credit, it has about a 25 percent fraud rate. We’re looking at \$20 billion to \$30 billion.’ Steve Contorno, ‘Rand Paul says Earned Income Tax Credit has 25 percent fraud rate that costs up to \$30 billion’, 30 January, 2015 at 1:27 pm, <<http://www.politifact.com/truth-o->

are intended to include not only overpayments, but also underpayments and payments that were not adequately documented.³² Thus in the EITC context, the improper payment rate should include figures for taxpayers who are eligible for EITC but fail to claim it, or claim less than they are entitled to claim. However, TIGTA has reported that the IRS has not provided estimates of EITC underpayments³³ as required by Executive Order 13520.

The EITC occupies a somewhat unique function in that it is housed in the Internal Revenue Code but serves as a social program to provide anti-poverty payments to low-income working individuals. Lawrence Zelenak has described the EITC as ‘a welfare program that happens to be administered through the tax system,’ and has contrasted the taxpayer’s self-declaration for eligibility for EITC through tax filing with the process for applying for government benefits through other agencies, which generally requires a claimant to establish eligibility to the agency prior to the receipt of any benefits.³⁴ With that function in mind, the high improper payment rate must also be viewed relative to the EITC program’s very low administrative costs, which approximate 1% of the total program benefits. Contrast this to other social welfare spending programs in the US that have far more direct contact with their recipients, resulting in lower overpayment rates but far higher administrative costs: the Supplemental Nutrition Assistance Program (SNAP), for example, is cited as having a typical overpayment rate of less than 5%, with an administrative cost that is more than 9% of the program’s benefits.³⁵

The Treasury Department has identified several factors that serve as barriers to reducing EITC noncompliance, with no single of these ‘considered the primary driver of program error.’³⁶ These factors include: the complexity of the tax law; structure of the EITC; confusion among eligible claimants; high turnover of eligible claimants; unscrupulous tax return preparers; and fraud.³⁷ Note that these factors include barriers to reducing both intentional and unintentional noncompliance. As to unintentional noncompliance, in January 2014, IRS Commissioner John Koskinen addressed the complexity of EITC provisions for taxpayers with children and went on to state: ‘Our biggest problem isn’t that people are stealing the money who have no right to it at all.

meter/statements/2015/jan/30/rand-paul/rand-paul-says-earned-income-tax-credit-has-25-per/> accessed 25 September 2015>.

³² GAO-11-575T, above n 30, 5.

³³ TIGTA, ‘Not in Compliance’ above n 27, 3, 9. The IRS report responding to the TIGTA report ‘indicated that it intends to incorporate underpayments into its estimates beginning with the Fiscal Year 2013 estimate’: at 9.

³⁴ Zelenak, above n 8, 1903.

³⁵ See Congressional Budget Office, *Refundable Tax Credits* (2013), <http://www.cbo.gov/sites/default/files/cbofiles/attachments/RefundableTaxCredits_One-Col.pdf> at 21, stating that ‘federal and state governments together spend approximately \$7 billion annually to administer the program (which paid out approximately \$75 billion in benefits in fiscal year 2011)’. Hereinafter ‘CBO Report’, access 21 October 2016.

³⁶ US Dept of Treasury, *Fiscal Year 2013, Agency Financial Report*, (Dec 16, 2013), 214. See <<https://www.treasury.gov/about/budget-performance/annual-performance-plan/Documents/2013%20Department%20of%20the%20Treasury%20AFR%20Report%20v2.pdf>> accessed 21 October 2016

³⁷ Ibid.

It is that the program is so complicated that people are inadvertently having difficulty figuring out where they fit and where they don't.³⁸

The most recent NRP study, published in August 2014, provides compliance estimates for EITC claimed on returns in tax years 2006–2008 and found ‘no discernible change in the overall tendency for noncompliance between 1999 and 2006–2008’.³⁹ It reported that the majority of taxpayers (an estimated 79–85%) who overclaim the EITC are in fact altogether ineligible for the credit, as opposed to overstating the amount of money for which they are eligible.⁴⁰ Among ‘known errors’, the NRP study identifies the most common error as income misreporting (appearing in 67% of returns with known errors, and cited as the only error in 51% of identified overclaims), particularly self-employment income misreporting. It is followed by qualifying child errors (occurring in 30% of known overclaim returns, 15% of the time as the only error), most commonly errors relating to the residency requirement. Lastly, the third-most common type of error is incorrect filing status. While qualifying child errors are less common than income misreporting errors, the former constitutes a higher percentage of overclaims by dollar amount.

While the dollar amounts of EITC overclaims are staggering in the aggregate, it is important to keep perspective as to the individual noncompliance amounts. The NRP study reports that ‘[a] large fraction’ (between 38% and 44%) of the taxpayers that overclaim the EITC ‘do so by less than \$500’.⁴¹

The NRP study also provides noncompliance estimates according to who prepares EITC returns. Significantly, the study finds ‘no statistical difference between self-prepared and paid-preparer returns in either the frequency of overclaims or the dollar overclaim percentage.’⁴² Among those who do use a preparer, the study notes that ‘EITC claimants are more likely to use an unenrolled return preparer (43 percent) or a preparer from a national tax return preparation firm (35 percent) than non-claimants (28 percent and 14 percent, respectively).’⁴³ Among those taxpayers who use a preparer, the report highlights its estimate that returns prepared by IRS programs including Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) have ‘much lower overclaim percentages’ than other types of preparers, with unenrolled return preparers representing ‘the highest frequency and percentage of EITC overclaims.’⁴⁴ The report cautions, however, that it cannot account for the *reasons* for these differences, and suggests this might reflect selection bias arising from the taxpayer’s choice of preparer and does not imply that certain types of preparers ‘are either less capable or more unscrupulous.’⁴⁵

To be sure, EITC overclaims are a significant issue, even if the improper payments caveats described herein suggest that the magnitude of the issue is overstated. The

³⁸ William Hoffman, ‘Koskinen Kicks off Filing Season with Spotlight on EITC’ (2014) 142 *Tax Notes* 617.

³⁹ ‘Compliance Estimates for the Earned Income Tax Credit’, above n 5, iii.

⁴⁰ *Ibid* iv.

⁴¹ *Ibid*.

⁴² *Ibid* 24.

⁴³ *Ibid*.

⁴⁴ *Ibid*.

⁴⁵ *Ibid*.

next section considers intentional taxpayer noncompliance generally and how intentional EITC noncompliance may and may not be different.

3. IS INTENTIONAL EITC NONCOMPLIANCE SIMILAR TO OTHER TYPES OF INTENTIONAL TAXPAYER NONCOMPLIANCE?

This section compares two types of intentional noncompliance: EITC noncompliance and sole proprietor noncompliance. It provides a brief overview of selected theories of noncompliance. In doing so, the article hopes to highlight that EITC misconduct is not fundamentally different than other types of tax misconduct.

Theories and models of tax compliance include: deterrence, tax morale,⁴⁶ norms (including group identity and also attitudes toward government),⁴⁷ complexity of the Code, the role of tax return preparers,⁴⁸ and opportunities.⁴⁹ Certain theories or models are more applicable to studies of specific types or contexts of taxpayer noncompliance. Thus, not all theories necessarily fit well to all types of noncompliance.

Though not intended as a comprehensive review of the research on this subject, this section examines some of what the IRS and academic researchers have studied and written about the motivation behind intentional taxpayer noncompliance in the specific context of sole proprietors. In doing so, it seeks to draw upon some connections specific to intentional EITC noncompliance.

At first blush, it may seem odd to compare sole proprietors and EITC claimants — one group earns cash and fails to report it accurately, while the other claims a social benefit and fails to determine eligibility accurately. Intentionally noncompliant sole proprietors deprive the fisc of revenue by underreporting, while intentionally noncompliant EITC claimants contribute to the tax gap by overstating or claiming credits to which the taxpayer knows he or she is not entitled.

This article posits that intentional EITC noncompliance in fact shares much in common with intentional sole proprietor noncompliance. With both sets of taxpayers, there is a lack of information reporting available to the government, which provides opportunities to cheat and perhaps evade detection. With both sets of taxpayers, there is evidence to suggest that community norms and/or a sense of systemic fairness or unfairness may drive decisions about intentional noncompliance, and evidence to suggest the limitations of deterrence-based IRS initiatives.

⁴⁶ For a literature review of 'tax morale,' see Marjorie Kornhauser, 'Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers' *2007 Annual Report to Congress* (2007) 138. Kornhauser emphasises that 'tax morale refers to taxpayer attitudes and beliefs—not behaviors': at 142.

⁴⁷ Susan Morse, Stewart Karlinsky and Joseph Bankman, 'Cash Businesses and Tax Evasion' (2009) 20 *Stanford Law & Policy Review* 37, 40–41.

⁴⁸ Sagit Leviner, 'The Role Tax Preparers Play in Taxpayer Compliance: An Empirical Investigation with Policy Implications' (2012) 60 *Buffalo Law Review* 1079; Book, 'One Size Does Not Fit All', above n 12, 1145.

⁴⁹ Kent Smith and Karyl Kinsey, 'Understanding Taxpayer Behavior: A Conceptual Framework with Implications for Research' (1987) 21 *Law & Society Review* 639, 642; Robert Kidder and Craig McEwen, 'Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance' in Jeffrey A Roth and John T Scholz (eds), *Taxpayer Compliance: Social Science Perspectives, Volume 2* (University of Pennsylvania Press, 1989) 47.

At least with respect to the concern of *intentional* noncompliance, studies of sole proprietor noncompliance may provide useful insights and analogies as to intentional EITC noncompliance.

3.1 Sole proprietor noncompliance

‘The problem [of the underground economy] is as old as the US tax system, and probably as old as taxation generally.’⁵⁰

The tax gap data discussed in section 2 above indicates a correlation between taxpayer compliance and information reporting, finding high levels of noncompliance among sole proprietors.⁵¹ Having identified this as the largest portion of the tax gap, the Taxpayer Advocate Service (TAS) conducted both a national survey and a community survey of sole proprietors, and it linked the results of these surveys to IRS estimates of the survey respondent’s actual tax compliance.⁵² This national survey sought to understand why those sole proprietors who pay their taxes voluntarily comply with the law, because prior research led TAS to conclude that increasing voluntary compliance is ‘the only practical way to reduce the tax gap’.⁵³ Accordingly, the national survey was designed to investigate six specific factors identified in previous research as ‘potentially driving voluntary compliance’:⁵⁴

1) deterrence (the perceived likelihood of getting caught outweighs the economic gain from cheating); 2) norms (taxpayers who believe most other taxpayers comply are more likely to reciprocate by complying); 3) tax morale (those who trust the government and feel the tax laws and procedure are fair and fairly enforced may be more likely to feel a moral obligation to comply, even if the outcome of those procedures is unfavourable); 4) trust (taxpayers may use unfair rules or procedures, unreasonable penalties, bad experiences with the IRS, or a lack of faith in government or the IRS to justify either reducing efforts to comply or active noncompliance); 5) complexity and convenience (taxpayers who face complicated rules may be unable to comply, or may use complexity as a reason to justify noncompliance); and 6) preparers and other third parties (tax preparers may have a significant effect on tax compliance).

From the survey results, TAS concluded that the primary types of noncompliance among sole proprietors are: 1) social noncompliance (taxpayers acting ‘in accordance with social norms and peer behaviour’) and 2) symbolic noncompliance (taxpayers ‘perceived the law or the IRS as unfair’).⁵⁵ With respect to both types of

⁵⁰ Hamilton, above n 17.

⁵¹ See text accompanying notes 23–24, above.

⁵² National Taxpayer Advocate, ‘Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results’, *2012 Annual Report to Congress* (2012) (hereinafter ‘Factors Influencing Compliance’). In its executive summary of the survey, TAS describes the survey as significant in that: ‘a large body of research discusses the potential effect of various factors on tax compliance, but this study is the first to link survey responses to IRS estimates of the respondent’s actual tax compliance...provid[ing] an unprecedented look at the differences between the views of the Schedule C filers that are the most and least compliant, at least according to IRS estimates’: at 4.

⁵³ National Taxpayer Advocate, ‘Researching the Causes of Noncompliance: An Overview of Upcoming Studies’, *2010 Annual Report to Congress* (2010) 75 (hereinafter ‘Researching the Causes’).

⁵⁴ ‘Factors Influencing Compliance,’ above n 52, 7–8, citing ‘Researching the Causes’, above n 53, 71–88.

⁵⁵ *Ibid* 7, 38.

noncompliance, the survey associated taxpayers with a distrust of government.⁵⁶ From these results, TAS recommended proposals that would promote trust in government and the IRS, including tax simplification and taxpayer education that is normative rather than technical.⁵⁷ TAS also concluded that '[t]raditional enforcement measures designed to deter could be ineffective, both because those likely to respond may be predisposed to comply and because the survey results did not suggest that asocial behaviour (ie, behaviour that may be addressed by increasing deterrence) is prevalent.'⁵⁸

In a similar vein, an earlier qualitative study of noncompliance among cash business taxpayers in the US conducted by Susan Clearly Morse, Stewart Karlinsky and Joseph Bankman noted the same connection between information reporting and compliance ('[b]y far the most important determinant of tax compliance is income source') and connected this relationship to opportunity as a causal factor:

The strong relationship between evasion and income source suggests that the primary causal factor that explains evasion is opportunity. Employees whose employers comply with wage reporting rules cannot cheat successfully and so such employees do not cheat. Individual business owners can cheat successfully ... and, in the aggregate, individual business owners do cheat.⁵⁹

Morse, Karlinsky and Bankman additionally cite peer influence, social norms, and tax preparer influence—not complexity, morality, or opposition to government policy—as the predominate drivers of cash business noncompliance.⁶⁰ Their qualitative study concluded that 'tax cheating follows opportunity, not complexity or immorality, and it is shaped by peer influence'.⁶¹ The authors note that 'opportunity' includes 'the low-perceived likelihood of detection and penalty' and further conclude that '[t]he perceived equity of the tax system has less importance, and the complexity of the tax law does not appear to play a significant role'.⁶² The taxpayers they interviewed reported that they learned tax evasion tactics from family and friends, and that tactics are 'shared wisdom among cash business owners'.⁶³ Interviewees noted a readiness to advise other business owners, with one stating: 'I tell people everything, like never, ever deposit the cash.'⁶⁴

Other interviewees involved in cash business rationalised intentional noncompliance as a form of rough justice: 'roughly equivalent to a sensible government subsidy for

⁵⁶ Ibid 38.

⁵⁷ Ibid 39.

⁵⁸ Ibid. The previous research on noncompliance, published in 2010, was similarly sceptical about traditional enforcement measures: 'Deterrence may be least effective among taxpayers operating in the cash economy — the largest component of the tax gap — precisely because the IRS cannot reliably detect unreported income that is not subject to information reporting. Deterrence will also be ineffective with respect to taxpayers whose noncompliance is unintentional.' 'Researching the Causes', above n 53, 76.

⁵⁹ Morse, Karlinsky and Bankman, above n 47, 38.

⁶⁰ Ibid 65.

⁶¹ Ibid 67.

⁶² Ibid.

⁶³ Ibid 65.

⁶⁴ Ibid.

small businesses’⁶⁵ or analogous to ‘direct subsidies to farmers or bail-outs to various international businesses’.⁶⁶

The characterisations described in these two studies of sole proprietors bear important similarities to observations about intentional EITC noncompliance. The next section outlines selected studies and scholarship on EITC noncompliance, with an emphasis on intentional noncompliance in particular.

3.2 Intentional EITC noncompliance

Intentional EITC noncompliance presents challenges similar to what the Service faces with sole proprietor noncompliance: in both cases, the lack of information reporting creates a knowledge asymmetry between IRS and taxpayer. Just as the IRS cannot readily verify how much cash is received in a small business, it also cannot easily verify the fact-intensive elements of EITC eligibility.⁶⁷

Among those taxpayers who knowingly claim refundable credits (including EITC) to which they know they are not entitled, it is reasonable to believe the same general factors drive noncompliance as those identified in the TAS research:⁶⁸ 1) the likelihood of getting caught; 2) norms; 3) tax morale; 4) trust; 5) complexity and convenience; and 6) preparers and other third parties.

In his scholarship, Book has proposed a typology of low income and EITC noncompliance⁶⁹ and identified specific structural incentives for certain types of intentional EITC noncompliance.⁷⁰ Book’s work provides a useful tool from which one can draw comparisons between sole proprietors and EITC claimants and also frame policy prescriptions.

Among other categories in his typology, Book identified two categories of EITC noncompliance that were also named by TAS as the primary types of noncompliance among sole proprietors:⁷¹ (1) social noncompliance and (2) symbolic noncompliance.

Of social noncompliance, Book writes: ‘if taxpayers believe that others are not complying, then taxpayers will resent complying and be more inclined to cheat.’⁷² Conversely, ‘to the extent that taxpayers believe others are complying, then taxpayers will not take advantage of the tax system.’⁷³ Thus, it follows that the very fact that

⁶⁵ Ibid.

⁶⁶ Ibid 67.

⁶⁷ Written Testimony of John Koskinen, Commissioner Internal Revenue Service, before the House Ways and Means Committee Subcommittee on Oversight on the 2014 Filing Season and Improper Payments, May 7, 2014 at 12 (noting ‘the significant degree of difficulty in enforcing compliance with the EITC, which derives in large part from its eligibility requirements. EITC eligibility depends on items that the IRS cannot readily verify through third-party information reporting, including marital status and the relationship and residency of children.’)

⁶⁸ ‘Factors Influencing Compliance,’ above n 51, 7-8, citing ‘Researching the Causes’, above n 53, 71–88.

⁶⁹ Book, ‘One Size Does Not Fit All,’ above n 12, 1167–1177. In this article, Book builds upon the work of sociologists Robert Kidder and Craig McEwen by developing their typology of taxpayer noncompliance into a ‘typology of EITC noncompliance’.

⁷⁰ Leslie Book, ‘Freakonomics and the Tax Gap: An Applied Perspective’ (2007) 56 *American University Law Review* 1163.

⁷¹ ‘Factors Influencing Compliance,’ above n 52, 39.

⁷² Book, ‘One Size Does Not Fits All’, above n 12, 1176, citing Dan Kahan’s reciprocity theory.

⁷³ Ibid.

EITC overclaims have become a political issue will itself lead to future taxpayers making intentional overclaims. As taxpayers read headlines highlighting EITC fraud, it undermines their faith in the system and creates a feeling that they are losing out by being an honest taxpayer.

A quick Google search will provide one insight into the culture of intentional EITC noncompliance, as well as the public perception of this noncompliance. As but one example, a website called Twitchy compiled a list of 22 tweets in January 2013 of ‘taxpayers looking to borrow children for tax credit’, commenting with a hint of disdain: ‘Gotta love American ingenuity. Yeesh.’⁷⁴ Upon closer examination, however, not all of the tweets linked were examples of noncompliance. The tweets did include several solicitations (‘Can I claim ur kid on my taxes ill give u 1500’; ‘Anybody have an extra kid I can claim on my taxes? I’ll split the cash’; and ‘Does someone have a kid I can use on my taxes this year? Thanks ahead of time.’), but also tweets more in the nature of wishful thinking (‘I need to find a single mom soon...so I can claim her kid on my taxes asap’) or laments (‘I take her kid to school off and on. The least she can do is let me claim her kid on my taxes’ and ‘the only reason why i would want a kid right now is to get more money on my taxes lol’).⁷⁵

The concept of claiming someone else’s child on one’s taxes stems from the possibility that the parents who reside with and support the child, and thus would be statutorily entitled to claim the child, will not benefit from doing so. The inability to benefit from a credit that other people benefit from, coupled with the perception that it is common for other people to wrongly benefit from claiming children that they are not entitled to claim, can foster the climate of intentional noncompliance. Note that this is very similar to the sole proprietor context, in which taxpayers who were interviewed admitted that they cheated on their taxes and justified it by pointing out that other people also cheat.

Book identified two common instances in which taxpayers fail to meet eligibility requirements and are left feeling frustrated, leading them to engage in symbolic noncompliance. He described these as ‘structural incentives within the EITC’ that create the motivation to cheat.⁷⁶ His first example is the taxpayer who has more than the maximum number of qualifying children.⁷⁷ Because the statute limits the benefit to a maximum number of children, Book noted that taxpayers who have additional children feel frustrated and are ‘tempted to ‘share’ the benefits with related parties who may have earned income, but fewer than two qualifying children on their own.’⁷⁸ His second example is the non-custodial parent who is connected to the children but fails to meet the residency requirement.⁷⁹ While a non-custodial parent might be eligible to claim his children as dependents and claim them for the child tax credit, he cannot claim his children for the more valuable earned income credit, and he cannot

⁷⁴ <<http://twitchy.com/2013/01/04/rent-a-kid-taxpayers-looking-to-borrow-children-for-tax-credit>> accessed 11 March, 2015). Some of the tweet links were still active, while others had been removed. Tweets on file with the author.

⁷⁵ Ibid.

⁷⁶ Book, ‘Freakonomics’, above n 70, 1176–1177.

⁷⁷ For tax years beginning after 2008, the maximum number of qualifying children for EITC is three. IRC §32(b)(1). From 1993 until 2007, the maximum number of qualifying children was two.

⁷⁸ Book, ‘Freakonomics’, above n 70, 1177.

⁷⁹ Ibid 1176–1177.

file using head of household status based upon his children.⁸⁰ This is true despite the fact that the non-custodial parent may be required to pay child support for his children. As Book noted, Taxpayer Advocate Nina Olson made a legislative recommendation many years ago to allow the non-custodial parent a credit in this situation,⁸¹ but Congress has not followed her recommendation, so the structural incentive remains.

In my work directing a low-income taxpayer clinic, I have seen or heard of instances of both of these types of symbolic noncompliance. But I am even more familiar with a third scenario, in which the taxpayer who would be entitled to claim the children has little or no earned income, but no one else is legally entitled to claim the children. In some cases this is because the taxpayer receives social security disability payments, which are not earned income as defined in section 32(c)(2). It may also be because the taxpayer is a mother who is out of the workforce for a period of years because she cares for her young children. In these cases, there may be a boyfriend in the household who does have earned income and plays a significant role in supporting his girlfriend's children. If he is not the father of the children and the couple is not married, he is not statutorily entitled to the claim the children for EITC.⁸² As with Book's other examples, a couple in this situation may be frustrated by the perceived inequity of the system and thereby motivated to engage in intentional symbolic noncompliance. After all, if other people are using Twitter to find strangers' children to claim, why should a hard-working taxpayer not benefit from his girlfriend's children whom he actually lives with and supports?

3.3 Combating social and symbolic noncompliance

If we accept that EITC claimants and sole proprietors share similar motivations in their intentional noncompliance, it follows, then, that proposals to reduce intentional EITC noncompliance should be crafted in a similar fashion as the TAS recommendations to address sole proprietor noncompliance. Recall that these recommendations include 'promoting trust in government and the IRS, including tax simplification and taxpayer education that is normative rather than technical.'⁸³ I am sceptical of TAS's recommendations, which I view as well-intended but unrealistic: regardless of the type of taxpayer or the type of noncompliance, it is not easy to affect cultural change regarding trust in government. As I discuss in section 6, the better way to combat noncompliance is to increase information sharing between the taxpayer and the government.

The next two sections of the article describe the different challenges that arise depending on whether the taxpayer uses a return preparer or chooses to self-prepare. The proposal in section 6 below attempts to bridge these two universes.

⁸⁰ IRC §§152(e); 32(c)(3)(A); 2(b)(1)(A)(i).

⁸¹ National Taxpayer Advocate, 'Tax Reform for Families: A Common Sense Approach' *2005 Annual Report to Congress* (2005) 397, 398.

⁸² In this example, he may be entitled to claim the children as dependents. IRC §152(d)(2)(H). Unless he is within the relationship described in §152(c)(2), he cannot claim the children for EITC or the child tax credit, and he cannot file using the Head of Household status. See IRC §2(b)(3)(B)(i).

⁸³ 'Factors Influencing Compliance,' above n 52, 38.

4. RETURN PREPARERS AND EITC NONCOMPLIANCE

This section will discuss EITC noncompliance in the return preparer context, including ways in which return preparers enable or instigate noncompliance. It will evaluate some of the IRS initiatives in place to detect and deter noncompliance. This is especially timely in light of the Service's recent efforts to regulate the tax return preparer industry. For years the Service has pointed to the return preparer industry as one reason for the high rate of EITC noncompliance, and this was part of the rationale for it developing the mandatory tax return preparer regulation scheme that was struck down in February 2014 by the DC Court of Appeals.⁸⁴ In the wake of that defeat, the IRS introduced a voluntary program for uncredentialed return preparers for the next filing season (known as the 'Annual Filing Season Program'), again with the hope of increasing competency and protecting taxpayers from unscrupulous preparers. The program was criticised as an end run around the court's decision,⁸⁵ but the IRS is likely to continue its efforts at some form of regulation in light of its latest EITC compliance study, which concludes that 'unenrolled preparers ... as a group have the highest overclaim percentages among known preparer types.'⁸⁶

A majority of EITC claimants rely on a paid preparer to file their income tax return. The most recent NRP study, based upon tax years 2006–2008, found that approximately 68% of EITC claimants used a paid preparer.⁸⁷ The study notes, however, that the rate at which EITC claimants use paid preparers has declined measurably in the years since.⁸⁸ In May 2014, IRS Commissioner John Koskinen noted that approximately 57 percent of the returns claiming the EITC are prepared by tax return preparers.⁸⁹

As noted in the previous section, IRS estimates show 'no statistical difference in either the frequency of [EITC] overclaims or the dollar overclaim percentage' between paid preparers and self-prepared returns.⁹⁰

However, within the data group of paid preparers, the IRS estimates show the error rate — and the dollar overclaim percentage — to be significantly higher within the subset of paid preparers who are not subject to regulation under Treasury Department

⁸⁴ See *Loving v IRS*, 2014 WL 519224 (CA DC), *aff'g* *Loving v IRS*, 917 F Supp 2d 67 (D DC 2013).

⁸⁵ In July 2014, the American Institute of Certified Public Accountants (AICPA) sued the IRS to block the voluntary program, calling it 'impermissible end run around *Loving v. IRS*' Complaint at 2, *Am Inst of Certified Pub Accountants v IRS*, No 14-1190 (D DC filed July 15, 2014). The IRS filed a motion to dismiss for lack of standing, and the district court dismissed the case on those grounds. More recently, the US Court of Appeals for the DC Circuit reversed on appeal, holding that the AICPA does have standing to pursue the challenge, so this issue remains unresolved. *Am Inst of Certified Pub Accountants v IRS*, No 14-5309 (DC Cir Oct 30, 2015).

⁸⁶ 'Compliance Estimates for the Earned Income Tax Credit,' above n 5, 27.

⁸⁷ *Ibid* v.

⁸⁸ *Ibid* [v] n 4.

⁸⁹ Koskinen testimony, above n 67, 13. See also Written Statement of Nina Olson, National Taxpayer Advocate, Hearing on the National Taxpayer Advocate's 2014 *Annual Report to Congress* Before the Subcommittee on Government Operations Committee on Oversight and Government Reform, US House of Representatives, Apr 15, 2015, 28 (with data showing that 55% of EITC returns in tax year 2013 were paid preparer returns).

⁹⁰ 'Compliance Estimates for the Earned Income Tax Credit,' above n 5, 24.

Circular 230 regulations governing practice before the IRS and are not affiliated with a nationally known tax preparation firm.⁹¹

The IRS's ill-fated attempt to regulate all return preparers was the culmination of years of concern about this phenomenon based on studies and reports of problems with the industry's accuracy, lack of due diligence, lack of professionalism, and unscrupulous behaviour.⁹²

The Taxpayer Advocate and others mention EITC returns as a particular concern due to the size and refundable nature of the credit.⁹³ A number of limited sample 'mystery-shopper' compliance studies, both government and private, have revealed disturbing levels of inaccuracy in EITC claims. Moreover, certain studies reveal evidence of intentional overclaims by paid preparers.⁹⁴

The role of return preparers in EITC noncompliance has been examined for nearly two decades, dating back to the findings of an IRS compliance study of tax year 1994.⁹⁵ Then as now, unscrupulous (and unregulated) return preparers have seized upon the event of a taxpayer receiving a large refundable credit as an opportunity to sell various products to the taxpayer.⁹⁶ This dynamic is inherently problematic, as it incents the return preparer to inflate the refund so the taxpayer has more money to spend.⁹⁷

⁹¹ Ibid v, 24; the study cautions that 'due to the problem of selection bias, one cannot conclude anything about the relative ability or integrity of unenrolled preparers without further study.' When stated as a dollar overclaim percentage by preparer type, the higher end estimates very close as between this subset of preparers and self-prepared returns.

⁹² See, eg, National Taxpayer Advocate, 'Regulation of Return Preparers: Taxpayers and Tax Administration Remain Vulnerable to Incompetent and Unscrupulous Return Preparers While the IRS Is Enjoined From Continuing its Efforts to Effectively Regulate Unenrolled Preparers', *2013 Annual Report to Congress* (2013) 67.

⁹³ See, eg, Nina Olson, 'More Than A Mere Preparer: Loving and Return Preparation' (2013) 139 *Tax Notes* 767. 'Taxpayers who are the beneficiaries of these credits are often the least educated and least financially sophisticated in the United States today. Thus, they become easy targets for marketing schemes of unregulated and unqualified so-called return preparers whose real interest in the tax return process is to push high-interest loans (formerly refund anticipation loans, and now in the form of 'pay-stub' loans) and charge high fees': at 769–770.

⁹⁴ For a compilation and summary of several of these studies, see Chi Chi Wu, 'How Errors and Fraud by Paid Tax Preparers Put Consumers at Risk and What States Can Do' (2013) *National Consumer Law Center Report*; see also Brief for Amici Curiae, National Consumer Law Center and National Community Tax Coalition in Support of Defendants-Appellants, *Loving v Internal Revenue Service*, No 13-5061 (DC Cir 2014). It is important to note that the inaccuracies described are far from limited to EITC overclaims. Other inaccuracies involved: intentional omission of income; falsifying information to make the taxpayer eligible for various deductions such as charitable deductions, job-related expenses, and Schedule C business expenses; inability to properly deal with education-related credits and income; misclassifying filing status; and data entry errors resulting in incorrect refunds. 'Errors and Fraud', 5–6.

⁹⁵ US Gen Accounting Office, *Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance*, GAO/GGD-98-150 (1998) (finding the EITC overclaim rate on returns prepared by unregulated preparers was 31%, while the overclaim rate on returns prepared by attorneys, CPAs, national tax preparation companies, and enrolled agents was 20%).

⁹⁶ For a detailed analysis of this phenomenon, see Danshera Cords, 'Paid Tax Preparers, Used Car Dealers, Refund Anticipation Loans, and the Earned Income Tax Credit: The Need to Regulate Tax Return Preparers and Provide More Free Alternatives' [2009] 59 *Case Western Reserve Law Review* 351, 374. While refund anticipation loans are no longer the product du jour, each filing season brings new products to the attention of consumer rights agencies.

⁹⁷ Cords, above n 96, 385; see also Leslie Book, 'Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor through the Tax System' [2006] *Wisconsin Law Review* 1103, 1116–1118.

As part of his work that builds on the Kidder and McEwen typology, Book categorises this type of intentional noncompliance as ‘brokered noncompliance’, meaning the overclaim occurred on the advice of a tax professional.⁹⁸ Book notes: ‘[t]here is a wide range in the honesty of preparers, and there were reports of illicit preparers generating business through their guaranteeing the windfall of government EITC dollars.’⁹⁹

Brokered noncompliance is of course not unique to EITC overclaims. It occurs in many contexts, including the sole proprietor context discussed above in section 3. Morse, Karlinsky and Bankman address this in their study and note that it includes a continuum of behaviour on the part of the preparer: ‘Many preparers in [the cash sector] adopt a “don’t ask, don’t tell” attitude toward their clients reported receipts. A small minority of preparers, however, actively aid in their clients’ evasion’.¹⁰⁰

Brokered EITC noncompliance should be viewed in that larger context, as it poses part of a larger challenge the IRS faces. As revealed in the IRS’s most recent EITC compliance study, there is significant overlap between EITC noncompliance and sole proprietor noncompliance: recall that the study identifies the most common (and 51% of time, the only) EITC overclaim error as income misreporting, in particular self-employment income misreporting.¹⁰¹ Income misreporting can result either at the suggestion of the return preparer or at the taxpayer’s initiative coupled with a ‘don’t ask, don’t tell’ attitude.

If approximately one-half of EITC overclaims are due to income misreporting, then this is part of a broader noncompliance phenomenon, and one that has proven very difficult for the IRS to enforce. Unfortunately, because it drives the improper payment rate, it in turn fuels the EITC’s image problem.

The IRS has honed in on paid preparers as part of the problem and is working to turn paid preparers instead into part of the solution. So far, it has been unsuccessful in its attempts to regulate preparers. It remains to be seen whether Congress will provide the IRS the authority to regulate preparers as there have been several bills introduced that would do so.¹⁰² Even if Congress does so, many (including this author) are sceptical that regulation will provide a magic panacea that will correct the problems with EITC noncompliance.¹⁰³

⁹⁸ Book, ‘One Size Does Not Fit All’, above n 12, 1173.

⁹⁹ Ibid.

¹⁰⁰ Morse, Karlinsky and Bankman, above n 47, 67.

¹⁰¹ See text accompanying notes 40 and 41 above. The 51% figure is not broken down as between paid preparers and self-prepared returns. It is not known how much of this is brokered noncompliance, but in either case it contributes to the sole proprietor tax gap.

¹⁰² See, eg, Tax Return Preparer Competency Act, HR 4141, 114th Congress (2015); Taxpayer Protection and Preparer Proficiency Act of 2015, S 137, 114th Congress (2015); Taxpayer Rights Act of 2015, HR 4128, 114th Congress (2015); Identity Theft and Tax Fraud Prevention Act of 2015, HR 3981, 114th Congress (2015).

¹⁰³ See Michelle Lyon Drumbl, ‘When Helpers Hurt’ (2014) 145 *Tax Notes* 1365; Justin Gelfand and Dan Alban, ‘Licensing Tax Preparers Won’t Help Taxpayers’, *wsj.com*, March 12, 2015 8:08 pm ET, <<http://www.wsj.com/articles/justin-gelfand-and-dan-alban-licensing-tax-preparers-wont-help-taxpayers-1426204063>> accessed 9 Dec, 2015.

The next sections provide an overview of some of the ways in which the IRS is addressing the problem of noncompliant return preparers short of industry-wide regulation.

4.1 Enforcing the due diligence requirement

One point of recent emphasis has been the requirement for paid preparers to exercise due diligence in determining a taxpayer's eligibility for the EITC.

This requirement was first enacted as part of the Taxpayer Relief Act of 1997,¹⁰⁴ and was in part intended to address concerns arising from the EITC compliance study of tax year 1994.¹⁰⁵ As originally enacted, the penalty was \$100 per failure. This was increased to the current penalty of \$500 in 2011.¹⁰⁶ The regulations promulgated under section 6695(g) in 2000 required the return preparer to complete a due diligence checklist (IRS Form 8867 or alternative), compute the credit using certain prescribed methods, and maintain the form in their records for three years.¹⁰⁷ In 2011, the Treasury Department amended the regulations to provide that Form 8867 must be submitted with the return or to the taxpayer for filing with the return.¹⁰⁸

The Treasury Regulations provide the following example of EITC due diligence:¹⁰⁹

Taxpayer asks Preparer D to prepare her tax return and tells D that she has a Schedule C business, that she has two qualifying children and that she wants to claim the EIC. Taxpayer indicates that she earned \$10,000 from her Schedule C business, but that she has no expenses. This information appears incomplete because it is very unlikely that someone who is self-employed has no business expenses. D must make additional reasonable inquiries regarding taxpayer's business to determine whether the information regarding both income and expenses is correct.

Form 8867 is a four page form, in which the first three pages consist of a series of 24 yes or no questions for the return preparer to answer, though not all questions apply to a given taxpayer. The questions are relatively straight-forward and can be used as the basis for a client interview. On the fourth page is a checklist on which the preparer must indicate the types of documents the taxpayer provided the preparer in connection with the return. The documents pertain to residency of any qualifying children claimed, disability of qualifying children (if applicable), and information used to complete Schedule C (if applicable). Notably, the preparer is not required to rely on any documents and can indicate such on the form.

¹⁰⁴ Taxpayer Relief Act of 1997, Pub L No 105-34, §1085(a)(2), 111 Stat 788, 956.

¹⁰⁵ Cords, above n 96, 374; HR REP 105-148, 105TH Cong, 1ST Sess 1997, 1997 WL 353016, 1997 USCCAN 678 (Leg Hist) at 695 ('the bill provides three compliance measures to address the EIC compliance problem').

¹⁰⁶ United States-Korea Free Trade Agreement Implementation Act of 2011, Pub L No 112-41, Title V, §501(a), 125 Stat 428, 459.

¹⁰⁷ TD 8905, 65 FR 61269, Oct 17, 2000. Additionally, the regulation imposed a knowledge and constructive element as to eligibility: 'The preparer may not ignore the implications of information furnished to, or known by, the preparer, and must make reasonable inquiries if the information furnished to, or known by, the preparer appears to be incorrect, inconsistent, or incomplete.' Treas Reg §1.6695-2(b)(3).

¹⁰⁸ TD 9570, 76 FR 78819, Dec 20, 2011; effective for tax years beginning after December 31, 2011.

¹⁰⁹ Treas Reg §1.6695-2(b)(3)(ii) Example 4.

The IRS makes efforts to educate return preparers about the due diligence requirements and Form 8867. Paid preparers who filed ten or more EITC returns without Form 8867 in filing season 2013 received a warning letter, and the IRS issued penalty letters to 225 of these preparers when they again filed ten or more EITC claims without the required form in the 2014 filing season.¹¹⁰ TIGTA reports that these 225 tax return preparers prepared 5,729 tax returns claiming more than \$18.7 million in EITC¹¹¹ — in other words, these preparers on average filed 25 EITC returns claiming an average EITC of \$3,264. The IRS proposed the section 6695(g) penalty against these 225 preparers for each claim, meaning the proposed penalties total nearly \$2.9 million.¹¹² The preparers are given 30 calendar days to respond to the proposed penalty and can request an appeals hearing. As of the release of the TIGTA report, only \$151,500 in penalties had been assessed against these 225 preparers.¹¹³

The Treasury Inspector General reports that its analysis of EITC claims filed during the 2012 through 2015 filing seasons shows that returns that include Form 8867 are more accurate than those that do not: ‘as of May 7, 2105, the IRS identified processing errors on 6.8 percent of EITC claims that were filed by a preparer without a Form 8867 compared to only 0.2 percent of EITC claims filed with a Form 8867’.¹¹⁴ However, ‘processing error’ is defined as ‘eg, mathematical errors, invalid EITC qualifying child Social Security Number (SSN), etc)’. This is not the same as evidence of a reduction in intentional EITC overclaims. As TIGTA has pointed out elsewhere:¹¹⁵

the majority of potentially erroneous EITC claims the IRS identifies do not contain the types of errors for which it has math error authority. For example, the IRS identified approximately 6.5 million potentially erroneous EITC claims totaling approximately \$21.9 billion in Tax Year 2012 for which it does not have math error authority. In Tax Year 2012, the IRS used math error authority to identify and systemically correct only 241,975 (.009 or less than 1 percent) of approximately 27.3 million EITC claims. The 241,975 returns claimed EITCs totaling \$299 million.

Still, it is evidence that the form increases accuracy to some degree.

One advantage of the EITC due diligence requirement is that it increases communication between the taxpayer and the return preparer. An ethical return preparer has every incentive to complete the form correctly and submit it. As to filling it out correctly, the preparer will not wish to be associated with a significant number of returns that examinations later reveal to be overclaims, because the IRS may turn its attention to the preparer. As to submitting the form, the IRS can impose the penalty

¹¹⁰ Treas Inspector Gen Tax Admin, ‘Results of the 2015 Filing Season’ 2015-40-080 (Aug 31, 2015) 6 (hereinafter TIGTA, ‘Results’).

¹¹¹ Ibid.

¹¹² Ibid.

¹¹³ Ibid. TIGTA had criticised the IRS in prior years for not issuing section 6695 penalties. See Leslie Book, ‘IRS Leaves Hundreds of Millions of Dollars in Preparer Penalties on the Table’ on Leslie Book, *Procedurally Taxing* (January 7 2014), <<http://www.procedurallytaxing.com/irs-leaves-hundreds-of-millions-of-dollars-in-preparer-penalties-on-the-table>> accessed 21 October 2016.

¹¹⁴ TIGTA, ‘Results’, above n 110, 6.

¹¹⁵ Treas Inspector Gen Tax Admin, ‘Assessment of Internal Revenue Service Compliance with the Improper Payment Reporting Requirements in Fiscal Year 2014’ 2015-40-044 (Apr 27, 2015) 9-10 (hereinafter TIGTA, ‘Assessment’).

even if the underlying EITC claims are correct, so relying on different due diligence practices while ignoring the regulation's specific requirements will not protect even the most honest preparer.¹¹⁶

Applying due diligence standards to the qualifying child requirements makes good sense. While qualifying child errors are the second most frequent error, this type of error represents 38% of overclaim dollars.¹¹⁷ The preparer's use of Form 8867 alerts the taxpayer to the requirements and the types of documentation that the IRS would request if the return were audited. It moves the question from 'how are you related to the child?' to 'do you have documentation showing how you are related to the child?' If the answer is no, the preparer can rely on the taxpayer's word, but the taxpayer is on notice that documentation may be required post-filing. In this regard, it surely reduces the chance of unintentional noncompliance due to a miscommunication or an incomplete interview process. At the same time, this due diligence requirement serves a gatekeeper role in that it informs the IRS whether a preparer (who at least in some cases is a professional subject to Circular 230) has seen documentation confirming EITC eligibility. For the IRS, this is beneficial — it places the preparer in the role of a de facto pre-refund auditor at no cost to the IRS. Presumably the IRS stratifies risk according to the type of preparer and the type of documentation recorded on Form 8867: a return prepared by an attorney or CPA who certifies that they have relied upon and retained school records verifying residence must surely be at less risk of audit than an unenrolled preparer who certifies that they 'did not rely on any documents'.

It is less clear how the EITC due diligence requirement will help reduce income misreporting, which is the most commonly made error and appears on an estimated two-thirds of EITC overclaim returns.¹¹⁸ Further, if due diligence could cure income misreporting, shouldn't it be explicitly required as a separate questionnaire on *all* sole proprietor returns? For instance, a preparer who relies on taxpayer records of gross receipts and expenses on an EITC return is required by the regulations to retain copies those records; however, on non-EITC returns, the preparer is not required to retain the taxpayer's records. Why not? In light of statistics and studies about cash business noncompliance, why not apply the same standards to all sole proprietor returns? This double standard highlights one way in which EITC noncompliance is stigmatised relative to other forms of noncompliance.

Finally, the due diligence requirement will not necessarily cure intentional noncompliance (or what Book calls 'brokered noncompliance'¹¹⁹). An unscrupulous return preparer who is determined to claim a bogus EITC can provide false information of Form 8867, fail to file the form, or fail to sign the return (making the return appear as if it were self-prepared, in which case the form is not required).

¹¹⁶ IRC §6695(g). See also Leslie Book, 'The Intersection of Preparer Penalty and Taxpayer Examinations' on Leslie Book, *Procedurally Taxing* (June 26 2014), <<http://www.procedurallytaxing.com/the-intersection-of-preparer-penalty-and-taxpayer-examinations/>> accessed 21 October 2016.

¹¹⁷ 'Compliance Estimates for the Earned Income Tax Credit,' above n 5, 17. ('Where the only error is a qualifying child error, the average estimated overclaim is \$2,327.')

¹¹⁸ Ibid. The report notes, however, 'Overclaim dollars associated with income misreporting (only) are disproportionately much lower, at 25 percent. The average overclaim associated with income misreporting alone is estimated to be \$673.'

¹¹⁹ Book, 'One Size Does Not Fit All', above n 12, 1173.

4.2 Targeted return preparer education

Though resource intensive, the IRS believes that targeted preparer education is an effective tool to combat EITC noncompliance. These include data-driven compliance and warning notices, preparer audits by field examiners, and ‘knock-and-talk’ visits from IRS Criminal Investigator agents.¹²⁰ The degree to which these efforts are effective in reducing noncompliance must surely be hard to measure, but the Commissioner reported that an expanded pilot program in 2013 ‘protected an additional \$590 million in revenue from being paid out improperly.’¹²¹ Of course, \$590 million is but a fraction of the estimated 17.7 billion in improper EITC payments made in fiscal year 2014.¹²²

4.3 Pursuing injunctions and permanent bars against the most egregious preparers

As the US District Court for the District of Columbia emphasised in its *Loving* opinion, ‘Congress has already enacted a relatively rigid penalty scheme to punish misdeeds by tax-return preparers.’¹²³ In addition to various monetary penalties, the Code permits the government to bring civil action to enjoin tax return preparers from engaging in certain conduct. The IRS and the Department of Justice Tax (DOJ) Division work together under this statutory authority to pursue injunctions and permanent bars against the most egregious offenders, including those who engage in intentional EITC noncompliance.¹²⁴ These injunctions and bars are publicised with press releases and website news items by both the IRS and the DOJ.¹²⁵

Certainly these actions are a resource and time intensive response to return preparer noncompliance. However, the expressive value of these injunctions and bars (and in some cases criminal prosecutions) may influence taxpayer perceptions of fairness, which is important in a voluntary reporting system.¹²⁶

4.4 Query: Are these initiatives driving some taxpayers to do-it-yourself noncompliance?

Preparers certainly play a significant role in the EITC noncompliance problem. Laws regulating the return preparer industry was the IRS’s favoured solution to address incompetence and unscrupulous behaviour, but absent Congressional action authorising such regulation, the IRS must focus its energy on other tactics.

There are reasons to suspect that noncompliance by return preparers is more intentional than not, and that the behaviour trends more unscrupulous than incompetent. The IRS should continue working with the DOJ to identify and pursue those preparers as they have been doing. The IRS’s efforts to crack down on paid preparer noncompliance are important and have both practical and symbolic value.

With that said, the added burdens on preparers, whether in the form of regulation or increased due diligence, do come with a financial cost that is likely passed on to the client. The IRS estimates that the average time needed to complete Form 8867 is 1

¹²⁰ Koskinen testimony, above n 67, 13.

¹²¹ Ibid.

¹²² TIGTA, ‘Assessment’, above n 115.

¹²³ *Loving v IRS*, 917 F Supp 2d 67, 75 (D DC 2013).

¹²⁴ See Drumbl, above n 103.

¹²⁵ See, eg, <<http://www.justice.gov/tax/program-shut-down-schemes-and-scams>>.

¹²⁶ See discussion of social noncompliance in section 3, above.

hour, 49 minutes.¹²⁷ As EITC returns inevitably become even more expensive for low-income taxpayers, the increased cost may drive the number of self-prepared returns higher. Taxpayers trying to ‘go it alone’ to save money run the risk of unintentional errors due to complexity.

Other taxpayers may ill-advisedly rely on a friend or family member who is willing to prepare the return on the cheap (or for free) but who plays fast and loose with the eligibility requirements in order to ‘help’ the taxpayer. Such returns appear to the IRS as self-prepared, and the amateur preparer is not subject to any risk of penalty — it is the taxpayer who is left vulnerable if the IRS questions the return.

At least one CEO of a national tax return preparation firm, William Cobb of H&R Block, thinks that another factor may drive taxpayers to ‘do-it-yourself’.¹²⁸

The implementation of inconsistent EITC eligibility standards and documentation requirements has resulted in a movement of this issue out of the assisted tax space and into the self-prepared channel (DIY), contributing to a material change in EITC taxpayer behaviors. ... The movement to DIY and the billion dollar increases in the improper payment rate have gone hand-in-hand.

In other words, there is concern that greater enforcement efforts directed at return preparers will drive taxpayers who know they are EITC ineligible to do their own false return on home software rather than face the stricter compliance standards imposed upon them by a regulated tax return preparer. Cobb likens this to the analogy of squeezing a balloon — if one part is squeezed, the air rushes to another.¹²⁹

With this concern in mind, and recalling that only 57% of EITC returns are prepared by tax return preparers,¹³⁰ the next section considers noncompliance on self-prepared returns.

¹²⁷ Instructions to IRS Form 8876, 3 (2014).

¹²⁸ Letter from H&R Block CEO William Cobb to the Senate Finance Committee, and House Committee on Ways and Means, Mar 10, 2015, on file with author and available at <newsroom.hrblock.com/download/126469/hrb-ceo-to-sfc.pdf>.

¹²⁹ Intuit chief tax officer David Williams used the balloon analogy first, but in the context of industry combating tax return fraud on a company by company basis: ‘If any one company ... decided to take a whole bunch of actions that would 100 percent determine that every single one of their customers was exactly who they said they were, that would not stop fraud in the industry. It would just push the fraud around. It would squeeze the balloon.’ Jonnelle Marte and Craig Timberg, ‘Who’s to blame when fraudsters use TurboTax to steal refunds?’ *Washington Post*, March 4, 2015. H&R Block CEO William Cobb built upon this analogy in a letter asking Congress to extend the EITC due diligence requirements to self-prepared returns. Of Williams’ balloon concern, Cobb wrote, ‘We could not agree more! In fact, we have been saying exactly this with respect to the EITC. Here, a fraud and improper payment filter (a series of questions) is being applied only to taxpayers who use paid preparers and the same fraud and improper payment filter is NOT being applied to DIY taxpayers.’ Letter from William C Cobb to Senators Orrin Hatch and Ron Wyden and Congressmen Paul Ryan and Sander Levin, March 15, 2015, on file with author and available online at <<https://presspage-production-content.s3.amazonaws.com/uploads/1475/hrb-ceo-to-sfc.pdf>> accessed 17 November, 2015).

¹³⁰ Koskinen testimony, above n 67, 13.

5. SELF-PREPARED RETURNS AND TAXPAYER ERROR

The IRS reports that in recent years the rate of EITC self-preparation has increased while the rate of paid preparation has declined.¹³¹ This section examines EITC noncompliance issues unique to self-prepared returns. These range from lack of taxpayer sophistication to lack of industry oversight, making it especially challenging (yet increasingly important) for the Service to respond effectively and correctly to this type of noncompliance. This section also describes the recent calls from industry and members of Congress to impose greater burdens on taxpayers who self-prepare in order to match the increased burdens that have been placed on return preparers.¹³²

It is unknown what percentage of self-prepared noncompliance is intentional as opposed to unintentional. Due to the complexity of the EITC, there is reason to believe that unintentional noncompliance is more common in this context than in the return preparer context.¹³³ This section will explain statutory complexity as the root cause of *unintentional* noncompliance and will also discuss how requiring more from taxpayers who self-prepare might drive down the rate of unintentional noncompliance.

Requiring more from taxpayers who self-prepare might also drive down the rate of *intentional* noncompliance, but for this to be effective, it must be coupled with more meaningful sanctions for wrongdoing. Section 3 above discussed several theories of intentional noncompliance that extend to self-prepared returns, such as social and symbolic noncompliance. This section will consider how requiring more information from taxpayers may affect these types of noncompliance, and how designing more meaningful sanctions for ‘do-it-yourself’ fraud may help combat this type of noncompliance.

5.1 Complexity: Why unintentional noncompliance may occur more often when taxpayers self-prepare

The EITC requirements are complex, and this is surely a challenge for taxpayers who self-prepare their returns. In her annual reports to Congress, Taxpayer Advocate Nina Olson has repeatedly recommended simplifying the credits.¹³⁴ While I agree that simplification would likely reduce taxpayer error, the statute is complex in part because Congress intended to make the credit available to workers in non-traditional family structures. It would be easier to administer a credit that is available only to parents (including stepparents) who live with their children year-round. However, that would be ignoring the demographic reality that children live in households headed by grandparents, aunts or uncles, and sometimes even older siblings. Further, children don’t necessarily live in the same household year-round. The Code sections governing filing status, dependency exemptions, and family-based refundable credits are complex because they attempt to capture certain of these demographic realities.

¹³¹ ‘Compliance Estimates for the Earned Income Tax Credit’ above n 5, [24] n 51.

¹³² See below section 5.

¹³³ If one accepts the estimate that the majority of all EITC noncompliance is unintentional, it is also reasonable to believe that unintentional noncompliance is higher among self-prepared returns than among those completed by paid preparers.

¹³⁴ See National Taxpayer Advocate, ‘Legislative Recommendation: Simplify the National Status and Related Requirements for Qualifying Children’, *2012 Annual Report to Congress* (2012) 507–511; National Taxpayer Advocate, ‘Research Study: Running Social Programs through the Tax System’, *2009 Annual Report to Congress* (2009) 75, 90; National Taxpayer Advocate, ‘Legislative Recommendation: Simplify the Family Status Provisions’, *2008 Annual Report to Congress* (2008) 363.

Congress should be applauded for the inclusiveness of these provisions, even if the downside is complexity (and a corresponding higher error rate).

The complexity used to be even worse than it is now. Congress moved to a uniform definition of qualifying child in 2004.¹³⁵ These changes were an improvement, but still today the Code's benefits for families do not perfectly align. For example, for a taxpayer to claim a qualifying child as a dependent, the qualifying child must not have provided more than half of their own support for the tax year.¹³⁶ A taxpayer claiming a 'qualifying child' for EITC has no support requirement at all, while a taxpayer claiming the head of household filing status must pay more than half the cost of 'maintaining the household' in a tax year.¹³⁷ If the child doesn't meet the 'qualifying child' test, the taxpayer might still be able to claim the individual as a dependent if they meet the 'qualifying relative' test, but only if (among other requirements) the taxpayer provided more than half of the person's total support for the year.¹³⁸ While a 'qualifying relative' can be claimed as a dependent, this individual cannot be claimed for EITC or child tax credit.¹³⁹ These subtle differences make it difficult for taxpayers to keep track of how to file properly. It is possible for the same taxpayer to be entitled to EITC but not head of household filing status; to be eligible for the EITC but not the child tax credit; or to be eligible to claim an individual as a dependent but for no other purpose.

Section 32, authorising the EITC, contains over 2,400 words. It contains cross-references to more than 20 other sections or subsections of the Code, including international tax provisions, passive loss rules, and capital gain definitions.¹⁴⁰ It references half a dozen federal statutes outside of the Code.¹⁴¹ It is no wonder that taxpayers — and even preparers — make unintentional errors in determining eligibility.

The Service attempts to translate these statutory requirements to plain English, using simplified forms, flowcharts and illustrations in its publications.¹⁴² Some of these resources are terrific, presuming the taxpayer can find them and/or has the patience and sophistication to study them. But the most logical place to provide the requirements is on Form 1040 itself — Form 1040 does capture the most essential information. Taxpayers claiming a qualifying child are required to fill out Schedule EIC to provide the child's name, social security number, year of birth, relationship to taxpayer, and number of months the child lived with the taxpayer during the tax year.

¹³⁵ Working Families Tax Relief Act of 2004, Pub L No 108-311, 118 Stat 1166, Sections 2001–2008; see John Buckley, 'Uniform Definition of a Child: Large Unintended Consequences' (Mar 20, 2006) 110 *Tax Notes* 1345 for background on the uniform definition and a discussion of how the uniform definition 'lacks uniform application.'

¹³⁶ IRC §152(c)(1)(D).

¹³⁷ IRC §2(b)(1).

¹³⁸ IRC §152(d)(1)(C).

¹³⁹ IRC §§32 and 24, respectively, refer to 'qualifying child' and do not extend to 'qualifying relative'.

¹⁴⁰ See §32(i).

¹⁴¹ See §32(l) and (m).

¹⁴² See, eg, IRS Publication 596 (2014). Though at 37 pages it may overwhelm a first-time claimant, the publication provides flowcharts, examples and sample worksheets. The publication helpfully informs taxpayers of the availability of free tax preparation services at Volunteer Income Tax Assistance (VITA) sites, but this information is located on p 26 rather than in the introduction where it might be more helpful to taxpayers.

Schedule EIC is written clearly and captures the most relevant information concerning the EITC requirements for a qualifying child on one page, but it doesn't fully capture the complexity, alert the taxpayer to certain pitfalls, or highlight the differences between the EITC, head of household filing status and the child tax credit. The next section of this article discusses why taxpayer intent matters, and how ascertaining intent is key to developing appropriate and effective sanctions. Section 6 will suggest an even more comprehensive approach to involving the taxpayer in information gathering.

5.2 Intentional noncompliance on self-prepared returns: How increasing due diligence can help the IRS ascertain taxpayer intent, and why that matters

Certainly some percentage of self-prepared return noncompliance is intentional. One problem the IRS currently faces is that its examination and enforcement mechanisms are reactive and not equipped to ascertain whether a taxpayer's overclaim was intentional or not. Increasing required due diligence, coupled with imposing more meaningful sanctions for intentional noncompliance, could serve to better deter social and symbolic noncompliance.

When the IRS detects a suspicious EITC return, a correspondence examination results. Once money is paid, it is difficult to recover. Therefore, more often than not, the IRS 'freezes' the credit pending the outcome of the examination, meaning the taxpayer does not receive the refund unless they prove to the satisfaction of the IRS (or, failing that, the US Tax Court) that they were entitled to it.

In a significant percentage of cases, the taxpayer never responds to the correspondence examination notices. One might infer one of two reasons for the silence: 1) the taxpayer did not receive the notice, did not understand its significance, or did not know how to meaningfully respond; or 2) the taxpayer knew they were not entitled to the credit, and therefore consciously chose not to respond, recognising that they had been 'caught'.

In either case, the silence is problematic because the Service cannot ascertain whether the noncompliance was intentional or unintentional. The former case denotes a taxpayer who may be disenfranchised, unsophisticated, unable to access legal representation, and/or may not even speak English. In some percentage of these situations, it is possible that the taxpayer is entitled to the EITC but is incapable of pursuing the matter further. This is the worst case scenario for the tax system, and the Service should work to reduce the number of these cases by making examination notices as simple as possible and informing taxpayers of the possibility of free legal representation through Low-Income Taxpayer Clinics. Of course in a percentage of these cases, the lack of sophistication or English literacy may have contributed to an unintentional error, and so the 'correct' outcome is achieved. I do not advocate for these taxpayers to be penalised for their error.

In the latter scenario, the taxpayer committed reckless or fraudulent behaviour and was caught. But because the taxpayer ignored the examination notices, the IRS likely does not have enough evidence to bring forth a civil fraud penalty case or other punishment. Thus, the intentional wrong-doer taxpayer is not penalised any differently than the unintentional or mistaken taxpayer. The lack of a meaningful sanction may serve to fuel social and symbolic noncompliance.

5.2.1 Accuracy related penalties apply to all overpayment claims

Taxpayers who erroneously claim the EITC are subject to the section 6662 20% accuracy penalty, regardless of whether the error was unintentional and intentional.¹⁴³ In November 2013, in a decision that was viewed as quite favourable to low-income taxpayers, the US Tax Court held that this accuracy related penalty could not apply to the *refundable* portion of a credit (commonly referred to as the negative income tax): that is, the amount refunded to the taxpayer in excess the amount of tax shown on the return.¹⁴⁴ However, the Tax Court was legislatively overruled two years later when Congress amended the definition of underpayment to explicitly include refundable credits in the calculation of the accuracy related penalty.¹⁴⁵

I have argued elsewhere that the IRS is overly punitive in its application of section 6662 because it does not attempt to distinguish between intentional and unintentional EITC noncompliance.¹⁴⁶ As a result, unsophisticated taxpayers face penalties of \$1,000 or higher even if their mistake was a wholly innocent one. To be clear, I do not wish to see the Service penalise inadvertent error. But as I will explain in section 6 below, increasing information with return filing may put the IRS in a better position to determine when the taxpayer is knowingly engaging in fraud.

5.2.2 Section 32(k) — taking away a right that one never rightfully had isn't a meaningful deterrent

In cases where there is evidence of reckless or fraudulent noncompliance, the IRS can impose (respectively) a two-year or ten-year EITC ban on the taxpayer.¹⁴⁷ Schedule EIC puts taxpayers on notice of this possibility: 'If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years.'¹⁴⁸

This ban sounds meaningful, but is of questionable deterrent effect: the possibility of a two-year or even a ten-year ban is likely meaningless for a taxpayer who is not eligible for EITC to begin with.¹⁴⁹ In other words, a dishonest taxpayer can intentionally claim an EITC to which they know they are not entitled, and not much is at stake: if the IRS is suspicious, it will freeze the refund and issue a correspondence examination notice. The taxpayer can simply ignore the notice, having given it a try and failed. Meanwhile, if the refund was frozen, there is no financial penalty, no interest to repay, and if the taxpayer was ineligible to begin with, the Code's

¹⁴³ For many years, the accuracy related penalty applied to EITC overclaims even if the refund had been frozen and never received by the taxpayer. See IRS Chief Couns Mem 200113028 (Mar 30, 2001). In 2012, Chief Counsel reconsidered this policy and issued guidance advising the Service not to impose the penalty on frozen refunds. IRS Program Manager Tech Adv Mem 2012-16 (May 30, 2012).

Presumably this guidance stands following the legislative overruling of *Rand*.

¹⁴⁴ *Rand v Commissioner*, 141 TC 12 (November 18, 2013).

¹⁴⁵ Consolidated Appropriations Act, 2016, Pub L No 114-113, Section 209(a).

¹⁴⁶ See generally Drumbl, above n 13.

¹⁴⁷ IRC §32(k)(1).

¹⁴⁸ IRS Form 1040, Schedule EIC.

¹⁴⁹ Judge Morrison made this point in his dissent in *Rand v Commissioner*: 'Many taxpayers who falsely claim the earned income credit for one year will not qualify for the credit for the subsequent two years anyway. ... For such taxpayers...section 32(k), even if applicable, deprives them of nothing to which they would otherwise be entitled.'

recertification requirement¹⁵⁰ and/or bans are meaningless. In other words, one loses nothing for trying.

The Service must find ways to require more information from the taxpayer on the return itself, and it must create better deterrents to noncompliance.

5.2.3 *How increasing due diligence requirements can help drive down intentional noncompliance, if coupled with more meaningful sanctions*

As discussed in section 4 above, return preparers who commit fraud face civil and criminal penalties, and the Justice Department and IRS publicise these cases as a measure of general deterrence for the return preparer community. However, as the preceding sections describe, there is no analogous deterrent for taxpayers who wish to engage in ‘do-it-yourself’ EITC fraud.

This is a significant problem. If we believe that taxpayers who commit social noncompliance do so because others are not complying, or because others are getting away with it,¹⁵¹ then there should exist a meaningful punishment for those who are caught — in the absence of that, anyone who tries ‘gets away with it’: even if the IRS doesn’t issue the refund, the taxpayer has lost nothing for trying.

While individual taxpayers are subject to criminal sanctions for wilfully making false statements on tax returns,¹⁵² it is rare for the IRS to bring criminal charges against a taxpayer in the context of the EITC fraud on their individual return.¹⁵³ At a minimum, the IRS should add a warning on Schedule EIC reminding a taxpayer that a false statement on a tax return is a criminal offense. Preferably, Congress should enact a provision providing specific criminal sanctions for EITC fraud. Individuals who commit fraud in other social benefit programs are subject to criminal penalties. For example, it is a felony offense for individuals to commit certain violations such as trafficking (the knowing and improper use, transfer, acquisition, or alternation) of benefits in the federal SNAP.¹⁵⁴ The punishment for SNAP trafficking is a maximum fine of \$250,000 or 20-year imprisonment. There is no reason to treat EITC fraud differently,¹⁵⁵ or not to at least have that option on the books.

One difficulty in imposing criminal sanctions is the high burden of proof required of the government. By way of example, the Internal Revenue Manual provides that imposition of the ten-year EITC ban requires a final determination that the taxpayer engaged in ‘affirmative acts of fraud’.¹⁵⁶ The manual includes the following as examples of indicators of fraud: ‘Claiming dependency exemptions for nonexistent, deceased, or self-supporting persons. Providing false or altered documents, such as

¹⁵⁰ IRC §32(k)(2).

¹⁵¹ See generally Book, ‘One Size Does Not Fit All’, above n 12.

¹⁵² IRC §7206.

¹⁵³ For one notable and recent example of the government pursuing criminal charges against an individual for filing false income tax returns claiming EITC, see <<https://www.justice.gov/usao-wdmo/pr/ozark-man-pleads-guilty-false-tax-claim-advertised-craigslist-dependents>> accessed 6 April, 2016.

¹⁵⁴ 7 USC §2024(b).

¹⁵⁵ Though I am by no means suggesting 20 years’ imprisonment is an appropriate punishment for individual EITC fraud.

¹⁵⁶ IRM 25.1.14.5(1) (06-19-2013), 10-Year Earned Income Tax Credit (EITC) Ban Consideration.

birth certificates, lease documents, school/medical records, for the purpose of claiming ... EITC, or other refundable credits.’¹⁵⁷

An evidentiary problem arises: currently, a taxpayer is not required to provide with the return any documents supporting an EITC claim. Thus, if audited, the taxpayer can respond with silence, effectively preventing the IRS from pursuing a fraud case, because it will never see the false documents.

This is why requiring more due diligence on self-prepared returns, or at least more affirmative statements on the Schedule EIC, can combat intentional noncompliance. If more due diligence were required, including affirmative statements about relationship, the circumstances of residency, and the types of documentation that can be provided upon request, the IRS would have some basis to pursue criminal charges against taxpayers who knowingly make false statements. The IRS needs the power to do so in the most egregious cases, just as it has the power to pursue a permanent injunction against the most egregious tax return preparers.

Realistically, the IRS does not have the resources to pursue a significant number of time-intensive cases with a high evidentiary requirement against individual taxpayers. Again by way of analogy, the IRS imposes the ten-year ban infrequently: based on data provided by the Taxpayer Advocate, it imposed it only 13 times, 27 times, and 17 times in 2009, 2010, and 2011 respectively.¹⁵⁸ But if it could hold itself out on the tax forms as having the authority to pursue criminal charges (rather than just a ban that is effectively meaningless) for EITC fraud, perhaps more taxpayers would think twice before making a false statement.

The mere threat of criminal sanction would serve as a general deterrence, and perhaps even create an expressive notion of integrity in the tax system among all taxpayers.

5.3 Combating unintentional error by increasing due diligence requirements: Easing the statutory complexity without a legislative fix

William Cobb, CEO of H&R Block, wrote to the IRS Commissioner and Treasury Assistant Secretary for Tax Policy and advocated for the IRS to modify Schedule EIC ‘to require all taxpayers — regardless of how they file — to answer the same eligibility questions and to submit those responses to the IRS’.¹⁵⁹ According to his letter, this proposal has been discussed since 2012 by an IRS-EITC Software Developers Working Group.¹⁶⁰ Cobb characterises this proposal as ‘a simple, common sense first-step to reduce improper payments among both self-preparers and paid preparers.’¹⁶¹

¹⁵⁷ IRM 25.1.2.3(2) (06-09-2015), Indicators of Fraud

¹⁵⁸ National Taxpayer Advocate, ‘Earned Income Tax Credit: The IRS Inappropriately Bans Many Taxpayers from Claiming EITC’, *2013 Annual Report to Congress* (2013) 104, n 12. It imposes the two-year ban far more frequently: 5,438 times in 2011; but in a significant percentage of cases, it does so inappropriately, because 39% of the time it does so without receiving any response from the taxpayer. This practice is contrary to published IRS Chief Counsel guidance, which provides that ‘a taxpayer’s failure to participate in an EITC audit does not justify imposing the ban’: at 103.

¹⁵⁹ Cobb letter, published in *Tax Notes Today*, Nov 11, 2014.

¹⁶⁰ Ibid.

¹⁶¹ Ibid.

Cobb believes that if this proposal were adopted, ‘the IRS would have better information more quickly on the sources and causes of improper payments, and it will likely see a reduction in the improper payment rate.’¹⁶²

Cobb notes that the IRS can implement this change without statutory authority.¹⁶³ Cobb’s proposal makes far more sense than waiting for Congress to simplify the EITC provisions (assuming one even thinks that simplification is desirable).

Book describes Cobb’s proposed changes as likely to be ‘good for the tax system’ because ‘changes that enhance visibility and accountability are the most effective and cost-efficient ways of decreasing errors.’¹⁶⁴ I agree with Cobb and Book, and describe in section 6 how the IRS can go even further in partnering with taxpayers for increased information.

Some members of Congress also agreed with Cobb’s proposal. A Senate appropriations bill for fiscal year 2016 directed the Department of Treasury to ‘ensure that the same eligibility questions are being asked of taxpayers whether they are preparing their returns with a paid tax preparer or via do-it-yourself methods such as paper forms, preparation software, or online preparation tools.’¹⁶⁵ The Senate Appropriations committee noted that this measure is intended to reduce the improper payment rate on EITC:¹⁶⁶

Implementing uniform eligibility questions for refundable credit filers is a common sense step that will help alleviate confusion over eligibility and better establish qualification for these credits. The Department of the Treasury shall ensure that all EITC eligibility questions included on Form 8867, such as questions 1 through 19 and the eligibility questions used to meet the requirements of question 24, will be included on the Schedule EIC. The Department of Treasury shall implement this for tax returns filed after January 1, 2016.

David Williams, chief tax officer of Intuit and formerly the Director of the Earned Income Tax Credit office at the IRS, disagrees with this premise. Williams states that ‘making self-preparation harder will likely increase EITC error, not reduce it’ and further states that increased information ‘is also a very bad idea because it puts the burden of tax compliance squarely on lower-income working taxpayers.’¹⁶⁷

¹⁶² Ibid.

¹⁶³ Ibid.

¹⁶⁴ Leslie Book, ‘H&R Block CEO Asks IRS to Make it Harder to Self-Prepare Tax Returns and Why That’s a Good Idea’, on Leslie Book, *Procedurally Taxing* (December 3 2014) <<http://www.procedurallytaxing.com/hr-block-ceo-asks-irs-to-make-it-harder-to-self-prepare-tax-returns-and-why-that-is-good-for-the-tax-system/>> accessed 21 October 2016.

¹⁶⁵ Senate Report 114-97, 37, ‘Financial Services and General Government Appropriations Bill, 2016.

¹⁶⁶ Ibid.

¹⁶⁷ ‘Intuit Chief Tax Officer Says Reducing EITC Errors Should Not Come on Backs of Poor,’ Leslie Book, *Forbes*, Mar 6, 2015 at 7:16 am, <<http://www.forbes.com/sites/procedurallytaxing/2015/03/06/intuit-chief-tax-officer-says-reducing-eitc-error-shouldnt-come-on-backs-of-low-income-taxpayers/#66e474ff4bfd>> accessed 21 October 2016.

So how to strike an appropriate balance? If too much is required of return preparers, taxpayers may prefer to self-prepare. If too much is required of self-preparing taxpayers, it may discourage eligible recipients from applying.

While I am not in favour of burdening a vulnerable population, I will address in section 6 why I believe requiring this information (and incenting additional documentation) is not more burdensome than what is asked in other tax and non-tax benefit contexts, and why it is ultimately the best solution for all EITC-eligible recipients.

6. KNOWLEDGE IS POWER: A TWO-STEP (COMMON SENSE) PROPOSAL TO REDUCE IMPROPER PAYMENTS AND COMBAT ALL FOUR TYPES OF EITC NONCOMPLIANCE

This section supports the calls for increased due diligence requirements on all returns, whether completed by a paid preparer or self-prepared, and builds upon theories of noncompliance to suggest that increased due diligence may help reduce both intentional and unintentional EITC errors.

The quote ‘knowledge is power’ is commonly attributed to Francis Bacon. A more modern variant is attributed to Ethel Watts Mumford: ‘Knowledge is power, if you know it about the right person’.¹⁶⁸

Research on noncompliance and the tax gap confirms the common sense suspicion that taxpayer compliance correlates with information reporting. In the case of the EITC, this means having knowledge about not just income but also a taxpayer’s personal situation. If the IRS had more knowledge before processing the return — if it could readily and easily ascertain information about residency, relationships, and income (ie, have better knowledge) on EITC claims — it could more effectively reduce the improper payment rate.

Building on what (we think) we know about noncompliance, this section will outline in two steps why requiring taxpayers to provide an increased amount of information with the return, coupled with slowing down the refund process generally, is a reasonable way to improve administration of the EITC program.

6.1 Step one: Increase information required on every return, with an additional statement required of taxpayers claiming children they didn’t claim last year and an expedited refund for those who can attach documentation to the return

Increasing due diligence requirements on all returns, including self-prepared returns, is an appropriate start. All taxpayers — regardless of whether they self-prepare or rely on a preparer, and regardless of whether they are claiming EITC for the first time or the twentieth time, should have to provide basic information on an IRS schedule indicating: the relationship; the number of months the qualifying child lived in their home; and a box indicating the type of documentation they can provide to the IRS upon request to substantiate their claim.

Currently, taxpayers are required to provide the first two items on Schedule EIC. The third requirement is a proposed twist on Form 8867: whereas the form asks the

¹⁶⁸ See, eg, Gyles Brandreth, *Oxford Dictionary of Humorous Quotations*, 5th edition (Oxford University Press, 2013) 252.

preparer to indicate which documents, if any, the preparer was provided by the taxpayer and relied upon in completing the return (and imposes a duty for the preparer to retain copies of those documents), the form should ask the question of the taxpayer and not just the preparer.

Why require this? Because it puts all taxpayers on notice that they may be required to substantiate their claim. Currently, self-preparing taxpayers are not required to consider such specifics about substantiation. Even taxpayers who rely on preparers can have a return prepared simply by answering questions and without providing or even describing the types of documents they have at home to substantiate the claim upon request.

Schedule EIC or a revised due diligence form for all taxpayers should require an affirmative statement from the taxpayer indicating that they can provide, upon request, some type of evidence to verify the EITC claim. It is crucial that the form present taxpayers with a wide array of options to indicate how they might substantiate the claim. I know firsthand from representing low-income taxpayers that not all claimants can provide the type of rigid documentation the IRS asks for upon examination, which includes school records, medical records and utility bills spanning at least a six-month period.¹⁶⁹ Not all children are school-aged, not all see the doctor regularly, and not all taxpayers have bills in their name. Some taxpayers are transient, but move as a family; some don't keep paperwork when they move from residence to residence. There are many legitimate obstacles that explain why low-income taxpayers may have trouble providing official documentation showing at least six months of shared residency with their qualifying children.

For this reason, it is imperative that taxpayers be allowed the option to indicate that they can (upon request) provide an affidavit from any third party (including, but not limited to, a spouse or relative) regarding the child's residency.¹⁷⁰ A taxpayer affirmatively indicating that they can provide a third-party affidavit upon request should by no means be an automatic trigger for examination. EITC controversies that go to trial in US Tax Court sometimes turn on the veracity of taxpayer testimony and witnesses rather than the rigid documentation preferred by the IRS.¹⁷¹

I propose that there should be a streamlined process for a taxpayer who claims the same children in the following tax year. Parents claiming the same children year after year should be provided an option to indicate on the form that their living situation is the same as the last year.

¹⁶⁹ For examples of why some taxpayers cannot provide such documentation, see 2002 GAO report 15–20. These descriptions are consistent with the various challenges I have seen in my representations.

¹⁷⁰ I have previously criticised both the automated nature of EITC correspondence examinations and the rigidity with which documentation is accepted. See Drumbl, above n 13, at 132–139. A Taxpayer Advocate Service study of 256 Tax Court cases in which the Service conceded that the taxpayer was entitled to the EITC (though had been denied such at the audit level) discovered that in 20% of the study's cases an Appeals Officer or Chief Counsel attorney accepted documents that the Tax Examiner had rejected. National Taxpayer Advocate, *2012 Annual Report to Congress* (2012) 89–90. In 5% of the cases studied, the Service conceded after concluding that the Tax Examiner misapplied the law.

¹⁷¹ See, eg, *Coats v Commissioner*, TC Memo. 2003-78 ('We find petitioner's testimony credible. We find convincing petitioner's explanation for the discrepancy between the school records and his testimony regarding where [his daughter] lived during 1998. Under these circumstances, we afford more weight to his testimony than to the school records.')

Those taxpayers claiming qualifying child(ren) for the first time present a different situation. The IRS should (and likely already does) primarily focus its enforcement (and education/outreach) efforts on these first-time claimants. Up to one-third of EITC claimants, each year, are ‘intermittent or first-time claimants,’¹⁷² and these taxpayers may be less likely to understand or appreciate the EITC requirements. Thus it is crucially important for the tax form itself to clearly communicate the requirements and also put taxpayers on notice as to the gravity of self-declaring eligibility and the potential post-filing consequences.

As part of increased due diligence, I propose that first-time claimants of qualifying children should have to add a statement to Form EIC indicating what changed (ie, why the children were not claimed last year). If this entry is left blank on the return, the IRS should follow up with a simple letter to the taxpayer explaining that they must provide a statement or the credit will not be processed.

Weighing the burden against the benefit, I do not think requiring a one or two sentence explanation for first-time claimants will adversely impact the take-up rate of eligible claimants. There are many easily-explained reasons a taxpayer may be claiming children for the first time: children are born; people get married and gain stepchildren; custody arrangements change; children move in with uncles or grandparents for a variety of economic and/or relationship reasons; or the financial support structure within a multi-generational household shifts.

Asking taxpayers to provide this information does not seem unreasonable given the amount of the credit at stake. Having to affirmatively provide this explanation will impress upon the taxpayer the significance of claiming entitlement for the first time. Providing even a brief one-sentence explanation demonstrates good faith. In the event the IRS decides to further scrutinise the return, the affirmative statement becomes the starting point for the examiner.

An even more proactive way to strengthen due diligence would be to invite these first-time claimants to optionally partner with the IRS in information sharing.

6.1.1 *‘EITC Fast-Track’ — A voluntary path for taxpayers to partner with the IRS in exchange for expedited refund consideration*

This proposal is inspired by a government agency that plays an entirely different role for the federal government: the Transportation Security Administration (TSA).¹⁷³ Think of the TSA line at the airport: every traveller who wishes to board the airplane must go through the security line. But some travellers decide it is worth it to go through the extra rigor of qualifying for the optional ‘TSA Precheck’ program: they fill out extra forms, provide documentation of citizenship or immigration status, provide fingerprints, and voluntarily subject themselves to a behind-the-scenes screening process. In exchange (assuming they are cleared), they receive a known

¹⁷² TIGTA, ‘Not in Compliance,’ above n 27, 2.

¹⁷³ The taxpaying public may not be so enthused about a proposal that borrows an idea from the TSA; past polls measuring opinions of government agencies have found both agencies equally unlikable. Eileen Sullivan, ‘Poll: Travelers Dislike TSA as Much as IRS’, Associated Press, USAToday.com, 12/20/2007 5:32 PM. However, in more recent years, the IRS has taken an even bigger popularity dip relative to the TSA. Joe Davidson, ‘Survey says Uncle Sam flunks government’, *Washington Post*, Nov 24, 2015.

traveller number and the privilege of expedited clearance every time they travel thereafter. The program is purely optional: not every traveller does this, though all travellers who clear security eventually arrive at the same destination. Some, however, clear more quickly because they have voluntarily provided a government agency with additional information. They have partnered with the government by sharing knowledge about themselves.

I envision a similar program that would serve as an EITC Fast-Track for first-time claimants. Imagine an example: Joe Taxpayer is claiming EITC for the first time this tax year because he married Jane Taxpayer and now has three stepchildren who are qualifying dependents. Assume that Jane does not have a filing obligation because her only income was from social security disability; thus, no taxpayer claimed the children last year. Presumably as a married couple they will now file a joint income tax return. Like all taxpayers, they will be required to provide the standard information indicating relationship, number of months the children resided in the household, and the type of documentation they can provide upon request to substantiate the claim. Like all first-time EITC claimants, Joe and Jane will have to make an affirmative one or two sentence statement explaining this straightforward change in circumstance if they wish to receive the EITC.

Beyond that, they have two options: 1) they can enclose substantiating documentation, which might include the marriage certificate and a letter from a relative or neighbour attesting that all five individuals lived together for at least six months of the year; 2) alternatively, they can choose not to submit any documentation. If they choose option one, the IRS will process the refund on a 'fast-track' basis. If they choose option two, they will still receive the refund, but it may take several weeks longer to process because the IRS would have to verify eligibility through its regular internal procedures (and as I propose in the next section, the IRS should slow down all refunds subject to these verification procedures). Depending on how those internal procedures turn out, Joe Taxpayer may be asked to provide the marriage certificate at a later time. Just as all compliant passengers eventually get on the airplane, all eligible taxpayers would get their EITC — but some would get it faster than others.

Consider these proposals for increased due diligence in the context of symbolic noncompliance. As discussed in section 3 above, one common type of noncompliance is when a boyfriend claims his girlfriend's children (and he is not the father). Under the current procedures, this may be likely to trigger an examination because the IRS will know he has never claimed the children before. If his return is audited and the refund frozen, he simply can ignore the notice and he is not penalised in any way for trying. There is also a chance that his claim would slip through undetected and that he would receive the improper payment without examination.

But imagine if this proposal were implemented and that the boyfriend (a first-time claimant of these children) was required to include a statement explaining the change in circumstance on Schedule EIC. Would he be so bold to write that he married the mother and these are now his stepchildren; particularly if Schedule EIC included a warning that a false statement is a criminal offense?

On the other hand, if the taxpayer indeed had married the mother last year, and he is making first-time claim to which he is entitled, he would simply include an affirmative statement to that effect, and he could even choose to submit documentation under the 'EITC Fast-Track' option.

This approach would incent a population of first-time claimants to affirmatively show they are entitled to the benefit. Of course not all taxpayers have the resources, means, or sophistication to provide the appropriate affirmative documentation with the return for a ‘fast track’ EITC refund. Again: this should not create a barrier to the EITC; in these cases the IRS should allow self-declared eligibility as it always has, but the refund will not be processed on an expedited basis.

Long-time observers of the EITC might find this proposal reminiscent of a controversial pilot program that the IRS once proposed and abandoned — EITC pre-certification. I rebut that comparison and distinguish my proposal in the section that follows.

6.1.2 *Pre-certification: Why it failed, and how this proposal is different*

To some, the ‘fast-track’ proposal may be reminiscent of a previous IRS pilot program that required pre-certification for a test sample of taxpayers for tax years 2003 and 2004.¹⁷⁴ The pre-certification pilot program proved to be quite controversial, and the Service ultimately abandoned the pilot program after two tax years. While policy makers and scholars noted that the program the program might improve compliance, common concerns included that it ‘also could significantly reduce participation, and might not save the government much money.’¹⁷⁵ Some criticised it as unfairly targeting poor taxpayers,¹⁷⁶ and for requiring something of EITC claimants that is not required of other taxpayers.¹⁷⁷

There are also real issues in subjecting EITC recipients to a pre-certification process that does not apply to any other tax filers. People do not need to pre-certify before taking a charitable deduction for a used car or clothing, even though there is ample evidence that these deductions are overstated. Sole proprietorships do not need to pre-certify that they are not hiding cash from the tax authority before claiming deductions for inventories, rent, and equipment, even though they are notoriously noncompliant. And so on.

The optional nature of the fast track EITC proposal draws in part on lessons learned from the IRS’s ill-fated pre-certification pilot program. That program selected a small population (45,000 taxpayers) and imposed an additional burden on them — one that was not imposed upon other EITC claimants or any other type of taxpayer. The mandatory nature of the pre-certification was, in my view, its greatest shortcoming. It burdened taxpayers who lacked the sophistication, means, language skills, or time to comply with its requirements.

I share the concerns about limiting participation and burdening a vulnerable population. For this reason, the fast-track program should be strictly optional, and taxpayers who do not opt in should be disadvantaged only as to timing of the refund. For those who do not opt in, the agency will have to take a more active role in verifying the claim. Hence, the longer processing time (which in the next section I

¹⁷⁴ See IRS Announcement 2003-40, 2003-26 IRB 1132, 2003-1 CB 1132, 2003 WL 21362731.

¹⁷⁵ Leonard E Burman, statement before The Committee on Ways and Means, United States House of Representatives, Subcommittee On Waste, Fraud, and Abuse, 11 (July 17, 2003): ‘The fear among those who care about the EITC is that the pre-certification strategy is tantamount to a 100 percent audit rate (in advance) for certain people who claim the EITC’: at 9.

