

# eJournal of Tax Research

Volume 10, Number 2

October 2012

(Special Edition: Atax 10<sup>th</sup> International Tax Administration Conference)

## CONTENTS

- 182** Editorial  
**Margaret McKerchar, Michael Walpole and Binh Tran-Nam**
- 184** Tax compliance costs for the small business sector in South Africa – establishing a baseline  
**Sharon Smulders, Madeleing Stiglingh, Riel Franzsen and Lizelle Fletcher**
- 227** Australian business taxpayer rights to compensation for loss caused by tax official wrongs – a call for legislative clarification  
**John Bevacqua**
- 250** Findings of tax compliance cost surveys in developing countries  
**Jacqueline Coolidge**
- 288** Tax compliance costs for small and medium sized enterprises (SMEs): the case of the UK  
**Ann Hansford and John Hasseldine**
- 304** FACTA and Schedule UTP: Are these unilateral US actions doomed unless accepted by other countries?  
**J. Richard (Dick) Harvey, Jr**

CONTENTS CONTINUED

- 329 Navigating a transition in US tax administration  
**Kristin Hickman**
- 345 Behavioural economics and the risks of tax administration  
**Simon James**
- 364 Improving tax compliance strategies: can the theory of planned behavior predict business compliance?  
**Jo'Anne Langham, Neil Paulsen and Charmine E. J. Härtel**
- 403 Intervening to reduce risk: identifying sanction thresholds among SME tax debtors  
**Elisabeth Poppelwell, Gail Kelly and Xin Wang**
- 436 Developing risk management strategies in tax administration: the evolution of the Australian Tax Office's compliance model  
**Robert Whait**
- 465 Tax return simplification: risk key engagement, a return to risk?  
**Jason Kerr**
- 483 New dimensions in regulatory compliance – building the bridge to better compliance  
**Stuart Hamilton**

# **eJournal of Tax Research**

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# **eJournal of Tax Research**

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The School of Taxation and Business Law (Atax) is part of the Australian School of Business at the University of New South Wales. We are the largest tax school in any university in Australia, bringing together a team of expert academic staff with backgrounds in law, commerce, tax, accounting and economics. At Atax, we're working towards building excellence in the tax profession, looking at tax from both a theoretical and practical perspective.

## **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**

Submission of original contributions on any topic of tax interest is welcomed, and should be sent as an email attachment (Microsoft Word format) to the Production Editor at <ejtr@unsw.edu.au>. Submission of a manuscript is taken to imply that it is an unpublished work and has not already been submitted for publication elsewhere. Potential authors are requested to follow the "Notes to Authors", which is available from the journal's website.

## **WEBPAGE**

Current and past issues of the *eJournal of Tax Research* are available via the journal's website: <http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Pages/default.aspx>



## Editorial

Given the global trend towards greater reliance on self-assessment together with the expectation that tax administrations achieve more with even fewer resources, maximising voluntary taxpayer compliance remains today a key challenge for tax administrators. Addressing the challenge requires the efforts of many – to bring fresh thinking and new directions to the table; to enhance awareness of new and emerging issues; to share new perspectives and innovative strategies; and to engage in dialogue, sharing and evaluating the lessons learnt. Many of the underlying issues are common. For example, how can tax administrations reduce tax avoidance and fraud? What can governments do to reduce costs for tax administrations and tax payers? To what extent should tax administrators seek to influence public policy? Whilst the solutions may vary between jurisdictions, the pursuit of understanding of taxpayer behavior and improvements in administrative efficiency are common goals, and collaboration by key stakeholders is an essential part of addressing the challenge.

To this end Atax was proud to host the Atax 10th International Tax Administration Conference, “Risky Business”, held in Sydney on 2 & 3 April 2012. This is a biennial Conference, sponsored in 2012 by CPA Australia, IBFD and The Tax Institute, which continues to attract leading tax administrators, academics, and practitioners from around the globe.

The 10<sup>th</sup> Conference was opened by the Hon Sir Anthony Mason AC KBE QC, former Chief Justice of the High Court of Australia. Keynote speakers explored international approaches across a range of tax compliance and administration issues including reforms, risks and change. They included Mr Michael D’Ascenzo AO, Commissioner of Taxation Australia; Mr Dave Hartnett CB, Permanent Secretary for Tax, HM Revenue & Customs; Mr Bob Russell, CEO, Inland Revenue Department, New Zealand; Professor Judith Freedman, Professor of Taxation Law at Oxford University and Adjunct Professor at the Australian School of Business; Ms Nina Olson, National Taxpayer Advocate, Internal Revenue Service; Mr Ali Noroozi, Inspector General of Taxation, Australia; and Professor Richard Highfield, OECD and Adjunct Professor at the Australian School of Business.

Attendees at the Conference came from far and wide including Australia, New Zealand, United Kingdom, United States, Japan, Malaysia, Singapore and South Africa. Sharon Smulders of the University of Pretoria was awarded The Cedric Sandford Medal for the best paper presented at the Conference. The medal is in memory of the late Emeritus Professor Cedric Sandford. Sharon’s paper, on establishing a baseline for the measurement of compliance costs in South Africa is included in this special edition of the *eJournal of Tax Research*.

Each of the selected papers presented at the Conference and published in this special edition after peer review makes a unique contribution to tax research. They

demonstrate critical thinking in many diverse aspects of tax administration, from legal reform to tax return simplification and the measurement of compliance costs. They also include developments from the disciplines of behavioural economics and psychology. There is reflection on the history and impact of the compliance pyramid – first developed in Australia and now embraced by many jurisdictions throughout the world. Finally, there is the sharing of latest developments in tax risk management models and practices in the Australian Taxation Office, widely recognised as a leading modern tax administration.

It does give us great pleasure to present to you this special edition on tax administration and we feel very privileged to be part of this strong and supportive research community. We do hope you will consider being part of Atax's 11<sup>th</sup> International Tax Administration Conference, to be held in Sydney in early 2014. Further details will be made available on our School website ([www.tbl.asb.unsw.edu.au](http://www.tbl.asb.unsw.edu.au)) in the second half of 2013.

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# Tax compliance costs for the small business sector in South Africa — establishing a baseline

Sharon Smulders, Madeleing Stiglingh, Riel Franzsen and Lizelle Fletcher\*

## ***Abstract***

This study is part of an international research project (across four countries) which is evaluating and comparing tax compliance costs affecting the small business sector. The primary objective of this empirical study was to measure the tax compliance costs of small businesses in South Africa and to establish a baseline against which future studies and enhancements to the tax system could be measured. The study also differentiated tax compliance activities from core accounting activities in order to identify the managerial benefits of tax compliance. It also investigated whether various South African small business tax concessions are perceived to be achieving their objective of relieving the tax compliance burden. The study, conducted by means of an electronic survey, provided plausible estimates proving that tax compliance costs as well as core accounting costs are regressive with respect to business size, with the compliance burden being heavier for smaller businesses. The perception that managerial benefits exist was also established for the first time in South Africa. Overall, small business tax concessions were perceived as being more complex than useful. A re-evaluation of these concessions or the introduction of a truly simplified tax system for small businesses is considered desirable.

## **1. INTRODUCTION**

### **1.1 Background to the study**

The single all-encompassing objective of the South African government's "New Growth Path" is employment creation (National Treasury, 2011:2). According to South Africa's Minister of Finance, employment creation will be the principal barometer of South Africa's progress in its aim to achieve a more inclusive and equitable economic future for the country (National Treasury, 2011:1). To achieve this objective, the government's aim is to create five million jobs over the next ten years and, in so doing, reduce the unemployment rate from 25% to 15% (National Treasury, 2011:39). The sector of the economy that will predominantly assist in achieving this objective is the small business sector (National Treasury, 2011:46).

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However, despite this critical role in the economy, this sector faces various challenges, one of them being a regulatory burden imposed by tax legislation (Strategic Business Partnerships for business growth in Africa (SBP), 2005:44; SBP, 2011:28). This plight of small businesses in South Africa with regard to taxation is confirmed in the following statement by one of the directors of the South African Black Entrepreneurs Forum:

“Overall, it is quite clear that our current [tax] system is biased against one of the most important sectors in the economy being small businesses. At a time where it is difficult for people to gain employment, they should be encouraged to start their own ventures and not be punished when they do.” (Qabaka, 2011:17).

This concern is echoed by the Small Business Project (2003:1), Abrie and Doussy (2006:1), the Foreign Investment Advisory Service of the World Bank Group (FIAS, 2007:1), Hassan (2011:1) and Retief (2011:2) who all concur that the tax system and its compliance requirements are a stumbling block to the growth of small businesses in South Africa.

The South African government is not oblivious to this dilemma. The following statement made in the 2005 budget speech by the then Minister of Finance, Mr Trevor Manuel, relating to small business and taxation, indicates governments’ acknowledgement of the problem:

“...we have directed attention this year at the costs and complexity for small businesses of the tax code, because there is compelling evidence that simplified arrangements can assist significantly in creating an environment conducive to enterprise development” (Manuel, 2005:28).

In 2005 the process of change in the South African Revenue Service (SARS) commenced. The intention was that these changes would assist small businesses in their start-up phase, reduce compliance costs and administrative complexity (red-tape), and include tax education and assistance (Manuel, 2005:1).

However, six years later, despite further tax relief offered to small business in South Africa in the 2011 budget speech (Gordhan, 2011:3), Retief (2011:1), the chairman of the South African Institute of Professional Accountants (SAIPA), points out that the relief was not enough and more needs to be done to push for a more equitable tax regime that enables growth for this sector. This sentiment is echoed by Hassan (2011:1), at that time the project director for tax of the South African Institute of Chartered Accountants (SAICA). Qabaka (2011:15) also has the following to say regarding small business tax incentives that have been introduced by the SARS since 2005 and the overall effect of the tax system on small businesses:



“While such incentives may have resulted in some limited relief, it is argued here that the actual structure of South Africa’s current tax system is so heavily biased against small businesses that any such relief is negligible”.

## **1.2 Need for the present study**

Statements such as the above (made in 2011) might have merit, but have no value without statistical evidence validating them. Studies were conducted by FIAS in 2006 (FIAS, 2007) and by Govender and Citizen Surveys in 2007 (Govender & Citizen Surveys, 2008) to identify and measure the tax compliance costs for small businesses in South Africa. These studies found that tax compliance costs for small businesses were regressive. No recent follow up study has been conducted to determine whether the tax compliance costs are still regressive and if they have increased or decreased since 2006/7.

Furthermore, although the abovementioned two studies considered the tax compliance costs incurred by small businesses, they did not consider or take into account in their determination of the tax compliance costs all the activities (broken down into their various components) that are necessary for a business to be tax compliant; nor did they delve into the time taken to perform the core accounting functions (broken down into their various components) involved in running a business — which is essential in addressing the tax/accounting overlap which is regarded as one of the pitfalls in tax compliance cost research (Tran-Nam, 1999:161).

The concept of tax compliance benefits, which come in the form of cash flow, tax deductibility and managerial benefits (Sandford, Godwin & Hardwick, 1989; Tran-Nam, Evans, Walpole & Ritchie, 2000:232) is another consideration that was not addressed in the above two compliance cost studies.

The perception of the effectiveness of the small business tax concessions is also considered an important element for consideration in the measurement of tax compliance costs, as is highlighted by Qabaka (2011:15). A need therefore arises to evaluate the perceptions of the effectiveness of these concessions.

## **1.3 Objective of the study**

The research objective of the study was the measurement of tax compliance costs for small businesses in South Africa. In fulfilling this objective, an evaluation of the gross tax compliance costs incurred by a small business in South Africa to meet its tax obligations was performed. An attempt was made to identify and measure the benefits (specifically managerial benefits) derived by small businesses in South Africa as a result of complying with tax obligations with the aim of establishing the net tax compliance costs (i.e. gross tax compliance costs less tax compliance benefits). To establish if the small business tax concessions are effective in reducing the level of compliance costs incurred by small businesses, an evaluation of the eligibility for,

adoption and usefulness and complexity of these concessions — as perceived by the respondents — was investigated.

This study will provide a baseline of tax compliance costs against which future studies and enhancements to the tax system could be measured. This study also forms part of an international tax compliance cost study across four different countries which, apart from South Africa, include Australia, Canada and the United Kingdom.

The remainder of the article will first describe the research methodology employed (section 2) and then define the terms used in the study (section 3). Thereafter, the empirical results will be presented (section 4), the conclusions documented (section 5), the need for future research highlighted (section 6) and acknowledgements for assistance with this study noted (section 7).

## **2. RESEARCH METHODOLOGY**

### **2.1 Overall methodology employed**

A deductive research approach was adopted using a survey strategy (Saunders, Lewis and Thornbill, 2007:119-122, 138). An empirical study was conducted collecting data from respondents by means of an electronic questionnaire distributed by the SARS, which was the measurement instrument in this study. The design of the electronic questionnaire (measuring instrument) was based on international best practice and utilised a common framework (adapted for South Africa) to ensure ultimate comparability in the international comparative study.

In order to detect weaknesses, not only in the design of the questionnaire but also in the procedures and protocols utilised during the data collection process (Cooper & Schindler, 2008:91), a pilot study was initiated on 17 March 2011 and completed on 3 April 2011. The pilot study was conducted in the same manner as envisaged for the final survey. Where possible, the recommendations made by local and international academics, and the World Bank international survey experts, were taken into consideration and adjusted where possible without jeopardising the international comparability. In addition to these comments, 28 responses from small businesses were received. This appears to be in line with the numbers contemplated by Cooper and Schindler (2008:91). These responses provided insight into potential questionnaire problems, as well as future analysis considerations. To the extent possible, the problems detected in the pilot study were corrected, thus ensuring that the final questionnaire was suitably adjusted to cater for the eventualities identified and to ensure that problems encountered did not occur again.

### **2.2 Population and response rate**

The unit of analysis and population consisted of small businesses (turnover of R14 million or less) registered with SARS for which SARS had an e-mail address at the time the questionnaire was distributed. As the whole target population (as described above) was selected, no statistical sampling techniques were used.

The questionnaire was sent out to 88 057 small business taxpayers (Murugan, 2011a). Reminder e-mails were sent out during the survey period and there was a definite increase in the number of responses due to these reminders (Meintjes, 2011). The number of usable questionnaires received from the respondents amounted to 5 865, which represents a response rate of 6.7%. Although Saunders et al. (2007:358) indicated that internet based surveys are likely to have a response rate of 11% or lower, these response rates are considered rather low even for web surveys (Cook, Heath & Thompson, 2000:829; Dilman, Phelps, Tortora, Swift, Kohrell, Berck & Messer, 2009:7, Shih & Fan, 2008:257). However, it must be mentioned that the electronic survey platform used to distribute the questionnaire could unfortunately not determine how many of the e-mails that were sent out were undeliverable (Murugan, 2011b:2). This could have had a major effect on the response rate and consideration should be given to this fact before concluding on the response rate. In addition to this, various other reasons and possible explanations for the low response rates, such as, inter alia, the fact that the questionnaire responses could not be saved at any given time resulting in the questionnaire having to be completed in one sitting by the respondents, the length of the questionnaire (it was long and of a detailed nature), the server downtime and the fact that the questionnaire was only provided in English should also be taken into account. Although one can therefore not come to any definite conclusions about how representative and statistically reliable the sample was, 5 865 responses should nevertheless provide invaluable information and insight into an area where there is currently no reliable and up to date statistical information available.

### **3. DEFINITION OF TERMS**

Before the results of the survey are discussed, it is critical to first establish what is meant by a “small business”, “tax compliance costs/benefits” and “small business tax concessions”. The definitions and explanations of these terms are discussed below.

#### **3.1 Small business**

South Africa has, from an economic as well as taxation perspective, no single consistent definition of a “small business” available (SARS, 2011a; Smulders, 2006:15-19). To ensure comparability to previous compliance cost research in South Africa, this study defined a small business as a business with a turnover of R14 million or less.

#### **3.2 Tax compliance costs**

For the purposes of this study, tax compliance costs include internal costs, as defined by Turner, Smith & Gurd (1998) that is, the cost of collecting, paying and accounting for tax on products or profits of the business, and on the wages and salaries of employees together with the costs of acquiring the knowledge to enable this work to be done; and external costs, mainly in the form of advisors costs — using professional tax service providers is one of the main costs contributing to the cost of complying with taxation legislation (Coolidge, Ilic & Kisunko, 2009:26). In an attempt to prompt the respondents to differentiate between their time spent on tax-related activities and time devoted to accounting activities, a separate list of both tax and accounting activities were provided to them in the questionnaire. It was hoped that this would minimise the impact of the purely accounting compliance costs on the survey results.

### **3.3 Tax compliance benefits**

Tax compliance does not necessarily only result in costs, but may also result in benefits (Sandford et al., 1989:13). Three broad categories of tax compliance benefits have been identified and become established by various authors in tax compliance literature (Lignier, 2009a:6; Tran-Nam, 2001:281; Tran-Nam et al., 2000:232; Pope, 1993:81; Sandford et al., 1989:89). The first being cash-flow benefits, the second being managerial benefits, and the third being tax deductibility benefits.

Cash-flow benefits arise from the use of tax revenues for a period before they must be paid over to SARS (Pope, 1993: 75; Rametse, 2010:4; Tran-Nam et al., 2000:232). An example of such a benefit is the lawful delay in payment of the tax collected by the business on behalf of the revenue authority — such as VAT and employees' tax (PAYE) in South Africa — to the revenue authority (SARS).

Managerial benefits, may arise in various forms such as better record-keeping and use of technology (Rametse, 2010:1; Coolidge et al., 2009:4), improved knowledge of the financial affairs of the business in particular in the form of increased knowledge of their complex accounting information systems (Lignier, 2008, 2009b:6-7, Lignier, 2009c:8,12), and improved business or managerial decision-making due to a requirement in terms of tax legislation to maintain records (Tran-Nam et al., 2000:232; Lignier, 2009c:6). For the purposes of this study, the focus will be on managerial benefits because, as far as small businesses are concerned, managerial benefits are expected to be much more significant than cash-flow and tax deductibility benefits and also because they have not been covered by previous studies (Lignier, 2011:1).

Tax deductibility benefits arise when the income tax system permits some tax compliance costs to be treated as a legitimate deduction for tax calculation purposes (Tran-Nam et al., 2000:233; Pope, 2001:14). An example would be provisions in the tax system permitting businesses a deduction from their taxable income for the services of their tax practitioners and tax-related incidental expenses.

### **3.4 Small business tax concessions (SBTCs)**

The South African government, recognising that small businesses are important to the economy, has granted certain tax concessions (tax relief measures) to these businesses. These concessions come in various forms such as the small business corporation (SBC) tax regime, the small retailers VAT package, the capital gains tax (CGT) concession for small businesses, the ability to submit VAT returns every four months (as opposed to every two months), the simplification of the basis on which to pay the second provisional tax payment and a reduced application fee for a private binding ruling. Annexure A summarises each of these concessions. Each of these concessions, except for the last two, was considered individually in the study. The fact that the last two concessions were not considered separately is noted as one of the possible areas for future studies of a similar nature.

## 4. EMPIRICAL RESEARCH FINDINGS

### 4.1 Measurement criteria

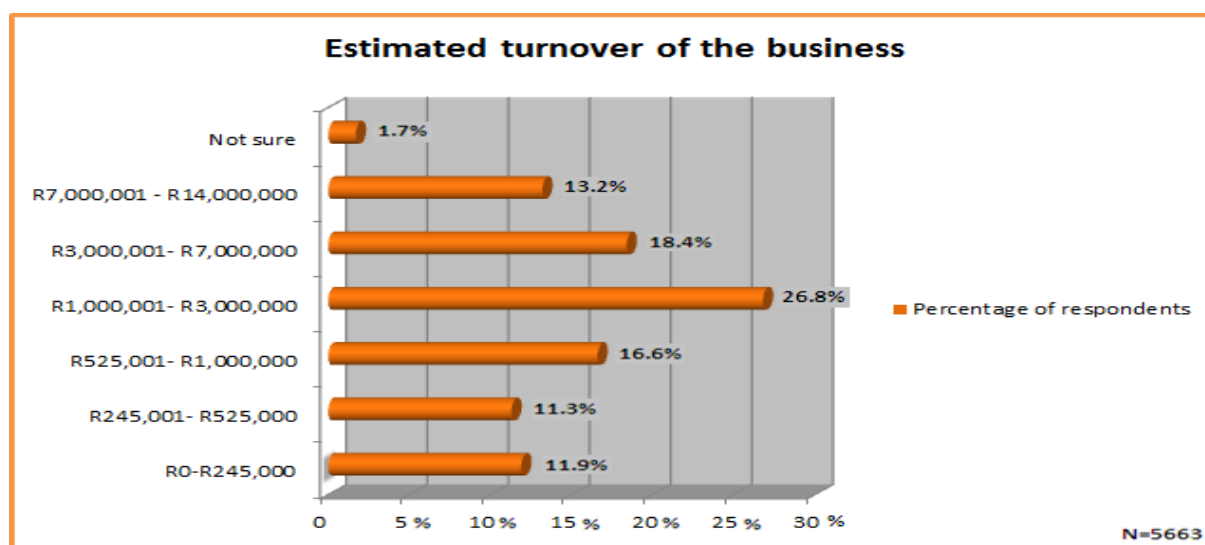
All compliance costs and times were calculated using the 5% trimmed mean, rather than the ordinary mean (average), to compensate for unusually high values being recorded in the responses to most of the questions. The trimmed mean is slightly different from the mean in that it removes a certain percentage of the responses from each extreme distribution (in this case 5% from the top and 5% from the bottom) before calculating the mean (Field, 2009:163). The use of a trimmed mean smoothes distortions in the data and provides a more systematic and useful method for detecting changes over a period of time, which is required for this study if it is to be used as a benchmark (Field, 2009:163). It was also used to ensure comparability of information across the five countries involved in the survey.

The questionnaire used to collect the information was divided into five components, namely (1) the profile of the respondents, (2) the time the respondents spend on internal tax and accounting activities, (3) the money the respondents spend on internal and external tax and accounting related activities, (4) the perceptions that the respondents have of the benefits of tax compliance, and (5) small business tax concession considerations. Each of these components will be discussed next.

### 4.2 Profile of the respondents

The majority of respondents conducted their activities in the professional services sector, traded in the form of close corporations (CCs), were established businesses that had been in operation for more than five years, and had a turnover (see Figure 1) and employee numbers that tended to lean towards the higher end of the small business spectrum.

**Figure 1: The estimated turnover of the business**



When the demograph profile (number of employees and age distribution) of the survey respondents was compared to the FinScope (2010:5-17) study, which included interviews with 5 676 small business respondents (businesses throughout South Africa with a turnover of between R70 000 and R14 million), it revealed that start-up businesses appear to be under-represented in the current study, possibly due to their lack of internet access/e-mail addresses, which could have resulted in their exclusion from this study from the start. As no scientifically valid universe or reliable database of small businesses currently exists (African Response, 2006:11, Statistics South Africa, 2010a:vii, FinScope, 2010:4), and since details of the total small business population on the SARS database were not available at the time of the research, it cannot be conclusively determined whether these respondents are representative of the whole small business population in South Africa, but there is potentially a systematic bias against the smaller and less sophisticated businesses — as is further discussed below.

To ensure that the results of the current study were comparable to the two tax compliance cost studies previously conducted in South Africa (FIAS, 2007, and the Govender & Citizen Surveys, 2008), the demographics of the respondents to the current study were compared, where possible, to those of the other two studies. The FIAS (2007:18) and Govender and Citizen Surveys (2008:31) studies used different turnover categories from this survey, making any form of direct comparison difficult, but Table 1 below, indicates the distribution of the businesses over two broad turnover categories for all three studies.

**Table 1: Comparison of turnover categories between current and other study results**

<b>TURNOVER/STUDY</b>	<b>Current study</b>	<b>FIAS (2007)</b>	<b>Govender &amp; Citizen Surveys (2008)</b>
R0 — R1 000 000	40.5%	56%	47%
R1 000 001 — R14 000 000	59.5%	44%	53%

This table shows that, although the current survey is more in line with the Govender and Citizen Surveys' results, it is definitely more biased towards the "larger" small businesses (businesses with a turnover of more than R1 million).

Despite these slight differences in the turnover, it was found that the current study appears to share a discernible common trend or pattern with the two other studies, which justifies a comparison between the three studies.

### 4.3 Quantification of internal tax compliance costs

In line with the latest methodology adopted by the Inland Revenue (New Zealand) (2010a:26), a four-step approach was adopted to quantify the internal tax compliance costs incurred by small businesses. The first step entailed establishing the hours taken by small businesses on tax compliance activities (per tax, per annum). A matrix format, as used by Evans, Ritchie, Tran-Nam & Walpole (1996), Colmar Brunton Social Research (2005:38) and the Inland Revenue (New Zealand) (2010a:16 and 2010b:37) in their surveys of small businesses, was used to collect the information regarding the time spent on the different taxes per tax compliance activity.

The second step required the respondents to indicate who performed the internal tax compliance activities in the business (owners, employees, or unpaid friends and relatives) and the percentage of time each of these persons spent on these tax activities. Establishing who spends the hours on tax compliance activities in the business facilitated the quantification of the tax compliance costs but, before this could be done, step three had to be performed.

The third step requested the respondents to provide what they would consider to be an appropriate hourly value for each of the categories of persons performing the tax compliance activities (owners, employees, or unpaid friends and relatives). To ensure that these values were reasonable, these self-evaluated values were benchmarked against externally available salary information to ensure that there was some degree of quality control over the values provided by the respondents.

Step four ultimately quantified the internal tax compliance costs by multiplying the total compliance time (hours) spent on each tax by the percentage of time spent by the different category of persons (owners, employees, or unpaid friends and relatives) on each tax, which was further multiplied by the appropriate cost (hourly rate) of internal time as established above. The results of this process are presented next.

#### 4.3.1 Step 1 — *Hours spent on tax compliance activities*

##### a) Survey results

Table 2 below reveals that it took small businesses an average of 255 hours per annum to deal with all tax compliance related matters. For those businesses on the turnover tax system (TTS) — a simplified tax system for micro businesses: a business with a qualifying turnover of R1 million or less — it took a total of 155.2 hours (which consists of 67.3 hours to comply with the TTS and 87.9 hours to comply with PAYE as the TTS does not replace PAYE).

**Table 2: Annual internal hours spent on different taxes: all small businesses**

Taxes	VAT	IT	PAYE	CGT	Customs	Excise duties	Total all taxes (excl TT)	TTS
Mean	283.9	209.4	154.5	17.9	14.1	5.7	<b>685.6</b>	89.5
5% Trimmed mean	98.9	69.9	83.2	2.5	0.5	0.1	<b>255.1</b>	67.3
Median	31.0	29.0	38.0	0.0	0.0	0.0	<b>98.0</b>	30.5
5% Trimmed mean - percentage of total time	39%	27%	33%	1%	0%	0%	<b>100%</b>	-
5% Trimmed mean - hours spent on PAYE by TT respondents	-	-	-	-	-	-	-	87.9
Total hours spent on tax by TT respondents	-	-	-	-	-	-	-	<b>155.2</b>

To ensure that the total tax compliance time by a business registered on the TTS is taken into account, the PAYE time was also included in the comparison. What was found was that the total time spent by a micro-business on complying with tax is slightly less than two thirds of the time (61%) taken by a normal business (business not registered on the turnover tax system) with a turnover of less than R1million (registered for VAT and not paying customs and excise duties). It appears that the turnover tax regime is meeting one of its intended objectives — reducing compliance costs by reducing the number of hours required for tax compliance activities.

When analysing the individual taxes, it was found that VAT is the most time-consuming tax for small businesses. From a size perspective, the number of hours needed internally to comply with tax legislation increased as the size of the business increased; however, it is evident that this time is regressive if taken as a percentage of turnover. This finding is graphically illustrated in Figure 2 below.

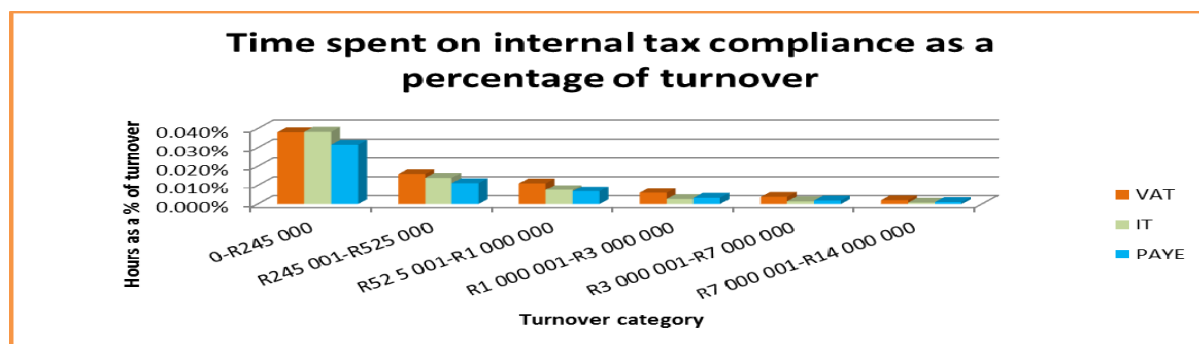
**Figure 2: Annual internal hours spent on tax compliance activities per tax (excluding the turnover tax) — as a percentage of turnover**



Figure 2 highlights the disproportionate burden faced by smaller businesses when it comes to tax compliance activities. When analysing this time in more detail (refer to Table 3 below), it became evident that recording information needed for tax, especially VAT, is the tax compliance activity that is the most time-consuming for small businesses. PAYE was the tax that took the most time to calculate, submit and pay the tax due. The number of hours spent dealing with SARS and learning about tax was also the highest for PAYE, which is possibly due to the recent changes to this tax brought about by SARS (SARS, 2011b:1-3). Tax planning and dealing with the tax advisor is the highest in respect of income tax.

**Table 3: Mean\* annual hours spent on different tax activities**

Activity	VAT	IT	PAYE	CGT	Customs	Excise duties	Total all taxes (excl TT)	TT
Recording information	64.78	31.4	35.31	0.46	0.18	0.02	132.24	26.7
Calculating tax, filing return & paying tax	13.77	11.32	18.50	0.25	0.07	0.01	43.92	17.4
Dealing with SARS	6.50	6.2	10.62	0.08	0.04	0.00	23.46	5.0
Tax planning	2.73	5.0	4.66	0.30	0.02	0.00	12.71	4.0
Dealing with tax advisor	5.14	8.2	5.48	0.28	0.02	0.01	19.11	6.9
Learning about tax	6.00	7.6	8.61	1.15	0.21	0.09	23.70	7.2
Other activities	0.00	0.0	0.00	0.00	0.00	0.00	0.00	0.0
<b>Total time spent</b>	<b>98.92</b>	<b>69.85</b>	<b>83.18</b>	<b>2.52</b>	<b>0.54</b>	<b>0.13</b>	<b>255.14</b>	<b>67.31</b>

\* 5% trimmed mean was used in this table

#### b) Comparison to other research

Unfortunately, none of the previous tax compliance cost studies broke the time taken to deal with tax activities down into as much detail as the current study did. However, certain activities were dealt with in both the current and previous studies, and these are set out in the table below.

**Table 4: Comparison to other tax compliance cost studies of time taken to perform various tax activities**

<b>STUDY</b>	<b>Current study (mean)</b>	<b>Current study (5% trimmed mean)</b>	<b>FIAS (2007)</b>	<b>Govender &amp; Citizen Surveys (2008)</b>
<b>HOURS PER TAX TAKEN TO:</b>	<b>Record information needed for tax</b>	<b>Record information needed for tax</b>		<b>Record information needed for tax &amp; submit tax returns</b>
VAT	167.26	64.78	-	Included below
Income Tax	82.43	31.49	-	Included below
PAYE	62.58	35.31	-	Included below
<b>TOTAL</b>	<b>312.27</b>	<b>131.58</b>	<b>-</b>	<b>Included below</b>
	<b>Calculate tax, submit return &amp; pay tax</b>	<b>Calculate tax, submit return &amp; pay tax</b>	<b>Prepare, complete &amp; submit tax returns</b>	<b>Record information needed for tax &amp; submit tax returns</b>
VAT	36.10	13.77	18.77	Included below
Income Tax	26.78	11.32	5.34*	Included below
PAYE	34.26	18.50	13.93	Included below
<b>TOTAL FOR SUBMISSION OF RETURNS</b>	<b>97.14</b>	<b>43.59</b>	<b>38.04</b>	<b>Included below</b>
	<b>Record information needed for tax + Calculate tax, submit return &amp; pay tax</b>	<b>Record information needed for tax + Calculate tax, submit return &amp; pay tax</b>	<b>Record information needed for tax + Calculate tax, submit return &amp; pay tax</b>	<b>Record information needed for tax + Calculate tax, submit return &amp; pay tax</b>
VAT	203.36	78.55	-	56.14
Income Tax	109.21	42.81	-	51.29*
PAYE	96.84	53.81	-	21.29**
<b>TOTAL FOR RECORDING TAX INFORMATION AND SUBMISSION OF RETURNS</b>	<b>409.41</b>	<b>175.17</b>	<b>-</b>	<b>128.72***</b>

\* Includes provisional tax

\*\* Includes UIF and SDL

\*\*\* An overall average time of 181.57 was mentioned in the study, which differs from the above due to (it is assumed) averaging of information per tax as calculated from information per turnover category. As the more detailed averages were needed for comparative purposes, these totals were used in the table above rather than the 181.57 hours.

Despite the activities and taxes being slightly different across all three studies, what is evident is that the overall time taken (using either the means or the 5% trimmed means) to record information needed for tax, prepare, complete and submit tax returns, has increased. If the activities are reviewed individually, an exception to this overall increase arises in respect of the filing and paying of VAT returns (FIAS study) and the recording of tax information and submission of the tax return (Govender and Citizen Surveys study) — but only if the 5% trimmed mean is used. The extent of the overall increase cannot be commented on further due to the differences mentioned above, but notwithstanding this, an increase in time to comply with tax legislation is not desirable, either from a SARS or taxpayer perspective.

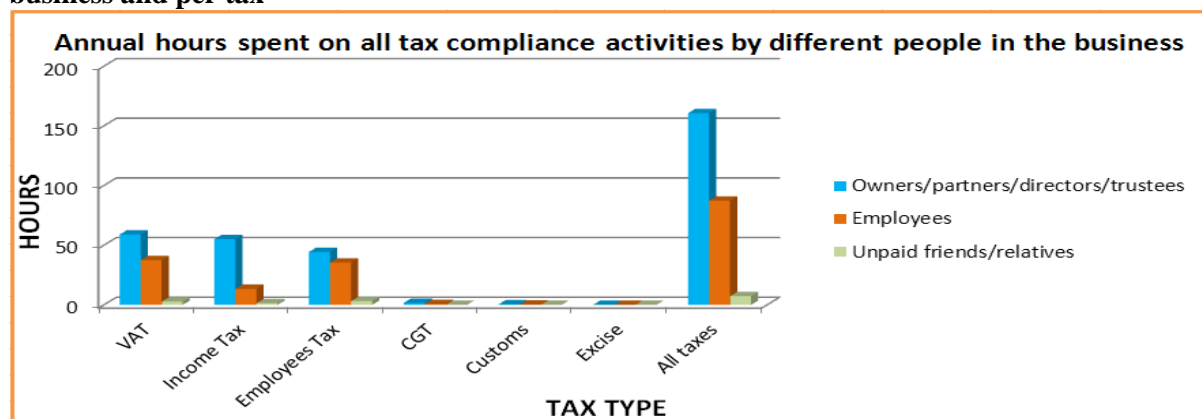
From a broad overall time perspective, a comparison can also be made with the PricewaterhouseCoopers (PwC) and IFC (2011:69) Paying taxes 2011 report which records the time taken to prepare tax figures, complete and file tax returns, and also pay the three major taxes — VAT, income tax (including provisional tax and CGT), and taxes on employees (PAYE, SDL and UIF). A case study methodology is used to record this information whereby tax experts from a number of different businesses compute the taxes and contributions payable based on standardised case study facts. This global study reveals that it takes 200 hours to perform the abovementioned functions in South Africa. This is slightly more than the 175.88 hours taken by the respondents of the current survey, i.e. 175.17 hours as in Table 4 above, plus CGT of 0.71 (0.46 + 0.25) being the time taken to record information, calculate, file and pay the tax due.

It is evident that the hours recorded by the respondents to the current survey are only slightly less than the PwC and IFC hours. What is of concern is that the PwC and IFC study bases its information on a “medium-sized” company that has five owners and 60 employees and that has a turnover of approximately R46 million (this is closer to a medium to large sized business from South Africa’s perspective). Although there are slight discrepancies between the exact tax activities that are included in these estimates, overall it appears that small businesses in South Africa are spending a large amount of time to comply with tax legislation when compared to medium to large-sized businesses.

Having established the hours spent internally on various tax compliance activities per year, it was necessary to determine how much this time is costing the business. Before this could be achieved, it was essential to determine who actually performs these functions within the business as the value of the time might depend on the person rendering the service.

#### **4.3.2 Step 2 — Who performs the tax compliance activities?**

Figure 3 indicates that most of the internal time spent on tax compliance activities was attributable to the owners, who performed 63% of annual hours related to tax compliance activities, with the employees performing 34% and unpaid friends or relatives the remaining 3%.

**Figure 3: Annual internal hours spent on tax compliance activities — by different people in the business and per tax**

VAT compliance took up most of the owners' and employees' time, with employees spending relatively more time on PAYE after VAT.

#### 4.3.3 Step 3 — Valuation of time spent on different taxes

A contentious issue discussed amply in the literature (Allers, 1994:54; Evans, Ritchie, Tran-Nam, & Walpole, 1997:11; Pope in Sandford, 1995:101) is the value to be placed on the time spent by owners and employees of a small business. The valuation of this time in the current research was based on the methodology adopted by the Inland Revenue (New Zealand) (2010a:26) in their study on the quantification of small business tax compliance costs. Using this valuation method, the values provided by the respondents (per turnover category) for each type of person working or assisting in the business are set out in Table 5 below.

**Table 5: Hourly rate of various persons' time according to the size of the business**

BUSINESS SIZE CATEGORY	Owner	Employee	Unpaid friend/relative
R0 — R245 000	R353.53	R153.07	R192.13
R245 001 — R525 000	R423.36	R180.50	R200.48
R525 001 — R1 000 000	R470.39	R155.08	R225.44
R1 000 001 — R3 000 000	R483.97	R159.82	R243.93
R3 000 001 — R 7 000 000	R432.89	R167.19	R230.22
R7 000 001 — R14 000 000	R508.50	R201.54	R158.15
Not sure	R456.51	R157.39	R93.33

The respondent's self-reported values were benchmarked against average hourly rates obtained from recently conducted local publicly available salary surveys. The Accountants on Call (2010:1) Salary Survey as well as the Statistics South Africa (2010b:xii) Monthly Earnings of South Africans Survey were both carried out in 2010 and were considered appropriate as a benchmark for two reasons; firstly, they were recent and related to the same or similar period that the survey related to and, secondly, because they contained information on "accounting type" positions which are similar to the functions/positions that a person would be required to carry out in order to comply with tax. Two managerial positions were selected to obtain a benchmark of the owners' time: financial manager and financial accountant, because both of these positions seemed to encompass the functions that an owner would fulfil in a small business, and were more aptly suited than the other categories documented.

As no indication of the size of the business paying these remuneration packages was provided in the Accountants on Call (2010) Salary Survey to ensure that these rates were reasonable in respect of payments made by small businesses, the average rates in terms of that salary survey were compared to the Chartered Institute of Management Accountants (2010:15) South Africa Part Qualified Salary Survey, which provided a break-down of the salary information by business size. This comparison revealed that the average salary initially chosen was too large compared to the average salaries paid by small businesses in South Africa. The rates used for the owners were therefore adjusted to a lower level, more in line with remuneration paid by small businesses. To ensure this choice was valid, a further comparison of average salaries in the accounting/finance field was made with the Walters (2011:408) Global Salary Survey and Macdonald & Company's (2011:6) Rewards and Attitudes Survey. The results of this comparison further justified the use of the lower-paid category of person to obtain the most appropriate and reasonable value for persons working in these positions in South African small businesses.

A valuation of the employee's time was obtained by selecting two clerical functions: assistant accountant and balance sheet bookkeeper from the Accountants on Call (2010) salary survey. A rate for a trial balance bookkeeper was also provided (at a lower remuneration package) in the survey, however, this was not used, as more of the respondents to the current survey indicated that they had a good rather than a basic bookkeeping knowledge, implying that the higher salary option would be more appropriate in the current circumstances. The remuneration for both clerical functions was selected from the category of staff without a degree and with two to eight years' experience because more than half of the respondent clerks or administrative staff, and more than a third of the respondent bookkeepers, indicated that their highest qualification was having completed high school. Although the managers that completed the survey indicated that their highest qualification was a university education, for the reasons mentioned above (specifically payments by small businesses rather than larger ones), it was decided to use the lower category of remuneration. The values obtained are set out in Table 6 below.

**Table 6: External average salary per hour\* for selected tax functions**

POSITION / VALUES	Lowest rate	Highest rate	Average rate
<b>OWNER</b>			
Financial manager	R 181.25	R 317.71	<b>R 249.48</b>
Financial accountant	R 145.83	R 250.00	<b>R 197.92</b>
<b>EMPLOYEE</b>			
Balance sheet bookkeeper	R 125.00	R 156.25	<b>R 140.63</b>
Assistant accountant	R 109.38	R 125.00	<b>R 117.19</b>

\* An average of 48 working weeks consisting of 40 hours per week was assumed

As these values were lower than those provided by the respondents in the present survey, it was decided to obtain a further benchmark against which these rates could be tested. This benchmark was obtained from the values in the survey of monthly earnings of South Africans (Statistics South Africa, 2010b:xii). These rates (refer to Table 7) are significantly lower than both the self-assessed hourly values of this survey, and the values recorded in the salary survey of Accountants on Call (2010:1).

**Table 7: Alternative national average salary per hour\* for selected tax functions**

POSITION / VALUES	Median
<b>OWNER</b>	
Manager	R65.63
Professional	R62.50
<b>EMPLOYEE</b>	
Technician	R46.88
Clerk	R28.13

\* An average of 20 working days per month consisting of 8 hours per day was assumed

One possible reason for this is because the Statistics South Africa survey included all occupations and not specifically those in the accounting or finance field. Taking cognisance of this and the fact that the Accountants on Call salary survey data appears reasonable in relation to other surveys performed in this sector of the working community, it appeared reasonable to adopt the Accountants on Call salary survey values. As to which of the category values would best represent the value of time spent by these people, it was believed that, because the owner would most likely be regarded as performing the role of financial manager whereas the employee's role could more likely be akin to that of a bookkeeper, these functions were considered to be the most appropriate representation for each of these categories of persons. In addition to this, the values for these categories were also more aligned with the self-reported values provided by the respondents in the present survey. Thus the average rate of each of these roles was considered the most appropriate basis for representing

the value of time for owners and employees of small businesses. The hourly rates to be used as an alternative valuation of the internal compliance costs of small businesses were therefore R249.48 for owners and R140.63 for employees.

The valuation of time for the unpaid friend or relative was a difficult undertaking and one which could not successfully be performed as no benchmark or selection criteria were clearly evident or available from the information obtained. For valuation purposes it was therefore decided to use the same values as those obtained for employees. This is regarded as prudent especially in the light of the fact that the respondents indicated that their unpaid friends or relatives were worth more than the employees of the business.

#### 4.3.4 Step 4 — Quantification of time spent on tax compliance

##### a) Survey results

When the time recorded in step one was converted into Rand values using the rates discussed above, the internal tax compliance costs for small businesses in this survey amounted to R53 356 (see Table 8 below).

**Table 8: Valuation of annual internal tax time by all persons**

<b>TAX / PERSON</b>	<b>Mean (R)*</b>	<b>Median</b>
VAT	20 317.75	6 367.27
IT	15 821.91	6 568.87
PAYE	16 532.52	7 552.72
CGT	540.09	-
Customs	116.50	1.59
Excise	28.05	0.55
<b>Total all taxes</b>	<b>53 356.81</b>	<b>20 491.00</b>
TT	14 030.34	6 365.87

\* 5% trimmed mean was used in this table

It is evident that cost of the internal time spent on VAT (mean: R20 317.75) was more than a third (38%) of the total amount spent on all taxes. Employees' tax was the next most expensive tax (mean: R16 532.52, closely followed by income tax (mean: R15 821.91) — this is the case even if CGT is added to the income tax time.

##### b) Comparison to other research

No direct comparison of these costs can be made to the FIAS and Govender and Citizen Surveys reports as the Govender and Citizen Surveys report did not manage to get respondents to attach a monetary value to the time taken by the owner or

employees on internal tax compliance activities and the FIAS study only calculated the cost incurred by small businesses to prepare, complete and submit tax returns for VAT, income tax, provisional tax and PAYE. Therefore Table 9 compares the findings of the current study to the FIAS study but only in respect of the costs to prepare, complete and submit the tax returns for those taxes. However, the FIAS study also established that an average retainer for tax services would cost small businesses R24 158 per annum (FIAS, 2007:31). A retainer is usually paid annually up-front and would generally include most tax-related services not only the preparation and submission of the tax return. The value of the retainer was therefore compared to the total value for all tax compliance activities as calculated in Table 9 below.

**Table 9: Comparison between two tax compliance cost studies of the valuation of annual internal tax compliance time**

INTERNAL TAX COMPLIANCE COSTS (PER TAX) / STUDY	Current study (mean) (cost for all tax services)	Current study (5% trimmed mean) (cost for all tax services)	FIAS (2007) Retainer usually = cost for all tax services)	Current study (mean) (only cost to calculate tax, submit return and pay tax)	Current Study (5% trimmed mean) (only cost to calculate tax, submit return and pay tax)	FIAS (2007) (only cost to prepare, complete & submit return)
VAT	58 307	20 318	-	7 415	<b>2 828</b>	2 975
IT	47 427	15 822	-	6 066	2 564	1 175*
PAYE	30 708	16 533	-	6 809	3 677	2 880
<b>Total all taxes</b>	<b>136 442</b>	<b>52 672</b>	<b>24 158</b>	<b>20 290</b>	<b>9 069</b>	<b>7 030</b>

Reaching definitive conclusions from this comparative data is contentious for the following reasons:

1. The FIAS study used means and not 5% trimmed means to calculate their costs (but the means for the current study have been provided in the table above for comparative purposes).
2. The FIAS study included the value of time to prepare, complete and submit the tax returns. Whether or not this includes recording of information for tax (record-keeping) and/or the payment of the tax is uncertain. The value for the current study excluded the record-keeping time, but included the value of the time to pay any tax due. Furthermore, the values above for the current study excluded any time taken to deal with SARS. Some of this time could arguably relate to the completion and/or submission of the tax return and should thus have been allocated here, but this has not been done (and the amounts used in the current study may therefore be understated).



3. The FIAS study separated provisional tax from income tax and did not mention CGT separately. The current study did not mention provisional tax separately, but did separate CGT from income tax (current study amounts above exclude CGT values and are presumed to include provisional tax).

Bearing all of these differences in mind, and if the FIAS (2007) figures are increased for inflation (at an average rate of 6.55% from 2007 to 2011 (Statistics South Africa, 2008:1; 2011a:1 and 2011b:1)), it appears that there has been an overall increase in internal tax compliance costs as the retainer value of R24 158 (R31 136 adjusted for inflation) has almost doubled if compared to the current study (R52 672). To ensure that a reliable conclusion on the incidence of internal tax compliance costs can be obtained, it is suggested that the current values be used as a baseline for future studies so that meaningful comparisons can be made in future and that the exact areas that have caused the increase in internal tax compliance costs can be pinpointed. This will ensure focused reforms that should be able to address the root of the problem.

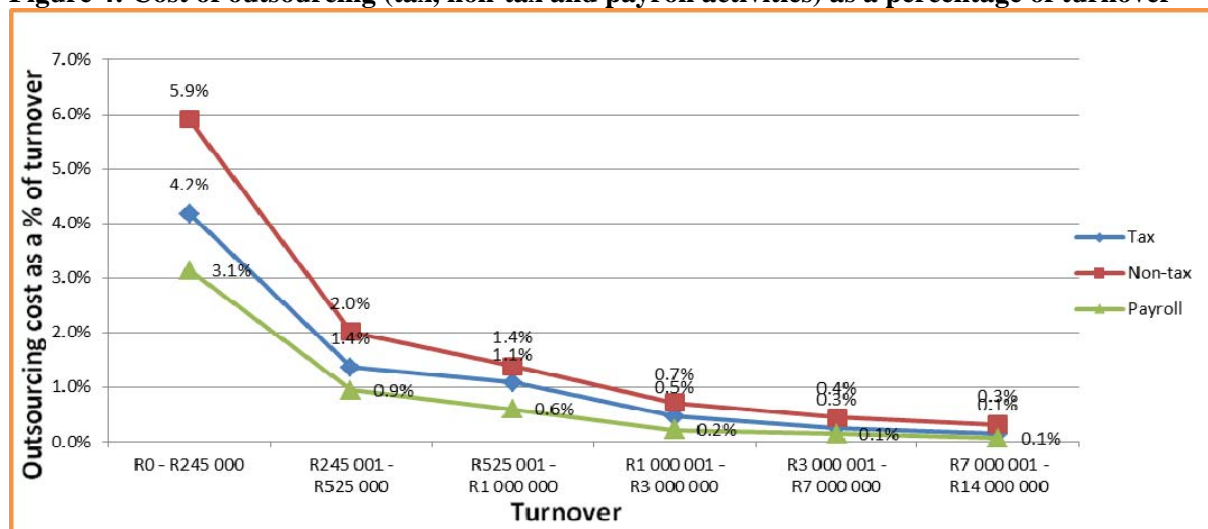
Tax compliance costs include not only the value of the time taken by the owners and employees of a business (internal costs) in complying with tax legislation, but also the money spent by these businesses on external service providers (for example accountants, bookkeepers, tax practitioners and lawyers) to assist with the business's tax compliance obligations. These costs will be considered next.

#### **4.4 External costs of tax compliance**

##### **a) Survey results**

It was found that more than three quarters (76%) of the respondents used the services of external service providers for tax, accounting and payroll services. These services are used the most by businesses in the professional, scientific and technical services sector and it appears that the use of these external services increases as the turnover of the business increases, no matter what form the small business is trading in. These external services are mainly in relation to tax services as opposed to non-tax services.

From a cost perspective, small businesses tend to spend on average R31 996 on outsourcing. If this is analysed further, it is found that small businesses spend on average R9 882 on external tax related services — which is less than the amount spent on non-tax services (R16 634) but more than the amount spent on external payroll services (R5 480). All these costs are regressive (as can be seen from Figure 4), with the smaller businesses spending disproportionately more than those with higher turnovers.

**Figure 4: Cost of outsourcing (tax, non-tax and payroll activities) as a percentage of turnover**

Almost half (48.9%) of the respondents perceived that there is a value in the information provided by their external service providers beyond the provision of tax services and tax advice, as they indicated that they would be prepared to pay for external accounting and payroll services even if South Africa were tax free. It was generally the smaller businesses (turnover of less than R1 million) that would probably not incur these expenses and therefore it appears as if they do not perceive as much value in the information provided by their external accounting and payroll service provider. Taxpayers who currently pay for external non-tax and payroll related services would be more likely to spend on external services in a tax compliance free environment.

Assuming that there were no tax obligations, these respondents were prepared to pay R10 095 for external accounting services and R4 764 for external payroll services. Some (10.9%/19%) were even prepared to spend more than they were currently paying, implying that they derive more benefits from their relationship with their accountant/external payroll service provider than what they are currently paying for.

#### b) Comparison to other research

A comparison of the findings in respect of the use of external service providers for tax and accounting services in the FIAS (2007), the Govender and Citizen Surveys (2008) and the current study are displayed in Table 10 below. The average (mean) costs as well as the 5% trimmed mean for the current study have been provided because the other two studies did not use the 5% trimmed mean, but rather the ordinary mean (Kisunko, 2011:1).

**Table 10: Three study comparison of annual costs of external tax and accounting related services**

<b>COST OF EXTERNAL SERVICE PROVIDERS / STUDY</b>	<b>Current study (mean)</b>	<b>Current study (5% trimmed mean)</b>	<b>FIAS* (2007)</b>	<b>Govender &amp; Citizen Surveys* (2008)</b>
Tax costs	R24 370	R9 882	R24 158	?
Accounting costs	R28 283	R16 634	R12 185	?
Total annual tax and accounting cost (excluding payroll costs)	<b>R52 653</b>	<b>R26 516</b>	<b>R36 343</b>	<b>R14 030</b>
Payroll costs	R9 267	R5 480	?	?
Total tax and accounting outsourcing cost	<b>R61 920</b>	<b>R31 996</b>	<b>R36 343</b>	<b>R14 030</b>

\* These studies used an ordinary mean to calculate these costs rather than the 5% trimmed mean

If one first considers the costs of outsourcing tax functions (excluding payroll costs), using the 5% trimmed mean as the comparative indicator, these have reduced since 2006 (when the FIAS study was conducted) and 2007 (when the Govender and Citizen Surveys study was undertaken) — even if inflation is taken into account and if it is assumed that the R14 030 was incurred exclusively for tax purposes, as 51% of the study's respondents believed this to be the case). This is a positive finding but the caveat here is that this is not necessarily the only cost incurred by the small business as other internal costs may need to be incurred to ensure its total tax compliance. Nevertheless, it is encouraging to see that tax outsourcing has not increased the compliance burden for small businesses. This, unfortunately, does not appear to be the case in respect of external accounting costs, which have increased (taking inflation into account).

#### 4.5 The accounting/tax overlap

Previous research (Tran-Nam in Evans, Pope & Hasseldine, 2001:51, 55) suggests that accounting and tax compliance activities overlap. What this implies is that various accounting and record-keeping functions are performed both for tax and accounting purposes (that is, for instance producing managerial information and also information required for complying with tax legislation) — resulting in a joint purpose. Determining how these joint-purpose costs should be divided between these two functions is what causes the “disentanglement” dilemma in tax compliance cost research (Lignier, 2009c:124).

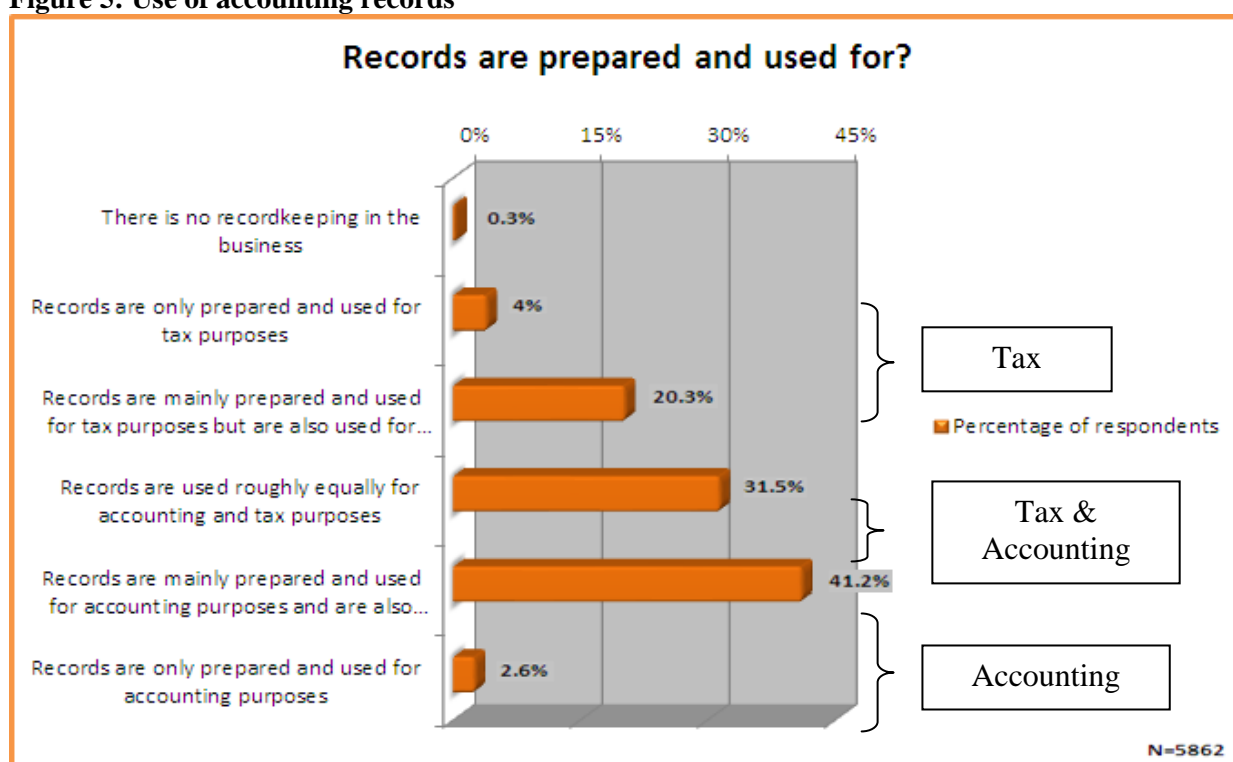
In an effort to disentangle the accounting and taxation costs from each other to ensure that only the tax compliance costs are taken into consideration in the tax compliance cost measurement criteria, the questionnaire prompted respondents to provide information regarding the type of accounting system used by their business, the reasons for keeping records and, ultimately, the time spent internally on accounting functions considered essential to the operation of the business.