¹⁷⁶ For a collection of such criticisms, see Zelenak, above n 8, 1870–1871.

¹⁷⁷ Burman, above n 175, 12.

suggest is appropriate for most taxpayers in any event). Taxpayers who do not opt in would not face a presumption of noncompliance; as with the current system, they would make a claim of eligibility and the IRS would use its filters to assess the risk of paying the credit without requesting documentation of eligibility through examination.

Some segment of the EITC population, however, is able to comply with additional information reporting, and may be willing to do so if it means receiving the refund on an expedited basis. The IRS should allow this population to self-select for a number of reasons. First, it is highly unlikely that a taxpayer who voluntarily submits documentation would engage in deliberate noncompliance. Morse, Karlinsky and Bankman conclude that intentional noncompliance is driven by opportunity and ‘a low-perceived likelihood of detection and penalty’.¹⁷⁸ The fast-track procedure would invite increased scrutiny, which is the opposite of what an intentionally dishonest taxpayer would want to attract. In a similar vein, Book writes of symbolic noncompliance: ‘to the extent that taxpayers believe others are complying, then taxpayers will not take advantage of the tax system’.¹⁷⁹ If a significant percentage of taxpayers were to elect to offer more documentation than is required in order to receive their EITC more quickly, it will demonstrate that this population is complying beyond the minimum requirement. Presumably, those who know that they do not meet eligibility requirements would not affirmatively draw attention to themselves by attempting a fast-track refund. In these regards, a fast-track option could advance the sort of cultural change and trust in government that underpinned the Taxpayer Advocate Service recommendations to address sole proprietor noncompliance.

Fast-track taxpayers would effectively remove themselves from the pool of claimants who would otherwise be scrutinised for eligibility with third-party information reporting. This in turn would allow the IRS to direct its limited resources to a relatively smaller population of claimants.

Would a ‘fast-track’ option unfairly target poor taxpayers? By definition, any form of increased due diligence requirement directed at EITC taxpayers is directed at lower income taxpayers. It is true that we do not subject sole proprietors, taxpayers claiming itemised deductions, or taxpayers claiming education credits to tougher due diligence requirements at the time of filing. Arguably, we should. But in any event, the EITC is somewhat special — as Zelenak notes, it is a hybrid provision that is housed in the tax system but functions as a social benefit.¹⁸⁰ And even with increased due diligence standards and an optional ‘fast-track’ program, claiming the EITC is far less burdensome than applying for more traditional welfare benefits such as SNAP or Temporary Assistance for Needy Families (TANF).¹⁸¹

¹⁷⁸ Morse, Karlinsky and Bankman, above n 47, 67.

¹⁷⁹ Book, ‘One Size Does Not Fit All’, above n 12, 1176.

¹⁸⁰ Zelenak, above n 8, critiques the pre-certification pilot program and analyses the hybrid characteristic. Though some of the details of the assistance programs that Zelenak describes in his article have changed over time, the current iterations of these programs require similar front-end determinations of eligibility by the agency before benefits are administered. Concluding that ‘overall EITC enforcement efforts remain much more similar to ordinary tax enforcement than to welfare-type enforcement’, Zelenak cautions that ‘[i]t may not be wise, then, for EITC proponents to object to every respect in which EITC enforcement may be more rigorous than income tax enforcement generally’: at 1915–1916.

¹⁸¹ Ibid. Consider also that states have the option to impose drug testing on welfare recipients. See Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub L No 104–193, 110 Stat 2105, Section 902. For an overview of this controversial practice, see Maggie McCarty, Gene Falk,

Even within the tax code, there are examples of increased reporting or due diligence requirements in other taxpayer realms, including ones that typically involve moderate- or high-income taxpayers. Consider the burdensome reporting regime imposed upon US citizens holding foreign accounts. At certain income thresholds, these taxpayers are subject to two separate and potentially overlapping reporting regimes: foreign bank and financial account reporting (FBAR) and the Foreign Account Tax Compliance Act (FATCA). Taxpayers who run afoul of these reporting requirements, even non-wilfully, can face significant civil penalties, and criminal penalties may also apply. The penalty structure is far more serious than anything faced by EITC claimants. While there are many legitimate reasons to hold an offshore account, all taxpayers are swept up in the reporting regime because the government has made this type of tax evasion an enforcement priority.

As discussed, the two biggest causes for EITC overclaims are income misreporting and the residency requirement. Of the two causes, income misreporting is the trickier one for which to require substantiation. Not all taxpayer income is reported on a Form W2 or 1099. But to the extent that income is subject to third-party reporting, the IRS would benefit by either 1) speeding up the matching process, or 2) slowing down the refund process. The next section describes why slowing down can reduce improper payments.

6.2 Step two: Slowing it down—the agency verifies the claim, maximizing information available to it

I am hardly the first person to suggest that the IRS should not issue a refund until it has had time to verify the claim. The IRS struggles with a difficult balance: the EITC is meant to lift people out of poverty, and delaying refunds hurts people who rely on the credit to pay bills. Yet rushing a refund creates different problems, including not just improper payments to people claiming the credit incorrectly, but also identity theft that diverts the refund from the taxpayer who is entitled to receive it.¹⁸²

Much of the information the IRS would like to have to verify EITC claims is available, but not always at the time of filing. While the ideal solution is for the IRS to modernise its technology so it could speed up verification, for the time being the more realistic solution is to slow down the refund to check it against the systems it has.

Randy Alison Aussenberg and David H Carpenter, 'Drug Testing and Crime-Related Restrictions in TANF, SNAP, and Housing Assistance', CRS Report R42394, 18 November 2015. Compared to such invasive monitoring and punitive administration, increased due diligence and a 'fast-track' proposal for EITC seem like fairly mild measures.

¹⁸² Book notes that 'dummying up tax returns with phony withholding amounts that take advantage of the IRS's lack of early access to information returns is the main tool of the identity theft fraudster.' Leslie Book, 'Warren Buffet Calls for Expanding EITC: Tax Administration Impact Highlights There is No Free Lunch' on Leslie Book, *Procedurally Taxing* (May 27 2015) <<http://www.procedurallytaxing.com/warren-buffet-calls-for-expanding-eitc-tax-administration-impact-highlights-there-is-no-free-lunch/>> accessed 21 October 2016. The Senate Finance Committee introduced a Bill to address this concern; the Bill would require employers to submit Forms W2 and 1099-MISC to the IRS by mid-February in most cases. Joint Committee on Taxation, 'Description of the Chairman's Mark of a Bill to Prevent Identity Theft and Tax Refund Fraud' (JCX-108-15), September 11, 2015.

As to income reporting, the IRS depends on third-party verification to verify accuracy. Under the current approach, the EITC refund is typically issued before the IRS has received and processed all third-party information including Forms W2 and 1099. Thus, if the taxpayer has made a mistake in calculating income, or has underreported income (whether inadvertently or intentionally), the IRS is left playing catch-up after the return has been processed. To the extent that the IRS cannot independently verify income, we must accept any accompanying EITC overclaim as an inevitable form of taxpayer noncompliance, just as we accept that cash business noncompliance is relatively high.

Moreover, information reporting as to residency is not as simple. The IRS needs to modernise; it needs to invest in upgrading its technology and database sharing, particularly with other social benefit programs administered by states. Along these lines, the Urban Institute undertook a recent case study using data from Florida ‘to explore whether SNAP data could be used to improve EITC enforcement and whether SNAP data can provide information that would help the IRS identify EITC-eligible workers who have not claimed the tax credit.’¹⁸³ There is far from perfect overlap between SNAP recipients and EITC eligible claimants: SNAP includes an asset test, whereas EITC does not. Approximately one-half of SNAP recipients have children, and approximately one-half of those who have children have earned income.¹⁸⁴ Of the Florida data set showing overlap between SNAP recipients and EITC claimants, the SNAP data verified the EITC relationship test in 99% of cases.¹⁸⁵ However, the available SNAP data was ‘insufficient’ to verify the EITC residency test in 20% of the cases.¹⁸⁶ The study concluded that ‘the information that applicants report to SNAP is not detailed enough to conclusively verify eligibility, but the data could help the IRS spot potential overclaims worthy of further examination as part of the audit process.’ Slowing down EITC refunds would aid the Service in maximizing these verification opportunities.

7. CONCLUSIONS

The EITC is overly complex, is not administered effectively, and has a high improper payment rate. The EITC process will never be perfect. It can’t be: it is impossible to design a benefits program with a 100% take up rate and a 0% noncompliance rate. The politicians and taxpaying population must accept that reality, especially as one of the ‘costs’ of administering a benefits program on the cheap.

Competing pressures are at play. If enforcement is too low, noncompliance may increase. But enforcement costs money, and one of the most attractive features of the EITC is its low administrative overhead relative to program size.

¹⁸³ Elaine Maag, Michael Pergamit, Devlin Hanson, Caroline Ratcliffe, Sara Edelstein and Sarah Minton, ‘Using Supplemental Nutrition Assistance Program Data in Earned Income Tax Credit Administration: A Case Study of Florida SNAP Data Linked to IRS Tax Return Data’, Urban Institute (Sept 2015) <<http://www.taxpolicycenter.org/sites/default/files/alfresco/publication-pdfs/2000438-using-snap-data-in-eitc-administration.pdf>> accessed 21 October 2016.

¹⁸⁴ Ibid 6.

¹⁸⁵ Ibid 10.

¹⁸⁶ Ibid. The SNAP data is considered ‘insufficient’ in cases in which ‘the tax filer(s) and the child receive benefits in the same case but the benefit receipt does not cover a six-month period or there are more than 10 months between benefit receipts.’ This illustrates one of the evidentiary challenges of the residency test.

Increasing due diligence requirements on all types of filers would increase the burden on low-income taxpayers. But the additional layers of due diligence recommended in this article would protect taxpayers, both from themselves and from their preparers. Given the amount of money at stake, it is not unreasonable to increase the burden, especially on those who are claiming qualifying children for the first time.

The IRS must continue to develop initiatives to improve the administration of the EITC; doing so may be key to the continued political viability of what is a very important anti-poverty program. Those who benefit from this program deserve this protection. Time and again, the program has been shown to improve the lives of children. The US cannot afford to lose those benefits because of the political fallout from inept administration of this program.

Taxpayer rights in Australia twenty years after the introduction of the Taxpayers' Charter

Duncan Bentley¹

Abstract

Twenty years after the introduction of the Australian Taxpayers' Charter this article reviews its purpose, its development and its sufficiency to meet future challenges. It outlines, in the context of developments in compliance theory, the Charter's important role in developing trust between taxpayers and the Australian Taxation Office. However, the article outlines future challenges and identifies the growing importance of research into a balanced legal and compliance framework. The article sets out a legal rights pyramid to balance the compliance pyramid and argues that it creates stability for the system and makes a trust based compliance environment more likely.

Keywords: Australian Taxpayers' Charter; taxpayer rights; tax administration; tax compliance; slippery slope framework

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1. INTRODUCTION

Twenty years ago, I set out a framework for formulating a Taxpayers' Charter of Rights.² My proposition was that the nature of any charter is complex and the final product will always depend both on what the drafters are trying to achieve and how they go about achieving it. The Australian Taxpayers' Charter (the Charter) has probably achieved far more than its drafters anticipated. Its nature and content has also gone beyond initial expectation.³

However, its effect remains constrained by its formulation as an administrative statement. As a standard bearer for the infusion of a service culture into the tax administration; as a support for the effective implementation of increasingly sophisticated compliance frameworks; as a basis for engaging more effectively with taxpayers in how the tax administration should operate: it has undoubtedly fulfilled its purpose. And that may have been quite adequate for the Australian tax system.

The Charter has done little to extend or clarify legal rights. That is not to underplay its role in developing 'soft law'.⁴ But its function was, at most, to articulate the administrative operation of legal rights. Any extension of legal rights was specifically excluded at its introduction.

Twenty years on, is its current role still sufficient? Or should there be consideration of a different approach?

First, I outline the context for the introduction of the Charter and explore the problem it was trying to solve as one of a range of policy measures. Second, I describe its nature and how it has developed as an important element of a stable system to fulfil its objectives: first as part of the tax compliance framework; and second as part of the legal framework. Third, I outline some of the pressing challenges to tax policy and administration, and use two current challenges to illustrate how these might develop in light of the experience in other jurisdictions and undermine current stability. Fourth, I set out a framework, in which the Charter plays an integral part, to address these challenges.

2. THE INTRODUCTION OF THE CHARTER

In 1990, the OECD noted the importance of mutual trust between taxpayers and the tax administration.⁵ The OECD argued that it would be more likely 'if the taxpayers' rights are clearly set out and protected'.⁶ This built on a growing body of compliance literature,⁷ which was a driver for the introduction of a self-assessment system in

² D Bentley, 'Formulating a Taxpayers' Charter of Rights: Setting the Ground Rules' (1996) 25 *Australian Tax Review* 97.

³ D Bentley, 'The Taxpayers' Charter: More Than a Mission Statement' (1995–96) 4 *Taxation in Australia Red Edition* 259.

⁴ D Bentley, 'The rise of "Soft Law" in tax administration: Good news for taxpayers?' (2008) 14 *Asia-Pacific Tax Bulletin* 32.

⁵ OECD, *Taxpayers' Rights and Obligations* (1990) 7.

⁶ *Ibid.*

⁷ A comprehensive analysis and review of the research to the late 1980s can be found in JA Roth, JT Scholz and AD Witte (eds), *Volume 1 - Taxpayer Compliance: An Agenda for Research* (University of Philadelphia Press, 1989) and JA Roth and JT Scholz (eds), *Volume 2 - Taxpayer Compliance: Social*

Australia.⁸ The introduction in Australia of partial self-assessment from 1 July 1986 and full self-assessment for companies and superannuation funds from 1 July 1989 highlighted areas of uncertainty.⁹ A system of binding public and private rulings was introduced in 1992 to make it easier for taxpayers to comply.¹⁰

The Joint Committee of Public Accounts (JCPA), a joint parliamentary committee which oversees the lawfulness, efficiency and effectiveness with which Commonwealth agencies use public monies, reported in November 1993 on the tax assessment system.¹¹ In light of the introduction of self-assessment and the importance of encouraging voluntary compliance, it recommended the introduction of a taxpayers' charter of rights and obligations to redress 'the balance of authority between the ATO and the taxpayer'.¹² It is a delicate balance that had framed the thinking of earlier reviews of the tax system, particularly flowing from the 1975 Asprey Report.¹³

The Asprey Report and later reviews have consistently framed their recommendations based on the premise that a tax system should operate in accordance with the principles of equity and fairness, certainty and simplicity, efficiency, neutrality and effectiveness.¹⁴ In order to be seen to give effect to these principles and to develop an acceptable basis for the self-assessment system, the ATO was an early adopter of the Ayres/Braithwaite model and has sought to adapt it to reflect developments in compliance research and practice over the years.¹⁵

It is in this context that the ATO released a Discussion Draft Taxpayers' Charter in 1995. It was an administrative charter based on the examples of similar charters in Canada, New Zealand, the United Kingdom and the United States. However, taxpayer representative groups remained unconvinced that an administrative charter would achieve the JCPA aim for the ATO to redress the balance of authority between the ATO and taxpayers.

Science Perspectives (University of Philadelphia Press, 1989). Research in the early 1990s is reviewed in J Wickerson, 'The Changing Roles of Taxpayer Audit Programs: Some Recent Developments in the Australian Taxation Office' (1994) 4 *Revenue Law Journal* 125; J Hasseldine, 'How do Revenue Audits Affect Taxpayer Compliance?' (1993) 47 *IBFD Bulletin* 424; V Tanzi and P Shome, 'A Primer on Tax Evasion' (1994) 48 *IBFD Bulletin* 328; and S James and C Alley, 'Tax Compliance, Self-Assessment and Tax Administration' (2002) 2(2) *Journal of Finance and Management in Public Services* 27.

⁸ Described in Auditor-General, *Audit Report No 3 2001–2002, Performance Audit, The Australian Taxation Office's Administration of Taxation Rulings* (2001) 173ff.

⁹ Ibid 178.

¹⁰ Taxation Laws Amendment (Self Assessment) Act 1992 (Cth).

¹¹ Joint Committee of Public Accounts, Parliament of Australia, *Report No 326 An Assessment of Tax, A Report on an Inquiry into the Australian Taxation Office*, (1993).

¹² Ibid 308.

¹³ Taxation Review Committee (Asprey Report), *Full Report* (1975) 13.

¹⁴ Asprey Report, *ibid*, 13 and see further the analysis in CR Alley and D Bentley, 'Remodelling Adam Smith's Tax Design Principles', (2005) 20 *Australian Tax Forum* 579.

¹⁵ See I Ayres and J Braithwaite, *Responsive Regulation: Transcending the deregulation debate* (Oxford University Press, 1992), and its extension in, for example, V Braithwaite (ed), *Taxing democracy: Understanding tax avoidance and evasion* (Ashgate, 2003); R Whait, 'Developing risk management strategies in tax administration: the evolution of the Australian Tax Office's compliance model' (2012) 10(2) *eJournal of Tax Research* 436; S Hamilton, 'New dimensions in regulatory compliance – building the bridge to better compliance' (2012) 10(2) *eJournal of Tax Research*, 483; and OECD, *Co-operative Compliance: A Framework* (2013), DOI: 10.1787/9789264200852-en.

There was much debate as to whether it should be legally enforceable.¹⁶ A range of stakeholders expressed concern that the rights and obligations in the Taxpayers' Charter were expressed in the form of a service charter and this formulation would undermine the operation of existing legal rights. First, informal articulation of legal rights would water down taxpayers' knowledge and understanding of the extent of their rights at law. Second, listing unenforceable rights was felt to be potentially meaningless.

However, as I pointed out at the time, there are three main approaches a taxpayers' charter can take.¹⁷

1. An administrative charter, which identifies, protects and enhances the ordinary rights of most taxpayers as they seek to comply with their obligations under the tax law. It focuses on the daily interface between taxpayers and the tax administration and seeks to improve the quality of interaction through 'collaborative capacity building'.¹⁸ It does not preclude and often reflects rights protected by separate legislation.
2. A legislative charter, which operates to protect taxpayers against the breach of specified legal rights that relate to the operation and application of the tax law.
3. A combination of legislated rights supplemented by an administrative charter, which is formulated and implemented as a complete and integrated set of rules. The aim is to protect taxpayers' basic legal rights in the context of an effective compliance framework so that the two are mutually reinforcing.

Similar to most jurisdictions at the time, the proposed Australian Charter was administrative in nature, but it was integral to the ATO's application of responsive regulatory theory. This meant that it was a critical component of the ATO's policy approach to improve taxpayer compliance and assure the integrity of the Australian tax system.

In part it was framed by history. It was a clear break from the extended period of tax avoidance and evasion that occurred through the 1970s and 1980s, which was seen by the ATO as a failure of the system to respond to blatant taxpayer activity.¹⁹ A new approach required a robust tax system (introduced progressively from 1985), supported by responsive regulation (the new compliance model), and effective administrative regulation reinforced by legislation upheld by the courts (a combination of self-assessment, a comprehensive binding rulings system and effective and enforceable anti-avoidance provisions).²⁰ An administrative Charter was therefore

¹⁶ The debate is described and analysed in Bentley, above n 2; and Bentley, above n 3.

¹⁷ Bentley, above n 2, 100.

¹⁸ J Braithwaite, 'The Essence of Responsive Regulation' (2011) 44(3) *UBC Law Review* 475.

¹⁹ Documented colourfully by former Commissioner of Taxation, Trevor Boucher in *Blatant, Artificial and Contrived: Tax schemes of the 70s and 80s* (ATO, 2010).

²⁰ Ibid ch 61–62; R Krever, 'Avoidance, Evasion and Reform: Who Dismantled and Who's Rebuilding the Australian Income Tax System' (1987) 10(2) *University of New South Wales Law Journal* 215; V Braithwaite and J Braithwaite, 'Managing Taxation Compliance: The Evolution of the Australian Taxation Office Compliance Model', in M Walpole and C Evans (eds), *Tax Administration in the 21st Century* (Prospect Media Pty Ltd, 2001) 215.

introduced from 1 July 1997 following systematic preparation, a review of previous experience and widespread consultation.²¹

3. THE NATURE OF THE CHARTER AND ITS DEVELOPMENT

3.1 The tax compliance framework

In 2004, the Australian National Audit Office (ANAO) undertook a Performance Audit of the Taxpayers' Charter (ANAO 2004).²² The role of the ANAO is 'to provide the Parliament with an independent assessment of selected areas of public administration, and assurance about public sector financial reporting, administration, and accountability'.²³ In the context of the ATO, it ensures that, 'The ATO uses compliance strategies to help optimise collections and to instil confidence in the community that the taxation system is operating effectively'.²⁴

ANAO 2004 noted that the Charter 'sets out the way the ATO will conduct itself when dealing with taxpayers'.²⁵ Importantly, it found that the ATO developed and used the three interlinked tools of the Charter, the ATO Compliance Model and its Brand Management to develop and instil confidence in the tax system.²⁶ The Charter uses the basic concepts of responsive regulation to provide the sense for taxpayers that they are being treated fairly. It was developed in conjunction with a taxpayer-focused service model using an increasingly risk-based approach towards taxpayers based on their behaviour. The Brand Management provided an effective communication strategy both to present a consistently professional approach to taxpayer and tax agent engagement and to reinforce the messaging of the twin pillars of the Charter and the Compliance Model. By 2004 the ANAO found that the Charter was indeed integral to the ATO's approach to compliance, although, unsurprisingly for the introduction of such a significant cultural change process, there were still areas requiring further systematic integration, improved quality assurance and performance measurement and evaluation.²⁷

The ATO adoption of responsive regulation means that much of its focus is on influencing taxpayer behaviour, engaging with taxpayers and 'nurturing willing participation'. The compliance model is based on an understanding that there are significant contextual factors affecting taxpayer compliance as shown in the first diagram at Figure 1. The ATO recognises that it needs to help to shape the impact of these contextual factors on how taxpayers interact with the tax system, if it is to address the cooperative capacity building depicted in the pyramid, shown in the second diagram at Figure 1. As noted by Braithwaite, there is substantial theory underpinning and supporting the responsive regulatory pyramid, which nonetheless is

²¹ Described in M McLennan, 'The Principles and Concepts in the Development of the Taxpayers' Charter' (2003) 32 *Australian Tax Review* 22.

²² The Auditor-General, *Audit Report No 19 2004-05 Performance Audit: Taxpayers' Charter*, Australian Taxation Office (2004) (ANAO 2004).

²³ See ANAO, <<http://www.anao.gov.au/about-us>> at 11 June 2016.

²⁴ ANAO, above n 22, 13.

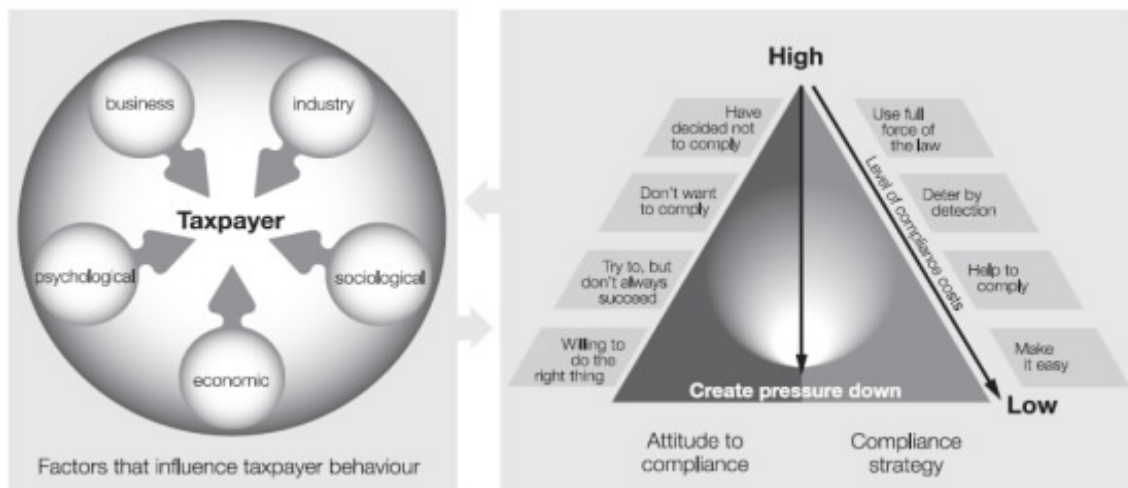
²⁵ Ibid.

²⁶ Ibid 14.

²⁷ Ibid 23ff.

a useful tool to capture the essence of a ‘strengths based’ approach to regulation that supports capacity building.²⁸

Figure 1²⁹



The ATO has developed a comprehensive strategy to implement a strengths based approach to its regulation.³⁰ The pyramid in Figure 1 demonstrates the starting point and allocation of most significant resources is at the base of the pyramid. Here the focus is on improving the attitude to compliance (and reducing associated compliance costs) and maintaining the strongest possible engagement to engender cooperation between the tax administration and taxpayers. The Charter provides the norms (taxpayer rights and obligations) underpinning that cooperation and the educative approach used in the first escalatory steps up the pyramid. The aim is to educate, build capacity and move taxpayers back down the pyramid. It is only for taxpayers that do not wish to comply that punitive approaches are taken reluctantly once dialogue and education has failed.³¹

Deterrence increases as a taxpayer moves up the pyramid, but the broad level of voluntary compliance among taxpayers means that the bulk of ATO resources can be applied to servicing, reinforcing and educating taxpayers. Much smaller levels of resources are committed to deterrence and punishment, but with significant publicity attached to emphasise the Charter values of justice and fairness and paying tax as ‘the right thing to do’. The combination of the Charter values and the practical steps taken

²⁸ Braithwaite, above n 18, 480. See further on the development of acceptance of the model and early capacity building within the ATO, RB Whait, ‘Let’s talk about tax compliance: Building understanding and relationships through discourse’ (2015) 13 *eJournal of Tax Research* 130 and M D’Ascenzo, ‘Modernising the Australian Taxation Office: Vision, people, systems and values’ (2015) 13 *eJournal of Tax Research* 361.

²⁹ Available at <<https://www.ato.gov.au/Print-publications/Developing-effective-compliance-strategies/?page=5>> at 11 June 2016.

³⁰ See, for example, *Guide for compliance officers: Developing effective compliance strategies* (ATO, 2009); available at <<https://www.ato.gov.au/>> at 11 June 2016.

³¹ Analysed in Braithwaite, above n 18, 482.

by the ATO at every stage powerfully reinforce voluntary compliance through legitimating the tax system.

For example, the penalty framework has been carefully integrated with the self-assessment system, particularly the rulings regime, to encourage taxpayers to enter into early dialogue with the ATO. This positive reinforcement to move taxpayers back down the pyramid can be seen in the combination of the law and ATO rulings, which both give significant discretion to the Commissioner and his staff in applying penalties and interest.³² Wilful non-compliance is dealt with severely, but every effort is made to encourage back down the pyramid those who don't want to or don't care about complying.

Figure 2 sets out the business model designed to take a risk-based approach to managing compliance in a self-assessment environment.

Figure 2³³



The ATO has embraced recent research supporting its model, which has demonstrated the importance of high levels of both legitimate power and reason-based trust as the key determinants of effective tax compliance.³⁴ A focus on developing trust and strong legitimacy is reflected in the next stage of the ATO's implementation of responsive regulation: *Reinventing the ATO*,³⁵ which the Commissioner of Taxation introduces by saying that 'Our blueprint for reinvention reflects what the community wants from the ATO – the kind of experience they want to have when they participate in the tax and super systems'. Concomitant with the effort to develop high levels of trust is recognition of the importance of demonstrating: vigorous enforcement to ensure tax compliance; whole of government detection; and punishment of tax evasion.

³² See, for example, Part 4–25 Schedule 1 Tax Administration Act 1953 (Cth) and Practice Statement PAS LA 2014/4. This is demonstrated further in the educative process demonstrated in ATO digital and other taxpayer engagement with the introduction of the new administrative penalty regime for Self-Managed Superannuation Funds from 1 July 2014: see <<https://www.ato.gov.au/Super/Self-managed-super-funds/administerin-and-reporting>> at 11 June 2016.

³³ Ibid 7.

³⁴ E Kirchler, E Hoelzl and I Wahl, 'Enforced Versus Voluntary Tax Compliance: The "Slippery Slope" Framework' (2008) 29 *Journal of Economic Psychology* 210; and E Hofmann, K Gangl, E Kirchler and J Stark, 'Enhancing Tax Compliance through Coercive and Legitimate Power of Tax Authorities by Concurrently Diminishing or Facilitating Trust in Tax Authorities' (2014) 36(3) *Law & Policy* 290.

³⁵ See <<http://reinventing.ato.gov.au/>> at 11 June 2016.

The focus on the exercise of legitimate authority and coercive power can be seen in a range of recent activities including the high profile Project Wickenby, which was a cross-agency task force established in 2006 to fight tax evasion, avoidance and crime; its successor, the Serious Financial Crime Taskforce to combat international tax evasion; and the publicity afforded to global cooperation including the ATO to combat tax avoidance, evasion and organised tax crime. The Government has supported ATO efforts with a range of measures, including the broadening of the general anti-avoidance provisions to combat an expanded definition of multinational tax avoidance,³⁶ which has led to a four-year International Structuring and Profit Shifting compliance program targeting companies that have undertaken international restructures or have significant cross-border arrangements.³⁷

The aim is to reinforce and develop reason-based trust at the same time as exercising legitimate power to enforce compliance with the law.³⁸ The result is to move from an antagonistic climate to a service climate based on well-defined rules and standards.³⁹ Taxpayers voluntarily comply because they perceive the tax authorities as largely supportive and competent in a stable environment. Single instances of poor service do not destroy the relationship as there is mutual interest in continuing to make the system work effectively. However, a 'disadvantage of a service climate may be the bureaucracy entailed in producing elaborate written rules as well as complex procedures to treat taxpayers fairly, which results in substantial administrative overheads'.⁴⁰

Once the service climate is well-established, Gangl, Hofmann and Kirchler suggest that the next step is to move to a confidence climate where implicit trust prevails based on automatic cooperation and trust.⁴¹ Habitual compliance is founded in shared moral values and a commitment to society that is reflected in compliance with the spirit of the law, removing the need for 'specific and complicated tax legislation'.⁴² While, the authors acknowledge that a confidence climate may be considered too optimistic, progress towards it is engendered through the stability and consistent practice of a service-based approach.⁴³

The ATO has grounded its development of the Charter deeply in its theoretical framework. The Charter is represented as comprising the norms and values of the compliance framework and the way the ATO operates. This is consistent with both the theories underlying responsive regulation and the 'Slippery Slope Framework'. The theories emphasise the importance of a service climate that establishes legitimate

³⁶ The Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015 (Cth) enacted on 11 December 2015.

³⁷ *ATO Corporate Plan 2015–19*, 8, available at <<https://www.ato.gov.au>> at 11 June 2016.

³⁸ K Gangl, E Hofmann and E Kirchler, 'Tax authorities' interaction with taxpayers: A conception of compliance in social dilemmas by power and trust' (2015) 37 *New Ideas in Psychology* 13, Section 4. See further the concept of 'justified trust' by the ATO in a taxpayer's compliance, where, for example, an ATO revenue performance criterion is the 'Tax Assured – Proportion of the tax base where the ATO has justified trust that it is accurate', *ATO Corporate Plan 2016–17*, available at <<https://www.ato.gov.au>> at 24 September 2016.

³⁹ Gangl, Hofmann and Kirchler, *Ibid* Section 5.

⁴⁰ *Ibid*.

⁴¹ *Ibid*.

⁴² *Ibid*.

⁴³ *Ibid* Section 6.

authority: service builds trust as it supports taxpayers and builds their capacity to comply with the law. The theories also encourage the exercise of power both to enforce compliance in the interests of justice and fairness and to deter non-compliance.

James, Murphy and Reinhart in 2004 argued that the Charter ‘has moved on from a simple list of principles and become more embodied in the culture of the ATO’.⁴⁴ Over a decade later, the Charter is still clearly seen by the ATO as a fundamental component of its culture and norms. The outcomes from the Inspector-General of Taxation 2015/16 review of the Charter will shed further light on whether and to what extent the ATO’s perspective is shared by taxpayers.⁴⁵

3.2 The legal framework

Australia opted for an administrative taxpayers’ charter. There is no legislative charter and neither is there a combination of legislated rights supplemented by an administrative charter formulated and implemented as a complete and integrated set of rules. Nonetheless, there is legislation that protects taxpayers’ basic legal rights. The question is whether the compliance and legal frameworks are mutually reinforcing.

Australia has a number of primary legal rights at the international or constitutional level that have high level but very limited application to tax matters. For example, although Australia is signatory to a range of international treaties, most do not relate to taxation and, where they do, they provide a margin of appreciation limiting the treaty’s interference with a state’s right to tax.⁴⁶ Given that international instruments are only given force if implemented by domestic legislation and do not prevent the Commonwealth from limiting rights, their force is ‘generally only through the interpretation of statutes that are clear or unambiguous’.⁴⁷ However, the Human Rights Commission actively promotes and reports on compliance with the human rights treaties to which Australia is signatory and this work helps to inform changes to domestic legislation.⁴⁸

Under Section 51(ii) of the Constitution, the Commonwealth has the power to make laws with respect to taxation provided it does not discriminate between States or part of States. When the Commonwealth increased income tax rates and provided grants to reimburse and compensate the States on the proviso they ceased to levy their own income taxes under Section 96 of the Constitution, this action was unsuccessfully challenged by the States both in 1942 and subsequently in 1957 in the *Uniform Tax*

⁴⁴ S James, K Murphy and M Reinhart, ‘The Taxpayers’ Charter: A Case Study in Tax Administration’ (2004) 7(2) *Journal of Australian Taxation* 336, 356.

⁴⁵ Inspector-General of Taxation, *Review into the Taxpayers’ Charter and taxpayer protections*, <<http://www.igt.gov.au>> at 11 June 2016.

⁴⁶ See, for example, Marrakesh Agreement Establishing the World Trade Organization, Legal instruments – Results of the Uruguay Round, vol 1, (1994) 33 *ILM* 1125, 1144. See further <<https://www.wto.org>> at 11 June 2016 and JH Jackson, *The World Trading System: Law and Policy of International Economic Relations*, 2nd ed (MIT Press, 1997). Discussed in AC Warren Jr, ‘Income Tax Discrimination Against International Commerce’ (2001) 54 *Tax Law Review* 131.

⁴⁷ *Dietrich v The Queen* (1992) 177 CLR 292, 305. The effect of international law on Australian domestic legislation is discussed at length in Australian Law Reform Commission (ALRC), *Traditional Rights and Freedoms – Encroachment by Commonwealth Laws*, Report 129 (2015) [1.9] and [2.35ff], available at <<http://www.alrc.gov.au>> at 11 June 2016.

⁴⁸ This process and the work of the Human Rights Commission is described on its website <<https://www.humanrights.gov.au/about/what-are-human-rights>> at 11 June 2016.

Cases.⁴⁹ As a result, income tax is levied by the Commonwealth and any taxpayer rights in respect of income, consumption and other Commonwealth taxes derive from Commonwealth legislation.⁵⁰

None of the five explicit Constitutional rights relate directly to individual taxation.⁵¹ There have been cases brought under Section 99 of the Constitution, which forbids the Commonwealth to prefer one State over another in matters of trade, commerce or revenue, to challenge disparities in effective tax rates,⁵² but recognises causes of action for individual taxpayers are extremely unlikely.⁵³ Recently implied rights relate to freedom of speech and have limited application in income tax cases.⁵⁴ This means that the traditional scrutiny mechanisms that ensure Australian laws are compatible with fundamental rights and principles are less meaningful in the context of tax law.⁵⁵

That said, the Acts Interpretation Act 1901 (Cth) provides the courts with guidance on interpretation of legislation. This is based upon the constitutional separation of powers and, as then Justice Brennan said,⁵⁶ ‘Judicial review is neither more nor less than the enforcement of the rule of law over executive action; it is the means by which executive action is prevented from exceeding the powers and functions assigned to the executive by law and the interests of the individual are protected accordingly’. The Constitution is therefore supplemented by a range of traditional rights and freedoms protected under the common law, which provides a firm basis for robust judicial statutory interpretation.⁵⁷

Section 15AA requires a purposive interpretation to give effect to the purpose or object of the Act. The purpose is framed in the context of the common law and, particularly in respect of laws limiting rights; the courts pay close regard to the principle of proportionality.⁵⁸ Section 15AB specifically allows the use of extrinsic materials by the courts to help determine the purpose of legislation, where the ordinary

⁴⁹ *South Australia v Commonwealth* (1942) 65 CLR 373 and *Victoria v Commonwealth* (1957) 99 CLR 575.

⁵⁰ This also largely limits the application of the Victorian and ACT Bills of Rights to protection of broader rights relevant to the application of State tax legislation, for example, the right to a fair hearing and rights in criminal proceedings: Charter of Human Rights and Responsibilities Act 2006 (Victoria); and Human Rights Act 2004 (Australian Capital Territory). See further *Momcilovic v The Queen* (2011) 245 CLR 1.

⁵¹ The right to vote (s 41); protection against acquisition of property on unjust terms (s51(xxxi)); the right to trial by jury (s 80); freedom of religion (s 116) and prohibition of discrimination on the basis of in which State a person is resident (s 117).

⁵² For example, *Permanent Trustee* (2004) 220 CLR 388.

⁵³ See the analysis of the approach to the High Court’s reasoning in A Simpson, ‘The High Court’s Conception of Discrimination: Origins, Applications and Implications’ (2007) 29 *Sydney Law Review* 263.

⁵⁴ *Australian Capital Television Pty Ltd v Commonwealth* (1992) 177 CLR 106.

⁵⁵ The robustness of these mechanisms is the subject of ALRC, above n 47.

⁵⁶ *Church of Scientology v Woodward* (1982) 154 CLR 25 at 70.

⁵⁷ Described in a speech by Chief Justice Robert French, ‘The Common Law and the Protection of Human Rights’ (Speech delivered at the Anglo Australasian Lawyers Society, Sydney, 4 September 2009). See also G Williams and D Hume, *Human Rights under the Australian Constitution*, 2nd ed (Oxford University Press, 2013) 33.

⁵⁸ See G Huscroft, B Miller and G Webber (eds), *Proportionality and the Rule of Law: Rights, Justification, Reasoning* (Cambridge University Press, 2014) and the analysis in ALRC, above n 47 [2.62ff].

meaning of a provision is not clear. Reports of bodies such as the Human Rights Commission and treaties or other international agreements are specifically included as material that may be considered by the courts in such circumstances.⁵⁹

Despite the absence of explicit rights, the effect of the Constitution and other statutes, as interpreted by the courts in the light of the common law, does therefore ensure that taxes must be imposed by law.⁶⁰ This satisfies the basic requirement that tax rules should not be arbitrary.⁶¹ Tax laws must be enacted in accordance with the Constitutional requirements for a valid law and are therefore published and transparent; tax laws must be understandable; the courts will interpret legislation so that it is not contradictory; and the courts will interpret tax laws so that they can be obeyed.⁶²

Tax law, because of its fiscal nature, is often retrospective, although there is a presumption that accrued rights will be retained except where expressly altered and that retrospectivity must be intentional.⁶³ The politics that surrounds any change to the tax law operates as a significant check on the exercise of government power.⁶⁴ The Government is therefore aware of the potential impact of retrospective legislation and this is supported by scrutiny processes in the Senate.⁶⁵ Consequently, the Australian Treasury, which is responsible for the formulation of tax policy, undertakes significant stakeholder consultation before new laws are implemented, especially where the date of effect is retrospective.⁶⁶ The Australian Law Reform Commission (ALRC) notes that, while in most cases the Government makes sufficiently detailed announcements of changes to be enacted and follows that with legislative enactment within a reasonable time, in some cases the time taken to make changes and the scope of those changes is contested.⁶⁷

Legal rights on which taxpayers may rely are found either in the laws governing the judicial and administrative process or in the tax laws themselves. These laws may be interpreted so as not to conflict with other laws protecting the individual, such as the

⁵⁹ For further examination of the role of the courts in interpretation, see the speeches by the Judges of the Australian High Court, available at <<http://www.hcourt.gov.au>> at 11 June 2016 and, in particular, Justice Crennan, *Statutes and the Contemporary Search for Meaning*, 1 February 2010.

⁶⁰ The history of the principle is analysed in J Spigelman, 'The Principle of Legality and the Clear Statement Principle' (2005) 79 *Australian Law Journal* 769, 775.

⁶¹ D Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (Kluwer Law International, 2007) 220.

⁶² These issues were specifically addressed in relation to capital gain and loss provisions of the Income Tax Assessment Act 1936 (Cth) in *FCT v Cooling* (1990) 22 FCR 42 and *Hepples v FCT* (1990) 22 FCR 1. See generally, *Coco v The Queen* (1994) 179 CLR 427, 437.

⁶³ *Repatriation Commission v Keeley* (2000) 98 FCR 108 at 123 and *MacCormick v FCT* (1984) 158 CLR 622.

⁶⁴ C Alley, D Bentley and S James, 'Politics and Tax Reform: A Comparative Analysis of the Implementation of a Broad-Based Consumption Tax in New Zealand, Australia and the United Kingdom' (2015) 15 *Revenue Law Journal* <<http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1244&context=rlj>> at 11 June 2016.

⁶⁵ Standing Order 44.

⁶⁶ See the discussion of how this process might be improved further in Australian Government, *Re:think, Tax Discussion Paper*, (2015) ch 11, available at <<http://bettertax.gov.au/publications/discussion-paper/>> at 11 June 2016.

⁶⁷ ALRC, above n 47, [13.89ff].

Racial Discrimination Act 1975 (Cth),⁶⁸ the Sex Discrimination Act 1984 (Cth), the Disability Discrimination Act 1992 (Cth) and the Age Discrimination Act 2004 (Cth).⁶⁹

Practice has tended to follow a process of amending offending provisions rather than recognising an individual right of challenge to legislation. For example, in 2007, the Human Rights and Equal Opportunity Commission noted in its report, *Same-Sex: Same Entitlements* that 'It is clear that same-sex couples and families are denied access to a range of tax offsets and concessions which are available to opposite-sex de facto couples and parents'.⁷⁰ The report recommended amending the offending legislation, outlined in detail where the problems lay across a number of Acts, including taxing Acts, and set out how they should be amended to ensure compliance with the Sex Discrimination Act.⁷¹ Reforms were enacted in 2008.⁷²

In Australia, as in any jurisdiction, tax law operates within the framework of the legal system and the operation of the rule of law. Taxpayers therefore have many rights that flow from the application of the law, which are not peculiar to taxation. Some are embedded in legislation and others arise under the common law. Examples include the operation of the court system, rights embedded in the criminal law, rights to legal aid, rights under administrative law, rights under family law, and rights at equity.

Specific legal rights exist in relation to each aspect of the tax process. However, what is important to note is that there is a combination of law and what is termed 'soft law', which I describe as pragmatic rights. Pragmatic rights are administrative practices that comprise good practice and non-legal frameworks, which often can bring greater clarity and meaning to the law.⁷³ For example, the extension by the Commissioner, as an administrative discretion, of client legal privilege to accountants' working papers;⁷⁴ and the Commissioner's self-imposed restraint during audits as set out in the ATO's published administrative guidelines.⁷⁵

Within each step of the tax process, taxpayers have legal rights embedded in the tax legislation. Some reflect the broader legal process but are tailored to tax matters, such as objection, review and appeal rights. The tax legislation sets out mechanisms and the detailed processes to implement the tax system: for example, the number of days within which an objection must be made. In some areas, such as collection and

⁶⁸ The Racial Discrimination Act is a good example of one of the few occasions where an international human rights treaty (the Convention on the Elimination of Racial Discrimination 1969) has been legislated in Australia

⁶⁹ Discussed in N Wilson-Rogers and D Pinto, 'Tax Reform: A Matter of Principle? An Integrated Framework for the Review of Australian Taxes' (2009) 7 *eJournal of Tax Research* 72, 77.

⁷⁰ Human Rights and Equal Opportunity Commission, *Same-Sex: Same Entitlements, National Inquiry into Discrimination against People in Same-Sex Relationships: Financial and Work-Related Entitlements and Benefits* (2007) [8.15].

⁷¹ Ibid.

⁷² Same-Sex Relationships (Equal Treatment in Commonwealth Laws--Superannuation) Act 2008 (Cth).

⁷³ Discussed in Bentley, above n 4 and D Bentley, 'International Constraints on National Tax Policy' 30(11) (16 June 2003) *Tax Notes International* 1127.

⁷⁴ See M Italia, 'Taxpayers' Legal privilege in the US and New Zealand: Lessons for the UK and Australia' (2014) 5 *British Tax Review* 642 and *Guidelines to Accessing Accounting Advisors' Papers*, available at <<https://www.ato.gov.au>> at 11 June 2016.

⁷⁵ See, for example, Audit Statistical Sampling Guidelines, Access and Information Gathering Manual, available at <<https://www.ato.gov.au>> at 11 June 2016.

enforcement, there are significant areas for the Commissioner to exercise discretion. The advantage of this is that the more stringent requirements of, for example, the Criminal Code are not applied to an administrative process. However, a wider discretion means that there is also more limited right of review for the taxpayer.

The tax law cannot set out every step of every process. Administrative rules that can change as the context changes ensure that the law and the system can operate effectively. This goes to the heart of the issue as to whether there is a gap in legal protection. In administering the tax law, the actions and decisions of the Commissioner are subject to both legal and merits review under the Taxation Administration Act 1953 (Cth) (TAA 53), and in specific sections of the relevant taxing acts. However, there is very limited legal review under the Administrative Decisions (Judicial Review) Act 1977 (Cth) (AD(JR) Act), except for serious breaches of procedural fairness or natural justice in the making of a decision. The latter might apply where there has been a breach of the requirement to provide reasons for certain decisions, for example, a decision not to remit the general interest charge or a decision to exercise access powers.⁷⁶

The rights of review under the AD(JR) Act deal with the legality of a decision by the Commissioner or their representative. Schedule 1(e) of the AD(JR) Act excludes decisions reviewable on their merits in other forums, such as a decision connected with the making or amending of assessments or the calculation of tax or duty. The onus of proving bad faith or improper purpose is the taxpayer's and is a question of fact. Very few actions succeed.

There is not, therefore, an avenue for judicial review of the decision-making process or the exercise of discretion, which provides meaningful recourse for taxpayers. Instead, the Charter refers taxpayers to internal ATO review mechanisms and to the Office of the Inspector-General of Taxation. Both are administrative avenues for review.

The office of Inspector-General of Taxation (IGT), an independent statutory agency,⁷⁷ reviews, investigates and provides advice to the government on the administration of the tax system for its improvement and to identify systemic issues. In 2015, it took over the complaint handling function of the Commonwealth Ombudsman in relation to matters of tax administration.⁷⁸ The scope of the complaint handling powers is very broad and includes extensive investigatory powers. It also includes the right to refer questions to the Administrative Appeals Tribunal or to recommend that a principal officer in the ATO makes such a referral. The IGT's complaint handling role is included in the report to the Assistant Treasurer, which is tabled in Parliament.

The IGT therefore provides an important check on the power of the ATO. The combination of the IGT's review and reporting on broader and systemic issues of tax administration with its complaint handling function ensures that it has a clear view of those areas of most concern to taxpayers. However, the IGT cannot provide legal remedies, but holds the ATO to its own standards of good practice.

⁷⁶ Section 13 AD(JR) Act, with the approach to be taken by the ATO set out in Practice Statement Law Administration 2013/1, available at <<https://www.ato.gov.au>> at 11 June 2016.

⁷⁷ Inspector-General of Taxation Act 2003 (Cth).

⁷⁸ Ibid.

Australia has taken the approach that the fundamental basis of the legal system and basic human rights are protected by the Constitution and international treaties implemented through domestic legislation. Rights are further assured by the requirement for the courts to take a purposive interpretation of both statutes and the common law and to uphold the rule of law and the concepts of justice embodied within it.

However, the legal rights relevant to tax law are limited. This is understandable, as they act to curtail the State's powers to tax. The development of a robust compliance framework, supported by an ombudsman, has ameliorated the negative effects of limited legal rights for taxpayers and provided the basis for mutual trust. The question is whether this is sufficient in times of challenge.

4. CHALLENGES TO TAX POLICY AND ADMINISTRATION

The Australian tax system has moved from the highly antagonist relationship between taxpayers and tax administrators in the 1970s and 1980s⁷⁹ to a stable service environment that has strengthened incrementally since 2000. A document such as *Reinventing the ATO* would have been unthinkable as the strategy document for the ATO two decades ago. The Charter has become a living document that represents the values and norms and service culture that are increasingly prevalent across the ATO. The levels of voluntary compliance also demonstrate high levels of societal trust in the ATO.⁸⁰

Nonetheless, there are challenges on the horizon, which threaten the stability of the current system. The Charter and the responsive regulation model will increasingly depend upon a clear perception in society that the Government and the ATO are exercising legitimate authority.⁸¹

I will outline some of the immediate challenges and use those challenges to illustrate the potential threat to the stability of the current system. In the next section I will outline the necessary development of an integrated legal framework that can reinforce and maintain stability in the face of significant challenge.

The compliance framework outlined so far is predicated on a steady and systematic development of a 'positive dynamic between legitimate power and reason-based trust'.⁸² The ATO strategy, *Reinventing the ATO*, implicitly assumes continued societal stability that will not impact negatively either on reason-based trust in what it is trying to achieve or the legitimacy of the authority and power which it exercises. A breakdown in either may arguably trigger movement down the 'Slippery Slope' back towards an antagonistic culture.

There are multiple challenges facing societies and these in turn threaten the revenue systems that support them. It is by no means certain that power of Governments or the

⁷⁹ Above n 19 and n 20.

⁸⁰ See the performance indicators in the ATO Annual Reports, available at <<https://annualreport.ato.gov.au/>> at 11 June 2016. Not only does the performance against the metrics show consistent improvement over time, but the nature of the information measured has changed to reflect a service culture.

⁸¹ Gangl, Hofmann and Kirchler, above n 38, Section 6.

⁸² Ibid.

ATO will continue to be viewed as reassuringly and increasingly legitimate in an environment of growing trust between citizens, their government and civic institutions. I summarise just a few areas that illustrate the fragility of our assumptions:

1. A stable, democratic Australia with one of the world's most robust economies, reinforced by membership of the most powerful economic, strategic and defence alliances, assures our future as citizens. The geopolitical reality is that financial (Greece and the global financial crisis), political (the 2016 US election or political collapse in a significant neighbour), economic (the actions of a major trading partner), security (escalating tensions in North Korea, the South China Sea and the renegotiation of the Antarctic Treaty) and geographic (earthquakes, drought and climate change) events or catastrophes could lead to a chain of events that radically changes our position.
2. There is no visible public discussion of the consequences to revenue collection of specific anticipated events such as terrorism and major disease outbreaks. It is not yet possible, for example, to determine the likely demographic and associated revenue impact of the rapid spread of antibiotic resistant diseases. We do know that the 1918 Spanish influenza infected approximately one-third and killed up to 5% of the world's population.⁸³
3. Economic stability is based on the reality of free trade for Australia and the assumption that trade flows will continue unabated. Similar assumptions underpinned the availability of credit prior to the global financial crisis. The interconnectedness of economies both diversifies and potentially increases risks to the Australian economy depending on the location and extent of any crisis.
4. Domestic stability is assumed, although increasing Commonwealth and State government gridlock over long-term policy, combined with lessons from the political stress faced in both the UK and the US suggest increasing fragility in domestic political systems. Significant instability, such as the fall of political and economic systems in Europe, comprehensive upheaval in the Middle East and radical changes across Africa, Latin America and Asia are not often canvassed as possible in Australia based on current debate.
5. The rise of 'monitory democracy':⁸⁴ the increasing intensity of media and popular scrutiny and monitoring through the use of instantaneous technology combined with extra-parliamentary power-monitoring institutions is potentially reinventing democracy as it currently exists. Keane describes it as 'the longing to bend the present world into a different and better future'.⁸⁵ It has arguably already influenced the longevity of Australian Prime Ministers⁸⁶

⁸³ JK Taubenberger and DM Morens, '1918 Influenza: the Mother of All Pandemics' (2006) 12(1) *Emerging Infectious Diseases* 15.

⁸⁴ See J Keane, *The Life and Death of Democracy* (Simon and Schuster, 2009).

⁸⁵ *Ibid* 1.

⁸⁶ For example, T Bramston, 'Revolving-door PMs not healthy for the nation', *The Australian*, September 28, 2015, available at <<http://www.theaustralian.com.au/opinion/columnists/revolving-door-pms-not-healthy-for-the-nation/story-fnbcok0h-1227546277572>> at 11 June 2016.

and will impact on how revenue authorities and other agencies will need to act.⁸⁷

6. The unanticipated disruption of the digital era, ranging from political uprisings, cyber-crime and cyber warfare, to undreamed of capacity to transfer and use big data is almost impossible to model at scale and is therefore largely ignored beyond incremental change based on the known.
7. The extent of future economic constraint and difficulties in assuring the national tax base in the face of the growth of corporate and individual mobility is the subject of public review and much hyperbole. However, political and public commentary remains largely uninformed, increasingly hysterical and largely ignores the inability of individual nation states to enforce their tax systems in the face of unconnected and highly competitive systems.⁸⁸

The potential for global disruption is self-evident. Its impact on the tax system could significantly upset the stability of the current compliance framework. To illustrate some potential effects, I consider just two recent developments arising from the last point: increasing debate over confidentiality of information; and pressure on resourcing the ATO.

The first, confidentiality of information is a subject that has been widely discussed but the consequences of significant changes in the nature of how and where information is processed and kept is still in flux. The second, resourcing of the ATO is not yet a material issue in Australia, but examples from elsewhere demonstrate its potential to become so and the consequences that might flow.

These challenges can almost be viewed as ‘business as usual’. However, I suggest that they are already sufficient to illustrate the importance of greater integration of legal rights and the compliance model to assure the stability of the tax system.

The ATO has extensive information gathering powers, including data matching, to prosecute its detection, deterrence and punishment of non-compliance.⁸⁹ These extend to obtaining information about a taxpayer from third parties under the law, other government departments under information sharing provisions and other jurisdictions under information exchange provisions. Australian taxpayers are required to produce records and information on request, attend interviews and may be subject to search of

⁸⁷ K James, in ‘An examination of convergence and resistance in global tax reform trends’, (2010) 11(2) *Theoretical Inquiries in Law* 475 analyses a number of factors that can both ‘contribute to tax policy convergence and provoke fierce resistance’ (at 486ff). She examines factors such as the environment, power distribution, culture and institutions.

⁸⁸ This is not a new phenomenon. See, for example, A Greenbaum, ‘United States Taxpayer Bills of Rights 1, 2 and 3: A Path to the Future or Old Whine in New Bottles?’ in D Bentley (ed) *Taxpayers’ Rights: An International Perspective* (Revenue law Journal, 1998) 347. For more recent examples, see H Ashton, ‘Senate aims to out tax dodgers with register of offending corporates’ *The Sydney Morning Herald*, August 16, 2015, <<http://www.smh.com.au/federal-politics/political-news/senate-aims-to-out-tax-dodgers-with-register-of-offending-corporates-20150815-gizpdu.html>> at 11 June 2016 and, on the other side, J Harpaz, ‘Congress Girds for a Showdown Over Global Tax Plan’ *Forbes*, 11 June, 2015, <<http://www.forbes.com/sites/joeharpaz/2015/06/11/will-u-s-congress-throw-a-wrench-in-beps/>> at 11 June 2016.

⁸⁹ Sections 263, 264 and 264A ITAA 36.

both business premises and private dwellings and associated seizure of documents without a search warrant.⁹⁰

As noted above, the grounds for review of the ATO's decisions under the AD(JR) Act, are largely limited to improper exercise of power or abuse of power, both of which are difficult for a taxpayer to prove. Important rights available to taxpayers are the common law right to client legal privilege, which is supported by an administrative right extending recognition of most aspects of privilege to accountants' working papers;⁹¹ and protection of privacy and confidentiality of information.⁹² However, there is no privilege against self-incrimination and⁹³ privilege does not extend to contractual and equitable obligations owed to third parties or spouses.⁹⁴

The ATO uses information gathering extensively to support its compliance program and help it to manage the risk of non-compliance. It uses its search and seizure powers sparingly, concentrating on high risk taxpayers. This is an appropriate approach to managing the compliance framework and reinforces its attempt to balance the exercise of its power and maintain taxpayer trust. However, there are areas where taxpayers who are potentially non-compliant or are suspected of non-compliance have limited rights. Fairness and justice in the system depend upon the ATO implementing its compliance model effectively.

For example, the power to search individual dwellings without a search warrant, but simply with authorisation from a senior ATO officer, goes beyond normal international standards.⁹⁵ Similarly, subject to general privacy and confidentiality laws, the scope of the ATO's information gathering powers is unlimited. There is little redress for taxpayers if third parties react adversely to an investigation into the taxpayer, where extensive information is required from the third party. The broader economic, commercial and personal ramifications are simply not covered by either legal or administrative rights. For example, a bank may delay or refuse a loan request when it is made aware that a taxpayer is under investigation, even though the taxpayer may be completely unaware both of the investigation and the request for information by the ATO from the taxpayer's bank. The consequences for taxpayers subsequently found to have no case to answer could be significant.

The ATO's restraint in most cases where there is low perceived risk, as generally articulated in its guidelines on the application of rulings,⁹⁶ has ensured that the full force of its power have been reserved for cases of suspected intentional non-

⁹⁰ M Dirkis and B Bondfield, 'The developing international framework and practice for the exchange of tax related information: evolution or change?' (2013) 11(2) *eJournal of Tax Research* 115, 116ff discuss the scope and limits of these provisions in an international context.

⁹¹ Above n 74.

⁹² The Privacy Act 1988 (Cth) and Division 355 Schedule 1 TAA 53.

⁹³ *Binetter v DCT* (2012) 90 ATR 327, *McMunn v The Queen* (2007) 69 ATR 384 and *DCT v De Vonk* (1995) 31 ATR 481.

⁹⁴ *Clyne v FCT* (1985) 16 ATR 938 and *Australian Crime Commission v Stoddart* (2011) 84 ATR 365.

⁹⁵ See OECD, *Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies*, (2015), DOI:10.1787/tax_admin-2015-en and the analysis in Bentley, above n 61, ch 8.

⁹⁶ See, for example, the name of the ATO compliance program, 'Building Confidence' and the documentation supporting the ATO approach to public and international groups, described at <<https://www.ato.gov.au/General/Building-confidence/Public-and-international-groups/>> at 11 June 2016.

compliance. Project Wickenby and the Serious Financial Crime Taskforce, described above, are consistent with this approach. As are the ATO's efforts to ensure that Australia's revenue base is not undermined by international tax fraud and evasion. Dirkis and Bondfield note this requires a range of international institutional bodies to 'develop complementary policy, administrative and legal responses',⁹⁷ if the international institutional framework is to work effectively 'to enhance and monitor tax information exchange'.⁹⁸

Currently there are limited taxpayer rights and remedies in respect of information exchange. However, this is balanced in part by the limits on revenue authorities in their practical and legal ability 'to exercise the essential taxation administrative processes (such as information gathering) needed to counter cross border tax avoidance and evasion'.⁹⁹

Australia's international tax treaties are supplemented by a significant number of taxation information exchange agreements based on the Organisation for Economic Cooperation and Development (OECD) process,¹⁰⁰ the Joint International Tax Shelter Information Centre Network,¹⁰¹ and the Australia and US intergovernmental agreement to implement the US Foreign Account Tax Compliance Act.¹⁰²

Most agreements contain some general protection, reflective of most OECD countries' and Australia's own requirements, for example, recognising the confidentiality of communications between a client and their admitted legal representative, and a right not to disclose trade secrets. The OECD has a comprehensive guide to the protection of information exchange for tax purposes.¹⁰³ However, they do not provide a taxpayer under investigation with any notification or appeal rights. They also offer the opportunity for the ATO to obtain significant quantities of data, often without the knowledge of the taxpayer or consequent recourse until it may be used.

While these measures are arguably important steps to protect the Australian revenue base, it does represent nonetheless an increasing commitment by the Australian Government and its agencies to transfer information to other jurisdictions. This in turn raises concerns that have yet to be fully considered and addressed.

The issues related to cross-border information exchange are not new. They were identified by Amparo Grau Ruiz in 2003, analysed extensively by Bentley in 2007,

⁹⁷ Dirkis and Bondfield, above n 90, 127.

⁹⁸ Ibid.

⁹⁹ Ibid 122, citing the example, of *Jamieson v Commissioner for Internal Revenue* [2007] NSWSC 324 and Foreign Judgments Act 1991 (Cth), ss 3(1) and 5(4).

¹⁰⁰ Art 26 Model Tax Convention on Income and Capital, <<http://www.oecd.org/tax/treaties/>> at 11 June 2016, Convention on Mutual Administrative Assistance in Tax Matters <<http://www.oecd.org/tax/exchange-of-tax-information/>> at 11 June 2016, Global Forum on Transparency and Exchange of Information for Tax Purposes, <<https://www.oecd.org/tax/transparency/>> at 11 June 2016.

¹⁰¹ Described at <<http://www.oecd.org/tax/forum-on-tax-administration/ftajitsicnetwork.htm>> at 11 June 2016.

¹⁰² Signed on 28 April 2014, the ATO has published extensive guidance material as to its operation and the obligations of Australian Financial Institutions at <<https://www.ato.gov.au/General/International-tax-agreements/In-detail/International-arrangements/FATCA-detailed-guidance/>> at 11 June 2016.

¹⁰³ OECD, *Keeping It Safe: The OECD Guide on the Protection of Confidentiality of Information Exchanged for Tax Purposes*, available at <<http://www.oecd.org/ctp/exchange-of-tax-information/keeping-it-safe-report.pdf>> at 11 June 2016.

both on the basis of a principled legal analysis, and were the subject of a 2016 review by the Inspector-General of Taxation into taxpayer protection in Australia.¹⁰⁴ However, little change is likely until it is accepted that such matters, which currently fall within a broad margin of appreciation in treaty law (discussed above), deserve consideration in the context of the operation of the rule of law. The politics simply prohibits rational argument unless change is introduced with the support of all stakeholders.¹⁰⁵

The issues arguably represent fundamental freedoms. But they have to be recognised as such so that the courts can protect them in a balanced and principled way.¹⁰⁶ They include:

1. The use of taxpayer information for ‘naming and shaming’ and the right of redress where this is found to be inappropriate and causes damage or harm to a taxpayer;¹⁰⁷
2. Greater clarity and specificity on levels of authorisation and the reasons required before confidential information is released to third parties;
3. Clarity on whether a taxpayer should ever have rights to be informed when information is being released either domestically or cross-jurisdictionally and any rights of review;
4. Greater clarity and specificity on the scope and extent of information that can be exchanged with other jurisdictions and the process of assessment of equivalent protection to Australia before such information is exchanged;
5. Rights of redress where information provided cross-jurisdictionally causes damage or harm to a taxpayer; and
6. Rights of redress where information provided to the ATO is subject to cyber-crime that causes damage or harm to a taxpayer.

The ATO’s compliance model means that there is currently considered application of each level of the compliance framework, with a focus on significant penalty only in cases of intentional avoidance or evasion. The stability of the system ensures that taxpayers accept the ATO approach and maintain a high level of trust.

However, the escalation in the number of taxpayers now engaging in cross-border commerce, in large part driven by government policy and incentives,¹⁰⁸ means that the

¹⁰⁴ See the extensive discussion in M Amparo Grau Ruiz, *Mutual Assistance for the Recovery of Tax Claims* (Kluwer Law International, 2003) and Bentley, above n 61, ch 8; and the review by the Inspector-General of Taxation into taxpayer protection, above n 45.

¹⁰⁵ See Alley, Bentley and James, above n 64 and Keane, above n 84.

¹⁰⁶ Otherwise, the courts have little room to extend human rights protection into tax matters. See, for example, a failed challenge by taxpayers under the UK Human Rights Act 1998 to the validity of notices issued by HMRC pursuant to an ATO request under the Double Tax Treaty: *Derrin Brothers Properties & Others v HMRC, HSBC and Lubbock Fine* [2016] EWCA Civ 15.

¹⁰⁷ For a discussion of the issues, see, for example, K Devos and M Zackrisson, ‘Tax Compliance and the public disclosure of tax information: An Australia/Norway comparison’ (2015) 13 *eJournal of Tax Research* 108; JD Blank, ‘What’s Wrong with Shaming Corporate Tax Abuse’ (2009) 62 *Tax Law Review* 541; and K Murphy and N Harris, ‘Shaming, Shame and Recidivism’ (2007) 47 *British Journal of Criminology* 900.

confidence and self-assurance the ATO displays on issues of domestic taxation may give way to a less consistent approach to grey areas in transactions that cross borders.¹⁰⁹ Where the taxpayers involved are confined to large taxpayers with the resources to understand fully their own position, this does not necessarily give rise to increased antagonism.¹¹⁰ On the other hand, where large groups of smaller business and individual taxpayers become part of a more uncertain tax environment, tensions can grow quickly.¹¹¹

This becomes increasingly likely in light of the ATO and Government approach to grey areas. The concept of ‘justified trust’ reflects the assurance that the ATO has that taxpayers are ‘paying the right amount of tax at the right time’ and will be measured as part of the ATO’s performance criteria.¹¹² Importantly, another performance criterion in the *ATO Corporate Plan 2016–17*, is ‘Community satisfaction with ATO performance’.¹¹³ Explaining the meaning of ‘justified trust’, Deputy Commissioner, Jeremy Hirschhorn as the question the ATO asks itself:¹¹⁴

If we were to tell a citizen jury what we had done to assure the tax paid by an individual company, would they be satisfied that we had done enough to make sure that the tax they have paid is correct?

The approach combines a community perception of fairness with an ATO compliance model predicated on the ATO’s level of assurance that taxpayers involved in international transactions have paid the right amount of tax. The approach is reinforced by Australia’s adoption (following the United Kingdom) of a multinational

¹⁰⁸ See, for example, <<http://www.austrade.gov.au/>> at 11 June 2016; <<http://www.business.vic.gov.au/export>> at 11 June 2016; and <<http://www.industry.nsw.gov.au/export-from-nsw/export-assistance/export-capability-building-program>> at 11 June 2016.

¹⁰⁹ Considered in the light of the experience in the European Union, by P Baker QC, ‘The Right to Confidentiality and Privacy in an Age of Transparency’, paper presented to the International Conference on Taxpayer Rights, 18–19 November 2015, Washington DC.

¹¹⁰ See, for example, Business Council of Australia comment on the OECD’s Base Erosion and Profit Shifting (BEPS) measures, ‘BCA Welcomes Release of OECD BEPS Package’, Media Release, 6 October 2015, <<http://www.bca.com.au/media/bca-welcomes-release-of-oecd-beps-package>> at 11 June 2016 but with the warning from the OECD BEPS Action Plan highlighted that, without careful coordination, unilateral measures ‘could lead to global tax chaos marked by the massive re-emergence of double taxation’.

¹¹¹ One example is the US Foreign Account Tax Compliance Act, which has seen taxpayers in many countries subject to sometimes draconian effects. See, for example ‘US anti-tax evasion law, FATCA, starts to hit home’, the UK *Daily Mail*, 7 November 2014, <<http://www.dailymail.co.uk/wires/afp/article-2824688/US-anti-tax-evasion-law-FATCA-starts-hit-home.html>> at 11 June 2016; and A Christians, ‘Know Thyself: Self-certification and the Taxpayer’s Right to be Informed’, paper presented to the International Conference on Taxpayer Rights, 18–19 November 2015, Washington DC. The US National Taxpayer Advocate identified it over several years as a continuing issue significant enough to warrant intervention. See *2015 Annual Report to Congress — Volume One*, <<https://taxpayeradvocate.irs.gov/reports/2015-annual-report-to-congress>> at 21 October 2016, LR#5 at 353.

¹¹² See *ATO Corporate Plan 2016–17*, above n 37.

¹¹³ Ibid.

¹¹⁴ J Hirschhorn, ‘Towards *justified trust* between the ATO and the Infrastructure industry’, paper presented to the 2016 National Infrastructure Conference, 26 May 2016, Melbourne, 4.

anti-avoidance law and proposed introduction of a diverted profits tax.¹¹⁵ Both measures are designed to address ATO and community concerns with base erosion and profit shifting by taxpayers operating across borders. However, the challenge is that the measures move away from the OECD's consensus-based approach to international tax reform and their application is interpreted far more aggressively than is accepted by most of Australia's trading partners.¹¹⁶

Taxpayers will therefore be forced to rely on other countries accepting the ATO's interpretation of how much tax Australia is entitled to. The measures raise concerns that the resulting complexity and potential double taxation will inevitably lead to increased antagonism between the ATO and taxpayers operating internationally.¹¹⁷ This becomes more likely if increasing numbers of taxpayers are faced with competing demands to pay a 'fair share of tax' by different tax authorities using laws that conflict, particularly where the laws over-ride double tax agreements.¹¹⁸

A second area of potential challenge is resource constraints on revenue authorities. In the US, in the preface to her *2015 Annual Report to Congress — Volume One*, the National Taxpayer Advocate states:¹¹⁹

... the IRS future state now under internal discussion proposes changes in agency operations that assume a constrained funding environment and therefore minimizes agency costs. As a result, these proposed changes have serious ramifications for taxpayers and taxpayer rights. Most significantly, the IRS future state vision redefines tax administration into a class system, where only taxpayers who are the most *noncompliant* or who can 'pay to play' will receive concierge-level service or personal attention. The compliant or trying-to-comply taxpayers will be left either struggling for themselves or paying for assistance they formerly received for free from the IRS.

Similar concerns have been raised in the United Kingdom¹²⁰ and Italy.¹²¹ In answer to criticism of falling standards, the 2016 UK Budget, for example, increased HMRC funding by £71 million 'to improve the service it provides taxpayers', including

¹¹⁵ Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015 and Treasury Consultation Paper, *Implementing a Diverted Profits Tax*, May 2016, available at <<http://www.treasury.gov.au>> at 24 September 2016.

¹¹⁶ M Bona, P Collins and S Landsberg, 'Coveting thy neighbour's tax base — Australia's changing approach to international taxation', paper presented to the 2016 Queensland Tax Forum, 18–19 August 2016, Brisbane, 10; and submission of the Law Council of Australia, <https://www.lawcouncil.asn.au/lawcouncil/images/3167_-_Implementing_a_Diverted_Profits_Tax.pdf> at 24 September 2016, in response to the Treasury Consultation Paper, *Ibid*.

¹¹⁷ *Ibid*.

¹¹⁸ *Ibid*.

¹¹⁹ <<https://taxpayeradvocate.irs.gov/reports/2015-annual-report-to-congress>> at 21 October 2016.

¹²⁰ CCH Daily, 'HMRC reorganisation risks pushing tax authority to breaking point' <<https://www.cchdaily.co.uk/hmrc-reorganisation-risks-pushing-tax-authority-breaking-point>> at 11 June 2016.

¹²¹ G Tieghi, 'The Italian Taxpayer Bill of Rights 15 Years Later', paper presented to the International Conference on Taxpayer Rights, 18–19 November 2015, Washington DC.

extending service hours, reducing call waiting times and supporting a transition to digital services.¹²²

It may be that the ATO will always be well resourced and will maintain its current levels of taxpayer satisfaction with its services. However, that may become more difficult, not just because more taxpayers are engaged in areas of controversy, such as cross-border commerce, but because as more taxpayers move into higher tax brackets they will become more engaged in finding ways to reduce their tax burden.¹²³

In the event that the ATO has to prioritise services such that its compliance framework cannot be delivered as effectively as it is currently, there is a danger that observance of taxpayer rights will deteriorate, as the National Taxpayer Advocate identifies has occurred in the US. Where, as in the UK, the issue has been recognised and remedial steps are taken, it is uncertain whether and how much remediation is required to arrest the retreat down the 'slippery slope' towards an antagonistic relationship.

However, the UK National Audit Office, in its 2016 report into *The quality of service for personal taxpayers*,¹²⁴ has identified the importance of further research into the correlation between poor service and a consequent reduction in compliance. It notes that, 'Though these findings indicate that taxpayers' attitudes to compliance might be influenced by service levels, they do not demonstrate to what extent, if at all, their behaviour is affected.'¹²⁵ It notes that the HMRC has reviewed international academic research and built an academic model 'using multi-country surveys to estimate the impact on the shadow economy (a proxy for the tax gap) of a change in tax morale, power and trust (proxies for customer experience)'.¹²⁶ The evidence proving the relationship between customer satisfaction and a decrease in the tax gap was not determinative and is therefore the subject of a further research project between HMRC and the National Audit Office.¹²⁷ Of particular importance, is the correlation between deterioration in service and an increase: first in negative perceptions of the tax authority; and second in non-compliance.

Information exchange and resource constraints are 'business as usual' challenges. Yet, even from these there is sufficient uncertainty to at least consider a more integrated model of legal and administrative rights, simply because it may not always be possible to rely on the goodwill of the ATO to provide comprehensive taxpayer protection. The untested hypothesis is that a comprehensive and integrated legal framework can potentially maintain stability and arrest a deteriorating relationship between tax authorities and taxpayers. It arguably provides a framework for a more balanced system in time of challenge; which citizens' will perceive as both fair and subject to the rule of law.

¹²² HM Treasury, *Policy Budget Paper 2016*, [4.11] and [7.38]
<<https://www.gov.uk/government/publications/budget-2016-documents/budget-2016>> at 11 June 2016.
Note that the UK Budget 2016 also set HMRC a compliance yield target of £27 billion, [7.36].

¹²³ Australian Government, above n 66, ch 3.

¹²⁴ Comptroller and Auditor General National Audit Office, *The quality of service for personal taxpayers* (2016) HC 17, Session 2016-17, 25 May 2016 <<https://www.nao.org.uk/wp-content/uploads/2016/05/The-quality-of-service-for-personal-taxpayers.pdf>> at 11 June 2016.

¹²⁵ Ibid 10.

¹²⁶ Ibid 39.

¹²⁷ Ibid.

5. ADDRESSING THE CHALLENGES

Currently, legal protection for taxpayers is limited to primary legal rights, which go to the formulation of the law itself and fundamental notions of justice and due process. There are few legal rights available to mirror the detailed and incremental escalation of the compliance framework as it applies to everyday transactions.

In the same way that the compliance framework requires detail at each stage of the process to ensure compliance, so there needs to be a detailed and integrated set of legal rights to support the administrative rights at each stage of an integrated legal and compliance framework. I set these out in my Model of Taxpayer Rights in 2007, reflecting on over a decade of practical implementation of administrative charters.

There is little dispute as to the content, which has been reflected in prior and subsequent legal analysis,¹²⁸ and provides detailed rules that mirror each stage of the compliance process. They do not represent a phalanx of rules designed to act against the administration of the tax system. Rather they provide legal support to the recognised and requisite service standards and widely recognised legal rights. In keeping with incremental escalation to encourage taxpayer compliance, so the rights provide incremental escalation to encourage the ATO to observe taxpayer rights in the context of detailed taxpayer obligations.

The case against providing legal rather than administrative support for such rights is traditionally framed in ‘fakers and floodgates’ arguments: simply making such rights available at law will result in a plethora of cases, often spurious, which will grind the system to a halt under the burden of costs and legal procedures.¹²⁹ The argument is framed in terms of risk to revenue and misallocation of resources on the basis of speculation as to how many taxpayers might claim the protection. In the US, Cardozo CJ said, in the context of negligence, the argument puts a concern that the courts should avoid, ‘liability in an indeterminate amount for an indeterminate time to an indeterminate class’.¹³⁰

Such arguments are generally given short shrift by judges and legal theorists.¹³¹ There is little empirical evidence to substantiate such arguments and fear of potential

¹²⁸ See Bentley, above n 61; D Albregtse and H van Arendonk, *Taxpayer Protection in the European Union* (Kluwer Law International, 1998); A Sawyer, ‘A Comparison of New Zealand Taxpayers’ Rights with Selected Civil Law and Common Law Countries — Have New Zealand Taxpayers Been “Short-Changed”?’ (1999) 32 *Vanderbilt Journal of Transnational Law* 1345; P Baker, ‘Taxation and the European Convention on Human Rights’ [2000] *British Tax Review*, 211; P Baker and A-M Groenhagen, *The Protection of Taxpayers Rights — An International Codification* (European Media Forum, 2001); HLM Gribnau, *Legal Protection Against Discriminatory Tax Legislation* (Kluwer Law International, 2003); S Peers and A Ward (eds), *The European Union Charter of Fundamental Rights* (Hart Publishing, 2014); W Nykiel and M Sek (eds), *Protection of Taxpayer’s Rights: European, International and Domestic Tax Law Perspective* (Oficyna, 2009); BJ Croome, *Taxpayers’ Rights in South Africa* (Juta and Company, 2010); and M Cadesky, I Hayes and D Russell, *Towards Greater Fairness in Taxation: A Model Taxpayer Charter* (AOTCA, CFE, STEP, 2013).

¹²⁹ Justice Blackmun (dissenting) in *Bivens v Six Unknown Agents of the Federal Bureau of Narcotics*, 403 US 388 (1971) at 430, was unsuccessful in convincing the majority with his arguments that the case might open a barrage of litigation that would burden federal agents and potentially alter their behaviour to avoid it.

¹³⁰ *Ultramares Corporation v Touche* (1931) 174 NE 441, 444.

¹³¹ See, for example, a recent consideration in MK Levy, ‘Judging the Flood of Litigation’ (2013) 80(3) *The University of Chicago Law Review* 1007; and TS Kaye, ‘Risk and Predictability in English

consequences should not undermine the basic principles that are at stake and which the law is designed to protect.¹³² The common law system has in-built checks and balances. Each case is decided on its own merits. The hierarchy of courts, an independent judiciary and the number of judges, assisted by counsel, that will bring their minds to each significant matter of law, means that the intent of any legislation is well-considered in each case.

The floodgates arguments fail to recognise that almost every law is designed with its consequences in mind and the legal system itself has transformed and modernised its processes such that it can rarely be manipulated.¹³³ Where a law does not work as intended, the law can be changed.

Another argument popularly used against legislation is cost and complexity. However, the courts have addressed the issue of cost of access to justice with an effective dispute resolution process that is similar to that used in the compliance framework.¹³⁴

There is no bar to the development of an effective framework of carefully designed legal rules operating similarly to other areas of the law. The basic principles taken from dispute resolution theory that need to be applied to make the framework effective, can be described as follows:¹³⁵

1. Prevent unnecessary conflict through notification, consultation and feedback
2. Create ways of reconciling the interests of those in dispute
3. Build in 'loop-backs' to negotiation
4. Provide low-cost alternatives where negotiation fails
5. Create sequential procedures moving from low-cost to high-cost
6. Provide the necessary motivation, skills and resources to allow the system to work
7. Provide effective mechanisms for measuring qualitative success

Common Law', in G Woodman and D Klippel (eds), *Risk and the Law* (Routledge-Cavendish, 2008), available at SSRN: <<http://ssrn.com/abstract=1263481>> at 11 June 2016.

¹³² See, for example, *Clinton v Jones* 520 US 681 (1997).

¹³³ Consider the deep concerns that surrounded the introduction of a general anti-avoidance provision in the form of Part IVA Income Tax Assessment Act 1936 (Cth) in 1981 and the judicial and legislative responses that have since ensured that the Commissioner's powers remain equal to challenges ranging from individual high net worth tax evasion seen in Project Wickenby (discussed above), transfer pricing activity seen in *Chevron Australia Holdings Pty Ltd v FCT (No 4)* [2015] FCA 1092 and the introduction of the Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015.

¹³⁴ See, for example, F Steffek, 'Principled Regulation of Dispute Resolution: Taxonomy, Policy, Topics' in F Steffek and J Unberath (eds), *Regulating Dispute Resolution: ADR and Access to Justice at the Crossroads* (Hart Publishing, 2013) 33.

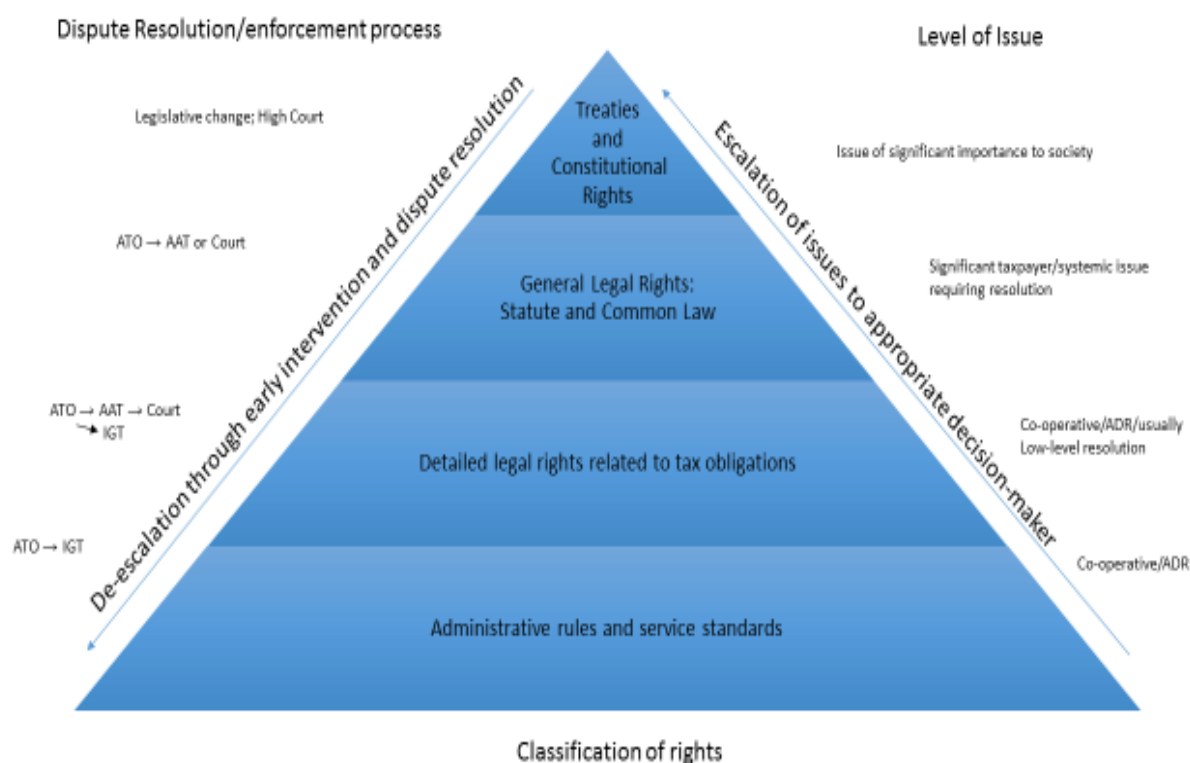
¹³⁵ Bentley, above n 61, 212, drawing from WL Ury, JM Brett and SB Goldberg, *Getting Disputes Resolved* (Program on Negotiation at Harvard Law School, 1993). In Chapter 5, I set out the theory and its detailed application to this model. See further for analysis and variations, S Mookhey, 'Tax dispute systems design' (2013) 11 *eJournal of Tax Research*, 79 and M Jone, 'Evaluating Australia's tax dispute resolution system: A dispute systems design perspective' (2015) 13 *eJournal of Tax Research*, 552.

8. Provide mechanisms for monitoring, review and continuous improvement both at individual and systemic levels.

The ATO has an extensive and highly effective dispute resolution service designed to prevent most cases from escalating and resolves approximately 80% of disputes in this way, although both Mookhey and Jone argue that the system could be improved further.¹³⁶ When an issue does go to a court or tribunal, mandated alternative dispute resolution, which is part of the normal tribunal and court process, results in over 80% of matters being resolved without proceeding to a formal hearing.¹³⁷ Add to these the Inspector-General of Taxation's complaint handling powers (discussed above) and there is a comprehensive framework of arrangements already in place to give effect to an integrated legal and compliance framework that fosters early resolution of disputes.

When depicted in a pyramid similar to that used for the compliance framework, a legislative rights framework can be shown in Figure 3.

Figure 3: Legislative rights framework



¹³⁶ See <<https://www.ato.gov.au/About-ATO/Access,-accountability-and-reporting/Informing-the-community/Our-effectiveness/Resolving-disputes/Our-dispute-resolution-strategies/>> at 11 June 2016, Mookhey, above n 135 and Jone, above n 135.

¹³⁷ See, for example, Administrative Appeals Tribunal, *Practice Direction, Review of Taxation and Commercial Decisions*, <<http://www.aat.gov.au>> at 11 June 2016.

Mirroring the ATO's identification of key influences on taxpayer behaviour shown in Figure 2, there are a number of key influences on taxpayer perception that drive trust in the tax system. These include:¹³⁸

1. Certainty
2. Consistency
3. Convenience
4. Effectiveness
5. Efficiency
6. Equity
7. Fairness
8. Non-discrimination
9. Reasonableness
10. Transparency

The danger, in failing to apply an integrated legal and compliance framework, is that when the compliance framework is challenged, as in the examples set out above, a trust gap begins to develop, which arguably triggers the movement down the 'slippery slope'.¹³⁹ The result would be that taxpayer perception in the trust influencers begins to decline.

An associated question arises when complex rules develop to counter increasing external and internal challenges to the tax system. Do these rules and the rules that ensure their enforcement, begin to outweigh significantly the framework of enforceable rights?¹⁴⁰ If compliance declines as complexity increases, as Richardson's study suggests, it can be argued that 'regulation and enforcement bloat' gives rise to a 'trust gap'.

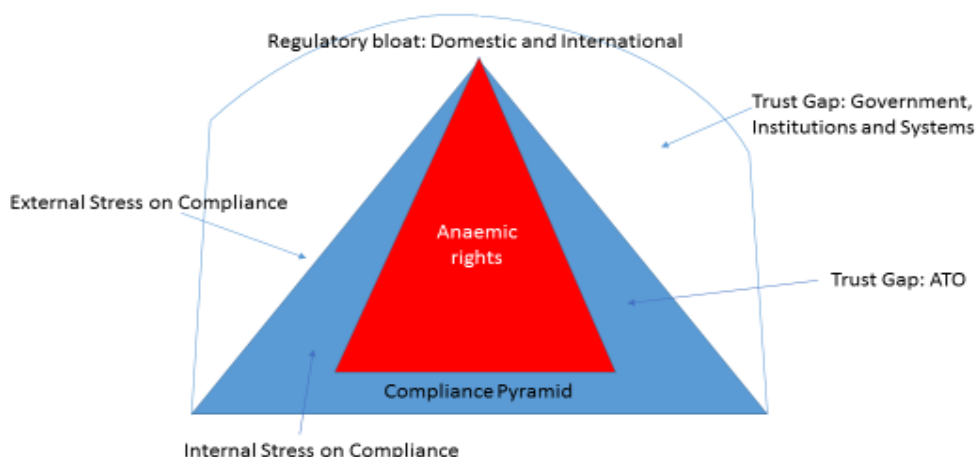
As indicated in the work of Kirchler et al,¹⁴¹ the negative effect of enforcement momentum can cope with some system failures. However, the combination of external factors placing stress on compliance and reduced resourcing internally, can soon build up pressure on the effective operation of the compliance framework. There is a danger that the trust gap will widen and result in movement from a trust-laden, stable legal and compliance framework back to an antagonistic framework. Absent a robust legal rights framework to act as a balance to regulatory bloat and aggressive enforcement, there is a danger that the downward momentum is inevitable in the context shown in Figure 4.

¹³⁸ Analysed in Alley and Bentley, above n 14.

¹³⁹ See the UK National Audit Office Report, above n 124.

¹⁴⁰ See the work of G Richardson, 'An exploratory cross cultural study of tax fairness perceptions and tax compliance behaviour in Australia and Hong Kong' (2005) 31 *International Tax Journal* 11 and 'Determinants of tax evasion: A cross-country investigation' (2006) 15 *Journal of International Accounting, Auditing and Taxation* 150.

¹⁴¹ Above n 34.

Figure 4

Despite arguments to the contrary, I suggest that the assumption that legal recognition of taxpayer rights acts as an impediment to the effective implementation of the compliance framework is misplaced. Instead, the insertion into the model of a robust legal framework to create an integrated legal and compliance framework acts as a support and a safety net not simply for taxpayers, but to secure the stability of the system itself.

It would not be difficult to achieve. For example, the ALRC could be charged to use the extensive work already completed domestically and internationally to complete a set of recommendations that builds upon its 2015 Report into traditional rights and freedoms.¹⁴²

I would also argue that an integrated legal and compliance framework is required to move from Gangl, Hofmann and Kirchler's 'service climate' to their conception of a 'confidence climate' of implicit trust.¹⁴³ The integration of the legal and compliance frameworks arguably provides the basis for the necessary automatic cooperation and trust found in a 'confidence climate': one that flows from a society-wide acceptance that it should live the spirit rather than the letter of the law.

6. CONCLUSION

Twenty years on, the Charter has shown how a clearly articulated set of values embedded into the culture of the ATO has supported the transformation of the ATO/taxpayer relationship. It has formed an integral part of the compliance framework and has developed with that framework to ensure that the ATO administers the tax system through relatively stable and co-operative engagement with taxpayers.

¹⁴² Above n 47.

¹⁴³ Above n 38.

Thus far the calls for the legislation of taxpayer rights or for the Charter to be incorporated into a legal document have seemed unnecessary. International trends and potential challenges have highlighted two concerns: one related to the undermining of basic legal rights and the other related to the impact on taxpayer rights of government and revenue authority responses to threats to the revenue base and the effectiveness of traditional methods of taxation. Both are relevant to consideration of how the Taxpayers' Charter might provide prospective protection against potential breaches of accepted taxpayer rights.

Although the development of soft law and the effectiveness of administrative rights have proven highly beneficial, there remains a question of whether they are sufficient to assure the stability of the compliance framework in the face of significant challenge.

The US provides a useful illustration of why both points are important. Although the introduction in the US of taxpayer rights and a National Taxpayer Advocate preceded similar developments in Australia, the National Taxpayer Advocate in 2014 succeeded in gaining acceptance for and the introduction of a Taxpayer Bill of Rights 2014,¹⁴⁴ which has not yet occurred in Australia.

There is need for significant further research to confirm earlier work suggesting the validity of the connection between the legal and compliance frameworks and their reinforcement of each other. Importantly, the research to date has focused on moving compliance from an antagonistic to a service climate. The factors that might cause compliance to move back down the slippery slope to an antagonistic climate remain relatively untested. Equally, research is needed to test whether anaemic rights, particularly when combined with regulatory bloat, accelerate that movement.

However, I continue to argue, based on the evidence available, that the creation of an integrated legal and compliance framework provides greater opportunity to protect the stability of the taxpayer/revenue authority relationship than relying solely on the capacity of the more powerful party (in this case the ATO) to do so alone. After all, as we celebrate now over 800 years since the signing of the Magna Carta, it is worth recalling that it formalised a separation of powers and a system of checks and balances. It did so because the King could not always be relied on in times of crisis.

¹⁴⁴ Available at <<https://www.irs.gov/Advocate/Taxpayer-Rights>> at 11 June 2016.

Tax disputes, litigation costs and access to tax justice

Binh Tran-Nam¹ and Michael Walpole²

Abstract

Tax dispute resolution is an integral part of the operation in any modern tax system. The availability of a fair, impartial and independent mechanism for resolving tax disputes between taxpayers and the central collection agency can be viewed as an indicator of how well-developed or advanced is the tax system under study. In Australia, in addition to the Australian Taxation Office (ATO)'s internal review, there exists a comprehensive system of external tax dispute resolution involving the Administrative Appeals Tribunal (AAT) and the courts, and, to a lesser extent, a variety of governmental bodies. At the same time, there is anecdotal evidence that the litigation costs of taxpayers engaging in tax disputes can be very high especially if professional (legal, tax or accounting) assistance is employed. The existence of such high costs can act as a barrier to the effective accessibility of the external tax dispute resolution system and to the neutrality of the outcomes of such disputes (in the sense that taxpayers with greater resources may be able to obtain more favourable outcomes than taxpayers with lesser resources). This paper provides a comprehensive review of the current state of play and sets out a future agenda for research on this topic.

Keywords: Tax disputes; Litigation costs; Access to tax justice

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1. INTRODUCTION

The operation of any modern tax system involves at least five distinct but interrelated aspects, namely, tax policy planning, tax law drafting and enactment, tax administration and enforcement, tax compliance, and tax dispute resolution.³ A fair, impartial and independent dispute procedure accessible to all taxpayers is fundamental to the proper operation of any tax system. In fact, the availability and quality of an external tax dispute resolution system⁴ can be viewed as a measure of how well developed or advanced a particular tax system under study is. In Australia the procedures for resolving tax disputes internally and externally are well-known.⁵ However far less is understood about the effective accessibility of external tax dispute resolution from the taxpayer perspective.

It is apparent that there are serious gaps of knowledge in the important but neglected connection between tax dispute resolution and tax justice. Such lack of knowledge has motivated a successful Australian Research Council (ARC) Discovery project aimed at determining how effective is external tax dispute resolution in Australia, whether or not taxpayers with greater resources are relatively more successful in tax litigation, and whether or not alternative dispute resolution (ADR) is an effective way for resolving tax disputes.

The paper intends to serve three specific purposes. First, it provides a critical and comprehensive review of the state of knowledge in the field of tax disputes, litigation costs⁶ and access to external tax dispute resolution. Secondly, it examines some recent developments in ADR in the area of taxation in Australia. Thirdly, it sketches out a research agenda on litigation costs, tax dispute resolution and tax justice. While the paper is motivated by Australian considerations, many of its discussions and proposals are of general applicability to comparable common law countries such as Canada, New Zealand, the United Kingdom (UK) and the United States (US).

Before proceeding any further it is helpful to clarify the meanings of 'tax dispute', 'litigation costs' and 'tax justice', and thus unambiguously define the scope of the paper. This paper focuses on disputes between taxpayers and the central revenue collection agency, the Australian Taxation Office (ATO). It is not concerned with tax disputes involving sub-national revenue collection agencies such as the various State Revenue Offices in Australia. (Further research into dispute resolution at the sub-national level would be warranted but this would be a separate project.) Tax disputes may also arise between two or more parties in a legal agreement or commercial dealing. For example, one of the parties may disagree with the meaning of a contractual agreement, or the operation of a statute, and whether or to what extent a tax is payable by one of the parties. These types of disputes are beyond the scope of this paper.

³ See, for example, B Tran-Nam, 'Tax Reform and Tax Simplification: Some Conceptual Issues and A Preliminary Assessment' (1999) 21(3) *Sydney Law Review* 500 at 500.

⁴ We distinguish between internal and external tax dispute resolution. Internal dispute resolution refers to that conducted by the central revenue collection agency (which is a party to the dispute), whereas external or independent dispute resolution is conducted by an independent body (which is not a party to the dispute) such as a tribunal or court.

⁵ See, for example, various tax law textbooks; S Mookhey, 'Tax Dispute System Design' (2013) 11(1) *eJournal of Tax Research* 79.

⁶ Tax litigation costs here are broader than the conventional view of litigation costs; see the following section.

Litigation costs in this paper refer to the costs incurred by the taxpayers in seeking to resolve their tax disputes with the ATO via an external, independent body such as the Administrative Appeals Tribunal (AAT) or the courts. Defined in this way, litigation costs constitute a part of the better-known tax compliance costs. Litigation costs include both out-of-pocket expenses (such as fees for professional assistance or court costs) and value of time losses. Some elements of litigation costs are tax deductible under the current Australian income tax law.

Tax justice is itself a multidimensional concept. It can be interpreted differently in different contexts. We can, for example, make a distinction between tax policy equity and tax procedural equity. 'Tax policy equity', frequently discussed in the public finance literature, is concerned with the distribution of tax burdens among individuals in a society. 'Tax procedural equity', mainly discussed in the tax administrative and legal literature, is concerned with the fairness of the procedures involved in tax audits and disputes, and the perceived treatment the taxpayer receives from the tax authority. This paper omits tax policy equity and focuses instead on the effective access to a fair, impartial and independent process of tax dispute resolution. Further, while all taxpayers (individuals and businesses) are covered under the study, the focus is on individual taxpayers to whom the issue of social justice is perhaps more relevant.

It should by now be apparent that the primary focus of the paper is not the Australian system of tax dispute resolution *per se*. Rather, it is the effective access to external tax dispute resolution that constitutes the primary research question of the study. Obviously the correctness, or otherwise, of the outcome of the process (that is, tax legal justice) is most important to the fairness of any tax systems. After all, it is little use having equal access to a system which is inherently unfair. This is a separate and complex issue that the present paper cannot address and for present purposes the Australian tax system is assumed to be fair provided one has access to its facilities for dispute resolution.

The organisation of the remainder of this paper is as follows. In the next section, key concepts such as tax complexity, tax disputes, litigation costs and tax justice and their relationships are explored. The subsequent section provides a review of the relevant literature and discusses existing information on tax disputes that is currently available in Australia. The literature review indicates that, despite a wide range of anecdotal evidence, there is indeed a paucity of rigorous studies on the connection between litigation costs of tax dispute resolution and tax justice, not only in Australia but also elsewhere in the world. It is also suggested that the ATO could support studies on tax dispute resolution and tax justice by making more data on tax disputes available on a regular basis. In the following section, recent developments of ADR for resolving tax disputes internally are reviewed. There is some evidence that ADR may at least reduce social tax compliance costs. The penultimate section then brings all elements that have been considered together to set out a research agenda to examine the relationship between tax disputes, litigation costs and tax justice. Concluding remarks are given in the final section.

2. ISSUES AND CONTEXT

2.1 Tax complexity, tax disputes and social justice

As tax complexity has been extensively discussed in the literature,⁷ it suffices to focus on selected aspects of tax complexity which are relevant to this paper. A quick examination of the literature reveals that traditional indicators of tax complexity such as the number of taxes, length and readability of tax codes, extent of the use of tax agents, tax operating costs (sum of tax compliance and administrative costs) tend to disregard the extent of tax disputes as a possible measure of tax complexity. The main advantage of tax disputes as a measure of tax complexity is that it can be precisely measured (for example, number of tax disputes per thousand of taxpayers per annum) and may readily be available (secondary data from tax collection agencies, administrative tribunals and the courts). The main disadvantage with using tax disputes as a complexity indicator is that a number of cases at the tribunal level have little to do with legal complexity and more to do with factual disputes.

Analysis of the impact of tax complexity has traditionally focused on efficiency costs of tax complexity. This has resulted in a substantial literature on tax operating costs, especially tax compliance costs. In addition, due to its adverse effect on economic incentives, tax complexity may also cause losses of output or a decrease in foreign direct investment inflows.⁸ Attention has also been drawn to the fact that tax complexity, via regressive tax compliance costs, can also reduce the progressivity of the income tax,⁹ thus damaging the equity objective of tax policy.

However, the literature is largely silent on the impact of tax complexity on social justice that demands that every person be treated equally by the law.¹⁰ Statutory and administrative tax complexity (primarily statutory complexity) gives rise to tax disputes. In view of the fact that taxation is one of the more important (and most common) relationships between a citizen and the government, fairness in resolving tax disputes is very significant, particularly from a social justice perspective (to be further elaborated later in the paper). While there exists a comprehensive system of tax dispute resolution in Australia, it is by no means clear whether or not those taxpayers who are in dispute with the ATO can equally access the external mechanisms for resolving tax disputes. It is thus imperative that a systematic and rigorous study of the effective access to external tax dispute resolution be undertaken with a view to safeguarding the tax system, a part of the social infrastructure critical to Australia's continuing prosperity.

⁷ See, for example, J A Roth, and J T Scholz (eds.), *Taxpayer Compliance, Volume 2: Social Science Perspectives*, (University of Pennsylvania Press, Philadelphia, 1989); C Evans, R Krever and P Mellor, (eds), *Tax Simplification* (Wolters Kluwer Law and Business, The Netherlands, 2015).

⁸ B Tran-Nam, 'An Integrated Approach to the Economic Measurement of the Costs of Tax Complexity' in C Evans, R Krever and P Mellor (eds), *Tax Simplification* (Wolter Kluwer Law and Business, the Netherlands, 2015) 55.

⁹ A theoretical discussion can be found in B Tran-Nam, 'Tax Compliance Costs Methodology: A Research Agenda for the Future' in C Evans, J Pope, and J Hasseldine (eds.), *Taxation Compliance Costs: A Festschrift for Cedric Sandford* (Prospect, Sydney, 2001) 51, whereas supporting evidence is available from B Tran-Nam, C Evans and P Lignier, 'Personal Taxpayer Compliance Costs: Recent Evidence from Australia' (2014) 29(1) *Australian Tax Forum* 135.

¹⁰ See further elaboration in the third section of this article.

2.2 Tax disputes and tax dispute resolution

Disputes are a common feature of any human society, regardless of time, space, social traditions or level of development. Tax disputes are thus a familiar feature of modern tax systems around the world. However, as argued elsewhere by the authors,¹¹ tax disputes are of special importance not only to tax academics. The reasons include:¹²

- Tax laws, particularly income tax law, tend to be more complex than civil or commercial laws.
- There is a reversal of onus¹³ in tax disputes when they are considered by the Tribunal or the courts (in comparison with civil dispute cases).
- Unlike most civil or commercial disputes, tax disputes typically involve a perceived asymmetry between the two parties concerned (the ATO and individual/small business).
- Tax disputes differ fundamentally from other civil and commercial disputes and criminal trials in terms of impact.¹⁴
- Unlike most civil and commercial disputes, the two parties to a tax dispute are also unevenly positioned with respect to the ability of each to influence the law after the court's judgment has been handed down.

Tax disputes are said to occur when taxpayers disagree with the view provided by tax administrators in respect of the taxpayer's tax liability or entitlements and related issues, and take some action regarding this disagreement.¹⁵ Tax disputes may arise at any stage after the disagreement between the tax administrators and taxpayers. In Australia they are classified into four broad categories:¹⁶

1. Complaints;
2. Objections to reviewable rulings;
3. Disputes as to facts or the application of tax law by a taxpayer as matters are being assessed (by the ATO)
4. Objections to assessments (including self-assessment and Commissioner adjustments).

¹¹ B Tran-Nam and M Walpole, 'Independent Tax Dispute Resolution and Social Justice in Australia' (2012) 35(2) *UNSW Law Journal* 470.

¹² In this context, it is worthwhile to briefly mention the ATO's test case litigation program. There are important issues where it is in the public interest to have the tax law clarified through litigation. Since the ATO cannot commence such litigation, they are willing to provide financial assistance to taxpayers to do so in order to develop legal precedents to such issues.

¹³ In tax dispute cases, the onus is on the taxpayer to prove that the ATO's assessment is incorrect.

¹⁴ Tax disputes and the legal ramifications of court decisions in them often have a high level of generality and applicability to other taxpayers.

¹⁵ In view of procedural justice briefly mentioned in the introductory section, the formal definition of tax disputes here seems to be somewhat narrow. Perhaps it should be broadened to include complaints by taxpayers about how they are treated by tax administrators.

¹⁶ Commissioner of Taxation, 'In Search of Solutions', (Speech delivered at the Administrative Appeals Tribunal and the ACT Bar Association seminar, Canberra, 26 August 2009).

Categories 2 and 4 generally refer to statutory rights, while 1 and 3 relate to administrative due process. The remedies of 1 and 3 are thus founded in administrative due process largely recognised in common law principles. Categories 2 and 4 are slightly different as they are based on rights established under the relevant statutes which allow, and set out the process for, review of decisions and the precise terms and extent of objections to assessment. They are thus statutory rights, but their scope and effect can overlap with rights available under administrative due process. Of these categories only 2 to 4 could result in litigation.

As mentioned previously, the institutions and processes for resolving tax disputes in Australia have been well discussed in the literature, including tax law textbooks. Suffice to say tax disputes can be ultimately resolved via judicial determination, as affirmed by the then Federal Assistant Treasurer:¹⁷

The ATO has sole responsibility for interpreting the taxation laws at first instance (for the purposes of administering those laws), while the Courts are the final arbiters.

Apart from the ATO's internal review (before the dispute is taken further) and the AAT, the Federal Court of Australia (Federal Court) and ultimately the High Court of Australia (High Court) have jurisdiction to finalise substantive federal tax disputes. Although State courts do not have jurisdiction to hear substantive tax disputes, they have jurisdiction in tax debt recovery disputes. In addition, the Inspector-General of Taxation, the Commonwealth Ombudsman and, to a much lesser extent, the Australian Human Rights Commissioner and the Australian Information Commissioner can examine how specific taxpayers have been treated by the ATO. However, to avoid tax litigation before the courts, there has been emphasis on ADR, which will be further discussed in the paper.

2.3 Litigation costs, effective access and tax morale

The effective access to a fair, impartial and independent process of dispute resolution is important not only from a social justice viewpoint but also from a more practical perspective on 'tax morale'. In recent years, there has been an increasing emphasis on the concept of tax morale, which can be defined as the intrinsic motivation to pay taxes, that is, the willingness to comply voluntarily. Tax morale, a term first introduced in 1969 by Strümpel,¹⁸ can be viewed as an integral component of the fiscal psychology model. A number of key determinants of tax morale have been identified in the literature. They include social norms, tax fairness, governance and trust, and taxpaying culture.¹⁹ It seems plausible to expect that, other things being equal, the fairer the taxpayer's perception of tax dispute resolution, the more positive attitude the taxpayer will have toward the tax authority and voluntary tax compliance.

There are clearly institutions, mechanisms and processes set up to ensure that Australian taxpayers can obtain legal justice in resolving disputes with the ATO. However, the elaborate system of administrative tribunals or courts can be ineffective

¹⁷ W Shorten, 'Tax as Social Solidarity', (Speech delivered at the Tax Forum, Canberra, 5 October 2011).

¹⁸ B Strümpel, 'The Contribution of Survey Research to Public Finance' in A Peacock (ed), *Quantitative Analysis in Public Finance* (Praeger, The Hague, 1969) 13.

¹⁹ See, for example, B Torgler, *Tax Compliance and Tax Morale* (Edward Elgar, Cheltenham, 2007); J Pope and M McKerchar 'Understanding Tax Morale and Its Effect on Individual Taxpayer Compliance' (2011) 5 *British Tax Review* 587, 592.

if, for a variety of reasons, taxpayers are discouraged or deterred from using those forums for dispute resolution. It is apparent the social costs of resolving tax disputes are high, especially from the taxpayer's perspective. Note that 'social costs' refer to costs borne by the society including those incurred by the taxpayer (litigation costs), ATO, AAT and the courts. While little systematic and reliable information about taxpayers' litigation costs is available, anecdotal evidence, based on plausible assumptions about legal representation costs, suggests these costs can be prohibitive to taxpayers, particular low-income personal taxpayers.²⁰

Excessive litigation costs of tax dispute resolution (relative to the potential benefits) to the taxpayer have several implications some of which are negative to social justice. First, the observed (ex post) level of tax disputes at the ATO level (internal review) is likely to be lower than that which would prevail if the objection costs to taxpayers were very low. Thus, the ATO statistics on internal tax dispute resolution most likely underestimate the true extent of taxpayers' disagreement (as some taxpayers who disagree with the ATO's assessment may not wish to formally object to the ATO's assessment for a number of reasons²¹ including objection costs relative to the tax amount in dispute). Secondly, and similarly, the observed level of tax disputes beyond the ATO is also lower than would prevail if the litigation costs to taxpayers were sufficiently low.²² Thus, taxpayers' effective access to independent tax dispute resolution can be compromised.

Significant litigation costs may have a further negative social justice implication, even if taxpayers who disagree with the ATO's assessment are willing to seek external resolution to their tax disputes. Due to the highly technical nature of tax law, it is conceivable that taxpayers with relatively more resources at their disposal are likely to achieve more favourable outcomes relative to taxpayers with fewer resources. That is, excessive litigation costs can also adversely affect the neutrality of the final outcome. Perhaps the clearest example is the case of a self-represented taxpayer at the AAT. In this situation, inadequate representation also acts as an effective barrier to tax justice just as the costs of professional assistance do. In this context, it has been argued, at least in relation to courts, that 'the court's capacity to discharge its societal function is impaired when it engages with the self-represented litigant, thus preventing strict compliance with the rule of law'.²³ It is known that the AAT will sometimes assist taxpayers (who are not vexatious or tendentious) in presenting their cases. The

²⁰ See Tran-Nam and Walpole, above n 9.

²¹ These may include taxpayers' concerns about the effect on reputation or future relationship with the ATO.

²² It can be argued that tax disputes may not truly be a dispute on a tax matter, but rather a delaying tactic for payment of tax. This may be possible although, in Australia, tax delaying is of very limited benefit to taxpayers because (i) under the '50/50' arrangement', if the taxpayer risks external review then the taxpayer is required to pay at least 50% of the disputed tax now (Commissioner of Taxation, *Practice Settlement Law Administration* 2011/4, 2011, 50/50 arrangement), and (ii) if the tribunal/court decision is in favour of the Commissioner of Taxation, the taxpayer must pay the ATO the balance plus interest (*Taxation (Interest on Overpayments and Early Payments) Act 1983* (Cth), Pt III and *Taxation Administration Act 1953* (Cth), s 8AAD). Delaying could still be helpful to taxpayers especially when the amount of tax in dispute is large and the time required to resolve the dispute is very long. Instances of this can be made part of our primary data collection.

²³ R. Stewart, 'The Self-Represented Litigant: A Challenge to Justice' (2011) 20(3) *Journal of Judicial Administration* 146. Although lawyers or accountants can choose to represent themselves without necessarily being at a significant disadvantage, in reality they still tend to employ professional advisers to present their cases.

assistance provided by the tribunal/courts to the taxpayers would, to some extent, redress the issue of effective accessibility being discussed. However, there is a limit to how much the tribunal/court can do to assist taxpayers whilst maintain their neutrality as required by law.

2.4 Accessibility and neutrality in a broader context

The accessibility and neutrality of independent tax dispute resolution should be placed in the broader context of socioeconomic changes in Australia, especially over the past 30 years. As a young nation, the notion of a 'fair go' has been enshrined in the Australian ethos. However, while data is limited, there is an agreement that income inequality in Australia has been on the rise since the 1980s.²⁴ Lack of access to and neutrality of independent tax dispute resolution accentuates this inequality. First, the inability of certain individuals to access an essential government service can be construed as a violation of social justice. Secondly, if tax dispute resolution is indeed not neutral between the 'haves' and the 'have-nots', then this may be regarded as a violation of distributive justice. Both undermine egalitarianism, a notion that many Australians continue to value.

Finally it is worthwhile to note that tax disputes are, in general, not socially wasteful from a pure economic point of view. This is because the outcomes of the disputes may help to clarify the tax law, especially in test cases sponsored by the ATO. In this case, while tax disputes will increase current operating costs of the tax system, it may reduce future tax operating costs. On the negative side, however, tax disputes may indeed sometimes increase future tax operating costs, for example, if unclear/testable outcomes generate more cases.

3. BRIEF REVIEW OF LITERATURE AND DATA AVAILABILITY

3.1 Literature review

Because of the country-specific nature of taxation, we will first review the Australian tax literature and then the international tax literature. The process of tax dispute resolution in Australia is thoroughly explained in Commonwealth statutes such as *Taxation Administration Act 1953* (Cth), Pt IVC; *Administrative Appeals Tribunal Act 1975* (Cth) and *Administrative Decisions (Judicial Review) Act 1977* (Cth). It has become textbook material²⁵ and there is some literature associated with it.²⁶ However, as indicated in the introductory section, there is only an insubstantial body of literature relating to the present study. In particular, there are no known Australian studies on whether the tax dispute resolution system favours the 'haves' over the 'have-nots'.

²⁴ See, for example, P Saunders, 'It's Official: Inequality Is Increasing Again', (2003) Oct *Impact* 4; P Whiteford, 'Are the Rich Getting Richer and the Poor Getting Poorer?', *Inside Story* (online), 28 September 2011, <http://inside.org.au/are-the-rich-getting-richer-and-the-poor-getting-poorer/>; D Neal, M Norton, D Ariely and C Govan, *Australian Attitudes Towards Wealth Inequality and Progressive Taxation*, (Report prepared for the Australian Council of Trade Unions, 2011), http://www.actu.org.au/media/121429/ACTU_Report_Inequality_and_Progressive_Taxation.pdf.

²⁵ See, for example, R Wollner, S Barkoczy, S Murphy, C Evans and D Pinto, *Australian Taxation Law 2016* (Oxford University Press, South Melbourne, 2016) 1725.

²⁶ See, for example, D Bentley, 'Problem Resolution: Does the ATO Approach Really Work?' (1996) 6(1) *Revenue Law Journal* 17 at 19–20; Mookhey, above n 5.

Indirectly related to the spirit of the study is a group of papers by Murphy,²⁷ Mookhey²⁸ and Jone.²⁹ From a compliance perspective, Murphy examined the relationship between procedural justice and tax non-compliance in order to design a more effective tax compliance framework. Mookhey and Jone evaluated the ATO's internal review system. While they found that the ATO dispute resolution model possesses much of the best-practice principles such as clear multi-step procedure and emphasis on negotiation, notification and consultation, the ATO model is still deficient in several respects. Specifically, Mookhey recommended that 'there is an increase in transaction costs at each level and affordable access to first-level external review is highly desirable, so as to increase the pressure for a negotiated outcome at an early stage',³⁰ whereas Jone proposed that the ATO provides 'taxpayers with the ability to enter the dispute resolution procedures at either the internal review level or external appeal level'.³¹

There are only a handful of Australian studies that explicitly consider the issue of compliance costs and accessibility to external tax dispute resolution. The first is a study by Chapple,³² which cited information about the legal costs of tax disputes from a submission by the Australian Attorney-General to the Senate Standing Committee on Legal and Constitutional Affairs.³³ While this information is almost 25 years old, it nevertheless provides a solid basis for checking new cost estimates. The second is an outdated, exploratory study by Tran-Nam and Blissenden,³⁴ which attempted to estimate the costs of tax dispute resolution from the social perspective.

More recently, Tran-Nam and Walpole³⁵ conducted perhaps the first systematic examination of the accessibility of the system of independent tax dispute resolution in Australia and the social justice implications of ineffective access to such a system. In addition to deriving plausible estimates of the compliance costs of tax dispute resolution from the taxpayer perspective under different scenarios, they also constructed a simple decision model to analyse the choice of an informed taxpayer using the traditional cost-benefit analysis. Under various assumptions, it is possible to determine whether the taxpayer will (i) settle with the ATO, or (ii) seek the AAT review without professional assistance, or (iii) seek the AAT review with professional assistance.³⁶

²⁷ K Murphy, 'Regulating More Effectively: The Relationship Between Procedural Justice, Legitimacy and Tax Non-compliance' (2005) 32(4) *Journal of Law and Society* 562.

²⁸ See Mookhey, above n 5.

²⁹ M Jone, 'Evaluating Australia's Tax Dispute Resolution System: A Dispute Systems Design Perspective' (2015) 13(2) *eJournal of Tax Research* 552.

³⁰ See Mookhey, above n 5 at 94.

³¹ See Jone, above n 29 at 577.

³² S Chapple, 'Income Tax Dispute Resolution: Can We Learn from Other Jurisdictions?' (1999) 2(5) *Journal of Australian Taxation* 312, 326.

³³ Attorney-General's Department (Cth), 'Submission to Senate Standing Committee on Legal and Constitutional Affairs', *Discussion Paper No 6, The Courts and the Conduct of Litigation*, (Commonwealth of Australia, Canberra, 1992) at [2.32] and [2.36].

³⁴ B Tran-Nam and M Blissenden, 'Compliance Costs of Tax Dispute Resolution in Australia: An Exploratory Study' in M Walpole and C Evans (eds), *Tax Administration and the 21st Century*, (Prospect, Sydney, 2001) 287.

³⁵ B Tran-Nam and M Walpole, 'Access to Tax Justice: How Costs Influence Dispute Resolution Choices' (2012) 22(1) *Journal of Judicial Administration* 1.

³⁶ See Tran-Nam and Walpole, above n 35 at 18.

There is also a paucity of international evidence on whether independent tax dispute resolution is accessible and the implications.³⁷ There is, however, a more substantial literature on the application of economic analysis to dispute resolution.³⁸ While these papers were concerned with legal disputes in general, their approaches and insights may be modified for analysing tax disputes. In a seminal work on the dynamics of litigation, Galanter³⁹ made an important distinction between one-shotter (OS) and repeat player (RP) in analysing whether the US legal system is effectively neutral between the ‘haves’ and the ‘have-nots.’ His framework has been widely adopted⁴⁰ and recently applied to tax litigation in the UK.⁴¹

3.2 Australian data availability

There is some published secondary data on tax disputes and tax dispute resolution in Australia. The main sources include various annual reports such as the

- Commissioner of Taxation Annual Report
- AAT Annual Report
- Federal Court Annual Report
- High Court Annual Report
- Commonwealth Ombudsman Annual Report
- Inspector General of Taxation Annual Report.

A particularly informative ATO publication on tax disputes is the *Your Case Matters: Tax and Superannuation Litigation Trends*. Unfortunately, this publication is only published on an irregular basis and the latest edition available is the third edition covering July 2007 to December 2012. This is therefore somewhat out-of-date.

While the data are reliable, they are only available in aggregate form and thus of limited value for the purposes of the present study. Unit record data on tax disputes are collected but they are generally unavailable to researchers.

³⁷ See, for example, P E Treusch, ‘What to Consider in Choosing a Forum to Resolve an Ordinary Tax Dispute’ (2001) 55(1) *Tax Lawyer* 83; L Lederman and W B Hrungr, ‘Do Attorneys Do Their Clients Justice? An Empirical Study of Lawyers’ Effects on Tax Court Litigation Outcomes’ (2006) 41 *Wake Forest Law Review* 1235; A Maples, ‘Resolving Small Tax Disputes in New Zealand—Is There a Better Way?’ (2011) 6(1) *Journal of the Australasian Tax Teachers Association* 96.

³⁸ See, for example, G L Priest and B Klein, , ‘The Selection of Disputes for Litigation’ (1984) 13(1) *Journal of Legal Studies* 1; R D Cooter and D L Rubinfeld, ‘Economic Analysis of Legal Disputes and Their Resolution’ (1989) 27(3) *Journal of Economic Literature* 1067; S Shavell ‘Alternative Dispute Resolution: An Economic Analysis’ (1995) 24(1) *Journal of Legal Studies* 1; E Friedman and A L Wickelgren, ‘No Free Lunch: How Settlement Can Reduce the Legal System’s Ability to Induce Efficient Behavior’ (2008) 61 *SMU Law Review* 1355.

³⁹ M Galanter, ‘Why the “Haves” Come Out Ahead: Speculations on the Limits of Legal Change’ (1974) 9(1) *Law and Society Review* 95.

⁴⁰ See, for example, H K Kritzer and S Silbey (eds.), *In Litigation Do the ‘Haves’ Still Come Out Ahead?* (Stanford University Press, Stanford, 2004).

⁴¹ M Blackwell, ‘Do the Haves Come Out Ahead in Tax Litigation? An Empirical Study of the Dynamics of Tax Appeals in the UK’ (Working Paper No WP 13/20 Oxford University Centre for Business Taxation, Oxford, 2013).

Other potential sources of data are the various Australian studies on tax compliance costs.⁴² Since taxpayers' compliance tasks are typically broken into activities, including tax dispute resolution, it should be, in principle at least, possible to derive estimates of taxpayers costs specifically related to tax dispute resolution. However, the send-out samples of taxpayers provided to the researchers by the ATO did not include any taxpayers who are currently disputing with the ATO. Thus the effective samples did not contain sufficient number of taxpayers who have been in dispute with the ATO so that no reliable estimates of taxpayer costs of tax dispute resolution could be derived.

In the interest of academic pursuit and social benefits, it is recommended that the ATO publishes data on tax disputes and tax dispute resolution on an annual basis and also makes limited form of (anonymous) unit record data on tax disputes and tax dispute resolution available to tax researchers upon formal requests.

4. RECENT DEVELOPMENTS IN ALTERNATIVE DISPUTE RESOLUTION IN AUSTRALIA

4.1 What is alternative dispute resolution?

ADR is a term that emerged in Australian legal circles in the 1980s.⁴³ Initially it was used to describe a procedure by which legal disputes are resolved by mediation. However, its meaning has been considerably expanded. ADR is now defined as 'an umbrella term for processes, other than judicial determination, in which an impartial person assists those in dispute to resolve the issues between them'.⁴⁴ ADR often takes the form of negotiation, mediation and arbitration.⁴⁵ Each of these can be observed in the current tax administration system. For example:

- Negotiation (no third party): Tax audits often conclude with a negotiated settlement⁴⁶
- Mediation (with mediator): The process followed in the AAT (via conferences) or Commonwealth Ombudsman's Office (via the Special Taxation Adviser)
- Arbitration: The AAT also provides an example of formal arbitration in the sense that it 'makes a binding determination of the law and facts in dispute'.⁴⁷

⁴² See, for example, Tran-Nam, Evans and Lignier, above n 7; C Evans, R Ritchie, B Tran-Nam and M Walpole, *A Report into Taxpayer Costs of Compliance*, (Australian Government Publishing Service, Canberra, 1997).

⁴³ D Porrester, 'Review of H Astor & CM Chinkin, *Dispute Resolution in Australia*, Sydney: Butterworths. \$55.00' (1992) 22(2) *UWA Law Journal* 447.

⁴⁴ National Alternative Dispute Resolution Advisory Council, *Dispute Resolution Terms* (NADRAC, Canberra, 2003) 4, <https://www.ag.gov.au/LegalSystem/AlternateDisputeResolution/Documents/NADRAC%20Publications/Dispute%20Resolution%20Terms.DOC>

⁴⁵ See Bentley, above n 26 at 19–20.

⁴⁶ See, for example, R Bryant, 'Tax Audit Experience—Key Issues' (Paper presented at the 31st Victoria Taxation Convention, Lorne, 29–31 October 1992); M D'Ascenzo, 'A Tax Office Insight into Business Audits' (Paper presented at the 23rd Queensland Tax Convention, 4–6 June 1993).

⁴⁷ H Astor and C M Chinkin, *Dispute Resolution in Australia* (LexisNexis Butterworths, Chatswood, 2002) 297.

4.2 Advantages and disadvantages of ADR

Five major advantages of ADR have been identified in the literature:⁴⁸

- reduced time in dispute
- reduced costs relating to the dispute resolution
- increased probability of settlement
- improved satisfaction among disputants with the outcome or manner in which the dispute is resolved
- increased compliance with agreed solutions.

The main disadvantage of ADR is that there is very limited opportunity for judicial review of an arbitrator's decision.

There is some Australian evidence suggesting that the above general advantages carry over to tax disputes. Sourdin and Shanks have recently provided an empirical analysis of the costs and benefits of ADR in taxation disputes.⁴⁹ They surveyed and analysed the experiences of ATO internal staff members, taxpayers, ADR practitioners, taxpayer representatives and ATO representatives who were involved in ADR processes in relation to taxation and superannuation disputes that took place between 1 July 2013 and 30 June 2014. The ADR processes that were considered include conciliation, mediation, neutral evaluation and case appraisal.

Sourdin and Shanks found that the median cost saved in the successful resolution of disputes after ADR was approximately \$70,000 per matter.⁵⁰ They noted, however, that in many instances significant costs had been incurred prior to commencing ADR processes.⁵¹ In particular, the study revealed that taxpayers involved in dispute resolution expended a considerable amount for external non-lawyer professionals such as external valuers.⁵²

Some cautionary remarks are in order. First, the estimated cost saving refers to self-reported, assumed saving in legal costs only (time costs and other incidental costs were excluded). Secondly, all five groups of respondents were asked more or less the same question about legal cost saving⁵³ and there is no clear explanation how the overall cost saving was aggregated. It seems that the legal costs saved refer to saving made by both the taxpayer and ATO, and it is not possible from the study to deduce the average or median value of legal cost saving enjoyed by the taxpayer only (which

⁴⁸ K Saville-Smith and R Fraser, *Alternative Dispute Resolution: General Civil Cases*, (NZ Ministry of Justice, Wellington, 2004) 25, <http://www.justice.govt.nz/assets/Documents/Publications/ReportFinal3.pdf>

⁴⁹ T Sourdin and A Shanks, 'Evaluating Alternative Dispute Resolution in Taxation Disputes: Exploring Selected ADR Processes that Took Place From 1 July 2013–30 June 2014', (Evaluation of ADR Paper No. 4, Australian Centre for Justice Innovation, Melbourne, 2015).

⁵⁰ See Sourdin and Shanks, above n 49 at [4.9].

⁵¹ See Sourdin and Shanks, above n 49 at [4.10]. This may be particularly so in recent times where ADR may have been mandated by the AAT or Federal Court after proceedings have been instituted and preliminary conferences, etc, have been held.

⁵² See Sourdin and Shanks, above n 49 at [4.12]; [4.15].

⁵³ See Sourdin and Shanks, above n 49 at Appendix C.

is the focus of our research). Thirdly, the sample size of taxpayers was small (19) and many of them did not report on costs incurred or saved.⁵⁴ So even if a separate estimate of legal cost saving for the taxpayer was available, this could not be validly generalised. As a result, the finding on legal cost saving must be interpreted with caution, as recognised by Sourdin and Shanks.⁵⁵

Sourdin and Shanks also found that the earlier the ADR intervention took place, then the more likely the dispute would be resolved with greater cost savings.⁵⁶ Of note, the survey results indicated that the timing of ADR referral varied between states, which the authors attributed to a range of factors including the approaches of the ATO, the AAT and the Federal Court, and whether there were 'ADR champions' who supported earlier referral.⁵⁷ As such, the authors concluded that the costs of dispute resolution to taxpayers could be reduced by an earlier clarification of issues and earlier use of ADR.⁵⁸

Despite some reservations, the thorough research by Sourdin and Shanks nevertheless suggests that ADR may provide an alternative option that can reduce not only taxpayers' litigation costs but also social compliance costs of tax disputes. ADR thus deserves to be explored much more deeply and extensively as a mechanism for resolving tax disputes.

4.3 Recent developments at the ATO

There have been many initiatives to improve the ATO's resolution of tax disputes following the 2015 Report of the House of Representatives Standing Committee on Tax and Revenue, and the 2015 Report of the General-Inspector of Taxation on tax disputes for large businesses and high wealth individuals.⁵⁹ Those initiatives include:

- move all objections into the Review and Dispute Resolution area
- a revised Code of Settlement practice
- early engagement
- 'pick-up-the-phone' approach
- in-house facilitation
- independent review
- development of communications protocols to enhance independence
- measuring fairness in disputes
- dispute resolution training.

⁵⁴ See Sourdin and Shanks, above n 49 at [1.16]; [4.12].

⁵⁵ See Sourdin and Shanks, above n 50.

⁵⁶ See Sourdin and Shanks, above n 49 at [4.13].

⁵⁷ See Sourdin and Shanks, above n 49 at [4.20].

⁵⁸ See Sourdin and Shanks, above n 49 at [4.12]; [4.15].

⁵⁹ A Orme, 'Australian Taxation Office Dispute Resolution' (Paper presented at the Victorian 3rd Annual Tax Forum, Melbourne, 8 October 2015) at 3.

According to the ATO, some of those measures have so far yielded positive results in reducing the number of disputes or the time required to resolve disputes.⁶⁰ For example, the ‘pick-up-the-phone’ strategy provides taxpayers the opportunity to explain their views and clarify the any misunderstanding about the facts and the law. Similarly, in-house facilitation is designed to provide taxpayers with an opportunity to meet with ATO case officers and an ATO impartial facilitator in an early, direct and open manner. However, a more thorough and independent analysis is necessary to confirm whether (i) ATO facilitators are impartial, and (ii) the results are indeed positive and, if so, sustainable.

5. A FUTURE RESEARCH AGENDA

To study the effective accessibility and neutrality of tax dispute resolution in Australia, it is proposed that a holistic approach be employed. The proposed approach should examine relevant issues under study from all stakeholders’ perspectives using a mixed method of quantitative and qualitative analyses of both primary and secondary data. Key elements of the research agenda, including recognition of relevant stakeholders, development of theoretical models and hypotheses, data collection, and data analysis, are briefly discussed in turn below.

5.1 Recognition of stakeholders

Relevant stakeholders include taxpayers (individuals and businesses) who have been in disputes with the ATO, the ATO and their legal representatives, professional tax practitioners who advise both the ATO and taxpayers in disputes, and AAT members and judges. In principle, those taxpayers who are dissatisfied with the ATO’s decisions but do not formally object should also be included. However, in practice it would be impossible to identify those taxpayers even with the assistance of the ATO.

5.2 Development of theoretical models and hypotheses

Once stakeholders have been recognised, it is necessary to conceptualise the decision facing the taxpayer who is in dispute with the ATO and state relevant hypotheses. In terms of theoretical modelling, two approaches can be employed:

- (i) taxpayer’s decision from the perspective of the taxpayer only, taking the ATO’s decision as given
- (ii) taxpayer’s decision taking into account the interaction and negotiation between the ATO and the taxpayer.

Under approach (i), the taxpayer’s decision whether to settle or to litigate can be modelled by the standard cost–benefit analysis. This will build upon an earlier model developed by the authors and discussed previously.⁶¹ Under approach (ii), the interaction between the ATO and the taxpayer in dispute resolution can be modelled using the game-theoretic approach.

⁶⁰ C Jordan, ‘Commissioner of Taxation Keynote Address’ (Presented at the 12th International Conference on Tax Administration, Coogee, 31 March 2016).

⁶¹ See Tran-Nam and Walpole, above n 35.

The modelling of the taxpayer's decision under approach (i) involves identifying the taxpayer's motive (maximising/minimising financial gains/losses), choices (settle before dispute, settle during dispute, or litigate with or without legal representation), and the consequences of each of these choices, which in turn depend on institutional factors (for example, legal costs are tax deductible or the AAT does not award costs to 'winners' while courts do award costs to 'winners'). There are several complications that need to be considered. For example, in addition to financial considerations, there are non-financial factors that cannot be easily captured quantitatively. Similarly, financial gains/losses can be either one-off or ongoing (especially if taxpayers seek clarity of the tax laws so that they can continue to engage in tax planning or make deduction claims in the future). These issues may be resolved by (i) incorporating a non-financial variable as a determinant of the taxpayer's objective function and (ii) formulating the taxpayer's motive as a multi-period objective function. Another relevant issue in this theoretical approach is the determination of the taxpayer's subjective probability of success in the AAT or the courts, which will depend, amongst other things, on whether or not professional assistance is engaged.

A more sophisticated approach is to take the role of the ATO into account and model the interaction between the ATO and the taxpayer as a game with mixed strategies (probabilistic approach to game theory). As previously reviewed, game theory has been applied with some success to the problem of paying taxes and auditing taxpayers⁶² but not to tax dispute resolution. This study will develop a game with mixed strategies to capture the process of tax dispute resolution. A major challenge in so doing is how to incorporate the role of tax advisers in the game.

There will be no formal model developed for investigating the neutrality of independent tax dispute resolution. There will instead be a comprehensive legal analysis as to whether the ATO (as ultimate repeat player (RP)) or large businesses (as RPs with non-trivial bargaining power) enjoy a position of advantage over one-shotters (OSs) in tax dispute resolution. Further, a number of testable hypotheses will also be proposed. They are:

- (i) *Alternative hypothesis A:* Costs to taxpayers and duration of tax disputes render access to independent tax dispute resolution ineffective
- (ii) *Alternative hypothesis B:* Legal representation of taxpayers makes a difference in the outcomes of the disputes
- (iii) *Alternative hypothesis C:* The ATO is more likely to lose against a RP than an OS
- (iv) *Alternative hypothesis D:* The ATO is more likely to appeal losses against OSs (individuals, trustees, etc) than RPs (large or foreign companies)
- (v) *Alternative hypothesis E:* RPs are more likely to appeal losses against the ATO than OSs.

⁶² See, for example, M Graetz, J F Reinganum and L L Wilde, 'The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement' (1986) 2(1) *Journal of Law, Economics and Organization* 1; B Erard and J S Fienstein, 'Honesty and Evasion in the Tax Compliance Game', (1994) 25(1) *Rand Journal of Economics* 1.

5.3 Data collection

The study will utilise both primary and secondary data from a variety of sources. Secondary data will be sought from publicly available sources (such as annual reports of the ATO, the AAT, Federal Courts and the High Court) as well as unpublished sources, principally the ATO. In addition, primary data will also be collected from a variety of surveys and structured interviews of relevant stakeholders. Like most empirical studies, primary data collection represents a very challenging aspect of the study.

The proposed primary data collection is summarised in the following table.

Table 1: Primary data collection by hypothesis

Hypothesis	Primary data
<i>A</i>	Interviews of tax advisers who have represented either taxpayers or the ATO at hearings or trials Survey of taxpayers who have been in dispute of the ATO Small scale e-survey of ATO officers
<i>B</i>	Interviews of tax advisers, tribunal members and judges
<i>C</i>	Interviews of tax advisers Small scale e-survey of ATO officers
<i>D</i>	Interviews of tax advisers Small scale e-survey of ATO officers
<i>E</i>	Interviews of tax advisers Small scale e-survey of ATO officers

The main survey will involve taxpayers who have been in dispute with the ATO. This will be a large scale, anonymous survey of appropriate scale (about 1,700, that is, half a percent of the objections lodged in 2011–12).⁶³ Particular information to be sought from such participants includes their time costs and out of pocket expenses, their perceptions of any non-monetary motives (such as issues of reputation, future relationship with the ATO, risk avoidance, the psychological satisfaction of winning against ATO or exercising inherent taxpayer rights, etc), their formation of subjective probability of success and whether the gains/losses are one off or recurring. In addition, based on information obtained from public sources (for example, AAT's open hearings), a small number (about 20) of taxpayers who have been in dispute with the ATO will be approached to participate in the study via structured interviews. The purpose of the interviews is to validate and elaborate the data obtained from the large-scale survey of taxpayers.

5.4 Data analysis

A variety of mixed methods will be employed to analyse the data obtained using the theoretical frameworks which will be developed. These methods include:

⁶³ Assistance from the ATO will be sought in conducting this survey.

- legal and qualitative analyses of qualitative data obtained from surveys and interviews of taxpayers, ATO officers, tax advisers, and members of the AAT and judges
- the Delphi method for triangulating responses from ATO officers and tax advisers
- statistical analyses of quantitative data derived from the survey.

The Delphi method is a technique that aims to obtain the most reliable consensus of a group of experts such as ATO officers or tax advisers. The participating experts are encouraged to revise their previous answers in view of the ‘collective intelligence’ so that the panel may move to a consensual view. Further, both descriptive and inferential statistical methods will be employed to summarise quantitative data and test the hypotheses stated above, respectively. In addition, econometric methods such as regression analysis will also be used to isolate the partial effects of various factors on key variables under study. In particular, the probit estimation (a type of regression where the dependent variable typically takes on two values only) will be applied to study the taxpayer’s decision and the outcome of their objections/appeals.

6. SUMMARY AND CONCLUSION

This paper has discussed conceptual issues, reviewed the literature and set out a research agenda related to an ARC Discovery project on tax disputes, compliance costs and access to tax justice. The aims of the study are to investigate whether or not (i) access to independent tax dispute resolution is effective, (ii) taxpayers with greater resources may obtain more favourable outcomes than taxpayers with lesser resources, and (iii) ADR is an effective way for resolving tax disputes. In addition, the study also examines the costs and benefits of external tax dispute resolution and social justice implications of accessibility to independent tax dispute resolution.

The study is motivated by several considerations. The primary driver of the study is the relative lack of knowledge of the procedural justice dimension of tax dispute resolution as an integral aspect of the operation of the tax system in Australia. Note that procedural justice is unrelated to the legal correctness of the outcome of the process.

In discussing conceptual issues and context four key points have been made. They are (i) the literature on tax complexity tends to ignore the impact of statutory and administrative complexity on tax justice, (ii) tax disputes differ fundamentally from other civil and commercial disputes in many important respects, (iii) litigation costs may act as a barrier to effective accessibility and neutrality of tax dispute resolution mechanisms, and (iv) lack of accessibility and neutrality can give rise to a violation of social and distributive justice, respectively.

The review of literature suggests that the body of relevant literature is insubstantial. Indirectly relevant to the purpose of the study is a small set of papers on tax dispute resolution system design in Australia. The more relevant literature on compliance costs and accessibility is very thin and not sufficiently authoritative. Further, there are no Australian studies on the effects of compliance costs on the neutrality of tax dispute resolution. There is some secondary data on tax dispute resolution published by the

ATO, AAT and the courts. However, the published data are aggregative and unit record data is not available. It is recommended that the ATO either publishes the same aggregate data annually or makes unit record data more readily available to researchers.

In recent years, the ATO has introduced many initiatives aimed at improving the internal resolution of tax disputes. While it seems to be somewhat premature to reach a definite conclusion, the improved ADR approach by the ATO has the potential of not only reducing the social compliance costs and the stress but also producing socially fairer outcomes for taxpayers.

In conclusion, the effective accessibility and neutrality of tax dispute resolution in Australia (and elsewhere) is a relatively neglected area of study among tax researchers. For a number of reasons, including social justice, distributive justice and tax morale, it is imperative that a systemic and comprehensive study of external tax dispute resolution in Australia be undertaken. Such a study necessitates a holistic approach that examines the issues under study from all stakeholders' perspectives using mixed methods of quantitative and qualitative analyses of both legal and economic data. Key components of the research methodology for such a study have been sketched out in the previous section.

International experiences of tax simplification and distinguishing between necessary and unnecessary complexity

Tamer Budak¹, Simon James² and Adrian Sawyer³

Abstract

Calls for the simplification of taxation are frequently heard but attempts to achieve actual tax simplification have rarely met with lasting success. To investigate further, the present authors asked relevant experts to report on the experience of tax simplification in Australia, Canada, China, Malaysia, New Zealand, Russia, South Africa, Thailand, Turkey, the UK and the USA. In addition to tax simplification, the country experts were asked to provide information on simplification in relation to the following aspects: tax systems, tax law, taxpayer communications, tax administration and any more fundamental approaches. Their accounts were published in a book edited by the current authors early in 2016. This paper analyses the experiences of the 11 countries and it is clear that a considerable degree of complexity is inevitable given the different aims of taxation and the complex socioeconomic environments in which tax systems have to operate. The key question is how to distinguish complexity which is necessary for the functioning of a successful tax system from that which is not. This paper focuses on the relevant factors and issues involved in classifying unavoidable and unnecessary complexity not only with respect to legislation but also tax policy and administrative systems.

Keywords: complexity, simplification, tax administration, tax communications, tax law, tax systems

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1. INTRODUCTION

The *Times* (2 February 2016, p. 26) pointed out that the Ten Commandments uses fewer than 200 words, the American Declaration of Independence 1,300, and Magna Carta consists of around 4,000 words. In contrast, the British tax code, which the *Times* suggests is nothing like as enlightening, has been estimated to contain 10 million words stretching over 17,000 pages. This is a type of comparison often made and the implication is that tax systems should be simplified. However, tax simplification is not a straightforward process as many governments embarking on such a policy have discovered. The academic analysis of tax simplification and how to achieve it has been the subject of an increasing amount of attention. An early contribution by Bachrach (1945) appearing in *The Accounting Review* considered that the results of tax simplification ‘will largely be measured by the number of pages remaining in the Code’, (p. 103). As soon becomes clear, success in simplification is rather more difficult to measure. In subsequent years there have been considerable developments in understanding the meaning and wider implications of tax simplification, for example, Cooper (1993) and Tran-Nam (1999), and how to measure it, for instance, Tran-Nam and Evans (2014) and the Office of Tax Simplification (OTS) (Jones et al., 2014; Whiting, Sherwood and Jones, 2015).

There are many reasons why modern tax systems become complex, not least because they are now so large and pervasive they have to take account of the complex and changing socioeconomic environment in which they operate as indicated, for example, by James and Edwards (2008). A useful contribution to this topic therefore has to go beyond simply counting the number of words or pages in tax legislation.

This paper begins in Section 2 by presenting the findings of a survey of 11 countries regarding tax simplification. They provide further evidence that complexity and tax simplification are difficult issues and there are powerful pressures which tend to increase the complexity of tax systems. This raises the question of distinguishing between necessary and unnecessary complexity. Ulph (2013) approached the issue by suggesting that some complexity is ‘fundamental’. The real aim in trying to measure complexity might not be to measure overall complexity but to measure the extent to which taxation is unnecessarily complex. This also may not be as simple as it sounds since dividing complexity into that which is ‘necessary’ and that which is not depends on the many competing factors in tax design and reform—the aims of policy, the interactions between different policies, trade-offs between efficiency and equity and so on. To provide a framework to consider these matters, Section 3 adapts a strategic approach to tax design and reform. The purpose of this approach is to incorporate the range of pressures and constraints on a tax system in a process aimed at identifying unnecessary complexity. Section 4 examines the use of complexity indexes, such as the index developed by the OTS. It considers their possible use, not only in measuring complexity, but also unnecessary complexity. Section 5 sets out our concluding observations.

2. SURVEY OF TAX SIMPLIFICATION IN 11 COUNTRIES

Following an earlier paper by James, Sawyer and Wallschutzky (2015), the present authors decided to undertake a much wider study of tax simplification in a range of different countries. Given the importance of the topic, agreement was reached with Palgrave Macmillan to publish a book on contributions on simplification from around

the world. This was duly published (James, Sawyer & Budak, 2016) and this paper analyses the findings. The first stage of this study was to identify experts on the tax systems of particular countries who also had knowledge of issues involving complexity and simplification they would be willing to share. This was not always an easy process but eventually an authoritative group of experts was established who were willing to report on the tax simplification experiences in particular countries. They are listed in Table 1.

Table 1: Country Simplification Contributors

County	Contributor(s)
Australia	Binh Tran-Nam, University of New South Wales
Canada	François Vaillancourt, University of Montreal and Richard Bird, University of Toronto
China	Nolan Cormac Sharkey, University of Western Australia
Malaysia	Veerinderjeet Singh, Chairman, Tax and Malaysia and Adjunct Professor, Monash University Malaysia
New Zealand	Adrian Sawyer, University of Canterbury, New Zealand
Russia	Alexander I Pogorletskiy, Elena V Kilinkarova and Nadezhda N Bashkirova, Saint Petersburg State University
South Africa	Theuns Steyn and Madeleine Stiglingh, University of Pretoria
Thailand	Thamrongsak Svetalekth, Kasetsart University
Turkey	Tamer Budak and Serkan Benk, Inonu University
UK	Simon James, University of Exeter
USA	Hughlene Burton, University of North Carolina Charlotte and Stewart Karlinsky, Emeritus Professor, San Jose State University

The contributors were sent a pre-publication version of the James, Sawyer and Wallschutzky (2015) paper as a guide to the matters under investigation and asked to include, if it were appropriate, relevant information on the following aspects:

1. simplification of tax systems
2. simplifying tax law
3. simplifying taxpayer communications
4. simplifying tax administration
5. longer term or more fundamental approaches to simplification.

Almost all of the 11 contributions included significant examples of all five aspects, which are useful themes in examining different dimensions of simplification.

However, even within this fairly specific framework, the expert contributions often varied considerably in the attention they gave to different issues and the actual experiences they examined. This is not surprising of course, not least because the political and socioeconomic environment within which tax systems operate often vary considerably between different countries. For instance, Sharkey (2016, p. 45) pointed out that the simplification of income tax in China is significantly different from most of the other countries represented in this study, essentially because the ‘tax institution environment’ is different. Nevertheless, the contributions also demonstrated that each country has significant challenges with tax complexity, tried different way to simplify taxation and achieved different degrees of success. The diversity of the experiences of these countries means a case study approach is the most appropriate method of analysis and perhaps the best way is to examine the experiences of the different countries is by the aspects listed above, starting with the simplification of tax systems.

2.1 The simplification of tax systems

Calls for tax simplification often focus on the tax system itself—the number of taxes, the tax bases, the exemptions and the structure of tax rates. However, the contributions from the 11 countries suggest that major simplification of tax systems is relatively rare. Some countries such as the United States (US) have proposed simplification of this sort but without much success. Others have made substantial improvements, for example, the legislative package introduced in Turkey in 2004 which simplified the taxation of personal income and corporate earnings (Budak and Benk, 2016, p. 212). Other countries such as Canada have abolished some taxes but seen complexity increase elsewhere in the tax system (Vaillancourt and Bird, 2016). One major advance in terms of simplification is the introduction of a flat tax in Russia. The flat tax, an idea developed by Hall and Rabushka (1983 and 2007), involves a single rate of tax. It has been examined, for example, by Keen, Kim and Varsano. (2008) and much discussed in the US and many other countries but without them actually going as far as introducing one. However, such a tax has been introduced in Russia. The Russian contributors (Pogorletskiy, Kilinkarova & Bashkirova, 2016) reported on its success since it was introduced from 2000 onwards when one basic rate of income tax of 13 percent on individual residents of the Russian Federation replaced five rates ranging from 12 percent to 35 percent. Some countries of Central and Eastern Europe have followed the Russian example, in particular, Belarus, Bulgaria, Hungary, Latvia and the Czech Republic.

2.2 Simplifying tax law

In some countries, notably Australia, New Zealand (NZ) and the United Kingdom (UK), there have been attempts to simplify tax law without simultaneously simplifying the tax system itself. It seems fair to conclude that simplifying taxation by re-writing the tax law alone has had limited success. The Australian contributor described the Tax Law Improvement Project (TLIP) set up to simplify tax law by rewriting and restructuring the *Income Tax Assessment Act 1936*. The rewritten legislation was incorporated in the *Income Tax Assessment Act 1997* which was intended to replace the 1936 Act. However, before the 1997 Act was completed the TLIP was brought to an end with the result that income tax in Australia is governed by two parallel pieces of legislation in the form of the 1936 and 1997 Acts (Tran-Nam, 2016, p. 28). New Zealand has been one of the most prominent countries in rewriting and reorganising its

income tax legislation and there is evidence that the NZ Rewrite Project led to improvements in readability and to a lesser extent improvements in understandability. Nevertheless, rewriting and reorganising tax law is ‘in itself no guarantee that the resulting text will be understandable when it is assessed using various forms of readability testing’ (Sawyer, 2016, p. 119). In the UK the Tax Law Review Committee (TLRC) was set up in 1994 and suggested that tax legislation could be written in plain language. This approach was adopted by the UK Government in 1995 and the Tax Law Rewrite (TLR) project was established in 1996 to rewrite primary legislation but without changing the law. The original intention was ambitious—to rewrite most of the primary legislation on income tax, corporation tax, capital gains tax, inheritance tax, petroleum revenue tax and stamp duties. As in Australia and NZ there was some success in simplification but it was decided to end the project. The Financial Secretary to the Treasury stated in a written report:

Since it was set up, the [TLR] project has played a key role in modernising tax legislation and making it far more accessible and easier to apply. Its work has rightly been widely praised, and has provided considerable benefits for users. However the benefits of rewriting other parts of the direct tax code are less clear and there is less support for extending the work of the project into these areas. I am satisfied that when the project’s next two Bills are enacted, the time will be right to bring this work to an end (Hansard HC, 16 July 2009).

In Australia, NZ and the UK some improvements were achieved but they were limited because they only tackled the complexity of tax legislation without paying proper attention to the full range of reasons why tax systems become complex (James, 2016, p. 236).

2.3 Simplifying taxpayer communications

Many examples of initiatives to improve taxpayer communications are reported, often involving the use of technology going well beyond the maintenance of comprehensive websites containing information designed for taxpayers. In NZ, there has been a particular focus on developing the Inland Revenue Department’s (IRD’s) website with the aim that it should become the principal means of interacting with taxpayers and there is a policy of making communications clearer. There are also plans for ambitious technological developments such as a ‘high-tech digital infrastructure’ in Russia and new digital tax accounts in the UK. Some countries, for example, Thailand, use social media to communicate with taxpayers (Svetalekh, 2016, p. 201).

Developments in taxpayer communications, as in other areas, are a reminder that taxation reflects circumstances and trends in society more generally. For instance, in the US legislation has been passed to ‘improve the effectiveness and accountability of Federal Agencies to the public by promoting clear Government communication that the public can understand and use’ (quoted by Burton and Karlinsky, 2016, p. 260). This legislation covers all executive branches of government including, of course, the Treasury Department and the Internal Revenue Service (IRS). In South Africa, there has been a range of initiatives to simplify taxpayer communications including a ‘filing season’ campaign of high interaction between the government and taxpayers, and both permanent and mobile branches as well as online help services (Steyn and Stiglingh, 2016, pp. 168–170).

2.4 Simplifying tax administration

There have been some major achievements in simplifying tax administration both in terms of limiting the numbers of tax returns issued in some countries and also in ‘pre-populating’ (pre-filling) tax returns that are sent out. In the UK most taxpayers have not been required to complete an annual tax return since the introduction of the cumulative Pay-As-You-Earn system in 1944 which, at least in principle, withholds tax accurately from employment and some other incomes. New Zealand has also moved in this direction removing the requirement of individual taxpayers to submit annual returns. This is possible where their income is taxed at source, the relevant information is received from third parties and employee deductions are eliminated. Malaysia has also made a change in this respect so that employees with specified straightforward circumstances are no longer required to file tax returns (Singh, 2016).

Improvements in information and communication technology have encouraged two particular developments. One is the electronic filing of tax returns, which is now widespread, though it cannot be said this always promotes simplification. The other is the practice of pre-filling tax returns. Tax authorities have long received information from third parties about taxpayers’ circumstances but it is now possible to transfer this information electronically directly to individuals’ tax returns. Denmark was one of the first to introduce such arrangements in 1988 followed by other Scandinavian countries. In the countries examined in this study moves in this direction are reported from several including Australia, Malaysia and Turkey. However there is enormous scope for such an arrangement to be extended. Pre-filled returns may contain details of most sources of income together with tax withheld as well as certain deductions. The taxpayer is then required to confirm that the information already included in the return is correct or amend it and provide any other information that is required.

2.5 Longer term or more fundamental approaches to simplification

As concerns about complexity may be raised throughout the different dimensions of tax systems, tax law, taxpayer communications and tax administration, overall improvements are only likely to be achieved with lasting effect through longer term or more fundamental approaches to simplification. These are rare. Indeed, it is a reminder that tax simplification is only one aspect of tax policy that it is usually, at best, only a modest part of tax reform initiatives. One initiative that has been widely reported was the establishment of the UK’s OTS in 2010. It has produced a range of reports on specific simplification topics and many of its recommendations have been accepted by the UK Government. It has also developed a very useful tax complexity index which is examined further in Section 4 below. The work of the OTS has illustrated the complexity of the UK tax system and that simplification is both a massive and ongoing challenge. While the changes the OTS has achieved are valuable, they are relatively minor and do not form a major simplification of the tax system as a whole and it is difficult to see how they could without a more fundamental approach to tax simplification (James, 2016, p. 242). In NZ a series of reforms over 30 years seem to have made real and substantial progress up to the last major reform following the report of the Tax Working Group (TWG) in 2010, although the contributor acknowledges that it is easier to achieve change when the size and scale of the economy and tax system are small (Sawyer, 2016, p. 126).

Although the reports of tax simplification from the 11 countries in the study include many examples of successful initiatives, almost all of them are confined to particular

aspects of the tax system and relatively few make a major impact on the tax system as a whole. It may therefore be helpful to consider a strategic approach to simplification and how it might assist in identifying unnecessary complexity.

3. A STRATEGIC APPROACH TO IDENTIFYING UNNECESSARY COMPLEXITY

3.1 Overview

It has been suggested before that a strategic rather than a piecemeal approach is necessary if a policy of simplifying taxation is to succeed (James and Wallschutzky, 1997). The benefits of a more strategic approach to taxation have also been examined with respect to tax compliance (James, 2005), tax administration (James, Svetalekh & Wright, 2006), particular taxes such as income tax (James and Edwards, 2007) and to tax reform generally (James and Edwards, 2008).

The advantages of such an approach include taking account of the full range of relevant factors so the appropriate level of complexity might be seen in the light of all the other considerations and trade-offs. This approach may therefore be used to identify unnecessary complexity. Ulph (2013; 2015) distinguished between design complexity and operational complexity. Design complexity covers the tax base and the structure of tax rates and these should be linked to the aims of taxation including raising revenue while promoting economic efficiency and fairness. Operational complexity covers how easy or costly it is for honest taxpayers to comply with the obligations of the tax system. A strategic approach incorporates such considerations but takes them further in an overall assessment of taxation and the degree of complexity that may be required in a wider context. The academic discipline of management is the subject area which has focused most on developing strategy including, for example, the work of Grant (2015) and Mintzberg (2004). James and Edwards (2008) drew on the relevant strategy literature to develop a strategic approach to issues of taxation in the form of ten distinct stages adapted for the current purpose as follows:

1. Identify the aims of taxation
2. Consider different methods of achieving the aims
3. Analyse in terms of economic criteria.
4. Examine administrative constraints and considerations
5. Identify different risks regarding unnecessary complexity
6. Analyse behaviour
7. Consider the relationship between different policies
8. Develop strategies
9. Plan and implement strategies including intended outcomes
10. Monitor and evaluate the performance of the strategies against the plan

These stages will be considered in turn. At each of these stages questions can be raised regarding the extent of complexity that may be necessary.

3.2 Identify the aims of taxation

Taxation is used to support a range of government policies in addition to raising revenue to support public expenditure. It is used to redistribute income as well as encourage some activities while discourage others. Identifying the aims of taxation is not, of course, sufficient to distinguish necessary from unnecessary tax complexity but it should be the starting point to examine whether the level of complexity is proportionate given the aims of taxation.

3.3 Consider different methods of achieving the aims

Taxation may not necessarily be the best way of achieving all the aims identified above. For example, tax expenditure describes the use of tax concessions to give a fiscal advantage to a particular activity or group of individuals rather than the more direct use of public expenditure (Surrey, 1973). If tax expenditures are being used as part of a policy of redistributing income their effectiveness will be seriously limited because, of course, the benefits to individuals will normally be determined by their marginal tax rate. Those with the highest taxable incomes benefit the most and non-taxpayers do not benefit at all. Tax expenditures may be a major cause of complexity. They may also provide perverse incentives to taxpayers for whom they were not intended. Therefore different methods, or combination of methods, which may be used to achieve the policy aims set should be assessed in terms of the relevant criteria, including the degree of necessary complexity necessarily involved.

3.4 Analyse in terms of economic criteria

The most important economic criteria that may be used to analyse taxation are efficiency and equity. These are laid out in much greater detail elsewhere (for example, in James and Nobes, 2015) but their relevance to the assessment of complexity can be introduced here. The efficiency criterion relates to how a tax might affect the efficiency of the economy through effects on the allocation of resources and the extent and nature of administrative and compliance costs. A tax may be examined for excessive levels of complexity with respect to each of these aspects, particularly administration and compliance.

Equity issues are important because taxes not considered fair by taxpayers are much more difficult, and sometimes impossible, to operate successfully. The simplest direct tax is one that is levied at the same amount for everyone and so avoids the complexity of establishing individuals' circumstances. However such taxes, if imposed at significant levels, are unlikely to succeed. This was unequivocally demonstrated by the UK's community charge quickly dubbed the 'poll tax' introduced in Scotland in 1989 and England and Wales in 1990 to replace a local domestic property tax. Although it scored well on all the usual criteria for a local tax (James, 2012) the fact that for most individuals it took no account of their circumstances aroused massive opposition including public demonstrations, a major riot in London and widespread non-payment (Butler, Adonis & Travers, 1994; Smith, 1991). It was also a factor in the subsequent fall of Margaret Thatcher as Prime Minister (Gibson, 1990) and it was replaced by the less inequitable council tax. Assessing the fairness of a particular tax is difficult but there are some useful concepts. One is horizontal equity which holds that individuals in the same circumstances should pay the same in taxation which, of course, introduces the complexity of establishing those circumstances. Similarly the ability to pay approach usually involves establishing a person's income.

As Vickrey (1969, p. 736) suggested, complexity in the relevant legislation and administration comes largely from the requirement to answer four types of questions:

1. Is it income?
2. Whose income is it?
3. What kind of income is it?
4. When is it income?

This gives a more precise indication of key areas where the extent of necessary and unnecessary complexity might be identified. With indirect taxes such as GST/VAT similar considerations arise when the taxes do not cover all goods and services and complexity is generated to determine which are subject to tax and which are zero-rated or exempt.

3.5 Examine administrative constraints and considerations

Although there is an enormous academic literature on taxation and tax reform, Bird (1998, p. 183) has suggested there is not much evidence that tax administration has been given sufficient attention. Neither has there been much more since Bird made that comment, although there has been an important contribution by Aaron and Slemrod (2004) which related tax administration to a range of important matters including tax simplification. Even if tax administration is not much discussed, its importance is acknowledged, for example, during the course of the Mirrlees Review (2010) by Shaw, Slemrod and Whiting (2010, p. 1158) who stated: 'administration and enforcement are often neglected in tax policy, but they are central to making a tax system work'. Indeed, issues of tax administration may be crucial in determining the success or otherwise of many aspects of taxation including simplification. Administrative complexity should be included in the above considerations of the aims of taxation, different methods of achieving those aims and the relevant economic criteria. It has been suggested that tax administration might not always be best left to tax administrators (for example, see Devas, Delay & Hubbard, 2001).

3.6 Identify different risks regarding unnecessary complexity

Even if the current level of tax complexity were acceptable, a systematic approach to the subject should identify risks that could result in increases in unnecessary complexity. Risk management is an important part of management generally and should be equally so for taxation. The European Commission's *Risk Management Guide for Tax Administrations* (2006, p. 13) described risk management as 'taking deliberate action to improve the odds' of good outcomes and reducing the odds of bad outcomes. The European Commission's publication also states:

Risk analysis also involves the why question: why is the taxpayer behaving in a particular fashion. This is important because it contributes to the assessment and the choice of the most efficient and effective form of treatment (p. 6).

It therefore enables an assessment to be made as to where further complications are likely to arise in the tax system.

3.7 Analyse behaviour

An understanding of individual behaviour is important not only for the success of a tax system, of course, but also as an indication where unnecessary complexity might be impeding its effectiveness. It may also be used to identify situations where over simplified taxation has undesirable effects—as in the case of the UK's disastrous community charge described above—and a better situation would be one that includes the appropriate degree of necessary complexity (James, 2012).

3.8 Consider the relationship between different policies

Unnecessary complexity may well arise as a result of the relationship of the tax system with wider government economic and social policies. Where different policy objectives are not entirely consistent or compatible, there is the risk that complicated regulations might be introduced in an attempt to make them work together in practice. Such operational complexity might be avoided if there were greater co-ordination at policy level.

3.9 Develop strategies

Strategies should be developed to take account of the different priorities attached to the factors described in the above stages. Simplification is unlikely to be the most important aspect but it is important it is included in the development of strategy. It may then be possible to identify areas where complexity becomes unnecessary.

3.10 Plan and implement strategies included intended outcomes

The significance of planning and implementing strategies in the best way should not be underestimated. Mintzberg (2004) stresses the importance of strategists having expertise in the area and that they should not simply pontificate at a high level of abstraction and leave it to others to implement the strategies. The role of administration has already been mentioned and that it is not always best, or indeed fair, to leave it entirely to tax administrators, not least of course because aspects of the implementation may have implications for other areas of policy. It is also important that outcomes should be identified so that the operation of the strategy in practice may be monitored and modified if necessary. This is another role for tax complexity indexes as examined in Section 4.

3.11 Monitor and evaluate the performance of the strategies against the plan

One of the reasons why it is difficult to keep taxes relatively simple is the continuous pressure to add complexity for the reasons described above. The purpose of monitoring and evaluation is to observe how far the original strategy is being achieved and whether unnecessary complexity is growing. Tax reforms are not always monitored appropriately with respect to their intended aims and whether and in what ways they should be modified over time.

3.12 Tax salience

A further contribution not suggested by James and Edwards (2008), is that of tax salience, and its interrelationship with tax complexity. Tax salience refers to the gap between a taxpayer's perception of a tax obligation and the amount that is actually owed (Mumford, 2015). Mumford looks at the work of the OTS with respect to confidence, fairness and salience, and the interaction between politics and the law.

One important observation made by Mumford (2015) is that the OTS was established in the midst of the 2008 financial crisis, with the economic crisis encouraging more thought from the bureaucracy with respect to complexity and salience of tax policy. As part of the Finance Bill 2016, provision is made in clauses 83–88 for the OTS to be permanently established, including setting out its functions and process of review of the OTS.

Salience is closely related to the concept of complexity, with the notion that low tax salience by taxpayers generally may be related to greater levels of tax complexity. This higher degree of complexity may arise due to the pursuit of goals that benefit the tax authority, or through ‘worthwhile and necessary objectives in the interests of the taxpayer’ (Mumford, 2015, p. 191). Mumford also observes:

[P]erhaps, taxpayers ask too much of tax legislation or place unreasonable demands upon the capacity of written legislation to communicate, effectively, what at first glance might appear to be simple concepts – for example, the tax terms of asset or gain (p. 191).

To date we would suggest the approaches taken to reducing tax complexity have not had a clear strategic focus, which may in part explain why initiatives to date have been largely unsuccessful in reducing (unnecessary) tax complexity. We now turn to examine a promising area of research into identifying and measuring tax complexity, namely the development of various forms of a tax complexity index.

4. COMPLEXITY INDICES

4.1 Overview to the Office of Tax Simplification’s Complexity Index development

A recent contribution to the debate over measuring complexity in tax legislation is the OTS’s Complexity Index, the first version being released in 2012 (OTS, 2012).

The aim of the Complexity Index, according to the OTS, is:

1. To provide an indication of which areas of tax legislation are considered to be particularly complex compared to others
2. To develop a tool that will help to prioritise the future work of the OTS
3. In the long term, possibly to provide tax policy makers with a methodology to help avoid unnecessary complexity in future and to help prioritise areas for future tax simplification.

In constructing the Complexity Index, the OTS sought to identify seven key criteria, which it believes influence the complexity of tax legislation. Each of these criteria is scored out of 5, assigned a weighting, enabling a complexity index score out of 10. Then, this relative score can be used to rank all of the tax legislation by degree of complexity. The seven criteria used are:

1. Legislative complexity
2. HMRC guidance complexity
3. Number of taxpayers impacted by the legislation

4. Average ability of taxpayers involved in the area
5. Avoidance risk
6. Cost of compliance
7. HMRC operating costs.

The Complexity Index is intended to be applied to the complete UK tax system (including EU legislation that operates in the UK).

Sawyer (2013), in a preliminary review of the Complexity Index, suggests that the first release of the Complexity Index:

... was developed pragmatically and without consideration for its limited rigour. Furthermore, it has included what may be an arbitrary choice of criteria (for instance, the readability score index used could be any one of a number of measures, with no explanation for provided as to why the Gunning-Fog index was selected) (pp. 336–7, emphasis added).

The Complexity Index, as originally proposed, combined compliance costs and HMRC operating costs as a single measure. Sawyer (2013) suggests that the features of these two measures are such that they are not readily comparable, since compliance costs and administration costs often reflect a conscious trade-off, and therefore need separate weights. Furthermore, the Complexity Index combines aspects of mathematical precision in some areas with ‘estimates’ or ‘feelings’ in others.

The release of the Complexity Index and invitation for feedback led to a number of responses, which in part led to further refinements in the first version of the Complexity Index. In February 2013, a second version of the index was released for comment (OTS, 2013). A major change in this version was the distinction drawn between underlying complexity and the impact of complexity. This revision both draws upon, and distinguishes in part, the work of Tran-Nam and Evans (2013/14). As defined by the OTS, ‘Underlying Complexity is the intrinsic complexity found in the structure of the tax which this consists of policy and legislative complexity’ (OTS, 2013, p. 1).

Underlying Complexity would have six measures:

1. The number of exemptions plus the number of reliefs
2. The number of Finance Acts with changes to the area (since 2000)
3. The Gunning-Fog Readability Index
4. The number of pages of legislation
5. Readability and availability of HMRC guidance
6. Complexity of information requirements to make a return.

Impact of Complexity was defined as:

... a combination of both the cost of compliance to an individual taxpayer and the aggregated cost of compliance for all taxpayers. *This is distinct from*

underlying complexity due to the role played by the impact of policy. Although underlying complexity can have an effect on the impact of complexity (i.e. by structuring a tax measure in a way that applies to more customers), how the measure is implemented can affect overall complexity (OTS, 2013, p. 1, emphasis added).

This component of the Complexity Index would have four measures:

1. Net average cost per taxpayer, incurred by taxpayers and HMRC
2. Number of taxpayers
3. Average ability of taxpayers
4. Avoidance risk.

The Complexity Index was recognised by the OTS to be a work in progress needing further methodological refinement. For instance, determination of the weightings to the various factors could be developed through use of the Delphi technique (Evans & Collier, 2012). The Delphi technique was developed by Dalkey and Helmer (1963) at the Rand Corporation in the 1950s. It is a widely used and accepted method designed to achieve consensus of opinion of experts, within certain topic areas, on a significant issue. As a group communication process, through the debate and discussions on a specific issue, the Delphi technique seeks to enable goal setting, policy investigation, and/or predicting the occurrence of future events. As Tran-Nam and Evans (2014) observe, any application of the Delphi technique to tax complexity index proposals has yet to be undertaken or reported on.

James, Sawyer and Wallschutzky (2015), observe in relation to the OTS's Complexity Index:

Whether the Complexity Index will prove effective remains unclear, as while it focuses on legislative complexity, it does not appear to be able to differentiate between business size and sector, both critical factors in the debate over complexity. As Evans and Tran-Nam (2014) observe, in order to "...develop a rigorous and acceptable tax system complexity index it is necessary to review both the tax complexity literature and the basic theory of index numbers". (pp. 296–7).

As noted in the previous section, Ulph (2015) views tax complexity within two broad concepts: design complexity, and operational complexity. Within these concepts Ulph (2015) seeks to breakdown the components of complexity further into fundamental complexity and unnecessary complexity, concepts which we will revisit later in the paper.

Commenting on how complexity may be measured, Ulph (2015) reviews the revised version of the OTS's Complexity Index, which he acknowledges remains a preliminary measure and work in progress. Ulph agrees with the OTS's approach to create two separate indices: one for intrinsic/underlying complexity and one for impact. However, Ulph (2015) would prefer to see design complexity and measurements of readability kept separate (with the readability index used by the OTS probably not capturing all of the compliance complexity factors). The number of pages is not seen by Ulph to be an appropriate measure of complexity, with the

potential also for double counting with the capture of number of reliefs provided (which in turn would add additional pages). With respect to impact, the hypothetical 'average' ability of taxpayers is not seen as appropriate by Ulph. Furthermore, in Ulph's view, the OTS has not made a strong case for including HMRC's operating costs. In this regard Ulph (2015, pp. 52–3) observes that: '[i]f the Chancellor (Minister of Finance) decides to cut public expenditure and so reduces HMRC's operating costs, that does not mean that the tax system has become less complex.' Overall we agree with Ulph's (2015) observations concerning the OTS's Complexity Index.

4.2 Other proposals for developing a complexity index

Tran-Nam and Evans (2014) is the most comprehensive attempt to date to develop a complexity index based on Australia's tax system. Tax complexity is a multidimensional concept without any universally accepted single overall measure of complexity. Tran-Nam and Evans (2014) suggest that this complexity index should be:

... interpreted as a summary indicator of the overall complexity of a tax system at a particular point in time, so a series of such an index can be used to monitor the changing level of tax system complexity of a country over time (pp. 342–3).

Tran-Nam and Evans (2014) review the sources and indicators of tax complexity, before reviewing basic index number theory. They conclude:

In summary, therefore, the purpose of the index number must be clearly identified from the outset, along with the factors to be included in the index, suitably weighted. In addition, a fixed base period needs to be established and appropriate formulas, based upon the geometric mean, devised. Finally, usable estimates that satisfy various axioms of integrity have to be derived (p. 355, emphasis added).