#### 4.5.1 Nature of the accounting system and reasons for keeping accounting records

The results indicated that just over three quarters of the respondents (77.7%) operated a computer based accounting system. Of those that didn't use a computer-based accounting system, 1.6% indicated that they used no accounting system at all. Of those that used no accounting system, 67.2% were businesses with a turnover of less than R1 million, with the majority of these having a turnover of between R0 and R254 000. This result is to be expected given the nature and size of the business, but what was surprising was that there were companies (12.5%) that have a turnover of between R3 million and R14 million, that also did not use any form of accounting system. The reasons for this and its effectiveness would need more investigation. Of the category of respondents that did not use a computerised accounting system, that is those that used a paper-based or manual system (11.9%), nearly half (48%) were also businesses with a turnover of less than R1 million. Respondents with a turnover of R1 million to R3 million were the ones that used a paper-based or manual system the most.

In a further endeavour to disentangle tax from accounting costs, the type of accounting system used (and for what it was used — tax versus accounting) and the owner's perception of the importance of accounting information and record-keeping (for tax and accounting purposes) were investigated. The results are set out in Figure 5 below.

**Figure 5: Use of accounting records**



Most of the respondents used computerised accounting systems with the micro businesses (turnover of R1 million or less) being the ones that tended not to use any accounting system at all. The reason for keeping records was mainly for accounting

purposes, with just under a third of the respondents stating that the records were kept roughly equally for accounting and tax purposes. It was interesting to note that a fifth of the respondents kept records mainly for tax purposes (but they were also used for accounting purposes). Tax therefore featured as a very important reason for keeping accounting records (even more important than for reporting to owners, internal management, other regulatory bodies and lenders).

#### 4.5.2 Time spent on various accounting activities

##### a) Survey results

In order to identify accounting activities that were not just carried out for tax purposes and that were beneficial to the business in some other way, question 14 in the questionnaire invited respondents to indicate the annual hours spent on specific core accounting activities. A similar methodology was used by Evans et al (1996:15), but two additional categories of activities were added to the list used in that study — those being investment planning unrelated to tax and budgeting and control. Venter and de Clercq (2007:147) found that small businesses in the three largest sectors in the South African economy (manufacturing, retail and business services) hardly use tax inputs, advice or information for management and planning purposes. It was therefore appropriate to see if perhaps the accounting information was used for investment planning and budgeting and control purposes as this could help resolve the disentanglement dilemma in respect of this activity. It was found (see Table 11) that the respondents spent on average 1 117 hours on core accounting activities, with most of this time spent processing customer invoices and cash received.

**Table 11: Annual hours spent on different accounting activities by small businesses**

<b>ACCOUNTING ACTIVITY</b>	<b>Mean*(hours)</b>	<b>Median (hours)</b>
Processing customer invoices and cash received	394.07	190.00
Following up debtors	105.74	30.00
Paying bills	100.29	48.00
Calculating and paying wages	62.46	30.00
Checking banking records against cash records	112.66	48.00
Stock-taking and stock control	44.20	5.00
Investment planning unrelated to tax	12.51	2.00
Budgeting and control	57.04	24.00
Other activities	0.76	0.00
<b>Total all taxes</b>	<b>1 117.34**</b>	<b>610.00**</b>

\* These results were based on the 5% trimmed mean

\*\* Not calculated as the sum of the above column but obtained from the 5% trimmed mean data set

The average of 1 117 hours (median: 610 hours) spent on core accounting activities is nearly four and a half times as much as the time spent on tax activities (255 hours). These hours spent were disproportionately high for the “smaller” businesses.

## b) Comparison to other research

The FinScope study (2010:26) revealed that the average small business owners spend 63.8 hours per week working on their businesses. If this is grossed up to an annual figure (using 48 working weeks as a basis), then small business owners spend on average 3 062 hours per year working on their businesses. When this is then compared to the hours obtained in the current study of 1 372 — tax activities: 255 hours, and accounting activities: 1 117 hours — it is evident that the times obtained in this study, although just less than half of the FinScope study time, appear to be reasonable — if not underestimated. Unfortunately no other benchmarks are available against which these results can be tested, and these times are therefore the best available to be used as a baseline for future studies in this area.

## 4.5.3 Valuation of accounting time

If the same valuation used for tax related activities is applied to the hours spent above, the costs involved in ensuring that all the internal accounting activities of the small business are performed, amount to the following:

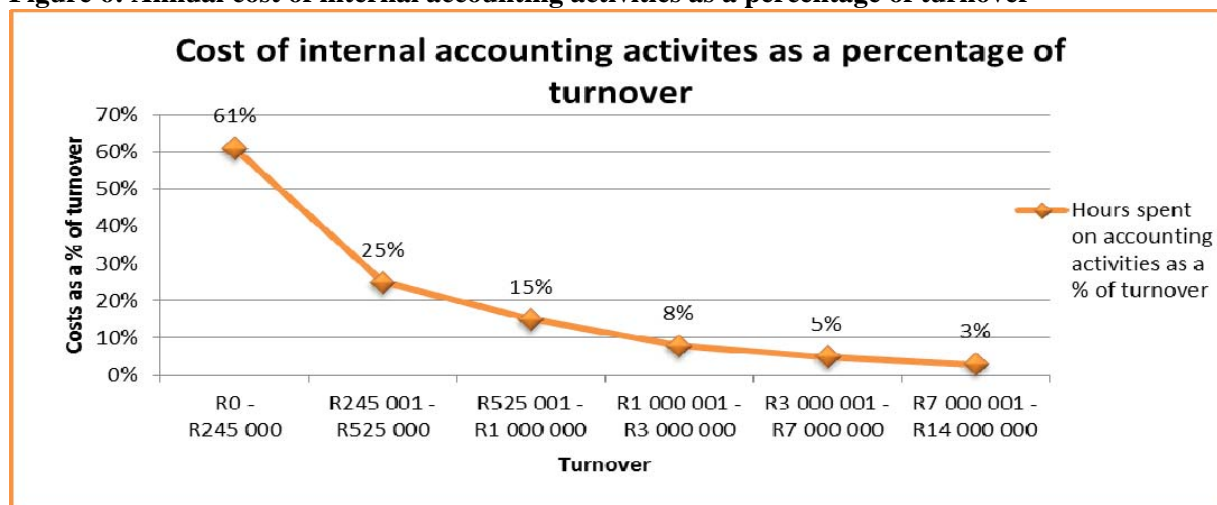
**Table 12: Annual internal cost of time spent by different people on accounting activities**

<b>ANALYSIS OF COSTS INCURRED ON ACCOUNTING ACTIVITIES PERFORMED BY:</b>	<b>Mean* (R)</b>	<b>Median (R)</b>
Owners, partners, directors and trustees	147 739.61	80 656.88
Employees	68 195.08	37 230.39
Unpaid friends & relatives	5 656.73	3 088.23
<b>Total all persons in business</b>	<b>221 591.43</b>	<b>120 975.51</b>

\* These results were based on the 5% trimmed mean

The value of time spent on accounting activities is R221 591 (median: R120 976) per year. It was also found that, as the business grows, so do the accounting costs, but that these costs are nevertheless regressive as is shown below.

**Figure 6: Annual cost of internal accounting activities as a percentage of turnover**



When comparing the total costs of R221 591 (median: R120 976) spent internally on accounting activities with the costs of tax activities (excluding the turnover tax) which amount to R53 356 (median R20 491), it is clear that performing the accounting activities of the business costs just over four times as much as the tax compliance activities. Thus more time and costs are spent on accounting activities than on tax compliance activities.

Having established the internal and external tax compliance costs incurred by small businesses, it was considered appropriate to establish if the respondents thought that there were any benefits that arose from complying with tax legislation. The next section thus focuses on the respondents' views of tax compliance benefits (if any).

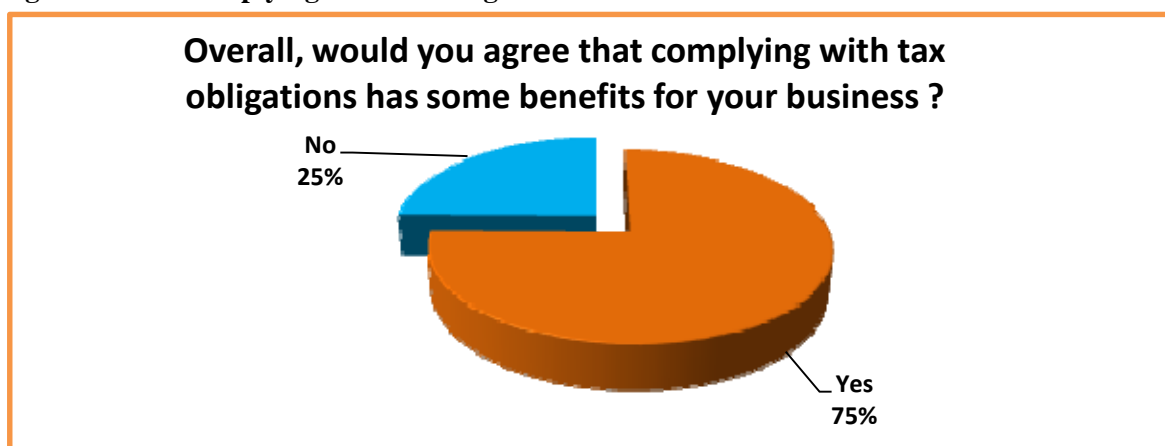
#### 4.6 Tax compliance benefits

The thought that tax compliance activities give rise not only to costs, but also to benefits, first came about in the early 1980's (Sandford, Godwin, Hardwick & Butterworth, 1981), but this has never been investigated from a South African perspective.

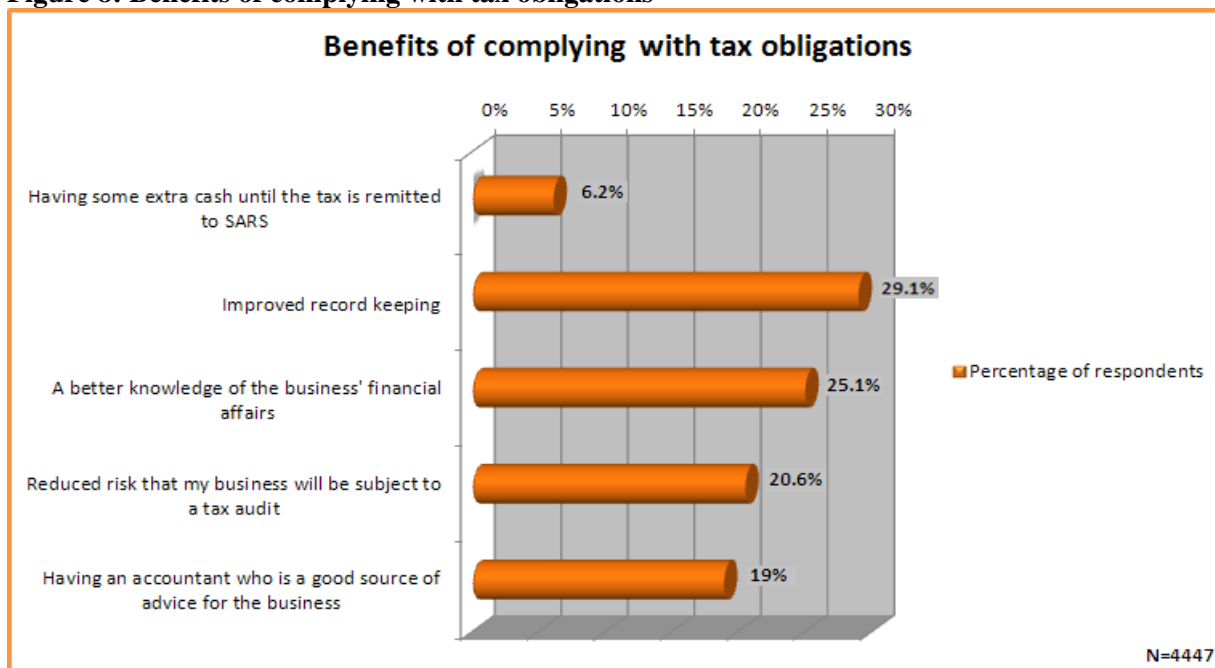
##### 4.6.1 Do tax compliance benefits exist?

This research, as is shown in Figure 7 below, established for the first time in South Africa that there is a perception that tax compliance benefits exist.

**Figure 7: Does complying with tax obligations have benefits for the business?**



This existence was acknowledged by three quarters of the small businesses irrespective of their size. The major perceived benefit of compliance with tax obligations (especially among the smaller businesses) is an improvement in record-keeping by the business, closely followed by a better knowledge of the business's financial affairs (see Figure 8 below). A reduced risk of having an audit and having an accountant who is a good source of advice for the business are also perceived as benefits, but not as great as the abovementioned benefits. The benefit that is perceived as the least significant is having some extra cash until the tax is submitted to SARS.

**Figure 8: Benefits of complying with tax obligations**

It has been argued that the requirement to keep tax records also has its benefits for the small business (Lignier, 2009a:106). Respondents were provided with a list of five statements regarding the benefits of keeping tax records and their perceptions about these benefits (based on a five point Likert scale) were sought. These perceived benefits and the responses thereto are set out below.

**Table 13: Perceptions about benefits of tax compliance**

	Agree or strongly agree		Disagree or strongly disagree		Unsure or not applicable	
	Count	%	Count	%	Count	%
Improves record keeping	4 329	76.2	951	16.7	404	7.1
Improves maintenance of accurate records	4 434	78	893	15.7	358	6.3
Improves knowledge of financial position of the business	3 659	64.7	1 373	24.3	619	10.9
Improves knowledge of profitability	3 567	63.1	1 422	25.2	663	11.7
VAT compliance obligations provide up to date information	3 532	62.5	1 417	25.1	699	12.3



The greatest perceived benefit was having more accurate records as a result of tax compliance obligations.

To determine if there was any perceived benefit in having an external advisor beyond the value of the tax information and services provided by their accountant, respondents were asked whether they would be prepared to pay for these external services if South Africa were tax free. Table 14 shows that 39% of the respondents would still be prepared to pay for external advisors for accounting service costs even if there were no tax obligations.

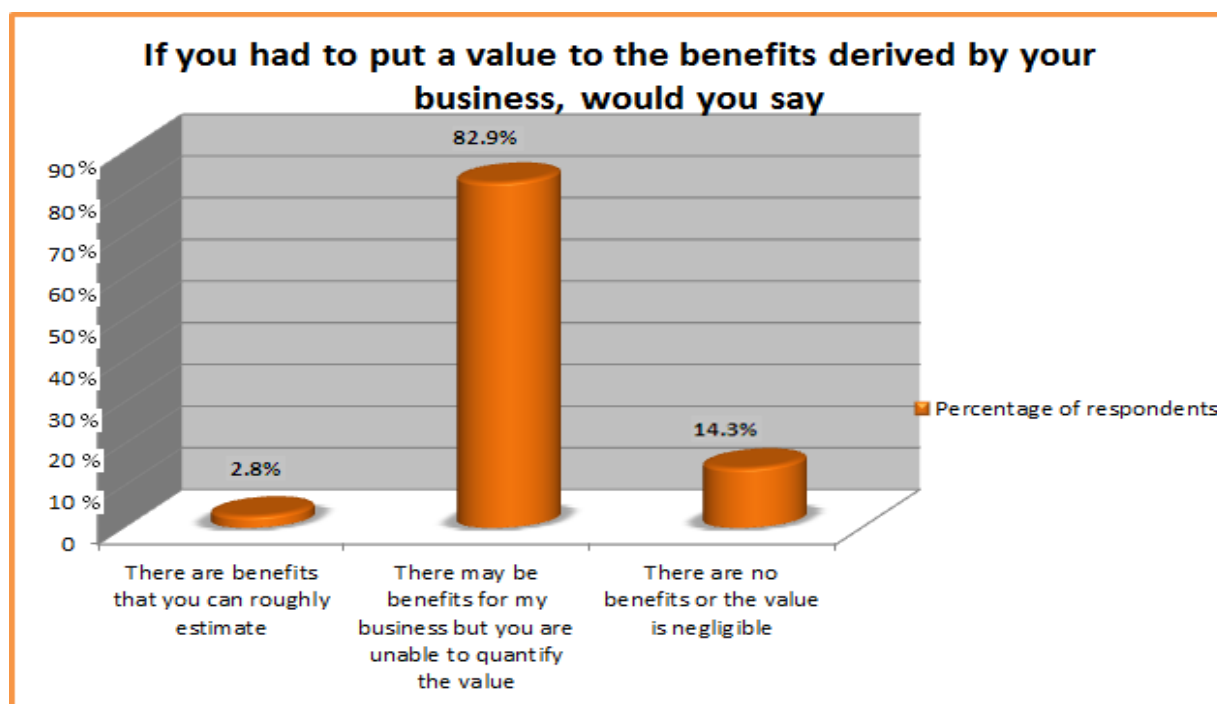
**Table 14: Analysis of respondents' use of external service providers**

	Number	Percentage
Respondents currently paying for external services (tax & non-tax)	4 463	76.1%
Respondents currently paying for non-tax services	2 987	50.9%
Respondents who would pay for external services even if there were no tax	2 312	39.4%
Respondents who would spend <b>more</b> than the current amount they are spending on non-tax services	641	10.9%
Respondents who would spend the <b>same amount</b> as the current amount they are spending on non-tax services	385	6.6%
Respondents who would spend <b>less</b> than the current amount they are spending on non-tax services	1 128	19.2%
<i>Total Number of respondents</i>	5 862	-

An interesting finding is that just over one tenth of those who actually paid for non-tax services would be willing to pay more than they are currently paying even if South Africa were tax free. This is a possible indication that these taxpayers may be deriving more benefits from the relationship with their accountant than what they are paying for; a conclusion also reached by Lignier (2008:370).

#### **4.6.2 What is the value of tax compliance benefits?**

Various methods have been employed to measure tax compliance benefits (Sandford et al. 1981:94; the National Audit Office (UK), 1994:20; Lignier, 2006:55 and Lignier 2009c:124). These methods all have their limitations, and taking these limitations into consideration as well as the financial and time constraints present during this research, the approach followed in this study was a subjective approach as used by Lignier (2006:55). Figure 9 below shows the results obtained from the respondents when they were asked if there were any benefits to complying with tax obligations and whether they could possibly be measured.

**Figure 9: Valuation of tax compliance benefits by respondents**

Despite the fact that, for the first time in South Africa, the establishment of the perception that tax compliance benefits exist was established, 82.9% of the respondents indicated that they could not accurately quantify these benefits. The research was thus unable to accurately measure the tax compliance benefits and future research in this area, using a more sophisticated approach as suggested by Lignier (2009c:38), is proposed.

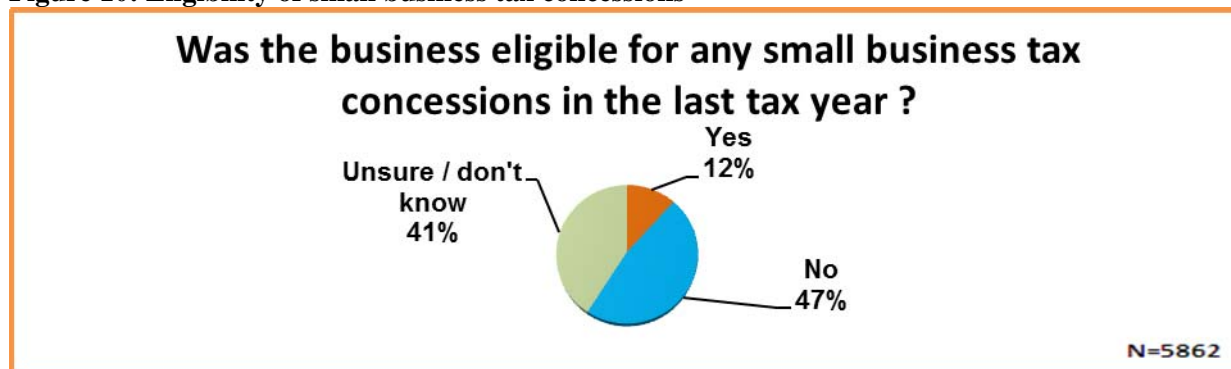
#### 4.7 Small business tax concessions (SBTCs)

Small businesses are arguably the most dynamic sector of the economy, but they are much more vulnerable than any other sector to the compliance burden created by the tax law and its complexity (OECD, 2010:5). The South African government, have made endeavours to reduce this compliance burden by introducing various strategies and measures (tax concessions) to achieve this reduction in the tax compliance burden (SARS, 2011c:30-32).

In view of these developments, it was believed that there would be value in researching the extent to which SBTCs achieved their objective of reducing the tax compliance burden in South Africa. In order to do this, the take-up (eligibility) of the specific tax concessions by small businesses in South Africa and the reasons why they were or were not used by these businesses were investigated in this study. The small businesses' perceptions of the concessions with regard to their usefulness and level of complexity were also considered.

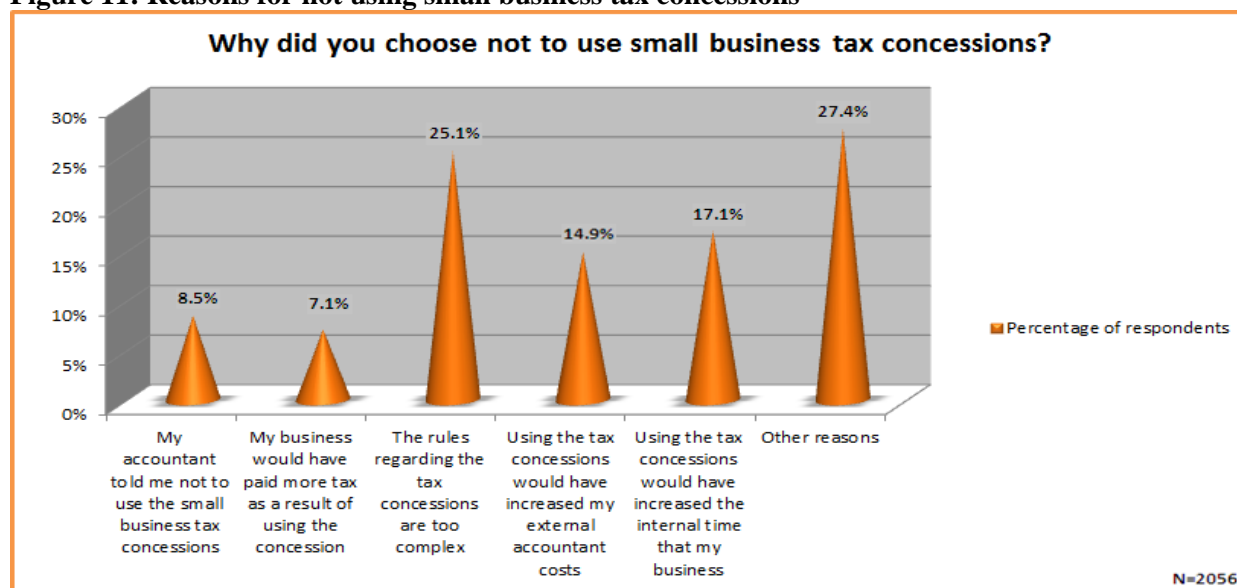
What was found (refer to Figure 10) was that almost half (47%) of the respondents indicated that they were not eligible for the SBTCs, 41% indicated that they were “not sure” if they were eligible, leaving only 12% stating that they were in fact eligible.

**Figure 10: Eligibility of small business tax concessions**



This finding is an indication that the eligibility criteria for the SBTCs could be too restrictive (confirmed by certain of the respondents' views provided in the survey) or that some small businesses or their external service providers are ignorant, not updated or not knowledgeable of the SBTCs, or that the marketing of these concessions has not been adequate or appropriately targeted. Upon further analysis of the data, it was found that there existed some confusion about the eligibility and use of these concessions (especially in respect of the turnover tax system).

Of those small businesses that were eligible for the SBTCs, 68% actually used the SBTCs, indicating good adoption of the concessions once the businesses are aware of them. Of those that did not use the concession despite being eligible for them, it was found that the main reason for not using the SBTCs was because the rules of the concessions were too complex, followed by the increase in internal or external time spent on tax related activities.

**Figure 11: Reasons for not using small business tax concessions**

The SBTCs used the most, are the SBC concession and the turnover tax system. The majority of the respondents felt unsure about the usefulness (Table 15) and complexity (Table 16) of these SBTCs and that in itself indicates that more research is needed into these concessions — because the very reason why they were implemented was to assist the small business community with their tax compliance burden, yet this appears not to have been successful.

**Table 15: Perceptions about usefulness of SBTC**

Concessions	Moderately or very useful	Not useful or not very useful	Unsure
			Not Applicable
			Not relevant
Small Business Corporation	10.10%	7.50%	82.40%
	(488)	(360)	(3 965)
Small Retailers VAT Package	6.30%	9.80%	83.90%
	(305)	(470)	(4 037)
CGT concession	7.10%	7.90%	85.00%
	(338)	(378)	(4 067)
Submission of VAT returns four-monthly	15.20%	11.50%	73.30%
	(735)	(554)	(3 542)
Turnover Tax System	8.70%	12.10%	79.30%
	(418)	(583)	(3 822)

**Table 16 : Perceptions about complexity of SBTC**

<b>Concessions</b>	<b>Not complex or not very complex</b>	<b>Moderately to very complex</b>	<b>Unsure Not Applicable Not relevant</b>
Small Business Corporation	7.10%	11.60%	81.20%
	(347)	(565)	(3 945)
Small Retailers VAT Package	5.60%	9.90%	84.50%
	(269)	(478)	(4 082)
CGT concession	4.30%	10.60%	85.00%
	(209)	(511)	(4 090)
Submission of VAT returns four-monthly	13.50%	10.10%	76.30%
	(655)	(490)	(3 693)
Turnover Tax System	8.40%	10.80%	80.70%
	(406)	(524)	(3 903)

All of the respondents, irrespective of their eligibility for or use of the SBTCs were asked their overall general attitude towards the SBTCs and if the SBTCs were a waste of time for everybody and whether small businesses would be better off with a lower tax rate and a simpler tax system. The findings are set out in Table 17 below.

**Table 17: Attitudes of respondents towards SBTC in general**

<b>Statement</b>	<b>Agree or strongly agree</b>	<b>Disagree or strongly disagree</b>	<b>Unsure Not applicable Not relevant</b>
SBTC saved my business some tax Rands	14.80%	13.40%	71.80%
	(715)	(644)	(3 463)
SBTC are so complex that it is hardly worth the effort	29.00%	12.10%	58.90%
	(1 400)	(585)	(2 844)
I was well advised by my accountant regarding the benefits of SBTC for my business	24.90%	14.70%	60.30%
	(1 198)	(708)	(2 901)
Accountants have a self-interest in pushing the use of SBTC	7.90%	22.00%	70.10%
	(379)	(1 049)	(3 345)
SBTC are a waste of time, we would be better off with lower taxes and a simpler tax regime instead	40.80%	10.40%	48.70%
	(1 992)	(510)	(2 380)

A preference for lower tax rates and a simpler tax system over the current SBTCs is what 40.8% of the respondents indicated was their attitude towards SBTCs. The large “unsure” and “not relevant/applicable” categories indicate either an unawareness or

lack of understanding of the SBTCs. Based on these views, it may be concluded that further research into the SBTC's role in reducing the compliance burden, and perhaps the effectiveness of the marketing campaign of SARS, is warranted.

## 5. CONCLUSION

Small businesses are critical in expanding the economy, because as they grow they become the employers of the future. Addressing the tax concerns of this sector of the economy should be a priority of the South African government. This study was designed as a large-scale survey with the objective of collecting primary data that would allow an evaluation of the impact of the tax system on small businesses' tax compliance costs. While evaluating and measuring the tax compliance costs incurred by small businesses, the study sought to differentiate tax compliance activities from core accounting activities, and to determine whether there were any managerial benefits or other tax compliance benefits that could offset the gross compliance costs identified. An attempt was also made to establish whether or not the SBTCs were effective in relieving some of the effects of the tax compliance burden on small businesses.

The findings of the survey indicate that there is possibly a slight bias towards the larger end of the small business sector, but that comparison with previous tax compliance cost studies was nevertheless justified. It was estimated that it took small businesses (not on the turnover tax system) an average of 255 hours per year to comply with tax legislation. Turnover tax respondents spent just under two thirds of the time (155 hours) to comply with their tax obligations compared to similar businesses not registered for this tax.

This study confirmed that gross tax compliance costs are regressive, and overall it cost small businesses R53 356.81 per annum on internal tax compliance activities and R9 982 to obtain external tax compliance assistance. It appears as if the internal costs have increased (for certain tax compliance activities) if compared to studies performed four to five years ago, although exact comparisons were difficult. The amounts paid for external tax services decreased when compared to previous studies performed four to five years ago, but the external non-tax services showed a noticeable increase.

Compliance with VAT represented around 38% of internal time costs, thus confirming previous research that compliance with this type of tax is very costly for the taxpayer. The most time-consuming activity for all taxes was recording information (representing 52% of total internal time).

The mean gross tax compliance cost for small businesses is R63 328 per year (R53 356 internal plus R9 982 external tax service provider costs). Net tax compliance costs could not be calculated as the value of the managerial benefits could not be quantified. Notwithstanding this, it was confirmed for the first time in South Africa that a large majority (75%) of the respondents perceived there to be benefits to tax compliance. In particular, they believed that keeping tax records was an incentive to keep better and more accurate records and that this, in turn, led to a better knowledge about the financial position and profitability of their businesses.

The findings regarding the effectiveness of small business tax concessions revealed that almost half of respondents (47%) in this survey were not eligible for any SBTCs, with a further 41% indicating that they were “unsure” if they were eligible. There is an indication that taxpayers generally did not understand SBTCs and that this is an obstacle to their adoption. The overall perception towards SBTCs is that they are more complex than useful and not worth the effort. Further empirical research in this area is clearly warranted.

Despite the government’s commendable efforts in efficiency and compliance cost reduction — South Africa’s tax system is ranked number one in the BRICS (Brazil, Russia, India, China and South Africa) economies for its efficiency and in easing the compliance burden for taxpayers (PwC, 2011:1) — the findings of this study tend to confirm the sentiments of Qabaka that the South African small business population is still in need of tax reform that will assist in minimising its tax compliance costs so that it can concentrate on one of the country’s primary needs — job creation. A truly simplified tax system available to all small businesses is regarded as desirable by the respondents. Research into the specifics of this system (or adjustments to the current concessions) is therefore considered a priority for a sector that is found in every inch of our economy.

## **6. FUTURE RESEARCH**

From a size perspective, the lower end of the small business sector (those with a turnover of R1 million or less, or with less than five employees) also known as “microbusinesses”, should also be investigated in more detail, especially those without internet access. This additional research is necessitated as the results of this survey were predominantly received from the “larger” small businesses. Some doubt was cast on the turnover tax respondents as there appeared to be some contradicting information obtained from these respondents with regard to their eligibility. This additional research is especially important as it is possible that these micro businesses could have adopted the turnover tax system, and their views on this system’s ability to reduce their compliance costs would be most valuable in providing further insight into the effectiveness of this tax regime. Should they not have adopted this system, their reasons for not doing so would also provide insight into this tax system and its effectiveness.

## **7. ACKNOWLEDGEMENTS**

Special thanks must be extended to Professor Chris Evans for the invitation to participate in the international comparative research, SARS (particularly Ms S Murugan), for making this research possible and the World Bank (Ms J Coolidge and Mr G Kisunko) for their valuable input and assistance with the research. Sincere appreciation is also given to University of Pretoria’s Statistical Department (Dr L Fletcher and especially Mrs J Jordaan) for their assistance with the statistical analysis for this research.

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## **ANNEXURE A**

### **SMALL BUSINESS TAX CONCESSIONS IN SOUTH AFRICA**

Concessions (since 2001) introduced by the National Treasury and/or SARS that specifically relate to small businesses are as follows:

1. The introduction in 2001 of section 12E of the Income Tax Act (South Africa, 1962), being the Small Business Corporation (SBC) regime.
2. The Small Retailers VAT Package (SRVP) which was introduced in 2004 to assist small businesses in VAT record-keeping and calculation (deleted from 1 March 2010) (SARS, 2011a:1).
3. The capital gains tax relief of R900 000 (R750 000 before 1 March 2011) for the sale of small business assets introduced into the Income Tax Act (1962) in 2001 (South Africa, 1962: Eighth Schedule paragraph 57).
4. Filing of VAT returns every four months (instead of every two months) for small businesses with taxable supplies of less than R1.5 million (R1.2 million before 1 March 2008) introduced from 1 August 2005 (South Africa, 1991: section 27&4B).
5. The exemption, from 1 August 2005, from having to pay the skills development levy (SDL) for employers with an annual payroll of R500 000 or less per annum (South Africa, 1999: section 4(b)).
6. The introduction of the turnover tax for micro businesses from 1 March 2009 (this coincided with the increase in the VAT threshold for registration from R300 000 to R1 million) (South Africa, 1962: Sixth Schedule).
7. The ability, from 1 March 2009, for businesses with a taxable income of R1 million or less to base the second provisional tax payment on either the “basic amount” or an estimate of the actual taxable income for the year of assessment (rather than just an estimate as is required by businesses with taxable income of more than R1 million which might require additional time and calculations) without having to incur a 20% underestimate penalty. The “basic amount” is essentially the taxable income for the last year assessed. This is only valid as long as the estimate used is at least equal to 90% of the actual final taxable income (South Africa, 1962: Fourth Schedule).
8. The payment of a reduced application fee (R2 500 rather than R10 000) by an SME (as defined in section 12E(a)(i)) for a binding private ruling application which includes 8 hours of reviewing free of charge (which is not available to other applicants either) (SARS, 2011d:5).

The benefits for a small business of being eligible for each of these small business tax concessions are summarised below.

#### ***SBC benefits***

Should the business entity qualify as a SBC, the tax-related benefits that it is entitled to are as follows: Reduced taxation payable as it is calculated on a sliding scale with a maximum rate of tax (currently 28%) applying only on taxable income in excess of R300 000, compared to a normal company, where this rate is levied from the first R1 of taxable income.

An accelerated (100%) write-off in comparison with the normal rules of the cost of manufacturing assets (plant and machinery) in the year the asset is brought into use for the first time. An accelerated write-off allowance in comparison with the normal rules for non-manufacturing assets (50% in the first year, 30% in the second year, and 20% in the third year) (South Africa, 1962).

***SRVP benefits***

A Small Retailers VAT Package was introduced by SARS in 2004 (SARS, 2005:1). This package provided an alternative method for qualifying small retail businesses to determine the value of the total taxable supplies — that is, it assisted in determining what proportion of the business' sales were taxable at the standard or zero rate. It was aimed at those small retail businesses that found it difficult to issue tax invoices for a large number of supplies made direct to the public. To qualify for this package, the business had to apply to SARS and had to sell standard, as well as zero-rated foodstuffs from the same business premises and had to make taxable supplies (excluding VAT) of less than R1 million in any 12 month period and did not have adequate point of sale equipment (SARS, 2005:1-3). The benefits of being registered for the SRVP was that the business was not required to purchase specialised equipment to record all of its standard and zero-rated sales and would only be required to retain limited records for VAT purposes (SARS, 2005:2). In addition, SARS would have supplied the approved small retailer with pre-printed booklets to assist it in determining its daily gross takings and zero-rated sales (SARS, 2005:2).

***Capital gains tax benefits***

Persons who operate small businesses as defined in paragraph 57 of the Eighth Schedule to the Income Tax Act (South Africa, 1962) are entitled to exclude R900 000 (R750 000 before 1 March 2011) of the capital gain made on the disposal of active business assets (subject to certain conditions) when they attain the age of 55 years, or where the disposal is in consequence of ill-health, other infirmity, superannuation or death.

***VAT benefits***

Small businesses with taxable supplies not exceeding R1 000 000 are not required to register for this tax and are therefore spared the burden of administering this tax. These businesses may, however, apply (in certain cases) for voluntary registration, which enables them to benefit from input tax credits on certain expenses, but also then imposes upon them the administrative burden of this tax. Certain small businesses are permitted to submit VAT returns every four months, instead of the normal monthly or two-monthly requirement (South Africa, 1991: section 27) which could assist in reducing their administrative burden. In addition, small businesses with taxable supplies of less than R2.5 million per year may elect to pay VAT on the cash basis, rather than the accrual basis (South Africa, 1991: section 15) which again might assist small businesses with their cash flow concerns.

***SDL benefits***

No SDL needs to be paid by businesses whose total remuneration subject to SDL paid/payable to all its employees does not exceed R500 000.

***Turnover tax system***

In essence, the benefits of being registered as a microbusiness under the turnover tax system is that these entities are subject to a low rate of tax on turnover without having to keep a record of their expenses and deductions (National Treasury, 2007:39-40). Minimal record-keeping is, however, required – micro businesses will need to retain records of the amounts received and dividends declared during the year of assessment, as well as proof of each asset and liability that has a value of more than R10 000 at the end of the year of assessment (SARS, 2011c:12).



### ***Provisional tax benefits***

The benefit available for businesses with a taxable income for the tax year that is R1 million or less, is that it may base its estimate of taxable income for purposes of calculating its second provisional tax payment on the lesser of the basic amount or 90% of its actual taxable income, without incurring any penalties for under-estimating its taxable income. A business that has taxable income of more than R1 million is not permitted to use the basic amount without the risk of incurring under-estimation additional tax/penalties.

### ***Binding private ruling benefits***

A small business has to pay only a R2 500 as opposed to a R10 000 application fee for a binding private ruling.

### ***General***

The exemption from SDL and relief on under-estimate penalties for provisional tax, were not separately considered in the survey. This is perhaps a flaw in the questionnaire, however, although the SDL is a separate tax, it is contained on the same return, almost calculated in the same way and is paid for in the same manner as employees' tax (PAYE) and is only payable at a rate of 1% (on a very similar amount used for PAYE purposes) and was thus not considered of great importance to this research.

In respect of the provisional tax, it must be noted that this is not a separate tax, but rather a system that makes taxpayers provide for their final tax liability by paying at least two amounts in a tax year. Thus it was inferred in the questionnaire that provisional tax was included in the income tax questions, but this fact could have been made clearer to the respondents and specific reference (in the small business tax concessions questions) could have been made to the provision of the alternative (simplified) manner in which the second provisional tax payment is calculated for businesses with a turnover of R1 million or less. This benefit should be incorporated into future studies of this nature.

The reduction in the binding private ruling fee is not a major benefit that is used frequently by small businesses, and was thus not considered important for the purposes of this study.

# Australian business taxpayer rights to compensation for loss caused by tax official wrongs – a call for legislative clarification

John Bevacqua\*

## **Abstract**

Australian business taxpayers seeking compensation for losses caused by the wrongs of tax officials have a number of judicially-enforceable and non-judicial avenues of relief. This article outlines each of these options and assesses the suitability and effectiveness of each for resolving compensation claims of business taxpayers. This examination reveals that there are no broadly applicable judicial avenues of relief with any realistic prospects for recovery available to assist Australian business taxpayers. Business taxpayers must turn to non-judicial avenues for recovering compensation from the Commissioner of Taxation. This article contends that these non-judicial avenues of relief are ill-suited for resolving many business compensation claims. Consequently, unlike other taxpayers, Australian business taxpayers often will have no appropriate, broadly applicable avenue for recovering compensation for tax official wrongs. This article calls for an express statutory statement to address this disadvantage by providing businesses with clarity and certainty as to their entitlements to compensation for loss caused by the wrongs of tax officials.

## **1. INTRODUCTION**

There is no comprehensive Australian statutory statement of taxpayer rights to compensation for loss caused by the wrongs of tax officials.<sup>1</sup> Taxpayer rights to monetary compensation from tax officials derive from a patchwork of judicial and non-judicial discretionary avenues of relief. This article contends that this patchwork of remedies especially disadvantages business taxpayers. It recommends the enactment of legislation to address this situation by clarifying business taxpayer rights to compensation for loss caused by tax official wrongs.<sup>2</sup>

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<sup>1</sup> A broad interpretation of the meaning of ‘wrong’ is adopted in this article. For the purposes of this article, the term encompasses not just tortious wrongs but any activity causing loss to business taxpayers which is not legislatively sanctioned. Legislatively-sanctioned losses would obviously include the collection of taxes by the Commissioner in accordance with the law. While statutory damages are available for particular wrongs such as breaches of the privacy principles in the *Privacy Act 1988* (Cth), there are no broad-based Australian statutory remedies.

<sup>2</sup> The author made broader similar recommendations in John Bevacqua, *Taxpayer Rights to Compensation for Tax Office Mistakes* (2011).

I set out the judicial avenues for recovering compensation. It deals with tortious avenues of relief, the equitable option of promissory estoppel, the possibility of recovering damages via a breach of contract action and the availability of damages in judicial review of administrative action proceedings. It reveals the very limited applicability in the tax context of all of these key legal paths to recovery of compensation.

Next I set out the various non-judicial avenues of compensatory relief. The examination extends to consideration of the Taxpayers' Charter, investigation by the Commonwealth Ombudsman, appeal to Australian Taxation Office ('ATO') Internal Complaints and ex gratia relief available under the Scheme for Compensation for Detriment caused by Defective Administration ('CDDA Scheme') administered by the Commonwealth Department of Finance and Administration.

The discussion reveals that the non-judicial avenues of relief provide the broadest and most viable options for taxpayers to pursue the Commissioner of Taxation for compensation for tax official wrongs.<sup>3</sup> Equally, however, these same avenues for relief are the least suitable for resolving claims which are factually complex, large and/or involve serious questions of law. Accordingly, they are not well suited for resolving many business taxpayer claims for compensation. This places business taxpayers at a distinct practical disadvantage relative to other taxpayers when seeking compensation from the Commissioner of Taxation. I next set out this argument.

Lastly I make the case for legislative action to address this disadvantage. It specifically calls for legislation to clarify the rights of business taxpayers to compensation for tax official wrongs to provide businesses with certainty and to foster a climate of trust and confidence in the Australian system of tax administration.

## 2. JUDICIAL AVENUES FOR BUSINESSES SEEKING COMPENSATION FOR TAX OFFICIAL WRONGS

This section deals with tortious, contractual, equitable and administrative law avenues for potential recovery of compensation from the Commissioner of Taxation. The discussion that follows addresses each of these avenues of relief in turn and illustrates the exceedingly slim prospects for businesses seeking to recover monetary compensation from the Commissioner through court action.

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<sup>3</sup> In this article the Commissioner of Taxation is variously referred to as 'the Commissioner' and 'the ATO'. Almost all of the avenues of relief examined in this article provide for recovery from the Commissioner of Taxation and not from the Commissioner's tax officers personally. The only exception is the tort of misfeasance in public office which is technically a personal tort against the offending official. However, the Commissioner has historically always agreed to indemnify any officer against whom allegations of misfeasance have been made. See, for example, *Re Young v Commissioner of Taxation* [2008] AATA 115. Accordingly the rights to compensation for tax official wrongs are essentially equivalent to the rights to recovery from the Commissioner of Taxation and the distinction is not laboured in this article.

## 2.1 Recovering Compensation in Tort

To date, no business or individual taxpayer has succeeded in recovering compensation from the Commissioner in any reported Australian tort case. In fact, very few attempts have been made to pursue the Commissioner in judicial proceedings. Some writers have speculated that this is because '[t]he ATO often pre-empts such legal claims, where negligence and subsequent financial loss to the taxpayer are clear from the facts, and pays compensation.'<sup>4</sup> However, the principles that have emerged from judicial consideration in these cases suggest that the Commissioner has little to fear in any compensation claims involving allegations of breaches of tortious duties.

For example, in cases where allegations of negligence or breach of statutory duty have been judicially considered, the uniform result has been summary dismissal. The comments of Grove J in *Harris v Deputy Commissioner of Taxation*<sup>5</sup> ('*Harris*'), which involved a negligence claim against the Commissioner by the operator of a horse-breeding business, are typical of the full extent of the treatment. In that case His Honour stated:

There is no basis upon which to conclude that there is a tort liability in the Australian Taxation Office or its named officers towards a taxpayer arising out of the lawful exercise of functions under the Income Tax Assessment Act.<sup>6</sup>

In arriving at this conclusion, Grove J in *Harris* did not apply any of the usual common law tools or principles for determining questions of tortious duties of care applied in cases where public authority tortious liability is in question.<sup>7</sup>

In *Lucas v O'Reilly*<sup>8</sup> ('*Lucas*'), Young CJ dealt similarly expediently with an argument by a partner of a share-trading business who alleged, among a number of causes of action, a breach of statutory duty by the Commissioner in respect of a foreshadowed (and, the taxpayer argued, erroneous) Notice of Assessment of his tax liability. His Honour stated:

If the cause of action relied upon by the plaintiff is based upon a breach of statutory duty, the plaintiff must show not only that the duty which is alleged

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<sup>4</sup> Duncan Bentley, 'The Taxpayers' Charter: More than a Mission Statement' (1995-1996) 4 *Taxation in Australia Red Edition* 259, 261.

<sup>5</sup> (2001) 47 ATR 406.

<sup>6</sup> Ibid, 408.

<sup>7</sup> His Honour only makes passing reference to the currently prevailing 'incremental approach' to resolving questions of public authority tortious duties of care. Above n 5, at 409, His Honour merely observes: 'In recent times the determination of the existence of a duty of care has been directed to be established by recognition of novel areas of duty on an incremental or case by case basis: *Perre v Appand Pty Limited* (1999) 198 CLR 180; *Crimmins v Stevedoring Industry Finance Committee* (1999) 200 CLR 1.'

<sup>8</sup> (1979) 79 ATC 4081.

to have been or to be about to be broken is a duty owed to him but also that the statute creating the duty confers upon him a right of action in respect of any breach...However, it is, I think, clear that the defendant owes the plaintiff no such duty. The duty of the Commissioner is owed to the Crown.<sup>9</sup>

Even torts specifically aimed at compensating citizens wronged by public officials such as the tort of misfeasance in public office<sup>10</sup> have not resulted in a single dollar of compensation to any Australian business to date. Misfeasance in public office allegations against the Commissioner usually fall at the hurdle of demonstrating that a tax official has acted with malice directed toward the taxpayer.<sup>11</sup> The difficulties of demonstrating the lack of good faith necessary to prove malice where tax officers are concerned were highlighted by Hill, Dowsett and Hely JJ in *Kordan Pty Ltd v Federal Commissioner of Taxation*<sup>12</sup>, a case involving the treatment of trading stock and business losses by the taxpayer:

The allegation that the Commissioner, or those exercising his powers by delegation, acted other than in good faith in assessing a taxpayer to income tax is a serious allegation and not one lightly to be made. It is, thus, not particularly surprising that allegations directed at setting aside assessments on the basis of absence of good faith have generally been unsuccessful. Indeed one would hope that this was and would continue to be the case.<sup>13</sup>

Hill, Dowsett and Hely JJ do not go so far as to suggest a presumption by our courts of tax official honesty. However, in most cases, the dishonesty requirement has served as

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<sup>9</sup> Ibid, 4085.

<sup>10</sup> The tort can not apply to private individuals and is only applicable to public officers. Expressing this idea in the context of the equality principle, Sadler points out that the tort of misfeasance ‘...is the only exception to the principle that, generally speaking, a public officer is not liable in tort unless the act complained of would, if done by a private individual, be actionable. It is the only tort having its roots and applications within public law alone. It cannot apply in private law; the defendant must be a public officer and the misfeasance complained of must occur whilst the public officer is purporting to exercise the powers of his or her office.’ Robert Sadler, ‘Liability for Misfeasance in Public Office’ (1992) 14 Sydney Law Review 137, 138-139.

<sup>11</sup> Knowledge of absence of power and malice have long been accepted as two separate limbs of the tort of misfeasance in public office. As Smith J noted in *Farrington v Thomason* [1959] VR 289, 292: ‘Some of the authorities seem to assume that in order to establish a cause of action for misfeasance in a public office, it is, or may be necessary to show that the officer acted maliciously in the sense of having an intention to injure...it appears to me, however, that this is not so, and that it is sufficient to show that he acted with knowledge that what he did was an abuse of his office.’ More recent literature views these simply as two types of malice, the former being referred to as ‘untargeted’ malice and the latter as ‘targeted’ malice. This is the approach taken in the leading UK misfeasance case, *Three Rivers District Council v Bank of England* [2000] 3 All ER 1.

<sup>12</sup> (2000) 46 ATR 191.

<sup>13</sup> Ibid, 193. The High Court recently discussed these comments favourably in *Commissioner of Taxation v Futuris Corporation Limited* (2008) 237 CLR 146.

a significant practical impediment to the ability of business taxpayers to recover compensation via this tort.<sup>14</sup>

The door has been left open for misfeasance claims against the Commissioner by cases such as *Lucas*<sup>15</sup> and, more recently, the High Court decision in *Commissioner of Taxation v Futuris Corporation Ltd*<sup>16</sup> ('*Futuris*'). It was observed in *Futuris* that s175 of the *ITAA36* would not protect the Commissioner from a challenge to a Notice of Assessment on the basis of an ATO officer having committed a misfeasance in public office.<sup>17</sup> This pronouncement, however, does not change the principles applied in misfeasance cases. Accordingly, it does little to advance the practical prospects of business taxpayer victims of the Commissioner's wrongdoing recovering compensation via a tortious action.

## 2.2 Recovering Compensation for Breach of Contract

No cases involving allegations of contractual breach arising out of the usual taxpayer interactions with the Commissioner have proceeded to judicial determination. It is generally accepted, however, that the Commissioner owes no contractual duties to taxpayers in carrying out his normal tax administration activities. Isaacs J in his 1926 judgment in *Moreau v FCT*<sup>18</sup> perhaps came the closest to imposing such duties on the Commissioner, asserting that the Commissioner's function was '...to administer the

<sup>14</sup> Cases in which the taxpayer has failed to demonstrate bad faith on the part of the relevant tax official include *Henderson v Deputy Commissioner of Taxation* [2005] FCA 1806, *Engler v Commissioner of Taxation (No 3)* [2003] FCA 1571, *Gates v Commissioner of Taxation* [2006] FCA 739, and *Madden v Madden & Ors* (1996) 136 ALR 98. For a detailed discussion of these cases see John Bevacqua, 'A Bridge too Far – The Prospect of a Successful Misfeasance Claim against the Commissioner of Taxation in the Wake of *Futuris* (2010) in ATAX, *International Tax Administration: Building Bridges* (2010), 43.

<sup>15</sup> Above n 8. In this case the taxpayer alleged that the Commissioner threatened to issue a Notice of Assessment knowing that it was not lawfully authorised and for a purpose foreign to the purpose for which the power to assess was granted. Young CJ held that this constituted a cause of action founded in misfeasance in public office even though not expressed in those terms in the plaintiff's Statement of Claim. His Honour further held that a sufficiently arguable case on this basis could be mounted and refused the application of the Commissioner to strike out the Plaintiff's Statement of Claim. The case never proceeded to a full hearing of the misfeasance argument.

<sup>16</sup> Above n 13.

<sup>17</sup> Section 175 of the *Income Tax Assessment Act 1936* (Cth) ('*ITAA36*') provides that an assessment is not invalid merely because the Commissioner has not complied with any provision of the *ITAA36*. The majority in *Futuris*, above n 13 at 164, observed that: 'The issue here is whether, upon its proper construction, s 175 of the Act brings within the jurisdiction of the Commissioner when making assessments a deliberate failure to comply with the provisions of the Act. A public officer who knowingly acts in excess of that officer's powers may commit the tort of misfeasance in public office...Members of the Australian Public Service are enjoined by the Public Service Act (s13) to act with care and diligence and to behave with honesty and integrity...These considerations point decisively against a construction of s 175 which would encompass deliberate failures to administer the law according to its terms.'

<sup>18</sup> (1926) 39 CLR 65. This case involved an ultimately unsuccessful challenge by the taxpayer to the powers of the Commissioner to amend a number of Notices of Assessment of the affairs of the taxpayer after the expiration of three years from the date when the tax payable on the assessment was originally due and payable.

Act with solicitude for the Public Treasury *and with fairness to the taxpayers*<sup>19</sup> (emphasis added). However, even Isaacs J stopped short of suggesting any implied *contractual* duty to treat taxpayers fairly. In any event, such comments have received little judicial attention in Australia.<sup>20</sup> The prevailing view remains akin to that expressed in the tortious cases discussed above; that the Commissioner's duties are owed exclusively to the Crown. There seems to be little room in this approach for implied contractual duties - of fairness or otherwise - to taxpayers.

The only situations in which the Commissioner has been held to owe quasi-contractual duties to taxpayers are cases where the Commissioner has made express binding promises to taxpayers (usually in the process of litigation settlement negotiations), and then later has sought to back away from those promises. One such case is *Cox v Deputy Federal Commissioner of Land Tax (Tas)*<sup>21</sup> ('Cox').

This case concerned a settlement of certain land tax liabilities of the taxpayer through an agreement between the Commissioner and the taxpayer. The Commissioner subsequently sought to re-open the land tax assessments. Griffith CJ denied the Commissioner's request to re-open the assessments, characterising the compromise followed by payment by the taxpayer as 'an executed agreement for valuable consideration.'<sup>22</sup>

Such cases are exceedingly rare.<sup>23</sup> Contractual relief is, therefore, unlikely to be a viable option for business taxpayers seeking compensation for loss caused by tax officer wrongdoing.

## 2.3 Recovering Compensation in Equity

Compensatory relief is available in equity in appropriate equitable estoppel actions.<sup>24</sup> Brennan J in *Waltons Stores v Maher*<sup>25</sup> clarifies that within the scope of the basic

<sup>19</sup> Ibid, 67.

<sup>20</sup> The implication of fairness has recently received judicial attention in a number of cases involving business taxpayers in the United Kingdom. Typical are the comments of Lord Scarman in *Inland Revenue Commissioners v National Federation of Self-Employed and Small Business Ltd* [1982] AC 617 in which His Lordship observed, at 651, that 'modern case law recognises a legal duty owed by the revenue to the general body of the taxpayers to treat taxpayers fairly.' Cases in which these comments have been positively received in Australia include *David Jones Finance and Investment Pty Ltd v Federal Commissioner of Taxation* (1990) 90 ATC 4730; *Darrell Lea v Commissioner of Taxation* (1996) 72 FCR 175; and *Bellinz v Federal Commissioner of Taxation* (1998) 39 ATR 198. None of these cases involved taxpayer compensation claims and the sentiments remain to be fully embraced in Australia. For further discussion of the duty of the Commissioner to act fairly see Bruce Quigley, 'The Commissioner's Powers of General Administration: How Far Can He Go?' (Paper presented at the 24<sup>th</sup> TIA National Convention, Sydney, 12 March 2009).

<sup>21</sup> (1914) 17 CLR 450.

<sup>22</sup> Ibid, 455.

<sup>23</sup> Similar findings arose in *Queensland Trustees v Fowles* (1910) 12 CLR 111 and, more recently, *Precision Polls Pty Ltd v FCT* (1992) 92 ATC 4549.

injunctive goal of estoppel, there is ample opportunity for monetary compensation to be awarded to a plaintiff.<sup>26</sup> Accordingly, monetary recompense for expenditure incurred has been awarded in some estoppel claims.<sup>27</sup>

Again, though, there has been no successful taxpayer claim for compensation in any equitable estoppel action against the Commissioner. In fact, irrespective of the remedy sought, estoppel is a difficult action to make out against the Commissioner. The prevailing judicial stance was bluntly and concisely stated by Kitto J in *Federal Commissioner of Taxation v Wade*<sup>28</sup>, a case involving a dairy farm business and the treatment of cattle as trading stock:

No conduct on the part of the Commissioner could operate as an estoppel against the operation of the Act.<sup>29</sup>

More recently, in *AGC (Investments) Ltd v FCT*<sup>30</sup>, a claim relating to tax assessment of the plaintiff's insurance business activities, Hill J expressed similar views:

[T]here is no room for the doctrine of estoppel operating to preclude the Commissioner from pursuing his statutory duty to assess tax in accordance with law. The *Income Tax Assessment Act* imposes obligations on the

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<sup>24</sup> While monetary relief may also be available via equitable relief through an unjust enrichment claim, the monetary relief in such cases is not compensatory in nature. In the case of unjust enrichment any monetary award is calculated to reflect the enrichment of the wrongdoer, rather than compensating for the loss suffered by the victim. Accordingly, the discussion in this section does not extend to consideration of the equitable doctrine of unjust enrichment.

<sup>25</sup> (1990) 170 CLR 394.

<sup>26</sup> His Honour points out, *ibid* at 423, that the goal of equitable relief in cases of promissory estoppel is 'not to compel the party bound to fulfil the assumption or expectation; it is to avoid the detriment which, if the assumption or expectation goes unfulfilled, will be suffered by the party who has been induced to act or to abstain from acting thereon.' Where the only viable avenue for avoiding the plaintiff's detriment is an award of monetary compensation, there is no prohibition on the court doing so. The various State Supreme Court Acts give the courts express powers in this regard. For example the *Supreme Court Act 1970* (NSW) provides in s 68 - 'Where the court has power (a) to grant an injunction against the breach of any covenant, contract or agreement, or against the commission or continuance of any wrongful act; or (b) to order the specific performance of any covenant, contract or agreement, the court may award damages to the party injured either in addition to or in substitution for the injunction or specific performance.' This legislation mirrors 19<sup>th</sup> Century British legislation known as "Lord Cairns' Act" (the *Chancery Amendment Act 1858*).

<sup>27</sup> For example, *Raffaele v Raffaele* [1962] WAR 238. See also the cases cited in J D Heydon, W M Gummow and R P Austin, *Cases and Materials on Equity and Trusts* (4 ed, 1993), 423. In a tax case involving allegations of estoppel by a business taxpayer, the sorts of compensable losses that might arise would 'include penalties and interest for non-compliance with the law, out of pocket expenses related to aborted transactions, and harm from paying more tax than might otherwise have been the case were it not for the erroneous representation.' Glen Loutzenhiser, 'Holding Revenue Canada to its Word: Estoppel in Tax Law' (1999) 57 *University of Toronto Faculty of Law Review* 127, 128.

<sup>28</sup> (1951) 84 CLR 105.

<sup>29</sup> *Ibid*, 117.

<sup>30</sup> (1991) 91 ATC 4180.



Commissioner and creates public rights and duties, which the application of the doctrine of estoppel would thwart.<sup>31</sup>

Consequently, there have been very few successful estoppel claims against the Commissioner of Taxation. The only successful cases have been those in which the Commissioner has sought to resile from a commitment tantamount to a contractual commitment to a taxpayer.<sup>32</sup> Accordingly, in the vast majority of cases, an equitable action is an unlikely option for businesses seeking to recover compensation from the Commissioner.

## 2.4 Recovering Compensation in Administrative Law Proceedings

The option of seeking compensatory relief via administrative law judicial review proceedings is not available in Australia. There is clear authority that monetary compensation is not available as a remedy for successful applicants.<sup>33</sup> Section 16(1) of the *Administrative Decisions (Judicial Review) Act 1977* (Cth) ('ADJR Act') sets out the available remedies in cases of judicial review under that Act.<sup>34</sup> While these remedies are 'very wide indeed'<sup>35</sup> this breadth has not been interpreted as permitting the Court to award damages in cases of review under any of the grounds set out in the *ADJR Act*.<sup>36</sup>

<sup>31</sup> Ibid, 4195. In relation to this case it was noted in *Bellinz v Federal Commissioner of Taxation*, above n 20, that: 'It was not suggested that the appellants could rely on estoppel, although the administrative law arguments advanced in reality seek to activate a doctrine of estoppel in a different guise.'

<sup>32</sup> One of these very rare cases, *Cox*, above n 21, has already been discussed as an example of a case concerning a binding quasi-contractual commitment made by the Commissioner. Similar cases are listed above at n 23. For a detailed exposition of these cases see Cameron Rider, 'Estoppel of the Revenue: A Review of Recent Developments' (1994) 23 *Australian Tax Review* 135.

<sup>33</sup> See, for example, *Park Oh Ho v Minister for Immigration and Ethnic Affairs* (1988) 81 ALR 288; *Conyngham v Minister for Immigration and Ethnic Affairs* (1986) 68 ALR 441; *Pearce v Button* (1986) 8 FCR 408; and *O'Neil v Wratten* (1986) 65 ALR 451.

<sup>34</sup> Section 16(1) provides as follows: (1) On an application for an order for review in respect of a decision, the Federal Court or the Federal Magistrates Court may, in its discretion, make all or any of the following orders: '(a) an order quashing or setting aside the decision, or a part of the decision, with effect from the date of the order or from such earlier or later date as the court specifies; (b) an order referring the matter to which the decision relates to the person who made the decision for further consideration, subject to such directions as the court thinks fit; (c) an order declaring the rights of the parties in respect of any matter to which the decision relates; (d) an order directing any of the parties to do, or to refrain from doing, any act or thing the doing, or the refraining from the doing, of which the court considers necessary to do justice between the parties.' Sub-sections (2) and (3) of s 16 respectively provide identical remedies in cases of conduct engaged in for the purposes of making a decision, and failure to make a decision or failure to make a decision within the requisite timeframe.

<sup>35</sup> Michael Walpole, 'Taxpayer Rights and Remedies - Australia, New Zealand and China' in *Second World Tax Conference* (2001), 31.

<sup>36</sup> As Sweeney J observed in *Park Oh Ho v Minister for Immigration and Ethnic Affairs*, above n 33 ('*Park Oh Ho*'): 'An applicant who merely establishes a ground of review under s 5 of the ADJR Act is not thereby entitled to an award of damages. The remedies of judicial review are those in the nature of certiorari, prohibition, mandamus, injunction and declaration, as s 16 of the ADJR Act makes plain.'

The availability of damages utilising s 22 of the *Federal Court of Australia Act 1976* (Cth)<sup>37</sup> and the jurisdiction of the Federal Court set out in s 39B of the *Judiciary Act 1903* (Cth) as an alternative to review under the *ADJR Act* has also been rejected.<sup>38</sup>

Accordingly, the recovery of damages as a remedy both in cases pursued by a business taxpayer under the *ADJR Act* as well as those pursued under the jurisdiction of the Federal Court set out in s39B of the *Judiciary Act 1903* (Cth) appears to be precluded.<sup>39</sup>

The overall picture that emerges is that business taxpayers are extremely unlikely to recover compensation via judicial avenues in Australia. The potential for recovery is slim and uncertain. This is especially true of the typical common law avenues for recovery – for breach of tortious or contractual duty. This is evident from the consistently restrictive judicial interpretation of the applicability of private law principles in claims against the Commissioner of Taxation. Judges have demonstrated a clear reluctance to impose on the Commissioner any private law duties which could be used as a foundation for a claim of damages. Judges generally accept that the duties of the Commissioner are owed exclusively to the Crown. This is despite the fact that there is no express statutory statement to this effect in any Australian tax legislation.<sup>40</sup>

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<sup>37</sup> Section 22 provides: ‘The Court shall, in every matter before the Court grant, either absolutely or on such terms and conditions as the Court thinks just, all remedies to which any of the parties appears to be entitled in respect of a legal or equitable claim properly brought forward by him or her in the matter, so that, as far as possible, all matters in controversy between the parties may be completely and finally determined and all multiplicity of proceedings concerning any of those matters avoided.’

<sup>38</sup> Sweeney J rejected this argument in *Park Oh Ho*, *ibid*, 297-298, observing that ‘[s]ection 22 does not enlarge the provision of substantive law so as to authorise the award of damages in circumstances for which the law does not provide.’ Morling J (at 310) and Foster J (at 317) made similar comments in that case. This case was subsequently overruled on other grounds by the High Court, but is still good authority on the question of the availability of damages in cases of judicial review of administrative action.

<sup>39</sup> This approach is consistent with the rejection in Australia of the availability of substantive relief in administrative law. Sir Anthony Mason has observed that ‘[i]t would require a revolution in Australian judicial thinking’ to bring about a change in this approach. Sir Anthony Mason, ‘Procedural Fairness: Its Development and the Continuing Role of Legitimate Expectations’ (2005) 12 *Australian Journal of Administrative Law* 103.

<sup>40</sup> Australian legislation even falls short of expressly imposing a duty on the Commissioner to collect the maximum amount of revenue payable under the law. This is in contrast to jurisdictions such as the United Kingdom and New Zealand which have both enacted legislation to that effect. For example see s13 of the *Inland Revenue Regulation Act 1890* (UK) and s6A of the *Tax Administration Act 1994* (NZ). In New Zealand, these provisions have been used as an express legislative basis for rejecting the existence of private law duties to taxpayers. For example, Keane J in the New Zealand negligence case of *Ch’elle Properties (NZ) Ltd v Commissioner of Inland Revenue* [2005] NZHC 190 at [96] characterised such provisions as creating an ‘intricate balance ... between efficacy, accountability and due process’ which would be inconsistent with the imposition of a private law duty of care. Commentators have also asserted that equitable duties are precluded by virtue of these provisions. See Andrew Alston, ‘Taxpayers’ Rights In New Zealand’ (1997) 7 *Revenue Law Journal* 211.

### 3. NON-JUDICIAL AVENUES FOR BUSINESSES SEEKING MONETARY COMPENSATION FOR TAX OFFICIAL WRONGS

The non-judicial alternatives for recovering compensation from the Commissioner of Taxation include damages payouts resulting from breaches of the Taxpayers' Charter, an investigation by the Commonwealth Ombudsman or from complaint to ATO Internal Complaints and the various options accessible via that avenue including ex gratia relief under the CDDA Scheme administered by the Department of Finance. This section discusses each of these options.

#### 3.1 Recovering Compensation for Breach of the Taxpayers' Charter

The Taxpayers' Charter (the 'Charter') consists of a series of booklets released by the Commissioner of Taxation in 1997.<sup>41</sup> The Charter lists taxpayer rights and obligations and Australian Tax Office standards of service, although none of these booklets are specifically aimed at business. The Charter has no legislative force<sup>42</sup> so it does not actually create any additional legal rights for taxpayers.<sup>43</sup> However, the Charter

<sup>41</sup>There was a substantial review of the Charter in 2003. A revised version was introduced in November of that year. The Charter publications are Australian Taxation Office, Taxpayers' Charter: What You Need to Know, NAT 2548 (2011) <[http://www.ato.gov.au/content/downloads/cor63133\\_n2548.pdf](http://www.ato.gov.au/content/downloads/cor63133_n2548.pdf)> at 11 April 2011; Australian Taxation Office, Taxpayers' Charter: Treating You Fairly and Reasonably, (2011)

<<http://www.ato.gov.au/corporate/content.aspx?doc=/content/25829.htm&pc=001/001/002/017&mnu=0&mfp=&st=&cy=>> at 11 April 2011; Australian Taxation Office, Taxpayers' Charter: Treating You as Being Honest, (2011) Australian

<<http://www.ato.gov.au/corporate/content.aspx?doc=/content/25833.htm&pc=001/001/002/017&mnu=0&mfp=&st=&cy=>> at 11 April 2011; Australian Taxation Office, Taxpayers' Charter: Helping You Get Things Right, NAT 15026 (2011)

<<http://www.ato.gov.au/corporate/content.aspx?doc=/content/68494.htm&pc=001/001/002/017&mnu=0&mfp=&st=&cy=>> at 11 April 2011; Australian Taxation Office, Taxpayers' Charter: Respecting Your Privacy and the Confidentiality, (2007) <

<http://www.ato.gov.au/corporate/content.aspx?doc=/content/25915.htm&pc=001/001/002/017&mnu=0&mfp=&st=&cy=>> at 11 April 2011; Australian Taxation Office, Taxpayers' Charter: Accessing Information Under the Freedom of Information Act, (2011)

<<http://www.ato.gov.au/corporate/content.aspx?doc=/content/25917.htm&pc=001/001/002/017&mnu=0&mfp=&st=&cy=>> at 11 April 2011; Australian Taxation Office, Taxpayers' Charter: Fair Use of Our Access and Information Gathering Powers, NAT 2559 (2011)

<[http://www.ato.gov.au/content/downloads/cor63142\\_n2559.pdf](http://www.ato.gov.au/content/downloads/cor63142_n2559.pdf)> at 11 April 2011; and Australian Taxation Office, Taxpayers' Charter: If You're Subject to Review or Audit, NAT 2558 (2011)

<[http://www.ato.gov.au/content/downloads/cor63140\\_n2558.pdf](http://www.ato.gov.au/content/downloads/cor63140_n2558.pdf)> at 11 April 2011.

<sup>42</sup>Contrary to the recommendations of the Australian Joint Committee of Parliamentary Accounts, *Report 326 - An Assessment of Tax* (1993); and OECD, Committee of Fiscal Affairs Working Party, 'Taxpayers Rights and Obligations - A Survey of the Legal Situation in OECD Countries' (Paper Number 8, OECD, 1990).

<sup>43</sup>Numerous authors have been critical of this fact. See, for instance, Karen Wheelright, 'Taxpayers' Rights in Australia' In Duncan Bentley (ed), *Taxpayers' Rights: An International Perspective* (1998). The criticism by Wheelright (at 60) is typical: 'The new Charter does not have legislative force and therefore does not create any new legal rights for Australian taxpayers. This compares unfavourably to countries like the USA and represents, on one view, a missed opportunity for Australia.' See also Adrian 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, and Duncan Bentley, 'A Taxpayers Charter: Opportunity or Token Gesture' (1995) 12 *Australian Tax Forum* 1.

publications envisage the possibility of awards of compensation for breaches of some Charter commitments. For example, the Commissioner in his publication *Taxpayers' Charter – What You Need to Know* states that '[i]n some circumstances you may be entitled to be paid compensation.'<sup>44</sup> However the entitlement to compensation for a breach of any of the commitments set out in the Charter is always at the discretion of the Commissioner. There is no right to compensation.<sup>45</sup>

It is also apparent from Commonwealth Ombudsman annual reports that in many cases the aggrieved taxpayer does not receive the desired remedy – including, in some cases, monetary compensation.<sup>46</sup> At best, the aggrieved taxpayer may obtain a concession from the Commissioner that the taxpayer has been treated unjustly or unfairly and that a taxation liability that has been assessed against the taxpayer (or the denial of a deduction or other concession) should be reversed.

Such remedies disregard the economic losses that might have been suffered by the taxpayer. This is particularly pertinent for business taxpayers where economic losses such as lost business opportunities or loss of profit might be significant heads of damage resulting from tax official wrongs. In such cases, the potential utility of this otherwise broad avenue for compensatory relief is significantly reduced.

### 3.2 Recovering Compensation through Complaint to the Commonwealth Ombudsman

Under s 5(1) of the Ombudsman Act 1976 (Cth) the jurisdiction of the Commonwealth Ombudsman extends to investigation of any 'action, being action that relates to a matter of administration' of a 'department'<sup>47</sup> or a 'prescribed authority'.<sup>48</sup> The Commissioner of Taxation is a 'prescribed authority'.<sup>48</sup> The Commonwealth Ombudsman has powers to make a broad range of recommendations in any investigation report.<sup>49</sup> These extend to a possible recommendation that the Commissioner pay monetary compensation to a taxpayer.

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<sup>44</sup> Above n 41, 11.

<sup>45</sup> As noted by Wheelright, above n 43, at 69, compensation may be available through the ATO's internal dispute resolution mechanisms in cases of serious maladministration such as extraordinary delay or misleading advice - but this possibility remains purely at the discretion of the ATO. This issue is discussed further in section 5 of this article.

<sup>46</sup> For example, at page 6 of his 2006 report, Office of the Commonwealth Ombudsman, *Activities 2006* (2007), the Commonwealth Ombudsman expressly notes the perceived inadequacy of the existing range of remedies: 'Many of the people who approach the Ombudsman's Office are frustrated that the system is seemingly unable to provide them with the resolution and remedies that they are seeking.'

<sup>47</sup> 'Department' is defined as a Department within the meaning of the *Public Service Act 1999* (Cth). Section 7 of the *Public Service Act* excludes from the meaning of that term any body that is a statutory agency. Section 4A of the *Taxation Administration Act 1953* (Cth) confirms that the Commissioner of Taxation and his employees are a Statutory Agency for the purposes of the *Public Service Act 1999* (Cth).

<sup>48</sup> 'Prescribed authority' is relevantly defined in s 3(1) of the *Ombudsman Act 1976* (Cth) as including a body established for a public purpose by or in accordance with the provisions of an enactment. The Australian Taxation Office constitutes a 'prescribed authority' by virtue of the clearly public role which the office of the Commissioner of Taxation fulfils.

<sup>49</sup> In accordance with s 15 of the *Ombudsman Act 1976* (Cth).

Nevertheless, any finding by the Commonwealth Ombudsman that the Commissioner should pay compensation to an aggrieved business taxpayer is not enforceable.<sup>50</sup> The sanction for ensuring the adoption of Commonwealth Ombudsman recommendations is the threat of adverse publicity. This is usually a sufficient incentive<sup>51</sup>, however Bentley has questioned the perceived effectiveness of this sanction in the taxation context:

There is a perception among taxpayers that bad publicity would seldom in fact prevent any revenue organisation from exercising its powers to the fullest extent possible when it felt it was in the right, whatever the rights of the taxpayers involved.<sup>52</sup>

If this perception accords with reality, the ramifications for business are significant. This is because, while Ombudsman investigation may generate a positive result for a business taxpayer, such a result cannot be predicted or budgeted for – even where the taxpayer is confident that the Ombudsman will recommend the payment of compensation.

### 3.3 Recovering Compensation via ATO Internal Complaints

The ATO makes passing reference to the government policies and ATO administered mechanisms for dealing with monetary compensation claims in the Taxpayers' Charter. The booklet Taxpayers' Charter – What You Need to Know contains the following statement:

In some circumstances, you may be entitled to be paid compensation. If you feel that our actions have directly caused you to suffer a financial loss, contact our toll-free compensation assistance line... For more information about compensation and when it may be available, visit our website at [www.ato.gov.au](http://www.ato.gov.au) and search for 'Compensation'.<sup>53</sup>

The Commissioner has also released a publication, 'Applying for Compensation', which elaborates on the availability of taxpayer compensation through direct approach

<sup>50</sup>There is occasional resistance to the Ombudsman's recommendations, particularly where compensation is recommended. Sir Anthony Mason has observed that: 'Although the Ombudsman appears to have become a permanent feature of the federal landscape, he has stated that there is an unwillingness on the part of some federal agencies to implement his recommendations, notably for the payment of ex gratia compensation.' Sir Anthony Mason, 'Administrative Review: The Experience of the First Twelve Years' (1988-1989) 18 *Federal Law Review* 122, 123.

<sup>51</sup>Section 16 of the *Ombudsman Act 1976* (Cth) entitles the Commonwealth Ombudsman to inform the Prime Minister of the failure of an authority to take action recommended by the Commonwealth Ombudsman within a reasonable time. Further, reports of the Commonwealth Ombudsman are to be tabled before Parliament in accordance with s 19 of the *Ombudsman Act 1976* (Cth).

<sup>52</sup>Duncan Bentley, above n 43, 23.

<sup>53</sup>Australian Taxation Office, *Taxpayers' Charter – What You Need to Know*, above n 41, 11.

to the ATO.<sup>54</sup> This specifies two general circumstances in which a claim for compensation can be made:

- compensation for legal liability (for example, negligence), or
- compensation under the Scheme for Compensation for Detriment caused by Defective Administration (CDDA Scheme).<sup>55</sup>

Where legal liability is alleged, there are a number of circumstances in which compensation might be paid.<sup>56</sup> These include negligence in the provision of tax advice to taxpayers, claims arising out of contracts with service providers, claims for breaches of privacy or for discriminatory actions or employment-related disputes such as industrial actions.

Where payments are sought for defective administration in circumstances other than those which give rise to legal liability to the taxpayer, the Commissioner will provide compensation in accordance with the principles of the Scheme for Compensation for Detriment caused by Defective Administration ('CDDA Scheme').<sup>57</sup>

In the event that cases do not fall under the CDDA Scheme<sup>58</sup> or give rise to relief by virtue of established grounds of legal liability an 'act of grace' payment can be sought. The Commissioner's publication *Claiming Compensation*<sup>59</sup> explains 'act of grace' payments:

The act of grace power is a unique discretion given to the Minister for Finance and Administration to make payments to people who may have been unintentionally disadvantaged by the effects of Australian Government legislation, actions or omissions and who have no other way to make a claim.

<sup>54</sup> *Applying for Compensation*, NAT 11669 (2009)

<<http://www.ato.gov.au/corporate/content.asp?doc=/content/48904.htm>> at 11 April 2011.

<sup>55</sup> *Ibid*, 1.

<sup>56</sup> The ATO define compensation claims for allegations of legal liability consistent with the *Legal Service Directions 2005* issued by the Attorney-General under s 557F of the *Judiciary Act 1903* (Cth). See Attorney-General's Department, Commonwealth of Australia, *Legal Service Directions 2005* (2005).

<sup>57</sup> This scheme is not unique to the ATO - it is an Australian Government scheme administered by the Minister for Revenue. For a detailed discussion of the Scheme, see Department of Finance and Deregulation, Commonwealth of Australia, Department of Finance and Deregulation, Commonwealth of Australia, Finance Circular No 2006/05 (2006) issued to all agencies under the Financial Management and Accountability Act 1997 (Cth) by the Department of Finance and Administration.

<sup>58</sup> Under the CDDA Scheme 'defective administration' is defined as: a specific and unreasonable lapse in complying with existing administrative procedures; an unreasonable failure to institute appropriate administrative procedures; an unreasonable failure to give to (or for) a claimant, the proper advice that was within the official's power and knowledge to give (or reasonably capable of being obtained by the official to give); or giving advice to (or for) a claimant that was, in all the circumstances, incorrect or ambiguous. Finance Circular No 2006/05, *ibid*, 14. This is a direct reproduction of the definition as described in paragraph 23 of the CDDA Scheme itself.

<sup>59</sup> Australian Taxation Office, *Claiming Compensation*, NAT 11668 (2009)

<<http://www.ato.gov.au/corporate/content.asp?doc=/content/48878.htm>> at 6 February 2009. This document is still referred to in the Commissioner's Application for Compensation form, however does not appear to be available via the Commissioner's website or for order. A search for its title and its NAT catalogue number reveals no trace. Consequently, it is unclear whether the document is still current.

The act of grace power should be seen as a remedy that may only be applied in special circumstances to ensure consistency and equity in the impact of Government activities.<sup>60</sup>

All this has a number of implications for business taxpayers with compensation claims. First, to the extent that a claim flows from a formal legal wrong, the same limitations on relief that apply in respect of the relevant formal legal wrong alleged (eg negligence) would equally apply as a constraint on potential recovery of compensation through the ATO's Internal Complaints mechanisms. As discussed in section 2 of this article, these constraints can be significant. Further, assuming the Commissioner is aware of these significant limitations there is little incentive for the Commissioner to be receptive to the taxpayer's claim in any settlement negotiations.<sup>61</sup>

Where recovery does not turn on demonstrating legal liability, the 'defective administration' and 'act of grace' avenues of informal relief hold much better prospects for recovery. However, there is no precedent, guide or assurance which can be relied upon by business to assess the prospect of a successful claim. The Department of Finance describes the CCDA Scheme as based on 'general principles' rather than 'prescriptive rules'.<sup>62</sup> Ex gratia payments, in particular, are acknowledged as not having pre-set criteria in the same way as other discretionary schemes<sup>63</sup> and as being based on 'moral' rather than 'legal' obligation.<sup>64</sup> Accordingly, it is difficult for businesses to plan, budget or predict a likely outcome or quantum utilising these compensatory mechanisms.

The preceding analysis reveals that, despite a number of shortcomings, the non-judicial avenues of relief raise significantly better prospects than judicial avenues of relief for businesses seeking to recover compensation from the Commissioner of Taxation. All of the non-judicial avenues of relief have the scope to apply to a broad range of factual circumstances giving rise to a compensation claim. There are advantages over court action in terms of cost, simplicity and procedural flexibility and informality.<sup>65</sup> These advantages are significant.<sup>66</sup> Further, there is no evidence of any

<sup>60</sup> Ibid, 3. The payments are authorised under s 33 of the *Financial Management and Accountability Act 1997* (Cth). At page 4, *Financial Circular No 2006/05*, above n 57, describes the circumstances in which 'act of grace' payments are payable. Notably, the circumstances under which a payment may be made extend to situations where the claim is a moral claim rather than a legal claim and can extend to cover both economic and non-economic losses sustained.

<sup>61</sup> According to the Commissioner's publication, *Applying for Compensation*, above n 54, the Commissioner will seek independent legal advice whenever a claim is for more than \$10,000. Accordingly the Commissioner will almost certainly be provided with advice which gives a realistic assessment of the prospects of a taxpayer's formal legal claim succeeding (eg a claim alleging negligence) and this will inform the Commissioner's negotiations with the taxpayer.

<sup>62</sup> *Finance Circular 2006/05*, above n 57, 3.

<sup>63</sup> Ibid, 6.

<sup>64</sup> Ibid, 11. It could be argued that allowing recovery of compensation in the absence of demonstrated legal liability breaches the Rule of Law by replacing it with non-legal values. An argument to this effect is advanced by Edwards. See Harry Edwards, 'Alternative Dispute Resolution: Panacea or Anathema' (1985) 99 *Harvard Law Review* 668, 678.

<sup>65</sup> It is conceded that the non-judicial avenues of relief hold a clear advantage over formal private law causes of action in each of these respects. For example, see The Law Commission, United Kingdom, *Administrative Redress: Public Bodies and the Citizen*, Consultation Paper No 187 (2008), in which the

policy of reluctance to recognise any private law duties of the Commissioner which, as revealed in section 2 of this article, fetters application of the judicial alternatives. Recovery is also possible based upon ‘moral’ justification rather than formal legal liability.

However, there are inherent uncertainties that are associated with the informal and discretionary nature of these non-judicial avenues of relief.<sup>67</sup> There are also real doubts that remain about the suitability of these avenues of relief for determining business taxpayer claims. Section 4 of this article explores the reasons for these doubts.

#### 4. THE SPECIAL DISADVANTAGES OF BUSINESS TAXPAYERS IN CLAIMING COMPENSATION FOR TAX OFFICIAL WRONGS

The preceding analysis of the various options available to businesses for pursuing compensatory relief for tax official wrongs reveals that the non-judicial avenues of relief are the only broad-based realistic alternatives. The judicial alternatives have all had their potential utility significantly restricted by judicial interpretation. As illustrated in section 2 of this article, judges typically summarily deny relief on the basis of an assumption that the duties of the Commissioner are owed exclusively to the Crown. This is despite the absence of any express legislative statement to that effect or any real attempt at elaborating an alternative justification for this stance. As a consequence the judicial view is that there is generally no room for imposing on the Commissioner common law or equitable duties to taxpayers.<sup>68</sup>

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UK Law Commission note, at [3.10], that court-based systems are at a disadvantage relative to non-court dispute resolution mechanisms due to the characteristically expensive and time consuming nature of court processes. For similar conclusions see also W P Jeffries, ‘ADR: The Advantages and Disadvantages from a Legal Viewpoint’ (1992) 18 *Commonwealth Law Bulletin* 763. The Australian Law Reform Commission notes the Australian research on the issue in *Adversarial Background Paper 2: Alternative or Assisted Dispute Resolution* (1996). For a challenge to the generally accepted views of speed and time savings associated with informal dispute resolution mechanisms see James Kakalik *et al*, *An Evaluation of Mediation and Early Neutral Evaluation under the Civil Justice Reform Act* (1996).

<sup>66</sup>It is easy, though, to be seduced into viewing ‘efficient and inexpensive dispute resolution as an important societal goal, without regard for the substantive results reached.’ Sir Anthony Mason, ‘From Procedure to Substance and Refinement of Legal Principle’ (1995) 7 *Singapore Academy of Law Journal* 253, 257. As Korteling has observed, the primary goal in resolving tax disputes should be the fostering of ‘good tax administration’ - not simply the efficient and expeditious resolution of disputes. See David Korteling, ‘Let Me Tell You How it Will Be: Here’s One for You and Nineteen for Me: Modifying the Internal Revenue Service’s Approach to Resolving Tax Disputes’ (1993) 7 *Administrative Law Journal of the American University* 659, 684.

<sup>67</sup>Addressing these uncertainties is a key motivation for the call for legislative reform of business taxpayer rights to compensation for tax official wrongs set out in section 5 of this article.

<sup>68</sup>Underlying this judicial approach are concerns that to impose common law duties on the Commissioner would see courts engaged in determining matters which were not intended by the legislature to be justiciable. In effect, there is an underlying policy concern not to offend the separation of powers. For comprehensive discussion see John Bevacqua, ‘The Duties of Tax Commissioners: The Sustainability of the General Judicial Denial of any Tortious or Equitable Duties to Australian and New Zealand Taxpayers’ (2009) 4 *Journal of the Australasian Tax Teachers Association* 95.



At first glance this places business taxpayers in a position no worse than other taxpayers. The Commissioner simply enjoys significant protection from suit in taxpayer damages actions - irrespective of the nature of the taxpayer plaintiff.<sup>69</sup> However, examined more closely, business taxpayers are more likely to be disadvantaged by having to rely on non-judicial avenues for recovery of compensation than other taxpayers. This is because the nature of business compensation claims makes them ill-suited to resolution through non-judicial means.

First, business compensation claims will often raise serious and/or complex legal issues. Such claims are ill-suited for resolution by non-judicial means. It has, in fact, been argued that it is 'necessary' and 'vital' that such claims are resolved through court action.<sup>70</sup> Underpinning the complexity in taxpayer compensation claims are important public law considerations such as weighing up the public duties of the Commissioner of Taxation against any private law duties owed to taxpayers or particular classes of taxpayers. Informal discretionary avenues of relief are especially inappropriate vehicles for resolving this public/private duty trade-off.<sup>71</sup>

It could be argued that the non-judicial avenues of relief will be entirely suitable for addressing business taxpayer claims for compensation from the Commissioner of Taxation once this public/private duty trade-off has been resolved (either judicially or through legislative action).<sup>72</sup> It is clear, however, from the exposition of the current state of the law in the preceding sections of this paper that these issues are presently far from settled in Australia.

Large quantum claims are also better suited to judicial determination. Business taxpayer disputes will more often involve large quantum than individual taxpayer claims. Goldstein has observed that:

An individual with a small amount at stake in a dispute...is likely to seek a more expedient and less-expensive resolution technique. Conversely, a party with a large financial stake in a transaction may be more willing to resort to litigation to protect his investments.<sup>73</sup>

Testament to this reality is the fact that almost all the reported cases of taxpayers suing the Commissioner for compensation have involved business taxpayers.

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<sup>69</sup>This article makes no judgment on whether this is appropriate or desirable. This would undoubtedly be a fertile matter for further and independent investigation. This article clears the way for such further investigation.

<sup>70</sup>The UK Law Commission, for example, has observed that '[f]or making findings of negligence and awarding complex and structured damages, civil courts are normally appropriate. If these are the types of remedies required by claimants, then access to the court is necessary and it is vital from the point of view of both the claimant and the respondent...' Above n 65, [3.93].

<sup>71</sup>Some writers have gone so far as to describe the use of non-judicial avenues for resolving these difficult public/private law conflicts as 'wholly inappropriate'. Harry Edwards, above n 64, 672.

<sup>72</sup>An general argument to this effect outlining the role of non-judicial avenues of relief in these circumstances is posited by Killefer in Campbell Killefer, 'A Hard-Nosed Look at Costs, Benefits of Pursuing ADR' (1993) 3(4) *Experience* 37.

<sup>73</sup>Bernard Goldstein, 'Alternatives for Resolving Business Transaction Disputes' (1984) 58 *St Johns Law Review* 69, 74.

Even if a business taxpayer compensation claim does not raise important or complex legal issues and is not for a large quantum, business taxation arrangements more frequently raise complex factual questions than individual taxpayer claims. Courts are arguably also the most appropriate forum for resolving these questions.<sup>74</sup> The reasons include the fact that evidence is typically recorded in written form enabling close analysis and scrutiny and witnesses can be cross-examined on the factual complexities.<sup>75</sup> Most pertinently, however, courts are well-versed in resolving complex factual questions of causation, fault and assessment of damages.<sup>76</sup>

Such complex factual questions are especially difficult to answer where a taxpayer's claim is for pure economic loss because economic loss claims are 'frequently the result of complex human relationships where the effects of any action can be particularly unpredictable.'<sup>77</sup> Further, economic loss claims raise particularly acute public policy concerns about 'floodgates and the fettering of decision-making and the creation of heavy demands on public funds.'<sup>78</sup> Business taxpayer compensation actions are most likely to include pure economic loss claims – typically centred on losses of profit and/or losses of business opportunities. Again, therefore, the absence of a realistic court-based or other formal legal mechanism for resolving compensation claims particularly disadvantages business taxpayers.

It is difficult to foresee any shift in judicial attitudes which would correct this disadvantage through significantly increasing business taxpayer prospects of recovering compensation from the Commissioner via any of the judicial avenues examined in this paper. The important implication is that any clarification or expansion of taxpayer rights to compensation from the Commissioner will need to be driven by legislative action. Section 5 of this article advances this argument.

## 5. STATUTORY REFORM OF BUSINESS TAXPAYER RIGHTS TO COMPENSATION FOR LOSS CAUSED BY TAX OFFICIAL WRONGS

Business taxpayers should not expect success in every compensation claim for loss caused by tax officials. They are, however, entitled to expect to be able to pursue their claims via avenues which are appropriate for resolving them and which hold some realistic and predictable prospects of recovery. The preceding sections of this paper have demonstrated that, due to the absence of any realistic judicial avenue for

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<sup>74</sup>It is conceded that not everyone agrees with this viewpoint. See, for example, Barry Boyer, 'Alternatives to Administrative Trial-Type Hearings for Resolving Complex Scientific, Economic and Social Issues' (1972) 71 *Michigan Law Review* 111.

<sup>75</sup>Cross-examination is especially seen as a critical safeguard for ensuring complex factual matters are resolved in a fair and just manner. It has been described as 'the greatest legal engine ever invented for the discovery of truth.' Hein Kotz, 'Civil Justice Systems in Europe and the United States' (2003) 13 *Duke Journal of Comparative and International Law* 61, 62.

<sup>76</sup>For detailed discussion of the merits of use of judicial hearings where complex or genuine and substantial issues of fact are raised see J. Skelly Wright, 'The Courts and the Rule-Making Process: The Limits of Judicial Review' (1974) 59 *Cornell Law Review* 375, especially at 384.

<sup>77</sup>The Law Commission, United Kingdom, Above n 65, [4.60].

<sup>78</sup>*Ibid.*, [4.61] citing Cherie Booth and Dan Squires, *The Negligence Liability of Public Authorities* (2006).

recovery and the unsuitability of the non-judicial avenues of relief for resolving business compensation claims, this expectation is not presently being met.

Further, the discretionary and informal nature of the non-judicial avenues of relief does little to provide clarity and certainty as to the entitlements to compensation of business taxpayers for losses caused by tax official wrongs. The absence of any express statutory directive to confirm the correctness of the judicial preclusion of private law compensatory relief in almost every situation on the grounds that the Commissioner's duties are owed exclusively to the Crown also adds to the uncertainty and lack of clarity.

These findings make a strong case for legislative intervention. The goal of this legislative intervention should be to address the current practical disadvantage of business taxpayers in claiming compensation from the Commissioner. To this end, any legislative instrument should encompass two interrelated primary objectives:

- Definition of the proper scope of application of existing judicial avenues of compensatory relief by defining if and when the Commissioner owes private law duties to taxpayers ; and
- The provision of greater general clarity and certainty as to business taxpayer rights to compensation through a formal statement of those rights.

The balance of this section explains how these interrelated objectives will aid in fostering a relationship of business trust and confidence in our system of tax administration and should, therefore, be pursued with or without any accompanying explicit policy determination to dramatically expand business taxpayer rights to compensation.<sup>79</sup>

### 5.1 Legislating to Define the Commissioner's Private Law Duties to Taxpayers

If business taxpayers are to be denied compensatory relief for ATO caused losses – as is presently the case in private law court actions - the reasons for any such denial should be fully explained and understood. This explanation and understanding is lacking in the current unquestioned acceptance by the judiciary that the duties of the

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<sup>79</sup>There are a number of intuitively logical reasons which could be argued both for and against such a move. For example, the Commissioner could oppose the move through arguing that any extension of liability would open the floodgates to litigious taxpayers and see the Commissioner involved in a large and possibly indeterminate number of claims. In particular, this concern is a central consideration in cases involving claims for pure economic loss. The use of this argument to resist extension of taxpayer rights in Australia is comprehensively discussed by the author in John Bevacqua, above n 68. Conversely, taxpayers could argue that the increased efficiencies in ATO functioning which would result from greater exposure to liability to taxpayers would outweigh any possible counter-arguments. For a comprehensive general discussion of such an argument see Lachlan Roots, 'A Tort of Maladministration: Government Stuff-Ups' (1993) 18 *Alternative Law Journal* 67. The resolution of this controversy is beyond the scope of this article and is a challenge most appropriately left to the legislature.

Commissioner are owed exclusively to the Crown. This view may be correct but there is presently no express legislative backing for it.<sup>80</sup>

Further, no judge has explained the reasons for deviation in tax cases from application of the usual private law principles for determining when public authorities owe duties to citizens.<sup>81</sup> At a minimum, therefore, there is also a role for legislative clarification to either confirm or reject this judicial approach.

Any such legislative clarification would serve to confirm the boundaries of acceptable tax administration behaviour toward business taxpayers. Any resultant recognition that the Commissioner owes some private law duties to taxpayers would restore the operation of compensation as a signalling mechanism for those boundaries of acceptable tax administration behaviour. Such a legislative move would consequently serve as a valuable aid in maintaining the legitimacy<sup>82</sup> and acceptability of the tax collection function of the Commissioner in the eyes of the business community.

Further, such legislative action could correct any current ‘feelings of frustration and alienation which breed adversity between individuals and institutions’<sup>83</sup> stemming from the current denial of effective private law avenues of compensatory relief. If this is true, statutory clarification and confirmation of the availability of private law compensatory relief may also help to avoid ‘overtly adversarial relations’<sup>84</sup> between business taxpayers and the Commissioner.

For example, the Commissioner might presently be well-advised to adopt an aggressive and adversarial approach to non-judicial settlements, safe in the knowledge that recourse to the courts for aggrieved business taxpayers presently holds little prospect of success. Statutory clarification and confirmation of the availability of private law compensatory relief for business taxpayers could remove the attraction of such an aggressive and adversarial stance.<sup>85</sup>

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<sup>80</sup>See the discussion in section 2 of this article and above at n 40.

<sup>81</sup>For example, in the case of the tort of negligence, the scope of any duty of care of public bodies in Australia has historically been determined through application of a guiding principle or approach such as the ‘policy/operational dichotomy’ (for example, see the judgment of Mason J in *Sutherland Shire Council v Heyman* (1985) 157 CLR 424), various proximity-based approaches (for example, see the approach of Deane J in *Jaensch v Coffey* (1983) 155 CLR 549) and, more recently, through the consideration of various public policy issues as part of an explicit preference for an ‘incremental approach’ to determining novel or difficult tortious actions (the rationale for which was described by Brennan J in *Sutherland Shire Council v Heyman*). Each of these approaches require consideration and weighing up of a range of issues around the nature of the complained of activity, the relationship between the citizen and the relevant authority and the many public policy ramifications which might be relevant to the determination of the existence or otherwise of a duty of care.

<sup>82</sup>Goodin discusses at length the general role compensation can play in the legitimisation of various government activities. See Robert Goodin, ‘Theories of Compensation’ (1989) 9 *Oxford Journal of Legal Studies* 56.

<sup>83</sup>*Ibid.*

<sup>84</sup>Richard Miller and Austin Sarat, ‘Grievances, Claims, and Disputes: Assessing the Adversary Culture’ (1980-81) 15 *Law Society Review* 525, 565.

<sup>85</sup>It could, of course, be argued that such legislation might simply create incentives for taxpayers to be more aggressive through clarifying or improving their prospects of recovery. However this is a matter that could be addressed through considered drafting of any legislative statement to ensure a reasonable

To the extent that such legislative action might encourage the use of formal reported avenues for business taxpayer recovery of compensation from the Commissioner it would also enhance business trust and confidence in our system of tax administration by making it easier to assess the Commissioner's performance in his interactions with business taxpayers.<sup>86</sup> Given that currently most compensation claims are resolved via confidential settlements or other unreported means, it is presently difficult to independently assess ATO performance by measuring the incidence or severity of loss causing mistakes or wrongs by tax officials.

This lack of transparency does little to foster taxpayer trust. In fact, it may serve to erode trust by raising suspicions that via confidential settlements and other unreported resolutions of claims the Commissioner is presently 'purchasing illegality',<sup>87</sup> or that the Commissioner may be using informal resolutions of claims as a 'tool for diminishing the judicial development of legal rights.'<sup>88</sup>

## 5.2 Legislating for General Clarity and Certainty of Business Taxpayer Rights

Beyond the clarification of business taxpayer private law rights to compensation via court action, there is a role for legislation to play in resolving a number of the general uncertainties stemming from the current heavy dependence on discretionary non-judicial avenues of compensatory relief. This clarification is also likely to bring about worthwhile benefits in terms of engendering greater business taxpayer trust and confidence in our system of tax administration.<sup>89</sup> In turn, this is likely to lead to increased business taxpayer compliance.<sup>90</sup>

For example, any legislative clarification which would more precisely specify the circumstances in which compensation will be available for losses caused by the wrongs of tax officials would enhance business trust and confidence by eliminating

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confinement of any rights to recover compensation from the Commissioner. It is not a sufficient argument for outright opposition to any legislative action.

<sup>86</sup>It might also lead to positive improvements in standards of service delivery of the ATO. For a forceful exposition of this type of argument see Lachlan Roots, above n 79.

<sup>87</sup>Carol Harlow, *State Liability: Tort Law and Beyond* (2004), 105.

<sup>88</sup>Harry Edwards, above n 64, 679.

<sup>89</sup>The Commissioner has been keen to foster taxpayer trust and confidence in recent times. For example, the Commissioner in his foreword to the *Taxpayers' Charter* observes that: 'We want to manage the tax system in a way that builds community confidence. To do this, we need to have a relationship with the community based on mutual trust and respect.' Michael D'Ascenzo, *Commissioners Foreword - Taxpayers' Charter* (2009), Australian Taxation Office, <<http://www.ato.gov.au/corporate/content.asp?doc=/content/25824.htm>> at 5 April 2011.

<sup>90</sup>The link between trust and confidence in tax administration systems and taxpayer voluntary compliance has been investigated in Australia. See Kristina Murphy, 'The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders' (2004) 28 *Law and Human Behaviour* 187; and Kristina Murphy, 'Procedural Justice and Tax Compliance' (2003) 38 *Australian Journal of Social Issues* 379. Murphy's conclusion is that a clear link exists, on the basis that if taxpayers 'perceive an authority to be acting fairly and neutrally, and they feel treated with respect and dignity, they will be more willing to trust that authority and will voluntarily obey and defer to its decision and rules.' See Kristina Murphy, 'The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders' (2004) 28 *Law and Human Behaviour* 187, 190. Similar results have been found in overseas studies. See, for example, John Scholz and Mark Lubell, 'Trust and Taxpaying: Testing the Heuristics Approach to Collective Action' (1998) 42 *American Journal of Political Science* 398.

any possible allegations of bias which could be directed at the present system, with its heavy dependence on discretionary self-enforced mechanisms such as the Taxpayers' Charter and appeal to ATO Internal Complaints.<sup>91</sup> The ATO are keen to dispel such allegations.<sup>92</sup> However, the potential for a perception of impartiality to be associated with any self-administered or government-administered system for monetary compensation clearly remains.<sup>93</sup> This is enough to erode taxpayer trust and confidence.

In general terms the elimination of the uncertainty associated with a system of business taxpayer rights to compensation which turns almost exclusively on uncertain discretionary avenues of relief has much to recommend it. Uncertainty has been linked to taxpayer non-compliance<sup>94</sup> and its elimination features prominently as a core underlying value of any model of a desirable tax system.<sup>95</sup>

The uncertainties inherent in the present system of discretionary self-administered avenues of compensatory relief which could be addressed by a formal legislative statement of business taxpayer rights to compensation are readily apparent. For example, with mechanisms such as the ATO Internal Complaints and the Taxpayers' Charter, the ATO decides on the scope of application of the remedy and the levels of compensation available. They can change the criteria or withdraw the avenue of relief entirely. Interpretation of the eligibility criteria for relief is also at the whim of the Commissioner.<sup>96</sup> These uncertainties erode business trust and confidence in our

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<sup>91</sup>See, for example, the comments of Wheelright in Karen Wheelright, 'Taxpayers Rights in Australia' (1997) 7 *Revenue Law Journal* 226, 240-241.

<sup>92</sup>This is consistent with the intent of the CDDA Scheme as set out in Department of Finance and Deregulation, Commonwealth of Australia, *Finance Circular No 2006/05* (2006), above n 56, which specifies, at 11, that 'decisions should be taken impartially.' The Commissioner does appear to have taken this approach to heart if the data cited by the Commonwealth Ombudsman is credible: 'Tax complainants should be especially encouraged to know that between 50 and 66 per cent of all complaints handled by ATO Complaints are either fully or partially upheld in the complainant's favour.' Office of the Commonwealth Ombudsman, *Activities 2005* (2006), 6.

<sup>93</sup>Bentley, in the context of calling for a binding *Taxpayers' Charter*, has alluded to the cynicism such self-administered mechanisms for taxpayer recovery can generate among taxpayers: 'Taxpayers could be forgiven for taking a cynical attitude towards a charter which purports to uphold their rights against the ATO, where the author and interpreter of the charter, and the primary judge as to when breaches have occurred, is the ATO itself.' Duncan Bentley, above n 43, 21.

<sup>94</sup>For example, Schuck has pointed out, whilst acknowledging the absence of empirical research into the issue, that '[t]axpayers bewildered by tax law's complexity and uncertainty appear more likely to violate it.' Peter Schuck, 'Legal Complexity: Some Causes, Consequences, and Cures' (1992) 42 *Duke Law Journal* 1, 23-24.

<sup>95</sup>For example, Bentley in his survey of the various international attempts to define the basic values underpinning desirable tax systems identifies twelve different such attempts - nine of which include some direct reference to certainty and/or simplicity as desirable traits. See Duncan Bentley, *Taxpayers' Rights: Theory, Origin and Implementation* (2007), 62-64. The Bentley list includes perhaps the most often cited characterisation of principles of a good tax system; the list of Adam Smith. The Smith list consists of certainty, convenience, economy and equity. See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* in Robert Heilbroner (ed), *The Essential Adam Smith* (1986). Bentley confirms, at 67, that 'certainty and simplicity are two of the most favoured, yet most elusive, qualities of any tax system.'

<sup>96</sup>For similar criticisms made in the context of discussion of ex gratia compensation schemes generally see the UK Law Commission, above n 65, [3.49].

system of tax administration. They also leave taxpayers and their advisers with the almost impossible task of predicting the outcome of any claim.<sup>97</sup>

Recent changes to the Taxpayers' Charter illustrate the point. The Commissioner in the current iteration of the Charter has removed a number of express references to rights to compensation which were contained in previous Charter publications. For example, the superseded publication *Taxpayers' Charter – Expanded Version* expressly referred to a right to compensation for financial loss or other damage suffered 'as a result of relying on misleading or incorrect advice or information',<sup>98</sup> from the ATO. There is no equivalent statement in the current suite of Charter publications. It is unclear whether this indicates a change in the Commissioner's attitude to taxpayer rights to compensation.

The CDDA Scheme and the Commonwealth Ombudsman at least take the decision to make such changes out of the hands of the Commissioner. Nevertheless, all aspects of entitlement to compensation remain at the discretion of the administering authority. Hence they also fall far short of providing the certainty and consequent taxpayer confidence that a statutory pronouncement of business taxpayer rights to compensation could provide.

## 6. CONCLUSION

This article has shown that there are no judicial avenues for businesses seeking to recover compensation from the Commissioner of Taxation with any realistic prospects of success. The judicial options for recovery all have very limited scope of application, either by virtue of the elements required to prove them or the general judicial reluctance to impose private law duties on the Commissioner. There is no evidence of any judicial inclination to adopt a less-restrictive approach to the applicability of private law avenues for recovering compensation from the Commissioner of Taxation.

This article has also shown that non-judicial discretionary avenues of relief, while promising reasonable prospects for recovery, are no substitute for the absence of a realistic judicially-enforceable option for business taxpayer claims for compensation.

<sup>97</sup>Some of these arguments have been raised to support the call for a legislatively binding Charter of Taxpayer Rights in Australia. See, for example, the comments of Russell in David Russell, 'Brave New World - Dawn Rises on Tax Rights' (1994) 29 *Taxation in Australia* 176.; McClellan in Margaret McClellan, 'The Principles and Concepts in the Development of the Taxpayers' Charter' (2003) 32 *Australian Tax Review* 22; and the views expressed in Taxation Institute of Australia, 'Taxpayers' Bill of Rights' (1993) 28 *Taxation in Australia* 50. See also the sources cited above at n 43. For general discussion of the need for charters of rights to be endowed with binding legislative force see Simon James, Murphy Kristina and Reinhart Monika, 'The Citizens' Charter: How Might such Initiatives be more Effective?' (Working Paper 65, Australian National University, 2005); Nicholas Deakin, 'Accentuating the Apostrophe: The Citizen's Charter' (1994) 15 *Policy Studies* 48; and Gavin Drewry, 'Whatever Happened to the Citizen's Charter?' [2002] *Public Law* 9.

<sup>98</sup>Australian Taxation Office, *Taxpayers Charter – Expanded Version*, Nat 2547 (2007) at 9 stated: 'If you sustain financial loss or other damage as a result of relying on misleading or incorrect advice or information from us, you may be eligible for compensation or other redress.' This statement is nowhere to be found in the current version of the Charter. The publication *Taxpayers' Charter – What You Need to Know*, above n 41, merely states that if ATO information is incorrect or misleading 'we will take that into account when determining what action, if any, we or you should take.'

Non-judicial discretionary avenues of relief are unsuitable for resolving many business taxpayer claims. In particular, the existing non-judicial options for recovery are inappropriate for resolving business claims which are factually complex, are for large quantum and/or raise serious legal questions. Thus, in such cases, business taxpayers are left with no suitable remedy.

In light of these findings, this article advocates legislative intervention to clarify the legal rights of business taxpayers to compensation for wrongs of tax officers. Two measures are specifically called for – clarification of the Commissioner's private law duties to taxpayers and a legislatively binding general pronouncement of business taxpayer rights to compensation.

It is conceded that this legislative intervention is likely to bring about an incidental extension of business taxpayer rights to compensation for tax official wrongs. However, this paper has not sought to advocate for any per se extension of business taxpayer rights to compensation.<sup>99</sup> Instead, this paper has called for legislation principally aimed at providing a clear backdrop of legal rules for determining business taxpayer compensation claims. This paper has demonstrated that there are likely to be significant benefits in terms of fostering business taxpayer trust and confidence in our system of tax administration which, of themselves, justify this type of legislative clarification.

In short, this article has stressed the importance of business taxpayer compensation claims for loss caused by tax official wrongs being dealt with in a clear and legally certain environment. This is a minimum requirement for fostering an environment of business confidence and trust in our tax administration system. It is also a minimum requirement for the proper administration of justice.

The reform recommendations in this paper undoubtedly burden legislators with the responsibility for dealing with difficult questions of public policy, taxpayer rights and tax administration standards. It is clear, though, that legislators ultimately need to take the lead in dealing with these issues rather than leaving judges, the Commonwealth Ombudsman and the Commissioner himself to operate largely in a legislative vacuum in determining business taxpayer compensation claims.

This legislative vacuum has allowed the inadequacies in the current system for compensating business taxpayers for losses caused by the wrongs of tax officials exposed by this paper to flourish. This article provides a primer for the filling of that vacuum. From this position we are less likely to see any further unconscious 'erosion of civil rights in the name of exaction of taxes'<sup>100</sup> in cases of wrongs of tax officials which cause business taxpayer loss.

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<sup>99</sup>Debate about the extent to which private law compensatory rights of taxpayers should be permitted to impinge upon the important statutory duties and responsibilities of the Commissioner is rightly left to the legislature. As noted above at n 69, this would undoubtedly be a fertile matter for further and independent investigation. This article flags the path for such further investigation without attempting to cover that territory.

<sup>100</sup>D G Hill, 'What do we Expect from Judges in Tax Cases?' (1995) 69 *Australian Law Journal* 992, 1005.



# Findings of tax compliance cost surveys in developing countries

Jacqueline Coolidge\*

## **Abstract**

The World Bank Group (WBG) has carried out a number of tax compliance cost surveys (TCCS) for businesses in developing and transition countries in Africa, Asia, Latin America and the Middle East between 2006 and 2011. While there has long been plenty of evidence of regressivity in tax compliance costs in the developed world, the WBG has documented extremely regressive patterns in the developing world, with small businesses incurring tax compliance costs of up to 15% or more of turnover. Complex tax accounting requirements are associated with high tax compliance costs, while well-designed tax accounting software and e-filing in middle-income countries appear to yield significant reductions in such costs. The WBG surveys have also documented very high rates of tax inspections and audits (including all kinds of visits, official and unofficial, by tax authorities). While both tax evasion and corruption seem to be common issues in the majority of developing countries, some show more evidence of the problem than others, and in some countries, tax officials appear to have a significantly better reputation for competence, helpfulness and integrity than other government officials. Most surveys also include questions about tax morale and evasion, and questionnaires for informal businesses regarding their perceptions about tax compliance and likelihood of future registration.

## **1. INTRODUCTION**

As the “tax and development” agenda has come to the fore as a priority for the G-20, the World Bank, the IMF, OECD and for governments around the world, one of the key issues of concern has been the task of broadening the tax base and ensuring fairness and inclusion especially for small businesses, many of which are currently operating in the informal sector. While the burden of tax payments themselves are obviously a deterrent to formalization, there is strong evidence that the burden of tax compliance – the time and cost associated with preparing tax returns, filing, effecting payment and interacting with the tax authorities – can often be heavier than the tax payments themselves.

The Investment Climate Department of the World Bank Group<sup>1</sup> (WBG) has undertaken about a dozen “tax compliance cost surveys” (TCCS) in developing and

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transition countries over the past several years, and has amassed a wealth of empirical data documenting the severity of the compliance burden for micro, small and medium enterprises, and perceptions about tax compliance from both formal and informal businesses.

The most commonly used definition for tax compliance costs<sup>2</sup> (TCC) appears to be one offered by Sandford (1995):

Costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities ... over and above the actual payment of tax; costs which would disappear if the tax was abolished.

Key questions of interest to revenue authorities (and to donor agencies assisting with reforms) include the following:

- How severe are tax compliance costs as a percent of business turnover?
- To what extent do simplified tax regimes reduce tax compliance costs?
- To what extent do computerized tax accounting systems, e-filing, and e-payment reduce tax compliance costs?
- To what extent can “risk-based audit” reduce the burden of tax inspections for business taxpayers?
- Do high tax compliance costs deter business formalization and/or graduation from simplified to regular tax regimes?
- What are perceptions about tax compliance (and tax morale more generally) among informal businesses? How can they be encouraged to formalize?
- How can all businesses be encouraged to improve compliance in terms of tax filing, reporting more of their income/turnover, and making tax payments?

While definitive answers to such questions are not yet in hand (and will probably never be answered conclusively or comprehensively for all settings), the WBG TCCS database sheds new light on each of these topics, and more.

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Gonzales, Raul Junquera-Varela and participants in a World Bank Group seminar on 1 February, 2012. All remaining errors are the responsibility of the author.

<sup>1</sup> Formerly known at the Foreign Investment Advisory Service of the World Bank Group (FIAS).

<sup>2</sup> There is also a distinction between gross versus net compliance costs. This article focuses on gross compliance costs unless otherwise noted.

The WBG TCCS database, as of end 2011, includes South Africa, Vietnam, Ukraine, Yemen, Peru, Uzbekistan, Armenia, Georgia, Laos, Kenya, Burundi, Bihar and Rajasthan (India), with Uganda and Bangladesh scheduled for early 2012 and several others in the pipeline. A repeat survey (after some reforms have been enacted) has recently been undertaken for South Africa and one will be carried out in Ukraine in 2012. (See Table below).

Topics covered by the surveys include:

- core time/cost questions for basic tax compliance tasks, usually broken down by:
  - type of tax (usually income tax, VAT and payroll taxes), and
  - by type of task (e.g., keeping up to date on changes in relevant laws and regulations, collecting financial information, making tax calculations, filling in tax forms, filing tax returns, making tax payments, responding to queries, being inspected/audited, etc.),
- bookkeeping practices (e.g., keeping receipts, simplified bookkeeping, full financial accounting, reliance on outsourcing),
- computer/internet access;
- experience with inspections/audits;
- tax morale;
- tax evasion;
- perceptions about tax authorities (e.g., competence, fairness, consistency, integrity).

Although the various TCCS are difficult to compare, due to the fact that each was tailored to the particular conditions and priorities in each country, they allow at least for direct comparison of the time required for specific tax compliance tasks in terms of person-hours per year. (For more details about survey methodology, please refer to Appendix A).