Tran-Nam and Evans (2014) support in principle the OTS's initiative of developing Complexity Index, but suggest a number of significant refinements are necessary. In taking the development process further, they recommend that, with respect to a complexity index:

... at this stage at least, we should focus on an index that facilitates temporal comparisons of the overall level of tax complexity in a particular country. It is further proposed that two indices – one for business taxpayers and one for personal taxpayers – should be separately developed. A mixture of the axiomatic and statistical approaches is considered to be the most suitable approach.

Finally, the paper proposes that the tax complexity index should be calculated as a weighted geometric mean of relative changes in identified complexity factors, which are in turn derived from careful empirical studies. It is acknowledged that the successful construction of such indices depends critically on the difficult and challenging task of obtaining reliable estimates of complexity factors. (pp. 367–8, emphasis added).

Borrego et al. (2015) develop three indices to measure *perceptions of complexity* based on empirical data gathered from a survey of tax professionals in Portugal.

These indices are referred to as the Legal Tax Complexity Index, Index of Complexity of Preparation of Information and Record Keeping, and the Index of Complexity of Tax Forms. Using principal component analysis, the authors conclude that these three indices can be regrouped into a new index, the General Tax Complexity Index. The authors intend this index to be a check on the relative weights of the three partial indices. One key variable to emerge from the data gathered was expressed by the authors as a Tax Knowledge Index, which illustrates that as tax knowledge increased, the level of tax complexity decreased. Borrego et al. (2015) suggest that a longitudinal study is needed to again further insights, as well as determine other exogenous factors that may influence perceptions of tax complexity.

Much work remains to be done to develop a reliable complexity index that can then be used as a basis for assessing the impact on complexity from changes to the policy and operations underlying the tax system of a particular country. Countries with complex tax systems, such as Canada (see Vaillancourt, Roy & Lammam, 2015), NZ (Sawyer, 2013) and the US (Partlow, 2013), have yet to formally embark down a path similar to that taken by the UK in developing a detailed complexity index. However, as a preliminary step, while Canada does not currently have a similar regulatory body to the UK's OTS, Vaillancourt, Roy and Lammam (2015) provide empirical data on tax expenditures, tax legislation and tax guides as potential indicators of the growth in complexity in Canada. Partlow (2013) applies a legal perspective to identifying what he sees as the inherent causes of complexity in the US. We will discuss Partlow's contributions in the next subsection of this paper.

4.3 Necessary complexity and unnecessary complexity

Critical to our paper is how one can distinguish between necessary (or fundamental) complexity and unnecessary complexity, with the aim to focus reform efforts on reducing or eliminating the latter as far as is practical. Jones et al. (2014) and Whiting, Sherwood and Jones (2015) state:

When the underlying complexity and impact of complexity have been calculated, it will be possible to know whether a tax is relatively complex or not, and why.

However, this is not enough to inform the OTS's work, *as often complexity in a tax measure can be because of real-world commercial complexity, which cannot be simplified.*

Some taxes may in fact be necessarily complex. This could be because they seek to tax complex financial transactions or commercial structures. This means that simplification of the tax is not possible without either:

- changing the policy objective
- finding a way to simplify the business situation or transaction
- creating avoidance or non-compliance where additional complexity could have prevented it.

Since the objective of the index is to provide the OTS with a measure to identify areas of tax which are appropriate for simplification, *being able to*

capture which taxes are necessarily complex and which are not would be helpful. (pp. 13–14, 249, emphasis added).

We agree with the sentiments of the OTS regarding certain areas of complexity being inevitable as a result of complex world, but are disappointed with their last statement. The OTS's last comment suggests that its Complexity Index is designed to assist in identifying areas where taxes could be simplified but (unfortunately in our view), is not intended to identify those taxes (or components of taxes) which are necessarily complex and cannot be simplified (or if they are, could lead to unintended consequences elsewhere in the tax system). We also wish to emphasise that the work of Ulph (2013; 2015) is instructional for developing an index to measure policy objective complexity, which in turn may inform the analysis over areas of 'necessary complexity'.

Most recently, the OTS (2015) offered some principles that it sees as helpful for avoiding complexity:

First: think through the policy to make sure the policy aims will be met by the tax measure being proposed: ...

Second: focus the measure carefully: ...

Third: design the measure to meet the aim: ...

Fourth: maintain the measure properly: ... (pp. 5–7).

Behind these broad statements are key steps that the OTS recommends should assist in aiming for a simpler tax system to the extent that the level of complexity in the wider world permits. The OTS has yet to publicly comment on how it is advancing its research in this area.

Partlow (2013) recognises the necessity for certain complexity in the US tax system as a result of the forces behind the system all lead to complexity (structural, technical and compliance complexity), along with the US having a 'complicated society'. Partlow's suggestion has a clear legalistic focus, namely that what is needed is the:

systematic elimination of inequities and unnecessary complexities in the individual [Internal Revenue Code] sections and in the application of the Code sections, taking into account how the provision interact with the rest of the Code (p. 327, emphasis added).

Unfortunately Partlow's (2013) modest proposal to remove a degree of 'unnecessary complexity' appears unachievable in the current US political environment with the impasses on major tax reform between Congress and the Office of the President.

As noted earlier, Ulph (2015) distinguishes between fundamental complexity and unnecessary complexity. In his analysis, Ulph (2015) recognises that while a revenue authority will also require information from taxpayers, with the advantage of improvements in technology for example, this information may only need to be captured once or through other avenues. In reducing complexity Ulph (2015) makes the following observation:

So drawing all this discussion together, when one talks of reducing tax complexity there are a number of different things that could be meant:

i. *Retaining the existing tax design but delivering it in a less complex way – essentially by reducing operational complexity* by, for example, writing legislation/guidance in a form that is easier to understand or removing unnecessary informational complexity.

ii. *Retaining the given aims of the tax system but trying to achieve these in a less complex way* – by reducing the *unnecessary design complexity*. (p. 47, emphasis added).

Sherwood (2015), then head of the OTS, in a UNSW Business School Thought Leadership Lecture in 2015, defined necessary complexity as ‘the minimum complexity needed to deliver the broad policy aims’. Examples offered by Sherwood include: political/social aims; economic aims; fairness; certainty; avoidance measures, and the like. On the other hand, Sherwood provided examples of unnecessary complexity as: ‘poor policy design, (for example, artificial boundaries); too many special cases; badly worded law; poor guidance; complicated and expensive processes, etc’. Within the UK, Sherwood pointed to examples of unnecessary complexity being the capital gains tax (CGT) taper relief, many badly targeted tax reliefs, and unclear VAT boundaries.

Further discussion that is directed at achieving consensus over what path(s) should be taken to reduce (unnecessary) tax complexity would be a positive further step to responding to Ulph’s observation. In this regard we would suggest that the Delphi technique should be applied to moving the discussion forward towards a consensus, following which the data gathering and analysis process can begin in earnest.

5. CONCLUSIONS

In the early work by the current authors, we reported on the experiences of 11 countries with respect to tax simplification initiatives. It was clear from analysing these reports that a considerable degree of complexity is inevitable given the different aims of taxation and the complex socioeconomic environments in which tax systems have to operate. The country reporters were asked to provide, as appropriate, relevant information on the following aspects:

1. Simplification of tax systems
2. Simplifying tax law
3. Simplifying taxpayer communications
4. Simplifying tax administration
5. Longer term or more fundamental approaches to simplification

Almost all of the 11 contributions included significant examples of all five aspects, which are useful themes for further analysis, but their reports often varied considerably in the attention they gave to different issues and the actual experiences they examined. Of most relevance to this paper were their observations on the longer term and more fundamental approaches to simplification. From our analysis, it is critical to explore the components of complexity and seek to identify which aspects

are necessary or fundamental for the functioning of a successful tax system, and those which are unnecessary (and able to be reduced or eliminated).

In this paper we focussed on the relevant factors and issues involved in classifying unavoidable and unnecessary complexity, not only with respect to legislation, but also tax policy and administrative systems. In identifying unnecessary complexity, we have explored the strategic approach to identifying unnecessary complexity advanced by James and Edwards (2008), supplemented by endorsing Mumford's (2015) argument for examining the impact of tax salience in relation to tax complexity.

The most significant development to date in seeking to measure the quantum and impact of various aspects of tax complexity is the work of the OTS in developing and refining its Complexity Index. While the components of the OTS's Complexity Index has been critiqued by many (including Ulph, 2015), it has served as a catalyst for debate and a closer inspection of the underlying components of tax complexity, including fundamental complexity and unnecessary complexity. The work of Tran-Nam and Evans (2014) offers in our view the most thorough review of the complexity in developing a tax complexity index. Borrego et al. (2015) offer the first contribution that has been developed from perceptions of tax professionals which were extracted from a large scale survey.

In terms of advancing the concepts of necessary and unnecessary complexity further, we would suggest that application of the Delphi technique may prove fruitful, as suggested earlier by Evans and Collier (2012). This recommendation is buttressed by the lack of any clear consensus from commentators in this area. We would also encourage further research that presents further examples of the delineation between necessary and unnecessary complexity.

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What's BEPS got to do with it? Exploring the effectiveness of thin capitalisation rules

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Abstract

In October 2015, the OECD made a best practice recommendation in Action 4 of its BEPS project, suggesting a Fixed Ratio Rule in place of thin capitalisation rules. This review was almost 3 decades in the making, with the most recent OECD report on thin capitalisation rules published in 1986, which omitted guidance on how these rules could best be designed.

Thin capitalisation rules' strong emphasis on revenue base protection has resulted in their exponentially increasing popularity internationally since the 1960s. However, there is a growing body of literature critiquing the effectiveness of thin capitalisation rules. Accordingly, this paper approaches the issue of thin capitalisation from a novel perspective by conceptualising the cross-border debt bias as the 'disease' and thin capitalisation as merely the 'symptom'. Grounded in the tax principle of efficiency, the overarching question guiding this paper is whether, given the opportunity to start over, the tax-induced cross-border debt bias would be better addressed by retaining thin capitalisation rules in their current form or whether an alternative reform would be more suited to dealing with this 'disease'.

The optimisation model developed in this paper shows that the OECD's Fixed Ratio Rule is more effective than the current regime of thin capitalisation rules at protecting the tax revenue base from the most tax-aggressive multinational enterprises (MNEs). However, the model also indicates that it is ultimately more effective to align the tax treatment of intercompany funding to eliminate the 'underlying disease' (the tax incentive for thin capitalisation), rather than adopting rules that mitigate the 'symptom' (such as the OECD's Fixed Ratio Rule).

This research presents a unique contribution to the literature by simulating complex cross-border intercompany tax planning strategies. This facilitates a formal analysis of one of the most significant challenges presented by the mobility and fungibility of capital; namely, anticipating how an MNE structures its internal affairs in a tax-optimal manner given the current tax regime and suggesting tax administrative responses to BEPS accordingly.

Keywords: Corporate Taxes; BEPS; Tax Competition; Mathematical Programming; Optimisation

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1. INTRODUCTION

For nearly a century, tax authorities have been developing international principles for tax treaties in attempts to address the problem of international tax coordination, with their focus evolving into designing international principles to prevent both the double taxation and double non-taxation of MNE income.²

In October 2015, the OECD made a best practice recommendation in Action 4 of its BEPS project, suggesting a Fixed Ratio Rule in place of thin capitalisation rules. This review was almost 3 decades in the making, with the most recent OECD report on thin capitalisation rules published in 1986,³ which omitted guidance on how these rules could best be designed.⁴

In response to whether the Australian Government has actioned the OECD's BEPS Recommendation on Action 4, the Treasury noted that: 'Australia has already tightened its Thin Capitalisation rules'.⁵ However, this position is contrary to commentary from both practitioners⁶ and academics,⁷ who note that tightening the safe harbour rule should not be conflated with strengthening the overall effectiveness of the thin capitalisation regime and, in turn, the ability of a jurisdiction to protect its tax revenue base.

While the OECD makes a distinction between combating BEPS and reducing distortions between the tax treatment of debt and equity,⁸ it is clear that both the OECD's BEPS project and the thin capitalisation rules' *raison d'être* is primarily concerned with protecting national tax revenue bases. However, it is the decision of

² 'The issue of international tax coordination has often been seen mainly as a problem of alleviating double taxation. This problem arises because most countries insist on their right to tax all income originating within their borders as well as all income earned by their residents. However, since some countries have found it in their interest to play the role of "tax havens", the international tax coordination problem may often be one of preventing tax evasion rather than a problem of double taxation': PB Sørensen, 'Issues in the Theory of International Tax Coordination' (Bank of Finland Discussion Papers No 4/90, 20 February 1990), 7–8.

³ OECD, *Report on 'Thin Capitalisation'* (OECD 1986), adopted by the OECD Committee on Fiscal Affairs on 26 November 1986 (the 'Thin Capitalisation Report'); Similarly, the OECD's survey of thin capitalisation regimes currently remains in draft form only, with no indication of when it will be finalised: OECD, *Thin Capitalisation Legislation: A Background Paper For Country Tax Administrations*, (draft paper), <http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf>.

⁴ E. Traversa E, 'Interest Deductibility and the BEPS Action Plan: Nihil Novi Sub Sole?' [2013] 5 *British Tax Review* 607.

⁵ Department of the Treasury (Cth), 'OECD Report Supports Australian Government Action on Multinational Tax Avoidance' (Media Release, 6 October 2015) <<http://sjm.ministers.treasury.gov.au/media-release/003-2015/>>.

⁶ J Dunne et al., *Limiting Base Erosion Via Interest Deductions—OECD finalises BEPS Action 4* (MinterEllison Alert, 12 October 2015) <<http://www.minterellison.com/publications/minterellison-alert-limiting-base-erosion-via-interest-deductions-oecd-finalises-beps-action-410122015/>>.

⁷ A Joseph, 'Discussion Paper on Arm's Length Debt Test' (2014) 21(3) *International Transfer Pricing Journal* 177, 177–78; see further: 'With the expectation that most businesses would turn to the arm's length debt test now that the thin capitalization safe harbours are due to become tighter on 1 July 2014, the Discussion Paper suggests that the arm's length debt test may have to be limited in its application ... The Discussion Paper also suggests consideration of introducing further safe harbour tests on earnings such as EBITDA, so that businesses need not resort to using the arm's length debt test ... Finally, unlike under transfer pricing rules, thin capitalization rules do not allow consideration of related-party credit support when determining the arm's length debt amount', 179.

⁸ OECD, *BEPS Action 4: Interest Deductions and Other Financial Payments* (Final Report, 5 October 2015), 47.

the revenue authorities to create a cross-border tax-induced debt bias which actually results in said tax base erosion.⁹

The current international tax framework incentivises the location of expenses in higher-tax jurisdictions and income in low- or no-tax jurisdictions as it can result in significant tax minimisation. Multinational enterprises (MNEs) can shift expenses to, and income from, source countries to minimise tax payable with relative ease.¹⁰ This is a particularly pressing issue for small, open economies such as Australia and New Zealand, which are net capital importers of capital. This can be achieved by interposing subsidiaries in low-tax jurisdictions such as Ireland or the Netherlands, and then utilise tax treaties to shift income onto tax havens such as Bermuda or the British Virgin Islands,¹¹ where profits can be stored for years. This is further exacerbated by the plethora of jurisdictions for MNEs to choose from, many of which are engaged in a 'race to the bottom' on corporate income tax rates. Of course, broader based corporate taxes with lower rates promote efficiency, investment and growth. However, if governments narrow their tax bases to attract the rerouting of flows of capital through, rather than to, their economies then this risks exiting the realm of productive competition and instead may result in harmful tax competition.

Given that cross-border intercompany transactions account for more than 60 per cent of global trade in terms of value,¹² remain largely absent from a group's consolidated accounts (and therefore beyond public scrutiny), and can be readily determined by corporate treasury centres,¹³ there is an urgent imperative for a strong conceptual basis in the tax treatment of cross-border intercompany transactions, grounded in the tax principle of efficiency.

⁹ D Hanlon, 'Thin Capitalisation Legislation and the Australia/United States Double Tax Convention: Can They Work Together?' (2000) 3(1) *Journal of Australian Taxation* 4.

¹⁰ 'the relative ease with which MNE groups can allocate capital to lowly taxed minimal functional entities (MFEs). This capital can then be invested in assets used within the MNE group, creating base eroding payments to these MFEs.' see further, OECD, *Public Discussion Draft, BEPS Action 8, 9 and 10: Discussion draft on revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation and Special Measures)*, 1 December 2014–6 February 2015, 38. For completeness, residence issues are beyond the scope of this paper.

¹¹ Somewhat relevantly, one of the British Virgin Islands is reputedly the model for Stevenson's 'Treasure Island'. More recently, the 'Panama Papers' exemplify the scale and scope of these structures: see further, Chittum R and Boland-Rudder B, 'Investigations, Protest, and Call For Election in Iceland as World Responds to Panama Papers', *The International Consortium of Investigative Journalists* (5 April 2015) <<https://panamapapers.icij.org/blog/20160405-global-response.html>>.

¹² ICC Commission on Taxation and the ICC Committee on Customs and Trade Regulations, *Transfer Pricing and Customs Value*, Policy Statement, Document No. 180/103–6–521, (February 2012) 2.

¹³ This is exemplified in the following extract from *Chevron Australia Holdings Pty Ltd v Federal Commissioner of Taxation (No 4)* [2015] FCA 1092, [152]–[155]:

Ms Taherian accepted, by reference to an email dated 19 November 2002 from Mr Lewis, on which she was copied, that she was told that the profit in CFC from the interest rate margin within CFC, being a reference to the interest expense and the interest derived, would not be subject to tax either in the United States or in Australia ... She agreed that one of ChevronTexaco's key objectives was to maximise sustainable leverage. She also agreed that an objective was to repatriate cash to the United States: a general goal, as corporate treasury, was to centralise cash holdings in the United States because it was more efficient ... She also agreed that the effect of not granting security was to make the interest rate on a loan higher rather than lower ... She said in general no Chevron intercompany loans had CVX guarantees and agreed there would not be any need to guarantee an inter-company loan:

The overarching question guiding this paper is whether, given the opportunity to start over, the tax-induced cross-border debt bias would be better addressed by retaining thin capitalisation rules in their current form or whether an alternative reform would be more suited to dealing with this 'disease'. Accordingly, the concept of the tax-induced cross-border 'funding bias' developed by the author is explored in section 2.

Section 3 begins by observing that linear programming using optimisation modelling is a relatively underutilised technique in analysing MNEs potential behavioural responses to international tax laws and proposed reforms. In particular, this section explores the literature on whether optimisation modelling is suitable in the context of international tax planning by an MNE.

Section 4 of this paper introduces and explores the optimisation model, specifically: developing the objective function; defining and applying constraints; and overlaying additional parameters in Section 4.3.

Section 5 presents the results of modelling the following four variations: first, Australia's tightening of the safe harbour ratio from 3:1 to 1.5:1, which the Federal Treasury has noted constitutes an adequate response to the OECD's BEPS recommendation. Second, Section 5.2 presents the results of simulating the unilateral implementation by Australia of the OECD's BEPS recommendation for a fixed ratio rule operating at 30 per cent of Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA). Third, Section 5.3 presents the multilateral implementation of the OECD's BEPS recommendation. Fourth, this paper proposes an 'extended thin capitalisation rule' as an alternative reform, the results of which are presented in Section 5.4. This proposal constitutes the first of three reform proposals developed by the author.

Finally, Section 6 summarises the findings of this paper and includes areas for further research.

2. ADDRESSING THE TAX-INDUCED CROSS-BORDER 'FUNDING BIAS'

Integrity rules that deal with charactering and taxing 'passive' income are general considered to include, inter alia, controlled foreign company (CFC), foreign investment fund (FIF), transfer pricing and thin capitalisation rules. However, as observed by Devereux and Vella, the allocation of primary taxing rights between 'active' and 'passive' income is ill-suited to dealing with modern MNE operations, particularly in the intercompany setting. This results in 'a system which is easily manipulated, distortive, often incoherent and unprincipled'.¹⁴

More specifically, in the context of thin capitalisation rules, which is the focus of this paper, '[t]here is no historical evidence that the OEEC gave any attention to thin capitalization when working on the dividend or interest articles'.¹⁵

¹⁴ M Devereux and J Vella, 'Double Trouble: Why Landmark OECD Tax Reform is Doomed Before it Starts', *The Conversation* (5 October 2015), <<https://theconversation.com/double-trouble-why-landmark-oecd-tax-reform-is-doomed-before-it-starts-48115>>.

¹⁵ JF Avery Jones et al., 'The Definitions of Dividends and Interest in the OECD Model: Something Lost in Translation?' (2009) 1(1) *World Tax Journal* 5, 27.

In the economic literature analysing intercompany funding distortions, much attention has been directed towards the debt bias.¹⁶ Given their focus on restricting debt deductions, there is a general assumption in the literature that thin capitalisation rules are an effective anti-avoidance measure that eliminates the debt bias. This is exemplified in statements from policymakers such as the Board of Taxation, who have observed, '... thin capitalisation rules address this "debt bias" by limiting the allowable level of debt deductions for the taxpayer's borrowings based on the level of debt'.¹⁷

The perceived effectiveness of thin capitalisation rules is similarly reflected in empirical studies by commentators such as Buettner et al.¹⁸ and Blouin et al.¹⁹ suggesting that thin capitalisation rules remove tax incentives related to debt financing. Key commentators such as Weichenrieder and Windischbauer,²⁰ Overesch and Wamser,²¹ Wamser,²² and Ruf and Schindler²³ form part of a substantial body of empirical analysis, in particular in the context of the German thin capitalisation rules, consistently finding that thin capitalisation rules are effective in reducing the debt-to-asset ratio of MNEs. The inference has been that thin capitalisation rules are therefore effective.

However, it is important not to conflate reducing debt-to-asset ratios of MNEs with eliminating the debt bias. As highlighted by Weichenrieder and Windischbauer²⁴ and noted by Ruf and Schindler,²⁵ the ostensible effectiveness of thin capitalisation rules could also be explained by the fact that MNEs may utilise loopholes in regulations allowing them to bypass thin capitalisation rules and leading to the false impression that the reform has been very effective. However, it is also necessary to acknowledge the two-fold limitations of this analysis: first, Weichenrieder and Windischbauer²⁶ focussed on the German context; and second, the thin capitalisation regime analysed (which utilised a safe harbour debt/equity ratio of 3:1) has since been replaced by the so-called 'interest ceiling rules' ('Zinsschranke') which restrict interest relief based on an EBITDA ratio.

¹⁶ See, for example, RA De Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions* (IMF Staff Discussion Note SDN/11/11, 3 May 2011); IMF Fiscal Affairs Department, *Debt Bias and Other Distortions: Crisis-related Issues in Tax Policy* International Monetary Fund Study (12 June 2009); PH Blessing, 'The Debt-Equity Conundrum—A Prequel' (2012) 66(4–5) *Bulletin for International Taxation* 198.

¹⁷ Board of Taxation (Cth) *Review of the Thin Capitalisation Arm's Length Debt Test: A Report to the Assistant Treasurer* (December 2014), 5.

¹⁸ T Buettner, M Overesch, U Schreiber and G Wamser, 'The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms' (2012) 96 *Journal of Public Economics* 930.

¹⁹ J Blouin, H Huizinga, L Laeven and G Nicodème, 'Thin Capitalization Rules and Multinational Firm Capital Structure' (IMF Working Paper WP/14/12, January 2014).

²⁰ AJ Weichenrieder and H Windischbauer, 'Thin-capitalization Rules and Company Responses—Experience From German Legislation' (CESifo Working Paper Series No 2456, CESifo Group Munich, November 2008).

²¹ M Overesch and G Wamser, 'Corporate Tax Planning and Thin -capitalization Rules: Evidence From a Quasi-experiment' (2010) 42 *Applied Economics* 563.

²² G Wamser, 'The Impact of Thin-capitalization Rules on External Debt Usage—A Propensity Score Matching Approach' (2014) 76(5) *Oxford Bulletin of Economics & Statistics* 764.

²³ M Ruf and D Schindler, 'Debt Shifting and Thin-Capitalization Rules—German Experience and Alternative Approaches' (2015) 1 *Nordic Tax Journal* 17.

²⁴ Weichenrieder and Windischbauer, above n 20.

²⁵ Ruf and Schindler, above n 23.

²⁶ Weichenrieder and Windischbauer, above n 20, 3.

A significant gap in the literature is that thin capitalisation rules' impact on tax planning has only been analysed on a piecemeal basis, and studies have not yet adequately considered the impact of thin capitalisation rules on MNEs' investment decisions. Notably, Ruf and Schindler observe that there are '... too few empirical studies investigating the effect of thin capitalisation rules on investment'.²⁷ Similarly, Merlo, Riedel and Wamser noted, 'the question of how thin capitalisation rules are related to real investment activities of MNEs has been widely neglected in the literature'.²⁸

However, investments by an MNE can be grouped as either real or 'pure paper'. In this context, despite the literature already analysing the isolated impacts of 'pure paper' profit shifting induced by international tax differences,²⁹ the literature has not yet focussed on the behavioural responses induced by thin capitalisation rules on MNEs 'pure paper' investment decisions. This analysis would likely form a key litmus test of whether a particular reform eliminates or encourages distortions between debt and equity financing.

Further, there is little emphasis on eliminating distortions in the tax treatment of cross-border intercompany passive income.³⁰ This paper posits that an unequal tax treatment of passive income involving certain categories of otherwise fungible intercompany debt and equity financing, licensing and finance leasing activities, can distort economic choices about commercial activities and encourage tax planning behaviours.

The reasoning for this is two-fold; first, intercompany dealings are fungible and mobile.³¹ Second, a parent company would likely be neutral to these different funding options³² particularly if they constitute purely financing activities that are determined and allocated by corporate treasury centres and eliminated on consolidation for accounting purposes.³³

An underlying assumption in this paper is that as long as an MNEs can benefit from tax planning opportunities presented by existing rules including, inter alia, the arm's length standard, thin capitalisation rules, debt/equity rules, withholding taxes and

²⁷ Ruf and Schindler, above n 23,18.

²⁸ V Merlo, N Riedel and G Wamser, 'The Impact of Thin Capitalization Rules on the Location of Multinational Firms' Foreign Affiliates' (CESifo Working Paper Series No 5449, CESifo Category 1: Public Finance, July 2015), 2.

²⁹ JH Heckemeyer and M Overesch, 'Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels' (ZEW Discussion Paper No 13-045, July 2013), 13.

³⁰ See further, A Kayis-Kumar, 'Taxing Cross-border Intercompany Transactions: Are Financing Activities Fungible?' (2015) 30(3) *Australian Tax Forum* 627-61; A Kayis-Kumar, 'Thin Capitalisation Rules: A Second-best Solution to the Cross-border Debt Bias?' (2015) 30(2) *Australian Tax Forum* 299-355.

³¹ For completeness, the OECD defines financial payments economically equivalent to interest as 'those which are linked to the financing of an entity and are determined by applying a fixed or variable percentage to an actual or notional principal over time': OECD, *BEPS Action 4: Interest Deductions and Other Financial Payments* (Final Report, 5 October 2015), 17.

³² C Burnett, 'Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach' (2014) 6(1) *World Tax Journal* 40, 45, 64.

³³ For example, a leading US consulting company recently advised that 'multinationals corporations need to view the intercompany payments as part of its cash repatriation strategy': PG Chen, 'Intercompany Payments Between Multinational Corporations and Their Affiliated Companies in China', in Charles River Associates, 'Insights: Transfer Pricing', 11.

foreign tax relief, there is a tax incentive to adjust its behaviour to maximise overall deductions in higher-tax jurisdictions to minimise the group-wide tax liability and, in turn, the overall net profit after tax.

The author recognises that not all MNEs will fall within this category in practice. Accordingly, this study is only concerned with MNEs that are responsive to cross-border tax-induced distortions.

Assuming that MNEs which exhibit tax planning behaviour make tax decisions as a global group with the objective of minimising total tax payable worldwide. Such tax planning is generally encouraged by tax professionals³⁴ and is statutorily, administratively and judicially condoned.³⁵ In other words, such an MNE is 'tax-minimising', albeit with varying degrees of aggressiveness.

Accordingly, the behaviourally distortive effects of existing and proposed tax rules relating to cross-border intercompany activities are of primary concern in this study. Specifically, the focus of this paper is on MNE's cross-border intercompany transactions relating to passive or highly mobile income; specifically how tax distortions affect MNE decisions on the funding mix between intercompany financing, licensing and finance leasing activities.

As such, this paper proposes restricting the tax deductibility of these otherwise fungible cross-border intercompany financing payments.³⁶ For completeness, other categories of intercompany payments also exist which may be included within the scope of the funding bias in future research. An analytical framework for this broader category of intercompany payments is extracted in Figure 1 below.

³⁴ TP Seto, 'Four Principles of Optimal Tax System Design' (Legal Studies Paper No 2008–36, Loyola Law School, March 2013), 10–11.

³⁵ 'Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes': *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935) (Hand J). In so stating, Judge Hand was reflecting on the appropriate role of judges in enforcing existing law, not on principles of sound tax design.

³⁶ This paper builds on earlier work by the author, see A Kayis-Kumar A, 'A Multinational Multiverse: Simulating Tax-optimal Intercompany Funding Structures' (Paper presented at the 28th Australasian Tax Teachers' Association Conference, Sydney: UNSW Business School, 20 January 2016); Kayis-Kumar, above n 30.

Figure 1: Various types of intercompany payments

	Strategy/technique	Reduces taxable profit	Cash
Pre-tax	Interest	√	√
	Royalties	√	√
	Service fees	√	√
	Purchase of depreciable assets (e.g., intangibles asset)	√	√
	Others: Swaps and other contractual arrangements	√	√
Post-tax	Dividends	x	√
	Purchase of non-depreciable assets (e.g., share of affiliates)	x	√
	Loans to affiliates	x	√

Perhaps the most controversial aspect of the funding bias concept is that royalties are fungible. However, this paper does not suggest that all intercompany royalties are equivalent and fungible with other financing activities. Rather, the scope is limited to some categories of licenses or royalty financing ostensibly similar in their capacity to provide access to an underlying asset with the ability to provide a revenue stream (termed 'royalties') but not dissimilar in operation to intercompany debt or equity financing or a finance lease.

It is noteworthy that, as observed by Vann, '[h]istorically, excess royalties were assumed by some OEEC delegates to be classified as dividends but it was decided to leave the question to domestic law'.³⁷ At a theoretical level, Benshalom provides an analysis on the fungibility of these intercompany financing activities, observing that 'almost every type of tax reduction plan that uses affiliated financial transactions could be executed via other types of affiliated transactions'.³⁸ The fungibility and mobility of these intercompany financial flows means that attempts to allocate ownership to any one entity within an MNE is an arbitrary exercise.³⁹ However, Benshalom's research is limited to separately and distinctly analysing the taxation of intercompany financing⁴⁰ and licensing, briefly mentioning leasing activities but distinguishing them as separate from financing transactions,⁴¹ despite acknowledging that 'it is impossible to draw a perfect line between financial transactions and non-

³⁷ R Vann, 'The History of Royalties in Tax Treaties 1921–61: Why?' in JF Avery Jones, P Harris and D Oliver (eds), *Comparative Perspectives on Revenue Law* (Cambridge University Press, 2008), 166, 186 and 193; see further, JF Avery Jones et al., 'The Definitions of Dividends and Interest in the OECD Model: Something Lost in Translation?' (2009) 1(1) *World Tax Journal* 5, 36.

³⁸ I Benshalom, 'The Quest to Tax Financial Income in a Global Economy: Emerging to an Allocation Phase' (2008) 28 *Virginia Tax Review* 165, 193–95; see also I Benshalom, 'Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method' (2009) 28 *Virginia Tax Review* 619.

³⁹ I Benshalom, 'Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method' (2009) 28 *Virginia Tax Review* 619, 660–61.

⁴⁰ Benshalom I, above n 38; see also, Benshalom, above n 39, 647.

⁴¹ Ibid, 647.

financial transactions ... affiliated leasing transactions could replicate the consequences of related lending'.⁴² Nonetheless, Benshalom observes that the mobility of intercompany activities erodes the source jurisdiction's tax base from both the perspective of intangible and tangible manufacturing and merchandise activities.⁴³

So, while the literature implicitly contains support for the proposition that cross-border intercompany financing, licensing and finance leasing activities are fungible, there is very little literature that directly studies the taxation implications of this observation. This is also typified in practice. However, there is some guidance from, for example, the US Treasury which defined a 'financing arrangement' as:

as a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or the right to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and there are financing transactions linking the financing entity, each of the intermediate entities, and the financed entity.⁴⁴

Similarly, the term 'financing transaction' was defined to include:

any other advance of money or property pursuant to which the transferee is obligated to repay or return a substantial portion of the money or other property advanced or the equivalent in value.⁴⁵

The following sections explore whether adopting this characterisation in the design of thin capitalisation rules would constitute a valuable step in equalising the playing field between MNEs and tax authorities. On one hand, MNEs are largely indifferent to the structuring of their internal financial flows because these are fungible and mobile with no substantial economic cost. In contrast, tax authorities generally do not have adequate resources to audit the increasing volumes of intercompany activities. Administrative complexity is further exacerbated by the arm's length standard requirement of finding the proper market comparables of specifically tailored financial flows.⁴⁶

3. APPLYING OPTIMISATION MODELLING TO INTERNATIONAL TAX PLANNING PROBLEMS

As observed by Markle and Shackelford:

We cannot observe how a firm structures its internal affairs in a tax-optimal manner. For example, we can observe firms' using leverage to lower their

⁴² Ibid, 642.

⁴³ Ibid, 647.

⁴⁴ On August 10, 1993, US Congress enacted section 7701(1) of the Internal Revenue Code; Section 1.881-3(a)(2) of the final regulations provides definitions of certain terms used throughout the regulations; see further, <<http://www.irs.gov/pub/irs-reg/td8611.txt>>; see further, DM Ring, 'Risk-Shifting Within a Multinational Corporation: The Incoherence of the U.S. Tax Regime' (1997) 4(4) *Boston College Law Review* 667, 712

⁴⁵ Ibid.

⁴⁶ I Benshalom, above n 38; see also, Benshalom, above n 39.

global tax liabilities through external debt financing, but we cannot observe their using internal debt to generate interest deductions in high-tax countries and interest income in low-tax countries ... intrafirm transactions are nontrivial and may even exceed the avoidance opportunities with third parties.⁴⁷

In the absence of a requirement to fully disclose their intercompany transactions in financial statements, cross-referencing the information reported to taxing authorities and reported in financial statements is a highly challenging task.⁴⁸ Further, if a subsidiary is a private company it does not even need to disclose comprehensive financial statements in the source jurisdiction.⁴⁹ Accordingly, this presents a gap in the literature.

Generally, quantitative evaluations are conducted utilising regression based evaluation methods and general equilibrium modelling. For example, there is a growing theoretical literature on the relationship between tax planning and investment locations, and its implications for tax policies.⁵⁰ There is also a rich literature which utilises empirical data in this context, extensively considering the relationship between MNE leverage and taxation with US, Canadian and European Union (particularly German) data.⁵¹

⁴⁷ KS Markle and DA Shackelford, 'Cross-Country Comparisons of the Effects of Leverage, Intangible Assets, and Tax Havens on Corporate Income Taxes' (2012) 65 *Tax Law Review* 415, 417-432.

⁴⁸ Commentators such as De Simone and Stomberg observe that '[f]inancial reporting for income taxes is so complex that even sophisticated financial statement users often ignore detailed tax disclosures' and 'taxation is often viewed by the market as beyond meaningful analysis': De Simone L and Stomberg B, 'Do Investors Differentially Value Tax Avoidance of Income Mobile Firms?' (Working Paper, University of Texas at Austin, June 2012), 2. Consolidated accounts undergo intercompany eliminations so are not helpful in this regard. While some MNEs provide some detail regarding their intercompany transactions in their segment reports, this is not a requirement across the board. See further, 'this large shift in pre-tax income without any corresponding change in revenues suggests the presence of significant intercompany payments—likely royalty payments attributable to the transfer of intellectual property into Ireland': K Balakrishnan, J Blouin and W Guay, 'Does Tax Aggressiveness Reduce Financial Reporting Transparency?' (Working Paper, Wharton School, University of Pennsylvania, 20 September 2011), 29.

⁴⁹ For example, in the financial year ending 2014, Google Australia Pty Ltd's disclosure omitted itemising over \$35 million in expenses from its financial statement and the corresponding notes, not even categorising these expenses as 'COGS' and/or 'Other expenses'. Further, Google Australia Pty Ltd's intercompany financing activities were presumably classified as 'operating' activities, as the 'financing' section of the cash flow statement was entirely blank, with no details afforded in the notes.

⁵⁰ Q Hong and M Smart, 'In Praise of Tax Havens: International Tax Planning and Foreign Direct Investment' (2010) 54(1) *European Economic Review* 82; see references cited therein, including: H Grubert and J Slemrod, 'The Effect of Taxes on Investment and Income Shifting to Puerto Rico' (1998) 80 *Review of Economics and Statistics*, 365-73; A Haufler and G Schjelderup, 'Corporate Tax Systems and Cross-country Profit Shifting' (2000) 52 *Oxford Economic Papers*, 306-25; J Mintz and M Smart M, 'Income Shifting, Investment, and Tax Competition: Theory and Evidence from Provincial Taxation in Canada' (2004) 88 *Journal of Public Economics* 1149-168; S Bucovetsky and A Haufler, 'Tax Competition When Firms Choose Their Organizational Form: Should Tax Loopholes For Multinationals Be Closed?' (Technical Report 1625, CESifo, 2005); J Slemrod and JD Wilson, 'Tax Competition with Parasitic Tax Havens' (Technical Report, University of Michigan 2006).

⁵¹ Substantial literature review by H Huizing, L Laeven and G Nicodème, 'Capital Structure and International Debt Shifting' (Economic Paper No 263, European Economy, December 2006), 3; see further references cited therein.

Substantially less developed is the literature on the effect of taxation on leverage in a multilateral context, with 'nxn countries'.⁵² Huizinga, Laeven and Nicodème present the primary exploration of whether MNEs make multilateral capital structure decisions based on the tax rates faced by various subsidiaries. Under their model, the MNE's objective is to maximize its overall firm value.⁵³

Even less attention has been directed to economic modelling frameworks beyond general equilibrium modelling. While many types of mathematical models can be utilised in practice to solve 'real-world' problems,⁵⁴ the focus of this research is optimisation modelling. Optimisation modelling using linear programming remains largely unexplored in the context of anticipating MNE behaviour; specifically, observing how an MNE may structure its internal affairs in a tax-optimal manner.

This is particularly surprising because some literature does exist suggesting that international tax planning decisions can be approximated as linear programming problems. Specifically, only two papers have been authored in this area: first, Brada and Buus, and second, Vasarhelyi and Moon. Each are briefly summarised below.

Brada and Buus focus on cross-border intercompany transfer pricing issues; specifically, whether it is possible to identify subsidiaries within an MNE which engage in profit shifting. They note that empirical studies are rare in this area since transfer pricing is considered to be a confidential issue for most MNEs.⁵⁵ Further, they observe that the extensive literature modelling optimal tax systems does not deal with MNEs utilising transfer pricing to profit shift.⁵⁶ Nonetheless, Brada and Buus provide a mathematical proof that the basic tax optimisation task of MNEs can be conceptualised as a linear programming problem.⁵⁷

Vasarhelyi and Moon also presented the suitability of linear programming for solving international tax planning problems. This was on the basis that international tax planning problems are concerned with the optimal allocation of tax, subject to relevant tax laws and other limitations; thereby echoing linear programming problems:

⁵² 'unlike previous research, our modeling and our empirical work take a fully multilateral approach and is the first to study the effect of taxation on leverage in a nxn countries context. The main contribution of our paper is to explore in an international context the possibility that multinationals set the capital structure of individual subsidiaries by taking into account the tax rate faced by all other subsidiaries of the firm. Our finding that subsidiary leverage within a multinational firm responds to bilateral tax rate differences vis-à-vis both the parent firm and other foreign subsidiaries provides direct support for this multilateral approach': H Huizinga, L Laeven and G Nicodème, 'Capital Structure and International Debt Shifting' (Economic Paper No 263, European Economy, December 2006), 3–4.

⁵³ H Huizinga, L Laeven and G Nicodème, 'Capital Structure and International Debt Shifting' (Economic Paper No 263, European Economy, December 2006), 8. For a further discussion of limitations, see A Kayis-Kumar, 'International Tax Planning By Multinationals: Simulating a Tax-minimising Intercompany Response to the OECD's Recommendation on BEPS Action 4' (2016) 31(2) *Australian Tax Forum* (forthcoming).

⁵⁴ E Castillo, AJ Conejo, P Pedregal, R García and N Alguacil, *Building and Solving Mathematical Programming Models in Engineering and Science* (New York, United States: John Wiley and Sons Ltd, 2001).

⁵⁵ J Brada and T Buus, 'Detection of Possible Tax-Evasive Transfer Pricing in Multinational Enterprises' (2009) 4(2) *European Financial and Accounting Journal* 65.

⁵⁶ T Buus and J Brada, 'VAT and Tax Credits: A Way to Eliminate Tax-Evasive Use of Transfer Prices?' (2010) 5(1) *European Financial and Accounting Journal* 28, 45.

⁵⁷ Brada and Buus, above n 55, 75; Brada and Buus note that further mathematical proofs and more detailed specification conditions of validity have not been conducted: Brada J and Buus, above n 55, 73–74.

International tax planning optimisation problems can be formulated as linear functions to maximize or minimize a particular objective function.⁵⁸

However, Buus and Brada's research in this area remains untested⁵⁹ and Vasarhelyi and Moon's work has also since ceased.⁶⁰

Accordingly, this paper presents a unique contribution to the literature by developing a tax optimisation model which simulates complex cross-border intercompany tax planning strategies by considering MNEs use of four forms of fungible intercompany financing across four jurisdictions. This facilitates a formal analysis of one of the most significant challenges presented by the mobility and fungibility of capital.

4. DEVELOPING THE OPTIMISATION MODEL

Given the focus of this paper on pure paper shifting by a tax-minimising MNE through intercompany financing, the optimisation model developed by the author simulates the behavioural responses of a hypothetical 'tax-minimising' MNE engaging in cross-border intercompany tax planning through the use of alternative—otherwise fungible—categories of intercompany financing.

This paper reflects results of optimisation modelling of 4 variations (or 'multiverses') simulating for each variation 20 different increments of MNEs tax aggressiveness, to model a range of 'tax minimising' MNEs' behavioural responses to different tax regimes and reform alternatives.

In doing so, this model demonstrates the tax effects of an MNE utilising various cross-border intercompany instruments at different rates of return and degrees of leverage to examine both: (a) the vulnerability to base erosion and, (b) the extent of cross-border funding neutrality (or lack thereof) across the existing tax system, variations to the existing system and proposed reform alternatives.

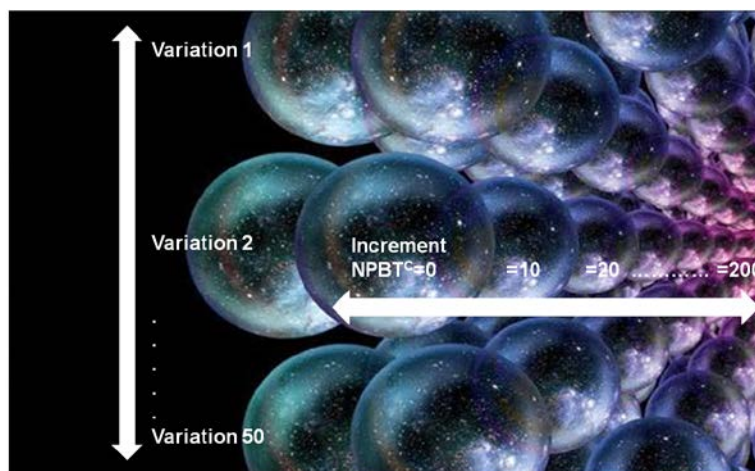
For completeness, further research by the author extends the analysis to 50 variations, each with 20 different increments of MNEs tax aggressiveness, to reflect other tax regimes and reform alternatives. This is illustrated in Figure 2 below.

⁵⁸ MA Vasarhelyi and D Moon, 'Optimizing Tax Allocation Among Countries in the Multinational Entity: A Tale Of Many Contingencies' (Presentation delivered at the TTN Taxation Seminar New York 2011, Morgan Lewis Bockius LLP: New York, NY, 16 May 2011), 6.

⁵⁹ For completeness, in a subsequent paper, Brada and Buus proposed that VAT be used as a solution to reach a Pareto-optimal state that would prevent harmful tax competition and tax-evasive transfer pricing; see: Buus and Brada, above n 56; see also, Kayis-Kumar, above n 53.

⁶⁰ Vasarhelyi and Moon developed a single-period model, with a 6-jurisdiction MNE subject thin capitalisation rules with 2 constraint functions only. Withholding taxes were assumed zero, foreign tax relief was not considered, none of the parameters were flexed and the model focussed on optimal firm policy only, not considering the government perspective. See further: Kayis-Kumar, above n 53.

Figure 2: The modelled ‘multiverse’ of policy iterations and MNE tax aggressiveness



This hypothetical approach is preferable due to the accessibility issues associated with collecting various revenue authorities' corporate tax return data and the limitations of using accounting data. Even if accounting data was gathered through annual reports this approach is problematic given the difference between accounting profit and taxable income. Specifically, MNEs start with accounting profit and then make adjustments to accounting profit⁶¹ to reach their taxable profit.⁶² Accordingly, it is difficult to glean intercompany tax-related information from financial statements.

Further, these difficulties are exacerbated by recent amendments to the *Corporations Act 2001*, enacted 28 June 2010, which have removed the requirement for companies to include full unconsolidated parent entity financial statements in their group annual financial reports under Chapter 2M of the *Corporations Act 2001* where consolidated financial statements are required.⁶³ This renders it even more difficult to discern intercompany tax-related information. Also, there is currently no requirement to produce 'general purpose' financial reports in subsidiary locations where the MNE determines that that subsidiary is not a 'reporting entity'. Further, given the gaps in reporting requirements and the fact that some items are off-balance sheet to begin with, it is highly difficult to undertake a meaningful analysis of data from financial statements in this context. This is made more problematic by the absence of official data about MNEs' non-portfolio investment activities, despite their significance to the Australian economy.⁶⁴

⁶¹ Net profit before tax pursuant to the relevant accounting standards.

⁶² This is discerned through applying the relevant tax regulations.

⁶³ APRA requests that 'APRA reporting' MNEs continue producing their general purpose financial reports to them, though this is on a voluntary basis: see further, <http://www.apra.gov.au/GI/Documents/Letter-for-Website_Parent-Entity-Financial-Statements-September-2010.pdf>.

⁶⁴ A McDonnell et al. (2011) 'A Profile of Human Resource Management in Multinational Enterprises Operating in Australia', University of South Australia, University of Newcastle, Victoria University, La Trobe University and Curtin University <http://www.unisa.edu.au/Global/business/centres/chrm/docs/projects/intrepid/Australia11_MNE_Report_Final.pdf>.

The remainder of this section outlines and justifies the optimisation model. Specifically, it expresses MNEs' decisions to utilise various conduit financing structures to minimise taxation for the overall group in the form of an algorithmic expression.

The optimisation model is developed using the IBM ILOG CPLEX for Microsoft Excel ('CPLEX') software.⁶⁵ Microsoft Excel is utilised to generate the data, delineate the parameters and display the solution in a multidimensional format, while the CPLEX software is used to express and solve the optimisation problem. Quantitative analysis facilitates a deeper understanding of the interplay of effects determining tax-induced distortions than may not be observable with a qualitative analysis alone.

The 'objective function' is to minimise the total tax payable by the MNE on global operations. The 'constraints' are the four groups of otherwise fungible intercompany debt and equity financing, licensing and finance leasing activities. The model can then be fine-tuned by overlaying various parameters.

Specifically, the hypothetical MNE modelled by this paper has entities in four jurisdictions; two high-tax jurisdictions (one capital-exporter and one capital-importer; specifically, a US parent and Australian subsidiary) and two lower-tax jurisdictions (one non-treaty country and one treaty country, in Hong Kong and Singapore, respectively).⁶⁶

Given its focus on intercompany funding options, this optimisation model focusses on funding constraints and regulatory limitations directly relevant to intercompany funding decisions; namely, withholding taxes, thin capitalisation rules and foreign tax credits. This ensures the model is complex and flexible enough to represent both funding structure decisions and regulations influencing those behavioural responses.

The baseline model in the optimisation problem consists of the current global tax framework and its treatment of fungible funding options. It is necessary to develop a baseline model because modelling in this area has not yet focussed on the fungibility of intercompany funding options. So far, the predominant focus in the literature has been on an economy-wide scale⁶⁷ with firms identified with, for example, one unit of

⁶⁵ CPLEX is a sophisticated software appropriate for both building and solving optimisation problems, and for interfacing with Microsoft Excel; 'IBM® ILOG® CPLEX® for Microsoft® Excel is an extension to IBM ILOG CPLEX that allows you to use Microsoft Excel format to define your optimization problems and solve them. Thus a business user or educator who is already familiar with Excel can enter their optimization problems in that format and solve them, without having to learn a new interface or command language. CPLEX is a tool for solving linear optimization problems, commonly referred to as Linear Programming (LP) problems': IBM ILOG CPLEX V12.1 IBM ILOG CPLEX for Microsoft: Excel User's Manual, 12
<ftp://public.dhe.ibm.com/software/websphere/ilog/docs/optimization/cplex/cplex_excel_user.pdf>.

⁶⁶ In the Australian context, it appears that Singapore is a relatively more popular jurisdiction than other well-known low-tax jurisdictions such as Ireland in terms of the volume of intercompany payments made by Australian companies; B Butler and G Wilkins, 'Singapore, Ireland Top Havens For Multinational Tax Dodgers', *Sydney Morning Herald* (online), 1 May 2014
<<http://www.smh.com.au/business/singapore-ireland-top-havens-for-multinational-tax-dodgers-20140430-37hzi.html>>.

⁶⁷ See, for example, OH Jacobs and C Spengel, 'The Effective Average Tax Burden in the European Union and the USA: A Computer-based Calculation and Comparison with the Model of the European Tax Analyzer' (ZEW Discussion Paper No 99-54, Centre for European Economic Research (ZEW) and University of Mannheim, September 1999).

capital with different firm types linked to different types of capital whereby MNEs dispose of as unit of mobile capital.⁶⁸ Even when the analysis is constrained to a single MNE, models developed have focussed on, for example, the 'model-firm' approach⁶⁹ or determining the MNE's optimal after-tax income by reference to labour, capital and production⁷⁰ or have only considered debt financing without exploring its economic equivalents.⁷¹

Rather than projecting MNEs' decisions over time, this paper considers behavioural implications of different rules at a given point-in-time. A key disadvantage of a single-MNE one-period model approach is that the results are heavily dependent on the particular characteristics of the hypothetical MNE. To that end, a consideration of various types of MNEs is beyond the scope of this study.⁷² However, this model takes into account different funding situations and planning options at different levels of MNE tax-aggressiveness. So, it has the ability to engage in detailed scenario/'what-if' analysis. This enables validation testing to be conducted to anticipate MNE behaviour and quantify the impact on the total tax payable by the MNE of different reform options. As observed by Jacobs and Spengel, the technique of sensitivity analysis is used in all important studies on international tax burden comparisons regardless of the methodical approach and the underlying model.⁷³

This model also extends the analysis of behavioural implications beyond the limited perspective of a single MNE by also considering optimal government policy. This was not previously contemplated by the literature in this area. More generally, the literature on transfer pricing contains very few papers considering both optimisation problems jointly, with Raimondos-Møller and Scharf presenting a notable exception.⁷⁴

Accordingly, this model presents a single-period model for a hypothetical MNE, applying four variations, each with 20 increments of MNE tax-aggressiveness. This framework is 'flexed' by adjusting the values of various parameters to test the relative impact of a change in specific tax laws. This facilitates a comparison between the baseline model and alternative reform options proposed both in this paper and subsequent papers by the author. Validation testing consists of representing algorithmically the alternative reform options by incorporating their different funding constraints and regulatory limitations. This aims to provide an objective assessment of each reforms' impact on an MNEs tax minimising behavioural responses.

⁶⁸ A Haufler and M Runkel M, 'Firms' Financial Choices And Thin Capitalization Rules Under Corporate Tax Competition' (2012) 56(6) *European Economic Review* 1087, 1090.

⁶⁹ Jacobs and Spengel, above n 67, 9.

⁷⁰ See further, C Sommer, *Separate Accounting Or Unitary Apportionment? The Fairy Tale of Arm's Length Pricing and General Equilibrium Analysis of Multinational Enterprise Behavior Under the Formulary Taxation Alternative* (Lohmar: Köln, Reihe Steuer, Wirtschaft und Recht, 2011).

⁷¹ M Mardan, 'Why Countries Differ in Thin Capitalization Rules: The Role of Financial Development' (CESifo Working Paper Series No 5295, CESifo Group Munich, 2015), 9. In Mardan's model each MNE's headquarters chooses the amount of internal loans that maximises the overall profits of the MNE such that the MNE's overall profits are:

$$\pi^j = (1 - t_1)\theta^j f(K^j) - rK^j + t_1 r D_E^j + t_1 \min(r D_I^j, \phi^j(z)) - t_2 r D_I^j - C(D_I^j)$$

⁷² This limitation has been echoed in the literature; see for example: Brada and Buus, above n 55, 69.

⁷³ Jacobs and Spengel, above n 67; and references cited therein at footnote 43.

⁷⁴ P Raimondos-Møller and K Scharf, 'Transfer Pricing Rules And Competing Governments' (2002) 54(2) *Oxford Economic Papers* 230, 234–35.

For ease of reference, the abbreviations used throughout the remainder of this section are summarised in Table 1 below:

Table 1: Abbreviations used in formulation of model

Abbreviations	
$NPBT_{i,0}$	Net profit before tax for company 'i' at the start of the period
$NPBT_{i,1}$	Net profit before tax for company 'i' at the end of the period
r_i^*	Headline corporate income tax rate in country 'i'
TTP	Total tax payable
r_{ij}^D	The rate of return on debt financing from company 'i' to company 'j'
D_{ij}	The balance of debt financing provided from company 'i' to company 'j'
I_i	The interest received by company 'i' (or, if negative, interest paid)
r_{ij}^E	The rate of return on equity financing from company 'i' to company 'j'
E_{ij}	The balance of equity financing provided from company 'i' to company 'j'
V_i	The dividends received by company 'i' (or, if negative, dividends paid)
r_{ij}^C	The rate of return on licensing from company 'i' to company 'j'
C_{ij}	The balance of licenses provided from company 'i' to company 'j'
R_i	The royalties received by company 'i' (or, if negative, royalties paid)
r_{ij}^S	The rate of return on finance leasing from company 'i' to company 'j'
S_{ij}	The balance of finance leases provided from company 'i' to company 'j'
P_i	The finance lease payments received by company 'i' (or, if negative, finance lease payments paid)

4.1 The objective function: Minimising total tax payable

Since this model is only concerned with the intercompany activities conducted to minimise tax, the only relevant constraints relate to these intercompany transactions.⁷⁵ $NPBT_{i,0}$ is the amount of Net Profit Before Tax ('NPBT') of company i at the beginning of the period; $NPBT_{i,1}$ is the amount of EBIT of company i at the end of the period; r_i^* is the tax rate⁷⁶ defined by the government of country i . For simplicity, the 'real' NPBT is a constant for each entity in each jurisdiction and is given ($NPBT_{i,0}$). The impact of the sum of intercompany transactions in each affiliate on NPBT is denoted as follows:

$$NPBT_{i,1} = NPBT_{i,0} + I_i + V_i + R_i + P_i \quad (1)$$

The general optimisation problem is the minimisation of the objective function by adjusting the design variables and at the same time satisfying the constraints. In the present analysis, the objective function is Total Tax Payable ('TTP') for the corporate group.

⁷⁵ Elements of Section 4 have been elaborated on in detail in a previous paper by the author: Kayis-Kumar, above n 53.

⁷⁶ While the 'effective tax rate' would arguably be preferable, for simplicity the headline corporate income tax rate is used in this variation of the model.

$$\text{Minimise: } TTP = \sum_{i=1}^n NPBT_{i,t+1} \times r_i^* \quad (2)$$

As illustrated in an earlier paper by the author,⁷⁷ the model is set with an initial NPBT at \$100 for both affiliates in the high-tax jurisdictions and with NPBT as \$0 for the affiliate in the lower-tax jurisdiction.⁷⁸

4.2 The constraints: Intercompany financing activities

Since this model is only concerned with the intercompany activities conducted to minimise tax, the only relevant constraints relate to these intercompany transactions, rather than extending to 'real' economic activities.

Accordingly, this optimisation problem is subject to four 'primary constraints'. Each constraint relates to one of the four categories of fungible intercompany funding that constitute the focus of this thesis; namely, debt financing, equity financing, licensing and finance leasing (' D_{ij} ', ' E_{ij} ', ' C_{ij} ' and ' S_{ij} ', respectively).⁷⁹ These can be characterised as the underlying capital amounts (' K_{ij} '). The 'flow' (' F_i ') or remuneration derived therefrom constitutes interest, dividends, royalties and finance lease payments (' I_i ', ' V_i ', ' R_i ' and ' P_i ', respectively).

This is formulated as follows for each constraint:

$$F_i = \sum_{i=1}^n \sum_{i \neq j} K_{ij} \times r_{ij}^K \quad (3)$$

In other words, the 'flow' or remuneration (' F_i ') is received by company i , where K_{ij} is the underlying capital provided by company i to company j , at a cost of capital of r_{ij}^K .

This optimisation problem can then be remodelled by layering additional parameters that reflect the tax laws applicable to each reform variation, as further detailed below in Section 4.3. One example is thin capitalisation rules, which apply in both the subsidiaries in the US and Australia. This is factored into the model by considering that the ratio of debt to equity for each company should be kept at less than 1.5, assuming the debt-to-equity ratio is 1.5:1 for both the US parent and Australian subsidiary.⁸⁰

This can be expressed algorithmically as follows:

⁷⁷ Kayis-Kumar A, above n 30, 646.

⁷⁸ As such, in the absence of any tax planning the group-wide effective tax rate is 34.50 per cent. This is on the basis that the US and Australian corporate income tax rates are 39 per cent and 30 per cent, respectively.

⁷⁹ For completeness, in the context of leases, this model focusses on finance leases only and this iteration does not contemplate the impact of depreciation.

⁸⁰ It is noteworthy that Australia's thin capitalisation regime had its safe harbour rules tightened from 3:1 to 1.5:1 through the *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014* (Cth), which received Royal Assent on 16 October 2014.

$$D_{ij} - 1.5 \times E_{ij} \leq 0 \quad (4)$$

With the above algorithm, it is possible to target both or either inbound and outbound investment. For simplicity, the amount of intercompany transfers between each company ranges from a minimum of \$0 to a maximum of \$1000.

This paper acknowledges that there may be an element of uncertainty in classification of various financing types in practice. This is exemplified by different jurisdictions' varying tax treatment of hybrids. Accordingly, future iterations of this model will explore treating this constraint as 'soft'.⁸¹ However, since this feature goes beyond standard linear programming, it is outside the scope of this paper.

4.3 Building the baseline model⁸²

Based on the previous Sections 4.1 and 4.2, this section outlines the baseline model in three steps: first, applying the objective function; second, including the constraints; and third, overlaying the parameters. Each are dealt with in turn.

First, the objective function is the minimisation of *TTP*. Once the current headline corporate income tax rates (r_i^*) are included, the objective function is denoted as:

$$\text{Minimise: } TTP = 0.39 \times NPBT_{A,1} + 0.17 \times NPBT_{B,1} + 0.30 \times NPBT_{C,1} + 0.165 \times NPBT_{D,1}$$

Second, the constraints are represented formulaically below, separated by category of funding; namely, debt financing, equity financing, licensing and finance leasing assuming for simplicity all rates of return (r) are 7.5 per cent for each entity within the MNE. The model is designed so that r can later be adjusted to simulate the impact of tax rules on the cost of capital, enabling a more complex analysis of MNE behaviour.

Third, the design of the optimisation model allows for the incremental inclusion of concurrent and/or alternative tax rules (or 'parameters') to simulate the impact of various rules on MNEs' tax planning behaviour. This scenario analysis makes it possible to address the question of what the most likely behavioural responses would be to alternative rates of taxes being levied on otherwise fungible intercompany activities and to what extent alternative reform proposals developed by this paper could ameliorate the distortions leading to said behavioural responses. A more complex analysis can be conducted which also highlights the breadth of the problem; specifically, that the literature has thus far been too focussed on modification of one parameter at a time. The behavioural responses incentivised by each parameter can then be examined and cross-referenced in the context of both the standalone entity and the overall group.

This paper highlights the use of withholding taxes in this context. Specifically, various withholding tax rates apply for each of the types of intercompany flows examined in this model. Table 2 below indicates the withholding tax rates for each type of intercompany funding applicable for each jurisdiction.

⁸¹ P Meseguer, F Rossi and T Schiex, 'Chapter 9: Soft Constraints', in F Rossi, P van Beek and P Walsh, *Handbook of Constraint Programming* (Elsevier, 2006), 281–328.

⁸² For a more detailed outline of the overlaying of parameters, including foreign tax credits and the use of conduit financing, please see: Kayis-Kumar A, above n 36. Parameters such as the PE rules and the CFC regime are beyond the scope of this iteration of the model.

Table 2: Overview of withholding tax rates between USA, Singapore, Australia and Hong Kong

Withholding tax rates					
		Interest	Dividends	Royalties	Finance lease payments
USA	A, B ○	30% □	30%	30%	30%
	A, C	0/10% ◇	0/5/15% ●	5% ⁸³	0/10% ◇
	A, D ○	30% □	30%	30%	30%
Singapore	B, A ○	15%	0%	10%	15%
	B, C	10%	0%	10%	10%
	B, D ○	15%	0%	10%	15%
Australia	C, A	0/10% ◇	0/5/15% ⁸⁴ ● ■	5%	0/10% ◇
	C, B	10%	0/15% ■	10%	10% ⁸⁵
	C, D ○	10%	0/30% ■	30%	10%
Hong Kong	D, A ○	0%	0%	4.95/16.5% ■	0%
	D, B ○	0%	0%	4.95/16.5% ■	0%
	D, C ○	0%	0%	4.95/16.5% ■	0%

Key: ○ represents absence of a comprehensive tax treaty; ◇ government authorities/ financial institutions are afforded a withholding tax exemption; □ interest on certain 'portfolio debt' obligations are exempt from withholding tax; ♦ withholding tax exemption applies to interest paid in relation to either a sale on credit of goods, merchandise or services, or a sale on credit of industrial, commercial or scientific equipment; ● higher withholding rates apply if there is a lower level of participation;⁸⁶ ■ relates to different rates arising from imputation system; the higher rate applies to unfranked dividends; ■ the higher rate applies if the royalties are received by or accrued to a non-resident from an associate.

For completeness, in the above Table 2 where one form of intercompany funding may be subject to varying rates of withholding tax, the rate most likely to apply is

⁸³ For completeness, the Australia–United States DTA was amended in 2003, reducing the rate of RWT from 10 per cent to 5 per cent; see further: *Protocol amending the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2003*.

⁸⁴ 'Australia does not impose withholding tax on dividends to the extent they are franked. To the extent dividends are unfranked, the rate is 0 per cent or 5 per cent, if the beneficial owner of the dividends is a company that holds at least 80 per cent or 10 per cent, respectively, of the voting power in the payer. In all other cases, the rate is generally 15 per cent': EY Worldwide Corporate Tax Guide (2015), 89–91; Australia–United States DTA, Article 10 amended in 2003; 'While the top withholding rates are similar across jurisdictions, substantial concessions are available to investors from the US and the UK, including a zero withholding tax rate on unfranked dividends which may be available where the investor beneficially holds an 80 per cent or greater stake in an Australian company': R Tang and J Wan, 'A refocused tax treaty network is key to achieving the Asian Century vision' (Corrs Chambers Westgarth, 20 November 2012); available at: <http://www.corrs.com.au/thinking/elsewhere/a-refocused-tax-treaty-network-is-key-to-achieving-the-asian-century-vision/>.

⁸⁵ 'Section 128AC was introduced by the *Taxation Laws Amendment Act (No 2) 1986* ... The mischief to be remedied was the loss of revenue by the use of non-traditional methods of finance where a resident enters into a hire-purchase agreement or finance lease arrangement with a non-resident ... The EM recognises the dual purpose served by the agreements in question, namely, purchase and financing the purchase. Consistent with this objective, the section deemed that part of the hire payments that were equivalent to interest in the financing arrangement to be interest for withholding tax purposes': Australian Taxation Office, *Income Tax: Withholding Tax Implications of Cross Border Leasing Arrangements* (2 December 1998) ATO Taxation Ruling TR98/12, 12 <<https://www.ato.gov.au/law/view/document?docid=TXR/TR9821/NAT/ATO/00001&PiT=20100630000001>>.

⁸⁶ However, the differences between direct and portfolio investment are beyond the scope of this iteration.

highlighted in bold. For example, assuming a high level of participation, the withholding tax rate of dividends from Co C and Co A would be zero per cent. It is important to note the difference in tax treatment between franked and unfranked dividends in the context of Australia's imputation system, which in the first instance, this model assumes are unfranked.

For the purposes of the optimisation model, the existence of withholding tax gives rise to a potentially increased *TTP*.

A run-time test indicates that the MNE will funnel all funds through a combination of the decision variable with the lowest withholding tax rate and the jurisdiction with the lowest corporate income tax rate. This can be further validated by a two-fold analysis; first, anecdotal evidence from leading tax practitioners suggests that this reflects MNEs' behaviour. Second, from the perspective of the MNE as a group, withholding taxes increase the cost of capital of the funding type by the amount of the tax rate withheld.⁸⁷

5. RESULTS OF THE OPTIMISATION MODEL

This section is designed to test the existing thin capitalisation regime against the OECD/G20 BEPS Project recommendation on Action Item 4; namely, the recommendation for a fixed ratio rule (the 'OECD's BEPS Recommendation'). Accordingly, this section presents the results of incrementally adding both concurrent and alternative tax rules (or 'parameters') to simulate four variations; first, the current tax regime; second, if the OECD's BEPS Recommendation were adopted by Australia; third, if the OECD's BEPS Recommendation were adopted by both Australia and the US; and fourth, an extended thin capitalisation rule, which constitutes this paper's proposal.

In terms of expressing the results, both the numeric value (as 'TTP') and the percentage value of the TTP relative to the global NPBT (as the group-wide effective tax rate) is presented. The latter is particularly meaningful because, at a practical-level, it is difficult to measure or estimate the budgetary impact of a reform. Accordingly, it is necessary to utilise a proxy instead. Given the usefulness of the average effective tax rate (AETR) in the context of measuring revenues of government⁸⁸ and discrete location decisions,⁸⁹ it is also appropriate to utilise this measure here.

⁸⁷ European Commission, 'The Economic Impact of the Commission Recommendation on Withholding Tax Relief Procedures and the FISCO Proposals' (European Commission Staff Working Document, 24 June 2009), 44.

⁸⁸ Fullerton observes that AETRs are 'relatively easy to calculate, and they are useful for measuring incomes of capital owners, revenues of government, and the size of the public sector'. It is however important to acknowledge that the 'measurement of average effective tax rates is not unambiguous': D Fullerton, 'Which Effective Tax Rate?' (NBER Working Paper No 1123, National Bureau of Economic Research, May 1983), 3–4.

⁸⁹ '[d]iscrete investment choices do depend on an average tax rate'. Further, Devereux and Griffith observe that:

Conditional on the choice of location, the size of investment depends on the EMTR. But the choice of location depends on the level of post-tax net present value ('NPV'); for a given pre-tax NPV in each location, the impact of taxation on the location choice is through its effect on the post-tax NPV. This can be measured by an effective average tax rate ('EATR')

5.1 Variation 1: Tightening Australia's thin capitalisation rules

One of the most surprising findings in relation to the existing system is that the hypothetical MNE is indifferent to the existence and/or variation in thin capitalisation rules. This is because while thin capitalisation rules change the funding mix of entities within an MNE, the TTP remains unchanged.

Specifically, where this variation is modelled with $NPBT^C$ increments between 0 and 100, the TTP remains the same for each increment of tax aggressiveness, such that the AETR is 26.50 per cent to 30.75 per cent regardless of whether thin capitalisation rules are tightened. In contrast, in the absence of any tax planning the AETR is 34.50 per cent for the hypothetical MNE. So, contrary to policymakers perception that thin capitalisation rules can be made more effective at restricting base erosion by simply tightened the debt-to-equity ratio, this model also finds no impact on TTP.

The model shows no change in TTP from tightening thin capitalisation rules from a debt-to-equity ratio of 3:1 to 1.5:1, as recently implemented by *Tax and Superannuation Laws Amendment (2014 Measures No 4) Act 2014* (Cth).

In addition, capital structure and both the quantum and direction of funds flow remains the same under so-called tightened thin capitalisation rules. In particular, the Australian subsidiary experiences no change in its funding mix between inbound-only, outbound-only, or both inbound/outbound rules. This result seem to be at odds with the literature that tightening thin capitalisation rules would impact MNEs' funding decisions. The reason is that the funding mix selected by the MNE is already beyond the scope of the thin capitalisation rules. For example, at a moderate level of tax-aggressiveness (where $NPBT^C=50$), the MNE utilises finance leasing payments (P^C) from Australia to Hong Kong and royalty payments (R^A) from the US to Hong Kong.

This result confirms the anecdotal evidence present in the literature in relation to both Australian and US base erosion techniques. In the Australian setting, as observed by both practitioners and academics, the scope of the current thin capitalisation regime does not include many finance leases:

At the moment most leasing activities are not subject to the thin capitalisation rules because of the definition of financing arrangement in ITAA s.974–130. Hence many finance leases are treated in the same way as other leases, and only a small subset of leases, recharacterised as a sale and loan, are subjected to thin capitalisation rules.⁹⁰

Similarly for the US parent, there is also no change in funding mix between inbound-only or inbound/outbound rules. These result in the same quantum and direction of intercompany payments specifically to Hong Kong. However, if inbound-only rules apply then the MNE switches the US parent's intercompany financing from royalties to finance lease payments by simply 'mixing and matching' to still obtain the same TTP as any of the above alternative reform configurations.

Devereux MP and Griffith R 'Evaluating Tax Policy for Location Decisions' (2003) 10 *International Tax and Public Finance* 107, 107–08.

⁹⁰ T Frost et al., Submission to the Treasury on Proposed Diverted Profits Tax Consultation Paper, *Implementing a Diverted Profits Tax*, 24 June 2016, 11 <<http://www.greenwoods.com.au/media/1794/dpt-submission.pdf>>.

While at first blush these results may appear unusual, the anecdotal research presented by Ruf and Schindler⁹¹ anticipates this result. This finding is significant because even though there is a growing body of literature challenging the traditional belief that thin capitalisation rules protect the tax revenue base, including Ruf and Schindler⁹² and Vann,⁹³ there is currently no empirical evidence that new FDI is simply financed at or around the debt-to-equity ratio limits set by thin capitalisation rules. Accordingly, this finding could have significant policy implications globally, especially given the worldwide popularity of implementing and tightening thin capitalisation rules.

5.2 Variation 2: Unilateral adoption of the OECD's BEPS recommendation

This section designs and tests the unilateral implementation of the OECD/G20 BEPS Project recommendation on Action Item 4;⁹⁴ namely, the recommendation for a fixed ratio rule (the 'OECD's BEPS Recommendation').⁹⁵

Released in October 2015, the OECD's BEPS Recommendation for a fixed ratio rule would substitute existing rules limiting the deductibility of interest, such as thin capitalisation rules. For completeness, a subsequent paper by the author explores the implementation of a cross-border ACE⁹⁶-CBIT⁹⁷ as an alternative to rules which only mitigate the 'symptom' of thin capitalisation.⁹⁸

Under the best practice approach, interest and payments economically equivalent to interest will be deductible to the extent that the net interest expense-to-EBITDA ratio is less than the allowable threshold (or benchmark fixed ratio). A benchmark fixed ratio within the corridor of 10 per cent to 30 per cent is recommended. As observed by the OECD and extracted in

Table 3 below, the majority of countries which currently adopt fixed ratio rules to restrict interest relief utilise a 30 per cent benchmark ratio:⁹⁹

⁹¹ M Ruf and D Schindler, 'Debt Shifting and Thin-Capitalization Rules—German Experience and Alternative Approaches' (NHH Discussion Paper, RRR 06-2012, 13 December 2012), 9–10; see further, Kayis-Kumar, above n 30; Kayis-Kumar, above n 30.

⁹² Ruf and Schindler, above n 91.

⁹³ RJ Vann, 'Corporate Tax Reform in Australia: Lucky Escape for Lucky Country?' [2013] 1 *British Tax Review* 59, 71.

⁹⁴ Please note, an earlier version of this section outlining the formulae developed by the author appears in Kayis-Kumar, above n 53.

⁹⁵ For completeness, the OECD's Recommendation was drafted with other key features, but this paper focussed only on the Fixed Ratio Rule. For an overview of the entirety to the OECD's Recommendation, see OECD, *BEPS Action 4: Interest Deductions And Other Financial Payments* (Final Report, 5 October 2015), 27.

⁹⁶ Allowance for Corporate Equity (ACE).

⁹⁷ Comprehensive Business Income Tax (CBIT).

⁹⁸ For an analysis of the economic theory, please see: Kayis-Kumar A, above n 30.

⁹⁹ OECD, *BEPS Action 4: Interest Deductions And Other Financial Payments* (Public Discussion Draft, 18 December 2014), 49.

Table 3: Convergence towards fixed interest-to-earnings ratios

Finland:	25 per cent of EBITD calculated based on the taxable profit and loss account. The calculation is made by entity and adjusted by taking into account group contributions received or made.
Germany:	30 per cent of taxable EBITDA.
Greece:	30 per cent of EBITDA. Phased-in system according to which the percentage will reduce from 60 per cent in 2014 to 30 per cent in 2017.
Italy:	30 per cent of EBITDA, adjusted by adding rental payments under finance lease transactions.
Norway:	30 per cent of taxable EBITDA.
Portugal:	30 per cent of EBITDA, adjusted by excluding certain items such as income resulting from shares eligible for the participation exemption or attributable to a permanent establishment outside Portugal to which the option for exemption is applied. Phased-in system according to which the percentage will reduce from 70 per cent in 2013 to 30 per cent in 2017.
Spain:	30 per cent of operating profits adjusted by adding certain items such as depreciation and amortisation and financial income from equity investments.
United States:	50 per cent of adjusted taxable income, ie. EBITDA plus specific deductions taken into account when calculating the taxable income.

Accordingly, this paper models the OECD's Recommendation using a 30 per cent benchmark ratio. This will be applied in both Sections 5.2 and 5.3.

For the US entity, the results of the modelling show that there is no change in either capital structure nor the funding mix from Australia's unilateral adoption of the OECD recommendation. Similarly, Australia also sees no substantial change, with the MNE simply switching the funding type utilised in Australia from finance lease payments to a combination of royalty and interest payments. This result is most likely attributable to the relatively close corporate income tax rates between these two jurisdictions, rendering neither a profit shifting destination for a tax-minimising MNE. On the other hand, Singapore would emerge as a substantial beneficiary because it would obtain the majority of NPBT from the most tax-aggressive MNEs through royalty payments (from $NPBT^C=0-60$) in a behavioural response similar to a corporate inversion.

Assuming that the OECD's BEPS Recommendation was adopted by Australia in place of the existing thin capitalisation rules, the AETR is between 26.89 per cent and – 30.75 per cent (where $NPBT^C=0-100$). Despite the complexities arising in the calculation of the EBITDA, this model adopts the simplifying assumption that the NPBT measure used in the model developed by this paper is effectively the same. Accordingly, the modelling demonstrates that this reform would result in an increase in TTP for the most tax aggressive MNEs, albeit nominally. Specifically, there would be a maximum 1.45 per cent increase in TTP for the most tax-aggressive MNE (where $NPBT^C=0$).

Relevantly, the US Treasury's recently finalised regulations under Section 385 of the Internal Revenue Code,¹⁰⁰ were originally proposed giving authority to the IRS to classify certain intercompany debt instruments as quasi-equity. Academics such as

¹⁰⁰ These final and temporary regulations establish "... threshold documentation requirements that ordinarily must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes, and treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes": US Department of the Treasury, Internal Revenue Service Federal Register 81 (204) [TD 9790] (21 October 2016); available at: <<https://www.gpo.gov/fdsys/pkg/FR-2016-10-21/pdf/2016-25105.pdf>>.

Shaviro noted that this strict reform would bring the US rules closer to the German earnings-stripping rules.¹⁰¹ However, there was much opposition to this 'bifurcation' rule. Commentators opposed to these regulations posited that they would likely exceed the interest deductibility limits contemplated as part of the OECD's BEPS Recommendation.¹⁰² Originally intended to be finalised by early-September,¹⁰³ the finalised regulations were released in mid-October. In what was described as a "significant change" by practitioners,¹⁰⁴ the final regulations did not contain this rule. Rather, the preamble to the final regulations indicated that the US Treasury's decision on this issue is reserved "pending additional study".¹⁰⁵

In any event, the modelling shows that a fixed ratio based on the level of interest expense and earnings appears to be a more robust base protection technique than rules which limit the deductibility of expenses by reference to leverage ratios.

5.3 Variation 3: Multilateral adoption of the OECD's BEPS recommendation

Multilateral implementation of the OECD's BEPS Recommendation by both the US and Australia would give rise to the same results as noted above in Section 5.2, irrespective of the benchmark fixed ratio selected by the US. This seemingly surprising result is attributable to the fact that the hypothetical MNE had ensured that NPBT^A remained zero throughout when applying a unilateral fixed ratio rule. Similarly, under a multilateral fixed ratio rule the tax minimising MNE would make the same capital structure and funding mix decision. This is presented graphically below in Figure 3.

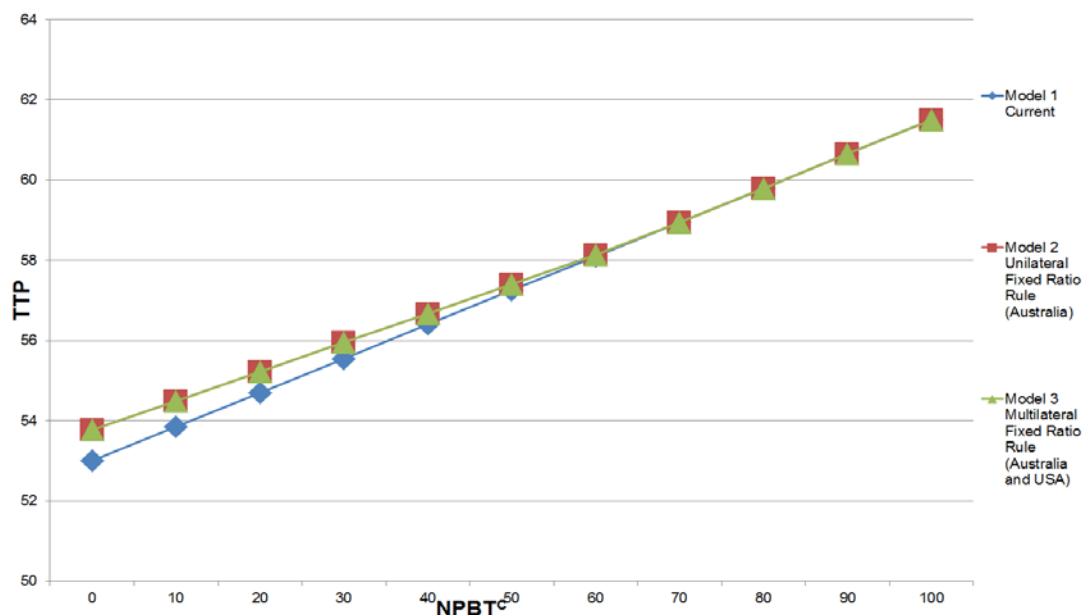
¹⁰¹ D. Shaviro, '10 Observations Concerning International Tax Policy' [20 June 2016] *Tax Notes* 1, 5.

¹⁰² S Van Weeghel, 'OECD Releases Discussion Draft On Interest Deductions In Banking, Insurance Sectors' [9 August 2016] *PwC Tax Policy Bulletin* 1, 5.

¹⁰³ However, Treasury had exceeded this expected deadline. At time of writing, October was considered a more likely time for the release of the final regulations: see, for example, B. Becker B, 'What Congress Ccan't Ddo (Hhelp Apple)', (*Politico, Morning Tax*, , 6 September 2016); available at: <<http://www.politico.com/tipsheets/morning-tax/2016/09/what-congress-cant-do-help-apple-216172#ixzz4JWJjiUkS>>.

¹⁰⁴ KPMG, TaxNewsFlash: United States, 'Section 385 final regulations: Initial reactions' (14 October 2016), 3; available at: <<https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/10/16460v5.pdf>>.

¹⁰⁵ US Department of the Treasury, Internal Revenue Service Federal Register 81 (204) [TD 9790] (21 October 2016), 1; available at: <<https://www.gpo.gov/fdsys/pkg/FR-2016-10-21/pdf/2016-25105.pdf>>.

Figure 3: Results of modelling the OECD's Recommendation

Accordingly, the model developed by this paper shows that both a unilateral and multilateral implementation of the OECD Recommendation will result in a slight increase in total tax payable by the MNE compared to the current regime, most markedly for the most tax aggressive MNEs. However, for the less tax aggressive MNEs (specifically, where $NPBT^C=70$ or higher) implementing the OECD Recommendation will not result in improved tax revenue base protection compared to the current tax regime.

5.4 Variation 4: Extending the thin capitalisation regime

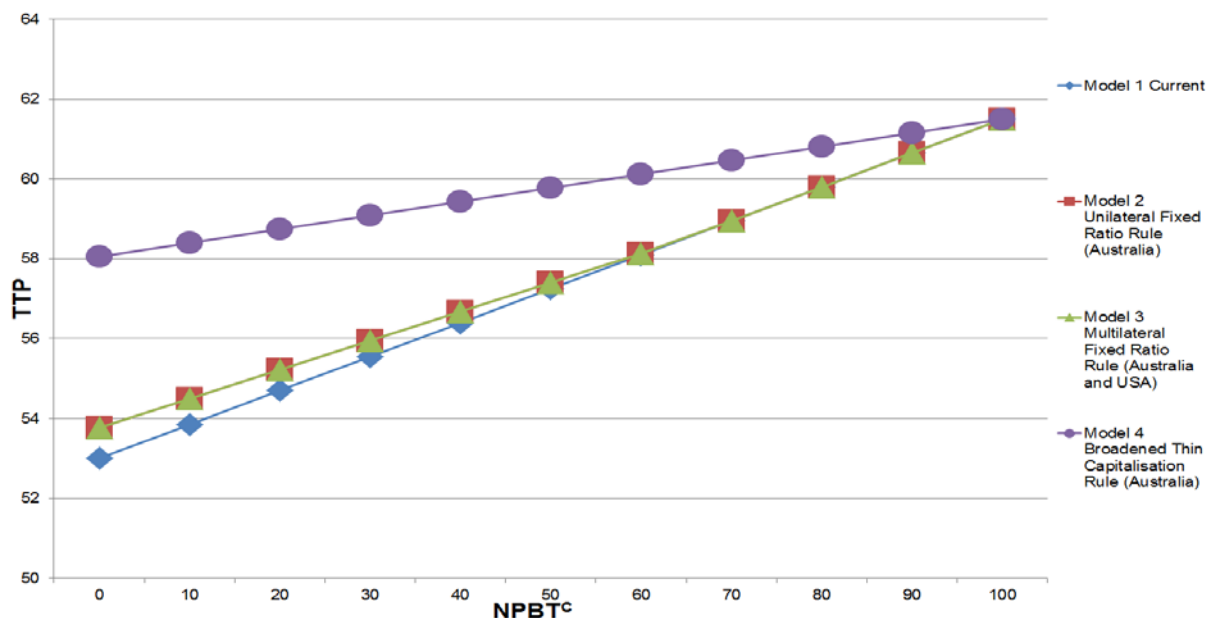
This section explores the implications of implementing an extended thin capitalisation rule; with a consistent outcome of an increased TTP as a result of broadening the scope of thin capitalisation rules such that the cross-border 'funding bias' is eliminated. Currently, the debt-to-equity rules set limits on the amount of debt, rather than the interest rate charged on debt. Since limiting the deductibility of the interest rate change on debt is considered in a subsequent paper by the author, this section focusses on the setting of limits on the amount of debt only.

The model shows improved tax base protection outcomes from broadening the scope of thin capitalisation rules to also include royalties and finance lease payments within the scope of financing because these flows are economically equivalent to, or fungible with, interest.

Specifically, where this variation is modelled with $NPBT^C$ increments between 0 to 100, the AETR is 29.03 per cent to 30.75 per cent. These findings suggest that, even though implementing an extended thin capitalisation rule cannot eliminate all tax planning (such that AETR is 34.50 per cent), this proposal is more effective at tax revenue base protection than the OECD Recommendation or any other reforms considered, particularly when dealing with the most tax-aggressive MNEs. This marked improvement in base protection afforded by an extended thin capitalisation

rule in comparison to both the existing regime and the OECD's BEPS Recommendation is presented in below in Figure 4.

Figure 4: Results of modelling the OECD's Recommendation and an Extended thin capitalisation rule



This finding has significant international tax policy implications; indicating that broadening the scope of existing thin capitalisation rules may be a highly effective reform alternative to the OECD's BEPS Recommendation. This results in two-fold tax policy advantages from a simplicity perspective. First, the relative ease of implementation since it can be built on the already-existing domestic rules and tax treaty network; and second, no transition issues as would be associated with implementing a more 'fundamental' ACE-inspired reform.

6. CONCLUSION

This paper approaches the taxation of MNEs from a novel perspective. Given the mobility and fungibility of cross-border intercompany activities, this paper establishes a framework to explore a utility-optimising MNE's behavioural responses to the international tax system. It analyses the hypothetical, 'utility-optimising' MNE's behavioural responses to laws relating to the taxation of cross-border intercompany activities; specifically, existing thin capitalisation rules against the OECD's BEPS Recommendation on Action 4, by developing an optimisation model. This model brings to the fore the range of possible 'optimal' behavioural responses by tax-minimising MNEs to various tax rules. It is instructive for policymakers to consider this because reforms may give rise to unintended or unanticipated behavioural responses in the form of profit shifting among an MNE's affiliates.

One of the most surprising findings in relation to the existing thin capitalisation regime is that the hypothetical MNE is indifferent to the existence of and/or variation in thin capitalisation rules. Further, the hypothetical MNE is also indifferent towards

the unilateral and multilateral implementation of the OECD's BEPS Recommendation, with both reforms resulting in an increase in total tax payable by the MNE, most markedly for the most tax aggressive MNEs. However, the most noteworthy finding in this paper is that an extended thin capitalisation rule is more effective at protecting a jurisdiction's tax revenue base than the OECD's BEPS Recommendation.

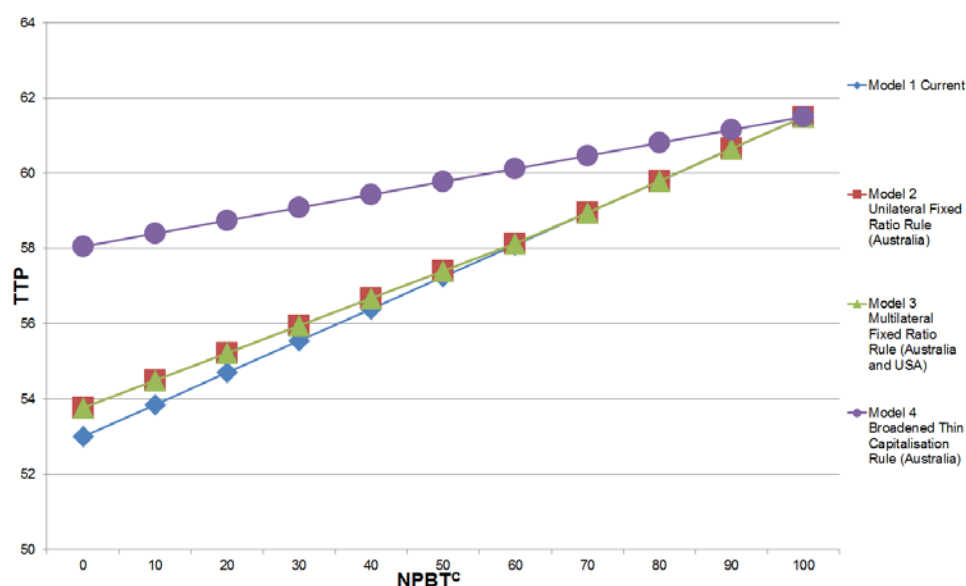
While the implementation of the OECD's BEPS Recommendation results in an improvement to tax revenue base protection, the improvement is only marginal and the reform ceases to deliver any improvement in tax revenue outcomes for the majority of MNEs (who are assumed to not be tax-aggressive). On the other hand, an extended thin capitalisation rule delivers a significant improvement to tax revenue base protection, particularly for the most tax-aggressive MNE but also across all levels of tax-aggressiveness, as shown in Figure 5.

Figure 5: Results of modelling the OECD's Recommendation and an Extended thin capitalisation rule

NPBT ^c	Variation 1 Current	Variation 2 OECD Recommendation (Unilateral Fixed Ratio Rule ^c)	Variation 3 OECD Recommendation (Multilateral Fixed Ratio Rule ^c)	Variation 4 Broadened TC ^c DECS
0	53.00	53.77	53.77	58.05
10	53.85	54.50	54.50	58.40
20	54.70	55.22	55.22	58.74
30	55.55	55.95	55.95	59.09
40	56.40	56.68	56.68	59.43
50	57.25	57.40	57.40	59.78
60	58.10	58.13	58.13	60.12
70	58.95	58.95	58.95	60.47
80	59.80	59.80	59.80	60.81
90	60.65	60.65	60.65	61.16
100	61.50	61.50	61.50	61.50
200	75.00	75.00	75.00	80.67

These results are further illustrated below in Figure 6.

Figure 6: Results of modelling the OECD's Recommendation and an Extended thin capitalisation rule



The model developed in this paper confirms the economic literature on the merits of eliminating distortions by presenting the foundations for an extended thin capitalisation regime as an alternative to existing thin capitalisation rules. This proposal constitutes the first of three reform proposals developed by the author.

Further research and reform proposals may be derived from simulations of the allowance for corporate equity (ACE), a comprehensive business income tax (CBIT) and a combined ACE-CBIT. This work coupled with subsequent legal comparative analysis carried out by the author will form the basis for suggested improvements to existing tax regimes.

Do perceptions of corruption influence personal income taxpayer reporting behaviour? Evidence from Indonesia

Arifin Rosid¹, Chris Evans² and Binh Tran-Nam³

Abstract

This paper addresses an identified gap in knowledge about whether, and how, perceptions of corruption may influence personal income taxpayer compliance behaviour. It examines how perceptions of five forms of corruption may impact upon intentional tax underreporting behaviour by adopting a sequential mixed-methods approach. Initially, a qualitative phase was carried out by conducting semi-structured in-depth interviews with nine participants (three taxpayers, three tax agents and three tax officers). The second—and core—phase of the research involved extensive data collection using a mixed-modes field survey conducted through 12 tax offices across four Indonesian regions. A total of 397 respondents were surveyed, comprising 196 self-employed and 201 employed taxpayers. Three principal findings have emerged from the data. First, as expected, the data from both the qualitative and quantitative phases suggest that high levels of perceived corruption were evident in Indonesia. Second, the quantitative findings clearly demonstrate that perceptions of corruption undermine taxpayers' intention to report actual income. Third, the findings ultimately suggest that high levels of perceived general corruption (that is, abuse of entrusted power by public officials for private gain), grand corruption (that is, corruption involving high-level public officials) and grand tax-corruption (that is, corruption involving high-level tax officials) were influential on intentional tax underreporting behaviour. The present empirical results support the notions that perceptions of corruption are important determinants and have a negative impact upon tax compliance behaviour. The results also imply that combating corruption, especially grand corruption, would have a beneficial effect on voluntary tax compliance in Indonesia.

Keywords: corruption, tax compliance, mixed-methods, personal income taxpayers

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1. INTRODUCTION

History indicates that tax compliance behaviour remains problematic around the globe (Chau and Leung, 2009; McKerchar and Evans, 2009; OECD, 2012a). Several strategies have been introduced and developed to address this issue (OECD, 2012a). Due mainly to inconsistent findings that have emerged from the economic deterrence approach (Andreoni, Erard & Feinstein, 1998; Kirchler et al., 2010), recent developments in compliance strategies have emphasised the importance of psychological and behavioural factors (Congdon Kling & Mullainathan, 2009; James, 2012; Kirchler, 2007; Kirchler, Kogler & Muehlbacher, 2014; Kornhauser, 2007; OECD, 2013; Reeson & Dunstall, 2009; Weber, Fookien & Herrmann, 2014; World Bank, 2015). Central to this is an increasing concern to obtain a deeper understanding of taxpayers' behavioural drivers rather than their non-compliance symptoms to effectively address non-compliance issues (Leviner, 2008; OECD, 2004).

Considering its multi-dimensionality, it is also necessary to examine tax compliance behaviour from cross-cultural perspectives (Kogler et al., 2013). Several empirical findings have indicated that cultural differences have a significant influence on tax compliance behaviour across countries (Cummings et al., 2009; Richardson, 2006). This is because revenue authorities in developing economies face quite different circumstances compared to their counterparts in developed economies due to widespread evasion, coercion, and corruption (McKerchar and Evans, 2009). Corruption creates inefficient tax systems and, as a result, lower levels of tax collection (Imam and Jacobs, 2007; Tanzi and Davoodi, 2000). To circumvent this problem, many authors recommend that developing countries should prioritise reducing the extent of corruption to improve tax compliance (Bird, 2003, 2015; Bird Martinez-Vazquez & Torgler, 2008; Flatters and Macleod, 1995; McKerchar and Evans, 2009; OECD, 2012b; Picur and Riahi-Belkaoui, 2006).

No country is immune from corruption issues (Shleifer & Vishny, 1993; Transparency International, 2015). Moreover, given its secretive nature, most of the indicators to assess corruption are based on subjective measurements (Campbell, 2013; León, Araña & León, 2012). This measurement is typically known as 'perceptions of corruption' (Campbell, 2013; Olken and Pande, 2012). Many authors argue that perceptions of corruption may have a negative impact upon the way taxpayers behave (Fjeldstad & Tungodden, 2003; Melgar, Rossi & Smith, 2010; Torgler, 2004; Torgler et al., 2008).

The principal aim of this study is to rigorously examine the impact of perceptions of corruption on tax compliance behaviour in Indonesia. The research in this study is focused upon personal income taxpayers (PITs) in Indonesia. These taxpayers are chosen because it is only at the level of the individual that perceptions of corruption and tax paying intentions are meaningful and can be fully addressed (Mendes, 2004).

Indonesia is chosen for this study for two major reasons. First, Indonesia has been classified as a major developing country (OECD, 2008; World Bank, 2013) with continual tax compliance issues (DGT, 2013, 2015; Francis, 2012; OECD, 2014). Partly due to corruption and poor governance, Bird and Zolt (2005) point out that the percentage of individual income tax revenue to GDP in Indonesia is the lowest among neighbouring countries, with 1.3 per cent compared to 1.9 per cent in Thailand, 2.1 per cent in Philippines, and 2.7 per cent in Malaysia.

Second, Indonesia appears to be among the more corrupt of the major countries in Asia-Pacific (Transparency International, 2015). Based on the Corruption Perceptions Index (CPI), Indonesia was ranked 88 out of 167 countries with a score of 36 in 2015.⁴ This is much lower compared to neighbouring countries such as Singapore (8), Australia (13), Malaysia (54) and Thailand (76) (Transparency International, 2015). Indonesia also has the highest percentage of respondents; 54 per cent felt that the level of corruption has increased over the past two years (Transparency International, 2013). Additionally, at least two studies by an Indonesian government entity—Corruption Eradication Commission (KPK)—indicate the pervasiveness of corruption in Indonesia with more than 94 per cent of its respondents conveying the view that corruption is common, has a negative impact on public finance, and erodes government revenue (KPK, 2010, 2011).

This study is motivated by three specific considerations. First, it is apparent that, corruption has, as an interesting phenomenon, attracted the attention of many researchers and scholars from different disciplines and various perspectives. However, attempts to specifically link it with intentional tax non-compliance behaviour are still in their infancy. Second, although much is currently known about the determinants of tax compliance, the mechanism by which perceptions of corruption influence tax compliance behaviour has not been clearly established. Research on the behavioural factors such as the impact of perceptions of corruption could reduce the necessity to make assumptions and improve the quality of the predictions. Third, to be able to scrutinise and to contribute to the body of existing knowledge, this study focuses on a single variable rather than several variables. As the literature suggests, limiting the scope of the study to a specific and well-defined variable may enhance its clarity.⁵

This paper intends to fill an identified gap in the knowledge of tax compliance behaviour and to further develop a deeper understanding as to whether, and how, perceptions of corruption influence taxpayers' compliance behaviour, particularly from a developing country's perspective. This study is crucial and relevant for developing economies particularly in relation to the 2030 United Nations' Agenda for Sustainable Development goals where strengthening domestic revenue mobilisation and improving domestic capacity for tax revenue collection are considered as a key driver of these goals (United Nations, 2015). The structure of this paper is outlined as follows. The literature, theoretical framework and research proposition are presented in Section 2. The research methods and the results are then elaborated in Sections 3 and 4 respectively. Finally, brief conclusions are discussed in Section 5.

⁴ The scores indicate the perceived level of corruption in the public sector on a 0-100 scale, where 0 means a country is perceived as very corrupt and 100 means it is perceived as very clean (Transparency International, 2015).

⁵ In a research process, this prescription refers to what social researchers generally term the 'isolation' phase (see, for example, Blunch, 2013; Gefen, Straub, & Boudreau., 2000). This prerequisite is crucial to be able to render a probability of causation between variables under study.

2. LITERATURE AND THEORETICAL FRAMEWORK

2.1 Corruption and perceptions of corruption

2.1.1 *Corruption*

Corruption is an ongoing global issue (Shleifer and Vishny, 1993; Transparency International, 2015) and is recognised as a major impediment in preventing economic development in many areas of the world (Blackburn, Bose & Haque, 2010; Wilhelm, 2002).

As a social phenomenon, the concept of corruption does not operate in a vacuum. Its meaning largely depends upon the specific social and political contexts in which it is applied (Brown, 2006).⁶ Social rules as well as moral views may also interrelate and vary significantly among different cultures and societies; as a result, an action could be a common courtesy in one society, but in a different context it could be considered as corrupt practice (Melgar, Rossi & Smith, 2010; Philp, 2006). Specifically, in the Indonesian context, apart from its political and economic situation, cultural aspects have indicated its significant influence in allowing corruption to flourish (Robertson-Snape, 1999).⁷ As there is no general consensus on the definition of corruption (UNDP, 2008), corruption can be defined in several ways (see, for example, Blackburn, Bose & Haque, 2010; Doig and Theobald, 1999; Shleifer and Vishny, 1993; Werlin, 1973). Most of these definitions, however, are emphasising governmental aspects of corruption by highlighting the abuse of public authority for personal gain.⁸

A popular way of classifying corruption is by using the scale of corruption (UNDP, 2008). In this sense, corruption is classified in the sector where it occurs or the amounts of money involved. For example, similar to Doig and Theobald (1999), UNDP (2008) also distinguishes two types of corruption: grand corruption and petty corruption. Grand corruption, on the one hand, represents the misuse of public power by high-level public officials such as ministers or senior staff for personal pecuniary gain. On the other hand, petty corruption refers to the extortion of small payments by low-level public officials in daily interaction to smooth transactions, and accordingly it is often called 'grease' money.⁹

2.1.2 *Perceptions of corruption*

Due to the secretive nature of corruption, most indicators used to assess corruption are based on subjective measurements (Léon Araña & León., 2012), which are generally

⁶ Accordingly, Hillman (2004, p. 1067) maintains "the people who can best describe corruption are those themselves engaged in corruption."

⁷ In this respect, for example, Donchev and Ujhelyi (2014) have suggested that to appropriately assess corruption, it should be on a country level basis given that each country has diverse characteristics.

⁸ It is worth emphasising that the adopted definitions of corruption in this study, for the sake of clarity, only refer to the involvement of public officials. It is crucial to distinguish since, in general terms, corruption may include the private sector (UNDP, 2008). For instance, corruption can be defined as "dishonest or illegal behaviour involving a person in a position of power, for example, accepting money for doing something illegal or immoral." See, <<http://dictionary.cambridge.org/dictionary/business-english/corruption>>, retrieved 2 October 2014. In other words, the focus of this study is "government corruption" (Shleifer and Vishny, 1993, p. 599).

⁹ Although different terms may be adopted, this classification is also used by other authors. For example, Mishler and Rose (2008) adopt the terms 'civic' and 'street-level' corruption.

known as ‘perception of corruption’ indicators (Campbell, 2013; Olken and Pande, 2012). The use of perception-based indicators to assess corruption can be potentially problematic. First, although there is a positive relationship between reported corruption perceptions and objective measurements of corruption, these two variables cannot be interchangeably used to measure corruption (Olken, 2009). Consequently, examining perceptions of corruption to measure the extent of corruption may lead to misleading conclusions (Olken, 2009). Second, the elusive phenomena of perception corruption indices have a tendency to mislead the readers into believing they are ‘actual’ levels of corruption (Urrea, 2007). Third, people are susceptible to being systematically biased in reporting corruption, either because their personal beliefs are biased or because the way individuals report corruption is biased (Kuncoro, 2006; Olken, 2009). Fourth, apart from its advantage of good coverage—it is obviously much easier and simpler to ask about people’s belief of corruption than to actually scrutinise it directly—perception-based measures may not precisely measure corruption (Olken and Pande, 2012).¹⁰ Fifth, as the perception-based data only capture opinion about the prevalence of corruption but do not gauge corruption itself (Treisman, 2007), the perception-based measurement is not accurate and tends to exaggerate (Miller, 2006). Thus, using perception-based indices as a measure of actual corruption may be more problematic than suggested by the current literature (Donchev and Ujhelyi, 2014).

For these reasons, high levels of perceived corruption can be destructive both at the social and at individual levels. At the social level, it may generate a cultural tradition that increases the pervasiveness of corruption. Mishler and Rose (2008) propose the so-called ‘echo chamber’ problem of perceptions of corruption. They highlight how the perceptions of national corruption linger as they are shaped by media reports or historical stereotypes and then captured by, for example, the CPI as ‘recorded facts’. These data then circulate, reinforcing the prevailing level of perceptions and generating a vicious circle maintaining its reliability without evaluating its validity. Supporting this, for instance, Dong, Dulleck & Torgler (2012) perform micro and macro data analysis on international panel data set of European Values Survey (EVS), World Value Survey (WVS), and the International Country Risk Guide (ICRG) data to understand whether the perception of corruption is contagious.¹¹ The empirical findings sharply suggest that the perceived activities of peers and other individuals influence the respondents’ willingness to engage in corruption—a phenomenon termed as ‘reciprocity’. In the corruption context, according to Dong, Dulleck & Torgler (2012, p. 611), reciprocity means ‘if corruption within a society is very prevalent, citizens feel less guilt when engaging in extra-legal activities, and are likely to act accordingly’. The findings from macro level panel data indicate that the prevailing level of perceived corruption is positively influenced by the past level of perceived corruption.

At the individual level, high levels of perceived corruption may have a downward spiral effect on individuals. Mishler and Rose (2008) outline that inflated corruption perceptions may have the negative effect of undermining individuals’ morality by

¹⁰ In the Indonesian context, for example, Olken and Pande (2012) assert that the discrepancy between actual and perceived corruption in the Indonesian post-Soeharto era can be induced by a much freer press which is able to make more corruption cases publicly accessible.

¹¹ The study includes 30 countries and 34 countries for the EVS and the WVS respectively, whereas the ICRG data covers 18 years (1986 to 2003).

unconsciously encouraging people to accept that engaging in corruption is normal and socially acceptable in a national context. In this regard, Ross, Greene & House. (1977, p. 279) argue that ‘in a sense, every social observer is an intuitive psychologist who is forced by everyday experience to judge the causes and implications of behaviour’. It is common that to decide on appropriate behaviour in a given situation, individuals attempt to seek relevant information as to how similar others have behaved or are behaving, to be able to evaluate the appropriateness of their own beliefs, attitudes, and behaviour—a notion referred to as ‘social validation’ (Cialdini, 1989).

2.2 Tax compliance behaviour

While there is no consensus of what precisely is meant by compliant behaviour (Devos, 2014; McKerchar, 2003; Weber, Fookien & Herrmann, 2014), definitions of tax compliance can be broadly categorised into two approaches: conceptual and operational. The conceptual approach tends to emphasise the taxpayers’ willingness to comply (see, for example, James & Alley, 2004; Kirchler, 2007; Weber, Fookien & Herrmann, 2014), whereas the operational approach focuses on the administrative fulfilment of particular tax obligations (see, for example, Alm, 1991; IRS, 2009; Jackson & Milliron, 1986; OECD, 2004). For practical purposes, the operational approach seems to offer an advantage. This approach generally evaluates whether taxpayers register in the system, file timely tax returns, make accurate and complete reports and pay the tax liability on time. Thus, based on this approach, taxpayers’ compliance levels can be easily measured by simply evaluating whether all aspects of their tax requirements have been fulfilled.¹²

It has been argued that it is more appropriate to view taxpayers’ behaviour toward the tax system as a continuous spectrum rather than a binary outcome (compliant and non-compliant) (Tran-Nam, 2003). It is also clear that tax compliance behaviour is a dynamic concept in two different senses. At the micro level, the tax compliance behaviour of a particular personal taxpayer may change over his/her lifetime. At the macro level, tax compliance exists not only in a dynamic environment but also involves differing types of taxpayers, in turn producing various types of compliance outcome (McKerchar and Evans, 2009).¹³

While strictly and legally speaking tax compliance behaviour is an ex-post definition,¹⁴ the diversity of possible outcomes of compliance behaviour has been recognised by several authors. For instance, the OECD (2004), based on their motivational postures, suggested that taxpayers can be sorted into four types: the disengaged, the resisters, the triers, and the supporters.¹⁵ Similar to McKerchar (2003), Langham, Paulsen & Hartel (2012) observe four major types of compliance behaviour: (i) deliberately or intentionally compliant; (ii) accidentally or

¹² For instance, data released by the Canadian Revenue Agency suggests that while tax compliance at the most basic level (that is, filing and lodging on time) is somewhat satisfactory, however, the more substantive criteria of tax compliance—determined by the share of taxpayers categorised at ‘crucial risk of non-compliance’—shows more issues (Trivedi, Shehata & Mestelman, 2005).

¹³ Consequently, measuring comprehensively the diversity of taxpayer compliance behaviour can be complicated and may be impractical (OECD, 2004).

¹⁴ That is ‘actual’ tax compliance behaviour can only be gauged once a thorough audit is performed—by the tax authority—and the outcome is obtained.

¹⁵ It should be noted, however, that it is not a permanent classification. An individual taxpayer tends to behave on a contextual basis and therefore is capable of embracing any of the described postures in a given context (OECD, 2004).

unintentionally non-compliant; (iii) accidentally or unintentionally compliant and (iv) deliberately or intentionally non-compliant.

It is apparent that two related aspects need to be taken into account in examining tax compliance behaviour: intention and outcome (see, for example, Antonides and Robben, 1995; Bird, 2015; Long and Swingen, 1991; McKerchar, 2003; Langham, Paulsen & Hartel, 2012; Tran-Nam, 2003; World Bank, 2015).¹⁶ While the outcomes of compliance behaviour vary, intention can be reasonably considered as the accurate proxy for the performed behaviour (Antonides & Robben, 1995; Lewis, 1982; OECD, 2010).

Taken together, to obtain a greater clarity on the definitional issues and to maintain the specificity of the results, this study sets out two conceptual boundaries. First, tax compliance is defined as 'taxpayers' willingness to accurately report income in accordance with the prevailing tax law' (Kirchler, 2007; McKerchar and Evans, 2009; OECD, 2004).¹⁷ Second, this study focuses on either 'intentional or deliberate' compliance or non-compliance behaviour. Accordingly, tax compliance behaviour in this study refers to the self-reported behaviour of the taxpayers' intended income reporting behaviour.¹⁸

2.3 Perceptions of corruption and tax compliance behaviour: How do they relate?

Perceptions of corruption and tax compliance behaviour are distinct and separate problems, but they can be easily intertwined. First, in highly corrupt countries reduced tax revenue that reaches government may be spent in unproductive or inappropriate ways before achieving designated public spending purposes and as a result, public finance may fail to fulfil its objectives (Hillman, 2004). This situation may erode taxpayers' willingness to contribute their fair share of tax (Gangl et al., 2015; Torgler et al., 2008). Moreover, perceptions of corruption may cultivate a culture of distrust among stakeholders towards related institutions (Melgar, Rossi & Smith, 2010), strengthening a damaging public perception that causes taxpayers to disengage from any reciprocal relationship with the government (Fjeldstad & Tungodden, 2003). As a higher level of perception of corruption crowds out the degree of tax morale,¹⁹ it may then reduce the moral cost of evading tax and further encourage taxpayers to behave opportunistically (Torgler, 2004).

Additionally, from a fiscal exchange perspective, it can also be argued that corruption may demotivate compliance as the taxpayers might perceive that, due to corruption, the presence (or benefit) of government expenditure they receive will be reduced (Alm, Jackson & McKee, 1992; Andreoni, Erard & Feinstein, 1998). Consequently,

¹⁶ For instance, according to Bird (2015, p. 31), "countries exhibit a wide variety of tax compliance levels, reflecting not only the effectiveness of their tax administrations but also taxpayer attitudes toward taxation and toward government in general. Attitudes affect intentions and intentions affect behaviour."

¹⁷ It is worth noting that this definition deliberately excludes the 'registration', 'filing', and 'payment' criteria.

¹⁸ Academically speaking, it is hardly possible to identify taxpayers' behavioural outcomes in the case of 'unintentionally compliant' and 'unintentionally non-compliant' as the comprehensive assessment regarding the actual taxpayers' compliance behaviour is beyond the scope of this study. See also fn. 14.

¹⁹ Tax morale can be loosely described as internal motivation to comply with tax law (Kornhauser, 2007)

perceptions of corruption may have a worse effect than the corruption itself (Melgar, Rossi & Smith, 2010).

Second, perceptions of corruption may influence the way taxpayers comply with their tax obligations. Individuals have an inclination to perceive corruption as ‘all of a piece’ where people tend to fail to recognise the difference between street-level corruption and its opposed type, political or civic institution corruption (Mishler & Rose; 2008). Also, according to Mishler and Rose (2008), individuals’ perceived corruption about one institution is inherently influenced by their perception of other institutions: the ‘echo chamber’ effect. Since taxpayers have limited capabilities in processing such information, they are not fully informed, tend to use heuristics, and are therefore vulnerable to biases in their tax decisions (Marriott, 2009; OECD, 2010; Reeson & Dunstall, 2009).

2.4 Behavioural intention model

An appropriate theoretical lens is needed to examine the possibility of a causal relationship between perceptions of corruption and the way taxpayers behave. In this regard, it is concluded that one established behavioural intention model, particularly capable of explaining and identifying how psychological and behavioural factors can be converted into certain behavioural outcomes, is the Theory of Planned Behaviour (TPB). Despite its weaknesses in certain contexts, this theory has considerable popularity among behavioural researchers and received the highest score of scientific impact among US and Canadian social scientists (Nosek et al., 2010).

In social psychology, TPB is a theory that correlates beliefs and behaviours in an attempt to understand and predict human behaviour. The theory conceptualises that attitude toward behaviour, subjective norms and perceived behavioural control lead to the formation of behavioural intention, in which behavioural intention enables the prediction of actual behaviour.

The justification for adopting the TPB is twofold. First, by definition, perception is closely related to belief.²⁰ In this context, belief in the TPB model is defined as ‘subjective probabilities’ (Fishbein & Ajzen, 2010). The TPB deals with three beliefs. First, behavioural beliefs represent the subjective probabilities that conducting certain behaviour produces a particular outcome. Second, normative beliefs consist of injunctive and descriptive normative beliefs. While injunctive normative beliefs are concerned with the subjective probabilities that certain group of referents encourage or discourage performance of a given behaviour, descriptive normative beliefs refer to subjective probabilities that important referents are doing or not doing the behaviour. Third, the subjective probabilities that certain factors can support or prevent the performance of a behaviour are elements of control beliefs (Fishbein & Ajzen, 2010). Once beliefs associated with a certain behaviour have been developed, these beliefs then provide the basis for the attitudes, subjective norms, and perceived control which in turn lead to the formation of intention and a given behaviour (Fishbein & Ajzen, 2010).

²⁰ Perception can be referred to as ‘a belief or opinion, often held by many people and based on how things seem’. See <<http://dictionary.cambridge.org/dictionary/british/perception>>, retrieved 16 October 2014. As is true for the definition of corruption, the definition of perception of corruption also depends on social and cultural factors (Melgar, Rossie & Smith, 2010).

Second, in the TPB framework, people are not assumed to be rational in their behaviour (Fishbein & Ajzen, 2010).²¹ Instead, the TPB accepts that people's behaviour follows reasonably from their salient beliefs. This view is supported by several authors (see, for example, Cialdini, 1989; Eveland & Glynn, 2008; World Bank, 2015).²² Given that beliefs are often based on information provided by others and on unreliable inference processes, these beliefs (behavioural, normative, and control beliefs) naturally need not be valid or veridical. As a result, they can be inaccurate, unreliable, biased, or may represent other irrational processes (Fishbein & Ajzen, 2010). This holds true for the perceptions of corruption, as many authors maintain that people are very susceptible to be biased in dealing with perceived levels of corruption (see, for example, Donchev and Ujhelyi, 2014; Kuncoro, 2006; Miller, 2006; Olken, 2009; Olken and Pande, 2012; Urra, 2007).

Referring to the relationship between background factors and beliefs, the formation of beliefs and the possibility of behavioural and psychological biases in the decision making process, it is reasonable to hypothesise that the perceptions of corruption might be capable of influencing the taxpayers' salient beliefs of both their attitudes toward behaviour and their subjective norms, but not their control beliefs to perform tax compliance behaviour. The rationale for this is, first, given that attitudes towards behaviour can be generally defined as an individual's psychological evaluation, that is, some degree of favourableness or unfavourableness of performing behaviour (Fishbein & Ajzen, 2010), the perceived corruption may crowd out the degree of tax morale, undermine the moral cost of evading tax, encourage taxpayer's to behave opportunistically (Torgler, 2004), erode taxpayers' willingness to contribute their fair share of tax (Torgler et al., 2008), pay less taxes (Kaufmann, Kraay & Mastruzzi, 2007), and eventually may change the taxpayers' latent disposition to perform compliance behaviour (Cialdini, 1989).

Second, provided that subjective norms generally deal with the perceived level of social pressure to execute (or not) the targeted behaviour (Fishbein & Ajzen, 2010), the perceptions of corruption might cultivate a culture of distrust (Melgar, Rossi & Smith, 2010), undermine citizens' morality by subtly encouraging people to accept the social reality that engaging in corruption is normal and acceptable in a national context (Mishler & Rose, 2008) and consequently may shift the taxpayers' overall perceived social pressure regarding tax compliance behaviour (Cialdini, 1989).²³ Additionally, perceptions of tax corruption and tax non-compliance behaviour can be considered as complementary activities. That is, while corruption may induce more taxpayers to underreport taxes, more underreported taxes create more opportunities for bribery of tax officials (Alm, Martinez-Vazquez & McClellan, 2014; Çule & Fulton, 2009). Thus, such perception may lead taxpayers to believe that they can negotiate

²¹ It is worth distinguishing between rational and rationality in this context. While choices are rational, rationality is considered as subjective and influenced by cultural values (Lewis, 1982).

²² For instance, supporting the view of Cialdini (1989) who argues that individuals have a tendency to adopt beliefs, attitudes, and behaviour of others—particularly those of similar others—as a guidance to evaluate their own beliefs, attitudes, and behaviour; Eveland & Glynn (2008, p. 159) maintain that '...perceptions of the beliefs, opinions, or behaviour of others as central determinants of human behaviour'.

²³ In this respect, according to Lederman (2003), perceiving that other taxpayers do not comply would undermine one's own tendency to comply. Noticing others' non-compliance might change someone's moral standard, and as a result someone might feel less guilty to commit non-compliance. Similarly, Wenzel (2005) argues that conforming misperceived social norms, namely, self-other discrepancy regarding the extent of tax evasion, could lead taxpayers to be less compliant.

with tax administrators so that taxpayers could end up paying less taxes than they would otherwise.

On the other hand, in terms of control beliefs, given that a perceived behaviour control (PBC) construct was added in the TPB to explain behaviours that are beyond complete volitional control, it can be intuitively assumed that perceptions of corruption are not related to taxpayers' salient beliefs on the perceived level of ease or difficulty to perform their behaviour.

2.5 Research problem and propositions

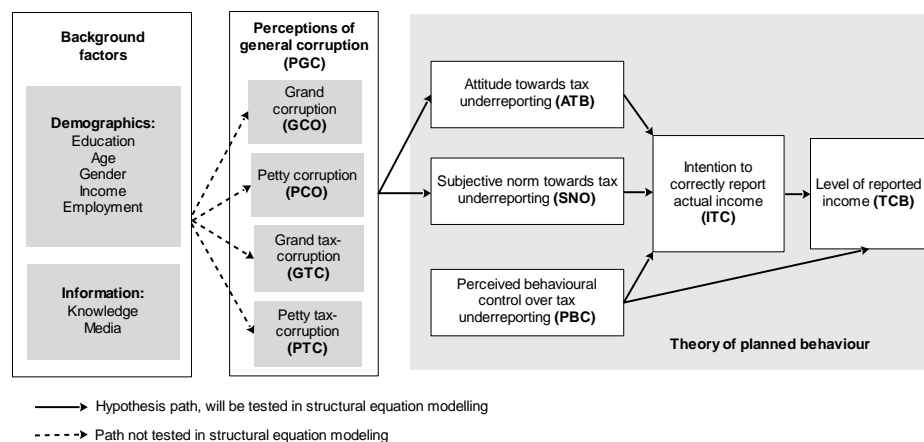
The research problem of this study is: do perceptions of corruption affect intentional non-compliance behaviour of personal income taxpayers in Indonesia? To elaborate upon this problem, and based on the theoretical framework and extant literature, the following research propositions are considered and illustrated in Figure 1.

First, taxpayers' perceived levels of corruption are influenced by their background factors.²⁴ There are five different forms of perception of corruption considered in this study. These are:

1. Perception of general corruption (PGC): The abuse of entrusted power by public officials for private gain
2. Perception of grand corruption (GCO): The misuse of public power by high-level public officials for private gain which often involves large sums of money
3. Perception of petty corruption (PCO): The extortion of small payments by low-level public officials in daily interactions with the public as 'grease money'
4. Perception of grand tax-corruption (GTC): The misuse of public power by high-level tax officials for personal pecuniary gains which often involves large illegal payment in dealing with certain tax cases
5. Perception of petty tax-corruption (PTC): The misuse of public power by low-level tax officials for personal pecuniary gains or the extortion of small payments by operational staff in daily interaction with taxpayers as 'grease money'.

Second, the extent of perceived levels of corruption will negatively influence taxpayers' attitudes and their subjective norms towards reporting actual income. Coupled with the opportunity for non-compliance, negative attitudes and subjective norms will lead to the formation of behavioural intentions to underreport income. Further, the level of reported income can be predicted from taxpayers' behavioural intentions to report actual income. Finally, it is hypothesised that perceptions of corruption have a negative effect on the level of reported income.

²⁴ This proposition, due to space considerations, is not considered further in this paper.

Figure 1: Conceptual model of the study

To clearly comprehend the scope of the study, the research propositions are presented as a set of alternative and null (H_0) hypotheses in Table 1 as follows:

Table 1: Research hypotheses

Hypothesis	Prediction
Hypothesis 1	H1 _a : Perceptions of corruption positively influence taxpayers' attitudes towards tax underreporting. H1 ₀ : Perceptions of corruption do not influence taxpayers' attitudes towards tax underreporting.
Hypothesis 2	H2 _a : Perceptions of corruption positively influence taxpayers' subjective norms towards tax underreporting. H2 ₀ : Perceptions of corruption do not influence taxpayers' subjective norms towards tax underreporting.
Hypothesis 3	H3 _a : Attitudes towards tax underreporting negatively influence taxpayers' intention to correctly report actual income. H3 ₀ : Attitudes towards tax underreporting do not influence taxpayers' intention to correctly report actual income.
Hypothesis 4	H4 _a : Subjective norms towards tax underreporting negatively influence taxpayers' intention to correctly report actual income. H4 ₀ : Subjective norms towards tax underreporting do not influence taxpayers' intention to correctly report actual income.
Hypothesis 5	H5 _a : Perceived behavioural control over tax underreporting negatively influence taxpayers' intention to correctly report actual income. H5 ₀ : Perceived behavioural control over tax underreporting do not influence taxpayers' intention to correctly report actual income.
Hypothesis 6	H6 _a : Intentions to correctly report actual income positively influence the level of reported income. H6 ₀ : Intentions to correctly report actual income do not influence the level of reported income.
Hypothesis 7	H7 _a : Perceived behavioural control over tax underreporting negatively influence taxpayers' level of reported income. H7 ₀ : Perceived behavioural control over tax underreporting do not influence taxpayers' level of reported income.
Hypothesis 8	H8 _a : Perceptions of corruption have a negative effect on taxpayers' level of reported income. H8 ₀ : Perceptions of corruption do not have a negative effect on taxpayers' level of reported income.

3. RESEARCH METHODS—POPULATION AND DATA COLLECTION

This study employs both the qualitative and quantitative paradigms in a sequential priority model of ‘*qual*→*QUANT*’ to enhance research method capabilities and to improve the quality of the research findings.²⁵ In the first phase, in-depth interviews are used to clarify, modify, and develop more robust observed independent and dependent variables in the design of the questionnaires from theoretical perspectives. This is then followed by an extensive survey to explain the structural patterns, through numeric measurement, of relationships among the variables of perceptions of corruption and the prescribed TPB constructs through quantitative analysis. A high-risk human research ethics approval, covering the research design for both the qualitative and the quantitative investigations, was granted prior to the research being conducted.

3.1 Phase one: In-depth interviews

3.1.1 Participants

There were nine participants in the qualitative phase: three taxpayers, three tax officers and three tax agents. They resided in two big cities of East Java province (Malang and Surabaya) and ranged in age from 36 to 54. Both the tax agents and tax officers have at least eight years of working experience while the taxpayers have at least five years of working experience.

3.1.2 Procedures

The participants were interviewed in the period from January to February 2015 using 20 semi-structured questions. The interviews were open-ended and interviewees were encouraged to provide their own thoughts and opinions on the questions. For data analysis, the interview data was transcribed into a verbatim format. Verbatim responses were then inputted into the CDC EZ-Text 4.0 software for further analysis. A deductive and theoretical thematic analysis procedure described by Braun and Clarke (2006) was used for qualitative data analysis.

3.2 Phase two: Survey instrument

3.2.1 Sample and survey coverage

Based on a careful estimation, it was concluded that the accessible population of this study was around 360,000 respondents.²⁶ Moreover, as this study adopted structural equation modelling (SEM) (see below), it was considered that the minimum samples for this study would be 384. The samples share an equal portion of self-employed and employed PITs.²⁷

²⁵ This symbol means that qualitative method is employed as a supplementary method whereas quantitative method is adopted as a core method (Morgan, 2014). In other words, the priority method in this study is the quantitative method preceded by the preliminary contribution of the qualitative method.

²⁶ This is an indicative number of the accessible population of each tax office, estimated by multiplying the number of registered PITs who were obliged to lodge annual tax returns as of December 2012 with the rate of filing ratio of each tax office under study.

²⁷ In particular, the surveyed self-employed PITs in this study are categorised as small and medium enterprises (SME) with annual sales turnover of operating business less than IDR 4.8 billion

The survey was conducted with PITs who were visiting any one of 12 tax offices across four Indonesian regions (Denpasar, Malang, Surabaya and Yogyakarta). The main purpose of their visit to the tax office was to submit personal tax returns. The survey was commenced in mid-March 2015 and ended in June 2015. Most of the tax offices (75 per cent) where the surveys took place were located on Java Island. The justification for this was two-fold. First, in terms of economic activity, despite its small size, Java Island accounts for almost 58 per cent of Indonesian GDP (BPS, 2013).²⁸ Second, the majority of income taxpayers (60 per cent) are administered by 189 tax offices (57 per cent of the total number of tax offices in Indonesia) in this area.

3.2.2 Procedures

The survey questionnaire employed 72 questions in total. The respondents were asked to indicate their beliefs, values, attitudes, intentions and behaviour with regard to ten constructs using a 7-point rating scale of interval measurement by using 56 reflective indicators. The employed constructs and the number of its indicators are as follows: (i) perceptions of general corruption (PGC) = 5; (ii) perceptions of grand corruption (GCO) = 5; (iii) perceptions of petty corruption (PCO) = 5; (iv) perceptions of grand tax-corruption (GTC) = 5; (v) perceptions of petty tax-corruption (PTC) = 5; (vi) attitude towards tax underreporting (ATB) = 9; (vii) subjective norm towards tax underreporting (SNO) = 8; (viii) perceived behavioural control over tax underreporting (PBC) = 8; (ix) intention to correctly report actual income (ITC) = 4; and (x) level of reported income (TCB) = 2 indicators.

Prior to the survey conduct, two-stage pilot tests were undertaken to ensure that the questionnaire was accurate and reliable for data collection: declared and undeclared. In the declared phase, 29 participants were explicitly asked to help in improving the questionnaire by providing comments or feedback whilst completing the questionnaire. Based on the written feedback from the declared stage, the questionnaire was then fine-tuned and the undeclared stage (that is, the respondents were not requested to provide comments or feedback about the questionnaire) was carried out with 30 participants. The result from the second pilot test indicated that the questionnaire had the potential to produce valid and reliable data in the actual survey.

Due to the sensitivity of the research topic, the survey was performed by research intermediaries (trained research assistants recruited from local universities). The use of research intermediaries was considered crucial to assure the potential respondents that the study was an academic project as well as to indicate that the study had no link

(equivalent to about AUD 466 926 as at 19 March 2014). Bookkeeping is not compulsory for them. Based on Government Regulation Number 46 Year 2013, they are taxed by way of a one per cent presumptive final income tax, which applies to their annual gross sales turnover. This new policy has an effective date of 1 July 2013. It is also worth noting that the potential role of tax agents upon the compliance behaviour of PIT in Indonesia in this study is assumed to be negligible. For instance, as of 31 July 2013, the number of registered tax agents in Indonesia is 1 883 tax agents and the number of taxpayers who used tax agents to deal with their tax affairs is only 5 410 taxpayers. Most of them were corporate taxpayers (see, <<http://www.pajak.go.id/node/8289?lang=en>>, accessed 9 November 2014). It is possible however that the representation of tax agents among taxpayers is underestimated. The plausible explanation is that many income taxpayers who actually used tax agents to handle their tax matters may not officially declare their engagement in their tax returns.

²⁸ With land area less than 7 per cent of the total land area, Java Island is inhabited by more than 53 per cent of the total population (BPS, 2013).

with the Indonesian tax authority. By doing so, it was considered that the extent of social desirability bias in responding to the questionnaire could be minimised.

The survey was conducted by using mixed-modes: a combination of face-to-face interviews and self-completion survey. Face-to-face interviews were initially used by the research assistants to recruit respondents while self-completion surveys were employed to capture respondents' answers. There were two justifications for adopting this mixed-modes approach. First, face-to-face interviews have had a good reputation for gaining cooperation (de Vaus, 2014). Second, reflecting on the sensitive nature of the study, self-completion questionnaire surveys were considered as the most suitable mode to particularly capture confidential responses.

Structural equation modeling (SEM) was used for inferential quantitative data analysis by using IBM SPSS Statistics and IBM SPSS Amos. Commonly used to assess dependence relationships among latent variables simultaneously (Hair et al., 2010),²⁹ SEM is defined as 'a technique to specify, estimate, and evaluate models of linear relationships among a set of observed variables in terms of a generally smaller number of unobserved variables' (Shah & Goldstein, 2006). Accordingly, this technique is considered as the most appropriate method to analyse the survey data in this study.

4. RESULTS

4.1 Results of phase one: In-depth interviews

The length of interviews ranged from 31 to 76 minutes. The qualitative data analysis was performed in four stages. First, based on a review of the literature on perceptions of corruption and the TPB, seven themes were established and coded: (i) taxpayers' general information (TGI); (ii) perceptions of corruption (PoC); (iii) attitude towards behaviour (ATB); (iv) subjective norms (SNO); (v) perceived behavioural control (PBC); (vi) intention to comply (ITC); and (vii) tax compliance behaviour (TCB).

Second, each of the themes, except PBC and ITC, was then categorised into relevant sub-themes, resulting in 15 sub-themes. Each sub-theme was coded as a 'child' of its original code in the software and each had a bipolar scale (for example, low-high, negative-positive, harmful-beneficial). For instance, a sub-theme 'experiential attitude' (coded as 'ExA', a child code of ATB) had two bipolar codes: negative experiential attitude (coded as 'ExAnega') and positive experiential attitude (coded as 'ExAposi'). A total of 34 pre-existing codes were established.

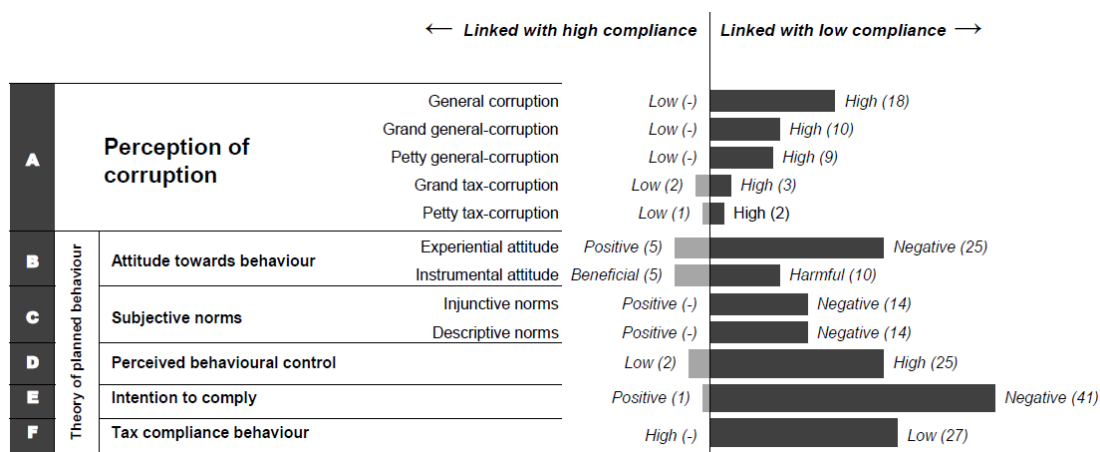
Third, the transcribed data was read carefully to identify meaningful patterns of texts relevant to the pre-existing codes. A special feature of the CDC EZ-Text 4.0 program was used in the data coding process to assign the identified text passages to relevant pre-existing codes.

Finally, the data was systematically reviewed to ensure that the meaningful text passages were fully identified and the assigned codes were appropriately entered. The deductive thematic analysis resulted in 28 categories being identified, which covered 82 per cent of available pre-existing codes, leaving six pre-existing codes unused. A

²⁹ According to Hair et al. (2010, p. 612), despite its practical use, traditional multivariate techniques such as multiple regression, factor analysis, multivariate analysis of variance and discriminant analysis share one common limitation: it 'can examine only a single relationship at a time'.

total of 272 assigned codes were identified from the transcribed interview data. To provide an easier description of the findings, a representation of the assigned codes was converted into clustered bar charts and depicted in Figure 2.

Figure 2: Diagrammatic interpretation of qualitative findings



Note: This figure shows the number of identified pre-existing codes for each category in a double-sided bar. The length of the bar proportionally indicates the number of identified codes. For instance, as shown at the top of the chart, there was no participant who had opined that general corruption was 'low' in Indonesia. In contrast, 18 codes were found indicating that general corruption was 'high'.

Several meaningful patterns emerged from the graph. Using the TPB as an analytical tool, the patterns were intuitively easy to interpret. First, the qualitative data suggests that PITs were perceived by participants as having a high likelihood not to comply with the tax law, indicated by the extent of negative intention to comply score. In this sense, the TPB posits that 'intention to comply' has three antecedents: (i) attitudes towards behaviour; (ii) subjective norms; and (iii) perceived behavioural control (Fishbein & Ajzen, 2010). Generally speaking, people will comply when the attitudes are positive and the subjective norms are to conform (Ajzen, 1991). In this sense, the data indicate the opposite. The participants were of the opinion that complying with the tax law was associated with 'bad' feeling and 'disadvantages' which represent overall negative attitudes toward compliance behaviour. The overall negative value on subjective norms also indicated that the perceived level of social pressures to comply with the tax law was completely absent, which in turn might implicitly encourage PITs to become non-compliant. The data also revealed that PITs were generally assumed to have a considerable control over whether or not they want to intentionally engage in tax evasion. Taken together, it seems reasonable to associate these three conditions with the extent of perceived likelihood not to comply with tax.

Second, taxpayers' compliance behaviour can be approached by its closest behavioural proxy. A wealth of literature has also emphasised the significance of taxpayers' behavioural intentions in explaining and predicting their behavioural outcomes (Fishbein & Ajzen, 2010; Langham, Paulsen & Hartel, 2012; Lewis, 1982; McKerchar, 2003). In this sense, the data suggests that a hypothetical link comes to exist between negative intention to comply and low levels of compliance behaviour. It should be noted, however, that while negative behavioural intention enables the prediction of actual non-compliance behaviour, the extent to which actual non-compliance behaviour can be performed depends on taxpayers' volitional control to perform the targeted behaviour (Fishbein & Ajzen, 2010).

Third, the data also demonstrate a hypothetical correlation between the high level of perceived corruption and low levels of compliance behaviour. However, little was known from the data about how this connection was linked. What the data might suggest is that high levels of perceived corruption could be related to both situational and motivational factors. The justifications for these links were two-fold. First, the situational factor was indicated by the extent of negative psychological evaluation towards a high level of perceived corruption and complying with tax.³⁰ Thus, corruption, either perceived or real, might lead to a negative psychological evaluation towards the completeness and the accuracy of information declared in the annual income tax return of PITs. Second, the motivational factor could be related to a lack of perceived social pressure among PITs to fully comply with the tax law, particularly in providing complete and accurate information declared in the annual income tax returns. Overall negative values on both injunctive and descriptive norms among the participants indicated that the beliefs of certain groups of referents discourage PITs from complying with the tax law and beliefs that PITs' important referents are not fully reporting their income were evident.

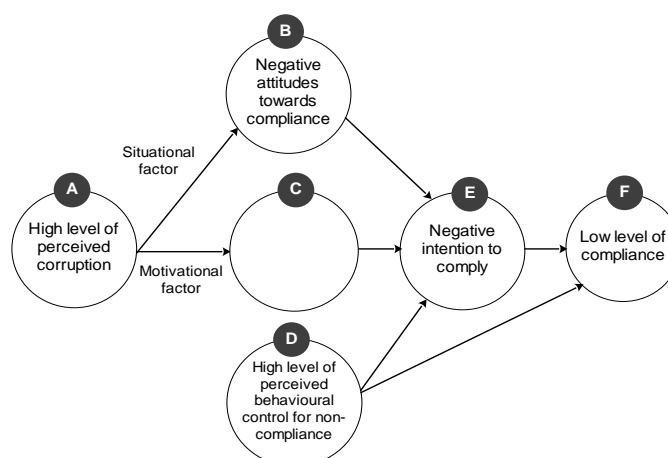
Taken together, it was possible to propose a hypothetical relationship between high levels of perceived corruption with low levels of compliance behaviour. In this sense, this hypothetical model conceptualises that perceived levels of corruption influence both attitudes and subjective norms of PIT. Further, the affected attitudes and subjective norms, combined with high level of perceived behavioural control for non-compliance, lead to the formation of a negative intention to fully comply with the tax law. Subsequently, this negative behavioural intention can be reasonably used to predict the low level of compliance behaviour.

It should be noted that, as the theory posits, high levels of perceived behavioural control not to comply with tax are assumed to have two effects on intended behavioural outcomes: an indirect effect through negative behavioural intention and a direct effect on behaviour. This hypothetical relationship is depicted in Figure 3.

Figure 3 illustrates the hypothetical relationships among seven variables under consideration arising from the qualitative findings. Each circle in this diagram represents one construct and the arrow indicates a direct path of relationship. For instance, an arrow from point 'A' to 'B' in this figure indicates that high levels of perceived corruption are assumed to have a direct negative influence over taxpayers' attitudes towards reporting behaviour. Next, negative attitudes towards reporting behaviour in point 'B' are assumed to negatively affect point 'E' (intention to report actual income), before reaching point 'F' (level of reported income). Thus, this figure implies that the relationship between perceived levels of corruption and levels of reported income is indirect. These key findings and hypothetical relationships were then used and further investigated in the quantitative phase.

³⁰ For instance, 'why should I pay tax if it is just being corrupted?' was a frequently expressed view heard from participants—this sentiment was uttered 18 times in total during the interviews. Also, as two participants have precisely described, to compensate for such a 'non-deductible payment' for tax calculation purposes, certain types of taxpayers might have no choice but to underreport their actual income. Otherwise, taxpayers may have to pay 'double-taxes' which obviously reduces their financial circumstances.

Figure 3: Hypothetical relationships between perceptions of pervasive corruption and poor level of tax compliance arising from qualitative findings



4.2 Results of phase two: Survey instrument

4.2.1 Representativeness test

Although the survey respondents were randomly recruited, basic comparisons were undertaken to ensure the representativeness of the sample. Upon the availability of the population data, the comparisons were performed on four levels: national, regional, tax office, and annual income levels. As the survey collected almost the same proportion of self-employed and employed PITs in each of the surveyed tax offices, the variability of this proportion would not be evident. For this reason, the variability of types of annual return lodged by employed PITs—who may use either 1770S or 1770SS tax returns—was used.³¹

A summary of the total population of lodged annual tax returns for fiscal year 2014 by employed PIT, as provided by the Indonesian tax authority, Directorate General of Taxation (DGT), is presented in Table 2. It shows that the proportion of survey respondents submitting the 1770S return forms (29 per cent) and 1770SS forms (71 per cent) was broadly comparable to the proportions shown at the surveyed tax office, regional level and national levels.

Table 2: Comparison of the number of annual tax returns lodged by employed PITs as sample frame

Level of Comparison	Lodged 2014 annual tax returns			Normalised comparison		
	1770SS	1770S	Total	1770SS	1770S	Total
National level (331 tax offices)	7,088,694	2,550,327	9,639,021	74%	26%	100%
Regional level (39 tax offices)	892,598	292,867	1,185,465	75%	25%	100%
Surveyed tax office level (12 tax offices)	299,186	112,292	411,478	73%	27%	100%
Surveyed respondents (201 employed PIT)	143	58	201	71%	29%	100%

³¹ In Indonesia, there are basically two types of annual income tax returns which explicitly reflect the way taxpayers source their income: (i) the 1770 form for self-employed PIT and (ii) the 1770S or 1770SS forms for employed PIT. The 1770SS form is only used by employed PIT who had annual taxable income less than or equal to IDR 60 million from one employer, otherwise the 1770S form must be used.

Additionally, because in the survey respondents were required to indicate their income levels, it was also possible to compare respondents' income levels to the sample frame according to types of annual tax returns and income groups.³² The results suggest that the portion of 1770SS and 1770S annual tax returns in the sample frame (that is, 73 per cent for 1770SS and 27 per cent for 1770S) was almost similar to the portion of surveyed employed PIT's income groups (that is, 76 per cent for those with annual income less than or equal to IDR 60 million and 24 per cent for those with annual income over IDR 60 million).

Based on these two tests, it was concluded that the respondents, at least in particular the surveyed employed PIT, were reasonably representative of the sample frame with regard to type of annual tax return and income group.³³

4.2.2 *Timing-bias test*

As mentioned earlier in Section 3.2.1, the survey conduct was commenced in the middle of March 2015 and ended in June 2015. To check whether those who answered the questionnaire in June 2015 were in agreement with those who answered the questionnaire in March 2015, a wave analysis as suggested by Armstrong and Overton (1977) was performed.³⁴ The data for late responses, as an observed distribution, was taken from the survey data with tax offices ID 9-12 (four last surveyed tax offices). The expected distribution was calculated from early survey data with tax offices ID 1-4 (four earliest surveyed tax offices). Questions related to intention to report income and the level of reported income (Questions I2 and J2) were selected as two key attitudinal questions for the test.

To statistically determine the extent of timing-response bias, a chi-square goodness of fit test was applied. The test was conducted using six and seven degrees of freedom for Questions I2 and J2 respectively, with an α equal to 0.05. The acceptance regions of the null hypotheses were $\chi^2 = 12.59$ and 14.07 for Questions I2 and J2 respectively. As the computed value of χ^2 for I2 was 5.89 and the p -value of 0.435 was greater than α , the null hypothesis for I2 was not rejected. Similarly, as the computed value of χ^2 for J2 was 5.76 and the p -value of 0.568 was greater than α , the null hypothesis for J2 was not rejected. These results accept the null hypothesis that the two distributions were in agreement. As a result, it was concluded that there was no timing-response bias in the survey data.

4.2.3 *Respondents' profiles*

By their annual income levels

The surveyed respondents consisted of two groups: 196 self-employed PITs and 201 employed PITs.³⁵ While self-employed PITs regardless of their income level used the

³² As mentioned earlier, depending on the level of their annual income, employed PITs may use either the 1770S or 1770SS annual tax returns. For this reason, it was impossible to compare self-employed PIT's income level and the annual tax return they used as only one type of annual tax return (that is, 1770) was available.

³³ Ideally, the representativeness test of the sample frame should be performed upon various demographic bases such as age, gender, level of education, race, etc. However, based on the nature and availability of data provided by the DGT, only these two variables could be utilised for the test.

³⁴ Personal taxpayers were surveyed in relation to their 2014 annual tax returns. Their 2014 annual income tax returns were due by 31 March 2015.

³⁵ For the detailed characteristics of the surveyed self-employed PITs in this paper, see above n. 27.

1770 form for their annual tax return, employed PITs used two types of annual tax return: the 1770S and the 1770SS. As noted earlier, the 1770S was used by employed PITs with annual income more than IDR 60 million and the 1770SS was completed by employed PITs with annual income less than or equal to IDR 60 million. The majority of respondents (70 per cent) had an annual income level less than IDR 60 million while only eight (2 per cent) respondents had an annual income more than IDR 200 million. Further, PITs who had an annual income level less than IDR 60 million were the majority for both self-employed (1770) and employed PITs (1770SS) with 63 per cent and 71 per cent respectively.

By their age groups

The respondents were concentrated in two age ranges, 24 to 34 and 35 to 44 years old with 35 per cent and 33 per cent respectively. This is followed by 45 to 54 years old group which comprised 19 per cent of the total respondents. Unsurprisingly, respondents who had ages exceeding 65 years old were the age group with the lowest number of respondents, with less than 2 per cent of total respondents in that age group.

By their levels of education and types of tax handling

In terms of levels of education, a majority of respondents have finished their undergraduate level (59 per cent). Conversely, postgraduate level was completed by seven per cent of respondents. In this case, employed PITs with annual income level less than IDR 60 million (1770SS) and self-employed PITs (1770) tended to have lower educational qualifications compared to employed PITs with annual income more than IDR 60 million (1770S).

Most respondents were 'self-preparers' in dealing with the completion of their 2014 annual tax returns (51 per cent), with only two per cent of them using tax agents to prepare their annual tax return. Findings from a correspondence analysis suggest that while employed PITs with annual income less than IDR 60 million (1770SS) tended to use tax offices' assistance, self-employed PITs (1770) were likely to either self-preparers or sought assistance from their families or friends. A tax agent tended to be used by self-employed PITs and employed PITs with annual income more than IDR 60 million.

By their previous interactions with the tax authority

A vast majority of respondents have reported that they have never been contacted by the Indonesian tax authority (74 per cent). Conversely, only around two per cent of respondents had experienced a tax audit. Moreover, findings from a correspondence analysis suggest that self-employed PITs appeared to have more chance of getting audited than employed PITs. Self-employed PITs also tended to be contacted more by the tax authority.

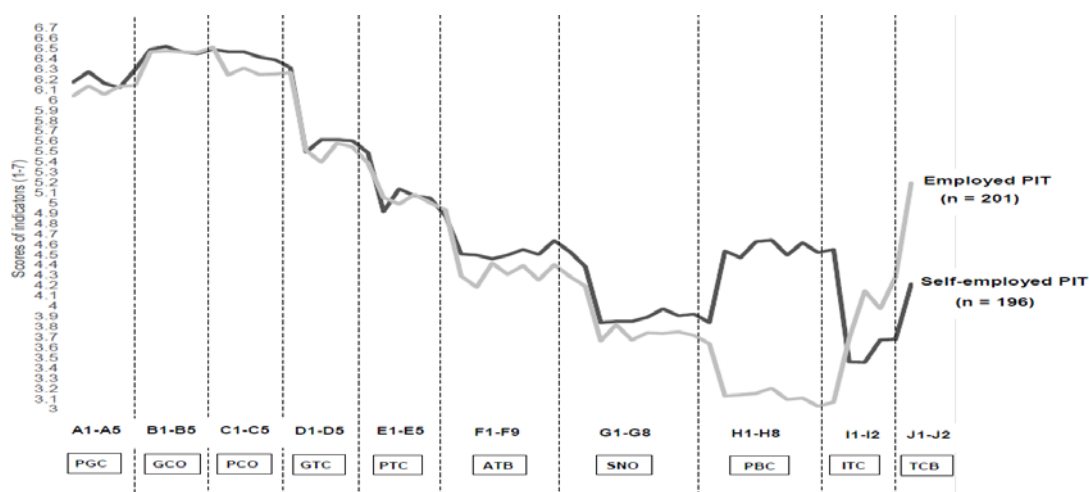
4.2.4 A comparison of indicators' mean of survey data: self-employed and employed PITs

To provide an easier description of the survey responses, at the risk of eliminating the variability of the data, each of the constructs under consideration was presented as a mean of their indicators. For the whole sample, in terms of perceived levels of corruption, it was apparent that the mean for indicators of perception of grand corruption was the highest (6.48) and the lowest was the mean of perceived petty tax corruption (5.01). Among all of the constructs, the lowest score was about 3.8 for both subjective norms towards tax underreporting and intention to report actual

income. Given that the respondents comprised two groups in terms of employment or self-employment status, it was possible to compare the indicators' mean of survey data according to the two groups.

Figure 4 indicates that the mean scores for indicators of the five types of perceptions of corruption (PGC, GCO, PCO, GTC, PTC) were higher than those of indicators of the adopted TPB constructs (ATB, SNO, PBC, ITC and TCB) for both the self-employed and employed PITs, with some degrees of variation. The widest gap was found in the indicators' mean of perceived behavioural control (PBC) over tax underreporting between self-employed and employed PITs, with self-employed PITs scoring much higher ($M = 4.56$) than employed PITs ($M = 3.12$). This notable gap represents the different nature of opportunity for non-compliance between employed and self-employed PITs.

Figure 4: A visualised comparison of indicators' mean of the survey data



4.2.5 Respondents' perceived levels of different forms of corruption

Table 3 details the respondents' scores of perceived levels of the five forms of corruption. The mean scores demonstrate that the perceived levels of corruption in Indonesia are very high. In general, the highest perceived level of corruption was grand corruption, with the lowest mean value for its indicator 6.46 out of 7. Perceptions of petty tax-corruption appeared to have the lowest mean score for its indicator of 4.91 out of 7.

Table 3: Respondents' perceived levels of different forms of corruption (n = 397)

Construct	Definition of corruption	Indicators	Min.	Max.	Mean	SD
Perception of general corruption (PGC)	The abuse of entrusted power by public official for private gain	A1	3	7	6.10	0.918
		A2	4	7	6.21	0.906
		A3R*	4	7	6.11	0.874
		A4	3	7	6.13	0.851
		A5	3	7	6.22	0.902
Perception of grand corruption (GCO)	The misuse of public power by high-level public official for private gain which often involves large sums of money	B1	4	7	6.48	0.676
		B2	4	7	6.51	0.646
		B3R	3	7	6.47	0.698
		B4	4	7	6.46	0.656
		B5	4	7	6.50	0.665

Construct	Definition of corruption	Indicators	Min.	Max.	Mean	SD
Perception of petty corruption (PCO)	The extortion of small payments by low-level public officials in daily interactions with the public as 'grease money'.	C1	4	7	6.36	0.705
		C2	4	7	6.39	0.679
		C3R	3	7	6.33	0.735
		C4	4	7	6.32	0.719
		C5	4	7	6.28	0.732
Perception of grand tax-corruption (GTC)	The misuse of public power by high-level tax official for personal pecuniary gains which often involves large illegal payment in dealing with certain tax cases.	D1	3	7	5.50	1.100
		D2	3	7	5.52	1.084
		D3R	3	7	5.60	1.139
		D4	3	7	5.58	1.090
		D5	3	7	5.44	1.110
Perception of petty tax-corruption (PTC)	The misuse of public power by low-level tax official for personal pecuniary gains or the extortion of small payments by operational staff in daily interaction with taxpayers as 'grease money'.	E1	2	7	4.98	1.069
		E2	3	7	5.06	1.032
		E3R	3	7	5.08	1.013
		E4	2	7	5.02	1.102
		E5	2	7	4.91	1.073

Note: For each of the questions, the respondents were asked whether the level of corruption was 'high'. The lowest score was 1 and the highest was 7. Score 1 refers to 'strongly disagree', score 7 means 'strongly agree'. * = reversed question.

4.2.6 Respondents' self-reported (non)compliance behaviour

Table 4 presents the extent to which respondents suggested they reported their actual income in their 2014 annual tax return.

Table 4: The extent to which respondents self-reported their (non)compliance behaviour

PIT types	(QJ1): I have fully reported my actual income in my annual tax return for fiscal year 2014 (SE) / I have fully reported my income other than salary, wage, or other tax withheld income on my annual tax return for 2014 (E)							
	Strongly disagree	Disagree	Somewhat disagree	Neutral	Somewhat agree	Agree	Strongly Agree	Total
Self-employed Employed	4	15	42	54	45	27	9	196
	5	18	13	27	13	84	41	201
Total	9	33	55	81	58	111	50	397

PIT types	(QJ2): As far as I can remember, the amount of income I have reported in my annual tax return was roughly ... of my actual income*								
	No (other) income	0%	16%	33%	50%	67%	83%	100%	Total
Self-employed Employed	7	2	7	34	42	53	37	14	196
	167	34	0	0	0	0	0	0	201
Total	174	36	7	34	42	53	37	14	397

* for employed PIT this refers to income other than salary, wage, or other tax withheld income

A detailed cross-tabulation of the data indicates that only 18 per cent (36 out of 196) of self-employed PITs agreed or strongly agreed that they had fully reported their actual income. In contrast, 63 per cent (125 out of 201) of employed PITs agreed or strongly agreed that they had reported their income other than salary, wage, or other tax withheld income in their annual income tax return. It is important to note however that a majority of employed PITs taxpayers had no additional income other than from employment (83 per cent), implying that the rest (17 per cent, or 34 employed PITs)

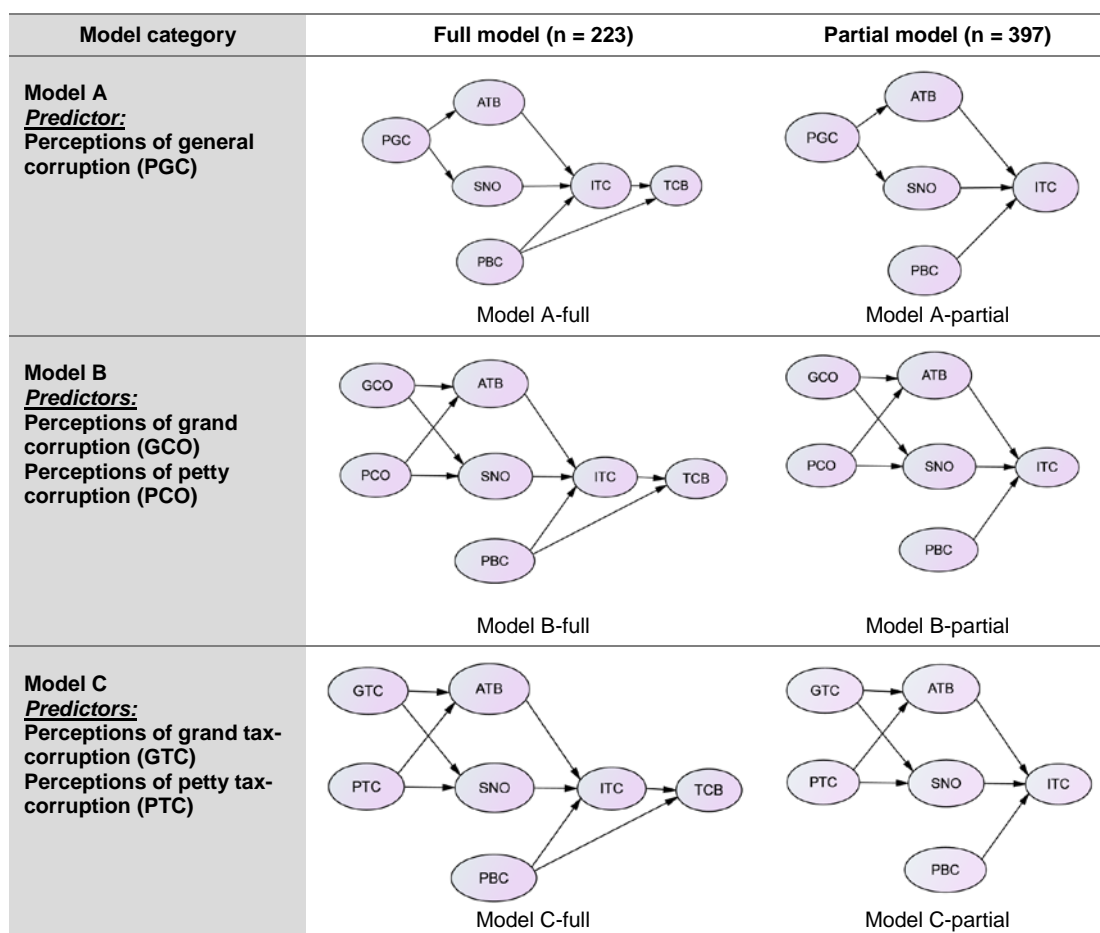
received additional income. Further, roughly four per cent of employed PITs (seven respondents) have reported that they did not earn income in 2014.

In terms of the amount of income being under-reported in the annual tax returns, the data indicated that 44 per cent of self-employed PITs had underreported between 50 per cent and 100 per cent of their actual income. Surprisingly, no respondent from employed PITs who received additional income other than from employment reported their additional income in the annual tax return—all of them (34 employed PITs) answered zero per cent.

4.2.7 Modeling the channels of causality

A hypothesised causal structure in SEM can be demonstrated in two ways: as a system of equations or as a diagram (Blunch, 2013). In this study, due to its greater communicative power, the diagrammatic approach is used throughout the paper.

Figure 5: Classification of recursive structural models under study



Note: ATB = attitudes towards tax underreporting; SNO = subjective norms towards tax underreporting; PBC = perceived behavioural control over tax underreporting; ITC = intention to report actual income; TCB = level of reported income

In modelling the channel of causality, the results previously presented in Section 4.2.6 have implications for further confirmatory analysis.³⁶ As in the conceptual model there is a 'level of reported income (TCB)' variable (see Figure 1), self-employed PITs who did not earn income (seven respondents) and employed PITs who did not receive additional income other than from employment (167 respondents) could not be included in the full model analysis.³⁷ As a result, while the whole sample (397 respondents) are used in the analysis of partial models, only 223 respondents can be used in the analysis of full models. For this reason, this study employs six recursive models for structural analysis. As illustrated in Figure 5, there are three categories of model: (i) model A uses perceptions of general corruption (PGC) as predictor variable, (ii) model B uses two types of perceptions of non-tax corruption (GCO and PCO) as predictor variables and (iii) model C adopts two types of perception of tax-corruption (GTC and PTC). Further, to make it easier to distinguish, the model category is added in the name of the model—for instance, the term 'Model A-full' means that the model employs perception of general corruption (PGC) as a predictor (exogenous) variable and tax compliance behaviour (TCB) as a dependent (endogenous) variable.

4.2.8 *Measurement and structural models assessment*

SEM analysis requires two model assessments: measurement and structural model tests (Hair et al., 2010). Measurement model tests aim to evaluate the construct validity of latent variables under study to examine whether an indicator adequately represents the observed latent variable and captures what it intends to measure. This examination was achieved by performing tests for convergent and discriminant validity. Convergent validity test is performed by evaluating the standardised construct loadings of indicators. The rule of thumb indicates that indicators with standardised factor loadings greater than 0.5 are acceptable.

The results of factor loadings test suggest that two out of 56 indicators have a factor loading value less than 0.5 ($G2 = 0.41$ and $H2 = 0.32$, both for full models). Consequently, these indicators are excluded in the structural analysis (see Appendix). Further, discriminant validity requires a high correlation between an indicator and its construct but low correlation with all other latent constructs. This assessment can be performed by examining correlation coefficients and the square root of Average Variance Extracted (AVE). The rule of thumb suggests that a construct which has a value of square root of AVE higher than its correlation coefficients among other constructs has good discriminant validity (for example, Bagozzi & Yi, 1988). The data suggest that the correlation coefficients among constructs were lower than the AVE values and as a result it was concluded that all of constructs under study have acceptable discriminant validity.

The second test, structural model assessment, aims to simultaneously analyse the relationships among constructs. Initially, the model estimation process is performed to measure the original model goodness-of-fit values. This paper adopts six measures: (1) Chi-square (χ^2); (ii) p-value, (iii) χ^2/df ; (iv) TLI, (v) CFI and (vi) RMSEA. In the

³⁶ Note that SEM is a 'confirmatory' tool rather than an 'exploratory' tool (Gefen et al., 2000; Kline & Rex, 2005). SEM is an a priori technique to simultaneously determine whether a pattern of linear relationships among a set of latent variables and manifest variables is valid, rather than to 'discover' an appropriate model (Shah & Goldstein, 2006).

³⁷ In this paper, the term 'full model' refers to the inclusion of 'level of reported income (TCB)' variable, while the term 'partial model' means the exclusion of the TCB variable (as illustrated in Figure 5).

initial model, the results of two measures, Chi-square and p-value, indicate that the six models do not fit well with the data. Accordingly, to obtain better structural models, model re-specifications are needed. The modifications were then made by adding five covariance of error terms in the initial model A-full (that is, e12 and e14, e63 and e69, e64 and e67, e91 and e94, e92 and e93) and two covariance of error terms in the initial models of B-full, C-full, A-partial, B-partial and C-partial (that is, e91 and e94, e92 and e93). The results suggest that the six models under consideration fit the data and, as a result, are ready for further hypotheses tests (see Appendix for a detailed description).

4.2.9 Hypotheses testing

To address the research problem, eight hypotheses previously described in Table 1 were examined at an α level of 0.05. The findings are as follows:

H1: the positive influence of perceptions of corruption on attitudes towards tax underreporting

It was found that a statistically significant positive relationship between perceptions of corruption and attitudes towards tax underreporting was evident in six out of ten observations. While there was no evidence of a statistically significant relationship between perceptions of petty corruption and attitude towards tax underreporting in both the full and partial structural models, it was found that perceptions of general corruption and petty tax-corruption were not related to attitudes towards tax underreporting only in the full models. Perceptions of grand corruption were the most influential variable in affecting respondents' attitudes towards tax underreporting in both the full and partial models, with the standardised coefficient values of 0.317 and 0.363 respectively. Based on this result, the null hypothesis H_{01} can be rejected.

H2: the positive influence of perceptions of corruption on subjective norms towards tax underreporting

It was found that a statistically significant positive relationship between perceptions of corruption and subjective norms towards tax underreporting was only evident in three out of ten observations. While there was no evidence of statistically significant relationship between perceptions of general corruption, grand corruption and petty tax-corruption, and subjective norms towards tax underreporting in both the full and partial structural models, it was found that perceptions of grand tax-corruption were not related to views on tax underreporting only in full models. Perceptions of petty corruption were the most influential variable in affecting respondents' views on tax underreporting in both full and partial models, with the coefficient values of 0.331 and 0.326 respectively. Based on this result, the null hypothesis H_{02} can be rejected.

H3: the negative influence of attitudes towards tax underreporting on intention to report actual income

A statistically significant negative relationship was found between respondents' attitudes towards underreporting income and their intention to report actual income in both full and partial models. Attitudes towards underreporting income were influential in undermining respondents' intention to report actual income in all models, with the coefficient values ranging from -0.400 to -0.451. Based on this result, the null hypothesis H_{03} was rejected.

H4: the negative influence of subjective norms towards tax underreporting on intention to report actual income

A statistically significant negative relationship was found between respondents' subjective norms on tax underreporting and their intention to report actual income in both full and partial models. Subjective norms towards underreporting income were influential in undermining respondents' intention to report actual income in all models, with the coefficient values ranging from -0.122 to -0.172. The statistical significance of the relationships in full models were evaluated at an α level of 0.10, while the statistical significance of the relationships in partial models were evaluated at an α level of 0.05. Based on this result, the null hypothesis H_04 was rejected.

H5: the negative influence of perceived behavioural control over tax underreporting on intention to report actual income

A statistically significant negative relationship was found between respondents' perceived behavioural control over tax underreporting and their intention to report actual income in both full and partial models. Attitudes toward underreporting income were influential in undermining respondents' intention to report actual income in all models, with the coefficient values ranging from -0.165 to -0.244. Based on this analysis, the null hypothesis H_05 was rejected.

H6: the positive influence of intention to report actual income on the level of reported income

This study hypothesised that intention to report actual income was the predictor of the level of respondents' reported income. As this involves the level of reported income as one of the variables under consideration, as previously discussed in Section 4.2.7, this analysis is only applicable in full models. Accordingly, this analysis was performed only on self-employed PITs who received income ($n = 189$) and employed PITs who received income other than their employment ($n = 34$). A statistically significant positive relationship was found between intention to report actual income and the levels of respondents' reported income. Intention to report actual income was influential in influencing respondents' reported income, with the score of 0.56. The statistical significance of these relationships were evaluated at an α level of 0.05. Based on this analysis, the null hypothesis H_06 was rejected.

H7: the negative influence of perceived behavioural control over tax underreporting on the level of reported income

The study hypothesised that perceived behavioural control over tax underreporting influence the level of respondents' reported income. As discussed earlier, this analysis is only applicable in full models. Based on the results, no evidence was found to support the rejection of the null hypothesis H_07 .

H8: the negative effect of perceptions of corruption on intentional (non)compliance behaviour

The study hypothesised that ultimately perceptions of corruption have a negative effect on intentional (non)compliance behaviour. This hypothesis was tested in two stages. First, to examine whether or not these perceptions have an effect on taxpayers' intention to correctly report actual income, the total effects of perceptions different forms of corruption upon intention to correctly report actual income was examined. Second, it then followed by examining the total effects of perceptions of different

forms of corruption on the level of reported income. Accordingly, the second test was performed on full models only.

It was found that while all types of perceptions of corruption had negative effects on intention to correctly report actual income in the partial models, perceptions of petty corruption and perceptions of petty tax-corruption had insignificant effects in the full models. In terms of levels of reported income, it was found that three out of five types of perceptions of corruption seemed to have significant negative effects on the level of reported income: general corruption, grand corruption and grand tax-corruption. Perceptions of grand corruption was the most influential with -0.073, followed by perceptions of grand tax-corruption with -0.071 and perceptions of general corruption at the least with -0.034. Based on these findings, the null hypothesis H_08 can be rejected.

4.2.10 Summary of findings

The previous hypotheses tests have studied causal relationships between five perceptions of corruption variables and five TPB-based variables under consideration. For easier comprehension, a summary of the tests for H1-H7 is presented in Table 5, while the test for H8 is described in Table 6.

Table 5: Summary of statistically significant relationships of path analysis between perceptions of corruption and (non)compliance behaviour arising from hypotheses H1-H7

Hypothesis & direct relationship		Number of models being analysed	Number of models with statistically significant results	The lowest score of effect	The highest score of effect	The nature of causal relationship	Final decision	Ranks based on the highest score of effect
H1a	PGC → ATB	2	1 ^a	0.289	0.289	Positive	Partly influential	6
H1b	GCO → ATB	2	2	0.317	0.363	Positive	Influential	3
H1c	PCO → ATB	2	-	n.a.	n.a.	n.a.	Not influential	n.a.
H1d	GTC → ATB	2	2	0.225	0.290	Positive	Influential	5
H1e	PTC → ATB	2	1 ^a	0.205	0.205	Positive	Partly influential	8
H2a	PGC → SNO	2	-	n.a.	n.a.	n.a.	Not influential	n.a.
H2b	GCO → SNO	2	-	n.a.	n.a.	n.a.	Not influential	n.a.
H2c	PCO → SNO	2	2	0.326	0.331	Positive	Influential	4
H2d	GTC → SNO	2	1 ^a	0.113	0.113	Positive	Partly influential	10
H2e	PTC → SNO	2	-	n.a.	n.a.	n.a.	Not influential	n.a.
H3	ATB → ITC	2	2	-0.400	-0.451	Negative	Influential	2
H4	SNO → ITC	2	2	-0.122	-0.175	Negative	Influential	9
H5	PBC → ITC	2	2	-0.165	-0.244	Negative	Influential	7
H6	ITC → TCB	1 ^b	1 ^b	0.558	0.559	Positive	Influential	1
H7	PBC → TCB	1 ^b	-	n.a.	n.a.	n.a.	Not influential	n.a.

Note: → = direct path/effect; PGC = perceptions of general corruption; GCO = perceptions of grand corruption; PCO = perceptions of petty corruption; GTC = perceptions of grand tax-corruption; PTC = perceptions of petty tax-corruption; ATB = attitude towards tax underreporting; SNO = subjective norm towards tax underreporting; PBC = perceived behavioural control over tax underreporting; ITC = intention to report actual income; TCB = level of reported income; a = partial model; b = full model; n.a. = not applicable

From Table 5 it is apparent that a number of statistically significant causal relationships were found. In general, perceptions of corruption were more influential to attitudes towards tax underreporting (ATB) than subjective norms towards tax underreporting (SNO). In this regard, two influential relationships and two partly influential relationships were found in H1 (that is, GCO→ATB, GTC→ATB,

PGC→ATB, PTC→ATB respectively), while only one influential relationship and one partly influential relationship were found in H2 (that is, PCO→SNO and GTC→SNO). Attitudes, subjective norms and perceived behavioural control towards tax underreporting were found to be negatively influential upon respondents' intention to report actual income, which in turn were related to the level of reported income (TCB). The effect of perceived behavioural control over tax underreporting (PBC) seemed to be fully mediated by intention to report actual income (ITC) as there was no statistically significant relationship was found between PBC and TCB. In terms of score of (direct) effect, it was found that the effect of ITC upon TCB was strongest with path coefficient greater than 0.55. In the second place was the effect of ATB upon ITC, with scores ranging from -0.400 to -0.455. The effect of perceptions of grand corruption upon ATB was in the third place with values ranging from 0.317 to 0.363. Lastly, a path between grand tax-corruption (GTC) and SNO was found to have the weakest effect of 0.113.