Section 2 presents illustrative findings regarding the basic time and cost associated with tax compliance. Section 3 discusses findings regarding tax inspections and audits. Section 4 focuses on findings on tax morale and perceptions of tax compliance. Section 5 discusses a possible future research agenda for deeper analysis of the TCCS data.

**List of WBG TCCS and key characteristics**

Country	Year of survey <sup>3</sup>	Type of Respondents <sup>4</sup>	Number of respondents <sup>5</sup>	WBG Reports/Publications based on survey results <sup>6</sup>
South Africa	2006	Tax Practitioners (re SMME)	2,530	FIAS (2007); Coolidge, et. al. (2008)
	2007	SMMEs	1,000	USAID (2008a), Coolidge, et. al, (2009)
	2007	Inf. businesses	1,000	USAID (2008b), Coolidge and Ilic (2009)
Vietnam	2007	Businesses	874	WB (inputs to country report)
Ukraine	2008	Companies	2,082	IFC (2009)
	2008	Sole Proprietors	1,000	IFC (2009) draft
Yemen	2008	Businesses	950	FIAS (2008) unpublished
	2008	Inf. businesses	860	(included in above)
Peru	2009	Tax Practitioners	1,949	WB (2008) inputs to country report
Uzbekistan	2009	Businesses	1,280	IFC (2010)
India (Bihar)	2009	Businesses	1003	IFC 2009
Kenya (module)	2010	Businesses	900	IFC (2011) unpublished
	2010	Inf. Businesses	600	(included in above)
Armenia	2010	Businesses	750	IFC (2011)
	2010	Sole Proprietors	250	(included in above)
Georgia	2010	SMMEs	820	(no report – findings incorporated in project)
Lao PDR	2011	Businesses	800	(no report – findings incorporated in project)
Burundi	2011	Businesses	250	(forthcoming)
	2011	Inf. Businesses	700	(forthcoming)
Nepal	2011	Businesses	990	(forthcoming)
India (Rajasthan)	2011	Businesses	929	(forthcoming)

<sup>3</sup> In most cases, the surveys asked respondents about the most recently completed tax year.

<sup>4</sup> “Tax Practitioners” are external bookkeepers or accountants hired by taxpayers to help with tax compliance tasks on a fee-for-service basis or retainer; “Businesses” are active business taxpayers and may sometimes be distinguished between “companies” (legal entities) and sole proprietors (physical persons); SMMEs are small, medium and micro-businesses; “inf. Businesses” are informal businesses defined as those not registered for tax (but usually with a fixed location).

<sup>5</sup> Number of valid responses for the survey (for tax practitioners, total number of clients about which they reported). For businesses, most survey samples were stratified random samples drawn from the database of active business taxpayers, and designed to be representative.

<sup>6</sup> Also includes USAID reports in cases where WBG had substantive involvement.

## 2. COMMON FINDINGS REGARDING BASIC TAX COMPLIANCE COSTS (TIME/COSTS)

The findings of the surveys can not necessarily be taken as typical for developing countries, as the majority of client governments only requested a tax compliance cost survey if there was a reason to believe that it was a problem for small business taxpayers (with the exception of South Africa, where we piloted the first such survey, and where tax compliance costs appear to be manageable for the majority of small businesses).

The core questions of interest are about the time and cost of basic tax compliance tasks, including primarily in-house staff time (in person-hours per year X gross wage rates) plus (when relevant) costs for hiring external tax preparers or advisors, tax forms, or other out-of-pocket expenses. We took care to separate the costs of tax compliance from those of general bookkeeping, asking specifically about both.

For example, in Armenia, the average business spent a total of about 400 person-hours per year on tax compliance, which was valued at just over \$1000. In other countries, the range has extended from less than 100 hours (or even 50 hours for sole proprietors using simplified tax regimes) to well over 1000 hours (e.g., in Ukraine before recent reforms). The table below illustrates the range for “medium” sized businesses, focusing on time required for income tax, VAT and payroll taxes in several of the countries in the database.

### Time required for Tax Compliance Tasks (Medium sized businesses)<sup>7</sup>

	Total Hours of staff time per year
Armenia	699
Nepal	508
Peru	632
S. Africa	105
Ukraine	1870
Vietnam	1030
Yemen	649

Sources: WBG Tax Compliance Cost Surveys

Complexity of tax regimes (e.g., multiple taxes, several different bases, requirements for multiple filings per year, etc.) appear to drive up tax compliance costs, as do requirements to submit detailed accounting records along with tax returns (as in Peru and Armenia), especially if tax accounting differs significantly from financial accounting. Substantial changes to tax legislation and regulations, even if they are

<sup>7</sup> “Medium” is defined relatively in each country: for South Africa, businesses with turnover between about US\$1 – 2 million; for Peru over \$1 million; for Ukraine between \$0.7 – 5 million; for Vietnam between \$0.5 – 15 million; for Yemen between \$100,000 to \$1 million; for Armenia between \$150,000 - 1.5 million; for Nepal between \$127,000 – 3 million.

designed to simplify the tax regime, require time for taxpayers to learn about them. In the case of Armenia, which enacted several major tax reforms in the year before the survey took place, taxpayers reported spending an average of over 80 hours (above and beyond the amounts reported above) just on learning about the changes.

Of course, there are several caveats and pitfalls regarding the survey data. Many small business taxpayers find it conceptually difficult to separate tax compliance costs from general bookkeeping, as they tend to carry out bookkeeping only to the extent required for tax compliance. Even knowledgeable tax experts may disagree with one another about where to draw the line, known as the “disentanglement problem”.<sup>8</sup> In fact, Sandford and others have pointed out that there are benefits to tax compliance to the extent that small business management is improved by the financial knowledge gained from tax compliance that wouldn’t have happened otherwise. In such an analysis, gross tax compliance costs minus benefits of tax compliance equal net tax compliance costs.<sup>9</sup> This report focuses on gross TCC.

For businesses that outsource some or all of their tax compliance work, the owners are usually unaware of the time spent by their accountant, while the accountant usually doesn’t know how much time the business spent internally on such tasks. In countries where almost all tax compliance work is done in-house, we would interview businesses directly; in countries where most such work is outsourced, we would interview the tax preparers. In countries where there is a broad mix of the two practices (e.g., in South Africa) it was necessary to interview both groups in order to get a comprehensive picture of the issue.

The surveys relied on a respondent’s memory about the “most recent tax-year”, and not on daily journals. Depending on what approach worked best in each country, interviewers would either walk a respondent through the details of each tax task for each type of tax, or started with an overall estimate of total time required for accounting and tax compliance and then broke it down by type of tax and type of task. Of course, in some businesses (especially the smallest ones), the owner or manager might have struggled through the tasks on a part-time basis while in medium and large businesses, it is common to have one or more accountants or bookkeepers on staff full time.

We noticed a pattern that in some regions where tax compliance tends to be relatively complicated and onerous (e.g., in former Soviet countries such as Ukraine) or where there is a legal requirement to do so (e.g., in some Latin American countries such as Peru), businesses either have one or more full time, certified accountants on staff or outsource to professional accountants.

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<sup>8</sup> See Turner, Smith and Gurd (2008).

<sup>9</sup> See Sandford, Godwin and Hardwick (1989), Tran-Nam, Evan, Walpole and Ritchie (2000); and Lignier (2006 and 2009).

In other countries (e.g., Burundi) most small business owners or managers undertake the work themselves. The latter case makes the valuation of time particularly difficult, as they usually do not pay themselves a salary. The opportunity cost of a business-owner's time is problematic to assess: the late evening or weekend hours often devoted to such tasks may not, strictly speaking, take away from time devoted to alternative business activities and might therefore be considered quite low in value (especially for relatively low-profit businesses). On the other hand, time taken by a highly-skilled professional might carry quite a heavy opportunity cost.

For example, the first tax compliance cost survey in South Africa (in 2006-2007) yielded an estimate of about \$1000 per small business per year. A more recent survey undertaken in 2011, which showed slightly higher time requirements but used different sources of time valuation, yielded estimates almost an order of magnitude higher.<sup>10</sup>

Thus, while time estimates appear to be the most solid and easy to compare between years or across countries, cost estimates can be heavily influenced by assumptions about the value of time, especially for business owners/managers who do not pay themselves a regular salary (which is quite common among small businesses in developing countries).

## 2.1 Patterns of regressivity in tax compliance costs across countries

A very common pattern seen across all countries where TCC have been studied is a striking degree of regressivity: they are much heavier, as a percent of turnover, for smaller businesses than for larger ones.<sup>11</sup> While medium and large businesses usually spent less than 1/10th of 1% of their turnover in TCC, small businesses often face TCC of 5% or more of turnover, which can be compared to an extra tax burden.<sup>12</sup>

Studies undertaken on TCC in developed countries before 2000 typically show burdens of one tenth of one percent of turnover or less for businesses over about \$200,000. However, a more detailed study in New Zealand documented TCC of up to 20% for businesses with turnover under \$20,000 (Colmar Brunton, 2005; although most of these businesses may have been start-ups with both low turnover and relatively high costs in "learning the ropes" of business tax compliance). One key question which could be addressed by regression analysis would be the relative importance of the TCC burden of "start-ups" versus "smallness" in this pattern, given that most startups are also small.

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<sup>10</sup> Smulders (2012) forthcoming.

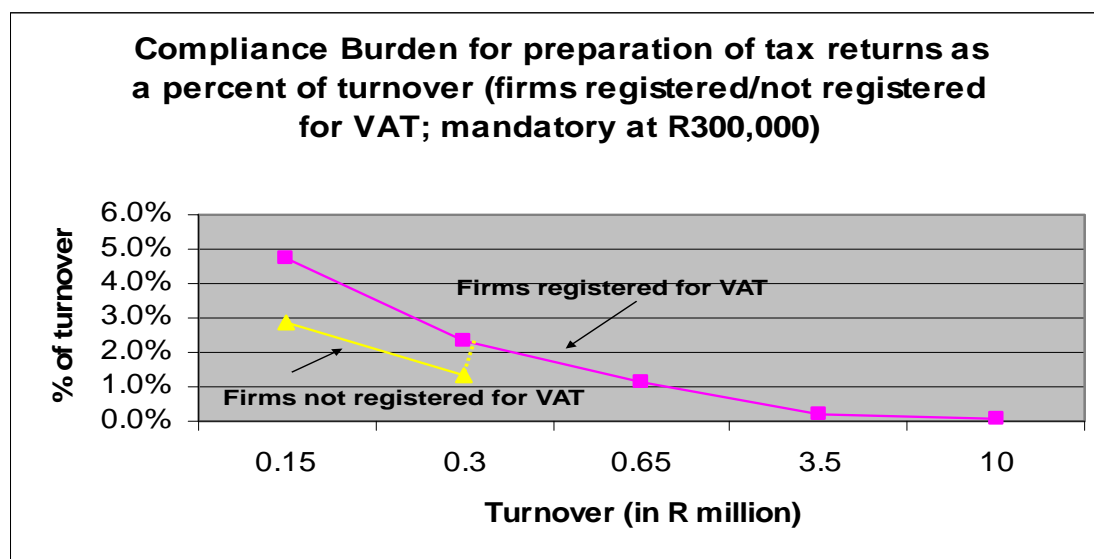
<sup>11</sup> See, for example, OECD (2012).

<sup>12</sup> It should be noted that in addition to the problems of the valuation of the time of small business-owners, such estimates can also be affected by under-reporting of turnover by business respondents.

The WBG's first TCCS was undertaken in 2006 in South Africa, where we estimated TCC of about 5% of turnover for businesses with turnover below \$50,000 and that were registered voluntarily for VAT. Those of similar size not registered for VAT had TCC / turnover of less than 3%.<sup>13</sup> (See Figure 1)

**Figure 1 Regressivity of Tax Compliance Costs in South Africa**

## South Africa Tax Compliance Cost Survey

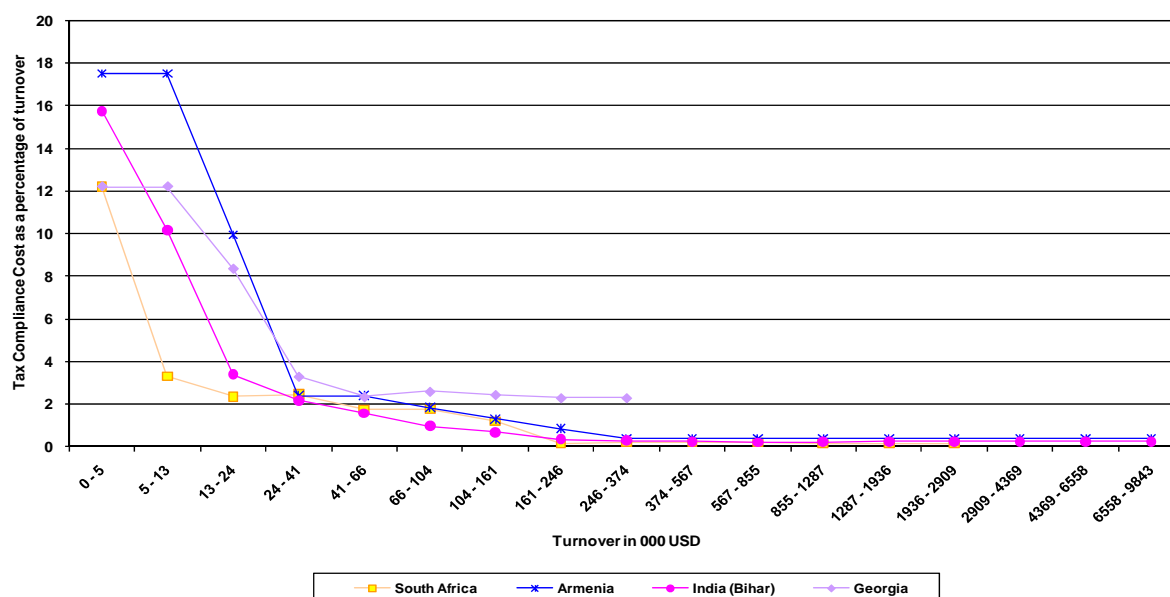


Source: FIAS 2007

Other countries showed even more extreme TCC burdens for small businesses, although some of the differences may be exaggerated due to relatively higher estimates of the imputed wages of owner/managers or possibly due to under-reporting of turnover by survey respondents. (See Figure 2).

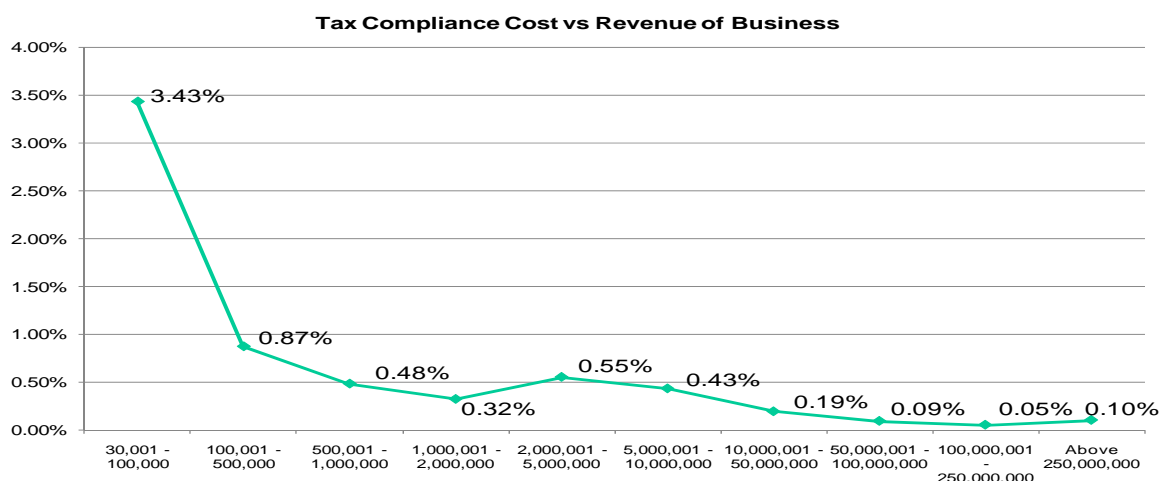
<sup>13</sup> Here it should be noted that businesses voluntarily registered for VAT were probably different from similar-sized businesses in other respects, such as numbers of employees and consequent implications for payroll and other taxes, so the difference can not necessarily be ascribed to VAT alone.



**Figure 2: TCCS / Turnover in Selected Developing/Transition Countries**

Source: Compilation from TCCS for countries cited

In two cases, the TCC Surveys showed a spike in TCC / turnover at the level of the VAT threshold. In the case of Nepal (see Figure 3) the data may suggest that the VAT threshold (about \$24,000) is currently too low, and may present a significant obstacle to growth for businesses below but close to the threshold. In the other case, Lao PDR, the spike might be related to the fact that the VAT had only very recently been introduced, and was still unfamiliar to businesses.

**Figure 3, TCC / Turnover in Nepal**

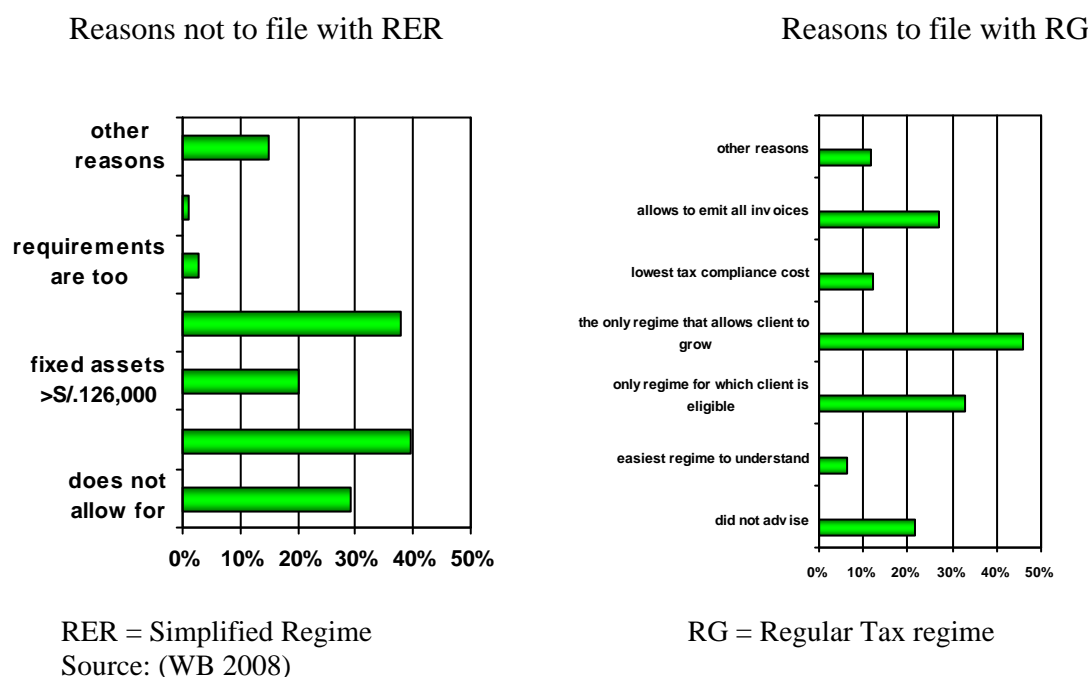
Source: IFC 2012 (forthcoming) [Nepal]

While many developed countries have no special tax regime for small businesses, most small businesses in developing countries face substantial capacity constraints: given the relatively low education levels, they often face problems of literacy and numeracy. They are often not capable of keeping books more detailed than simple journals, and struggle to understand tax forms and requirements for calculation of percentages or tax tables. In Yemen, for example, over 40% of micro-enterprises surveyed did not even keep physical receipts of transactions and only about two-third of them kept any books.

One of the most common forms of simplified (or “presumptive” taxation) for small businesses is a turnover tax in lieu of profit tax (and sometimes other taxes as well). Generally speaking, revenue authorities estimate typical profit margins and then design turnover taxes such that they will be a roughly equivalent tax burden for the majority of small businesses. They are intended to be less of a compliance burden, as businesses are not required to keep track of expenses and usually fill in a very simple form reporting turnover and the associated tax liability.

However, there are often differences between sectors in profit margins on turnover, with retail (usually the most common sector for small businesses in developing countries) facing the strongest competition and tightest profit margins. For such businesses, a turnover tax may be relatively unattractive. On the other hand, most revenue authorities limit eligibility to the presumptive regime not only with a threshold on turnover, but sometimes on the value of fixed assets and/or sector (e.g., excluding professional services on the assumption that professionals are fully capable of complying with the regular tax regime). For example, in Peru, the turnover tax regime was not very popular as it was seen as relatively restrictive (see Figure 4, below).

**Figure 4: Perceived Advantages and Disadvantages of the simplified regime in Peru**

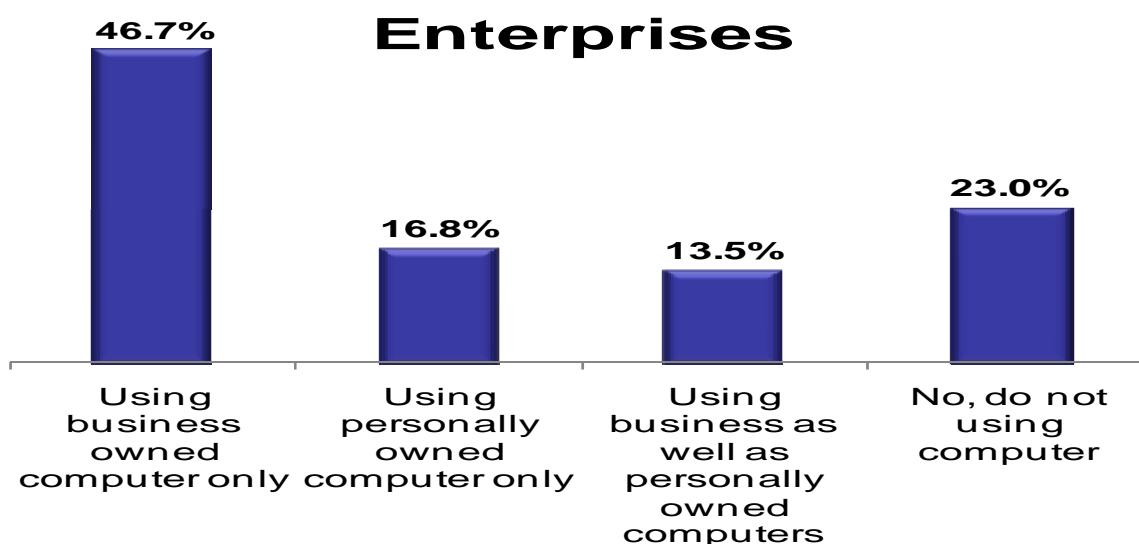


## 2.2 Differences between those using computer software, e-filing and e-payment and those not

Another way to reduce compliance costs is to encourage use of accounting software and e-filing, but of course most small businesses in developing countries have limited ability to make use of such technology.

In Armenia, the majority of micro and small businesses use manual accounts (including over 90% of sole proprietors), which is largely a reflection of those who can afford computers. Almost one quarter of all businesses in Armenia do not have access to a computer, but of those who do, almost three quarters have internet connections (See Figure 5). Among sole proprietors in Armenia, 83% do not have access to a computer, but among those who do, over 70% also have an internet connection.

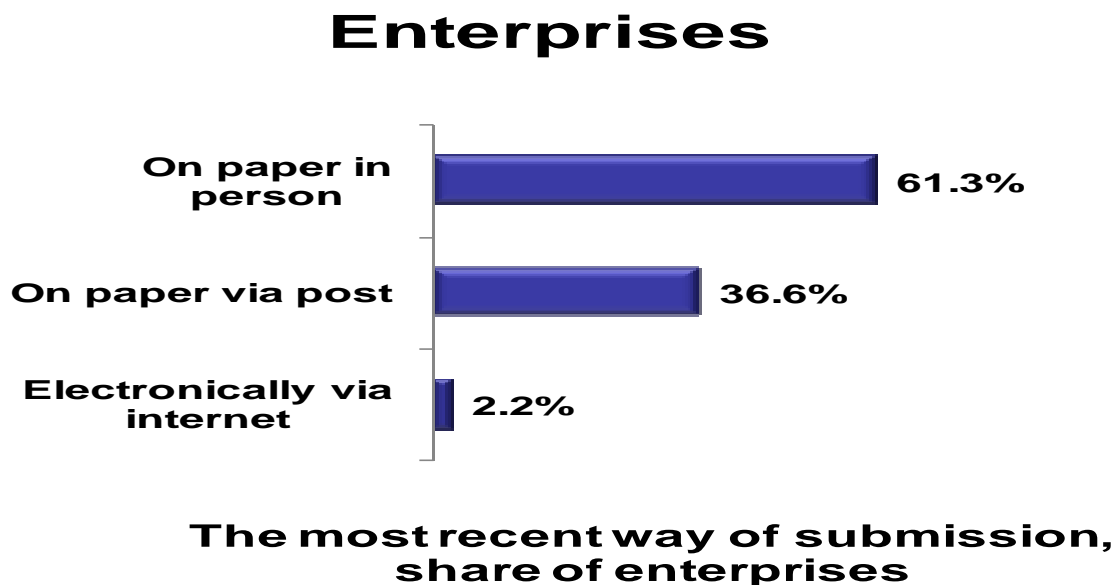
**Figure 5: Use of Computers in Armenia**



**73.2% of enterprises who used  
computers had internet  
connection**

Source: IFC 2011 [Armenia]

But access to internet and the possibility of e-filing still does not mean that businesses that are capable of e-filing will do so. In Armenia, barely 2% of business taxpayers use e-filing (roughly one-eighth of those with an internet connection). Just over one third send tax returns by mail, and almost two-thirds still bring it personally to the tax office (see Figure 6). The most common reason offered for physical filing of tax returns was that “it was the most reliable way,” but anecdotal evidence suggests that face-to-face interaction between taxpayers and tax officials may often be a venue for corruption.

**Figure 6: Ways of submitting tax reports in Armenia**

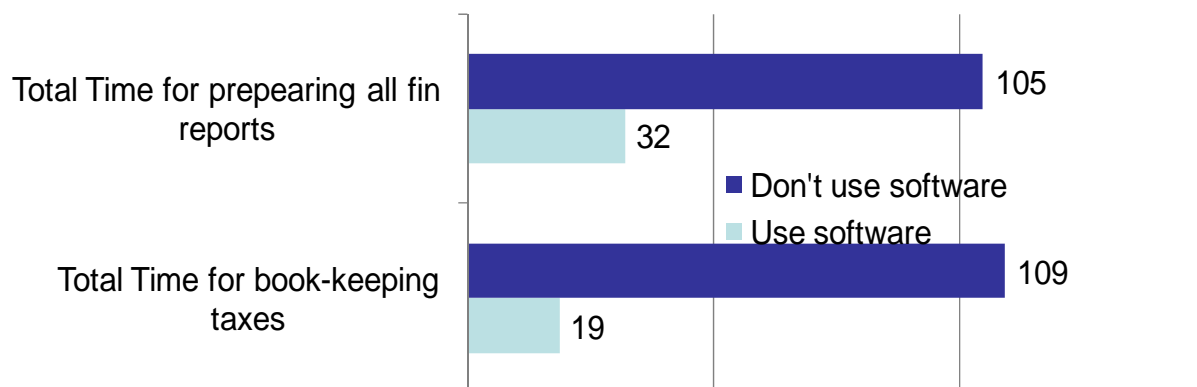
Source: IFC 2011 [Armenia]

Similarly, in Ukraine, even though e-filing is legally possible and many businesses had an internet connection at the time of the TCCS in 2007, relatively few bothered to use it because they were still required to submit hard copies of accompanying documentation, and focus group respondents told us that they were afraid of the possibility that the tax office could lose it. Although the relevant tax legislation protects taxpayers who submit required materials by registered mail, such protection was either not widely known or trusted. Thus in the case of Ukraine, even those who used e-filing did not show a significant reduction in tax compliance time, since they still visited the tax office to submit the required hard-copy documentation. On average, business taxpayers made 47 visits per year to tax offices in Ukraine, which is time-consuming and therefore drives up tax compliance costs.

In Uzbekistan, barely a quarter of businesses used accounting software in 2008. Such software reduced the time required for tax accounting by over 80% (from 109 hours per year to 19; see Figure 7).<sup>14</sup> While e-filing is officially encouraged in Uzbekistan, barely 1% of businesses used it. Asked why not, most said there were “bugs” in the software sanctioned by the tax office, and that local tax inspectors unofficially discouraged it in favor of bringing returns in physically.

<sup>14</sup> In other countries, use of computers and software does not appear to be associated with such a large reduction in time. Some observers have speculated that the availability of tax software facilitates and encourages more “tax planning”.

**Figure 7: Staff time required for financial reporting and tax compliance in Uzbekistan (staff-hours per year).**



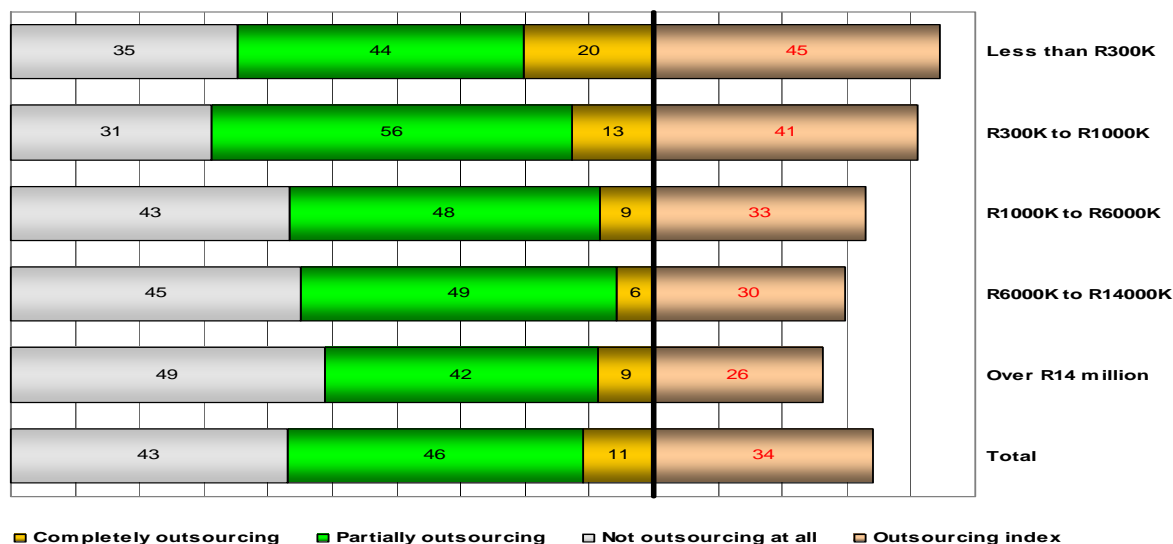
Source: IFC 2009 [Uzbekistan]

In Nepal, only about 16% of businesses are registered for e-filing. Of the remainder, about half said they are “considering it” but the remainder, when asked “why not” said they are “not required by law” or “don’t know the process”.

### 2.3 Difference between those who outsource tax compliance work and those who do it in house

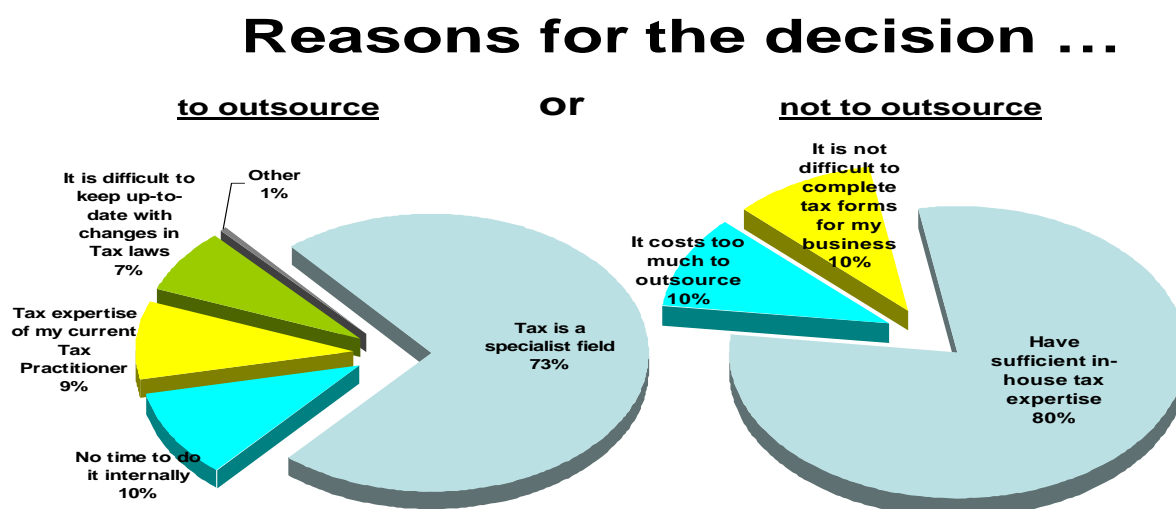
As described above, countries differ substantially in their habits of outsourcing tax compliance. While most of the former Soviet countries involved in TCCS seem to prefer (or need) accountants on staff, those in Latin America are almost opposite: in Peru, for example, tax filings are legally required to be prepared by a certified accountant, most of whom service multiple clients (although large businesses seem to have them on staff).

In South Africa, the pattern is more mixed: some businesses do all their tax compliance work in-house, some outsource it entirely, and some use a mix of in-house work and outsourcing. (See Figure 8).

**Figure 8 Outsourcing practices among small business taxpayers in South Africa**

Source: Coolidge, et. al, 2009

For the most part, small businesses in South Africa base their decisions on the availability of the necessary skills. Among those who do most of their tax compliance work in-house, most say they have sufficient expertise. Among those who outsource, most say they do it because “tax is a specialist field” that they lack. Only about 10% of those who do not outsource say it is because it costs too much, although among the smallest businesses, 25% say that is their reason (see Figure 9).

**Figure 9 Reasons for Decisions to Outsource or Not in South Africa**

Source: Coolidge et. al, 2009

Examining the data in South Africa more deeply, it appeared that the mix of in-house and out-sourced tax compliance was significantly more expensive than either doing all the work in-house or out-sourcing all the work. Apparently, when part of the work is done in-house (e.g., basic bookkeeping, VAT accounting etc) and some tax compliance work is outsourced, the outside tax practitioner needs to review the in-house work before he/she can proceed to the tax compliance work, in order to check for mistakes and correct them if necessary.<sup>15</sup>

### 3. TAX INSPECTIONS AND AUDITS

Tax inspections and audits are usually a much more important concern for businesses in developing and transition countries than they are in developed countries, and add significantly to tax compliance costs. Most revenue authorities in developing and transition countries do not have a well-functioning system of “risk based audit”, nor of reliable “self assessment” on the part of taxpayers that they feel they can trust. Compounding the problem, many individual tax officials in such countries are alleged to unofficially “negotiate” with taxpayers to reduce their tax payments in return for a bribe. The latter practice may reduce overall costs (tax payments plus bribes) to the taxpayer at the expense of the Treasury.<sup>16</sup>

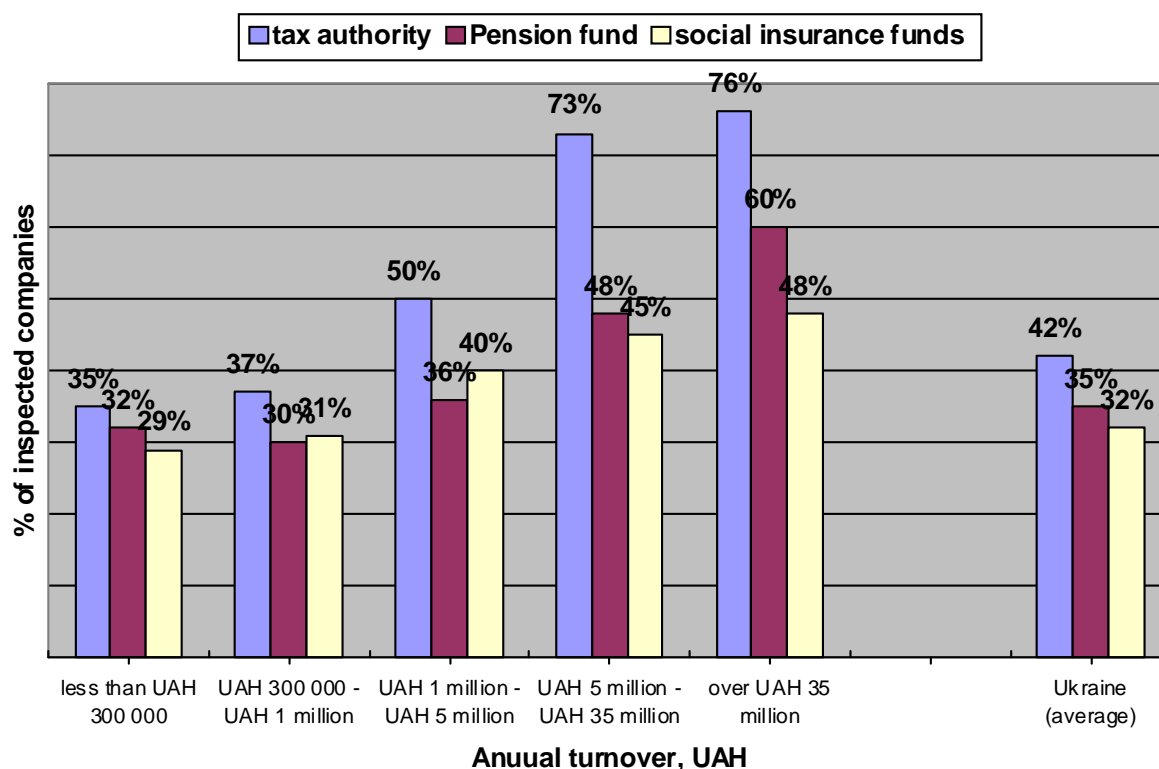
A well-designed and well-implemented system of risk-based audit, alongside self-assessment of tax liabilities by business taxpayers, should both improve the efficiency of the tax regime and reduce opportunities for bribery inherent in face-to-face contacts between tax officials and taxpayers. It also reduces wasted time for taxpayers and thereby reduces tax compliance costs.

In Ukraine in 2007, for example, even small businesses faced about a one-third chance of inspection not only by the tax authority but also by the pension fund and social insurance fund (See Figure 10).

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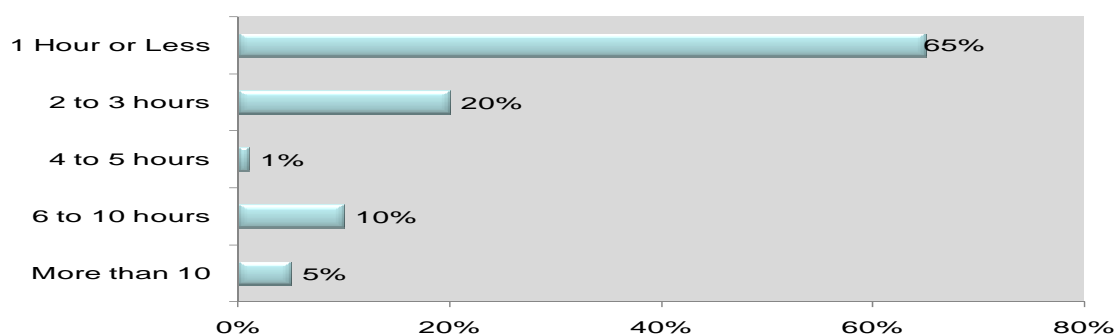
<sup>15</sup> Coolidge, et. al, 2009.

<sup>16</sup> It is also possible that some tax officials threaten taxpayers with a higher tax bill than their legal liability; taxpayers may rather pay a bribe to the tax official to pay the “right” amount of tax than go through the uncertain (and usually lengthy and expensive) process of trying to appeal.

**Figure 10 Incidence of Inspections among business taxpayers in Ukraine**

Source: IFC (2009)

In Kenya, over half of small businesses and three quarters of medium-sized businesses reported an inspection in 2010, although almost two-thirds of such inspections were under one hour in duration and only 15% were over six hours. (See Figure 11).

**Figure 11: Duration of tax inspections in Kenya, Percent of those inspected**

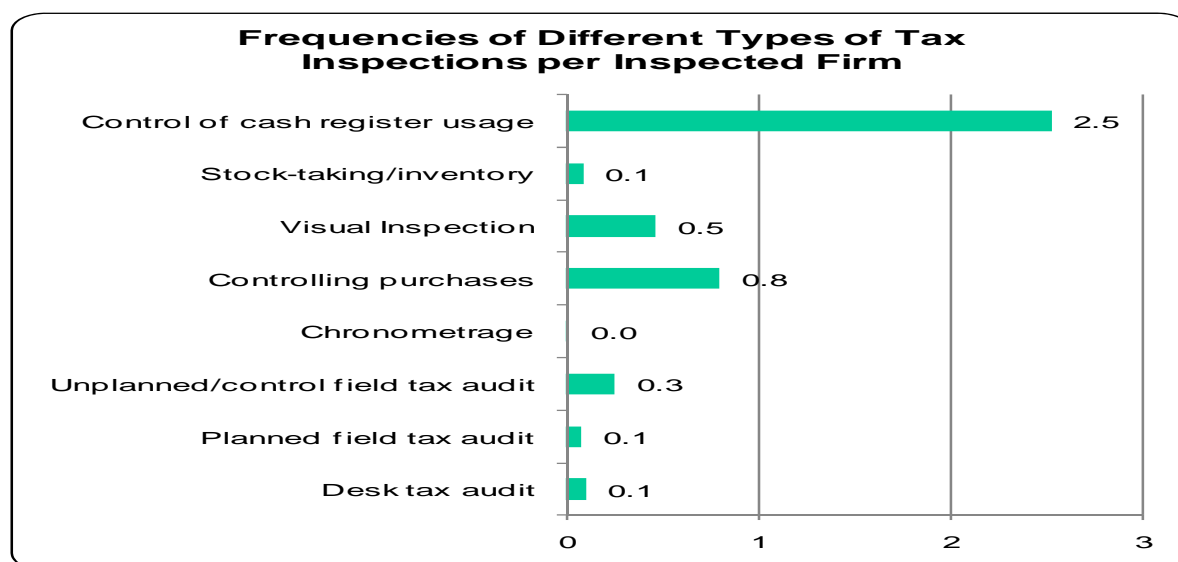
Source: IFC (2011)



In most countries where we have done a TCCS, the revenue authorities state that their official figures show a much lower rate of inspection. In the case of Ukraine, after discussions with the State Tax Committee and focus groups of business accountants, we concluded that the majority of “inspections” were in fact brief checks of cash registers. In the case of Kenya, officials from the Kenya Revenue Authority (KRA) said that many of the short visits were likely “informational visits” by tax officials, which were not inspections at all. However, they also speculated that there may be some “unofficial visits” or even fraud – i.e., people claiming to be tax inspectors who are not.

The TCCS in Georgia included a breakdown of types of inspections (see Figure 12):

**Figure 12 Different types of Tax Inspections in Georgia**



Source: IFC (2011) [Georgia]

Definitions of some of the more technical terms in the chart above are as follows:

*control of cash register*: Check that cash register is in compliance with set standards.

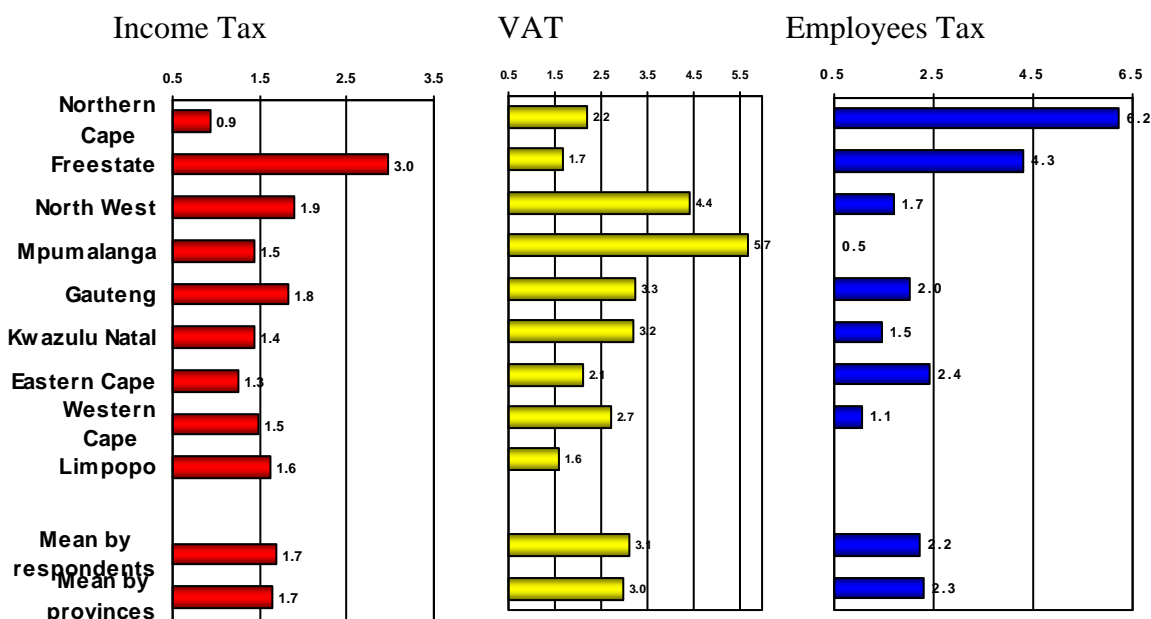
*visual inspection*: A visual inspection of premises without checking accounting documents, stock, etc.

*controlling purchases*: Tax inspectors buy goods from a store and check if salesperson registers the transaction in cash register and gives them receipt. If not, business is penalized. This is the most frequent form of tax inspection (usage of cash registers is a legal requirement).

*chronometrage/invigilation*: Tax inspectors monitor sales (of a restaurant or a hotel) for a certain period of time, usually for at least one week. If sales during this period exceed sales from previous period as reported by business, then the business gets penalized. Such penalties existed during the survey but have since been abolished.

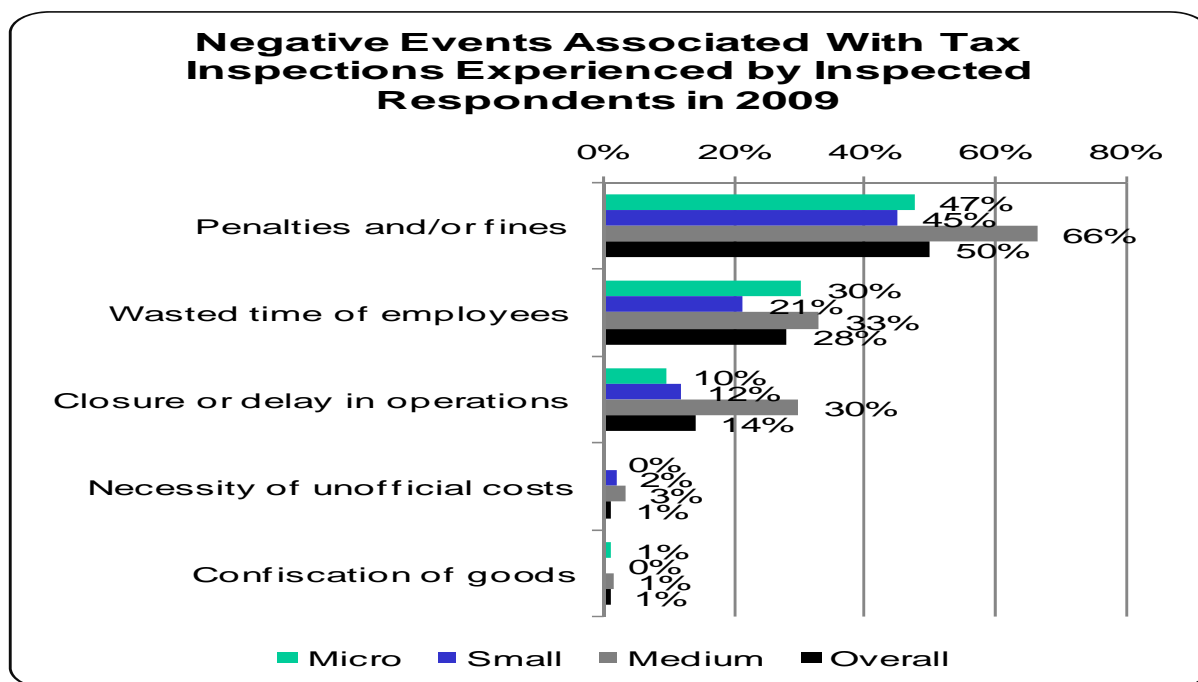
By way of comparison, we have used the case of South Africa as an example of a country with a well-functioning system of Risk Based Audit. Overall, small and medium businesses in South Africa in 2006 (those with turnover under about \$2 million) faced only about a 2% chance of inspection for Income Tax and Employees taxes and about 3% for VAT. Some of the less populous provinces showed a slightly higher likelihood of inspection. (See Figure 13).

**Figure 13 Incidence of Tax Inspections by type of tax and by region – South Africa (2006)**



Source: FIAS, (2008)

From the point of view of business taxpayers, any visit from a tax official, no matter the duration or purpose, is a disruption to their work schedule and a cause for anxiety. From the point of view of those of us interested in improved governance and transparency, such visits are potential opportunities for corruption. The TCCS in Georgia provides some feedback from taxpayers on some of the consequences of inspections (See Figure 14).

**Figure 14 “Negative Consequences” associated with tax inspections\* in Georgia**

\* Among businesses reporting any inspection in 2009; Source: IFC (2011) [Georgia]

On the other hand, businesses also understand the need for at least some inspections to catch and deter evasion. They perceive, however, that many inspections are motivated by a need to achieve revenue targets, to extract bribes, or in some cases to harass “opposition figures” or competitors to “cronies” of politicians.

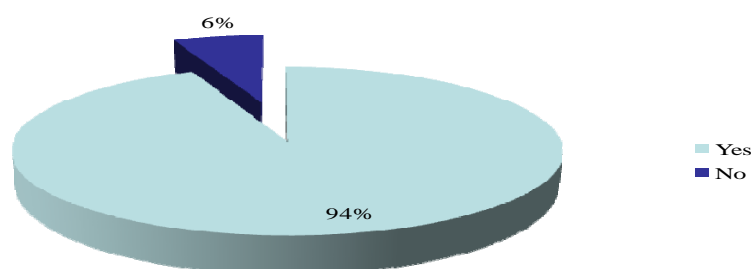
#### 4. TAX MORALE AND PERCEPTIONS ABOUT TAX COMPLIANCE

Some TCCS include a number of questions about subjective perceptions of tax compliance, and some are accompanied by a survey of informal businesses (defined for these purposes as businesses not registered for tax, excluding itinerant hawkers) inquiring about their perceptions of tax compliance.

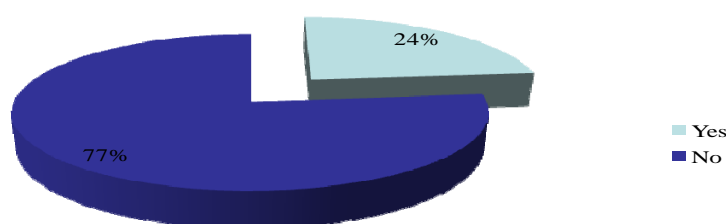
One of the first problems of getting informal businesses to register for tax is that they are often not even aware that they are legally required to do so. For example, in Kenya, 94% of informal businesses reported that they were required to have a business license (although many did not have one), while over three quarters of them, when asked whether they were required to pay taxes, answered “no.” In fact, businesses in Kenya face a legal requirement for both. And although some employees are exempt from taxation if their earnings are below a threshold, self-employed and small

business owners are legally liable for income tax on all their earnings.<sup>17</sup> (See Figures 15 and 16).

**Figure 15** Percent of informal businesses in Kenya reporting that they are required to have a business license



**Figure 16** Percent of informal businesses in Kenya reporting that they are required to pay taxes



Source: IFC 2011 [Kenya]

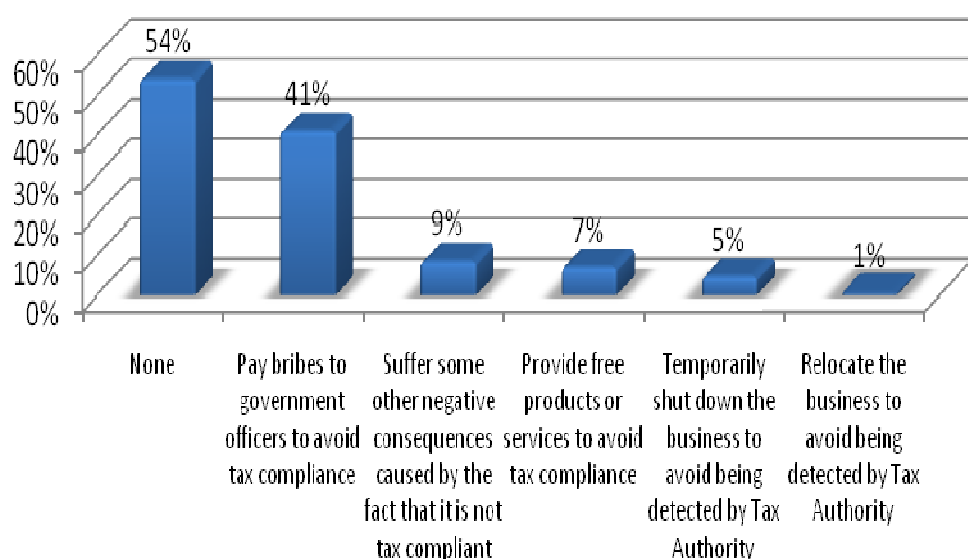
Asked their reasons for not registering for tax, most informal businesses in Kenya (similar to earlier WBG surveys of informal businesses in Liberia, Sierra Leone, Rwanda and Madagascar) said “my business is too small”. This was usually the most common answer, followed by a concern that tax compliance is too difficult, fear of “administrative problems” with inspections, competition from other informal businesses and the fact of weak enforcement.

<sup>17</sup> The World Bank Group sometimes advises client governments to establish a comparable threshold for micro-enterprises, so there is no distortion favoring wage employment over self-employment and to avoid onerous tax burdens on those who are truly too poor to afford them.

However, businesses also were concerned about the disadvantages and costs of staying informal. Many feared government “retribution” or legal sanctions, or the need to pay bribes to stay off the tax register. A certain proportion would also usually note that their lack of registration for tax reduced their business opportunities (e.g., ability to sell to formal enterprises or a wider customer base), their access to finance, or access to other public services.

In the case of Yemen, about half of informal businesses said they did not face any noticeable costs by staying in the informal sector, but over 40% said they had to pay bribes and others cited a range of negative consequences including the need to “temporarily shut down the business” to avoid detection. (See Figure 17).

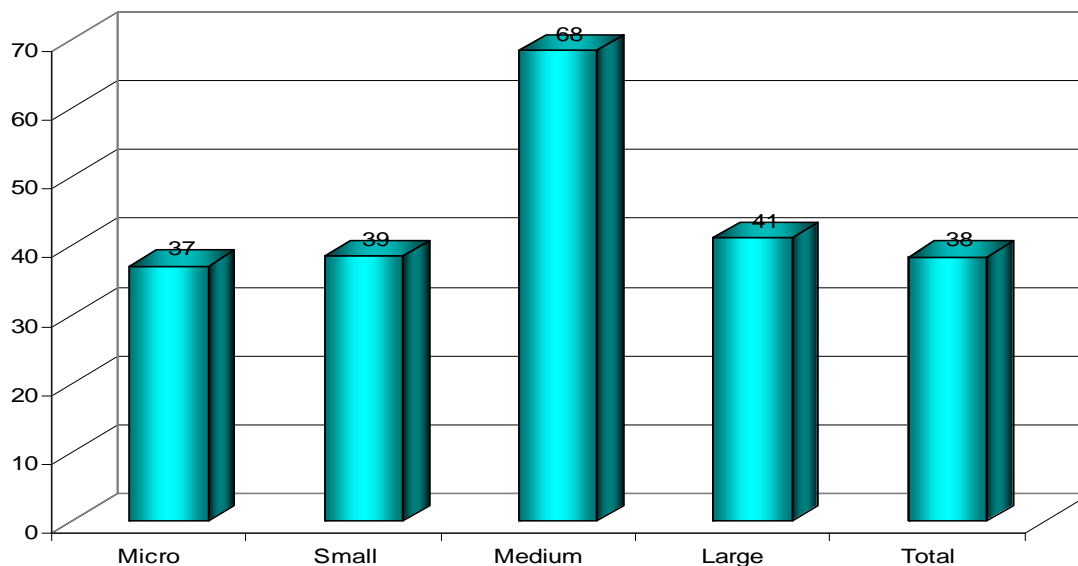
**Figure 17** Percentage of informal Yemeni businesses facing costs to avoid tax payments or remain informal



Source: FIAS 2008 [Yemen]

What is particularly striking is that a similar proportion of formal businesses in Yemen (38%) reported paying bribes to tax officials (see Figure 18, below)

**Figure 18 Reported incidence of bribes to tax officials by formal businesses in Yemen (% of respondents)**



Source: FIAS 2008 [Yemen]

In South Africa in 2007, we carried out an in-depth analysis of the survey data from informal businesses about their key characteristics (size, sector, location, etc.), perceptions about tax compliance, capability for tax compliance (e.g., bookkeeping practices and skills) and their reported likelihood to register for tax in the near future. Overall, two thirds reported a positive likelihood that they would register for tax within the following two years.<sup>18</sup> There were some noteworthy patterns in the answers:

Those in the service sector reported a lower likelihood to register for tax (62% of respondents in the service sector) than those in trade (66%) or agriculture, manufacturing and construction sectors (78%).