Table 6: Summary of statistically significant total effects of perceptions of corruption on intentional (non)compliance behaviour arising from hypothesis H8

Hypothesis & indirect relationship		Number of models being analysed	Number of models with statistically significant results	The lowest score of effect	The highest score of effect	The nature of causal relationship	Final decision	Ranks based on the highest score of effect
H8a	PGC →→ ITC	2	2	-0.061	-0.142	Negative	Influential	2
H8b	GCO →→ ITC	2	2	-0.131	-0.167	Negative	Influential	1
H8c	PCO →→ ITC	2	1 ^a	-0.061	-0.061	Negative	Partly influential	5
H8d	GTC →→ ITC	2	2	-0.121	-0.127	Negative	Influential	3
H8e	PTC →→ ITC	2	1 ^a	-0.107	-0.107	Negative	Partly influential	4
H8a	PGC →→ TCB	1 ^b	1 ^b	-0.034	-0.034	Negative	Influential	3
H8b	GCO →→ TCB	1 ^b	1 ^b	-0.073	-0.073	Negative	Influential	1
H8c	PCO →→ TCB	1 ^b	-	n.a.	n.a.	n.a.	Not influential	n.a.
H8d	GTC →→ TCB	1 ^b	1 ^b	-0.071	-0.071	Negative	Influential	2
H8e	PTC →→ TCB	1 ^b	-	n.a.	n.a.	n.a.	Not influential	n.a.

Note: →→ = indirect path/effect; PGC = perceptions of general corruption; GCO = perceptions of grand corruption; PCO = perceptions of petty corruption; GTC = perceptions of grand tax-corruption; PTC = perceptions of petty tax-corruption; ITC = intention to report actual income; TCB = level of reported income; a = partial model; b = full model; n.a. = not applicable

From Table 6 it is apparent that, through indirect paths,³⁸ perceptions of corruption were generally influential in causing respondents to intentionally underreport their income. In terms of intention, the findings suggest that perceptions of grand corruption were the strongest in undermining respondents' intention to report actual income, with scores ranging from -0.131 to -0.167.³⁹ It was then followed by perceptions of general corruption (with scores between -0.061 and -0.143) and grand tax-corruption (with scores between -0.121 and -0.1127) respectively. Both perceptions of petty corruption and petty tax-corruption were found to be partly influential in undermining respondents' intention to report actual income. Further, the impact of perceptions of corruption upon actual compliance behaviour can only be demonstrated in the full models.

³⁸ That is the relationship between the two corresponding constructs was not directly connected, as previously shown in Figure 5.

³⁹ As indicated by the negative value of the total effect.

The findings suggest that three out five of the types of perceptions of corruption were influential in undermining the respondents' level of reported income. It was found that when perceived levels of grand corruption, grand tax-corruption and general corruption increase by one standard deviation, intentional tax underreporting behaviour increases by 0.073, 0.071 and 0.034 standard deviations respectively.

5. CONCLUSION

This paper has examined the relationship between perceptions of different forms of corruption and the way Indonesian personal income taxpayers behave, in the context of reporting income in their 2014 annual tax returns. Confirming the qualitative findings with the quantitative findings is one of the important aspects of the adoption of the mixed-methods approach in this study. That is, in areas where convergence emerges, conclusions can be reached with greater confidence. In this regard, there are a number of confirmations where the findings of the quantitative phase support the qualitative findings, including the significance and the nature of relationships between perceptions of corruption and compliance behaviour.

The paper has demonstrated that, in general, high levels of perceived corruption influence Indonesian PITs to intentionally underreport their income tax. While the extent of perceived levels of different forms of corruption is confirmed by both the qualitative and quantitative approaches, the mechanism by which perceptions of corruption impact upon intentional tax underreporting behaviour are indicated by the empirical results of the quantitative approach. This is demonstrated by way of four important findings.

First, as indicated in the full models, the findings suggest that intention to report actual income is a good predictor of tax reporting behavior, with path coefficients greater than 0.55.

Second, taxpayers' attitudes towards tax underreporting and their subjective norms towards tax underreporting, coupled with the perceived behavioural control over tax underreporting, appeared to undermine taxpayers' intention to report actual income. This pattern of results was found in both full and partial models. Attitudes towards tax underreporting seem to have the strongest direct effect upon taxpayers' intention to report actual income (with path coefficients ranging between -0.400 to -0.445), followed by perceived behavioural control over tax underreporting in the second place with path coefficients ranging from -0.165 to -0.244.

Third, perceptions of corruption appeared to have stronger influences on taxpayers' attitudes towards tax underreporting than their subjective norms towards tax underreporting. In this regards, perceptions of grand corruption and grand tax-corruption were found to be influential in affecting taxpayers' attitudes towards tax underreporting (with path coefficients ranging from 0.317 to 0.363, and 0.225 to 0.290 respectively), while perceptions of petty corruption have a tendency to affect taxpayers' subjective norms towards tax underreporting (with path coefficients ranging from 0.326 to 0.331).

Finally, it was demonstrated that perceptions of corruption have an impact upon taxpayers to intentionally underreport their income tax. Perceptions of grand corruption, grand tax-corruption and general corruption appeared to be influential on

intentional underreporting behaviour with standardised total negative effects of 0.073, 0.071 and 0.034 respectively.

It is acknowledged that, as in all research, this study has inherent limitations. First, in generating empirical results, the main part of this study used a self-report survey. While to some extent self-reported data has been considered to be the only method capable of providing detailed information on taxpayer attitudes, motivation and beliefs, the accuracy of self-reports of past behaviour can be difficult to ascertain. That is, as a typical method, self-reporting in social research could potentially create its own problems attributable to the potential disparity of what people declare of their reported beliefs or they would do and what their actual beliefs or their actual actions are. Second, in the quantitative strand, this study treats perception data as a ratio variable while it is in fact an ordinal variable. Third, the study excludes taxpayer reporting behaviour at an unintentional level. Fourth, the study was limited to personal income taxpayers in Indonesia, a country where perceived levels of corruption are very high. Thus, the relevance of the findings to other types of taxpayers, or other jurisdictions, is unknown.

Overall, the present findings support the notions that perceptions of corruption are important determinants and have a negative impact upon tax compliance behaviour. The findings suggest that governments, particularly those in developing economies where perceived corruption is evident, should consider their citizens' concerns about perceived levels of corruption as one of the most important potential causes of intentional non-compliance behaviour.

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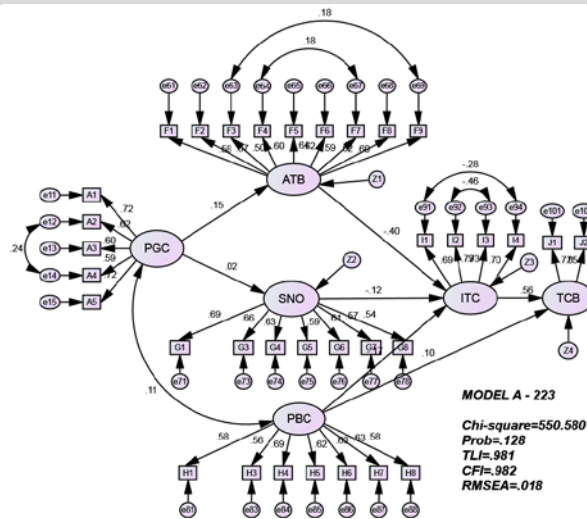
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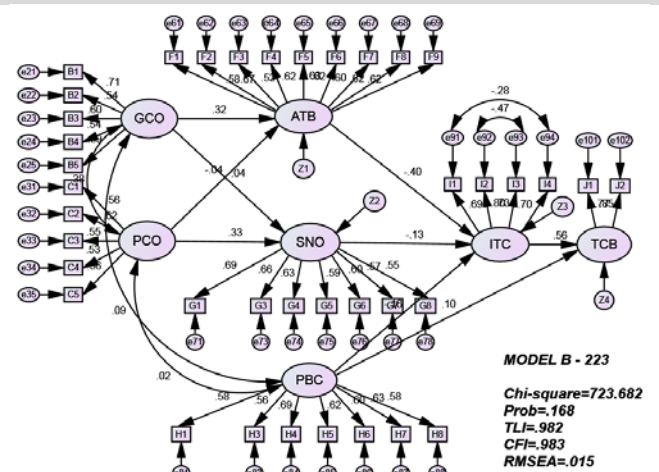
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APPENDIX

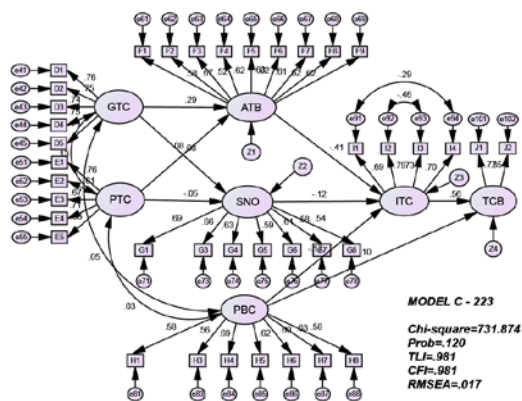
1. Model A-full (modified)



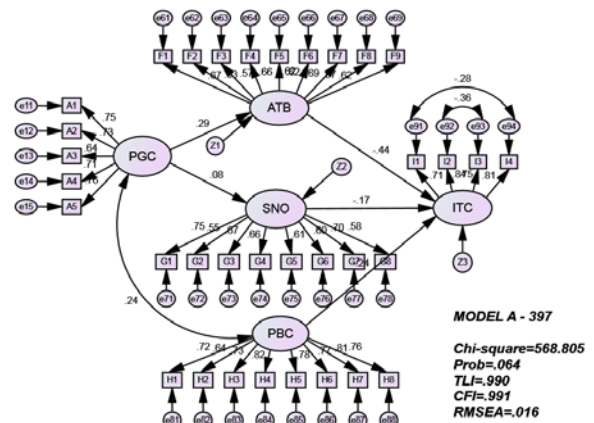
2. Model B-full (modified)



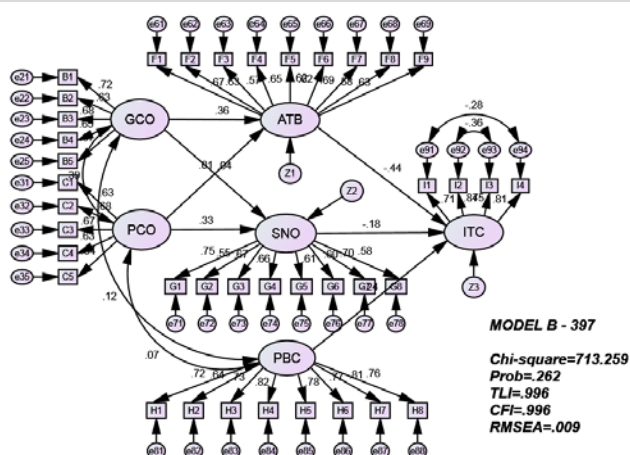
3. Model C-full (modified)



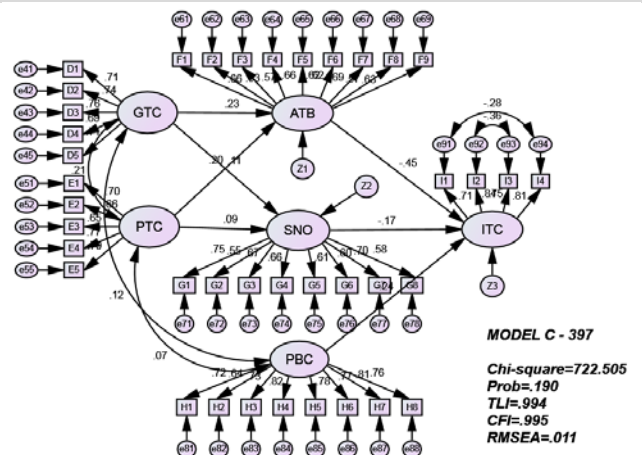
4. Model A-partial (modified)



5. Model B-partial (modified)



6. Model C (modified)



The applicability of the OTS Complexity Index to comparative analysis between countries: Australia, New Zealand, Turkey, and the UK

Tamer Budak¹ and Simon James²

Abstract

Tax systems world-wide are becoming more complex for a variety of reasons. Countries such as Australia, New Zealand (NZ) and the UK have attempted to simplify their taxes but with limited success. The Complexity Index produced by the Office of Tax Simplification (OTS) in the UK is an important contribution in this field. This paper considers general issues in relation to complexity and simplification and then examines the usefulness of the OTS Complexity Index for making international comparisons by applying it to income tax and VAT or GST in Australia, NZ, Turkey and the UK. It finds some striking differences in the complexity of the taxes in these countries. For example, Turkey's score is much better in terms of total underlying complexity, whereas NZ's score is better in terms of total impact complexity for taxes. This paper provides evidence that identifies certain areas where the level of complexity might be unnecessarily high. It also finds that the OTS Complexity Index is not appropriate for international comparative analysis although it can be utilised to gather common data in different countries. This paper suggests that by creating an international index based on the OTS method would make a major contribution to the development of a new approach in tax simplification.

Keywords: Office of Tax Simplification, complexity index, income tax, VAT, GST

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1. INTRODUCTION

Comparative analysis of different countries has evolved in recent decades and plays a vital role since it may increase understanding of which systems or applications are better than others according to particular criteria. It is becoming an important area especially in international studies. In recent years, some international research centres and institutions have produced reports in specific fields and some of them are related to taxation and tax systems. Furthermore, the amount of tax reform has increased. One of the aims of tax reform is to make tax systems more user-friendly but this in general, and tax simplification in particular, are complex issues. Simplification is a very desirable feature of a tax system but it is only one of many important considerations involved in the design of tax systems. Some countries such as Australia, NZ and the UK have made serious attempts to simplify their tax systems and simplification initiatives have been made in many other countries as well. However, it would be very helpful to have a new method or tool to enhance comparative analysis of tax systems which takes into account the circumstances and institutions of each country.

Comparing tax systems based on simplification or complexity has, of course, difficulties and limitations. There are few comparative studies of tax system complexity in two or more countries. Countries have different features of language, culture and types of system and so comparisons are difficult. Nevertheless, it might be possible to establish common features and objective assessments even across countries with different characteristics. Perhaps the most important aspect is to establish how to measure tax complexity. This paper begins in section 2 with a comparative analysis of initiatives in different areas followed by an examination of the definition of tax complexity or simplification in section 3. Section 4 examines some of the main initiatives concerned with measuring complexity. Section 5 tests the Office of Tax Simplification (OTS) Complexity Index for comparative analysis and Section 6 presents the findings of the application of this index to income tax and value added tax (VAT)/Goods and Services Tax (GST) in Australia, NZ, Turkey and the UK. Finally, Section 7 offers some conclusions and proposals.

2. COMPARATIVE ANALYSIS IN DIFFERENT AREAS

There have been comparative analyses in different fields around the world. They relate to social life, education, political systems, law, air pollution, tax systems and so on. The majority of methods and data used in these studies are objective and some of these comparative analyses are:

1. Family policies in OECD countries: A comparative analysis³
2. Education systems in ASEAN+6 countries: A comparative analysis of selected educational issues⁴

³ Olivier Thévenon, 'Family Policies in OECD Countries: A Comparative Analysis' (2011) 37(1) *Population and Development Review* 57–87.

⁴ UNESCO Bangkok Office, 'Education Systems in ASEAN+6 Countries: A Comparative Analysis of Selected Educational Issues' (Discussion Document No.5, UNESCO Education Policy Research 2014) 1-75 <<http://unesdoc.unesco.org/images/0022/002267/226757E.pdf>>.

3. Trans-pacific partnership countries: Comparative trade and economic analysis⁵
4. Comparative analysis of firm demographics and survival: Micro-level evidence for the OECD countries⁶
5. Financing democracy: funding of political parties and election campaigns and the risk of policy capture⁷
6. Languages in education and training: final country comparative analysis⁸
7. A comparative analysis of health policy performance in 43 European countries⁹
8. Why are saving rates so different across countries? An international comparative analysis¹⁰
9. A comparative analysis of the structure of tax systems in industrial countries¹¹
10. Paying taxes 2016: The global picture¹²
11. Are stock prices related to the political uncertainty index in OECD countries? Evidence from the bootstrap panel causality test.¹³

The number of the such studies will undoubtedly rise considerably in the future given the opportunities they offer to compare topics in different countries. Nevertheless they have to be comprehensive and thorough. For example, regarding taxation it is important to consider governments' fiscal and non-fiscal aims and other relevant considerations related to the development of a tax system and its administration. One of the main issues that is constantly discussed is the complexity of tax systems.

⁵ Brock R Williams, 'Trans-Pacific Partnership (TPP) Countries: Comparative Trade and Economic Analysis' (Report No 7-5700, Congressional Research Service 2013) <<https://www.fas.org/sgp/crs/row/R42344.pdf>>.

⁶ Eric Bartelsman, Stefano Scarpetta and Fabiano Schivardi, 'Comparative Analysis of Firm Demographics and Survival: Micro-Level Evidence for the OECD Countries' (Working Paper No 348, OECD 2003) <http://www.oecd-ilibrary.org/economics/comparative-analysis-of-firm-demographics-and-survival_010021066480>.

⁷ OECD, *Financing Democracy: Funding of Political Parties and Election Campaigns and the Risk of Policy Capture* (Paris: OECD Publishing, 2016).

⁸ Shane Beadle and David Scott, 'Languages in Education and Training: Final Country Comparative Analysis' (Report No. J9241, European Commission 2014) <http://ec.europa.eu/languages/library/studies/lang-eat_en.pdf>.

⁹ Johan P Mackenbach and Martin McKee, 'A Comparative Analysis of Health Policy Performance in 43 European Countries' (2013) 23(2) *European Journal of Public Health* 195–201.

¹⁰ Sebastian Edwards, 'Why are Saving Rates so Different Across Countries?: An International Comparative Analysis' (1996) 51(1) *Journal of Development Economics* 5–44.

¹¹ Enrique G Mendoza, Assaf Razin and Linda L Tesar, 'A Comparative Analysis of the Structure of Tax Systems in Industrial Countries' (Working Paper No WP/39/14, International Monetary Fund 1993).

¹² PricewaterhouseCoopers International Limited, *Paying Taxes 2016* (2016) <<http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Special-Reports/Paying-Taxes-2016.pdf>>.

¹³ Tsangyao Chang, Wen-Yi Chen, Rangan Gupta and Duc Khuong Nguyen, 'Are Stock Prices Related to the Political Uncertainty Index in OECD Countries? Evidence from the Bootstrap Panel Causality Test' (2015) 39(2) *Economic Systems* 288–300 <<http://www.sciencedirect.com/science/article/pii/S0939362515000229>>.

3. THE DEFINITION OF TAX COMPLEXITY OR SIMPLIFICATION

Although tax complexity is a much debated topic, defining or measuring what is meant by complexity is difficult and a serious barrier to tax simplification.¹⁴ To arrive at a definition of ‘complexity’ is not an easy task. Most scholars do not define tax complexity but they have listed and categorised some characteristics that contribute to complexity. For instance, Slemrod lists four main dimensions of tax complexity: enforceability, predictability, difficulty and manipulability. He also provides a description of tax complexity as the sum of compliance costs or the total resource cost and administrative costs incurred in complying with the system’s requirements. This description provides a link between costs of compliance and tax complexity.¹⁵ Manipulability and difficulty refer to taxpayers’ compliance with tax law enforceability and predictability relates to tax law.¹⁶ In another important study carried out by McCaffery, it is observed that a separation of three main types of tax complexity as between technical, structural and compliance complexity is required.¹⁷ Cooper suggests that tax complexity may include the dimensions of proportionality, predictability, compliance, consistency, administration, coordination and expression¹⁸ and his contribution may be considered as a more comprehensive version of Slemrod’s.¹⁹

There is much political debate regarding a tax system’s complexity and its simplification process may have many forms in a complex socio-economic environment.²⁰ It is often believed that tax simplification requires changing the wording of tax law so that it is not only user friendly but also understandable for everyone. This is not sufficient to have a successful tax system. In reality, simplification means that it would also be necessary to design plain and understandable laws, reduce distortions and harmonise taxes at national or federal and local level.²¹ Simplified taxes may reduce taxpayers’ burdens of complying with the tax system in terms of time and money. By reducing these costs, simplification can also reduce the whole burden of taxation on the taxpayer.²² At the same time, a simple tax system increases transparency and reduces the number of points of contact between businesses and tax authorities.²³ So there are many advantages associated

¹⁴ David Morris, *Tax Cheating: Illegal—But Is It Immoral?* (State University of New York Press, 2012) 73.

¹⁵ Joel Slemrod, ‘Complexity, Compliance Costs, and Tax Evasion’ in Jeffrey Roth and John Scholz (eds), *Taxpayer Compliance: Social Science Perspectives* (University of Pennsylvania Press, 1989) 156–81.

¹⁶ Chris Evans and Binh Tran-Nam, ‘Managing Tax System Complexity: Building Bridges Through Pre-Filled Tax Returns’ (2010) 25 *Australian Tax Forum* 247–76.

¹⁷ Edward J McCaffery, ‘The Holy Grail of Tax Simplification’ (1990) 5 *Wisconsin Law Review* 1267–322.

¹⁸ Graeme S Cooper, ‘Themes and Issues in Tax Simplification’ (1993) 10 (4) *Australian Tax Forum* 417–60.

¹⁹ Evans and Tran-Nam, above n 16.

²⁰ Organisation for Economic Co-operation and Development, *Fundamental Reform of Personal Income Tax* (May 2006) <http://www.oecd-ilibrary.org/taxation/fundamental-reform-of-personal-income-tax_9789264025783-en>.

²¹ Victor Thuronyi, ‘Drafting Tax Legislation’ in Victor Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1996) 71–94.

²² William Gale, ‘Tax Simplification: Issues and Options’ (2001) 92(11) *Tax Notes* 1463–481.

²³ Sebastian S James, *A Handbook for Tax Simplification* (November 2009) <http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2011/01/06/000334955_20110106032224/Rendered/PDF/588150WP0FIAS110BOX353820B01PUBLIC1.pdf>.

with a simple tax system and they may be summarised as lower compliance costs, lower administrative costs, fewer economic distortions, fewer errors and, as a result, more transparency and accountability.²⁴ Of course, tax simplification must still take account of other policy objectives.²⁵ A degree of complexity may be required to achieve fairness between taxpayers and other government objectives and there are often trade-offs between these various aspects.²⁶ However, it should be possible to distinguish between ‘necessary’ complexity where simplification is difficult to achieve and ‘unnecessary’ complexity where it should be relatively straightforward.²⁷

As discussed above, Cooper’s analysis shows there are at least seven issues that should be considered, that the idea of simplification is very complex and that any tax simplification project would have to clearly state what its aims are and to be carried out with considerable care.²⁸ In order to create a new approach to tax simplification, the OTS has considered a range of options, such as Adam Smith’s four criteria (equity, certainty, efficiency and simplicity) and Cooper’s seven dimensions of tax system simplification.²⁹

It has to be emphasised that the main cost of tax complexity relates to compliance costs. The two major types of costs associated with raising tax revenue are collection and efficiency costs. Collection costs cover administration costs³⁰ and the compliance costs incurred by taxpayers in meeting their obligations under tax system.³¹ Compliance costs can also be further categorised into mandatory costs that taxpayers face to meet their legal liabilities and voluntary costs, which refer to extra burdens taxpayers may incur to determine or minimise their tax liability.³² Tax complexity in general contributes to the rise in higher administrative and compliance costs.³³

²⁴ Mark Nicholson, *Keep it Simple: Proposals to Reduce the Complexity of the UK Tax System* (30 January 2006) The Bow Group
<<http://www.bowgroup.org/sites/bowgroup.uat.pleasetest.co.uk/files/Keep%2520It%2520Simple.pdf>>

²⁵ Simon James and Alison Edwards, ‘Developing Tax Policy in a Complex and Changing World’ (2008) *Economic Analysis and Policy* 35–53.

²⁶ Simon James, Adrian Sawyer and Tamer Budak (eds) *The Complexity of Tax Simplification: Experiences from Around the World* (Palgrave Macmillan, 2016).

²⁷ Tamer Budak, Simon James and Adrian Sawyer, ‘International Experiences of Tax Simplification and Distinguishing Between Necessary and Unnecessary Complexity’ (forthcoming) *eJournal of Tax Research*.

²⁸ Simon James and Ian Wallschutzky, ‘Tax Law Improvement in Australia and the UK: The Need for a Strategy for Simplification’ (1997) 18(4) *Fiscal Studies* 445–60.

²⁹ Gareth Jones, Phillip Rice, Jeremy Sherwood and John Whiting, *Developing a Tax Complexity Index for the UK* (14 September 2014) Office of Tax Simplification
<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/285944/OTS_Developing_a_Tax_Complexity_Index_for_the_UK.pdf>.

³⁰ Vjekoslav Bratić and Mihaela Bronić, ‘The Administrative Costs of Taxation and Customs Clearing in Croatia 1999-2001’ (Occasional Paper No 24, Institute of Public Finance, 30 November 2004)
<<http://www.ijf.hr/OPS/24.pdf>>.

³¹ Tracy Oliver and Scott Bartley, ‘Tax System Complexity and Compliance Costs—Some Theoretical Considerations’ (2005) 3 *Economic Round-up*, 53–68
<<http://search.informit.com.au/documentSummary;dn=371069343630084;res=IELBUS>>.

³² Arindam Das-Gupta, ‘Economic Theory of Tax Compliance with Special Reference to Tax Compliance Costs’ (Working Paper No 13, National Institute of Public Finance and Policy, March 2004) <http://www.nipfp.org.in/working_paper/wp04_nipfp_013.pdf>.

³³ Jonathan Shaw, Joel Slemrod and John Whiting, ‘Administration and Compliance’ in Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson,

Furthermore, there are also some hidden costs, which relate to time, money, foregone economic growth, gaps in revenue collection, and lobbying expenditures. For instance, in the USA, estimates of such hidden costs have ranged from \$215 billion to \$987 billion in addition to a \$452 billion revenue gap in unreported taxes³⁴

According to research conducted by the World Bank, it has been estimated that businesses globally on average spend over a month each year complying with tax regulations. This includes 9 days for corporate taxes, 12 days for labour taxes and contributions and 13 days for consumption taxes.³⁵ That research also concluded that in relation to economic growth, it is more strongly related to decreasing the administrative burden on business than with reducing tax.³⁶ The overall research on tax compliance indicates that tax compliance costs may represent economic waste but also that when tax compliance costs are high, they disproportionately affect small businesses and lower-income individual taxpayers³⁷ and their compliance costs.³⁸

4. INITIATIVES FOR MEASURING COMPLEXITY

Measuring tax complexity involves a range of difficulties³⁹ but, although it is not easy, it is possible. The lack of a definition of complexity and a measuring tool makes it very difficult to determine any progress towards simplification precisely. Detecting tax complexity provides a quantitative measurement by which different tax systems can be compared, and by which the administrative view of a specific tax system can be interpreted relative to its impact on efficiency, equity, and revenue.⁴⁰

Modern tax systems are becoming very complex. Nevertheless, there are some institutional initiatives such as the Progressive Policy Institute's State Tax Complexity Index,⁴¹ the World Bank/IFC's Doing Business project,⁴² the OTS

Gareth Myles, and James Poterba (eds), *Dimensions of Tax Design The Mirrlees Review* (Oxford University Press, 2010) 1100–162.

³⁴ Jason J Fichtner and Jacob M Feldman, *The Hidden Costs of Tax Compliance* (20 May 2013) Mercatus Research Center <http://mercatus.org/sites/default/files/Fichtner_TaxCompliance_v3.pdf>.

³⁵ PricewaterhouseCoopers International Limited, *Paying Taxes 2014* (2014) <<http://www.pwc.com/gx/en/paying-taxes/assets/pwc-paying-taxes-2014.pdf>>.

³⁶ Jason Piper, 'Simplicity in the Tax System' (Technical Report, Association of Chartered Certified Accountants 2013) <<http://www.accaglobal.com/content/dam/acca/global/PDF-technical/tax-publications/tech-tp-sitts.pdf>>.

³⁷ Scott Moody, Wendy Warcholik and Scott Hodge, 'The Rising Cost of Complying with the Federal Income Tax' (Special Report No 138, Tax Foundation 2005) <<http://taxfoundation.org/sites/default/files/docs/sr138.pdf>>.

³⁸ Chris Evans, Phil Lignier and Binh Tran-Nam, 'Tax Compliance Costs for the Small and Medium Enterprise Business Sector: Recent Evidence From Australia' (Discussion Paper No 003-13, Tax Administration Research Centre 2013) <https://tarc.exeter.ac.uk/media/universityofexeter/businessschool/documents/centres/tarc/publications/discussionpapers/13_09_24_Evans_Tax_compliance_costs_in_SMEs_Exeter.pdf>.

³⁹ Joel Slemrod, 'Which is the Simplest Tax System of Them All?' in Henry J Aaron and William G Gale (eds), *Economic Effects of Fundamental Tax Reform* (Brookings Institution Press: 1996) 335–91.

⁴⁰ Simon James, 'Simplicity? It's a Complicated Business' (online), *Tax Adviser* (11 July 2008) <http://old.tax.org.uk/attach.pl/7004/8276/TA_July_2008_p26-p27.pdf>.

⁴¹ Paul Weinstein, 'The State Tax Complexity Index: A New Tool for Tax Reform and Simplification' (online), (4 April 2014) *Policy Memo* <http://www.progressivepolicy.org/wp-content/uploads/2014/04/2014.04-Weinstein_The-State-Tax-Complexity-Index_A-New-Tool-For-Tax-Reform-and-Simplification1.pdf>.

complexity index,⁴³ and contributions such as Tran-Nam and Evans' combination of the axiomatic and statistical approaches⁴⁴, and Borrego, Loo, Lopes and Ferreira's General Tax Complexity Index⁴⁵ related to the measurement of complexity in specific countries and around the world. These valuable studies have made important progress in improving methods of calculating complexity in order to make comparative analyses but much remains to be done.

4.1 The Progressive Policy Institute (PPI)

In 2010, the US President's Economic Recovery Advisory Board Report noted that the level of tax system complexity is very high. This complexity generates substantial costs for affected taxpayers and represents both time and money that taxpayers spend every year to prepare and file their taxes. It was estimated that taxpayers spend 7.6 billion hours and incur substantial expenses in meeting their federal income tax filing obligations. These costs are approximately equal to one percent of GDP yearly (or about \$140 billion in 2008). These taxpayers' costs are also estimated at more than 12 times the IRS budget.⁴⁶

The Progressive Policy Institute (PPI) reported a study ranking the tax systems of all 50 US states plus the District of Columbia (the State Tax Complexity Index). The index calculates tax complexity with regard to the number of tax expenditures in the tax code for each state revenue system. In other words, PPI has prepared an index of tax complexity based on the number of tax expenditures offered by each state. Several states do not provide complete reports on tax expenditure data. These non-transparent states received the highest ranking in the survey because producing a thorough list of tax expenditures is a key first stage in reducing complexity. Several relevant conclusions were drawn from the data summarised in Table 1 below:

1. All tax systems suffer from too much complexity
2. The type of tax structure does not define the level of complexity. Complex tax systems exist in states with progressive income taxes, states with a flat rate income tax, as well as states with no income tax. Tax complexity is everywhere in the US
3. Decreasing tax complexity through removing tax expenditures can finance lower tax rates and rise fairness because their benefits commonly go to higher income individuals and businesses.⁴⁷

⁴² PricewaterhouseCoopers International Limited, *Paying Taxes 2013* ((2013) <<http://www.pwc.com/gx/en/paying-taxes/assets/pwc-paying-taxes-2013-full-report.pdf>>.

⁴³ Jones et al., above n 29.

⁴⁴ Binh Tran-Nam and Chris Evans, 'Towards the Development of a Tax System Complexity Index' (2014) 35(3) *Fiscal Studies* 341–70.

⁴⁵ Ana Borrego, Ern Chen Loo, Cidália Lopes and Carlos Ferreira, 'Tax Professionals' Perception of Tax System Complexity: Some Preliminary Empirical Evidence From Portugal' (2015) 13(1) *eJournal of Tax Research* 338–60.

⁴⁶ President's Economic Recovery Advisory Board, '*The Report on Tax Reform Options: Simplification, Compliance and Corporate Taxation*' (27 August 2010) <https://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf>.

⁴⁷ Weinstein, above n 41.

Table 1: State Tax System Complexity Index: Complexity as measured by tax expenditures

State	Range of Tax Expenditures	Rank	State	Range of Tax Expenditures	Rank
Alabama	N/A	1	Rhode Island	200 to 250	24
Florida	N/A	1	Texas	200 to 250	24
Indiana	N/A	1	Colorado	150 to 200	29
Nevada	N/A	1	Connecticut	150 to 200	29
New Hampshire	N/A	1	Michigan	150 to 200	29
South Dakota	N/A	1	Missouri	150 to 200	29
Wyoming	N/A	1	North Dakota	150 to 200	29
Washington	550 to 600	8	South Carolina	150 to 200	29
Louisiana	450 to 500	9	Vermont	150 to 200	29
Oklahoma	450 to 500	9	Virginia	150 to 200	29
Arizona	400 to 450	11	California	100 to 150	37
New York	400 to 450	11	Hawaii	100 to 150	37
Georgia	350 to 400	13	Idaho	100 to 150	37
Oregon	350 to 400	13	Kansas	100 to 150	37
Wisconsin	350 to 400	13	Mississippi	100 to 150	37
Maryland	300 to 350	16	Montana	100 to 150	37
Minnesota	300 to 350	16	New Mexico	100 to 150	37
Nebraska	300 to 350	16	Ohio	100 to 150	37
North Carolina	300 to 350	16	Tennessee	100 to 150	37
Iowa	250 to 300	20	Utah	100 to 150	37
Kentucky	250 to 300	20	DC	100 to 150	37
Maine	250 to 300	20	Arkansas	50 to 100	48
New Jersey	250 to 300	20	Delaware	50 to 100	48
Illinois	200 to 250	24	West Virginia	50 to 100	48
Massachusetts	200 to 250	24	Alaska	0 to 50	51
Pennsylvania	200 to 250	24			

Key: White: State with No Income Tax.
 Blue: State with Progressive Income Tax.
 Yellow: State with Flat Income Tax.
 Brown: Income Tax on Interest/Dividends.

Source: Paul Weinstein, 'The State Tax Complexity Index: A New Tool for Tax Reform and Simplification' (online), (4 April 2014) *Policy Memo* <http://www.progressivepolicy.org/wp-content/uploads/2014/04/2014.04-Weinstein_The-State-Tax-Complexity-Index_A-New-Tool-For-Tax-Reform-and-Simplification1.pdf>

This index shows that there are no differences whether states depend on income or sales taxes, or whether they rely on a single rate or multiple rates. All of these systems can be affected by complicated tax breaks. For instance, Kansas, which has more marginal rates than the federal code, and California have very progressive income-tax systems but they were ranked among the least complex tax systems in terms of special tax preferences. Meanwhile, states with no individual income tax such as Alaska, Texas and Washington ranged all over the spectrum. Washington ranked near the top of the complexity scale, Rhode Island finished in the middle and Alaska was toward the bottom. In contrast, some states rely on a flat tax around the middle of the survey, with the exception of Utah, which tied for 37th position.⁴⁸

⁴⁸ Will Marshall and Paul Weinstein, 'Uncluttering State Tax Systems' on *Real Clear Policy* (15 April 2014) <http://www.realclearpolicy.com/blog/2014/04/15/uncluttering_state_tax_systems_910.html>.

On the basis of these findings there does not seem to be a significant link between the level of tax expenditures, the tax structure, and complexity. States which depend on flat or sales tax systems are just as likely to have high levels of complexity as those states that have progressive income tax systems.⁴⁹

4.2 PwC and the World Bank: Paying tax

A joint report by PwC and the World Bank Group set out to calculate the level of tax complexity worldwide. The PwC Paying Taxes index, developed on behalf of the World Bank/IFC's Doing Business project, aimed at estimating the ease of paying taxes in countries over certain periods of time. The ranking is based on taxes and compulsory contributions imposed by all levels of government which include federal, state/province or local, and especially on medium-sized companies in 189 countries around the world.⁵⁰ The PwC Paying Taxes ranking was calculated according to three main indicators: total tax rate, time taken to comply with tax laws (hours per year), and number of payments per year.

Taxes and contributions measured include: the profit or corporate income tax, social security contributions and labour taxes paid by the employer, property taxes, property transfer taxes, dividend tax, capital gains tax, financial transactions tax, waste collection taxes, vehicle and road taxes and any other small taxes or fees. These taxes are conventionally collected by the company from the taxpayers or employees on behalf of the tax authorities. Although there is no direct effect on the income statements of the company, they add to the administrative burden of complying with the tax system and are included in the tax payments measures. Time is recorded in hours per year. The indicator measures the time taken to prepare, file and pay three major types of taxes and contributions: the corporate income tax, value added or sales tax and labour taxes, which include payroll taxes and social contributions. Payment time considers the hours required to make the payment manually at the tax authorities or online where taxes and contributions are paid in person, the time includes delays while waiting.⁵¹ PwC's Paying Tax 2016 study included comparisons across EU countries, Australia, NZ, Turkey and the UK in terms of the hours companies took to comply with their taxes and ease of paying taxes. As can be seen from Table 2, in terms of the Ease of Taxes the UK has been ranked 15th, NZ 22nd, Australia 42nd and Turkey's position is 61st. Comparing these four countries on this basis, the UK and NZ levels score better than Australia and Turkey.

⁴⁹ Weinstein, above n 41.

⁵⁰ PricewaterhouseCoopers International Limited, above n 35.

⁵¹ PricewaterhouseCoopers International Limited, above n 12.

Table 2: Paying taxes: Overall ranking

Economy	Ease of Taxes Rank (in 189 economies)	Time to comply (hours)	Number of payments
<i>Qatar</i>	1	41	4
<i>Saudi Arabia</i>	3	64	3
<i>Singapore</i>	5	84	6
<i>Canada</i>	9	131	8
<i>Denmark</i>	12	130	10
<i>Norway</i>	14	83	4
United Kingdom	15	110	8
<i>Finland</i>	17	93	8
<i>Switzerland</i>	19	63	19
<i>South Africa</i>	20	200	7
New Zealand	22	152	8
<i>Netherlands</i>	26	123	9
<i>Sweden</i>	37	122	6
Australia	42	105	11
<i>Cyprus</i>	44	146	27
<i>Russian Federation</i>	47	168	7
<i>United States</i>	53	175	11
<i>Spain</i>	60	158	9
Turkey	61	226	11
<i>Portugal</i>	65	275	8
<i>Greece</i>	66	193	8
<i>Thailand</i>	70	264	22
<i>Germany</i>	72	218	9
<i>France</i>	87	137	8
<i>Bulgaria</i>	88	423	14
<i>Belgium</i>	90	161	11
<i>Israel</i>	103	235	33
<i>Japan</i>	121	330	14
<i>Czech Republic</i>	122	405	8
<i>China</i>	132	261	9
Italy	137	269	14
<i>Argentina</i>	170	405	9
<i>Brazil</i>	178	2600	10
<i>Venezuela, RB</i>	188	792	70
<i>Bolivia</i>	189	1025	42

Source: PricewaterhouseCoopers Limited, *Paying Taxes 2016* <<https://www.pwc.com/gx/en/paying-taxes-2016/paying-taxes-2016.pdf>>.

Table 2 indicates there is a considerable variation for European countries for the time involved in paying tax and the ease of paying taxes and so, potentially at least, indicates there may be room for improvement. Bulgaria has the worst ranking in terms of time (hours) and the ease of taxes among European countries. Italy is another country where there may be particular potential for improvement. Australia, Turkey and NZ levels are around the middle of rankings of European countries.

This ranking has been criticised by Tran-Nam and Evans.⁵² Even though the PwC Paying Taxes ranking ensures an appropriate method for the international comparison, its usefulness as an index of overall tax complexity appears to be limited for a number of reasons as follows:

1. The indicator of the total tax rate is calculated as a tax burden instead of tax complexity. Although there is a tendency to relate total tax rate to tax planning by businesses, PwC has not considered this argument.
2. The PwC Paying Taxes ranking is restrictive since it has mainly focused on medium-sized companies, in spite of the fact that most businesses worldwide are small businesses.
3. The report does not adequately explain the methodology used for combining the three indicators. In the meantime, it is unclear how the three indicators are utilised in order to get the final ranking.
4. The compliance time with tax regulations and number of payments are not sufficient to include the total burden of tax compliance. An important omission is external tax advisers' costs.
5. The other matter of concern is the statistical availability of the method and its results. There is little information provided in the report regarding its sampling procedure in each country.⁵³

4.3 The OTS, the index and its limitations

In the UK, the OTS was established as an independent Office of the Treasury in 2010 to advise the Chancellor on how to achieve a simpler tax system and to provide specialist unbiased advice on possible ways of addressing existing complexity in the tax system. The objective was to reduce the burden of tax compliance on both individual taxpayers and businesses.⁵⁴ Originally the OTS was set up on a temporary basis but it was made permanent on 21 July 2015.

By addressing and monitoring the level of tax complexity, the OTS has taken an important step towards measuring tax simplification. The present literature indicates that not only by creating an index based on the overall complexity of a tax system at a given period is required but also that a series of such indexes to monitor the changing level of tax complexity over time are needed as well. The absence of any single measure of tax system complexity may contribute to the neglect of the concepts of tax complexity and tax simplicity.

It is significant to remember that the OTS began the Tax Complexity project in order to calculate the level of complexity in the UK tax system. The OTS index is a relative rather than an absolute measure of complexity and its aim is to provide an indication of which areas of tax legislation are considered to be particularly complex. This task is achieved by developing a tool which can help prioritise the future work of the OTS. The first version of the index was divided into two parts. The aim of the first part was

⁵² Tran-Nam and Evans, above n 44.

⁵³ Ibid.

⁵⁴ HM Treasury *Office of Tax Simplification Framework Document* (20 July 2010) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193545/ots_framework_document_jul10.pdf>.

to measure *underlying complexity*, which indicates the level of intrinsic complexity related to the structure of the tax system. The second purpose was to obtain the *impact of complexity*, which indicates a combination of the cost of compliance to an individual taxpayer and the aggregated cost of compliance for all taxpayers. The OTS has developed a map based more closely on the elements of the policy making process. According to the map, policy and legislation complexity increases the underlying complexity. Factors such as policy, legislation and implementation affect the impact of complexity as well as the underlying complexity.⁵⁵

The OTS has pointed out that the policy process is of paramount importance in addressing the issues of complexity. Complexity may be reduced if some broad guidelines are followed upon designing policy, legislation, and implementation. The OTS has put forward some general principles to minimise tax complexity in the future and has developed a second version of the Comprehensibility Index.⁵⁶ However, the first version of the index has some drawbacks. Since the original index aggregates the complexity factors into two sets of data through a formula, which require examining every single indicator of complexity and then producing a Complexity Index score out of 10. The Index has faced a number of problems:

1. It caused many problems when measuring the index
2. The formula can produce scores above 10, which means that truncation has to be applied to the final scores
3. By considering the changes in the tax system, every year to keep each of the indicators in equal value in relation to each other, the weightings would have to be re-adjusted.

The second version of the Complexity Index used the *feature scaling* method in order to standardise the range of variables or data. In terms of data processing, it is known as data normalisation and is generally undertaken during the data pre-processing stage.⁵⁷ The simplest method for rescaling the range of characters is to make the features independent from each other. Selecting the target range depends on the original data with an aim to scale the range between [0, 1] or [-1, 1]. The general formula is given as:

$$Y^1 = (Y - Y^{\min}) / (Y^{\max} - Y^{\min})$$

‘Y’ is the value of the indicator for a tax measure. ‘Y^{min}’ represents an indicator’s lowest value across all tax measures, while ‘Y^{max}’ represents the highest value. This formula will produce a score between 0 and 1. Therefore, it removes the need for truncation entirely, provides a much clearer presentation and eradicates the need to adjust the weightings every year. At the same time the formula allows us to compare the complexity of taxes across different countries, since the ‘Y^{max}’ is the highest number for an indicator from each country’s data and ‘Y^{min}’ is the lowest number.

⁵⁵ Jones et al., above n 29.

⁵⁶ Office of Tax Simplification, *The OTS Complexity Index—Version 2* (8 February 2013) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/250995/ots_complexity_index_version2.pdf>.

⁵⁷ T J Lakshmi and A Santhakumaran, ‘Statistical Normalization and Back Propagation for Classification’ (2011) 3(1) *International Journal of Computer Theory and Engineering* 1793–201.

The aggregation formula is much simpler and a multiplication factor is included to extend the index to give scores between 1 and 10:

$$[(Y^1 + Z^1 + \dots n^1)/4]*10$$

where 'n¹' represents a normalised indicator, a score of 10 means the most complex tax possible and a score of 0 the least complex. As mentioned above, the OTS Complexity Index is made up of two main complexity indexes. One is the Underlying Complexity Index, which contains policy complexity, legislative complexity, and operational complexity. The other is the Resource Impact Index, which includes average resource cost and aggregate impact.

The gathered data should be objective in order to allow comparative analysis between different countries. However, the data of operational complexity regarding 'readability and availability of HMRC guidance', and 'complexity of information requirement to make a return' very much depend on a subjective rating. The data for 'guidance complexity' and 'complexity of information required to make a return' are compiled by a process of discussions between tax professionals. The tax professionals consulted were from the private sector and HM Revenue and Customs (HMRC) and have experience of a very wide range of tax and tax policy. Regrettably, there are no data and information about this part of the process on the HMRC website. Consequently, the formula ignores the data because information gathered from this source is not objective. Hence, to receive more comparative results, the original formula is altered from $[(Y^1 + Z^1 + \dots n^1)/6]*10$ to $[(Y^1 + Z^1 + \dots n^1)/4]*10$.

The OTS released the latest version of the tax Complexity Index in June 2015, in the form of a table.⁵⁸ The latest index became more complex. This is due to the fact that the tax system has been broken down into 111 areas, divided by different functions such as corporation tax and aggregates levy which are presented as a single table. It has to be emphasised that the Index is not easy to understand and does not allow the user and researchers to develop a comparative analysis between different countries using this method.

4.4 Other studies

Evans and Tran-Nam have made an important contribution to the research of tax simplification. In their study, the very purpose of constructing a tax system complexity index is to illustrate how the overall complexity of a particular tax system changes over a period of time. They suggested that such constructions must possess the following three main characteristics:⁵⁹

1. The proposed index number must cover all fundamental dimensions of tax complexity
2. All data must be measured empirically with reasonable expenditure of time, effort and resources
3. It must be useful to policy makers, tax researchers and tax advisers and accepted universally by stakeholders.

⁵⁸ Office of Tax Simplification, *The OTS Complexity Index* (3 July 2015) <<https://www.gov.uk/government/publications/office-of-tax-simplification-complexity-index>>.

⁵⁹ Tran-Nam and Evans, above n 44.

They have contributed to the complexity literature and mainly focused on the construction of a tax complexity of a specific country at a particular time. Moreover, it has to be said that it was over-ambitious to put together a single index number for the entirety of a tax system. Their approach was based upon a combination of the test and statistical approaches in index number theory. The proposed index possesses certain desirable properties, which limit the functional form of the index formula. The statistical method was also utilised in a manner that the index formula was derived as a measure of central tendency.

Evans and Tran-Nam have considered two indexes, one devoted to business taxpayers and the other for personal taxpayers. A combination of the test and statistical method was considered to be the most appropriate approach. However, the index designed has not been tested by the authors.

Another important study was conducted by Borrego, Loo, Lopes and Ferreira⁶⁰, which produced the General Tax Complexity Index in 2015. This index combines three indexes, namely; (i) Index of Complexity of Preparation of Information and Record Keeping; (ii) Index of Complexity of Tax Forms; (iii) Legal Tax Complexity Index. This study was mainly based on empirical data collected from a survey of tax professionals in Portugal.

The different initiatives show serious attempts have been made to develop a complexity index that would assist moves to make tax systems more simplified and user-friendly. While these studies make important contributions they also indicate that further work is needed to develop an even better complexity index that would be appropriate for all tax systems.

5. TESTING THE OTS COMPLEXITY INDEX FOR COMPARATIVE ANALYSIS

As already pointed out, comparing levels of tax complexity in different countries is a difficult task as all countries have their own distinct characteristics. They may have different languages, traditions, cultures, legal systems and be at different stages of economic development. Nonetheless, comparisons between different countries could be made if at least some common features and objective data in their tax legislation and systems exist. All indicators should be objective and accessible to users and researchers and methods have to be devised to develop indicators that enable meaningful comparisons to be made. However, the first aim must be to clarify the process of measuring tax complexity.

In this present study, the OTS Complexity Index is used to make comparisons between Australia, NZ, Turkey and the UK tax systems for income tax and VAT/GST. Before the comparative analysis, it is necessary to format some data to a scale of 1–5. Each of the seven criteria used in the OTS index is assigned a score out of 5. For every criterion each number from 1 to 5 represents a specific rating. For instance, for ‘number of taxpayers’ it defines 1 as a tax that impacts on less than 10,000 taxpayers;

⁶⁰ Borrego, et al., above n 45.

2 affects 10,000 to 100,000 taxpayers; and it continues up to 5, which impacts on 10 million and above taxpayers (for example, VAT and income tax).⁶¹

Comparative data for the four countries were collected from the Australian Government official website⁶², New Zealand Government and Treasury⁶³, the Turkish Ministry of Finance⁶⁴, and (HMRC in the UK⁶⁵. Only the income taxpayers' numbers of 19 million in Turkey⁶⁶ were gathered from different sources. Using the OTS methodology, the data from Australia, NZ, Turkey and the UK were gathered and are presented at the end of this study.

In addition, the 'administrative costs for tax administration/net revenue collected has been considered. This is not collected separately from taxes such as income tax and VAT/GST. However, the 'Ratio of aggregate tax administration costs per 100 units of net revenue collection' is available from the OECD database⁶⁷ and can be used instead of 'administrative costs for tax administration/net revenue collected' and the general aggregated data will be used for all taxes. This data is given by the OECD database as one set of data for all taxes for each country, according to which Turkey's score is 0.64; whereas the UK has 0.73, NZ has 0.85, and Australia has 0.93.

5.1 The results with respect to the taxes

Although, as summarised above, there are limitations to using a tax complexity index for comparative analysis, not least in deriving appropriately comparable figures, the results are of considerable interest and indicate areas where there may be the greatest potential for reducing complexity.

5.1.1 Income Tax

Starting with the overall position for income tax as shown in Tables 11–14. In terms of the underlying complexity index, Turkey has the best score of 1.68 (Table 13) followed by NZ with a score of 3.23 (Table 12), the UK with 5.92 (Table 14) and Australia 5.97 (Table 11).

The components that make up those figures provide some further interesting comparisons as shown in Tables 3–6. For income tax exemptions and relief NZ has only 37 (Table 4), Turkey 58 (Table 5), Australia 60 (Table 3) but the UK has nearly

⁶¹ Office of Tax Simplification, *The OTS Complexity Index* (3 September 2011) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193493/ots_complexity_index_methodology_paper.pdf>.

⁶² Department of – Treasury (Cth) <<http://www.treasury.gov.au>>; The Federal Register of Legislation <<https://www.legislation.gov.au>>.

⁶³ New Zealand Treasury <<http://www.treasury.govt.nz>>; New Zealand Legislation <<http://www.legislation.govt.nz>>.

⁶⁴ Republic of Turkey Minister of Finance <<http://www.maliye.gov.tr/Sayfalar/AnaSayfa.aspx>>; Mevzuat Bilgi Sistemi <<http://www.mevzuat.gov.tr>>.

⁶⁵ HM Revenue and Customs <<https://www.gov.uk/government/organisations/hm-revenue-customs>>; The National Archives <<http://www.legislation.gov.uk>>.

⁶⁶ Sukru Kizilot, 'Neden 50 Milyon Secmene Karsilik 1.7 Milyon Vergi Mukellefi Var?', *Hurriyet Gazetesi* (online), 27 October 2013 <<http://www.hurriyet.com.tr/neden-50-milyon-secmene-karsilik-1-7-milyon-vergi-mukellefi-var-24994293>>.

⁶⁷ OECD, *Tax Administration 2015: Comparative Information on OECD and Other Advanced and Emerging Economies* (OECD Publications, Paris) 181 <https://dx.doi.org/10.1787/tax_admin-2015-en>.

five times that many with 291 (Table 6). A remarkable contrast also occurs with changes to legislation from period 2000–2014. New Zealand made only 51 changes, Turkey 146, but the UK had 1,500 changes, and Australia 3,972. There is also a notable difference in pages of primary legislation, ranging from Turkey with 101 pages to Australia with 4,849. Regarding readability and the Gunning-Fog Readability Index, all four countries have tax legislation that is difficult to understand but with scores relatively close together and ranging from 16.9 for the UK to 19.4 for Australia, and 19.7 for NZ to 20.1 for Turkey.

The Resource Impact Index combines administration costs for 100 units of net revenue collected, the number of taxpayers, the average ability of taxpayers and avoidance risk. Tables 11–14 give the overall position. For income tax, the UK has the best score of 3.65, followed by 4.62 for NZ, 6.93 for Australia and 8.9 for Turkey. Tables 3–6 present the components that make up these overall scores and there are some notable contrasts, for example in average resource cost where Turkey has the lowest score of 0.64 and Australia the highest at 0.94 and avoidance risk with NZ having the lowest score of 2, Australia 3 and the UK and Turkey scoring 5.

Finally Tables 11–14 present some interesting overall comparisons for income tax between the four countries, in particular that Turkey seems the most efficient at policy and legislative complexity and the UK doing best at implementation.

5.1.2 *Value Added Tax (VAT)/Goods and Services Tax (GST)*

For VAT/GST, according to the Underlying Complexity Index, Turkey has the lowest score, of 2.6 (Table 13), as it did with income tax, but the positions of the UK and NZ are reversed. For VAT, the UK has the second lowest score of 3.84 (Table 14), NZ 5.18 (Table 12), and Australia again has the highest figure of 7.14 (Table 11).

As with income tax, the components that make up these figures provide further indications where complexity might be most advanced. For VAT/GST Turkey has the fewest exemptions and relief with only 16 (Table 5), the UK has 20 (Table 6), Australia 28 (Table 3), but NZ, which has the fewest for income tax, has the highest figure for VAT/GST with 58 (Table 4). For legislative changes over the period 2000–2014, NZ made only 52 changes to its GST, Turkey 91 and the positions for the third and fourth highest number of changes was reversed as compared to income tax with Australia making 665 changes and the UK 854. Of course there are important differences in the two taxes but it is interesting to observe that while Australia and the UK make by far the most legislative changes to the two taxes, in relative terms Australia makes more changes to its income tax and the UK more changes to its VAT. There is again a big contrast in the number of pages of legislation for VAT/GST with Turkey having 33 pages and Australia 617 and the other two countries falling in the middle—NZ with 237 pages and the UK 298. For readability and the Gunning-Fog Index the spread is greater but otherwise similar to income tax, with the lowest score for the UK of 12.1, followed by NZ 22.2, Australia 23.4 and Turkey 26. This means the UK's VAT legislation is classified at a medium level for readability whereas legislation in the other countries is classified as difficult to understand. The UK's relative success might suggest the readability of legislation is something to be considered further. The Resource Impact Index results are shown in Tables 11–14. In contrast to its position with income tax, Australia has the best score for VAT/GST with 2.35, followed by the UK with 2.68, NZ 2.95 and Turkey 4.51. Tables 3–6 present the components that make up these figures. The average resource costs have

not been separated out between different taxes but it is noticeable that, as might be expected, the aggregate impact of VAT/GST is usually lower than for income tax.

Taking the Underlying Complexity Index together with the Resource Impact Index, Turkey has the lowest score for the former and the highest for the latter. There are also significant differences for the other three countries with the Underlying Complexity Index though they are much closer together regarding the Resource Impact Index. However, it may well follow from the figures for the component parts that make up these indexes that, for both income tax and VAT/GST, a relatively modest performance in particular areas by particular countries might indicate areas with the greatest potential improvement.

5.1.3 *The Cumulative complexity for the taxes*

In this final stage, the aggregation formula $[(Y^1 + Z^1 + \dots + n^1)/6] \times 10$ is used to assess the combined complexity of all the taxes examined in terms of a range of possible scores from 1 (least complex) up to 10 (most complex).

According to the total underlying complexity shown in Tables 11–14, there are significant differences between the four countries. Australia's score is 8.74 which is higher than the UK's score of 7.08, NZ's score of 5.61. Turkey has the lowest score of 2.98. It is clear that Australia, NZ and the UK have high levels of total underlying complexity in selected taxes. For the total impact of complexity, also shown in Tables 11–14, the scores for the countries considered are much closer to each other. The score for NZ is 6.22, Australia 6.38, the UK 6.66, and Turkey 6.94. These rates indicate that all the countries have high levels of total impact complexity. In terms of both total underlying complexity and the total impact of complexity there is significant potential for simplification in the tax systems of Australia, NZ, the UK and Turkey.

6. CONCLUSION, LIMITATIONS AND PROPOSALS

6.1 Conclusions and limitations

As noted above, in spite of the substantial benefits associated with simplifying a tax system, in order to achieve simplification a variety of important factors have to be considered. For tax systems to function successfully, they must strike a balance between reasonable levels of efficiency and fairness as well as possess an acceptable level of certainty. A failure to take proper account of all the relevant factors helps to explain the very limited success of simplification initiatives in countries such as Australia, NZ and the UK.

The 1990s, especially in Common Law countries, heralded a time of increasing recognition of tax systems' complexity and the need for simplification. As a result, Australia, NZ and the UK all implemented major projects for rewriting their tax legislation, each with their own particular approach. All these simplification initiatives took much longer than was planned. In contrast, Turkey did not have and still has not got a specific project or an office specifically concerned with tax simplification. Nevertheless, in Turkey the tax authority has declared that the tax system is very complex and there have recently been initiatives for rewriting income tax and procedural tax law.

Measuring tax complexity is not easy and there are aspects where it is very difficult indeed. Comparative analysis between different countries is even harder. Every country has its own methods of measuring tax complexity at least partly because of differences in culture and other factors. Furthermore, countries have different methods of compiling their data which are not necessarily objective. Nonetheless, in spite of all these difficulties the current study has endeavoured to compare the levels of tax complexity in Australia, NZ, Turkey and the UK. Some interesting conclusions have been reached.

The four countries have some striking differences in terms of complexity. The 'number of exemptions and reliefs' in the two taxes examined, namely VAT and income tax, in Turkey are 16 and 58 but in the UK 20 and 291, in Australia 28 and 60 and in NZ 58 and 37. At the same time, the 'effect of the number of changes' to the relevant legislation in relation to VAT and income tax in Turkey is 91 and 146 but in the UK is 854 and 1500, in Australia is 665 and 3972 and in NZ 52 and 51.

For total underlying complexity, on these measures the Turkish taxes were less complex than their Australia, NZ, and UK equivalents. It may be that the effects of changes to tax legislation and pages of legislation in Australia may be justified in terms of other relevant factors in Australia and this comparison highlights that these factors have a role in tax simplification.

In terms of the 'aggregate tax administration costs per 100 units of net revenue collection', a ratio of 0.64 for Turkey compares favourably with a ratio of 0.94 for Australia, 0.85 for NZ, and 0.74 for the UK. New Zealand did slightly better in terms of the total impact of complexity with a score of 6.22 for the two taxes compared to the figures for the other countries. Overall, the application of the OTS Complexity Index to a comparison between Australia, NZ, Turkey and the UK indicates that Turkey scores better in terms of policy and legislative complexity, whereas the UK does better in terms of implementation. In the four countries, the income tax is clearly a much more complex tax than VAT/GST and therefore may have the most potential for simplification measures.

There are limitations to using the OTS Tax Complexity Index to obtain more objective results. First, not all of the data are transparently objective, including 'readability and availability of HMRC guidance' and 'complexity of information requirement to make a return' because this information is gathered through discussion and consensus between selected tax professionals. Second, there is also some uncertainty about 'ability of taxpayers'. There are only rates on the relevant HMRC website and there may be important further information about how the figures were derived which is not in the public domain. Third, the number of the 'changes to legislation' does not reflect complexity every time. Hence this varies from the number of 'changes to legislation' to the number of the 'effects of legislation amendments'. Fourth, all standardised figures have changed depending on the number of taxes analysed. So if other studies examine more than two taxes for comparison between selected countries, the results might be different. Fifth, a readability index is important for measuring complexity. However, there is no fundamental reason why the Gunning-Fog Readability Index was used by the OTS. It may therefore be worth assessing other readability indexes to apply to legislation, particularly in different languages. Finally, it is not possible to find the rate of the 'administrative costs for tax administration/net revenue collected' for all taxes separately in countries; this rate should be modified for all taxes and all countries. The 'ratio of aggregate tax

administration costs per 100 units of net revenue collection’ comes from the OECD database and was used instead of ‘administrative costs for tax administration/net revenue collected’. However, it is not an entirely suitable source of data for the present purpose.

Nonetheless, there are also some good reasons for using the OTS index, not least because some of the required data that is already available is fairly objective. First, ‘pages of legislation’ has been calculated from the legislative website. The majority of the countries use the same or similar font size and paper size. Second, the rate of avoidance risk is based on tax revenue and the number of taxpayers and, while there is scope to develop the calculations further, they should produce reasonably objective figures.

6.2 Proposals

The analysis above suggests that the Complexity Index can be utilised to produce useful international comparisons but it would be even better if all indicators were clear and objective. It should be noted that the OTS did not produce the Complexity Index to make international comparisons. There is a vital requirement for an effective complexity index to be used in international comparisons between the countries under consideration. This index may have been produced by the OTS with another aim in mind but, with the tangible experience of the OTS in this field, it is argued that the Index may be considered as a milestone in terms of tax simplification in different countries.

As far as a government is concerned, simplifying the tax system is not its sole priority and there are trade-offs to be made between tax simplification, fairness and other priorities in a complex and changing socioeconomic environment. The question that arises is how to achieve an acceptable level of simplification considering all the other related factors. This must include advances in technology which have contributed to the development of pre-filled tax returns and other means of assistance for taxpayers to help them despite long and complex tax codes.

To achieve an acceptable level of tax simplification and tax reform across all taxes, a more systematic and strategic process must be applied and undoubtedly a crucial factor in achieving a strategy is implementation. A comprehensive method requires an interactive process which plays a vital role with constant feedback between thought and action and understanding that successful strategies are born out of experience. The comprehensive tax simplification process may be summed up in four main areas:⁶⁸

1. To take into account the importance of different aims of tax policy
2. Simplification has to be incorporated into the tax policy process itself
3. Develop a ‘simplification culture’
4. To create a system of constant monitoring and reviewing process.

As this paper has argued, tax simplification is not the sole priority of a government and other aims may change over time so the process of simplification must be consistently implemented and monitored. Creating a simplification culture is at the

⁶⁸ James and Wallchutzky, above n 28.

heart of this process which inevitably encourages progress and brings considerable benefit to the wider public. It is obvious that there is a need for fundamental changes in tax simplification culture.

7. ANNEX

Table 3: Australia data (2014)

Taxes	Underlying Complexity Index				Resource Impact Index			
	Policy Complexity		Legislative Complexity		Average resource cost	Aggregate impact		
	<i>Numbers of exemptions plus the number of reliefs</i>	<i>Changes to legislation: (since 2000)</i>	<i>Gunning-Fog Readability Index</i>	<i>Pages of legislation</i>	<i>Ratio of aggregate tax administration costs per 100 units of net revenue collection</i>	<i>Number of taxpayers</i>	<i>Average ability of taxpayers</i>	<i>Avoidance risk</i>
Income Tax	60	3972	19.4	4849	0.94	5	5	3
VAT (GST)	28	665	23.4	617	0.94	3	4	2

Table 4: New Zealand Data (2014)

Taxes	Underlying Complexity Index				Resource Impact Index			
	Policy Complexity		Legislative Complexity		Average resource cost	Aggregate impact		
	<i>Numbers of exemptions plus the number of reliefs</i>	<i>Changes to legislation: (since 2000)</i>	<i>Gunning-Fog Readability Index</i>	<i>Pages of legislation</i>	<i>Ratio of aggregate tax administration costs per 100 units of net revenue collection</i>	<i>Number of taxpayers</i>	<i>Average ability of taxpayers</i>	<i>Avoidance risk</i>
Income Tax	37	51	19.7	3218	0.85	4	5	2
VAT (GST)	58	52	22.2	237	0.85	3	4	2

Table 5: Turkey Data (2014)

Taxes	Underlying Complexity Index				Resource Impact Index			
	Policy Complexity		Legislative Complexity		Average resource cost	Aggregate impact		
	<i>Numbers of exemptions plus the number of reliefs</i>	<i>Changes to legislation: (since 2000)</i>	<i>Gunning-Fog Readability Index</i>	<i>Pages of legislation</i>	<i>Ratio of aggregate tax administration costs per 100 units of net revenue collection</i>	<i>Number of taxpayers</i>	<i>Average ability of taxpayers</i>	<i>Avoidance risk</i>
Income Tax	58	146	20.1	101	0.64	5	5	5
VAT	16	91	26	33	0.64	4	4	4

Table 6: The UK Data (2014)

Taxes	Underlying Complexity Index				Resource Impact Index			
	Policy Complexity		Legislative Complexity		Average resource cost	Aggregate impact		
	<i>Numbers of exemptions plus the number of reliefs</i>	<i>Changes to legislation: (since 2000)</i>	<i>Gunning-Fog Readability Index</i>	<i>Pages of legislation</i>	<i>Ratio of aggregate tax administration costs per 100 units of net revenue collection</i>	<i>Number of taxpayers</i>	<i>Average ability of taxpayers</i>	<i>Avoidance risk</i>
Income Tax	291	1500	16.9	694	0.74	5	5	5
VAT	20	854	12.1	298	0.74	3	4	3

In this step, the standardisation formula $Y1 = (Y - Y^{\min}) / (Y^{\max} - Y^{\min})$ is applied to scale each of the countries' indicators between 0 and 1. Those indicators are shown below:

Table 7: Standardised Indicators for Australia

Taxes	Underlying Complexity Index				Resource Impact Index			
	Policy Complexity		Legislative Complexity		Average resource cost	Aggregate impact		
	<i>Numbers of exemptions plus the number of reliefs</i>	<i>Changes to legislation: (since 2000)</i>	<i>The Gunning-Fog Readability Index</i>	<i>Pages of legislation</i>	<i>Administration costs for tax administration/net revenue collected</i>	<i>Number of taxpayers</i>	<i>Average ability of taxpayers</i>	<i>Avoidance risk</i>
Income Tax	$Y^1=0,16$	$Y^2=1$	$Y^3=0.274$	$Y^4=0.954$	$Y^5=1$	$Y^6=0.5$	$Y^7=1$	$Y^8=0.333$
VAT (GST)	$Z^1=0.285$	$Z^2=0.76$	$Z^3=0.812$	$Z^4=1$	$Z^5=1$	$Z^6=0.$	$Z^7=0$	$Z^8=0$

Table 8: Standardised Indicators for New Zealand

Taxes	Underlying Complexity Index				Resource Impact Index			
	Policy Complexity		Legislative Complexity		Average resource cost	Aggregate impact		
	<i>Numbers of exemptions plus the number of reliefs</i>	<i>Changes to legislation: (since 2000)</i>	<i>The Gunning-Fog Readability Index</i>	<i>Pages of legislation</i>	<i>Administration costs for tax administration/net revenue collected</i>	<i>Number of taxpayers</i>	<i>Average ability of taxpayers</i>	<i>Avoidance risk</i>
Income Tax	$Y^1=0.076$	$Y^2=0$	$Y^3=0.546$	$Y^4=0.670$	$Y^5=0.7$	$Y^6=1$	$Y^7=1$	$Y^8=0$
VAT (GST)	$Z^1=1$	$Z^2=0$	$Z^3=0.726$	$Z^4=0.349$	$Z^5=0.7$	$Z^6=0.333$	$Z^7=0$	$Z^8=0$

Table 9: Standardised Indicators for Turkey

Taxes	Underlying Complexity Index				Resource Impact Index			
	Policy Complexity		Legislative Complexity		Average resource cost	Aggregate impact		
	<i>Numbers of exemptions plus the number of reliefs</i>	<i>Changes to legislation (since 2000)</i>	<i>The Gunning-Fog Readability Index</i>	<i>Pages of legislation</i>	<i>Administration costs for tax administration/net revenue collected</i>	<i>Number of taxpayers</i>	<i>Average ability of taxpayers</i>	<i>Avoidance risk</i>
Income Tax	$Y^1 = 0.152$	$Y^2 = 0.023$	$Y^3 = 0.575$	$Y^4 = 0$	$Y^5 = 0$	$Y^6 = 1$	$Y^7 = 1$	$Y^8 = 1$
VAT	$Z^1 = 0$	$Z^2 = 0.04$	$Z^3 = 1$	$Z^4 = 0$	$Z^5 = 0$	$Z^6 = 0.5$	$Z^7 = 0$	$Z^8 = 0.666$

Table 10: Standardised Indicators for the UK

Taxes	Underlying Complexity Index				Resource Impact Index			
	Policy Complexity		Legislative Complexity		Average resource cost	Aggregate impact		
	<i>Numbers of exemptions plus the number of reliefs</i>	<i>Changes to legislation: (since 2000)</i>	<i>The Gunning-Fog Readability Index</i>	<i>Pages of legislation</i>	<i>Administration costs for tax administration/net revenue collected</i>	<i>Number of taxpayers</i>	<i>Average ability of taxpayers</i>	<i>Avoidance risk</i>
Income Tax	$Y^1 = 1$	$Y^2 = 0.369$	$Y^3 = 0$	$Y^4 = 1$	$Y^5 = 0.333$	$Y^6 = 1$	$Y^7 = 1$	$Y^8 = 1$
VAT	$Z^1 = 0.09$	$Z^2 = 1$	$Z^3 = 0$	$Z^4 = 0.45$	$Z^5 = 0.333$	$Z^6 = 0$	$Z^7 = 0$	$Z^8 = 0.333$

In this step, the aggregation formula $(Y^1 + Z^1 + \dots + n^1)/4 \times 10$ is applied to give each tax a score between 1 and 10.

Table 11: Indexes for Australia

		Income Tax	GST	Total Underlying Complexity
1- Numbers of exemptions plus the number of reliefs 2- The number of Finance Acts with changes to the area (since 2000)	Policy Complexity	2.9	2.61	8.74
3- The Gunning-Fog Readability Index 4- Number of pages of legislation	Legislative Complexity	3.07	4.53	
Underlying Complexity Index		5.97	7.14	Total Impact of Complexity
5- Administration costs for tax administration/net revenue collected	Average resource cost	2.35	2.35	6.38
6- Number of taxpayers 7- Average ability of taxpayers 8- Avoidance risk	Aggregate impact	4.58	0	
Resource Impact Index		6.93	2.35	

Table 12: Indexes for New Zealand

		Income Tax	GST	Total Underlying Complexity
1- Numbers of exemptions plus the number of reliefs 2- The number of Finance Acts with changes to the area (since 2000)	Policy Complexity	0.19	2.5	5.61
3- The Gunning-Fog Readability Index 4- Number of pages of legislation	Legislative Complexity	3.04	2.68	
Underlying Complexity Index		3.23	5.18	Total Impact of Complexity
5- Administration costs for tax administration/net revenue collected	Average resource cost	2.12	2.12	6,22
6- Number of taxpayers 7- Average ability of taxpayers 8- Avoidance risk	Aggregate impact	2.5	0.83	
Resource Impact Index		4.62	2.95	

Table 13: Indexes for Turkey

		Income Tax	VAT	Total Underlying Complexity ⁶⁹
1- Numbers of exemptions plus the number of reliefs 2- The number of Finance Acts with changes to the area (since 2000)	Policy Complexity	0.43	0.1	2.98
3- The Gunning-Fog Readability Index 4- Number of pages of legislation	Legislative Complexity	1.43	2.5	
Underlying Complexity Index		1.68	2.6	Total Impact of Complexity
5- Administration costs for tax administration/net revenue collected	Average resource cost	1.6	1.6	6.94
6- Number of taxpayers 7- Average ability of taxpayers 8- Avoidance risk	Aggregate impact	7.5	2.91	
Resource Impact Index		8.9	4.51	

Table 14: Indexes for the UK

		Income Tax	VAT	Total Underlying Complexity
1- Numbers of exemptions plus the number of reliefs 2- The number of Finance Acts with changes to the area (since 2000)	Policy Complexity	3.42	2.72	7.08
3- The Gunning-Fog Readability Index 4- Number of pages of legislation	Legislative Complexity	2.5	1.125	
Underlying Complexity Index		5.92	3.84	Total Impact of Complexity
5- Administration costs for tax administration/net revenue collected	Average resource cost	1.85	1.85	6.66
6- Number of taxpayers 7- Average ability of taxpayers 8- Avoidance risk	Aggregate impact	1.8	0.83	
Resource Impact Index		3.65	2.68	

The aggregation formula $(Y^1 + Z^1 + \dots + n^1)/6 \times 10$ is applied to find the index for total taxes scores between 1 and 10.

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The relationship between principles and policy in tax administration: Lessons from the United Kingdom capital gains tax regime with particular reference to a proposal for a capital gains tax for New Zealand

Simon James¹ and Andrew Maples²

Abstract

It is unusual to find a tax in operation which does not represent a compromise between tax principles, policy and administrative considerations. However, the third of these, tax administration, often does not receive the attention it should as proposals for tax reform are developed. This paper examines one particular case, the possibility that attempts to introduce a capital gains tax (CGT) in New Zealand (NZ) have been unsuccessful because the right balance between the three dimensions of tax reform has not been achieved and that for this and other possible reforms each of these aspects should be given the appropriate consideration. New Zealand does not currently have a comprehensive CGT. In fact, political commentators have long said that the enactment of a CGT in NZ would be 'political suicide'. The reasons for such antipathy towards a CGT are not entirely clear especially given the successful implementation and operation of CGT in many jurisdictions, including the United Kingdom (UK). However, sentiment towards a CGT in NZ appears to have softened more recently. Perhaps sensing this rise in support, the centre-left New Zealand Labour Party in the 2011 and 2014 general elections unsuccessfully campaigned on, inter alia, introducing a comprehensive CGT. It is unclear what part the CGT proposal played in its defeat in both elections with other factors in play. However, noting that the CGT policy may have alienated voters in the 2014 election, Labour Party leader, Mr Andrew Little has indicated that reform of the NZ tax system, including a possible CGT, would not be made 'without going to the people first and getting a mandate to do so'.³ Accordingly, the electorate support for a CGT, and its design (including the administration of the tax), will be crucial for its political viability in NZ; hence the rationale for this paper. The paper finds that the UK CGT is a very robust tax but has never taken a pure form based only on the principles of good tax design. Indeed its success in tax policy terms has been largely accounted for by pragmatic modifications over the years to accommodate the different and changing political and economic pressures applying to modern tax systems. The paper concludes that a more pragmatic approach could lead to the design of a CGT that may gain the broad support of the NZ electorate and also be as enduring as it has been in the UK.

Keywords: capital gains tax, tax administration, tax policy, tax principles, sustainability, tax compliance

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³ 'Little, Robertson Confirm Labour's Ditched Policies and Reveal Some New Ones', *The National Business Review* (online), 7 November 2015 <http://www.nbr.co.nz/article/little-robertson-confirm-labours-ditched-policies-and-reveal-some-new-ones-ng-181292?utm_source=newsletter&utm_medium=email&utm_campaign=NBR%2520Heads%2520Up>

1. INTRODUCTION

It has been suggested that tax administration has not been given sufficient attention in the voluminous literature on tax reform⁴ although its importance is clear and acknowledged, for instance, in their part of the Mirrlees Review⁵ by Shaw et al. who stated: ‘administration and enforcement are often neglected in tax policy, but they are central to making a tax system work’.⁶ Tax administration covers a range of aspects of taxation. One view seems to be that it is concerned only with the implementation, management and enforcement of existing tax legislation and other regulations. However, some authorities have taken a wider view. For example, Gordon’s analysis⁷ is developed in terms of the law of tax administration and procedure while USLegal notes that the term ‘tax administration’ has also been used to include the development and formulation of tax policy relating to tax legislation and related regulations.⁸ Mansfield observes that ‘tax administration is a loosely defined area that embraces law, public administration, sociology, and psychology as well as economics’.⁹

In developing tax design the natural place to begin is with tax policy as it reflects government aims and objectives but these should take into account tax principles and practice in the form of tax administration. In this context the term ‘tax principles’ refers to criteria such as equity and efficiency which may be used to assess existing taxes or proposed tax reforms.¹⁰ Although tax principles are a valuable guide to tax design, the optimal outcome might require modification in the light of tax policy and the reality of tax administration. As already indicated, tax administration should also be considered but administrative solutions should take account of both policy and principles. Figure 1 illustrates the view that all three dimensions interact and each should take account of the other two.¹¹

⁴ See, for example, Richard M Bird, ‘Administrative Constraints on Tax Policy’ in Cedric Sandford (ed), *Further Key Issues in Tax Reform* (Fiscal Publications, 1998).

⁵ Sir James Mirrlees (Chair), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, 2010).

⁶ Jonathan Shaw, Joel Slemrod and John Whiting, ‘Administration and compliance’ in Sir James Mirrlees (Chair), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, 2010) 1100–162.

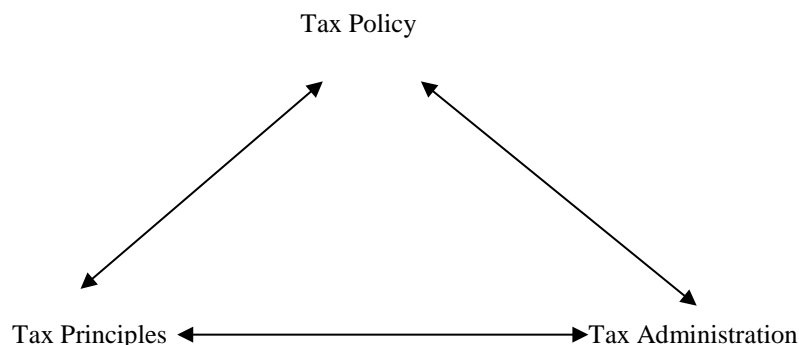
⁷ Richard K Gordon, ‘Law of Tax Administration and Procedure’ in Victor Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1996) vol. 1 ch. 4.
<<https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch4.pdf>>.

⁸ US Legal, definition <<http://definitions.uslegal.com/t/tax-administration/>>.

⁹ Charles Mansfield, ‘Tax Administration in Developing Countries—An Economic Perspective’ *Staff Papers* (International Monetary Fund, 1988) vol. 35, 181.

¹⁰ In his definitive work, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Pt 2, Ch 2, Bk 5), (William Benton, 1952), 361–62, Adam Smith identified four principles or maxims (equity, certainty, convenience and freedom from economic burden) with regard to taxes in general which have been a starting point for evaluating a tax. More modern commentators have tended to condense these four criteria into the three mentioned above (equity, efficiency and simplicity): Gordon Cooper, Chris Evans and Kirk Wilson *Australian CGT Handbook 2014–2015* (Thomson Reuters, 2014), 13. For a discussion of these principles see Cooper, Evans and Wilson, 13–16. James and Nobes define tax principles primarily in terms of equity and efficiency: Simon James, and Christopher Nobes, *The Economics of Taxation: Principles, Policies and Practice* (Fiscal Publications, 2016).

¹¹ The authors would like to thank David Guttormsen for his comments that led to the development of this diagram.

Figure 1: The Interdependence of Tax Policy, Principles and Administration

The UK experience is that all three have an important role in the design, reform and operation of CGT and it is not easy to separate out each aspect with regard to individual features of the UK CGT. Often all three are involved and sometimes in more than one way. The relationship between the three is therefore a close and complex one. With respect to the recent proposal by the New Zealand Labour Party (Labour) for the introduction of a CGT in NZ, the UK experience over a period of fifty years is that all three should be carefully considered.

In addition, and related to, the above three dimensions, the Victoria University of Wellington Tax Working Group (TWG) (and others) highlight the need for any tax reform (and a tax system) to be politically sustainable.¹² This not only requires tax reform to be supported by voters but ‘that the tax system be designed to minimise vulnerability to interest group pressure and political temptation to tamper with or reverse the critical elements of a coherent system’.¹³ As a cautionary note, the TWG continue: ‘[p]iece-meal changes to the [NZ] tax system have undermined the integrity, acceptability and political sustainability of the system. It is important to bear this lesson in mind when considering ... base-broadening options’.¹⁴ In terms of CGTs specifically, Quintal, Snell and Chan warn that from a legislative perspective, CGTs ‘tend to be particularly unstable’.¹⁵

In considering tax reform and the tax system generally, it is also important to acknowledge the impact of self-assessment on tax administrations and taxpayers. Under self-assessment the role of the revenue authority is more focussed on audit. For taxpayers, in the context of CGT, self-assessment requires them to determine if it applies to them and the amount of that tax obligation. Thus, while a concession such as a tax-free threshold may reduce both the CGT’s application (and therefore enhance its political sustainability) as well as revenue authority audits (tax administration),

¹² Centre for Accounting, Governance and Taxation Research, *A New Tax System for New Zealand’s Future, Report of the Victoria University of Wellington Tax Working Group* (Wellington, January 2010) 10, 64. Nobel prizewinner James E. Meade wrote: ‘I am an economist and have tried to give you an economic solution for an economic problem. Please do not argue that I am a rotten economist on the grounds that the economic solution is politically unacceptable’: James E Meade, ‘Stagflation in the United Kingdom’ (1979) 7 *Atlantic Economic Journal*, 9.

¹³ Ibid 64.

¹⁴ Ibid.

¹⁵ Aaron Quintal, David Snell and Nicholas Chan ‘Key Issues In The Design Of Capital Gains Tax Regimes: The Impact On Tax Practice [Part 2]’ (October 2015) *Taxation Today* 19.

taxpayers must determine and calculate the capital gain to validly apply the concession (and are therefore subject to increased compliance costs). For some taxpayers this will be straightforward. In other cases, where for example a person has been involved in multiple asset sales in a year, this will be a time-consuming exercise.

To define income, the authors in this paper adopt the concept of ‘comprehensive income’, also known as the Haig-Simons concept of income. Comprehensive income for a period represents the difference in wealth between the beginning and end of the period, together with consumption during the period. As such all gains (realised and unrealised) are income and should be taxable on a periodic (for example, annual) basis. Harris et al. observe:

It should be stressed that that the notion of comprehensive income is a theoretical concept that can never be fully achieved under any real-world income tax. Among other things, implementation of a comprehensive income tax would require measuring on an accrual basis the annual change in value of every asset and liability of every taxpayer. Instead, the concept is best regarded as a benchmark against which the properties of our income tax, and of potential changes to it, can be assessed.¹⁶

Acknowledging that the concept is a benchmark, departures or modifications are made for a variety of (often inter-related) reasons, including:

1. Tax policy and principles
2. Practical issues, such as (under an accrual-based system) the difficulties of valuing assets and lack of cash to pay the tax
3. Tax administration, including the inability of the revenue authority to verify a gain
4. Tax compliance
5. Complexity of the application of the tax for taxpayers and the related costs to comply
6. Political sustainability, in respect of a particular tax reform and the tax system generally.

The discussion in this paper focusses on departures or modifications from the Haig-Simons definition of income based on tax administration, tax policy and tax principle considerations. In addition, as already indicated, the need for tax reforms to be politically sustainable impacts on, and interacts with, these three considerations.

By way of background to this paper, NZ operates a broad-base, low rate (BBLR) tax system, which includes an income tax for individuals with four tax rates (and a low top tax rate of 33%),¹⁷ and a comprehensive goods and services tax (GST).¹⁸

¹⁶ Garth Harris, Chris Ohms, Casey Plunket, Audrey Sharp and Nigel Smith, *Income Tax in New Zealand* (Brookers Ltd, 2004), 41–2.

¹⁷ Perhaps unusually compared with countries such as the UK and Australia there is no tax-free threshold.

¹⁸ NZ does not have (i) an inheritance tax, (ii) local or state taxes apart from property rates levied by local councils and authorities, (iii) a payroll tax, (iv) social security tax, or (v) a health care tax, apart from a very low levy for New Zealand’s accident compensation injury insurance scheme.