As expected, those with relatively more employees were more likely to express a likelihood to register (75% for those with six or more employees) than sole proprietors with no employees (61%). Those who kept complete financial records on paper or computer were more likely to report an intention to register for tax (75%) than those not keeping such records (63%).

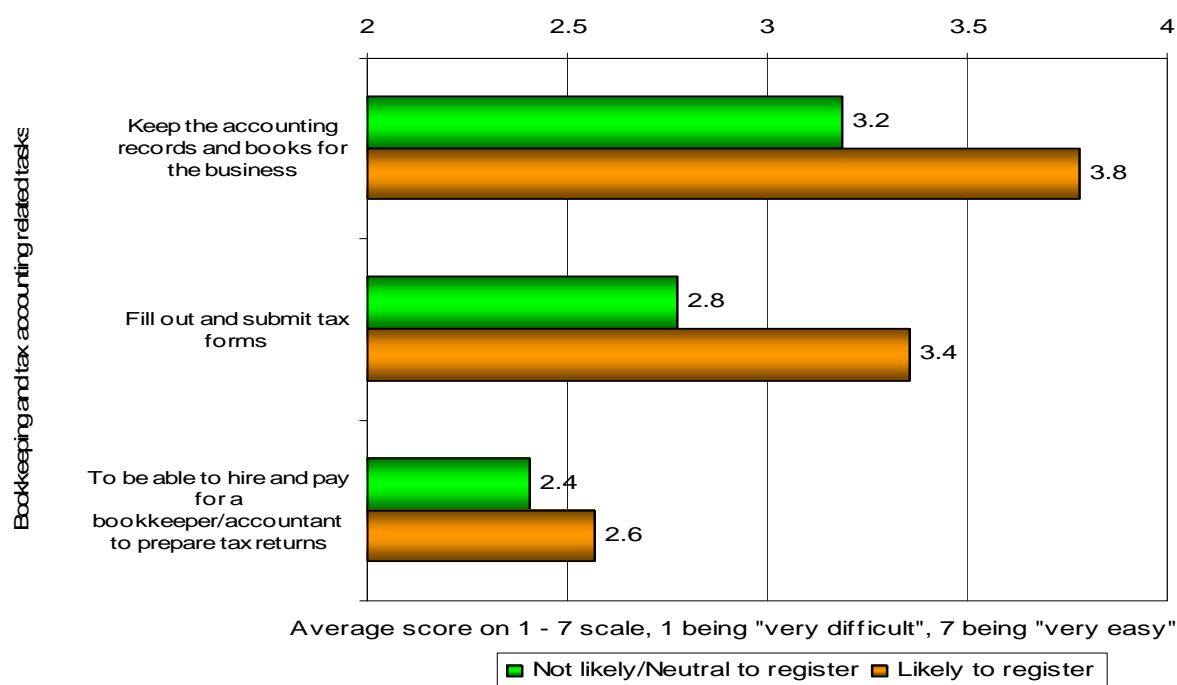
<sup>18</sup> Coolidge and Ilic, 2009 "Tax Compliance Perceptions and formalization of small businesses in South Africa", World Bank Policy Research Working Paper no. 4992.

What was less expected was that those who rented separate premises for their business reported a much higher likelihood of registering for tax (74%) than others, perhaps because they were aware that their tax payments would probably be officially reported by their landlords. Those who were within 30 minutes of a SARS office reported a higher likelihood to register (75%) than those farther away (67%) and much higher than those who said they did not know where the nearest SARS office was located (57%).

Even larger disparities were associated with perceptions of public services. Those who agreed that Government “gives a good return on taxes paid” in the form of government services reported a much higher likelihood of registration (80%) than those who disagreed (57%). Meanwhile, the effect of the fear of “getting caught” was relatively less: among those who believed that more than 10% of non-registered businesses were “caught by SARS last year,” about 74% reported a likelihood of registering for tax.

Perhaps most interesting were the associations between bookkeeping (and perceived competence for tax compliance) and the likelihood to register. Those who believed that keeping books was relatively easy, or that tax compliance was relatively easy reported a higher likelihood of registering, although the question of the cost of hiring an accountant yielded a more muted response. (See Figure 19).

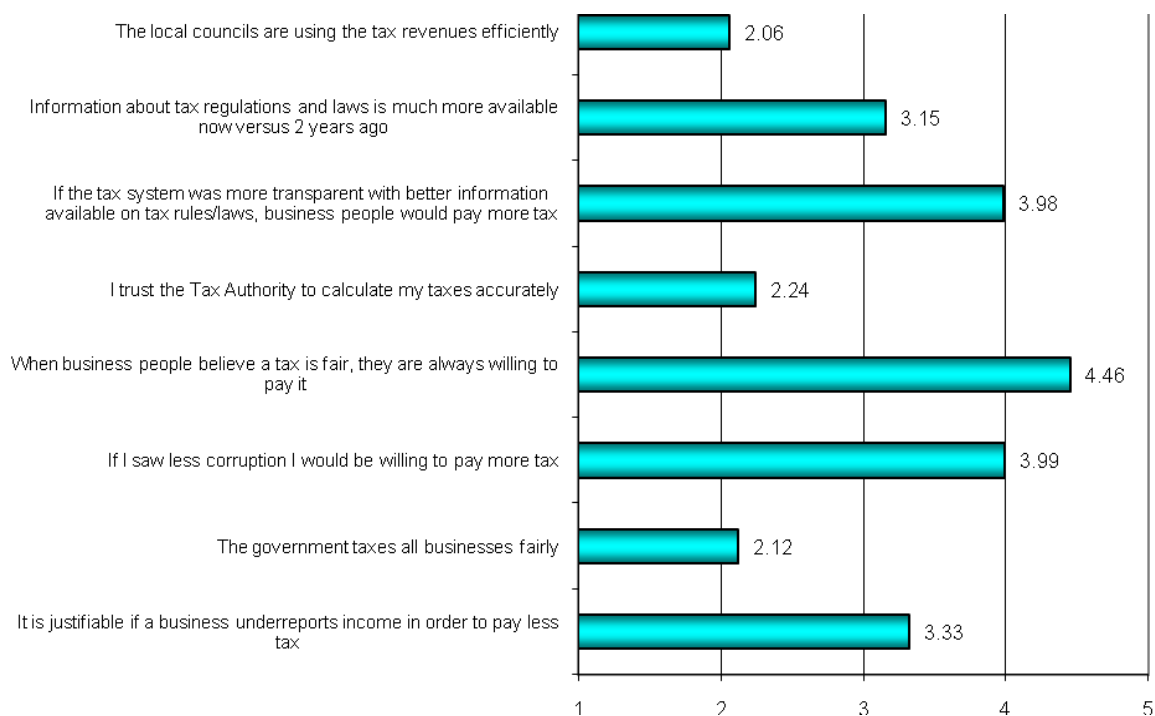
**Figure 19 Perceived ease of bookkeeping and likelihood of registering for tax among informal businesses in South Africa**



Source: Coolidge and Ilic (2009)

The TCCS in Yemen displayed evidence both of low tax morale and high levels of perceived tax evasion. Figure 20 below shows average responses (by turnover band) to standard questions of tax morale. Most respondents were strikingly negative about tax “fairness” and competence, with medium-sized businesses being the most scathing about their trust in the Tax Authority to “calculate my taxes accurately.”

**Figure 20 Tax Morale in Yemen: Agreement with statement, scale 1 – 5**

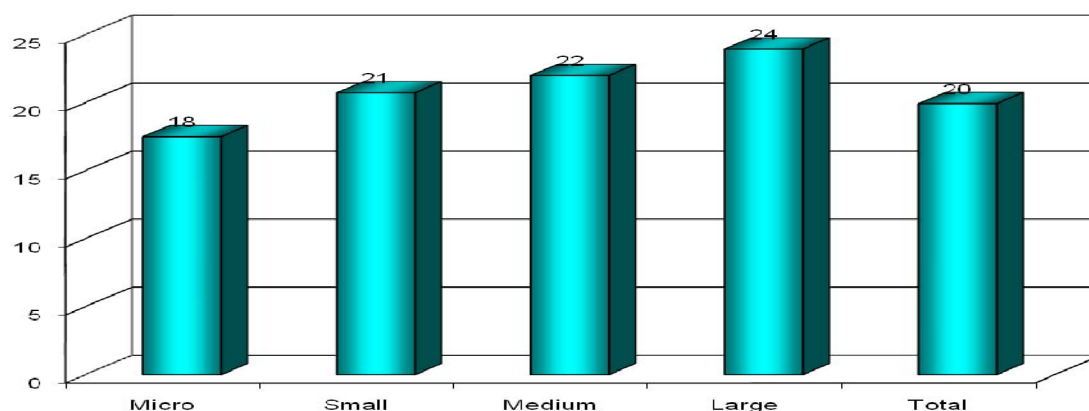


Source: IFC 2008 [Yemen]

Asked to estimate the percent of the taxes businesses pay that they “get back” through government services, the overall average was less than 20%. As one might expect, micro-enterprises saw the lowest “return” (17.5%) and large businesses saw the highest (24%). (See Figure 21).



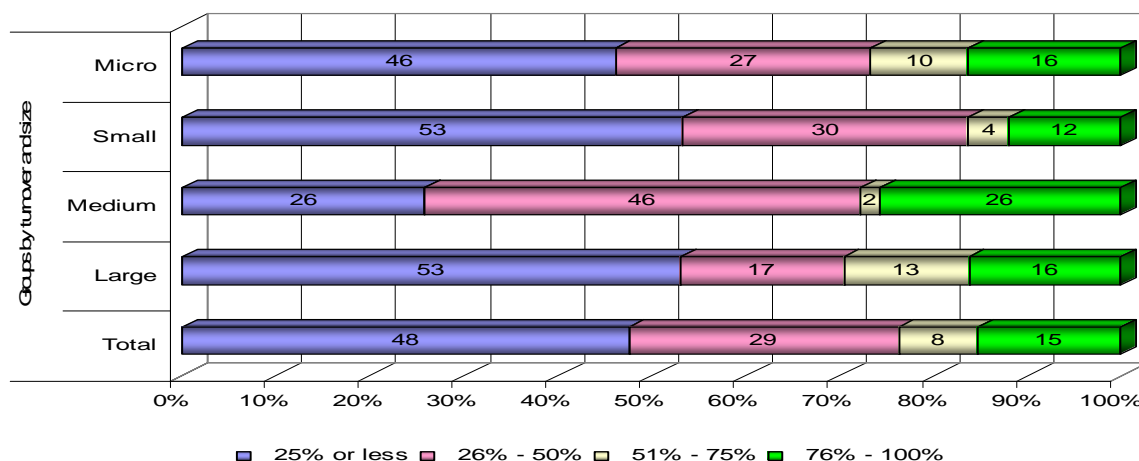
**Figure 21** Percent of taxes businesses say they “get back” through government services in Yemen



Source: IFC 2008 [Yemen]

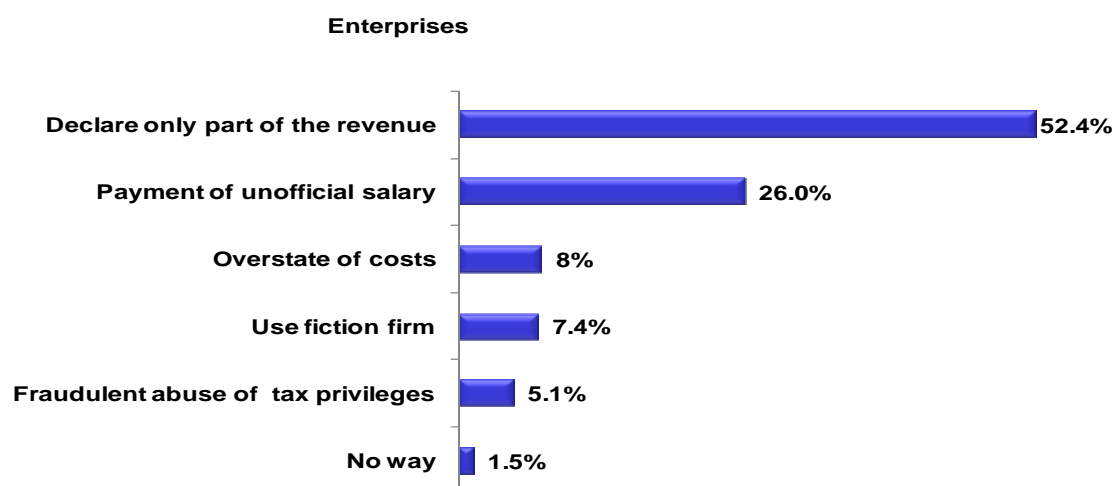
Yemen also provides further evidence of the link between low tax morale and low tax compliance. Survey respondents were asked “Having in mind businesses similar to yours (in the same line of this business, same size, same area), ... what percentage of the taxable profit would you estimate they usually report for tax purposes?” This is less confrontational than asking business owners about their own evasion, but we assume that the response will reflect their own habits. (See Figure 22).

**Figure 22** Estimated proportion of profit reported for tax purposes in Yemen



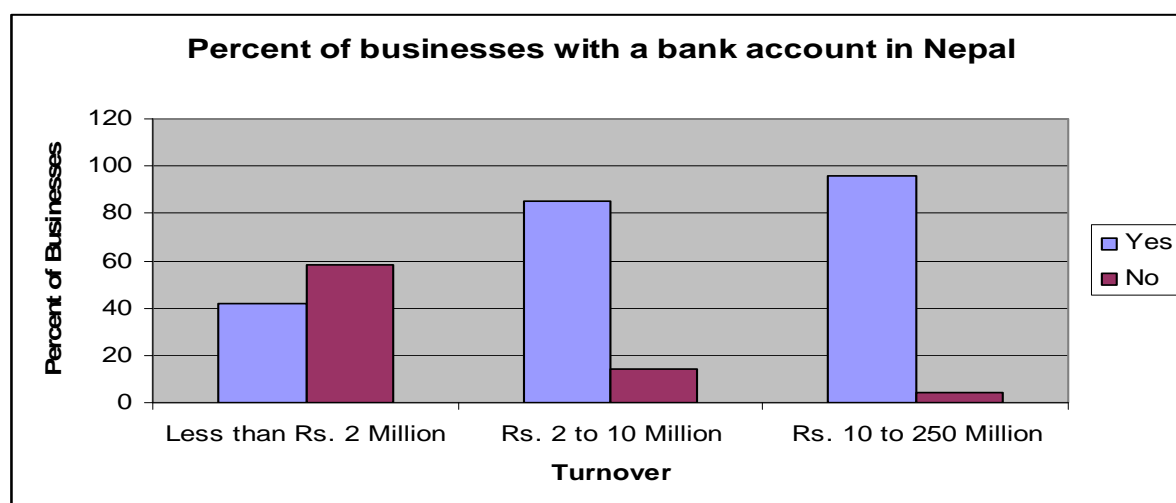
Source: IFC 2008 [Yemen]

In Armenia, we asked respondents about the most common methods of tax evasion. Of course, many did not answer the question, but among those who did, over half mentioned under-declaration of revenue or salaries, while less than 10% mentioned padding of expenses. (See Figure 23)

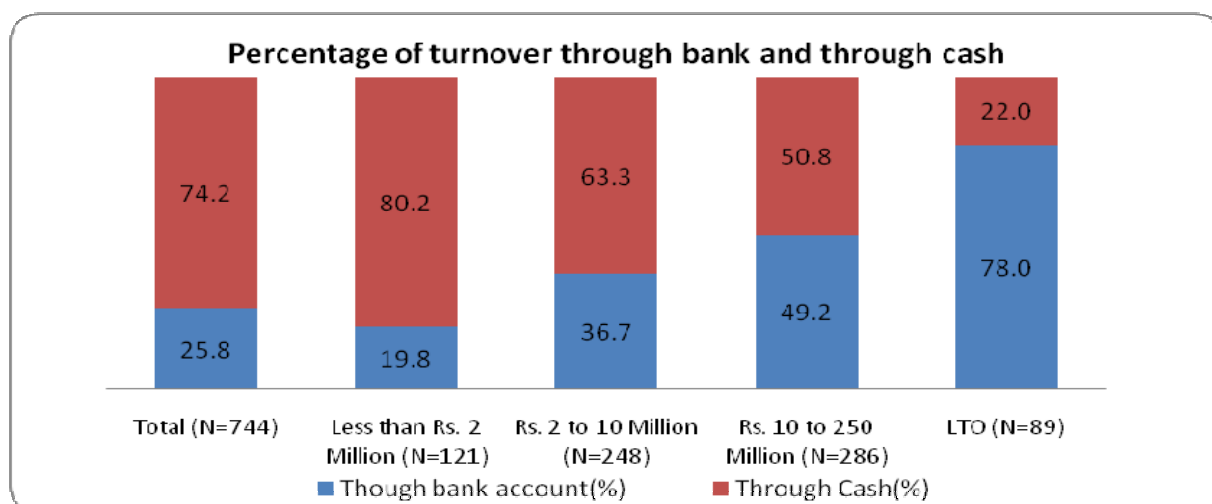
**Figure 23 The most popular methods of tax evasion for enterprises in Armenia**

Source: IFC 2011 [Armenia]

Declaring only part of the revenue is of course easiest when using cash, so increasing reliance on banks may help mitigate evasion. In Nepal, we asked a series of questions about whether a business had a bank account and if so, the degree to which they relied on it for payments. Less than half of the smallest businesses (those under \$25,000 turnover) had a bank account in Nepal, and even 4% of larger businesses lacked a bank account (See Figure 24).

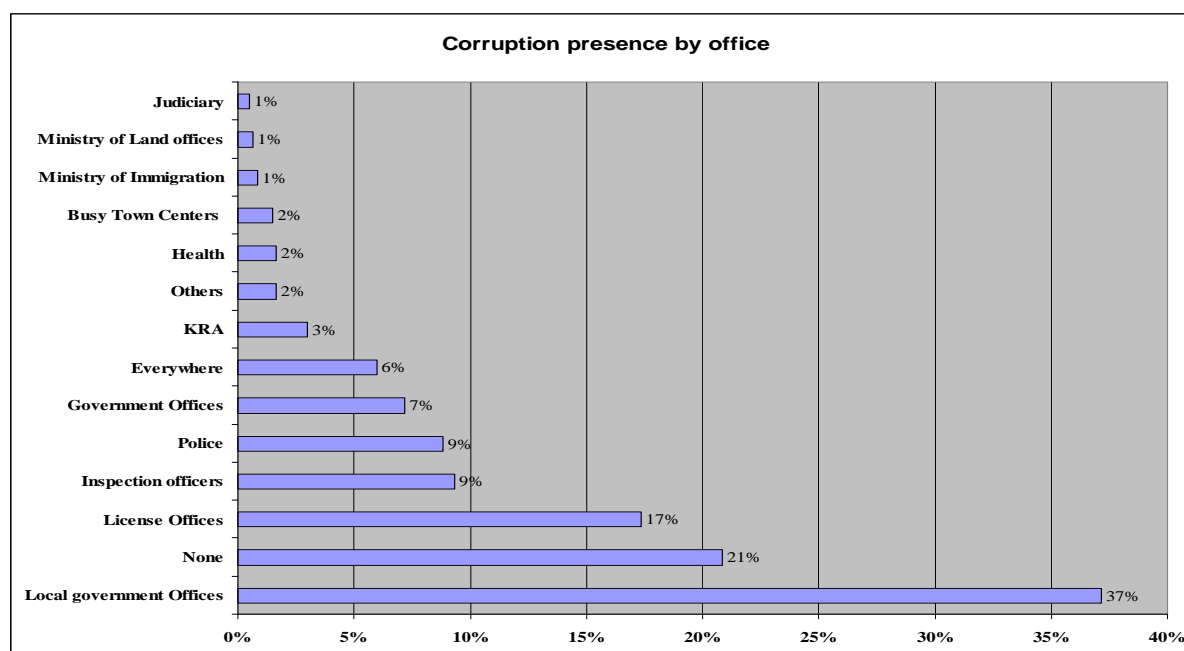
**Figure 24 Prevalence of bank accounts among businesses in Nepal**

Even among those who did have a bank account, respondents reported that about three quarters of their transactions took place in cash. As expected, the reliance on bank transactions increases with size, but even for businesses in the LTO, 22% of transactions took place through cash (see Figure 25).

**Figure 25 Reliance on bank transactions by turnover in Nepal**

Source: IFC (2012) forthcoming

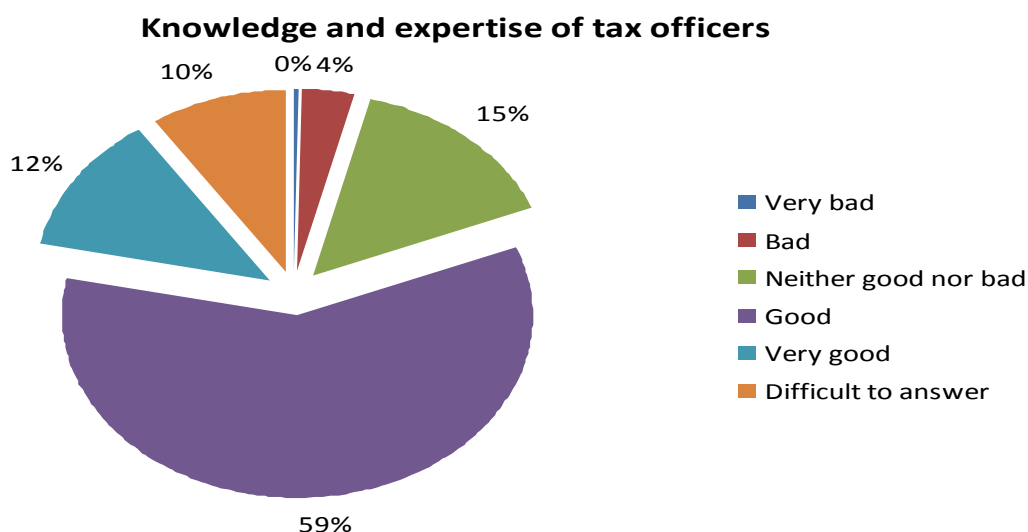
Businesses' perceptions about tax officials can also provide useful information. In Kenya, while most government agencies are considered to be relatively corrupt, the KRA is among the more transparent agencies as reported by the business community (see Ranking in Figure 26).

**Figure 26 Perception of ranking of agencies in Kenya by prevalence of corruption**

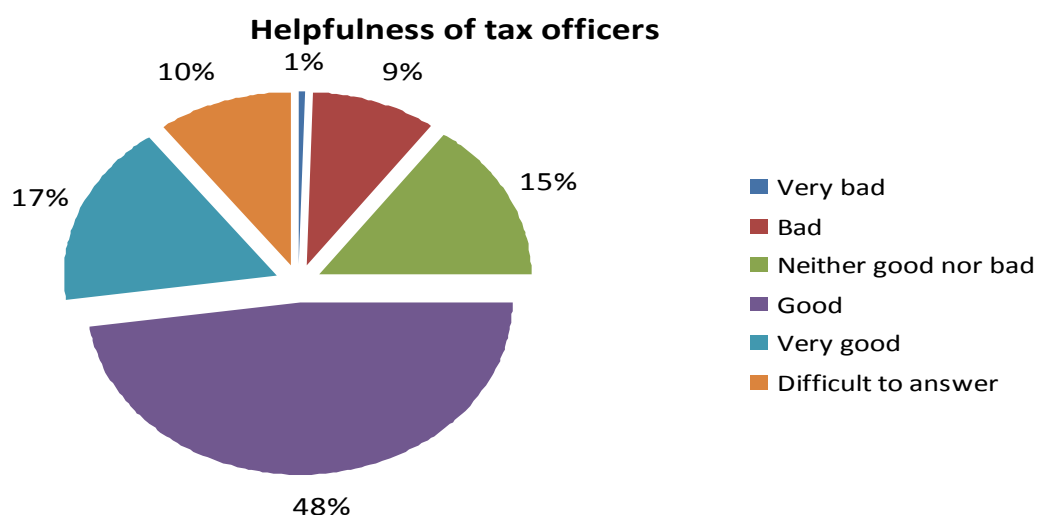
Source: IFC 2011 [Kenya]

In addition, the KRA received relatively good marks from formal businesses for competence, fairness and helpfulness, while tax legislation was perceived mostly as clear and transparent (see Figures 27 – 30).

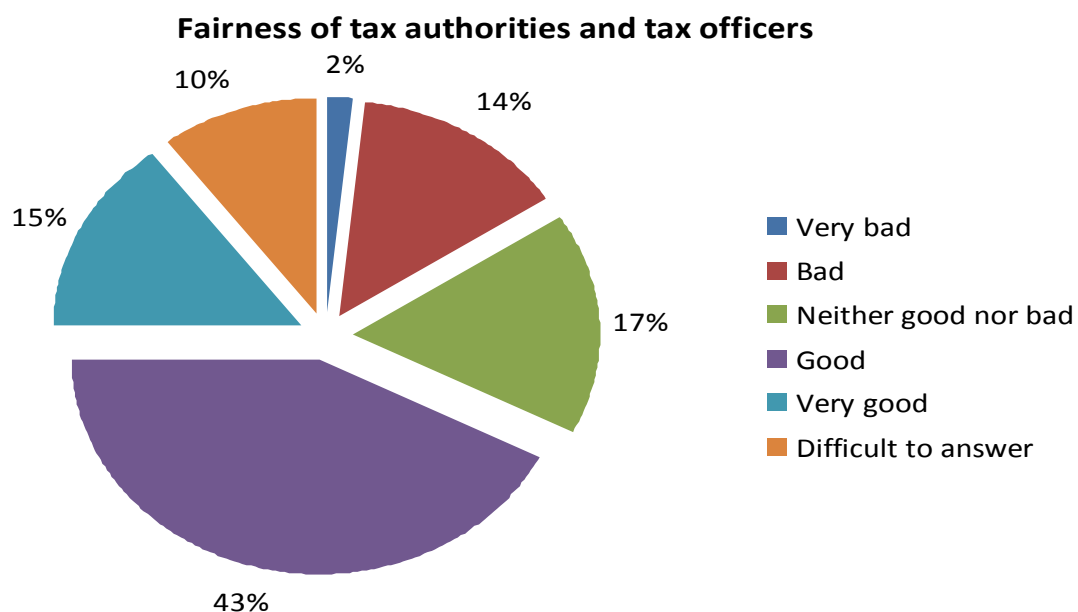
**Figure 27 Perception of Kenya Revenue Authority – percent of formal sector businesses rating KRA on the competence of tax officers**



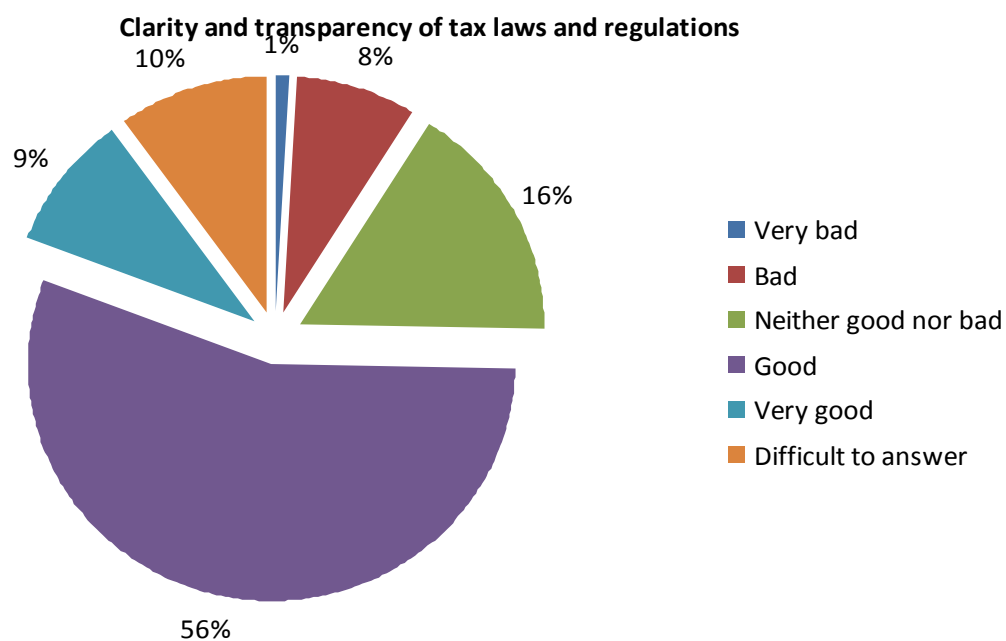
**Figure 28 Perception of Kenya Revenue Authority – percent of formal sector businesses rating KRA on the helpfulness of tax officers**



**Figure 29 Perception of Kenya Revenue Authority – percent of formal sector businesses rating KRA on the fairness of tax officers**



**Figure 30 Perception of clarity of tax laws and regulations in Kenya**



Source: IFC (2011) [Kenya]

## 5. FUTURE RESEARCH AGENDA

So far, there has been very little research or statistical analysis of the TCCS data beyond relatively superficial descriptive statistics, as presented in this paper. Two pieces of more in-depth research on the data from South Africa were undertaken: one analyzing the use of outsourcing by small businesses<sup>19</sup> and the other examining the demographics and attitudes of informal businesses regarding tax registration.<sup>20</sup>

Plans are currently in train to analyze the data from as many countries as possible to examine some of the key drivers of TCC that could be improved by reforms in developing countries: specifically, presumptive taxation for small businesses, use of accounting software (compared to manual accounting) and use of e-filing and e-payment.

Other ideas being considered include analyzing the effects of Risk Based Audit on tax compliance costs and perceptions, and others would focus more on the effect of tax morale and perceptions, as well as TCC, on decisions about tax formalization and compliance. More robust research will become possible as more countries enact reforms and repeat their TCCS.

Such research is expected to help inform tax reforms in developing countries that will not only reduce tax compliance costs, but also encourage more informal businesses to register for tax and encourage formal businesses to comply more fully, broadening the tax base and improving a level playing in business taxation.

## APPENDIX A

### TCCS METHODOLOGY<sup>21</sup>

Common methodological issues include the sample size and sampling methodology. One of the first questions in preparing the TCCS in each country has always been to figure out how many respondents are needed (sample size). And the answer is “It depends”. But a blanket answer “the more – the merrier” is generally misleading.

The mathematics of probability shows that the size of the population (e.g., for a country with a business community of several thousand versus many millions) is practically irrelevant to the decision. This means that to achieve a confidence interval of 3% and confidence level of 95%<sup>22</sup> one would need a sample of 1,056 respondents

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<sup>19</sup> Coolidge, Ilic and Kisunko (2009).

<sup>20</sup> Coolidge and Ilic (2009).

<sup>21</sup> Thanks to Gregory Kisunko.

<sup>22</sup> The margin of error, a.k.a. confidence interval (the plus-or-minus figure usually reported in newspaper or television opinion poll results) of 3% tells you that if 55% percent of your sample picks “X” as an answer, you can be “sure” that if you had asked the question of the entire relevant population between 52% and 58% would have picked that answer. The confidence level tells you “how sure” you can be,

for a population of 100K and a sample of 1,067 for a population of 10 million ... and for a population of 100 million. The mechanics of proper sampling are more important.

Having a tight confidence interval is particularly desirable for purposes of assessing whether a change over time might be attributable to a particular reform (e.g., whether introduction of a new small business tax regime led to a significant reduction in time required for TCC).

The number of needed respondents can grow rapidly if one wants to have high levels of confidence for specific sub-populations. For example, if you want to have high confidence at a provincial level and you targeted country has 10 provinces; or if you would want to compare small, medium and large taxpayers and have the same confidence in the results for each group, etc.

It is important to know the availability and quality of data about taxpaying population of interest. The best data source - database from the tax authority (for example, covering business taxpayers that filed a tax return in the previous tax year), but in many cases this database is not readily available, either because of legal confidentiality of tax data or lack of a centralized, computerized database of business taxpayers (for more detail, please see IFC (2011)).

If the taxpayer database is not available, other sources of information and other databases should be explored (such as a statistical office database, commercial registry database, court registry database, or any other kind of appropriate, available database). These should be considered second-best options because they usually contain a lot of “dead” firms (whereas the database of taxpayers should include data on which firms filed in the most recent tax period and the tax regime used by each business taxpayer).

If no database of any kind is available, alternative survey approaches and sampling methods can be considered. Examples used for TCCS include:

- Area-based sampling (used in South Africa for a survey of informal firms and in the Republic of Yemen for most of the survey)
- Screening used in Ukraine (where a database on sole proprietors was collected in front of tax offices during tax filing by counting clients and doing screening interviews).
- As a last resort, a “snowball” technique may be used to facilitate fieldwork.

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i.e. how often the true percentage of the population who would pick an answer lies within the margin of error. The most commonly used confidence level is 95%. Taken together with the margin of error, these mean that you can say that you are 95% sure that the true percentage of the population that picked X is between 52% and 58%.

However, such alternatives usually result in less representative data and fewer options for generalization.

Another important factor when choosing the sampling strategy and technique is the capacity of the survey company contracted to execute the survey. Planning a complex survey strategy and complicated survey techniques for a contractor with limited survey capacity and ability to execute such a sampling strategy may be a waste of resources.

After reviewing the population structure, some changes are usually made in sample structure relative to a purely representative picture. Most businesses in all countries are small, and a simple representative image of the population in the sample would leave only a handful of medium-size and large businesses. The same situation often exists with sectors, where the dominant sector is usually trade.

For this reason the approach taken in most WBG TCCS has been stratified random sampling, which means that the number of small and trade businesses is reduced relative to the simple representative image to give more room in the sample for businesses of different sizes and sectors. This technique then requires reweighting the survey data to reflect the actual proportions of the different strata within the actual population.

Surveys may also cover groups other than businesses registered for taxation. South Africa's TCCS was composed of three separate surveys that require somewhat different sampling approaches and techniques (see Figure A-1, below):

- Survey of micro, small, and medium-size enterprises registered for taxation (representative survey based on stratified random sample from SARS database, done "face to face")
- Survey of informal businesses—those not registered for taxation (area based sample in same geographic locations as formal businesses, using telephone)
- Survey of tax practitioners or intermediaries (invitation to all members of the main associations of accountants and bookkeepers with e-mail addresses, using a web-based survey)



**Figure A-1 Advantages and Disadvantages of different survey methodologies**

Feature	Face to face	Telephone	Online
Questionnaire duration	Long	Short	Long
Relative response rate	High	Medium	Low
Sensitive information likely to be provided by respondents?	Yes	No	Maybe
Possible to use assisting materials?	Yes	No	Yes
Possible to use accreditations and references?	Yes	No	Yes
Level of contractor capacity needed	Medium	High	High
Cost	High	Medium	Low
Fieldwork duration	High	Medium	Medium/ Low

Source: IFC (2011) pg. 30.

When surveying informal businesses, there is little hope that any kind of statistically reliable data will be available. For this reason area-based sampling is usually used, an approach that involves selecting a number of locations in which it is assumed an informal economy exists and then, using certain techniques, selecting businesses to interview. It is much harder to control the quality of sampling in such a survey, but it can be achieved using experienced supervisors who track the fieldwork process on the spot.

Sampling for surveying intermediaries usually presumes using list-assisted random sampling of available respondents and if using a web-survey, often contacting all available respondents. This is why support from professional associations is so important in these cases. It is advisable to attempt such surveys only in countries where associations of this nature are strong and most practitioners belong to them. In the Peru and South Africa TCCSs all members of the official accountant associations were contacted, but this was only possible due to the method used: web-based surveys.

One of the main drivers of the type and size of a survey is COST. Usually the first question on the mind of a project manager is: “How much would this cost?” The range of variation is very wide, with the most important variables usually the availability of skilled labor and competitiveness of the market for survey companies. Countries such as India can be relatively inexpensive for even a quite sophisticated survey. Unfortunately, for many small, low-capacity countries, the costs can be quite high.

Other variables include:

- Research agenda;
- Type of survey (e.g., face-to-face surveys are generally more expensive);
- Expected coverage (deeper coverage, e.g. provincial level, etc. = higher cost);
- Targeted population(s);
- Level of involvement of the WB staff and/or experienced international consultants.

For example, in South Africa, where the cost of skilled labor is extremely high, the survey of 1,000 formal and 1,000 informal businesses cost about \$450,000, while a web-survey that yielded a sample of over 2,500 tax practitioners cost less than \$50,000.

The Research agenda usually manifests itself in two ways – in the length/detail of the questionnaire and depth of analysis. Both affect the cost, the former by making the fieldwork longer and more expensive, the latter by the need either to find the most sophisticated contractor or (more often) higher level of involvement of the WB staff and experienced consultants. The latter, while expensive are usually the main “tool” of quality assurance and source of more sophisticated data analysis (see Figure A-2).

**Figure A-2 Roles of Team Members in a TCCS**

**Project Leader:** Is the immediate client of the TCCS (who is working closely with the project client – the government). You can compare this to someone who is commissioning a large new building construction. This person may be relatively more or less experienced in this role.

**Survey expert:** Is like the “supervising engineer” for the large building. He/she is responsible for the design and supervision of the construction, according to the needs of the consumer and ensuring both good building standards and appropriate cost control.

**Survey company:** Is like the contractor who actually builds the building. The company should be well qualified and experienced, but they still need supervision to ensure they don’t cut corners or over-charge the customer.

In other words, good quality and poor quality surveys can be compared to buildings: if there are flaws (e.g., too much sand mixed into the concrete) it won’t be obvious to the customer until it’s too late. For example in the earthquake in Szechuan province, some buildings fell down and others withstood the earthquake. A lay-person couldn’t tell which ones would stand and which would fall, but it was certainly not a random phenomenon.

In the case of surveys, a good quality survey yields robust and reliable survey data and a poor quality survey yields data that do not stand up to scrutiny. For example, if questions in the questionnaire were somewhat ambiguous (e.g., “what is the average wage for your bookkeepers”), some respondents may interpret and answer the question one way (wages per month) and others may interpret and answer the question another way (wages per week) and you might not know which ones answered which way. Such data have to be discarded.

Lack of clear definitions, poor translation, and/or poor training of interviewers may also lead to inconsistent answers and thus data that can’t be used. Poor supervision of (or collusion with) interviewers may lead to “curb sitting” (interviewers who sit on a curb and fill out interview reports without bothering with a real interview). Sloppy input of data can introduce more errors.

Another problem might be lack of detail or specificity (e.g., expenditure categories of “material inputs”, “payroll” and “rent” and “other” which does not ensure that a respondent remembers to include the cost of equipment purchased in years past and is still being depreciated on the company books).

Samples that are too small may yield data with such large statistical errors that the “signal” can’t be distinguished from the “noise.” Samples that are not representative may yield data that are biased.

“Data cleaning” is usually needed to eliminate erroneous responses, but it’s hard to distinguish between an error and an “outlier” (a true but extremely unusual response, such as a delay in a procedure of several years). How one defines, identifies and treats “outlier” data can make a substantial difference.

Finally, every survey has some data that, upon examination, may have to be discarded. A poor quality survey may have so little usable data left that the whole exercise lacks credibility, in which case the entire cost and effort of the survey has been wasted.

Source: IFC (2011) pg 17.

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# Tax compliance costs for small and medium sized enterprises: the case of the UK

Ann Hansford and John Hasseldine<sup>1</sup>

## ***Abstract***

This paper presents a section of the findings from the UK arm of an international research project that is evaluating and comparing tax compliance costs affecting small and medium sized enterprises (SMEs) across four countries.

It has been argued that the regulatory requirements on businesses, particularly those on SMEs, are burdensome and can be a constraint on their growth and so success. There have been considerable developments in tax policy, which have impacted on compliance costs within the UK over the last 20 years, and these are reviewed in order to set the current findings into context. The literature review considers developments in the split between core compliance costs, total costs and the costs of activities that are required for ongoing business decisions unconnected with tax.

In accordance with researchers working in other countries taking part in the international study, a questionnaire was developed to investigate the amount of money and time spent on accounting and tax related activities, eg external services, payroll services, together with details of record keeping and accounting including an assessment of the benefits of keeping tax records. The Association of Chartered Certified Accountants (ACCA) agreed to be involved by circulating their members working within SMEs with an e-mail from their Head of Taxation, Chas Roy-Chowdhury, inviting them to complete the questionnaire and submit their responses online. These were then processed by an online survey website and this data formed the basis of the input for analysis using SPSS.

Initial findings suggest that 85% of SMEs paid for external services for tax related work with the amounts ranging from < £1,000 to over £40,000, excluding VAT. Rather less, 66% of SMEs, paid for non tax related services with the amounts paid ranging from £500 to £128,000. Only 32% of the firms our respondents worked in paid for payroll services, and this may be due to the fact that our sample were qualified members of ACCA and so able to manage an in-house payroll service.

The main time consuming activities are completing returns, calculating and paying tax with VAT consistently more time consuming than the other taxes in the survey, income tax / corporation tax, PAYE and capital gains tax. This is closely followed by keeping up to date on tax matters, such as learning about tax law, reading newsletters and bulletins and visiting the HMRC website.

In assessing the benefits of keeping records almost 50% agreed that having to comply with tax obligations helps improve the record keeping of the business. This compares to 27% who agreed that having to comply with tax obligations improves the knowledge of the profitability of the business and a similar percentage who agreed that complying with VAT obligations provides the business with up to date useful information. In conclusion we reflect on these results in the context of ongoing changes in tax policy in the UK.

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## **1. INTRODUCTION**

The U.K. has been a focus for compliance costs researchers, largely due to the pioneering work of Cedric Sandford. From his early work on VAT (Sandford, 1973) there has been interest in compliance costs, across businesses, government departments and academia. Almost forty years later there is still considerable debate on tax compliance costs especially as they affect smaller firms.

However, there are considerable challenges in the field of tax compliance costs (Evans et al. 2001). These include the challenges of definitional issues and research method. For instance, large scale questionnaire surveys with their inherent issues of time valuation and low response rates are just one way of focusing on the topic. Another theme is that compliance costs must be linked to policy and understanding the consequences, and not just the causes, of compliance costs is a continuing challenge.

The current paper is part of a larger continuing and evolving project (involving researchers from Australia, Canada and South Africa – see Evans et al. 2012). Our results in this paper are based on a survey sent to members of the Association of Chartered Certified Accountants (ACCA) and are of a preliminary nature. In particular we focus on the costs affecting SMEs.

## **2. UK COMPLIANCE COST - POLICIES AND ENVIRONMENT**

In the UK, sections 382 and 465 of the Companies Act 2006 define a SME for the purpose of accounting requirements. A small company is one that has a turnover not exceeding £6.5 million, a balance sheet total not exceeding £3.26 million and not more than 50 employees. A medium-sized company has a turnover not exceeding £25.9 million, a balance sheet total not exceeding £12.9 million and not more than 250 employees.

In practice SMEs encompass an extensive range of organisations with widely varying compliance issues. It could be said that no two SMEs are alike and as a result they present extensive challenges for policy makers. Previous studies have found that compliance costs fall disproportionately on small firms (Sandford et al. 1989). In comparison large firms can sometimes barely notice tax compliance costs and for the very largest firms they can benefit from cash flow benefits in retaining taxes collected from employees (PAYE) and customers (VAT) and paying over the collected taxes to HM Revenue and Customs several days or weeks after collection (Sandford & Hasseldine, 1992). The increased compliance burden on small businesses and the benefits of economies of scale for large organisations have resulted in compliance costs being considered to be ‘regressive’ (Hansford et al. 2003).

The complexity within the firm grows as it extends its markets and product lines (Dodge & Robbins, 1992) and this in turn requires more time to be allocated to management and control. Compliance costs are increased, as formal systems need to be put into place. This is all within an organisation with limited resources to cover, what for some may be considered to be, these ‘dead’ costs.



A full literature review is considered unnecessary (See Evans, 2001 for full details), but there have been a number of studies specifically focusing on small firms. These include studies in Australia (Wallschutzky, 1995), Malaysia (Ariff and Pope, 2002), New Zealand (Ritchie, 2001), U.S. (Slemrod, 2004) as well as a multi-country study (OECD, 2001). None of the studies specifically focusing on SME tax compliance costs have been carried out in the UK, which we consider to be a gap in prior literature.

In the recent *Mirrlees Review* conducted by the Institute of Fiscal Studies, Crawford and Freedman (2010, pp. 1080-1083) review relevant compliance cost literature as it affects small firms. They suggest that the high VAT threshold in particular may cause problems for SMEs (especially with regard to expansion and efficiency).

While there can be a link between the level of compliance costs and actual tax compliance, this does not mean that policy should ignore the high burden placed on small businesses. For example, small businesses such as sole proprietors tend to exhibit the lowest voluntary compliance rates while also facing the highest compliance costs (Sandford et al. 1989; Slemrod, 2004). One reason is that they may have the opportunity to not comply, but additionally, such firms simply may not understand their tax obligations, especially those without access to expert professional advice.

Attempts by successive governments to make it easier for small businesses to develop and grow have had mixed outcomes. From a policy angle, the U.K. government has had a mantra of reducing compliance cost burdens with it featuring as a Public Service Agreement (PSA) target for HM Revenue and Customs (HMRC). The Department carried out an exercise with KPMG to measure compliance cost obligations using a Standard Cost Model (HMRC, 2005) resulting in various initiatives that are worth reviewing briefly at this stage.

Following publication of the KPMG research HMRC published a reflection on how changes were going to be implemented in order to address some of the issues raised (HMRC, 2006). The overarching targets were to reduce by at least 10% the administrative burden on business of dealing with HMRC forms and returns over a five year period and reduce the burden of dealing with audits and inspections by 10% over three years and 15% over 5 years. Practical manifestations of these include the requirement that businesses should have to provide information only once, have a single point of contact with HMRC and receive support, education and guidance at the time when they most need it. The KPMG research identified complexities and, what they term, the “irritation factor”, which identified a number of obligations that impose the majority of administrative burdens on businesses dealing with the UK tax system; the most important one being the main tax returns. In addition there was an acknowledgement that “We know many of our customers want to comply but are unsure of what to do or where to find appropriate help” (HMRC, 2006, p. 21).

Compliance cost reviews (CCRs) introduced by HMRC had an overall aim of minimising the costs of complying with new and existing tax obligations. In order to achieve this improved training and guidance was introduced for those dealing with impact assessments, better support with quality assurance of each impact assessment

and regular liaison with the Better Regulation Consultative Committee (HMRCa, 2010). The outcomes identified included the need to give more consideration to the effects of changes on all sizes of business, to address the lack of understanding of commercial practices and business models and impact assessments need to better identify data sources and more clearly explain the analysis they contain and underlying assumptions, including the impacts on tax agents (HMRCb, 2010).

The next section outlines the stages in our questionnaire design and method adopted in collecting data and we also acknowledge tradeoffs encountered and limitations in our method.

### **3. METHOD**

At the start of this project, we considered how to contact respondents in SMEs. As professional accounting organisations consider this to be a relevant topic for their members, initial discussions took place with the ACCA Head of Taxation to enlist the Association's support for the research study and to allow the survey instrument to be distributed to their members. The database of members identifies those working within SMEs and all those members were sent an e-mail from the Head of Taxation inviting them to be involved in the study through the attached link to the online survey instrument. The benefit of this is that respondents would all, by definition, have a professional accounting qualification. All 4,420 ACCA members working in small (those with 50 or less employees) and 4,960 ACCA members working in medium sized businesses (those with 51-250 employees) were contacted. We were warned that the database had been proved not to be necessarily up to date with e-mail addresses or job descriptions and so we were aware that the response rate would be affected by the limitations of the accuracy of the database. However, the opportunity to gain insight into professional views on compliance costs for SMEs was considered to be worth the admitted limitations of the sampling frame. This also explains, to some extent, the disappointing response rates.

A questionnaire survey was considered an appropriate method given the previous tax compliance costs research studies. Oppenheim (1966) warns that: "A questionnaire is not just a list of questions or a form to be filled out. It is essentially a scientific instrument for measurement and for collection of particular kinds of data. Like all such instruments, it has to be specifically designed according to particular specifications and with specific aims in mind" (p. 2). In order to acknowledge these requirements, a study-specific questionnaire was designed for the purpose of this UK research. The basis of the questionnaire was the one used by Evans & Lignier (2012) and Smulders (2012) in their studies, which were also influenced by prior literature (Evans & Walpole, 1999).

In order to be confident that the questionnaire was appropriate for the task there had to be a departure from the strict positivist tradition. An approach where participants were able to discuss and delve into issues was considered to be most appropriate in order to establish a full and complete set of questions for the survey instrument to be used in this UK arm of the international study.

A small focus group of ACCA members, together with an IT specialist who could advise on generic questionnaire survey issues within ACCA, considered the first draft of the questionnaire. This was an important step as the ACCA were supporting the distribution of the questionnaire to their members and provided access to their database of ACCA qualified accountants working within SMEs. The overall benefits of focus groups have been discussed widely in the literature and the combined efforts of the group should produce a wider range of information, insight and ideas. There can be a “snowball” effect with one individual triggering off a chain of responses from the other participants. The group members find comfort in the fact that their feelings are not greatly different to that of their peers and they can expose an idea without having to defend or elaborate on it. Krueger (1988) found that focus groups enable individual responses to be more spontaneous and provide a more accurate picture of their position on a particular issue.

Amendments followed and further minor adjustments were made. As far as possible the questionnaire used for the UK study<sup>2</sup> was kept as similar as possible to those used by other researchers in the international study (Evans & Lignier (2012), Ebrahimi & Vallaincourt (2011) and Smulders (2012)). The main adjustments were made for the purposes of administering the instrument in the U.K., with adjustments to various questions (e.g. turnover) to reflect local demographic and definitional issues (i.e. definition of an SME) and we tailored the instrument to reflect the domestic U.K. tax environment. In particular we were interested to know whether the firm the respondent worked for was VAT registered and so a turnover band of 0 - £73,000 was included. Research has shown (Chittenden et al, 1999) that one of the key factors constraining small business growth is the VAT registration threshold. It has been suggested that businesses ‘manage’ their turnover for VAT purposes which creates an artificial barrier to growth within small businesses (Kausar et al, 2001).

Other important turnover limits are based on the Companies Act definition of ‘Small’, the limit being £6,500,000 and for cash accounting for VAT the limit is £1,350,000. This is an allowance specific to the UK VAT system in that those eligible and actually electing for cash accounting treatment can reduce the amount of record keeping required and bad debt relief is more generous and timely. However, the method of asking respondents to estimate hours spent on certain activities, who performed these functions and the value of their time was unchanged from the instruments used by our overseas colleagues.

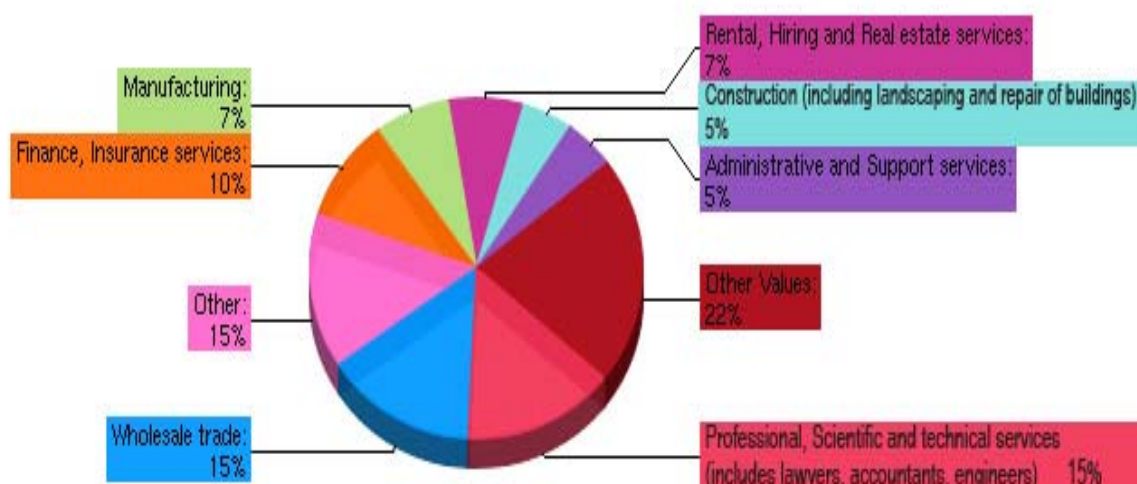
Research has shown (Storey, 1994) that for some individuals working in small businesses they are required to undertake a multitude of tasks and so reduces the amount of time available for each specific task (Reid & Jacobsen, 1988). By surveying ACCA members then we should be in a position to extract responses from those well-informed individuals who have a good basic understanding of tax compliance.

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<sup>2</sup> Copy available from the authors.

The questionnaires were sent out in June 2011 to members of ACCA and so by definition all responses were filled out by a qualified accountant. Forty one ACCA members responded and of those over half (55%) had been admitted to membership over ten years ago, with a further 15% admitted 5-9 years ago and 12 respondents admitted in the past four years. They represented firms from a variety of sectors (see Figure 1). In terms of legal structure, 35 firms (85%) were private limited companies.

**Figure 1: The sector of the respondents to the questionnaire**



The number of years the firms have been trading ranged from over ten years for 24 firms (60%) to one firm that had been in business for less than a year.

In terms of size by turnover, two firms reported a turnover under £73,000 (the current UK VAT registration threshold) with two firms reporting turnover exceeding £25,900,000. The median firm had a turnover between £1,350,000 and £6,500,000, so being between the VAT cash accounting limit and upper turnover limit for a small company.

For the opinion driven questions (detailed in Section 4.2) respondents were asked how confident they were on a five point Likert scale in their estimates of their firm's compliance activities. After reviewing the dataset one outlier was dropped from the analysis due to a response of "Very Unconfident" to the question, How confident are you in your estimates? This response also included extremely high and seemingly disproportionate compliance costs.

In summary, the study involves collecting the views of UK based ACCA members on a range of issues relating to tax compliance costs. Standard questionnaire methodology has been applied in accordance with studies involving other countries in the wider international study, involving Australia, South Africa and Canada. Section 4 now sets out the findings from the analysis of the questionnaire responses.

## 4. RESULTS

This section reports the empirical results from our survey with tax compliance costs being covered in Section 4.1, while we outline respondents' views on record keeping in Section 4.2.

### 4.1 Tax Compliance Costs

#### 4.1.1 External Compliance Costs

An important component of compliance costs are the professional fees paid to external advisers. These fees (excluding VAT that firms can claim back) were classified as tax-related, non tax-related (including general accounting services, managerial advice, and computerised accounting software assistance) and lastly, external payroll services.

Table 1 below reports means and standard deviations for these three categories, together with inter-quartile amounts and the mean amount per full time employee.

**Table 1: External Compliance Costs**

	<b>Tax Related</b>	<b>Non Tax-related</b>	<b>Payroll services</b>
N	34	25	13
Average total costs	£5,484	£12,002	£2,803
(standard deviation)	(8,047)	(25,165)	(2,301)
1 <sup>st</sup> quartile	£1,000	£1,000	£500
median	£2,500	£5,000	£2,100
3 <sup>rd</sup> quartile	£5,000	£11,000	£6,000
Average cost per employee	£281	£261	£624
(standard deviation)	(466)	(434)	(1,976)

Most firms (85%) paid for external tax-related services with a mean tax-related fee of £5,484 however this figure is skewed by a small number of very large fees, with the median fee being £2,500 and the third quartile figure being only £5,000. In addition to tax work, 25 out of 40 firms (62.5%) paid external advisers for non tax-related work.

Only about one-third of the firms in the sample employed an external adviser for payroll services with a mean / median fee of £2,803 / £2,100 respectively.

In terms of considering the role of the external adviser (Hite et al, 2003), when respondents were asked to imagine for a brief moment that the U.K. was tax free; and whether they would still pay for an external advisor for accounting and related services, 14 firms (38%) would still employ an advisor and 21 firms (57%) would refrain from doing so.

### 4.1.2 In-house Compliance Costs and Time

Apart from fees paid to external advisers, internal compliance activities can be significant in terms of the actual hours taken in that area and activity and the commercial value of that time. Our survey focused on four distinct areas: VAT, Income Tax and Corporate Tax, PAYE and Capital Gains Tax.

**Table 2: In-house Compliance Costs and time spent allocated to different taxes**

	VAT	Inc./Corp. Tax	PAYE	CGT	Total
Average Cost	£ 6,062	£ 4,362	£ 3,645	£ 602	£ 14,671
% in-house cost	41.3%	29.7%	24.9%	4.1%	100.0%
Average Hours	219	85	115	15	434
% in-house time	50.5%	19.6%	26.5%	3.4%	100.0%

The results show that VAT consumes, on average, over half of all in-house time spent on tax compliance and incur over 40% of the value of that time. In contrast Income Tax and Corporation Tax only incur roughly 20% of in-house time, but cost approximately 30% of the value of that time. This might be due to the, often, complex nature of direct tax in the U.K. PAYE consumes about one-quarter of firms' time and value, and lastly, CGT occupies a small percentage of firms' tax compliance time and value.

### 4.1.3 Breakdown of Time spent on In-house Compliance Activities

Across the four areas of taxation considered in this study, there are distinct activities that constitute tax compliance. In terms of the hours spent on different activities, our results show that two-thirds of respondents' time is spent on recording information needed for tax (i.e. 289/434 hours on average per Table 3).

The only other significant activity is completing the actual tax returns and making the computations. However, we would caution that while proportionately less time is spent on activities such as tax planning and tax advice, learning about taxation and dealing with advisors, these activities can be of crucial importance, to tax compliance strategies and not falling foul of the tax agency.

**Table 3: Time spent on In-house Tax Compliance**

Activity	Mean (Hours)	%
Recording information needed for tax	289	66.7
Calculating tax, completing return and paying	47	10.8
Dealing with tax office (phone, email, visits)	17	4.0
Tax planning and tax advice	16	3.9
Dealing with external advisers, providing info	29	6.8
Learning about tax laws, reading, web browsing	33	7.7
Other activities	3	.1
Total	434	100.0

#### 4.1.4 Total Tax Compliance Costs

Total tax compliance costs are the sum of in-house and external costs of complying with taxes. The mean total costs of compliance were £21,362 (standard deviation £19,825) ranging from £1,375 to £76,950. However, these costs are skewed by several large observations and the table below reports these costs by quartile. As not all respondents answered each question, and some respondents use external advisers only (or in-house compliance activities only), the rows are not additive.

Table 4 shows variation in in-house, external and total compliance costs for the sample. The means reported in the final column (All Firms) show that all classes of compliance cost figures, in addition to the number of full time employees, are skewed by large observations. For this reason, we report quartile statistics. Note that relatively, more costs are incurred on internal activities relative to the fees paid to external advisers.

**Table 4: Total Costs of Tax Compliance**

	1 <sup>st</sup> Quartile	Median	3 <sup>rd</sup> Quartile	All Firms
Total Compliance Costs	£ 8,267	£ 13,070	£ 37,400	£ 21,362
In-house Compliance Costs	£ 2,800	£ 9,960	£ 22,431	£ 14,671
External Compliance Costs	£ 1,000	£ 2,500	£ 5,000	£ 5,485

[Note: Due to differences in numbers of available respondents per category (in-house / external compliance costs), columns are not additive]

In terms of the behaviour of compliance costs by size of firm, we use reported turnover to segment the firms into three categories. There are small firms with turnover less than £600,000; intermediate SMEs with turnover between £600,001 - £6,500,000 and large SMEs with turnover exceeding £6,500,000. Table 5 reports mean / median statistics with this data then scaled by number of employees.

**Table 5: Mean / Median Compliance Cost Data Split by Firm Size**

Turnover	< £600,000	£600001-6.5m	> £6.5m
N	12	16	12
Full time Employees	6/3	33/30	98/37
	£	£	£
Total Compliance Costs £	23687/10876	16657/13015	24908/13540
In-house Compliance Costs £	16278/6200	14063/11070	14938/9960
External Compliance Costs £	2683/500	3284/2,500	9970/5000
Total Costs / FT employees	8526/4410	698/448	768/361
In-house Costs/ FT employees	6687/2800	567/415	497/172
External Costs / FT employees	537/125	125/93	271/134

As larger observations skew the mean statistics upwards, our discussion draws upon the median statistics reported in the preceding table. First, the smallest size category reports lower median compliance costs (external, in-house, total) than the other two groups with higher turnover.

When compliance costs are scaled by the number of full time employees then the regressive nature of these costs becomes apparent, especially for in-house and total compliance costs. For example, for total compliance costs per full time employee, median costs decrease from £4,410 to £448 to £361 as turnover increases. A similar trend occurs for in-house costs per employee i.e. £2,800 to £415 to £172 as firm size category rises. The results in Table 5 thus again, like earlier studies, confirm the economies of scale associated with tax compliance costs in the U.K.

## 4.2 Record keeping and Accounting

Apart from measuring tax compliance costs, our aim is to study the amount of time spent on various in-house managerial accounting tasks, whether these tasks are viewed as important or unimportant, and finally whether the process of tax compliance is viewed beneficially, and how.

### 4.2.1 Breakdown of Time spent on in-house accounting activities not related to tax compliance, by type of activities, SME firms

Earlier, in Section 4.1.3 we reported the average hours spent for various tax compliance activities. The largest of these was recording information needed for tax (289 hours). This was followed by calculating tax, completing tax returns and paying taxes (47 hours), dealing with external advisers and providing them with information (29 hours) and learning about tax laws, reading newsletters, Revenue websites, bulletins etc. (33 hours).

We then asked how much time was spent on various accounting activities that are not related to tax compliance. The figures are reported in Table 6 below.

**Table 6: Time spent on General Accounting Functions**

Activity	Hours	%
Processing customer invoices/cash received	857	24.3
Following up debtors	334	9.5
Paying bills	338	9.6
Calculating and paying wages	179	5.1
Checking bank against cash records	135	3.8
Stocktaking and stock control	349	9.9
Investment planning unrelated to tax	267	7.6
Budgeting and control	417	11.8
Other	<u>651</u>	<u>18.4</u>
Total	3527	100.0



A comparison of the hours spent by firms on general accounting activities with the hours spent on tax compliance activities shows that general accounting activities (mean of 3,527 hours) exceeds time spent internally on tax compliance activities (mean of 434 hours). We now turn to the question of whether the process of tax compliance helps with these other activities.

#### 4.2.2 Evaluation of various reasons for keeping accounting records

Our questionnaire asked respondents the type of accounting system used by their firm. Over 80% used off-the-shelf accounting software in-house with ten firms (24%) using customised software in-house. Four firms used a paper-based system.

The reasons given and level of importance for keeping accounting records are contained in Table 7 (note the rows report both percentages and cell counts).

**Table 7: Importance of Record Keeping**

Reason:	Not important at all	Not very important	Unsure	Moderately important	Very important	Not applicable/Not relevant	Total
Tax Calculation	0.0% 0	4.9% 2	0.0% 0	12.2% 5	82.9% 34	0.0% 0	100% 41
Reporting to other Regulatory Bodies	4.9% 2	14.6% 6	0.0% 0	29.3% 12	48.8% 20	2.4% 1	100% 41
Reporting to Owners	0.0% 0	7.3% 3	0.0% 0	12.2% 5	75.6% 31	4.9% 2	100% 41
Reporting to Lenders or other External Stakeholders (eg. franchisers)	9.8% 4	9.8% 4	0.0% 0	34.1% 14	34.1% 14	12.2% 5	100% 41
Internal Management	0.0% 0	9.8% 4	0.0% 0	17.0% 7	68.3% 28	4.9% 2	100% 41

Table 7 shows that tax calculations and reporting to owners are the most important reasons followed by internal management and reporting to other regulatory bodies. Reporting to lenders and other external stakeholders was less important, which we expected based on the sample firms (i.e. SMEs).

In terms of the use of accounting records, results from our respondents show that one firm only used their accounting records for tax purposes solely; whereas most firms used their accounting records for other reasons as well. These include the monitoring of business profitability, cash flow and financial position, debtors collection, payments to creditors/lenders. However, fewer than one in five firms used their accounting records to monitor trading stock.

#### 4.2.3 Benefits derived from having to keep tax records

While the prior sub-section outlined the purpose of keeping accounting records, we also asked respondents their level of agreement on the benefits that their business derives from having to keep tax records. The results (including percentages and cell counts) are shown in Table 8.

**Table 8: Benefits of Keeping Tax Records**

<b>Benefit of Tax Compliance:</b>	<b>Strongly Disagree</b>	<b>Disagree</b>	<b>Unsure</b>	<b>Agree</b>	<b>Strongly Agree</b>	<b>Not Applicable/Not relevant</b>	<b>Total</b>
Having to comply with tax obligations helps to improve the record keeping of the business	14.6% 6	29.3% 12	7.3% 3	36.6% 15	12.2% 5	0.0% 0	100% 41
Having to comply with tax obligations helps to maintain more accurate records	14.6% 6	24.4% 10	7.3% 3	41.5% 17	12.2% 5	0.0% 0	100% 41
Having to comply with tax obligations improves the knowledge of the financial/cash flow position of the business	29.3% 12	26.8% 11	17.1% 7	19.5% 8	7.3% 3	0.0% 0	100% 41
Having to comply with tax obligations improves the knowledge of the profitability of the business	22.0% 9	34.1% 14	17.1% 7	19.5% 8	7.3% 3	0.0% 0	100% 41
Having to comply with VAT obligations provides the business with up-to-date info	31.7% 13	36.5% 15	4.9% 2	22.0% 9	4.9% 2	0.0% 0	100% 41

Table 8 shows that for the first two statements, after removing the category of 'unsure', a majority of respondents agree that tax compliance obligations help with general record keeping and levels of accuracy. However, this agreement does not extend to tax compliance helping with knowledge of financial aspects of the business, and respondents disagree that VAT compliance provides their firm with up-to-date useful information.

Apart from the results shown in Table 8 our questionnaire probed the issue of record keeping further. Respondents listed the following as being a benefit to their business resulting from tax compliance: improved record keeping (73%), reduced risk of the firm being subject to a tax audit (58%) and having an accountant who is a good source of advice for the business (54%). Only a minority agreed that tax compliance gives a better knowledge of the firm's financial affairs (38%) and tax compliance provides extra cash until the tax is remitted to HMRC (35%) – i.e. the last two are not really seen as benefits.

As a summary question, when respondents were asked "Overall, would you agree that complying with tax obligations has some benefits for your business?" 25 firms (61%) answered "Yes", with 16 firms (39%) answering "No". Accordingly, there are mixed views on whether tax compliance has follow-on benefits for other non-tax areas in the firm such as general financial management.

## **5. CONCLUDING REMARKS**

Our results from this preliminary study of current U.K tax compliance costs support the findings from previous work in relation to VAT compliance costs (Crawford & Freedman, 2010; Hansford et al. 2003). VAT compliance consumes a disproportionate amount of in house time, as set out in Table 2, with over 40% of costs and over 50% of time spent on VAT as compared to other taxes; income tax / corporation tax, PAYE and CGT.

The regressive nature of overall tax compliance costs has been discussed at length in the literature, and our findings, so far, support this for both total and in-house compliance costs when these costs are computed per full time employee, as shown in Table 5.

Our findings relate also to the role of the external adviser. While accountants in public practice provide much of their services to SMEs in relation to tax work, they also act as a general business adviser. For example, when respondents were asked to imagine for a brief moment that the UK was tax free; and whether they would still pay for an external advisor for accounting and related services, 14 firms (38%) would still employ an advisor and 21 firms (57%) would refrain from doing so. So even for small firms, external advisers can provide 'value-added' services. Consistent with prior research, it also seems likely that when taxes are considered, these advisers play an "enforcing" role in tax compliance (Hite et al. 2003).

The results would indicate that there is some way to go before it can be said that the aims of the Compliance Cost Review have been met. Table 3 shows that over three quarters of in-house costs relate to recording, calculating and returning information on tax returns. Table 7 shows that 95% of our respondents consider record keeping to enable the tax calculations to be computed are moderately or very important. On balance our respondents were just positive in assessing whether having to comply with tax obligations – ie actually incurring these compliance costs - helps to improve record keeping.

Previous research has shown that SMEs present issues for policy makers aiming to reduce red tape and burdens on these, often, fledgling businesses. There is an overlap of purposes for keeping business records and these purposes will change and evolve over the life of the SME as the business expands. An example from our study is given in Table 1 where external payroll costs, when assessed per full time employee (£624) appears out of line with tax related (£281) and non tax related (£261) costs. This perhaps reflects the stage of the businesses of our 13 respondents at the time of completing the questionnaire; their staff size is not big enough to perform this function in house. They cannot benefit from internal expertise and so have to engage expensive outside support.

As with all preliminary studies, it is important to establish the limitations of the work done so far before progressing further with this study. Our research methods involving ACCA members were helpful in addressing the challenges of a large scale questionnaire survey. Support with customising some of the questions and active support from the Head of Taxation was important. However, the response rate was disappointing and compliance costs must be linked to policy and understanding the consequences, and not just the causes, of compliance costs is a continuing challenge.

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# FATCA and Schedule UTP: Are these unilateral US actions doomed unless adopted by other countries?<sup>1</sup>

J. Richard (Dick) Harvey, Jr.<sup>2</sup>

## **Abstract**

Since the last ATAX conference in April 2010, the US has unilaterally adopted two, very controversial transparency initiatives:

- FATCA - Imposes a 30% withholding tax on a foreign financial institution (FFI) that desires to access the US financial market unless the FFI agrees to report information about its US customers.
- Schedule UTP - Requires large corporations to disclose uncertain tax positions (UTPs) for which a tax reserve has been recorded in audited financial statements.

While a senior US government tax official, the author was heavily involved in developing both FATCA and Schedule UTP. The primary purpose of this article is to discuss certain of the global considerations of these two ground-breaking initiatives. For example: Does the US need multilateral action to accomplish its goals with respect to either FATCA or Schedule UTP, and if so, what form might such action take?

The paper concludes the following:

- The US likely needs multilateral action to successfully implement FATCA, but it does not for Schedule UTP.
- Foreign countries would benefit greatly from using the US's leverage to effectively force financial institutions to join a multilateral FATCA system. The US would benefit from reducing the number of viable investment options available to US tax cheats.
- A successful multilateral FATCA system could incorporate multiple design features. For example, it could accommodate both a reporting and withholding model. However, if this option is selected, a "punitive withholding model" should be adopted that has a relatively high tax rate and applies to both investment income and new money. The failure to apply withholding tax to new money is a major deficiency of the recent withholding agreements between Switzerland and the UK/Germany.
- Schedule UTP requires a corporation to link a tax reserve with a specific tax issue. If tax reserves are recorded on an aggregate basis, the link between a tax reserve and a specific tax issue may be more difficult to establish. This issue had been resolved by FIN 48 in US GAAP, but it still exists for IFRS. Fortunately, there is a solution.

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<sup>1</sup> This article is based on a paper prepared for the 10th International Conference on Tax Administration hosted by ATAX, Australian School of Business, Sydney, Australia (April 2012). The date of the article is February 23, 2012.

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## 1. INTRODUCTION

Since the last ATAX conference in April 2010, the US has unilaterally adopted two, very controversial transparency approaches:

- FATCA - Short for Foreign Account Taxpayer Compliance Act, FATCA generally imposes a 30% withholding tax on a foreign financial institution (FFI) that desires to access the US financial market unless the FFI agrees to report information about its US customers to the US tax authorities.
- Schedule UTP - Requires large corporations to disclose on their tax return uncertain tax positions (UTPs) for which a tax reserve has been recorded in audited financial statements.

These ground-breaking transparency initiatives were designed to improve compliance for taxpayers the IRS has historically had significant difficulty auditing. Both could have global implications.

The primary purpose of this article is to discuss certain of these global implications. For example: Does the US need multilateral action to accomplish its goals with respect to FATCA or Schedule UTP, and if so, what form might such action take? Will these unilateral transparency approaches spread to the rest of the world? A secondary purpose is to provide background on the two initiatives for those with limited prior experience.

The article is written for several audiences. The entire article should be of interest to students and academics. Global tax policy makers and other tax professionals may want to focus on the global considerations in Section 3, and specifically:

Section 3.1.3 - Discusses key design issues in a multilateral FATCA regime, including whether there should be a reporting, withholding, or some hybrid model. Although a global reporting model would clearly be preferable, a model that accommodates both is feasible – especially if needed to initially obtain global consensus. However, a withholding model would have to be carefully structured and should apply to new money, as well as investment income.

Section 3.2 - For countries considering whether they should adopt an approach similar to Schedule UTP, this section discusses issues tax administrators may want to consider.

## 2. BACKGROUND

This section is intended for those that want to understand the history and basics surrounding either FATCA or Schedule UTP. If you already have such background, or alternatively are short of time, you should advance directly to Section 3 that discusses the global considerations of each.



## 2.1 FATCA<sup>3</sup>

Although US taxpayers have been hiding income overseas for decades<sup>4</sup>, US tax authorities (IRS) historically have had little success pursuing such income; the primary reason being that foreign financial institutions (FFIs) reported little or no information to the IRS. Occasionally the IRS became aware of an offshore account<sup>5</sup>, but effectively US taxpayers were on the honor system. Given that over 33,000 US taxpayers submitted voluntary disclosures surrounding their offshore accounts since 2009, it would appear many US taxpayers have not been very honest.<sup>6</sup>

In order to understand why the US adopted FATCA one needs to go back to January 1, 2001; the effective date for implementation of the US's Qualified Intermediary (QI) system.

### 2.1.1 The Qualified Intermediary (QI) system<sup>7</sup>

Prior to 2001, foreign financial institutions (FFIs) generally did not (i) collect U.S. tax documentation with respect to either US or foreign taxpayers, (ii) file information returns with the IRS, or (iii) submit to IRS oversight. As a result, there were two major problems:

Foreign Taxpayers - US withholding agents (e.g., US banks) did not obtain adequate documentation from FFIs to document a reduced US withholding tax rate on payments to foreign customers. This was not surprising given the FFI had the customer relationship, and the FFI was not anxious to share the identity of its clients with a potential competitor (i.e., a US bank).

US Taxpayers - A US taxpayer could invest with a FFI and the FFI was not required to report anything to the IRS.

Because of these problems, the US unilaterally implemented a Qualified Intermediary (QI) system. The primary purpose of the QI system was to address the first problem (i.e., source country withholding on payments to foreigners). The QI system only partially addressed the second (i.e., residence country reporting for US customers). As will be described in Section 2.1.3, FACTA directly results from the QI system's failure to comprehensively address the US customer issue.

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<sup>3</sup> For substantially more background, see J. Richard (Dick) Harvey, Jr., *Offshore Accounts: Insider's Summary of FATCA and Its Potential Future*, forthcoming Villanova Law Review (Spring 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1969123](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1969123).

<sup>4</sup> For example, in a letter dated May 29, 1937 to President Franklin Roosevelt, then Secretary of the Treasury Henry Morganthau explains why tax collections are less than anticipated. In this letter, Secretary Morganthau describes offshore accounts held by US taxpayers as part of the problem.

<sup>5</sup> For example, through a whistleblower like a former business partner or former spouse

<sup>6</sup> See <http://www.irs.gov/newsroom/article/0,,id=251240,00.html> for IRS Commissioner Shulman's speech on Dec. 15, 2011.

<sup>7</sup> US Treas. Reg. 1.1441-1(e)(5).

In summary, the QI system requires QIs to identify their customers. If they are foreign customers, the QI can keep the identity of their customer secret as long as the correct amount of US withholding tax is imposed on any US source payments. For US customers, the QI is only required to report US source income to the IRS. Foreign source income earned by a US customer is not reported.

It is important to note that the QI system was a major advancement when compared to the pre-2001 world, especially with respect to determining the correct amount of withholding tax to be applied on payments to foreigners. However, as time passed, it became very apparent that the QI system was not preventing US taxpayers from using offshore accounts to avoid US tax.

### **2.1.2 Major Issues with the *Qualified Intermediary (QI)* system**

Although the QI system did include some reporting to the IRS with respect to US taxpayers, there were several major loopholes that were exploited by US taxpayers, their advisors, and foreign financial institutions (FFIs). For example:

- Foreign Source Income Not Reported - QIs were only required to report the US source income of their US customers. Since foreign source income was not reported, US taxpayers invested in foreign source assets to avoid reporting.
- No Requirement to Determine the Beneficial Owner - QIs were not specifically required to look-through foreign shell entities to determine whether a US customer was a beneficial owner. Thus, if a US taxpayer wanted to invest in US source assets and avoid reporting, it could establish a foreign shell entity and argue the entity was the beneficial owner of the income.
- QI Could Represent Only a Portion of the Worldwide Accounts – Since the primary emphasis of the QI system was to make sure the proper withholding tax was imposed on payments to foreigners, the QI system allowed foreign financial institutions to designate those accounts that were part of the QI system. This was done to avoid the QI having to perform detailed due diligence procedures on its entire customer base, especially those that never invested in the US.<sup>8</sup> The result was that a QI could exclude certain customers from the QI system, especially so-called “undeclared accounts”.<sup>9</sup>
- QIs Were Primarily Banks – Given the QI system was primarily aimed at custodial relationships, QIs were usually banks or trust companies. If a US taxpayer wanted to avoid any possibility of US reporting, they could invest in (i) a foreign mutual fund or private equity fund treated as a corporation for US tax purposes, or (ii) any other FFI that was not a QI.

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<sup>8</sup> In most foreign financial institutions, the percentage of the customer base that invested in US source assets was very small. Although I am not aware of any statistics, it could be less than 1% in many cases.

<sup>9</sup> These are accounts where the customer refused to identify themselves.

- **QI Audits** – The QI audit was not really an audit, but rather was a list of procedures that needed to be performed. The procedures did not include any requirement for a QI auditor to look for, or report fraud. More importantly, the focus of the audit was on reviewing non-US customer accounts within the QI system, and not testing to determine whether US taxpayers were avoiding reporting by either (i) investing in foreign source assets, or (ii) holding US source assets in a foreign shell entity.

As will be described in Section 2.1.3, these loopholes were front and center on the minds of IRS, Treasury, and Congressional staff as they proposed and drafted FATCA in 2009 and 2010.

### 2.1.3 FATCA is conceived

Given the loopholes and issues surrounding the Qualified Intermediary (QI) system, there was general agreement among senior US government officials that something had to be done. The question became: What specific changes should be made to the QI system to make it more effective at preventing US taxpayers from hiding income offshore? The obvious answer was to attempt to address the problems identified in Section 2.1.2, and hence it was decided that QIs should be required to:

- Report both US and foreign source income for US taxpayers
- Determine if US taxpayers are the beneficial owners of foreign shell entities
- Review all customer accounts within the affiliated group to identify US taxpayers.

Thus, the concept of FATCA was born. However, as the US started down this path, several issues arose, including:

- **Would US Taxpayers switch their Investments from QIs to other financial institutions (e.g., mutual funds, private equity, and insurance companies)** – Since the QI system was a “carrot” primarily utilized by custodial and private banks, the QI system practically did not include many other foreign financial institutions (FFIs). There was significant concern that if the US made it difficult for US taxpayers to hide money offshore in bank and trust companies, many US taxpayers would start hiding their money in other offshore vehicles (e.g., various funds). Therefore, any proposal needed to either (i) expand the QI regime to include substantially all foreign financial intermediaries, or (ii) adopt some other approach to reduce the opportunities of US “tax cheats”<sup>10</sup> to invest with non-QIs (NQIs).
- **Would QIs Abandon the QI System?** – The QI system was designed to encourage FFIs to become QIs so they could avoid disclosing their customer’s identity to potential competitors (e.g., US banks). Given the QI system utilized this carrot approach, there was significant concern that many QIs would abandon the system if they were now required to perform substantial

<sup>10</sup> Used throughout the article to refer to taxpayers that use, or want to use, offshore accounts to evade their residence country tax obligations.

additional burdens, including: (i) report both US and foreign source income for US taxpayers, (ii) determine the true beneficial owner of a shell entity, and (iii) perform customer due diligence on their entire customer base (including affiliates) to identify potential US customers.

As a result of the above issues, it was decided the new and improved QI system needed a penalty for FFI's that failed to participate. The penalty adopted was the imposition of withholding tax on US source payments (both income and gross proceeds) to a NQI.

In addition to the concerns that led to the introduction of a 30% withholding tax on NQIs, two others are worthy of note:

- Recalcitrant customers - As originally proposed, FATCA required QIs to close accounts for customers that refused to provide certain information. Given local country restrictions surrounding the closing of pre-existing accounts, FATCA was ultimately modified to allow these so-called "recalcitrant customers". However, QIs are required to report aggregate information to the IRS with respect to recalcitrant customers, and it was recognized that future multilateral discussions between governments may be needed to address the issue.
- Customer due diligence surrounding QI affiliates – The typical FFI has many legal entities around the world. If any part of such financial institution desired to be a QI, the US ideally needed to make sure all the legal entities around the world were performing adequate customer due diligence to identify US customers. Unfortunately, there are practical issues with requiring a global financial institution to identify US customers throughout its entire customer base.<sup>11</sup>

It was ultimately decided the US Treasury would have authority to address this issue after FATCA was enacted. Again, this issue was recognized by some drafters as another reason for potential multilateral discussions. Specifically, it would be a lot easier for a FFI to perform detailed due diligence on its entire worldwide customer base (including affiliates) if such due diligence was required by more countries than just the US.

#### **2.1.4 FATCA is enacted**

Legislation was ultimately introduced in October 2009,<sup>12</sup> modified again in December 2009,<sup>13</sup> and finally enacted in March 2010 as part of the Hire Act<sup>14</sup>. Given the known

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<sup>11</sup> For example, assume a FFI has millions of customers, but less than 1% are US customers. In such a situation, it is difficult to force the FFI to perform detailed customer due diligence on its entire customer base (including affiliates) to find a relatively small number of US customers.

<sup>12</sup> See H.R. 3933 and S. 1934, and Technical Explanation of the Foreign Account Tax Compliance Act of 2009, prepared by the Staff of the Joint Committee on Taxation, October 27, 2009 (JCX-42-09).

<sup>13</sup> See H.R. 4213 and the Technical Explanation of H.R. 4213, The Tax Extenders Act of 2009, prepared by the Staff of the Joint Committee on Taxation, December 8, 2009 (JCX-60-09).

<sup>14</sup> See P.L. 111-47, sections 501-535 and Technical Explanation of the Revenue Provisions Contained in ... the Hiring Incentives to Restore Employment Act, prepared by the Staff of the Joint Committee on

problems with the QI system, the core FATCA provisions were not a surprise. FATCA requires participating foreign financial institutions (P-FFIs)<sup>15</sup> to:

- Report both US and foreign source income for US taxpayers,
- Determine whether US taxpayers are the beneficial owners of foreign shell entities, and
- Potentially perform detailed due diligence on all customer accounts within an affiliated group of companies to identify US taxpayers.

If a FFI does not become a participating P-FFI, it is subject to a 30% withholding tax on payments of both US source income and gross proceeds it receives on its own behalf, or on behalf of customers. This was primarily designed to encourage FFIs to become P-FFIs and be part of the FATCA system. It should also be noted that FATCA has the practical effect of extending the QI regime to a much broader group of foreign financial intermediaries, including offshore funds. In 2008, it was estimated there were approximately 5,600 QIs.<sup>16</sup> The number of FFIs ultimately impacted by FATCA is likely into the hundreds of thousands.

Finally, when FATCA was being designed, there was a clear understanding that it would not unilaterally eliminate all opportunities for a US taxpayer to hide income offshore. For example, a US tax cheat could invest in non-US source assets with a Nonparticipating FFI (NP-FFI) and avoid reporting to the IRS. However, the hope was that substantially all reputable FFIs would become P-FFIs. If this occurred, US tax cheats would be relegated to 2nd or 3rd tier foreign financial institutions that could cause the US tax cheat to question whether they really wanted to invest with such institution.

In summary, FATCA was enacted to address the deficiencies in the existing QI system with respect to (i) the identification of US customers, and (ii) US customer's investments in non-US source assets. However, as FATCA was being conceived and enacted, it was clear to some that in order for FATCA to be a success, multilateral action was likely to be needed. Specific concerns included: (i) local country restrictions on closing accounts and/or reporting information to the US; (ii) the need to have P-FFIs perform detailed due diligence on their entire customer base, including affiliates; and (iii) the need to narrow the investment options available to potential US tax cheats. See Section 3.1 for additional discussion of these concerns and how multilateral action could address them.

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Taxation, February 23, 2010 (JCX-4-10). Although FATCA technically includes sections 501-535, section 501 is the subject of this article.

<sup>15</sup> FACTA uses the term "P-FFI", rather than QI. In addition, technically the US is maintaining its QI system, but it is possible the QI and P-FFI systems may ultimately be merged.

<sup>16</sup> See IRS Commissioner Shulman's testimony to Permanent Subcommittee of Investigations, US Senate, on July 18, 2008. Available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/tax-haven-banks-and-u-s-tax-compliance>.

## 2.2 Schedule UTP<sup>17</sup>

A former IRS commissioner has called Schedule UTP the biggest change in US corporate tax administration in the last 50 years.<sup>18</sup> Others have made less flattering comments, but most everyone working in the US corporate tax community would admit it has been a big deal and will have a material impact on the way the IRS and large corporations approach audits in the future.

The obvious question is whether other tax administrators will consider adopting IRS Schedule UTP, or some variation, for their own purposes. Clearly the Australian tax authorities are, and one expects that ultimately other tax administrators may as well. This Section briefly discusses why Schedule UTP was adopted (Section 2.2.1), and the major concepts of Schedule UTP (Section 2.2.2).

### 2.2.1 Reason for adoption

Like most decisions, there were many factors. However, from my vantage point as one of the main architects of Schedule UTP, the ones below were most important:

- Tax audits of large corporations are inefficient and often times ineffective - The IRS has estimated that it spends approximately 25% of its time in corporate audits identifying issues.<sup>19</sup> Furthermore, in many cases the IRS does not identify all the major issues. Schedule UTP is intended to more quickly identify issues and hopefully minimize situations where major issues are not discovered.
- Favorable experience with Compliance Assurance Program (CAP) program - Since 2005, the IRS has administered the voluntary CAP program which promises quicker audits in exchange for increased transparency by corporations.<sup>20</sup> The IRS believed the CAP program was successful, but the program (i) required a significant commitment of IRS resources, and (ii) needed corporations to voluntarily participate. Thus, Schedule UTP is a way of improving transparency for thousands of large corporations without (i) the need for corporations voluntarily agreeing to participate, and (ii) a massive commitment of IRS resources to the labor intensive CAP program.
- FIN 48 was adopted<sup>21</sup> - Schedule UTP requires corporations to disclose tax issues for which a reserve was recorded in audited financial statements. Prior

<sup>17</sup> For a very comprehensive discussion of the background surrounding schedule UTP, see J. Richard (Dick) Harvey, Jr., *Schedule UTP: An Insider's Summary of the Background, Key Concepts, and Major Issues*, DePaul Business and Commerce Law Journal (Spring 2008) also available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1782951](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1782951).

<sup>18</sup> Mary Lou Fahey, *Transparency, Trust, and TEI*, 61 *Tax Executive* 369, 370 (2010), and also direct discussion by the author with former Commissioner Lawrence Gibbs, now with Miller Chevalier

<sup>19</sup> See IRS Commissioner Shulman speech to New York State Bar Association on Jan. 26, 2010 announcing Schedule UTP concept. Speech available at <http://www.irs.gov/newsroom/article/0,,id=218705,00.html>

<sup>20</sup> As of February 2012 there are approximately 150 taxpayers in the CAP program.

<sup>21</sup> Issued by the Financial Accounting Standards Board in June 2006 and subsequently incorporated into ASC 740.

to FIN 48, it was possible for a business preparing its audited financial statements under US Generally Accepted Accounting Principles to record so-called “aggregate tax reserves” (i.e., one reserve covering a number of issues, or possibly even an entire tax year or audit cycle). Given FIN 48 requires the tax reserve analysis to be done on an issue by issue basis, its adoption in 2006 made it easier to establish a one-to-one relationship between a tax reserve and a tax issue and thus helped pave the way for Schedule UTP.<sup>22</sup>

- Litigation surrounding Tax Accrual Workpapers (TAWs) - Although the composition of TAWs varies from case to case, they generally include both (i) a description of each of the taxpayer’s material tax issues, and (ii) the tax reserve recorded for each issue. In some cases, TAWs may also include tax opinions/memorandums.

Based on various court cases,<sup>23</sup> some believed the IRS was entitled to a business’s complete set of TAWs. Others, usually corporations and their tax advisors, did not agree with this conclusion. When combined with Announcement 2010-76, the issuance of Schedule UTP could be viewed as a compromise whereby the IRS generally agrees to forgo the pursuit of tax reserves and tax opinions in exchange for a description of the tax issue.<sup>24</sup>

Given the above background, the IRS made a decision to pursue Schedule UTP. The decision primarily resulted from the IRS’s need to improve the efficiency and effectiveness of all large, corporate audits by obtaining enhanced transparency. In addition, the IRS was having favorable experiences with the CAP program, but expansion of that program to all large, corporations was not practicable.

For some, the decision to pursue Schedule UTP coupled with Announcement 2010-76 may also have been partially motivated by a desire to reduce the tension surrounding TAWs.<sup>25</sup> Finally, rather than attempting to develop a new standard for disclosure, the issuance of FIN 48 allowed the IRS to leverage the work done by corporations when preparing their audited financial statements.

### 2.2.2 Major concepts

The two major concepts surrounding Schedule UTP are:

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See <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175822209924&blobheader=application%2Fpdf>.

<sup>22</sup> See Section 3.2.2 for a discussion of IFRS and the potential for aggregate reserves.

<sup>23</sup> For example: *Arthur Young*, 465 U.S. 805 (1984) and *United States v. Textron, Inc.*, 560 F.3d 513 (1st Cir. August 2009). However, these were specific taxpayer cases, as opposed to a broad based request to all large corporations to provide TAWs.

<sup>24</sup> See IRS Announcement 2010-76, 2010-41 I.R.B. 432 (Sept. 24, 2010) that further enhanced the IRS’s policy of restraint by stating the IRS would not pursue TAWs that are “otherwise privileged”, but for disclosure to the taxpayer’s external auditor. Nevertheless, the IRS still has the ability to pursue tax reserves and tax opinions in certain cases (e.g., when there is a listed transaction or the documents are not “otherwise privileged”).

<sup>25</sup> The effort to reduce tension may have been partially successful. Per a quote attributed to Eli Dicker, Tax Counsel for Tax Executives Institute, “at least the temperature has been dialed down a bit”. See Jeremiah coder, UTP Guidance A High Priority, *Wilkins Says*, 129 Tax Notes 165 (Nov. 11, 2010).

- Criteria for disclosure - Large corporations are required to disclose a concise description on their tax return of tax positions for which they have either (i) recorded a reserve in audited financial statements; or (ii) not recorded a reserve and in reaching this conclusion it was assumed there was a greater than 50% probability of litigation (so-called “expect-to-litigate” provision). Thus, the criteria for Schedule UTP disclosure piggy-back’s on decisions made in the audited financial statements.

The expect-to-litigate provision was included because it is possible to avoid recording a reserve under FIN 48 in cases where the taxpayer expects litigation, but believes it has a greater than 50% probability of winning such litigation. Given the corporation is expecting litigation, the IRS concluded the issue must be contentious and therefore disclosure is appropriate.

- Concise description - A concise description is defined as a “description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue”.<sup>26</sup> It is generally expected the description will be approximately 2-5 sentences long.

The preliminary instructions to Schedule UTP also required disclosure of “the rationale for the position and the reason for determining the position are uncertain”. Several commentators questioned whether such disclosure is needed and suggested it could possibly violate a corporation’s privilege and work product protection.<sup>27</sup> In reaction to these comments, the IRS modified the instructions to remove the questioned language.

Other noteworthy Schedule UTP concepts include requirements to (i) identify tax positions that comprise more than 10% of the aggregate tax reserve for issues disclosed on Schedule UTP (i.e., so-called “major tax positions”), (ii) rank reserves from the largest to the smallest, and (iii) disclose whether the tax position is attributable to a permanent or temporary difference.

### 3. GLOBAL IMPLICATIONS

This section discusses selected global implications of FATCA and Schedule UTP. For example: Does the US need multilateral action to accomplish its goals with respect to either FATCA or Schedule UTP, and if so, what form might such action take? Will these unilateral transparency approaches adopted by the US spread to the rest of the world?

In summary, FATCA likely requires multilateral action to be successful, but it is far from clear whether such action will occur. In the case of Schedule UTP, multilateral action is not needed, but it is entirely possible several other countries might adopt the

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<sup>26</sup> See 2011 Schedule UTP instructions, Part III at <http://www.irs.gov/pub/irs-pdf/i1120utp.pdf>.

<sup>27</sup> For example, see Tax Executives Institute comments at 2010 TNT 104-67 (May 28, 2010) and American Bar Association comments at 2010 TNT 104-66 (May 28, 2010).



principles of Schedule UTP. Thus, like many things in life, when you don't need something it is often easier to obtain; but when you do need it (e.g., FATCA), it can be very difficult. Fortunately, a multilateral FATCA system can be designed to accommodate different approaches, and therefore there is hope countries can agree on creating such a system.

### 3.1 Foreign Account Tax Compliance Act (FATCA)

Since FATCA was a bold, unilateral action by the US impacting global financial institutions and capital flows, there are many potential global implications. This Section 3.1 will discuss the potential need for multilateral cooperation among governments in order to (i) successfully implement FATCA within the US, and (ii) potentially extend FATCA to other countries around the world. Key design issues surrounding a multilateral FATCA regime will also be discussed in Section 3.1.3.

#### 3.1.1 Key US implementations issues

Although there are many issues surrounding FATCA, the key issues surrounding the long-term success of FATCA from a US perspective are:

- Local country law restrictions on P-FFIs - These restrictions include laws that prevent foreign financial institutions (FFIs) from (i) closing existing customer accounts, and (ii) disclosing customer information to the IRS. The first issue was recognized as FATCA was being drafted and is what led to the "recalcitrant customer" provision in FATCA.<sup>28</sup> However, it was understood by some drafters that recalcitrant customers could not be allowed to exist indefinitely and a multilateral solution might be needed.

The second issue was also recognized during drafting, but given that FFIs had previously figured out a way to report information to the IRS as part of the QI system, it was not presumed to be a serious problem. Rather, it was assumed US customers could waive their right to any sort of disclosure restrictions. Subsequent to the enactment of FATCA, this second issue has become a more serious concern.

- Assuring adequate customer due diligence is done by P-FFIs and their affiliates – As briefly discussed in Section 2.1.3, FATCA unilaterally attempts to force participating FFIs (P-FFIs) and their affiliates to perform detailed due diligence on their entire customer base. This has led some to ask: Is it fair, or practical, to request that a FFI with millions of customers perform detailed customer due diligence on its entire customer base (including affiliates) in order to discover a few US customers?
- Reducing investment options available to offshore US tax cheats – Given a dedicated US tax cheat can avoid FATCA by investing in non-US assets with

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<sup>28</sup> Internal Revenue Code 1471(d)(6).

a NP-FFI, a key goal of the US tax authorities going forward should be to limit the investment opportunities for US tax cheats.

There are two key variables surrounding investment options for a US tax cheat: (i) the number and quality of financial institutions to invest with, and (ii) the range of non-US assets available to invest in. If ultimately US tax cheats are relegated to investing in very small, disreputable financial institutions or the assets available to invest in are severely limited, offshore tax evasion should be greatly reduced. If both occur,<sup>29</sup> offshore tax evasion should be effectively eliminated.

There are two basic approaches the US could use to address these key issues:

- Unilateral Action - The US could attempt unilateral adoption of FATCA with the hope the US investment market is sufficiently large that substantially all FFIs will need to become P-FFIs, and thus foreign governments will change local laws to accommodate FATCA's reporting obligation. Although this is possible, it is unlikely. For example, even if P-FFIs and their affiliates perform adequate due diligence, all a US tax cheat needs to do is find one reasonably reputable NP-FFI and invest in non-US assets with such NP-FFI. Given there are likely to be reasonably reputable FFIs that decide to be NP-FFIs, this is a real concern.
- Multilateral Action - Alternatively, the US could pursue multilateral action to help address the key issues. Multilateral action could take many forms, including:
  - Bilateral agreements to address local country restrictions on closing accounts and reporting information to the IRS
  - Bilateral, or multilateral agreements, surrounding uniform customer due diligence procedures
  - Full fledged multilateral system that comprehensively addresses all issues, including the narrowing of investment options for tax cheats.

In order to obtain multilateral action, the US could work through the OECD, but such an effort could take many years to accomplish.<sup>30</sup> One alternative is for the US to approach other major countries individually about jointly addressing offshore accounts.

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<sup>29</sup> Tax cheats are relegated to investing in very small, disreputable financial institutions, and the assets available to invest in are severely limited.

<sup>30</sup> For example, the OECD's Treaty Relief and Compliance Enhancement (TRACE) project started in 2006. See [http://www.oecd.org/document/15/0,3746,en\\_2649\\_33747\\_45704847\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/15/0,3746,en_2649_33747_45704847_1_1_1_1,00.html).

Based upon the joint statement by 6 countries (US, France, Germany, Italy, Spain, and the UK) on February 8, 2012<sup>31</sup>, it appears the US has been approaching individual countries. At a minimum, the US is pursuing a solution to the various local law restrictions on P-FFIs reporting information directly to the IRS. However, based on the last sentence of the joint statement (i.e., section B.4.a) it appears the US's goals may be broader (i.e., a full fledged multilateral FATCA system). The last sentence states:

“Commit to working with other FATCA partners, the OECD, and where appropriate the EU, on adapting FATCA in the medium term to a common model for automatic exchange of information, including the development of reporting and due diligence standards.”

The remainder of the FATCA section of this article will assume the US and other countries are pursuing a broad global solution to the offshore account problem being faced by many “residence” countries, as opposed to just trying to work around various local country restrictions surrounding FATCA. Section 3.1.2 will discuss the potential benefits of a multilateral system, while Section 3.1.3 will focus on key design issues.

### ***3.1.2 Benefits of a Multilateral FATCA system***

Before discussing some of the key design issues surrounding a multilateral system, it may be helpful to explain the potential benefits of a multilateral FATCA system by illustrating what would happen if another country joined with the US in implementing FATCA as it is currently designed.<sup>32</sup>

Assume Country A decided to join the US in its FATCA system. In such case, the following would result:

- If a foreign financial institution (FFI) wanted to invest in either the US or Country A, it would need to execute an agreement with both the US and Country A.<sup>33</sup>
- The FFI and its affiliates would agree to identify both US and Country A customers and report information on such customers to the appropriate residence country (i.e., the US or Country A).

The US would obtain three principle benefits:

- First, since an FFI and its affiliates would need to perform detailed due diligence on its customer base to identify both US and Country A customers,

<sup>31</sup> For joint statement, see <http://www.treasury.gov/press-center/press-releases/Documents/020712%20Treasury%20IRS%20FATCA%20Joint%20Statement.pdf>.

<sup>32</sup> FACTA focuses on P-FFIs reporting directly to their customer's country of residence, and imposes a 30% withholding tax penalty on FFIs for not participating. See Section 3.1.3 for discussion of other design options.

<sup>33</sup> There could be one multilateral P-FFI agreement with both countries, or there could be separate bilateral agreements.

it would mitigate some of the criticism currently applicable to FATCA (i.e., a unilateral approach requiring FFIs to perform an unreasonable amount of due diligence to identify the proverbial needle in the haystack – a US customer).

- Second, for an FFI deciding whether to participate in FATCA, they would effectively have to make a decision to avoid the financial markets of both the US and Country A. This is obviously a tougher decision than just boycotting the US.
- And third, for a US tax cheat the investment opportunities would be reduced through a reduction in available (i) NP-FFIs, and (ii) asset classes (i.e., US and Country A assets would no longer be available).

Country A would also receive substantial benefits for joining with the US. Specifically, it could leverage the desire of financial institutions (FIs) to do business in the US. Said differently, if Country A tried to implement FATCA on its own, it is highly likely a substantial number of FIs would boycott Country A's stand-alone FATCA system. But if Country A joins-up with the US, it will be substantially more difficult for a FI to boycott both the US and Country A. Thus, even though the US would clearly benefit from Country A's participation, practically the potential benefits to Country A could be even greater.

Although it would be ideal if all countries in the world agreed to join the US's FATCA system, in reality, the US likely only needs several other major countries to participate in a multilateral FATCA regime to mitigate the major issues being raised with the US's unilateral adoption. Plus, as each additional country joins in a multilateral FATCA system, the number of investment opportunities available to a US tax cheat continue to dwindle (i.e., both NP-FFIs and asset classes are reduced).

### ***3.1.3 Key design issues of a multilateral FATCA system***

Assuming there is general agreement among participating countries surrounding customer due diligence procedures that include all affiliates of participating foreign financial institutions (P-FFIs), key design issues in structuring a multilateral system include:

- Should the system be based upon a reporting, withholding model, or hybrid model?
- Should P-FFIs report information directly to the customer's residence country, or report to the tax authorities of the source country who in turn would exchange information with the customer's country of residence?<sup>34</sup>

<sup>34</sup> Note the same conceptual question could also arise in a withholding model (i.e., should the P-FFI withhold and remit directly to the residence country, or first remit to the source country who in turn would remit to the residence country). This article assumes withholding, if applicable, will be routed through the source country to the residence country.

- Should countries or financial institutions be the focus of the system, and what is the appropriate penalty for not participating in the system?

Each of these design issues will be discussed below.

### 3.1.3.1 Reporting vs. withholding vs. hybrid model?

Before embarking on a discussion of the possibility of incorporating both a reporting model and a withholding model into a full fledged multilateral system, I want to make it explicitly clear that I have a very strong preference for a reporting model. I agree with the conclusion reached by Itai Grinberg in his recent paper<sup>35</sup> that a reporting model is clearly superior to a withholding model. However, I am also a realist and understand that recent tentative withholding agreements between Switzerland and the UK and Germany could make it difficult to implement a comprehensive global reporting model.<sup>36</sup> Thus, this discussion is intended to provide a potential alternative in the event a global reporting model is not possible.

Most tax authorities prefer a reporting model because it is substantially more difficult for a tax cheat to avoid paying taxes on both the principal deposited in an offshore account, and the investment income earned on the account.<sup>37</sup> Bank secrecy jurisdictions have a strong preference for a withholding model so as to protect the identity of their customers. The recent tentative withholding agreements involving Switzerland are examples of what can result from the tension between these opposing views.

Having reviewed the public information available on these two withholding agreements, my main objection to these agreements is that they do not adequately address the possibility of new money flowing into Swiss accounts in the future.<sup>38</sup> The agreements seem to assume that the only potential future tax evasion surrounds investment income on the existing account balance. It is entirely possible that a tax cheat could prospectively use a Swiss bank account to avoid tax on new money contributed to the account. This possibility appears to be a serious deficiency in these agreements and should be cause for major alarm by tax administrators around the world.

One possible response by global tax policy makers to this deficiency could be to not consider future withholding agreements and only pursue reporting agreements. If this is the result and a comprehensive multilateral reporting model can be adopted, I am all for it. However, if a comprehensive reporting model is not possible, an alternative is

<sup>35</sup> See working paper by Itai Grinberg, *Beyond FATCA: An Evolutionary Moment for the International Tax System* (January 27, 2012) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1996752](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1996752).

<sup>36</sup> The German agreement was signed Sept. 21, 2011 and the UK agreement was signed Oct. 6, 2011. Both provide for the possibility of imposing withholding, rather than reporting, with respect to existing account balances. In addition, prospectively both only provide for withholding on certain income.

<sup>37</sup> In addition, transparency makes it more difficult for a tax cheat to claim non-tax benefits (e.g., social security or other welfare type payments based on income levels).

<sup>38</sup> This is somewhat surprising since the issue of tax evasion on the existing principal was addressed through the withholding agreement.

to allow certain countries (e.g., Switzerland) to prospectively participate in a multilateral FATCA arrangement if they agree to what I will refer to as a “punitive withholding model”. The key design features of a punitive withholding model should include:

- Withholding on all future income and new money<sup>39</sup> - The imposition of withholding tax on new money is crucial to preventing tax cheats from using offshore accounts to avoid tax on the new money contributed to the account.<sup>40</sup> In addition, the definition of income should be relatively broad so tax cheats could not structure investments to avoid withholding.
- High Withholding Tax Rates - Rates should be equal to approximately the highest tax rate of tax in the customer’s residence country. A decision would have to be made as to whether a P-FFI applied different withholding rates to different classes of income, or whether one high rate was applied to all income. Multiple classes of income could greatly complicate a P-FFI’s withholding calculations because of the line drawing required. Thus, within a withholding model, it may be preferable to have one class of income for each residence country with a high tax rate.
- Opt out option - Because of the potential for over taxation, or even double taxation<sup>41</sup>, a “punitive withholding model” should allow a customer to opt out of the withholding model into a reporting model on a customer by customer basis. One would expect that substantially all honest taxpayers would elect this option.

In summary, if necessary, a global hybrid FATCA system could be developed that allows certain bank secrecy countries to participate through a punitive withholding model, while other countries participated through a reporting model. Although not as optimal as a comprehensive reporting model, it could be a second best option.

If bank secrecy countries like Switzerland refuse to agree to a punitive withholding model as outlined above, it suggests they are clearly interested in continuing their efforts to assist tax cheats. In such case the rest of the world should aggressively pursue a global reporting model that severely penalizes countries and FIs for not participating. The end result is that such countries and FIs would hopefully become pariahs within the global financial system.

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<sup>39</sup> It is assumed that any countries participating will have entered into a comprehensive withholding arrangement to address past deposits and investment income (i.e., similar to the UK and German agreements with Switzerland).

<sup>40</sup> In order to address the potential duplication of tax that could result from transfers of money between accounts, transfers within the country or from a country that is part of the multilateral FATCA system could be exempted from the withholding tax.

<sup>41</sup> For example, on transfers of amounts previously subject to tax.

### 3.1.3.2 Information flow in a reporting model?

Assuming a reporting model is adopted to some degree, one key question is whether reporting should be (i) direct from the P-FFI to the customer's residence country, or (ii) from the P-FFI to the source country that in turn exchanges the information with the customer's residence country. FATCA is designed to require the first alternative, while the TRACE project and the EU Savings Directive are designed to use the second.

In the abstract, I prefer the reporting model in FATCA because it eliminates the middleman and the possibility of more mistakes. However, given various issues surrounding local law, the alternative reporting model is acceptable and is the model the US appears to be pursuing with the 5 countries that it recently issued the joint statement surrounding FATCA.<sup>42</sup>

Despite the direction the US is heading with these 5 countries and possibly others, it is likely the US will not agree to FATCA information exchange agreements with all countries. In this case, it would appear FFIs located in countries that do not reach agreement with the US will either (i) agree to become a P-FFI and report directly to the US, or (ii) decide to not become a P-FFI. Presumably a similar scenario could develop in a full-fledge multilateral FATCA system whereby certain countries agree to participate, and others do not. In such case, a decision will need to be made whether individual FFIs in countries not participating, could still nevertheless participate in a multilateral system by agreeing to report directly to their customer's residence country. See Section 3.1.3.3 immediately below for additional discussion.

### 3.1.3.3 Should focus be on countries, FIs, or some combination?

FATCA focuses on financial institutions (FIs) rather than countries. Said differently, FATCA attempts to "blacklist" FIs for not participating, as opposed to blacklisting countries. When one first thinks about a multilateral FATCA system, one's knee jerk reaction is that the focus will need to shift from blacklisting FIs to blacklisting countries. However, this is not necessarily the case. It is still very possible for a group of countries to decide the focus should still be on participating FIs, as opposed to participating countries.<sup>43</sup>

Alternatively, one could envision a system where the focus is on both countries and FIs. In determining which focus to use, a key question will be: What to do about FIs located in countries that are not part of the global FATCA system? Will they be automatically excluded from the system and therefore subject to penalties, or will they be allowed to participate if they agree to provide information or withholding directly to residence countries?

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<sup>42</sup> Joint statement issued on February 8, 2012 by US, France, Germany, Italy, Spain, and UK. Supra, note 31.

<sup>43</sup> For example, see the Example in Section 3.1.2. This example effectively assumes a multilateral FATCA system where countries get together and blacklist FIs, rather than countries.

Another key question is whether a country participating in a multilateral FATCA system requires 100% participation from FIs located in the country. If the answer is “no”, then it would seem a multilateral FATCA system would need to penalize non-participating FIs regardless of location.

In summary, because of the issues discussed above, it is not clear whether a multilateral FATCA system should penalize non-participating FIs, countries, or some hybrid. My suspicion is that in the early stages of a multilateral FATCA system it may need to be designed to penalize non-participating FIs, rather than all FIs in non-participating countries. The reason is that as a practical matter many countries may not have the ability to quickly join a multilateral FATCA system. Thus, for some transition period, one could imagine a system that allowed FIs in non-participating countries to join the multilateral FATCA system as long as they comply with the various customer due diligence and reporting obligations. However, after some suitable transition period, policy makers may want to effectively force all FIs within participating countries to join the system. Otherwise, there will always be NP-FIs willing and able to tailor their business to serve tax cheats.

#### ***3.1.3.4 Penalties to encourage participation?***

Although I am tempted at this point in the article to suggest non-participants be forced to watch a year’s worth of American reality TV shows as punishment, I will not. More realistic and appropriate penalties would include financial and/or operational penalties. When adopting FATCA, the US decided on a 30% withholding tax on payments to recalcitrant customers and NP-FFIs.

If there is a multilateral FATCA system, it would be helpful if the penalty for not participating was relatively uniform from country to country so as to avoid arbitrage opportunities. However, it is not crucial. Each country could determine its own penalty for not participating, but the key is making sure the penalty has significant teeth so as to encourage participation.

If enough countries participate in a multilateral FATCA system, it could be possible to totally blacklist a FI for not participating (i.e., wall the financial institution off from the rest of the world’s financial system). Although this may be a utopian solution for some, as a practical matter we are not likely to see this solution for many years, if ever. Thus, financial penalties with teeth are likely to be what is focused on in the foreseeable future.

#### ***3.1.4 FATCA Summary***

The US and foreign countries have made significant headway in the past several years addressing the use of offshore accounts to evade tax. The US has benefited from whistleblowers and two very successful offshore voluntary compliance initiatives. Other countries have also benefited from whistleblowers and voluntary compliance initiatives.

FATCA was enacted to help give the IRS the long-term tools necessary to better combat offshore tax evasion by US taxpayers, as opposed to relying on whistleblowers and voluntary compliance initiatives. However, since FATCA is a unilateral action by



the US, there are several major implementation issues surrounding FATCA, including how to (i) address conflicts between FATCA and various country's laws (e.g., restrictions on closing accounts and reporting customer information), (ii) require detailed customer due diligence procedures for a FFI and its affiliates, and (iii) minimize the offshore investment options for US tax cheats.

In the long-run, the US could greatly increase the probability of FATCA's success by continuing discussions with other major countries. The recent joint announcement<sup>44</sup> by the US and 5 countries is a step in the right direction, but much needs to be accomplished. The goal of such discussions should at a minimum be to agree on (i) solutions to address the local law issues, and (ii) common customer due diligence procedures. However, if FATCA is really going to be successful, other countries may need to join the US in administering a multilateral FATCA type system. Foreign countries would benefit greatly from using the US's leverage to effectively force FFIs to join the system. The US would benefit from reducing the number of investment options available to US tax cheats.

There are several key design features of a multilateral FATCA system that need to be addressed, including: (i) a reporting vs. withholding vs. hybrid model, (ii) information flow under a reporting model, (iii) whether penalties are imposed on countries or nonparticipating financial institutions, and (iv) the nature of any penalties. Fortunately, a successful multilateral FATCA system could incorporate multiple design features. For example, a system could be designed that primarily uses a reporting model, but accommodates a withholding model for certain countries very sensitive to bank secrecy issues. This article argues that if a hybrid model is selected, it should include a "punitive withholding model" designed to apply to both new money and investment income with such amounts being subject to a relatively high tax rate.

### 3.2 Schedule UTP

When considering the global implications of Schedule UTP, there are several topics to consider, including:

- Will other tax administrators (e.g., non-US countries) be interested in adopting some form of Schedule UTP?
- Is Schedule UTP compatible with International Financial Reporting Standards (IFRS)?<sup>45</sup>
- Is a successful US adoption of Schedule UTP dependent to any significant extent on obtaining multilateral cooperation?

In short, the answers to these questions are "yes"; "yes, but ... "; and "not really". The following sections will discuss these topics in more detail.

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<sup>44</sup> Supra, note 31.

<sup>45</sup> IFRS are issued by the International Accounting Standards Board (IASB). See [www.ifrs.org](http://www.ifrs.org).