However, the country is unusual among Organisation for Economic Development and Cooperation (OECD) countries as it does not have a comprehensive capital gains tax (CGT).¹⁹ Rather, certain specified capital gains are taxed in the *Income Tax Act 2007* (NZ). Despite various committees considering the implementation of a CGT in NZ, admittedly with differing conclusions,²⁰ and overseas bodies such as the OECD²¹ noting the benefits of a CGT for the NZ economy, there has been a longstanding antipathy against adopting the tax. While more recently sentiment may have softened among some business leaders and politicians,²² more will be required in order for any proposal for a CGT to be supported by the electorate.

The remainder of this paper is structured as follows: Section 2 considers, by way of background, the possible reasons for the hostility towards a CGT in NZ, in part to inform decisions concerning the design of a future NZ CGT. The recent moves by Labour to promote such a tax are also noted in this section. Section 3 provides an overview of the UK's experience with a CGT. Section 4 outlines and critiques key aspects of Labour's CGT policy set against the UK experience and in the context of the strength of feeling against a NZ CGT. The purpose of this section (and the paper) is not to evaluate Labour's CGT proposal comprehensively,²³ nor is it the authors' intention to design a CGT for NZ. Rather, in the context of the UK CGT, the authors' aim is to illustrate the interplay between tax administration, tax design and tax principles and how this interplay may lead to a more palatable and politically sustainable CGT policy for NZ. Concluding comments and observations are made in Section 5.

2. ANTIPATHY IN THE ANTIPODES—NEW ZEALAND AND CAPITAL GAINS TAX

2.1 Why the angst?

As indicated in Section 1, NZ has adopted a BBLR tax framework; one that politicians and policymakers are quick to extol.²⁴ However, claims that without a CGT NZ is operating under such a framework are somewhat debateable. The arguments in

¹⁹ Cooper, Evans and Wilson observe that among OECD countries NZ is 'the notable exception' without a CGT: Gordon Cooper, Chris Evans and Kirk Wilson *Australian CGT Handbook 2015–2016* (Thomson Reuters, 2015), 11. Further, based upon the IBFD Tax Research Platform, 167 countries out of 219 had a CGT system in place: *ibid* 11.

²⁰ See for example, Melinda Jacomb, 'A History of taxing Capital Gains in New Zealand: Why Don't We?' (2014) 20 *Auckland University Law Review* 124, 131–44.

²¹ See, for example, in its June 2013 economic survey of NZ, the OECD highlighted the lack of a CGT as a weakness in the NZ tax policy framework and stated that a CGT could, along with other tax changes, 'facilitate a more efficient and equitable tax structure'; OECD, *OECD Economic Surveys: New Zealand* (OECD Publishing, 2013) 24.

²² See, for example, Ben Chapman-Smith, 'Capital Gains Tax No Good Unless Comprehensive—English', *The New Zealand Herald* (online), 25 July 2013; Thomas Pippas, 'Capital Gains Tax An Inevitable Part Of The Future Landscape', *The New Zealand Herald* (online), 23 July 2013; Jamie Gray, 'Labour's Tax Plan Centre Stage For Our CEO's', *The New Zealand Herald* (Auckland), 12 September 2014, <<http://www.nzherald.co.nz/mood-of-the-boardroom/news/print.cfm?objectid=11322939>>.

²³ See, for example, Andrew Maples, 'A Comprehensive Capital Gains Tax in New Zealand—No Longer Political Hari-Kari? A Consideration of the Labour Party Proposal of 2011' (2014) 20 *New Zealand Journal of Taxation Law and Policy* 144.

²⁴ See, for example, Hon Todd McClay, Speech (Chartered Accountants Australia and New Zealand Tax Conference, 31 October 2014) <<http://taxpolicy.ird.govt.nz/news/2014-10-31-address-caanz-tax-conference#speech>>.

support of a CGT in NZ (such as equity²⁵ and efficiency)²⁶ have been well canvassed as have the flaws in the current income tax system in the absence of such a tax.²⁷ While some review committees have supported the implementation of a CGT in NZ,²⁸ it has been a long held belief that the enactment of a comprehensive CGT in NZ would be '[a] sure-fire path to political suicide'.²⁹ Former Prime Minister, the Rt Hon David Lange reputedly characterised 'a capital gains tax policy as one likely to lose you not merely the next election, but the next three'.³⁰ Interestingly, the closest NZ has ever come to comprehensively taxing capital gains was under the reformist fourth Labour government, which was led by Lange until 1989.³¹

The strength of feeling against a CGT is curious to those outside NZ, including one of the authors of this paper, given that CGTs have been implemented around the world, including the UK and, more recently, South Africa (in 2001). On the bases of its widespread adoption and relative longevity as a tax, CGT has been successful. One of the reasons for such success is that CGT scores well in terms of the principles of

²⁵ See, for example, Alvin Cheng, Howard Davey and Keith Hooper, 'The Perceptions of Tax Teachers on Taxing Capital Gains in New Zealand' (2010) 16 *New Zealand Journal of Taxation Law and Policy* 217, 233.

²⁶ For a discussion of the principles in support of a CGT, see Rick Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for Institute of Policy Studies, Wellington, 1990); Paul Kenny, 'Capital Gains Taxation for New Zealand: Fairer and More Efficient' (2001) 7 *New Zealand Journal of Taxation Law and Policy* 265; Leonard Burman and David I White, 'Taxing Capital Gains in New Zealand' (2003) 9 *New Zealand Journal of Taxation Law and Policy* 355; Leonard E Burman and David I White, 'Taxing Capital Gains in New Zealand: Assessment and Recommendations' (Paper presented at session three of the Victoria University of Wellington Tax Working Group, 16 September 2009) Victoria University of Wellington Tax Working Group <<http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/>>; Craig Elliffe, 'Building a Better Bridge: The Case for Taxing Capital Gains in New Zealand' (2010) 16 *NZBLQ* 178.

²⁷ See, for example, Elliffe, above n 26.

²⁸ Julie Cassidy, Alvin Cheng and Sue Yong, 'Is a Capital Gains Tax the Answer to New Zealand's Tax Alchemy?' (2014) 20 *New Zealand Business Law Quarterly* 40, 41 cite as examples Paul Bevin, Avery Jack and John Jensen, *Income Maintenance and Taxation: Some Options for Reform* (New Zealand Planning Council, June 1978) [10.25]; Valabh Committee *Consultative Document on the Taxation of Income from Capital* (Government Printer, Wellington, 1989) [12.7].

²⁹ Bob Edlin 'A sure-fire path to political suicide', *The Independent* (New Zealand), 5 February 2008, 14.

³⁰ Barrett and Veal, referring to overseas experiences, conclude: '[m]emorable as Lange's aphorism may have been, its plausibility is dubious': see Jonathan Barrett and John Veal 'Equity versus Political Suicide: Framing the Capital Gains Tax Debate in the New Zealand Print Media' (2013) 19 *New Zealand Journal of Taxation Law and Policy* 91, 94, footnote 25.

³¹ Following the 1989 Budget, the then Labour Government established a consultative committee which published in December 1989 a 400-page report on taxing income from capital (Valabh Committee *Consultative Document on the Taxation of Income from Capital* [Government Printer, 1989]). Griffiths writes that the consultative committee 'did not intend a "new and separate tax on income that happens to be called "capital gain". It stated that the current exemption of certain types of capital income was not the result of an overt legislative decision. Rather, it was the consequence of judicial interpretations that drew upon concepts that had evolved in the unrelated area of trust law ... The current set of rules ... were "arbitrary" and "confused". The Consultative Committee's report did not propose a separate "capital gains" legislation. Rather there ought to be a "comprehensive and rational" analysis of the income tax legislation and the case for each exemption would be coolly analysed'..: Shelley Griffiths, 'The Game is Not Worth the Candle': Exploring the Lack of a Comprehensive Capital Gains Tax in New Zealand' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 51, 63–4. The proposal did not proceed as Labour lost the 1990 election. Instead, the Valabh Committee, which was subsequently formed to further consider the report, concluded that the first priority 'was to address existing "anomalies" and do "repairs and maintenance" on the current legislation.'; *ibid* 64. The comprehensive taxation of income regime was not part of the National governments policy and so the proposal did not proceed any further.

equity and efficiency. An understanding of the antipathy toward the tax in NZ, and whether Labour's proposals contain the right balance between policy, principles and administration, may aid in the development of a CGT policy in NZ.

In fact, at first sight, one of the difficulties with the various committee reports considering the introduction of a CGT in NZ as well as Labour's recent proposals is that administrative issues have been insufficiently addressed and as a consequence seen as insurmountable.³² Huang and Elliffe posit that:

The reason historically that New Zealand does not have a CGT is not because New Zealand policymakers fail to recognise the benefits of such a form of taxation, but because they have been overawed by the perceived problems and cost associated with it. In looking at the history of this tax policy, it is possible to conclude that the rejection is primarily due to unsubstantiated assertions that the law will become *too complex from an administrative and technical perspective*, and, bearing this burden in mind, is not worth the trouble from the revenue-collection perspective.³³

Considering the various NZ government reviews of CGT, Huang and Elliffe conclude that 'in deciding against adopting a CGT, NZ governments have not carefully and explicitly considered the experience of other jurisdictions'.³⁴

Griffiths more cautiously observes that: 'It is ... true that it is difficult to discern why New Zealand has almost uniquely chosen to not enact an overt CGT'.³⁵ In her review of the NZ tax system since the introduction of income tax in 1891, she suggests hostility to a CGT is 'no historical accident'³⁶ observing:

The opportunity for land ownership lay at the heart of the New Zealand egalitarian dream. Policy was often focussed on encouraging land ownership and disaggregating large holdings. ... At the same time, a young country needed to build up its capital base and the tax system needed to buttress that, not put capital aggregation and growth at risk.³⁷

However, Griffiths does also acknowledge the potential impact of tax administration in the CGT debate in NZ, observing that following the 1951 Tax Committee, where issues of measurement and administration were raised for the first time, '[o]ver the next 50 years, the practical problems underpinned the discussions about and rejection of the comprehensive taxation of capital gains'.³⁸

³² For the history of the CGT debate, including the findings of previous committees which have looked into a CGT for New Zealand, see further Chye-Ching Huang and Craig Elliffe, 'Is New Zealand Smarter than Other Countries or Simply Special? Reconsidering a Realisation-based Capital Gains Tax in the Light of South Africa's Experience' (2010) 16 *New Zealand Journal of Taxation Law and Policy* 269, 274–79; Julie Cassidy and Clinton Alley, 'Capital Gains Tax: Lessons From Across the Ditch' (2012) 18 *NZBLQ* 97, 97, 100–05, and Griffiths: *ibid* 51.

³³ Huang and Elliffe, above n 32, 304. Emphasis added.

³⁴ *Ibid* 273.

³⁵ Griffiths, above n 31, 51.

³⁶ *Ibid* 68.

³⁷ *Ibid*. Griffiths notes, for example: 'In 1922 and 1924, two general reports on taxation in New Zealand highlighted the need for the tax system not to discourage the disaggregation and growth of capital', *ibid*.

³⁸ *Ibid* 61, citing for example the Taxation Review Committee *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, Wellington, 1967).

New Zealand's experience with another new form of taxation—the goods and services tax—has been very positive³⁹ partly because it did not face serious administrative concerns. The emphasis of the policy design of the GST strongly focussed on simplicity with equity concerns being dealt with outside the GST itself (via the welfare transfer system).⁴⁰ As a consequence the GST is economically very efficient. This positive experience with a comparatively 'pure' tax, with its few exemptions, may have negatively impacted on perceptions of, and support for, a CGT. Griffiths observes: '... the experience with a very broadly based and successful goods and services tax has meant there has been a reluctance to settle for what seems like a CGT complicated by exceptions and imperfections'.⁴¹ The very success of one significant tax reform perversely may hinder the support for, and implementation, of another major tax reform—a CGT.

To the extent that tax administration concerns have impacted on the decision not to implement a CGT in NZ, as already noted it is important that any future proposal contain the right balance between policy, principles *and* administration.

2.2 A change in the mood?

Sentiment towards a CGT in NZ has softened more recently with a number of commentators as well as business and political leaders supporting (or acknowledging the need for) the introduction of a CGT.⁴² Backing for a CGT has also been evident among the wider community,⁴³ although it is arguably 'not [yet] ... to the level of popular support'.⁴⁴

Perhaps sensing this change in the mood towards a comprehensive CGT, the centre-left New Zealand Labour Party in the 2011 and 2014 general elections unsuccessfully campaigned on, *inter alia*, introducing a comprehensive CGT levied at a flat rate of 15 per cent. It is unclear what part the CGT proposal played in its defeat in both elections⁴⁵ with other factors in play, including (especially in 2014) an economy experiencing very strong growth. However, noting that the CGT policy may have alienated voters in the 2014 election, Labour Party leader, Mr Andrew Little has

³⁹ Hon Sir Roger Douglas, 'The New Zealand GST Policy Choice and its Political Implications' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers Ltd, 2007) 3.

⁴⁰ Equity concerns (including the impact of regressivity) were dealt with in a parallel system offering benefits and incentives for lower income taxpayers and families: *ibid* 6.

⁴¹ Griffiths, above n 31, 68.

⁴² See, for example, Chapman-Smith, above n 22; Pippos, above n 22; Gray, above n 22.

⁴³ A poll by Fairfax Media-Ipsos undertaken in October 2013 found 52.3 per cent believed a CGT on investment properties would help control rising house prices, up from 37.1 per cent in an August poll (although not stated, presumably also conducted by Fairfax Media-Ipsos): Michael Fox, 'Kiwis 'Ready' For Capital Gains Tax', *The Press* (Christchurch), 12 November 2013, A5.

⁴⁴ Thomas Pippos, 'Stealthy capital gains regime already in place', *Sunday Star Times* (Auckland), 11 May 2014, D11.

⁴⁵ On the role of the CGT policy in Labour's 2011 election defeat, political commentator Colin James observes: 'Whether the capital gains tax was the cause, or just opened the trapdoor through which Labour was destined to fall, is debateable. Judging by subsequent ratings in the polls, I think it was probably the latter.' Colin James, 'On a Wing and a Smile: Political Transition in National's Business-as-Usual Re-Election' in Jon Johansson and Stephen Levine (eds), *Kicking the Tyres: The New Zealand General Election and Electoral Referendum of 2011* (Victoria University Press, 2012) 65, 66 as cited in Barrett and Veal, above n 30, 94, footnote 28.

indicated that reform of the NZ tax system, including a possible CGT, would not be made ‘without going to the people first and getting a mandate to do so.’⁴⁶

Labour’s 2011 CGT proposal⁴⁷ was retained essentially unchanged as part of its 2014 tax policy.⁴⁸ The two policy statements are referred to in this paper as the ‘2011 policy statement’ and ‘2014 policy statement’. This paper primarily focusses on the 2014 policy statement as it reflects the most recent iteration of Labour’s CGT policy.

At the 2011 and 2014 general elections, the policies of the left-of-centre Green Party of Aotearoa New Zealand (Greens)⁴⁹ and the smaller Mana Party⁵⁰ also included the introduction of a CGT in NZ. On the basis that the Mixed Member Proportional (MMP) electoral system produces coalition-based governments and the Greens and Labour (at least) are likely coalition partners in a future government, a CGT in New Zealand is a distinct possibility in the medium term. Pressure on the fiscal purse from an aging population will also necessitate the exploration for alternative revenue sources (such as a CGT) for future governments.⁵¹ However, presently NZ is in a unique position. The country is not in the dire economic position it was in 1984⁵² when the incoming Labour government, led by Rt Hon David Lange, was forced to undertake major structural changes to the tax system within a short period (including the introduction of the goods and services tax). The country has weathered the 2008 global financial crisis comparatively well.⁵³ Major structural tax reform, such as the introduction of a CGT, at this time is not pressing. Further, as a late adopter of a CGT it has the advantage that it can look to the practices of other jurisdictions including the UK. Accordingly, it is timely to consider design and administration aspects of a potential CGT in NZ; hence the purpose of this paper.

Key aspects of Labour’s recent CGT proposals were chosen for comparison with the UK experience for two reasons. First, as the major party in any future coalition of the

⁴⁶ Above n 3.

⁴⁷ Labour Party, ‘Labour’s Fairer Tax System Explained’ <<http://img.scoop.co.nz/media/pdfs/1107/CGTWebdoctJuly20111.pdf>>. As recently as 24 May 2016 Labour have confirmed that a CGT is ‘not off the table’ if they win the 2017 general election and it would be considered by a working group looking at the tax system: Vernon Small, ‘Labour Explores Need For Tax Rises’, *The Press* (Christchurch), 24 May 2016, A2.

⁴⁸ Labour Party, ‘Capital Gains Tax’ (2014).

⁴⁹ The Greens tax policy has included the introduction of a CGT for a number of years: see Green Party, ‘Green Taxation and Monetary Policy Summary’ (3 February 2014) <<http://www.greens.org.nz/policysummary/green-taxation-and-monetary-policy-summary>>.

⁵⁰ The Mana Party campaigned on the introducing a CGT on all assets except the family home and Maori land, see, for example, <<https://www.kpmg.com/NZ/en/IssuesAndInsights/ArticlesPublications/Taxmail/Documents/Taxmail-issue1September2014.pdf>>.

⁵¹ In its briefing to the Minister of Finance, Inland Revenue noted in the context of broadening the tax base: ‘The largest area of non-taxation of income in New Zealand that could practically be taxed is capital gains.’ Inland Revenue, *Briefing for the Incoming Minister of Revenue—2014* (Wellington, 12 November 2014) 36 <<https://www.ird.govt.nz/resources/8/d/8d8ea8f9-53fe-4934-87c5-9094338af754/bim-2014.pdf>>.

⁵² In 1984 the fiscal deficit blew out to 9 per cent of GDP: Ian Dickson, ‘The New Zealand GST Policy Choice: An Historical and Policy Perspective’ in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers Ltd, 2007) 47.

⁵³ The New Zealand Treasury are forecasting economic growth to be an average of 2.7 per cent over the next five years: Audrey Young, ‘Tax cuts likely despite slower economy’, *The NZ Herald* (online), 9 February 2016 <http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=11586415>.

centre-left parties, it is probable that Labour will drive the policy design of any future CGT. The 2011 and 2014 policy statements are currently the best indication of the shape of such a tax at this point and no doubt will inform the development of any future policy. It is clear from a reading of the policy statements that they are the product of much research and analysis (even though essentially produced as part of Labour's election manifesto). Second, and related to the first point, of the political parties which have included the introduction of a CGT in their tax policy, Labour's is the most developed proposal. The next section provides an overview of the UK's experience with a CGT.

3. CAPITAL GAINS TAX IN THE UNITED KINGDOM

3.1 Overview

CGT was introduced in the UK in 1965 giving half a century of experience which may be relevant to discussion of a possible CGT in NZ. There are several interesting strands to the UK experience. First of all there are strong theoretical reasons for the introduction of a CGT on the grounds of economic efficiency and fairness and both were used to support the case for the tax in the UK. Nevertheless, a second relevant observation is that the UK CGT has never been of the pure form indicated by basic principles of good tax design. Sometimes it has moved closer to the theoretical ideal and sometimes further away indicating the importance of other factors in the development of the tax. Indeed a third point is that such changes suggest CGT is a fairly robust tax unlike, for example, the ill-fated capital transfer tax.⁵⁴ A further strand of interest in the present context is that, however close its relation to basic principles has or has not been, the UK CGT has not aroused much general opposition and what there has been is insignificant compared to the negative reaction to some other tax changes such as the introduction of the community charge.⁵⁵ Sir Thomas White once suggested that the only popular tax is one on someone else⁵⁶ and it is true that the lack of opposition to the UK CGT is partly due to it being levied on a relatively small proportion of taxpayers but even they have not generally voiced much criticism of the tax. Where significant criticism has been raised about particular aspects of the tax it has led to reform, as for instance in 2008 with the introduction of entrepreneurs' relief. This was a policy change to accommodate political pressure. Finally, the fact that there do not appear to have been any particular difficulties in administration and compliance beyond that which might be expected with a tax of this nature is an important lesson for NZ. It seems reasonable to conclude that the CGT in the UK has managed to achieve an acceptable balance between policy, principles and administration as well as reflecting political realities.

Several basic principles are relevant to developing a good tax system but the most important with respect to CGT are economic efficiency and equity together with

⁵⁴ See, for example, Alister Sutherland, 'Capital transfer tax: an obituary' (1981) 2 *Fiscal Studies* 37–51 and Alister Sutherland, 'Capital transfer tax: adieu' (1984) 5 *Fiscal Studies* 68–83.

⁵⁵ See, for example, Simon James, 'The contribution of behavioral economics to tax reform in the United Kingdom' (2012) 41 *Journal of Socio-Economics* 468–75.

⁵⁶ Sir Thomas White, 'In such experience as I have had with taxation – and it has been considerable – there is only one tax that is popular, and that is the tax on the other fellow' (debate in the Canadian Parliament, 1917).

administrative considerations.⁵⁷ Economic efficiency holds that taxes should not unnecessarily distort markets that are working well though, if there are market imperfections, there may be a case for corrective taxation. An equitable tax is one that is seen by taxpayers as fair and is consistent with distribution policy more generally. Administrative considerations include the avoidance of excessive complexity and administrative and compliance costs.

In terms of the economic principles of taxation, capital gains can have similar characteristics as the Haig-Simons definition of income. For instance, the capital appreciation of securities as a result of ploughing back profits may be seen as another form of income. In economic terms, the precise definition of income has been the subject of considerable debate among eminent economists. For Haig-Simons 'income is the money value of the net accretion to economic power between two points of time'⁵⁸. Henry Simons' comprehensive definition of income was that: 'Personal income may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in the value of the store of property rights between the beginning and end of the period in question'⁵⁹. Hicks' definition took income as the 'maximum amount of money which the individual can spend this week, and still be able to spend the same amount in real terms in each ensuing week'.⁶⁰ The definition that seems to be increasingly accepted is that of total accretion, that is the accrual of wealth. This includes as income an individual's spending in a given period, plus any changes in net wealth. With such a definition a range of other gains including inheritances, gifts, winnings from gambling and any 'windfall' gains might be considered as income for tax purposes.

Considered in this way, if only some forms of income are subject to tax, the result may well be significant economic distortions as taxpayers manipulate their affairs for tax purposes. An important aspect is that, in the absence of a CGT, there may be a significant tax incentive to invest in 'non-productive' assets such as antiques, coins, paintings, precious stones and stamps and so on which are bought because of anticipated increases in their value, rather than for any productive purpose. On equity grounds, if capital gains are equivalent to income they should be subject to tax in the same way. The fairness argument is also a strong one because, of course, capital gains accrue very unevenly across the population. The importance of equity in the introduction of the CGT in the UK is evident from the following statement by the Chancellor of the Exchequer (Mr. James Callaghan) in 1965:

First, I begin with tax reform. The failure to tax capital gains is widely regarded, outside as well as inside the Labour Party, as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage and salary earner. It has in the past been one of the barriers to the progress of an effective incomes policy, but now my right hon. Friend the First Secretary of State has carried this policy

⁵⁷ Simon James and Christopher Nobes, *The Economics of Taxation: Principles, Policy and Practice* (Fiscal Publications, 2015).

⁵⁸ Robert M Haig, 'The concept of income' in Robert M Haig (ed), *The Federal Income Tax* (Columbia University Press, 1921).

⁵⁹ Henry C Simons, *Personal Income Taxation* (University of Chicago Press, 1938).

⁶⁰ John R Hicks, *Value and Capital* (Oxford University Press, 1974).

forward to a point which many did not believe was possible six months ago. This new tax will provide a background of equity and fair play for his work.

Moreover, there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains. We shall only make headway against avoidance of this sort when capital gains are also taxed.⁶¹

So, in theory at least, the economic principles of efficiency and equity suggest there is a straightforward case for treating all capital gains as income but there is also the third criterion mentioned above of administrative considerations. Needless to say, there would be practical difficulties in taxing capital gains in precisely the same way as other income. The first and most obvious difficulty concerns capital gains which arise only through increases in the price level. Such nominal gains do not, of course, increase an individual's real spending power and should not in principle be counted as income.

A second problem is that, in theory, CGT should be levied on an accruals basis. In practice this would involve the valuation of capital assets for each tax year, so imposing a considerable administrative burden. It would also involve the risk that individuals might be forced to liquidate assets in order to pay the tax which might involve undesirable outcomes regarding business assets. In the UK, CGT avoids such problems because it is levied on a realisation basis. However, this also presents challenges. Taxpayers might find themselves 'locked in', in the sense they have an incentive to postpone payment of the tax by not realising the asset even when it might otherwise be economically efficient to do so. Also, because assets are realised in uneven lumps, it is difficult to make the tax progressive. This difficulty may be aggravated because capital gains, whether realised or not, may occur irregularly.

Valuation can also be a consideration. Even with the realisation basis, it is necessary to determine the value of the asset when acquired and when realised. This will often be a straightforward exercise—it will simply be the value agreed between third party buyers and sellers. For other transactions, such as the sale of an asset originally received by way of gift, determining the value of the asset (in this case when received) may be more difficult.

3.2 The United Kingdom experience

Although there had been previous attempts to tax certain types of capital gains, especially from land, the systematic taxation of gains did not begin until 1962. In that year a tax on short-term gains was introduced. In 1965 a more comprehensive CGT came into operation. The tax is levied on a wide range of assets, but there are several exemptions, including a taxpayer's only or main residence, motor vehicles and gambling winnings. The justification for exempting the last of these was that, as there is no capital asset, there cannot be a capital gain. There is also an individual annual allowance of £11,100 (in 2016–2017 this was approximately \$26,500 NZ dollars).

In its early years, CGT was subject to a separate rate of tax, which was 30 per cent from 1965 to 1988. However, the argument that capital gains are a form of income

⁶¹ HC Deb 06 April 1965 vol 710 c245 245 § The Chancellor of the Exchequer (Mr James Callaghan).

and should be taxed accordingly eventually prevailed. In his 1988 Budget speech the Chancellor of the Exchequer stated:

In principle, there is little economic difference between income and capital gains, and many people effectively have the option of choosing to a significant extent which to receive. And in so far as there is a difference, it is by no means clear why one should be taxed more heavily than the other. Taxing them at different rates distorts investment decisions and inevitably creates a major tax avoidance industry. Moreover, at present, with capital gains taxed at 30 per cent for everybody, higher rate taxpayers face a lower—sometimes much lower—rate of tax on gains than on investment income, while basic rate taxpayers face a higher rate of tax on gains than on income. This contrast is hard to justify.⁶²

From 1988/89 onwards the rates of CGT were brought into line with those of income tax so that CGT was charged at the taxpayer's highest income tax rate. Nevertheless capital gains were still treated more favourably than other forms of income. As Robinson pointed out, even after the 1988 reform, CGT was payable in arrears, deferred on gifts, gave relief on retirement and exemptions on death.⁶³ After years of criticism of the inequitable effects of inflation on capital gains the government brought in a system of indexation based on the Retail Prices Index. This 'indexation allowance' gave relief for inflation between 1982 and 1998. From 1998 taper relief was introduced which reduced the amount of the gain according to the length of time the asset had been owned.

However in 2008 both taper relief and indexation allowance were withdrawn and the rate of CGT was changed from a person's top rate of income tax to a flat rate of 18 per cent. There were both winners and losers as a result of this change and after strong lobbying an entrepreneurs' relief was also introduced in 2008. This applied where, subject to certain restrictions, all or part of a business is sold and can reduce the effective rate of tax on some gains to 10 per cent. In 2010 a new rate of 28 per cent was introduced for capital gains of individuals with total taxable gains and income which put them in the higher rate income tax band (currently 40 per cent). In the 2016 Budget, with effect from April 2016, the government announced the reduction of the CGT rates from 18% and 28% to 10% and 20% for chargeable gains, except for residential property (other than the main or sole residence) and alternative investments such as private equity and hedge funds. Outlining the rationale for the policy change, HM Revenue and Customs (HMRC) stated:

The government wants to create a strong enterprise and investment culture. Cutting the rates of CGT for most assets is intended to support companies to access the capital they need to expand and create jobs. Retaining the 28% and 18% rates for residential property is intended to provide an incentive for individuals to invest in companies over property.⁶⁴

⁶² Hansard, 15 March 1988, col. 1005.

⁶³ Bill Robinson, 'Reforming the taxation of capital gains, gifts and inheritances' (1989) 10 *Fiscal Studies* 32–40.

⁶⁴ HM Revenue and Customs, *Policy paper: Changes to Capital Gains Tax Rates* (16 March 2016) <<https://www.gov.uk/government/publications/changes-to-capital-gains-tax-rates/changes-to-capital-gains-tax-rates>>.

Capital gains accruing to incorporated companies are also taxed but by corporation tax on their gains rather than CGT.

Although there have been several different ways of taxing a chargeable gain, the calculation of the gain itself has remained much the same. As one might expect, this is basically the sale proceeds less the purchase cost. One way in which the gain may work out to be smaller than at first expected is due to the sensible treatment of expenses. Those paid at acquisition are added to the original costs; those paid at disposal are deducted from the proceeds.

4. LESSONS FROM THE UNITED KINGDOM

4.1 Labour's capital gains tax policy—an introduction

Not unexpectedly the purpose of Labour's CGT proposal is couched in somewhat political and populist rhetoric. For example, comments in the 2011 policy statement such as '[t]his tax switch is about creating a fairer tax system' echo Adam Smith's equity canon for a good income tax⁶⁵ and resonate with commentators,⁶⁶ and groups such as the OECD⁶⁷ who have long highlighted the inequity present in the NZ tax system absent a comprehensive CGT. As noted from the UK Chancellor of the Exchequer's speech (referred to in Section 3.1 of this paper), equity concerns were pivotal to the introduction of a CGT in the UK.⁶⁸

The 11-page 2014 policy statement contains detailed discussion of aspects of the design features of the proposed CGT. The realisation-based CGT would apply to a wide range of assets and be levied at a single rate of 15% and with no tax-free threshold. Personal assets, collectables, small business assets sold for retirement and payouts from retirement savings schemes would be exempt from the CGT. The CGT would apply to gains accrued after implementation, that is, from a specific valuation date. Capital gains on inheritance passed on after death would be rolled over to the heir and CGT would be payable when the asset is realised. Capital losses would be carried forward and offset against future capital gains. Individuals classified as dealers would continue to be subject to income tax on such gains at their marginal tax rates. An Expert Panel would be established to deal with technical issues. The 2014 policy statement estimated the CGT would raise an additional \$1.035 billion in tax revenue by 2020/21.⁶⁹

The design of a comprehensive CGT for NZ could essentially proceed along two lines (or a combination of the two). First, the CGT could be developed on the basis of the strict (or close) adherence to the Haig-Simons concept of income, levied on an accrual

⁶⁵ Labour Party, above n 47, 4.

⁶⁶ See, for example, Chris Evans and Cedric Sandford, 'Capital Gains Tax—The Unprincipled Tax?' [1999] 5 *British Tax Review* 387, 403.

⁶⁷ OECD, above n 21, 24.

⁶⁸ A number of NZ reviews have also noted the importance of equity: Taxation Review Committee, *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, Wellington, 1967) [983] and Task force on Tax Reform, *Report of the Task Force on Tax Reform* (Government Printer, Wellington, 1982) [10.22]. Further, the Victoria University of Wellington Tax Working Group (TWG) in 2010 identified 'equity and fairness' generally as the policy reasons behind moves to broaden NZ's tax base: Centre for Accounting, Governance and Taxation Research, above n 12, 19.

⁶⁹ Labour Party, above n 48, 2.

basis with few, if any exemptions.⁷⁰ This form of CGT has been rejected by various NZ committees, let alone other countries including the UK, as unworkable. Second, (and the approach favoured by the authors) is that it could be based on a pragmatic approach which, considering broader tax administration, tax policy and design principles, departs from the comprehensive concept of income. Compromise and trade-off will be required under such an approach but hopefully will lead to a tax that is politically sustainable. Such an approach is contrary to that adopted by the GST where the policy design strongly focussed on simplicity but will be necessary for the successful implementation of a CGT.⁷¹

Labour's policy has taken certain administrative issues into consideration. As noted, the CGT would be levied on a realisation basis and will thus avoid both the burden of valuing assets annually and the potentially negative cash flow impact on taxpayer's required to fund an accruals-based tax. The policy trade-off will be the potential 'lock-in' of assets. Further, the tax base is not indexed for inflation. In a period of low inflation, as is the modern experience of most developed countries including NZ, this makes sense and avoids the practical compliance issues for taxpayers of indexation (and the consequent administrative impacts). Indeed, the 2014 policy statement acknowledges that indexation has been abandoned in the CGT regimes the United Kingdom and Australia due to its practical difficulties.⁷²

To reiterate, the purpose of this paper is not to comprehensively compare and evaluate Labour's CGT proposal with that adopted by the UK. Rather it aims to illustrate the potential importance of tax administration considerations and the interaction with tax policy and tax principles. The following Table summarises key characteristics of the UK CGT with the Labour Party policy, a number of which will be discussed later in this section.

⁷⁰ See, for example, Burman and White, above n 26, 355. Therefore, '[f]rom a design perspective, there should be no exemptions as having exemptions means opportunities for manipulation of the regime': Shaleshni Sharma and Howard Davey, 'Characteristics of a Preferred Capital Gains Tax Regime in New Zealand' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 113, 125.

⁷¹ Jeff Todd, 'Implementing GST—Information, Education, Co-ordination' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers Ltd, 2007) 31.

⁷² Labour Party, above n 48, at 5. Evans and Sandford also argue against indexation on the basis it does not exist for capital or income and there is no need in a low inflation environment: Evans and Sandford, above n 66, 404.

Table 1: Summary of CGT characteristics UK vs NZ Labour Party Policy

	UK	NZ
Introduced (general)	1965	Proposed
Implementation	From 6 April 1965	From specific date ('valuation day').
Tax Base	Capital gains realised on disposal of capital assets.	Capital gains realised on disposal of capital assets.
Separate Tax or part of the income tax code?	Separate—under the Taxation of Chargeable Gains Act 1992. Taxpayer required to file "supplementary page" (Capital gains summary, SA108) with income tax return as part of self-assessment.	No information.
Distinction between long term and short term gains (including tapering relief)	No—taper relief ceased from 5 April 2008.	No information.
Tax Rates	There is a flat rate of 18% for basic rate income taxpayers on capital gains net of any losses. For additional and higher rate income taxpayers the rate is 28%. Trustees pay 28% on capital gains and 10% for sole traders or partnerships if the gains qualify for Entrepreneurs' Relief. Companies pay corporation tax at 20% on gains not CGT. ⁷³ From April 2016 the CGT rates reduce to 10% and 20% for chargeable gains, except for residential property (other than the main or sole residence) and alternative investments such as private equity and hedge funds.	Flat rate of 15% for individuals. Expert Panel to consider CGT application to other entities including companies and trusts.
Indexation of cost base	No indexation relief since 6 April 2008.	No
Tax-free threshold (for capital gains)	Annual at £11,100 (for 2015–2016 and 2016–2017). Trusts £5,550. Adjusted from time to time.	No
Capital losses 'ring-fenced'?	Yes—offset against current and future gains indefinitely.	Yes - offset against current and future CGT liability. Expert

⁷³ As a matter of tax policy, the capital gains of a corporation are subject to corporation tax in full.

	UK	NZ
	Can be carried backwards for gains at death.	Panel to consider upper limit for offset of losses.
Treatment of gains at death	No CGT but rollover provisions for heirs and taxable at market value on realisation.	No CGT but rollover provisions for heirs and taxable at market value on realisation.
Treatment of gifts	Gifts subject to CGT unless to spouse, partner, civil partner or charity.	Gifts subject to CGT. Rollover where assets transferred between a couple in relationship break-up.
Private residence exempt?	Yes	Yes
Personal property exempt?	Yes—CGT on disposal of personal possession for £6,000 or more (eg jewellery, paintings, antiques, coins and stamps, sets of things such as matching vases or chessmen). No CGT on motor vehicles unless used for business and anything with a limited lifespan, eg clocks, unless used for business.	Yes - personal property (eg, boats, furniture, electrical goods, household items) and ‘collectables’ (eg, jewellery, antiques, artwork, stamp collections).
Treatment of savings schemes	No CGT on shares or units held in NISAs (New ISAs), ISAs (Individual savings accounts) or pensions.	Expert Panel to consider taxation of KiwiSaver and Portfolio Entity (PIE) ⁷⁴ funds. Pay-outs from retirement savings schemes, such as KiwiSaver exempt.
Other exemptions	UK government gilts and Premium Bonds, compensation for damages for personal or professional injury, betting, lottery or pools winnings.	Lump sum compensation (eg, redundancy, ACC or court awards), life insurance policy surrendered or sold, winnings or losses from gambling, medals.
Business relief	Yes—provided under the Entrepreneurs’ Relief which allows for a lower rate of CGT (10%) to be paid by people who have been with and employed by a trading company for more than a year and have at least a 5% shareholding. Claims may be made on more than one	Yes – gains up to a maximum of NZ\$250,000 for small business assets sold for retirement, where the owner is over a certain age (eg, 55) and has owned the business for 15 years and has been working in the business. Other rollovers not detailed – rollover where taxpayer disposes of one asset and replaces with a

⁷⁴ At present where a PIE has portfolio investment (that is, less than 10 per cent interest) in offshore companies the methods specified under the foreign investment fund (FIF) rules (such as comparative value) tax unrealised gains. The Expert Panel would need to grapple with integrating a realised CGT with the taxation of (unrealised) FIF income, with the attendant administrative and compliance issues this would raise. Investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange are exempt from the FIF rules.

	UK	NZ
	occasion up to a ‘lifetime’ total of £10 million. Business Asset Rollover Relief – allows deferral of CGT if carrying on business and new business assets acquired within 3 years of disposal of old assets. Gift Hold-Over relief – no CGT where business assets are given away or sold for less than they are worth.	similar asset suggested in Labour policy statement.
CGT apply to non-residents?	Only on gains on sale of UK residential property made after 5 April 2015 (unless private residence exemption applies).	Yes – Expert Panel to consider details.
Persons migrating from the subject country	No deemed disposal on leaving the UK. No CGT charge unless legislation deems the departure to be an event giving rise to a deemed disposal.	Subject to CGT with the exception of land, buildings and business assets.

The remainder of this section critiques several key aspects of the design of Labour’s CGT with the UK experience, using a very ‘pragmatic’ approach. Due to limitations of space other aspects of CGT design pertinent to NZ, such as whether the tax is a separate tax with separate tax returns or is included in the income tax return, are not considered. Following the lead of Labour’s policy statements, this paper focusses on the application of the CGT to individuals and not entities.

4.2 Who pays the tax?

Echoing Sir Thomas White’s observation in Section 1 of this paper, Sharma and Davey in their NZ survey similarly observe: ‘[o]ne of the major challenges identified by 50 per cent of the participants is the negative public perception of CGT. Participants argued that people do not like to pay tax and CGT is another form of taxation’.⁷⁵ This emphasises the importance of the political sustainability of the tax. The 2014 policy statement estimates, based on Australia’s experience, that the CGT would impact in any one year on less than 10 per cent of taxpayers, or approximately 267,000 people, that is, ‘the few’.⁷⁶ At the outset of any future debate on a CGT in NZ, to ensure (ongoing) public support for a CGT, policy makers therefore need to clearly articulate the limited impact of the CGT. A full analysis should include the likely incidence of the tax rather than simply who ‘hands over the money’.

The inclusion of a tax-free threshold, as adopted in the UK, would further reduce the number of taxpayers subject to the tax, thus increasing its support (by ‘the many’). Support for a tax-free threshold (of \$10,000) was provided by interviewees in Sharma

⁷⁵ Sharma and Davey, above n 70, 132.

⁷⁶ Labour Party, above n 48, 2.

and Davey's NZ study.⁷⁷ There are two very practical tax administration impacts from the introduction of a tax-free threshold. First, it 'has the advantage of significantly reducing the operating ... costs related to the CGT, by eliminating the 'minnows and tiddlers' from the CGT net, without impugning the overall integrity of the regime'.⁷⁸ However, as previously indicated, this 'advantage' is actually a double-edged sword. From the perspective of the revenue authority it allows it to focus its activities on audit. As far as taxpayers are concerned, while it reduces the number of taxpayers subject to the tax, some taxpayers will still need to calculate the amount of any gain to determine whether the tax-free threshold applies. As noted in Section 1, for some taxpayers this will be straightforward, while for others it will be a time-consuming exercise. In the UK, for most taxpayers this is simply not an issue as they have no significant relevant capital gains.

The second tax administration impact of a tax-free threshold arises from the fact that in NZ individuals who are classified as a 'non-filing taxpayer' are currently not required to file a tax return. Typically such a person has all their annual gross income taxed at source and any interest or dividends will have resident withholding tax (RWT) deducted. The implementation of Labour's CGT (or an equivalent) would see this group required to file a tax return upon making a capital gain with the consequent costs this would entail. A tax-free threshold would ensure this group—to the extent they only make small capital gains—will retain their non-filing status. This has the advantage of reducing both compliance and administrative costs. On this point it should be noted that the NZ Inland Revenue (IR) has embarked on the 'Business Transformation programme'. This is a multi-year, multi-stage change programme seeks to 'modernise New Zealand's tax service to make it simpler and faster for New Zealanders to pay their taxes and give more certainty that they'll receive their entitlements'.⁷⁹ This programme is certain to have an impact on the 'non-filing taxpayer' category and their interaction with IR in the future.

It is important to note at this point that a tax-free threshold would not encourage economic efficiency as capital gains could still be favoured over income gains. As a general observation, economic efficiency can be more complicated if there are market imperfections to consider, in which case tax should not necessarily apply equally everywhere. Regarding thresholds the point is that there are trade-offs between economic efficiency in its pure form and other considerations. It may be preferable to have a CGT with a tax-free threshold (despite its compliance impact for some taxpayers) rather than no CGT because the lack of a tax-free threshold made it politically unacceptable—a point made by the TWG. In terms of economic efficiency, the tax-free threshold should apply to the net not the gross proceeds. Otherwise, for example, someone could be liable to CGT if their gross gains exceeded the threshold even if their net gains were below it or even negative as a result of capital losses elsewhere.

Finally, from the perspective of tax principles (equity) and political sustainability, a tax-free threshold could positively impact perceptions of greater progressivity,

⁷⁷ Sharma and Davey, above n 70,129.

⁷⁸ Evans and Sandford, above n 66, 404.

⁷⁹ Inland Revenue, *Business Transformation: About Business Transformation* (25 February 2015) <<http://www.ird.govt.nz/transformation/about-business-transformation/about-business-transformation-index.html>>.

especially if adopted in conjunction with a second, higher tax rate for capital gains above a specified threshold, as adopted in the UK (see Section 4.3).

4.3 Introducing progressivity

As outlined in Section 2.2, Labour proposes imposing a CGT at the flat rate of 15 percent on the net gain made by individuals. This rate compares with individual income tax rates on ordinary income in NZ which range from 10.5 per cent to 33 per cent⁸⁰ and ‘makes some allowance for the effect of inflation’.⁸¹ It also reflects that there is ‘often some risk associated with investment for capital gains as opposed to other investments.’⁸² The low CGT rate would reduce the risk of taxpayers holding onto assets, that is, ‘lock-in’ effects referred to above.⁸³

The UK, by way of contrast, taxes capital gains at one of three CGT rates.⁸⁴ Capital gains up to £11,100 are exempt from CGT. Prior to April 2016, individuals deriving gains above that threshold are subject to CGT at the flat rate of 18 per cent, or 28 per cent for individuals earning more than the income tax band of £31,785 (2015–2016 tax year) and £32,000 (2016–2017 tax year).⁸⁵ As noted in Section 3.2, as a tax policy measure CGT rates reduced to 10 per cent and 20 per cent for chargeable gains from April 2016. The previous, higher rates (18 per cent and 28 per cent) still apply to sales of residential property (other than the main or sole residence) and certain alternative investments. The three rate structure (plus the differential for owners of multiple residential properties) introduces progression into the CGT system, particularly incorporating elements of vertical equity. It is interesting to note that the UK has twice moved away from a flat CGT rate, in 1988 and 2010.

In the NZ context while the flat CGT rate proposed by Labour is lower than the tax rates on ordinary income, a situation which would not normally be viewed as increasing progressivity and meeting the principle of (vertical) equity, since NZ

⁸⁰ The NZ income tax rates for individuals are:

<i>Income bracket</i>	<i>Tax rate</i>
\$0–\$14,000	10.5 per cent
\$14,001–\$48,000	17.5 per cent
\$48,001–\$70,000	30.0 per cent
\$70,001 and over	33.0 per cent

⁸¹ Labour Party, above n 48, 5.

⁸² Ibid.

⁸³ Ibid.

⁸⁴ In fact, if the Entrepreneurs Relief, with a tax rate of 10% (see Section 4.7 of this paper), is included, there are in fact four CGT rates.

⁸⁵ The UK income tax rates for individuals for 2015/16 (2016–2017 in brackets) are:

<i>Income bracket</i>	<i>Tax rate</i>
£0–£31,785 (£0–£32,000)	20 per cent
£31,786–£150,000 (£32,001–£150,000)	40 per cent
Over £150,000	45 per cent

In addition, there is a personal allowance of £10,600 and £11,000 for 2015–2016 and 2016–2017, respectively.

presently does not tax capital gains, this is a move toward vertical equity.⁸⁶ However, equity concerns remain. While there is clear rationale for the 15 per cent CGT rate, the low rate ‘negates many of the benefits of introducing the tax’.⁸⁷ The reality is that as it is lower than three of the present four tax brackets for individual taxpayers—in fact, half or less than the top two rates—an arbitrage opportunity will exist between income from capital and income from labour. This will lead to horizontal inequity and impact on the administration of the tax. The difficulties that exist in differentiating between income and capital in the current NZ tax system absent a CGT ‘will continue to be perpetuated despite the introduction of a CGT’⁸⁸ under Labour’s proposal. In addition, on the basis that capital gains tend to be derived by higher wealth individuals, the effective concessional tax rate for capital gains will benefit that group more.

In terms of tax design, these equity concerns could be addressed to a degree in NZ through the adoption of a more progressive CGT scale as utilised in the UK. This could be achieved through the adoption of two measures, the first, discussed in Section 4.2 of this paper, is the introduction of a tax-free threshold. The second measure would incorporate into the CGT regime at least one additional tax rate for capital gains above a certain level. As a variation of this, to further address issues of equity, a higher rate(s) could apply to owners of multiple residential properties—the approach recently adopted in the UK for tax policy reasons.

Introducing differential CGT rates, based on the level of capital income and/or number of properties, will have trade-offs. While it focusses on the tax principle of equity, the complexity of the CGT will increase which will impact on the administration of the CGT, particularly for taxpayers in determining their actual CGT liability. Tax returns and the tax system would need to accommodate any such measures (including the need for potential audit activities). To avoid imposing such levels of complexity capital gains could be treated as ordinary income subject to the existing individual income tax rates. In addition, rather than, for example differential rates for multiple properties, capital gains could potentially be taxed at varying percentages to reflect factors such as risk, inflation and the number of properties. An integrated system would have tax administration savings in terms of tax returns and the tax system. However, as NZ does not have a tax-free threshold for ordinary income, unlike Australia for example, under this approach all capital gains would be subject to tax (unless a specific zero-rate was implemented) which would significantly impact on the administration of the income tax (for example, for those currently classified as non-filing) and the political sustainability of the CGT. If such an approach also included the application of varying percentages to reflect the factors mentioned such as risk, this would introduce further complexity into the determination of a taxpayer’s CGT liability and underline the administrative benefits of integrating the CGT with income tax.

⁸⁶ This impact on progressivity is acknowledged by the New Zealand Treasury in July 2013 who observed that a CGT could have (positive) implications for both horizontal and vertical equity; with respect to the latter probably making the tax system more progressive: The Treasury, *Affording Our Future—Statement on New Zealand’s Long-Term Fiscal Position* (Wellington, July 2013) 27 <<http://www.treasury.govt.nz/government/longterm/fiscalposition/2013/affordingourfuture/lfts-13-aof.pdf>>.

⁸⁷ Cassidy and Alley, above n 32, 120.

⁸⁸ Ibid.

As a consequence, and as indicated in Section 4.2, the authors favour a separate CGT with a tax-free threshold. This will ensure a level of progressivity with the CGT. Multiple CGT rates could also be introduced depending on the strength of the equity concerns to be addressed by the CGT. However, in addition to the complexity and tax administration issues noted above, differential rates could also encourage manipulation to avoid the higher rate(s). Therefore any decision to include more than one CGT rate will require careful consideration.

4.4 Tax appeasement—the main residence exemption

In line with the UK (and other CGT regimes), Labour's 2014 policy statement provides an unlimited exemption for the main residence. This tax policy measure reflects overseas experiences that suggest 'an exemption for the primary residence is needed in order to garner support and make the introduction of a CGT politically palatable'.⁸⁹ Holiday homes would be included as part of the CGT regime (except where passed down from one generation to another) as to exempt them would lead to loopholes, as well as definitional and administrative issues.⁹⁰ Where the main residence was also used for business purposes, there would be a partial exemption from the CGT for that portion of the property used as the family home.⁹¹ Similarly, in respect of farms, the primary farm residence and surrounding land used for domestic purposes (the curtilage) would be exempt from CGT⁹² while the land used in the farming business would be subject to the tax.

The exemption of the primary residence is contrary to the comprehensive concept of income and reduces the revenue to be raised from the tax.⁹³ Huang and Elliffe note that the unlimited (in terms of dollar amount) exemption in Australia 'has caused significant loss to the CGT base'.⁹⁴ Whether such an exemption is included in a future NZ CGT requires a consideration of, and trade-off, between tax principles and tax administration. The unlimited exemption would advantage wealthier taxpayers who typically own more expensive homes, hence having a negative impact on equity. In addition, it could be economically inefficient by favouring investment in private residences over other investments. If the focus is on addressing concerns over tax principles (that is, equity and economic efficiency) there are three alternative approaches to implementing an unlimited exemption for the main residence. The first approach would be to have no exemption at all—a politically unpalatable approach. The second approach, a variation of which was practised by the US prior to the enactment of the current exemption in 1997, is the deferral of the gain where the proceeds (up to the amount of the gain) are rolled over into the acquisition of a new

⁸⁹ Jacob Spoonley, 'A Sanctuary from the Taxman? The Design of the Primary residence Exemption' (2015) 21 *New Zealand Journal of Taxation of Law and Policy* 69.

⁹⁰ Labour Party, above n 48, 7.

⁹¹ Ibid 8.

⁹² Ibid 7.

⁹³ Estimates are that owner occupied housing accounts for two-thirds of the property market: Rob Hosking, 'Officials raise land tax idea again', *The National Business Review* (online), 10 December 2012. Shewan has estimated that the revenue from a CGT in NZ would drop from \$8.89 billion annually to \$4.54 billion annually if owner-occupied housing was excluded: Shewan, at slide 6, as cited in Spoonley, above n 89, 86.

⁹⁴ See Peter Abelson and Roselyne Joyeux, 'Price and Efficiency Effects of Taxes and Subsidies for Australian Housing' (2007) 26 *Economic Papers: A Journal of Applied Economics and Policy* 147, 150, as cited in Huang and Elliffe, above n 32, 296.

main residence.⁹⁵ In the US context, the deferral was only available where a new residence of equal or greater value was acquired. As a result the deferral was criticised on the basis that, as it locked-in taxpayers, it was a significant barrier to mobility.⁹⁶ It accordingly caused distortions in a homeowner's purchasing decisions, including the elderly, and thus violated the principle of economic efficiency.⁹⁷ The issues referred to in the US context (such as lock-in and economic inefficiency) would still arise in the absence of any restrictions on the value of the newly acquired residence (although perhaps be less pronounced), for example where, as noted by Spoonley above, a taxpayer wishes to no longer own a home but intends to rent. The third option to address concerns over tax principles would be to limit the exemption to a specific amount with gains above that predetermined threshold subject to CGT. This latter approach has been adopted in the US⁹⁸ and more recently South Africa.⁹⁹ Spoonley notes that a limited exemption 'provides a significant opportunity to contribute greater vertical equity and progressivity'.¹⁰⁰ Against this, there is the need to address administrative considerations. A CGT is complex. A minimum exempt threshold or rollover option would add a further layer of complexity and consequent additional costs, both of a compliance and administrative nature. By contrast, a blanket exemption reduces the required audit focus of the revenue authority and tax compliance required of taxpayers. On the basis of tax administration savings, and to ensure electorate support (political sustainability), despite the impact on equity and economic efficiency, an uncapped exemption for the main residence (as adopted in the UK) may be preferable.

⁹⁵ This approach is currently used in Sweden for example: PWC Sweden *Individual—Income Determination* (23 August 2016) <<http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Sweden-Individual-Income-determination>>.

⁹⁶ Spoonley, above n 89, 87. In this respect, Spoonley notes for example that CGT would arise on the difference in the cost of housing "where a taxpayer wanted to downsize from owning a home to renting, or if they were required (due to employment or personal circumstances) to move to another part of the country that had lower house prices.": *ibid* 88.

⁹⁷ "Since homeowners could not downsize their housing as family sizes decreased, the rollover provision often forced them to purchase larger and more expensive homes than needed": Pete H Oppenheimer 'The Taxpayer Relief Act of 1997 and the Housing Boom of the 21st Century' (2014) 16 *Journal of Applied Business and Economics* 112, 113.

⁹⁸ In the United States, a person's main personal resident is not excluded from capital gain treatment, but there is a USD 500,000 exemption (for married filing jointly and USD 250,000 for single taxpayers), subject to certain conditions including living in the home for a specified period: Spoonley, above n 89, 76. This capped threshold was introduced, at this level in 1997 and has not increased. When enacted it was generous, being 'set well above the median house price at the time': *ibid*.

⁹⁹ South Africa's regime exempts gains on primary residences up to ZAR 1.5 million: Huang and Elliffe, above n 32, 296. At the time of writing, ZAR 1.5 million is equivalent to NZD 141,402 (23 May 2016). Alternatively, CGT could be deferred through roll-over: Evans and Sandford, above n 66, 404. In reality, Spoonley concludes that from a tax design perspective horizontal equity improvements from a capped exemption are 'only small': Spoonley, above n 89, 74. Spoonley also cites Jane G Granville and Pamela J Jackson, 'The Exclusion of Capital Gains for Owner-Occupied Housing' (RL32978, Congressional Research Service, 26 December 2007) 7, who acknowledge that in the US the capped exemption 'has not reconciled inequities between homeowners with different job circumstances, between those who live in different parts of the country, and between those with different health needs'. They do note, with the exception of regional-based inequities, allowances for certain taxpayers can address inequities related to job and health circumstances: Spoonley, above n 89, 7.

¹⁰⁰ Spoonley, above n 89, 74. In support, Spoonley cites for example Richard Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for the Institute of Policy Studies, 1990) 93.

4.5 Attracting tax investment or tax preference—residential property and non-residents

Labour's 2014 policy statement provides that, in principle, non-residents will be subject to the CGT in the same way as NZ resident taxpayers.¹⁰¹ Elliffe¹⁰² observes that 'many other countries do not tax non-residents on the sale of personal property and, in particular, shares in companies resident in their country, where the income could be said to have a source in their jurisdiction'.¹⁰³ The issue from a tax policy perspective with a non-comprehensive CGT regime is that it could give foreigners a tax advantage that cannot be enjoyed by NZ residents.¹⁰⁴ However, the argued benefit for countries such as Australia, which have narrowed the range of assets for which a non-resident may be subject to CGT, is to enhance the status of that country as an attractive place for investment and business.¹⁰⁵ This is a difficult policy issue.

The CGT in the UK does not generally apply to non-residents. However, recent changes in this respect in the UK may be instructive from a design perspective. As a result of legislative amendments, UK residential property disposals by UK non-resident individuals may be subject to CGT on any gains made on disposals made after 5 April 2015. A non-resident will pay CGT on the gain from the sale of a UK residential property that is not their main home, or their main home if it is let out, if they have used it for business, had long periods of absence or the home is very large. The measure will increase compliance and administrative costs, however, in this case tax principles and policy have trumped tax administration impacts. The HM Treasury Autumn Statement 2013¹⁰⁶ announcing this extension of the CGT stated that, *inter alia*, the change was to 'ensure that those with the most in society make a *fair contribution*',¹⁰⁷ a reference to equity. Related to this, and reflecting policy concerns, it was also reported that the measure was aimed at curbing soaring house prices¹⁰⁸ which impacts greatest on lower-income and first-home buyers. In addition, from a broader tax policy perspective the change 'is intended to harmonise the UK system with other jurisdictions that charge tax on the basis of where the property is located rather than where the owner is resident'. This change to the taxation of real property owned by non-residents will broadly align the UK position with to the US, South Africa and Canada.¹⁰⁹

New Zealand house prices (particularly in Auckland)¹¹⁰ have grown strongly in recent years. Among the reasons cited include the impact of speculators, investors and

¹⁰¹ Labour Party, above n 48, 11.

¹⁰² Craig Elliffe, 'Key Issues in the Design of Capital Gains Tax Regimes: Taxing Non-Residents' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 90.

¹⁰³ *Ibid* 93.

¹⁰⁴ *Ibid*.

¹⁰⁵ *Ibid* 94.

¹⁰⁶ HM Treasury, *Autumn Statement 2013* (HM Treasury, United Kingdom, December 2013) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_Statement_2013.pdf>.

¹⁰⁷ *Ibid* 9. Emphasis added

¹⁰⁸ 'Britain to tax foreign property investors from 2015—Osborne', *Reuters.com* (online), 5 December 2013.

¹⁰⁹ Elliffe, above n 102, 94.

¹¹⁰ Suze Metherell, 'House Prices Rise at Fastest Pace in Nine Years', *NBR* (online), 3 November 2015 <http://www.nbr.co.nz/article/house-prices-rise-fastest-pace-9-years-b-181041?utm_source=newsletter&utm_medium=email&utm_campaign=NBR%2520Property%2520-%25207-Day%2520Wrap>.

foreign investors in the market.¹¹¹ From a tax policy perspective, measures such as those introduced into the UK with respect to non-resident property owners would sit well in the NZ context in terms of the political viability of the CGT given housing affordability issues and broader equity concerns. However, the benefit of this measure, at least in the NZ context, may primarily be symbolic as the impact foreign speculators have had on house prices compared with, for example, lack of supply and increasing immigration into NZ, is unclear.¹¹²

4.6 Compliance and administrative cost minimisation—personal use property

The Labour Party proposal would entirely exempt items such as boats, furniture, electrical goods and household items (termed ‘personal property’)¹¹³ along with ‘luxury’ items such as ‘the millionaire’s super yacht’.¹¹⁴ The policy rationale for this exemption is that such assets (especially luxury items) tend to depreciate over time and to levy the CGT on such items would provide a tax incentive due to the ability to write off capital losses (against capital gains).¹¹⁵

‘Collectables’ such as jewellery, antiques, artwork, rare folios or stamp collections would also be exempt unless the person is a trader.¹¹⁶ Taxpayers who regularly trade in these items (and personal property)¹¹⁷ would continue to be assessed on their profits as ordinary income under existing sections in the *Income Tax Act 2007*.¹¹⁸

The exemption for collectables makes sense from a tax administration perspective. First, a CGT on these items would be intrusive (and lead to resentment among taxpayers at the invasion of their privacy). Second, it would result in high compliance costs and administrative costs and, finally it would not raise significant revenue (especially when compared with the related compliance and administrative costs).

However, the exemption also needs to be considered in the light of good tax policy design as the likely behavioural response of taxpayers will be to invest in these types of assets. Collectables, such as artworks and antiques, tend to be owned by higher wealth individuals and appreciate in value. Labour’s policy, in this respect, is therefore contrary to its overall objectives for implementing the tax—‘creating a fairer tax system’¹¹⁹—as essentially it provides a tax break for (generally higher wealth) owners of these assets. The broader question that also needs to be answered is

¹¹¹ ‘Tighter Rules on Residential Property Investors and Overseas Buyers’, *The National Business Review* (online), 17 May 2015 <<http://www.stuff.co.nz/business/68612603/tighter-rules-on-residential-property-investors-and-overseas-buyers>>.

¹¹² New disclosure requirements apply to foreign purchasers of residential properties in NZ from 1 October 2015. Data released by Land Information New Zealand shows that 3 per cent of houses sold between January and March 2016 went to people who were not NZ citizens, or holders of a residency, student or work visa. The data is limited both in terms of the period covered and limitations of the disclosure rules, Isaac Davison, ‘The Truth About Foreign Buyers’, *The New Zealand Herald* (online), 10 May 2016 <http://m.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11636711>.

¹¹³ Labour Party, above n 48, 6.

¹¹⁴ Ibid 4.

¹¹⁵ Ibid.

¹¹⁶ Ibid 4, 6.

¹¹⁷ Ibid. Transactions in respect of land are covered by a separate suite of sections in the *Income Tax Act 2007*, ss CB 6A – CB 23.

¹¹⁸ See, for example, s CB 5 of the *Income Tax Act 2007* (NZ).

¹¹⁹ Labour Party, above n 47, 4.

whether investment in such collectables is to be encouraged. As a tax policy consideration, arguably these are generally not the types of assets that a nation wants to incentivise investing in; instead, tax policy should focus investment into productive sectors of the economy, encourage investment and innovation as well as the creation of jobs. One of the key reasons a CGT is promoted by Labour (along with some commentators) is that it ‘will help shift the focus of investment from speculation on property to the productive export sector’.¹²⁰ The exemption of collectables is clearly contrary to that policy and will not improve economic efficiency but lead to further investment in non-productive assets. This approach is also a departure to the general NZ approach to tax policy which aims to take tax ‘out of the equation’ and ensure it is not a disincentive to investment.

The UK has adopted a more restrictive approach, in particular with what equate to ‘collectables’ under Labour’s 2014 policy statement. Individuals are liable to CGT if their gain on sale of a personal possession is £6,000 or more. Personal possessions include jewellery, paintings, antiques, coins and stamps and sets of things, for example, matching vases or chessmen. There is no CGT on a car (unless it has been used for business) or anything with a limited lifespan, for example, clocks, unless used for business. An individual is exempt from paying CGT on the first £6,000 of their share if they own a personal possession with other individuals. The inclusion of an exempt threshold has three benefits. First, as a matter of tax principle, taxing gains over a certain level maintains a measure of progressivity with the CGT system for this class of asset. Second, reflecting political realities, it recognises that a wide range of individuals may ultimately own these assets, perhaps through obtaining by inheritance, including those on lower incomes. Third, from a tax administration perspective the threshold eliminates the potential compliance and administrative costs for smaller transactions. However, as already noted the inclusion of a tax-free threshold will require some taxpayers to determine whether they satisfy the particular concession, potentially imposing compliance costs on these taxpayers.

In terms of tax principles, if any future CGT in NZ is to encourage greater equity and economic efficiency in the tax system, it should apply to collectables. As mentioned, this would make the CGT more progressive as these assets tend to be owned by wealthy individuals. To ease tax administration issues, smaller gains could be excluded either by a targeted threshold as in the UK or to the extent any gains come within the general tax-free threshold (assuming one exists, as discussed in Section 4.2 of this paper). However, this overall approach will also have negative implications for tax administration. Taxpayers buying and selling collectables will be incentivised to adopt the position that they are not dealing and are therefore subject to the CGT (including any exempt threshold) and not income tax. While a similar incentive presently exists and there is case law which considers the characteristics of a dealer, the boundary (of who a dealer is) will come under greater pressure with the consequent effect on the administration of the tax by Inland Revenue.¹²¹ The same incentive arises in respect of gains from the sale of personal property outside the collectable (and personal use) category except where a loss arises, in which case a taxpayer would want to adopt the converse position (and offset the loss against ordinary income). The incentive to undertake such positions will negatively impact on

¹²⁰ Ibid 15.

¹²¹ Maples, above n 23, 161.

the administration of the tax. Despite this a UK approach to ‘collectables’ can be justified when the focus is on tax policy and tax principles.

An alternative approach to address the concerns over determining who is (or is not) a dealer, would be to treat all gains from the disposal of personal property as ordinary income subject to income tax. While this would remove the boundary issues referred to above, and therefore positively impact on one aspect of the administration of the tax, in the absence of a tax-free threshold for ordinary income, this treatment would also impose compliance costs on taxpayers deriving small gains and administrative costs for Inland Revenue. This, in turn, would undermine the political sustainability of any such measure.

4.7 ‘Remember the little fella’—business concessions

The 2014 policy statement proposes the exemption of ‘[s]mall business assets, up to a maximum of \$250,000, sold for retirement, where the owner is above a certain age (e.g. 55) has held the business for 15 years and has been working in the business’.¹²² The term ‘small business’ is not defined. This and other details would be considered by the Expert Panel in consultation with the small business community.¹²³ The concession would also apply to the sale of farming businesses.

From a tax administration perspective any such exemption has the potential to create additional complexity, irrespective of how the term ‘small business’ (or equivalent) is defined and will lead to taxpayers attempting to structure into the provision. A specific anti-avoidance provision would be required to prevent this. This in turn would impact on tax compliance and administrative costs. In addition, any threshold would require monitoring by future governments to ensure it retains its currency and the policy goals of the concession continue to be met.

Labour justifies the exemption on the basis that it ‘means that those who have saved through investing in a small business will not be negatively disadvantaged’.¹²⁴ The argument goes that for many of these enterprises the owner’s resources are invested in the business and thus it is their de facto retirement savings vehicle. Further, it is unlikely that they will have made separate provision for retirement via a savings scheme. While as a part of good tax policy the CGT should not penalise investment generally and, specifically those making provision for their retirement through running a small-to-medium enterprise (SME) should not be disadvantaged, this exemption in fact favours this form of retirement saving and has negative implications for equity and efficiency. New Zealand taxes savings on a ‘taxed-taxed-exempt’ (TTE) basis (on accrual). This means that contributions are made out of after-tax income, any gains are taxed at the time they are earned, and all withdrawals are tax-free. To the extent that the gain from a business is exempt from the CGT, it can be seen as being treated on an exempt-exempt-exempt (EEE) basis as the expenditure to develop and to grow the business is typically deductible. Evans and Sandford argue in support of relief from CGT for disposal of a business or its assets to fund retirement ‘*assuming* that concessional tax treatment is also available to other taxpayers who save—voluntarily

¹²² Labour Party, above n 48, 6.

¹²³ Ibid 7.

¹²⁴ Ibid 6.

or forcibly—to fund their retirement, and subject to the caveat that the CGT-free business disposals be integrated with the superannuation/pensions system’.¹²⁵

Due to these equity and efficiency issues, in the absence of such concessional tax treatment being extended to other forms of saving, the principal justification for Labour’s small business concession is political sustainability recognising the reality that NZ is a nation of small businesses. It is estimated that there are 460,000 SMEs in NZ.¹²⁶ SMEs make up about 97 per cent of businesses in NZ, and almost 70 per cent of them are single-worker businesses. Support for a CGT among businesses has been far from universal with one poll suggesting that ‘60 per cent of small and medium-sized business owners are negative about the Labour Party’s [2014] capital gains tax’.¹²⁷ Policies which recognise these political realities will be important for the support for, and success of, any CGT proposal in NZ. There are also tax policy grounds to support this concession. In addition, on the basis that SMEs face high (regressive) tax compliance costs,¹²⁸ there are tax policy arguments in support of any measures that can address or minimise any such costs for SMEs.

Labour’s small business exemption raises two issues, assuming that the decision is made to proceed with it.¹²⁹ First, given the objective of political sustainability and therefore to limit the inevitable lobbying over the level of the exempt threshold, should the exempt amount be higher? Second, does the exemption need to be extended, for example, should other forms of (small) business relief be considered to encourage investment and innovation?

The UK has adopted a broader set of business concessions, largely for reasons of political sustainability. As a general observation, the relief available is not limited to retirement and includes the following. First, the Entrepreneurs’ Relief allows for a lower rate of CGT (10 per cent) to be paid on gains arising from the sale of certain business assets by individuals who have been with and employed by a trading company for more than a year and have at least a 5 per cent shareholding. Claims may be made on more than one occasion up to a ‘lifetime’ total of £10 million.¹³⁰ In addition, Business Asset Rollover Relief allows for the deferral of CGT on sale of a business asset if a person is carrying on a business and new business assets are

¹²⁵ Evans and Sandford, above n 66, 405.

¹²⁶ ‘SMEs Still Backbone of NZ Business’, *Stuff* (online), 25 June 2014 <<http://www.stuff.co.nz/business/small-business/10198006/smes-still-backbone-of-nz-business>>.

¹²⁷ ‘Small Business Owners Negative On Capital Gains Tax survey’, *The New Zealand Herald* (online), 5 September 2014) <http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11319576>.

¹²⁸ Chris Evans and Binh Tran-Nam, ‘Tax Compliance costs in New Zealand: An International Comparative Evaluation’ *Tax Administration for the 21st Century Working Papers* (Victoria University of Wellington, 2014), 14, 28.

¹²⁹ Interestingly, 67.5 per cent of those interviewed by Sharma and Davey did not advocate exemptions for small or new businesses in NZ on the basis such an exemption could be manipulated: Sharma and Davey, above n 70, 129. In addition, the interviewees ‘argued that the size of the business is irrelevant to the imposition of and liability to pay CGT; otherwise, the effects of CGT are watered down which defeats the purpose of having CGT in the first place’: *ibid*.

¹³⁰ HM Revenue and Customs, *Guidance: HS275 Entrepreneurs’ Relief* (2015) <<https://www.gov.uk/government/publications/entrepreneurs-relief-hs275-self-assessment-helpsheet/hs275-entrepreneurs-relief-2015>>. The 2016 Budget made a number of changes to the relief, such as extending it to long-term investors: HM Revenue and Customs, *Personal Tax—Policy Paper Capital Gains Tax: Entrepreneurs’ Relief: Extension to Long-term Investors* (16 March 2016) <<https://www.gov.uk/government/publications/capital-gains-tax-entrepreneurs-relief-extension-to-long-term-investors>>.

acquired within 3 years of the disposal of the original assets. Further, under the Gift Hold-Over relief, no CGT arises where business assets are given away or sold for less than they are worth.

Evans and Sandford argue on equitable grounds that rollover ‘provisions need to exist where involuntary disposals occur (compulsory acquisitions, corporate takeovers and mergers, destruction of assets through natural disasters, etc)’.¹³¹ Similarly, on efficiency grounds they argue ‘for deferral of the capital gain where taxpayers are rolling the proceeds of the disposal of one asset into a bigger asset, in order to grow a business’.¹³²

Aside from Evans and Sandford’s arguments in favour of the very specific concessions referred to above, based on equity and efficiency considerations, broader business concessions than those proposed by Labour, potentially modelled on the UK concessions, are warranted on the basis of political sustainability. However, even here the grounds for special treatment come with a ‘health warning’. Quintal, Snell and Chan sound a cautionary note in respect of rollover relief for reinvestment: ‘the extent to which investment, entrepreneurship and divestment should be encouraged appears something of a political football. That leads to a shifting, overlapping and poorly enforced range of reliefs and concessions’.¹³³ Further, any such concessions will also need to acknowledge that there will be a trade-off in the form of tax administration impacts. Cassidy and Alley argue that rollovers and exemptions generally ‘necessitate the introduction of anti-avoidance measures which add to complexity of the provisions’.¹³⁴

5. CONCLUSION

Tax administration covers a range of aspects of taxation and includes the development and formulation of tax policy in relation to tax legislation. As noted at the commencement of this paper, in developing tax design, tax principles are a valuable guide. However, the optimal outcome may require modification in the light of tax policy and the reality of tax administration. In addition to these three dimensions of tax reform, it is also important that any tax reform is politically sustainable.

The overarching policy underpinning the design of the NZ tax system is that it should have a broad-base, low rate tax structure. In practice this means a focus on the principles of simplicity and convenience—New Zealand’s very successful GST is a good example of this policy. In an ideal world the design of a CGT should complement the BBLR approach. However, the long-standing antipathy against a CGT means that policymakers will need to address key electorate concerns for a CGT to be politically sustainable in NZ, both prior to and after its implementation. As posited in Section 2.0 of this paper, the lack of consideration of tax administration aspects of a possible CGT in the various reports and Labour’s policy statements may go some way to explain the hostility to the tax. Therefore in designing a future CGT policymakers will need to balance good tax design principles with tax administration considerations. This will be a challenge. At a practical level a departure from the

¹³¹ Evans and Sandford, above n 66, 404.

¹³² Ibid.

¹³³ Quintal, Snell and Chan, above n 15, 19.

¹³⁴ Cassidy and Alley, above n 32, 99.

BBLR and its consequential focus on simplicity and broad coverage will therefore be required. It is clear from a consideration of the UK CGT regime that it introduces significant additional complexity into the tax system, due in part to policymakers introducing specific concessions. While in a 'pure' system such exemptions and concessions should be limited to minimise complexity and opportunities for tax planning, from an administration perspective there are strong arguments for some relief, such as a tax-free threshold, to reduce compliance and administrative costs.

As noted earlier in this paper, its purpose is not to evaluate Labour's CGT proposal comprehensively but, in the context of the UK, to consider the interplay between tax policy, tax principles and tax administration. Accordingly, the paper does not conclude with detailed recommendations on the design of a CGT. However, based on the discussion in the paper, the authors support the inclusion of a tax-free threshold in any future NZ CGT. While it would narrow the tax base and create complexity for those taxpayers required to determine its application, it would have tax administration benefits for Inland Revenue and taxpayers deriving small gains. In addition, it would introduce a measure of progressivity (equity) into the CGT. This measure, along with an uncapped exemption for the main residence reflect that successful tax policy must take account of political reality. While, from the perspective of tax principles (equity and economic efficiency) an uncapped exemption for the main house would have negative implications, not to have such an exemption would impact on tax administration and could undermine the political sustainability of the tax leading to pressure on subsequent governments to introduce such a threshold. Subjecting non-resident taxpayers to a CGT could have advantages from a tax principles/policy perspective but lead to increased administrative and compliance costs. On the basis of similar arguments to those raised above with respect to a tax-free threshold (including tax administration benefits), a limited exemption for personal use property could be included in the CGT. New Zealand has a large number of SMEs. Driven by the political sustainability concerns, a future CGT should consider concessions for this group, for example on retirement.

The success of a CGT, or any tax, will therefore inter alia depend on a clear policy rationale which informs the design, consultation and implementation phases:

Should New Zealand introduce a CGT merely to introduce a CGT, the CGT is likely to miss the mark and will be subject to constant remedial changes. During the design process, New Zealand needs to define the problem(s). The CGT then needs to be designed with the specific problem(s) in mind.¹³⁵

However, the design process should not simply focus on good tax principles but also tax administration considerations.

Ministers of Parliament and officials will face heavy lobbying from sector groups if, and when, a CGT finally receives the 'go ahead'. At that point it will be crucial that the objectives of the CGT are clear and that the administration issues of the tax are given due consideration along with principles of a good tax design. Policymakers

¹³⁵ Brad Bowman, 'Capital Gains Tax: Setting a Good Foundation (Before the Inevitable Squabble)' (2014) 78 *Taxation Today* 13, 14.

should keep in mind Gammie's caution: '[a CGT] is a compromise, and, as is so often the case with a compromise, it functions badly and pleases no one'.¹³⁶

The near future would be an ideal opportunity to implement a CGT in NZ as the Inland Revenue has embarked on the Business Transformation programme (referred to in Section 4.0). This 10-year programme¹³⁷ involves changes that 'will simplify and streamline [Inland Revenue's] business processes, policies and customer services as well as upgrade [Inland Revenue's] technology platform'.¹³⁸ Any future CGT design should benefit from the fruits of the Business Transformation programme with its focus on tax administration considerations.

The introduction of the goods and services tax in NZ in 1986 'suggests that a politically controversial new tax can be implemented in New Zealand, with exemptions that depart from the theoretical ideal, but not disintegrate over time'.¹³⁹ New Zealand is in a unique position. As a late adopter of a CGT it has the advantage that it can look to the practices of other jurisdictions including the pragmatic approach of the UK. Two related lessons can be drawn from the UK experience. First, tax policy, principles and tax administration all have an important role in the design, reform and operation of CGT. Second, it is not easy to separate each aspect with regard to each individual feature of the UK CGT. Often all three dimensions are involved and sometimes in more than one way. The relationship between the three is therefore a close and complex one and trade-offs are required. With respect to the NZ proposals, the UK experience is that all three dimensions (tax policy, tax principles and tax administration) should all be carefully considered. In addition, as the UK experience demonstrates, a successful tax policy also has to take account of political realities.

¹³⁶ Malcolm Gammie, 'Taxing Capital Gains—Thoughts from the UK' (2000) 23 *University of New South Wales Law Journal* 309.

¹³⁷ Paul McBeth, 'IRD's Business Transformation Project to Come in Under Budget', *The National Business Review* (online), 11 November 2015 <<http://www.nbr.co.nz/article/irds-business-transformation-project-seen-coming-under-1-billion-b-181435>>. In fact, the programme is ahead of schedule and may be completed in 7 years.

¹³⁸ Inland Revenue, above n 79.

¹³⁹ Huang and Elliffe above n 32, 304.

To shame or not to shame: That is the question

Kalmen Datt¹

Abstract

This paper evaluates the naming and shaming of large corporations and concludes that such a response is unhelpful and counterproductive. The author argues that the only effective response to tax planning schemes is to enact effective laws that capture the income sought to be taxed.

Without the media, naming and shaming would not be effective. Naming and shaming campaigns appear to be a (deliberate?) misconception of the tax laws. 'Avoidance' is given an indeterminate and open-ended meaning. The media is not sufficiently versed in the tax laws to make an expert judgement of avoidance. It is not their role to punish extra-curially without any legal basis for assigning blame/guilt.

Keywords: Naming and shaming; tax planning; avoidance; effective legislation and Google.

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1. INTRODUCTION

This article evaluates the approach that the media, activists and politicians take to the manner in which large Australian and multinational corporations structure either themselves or individual transactions to ensure they limit their tax liability.² The response is to name and shame the entities concerned.

This article concludes that naming and shaming is unhelpful, counterproductive and may be based on a misconception of the law. It may also be a call for directors to breach their obligations to the corporation's shareholders and other stakeholders. The author argues that the only effective response to the tax planning techniques of these corporations is for the enactment of effective laws that capture all the income sought to be taxed. Without such laws there can be no liability for tax. As Lord Wilberforce stated:

A subject is only to be taxed on clear words, not on 'intendment' or on the 'equity' of an Act.³

Implicit in the naming and shaming response is the suggestion that those corporations named are in some way either acting illegally or breach the anti-avoidance rules of the jurisdiction in which they do business. The reality, however, appears to be that to date legislatures have been unable to draft tax laws that capture the income or at least portions of the income these corporations derive within their jurisdictions.

In naming these entities there is a constant reference to 'tax avoidance'. This phrase is becoming one of indefinite meaning both in Australia and internationally. Tax avoidance now encompasses the obligation of these corporations to pay what is often described as 'a fair share of taxes'⁴ or some other open-ended means of calculating an entity's tax.

This extended meaning of avoidance is made even more confusing when regulators in Australia and other jurisdictions refer to avoidance as following the 'letter', but not the 'spirit', of the law; or as not following the policy of the law; or as being a scheme that undermines the integrity of the tax system.⁵ According to Hasseldine and Morris, references to the 'spirit of the law' imply 'the existence of some form of shadowy parallel tax code to which only a privileged few have access while everyone else has

² In the context of this article the media includes all forms of mass communication.

³ *W T Ramsay Ltd v Inland Revenue Commissioners, Eilbeck (Inspector of Taxes) v Rawling*, [1982] AC 300, [1981] 1 All ER 865. Griffiths J noted in *Webb v Syme* [1910] HCA 32; (1910) 10 CLR 482 that: 'The scheme of the Acts can only be ascertained from their express provisions, for there is no common law of income tax'. See also *Hans Jurgen Liedig v Commissioner of Taxation* [1994] FCA 1058.

⁴ Fisher notes, '[A]ntiavoidance advocates already have begun to use modern platforms in pursuit of change, rallying support with the claim that big corporations need to pay their fair share of taxes.' Jasmine M Fisher, 'Fairer Shores: Tax havens, Tax Avoidance, and Corporate Social Responsibility', (January 2014) 94 (1) *Boston University Law Review* 337.

⁵ In *Bropho v Human Rights and Equal Opportunity Commission* 204 ALR 761 [93], Justice French describes the 'spirit of the law' in these terms:

In a statutory setting a requirement to act in good faith, absent any contrary intention express or implied, will require honest action and fidelity to whatever norm, or rule or obligation the statute prescribes as attracting the requirement of good faith observance. That fidelity may extend beyond compliance with the black letter of the law absent the good faith requirement. In ordinary parlance it may require adherence to the 'spirit' of the law.

to make do with the ‘letter of the law’.⁶ Freedman argues that proper consideration has to be given to the actual legal position, rather than focusing on vague and unenforceable notions.⁷ If corporations pay all the tax required by law, the integrity of the system presumably cannot be impaired in any way. The contrary would appear to be the case. Irrespective of the foregoing it is this extended and indeterminate meaning of ‘tax avoidance’ that is used to name and shame these corporations.

Before commencing the evaluation of the naming and shaming option a number of facts must be borne in mind. The first is that the all regulators accept tax planning is a legitimate function of taxpayers.⁸ Second, avoidance in Australia has usually been understood to be a breach of either the general anti-avoidance rule or specific anti-avoidance rules contained in the tax laws. This is generally the case in all countries although some rely on the courts to devise methods to restrain avoidance.⁹ If a transaction complies with the other provisions of the tax laws and cannot be challenged under the avoidance provisions it is unobjectionable and legally valid. Third, the late Justice Hill noted that the obligation of the regulator is ‘to collect tax in accordance with a correct assessment, that is to say, to collect the correct amount of tax, no more and no less.’¹⁰ One would have expected the view of Justice Hill would be axiomatic. Unfortunately the contrary appears to be the case.

The scheme of this paper is as follows. Section 2 considers what constitutes naming and shaming, why it is used and how, in theory, it operates. Section 3 refers to the problems that may be encountered when naming and shaming techniques are utilised. Section 4 considers the case of Alphabet Incorporated, formerly Google Incorporated (Google) in the UK and Australia. Google was and still is the subject of a concerted campaign of being named and shamed. Section 5 sets out the author’s conclusions.

2. NAMING AND SHAMING

According to Pawson the purpose of naming and shaming is to transform ‘under-performance’ or ‘deviant behaviour’ through a process of:

1. Identifying and classifying that behaviour;
2. Naming the party involved and describing the behaviour to which complaint is made;
3. The community responds to this disclosure (the act of shaming); and
4. As a result the respondent changes its behaviour.¹¹

⁶ John Hasseldine and Gregory Morris, ‘Corporate Social Responsibility and Tax Avoidance: A Comment and Reflection’ (2013) 37(1) *Accounting Forum* 1, 11.

⁷ Judith Freedman, ‘Responsive Regulation, Risk and Rules: Applying the Theory to Tax Practice’, (2012) 44(3) *University of British Columbia Law Review* 627, 648–51.

⁸ See, for example, Michael Carmody, ‘Managing Compliance’ (Speech delivered at the Tasmanian Chamber of Commerce and Industry, Tasmania, 3 September 2003).

⁹ See, for example, *W T Ramsay Ltd v CIR* [1981] 1 All ER 865. The *Ramsay* principle requires a court to interpret legislation purposively and then to apply that finding to the facts found as a composite whole and viewed realistically.

¹⁰ *Brown v FCT* 99 ATC 4516, (51).

¹¹ Pawson Ray, ‘Evidence and Policy and Naming and Shaming’, (2002) 23(3) *Policy Studies* 211.

When shaming occurs there is some form of conscious manipulation of an entity with the purpose of obtaining some desired but different result to that about which complaint has been made.¹² Pfaltzer is of the view that even though many large corporations can hide behind the façade of the corporation ‘shaming works on them largely because they are concerned with reputation and as such feign shame for reputational and commercial reasons.’¹³

Braithwaite and Drahos believe that naming and shaming may cause corporations to take steps to determine personal responsibility and ‘[put] things right’.¹⁴ According to them this is a relatively cheap remedy and it could reflect society’s moral outrage at the conduct.¹⁵ They contend that if the corporation is named, then internal compliance systems go to work to define personal responsibility for putting things right.

Morse suggests that where reputation is important, it is possible to cast compliance as reputation enhancing; however, it is necessary to target the leaders of the corporation because they influence the views of the remainder of the organisation.¹⁶

As will be seen from the example of Google below there can be considerable damage to a company’s reputation if it is named and shamed. The damage may, in monetary terms be greater than any fine a court could impose.¹⁷ Naming and shaming does not prevent the regulator from challenging the taxpayer under the remedies granted to it by the tax laws. The ability of the regulator to proceed either civilly or criminally post such shaming could result in the imposition of a double penalty. This is undesirable. As Justice Starke noted:

But I protest against the injustice of this double penalty against practically the same party, the company and the respondent, for identically the same acts. The way of the wrongdoer must not be made easy, but he should not be oppressed. If the penalties inflicted on the company be recovered, those inflicted on the respondent should not, as I venture to think, be enforced, or they should be remitted by the proper constitutional authority.¹⁸

¹² Elizabeth L Rosenblatt, ‘Fear and Loathing: Shame, Shaming, and Intellectual Property’, (2013–2014) 63(1) *DePaul Law Review*, 9.

¹³ Juliette JW Pfaltzer, ‘Naming and Shaming in Financial Market Regulations: A Violation of the Presumption of Innocence?’ (January 2014) 10(1) *Utrecht Law Review* 134.

¹⁴ John Braithwaite and Peter Drahos, ‘Zero Tolerance, Naming and Shaming: Is There a Case For It With Crimes of the Powerful?’ (Paper delivered at the Australian and New Zealand Society of Criminology Conference, Perth, 30 September 1999).

¹⁵ For a review of issues around shaming, see David A Skeel Jr, ‘Shaming in Corporate Law’ (June 2001) 149(6) *University of Pennsylvania Law Review* 1811, 1814.

¹⁶ Susan C Morse, ‘Tax Compliance and Norm Formation under High-Penalty Regimes’ (2012) 44(3) *Connecticut Law Review* 675, 695–9.

¹⁷ See, for example, R Macrory and G Britain, *Regulatory Justice: Making Sanctions Effective (Final Report)*. Cabinet Office, London, November 2006).

¹⁸ *Adams v Cleeve* (1935) 53 CLR 185. Chief Justice Allsop made similar comments in *Australian Competition and Consumer Commission v Coles Supermarkets Australia Pty Limited* [2015] FCA 330 [85] where he said:

I propose to identify a single penalty in respect of all contraventions in accordance with the totality principle, bearing in mind that what can be seen as four courses of conduct formed part of a single marketing strategy. This is appropriate to ensure that there is not double punishment.

The learned judge in the above extract was commenting on the injustice of a penalty being imposed on different entities for the essentially the same act. With naming and shaming a penalty may be imposed for no wrongful conduct, but if such wrongful conduct were found to exist there would be a double penalty on the same party first in being shamed and second the penalty imposed by the court or regulator.

Grabosky and Shover, although referring to criminal conduct, consider that the refusal to acknowledge the criminality of conduct is one of the sharpest distinguishing characteristics of 'white-collar' criminals. Ways of mobilising public indignation to combat this is something worthy of consideration, to induce those targeted to acknowledge their wrong and to take steps to make amends.¹⁹

Shame can occur without the publicity of being publicly named. Grasmick and Bursik describe shame as the feeling of guilt one experiences after having committed a wrong; it is a self-imposed punishment.²⁰ The greater the wrong committed, the greater is the prospect and extent of the feeling of shame.²¹ Grasmick and Bursik found, after surveying a number of respondents, that the prospect of feeling shame inhibited tax cheating.²²

Kahan and Posner suggest that, because shaming shows moral condemnation of the relevant conduct, it has an advantage over imposing fines, which are either not publicised or if publicised do not receive the same attention as does naming and shaming.²³ Naming and shaming can destroy a company's reputation and influence the decisions of customers, suppliers, financiers and other stakeholders doing business with the corporation. A monetary fine generally does not do this. This issue is of great concern to directors because they have an obligation to promote the company's reputation. It is often difficult for a company that is publicly named and shamed to respond to or to ensure that its response receives the same attention as the original adverse publicity.²⁴

Skeel says naming and shaming occurs when 'the enforcer expresses moral outrage at the offender, expecting that the intended audience will respond with similar moral disapproval'.²⁵

Shaming, according to Buell, may not be the same as reputational damage, although there are elements of this present. Buell suggests that reputational damage occurs

¹⁹ Peter Grabosky and Neal Shover, 'Forestalling the Next Epidemic of White-Collar Crime: Linking Policy to Theory' (August 2010) 9(3) *Criminology & Public Policy* 641, 645.

²⁰ Harold G Grasmick and Robert J Bursik Jr, 'Conscience, Significant Others, and Rational Choice: Extending the Deterrence Model' (1990) 24(3) *Law & Society Review* 837. See also, Kristina Murphy, 'Procedural Justice, Shame and Tax Compliance' (Working Paper No 50, Centre for Tax System Integrity Research, School of Social Sciences, Australian National University, Canberra, ACT, November 2004).

²¹ Grasmick and Bursik above, n 20 at 840.

²² For discussion on theories behind shaming see, John Braithwaite, Eliza Ahmed and Valerie Braithwaite, 'Shame, Restorative Justice, and Crime' in Francis T Cullen, John Paul Wright and Kristie R Blevins (eds), *Taking Stock: The Status of Criminological Theory. The Advances in Criminological Theory* (Transaction Publishers, 2008).

²³ Dan M Kahan and Eric A Posner, 'Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines' (1999) 42 *Journal of Law & Economics* 365, 368.

²⁴ David F Williams, 'The Concept of Tax Governance' (Paper presented at the KPMG Tax Business School, UK, 2007).

²⁵ Skeel, above n 15.

when criminal charges have been laid and made public because the public ascribes real meaning to cases in which criminal conduct is alleged by the state. This has particular resonance in the US, where corporations may be obliged to waive legal professional privilege and accede to the wrongfulness of their conduct with a view to a limitation of possible consequences.²⁶

Leighton, writing on the US experience, says:

Several states have had success with publicizing the names of individuals and corporations that have the largest unpaid tax bills, which is a strategy that might substitute for the publicity of the criminal prosecution noted by Levi.²⁷

In a European context Van Erp²⁸ notes that ‘more and more, public regulators are disclosing names of sanctioned companies or experimenting with naming and shaming, in the expectation that this will enhance the impact of their enforcement strategies on compliance.’ In the EU and US naming generally occurs when a taxpayer has had some penalty imposed either by the regulator or courts or has failed to pay an assessed amount or failed to submit a return. There is an objective standard that is breached before an entity is named and shamed.

A key issue with naming and shaming is whether the audience believes the behaviour is worthy of moral outrage. According to Kahan, shaming expresses moral condemnation of conduct, albeit to a lesser extent than do criminal sanctions.²⁹ Morse suggests that to be effective, there must be a link between the listener’s values and the story.³⁰ The secrecy provisions of the tax laws may impede drawing an accurate link between the listener’s values and the story.³¹

Pawson states that ‘shaming sanctions will only become adequately public and therefore bite if the media deem the information sufficiently ‘newsworthy’.³² The role of the media and their need to publish stories that sell is often overlooked when considering naming and shaming. The author suggests that without the media the necessary publicity required to make known the conduct complained of would not be present. The media’s role is pivotal to a corporation being named and shamed. This is the case irrespective of the identity of the party initiating the complaint against the corporation.

²⁶ Andrew Weissmann and David Newman, ‘Rethinking Criminal Corporate Liability’ (Spring 2007) 82(2) *Indiana Law Journal* 411.

²⁷ Paul Leighton, ‘Fairness Matters—More Than Deterrence: Class Bias and the Limits of Deterrence’ (August 2010) 9(3) *Criminology & Public Policy* 525, 526–7.

²⁸ Judith van Erp, ‘Reputational Sanctions in Private and Public Regulation’ 2008 (1) 5 *Erasmus Law Review* 145; Pfaeltzer, above n 13.

²⁹ Dan M Kahan, ‘What Do Alternative Sanctions Mean?’ (Spring 1996) 63(2) *University of Chicago Law Review* 591, 635.

³⁰ Susan C Morse, ‘Narrative and Tax Compliance’ (University of California Hastings Research Paper No 14, 24 September 2013) 9–10.

³¹ *Taxation Administration Act 1953* (Cth) Division 355.

³² Pawson Ray, above n 11.

Kohn notes ‘since the latter part of the 20th century, humiliation has become amplified through the mass media in the name of crime control and entertainment’³³ Skeel referring to the financial press in the US states:

Business Week and its peers, by contrast, have a huge reputational stake in the accuracy—or at the least, the objectivity—of their reports. Readers buy the magazines because they offer sophisticated, inside looks at the business world.³⁴

As this article demonstrates it seems this objectivity may be lacking when corporations are named and shamed.

Silverman says the publication by the media on some issues at best, creates a permissive climate for intolerance and, at worst, for vigilantism.³⁵

The media

[e]njoy better protection when revealing corporate wrongdoing. For instance, in the U.S., freedom of the press is guaranteed in the First Amendment of the Constitution, and in many countries, the legal protection afforded to journalists prevents firms from suing them for defamation.³⁶

Corporations in Australia, with limited exceptions, are unable to sue for defamation.³⁷ Even if they are able to sue for defamation in other jurisdictions the proceedings are subject to reports of the proceedings by the media which may exacerbate the problem. Further, corporations have significant evidential hurdles to overcome, making such actions rare. As Mark Twain famously said:

It is a free press—a press that is more than free—a press which is licensed to say any infamous thing it chooses about a private or a public man, or advocate any outrageous doctrine it pleases... There are laws to protect the freedom of the press’s speech, but none that are worth anything to protect the people from the press. A libel suit simply brings the plaintiff before a vast newspaper court to be tried before the law tries him, and reviled and ridiculed without mercy.³⁸

Activist groups and politicians actively encourage naming and shaming to achieve a political agenda where there may have been no wrongdoing on the part of a corporation. For example, in a joint report produced by United Voice and the Tax Justice Network it was contended by innuendo and a selective use of information that as large number of corporate taxpayers quoted on the Australian Stock Exchange did not pay the headline 30% rate of tax the Government had been done out of not less

³³ Steven A Kohm, ‘Naming, Shaming and Criminal Justice: Mass-mediated Humiliation as Entertainment and Punishment’, August 2009 (5)2 *Crime Media Culture* 188–205.

³⁴ Skeel Jr, above n 15.

³⁵ Jon Silverman, ‘The Shaming in Naming’, (March 2003) 14 *British Journalism Review* 49–53.

³⁶ El Ghoul, Sadok, Omrane Guedhami, Robert C Nash and Ajay Patel, *New Evidence on the Role of the Media in Corporate Social Responsibility* <<http://ssrn.com/abstract=2712239>> or <<http://dx.doi.org/10.2139/ssrn.2712239>>, accessed 7 January 2016.

³⁷ See, for example, section 9 of the *Defamation Act 2005* (NSW).

³⁸ Mark Twain, *License of the Press*, Monday Evening Club at Hartford, March 31, 1873.

than \$8.4 billion of tax.³⁹ Although not directly alleging wrongful conduct on the part of the corporations named in the report the inference (incorrectly) drawn is that these companies either have been guilty of what is referred to as ‘aggressive corporate tax avoidance’ or ‘aggressive tax avoidance’ or ‘tax aggressive behaviour’ or ‘aggressive tax minimisation practices’. The meaning of these terms is never explained.

The fact that a corporation pays little or no tax in Australia means nothing without reference to the particular circumstances of that corporation and how the tax laws impact on its various transactions. Notwithstanding the foregoing, the report advocates that these corporations be named and shamed. It states:

Disclosure and transparency of corporate tax practices needs to be increased. Greater public awareness of aggressive tax avoidance will provide an incentive to Australian corporations to be less tax aggressive. Tax dodging practices, when exposed, will damage corporate reputations and may increase regulatory and financial risks. Responsible companies should not wait for inevitable changes to the rules before deciding to act.⁴⁰

This report was given headline treatment in the media. Examples include: Aston and Wilkins⁴¹ who describe the main findings of the report and then give some views that do not agree with the conclusions reached; and Shorten and AAP where the results of the report are extensively reported.⁴²

It is the media that gives credence to misleading claims about the tax affairs of corporations by politicians and activists rather than objectively and accurately reporting on their tax affairs. Reality and candour appear to be of little consequence.

Tulberg argues that corporations are vulnerable to media power and that the solution is one of appeasement to avoid being a target and to protect the value of the company brand.⁴³ According to Tulberg, there is an absolute right or wrong and the media are the sole arbiters on these issues, irrespective of whether their views are correct. It is often difficult to respond to such attacks in a way that resonates with the public.

There would appear to be little or no accountability on the part of the media, politicians or activists as to the accuracy and truth of what they publish or disseminate. Simply to make broad unsubstantiated allegations is not acceptable conduct from elected representatives who have the power to enact effective laws that capture within the tax net that income which is currently not assessable. Similarly the media may be abusing their power in publishing reports without comment when objectively these reports may be incorrect.

³⁹ United Voice and the Tax Justice Network, *Who pays for our Common Wealth? Tax practices of the ASX 200*

<http://www.google.com.au/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=0ahUKEwiA89PFg_zPAhWHJ5QKHWe5BEwQFggiMAE&url=http%3A%2F%2Fwww.unitedvoice.org.au%2Fdocuments%2Fwho-pays-our-common-wealth-full&usg=AFQjCNGoo94O-2LN-LI9WpqSw3Y5VpFIFQ&sig2=dm7GKLtZw-lp0l8HERTLsg>

⁴⁰ Ibid at 9.

⁴¹ Heath Aston and Georgia Wilkins, ‘ASX 200 Company Tax Avoidance Bleeds Commonwealth Coeffs of Billions a Year, Report Finds’, *Business Day, Sydney Morning Herald*, 29 September 2014.

⁴² Kristin Shorten and AAP, ‘Tax Justice Network Report Reveals Tax Burden Shifting From companies to ordinary taxpayers’, *News Corporation Australia Network*, 29 September 2014.

⁴³ Jan Tulberg, ‘Reflections upon the Responsive Approach to Corporate Social Responsibility’ (2005) 14(3) *Business Ethics: A European Review* 261.

Silverman, referring to the media states:

Then there is the question of accountability. Kipling's resonant description of the press as the wielder of "power without responsibility—the prerogative of the harlot throughout the ages" needs no updating to depict accurately much of today's media.⁴⁴

An example of how damaging media reports can be even where there is a finding of guilt appear from the following. ASIC published many disparaging remarks at the time of commencing proceedings and during the process of those proceedings against a high-ranking company executive by the name of Fysh.⁴⁵ He was found guilty by the court of first instance, which sentenced him to a term of imprisonment. The matter went on appeal, pending which Fysh was incarcerated. The Court of Appeal found that Fysh had no case to meet and he was released from gaol after having been incarcerated for seven months. It is reported that Fysh, in submissions to a Senate enquiry, asked '[d]id ASIC's early rush to publicise successful pursuit of a high ranking overseas oil company executive and freeze his assets colour ASIC's judgment?' In response, ASIC noted that 'the media will inevitably escalate any hint of an investigation, naming names, drawing inferences and beating up the story-and this can affect any future legal action'. This report should be a salutary lesson to all those who seek to name and shame.

Irrespective of what the media disseminates or what politicians or activists may say, the vast majority of persons will not know or understand or accept that, notwithstanding what is said or reported a corporation may be fully compliant with its tax obligations. A program of disparagement should not be commenced without first determining, at the very least, that there has been some legally actionable non-compliance. Vague notions of fairness or morality not based on a proper application of the facts to the tax laws should be discouraged. The media, politicians and to a lesser extent activist groups have significant influence on community attitudes and a concomitant responsibility to report objectively and accurately. A truthful and dispassionate discourse on how these corporations deal with tax issues appears to be absent in the majority of cases.

The House of Lords has acknowledged that naming and shaming is arbitrary and difficult to justify when the transaction is within the law. The House of Lords suggests that if a scheme is not accepted, imposing penalties by the courts is a better option.⁴⁶ This suggestion does not appear to have been accepted by the media.

Mention must be made of the apparent cynical attempt by the Australian Parliament to encourage naming and shaming by enacting legislation⁴⁷ directing the Commissioner to publish certain information without comment about the tax affairs of large corporate

⁴⁴ Silverman, above n 35.

⁴⁵ Gareth Hutcheons, 'Damage Done in the Rush to Go Public', *Weekend Business, The Sydney Morning Herald*, 18–19 January 2014, 7.

⁴⁶ Select Committee on Economic Affairs, *1st Report of Session 2013–14, Tackling Corporate Tax Avoidance in a Global Economy: Is a New Approach Needed?*, House of Lords, (31 July 2013) [50], [69]–[80].

⁴⁷ *Tax Laws Amendment (2013 Measures No 2) Act 2013* (Cth).

entities (with income in excess of \$100 million).⁴⁸ This information is the company's name, its Australian Business Number, its total income, taxable income and tax payable.⁴⁹ The requirement to publish information is not because of some alleged wrong committed by the corporations. There is no obligation on the ATO either to verify the accuracy of the information made public or to determine whether the amount of tax payable as reflected in the corporation's tax return is as prescribed by law. Since its enactment the legislation has been amended to limit the scope of these provisions on Australian private companies.

When originally enacted the objective of this legislation was, *inter alia*, said to be:

[t]o discourage large corporate tax entities from engaging in aggressive tax avoidance practices.⁵⁰

The distinction, if any, between aggressive and other tax avoidance practices eludes the author.

The purpose alluded to above cannot be achieved by a mere perusal of the return and certainly not from the limited information that must be published by the Commissioner. It is doubtful that anyone can determine from a tax return alone whether the taxpayer is fully compliant with the tax laws; has entered into an avoidance scheme or is a participant in some tax crime; or even whether there has been some inadvertent omission or addition to the return. To achieve the aim of the legislation requires an in-depth understanding of the tax laws and an investigation and understanding of how and why certain transactions are structured in a particular way and how the tax laws apply to these transactions.

The media, activists and politicians are not so constrained and in the vast majority of cases (the author would suggest all) they are not sufficiently versed in the tax laws to be able to do so.

It would seem the reason for this legislation is in large a measure to encourage the media to name and shame some or all of these corporations into paying more tax than they currently do, or to pay what is euphemistically called 'a fair share of taxes.'⁵¹ The fact that these companies may be fully compliant with their tax obligations seems to be irrelevant. If this view is correct (and it seems to be), it is an indictment on politicians that seeks by extra legislative and judicial means to impose taxation on corporations when the law is unable to do so. As Terry McCrann noted (referring to a report published by the Commissioner in terms of this legislation) albeit in somewhat exaggerated terms:

⁴⁸ The idea for this legislation may be found in Marjorie E Kornhauser, 'Doing the Full Monty: Will Publicizing Tax Information Increase Compliance' (2005) 18 *Canadian Journal of Law & Jurisprudence* 95.

⁴⁹ All corporations must file a return reflecting their income, claimed deductions and the amount of tax payable on the assessable income reflected in the return. The return is deemed to be an assessment: Section 166A of the *Income Tax Assessment Act 1936* (Cth).

⁵⁰ Explanatory Memorandum, *Tax Laws Amendment (2013 Measures No 2) Bill 2013* (Cth) Schedule 5 [5.6].

⁵¹ Datt argues that the call to pay a 'fair share of taxes' is meaningless and constitutes empty rhetoric: Kalmen Datt, 'Paying a Fair Share of Tax and Aggressive Tax Planning—A Tale of Two Myths' (Nov 2014) 12 (2) *eJournal of Tax Research* 410-432
<<http://search.proquest.com/docview/1674651839?accountid=12763>>.

What he (the Commissioner) should have done is headline the first page of both the report and his press release with a sentence in 18 point capitalised red ink saying something like: “Warning these figures are published by legislative direction, but they are not just meaningless but potentially grossly misleading. Absolutely no inferences can be drawn from them about any individually named company’s tax affairs, and in particular its compliance or otherwise with both the letter and the spirit of its tax obligations.”⁵²

A majority of the Senate Economics Legislation Committee when considering possible amendments to this disclosure legislation noted some misgivings about the operation of the law. Heath Ashton reports that they were of the view that:

The transparency law had the potential to result in the publication of taxation information of privately owned companies that could be misused, misinterpreted or mislead due to poor understanding of the relationship between gross accounting turnover and net taxable income.⁵³

The views expressed above are of application to all corporations.

Further a consultation paper on a Tax Transparency Code issued by the Board of Taxation on 15 December 2015 gives implicit support for the views expressed by the author. The report from the Board of Taxation states:

The business tax system and tax accounting for businesses are complex areas not easily accessible to non-expert readers of financial statements and other tax disclosures. The public interest in tax disclosure will be best served if there is a concerted and ongoing effort to raise the level of understanding of business taxation... One common misconception that could usefully be addressed through public education concerns the reasons why effective tax rates may be lower than the headline tax rate. For example, many governments provide tax incentives to businesses which invest in designated research and development activities. Recoupment of prior year losses, exposure to foreign exchange fluctuations and conducting overseas operations are other factors which may have the effect of reducing the effective tax rate.⁵⁴

In the 2016 Budget, the Government has recommended large and medium-sized corporations adopt the tax transparency code (released by the Board of Taxation in May 2016). The Code suggests that corporations voluntarily disclose details about their tax affairs even where they are under no legal obligation to do so. It is suggested corporations report on inter alia:

A reconciliation of accounting profit to tax expense and to income tax paid or income tax payable;

⁵³Heath Ashton, ‘Public Doesn’t Understand Taxation Well Enough for Companies to Publish Tax Contributions: Senate Committee’, *Sydney Morning Herald*, 13 October 2015.

⁵⁴ Board of Taxation, *ibid*.

Identification of material temporary and non-temporary differences; and Accounting effective company tax rates for Australian and global operations (pursuant to AASB guidance).⁵⁵

As noted above any such disclosure is meaningless without expert knowledge of the tax laws and a careful consideration of all the facts.

Corporations cannot ignore being named and shamed by the media. The prospective publication of some company tax returns in Australia will no doubt facilitate such scrutiny in Australia. Adverse reports can be so devastating that corporations need their own media and public relations consultants to advise them on how best to disclose information and handle adverse reports if necessary. As the example of Google shows, apparent attempts at being fully compliant are not a safeguard against being targeted.

The recent Base Erosion and Profit Shifting (BEPS) documentation issued by the OECD and the response of various countries such as the UK Diverted profits Tax⁵⁶ and the Australian Multinational Anti Avoidance Law (MAAL)⁵⁷ appear to be attempts to ensure income derived in a country is taxed in that country and not diverted to some zero or low tax jurisdiction. These are attempts to draft effective legislation that targets the income sought to be taxed. Such an approach is the only effective way to counter what is described in the media as ‘avoidance’.

The foregoing shows that the concept of ‘avoidance’ has taken on an indeterminate and open-ended meaning. What constitutes avoidance in the media bears no relationship to the interpretation that term has both in legislation and the common law.

The reasons for naming and shaming include identifying unacceptable behaviour and seeking by publication of this behaviour to change it. Tax can only be imposed by law and any deviant behaviour in a tax context must be found in the law. To name and shame without a legal foundation for the deviant behaviour being found would appear to be an anathema to the assertion we live in a fair and just society. When corporations are named and shamed it can have significant consequences for their reputations.

There can be no issue with a corporation that manages its tax affairs to ensure it pays no more than the law requires. This is what all tax regulators accept as being permissible conduct.

This article now turns to evaluate problems that may arise when a party is named and shamed and its effectiveness or otherwise.

⁵⁵ ATO, *Voluntary Tax Compliance Code* (20 September 2016) <<https://www.ato.gov.au/Business/Large-business/In-detail/Tax-transparency/Voluntary-Tax-Transparency-Code/>>.

⁵⁶ This tax is designed inter alia to address arrangements which avoid a UK permanent establishment (PE) and comes into effect if a person is carrying on activity in the UK in connection with supplies of goods and services by a non-UK resident company to customers in the UK, provided that the detailed conditions are met. In the 2016 Australian budget the Treasurer made reference to the intention to introduce a similar law in Australia.

⁵⁷ *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015* (Cth).

3. ISSUES WITH NAMING AND SHAMING

Possibly the most fundamental issue with naming and shaming is that an entity should not be deemed to be blameworthy unless there is some robust legal test based on fact that assigns such blame. Aligned to this issue is the fact that the alleged offender has no or little recourse against those doing the naming and shaming.⁵⁸ This can result in innocent entities being shamed, with potentially catastrophic results for the victim. Naming and shaming presumably only occurs where there is knowledge of how much tax is paid. Those taxpayers whose information remains confidential may be immune from this type of sanction.

Shaming is regarded by some as an aspect of punishment. Blank, in dealing with the case in which governments name and shame, says few punishments are as dramatic and spectacular as naming and shaming. He continues:

When the government imposes a shaming sanction, it condemns the offender in full view of the community for engaging in a socially repugnant act. By resorting to shaming, the government invites the community to take part in the punishment process.⁵⁹

Governments should not name and shame unless there is some legal basis (at the very least) for contending there has been misconduct.

Pawson identifies other areas of concern with naming and shaming.⁶⁰ These are:

1. the performance or behaviour in question is classified inappropriately (often the case when avoidance is alleged)
2. the disclosure is poorly managed by sparse or excessive publicity
3. the wider public apply measures that go beyond ‘shaming’—such as humiliation, deprivation, vigilantism, defamation, banishment, etc. *or* fall short of shaming—such as disapproval, stoicism, apathy, sympathy, collusion
4. the individual or institution under sanction reacts to ‘shaming’ by accepting the label and amplifying deviant behaviour, or by ignoring/rejecting the label and continuing existing behaviour.

This article argues that those who name and shame corporations for breaching their tax obligations may be acting on a mistaken view of the law, the facts or both. This mistaken view may be deliberate. Those who name and shame are *prima facie* seeking community outrage against what may be blameless conduct. It is not for the media or politicians or activists to be the sole arbiter of blame/guilt based on some subjective, indeterminate and non-legislated basis known only to them. The media, politicians and activists are not capable of making complex legal distinctions between compliance and non-compliance and it is certainly not their role to punish extra-curially without any legal basis for assigning blame/guilt.

⁵⁸ Seth F Kreimer, ‘Sunlight, Secrets, and Scarlet Letters: The Tension between Privacy and Disclosure Constitutional Law’ (November 1991) 140(1) *University of Pennsylvania Law Review* 1, 5–12, 117–26, 137–8.

⁵⁹ Joshua D Blank, ‘What’s Wrong With Shaming Corporate Tax Abuse’ (2009) 62 *Tax Law Review* 539.

⁶⁰ Pawson Ray, above n 11.

A tax liability can only be created by legislation and liability should not be based on attempts to appease what may be unjustified, uninformed and vociferous criticism. For corporations to act in this way may require directors to breach their common law and legislative obligations to the corporation and its stakeholders. This in fact occurred in the UK, when a spokesperson of Starbucks was reported as stating:

We listened to our customers in December and so decided to forgo certain deductions which would make us liable to pay £10m in corporation tax this year and a further £10m in 2014. We have now paid £5m and will pay the remaining £5m later this year.⁶¹

Conduct such as that set out above demeans the rule of law. It is the antithesis of corporate conduct required by the media, politicians and activists.

Naming and shaming should be used in situations in which there has been some legally demonstrable deviant behaviour. If there is no breach of the tax laws, then attacks on the reputation of corporations should not occur. The media, politicians and activists appear to be unrestricted in determining whether corporations are blameworthy when discussing their tax affairs. No regard appears to be given to what the law requires when publishing reports about corporations in which it is contended they are 'guilty' of tax avoidance. The deviant behaviour identified by these entities is based on some indeterminate, non-legislated basis on which they are the sole arbiter of what is right or wrong.

Naming and shaming is now used as a means of punishment by law enforcement bodies. It is inappropriate, as appears from this article that a regulator should act in this manner.

It is neither the role nor right of the media, politicians or activists to determine blame and punish without first establishing a justifiable legal basis for such actions. A policy of appeasement by corporations from these vociferous and seemingly unjustified attacks demeans the rule of law.

This article now turns to the example of Google to illustrate the effect and possible abuse of naming and shaming and the care that must be taken by those who use it or encourage its use as a tool to compel some corporations to pay more tax than they currently do.⁶²

4. GOOGLE

Google earned significant monies in the UK, but paid little tax on these earnings. In response, the media, activists and politicians in that country embarked on a sustained campaign against Google. Examples from this campaign in the media follow.

The *Telegraph* on 2 January 2013 reports the following about Google:

⁶¹ Terry Macallister, 'Starbucks Pays Corporation tax in UK for First Time in Five Years' *The Guardian* (online) 24 June 2013 <<http://www.theguardian.com/business/2013/jun/23/starbucks-pays-corporation-tax>>. See also Select Committee on Economic Affairs, *1st Report of Session 2013–14, Tackling Corporate Tax Avoidance in a Global Economy: Is a New Approach Needed?*, House of Lords, (31 July 2013)[68].

⁶² There are many other examples, particularly with large multinational corporations. These include Amazon, Starbucks and Apple.

Google funnelled £6 billion through Bermuda last year, halving its 2011 tax bill and paying £1 billion less to government coffers.

The company paid £6 million in UK tax last year, funnelling 80 per cent of its global revenue through the tiny island of Bermuda, twice as much as three years ago.⁶³

BBC News Magazine on 21 May 2013 reports:

In a report published on Monday, the committee's chairwoman Margaret Hodge said the level of tax taken from some multinational firms was "outrageous" and that HM Revenue and Customs needed to be "more aggressive and assertive in confronting corporate tax avoidance".⁶⁴

The Register of 14 June 2013 states:

British MPs have demanded that the government act to revamp the tax structure after damning revelations about Google's corporate payments structure in the country.⁶⁵

The Telegraph of 28 June 2013 reports:

Google's reputation in Britain has taken a heavy blow as a result of criticism over its avoidance of taxes, a major survey of consumer attitudes suggests.⁶⁶

Google has also been criticised in Australia for the same reasons as in the United Kingdom. For example, *ABC News* on 9 April 2015 reports a Google representative on being challenged on the amount of tax it pays in Australia before a senate enquiry as saying:

"I guess my answer to that one is that fundamentally, Google does not structure itself based on tax, it structures itself based on being competitive, right?" Ms Carnegie said.

"We are not opposed to paying tax. What we're opposed to is being uncompetitive".⁶⁷

Matt Wade on the same day reports:

Apple's Tony King, Google's Maile Carnegie and Microsoft's Bill Sample each said their company complied fully with Australian tax laws and drew

⁶³ Matt Warman, 'Google's £6 Billion Bermuda Tax Shelter' *The Telegraph* (online) 2 January 2013 <<http://www.telegraph.co.uk/technology/google/9775216/Googles-6billion-Bermuda-tax-shelter.html>>.

⁶⁴ Vanessa Barford and Gerry Holt, 'Google, Amazon, Starbucks: The Rise of Tax Shaming', *BBC News Magazine*, 21 May 2013 <<http://www.bbc.com/news/magazine-20560359>>.

⁶⁵ Brid-Aine Parnell, 'MPs Demand UK Rates Revamp After Google's "Extraordinary Tax Mismatch"' *The Register* (online) 14 June 2013 <http://www.theregister.co.uk/2013/06/14/mp_google_tax_report/>.

⁶⁶ Christopher Williams, 'Google Brand Damaged By Tax Row' *The Telegraph* (online) 28 June 2013 <<http://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/10146737/Google-brand-damaged-by-tax-row.html>>.

⁶⁷ ABC, 'Google, Apple and Microsoft Deny Tax Avoidance at Senate Inquiry', *ABC News*, 9 April 2015 (Simon Santow) <<http://www.abc.net.au/news/2015-04-08/google-apple-microsoft-deny-tax-avoidance-senate-inquiry/6379024>>.

attention to the way Australia benefited from their products and services. Mr King said Apple believed in “leaving the world a better place” and Ms Carnegie said she was “proud of Google’s contribution to Australia”.⁶⁸

When representatives of Google, Apple and Microsoft came before the Australian Senate enquiry McGrath reports that:

Chair of the enquiry, Senator Sam Dastyari, said the issue was “a question of morality”, rather than legality.

“I think there are some very, very legitimate community concerns about how you are structured, how your companies are engaged in what appears ... to be tax minimisation.”

“I’m not casting the activity as being illegal, but the structure of your companies in places like Bermuda, Singapore, and Ireland ... raises concerns”.⁶⁹

The comments cited above in the article by McGrath are almost in identical terms to those of Margaret Hodge the chairperson of a similar enquiry in the UK and mentioned below.

The basis for naming and shaming Google is that presumably it unlawfully and intentionally did not pay the tax in the UK or Australia that was properly assessable under the respective tax laws of these countries, or that it entered into one or more schemes not permitted by law to limit its tax liability.

The conduct of Google in relation to its tax affairs would appear to be part of its corporate strategy and is actively encouraged by its board of directors. A news report in *BBC News Technology* of 17 June 2013 states:

Scott Rubin, Communications Director, Google has been asked about Google’s tax arrangements and said that his company pays what is “required by law”.⁷⁰

If Google pays all tax mandated by law, as it contends, the premise for it being named and shamed may be false or at least based on an incorrect view of the law. It is up to the courts to say that the view taken by Google is incorrect. The mere fact that a corporation pays tax at a rate lower than the headline rate or pays no tax at all in a country in which income is generated does not mean the company has not complied with all the tax laws of that country.

On 6 January 2014, a report in *The Times* notes that in 2012 Google had income in the UK of £3.1 billion, profits of £889 million and a potential tax liability if tax was paid on all profits of £213 million. Tax in the sum of £11.6 million was paid. The report notes that after investigations since 2010 by Her Majesty’s Revenue and Customs (HMRC), Google was required to pay back tax of £24 million (it is not stated over

⁶⁸ Matt Wade, ‘Tax Avoidance Hearing: Google, Microsoft and Apple Tell Senate Committee They Fully Comply with Australian Laws’, *Business Day*, *Sydney Morning Herald*, 9 April 2015.

⁶⁹ James McGrath, ‘Tax “A Question of Morality”—Tech Giants Grilled By Senators’, *AdNews*, 9 April 2015 <<http://www.adnews.com.au/news/tax-a-question-of-morality-tech-giants-grilled-by-senators>>.

⁷⁰ ‘Google: “We pay tax required by law”’, *BBC News Technology* (online), 17 June 2013 <<http://www.bbc.co.uk/news/technology-22932794>>.

which income years these back taxes are calculated). These taxes were for the disallowance of specific deductions claimed in previous years.⁷¹

After what was presumably an intensive investigation of more than three years, the disallowed deduction of £24 million is miniscule in relation to Google's earnings in the UK over the period 2010 to 2013 (assuming 2012 is representative). This gives some credence to Google's statement that, as far as it is concerned, it pays such tax as is required by law. Further, there is no direct assertion in the 2014 *The Times* report that HMRC contended that the deductions sought to be set aside were tainted by avoidance or criminal conduct. Significantly the claim by HMRC was for a deduction that was disallowed and not for undeclared income.

This report in *The Times* notes that alongside Google, Apple, Amazon and Facebook claimed deductions on same basis (it concerned employee share schemes). Since a conspiracy by each of these companies to defraud HMRC of tax in an identical manner is highly improbable, this suggests that each of these companies believed they were entitled to these deductions on their interpretation of the UK tax laws. That their view of the law may be mistaken cannot be doubted; however, the genuineness of their belief must presumably also be accepted.

At the time Google was being named and shamed in 2013 and earlier it was not known that an amended assessment would be issued on the above grounds. The naming and shaming of Google in these years did not suggest, even implicitly, that its failure, at least in part, to pay more tax in the UK was based on a mistaken but genuine view of the law, or that such taxes as were payable by law were not paid. For example, in evidence before the UK Parliament's Public Accounts Committee, the chair, Margaret Hodge (a vociferous critic of Google), in a question to Matt Brittin, vice-president for Google in northern and central Europe, said, '[w]e are not accusing you of being illegal; we are accusing you of being immoral'.⁷² What Hodge appears to be saying is that the UK would like Google to pay more tax in the UK than it currently does and presumably in an amount greater than is required by law.

The parliamentary enquiries both in Australia and the UK were apparently not directed at some unlawful activity on the part of these multinational companies or even avoidance but appear to be an attempt to name and shame these entities to pay more tax than possible is required by law. The various reports of these enquiries reflect no wrongful conduct but if distilled reflect an indictment on the legislature's inability to legislate effective tax laws which would capture the income sought to be recovered from these entities.⁷³

⁷¹ Dipesh Gadhur and Simon Duke, 'British Hit Google With \$44m Backdated Tax Bill', *The Times* (London), 6 January 2014, as cited by *The Australian* (online) <<http://www.theaustralian.com.au/news/world/british-hit-google-with-44m-backdated-tax-bill/story-fnb64oi6-1226795373948#>>.

⁷² Evidence to Public Accounts Committee, UK Parliament, 2 November 2012 (Margaret Hodge).

⁷³ These reports, issued in two parts, can be found at <http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Report_part_1>; <http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Corporate_Tax_Avoidance/Report_part_2>

In 2016, in what was triumphantly announced as a major victory for HMRC Google entered into an agreement to pay HMRC £130 million. *The Guardian* reports:⁷⁴

Google has agreed a deal with British tax authorities to pay £130m in back taxes and bear a greater tax burden in future. The deal will cover a decade of underpayment of UK taxes by the company, which has been criticised in the past for its tax avoidance policies... A Google spokesman confirmed reports that the firm was to pay £46.2m in taxes on UK profits of £106m for the 18 months to June 2015, as well as back taxes owed for the previous decade.

This ‘triumph’ was immediately criticised. An example appears from an *ABC News* reports as follows:⁷⁵

John McDonnell, finance spokesman for the Opposition Labor Party, said that the tax authorities needed to explain how they had settled on the figure of 130 million pounds, which he described as relatively insignificant.

“It looks to me ... that this is relatively trivial in comparison with what should have been made, in fact one analysis has put the rate down to about 3 per cent, which I think is derisory”, he told BBC Radio.

“This looks like another sweetheart deal.”

Prem Sikka, professor of accounting at Essex University, agreed, saying that for a company that enjoyed UK turnover of around 24 billion pounds over the period and margins of 30 percent, the settlement represented an effective tax rate in the low single digits for Google.

“This is a lousy number and we need to know more”, he said. (Emphasis added.)

Nassim Khadem reports Rupert Murdoch saying the following about the Google agreement with HMRC:⁷⁶

Rupert Murdoch may be right, well this time any way...

“Google et al broke no tax laws”, Murdoch wrote on twitter.

“Now paying token amounts for PR purposes. Won’t work. Need strong new laws to pay like the rest of us.”

An issue that illustrates how ineffective this transaction is from the perspective of HMRC appears from a report in *The Guardian* of 4 February 2016 which records:⁷⁷

⁷⁴ Kevin Rawlinson, ‘Google Agrees to Pay British Authorities £130m in Back Taxes’, *The Guardian*, 23 January 2016.

⁷⁵ ‘Google Agrees to Pay Britain 130 Million Pounds in Back Taxes, Opposition Label Figure “Derisory”’, *ABC News online* (updated 24 January 2016) <<http://www.abc.net.au/news/2016-01-24/google-agrees-to-pay-back-taxes-to-britain/7110044>>.

⁷⁶ Nassim Khadem, ‘Rupert Murdoch is Right, The Tax Deal With Google is “Token”’, *Business Day, The Sydney Morning Herald*, 29 January 2016.

⁷⁷ ‘Google Tax Deal Under Fire as it Emerges Figure Included Share Options Scheme’, *The Guardian* (on line), 4 February 2016 <<http://www.theguardian.com/technology/2016/feb/04/google-uk-tax-deal-share-options-scheme>>.

George Osborne's claim that the government secured a major corporation tax deal with Google appear to be unravelling after it emerged that a quarter of the £130m recovered by HM Revenue & Customs related to the US company's share options scheme.

Filings by Google's UK subsidiary show that £33m of the funds paid to the Treasury followed a wrangle over share options handed to staff, which the US business had argued were exempt from UK tax.

The company's accounts show that the government was only able to claw back less than £100m in corporation tax from Google for the 2005–2014 period, and not the £130m the chancellor claimed. MPs and foreign governments have criticised the deal for allowing Google to generate billions of pounds in profits from its UK business and pay little corporation tax. (Emphasis added.)

The agreement with Google, as Murdoch suggests, appears to be a stratagem on its part to obtain respite from the attention of the media. The monies paid to HMRC appear to be but a token amount of all the taxes it is contended it should have paid in the past. How the sum of £130 million is made up is not disclosed. Significantly part of the amount Google agreed to pay was the sum of £33 million in relation to staff options. This is the same cause for the amended assessment in 2014 as referred to in *The Times* report of 4 January 2014.

The naming and shaming campaign against Google although causing a loss of reputation resulted in minimal gain to HMRC. There have to the author's knowledge been no successful challenges to the tax affairs of Google in Australia despite intensive investigations into its affairs. The only way in which the UK or any other country is able to tax entities such as Google for income derived in their countries are to enact effective tax laws that capture this income. Whether the Diverted profits tax in the UK or the MAAL in Australia accomplishes this task is yet to be demonstrated.

5. CONCLUSION

The media plays an important role in naming and shaming. Without the media, naming and shaming would not be effective. There are significant issues with such campaigns. Fundamentally blameless entities may be targeted. With such campaigns the media appears to be the sole arbiter of what is right and wrong. The targets of these campaigns can do very little to counter it.

The media, politicians and activist groups campaign against what they refers to as 'tax avoidance'. These campaigns are and continue to be based on what would appear to be a misconception of the scope and ambit of the tax laws and what constitutes avoidance. This misconception may be deliberate. The concept of 'tax avoidance' as used in these campaigns appear to have a meaning which is indeterminate and open ended which enables the media to label any conduct other than the payment of the headline rate of tax as avoidance.

One of the corporations targeted was Google. As a result of this campaign Google's reputation was damaged. After many years of being the brunt of a naming and shaming campaign it concluded an agreement with HMRC apparently to cover taxes not paid over a period of a decade. This payment is seen to a stratagem to limit the

media campaign against it. The amount paid bears no relationship to the income earned over the decade in question or the tax on that income which it was contended was not paid.

Campaigns of naming and shaming which cause corporations to make payments to the revenue authorities of sums of money that are not payable under the tax laws demean the rule of law. Taxes should only be paid in relation to those amounts which the law requires. To determine if there has been noncompliance with the tax laws whether it is avoidance or some other breach requires expert knowledge of the tax laws and a careful consideration of the facts to which it is sought to apply such laws. The media, politicians and activist groups are not capable of making complex legal distinctions between compliance and non-compliance and it is certainly not their role to punish extra-curially without any legal basis for assigning blame/guilt.

The obligation to pay tax should be based on a liability created by legislation and not be an ex gratia payment or attempt to appease unjustified, and often uninformed and vociferous criticism. If there are to be naming and shaming campaigns against corporations the media should ensure their allegations of misconduct are based on breach of the tax laws and not a breach of some intangible and indeterminate amount of which they are the sole arbiters.

The use of CAATTs in tax audits—lessons from some international practices

Agung Darono¹ and Danny Ardianto²

Abstract

This article presents a comparative study of the state-of-the-art computer-assisted audit tools and techniques (CAATTs) regulation and practice in five countries (Australia, Finland, Germany, Indonesia, and the US), in an effort to progress the use of CAATTs in supporting effective tax audits. For practitioners, the findings suggest several ways to improve the use of CAATTs. On the theoretical side, we found that not all types of CAATTs are equal in effectively achieving tax audit goals. Data extraction and analysis techniques, also known as generalised audit software, are by far the most prevalent and relevant ones for tax audits. In certain cases, several tax authorities were determined to streamline the use of CAATTs by requesting taxpayers to provide a standardised file format for tax audit purposes. There was also a case when a tax authority had attempted to implement continuous auditing techniques while paying attention to the running of taxpayers' business. The exploratory findings from this study may become a source of reference about CAATTs for tax authorities, taxpayers, and tax agents/advisers.

Keywords: audit, comparative, computer, tax, techniques, tools

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1. INTRODUCTION

It is within a country's tax authorities' power to determine whether a taxpayer has fulfilled their tax obligations in accordance with the provisions of the applicable law. Tax auditors will provide their recommendations on the compliance level of the audited taxpayer following consideration of evidence collected from either the taxpayer or related parties. Rapid advances of information technology in business have made digital trails dominate the form of evidence in tax audits. Consequently, tax auditors will need to deal with electronic data as the output of the computer-based information systems and incorporate them as evidence in tax audits.

The computer audit field addresses the role of the computer from two perspectives; as a subject of assurance (the audit object) and an audit tool (deBoer et al., 2014). Auditing in a broader sense (including, but not limited to, financial, compliance, operational, human resources, and information systems audits) has embraced computer assisted audit tools and techniques (CAATTs), which is defined as a set of audit techniques based on computer functions aimed to improve the efficiency of an audit in all phases: from planning and implementation to reporting of the audit (Braun & Davis, 2003; Coderre, 1998; deBoer et al., 2014; Debreceeny et al., 2005; Flowerday et al., 2006; Hunton et al., 2004; Pathak, 2005; Pedrosa & Costa, 2014). The significant roles of CAATTs have also attracted some audit standards setting bodies to incorporate this tool into their standards (Debreceeny et al., 2005; Widuri, 2014). Recently, IAASB (2013,p. 40) has also observed sensitivity to the various aspects pertaining to audit evidence generated from the application of advanced techniques in data analysis, including the effects on the risk assessment and response made by auditors, the objectives and schedule of other audit procedures and the auditors' capacity to acquire the proper audit evidence. This observation shows that regardless of the type of assurance services rendered, auditors would benefit from familiarity with CATTs (Byrnes et al., 2012; Darono, 2015).

The conduct of audits has largely benefited from the use and development of CAATTs. Most tax administrations around the world have adopted CAATTs as part of their mandatory tax audit procedures, with slight variations between each jurisdiction. The variations can be classified from a number of different perspectives: the underlying legal foundations, use protocols, and actors (Darono 2015; Ernst & Young, 2014; FTA, 2006; IOTA 2010; Nevelsteen & Frenckell, 2014; OBG, 2014). The variations include the use of the term CAATTs in tax audits. The academic literature and several practitioners refer to CAATTs as 'tax e-audit' (for example, Ernst & Young, 2014; Nevelsteen & Frenckell, 2014; OECD, 2010), 'computer assisted audit program' (for example, DOR [no date]) or 'EDP Audit' (for example, IOTA 2010), or 'data analysis technology' (deBoer et al., 2014; Lambrecht et al., 2011). According to Shue (2006), the OECD has also taken a step further in facilitating the use of CAATTs in tax audits (tax e-audit) through the commissioning of a task group which develops guidelines that allow the taxpayers' accounting system relatively easily to produce audit evidences in an electronic data format. The resulting recommendation by the task group is known as Standard Audit File for Tax (SAFT).

However very little research has been conducted on the use of CAATs in tax audits in comparison to research on the use of CAATTs in non-tax audits (for example, the commercial sector). A number of scholars (for example Coderre, 1998; deBoer et al., 2014; Janvrin et al., 2009; Lambrecht et al., 2011; Moeller, 2009; Pedrosa & Costa,

2014; Widuri, 2014) have taken up the issue by suggesting the details on the role, relative position, and innovations around the use of CAATTs in audits of the commercial sector. However, tax practitioners seem to be 'reasonably content' with utilising this body of literature (articles, cases and research reports) without taking a more active role in promoting the need for research on CAATTs in tax audits. In this paper, we argue that the tax audit field needs to break this tradition by initially taking up the comparative tax research tradition suggested by Garbarino (2009). To the best of our knowledge, this has not been attempted before and is necessary for building cumulative understandings in the tax audit field. The literature on CAATTs in tax audits is predominantly focused on technical how-to guidelines issued by several research institutions and private consulting firms (for example, Ernst & Young, 2014; IOTA 2010; OECD 2010). From a methodology perspective, most of this body of literature is descriptive in nature (for example, Nevelsteen & Frenckell, 2014). In the educational settings, Boritz and Datardina (2007) paid little attention to CAATTs in comparison to other topics in their academic classes.

The IOTA (2010) compared the use of CAATTs among its country members. The comparisons included business process mapping and evaluation of internal auditing, coordination with developers of accounting and e-audit software, and use of taxpayers' data from either internal audits or audits carried out by chartered accountants. To this end, this article aims to supplement the work of IOTA by exploring a few aspects that have not been discussed, for example, the presence of continuous auditing techniques or digital forensics, and expanding the comparative cases of CAATTs use in countries outside of IOTA memberships.

Based on the above, this paper aims to reveal how CAATTs has been utilised by tax administrations in tax audits. It achieves this goal through a comparative study on the use of CAATTs within a number of tax jurisdictions. Using comparative institutional analysis (Cole, 2013; Garbarino, 2009), this study seeks to reveal how CAATTs institutional practices may differ from one tax administration to another. The study is expected to contribute to the larger body of knowledge about CAATTs in the auditing field. Methodology-wise, this study presents a comparative research approach that is built upon interpretive data analysis combined with our accumulated experience in the fields of tax audit, information technology, and CAATTs.

This paper is structured as follows: introduction, research design then the contextual and analytical foundations of the study are presented. Next, the findings of the comparative study are discussed. The paper concludes by outlining the contribution of the study and suggestions for future research.

2. RESEARCH DESIGN

Creswell (2009, p. 22) defines research design as a plan of action and procedure in research that comprises the worldview and detailed techniques for collecting and analysing data. It specifically includes ' (1) informing this decision should be the worldview assumptions the researcher brings to the study; (2) procedures of inquiry (called strategies); (3) specific methods of data collection, analysis, and interpretation'. This study is qualitative-interpretive in which the researchers construct social reality and offer their interpretation of the reality based on their knowledge, experience, and contextual information that presents to them. The case study method used in this research enables us to thoroughly explore the events,

programs, activities, and processes of an individual and a group of individuals in their natural settings. A case study is bound by time and activities which define the scope of the research (Bhattacharya, 2008; Creswell, 2009; Yin, 2009).

According to Creswell (2009), research design is also concerned with methods; the means through which data is collected and analysed to construct an interpretation of the object of study. In this study, the data was sourced from documentary materials around the implementation of CAATTs issued by each of the tax authorities as well as published by consulting firms, research institutions and media releases. Bowen (2009) defines document analysis as a systematic procedure for examining electronic and print documents to reveal empirical research findings.

More specifically, the study used comparative institutional analysis (hereinafter 'CIA') as a frame of reference in collecting, transforming, analysing, and interpreting the data. Referring to Bowen (2009), document analysis can be part of (or incorporated with) other types of data analysis techniques. In this regard, we combined document analysis and CIA. CIA is one method available for comparative tax research. It uses a technique that combines tax problem, tax model, and tax mechanism; a pattern suggested by Garbarino (2009). The relationship between the three as a data analysis technique is determined by combining them with the core elements of CIA as follows:

1. determining the tax problem, in which case how the use of CAATTs influence tax audits
2. determining the tax model, which is the amount of available institutional choices with regards to tools and audit techniques including regulations surrounding CAATTs
3. determining the tax mechanism, which refers to the working rules or the selected institution for exchange. In this regard, it transpires in how the tax authority eventually determine the tax audit procedures which should use CAATTs.

Detailed explanations on CIA are presented in Section 4.

This study follows the analytical framework in Debreceeny et al. (2005) which uses qualitative methods to examine the extent to which generalised audit software has been utilised in banking sectors. The paper begins with a description on the sequential steps of conducting CIA for the purpose of comparative tax research (Garbarino, 2009). The detailed steps are important to illustrate the trilogy of tax problem, tax model, and tax mechanism in relation to the deployment of CIA. This will also be a critical contribution for other comparative tax research in this area.

Firstly, the context of CAATTs used in the case study is explicated which comprises tax authorities in five countries: Australia, Finland, Indonesia, Germany, and the US. The choice of these countries is based on availability of data to the researchers and also aimed to increase the transferability of findings from the present study. Transferability implies that certain elements and experiences of a study can be related, transferred, and applied in other similar settings. The similarity of research and implementation settings allows the reader to transfer the findings from another study into the new context (Barnes et al., 2012). The explication of the study context is an attempt to situate the tax problem into the exchange arena. As a qualitative study, we

strive for transferability instead of statistical generalisation of the findings (Bhattacharya, 2008; Brown, 2015; Maxwell & Chmiel, 2014; Yin, 2009).

Secondly, the tax model and the choice of available tax institutions are reviewed. CAATTs, as a form of IT applications, can be viewed as a manifestation of institutional choice (Avgerou, 2000) which constitutes part of tax audits. Finally, the last step explores the selected tax mechanism by each tax administration based on the tax problem it encounters and the choices of tax models available. Based on the aforementioned steps, we offer our interpretation, conclusion and recommendations of the findings.

3. AUDIT IN TAX ADMINISTRATION: CONTEXT OF THE CASE

Tax administration has the authority to determine the amount of tax payable regardless of the tax regimes followed: self-assessment, official assessment, or withholding. It will then need to determine the amount of tax in question. Audits are one of the most prevalent ways to obtain that amount. Tax audits are concerned with collecting and transforming evidence from multiple sources in order to conclude whether the audited taxpayer has complied with the law. If the taxpayer were found to be non-compliant, relevant penalties shall be given. In other words, tax audits hold a central role in the enforcement of tax laws. Table 1 shows a summary of tax audit practices used by a number of tax authorities (PwC, 2015). The PwC document consists of key tax regulations in the countries in which they are operating. For the purpose of this study, only the five countries pertinent to the study are considered.

Table 1: Summary of the relative position of audits in tax administration

Tax authority	Description
Australia	The Australian tax system for corporations is based on self-assessment; however, the Australian Tax Office (ATO) undertakes ongoing compliance activity to ensure corporations are meeting their tax obligations. The ATO takes a risk-based approach to compliance and audit activities, with efforts generally focused on taxpayers with a higher likelihood of non-compliance and/or higher consequences (generally in dollar terms) of non-compliance. Compliance activities take various forms, including general risk reviews, questionnaires, reviews of specific issues, and audits.
Finland	Tax audits are performed at irregular intervals by tax auditors, who are entitled to examine the accounts of a company and to request additional information necessary to the examination. Generally, the taxpayer receives advance notice of an audit from the tax authorities.
Germany	Germany relies heavily on tax audits as a means of ensuring taxpayer discipline. Audits of small businesses are carried out at random, although those for larger operations and for the local subsidiaries of foreign groups tend to be regular. With some district variations, audits are usually conducted at four to five yearly intervals, though not always with equal intensity for the entire period since the auditors' previous review.
Indonesia	Indonesia uses a self-assessment system under which taxpayers are trusted to calculate, pay and report their own taxes in accordance with prevailing tax laws and regulations. However, the Directorate General of Taxes (DGT) may issue tax assessment letters to a particular taxpayer if it finds that, based on a tax audit or on other information, the taxpayer has not fully paid all tax liabilities. A tax assessment letter may also be

Tax authority	Description
	issued by the DGT to a taxpayer who ignores a warning letter to file a tax return within a specified period. A tax refund request will always trigger a tax audit. Due to the requirement for the DGT to decide on a refund request within 12 months, a tax audit will typically begin within a few weeks to several months from the refund request date
US	Generally, the US tax system is based on self-assessment; however, many large and medium-sized businesses are under continuous audit by the Internal Revenue Service (IRS) and state tax authorities. The audits may include the entire list of taxes for which the business is liable. Smaller business and persons with lower incomes are generally subject to audit on a random basis

Source: PwC (2015)

From Table 1, it can be concluded that tax audits are vehicles for the tax authorities to re-assess the amount of tax payable. This highlights the importance of gathering evidence during an audit and dealing with the inevitable presence of electronic data. In relation to handling electronic data, the tax problem framework (Garbarino, 2009) is most relevant in this situation. The tax problem approach views a situation as a comparative problem to be solved. An analytical framework will be found that can be used to solve a similar problem in the future. In the following section, a description of tax model from Garbarino's comparative tax framework (2009) is presented. In particular, the benefits of the use of CAATTs for tax audits are discussed.

4. CAATTs AS AN INSTITUTION: THE MODEL

Tax audits are an element of tax administration that takes part in the creation of social welfare. They are constructed social realities that could be hindered by social dilemmas (Cole, 2013). To reduce and minimise the dilemmas, relevant actors within tax audits need to decide which institutions are most suitable to act as the 'action arena' (Ostrom, as cited in Cole, 2013) or 'the game being played' (Aoki, 2001). In the literature, there has been a variety of understanding about the structure and relative position of institutions. They differ in the way that they are used in an analytical framework to solve real-world social problems. Thus, we will outline the definition of institutions that is used in this comparative tax research on CAATTs.

Institutions are boundaries created by humans that allow for social, economic and political interactions. The boundaries can be formal (constitution, law, property rights) or informational (traditions, agreements, norms and etiquettes). Institutions exist to facilitate order and reduce uncertainty in humans' lives (North, 1991), or reduce the associated transaction costs (Richter, 2015, p.11). Institutions can be defined as regulations used to specify the quality of the person in charge of making decisions in some spheres, the types of permitted and restricted actions, the rules to be applied, the procedures to follow, the types of information to be provided or to be kept, and the rewards for each person based on their contributions (Ostrom, as cited in Cole, 2013, pp. 109). Regulations determine what actions are prohibited, permitted, or required, and consist of rules which are effectively in place when each individual decides what to do. Komesar, cited in Cole (2013), defines institutions as an alternative mechanism for actors to achieve their goals in the form of markets, communities, political process, and courts. Understanding the different meanings of institutions is important to denote the operational definition of which actors will apply in terms of using CIA as a framework (Cole, 2013).

In response to the variety of institutional roles and positions, Williamson (1998) suggests four levels of social analysis to differentiate institutional roles and positions based on the level of durability and maturity. These four levels distinguish one form of institution from another in which the lower level assumes less maturity than the higher level. The four levels of analysis are:

1. social embeddedness level; the level in which norms, customs, mores, and traditions are located
2. institutional environment as a product of politics that provide the rules of the game within which economic activity is organised. The polity, judiciary, and bureaucracy of governments are located here
3. institutions of governance, which are concerned with the play of the game,
4. resource allocation and employment.

In this study, changes in audit techniques (level 4) are easily comparable to changes in tax assessment system (levels 2 and 3).

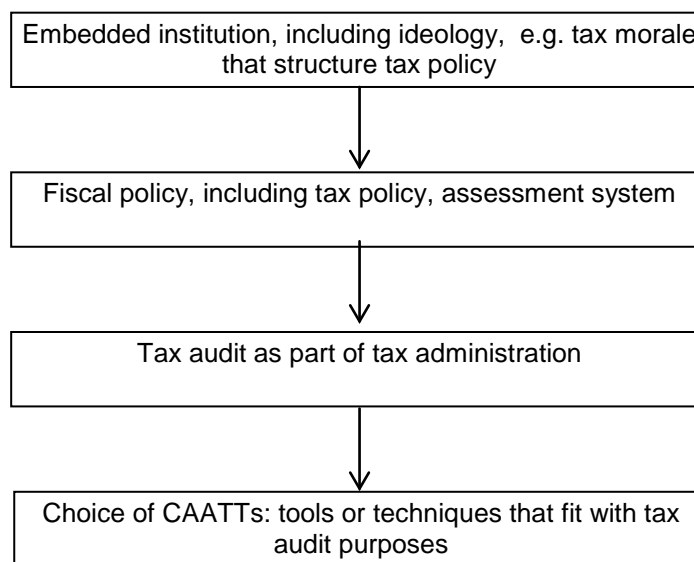
Institutional analysis is principally concerned with selecting the appropriate institution to accomplish the game being played (Aoki, 2001; Garbarino, 2009). Williamson (1998) denotes this as the 'rules of the game' and the 'play of the game'. Ostrom, in contrast, labels these as 'prescription' and 'working' rules (as cited in Cole, 2013). There are a multitude of schools of thought within institutional analysis which result in the proliferation of analytical techniques within each of the different traditions. To name a few, institutional pressure and isomorphism, institutional logics, institutional arrangements, and institutional entrepreneurship are amongst the more popular techniques. They highlight certain viewpoints in examining how a social situation can be explained or predicted using the many different features from each of the analytical lenses available (Darono & Panggabean, 2015; Richter, 2015; Wahid & Sein, 2013).

CIA is not a 'comparative analysis of institutions'. It does not aim to differentiate between one institutional feature and another. CIA techniques emphasise how an institution works to achieve social welfare (Cole, 2013). The understanding is derived from the multiple definitions and shapes of institutions. Cole (2013) denotes 15 definitions of institutions from a variety of disciplines. Consequently, institutional analysis (including CIA) will be influenced by the operational definition of institutions. (Cole, 2013). CIA functions to understand why an institution fails to become a social interaction medium and why it instead causes social-cost problems or social dilemmas. For example, if the market as an institution fails to become a socio-economic interaction medium, would that imply total replacement by the country? Furthermore, what would happen if the country as an institution also fails? What sort of replacement will be needed? CIA provides a framework to conduct such analyses with the view of facilitating institutions to perform as expected.

An institutional perspective of a social situation is needed to resolve social interaction problems (human relationships within a society). This includes social interactions that comprise completing tax obligations of an individual within the broader society. According to Garbarino (2009), society needs fiscal institutions that include regulations and procedures that facilitate effective tax administration (as a social interaction). Following the above propositions, the use of CAATTs for tax audits is a

form of fiscal institution. Tax audits and CAATTs are both the selected institutions to realise the expected social interactions, that is, tax compliance. Building upon Williamson (1998), CAATTs can be positioned as a configuration shown in Figure 1. CAATTs in this setting are situated within levels 3 and 4 which afford a discussion on institutional choices and the most relevant mechanism options available to the environment.

Figure 1: Choice of CAATTs and tax administration in four levels of social analysis—adapted from Williamson (1998)



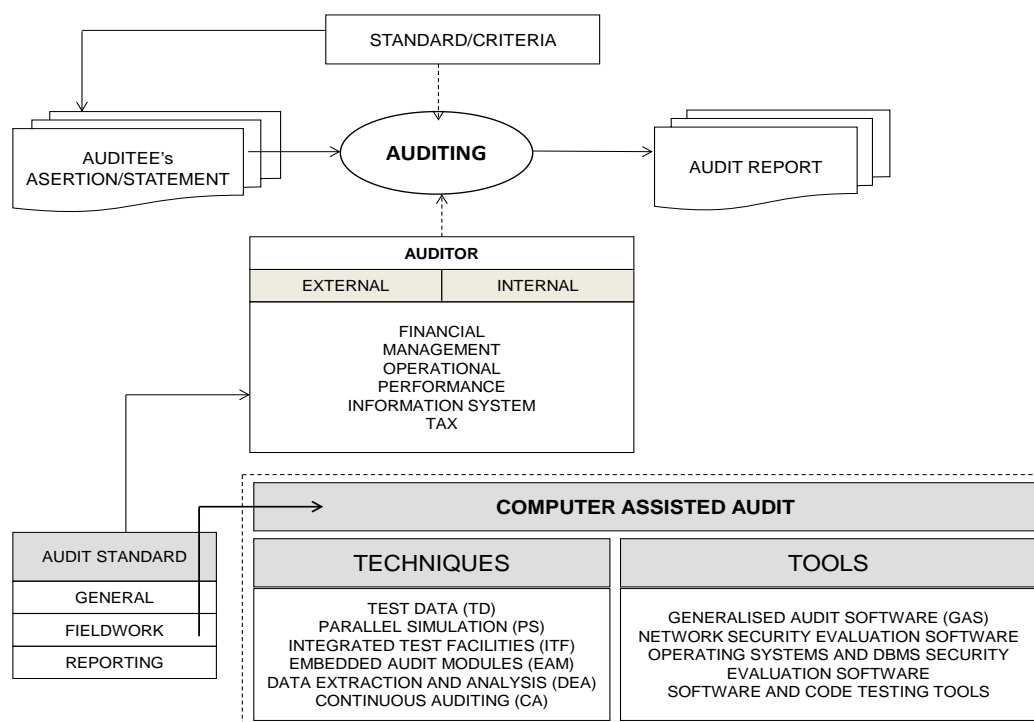
From a conceptual and practical perspective, CAATTs use in audits is a response to the ubiquity of enterprise information systems which produce digital audit trails. Such a response manifests in the handling of digital audit trails from data test techniques to continuous auditing. Hardware-wise, CAATTs can take place in the form of spreadsheet or decision support systems. The following section will elaborate on the practices of CAATTs from an institutional perspective in light of eliciting the features of CAATTs relevant for comparative tax research.

In a more practical context, adopting a CAATTs vision for effective handling of digital audit trails is not so easy. Using Indonesian public accounting firms as a setting, Widuri (2014) concludes that CAATTs (that is, generalised audit software) has yet to be fully embraced although the professional body of auditing practices has mandated such techniques to be used. Darono (2009) reveals the need for adequate legal support that outline the audit protocols for CAATTs and the inception of a special unit dealing with CAATTs in tax authorities. Likewise, attempts to increase the comprehensiveness and dynamics of continuous auditing techniques should continue to be prioritised in relation with advanced use of CAATTs (Kiesow et al., 2015; Kiesow et al., 2014). Coderre (2005) suggests a practical and conceptual framework to implement continuous auditing. Similar initiatives have been underway by the Indonesian Supreme Audit Board which promotes ‘e-audit’ to indicate continuous online audit techniques across its auditees. In this type of e-audits the data centres of the auditors and auditees remain connected (Darono, 2015).

Coderre (1998) states that CAATTs are a mechanism that enables auditors to examine data and information interactively and react timely on an audit finding by changing and improving the audit approaches. CAATTs increase the effectiveness and efficiency of audit procedures in obtaining and evaluating audit evidences. This is facilitated by way of (1) examining more transactions in a shorter period of time at a fraction of a cost of the manual procedures; (2) enabling more reliable substantive tests through the use of supplementary audit procedures, hence increasing the level of confidence of the auditors.

However, CAATTs seem to be confused with other terms in the literature. Misconceptions occur when generalised audit software/GAS (as a tool) is interpreted the same as data extraction and analysis/DEA (as a technique) or make GAS and DEA equivalent to CAATTs (deBoer et al., 2014; Lambrecht et al., 2011; Widuri, 2014) or even equating DEA/GAS/CAATTs with information systems audit. To clarify this, Darono (2015) suggests a scheme to depict the relationship between tools and techniques in CAATTs. From Figure 2, it can be seen that regardless of the audit types and the auditors, CAATTs can be used in accordance with the variety of tools and techniques available.

Figure 2: CAATTs in audit—adapted from Darono (2015)



The term 'tools' in CAATTs include multiple forms from spreadsheets and database management systems to expert systems. Meanwhile, the term 'techniques' can include data filter procedures which are then matched with certain criteria, and the use of artificial intelligence tools as a way to predict financial failure or financial statement structures. Sayana (2003) classifies CAATTs hardware into four major categories: (1) data analytics software; (2) network security evaluation software; (3) operating systems and database management systems evaluation software; (4) code

testing software. Newer schemes of categorisation are suggested by Pedrosa and Costa (2014) which include: big data analytics, cloud analytics, and security and privacy tools.

Weber (2001) categorises audit approaches into two main strands: audit through the computer and audit around the computer. Cerullo and Cerullo (2003) add an audit approach known as 'audit with the computer'. Audit with the computer is, in essence, an audit using GAS (Byrnes et al., 2012). Coderre (1998) further suggests a classification scheme between 'system approach' and 'data approach'. System approach is a procedure to test data by examining the system flow and control in order to assess reliability of the data. On the contrary, data approach is focused on testing of the data with less attention on how the system produces the data. Hunton et al. (2004) label system approach as 'application controls test' and data approach as 'data integrity test'.

ISACA (2010) denotes that CAATs can be used for a range of audit procedures such as balance and transaction details testing, testing of general and application controls, or penetration testing. Following Hall (2001), Cerullo and Cerullo (2003), Braun and Davis (2003), Hunton et. al (1998), as well as Coderre (2005), testing techniques can be divided into:

1. test data (TD)
2. parallel simulation (PS)
3. integrated test facilities (ITF)
4. embedded audit module (EAM)
5. generalised audit software (GAS)
6. continuous audit techniques (CAT).

The professional judgment of the auditors will determine when the above techniques are to be used. Darono (2010) suggests a summary of relationships between the goals and types of audit testing. For instance, if an auditor is to compare aggregated data with the transaction details of the data, then s/he can use professional judgment to select from the range of available techniques shown in Table 2.

Table 2: Type of audit and its CAATs form of tests

Reference	Type of audit tests	Form of tests
Hall (2001); Braun & Davis (2003)	Application control	TD, PS, ITF
	Substantive test	EAM, GAS
	Direct test to internal application logic	TD, PS, ITF, EAM
	Indirect test to internal application logic	GAS
Hunton et. al (2004)	Application control	TD, PS, ITF
	Data integrity test	GAS, CAT
Coderre (1998)	System approach	TD, PS, ITF

Reference	Type of audit tests	Form of tests
	Data approach	GAS, EAM
Cerullo & Cerullo (2003)	Application control	TD, PS, ITF, EAM

Source: adapted from Darono (2009)

Further development of CAATTs shows a possibility of changes in CAATTs use in the future. DeBoer et al. (2014) suggest a reengineering concept of CAATTs in financial audits by giving weight to audits on process mining, metadata and big data. Kiesow et al. (2014) take a similar position in this regard. From late 1990s, continuous audits have also been very popular due to the pervasive use of enterprise information systems (Byrnes et al., 2012; Coderre, 2005; Flowerday et al., 2006;; Pedrosa & Costa, 2014). Pedrosa and Costa (2014) conclude from their surveys that financial audits are mostly dominated with the use of GAS and DEA. They suspect that the overall landscape of CAATTs will change along with the rise of data mining, big data, analytics, text mining, controls related to bring your own device (BYOD), and cloud auditing.

To sum up, this section has presented the key features of CAATTs and their recent developments which will be compared using an institutional analytical framework with respect to tax audits. The next section will describe how tax audits can benefit from CAATTs by means of comparison between different institutional mechanisms.

5. INSTITUTIONAL COMPARATIVE FOR USE OF CAATTs: THE MECHANISM

The section will begin with a description of CAATTs used for tax audits in the aforementioned five countries. We will then submit a comparative analysis using the framework of North (1991) and Williamson (1998): examining institutions within their socio-organisational constellations, then deciding which institution has the lowest transaction cost, or finding a new equilibria from the game being played (Aoki, 2001). Transaction cost is nothing new in tax administration. Within the tax field, it is commonly referred to as compliance cost. It is costs incurred by taxpayers in complying (or sometimes not complying) with their tax obligations (Evans et al., 2013; Tran-Nam et al., 2000).

The notion of CAATTs emphasises the use of techniques or devices irrespective of the actors. They can be the auditors themselves or any other parties, for example, IT experts from database administrators to data communication specialists, from whom the auditors ask for assistance. Consequently, the tax auditors must equip themselves with a variety of tools and techniques should they use CAATTs on their own. Another option is through the inception of a special unit which provides assistance to the auditors. Within the perspective of comparative institutional analysis, this poses a choice for the organisation to determine which option has the lowest transaction cost (North, 1991; Williamson, 1998) or to find a new-equilibria (Aoki, 2001).

The options available to minimize transaction costs in the context of the tax audit CAATs is coupled with the results of the OECD study on SAFT (Standard Audit File for Tax). This SAFT file format allows for a standardised data format that reduces uncertainty and increase compatibility of data files. It is important to note that the

introduction of SAFT will place a burden on taxpayers in their efforts to meet the requirement of the standardised data format.

Based on the above, the authors propose some important criteria to compare how those tax authorities apply CAATTs in their tax audit. The criteria are useful to help tax practitioners identify which CAATTs to use that will fit the overall audit context, for example, how taxpayers must prepare documentation of system that they use or what techniques should be used by tax auditors if examining a taxpayer who uses a particular accounting information system. The following are key comparative criteria of CAATTs in tax audits that we examined:

1. terms used: his to delineate the extent of agreement in labelling similar practices of CAATTs utilization in the five countries
2. tools used to perform CAATTs: to determine techniques deployed in analysing gathered data
3. data standards imposed on taxpayers to meet the requirements
4. a dedicated CAATTs unit to assist tax auditors.

Table 3 displays the four categories of CAATTs use. In Table 3, we compared ‘the mechanism’ with CAATTs (‘the model’) and effective tax audits (‘the problem’) in one instance. Nevertheless, there are a number of things that remain to be addressed:

1. The lack of attention to SAFT. If seen as a form of institution, SAFT does not seem to offer lower total transaction costs. It only shifts the cost from tax auditors to taxpayers. The tax authorities seem to consider that transaction cost from using SAFT is much higher than the cost of increasing the capacity of tax auditors in dealing with multiple data formats or a dedicated CAATTs unit has lower transaction cost than having SAFT in place.
2. SAFT was formulated to make it easier and faster for auditors to carry out the audit as all the required data is available in an accessible and processable format. However, a further question to ask is whether the auditors will still need other (accounting) data in addition to the ones available in SAFT forms.
3. The dominance of DEA techniques through GAS. This brings the question of the positioning of other audit techniques in a tax audit. Continuous auditing techniques have been regarded as ‘killer apps’ to the auditing profession. As was found in Finland’s case (Vero Skatt, 2010), the tax authority was very careful in maintaining relationships with taxpayers that tax audits (and the use of audit techniques within them) were not to interfere with the taxpayers’ running of their businesses:

It is less disruptive to business. —Electronic audits permit tax auditors to work at the tax office most of the time. Computer-assisted tax audit techniques reduce on-site audit time. In this way, there is minimal interference with the normal business of your company.

This means that the use of continuous auditing as a type of CAATTs applications for tax audits may be considered to complement the DEA

techniques so long as the implementation does not temper the taxpayers' running of business while being audited.

4. The relative position of digital forensics in the landscape of CAATTs use in tax audits. Tax audits have the potential to reveal fraud. This would require further treatment in the form of investigative audits. Questions remain on how the transition from CAATTs use in tax audits can be facilitated productively towards investigative audits. The former emphasises the form of electronic audit evidence while the latter is concerned with constructing electronic evidence for the court.
5. Following Aoki (2001), there existed a new-equilibria. This was related to the presence of a special unit which deals with CAATTs (that is, e-tax auditor). The unit catered for tax audit purposes through standardisation of file formats. It also contributed to digital forensic activities. The audited taxpayers were required to render a standardised file format to assist with the work of the tax auditors without necessarily involving e-tax auditors. E-tax auditors will have time to focus more on the specific audit skills such as digital forensics. The area of digital forensics is one that, in our view, requires more attention for the tax administration than the standard e-tax audit skills.

Table 2: Comparing the main features of CAATTs in tax audits

Tax authority	Features of CAATTs				
	Term used	Tools	Techniques	Data standard	Dedicated CAATTs unit
Australia	Computer assisted verification (CAV), Computer-Assisted Tax Audit (CATA) or e-audit	GAS	DEA with Caseware IDEA	Not specifically described	CATA-team to help case officers
	<u>Additional information:</u> <ul style="list-style-type: none"> • ‘[c]onduct a series of tests on your data to ensure you comply with the tax law. Tests are conducted in accordance with the nature of the compliance activity being undertaken. CAV software will read the electronic information provided but does not allow any changes to be made to the data you have supplied’.³ • ‘Accessing electronic information should be considered, including what assistance is required and what information should be accessed—the Computer-Assisted Tax Audit (CATA) team can help case officers with the gathering, accessing and analysing of electronically-held information’.⁴ • ‘E-audit involves the collection of electronic data from taxpayers which, through the use of Data Analysis software, can be read, displayed, analysed, sampled and reported on. This is known as Data Analysis’.⁵ 				
Finland	CATA techniques, electronic auditing is computer-assisted auditing that uses electronic records to complete all or part of the tax audit	GAS	DEA but the software used is not specifically described	Accounting transactions and additional files (see additional information below)	Not specifically described
	<u>Additional information:</u> <ul style="list-style-type: none"> • The files should consist of fixed-length consecutive strings and be free of software-specific characters (and they should not be backup files). • Accounting transactions and additional files such as charts of accounts and lists of cost centres should be delivered to us on a physical data medium, which is usually a CD or DVD. • The following technical information is mandatory: encoding (ASCII; EBCDIC), existence of zipped/compressed data elements (please 				

³ Australian Taxation Office (ATO), *Computer assisted verification for businesses* (17 August 2016) <<https://www.ato.gov.au/General/Building-confidence/In-detail/Computer-assisted-verification-fact-sheet-for-businesses/>>.

⁴ <https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Large-business-active-compliance-manual---income-tax/?page=44#3_9_Issues_to_consider>.

⁵ ATO, *Public and private groups (indirect tax) compliance risk manual—chapter 3* (18 September 2014) <[https://www.ato.gov.au/Business/Bus/Public-and-Private-Groups-\(Indirect-Tax\)-Compliance-risk-manual---Chapter-3/](https://www.ato.gov.au/Business/Bus/Public-and-Private-Groups-(Indirect-Tax)-Compliance-risk-manual---Chapter-3/)>.

	unzip/uncompress), number of records, length of records. • If company cannot deliver accounting system files where transactions are primarily recorded, tax auditors alternatively utilise reporting files or list files. Accounting systems create reporting files and transaction lists associated with the general ledger and journal, accounts receivable and accounts payable. ⁶				
Germany	Not specifically described	Direct access (Z1): Auditor has the right to independently access the taxpayer's computer systems which contain tax-relevant data by using a user role that has been set up for the auditor. The taxpayer has to provide the hardware and software so that the auditor can inspect the data and evaluate it automatically. Indirect access (Z2): Requires the taxpayer or an authorised third party to evaluate the data according to his/her specifications automatically with a read-only access. The taxpayers are obliged to support the auditors by providing persons who are familiar with the computer system. Transfer on machine-readable data medium (Z3): Use of data extraction and	Adjusted with type of access. If the auditor comes with Z1 or Z2 type, practically speaking he/she can use any CAATTs techniques. In the case of Z3 type access, actually this is a 'GAS using DEA' approach.	Should comply with 'GDPdU', ('Grundsätze zum Datensugriff und zur Prüfbarkeit digitaler Unterlagen', which is German for 'principles of data access and auditing of digital documents).	Some Federal States have established or are establishing jobs for special computer auditors to support the auditors, while other Federal States are pursuing the objective that the auditors themselves access the data.

⁶ Vero Skatt, *Auditing in an electronic environment (e-auditing)* (24 September 2014) <[https://www.vero.fi/en-US/Precise_information/Taxpayer_rights_and_obligations/Auditing_in_an_Electronic_Environment_eA\(14895\)>](https://www.vero.fi/en-US/Precise_information/Taxpayer_rights_and_obligations/Auditing_in_an_Electronic_Environment_eA(14895)>).

		analysis techniques.			
	<p><u>Additional information:</u></p> <p>The term ‘tax-related data’ has not been defined nor specified respectively within the scope of the legal provisions for data access. The statutory record retention requirements and the data access refer to the documents mentioned in § 147 Sect. 1 AO.</p> <ul style="list-style-type: none"> • Accounts and records, inventories, financial statements, management reports, opening balance sheet as well as the instructions required for their comprehension and other organisational documents. • The received commercial or business letters. • Reproduction of the sent commercial or business letters. • Accounting records. • Documents that have to be attached to a customs declaration, which has been submitted with data processing media in accordance with Art. 77 Sect. 1 in connection with Art. 62 Sect. 2 Customs Code, provided that the customs authorities in accordance with Art. 77 Sect. 2 Cl. 1 Customs Code have dispensed with the submission of originals or has returned the originals after submission. • Other documents if they are significant for taxation.⁷ 				
Indonesia	e-Audit	Not specifically described, under Ministry of Finance Number 17/PMK.03/2013 concerning Tax Audit Procedures as well as Circulair Number: SE-25/PJ/2013 concerning e-Audit Procedures. Practically speaking, the e-auditor/tax auditor has a right to use any technique in order access electronic data. Auditee (the taxpayer) has to provide a person to help the tax auditor in case they need it to access the taxpayer’s electronic data.	DEA using audit software such as ACL, IDEA, MS-Excel or MS-Access ⁸	Requested by e-auditor and tax auditor during audit process	e-auditor, tax officer or expert hired by tax authority to conduct e-audit

⁷ DSAG Work Group GDPDU, *Recommendations on how to apply the GDPDU* (25 August 2008) <https://www.dsag.de/fileadmin/media/Leitfaeden/101125_Handlungsempfehlung_engl_AK2.pdf>.

⁸ Auditors Online Forum <<http://forum.tax-auditors.com/index.php>>.

	<u>Additional information:</u> <ul style="list-style-type: none"> • e-audit is a process of understanding the taxpayer's organisation, business processes, and electronic systems as well as the acquisition and conversion of electronically-managed data in order to assist the tax audit. • The tax audit has to be performed by tax auditors or e-auditors as part of tax auditor team. • The e-auditor could download the data directly from the taxpayer's computer or ask the taxpayer to do this.⁹ 				
US	Not specifically described	GAS	DEA using MS-Excel or MS-Access	Not specifically described	Computer Audit Specialist (CAS) is an experienced revenue agent who has completed an intensive computer-training program. This training concentrates on large multi-user computer systems that process voluminous data.
	<u>Additional information:</u> <ul style="list-style-type: none"> • The complexity of computer-based records makes the use of a CAS a necessity. Most of the records of larger cases are computer-generated and frequently can involve millions of transactions per year. The use of CAS is imperative to maintaining an efficient and well-organised examination that effectively utilises resources. • The role of the CAS is varied and complex. From the perspective of the an Examination Process (EP) agent, there are three main areas to consider: systems analysis and record evaluation, computer applications (reports and downloading files, etc.), and statistical sampling. The request for a CAS should be made as far as possible in advance of the examination. This will ensure maximum availability of a CAS to examine the computerised books and records in a timely matter.¹⁰ 				

⁹ Peraturan Ortax Circulair Letter of Director General of Tax Number SE - 25/PJ/2013 concerning e-Audit Guidelines
<http://www.ortax.org/ortax/?mod=aturan&hlm=7&page=show&id=15307>.

¹⁰ Johnson, K, Quaal, L & Chesney, A [no date], *Audit techniques for electronic records and data systems*, report to Internal Revenue Service (IRS) <https://www.irs.gov/pub/irs-tege/epche403.pdf>.

6. CLOSING REMARK

This paper describes the first qualitative-interpretive study on the use of CAATTs in tax audits by comparing numerous regional tax authorities' practices and various economic scales. The findings benefit various participants in the tax system, for example, tax authorities may gain a greater overall understanding, taxpayers can better position themselves in discussions with the tax authorities, and professional bodies can enhance their audit standards as well as tax adviser/professional practices.

6.1 Contributions of this study

This paper has shown the use of comparative tax research with an interpretive approach which is different from previous studies that are mostly descriptive (for example, IOTA, 2010; Nevelsteen & Frenckell, 2014, OECD, 2010). The paper has provided an interpretation of the existing practices and given recommendations to improve such practices. It has applied the functional analytical framework ('tax problem', 'tax model', 'tax mechanism') and CIA (Garbarino, 2009). The study however has limitations particularly on its reliance to secondary data. Further research should include primary sources such as interviews, surveys, and observation through interaction with stakeholders (tax authorities, taxpayers, tax agents/advisers).

With regards to the use of CAATTs in tax audits, the paper promotes further research on relatively unaddressed topics such as: (1) the adoption of continuous auditing techniques (deBoer et al., 2014; Hunton et al., 2004); (2) the readiness of digital forensic functions as a continuation of fraud cases in tax audit findings (IOTA, 2010; Pedrosa & Costa, 2014).

6.2 Suggestions for tax practitioners

Consequential to the nature of the interpretive study, the study findings are transferable to similar contexts (tax authority, tax payer, tax professional association) especially with institutions which have similar socio-organisational settings. For practitioners, this study is also relevant to inform state-of-the-art practices amongst tax auditors in the five countries. The tax professionals, who provide their services while dealing with tax authorities' behaviour and all the complicated provisional details, could take the research results at least as an additional reference for improving the quality of their services.

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