### 3.2.1 Will other tax administrators adopt some form of Schedule UTP?<sup>46</sup>

Given Australia is already well on its way to adopting its own version of Schedule UTP (referred to as Schedule RTP),<sup>47</sup> and certain state tax administrators in the US are also considering their options,<sup>48</sup> it seems the answer is clearly “yes”. However, there are impediments that tax administrators need to consider, including:

- Is Schedule UTP compatible with IFRS? – see the discussion below in Section 3.2.2.
- Privilege and work product concerns - When considering Schedule UTP the IRS was very mindful of US law surrounding privilege and work product protections. As a result, the IRS decided to only require corporations to disclose a concise description<sup>49</sup> of an uncertain tax position, even though certain court cases gave the IRS access to even more sensitive taxpayer information.<sup>50</sup> For example, the IRS did not request disclosure on Schedule UTP of either a corporation’s (i) tax reserve for a specific issue, or (ii) related tax opinions or memoranda. In fact, concurrent with the finalization of Schedule UTP the IRS made it more difficult to obtain such information.<sup>51</sup>

Given privilege and work product laws will obviously vary by jurisdiction, tax administrators should carefully consider how such laws might impact consideration of a Schedule UTP approach.

- Other transparency efforts - Various countries have embraced the notion of transparency. For example, a few countries have a voluntary code of conduct<sup>52</sup> or some other form of enhanced relationship with large corporate taxpayers. If a country is considering a Schedule UTP approach, it should consider how Schedule UTP might interact with other transparency efforts. In its Schedule RTP, Australia requires disclosure if any of three scenarios are

<sup>46</sup> For a comprehensive discussion of various issues US state tax administrators should evaluate when considering Schedule UTP, see J. Richard (Dick) Harvey, Jr., *Should the States Piggyback on Federal Schedule UTP*, State Tax Notes, Aug. 1, 2011, p. 327. Several of these issues also could be applicable to foreign tax administrators. Also available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1903991](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1903991).

<sup>47</sup> See <http://www.ato.gov.au/content/00279408.htm>.

<sup>48</sup> For example, California and Alabama at [http://www.ftb.ca.gov/professionals/taxnews/2010/December/Article\\_13.shtml](http://www.ftb.ca.gov/professionals/taxnews/2010/December/Article_13.shtml) and [http://www.alvarezandmarsal.com/en/global\\_services/tax/enewsletter/archives/DisplayEnewsletter.aspx?newsletter\\_id=375](http://www.alvarezandmarsal.com/en/global_services/tax/enewsletter/archives/DisplayEnewsletter.aspx?newsletter_id=375), Question 11.

<sup>49</sup> Defined as: “description of the relevant facts affecting the tax treatment of the position and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue”. *Supra*, note 26.

<sup>50</sup> For example: *Arthur Young*, 465 U.S. 805 (1984) and *United States v. Textron, Inc.*, 560 F.3d 513 (1st Cir. August 2009). However, these were specific taxpayer cases, as opposed to a broad based request to all large corporations to provide sensitive information.

<sup>51</sup> See IRS Announcement 2010-76, 2010-41 I.R.B. 432 (Sept. 24, 2010).

<sup>52</sup> See *A Framework for a Voluntary Code of Conduct for Banks and Revenue Bodies*, issued by the OECD Forum of Tax Administration in conjunction with its Istanbul meeting on September 15, 16, 2010.

present. Only one of these scenarios relates to the recording of a reserve. It would appear Australia decided to integrate a Schedule UTP approach with other indicia that it would like taxpayers to disclose.

In summary, one would expect tax administrators to be very interested in a Schedule UTP approach because it has the potential to target issues more quickly, and identify issues that could possibly be missed in an audit. However, at a minimum, tax administrators need to consider the above two issues<sup>53</sup> before rushing in to adopt a Schedule UTP approach.

### 3.2.2. *Is Schedule UTP compatible with IFRS?*

The key design feature of Schedule UTP is that a corporation must disclose tax positions for which a reserve has been recorded. Thus, in order for Schedule UTP to be workable, there needs to be a way to link a reserve with a specific tax position.

Prior to FIN 48<sup>54</sup> there was a wide variation in practice under US Generally Accepted Accounting Principles with some businesses recording reserves in the aggregate, rather than building-up reserves on a position by position basis.<sup>55</sup> When tax reserves are recorded in the aggregate it could be more difficult to determine whether a tax reserve has been recorded for a specific tax position. As a result, the requirement in FIN 48 to analyze each tax position separately was a key factor in the IRS's decision to adopt Schedule UTP.

Although a very high percentage of corporations filing US tax returns prepare their audited financial statements using FIN 48, some do not - especially subsidiaries or branches of foreign corporations using IFRS. As the IRS was developing Schedule UTP it was aware that IFRS was "silent on how to treat any uncertainty relating to amounts submitted to the tax authorities".<sup>56</sup> The IRS was concerned some corporations using IFRS may record aggregate reserves and therefore argue Schedule UTP would be inapplicable. The IRS took some solace in the IFRS exposure draft issued by the IASB in March 2009 that would have moved IFRS significantly closer to FIN 48.<sup>57</sup> However, by the time the IRS announced Schedule UTP in January of 2010<sup>58</sup>, the IASB had effectively shelved its exposure draft, especially the portion with respect to tax reserves.<sup>59</sup>

<sup>53</sup> For other issues, see *Supra*, note 46.

<sup>54</sup> *Supra*, note 21.

<sup>55</sup> Although the US SEC actively discouraged the recording of general reserves, the practice survived to some extent for public companies, and was even more prevalent for private companies that were not subject to SEC oversight.

<sup>56</sup> See paragraph BC 58 in Basis for Conclusions, IASB Exposure Draft ED/2009/2 (March 2009), available at <http://www.ifrs.org/NR/rdonlyres/A119DC06-B150-49FF-B60B-88CD8ED5FB20/0/EDIncomeTaxesBC.pdf>.

<sup>57</sup> See IASB Exposure Draft ED/2009/2 (March 2009), available at <http://www.ifrs.org/NR/rdonlyres/8A6D0AC9-B6BE-4B87-BD02-B058B5F12148/0/EDIncomeTaxesStandard.pdf>.

<sup>58</sup> See Announcement 2010-9, 2010-7 I.R.B. 408, and IRS Commissioner Shulman speech to New York State Bar Association on Jan. 26, 2010 at <http://www.irs.gov/newsroom/article/0,,id=218705,00.html>.

<sup>59</sup> The IASB decided to significantly narrow the scope of its income tax project and thus its consideration of tax reserves has effectively been delayed. See

Despite the IASB's inaction, the IRS decided to move forward with Schedule UTP because most corporations filing US tax returns use FIN 48; but it provided special rules for corporations recording reserves on an aggregate basis. The Schedule UTP instructions are less than clear, but generally instruct the corporation to apply a hypothetical FIN 48 unit of account.<sup>60</sup>

What are the implications of the above discussion for the US and other countries?

- US - If the US ultimately adopts IFRS and there is no requirement in IFRS to determine tax reserves on an issue by issue basis, the US will likely need to rethink Schedule UTP. It could (i) expand on the "hypothetical FIN 48" approach currently in the Schedule UTP instructions, (ii) evaluate whether US corporations using IFRS will really attempt to record aggregate tax reserves to avoid Schedule UTP (especially given the SEC's views about general reserves), and/or (iii) lobby the FASB/IASB to adopt guidance requiring reserves to be determined on an issue by issue basis. Alternatively, the US could determine to abandon Schedule UTP.
- Other countries - Given most of the rest of the world is already using IFRS, other countries will clearly need to face this aggregate reserve issue prior to adopting their version of Schedule UTP. My personal suspicion is that most businesses using IFRS currently record reserves on an issue by issue basis, but given the opportunity to avoid tax return disclosure, many businesses may be willing to change to an aggregate reserve approach.

The good news for non-US tax administrators is that aggregate reserves should not be fatal to a Schedule UTP approach. Countries could adopt a "hypothetical FIN 48" approach, but this would seem unlikely.<sup>61</sup> Rather, one could imagine a foreign country adopting broad language that states something like "if a reserve is in any way connected to a specific tax issue", such tax issue needs to be disclosed. Even though a corporation may record reserves on an aggregate basis, the reserve needs to be supported by the existence of various tax uncertainties. If an aggregate reserve is in anyway based on a particular issue, such broad language should necessitate disclosure.

In summary, if a country (either foreign or the US) wants to adopt Schedule UTP in an IFRS world, they need to focus on the aggregate reserve issue. Fortunately, it seems plausible that countries (both foreign and the US) could tweak the language in Schedule UTP to satisfactorily address the concern surrounding aggregate reserves. Nevertheless, it would be preferable if IFRS explicitly required that tax reserves be recorded on an issue by issue basis.

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<http://www.ifrs.org/Current+Projects/IASB+Projects/Income+Taxes/Meeting+Summaries+and+Observer+Notes/IASB+November+2009.htm>.

<sup>60</sup> See Schedule UTP instructions surrounding "Unit of account" on page 3 of the 2011 instructions. Available at <http://www.irs.gov/pub/irs-pdf/i1120utp.pdf>.

<sup>61</sup> It was a stretch for the IRS to require a hypothetical determination on a method of accounting not used by a taxpayer, but at least the method of accounting in question is a method used in the US. Given that FIN 48 is little used in the rest of the world, it would seem more difficult for another tax administrator to insist on such hypothetical calculation.

### 3.2.3. Does the US need multilateral cooperation to successfully adopt Schedule UTP?

As discussed in Section 3.1, multilateral cooperation is likely to be very important in successfully implementing FATCA. This is not the case for Schedule UTP. Schedule UTP is a disclosure regime only applicable to businesses filing US corporate tax returns, and is therefore relatively self-contained to the US.

Two areas where multilateral cooperation could be of some minor benefit are:

- IFRS – As discussed in Section 3.2.2, it would be helpful if IFRS required businesses to record tax reserves on an issue by issue basis, rather than leaving open the possibility of recording a reserve on an aggregate basis. To the extent various countries put pressure on the IASB to issue more specific guidance, it might help the Schedule UTP approach, but it is not crucial. Plus, it is far from clear how the IASB might react to such multilateral pressure.
- Reserves recorded by related parties - Schedule UTP has a special rule that requires disclosure of a tax position if a corporation, or a related party, records a reserve for such tax position. This special rule was aimed primarily at US subsidiaries of foreign corporations where tax reserves are sometimes recorded on the foreign parent, rather than the US subsidiary.

Since the IRS was concerned the foreign parent may not share its tax reserve information with the US subsidiary, Schedule UTP provides that the US subsidiary may check a box indicating a related party (e.g., a foreign parent) has not shared its tax reserve information. This is a fact pattern where one could imagine the US may request assistance from a foreign tax administrator under information exchange agreements. Thus, some multilateral cooperation may be required.

In summary, although there is some minor multilateral action that might help the US successfully implement Schedule UTP, it is not crucial.

## 4. CONCLUSIONS

Although the US unilaterally adopted FATCA and Schedule UTP, both of these ground-breaking transparency initiatives are being studied by other country's tax administrators. For example, as of the date of this article,<sup>62</sup> the US and five countries have issued a joint announcement with respect to FATCA,<sup>63</sup> and Australia has announced it is adopting Schedule RTP that incorporates many of the concepts of Schedule UTP.<sup>64</sup>

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<sup>62</sup> February 23, 2012.

<sup>63</sup> Released on February 8, 2012. *Supra*, note 31.

<sup>64</sup> *Supra*, note 47.

The primary purpose of this article was to answer the following questions:

- Does the US need multilateral action to accomplish its goals with respect to either FATCA or Schedule UTP?
- If so, what are the key issues that need to be addressed to obtain multilateral action?
- Will these unilateral transparency approaches adopted by the US spread to the rest of the world?

In summary, the US likely needs multilateral action to successfully implement FATCA, but it does not for Schedule UTP. The recent joint announcement by the US and 5 other countries with respect to FATCA is the first step towards multilateral action, but it is only the beginning. Specific issues the US needs to address in order to make FATCA a success include:

- Conflicts between FATCA and various country's laws (e.g., restrictions on closing accounts and reporting customer information),
- The need for common detailed customer due diligence procedures for financial institutions and their affiliates, and
- A further reduction in the offshore investment options for US tax cheats.

In the long-run, the US could greatly increase the probability of FATCA's success by continuing discussions with other major countries. The goal of such discussions should at a minimum be to agree on (i) solutions to address the local law issues, and (ii) common customer due diligence procedures. However, if FATCA is really going to be successful, other countries may need to join the US in administering a multilateral FATCA type system.

It is important to note that foreign countries would benefit greatly from using the US's leverage to effectively force financial institutions to join the system. The US would also benefit from reducing the number of investment options available to tax cheats. There are several key design features of a multilateral FATCA system that need to be addressed, including:

- Reporting vs. withholding vs. hybrid model
- Information flow under a reporting model
- Whether penalties are imposed on countries or nonparticipating financial institutions
- The nature of any penalties.

Fortunately, a successful multilateral FATCA system could incorporate multiple design features. For example, even though a comprehensive reporting model would clearly be preferable, a multilateral system could be designed that primarily uses a reporting model, but also accommodates a withholding model for certain countries very sensitive to bank secrecy issues. This article concludes that if a withholding option is included, it should be a "punitive withholding model" and apply to both new

money and investment income. The failure to apply withholding tax to new money is a major deficiency of the recent tentative withholding agreements between Switzerland and the UK/Germany.

Unlike FATCA, Schedule UTP does not require multilateral cooperation for successful adoption by the US or other countries. Nevertheless there are some global implications. The most notable is that Schedule UTP requires a corporation to link a tax reserve with a specific tax issue. If tax reserves are recorded on an aggregate basis (i.e., by groups of issues, or by tax year, or even by audit cycle), the link between a tax reserve and a specific tax issue may be more difficult to establish. This issue was resolved in US GAAP through the issuance of FIN 48/ASC 740. Nevertheless, the US may need to confront the issue again if it adopts IFRS and IFRS continues to have no requirement to record tax reserves on an issue by issue basis. Since most of the world uses IFRS, or is in the process of switching to IFRS, this aggregate reserve issue will also need to be addressed by non-US tax administrators considering a Schedule UTP approach.

In conclusion, FATCA and Schedule UTP are two unilateral US initiatives that have the potential to greatly increase transparency in two very difficult areas of tax administration: offshore accounts and complex corporate tax returns. The joint FATCA statement is a step in the right direction, and Australia has already adopted a version of Schedule UTP. However, there is much still to be done with multilateral cooperation potentially being crucial to FATCA's long-term success in the US. Other countries could substantially benefit from joining the US in a worldwide FATCA system.

# Navigating a transition in U.S. tax administration

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## 1. INTRODUCTION

Judicial review is often an afterthought in many conversations about tax compliance and tax administration. To some extent, this lack of attention is entirely appropriate. Most taxpayers prefer to comply with rather than challenge the taxing authorities' interpretation of the law. Likewise, the goal of tax administrators is to encourage and facilitate voluntary tax compliance. For that matter, few enforcement matters lead to actual litigation. Hence, most tax professionals never see the inside of a courtroom.

Nevertheless, judicial review ought to be a consideration in evaluating tax risk. For one thing, despite best efforts by legislators and regulators, statutory and regulatory language is often ambiguous. Reasonable people will sometimes disagree over the proper application of the law to a particular set of facts. Taxpayers may believe they are complying with the law, only to find that tax administrators disagree. When these disputes arise, sometimes the government wins, and sometimes the taxpayer does.

But disagreements regarding the substantive meaning of the tax laws are only one part of the risk assessment equation. Most assessments of tax risk simply assume a fair degree of consistency both in how the government adopts regulations and other pronouncements interpreting the tax laws and also in how the courts evaluate disagreements between taxpayers and the government. For tax professionals in the United States, such consistency is now in question.

After years of ignoring changes in administrative law doctrine, judicial review of tax administration efforts in the United States is undergoing a period of transition as a result of three recent, high-profile cases. Early in 2011, in *Mayo Foundation for Medical Education and Research v. United States*<sup>1</sup> the United States Supreme Court held that general authority Treasury regulations promulgated using the public notice and comment procedures imposed by the Administrative Procedure Act (APA) are eligible for the highly deferential standard of judicial review articulated in *Chevron*

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<sup>1</sup> 131 S.Ct. 704 (2011).



U.S.A. Inc. v. Natural Resources Defense Council, Inc.<sup>2</sup> A few months later, in *Cohen v. United States*, the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit), sitting en banc, reached a series of conclusions regarding the interaction of the Internal Revenue Code (IRC) and the APA that allowed a taxpayer challenge to the procedural validity of an IRS Notice to proceed on the merits irrespective of IRC limitations on the justiciability of taxpayer claims.<sup>3</sup> Finally, the Supreme Court recently issued a decision in *United States v. Home Concrete & Supply, LLC*, invalidating a Treasury regulation on statutory grounds, but leaving untouched a budding disagreement among the lower courts regarding the procedures by which Treasury adopts many of its regulations.<sup>4</sup>

Collectively, these cases have tremendous potential to alter both judicial review of Department of Treasury (Treasury) and Internal Revenue Service (IRS) interpretations of the U.S. tax laws and also the procedures that Treasury and the IRS utilize in promulgating tax regulations and rulings. Indeed, the IRS has already modified Internal Revenue Manual provisions governing its employees in response to the *Mayo* decision. To a great extent, however, these questions raise as many or more questions as they answer, substantially complicating informed risk analysis. The purpose of this essay is to summarize the *Mayo*, *Cohen*, and *Home Concrete* cases and consider their implications for U.S. tax administration and for tax professionals seeking to assess tax risk in the midst of the questions these cases raise.

## 2. THREE KEY CASES

### 2.1 *Mayo Foundation for Medical Education and Research v. United States*

The Treasury Department promulgates regulations by exercising one of two types of delegated power from Congress. In various provisions of the Internal Revenue Code, Congress has authorized Treasury to adopt rules and regulations for the purpose of resolving specific issues.<sup>5</sup> Separately, IRC § 7805(a) grants Treasury the general power to develop “all needful rules and regulations for the enforcement of” the IRC.<sup>6</sup>

The *Mayo* case concerned a Treasury Department interpretation of IRC § 3121(b), which defines “employment” for purposes of taxes assessed on wages under the Federal Insurance Contributions Act and specifically excludes services performed by

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<sup>2</sup> 467 U.S. 837 (1984).

<sup>3</sup> 650 F.3d 717 (D.C. Cir. 2011) (en banc).

<sup>4</sup> 132 S.Ct. 1836 (2012).

<sup>5</sup> See, e.g., IRC § 482 (giving Treasury the power to allocate income among businesses with common ownership as “necessary to prevent evasion of taxes or clearly reflect [their] income”); IRC § 1502 (authorizing the regulations that Treasury “deem[s] necessary” for affiliated corporate groups to prepare and file consolidated income tax returns “in such manner as clearly to reflect” their tax liabilities and “to prevent avoidance” of the same). The New York State Bar Association Tax Section a few years ago wrote a helpful report in which they claimed and categorized more than 550 specific delegations of rulemaking authority in the IRC. See N.Y. State Bar Ass’n Tax Section, Report on Legislative Grants of Regulatory Authority 2–6 (Nov. 3, 2006), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1121Report.pdf>.

<sup>6</sup> 26 U.S.C. § 7805(a).

students who work for the academic institutions in which they are enrolled.<sup>7</sup> In 2004, Treasury exercised its general rulemaking authority under IRC § 7805(a) to adopt a regulation declaring that medical residents are not students, reversing a longstanding IRS interpretation and rejecting federal circuit court precedent reaching the opposite conclusion.<sup>8</sup> Institutions that withheld and paid the taxes unsuccessfully sought refunds and then promptly sued the government, challenging the validity of the regulation.

The standard of judicial review for most agency regulations derives from *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*<sup>9</sup> The Chevron standard instructs a reviewing court to ask first whether the statute being interpreted is clear, “for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.”<sup>10</sup> In evaluating statutory clarity, reviewing courts employ “traditional tools of statutory construction” as they have always done.<sup>11</sup> But where traditional interpretive methods fail to yield a conclusive sense of congressional intent, and the statute is susceptible of more than one reasonable construction, the Chevron standard recognizes the choice between competing alternatives to be a matter of policy preference instead of mere interpretation.<sup>12</sup> In such circumstances, expert agencies to which Congress has delegated administrative power are better situated to make policy choices than generalist courts.<sup>13</sup> Accordingly, under Chevron, if the reviewing court finds a statute to be ambiguous, then “the question for the court is whether the agency’s answer is based on a permissible construction of the statute.”<sup>14</sup> More recently, in *United States v. Mead Corp.*, the Supreme Court limited the scope of Chevron’s applicability to agency actions that carry “the force of law.”<sup>15</sup>

For years prior to *Mayo*, the courts and the tax community had debated whether or not the Chevron standard applied in evaluating general authority Treasury regulations.<sup>16</sup> Many tax lawyers, the United States Tax Court, and some federal circuit courts maintained that an arguably less deferential standard articulated prior to Chevron in the tax-specific case of *National Muffler Dealers Ass’n, Inc. v. United*

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<sup>7</sup> 26 U.S.C. § 3121(b)(10).

<sup>8</sup> See Treas. Reg. § 31.3121(b)(10)-2(d), (e) (Example 4); T.D. 9167, 69 Fed. Reg. 76404 (Dec. 21, 2004); see also, e.g., *Minnesota v. Apfel*, 151 F.3d 742, 743 (8th Cir. 1998) (holding that medical resident stipends were exempt under identical language concerning Social Security taxes); Internal Revenue Service, Treasury, *Notice of Proposed Rulemaking and Notice of Public Hearing; Student FICA Exception*, 69 Fed. Reg. 8604 (Feb. 25, 2004) (proposing regulatory language and acknowledging contrary decision in *Minnesota v. Apfel*).

<sup>9</sup> 467 U.S. 837 (1984).

<sup>10</sup> *Id.* at 842-43.

<sup>11</sup> *Id.* at 843, n.9.

<sup>12</sup> See *id.* at 843.

<sup>13</sup> See *id.* at 865-66; see also *United States v. Mead Corp.*, 533 U.S. 218, 226-227 (2001) (holding that Chevron only applies when Congress delegates the power to act with the force of law and the agency exercises that delegated power).

<sup>14</sup> *Chevron*, 467 U.S. at 843.

<sup>15</sup> 533 U.S. at 226-27.

<sup>16</sup> See, e.g., Kristin E. Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 Minn. L. Rev. 1537, 1556-59 (2006) (summarizing the disagreement among courts and legal scholars).

States,<sup>17</sup> applied instead.<sup>18</sup> Other circuits expressly adopted Chevron rather than National Muffler as the standard of review for general authority Treasury regulations.<sup>19</sup> Still other federal circuit courts wondered whether the Chevron and National Muffler standards were meaningfully different.<sup>20</sup> The Supreme Court's previous discussions of the issue were muddled and contradictory.<sup>21</sup> Finally, the Mayo case brought the issue squarely before the Supreme Court. The National Muffler standard expressly called for considering, among other factors, an interpretation's consistency and longevity—factors that weighted against Treasury's new regulation—while Chevron expressly recognizes the need to allow agencies to change their interpretive positions. Also, unlike in prior cases before the Court, briefing in Mayo by the parties and by dueling amici clearly raised and thoroughly addressed the question of Chevron versus National Muffler review.<sup>22</sup>

In upholding the regulation, an undivided Court unequivocally chose Chevron and rejected National Muffler as the standard of review for general authority Treasury regulations.<sup>23</sup> In reaching that decision, the Court offered several observations and conclusions, including that the Chevron and National Muffler standards “call for different analyses of an ambiguous statute”;<sup>24</sup> that National Muffler factors such as an agency's inconsistency or an interpretation's longevity or contemporaneity (or lack thereof) are not reasons for denying Chevron deference to a Treasury regulation;<sup>25</sup> that “[t]he principles underlying our decision in Chevron apply with full force in the tax context”;<sup>26</sup> and, finally, that “Chevron and Mead, rather than National Muffler ..., provide the appropriate framework for evaluating” the Treasury regulation at issue.<sup>27</sup> Furthermore, in considering the regulation at issue under the Chevron framework, and drawing further from earlier jurisprudence applying that standard, the Court rejected as irrelevant that Treasury had promulgated its regulation in response to litigation and in the face of a contrary lower court precedent.<sup>28</sup>

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<sup>17</sup> 440 U.S. 472, 477 (1979).

<sup>18</sup> See, e.g., *St. Jude Med., Inc. v. Comm'r*, 34 F.3d 1394, 1400, 1402 (8th Cir. 1994); *Snowa v. Comm'r*, 123 F.3d 190, 197 (4th Cir. 1997); *Snap-Drape Inc. v. Comm'r*, 98 F.3d 134, 197 (5th Cir. 1996); see also *Irving Salem et al., ABA Section on Taxation: Report of the Task Force on Judicial Deference*, 57 Tax Law. 717 (2004).

<sup>19</sup> See, e.g., *Swallows Holding, Ltd. v. Comm'r*, 515 F.3d 162 (3d Cir. 2008); *McNamee v. Dep't of Treasury*, 488 F.3d 100, 105 (2d Cir. 2007); *Peoples Fed. Sav. & Loan Ass'n of Sindy v. Comm'r*, 948 F.2d 289, 299, 304 (6th Cir. 1991).

<sup>20</sup> See, e.g., *Bankers Life & Cas. Co. v. United States*, 142 F.3d 973, 978-83 (7th Cir. 1998).

<sup>21</sup> See Kristin E. Hickman, *Agency-Specific Precedents: Rational Ignorance or Deliberate Strategy*, 89 Texas L. Rev. See Also 89, 107-08 (2011) (analyzing Supreme Court tax deference precedents).

<sup>22</sup> See Brief for Petitioners, *Mayo Found. for Med. Educ. & Research v. United States*, 131 S.Ct. 704 (2011) (No. 09-837); Brief of Amicus Curiae Professor Kristin E. Hickman in Support of Respondent, *Mayo Found. for Med. Educ. & Research v. United States*, 131 S.Ct. 704 (2011) (No. 09-837); Brief of Tax Professor Carlton M. Smith as Amicus Curiae in Support of the Petitioners, *Mayo Found. for Med. Educ. & Research v. United States*, 131 S.Ct. 704 (2011) (No. 09-837).

<sup>23</sup> See *Mayo*, 131 S. Ct. at 712-14.

<sup>24</sup> *Id.* at 712.

<sup>25</sup> *Id.* at 712-13.

<sup>26</sup> *Id.* at 713.

<sup>27</sup> *Id.* at 714.

<sup>28</sup> See *id.* at 712-13.

In the midst of this analysis, the Court also offered a short discussion of the relationship between tax administration and administrative law doctrine with potential implications beyond the standard of review question. First, the Court stated explicitly, “[W]e are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly ‘[r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action.’”<sup>29</sup> In making this statement, the Court quoted *Dickinson v. Zurko*, a non-tax (patent) case with an extensive discussion regarding Congress’s intent that the Administrative Procedure Act bring uniformity to the otherwise disparate field of federal administrative action.<sup>30</sup> The Court also cited *Skinner v. Mid-America Pipeline Co.*<sup>31</sup> for “declining to apply ‘a different and stricter nondelegation doctrine in cases where Congress delegates discretionary authority to the Executive under its taxing power.’”<sup>32</sup> Other turns of phrase within the *Mayo* Court’s analysis reflect a similar orientation toward reconciling the tax and non-tax contexts.

## 2.2 *Cohen v. United States*<sup>33</sup>

The D.C. Circuit’s subsequent en banc decision in *Cohen* was less immediately consequential but, consistent with the Supreme Court’s policy in *Mayo* of administrative law uniformity, represents a further shift in favor of bringing tax administration back in line with administrative law norms. The case grew from several challenges against an old telephone excise tax made defunct by changes in telephone technology and long-distance billing practices.<sup>34</sup> After several federal circuit courts rejected the IRS’s arguments in favor of the continued vitality of the tax,<sup>35</sup> the IRS adopted special refund procedures for the tax by issuing informal guidance, Notice 2006-50.<sup>36</sup>

The APA generally requires agency rules carrying the force and effect of law to be adopted through using procedures including public notice and opportunity for comment.<sup>37</sup> Consistent with its standard practice for informal guidance documents, in issuing Notice 2006-50, the IRS did not utilize APA notice-and-comment rulemaking procedures. Taxpayers who consider the IRS’s special refund procedures for the telephone excise tax to be fundamentally flawed challenged Notice 2006-50 on APA

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<sup>29</sup> *Id.* at 713.

<sup>30</sup> 527 U.S. 150, 154 (1999).

<sup>31</sup> 490 U.S. 212, 222-23 (1989).

<sup>32</sup> *Mayo*, 131 S. Ct. at 713.

<sup>33</sup> 650 F.3d 717 (D.C. Cir. 2011) (en banc).

<sup>34</sup> *See id.* at 719-20 (summarizing the history of the tax); *see also* 26 U.S.C. §§ 4251-54 (imposing the tax).

<sup>35</sup> *See, e.g.,* *Am. Bankers Ins. Group v. United States*, 408 F.3d 1328 (11th Cir. 2005); *Office Max, Inc. v. United States*, 428 F.3d 583 (6th Cir. 2005); *Nat’l R.R. Passenger Corp. v. United States*, 431 F.3d 374 (D.C. Cir. 2005).

<sup>36</sup> *See* IRS Notice 2006-50, 2006-1 C.B. 1141.

<sup>37</sup> *See* 5 U.S.C. § 553(b)-(c); *see also* *Chrysler Corp. v. Brown*, 441 U.S. 281, 301-03 (1979) (using “force and effect of law” language to describe agency rules subject to APA notice-and-comment rulemaking procedures).

procedural grounds, seeking notice and comment as the appropriate forum for requiring the IRS to address the alleged inadequacies.

The Supreme Court has interpreted the APA as establishing a presumption in favor of judicial review of final agency action.<sup>38</sup> Separately, IRC § 7421, also known as the Anti-Injunction Act, generally prohibits any lawsuit “for the purpose of restraining the assessment or collection of any tax” until either the IRS issues a notice of deficiency to a taxpayer or denies a taxpayer-requested refund.<sup>39</sup> Correspondingly, the Declaratory Judgment Act prevents courts from providing declaratory relief for controversies “with respect to Federal taxes.”<sup>40</sup> In a series of cases in the 1960s and 1970s, the Supreme Court interpreted these provisions as precluding judicial review of virtually all tax cases except for statutory deficiency or refund actions.<sup>41</sup> Although the Court has never interpreted the Anti-Injunction Act or the Declaratory Judgment Act as limiting judicial review of APA procedural challenges against Treasury regulations and IRS rulings to statutory deficiency or refund actions, a few lower courts interpreted the Court’s precedents as requiring that conclusion.<sup>42</sup>

In *Cohen*, however, after the district court dismissed the case for lack of jurisdiction, a divided three-judge panel of the D.C. Circuit reversed and remanded the case for consideration of the merits of the taxpayers’ APA procedural claims, holding that Notice 2006-50 was reviewable under the APA as final agency action.<sup>43</sup> Several months later, that court granted the government’s petition for review by the full court sitting en banc and requested briefing on several questions pertinent to interpreting the Anti-Injunction Act and the Declaratory Judgment Act as potential limitations on judicial review of the *Cohen* taxpayers’ case.<sup>44</sup> In summer 2011, a divided en banc court issued its decision, also in favor of the taxpayers, reaching several conclusions regarding the courts’ jurisdiction to consider APA procedural claims in the tax context.<sup>45</sup>

First, the court held that APA § 702 waives sovereign immunity for APA procedural challenges in the tax context, just as it does in other regulatory areas; there is no tax

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<sup>38</sup> See *Abbott Laboratories v. Gardner*, 387 U.S. 136 (1967).

<sup>39</sup> See 26 U.S.C. § 7421(a).

<sup>40</sup> 28 U.S.C. § 2201(a).

<sup>41</sup> See, e.g., *United States v. Am. Friends Serv. Comm.*, 419 U.S. 7, 8, 12 (1974) (per curiam); *Alexander v. “Ams. United” Inc.*, 416 U.S. 752, 756-57, 763 (1974); *Bob Jones Univ. v. Simon*, 416 U.S. 725, 727, 735-36 (1974); *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1, 5-6 (1962).

<sup>42</sup> See, e.g., *Stephenson v. Brady*, 927 F.3d 596, 1991 WL 22835, at \*2, \*4-5 (4th Cir. 1991) (per curiam) (unpublished table decision); *Reimer v. United States*, 919 F.2d 145, 1990 WL 186825, at \*1-3 (9th Cir. 1990) (unpublished table decision); cf. *Inv. Annuity, Inc. v. Blumenthal*, 609 F.2d 1, 8-9 (D.C. Cir. 1979) (reading the Anti-Injunction Act and the Declaratory Judgment Act as statutory limitations on pre-enforcement judicial review in the tax context, notwithstanding the APA presumption in favor thereof). But see *E. Ky. Welfare Rights Org. v. Simon*, 506 F.2d 1278, 1285-86 (D.C. Cir. 1974), vacated on other grounds, 426 U.S. 26 (1976) (concluding before vacatur that the Anti-Injunction Act, the Declaratory Judgment Act, and the APA do not operate to preclude judicial review of all pre-enforcement tax claims).

<sup>43</sup> See *Cohen v. United States*, 578 F.3d 1 (D.C. Cir. 2009), vacated in part, 599 F.3d 652 (D.C. Cir. 2010).

<sup>44</sup> See *Cohen v. United States*, 599 F.3d 652 (D.C. Cir. 2010).

<sup>45</sup> See *Cohen v. United States*, 650 F.3d 717 (D.C. Cir. 2011) (en banc).

exception from the APA.<sup>46</sup> Picking up the Supreme Court's admonition in *Mayo* in favor of administrative law uniformity, quoted elsewhere in the majority opinion, the court concluded that "[t]he IRS is not special in this regard; no exception exists shielding it—unlike the rest of the Federal Government—from suit under the APA."<sup>47</sup>

Next, the court held that the Anti-Injunction Act and the Declaratory Judgment Act do not bar judicial review of the taxpayers' APA procedural claim.<sup>48</sup> Citing and quoting extensively from *Hibbs v. Winn*, in which the Supreme Court interpreted a similar provision governing state taxation,<sup>49</sup> the court adopted a narrow, textualist interpretation of the Anti-Injunction Act's limitation on judicial review. According to the court, the Anti-Injunction Act's prohibition against suits to restrain "the assessment or collection of any tax" does not refer to a "single mechanism" that ultimately determines the amount of revenue the Treasury retains" and is not "synonymous with the entire plan of taxation."<sup>50</sup> Instead, "assessment" and "collection" are defined terms in the IRC: assessment represents "the trigger for levy and collection efforts," and collection is "the actual imposition of tax against a plaintiff."<sup>51</sup> The Cohen appellants' APA procedural claim did not concern the assessment or collection of taxes because "[t]he IRS previously assessed and collected the excise tax at issue"; rather, their suit was merely about the procedures under which the IRS will refund taxes that it has already collected.<sup>52</sup> Although the text of the Declaratory Judgment Act is arguably broader in its prohibition of declaratory relief in tax cases, the Cohen court held that the Declaratory Judgment Act is to be interpreted coterminously with the Anti-Injunction Act and not as a separate limitation on judicial review.<sup>53</sup>

While the government argued that interpreting the Anti-Injunction Act and the Declaratory Judgment Act in this way would open the floodgates for APA challenges against Treasury and IRS actions, those provisions are not the only potential limitations on judicial review of agency action, whether in the tax context or otherwise. In fact, the majority and dissenting opinions in *Cohen* considered several. Particularly where (as in the case of the Internal Revenue Code) a specific statute provides its own legal mechanisms for seeking judicial review, APA §§ 703 and 704 limit the availability of judicial review under the APA to cases in which the challenging parties otherwise lack an adequate legal remedy.<sup>54</sup> The dissenting judges in *Cohen* contended that statutory refund actions authorized by IRC § 7422 offered the appellants just such legal remedy.<sup>55</sup> The majority disagreed on the ground that the taxpayers' APA procedural challenge sought equitable relief rather than a tax refund

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<sup>46</sup> See *id.* at 723.

<sup>47</sup> *Id.*

<sup>48</sup> See *id.* at 724-27.

<sup>49</sup> See *Hibbs v. Winn*, 542 U.S. 88, 99-108 (2004) (interpreting 28 U.S.C. § 1341).

<sup>50</sup> *Id.* at 726.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 725-26.

<sup>53</sup> See *id.* at 727-31.

<sup>54</sup> See 5 U.S.C. § 703 (providing form and venue for judicial review of agency action where "no special statutory review proceeding" is otherwise available); 5 U.S.C. § 704 (authorizing judicial review of final agency action "for which there is no other adequate remedy in a court").

<sup>55</sup> See *Cohen*, 650 F.3d at 738-41 (Kavanaugh, J. dissenting).

(even if a refund was their ultimate goal), and IRC § 7422 does not offer that remedy.<sup>56</sup> Both opinions additionally discuss the doctrines of ripeness and exhaustion at some length, while standing and finality limitations make brief appearances as well. In analyzing these different barriers to judicial review, the Cohen majority construed its conclusions very narrowly. Indeed, the court labeled the case before it as “*sui generis*” and either assumed or stated outright that judicial review of many if not most APA procedural challenges to Treasury and IRS actions will be limited by one or more of these obstacles.<sup>57</sup> Hence, while the taxpayers’ APA claim may not be the only one eligible for judicial review outside of the statutory mechanisms provided by the IRC, just how many others will be able to run this gauntlet of limitations is unclear. Regardless, the Cohen court’s insistence upon treating the taxpayers’ APA challenge as such, and its interpretation of the Anti-Injunction Act and the Declaratory Judgment Act as interacting with rather than wholly displacing the APA, represent bold statements about tax as part of and not separate from administrative law more generally.

One final point of interest from Cohen concerns the court’s statement regarding the finality of Notice 2006-50. The initial panel decision in the case determined that Notice 2006-50 represents final agency action because it determines taxpayer rights and obligations and binds the IRS.<sup>58</sup> In discussing other issues concerning the justiciability of the taxpayers’ APA claim, the en banc court reiterated that holding.<sup>59</sup> The IRS typically does not employ APA notice-and-comment rulemaking procedures in issuing notices (or other informal guidance documents, like revenue rulings or revenue procedures). The APA contains exceptions from its public notice and comment procedures for “interpretative rules” and “general statements of policy.”<sup>60</sup> As it did in Cohen, the IRS generally takes the position that guidance documents like Notice 2006-50 are either interpretative rules or policy statements and thus exempt from APA notice-and-comment rulemaking procedures.<sup>61</sup> Of course, since the Cohen taxpayers’ principal claim is that the IRS should have subjected the rules contained in Notice 2006-50 to notice-and-comment rulemaking and failed to do so, the merits of their case now turns on the eligibility of Notice 2006-50 for these exceptions.

General administrative law doctrine surrounding the interpretative rule and policy statement exemptions from notice-and-comment rulemaking is notoriously

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<sup>56</sup> See *id.* at 731-32.

<sup>57</sup> *Id.* at 733.

<sup>58</sup> See *Cohen v. United States*, 578 F.3d 1, 7-10 (D.C. Cir. 2009), *vacated in part*, 599 F.3d 652 (D.C. Cir. 2010).

<sup>59</sup> See *Cohen*, 650 F.3d at 723.

<sup>60</sup> 5 U.S.C. § 553(b)(A).

<sup>61</sup> See Final Brief for the Appellee, *Cohen v. United States*, 650 F.3d 717 (D.C. Cir. 2009), 2009 WL 857437 (arguing that Notice 2006-50 was not reviewable as final agency action because it was a policy statement lacking the force of law); see also generally Treas. Reg. § 601.601(d)(2)(v)(d) (as amended in 1987) (stating that such guidance documents “do not have the force and effect of Treasury Department regulations”).

murky,<sup>62</sup> but overlaps substantially with finality doctrine. A conclusion that Notice 2006-50 represents a justiciable final agency action does not automatically compel a decision that the IRS should have used notice and comment in that pronouncement's development, but a contrary holding is difficult to justify. On remand, the district court recognized as much, drawing a straight line between the D.C. Circuit's finding that "Notice 2006-50 binds the IRS" and its own conclusion that the IRS "was required to abide by the APA's notice-and-comment requirements or to, alternatively, provide good cause for not doing so."<sup>63</sup>

## 2.3 United States v. Home Concrete & Supply LLC<sup>64</sup>

Most recently, the Supreme Court issued its much-anticipated opinion in *Home Concrete*. Like the *Mayo* case before it, first and foremost, *Home Concrete* concerned the meaning of the statute. IRC § 6501(a) generally requires the IRS to assess a tax deficiency within three years after a taxpayer files its return.<sup>65</sup> IRC § 6501(e)(1)(A) in turn extends that limitations period from three to six years "[i]f the taxpayer omits from gross income an amount properly includible therein" and certain other requirements are met.<sup>66</sup> The statutory question at issue in *Home Concrete* was whether an overstatement of asset basis, and the corresponding understatement of gain on the disposition of that asset, represents an omission of an amount from gross income that extends the limitations period for assessing a deficiency from three to six years. Nevertheless, as in *Mayo*, however, the case raised several other issues concerning the circumstances surrounding Treasury's adoption of the temporary and final regulations interpreting § 6501(e)(1)(A).

In 1958, in *Colony Inc. v. Commissioner*, the Supreme Court concluded that virtually identical predecessor language from the Internal Revenue Code of 1938 did not encompass basis overstatements.<sup>67</sup> After two federal circuit courts relied on *Colony* to reject a contrary IRS interpretation of IRC § 6501(e)(1)(A),<sup>68</sup> Treasury issued temporary and proposed regulations in 2009<sup>69</sup> and final regulations in 2010<sup>70</sup> providing that basis overstatements constitute omissions from gross income under IRC § 6501(e)(1)(A).<sup>71</sup> In light of the Supreme Court's holding in the *Mayo* case that Treasury regulations are eligible for judicial deference under the *Chevron* standard of review, the government claimed *Chevron* deference first for its temporary

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<sup>62</sup> See, e.g., Richard J. Pierce, Jr., *Distinguishing Legislative Rules from Interpretative Rules*, 52 Admin. L. Rev. 547, 547-48 (2000) (citing cases describing the distinction between legislative and interpretative rules as "'fuzzy,' 'tenuous,' 'blurred,' 'baffling,' and 'shrouded in considerable smog'").

<sup>63</sup> In re Long-Distance Telephone Service Federal Excise Tax Refund Litigation, \_\_ F.Supp.2d \_\_, 2012 WL 1179063, at \*4 (D.D.C. Apr. 10, 2012).

<sup>64</sup> 132 S.Ct. 1836 (2012).

<sup>65</sup> IRC § 6501(a).

<sup>66</sup> IRC § 6501(e)(1)(A).

<sup>67</sup> 357 U.S. 28 (1958).

<sup>68</sup> See *Salman Ranch Ltd. v. United States*, 573 F.3d 1362 (Fed. Cir. 2009); *Bakersfield Energy Partners LP v. Comm'r*, 568 F.3d 767 (9th Cir. 2009).

<sup>69</sup> T.D. 9466, 74 Fed. Reg. 49321 (Sept. 28, 2009).

<sup>70</sup> T.D. 9511, 75 Fed. Reg. 78897 (Dec. 17, 2010).

<sup>71</sup> See Treas. Reg. § 301.6501(e)-1(a)(1)(iii).



regulations and then for its final ones in several cases. In 2010, in *Intermountain Insurance Service of Vail LLC v. Commissioner*, the United States Tax Court invalidated Treasury's 2009 temporary regulation on the ground that Colony controlled the interpretation of § 6501(e)(1)(A).<sup>72</sup>

The Tax Court's decision in *Intermountain* represented a big loss for the government. Because the temporary regulation in question concerned the limitations period for assessing a deficiency, the case impacted numerous other pending cases, including many concerning deficiencies assessed against taxpayers who had participated in the notorious Son-of-BOSS tax shelter.<sup>73</sup> These cases allowed the government to appeal the Tax Court's *Intermountain* decision to several federal circuits in short order, during which time Treasury also finalized the temporary and proposed regulations invalidated by the Tax Court.<sup>74</sup> The federal circuit courts disagreed sharply over the meaning of § 6501(e)(1)(A), the significance of Colony in interpreting that provision, and the eligibility of Treasury regulations for Chevron deference,<sup>75</sup> leading both taxpayers and the government to request Supreme Court review.

In many respects, *Home Concrete* seems very similar to *Mayo*: in response to court decisions it did not like, Treasury promulgated regulations adopting its preferred interpretation and now asks the Court to defer under Chevron. Yet, minor contextual differences between *Mayo* and *Home Concrete* made the latter a substantially more difficult case as a matter of legal doctrine.

For example, in *National Cable and Telecommunications Association v. Brand X Internet Services*, the Supreme Court held that a federal circuit court decision construing ambiguous statutory language would not preclude an administering agency from claiming Chevron deference for a contrary interpretation later adopted using APA notice-and-comment rulemaking procedures.<sup>76</sup> In *Mayo*, Treasury promulgated the regulation at issue in reaction to a decision by the United States Court of Appeals for the Eighth Circuit;<sup>77</sup> later, in the *Mayo* litigation itself, the Eighth Circuit opined

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<sup>72</sup> 134 T.C. 211, 222-24 (2010).

<sup>73</sup> Roughly six months after the Tax Court's *Intermountain* decision, one blog reported a Department of Justice assertion that there were then "35-50 cases pending in the federal courts raising the same issue, with approximately \$1 billion at stake." *Son-of-BOSS Statute of Limitations Issue Inundates the Courts of Appeals*, <http://appellatetax.com/2010/11/30/son-of-boss-statute-of-limitations-issue-inundates-the-courts-of-appeals/> (Nov. 30, 2010).

<sup>74</sup> Two cases during this period, including the *Home Concrete* case itself, were appealed from federal district courts but had not yet been decided when the Tax Court issued its decision in *Intermountain*. See *Home Concrete & Supply, LLC, United States*, 599 F.Supp.2d 678 (E.D.N.C. 2008), appeal docketed, No. 09-2353 (4th Cir. Dec. 9, 2009); *Burks v. United States*, 108 A.F.T.R.2d 2011-6665 (N.D. Tex. June 13, 2008), appeal docketed, No. 09-11061 (5th Cir. Oct. 26, 2009).

<sup>75</sup> See *Intermountain Ins. Serv. Of Vail LLC v. Comm'r*, 650 F.3d 691 (D.C. Cir. 2011); *Salman Ranch Ltd. v. Comm'r*, 647 F.3d 929 (10th Cir. 2011); *Grapevine Imports Ltd. v. United States*, 636 F.3d 1368 (Fed. Cir. 2011); *Home Concrete & Supply, LLC*, 634 F.3d 249 (4th Cir. 2011); *Burks v. United States*, 633 F.3d 347 (5th Cir. 2011); *Beard v. Comm'r*, 633 F.3d 616 (7th Cir. 2011).

<sup>76</sup> 545 U.S. 967 (2005).

<sup>77</sup> See Internal Revenue Service, Treasury, *Notice of Proposed Rulemaking and Notice of Public Hearing; Student FICA Exception*, 69 Fed. Reg. 8604 (Feb. 25, 2004) (proposing regulatory language and acknowledging contrary decision in *Minnesota v. Apfel*, 151 F.3d 742 (8th Cir. 1998)).

that the relevant statutory language was ambiguous,<sup>78</sup> and the Supreme Court agreed, thus opening the door for Chevron deference in light the Court's holding in *Brand X*.<sup>79</sup> By contrast, *Colony* was a Supreme Court decision. The Court had never addressed whether its reasoning in *Brand X* allowing agencies to reject federal circuit court outcomes through notice-and-comment rulemaking extends to its own opinions.

The procedures that Treasury used in promulgating the *Home Concrete* regulations were also potentially problematic. The APA contemplates a particular procedural sequence for agencies adopting regulations that carry the force and effect of law like those at issue in both *Mayo* and *Home Concrete*. Specifically, APA § 553(b) requires an agency to provide public notice of its proposed rules through publication in the *Federal Register*.<sup>80</sup> Next, APA § 553(c) commands the agency pursuing the rulemaking to offer interested persons an opportunity to participate through the submission of written comments.<sup>81</sup> Only “after consideration of the relevant matter presented” through the comments may the agency issue the final, legally binding regulations along with a “concise general statement of their basis and purpose.”<sup>82</sup> In other words, the APA anticipates that regulated parties will receive notice of proposed agency rules and have the opportunity to submit comments before finding themselves legally bound by those rules.

In adopting the regulation at issue in *Mayo*, Treasury followed the procedural sequence contemplated by the APA.<sup>83</sup> And in extending Chevron deference to that regulation, the Court particularly acknowledged Treasury's use of notice-and-comment rulemaking.<sup>84</sup> In promulgating the regulation at bar in *Home Concrete*, however, Treasury employed an alternative procedural sequence known most commonly by courts and administrative law scholars as interim-final rulemaking. Specifically, as noted above, Treasury issued legally-binding temporary regulations simultaneously with its notice of proposed rulemaking requesting comments. In other words, Treasury inverted the procedural sequence contemplated by the APA, providing the public with the opportunity to comment only after they were already legally bound. The government has acknowledged that the final regulation, issued several months later, “track[ed] the temporary regulation in virtually every respect.”<sup>85</sup>

The general legal consensus holds that interim-final rulemaking violates the APA unless the agency can validly claim an exception from the procedural requirements of

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<sup>78</sup> See *Mayo Foundation for Medical Educ. & Research v. United States*, 568 F.3d 675, 679 (8th Cir. 2009). Four other circuits found the statute unambiguously supportive of the taxpayers' interpretation, *see id.* (citing cases), but the Supreme Court in *Mayo* agreed with the Eighth Circuit's conclusion that the meaning of IRC § 3121(b)(10) was ambiguous.

<sup>79</sup> See *Mayo*, 131 S. Ct. at 712-13.

<sup>80</sup> See 5 U.S.C. § 553(b).

<sup>81</sup> See 5 U.S.C. § 553(c) (calling for opportunity to comment “after notice”).

<sup>82</sup> *Id.*

<sup>83</sup> See T.D. 9167, 69 Fed. Reg. 76404 (Dec. 21, 2004) (documenting the regulation's procedural background).

<sup>84</sup> See *Mayo*, 131 S.Ct. at 714.

<sup>85</sup> Brief for the United States, *United States v. Home Concrete & Supply, LLC*, No. 11-139 (Nov. 15, 2011).

APA § 553.<sup>86</sup> Although the government has asserted a couple of exceptions from APA § 553 in the course of the Home Concrete litigation,<sup>87</sup> those claims are legally questionable.<sup>88</sup> Yet, the fact remains that Treasury did accept public comments in the course of finalizing the challenged regulations. Even as they disapprove of post-promulgation notice and comment, the federal circuit courts have disagreed over whether invalidating the regulation ought to be the appropriate remedy for under these circumstances.<sup>89</sup> Meanwhile, the Supreme Court has never addressed the legality of or the remedy for interim-final rulemaking. Nor has the Court considered whether it ought to extend Chevron deference to otherwise legally binding regulations adopted through questionable procedures.

The lower courts have divided over the implications of Treasury's procedures in adopting its regulations interpreting § 6501(e). While Tax Court's majority in Intermountain cited Colony in invalidating the regulations, Judges Halpern and Holmes writing in concurrence concluded unequivocally that temporary Treasury regulations violate the APA.<sup>90</sup> By contrast, the Seventh Circuit in *Beard v. Comm'r*, while resolving the case for the government on other grounds, indicated in dicta its inclination to extend Chevron deference to temporary Treasury regulations.<sup>91</sup> The Fifth Circuit in the *Burks v. United States* relied on Colony in siding with the taxpayer, but chastised Treasury for issuing temporary regulations and suggested that the final regulations might be ineligible for Chevron deference as a result.<sup>92</sup> The *Burks* court explicitly rejected the adequacy of post-promulgation notice and comment to satisfy APA requirements.<sup>93</sup> Meanwhile, the Federal Circuit in *Grapevine Imports, Ltd. v. United States* and the D.C. Circuit on appeal in the Intermountain case both decided that § 6501 was ambiguous and extended Chevron deference to Treasury's interpretation, concluding that Treasury's consideration of public comments in

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<sup>86</sup> See, e.g., Administrative Conference of the United States, *Notice; Adoption of Recommendations*, 60 Fed. Reg. 43108, 43111-12 (Aug. 18, 1995) ("Courts generally have not allowed post-promulgation comment as an alternative to the prepromulgation notice-and-comment process in situations where no exemption is justified."); Michael Asimow, *Interim-Final Rules: Making Haste Slowly*, 51 Admin. L. Rev. 703, 717, 725-26 (1999) (observing that, without a statutory exception from notice-and-comment rulemaking, "a rule adopted with post- rather than pre-adoption notice and comment is procedurally invalid").

<sup>87</sup> See Brief for the United States, *United States v. Home Concrete & Supply, LLC*, No. 11-139 (Nov. 15, 2011).

<sup>88</sup> See Brief of Amicus Curiae Professor Kristin E. Hickman In Support of Respondents, *United States v. Home Concrete & Supply, LLC*, No. 11-139 (Dec. 22, 2011) (challenging the government's claims).

<sup>89</sup> Compare, e.g., *Air Transp. Ass'n of Am. v. Dep't of Transp.*, 900 F.2d 369, 379-80 (D.C. Cir. 1990), *vacated without opinion and remanded*, 498 U.S. 1023 (1991), *vacated as moot*, 933 F.2d 1043 (D.C. Cir. 1991), and *Sharon Steel Corp. v. EPA*, 597 F.2d 377, 381 (3d Cir. 1979), with *Advocates for Highway & Auto Safety v. Fed. Highway Admin.*, 28 F.3d 1288, 1292 (D.C. Cir. 1994), and *Levesque v. Block*, 723 F.2d 175, 188 (1st Cir. 1983).

<sup>90</sup> See *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 134 T.C. 211, 238-48 (2010) (Halpern & Holmes, J.J., concurring).

<sup>91</sup> See *Beard v. Comm'r*, 633 F.3d 616, 623 (7th Cir. 2011).

<sup>92</sup> See *Burks v. United States*, 633 F.3d 347, 360 n.9 (5th Cir. 2011).

<sup>93</sup> See *id.*

finalizing its regulations resolved any procedural flaws in the temporary regulations and rendered the taxpayer's APA procedural challenge moot.<sup>94</sup>

In the end, in a 5-4 decision, with Justice Breyer writing for the majority, the Supreme Court rejected Treasury's interpretation of IRC § 6501(e)(1)(A), holding that the Court's earlier decision in *Colony* "determines the outcome of this case"<sup>95</sup> and that language in IRC § 6501(e)(1)(A) extending the limitations period for IRS deficiency assessments "does not apply to an overstatement of basis."<sup>96</sup> The dissent, written by Justice Kennedy, contended that *Colony* did not consider 1954 congressional amendments to IRC § 6501(e), that *Colony* thus did not control the outcome in *Home Concrete*, and that "there was room for the Treasury Department to interpret the new provision in" the manner that it did.<sup>97</sup> In short, the majority and dissenting opinions offer relatively straight-forward presentations of two competing interpretations of § 6501(e), with the majority siding with the taxpayer.

From there, however, the Court split three ways. Justice Breyer, joined by Chief Justice Roberts and Justices Thomas and Alito, spoke at some length regarding the *Brand X* question.<sup>98</sup> For this plurality of the Court, *Brand X* only authorized an agency to adopt regulations contrary to a judicial decision when a statute's silence or ambiguity represents a congressional delegation of gap-filling authority to the agency. But Congress's intent with § 6501(e) was clear at the time of *Colony* and continues to be clear now, at least in the *Chevron* sense of what it means for Congress's intent to be clear. As a result, there was no need to resolve whether the Court ought to extend *Brand X* to Supreme Court decisions, although the plurality opinion seemed open to the idea. Likewise the four dissenters: By concluding that *Colony* did not apply at all, the dissenters were able to find § 6501(e) ambiguous and defer to Treasury's interpretation without actually deciding whether *Brand X* extends to Supreme Court decisions.<sup>99</sup> Nevertheless, the dissenting opinion speaks of a "continuing dialogue among the three branches of Government on questions of statutory interpretation and application," thus suggesting the theoretical possibility of extending *Brand X*.<sup>100</sup> Finally, Justice Scalia, writing in concurrence continued his outright rejection of the "ugly and improbable structure" created by the Court's decisions in *United States v. Mead Corp.* as well as in *Brand X*.<sup>101</sup> In short, while the Court offered plenty of rhetoric for administrative law aficionados to chew on, the Court went no further toward actually resolving the applicability of *Brand X* to its own opinions.

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<sup>94</sup> See *Intermountain Ins. Serv. of Vail, LLC v. Comm'r*, 650 F.3d 691, 709-10 (D.C. Cir. 2011);

*Grapevine Imports, Ltd. v. United States*, 636 F.3d 1368, 1380 (Fed. Cir. 2011).

<sup>95</sup> 132 S.Ct. 1836, 1841 (2012).

<sup>96</sup> *Id.* at 1839.

<sup>97</sup> *Id.* at 1851 (Kennedy, J. dissenting).

<sup>98</sup> See *id.* at 1842-44.

<sup>99</sup> See *id.* at 1851-52 (Kennedy, J. dissenting).

<sup>100</sup> *Id.* at 1852 (Kennedy, J. dissenting).

<sup>101</sup> *Id.* at 1847 (Scalia, J. concurring in part and concurring in the judgment). Justice Scalia dissented vehemently and at length from the approach to *Chevron* deference advanced by the Court in both *Mead* and *Brand X*. See *National Cable & Telecomm. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 1014-20 (2005) (Scalia, J. dissenting); *United States v. Mead Corp.*, 533 U.S. 218, 239-61 (2001) (Scalia, J. dissenting).

Meanwhile, none of the opinions issued in the *Home Concrete* case said a word about the procedural question raised by the case: whether Treasury regulations issued initially in temporary form with only post-promulgation notice and comment violate APA procedural requirements or are eligible for Chevron deference. The Court thus left standing the existing disagreement among the lower courts regarding this issue.

### 3. OPEN QUESTIONS

The Mayo Court's emphasis on administrative law uniformity has certainly captured the attention of the U.S. tax community. Thus, with the heightened awareness of the relevance of administrative law doctrine for tax practice comes tremendous uncertainty, leaving U.S. tax professionals scrambling to assess tax risk in a changing environment.

Tax professionals, including those in government and on the bench, have largely ignored developments in administrative law doctrine for years.<sup>102</sup> Yet, as the Court observed in the Mayo case, "the administrative landscape has changed significantly" in recent decades.<sup>103</sup> As a result of the neglect, contemporary tax administrative practices do not always quite match up with the typical administrative law expectations.

Deviations from general administrative law norms are not unique to tax. Every area of federal government administration is at least a little different from the others, sometimes because provisions and requirements of organic statutes vary, but just as often simply because each agency develops its own habits and norms in administering the statutes within its jurisdiction. Also, lawyers in many practice areas tend to over-rely on precedents specific to the agencies with which they frequently interact, leading to deviations from general administrative law principles in many areas of regulatory law.<sup>104</sup> Regardless, as the Cohen and *Home Concrete* cases demonstrate, many now-routine practices in contemporary tax administration raise significant administrative law questions for which no clear answers exist.

Consider, for example, the circumstances of the regulation at issue in *Home Concrete* case. Treasury's use of interim-final rulemaking—temporary regulations issued with only post-promulgation notice and comment—is hardly new. Treasury has been issuing temporary regulations for decades.<sup>105</sup> Consequently, hundreds of Treasury

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<sup>102</sup> See, e.g., Paul L. Caron, *Tax Myopia, or Mamas Don't Let Your Babies Grow Up to Be Tax Lawyers*, 13 Va. Tax Rev. 517, 518 (1994) ("[T]ax law too often is mistakenly viewed by lawyers, judges, and law professors as a self-contained body of law . . . [T]his misperception has impaired the development of tax law by shielding it from other areas of law that should inform the tax debate.").

<sup>103</sup> *Mayo*, 131 S.Ct. 704, 713 (2011).

<sup>104</sup> See generally Richard Levy & Robert Glicksman, *Agency-Specific Precedents*, 89 Texas L. Rev. 499 ((2011) (describing several examples, including but not limited to the tax context).

<sup>105</sup> See Michael Asimow, *Public Participation in the Adoption of Temporary Treasury Regulations*, 44 Tax Law. 343 (1991) (documenting Treasury's use of temporary regulations more than twenty years ago); Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 Notre Dame L. Rev. 1727, 1797 (2007) (describing the evolution of Treasury's use of temporary regulations). In one relatively recent

regulations interpreting the tax laws are susceptible to the same arguments concerning their procedural validity as have been raised in the Home Concrete litigation. In light of the opinions the Fifth Circuit in *Burks* case and of Tax Court Judges Halpern and Holmes in *Intermountain*, taxpayers in at least some circuits may have a potentially winning procedural argument they can raise in challenging tax assessments based on regulations that Treasury initially issued in temporary form.<sup>106</sup> Given particularly the recent decisions of the Federal Circuit in *Grapevine Imports* and the D.C. Circuit in *Intermountain*, however, other taxpayers are faced with the prospect that such regulations will not only be considered procedurally valid but will be reviewed under the highly deferential *Chevron* standard.<sup>107</sup> Given the sheer number of Treasury regulations with temporary origins, what will happen to the tax system if one or two circuits begin regularly invalidating Treasury regulations on APA procedural grounds while other circuits do not?

Likewise, the pronouncement at issue in *Cohen*, Notice 2006-50, is by no means unique among IRS guidance documents. The IRS annually issues hundreds of revenue rulings, revenue procedures, and notices, many if not most of which contain substantive interpretations of the tax laws.<sup>108</sup> The IRS now considers itself bound by these pronouncements<sup>109</sup> and predicates many enforcement actions on the failure of taxpayers to comply with the interpretations advanced therein. But the IRS almost never seeks public comments in issuing IRB guidance; on the rare occasions when the IRS does seek public input,<sup>110</sup> it does not purport to comply with APA notice-and-comment rulemaking procedures. Largely on the basis of this lack of public notice and comment, the federal circuit courts thus far have declined to extend *Chevron* deference to legal interpretations advanced in these formats.<sup>111</sup> Yet, the legal arguments and conclusions that led the courts to invalidate Notice 2006-50 in the *Cohen* litigation apply equally to many if not most other such guidance documents, leaving them susceptible to invalidation on APA procedural grounds.

One last aspect of particularly the *Mayo* and *Home Concrete* cases has U.S. tax professionals especially troubled when it comes to assessing risk. Both cases concern regulations promulgated by Treasury in the midst of ongoing litigation concerning the proper interpretation of the IRC. Long before *Mayo*, in *Smiley v. Citibank* (South Dakota), N.A., the Supreme Court explained that, where an agency adopted an interpretation using APA notice-and-comment rulemaking procedures, the fact that the

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three-year period alone, Treasury issued temporary regulations in 84 of 232, or 36.2%, of regulation projects undertaken. See Hickman, *supra*, at 1748-49 (documenting study of Treasury regulation projects from 2003 through 2005).

<sup>106</sup> See discussion *supra* notes 91-94 and accompanying text.

<sup>107</sup> See *id.*

<sup>108</sup> See Kristin E. Hickman, IRB Guidance: The No Man's Land of Tax Code Interpretation, 2009 Mich. St. L. Rev. 239, 242-52 (examining IRS use of revenue rulings, revenue procedures, and notices).

<sup>109</sup> See, e.g., Internal Revenue Manual § 32.2.2.10 (Aug. 11, 2004), available at <http://www.irs.gov/irm/part32/index.html> (requiring IRS attorneys to follow legal positions established in published revenue rulings, revenue procedures, and notices, even if case law would support a position less favorable to taxpayers).

<sup>110</sup> See, e.g., IRS Notice 2008-80, 2008-40 I.R.B. 820 (seeking comments on proposed revenue procedure); IRS Notice 2007-59, 2007-30 I.R.B. 135 (same).

<sup>111</sup> See, e.g., *Kornman & Assoc., Inc. v. United States*, 527 F.3d 443, 452056 (5th Cir. 2008); *Aeroquip-Vickers, Inc. v. Comm'r*, 347 F.3d 173, 181 (6th Cir. 2003).

agency's action was prompted by litigation was irrelevant for purposes of Chevron analysis.<sup>112</sup> In *Mayo*, the Court relied on *Smiley* in rejecting the argument that Chevron deference was inappropriate because Treasury adopted the regulation in question in the midst of litigation.<sup>113</sup> Also, as noted, the Supreme Court in both *Mayo* and in earlier cases extended Chevron deference to notice-and-comment regulations adopted in repudiation of contrary federal circuit court precedents.<sup>114</sup> As the Court observed in *Smiley*,<sup>115</sup> such regulations are susceptible to challenge under the APA as arbitrary and capricious for a lack of due deliberation.<sup>116</sup> Nevertheless, particularly depending upon the outcome in *Home Concrete*, U.S. tax professionals wonder how to evaluate tax risk if Treasury can change the law after the transaction has been completed, and even after litigation has commenced.

#### 4. CONCLUSION

U.S. tax administration is experiencing a transitional period triggered by the Supreme Court's decision in *Mayo* and furthered by subsequent decisions in *Cohen* and *Home Concrete*. The results may ultimately be quite positive, increasing Treasury and IRS transparency and accountability in the promulgation of legally binding tax rules. For that matter, as in *Home Concrete*, and hopefully in future cases to come, unique aspects of contemporary U.S. tax administrative practices will push at the boundaries of existing administrative law doctrine, perhaps requiring the Supreme Court to confront some of the more extreme potential implications of its past decisions particularly regarding the scope of the Chevron standard's applicability. Nevertheless, for now, U.S. tax professionals face an uncertain environment likely to complicate their efforts to assess tax risk for some time to come.

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<sup>112</sup> 517 U.S. 735, 740-41 (1996).

<sup>113</sup> See *Mayo*, 131 S.Ct. 704, 712 (2011).

<sup>114</sup> See discussion *supra* notes 76-79 and accompanying text.

<sup>115</sup> See *Smiley*, 517 U.S. at 740-42.

<sup>116</sup> See 5 U.S.C. § 706(2)(A); *Motor Vehicle Mfrs. Ass'n of United States, Inc. v. State Farm Mut. Automobile Ins. Co.*, 463 U.S. 29, 46-57 (1983).

# Behavioural economics and the risks of tax administration

Simon James\*

## ***Abstract***

Tax Administration is a risky business. When taxes are not well administered, tax morale may be undermined and unnecessary administrative and compliance costs incurred. Mainstream economics and the self-interested rational choice model provide a powerful contribution to understanding the effects of taxation but that analysis has not always been enough to avoid serious and expensive difficulties. Behavioural economics has been making an increasing contribution to understanding how tax administration may be improved. Some of the assumptions of mainstream economics have been subject to close scrutiny and DellaVigna (2009) summarized deviations from the standard model as non-standard preferences, non-standard beliefs and non-standard decision-making. In recent years considerable analysis and evidence have been presented on the importance of aspects such as fairness in taxation, the endowment effect, framing of decisions, limited attention, loss aversion and mental accounting and their impact on the operation of a tax system. A risk management approach to tax administration has been developed by the European Commission, the OECD and others. One area that has received less attention than may be appropriate is the performance of tax agencies themselves. This paper therefore outlines the contribution behavioural economics can make to existing approaches in reducing the risks of tax administration and extends it to the performance of tax authorities themselves.

## **1. INTRODUCTION**

Challenges in dealing with taxpayer behaviour and the risks of tax administration are as old as taxation itself. A remarkable example is that, when income tax was first introduced in the UK in 1799, it was thought unacceptable that taxpayers should be required to disclose the precise level of their incomes. To deal with the obvious risks involved, the response was to require that taxpayers should declare that the tax paid was not less than the required 10 per cent of their income. As Pitt explained in introducing the income tax:

The statement of income is to proceed from the party himself. In doing this it is not proposed that income shall be distinctly laid open, but it shall be declared only that the assessment is beyond the proportion of a tenth of the income of the person on whom it is imposed. In this way, the disclosure at which many may revolt may be avoided (Pitt, 1798).

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This led to a form of declaration given in an Act (39 Geo 3, c. 22) passed three months after the original Act, and shown in Figure 1 – and one of the simplest tax returns ever.

### Figure 1 The Original UK Income Tax Return.

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I        do declare that I am willing to pay the sum of        for my contribution for one year, from the fifth day of April        until the fifth day of April        in pursuance of an Act passed in the thirty-ninth year of the reign of His present Majesty intituled...[the full name of the Act was entered here] and of another Act for amending the said Act: and I do declare that the said sum of        is not less than one tenth part of my income, estimated according to the directions and rules prescribed by the said Acts, to the best of my knowledge and belief. Dated this day of

Signed

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To deal with the risk the Commissioners could demand further information and a hearing. Nevertheless, after the taxpayer had stated his case at the hearing and made an oath as to the truth of his return, he:

shall not be compelled to answer; his books shall not be called for, not his confidential clerks or agents examined. If, however he declines to submit to the investigation of his books, and the examination of his clerks, and other means of ascertaining the truth, it shall be competent for the Commissioners to fix the assessment, and their decision shall be final, unless he appeals to the higher Commissioners. No disclosure is necessary, but if the party is unwilling to disclose, he must acquiesce in the decision of the Commissioners, who shall not be authorised to relieve without a full disclosure (Pitt, 1798).

Since that time, the level and complexity of taxation have risen enormously and so has the pressure to deal with non-compliance. Behavioural economics has also been developing rapidly and adds to the contribution of more traditional analysis of economic behaviour. Mainstream economics has made a considerable contribution to understanding taxation but its basic assumption of self-interested rational behaviour narrowly defined does not give a good explanation of tax compliance. The penalty for ordinary tax convictions is usually modest, the chance of detection often trivial and yet most individuals pay their taxes. Hence some further explanation is required (Posner, 2000, p. 1782).

Sometimes the limitations of the mainstream approach are dramatically exposed. At a briefing by economists on the credit crunch at the London School of Economics on 5 November 2008, the Queen was reported as asking why no one saw the credit crunch coming. Her Majesty's question was debated by economists and others at a forum at the British Academy and their response indicated the importance of factors not

normally included mainstream economic analysis – such as ‘wishful thinking’, ‘a psychology of denial’, and ‘the psychology of herding’ (Besley and Hennessy, 2009, pp. 2-3). Furthermore, the Queen was advised that ‘Everyone seemed to be doing their own job properly on its own merit. And according to standard measures of success, they were often doing it well’ (ibid., p. 3).

Behavioural factors can improve understanding of such events including tax compliance and non-compliance. As described further below, the behavioural approach draws on a wider range of assumptions than purely ‘rational’ ones in understanding individuals’ actions. One particular example is that it is conceptually better placed than the ‘rational’ approach to give issues of fairness and ‘tax morale’ the importance they deserve.

Tax systems have, of course, taken account of phenomena described by behavioral economists, even if they were not explicitly recognized as such. For example, withholding at source, which can be traced back to the sixteenth century in England (Soos, 1995), deals with phenomena now described as the endowment effect, loss aversion and status quo bias. Nevertheless, taking account of such factors more explicitly may improve compliance more generally and systematically. This is particularly true because measures to improve compliance have often taken the form of mechanistic and relatively simplistic arrangements regarding auditing and penalties on the assumption, implicitly or explicitly, that taxpayers are motivated to comply with the tax system only on the balance of the associated financial gains and losses. They may also, of course, be motivated by other factors. Furthermore, it has always been clear that some areas of taxation are more likely than others to have a higher risk of uncollected taxation and consequently have been subjected to a greater level of enforcement activity. In recent times more systematic approaches have sometimes taken the form of developing risk management procedures. The paper therefore begins with a discussion of risk management in the present context in Section 2 followed by the contribution behavioural economics adds to more ‘rational’ approaches in Section 3. Section 4 turns to the related area of responsive regulation in taxation.

A relatively under explored application of the behavioural approach is the contribution it may make with regards to the performance of tax agencies. External change and management fashion (see Abrahamson, 1966) can pose serious risks to the functioning of organisations including tax authorities. In Section 5, this paper therefore turns to the management of tax agencies. It examines some of the risks of a ‘rational’ approach to management reform and the importance of a behavioural perspective. Some of issues are illustrated by drawing on radical changes to UK tax administration. Finally, Section 6 draws some conclusions.

## **2. RISK MANAGEMENT AND TAX ADMINISTRATION**

Within the study of management, ‘risk management’ has expanded dramatically in the last twenty years, developing from an element of management control to an aspect of good governance for many organisations. Despite this huge growth and the impressive development of concepts and techniques (see for example, McNeil, et al. 2005) it can still be argued that risk management ‘is first and foremost about sound general management’ (Culp, 2001, p. ix) and that perhaps it is not all about real hazards and

opportunities but quite a lot about organisational accountability and legitimacy (Power, 2007). It is therefore relevant to examine not only risk management with respect to taxpayers, of which there is an existing literature, but also risk management with respect to the conduct of tax administrators more generally, about which less has been said in this respect.

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. It is not a magic formula that will always give the right answers but it is 'a way of working and thinking that will give better answers to better questions'. Interestingly, the EC guide goes on to suggest that the concept of risk has its roots in the ancient Italian maritime trade – from the concept of uncertainty and possibility of loss. Risks consist of the characteristics of 'vulnerability, severity or significance and relative occurrence or frequency'. The European Commission's Guide also states that '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).

The OECD's (2004, p. 37) Compliance Risk Management cites the analysis of James et al., (2001) in identifying two main approaches to examining compliance. The first of these is based on economic assumptions of rationality of the sort mentioned above with a reliance on penalties. However, there has been an increasing awareness that understanding the factors influencing taxpayers' behaviour may also have an important role to play and this is examined further in the following section. The OECD (2004, p. 8) formally describes compliance risk management as a 'structured process for the systematic identification, assessment, ranking and treatment of tax compliance risks' such as the failure to register or the failure to report tax liabilities properly. The OECD outlines the way a compliance risk management process may be applied by a revenue authority in the following stages:

Identify risks

Assess and prioritise risks

Analyse compliance behaviour (causes, options for treatment)

Determine treatment strategies

Plan and implement stages.

The two stages that may benefit most from a behavioural approach are the analysis of compliance behaviour and determining 'treatment strategies'. The process would continue with the compliance outcomes regarding registration, filing, reporting and payment being evaluated and performance measured against plan. As the OECD (2004, p. 8) points out this is consistent with the existing management literature which has also been applied more generally, for example by James and Edwards (2007) to income tax.

The International Bureau of Fiscal Documentation (2012) provides an online collection of tax compliance arrangements in different countries including a guide to tax risk management for designing an internal structure and strategy for minimising the unintended risks of non-compliance. A further contribution by Thompson (2008)

on behalf of the Caribbean Organization of Tax Administration illustrated the principles and application of risk management and how tax authorities may use them to improve voluntary compliance.

An additional point has been made by the OECD (2009): that large businesses are increasingly considering tax risk management as a specific element of corporate governance. In examining the experience of three countries – Australia, Canada and Chile – the OECD found that ‘large businesses that have good corporate governance and more transparent relationships with tax administrations can expect fewer audit interventions and greater certainty’.

### **3. THE CONTRIBUTION OF BEHAVIOURAL ECONOMICS**

The academic literature relating to behavioural economics is now very substantial. Schwartz (2008) and Wilkinson (2008) have both provided introductions and collections of papers on behavioural economics have been edited by Altman (2006), Loewenstein, (2007), and Maital (2007). There is also a collection of readings specifically on behavioural public finance edited by McCaffery and Slemrod (2006). There have been specific applications to taxation – for example, Congdon et al. (2009) related behavioural economics and tax policy and Reeson and Dunstall (2009) examined the implications of behavioural economics and complex decision-making for the Australian tax and transfer system.

Behavioural economics has been described as increasing the explanatory power of economics by providing it with more realistic psychological foundations’ Camerer and Loewenstein (2004, p. 3) though it also draws on other disciplines. Its approach involves modifying ‘the standard economic model to account for psychophysical properties of preference and judgement, which create limits on rational calculation, willpower and greed’ (Camerer and Malmendier, 2007, p. 235) and further analysis is presented by Tomer (2007).

A particular theme arising from this approach is the importance of fairness both in economic behaviour in general (see for example Kahneman et al., 1986a and 1986b) and behaviour with respect to tax compliance in particular (for instance Bordignon 1993 and Cowell, 1992).

Such an approach is consistent with the contribution of the classical economists. For example Adam Smith has been described as a behavioural economist and his ‘world is not inhabited by dispassionate rational purely self-interested agents, but rather by multidimensional and realistic human beings’ (Ashraf et al. p. 142). However, the main thrust of the analysis in mainstream economics and, indeed, parts of some other disciplines such as management, has developed on the basis of that part of Adam Smith’s (1776) contribution that economic behaviour was motivated by self-interest. Economics therefore became the mechanics of utility and self-interest and simply a ‘calculus of pleasure and pain’ (Jevons, 1888). Such an approach has led to many important insights and understanding of economic behaviour but the central assumption that human beings are largely motivated by immediate self-interest and

rationality, narrowly defined, has its limitations. This approach has been vividly described by Veblen as follows:

The hedonistic conception of man is that of a lightning calculator of pleasures and pains who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact. He has neither antecedent nor consequent. He is an isolated definitive human datum, in stable equilibrium except for the buffets of the impinging forces that displace him in one direction or another. Self-imposed in elemental space, he spins symmetrically about his own spiritual axis until the parallelogram of forces bears down upon him, whereupon he follows the line of the resultant. When the force of the impact is spent, he comes to rest, a self-contained globule of desire as before (Veblen, 1898, pp. 389-90).

However, such an approach does not explain much observed behaviour such as the willingness of citizens to act in the public interest, even when it may not appear to be in their own immediate self-interest. As already mentioned above, this happens when taxpayers meet their liabilities to a large extent without the need for an unduly coercive tax regime. Another example is the well-known tendency of some US taxpayers to make interest-free loans to government by having more income tax than necessary withheld from their salaries followed by a refund after the end of the tax year (Fennell, 2006).

Furthermore it taxpayers may not react well to an onerous regime, however much it may look to be effective. For instance both Schmolders (1970) and Strümpel (1969) reported that the German system was very rigid in its assessment procedures which led to an 'effective' but expensive and confrontational system. A notable outcome 'of the relatively coercive tax-enforcement techniques is the high degree of alienation from the state...[which] negatively influences the willingness to cooperate' (Strümpel, 1969, p. 29).

In contrast to the approach based heavily on self-interest, behavioural economics has involved subjecting the assumptions of mainstream economics to close scrutiny. DellaVigna (2009) summarized deviations from the standard model as non-standard preferences, non-standard beliefs and non-standard decision-making. In recent years considerable analysis and evidence have been presented on the importance of aspects such as fairness in taxation, the endowment effect, framing of decisions, limited attention, loss aversion and mental accounting that may impact on the administration of a tax system. Congdon et al. (2009: 375) stated: the implications of behavioural economics' for public policy, including tax policy, have yet to be systematically explored, and ...this oversight leads to both mistaken policy and missed opportunity'.

Behavioural economics has also reached a wider audience. For example, the book *Nudge* by Thaler and Sunstein (2008) became 'required reading' on a 2008 summer reading list for Conservative MPs in the UK. This was because authors' argue that sometimes voters need a gentle push to do the right thing, a view seemingly consistent with the Conservative Party's tax and welfare policies. From that approach came the Behavioural Insight Team or 'nudge unit' which was set up 2010 in the UK Cabinet

Office. Its role is to develop ways of helping people make better choices rather than trying to force them to do so. One early initiative in taxation improved some taxpayers' responses by changing letters from the tax office to explain that most people in their area had already paid their taxes.

For the present purpose, the behavioural economics approach examines a range of factors which may influence taxpayers' compliance behaviour. Some of the work also draws on other academic disciplines such as sociology in considering variables such as social support, social influence and certain background factors such as age, gender, race and culture. Psychology reinforces this approach and has even created its own branch of 'fiscal psychology' pioneered by Schmolders (1959) and reinforced by others such as Lewis (1982). A specific example of a relevant factor is referred to as 'framing' where it has been observed that the way an issue is framed can be an important influence on individuals' responses (Tversky and Kahneman (1981). This seems to be true in general and with respect to tax compliance in particular (see, for example, Holler, et al., 2008). Other important aspects include fairness in taxation, the endowment effect, limited attention, loss aversion and mental accounting.

There are many detailed contributions to the behavioural approach. Reflecting widely held views, Braithwaite et al. (2003) examined such factors as the perception of justice and Feld and Frey (2007) suggested that taxpayers are prepared to comply with the tax system if they perceive the political process is fair and legitimate. The roles of individuals in society and accepted norms of behaviour have also been shown to have a strong influence (Wenzel 2004 and 2005). This all has links with the rapidly expanding literature on tax morale which might be defined as 'an individual's intrinsic willingness to pay taxes' (Alm and Torgler, 2006, p. 224) and which is examined further in Torgler (2007). Background factors such as cultural influence have been examined by Coleman and Freeman (1997) and Cummings et al. (2004), and so have the implications of different political systems (Pommerehne et al., 1994). More direct contributions to policy in this area have come from a number of authors. For example, one is an appeal to taxpayers' conscience (Hasseldine and Kaplan, 1992) and also to feelings of guilt and shame (Erard and Feinstein, 1994). Others have suggested more positive help for taxpayers (Hite, 1989) and different methods of achieving this - such as the use of television to change taxpayers' attitudes towards fairness and compliance (Roberts, 1994) and information campaigns about the public goods and services paid for by taxation (Leder, et al. 2010).

Experimental work has also generated some potentially useful insights and one of these is the 'echo effect' Kastlunger, et al. (2009). This is the idea that tax audits can reverberate in a taxpayer's mind and increase their compliance with the tax system in the future. Experimental evidence suggests that when taxpayers are audited early in their taxpaying careers this can lead them to overestimate the probability of being audited in the future and thus increase their compliance. However the echo effect may be much less if such a tax audit is only undertaken after an individual has experienced many years without such an audit. There are other ideas coming from experimental evidence, such as the 'bomb crater effect' (Mittone, 2006), which may be less convincing. The term comes from the observation that troops in battle take cover in the craters of recent explosions thinking it unlikely that subsequent shells will fall in

exactly the same place. Similarly it is conjectured that some taxpayers think a tax audit will not soon be followed by another one. However it is not known how significant such an effect might be in practice, particularly as tax authorities are likely to pay additional attention to less compliant taxpayers. Nevertheless all such aspects are worth exploring. In addition, a similar development to behavioural economics has taken the form of 'responsive regulation' and to this we now turn.

#### **4. RESPONSIVE REGULATION IN TAXATION**

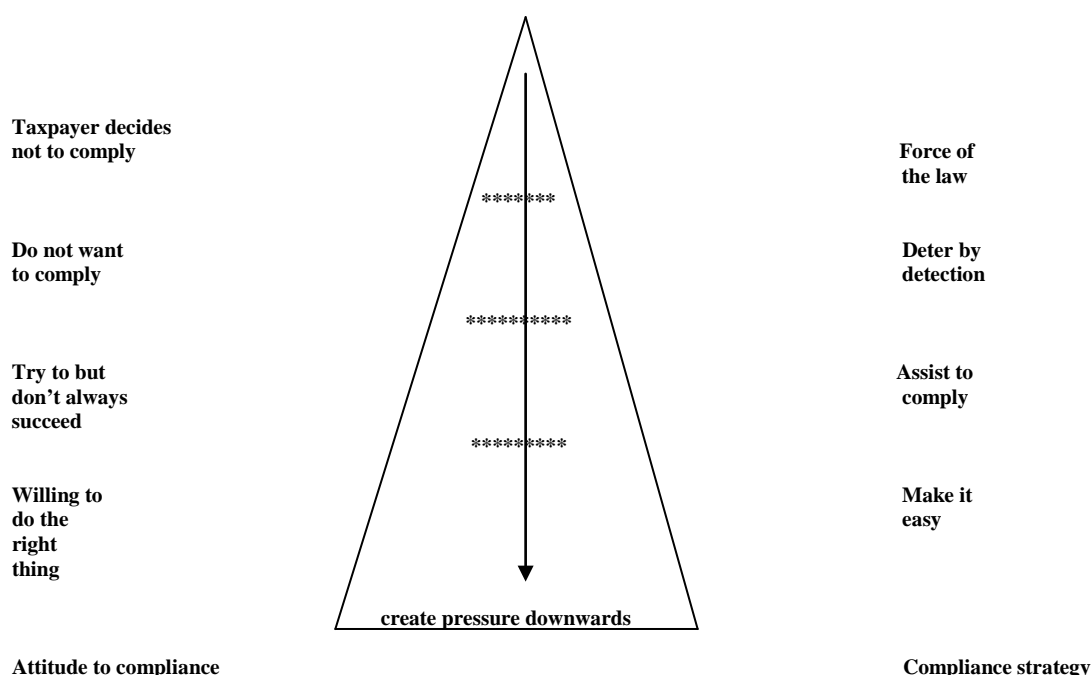
Like the behavioural approach, the development of 'responsive regulation' has made an additional contribution to regulation including its application to taxation. There have been some valuable contributions such as those by Braithwaite (2007), Kirchler et al., Leviner (2008) and Ventry (2008). Responsive regulation fits well with behavioural economics as Valerie Braithwaite's (2007: 5) comment illustrates:

Responsive regulation is a complex business. It welcomes the voice of dissidents, it deliberates on shared community goals and understandings, it enforces agreed upon standards, preferably through teaching, persuading and encouraging those who fall short...It seeks to dismantle any formula that presumes that individuals or groups are uniformly programmed in the way that they will respond to regulatory demands.

Since responsive regulation is also based on taxpayer motivation, further developments may benefit considerably from insights generated by behavioural economics. Essentially, the idea is that the response to non-compliance should be related to the reasons for non-compliance. Official activity with respect to taxpayers may therefore vary from the case of individuals or firms who are deliberately non-compliant to people who are trying to comply and simply need help to do so. In terms of taxation, there have been considerable developments, not least in Australia and New Zealand and the approach is illustrated in Figure 2 where the action taken by the tax authorities is responsive to taxpayers' willingness to comply.

Responsive regulation involves taking account of a range of factors which may affect the response of taxpayers to changes in legislation, supporting taxpayers in meeting their obligations to comply and recognising that different taxpayers may respond in different ways. Baldwin and Black (2008: 59) go on to suggest that 'really responsive regulation' with respect to firms 'seeks to add to current theories of enforcement by stressing the case for regulators to be responsive not only to the attitude of the regulated firm but also to the operating and cognitive frameworks of firms; the institutional environment and performance of the regulatory regime'. The next task is to consider these ideas with respect to tax authorities themselves.

**Figure 2**  
**Compliance Model Developed in Australia and New Zealand**



## 5. RISK MANAGEMENT AND THE TAX AUTHORITIES

The approach of behavioural economics may also contribute to avoiding the risks of poor performance of the part of tax authorities themselves since, of course, tax officials are also human! In a study of Australian taxpayers and tax officials, Kirchler et al. (2006, p. 515) concluded that treating taxpayers reasonably and fairly, explaining rules and decisions and providing reliable information will improve the reputation of tax officers which may lead to an increasing willingness to comply with the spirit of the law. Unfortunately, a poor level of service may lead to the opposite outcome and sometimes tax administrations can face difficulties even - paradoxically – when spending considerable effort on changing their management systems.

Also unfortunately, tax administration in the UK provides an illustration of such difficulties, with a major merger, a substantial cut in resources and a radical change in management culture involving private sector techniques based on ‘rational’ rather than ‘behavioural’ principles. Indications of problems had been emerging for some time with taxpayer complaints about the failure of HM Revenue and Customs (HMRC) to respond to telephone calls and letters. In addition there were several serious errors which affected millions of taxpayers and the difficulties increasingly attracted official attention. The Treasury Select Committee (2011, ‘Conclusions and Recommendations’, para. 46) report on HMRC concluded:



The evidence we have received in this inquiry has been disturbing. HMRC's delivery of services to the general public has fallen to unacceptable levels in several areas. Many factors have contributed to this process: overly ambitious expectations for IT projects, sustained cuts to resources, a management culture of 'command and control', increasingly complex tax legislation and the legacy of the merger.

The Treasury Select Committee (2011) also looked specifically at management issues. It reported that the Cabinet Office's people survey of Autumn 2010 ranked HMRC bottom of the entire civil service – indeed the HMRC score was even lower than in the previous year. The Committee stated in its conclusions and recommendations (para. 4) that:

The evidence we have received about the management culture within HMRC, supported by the staff survey results, is very disturbing. There is a perception that the Department is run on the principles of close control and management scrutiny, with little opportunity for individuals to develop autonomy and exercise their skills. Whilst there is a need for consistency in dealing with people's tax affairs and appropriate performance management, a culture such as the one described to us is likely to harm staff morale and lead to disengagement and poor performance.

The first of the factors mentioned above – the merger between the Inland Revenue and Customs and Excise to form HM Revenue and Customs - took place in 2005. Both departments had very long and well-established but different cultures and organisation. The Financial Times (9 July 2004), described the merger as the mating of the Inland Revenue retriever with the Customs and Excise terrier. The Inland Revenue was primarily responsible for direct taxation and its origins can be traced back to the Board of Taxes established in 1665. A separate Board of Stamps was set up in 1694. Customs and Excise was responsible for collecting customs duties, excise duties and value added tax and also had certain agency functions. The role of customs officers can be traced back to the thirteenth century and a Board of Customs to the seventeenth century. After the merger of the two departments HM Inspectors of Taxes and other tax officials were all designated Officers of Revenue and Customs, which may not have helped morale either.

In addition to the merger, the resources available to HMRC are being reduced – it is required to reduce its running costs in real terms by 25 per cent by the end of 2014-15 (National Audit Office, 2011, para. 3). Both the merger and the cut in resources were likely to lead to difficulties but the focus here is on managerial change where a behavioural approach may have most to offer.

The management changes at HMRC can be seen as a feature of the 'New Public Management' (NPM) in many countries as described, for example, by Pollitt and Bouchaert (2011). NPM takes a 'business-like' approach to public sector management and places a greater emphasis on 'performance' particularly through the measurements of 'outputs', market-type mechanisms and treating 'service-users' as 'customers'. As Pollitt and Bouchaert, (ibid. p. 10) point out, a number of commentators have

observed tensions between the 'economistic' low trust way of thinking involving rational systems of rewards and punishments and a more behavioural way of thinking with a greater trust in the inherent creativity of staff provided they are properly led and motivated.

The implicit 'economistic' assumption of some fashionable management theories may account partly for their initial appeal. Managing people within a formal and rational structure with incentives, targets and so on seems consistent with a basically logical process and to promise improvements in efficiency. Indeed, there has been comment about such theories being advanced in this way by vested interests. For example, Newall et al. (2001, p. 8) describe active management fashion setters (consultants, gurus, IT suppliers, professional groups and so on) developing 'rhetorics about best practice...by echoing felt gaps in efficiency and performance'. It was put even more clearly by Baskerville and Myers (2009, p. 647) who defined a management fashion as 'a relatively transitory belief that a certain management technique leads to rational management progress'.

With respect to the UK and the HMRC, concerns have been examined in the academic literature (for example by, Carter, et al. 2011a and 2011b). One issue of concern has been the use of 'lean techniques' at HMRC. Such techniques were developed in the business sector, primarily in the motor industry, and the central idea is that removing wasteful processes from production will lead to improvements in efficiency and quality (see for example, Womack et al. 1990 and Holweg, 2007). It was an indication of how things were to be changed that Sir David Varney from the private sector joined HMRC in 2004 and was appointed as the first Chief Executive of the newly merged HMRC 2005. Also in 2005 it was decided to introduce lean management techniques across HMRC and lean management formed a major part of the PaceSetter Programme which had the aim of improving business performance and staff engagement (National Audit Office, 2011, para. 5). In a review for HMRC, Radnor and Bucci (2007, p. 20) found that the principles of lean management were absorbed by HMRC staff and there was a 'very good understanding of the background to Lean and its principles' across all the sites they visited and across all grades of staff. They also found that the most commonly cited principles of Lean were customer focus, developing and improving standard processes, increasing efficiency, removing waste and increasing productivity and quality. In a later paper, Radnor and Bucci (2008 as quoted by Carter et al. 2011a) stated that HMRC 'are the closest of any public service to date in implementing the Lean philosophy'.

Furthermore it was anticipated that the changes would address the requirement to save resources. For instance the Varney Review (2006, p. 5) by Sir David Varney required an improvement in 'public sector contact centre performance by establishing performance targets and best practice benchmarks... [so]...reducing operating costs by 25 per cent'.

No doubt changes in tax administration are necessary as the tax environment and technology change but possibly there was insufficient appreciation of advantages of the methods of tax administration that had developed over long periods. There were also concerns whether such management techniques were entirely appropriate in such a public sector context. Indeed there has been a growing body of evidence that this approach is associated with some undesirable outcomes.

A study by Carter et al. (2011a and 2011b) of HMRC staff in 2008/09 involving an initial interview analysis followed by a questionnaire survey produced results that were some way removed from the advantages claimed for such management approaches. They found that the fragmentation of processes and the imposition of hourly targets had adversely affected quality and productivity, there had been a negative impact on non-targeted work, a loss of control and discretion leading to deskilling and difficulties for managers and supervisors in managing effectively as their attention was focused on statistical information. A conclusion of particular concern was that while ‘statistics may reveal productivity and performance improvements, further investigation reveals that they are constructed accordingly and collusion in this process occurs on many different levels’ (Carter et al. 2011a, p.120). In a further paper on the subject, Carter et al. (2011b, p. 94) concluded that the enforcement of the ‘appositely named lean “PaceSetter” system generated a series of damaging outcomes for a hitherto skilled and loyal public servant workforce’, with much previously skilled service reduced to ‘little more than semi-skilled assembly line work’ (p.95).

A behavioural perspective of such issues has considerable advantages over such an approach. Echoing Veblen’s comment above, in a management context, Kaufman (1999, p. 387) suggests that the closest real world approximation of economic man and the model of self-interested rational choice is a child under eight years old where behaviour can be predicted on the basis of ‘getting what you want makes you happy’. Kaufman concludes that, although the rational choice model is a powerful device, it cannot adequately explain employee behaviour in many cases. In contrast, behavioural economics has indicated directly some of the advantages of management based on ‘employee involvement, commitment and empowerment...[but not]...employee control’ (Tomer, 2001, p. 64). Indeed there is substantial evidence that using workers’ contributions in this way produces better results in complex situations than have more mechanistic approaches to management.

## **5.1 Fairness**

A further general concern in the UK in the recent past has been the fairness of tax administration. As pointed out above, behavioural economics recognises the importance individuals place on fairness in a way that the rational approach does not. In taxation this can mean the difference between a successful tax and a failed one – such as the UK’s community charge (James, 2012). HMRC has been the subject of considerable press coverage about the allegedly favourable terms granted to certain very large organisations but not to the great majority of taxpayers. One of the conclusions of the Public Accounts Committee (2011) was:

The Department is not being even handed in its treatment of taxpayers. It is unfair that large companies can settle their tax disputes...at less than the full amount due and that they have been allowed up to 10 years to pay their tax liabilities, while small businesses and individuals on tax credits are not allowed similar leeway.

While the approach of 'doing deals' with large taxpayers might be consistent with a business-like approach described above, it can undermine the public sector ethos of tax administration and therefore the tax morale of the vast majority of individuals.

## 6. CONCLUSION

Mainstream economic analysis, based on the self-interested rational choice model, has proved to be a powerful means of understanding taxation. However this approach has its limitations and a more comprehensive approach can be developed by drawing on behavioural economics. Tax authorities have managed risk throughout the history of taxation but in recent years there have been considerable developments in applying risk management to tax administration by the European Commission, the OECD and others. There have also been considerable developments in behavioural economics. These offer valuable insights regarding taxpayer behaviour and many further applications are likely to prove worthwhile. Responsive regulation has also contributed to a more sensitive approach to managing taxpayer risk and is based on taxpayer motivation. Responsive regulation may also benefit from applications of behavioural economics.

Taxpayers are also affected by the operation of tax agencies. Individuals who are treated reasonably and assisted effectively where appropriate are more likely to comply with the spirit of the law than individuals who are poorly treated. Insights from behavioural economics may not only be helpful in improving taxpayer compliance but also the performance of tax officials. A particular aspect has been the development of management methods used within tax authorities themselves. Unfortunately management techniques, often transplanted from the private sector and based on the self-interested rational choice model, have not always delivered the promised benefits. Some of the difficulties arise because tax authorities are not market based profit maximizing organizations. However, difficulties may also arise because tax officials have to deal with important and complex issues in a public sector context. The performance of tax officials may be enhanced if they are able to develop a professional approach to their duties rather than be subject to more mechanistic methods of management.

In conclusion, there is evidence to suggest that many taxpayers do not act in their own immediate self-interest by pursuing every possible opportunity to avoid or evade taxation and so do not have to be tightly regulated. Rather, there may be significant advantages in shifting the emphasis of tax compliance policy towards treating the majority of them as responsible citizens and using the insights of behavioural economics to do this in the most effective ways. Similarly using a more behavioural approach might avoid the disadvantages of some managerial systems being employed in tax agencies with outcomes such as those noted above. Developing a professional approach among tax officials would also encourage responsible citizens to fulfil their tax obligations.

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# Improving tax compliance strategies: Can the theory of planned behaviour predict business compliance?

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## **Abstract**

For many taxpayers the uncertainty inherent in the tax system makes paying taxes akin to a game of chance. Some people gamble on the ambiguity of the law and intentionally under-report their earnings, whilst at the other end of the spectrum, others overcompensate for any possible misdemeanours and pay more than they owe. There is great variety of taxpayer behaviour patterns in between these extremes. Existing theories have failed to clarify the complexities of taxpayer decision making and thus failed to establish a useful platform for agencies to influence and encourage voluntary compliance.

This study investigated the factors influencing business tax payers' decision on whether to report income and deductions correctly in their 2011 income tax return. The proposed model based on Ajzen and Fishbein's reasoned action approach (the Theory of Planned Behaviour -TPB) has genuine applicability in the tax compliance context. The research was conducted in two phases. Firstly, an online pilot survey was used to elicit salient beliefs in order to construct the primary (TPB) questionnaire. The resulting online survey was distributed to taxpayers who were asked to identify whether, in the previous 12 months they had (i) self-initiated contact or received assistance from the Tax Office; (ii) been contacted via an audit or other verification scenario; or (iii) had no personal contact with the Tax Office. The aim was to determine whether the TPB can reliably predict taxpayers' intention to fulfil their tax obligations and if so, whether it can be used to develop intervention strategies to improve voluntary compliance.

The results show that intention to comply is not always a strong predictor of compliance behaviour. The majority of taxpayers who wanted to comply, failed. As complexity and difficulty in performance increases, additional factors are required to predict compliance, such as awareness of the rules. Complexity also reduces the predictability of behaviour. Behaviour prediction can be enhanced by quantifying environmental complexity, providing performance support, and eliminating potential obstacles. Intention can only be leveraged for compliance strategies when the tax system creates the optimal environment for taxpayers to successfully comply.

The paper reports the findings and discusses their theoretical and practical implications. The results have significant implications for both behaviour prediction and tax compliance strategy development. The study has broad generalisability as it provides a new model for government agencies to assist them to understand and engage effectively with the people they serve.

## **1. INTRODUCTION**

The effective management of taxpayer compliance with the tax laws is an essential but complex issue for administrative authorities (Alm, Sanchez, & Dejuan, 1995; Bobek

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& Hatfield, 2003). Tax authorities must apportion their resources to ensure optimal targeting of those taxpayers who deliberately evade whilst providing support for those who attempt to comply. In addition, tax collectors must be vigilant in ensuring fair and equitable treatment for all taxpayers and continually make efforts to improve the process in order to respond to social, economic and demographic changes in the population.

The growing demands on tax administration mean that traditional approaches to compliance management are unsustainable. This issue is particularly problematic in Australia as the population increases and immigrants from countries with different attitudes and traditions make enforcement of tax compliance through conventional methods more difficult.

Research and development in tax compliance has centred on economic theory with few practical models for managing and changing unwanted taxpayer compliance behaviour. The study reported in this paper uses self-reported data from a large scale survey used to investigate whether compliance behaviour can be predicted using a combination of predictive factors from both the domains of economics and social psychology. Once predicted, behaviour can be influenced by addressing the causal salient beliefs. Legal complexity and the effects of system obstructions will also be explored to determine the strength of intention in the success of correct tax reporting. This research will be used to improve our ability to design compliance interventions which support and guide those taxpayers who are willingly compliant. At the same time the new model will be evaluated as a tool for limiting or preventing detrimental non-compliant behaviour.

## 1.1 Australian context and research background

In Australia during the period 1999 to 2009, the individual taxpayer population increased from 10 to 12 million and the number of listed companies nearly doubled<sup>2</sup>. Businesses also increased the expenses claimed on their tax returns from \$1,217 billion in 1999 to \$2,142 billion in 2009 (Commonwealth of Australia, 2002, 2011). The risk and subsequently the consequences of tax evasion through fraudulent claims for Australia have increased dramatically.

Due to the increasing complexity of tax legislation, advanced technology is required to maintain the high volume of returns processed. The Tax Office is forced to rely increasingly on automated systems to safeguard compliance and less on the individual partnerships forged between tax officers and the community. Paradoxically, the adoption of sophisticated information technology to enhance voluntary compliance is a poor cousin to the primary compliance strategy used by the Tax Office: audit. Audit requires an immense workforce to maintain high levels compliance. The Tax Office's operating budget for 2008-09<sup>3</sup> was \$3.2 billion of which approximately one third was spent on auditing tax returns in order to collect \$6.4 billion in revenue (Australian

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<sup>2</sup> In the 1999-2000 financial year there were 1723243 companies, partnerships and funds, in 2008-09 there are 2179935 (Commonwealth of Australia, 2002, 2011).

<sup>3</sup> The most recent published budget available for the Taxation Office is 2008/09.

Taxation Office, 2009). However, it is debatable whether this is an effective use of resources, considering that approximately 97% of the country's revenue (\$264 billion) results from voluntary contributions (Australian Taxation Office, 2009).

The Australian Taxation Office is a world leader in taxation compliance (Inspector-General of Taxation, 2005; Shorten, 2011). The organisation has introduced several innovative solutions to compliance problems, such as E-tax to assist individual taxpayers with tax returns, several targeted task forces such as High Wealth Individuals (Australian Taxation Office, 2008b); The Cash Economy (Australian Taxation Office, 2008a) and Project Wickenby<sup>4</sup>. In addition, ideas adopted from social psychology, such as Braithwaite's (2003) compliance model, are used to aid in compliance management.

However, since tax collection became the Commonwealth's responsibility in 1946 (Boucher, 2010, p. 3), the fundamental methods for managing tax compliance have remained virtually static. Primarily compliance interventions rely on the administrator's ability to verify taxpayer records, detect non-compliance and to instigate actions that deter future evasion. Tax administration has for many years relied on economic theory to attempt to enforce tax compliance behaviour, the basis of this policy is the theory of Expected Utility (EU, Von Neumann & Morgenstein, 1944). EU assumes that humans are rational and act accordingly to prosper. Therefore, deterrence works on the principle that taxpayers fear reprimand, financial penalties or even legal action and criminalisation. Any of these will lead to offenders experiencing a reduction in the quality of life. The premise of EU is that the primary tool for managing tax compliance is through interventions such as audit and penalties. Tax agencies around the world have applied the principles of EU as a foundation on which to build their compliance management models.

However, recent research (Bergman & Nevarez, 2006; Johnson, Masclet, & Montmarquette, 2010; Kirchler, 2007; Mittone, 2006) demonstrates overwhelmingly, that these methods may not only be ineffective but also counterproductive. As the tax authority increases its use of enforcement measures, voluntary compliance often declines and overt dishonesty increases due to a growing environment of mutual distrust (Kirchler, 2007, p. 168; Torgler, 2002). However, few realistic alternatives exist.

Intervention methods directed at improving voluntary compliance through reward and reinforcement of responsible behaviour are tentative and generalised (Alm, Cherry, Jones, & McKee, 2010). Such interventions attempt to educate taxpayers with regard to the tax laws and provide broad regulatory guidance for market segments. However, the information provided by tax agencies presupposes that individuals have the knowledge, experience and confidence to translate the information provided to their own circumstances. The role of the tax agent developed as an additional support for the community to overcome such obstacles. Notwithstanding even tax professionals

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<sup>4</sup> A cross agency task force established in 2006 to prevent the abuse of secrecy havens ([Australian Taxation Office, 2012](#)).

make mistakes for which the individual is liable<sup>5</sup>. For most taxpayers, maintaining their tax affairs is akin to a game of chance: many approach it anxiously hoping their interpretation of the law is correct and assuming that the Tax Office will treat them fairly if genuine mistakes are made. However, when individuals have attempted to comply but are penalised, they feel their trust has been violated which, in turn, changes their subsequent behaviour (Hobson, 2002). The consequences are disengagement and disillusionment resulting in defiance and resentment (Braithwaite, 2009; Hobson, 2002).

A further dilemma for the Tax Office is that, although the majority of taxpayers behave honestly when treated with trust and respect (Hessing, Elffers, & Weigel, 1988), there is a significant minority who abuse the system. Therefore, the tax administration must strike a balance between interventions to encourage voluntary compliance whilst maintaining firm authority over misconduct. The Tax Office has a myriad of strategies at its disposal based on the Compliance Model (Braithwaite, 2003). However, applying broad compliance interventions to large segments of the population is impractical without methods for distinguishing the many different motivations and intentions of the taxpayers involved and then designing the treatments accordingly. Current methods are unable to cope with the immense diversity within the community and the plethora of different management strategies at both the population and individual level to ensure that each taxpayer receives the most appropriate compliance support.

The complexity of the compliance dilemma necessitates the development of a comprehensive model and a methodology for applying that model in order to influence and shape the behaviour of large groups of taxpayers. The lacuna has been noted by researchers, such as Kirchler (2007, p. 2), who admits that “research has yet to be integrated into a comprehensive model of taxpaying behaviour” and calls for a model “integrating the most recent findings in the social sciences”. However, to have any practical value, a new model must not only cope with the wide range of values, beliefs and contexts that influence taxpayer behaviour but also provide direction to guide the establishment of large scale strategies and interactions with the population. Any new model to manage the increasing size and diversity of the population taxpaying behaviour must still be fair and provide personal treatment. Such an approach necessitates the abandonment of the current economic view of compliance behaviour, as the solution requires the understanding of social relationships and how the people involved make sense of both the events and the consequences of their actions.

## 1.2 The Compliance Behaviour Model

The dual purposes of our study is to: i) determine the most appropriate model for use in predicting and shaping tax compliance behaviour; and ii) evaluate the new model’s application in the tax compliance context. Several existing models and economic theories were evaluated prior to the development of the new model and these included: equity theory (Adams, 1965); exchange equity (Moser, Evans, & Kim,

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<sup>5</sup> Note the new safe harbour legislation which has been introduced to ensure tax agents provide duty of care with their handling of client’s tax affairs - subsection 286-75(1A) of Schedule 1 of the Taxation Administration Act 1953 (TAA).

1995); procedural justice (Murphy, 2004); economics of crime (Becker, 1968); prospect (Kahneman & Tversky, 1979) expected utility (Allingham & Sandmo, 1972) and reasoned action (Beck & Ajzen, 1991; Hanno & Violette, 1996; Hessing, et al., 1988). In addition, a number of social psychological theories were examined including: the compliance model (Braithwaite, 2003), self-regulation and control (Carver & Scheier, 1998), social cognitive theory (Bandura, 1989), self-efficacy (Bandura, 1977), self-identity and symbolic interactionism (Rise, Sheeran, & Hukkelberg, 2010; Sparks & Guthrie, 1998; Tice & Wallace, 2005) and mixed embeddedness (Rothengatter, 2008).

Our review reveals that the most appropriate model for developing our understanding and thereby shaping taxpayer behaviour is the Theory of Planned Behaviour (TPB, Ajzen, 1991) one which has been applied broadly to community behaviour change in regards to health (Armitage & Conner, 1999) and traffic control (Elliott, Armitage, & Baughan, 2005; Letirand & Delhomme, 2005), but until recently has had minimal attention from tax researchers. Our research proposes a new model for compliance based on the TPB (Ajzen, 1991), which we believe is capable of not only clarifying the complexity of tax compliance decision making but, importantly, can also be utilised for the development of broad population compliance strategies.

The TPB has its origins in the earlier theory of Expected Utility but introduces a number of additional explanatory variables which are, according to Ajzen & Fishbein (1980, p. 4) “designed to explain virtually any human behaviour”. If they are correct in their claims that “behaviours are not really difficult to predict”, then the TPB has the potential to aid the Tax Office, in predicting, supporting and thus re-shaping taxpayer behaviour.

TPB proposes a direct relationship between intention and behaviour. This relationship is critical to any significant change in policy. Intention is an essential component of tax compliance as it is only through the willing participation of taxpayers that revenue is collected. Thus predicting taxpayer intention to comply is as important as predicting the actual compliance behaviour. Determining if behaviour is motivated by unwillingness to comply (as opposed to external factors preventing compliance) will shape the treatment to improve performance of the behaviour. The tax authority would design interventions that pre-emptively address the cause of the non-compliance rather than administer solutions *post hoc* which may encourage further non-compliance.

In addition to intention, the TPB addresses the issue of behavioural control with the inclusion of two variables, perceived behavioural control and actual control. Perceived behavioural control is composed of two elements: the individual's controllability of the behaviour and their self-efficacy in performing the requisite behaviour. This variable encapsulates the factors which determine an individual's persistence and effort in performing the actions necessary for the behaviour. Actual control is only a recent addition to the model (2010) but is an essential component when investigating behaviours that are complex or require the individual to overcome performance obstacles. Actual control has been defined as “the relevant skills and abilities as well as barriers to, or facilitators of, performance” (Fishbein & Ajzen, 2010, p. 21).

Further to perceived behavioural control, intention has two other antecedents: attitudes and norms. Attitudes have been shown widely in the tax compliance literature as a foremost contributor to tax compliance behaviour, positive attitudes are associated with compliance and negative attitudes with evasion (Chan, et al., 2000; Eriksen & Fallan, 1996; Hofmann, et al., 2008; Kirchler, 1999; Torgler & Valev, 2010; Vogel, 1974). Norms are also shown to exert influence over the tax behaviour through personal, social and societal referents (Kirchler, 2007, pp. 58-72). Norms have also been considered a strong contributor to white collar crime (Kroneberg, Heintze, & Mehlkop, 2010). Kroneberg, Heintze and Mehlkop (2010) investigated the effects of norms on the two contrasting criminal activities: shoplifting (common crime) and tax fraud (white collar crime). Their findings revealed norms determine whether individuals even consider a criminal activity as an option. In circumstances where strong moral norms were in place, individuals were not affected by instrumentality and rational choice factors. However, where norms were absent, individuals were not bound by what most people would regard as acceptable behaviour. Therefore, both attitudes and norms are highly relevant in the context of tax behaviour research.

The TPB is a robust model for predicting all types of behaviour. However, weaknesses in the model relate to effective operationalisation of variables and its applicability in certain contexts. Few studies have empirically tested the full TPB model due to the misapplication of key methodological factors, such as the correct specificity of behavioural measures or the temporal instability of intentions. Further difficulty is encountered when the behaviour is complex or when it involves a third party. Therefore, to account for these factors, we considered three additional variables for inclusion in the new model: taxpayer identity, perceptions of cooperation by the Tax Office and awareness of the law.

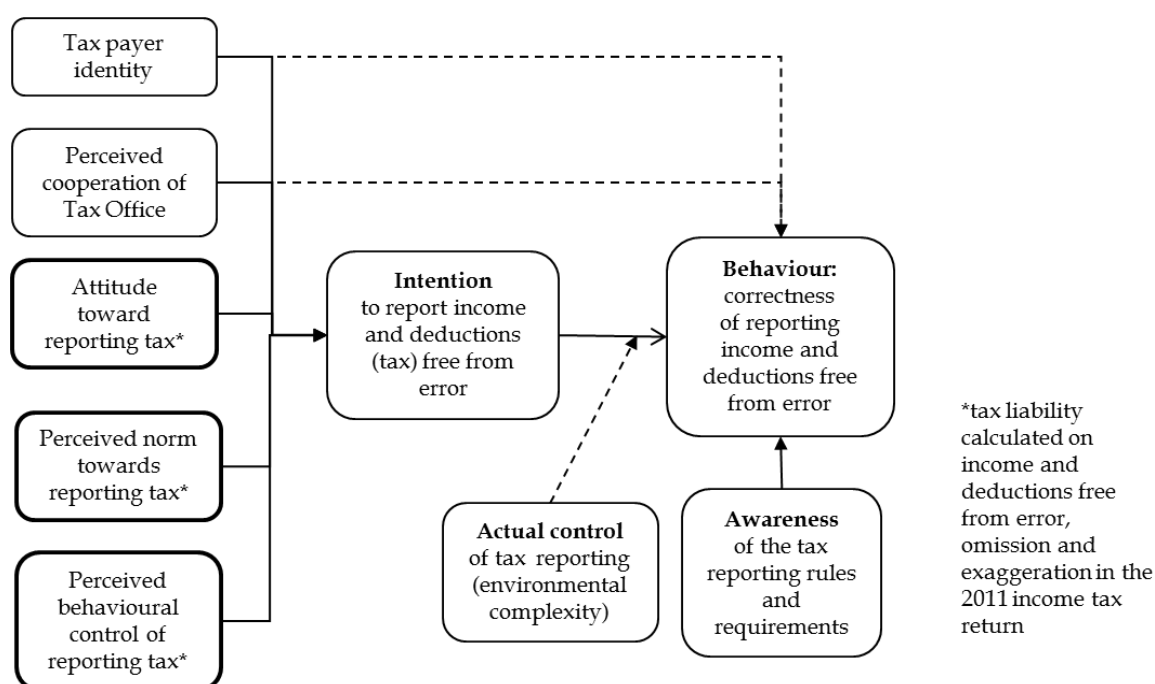
The decision to include perceptions of cooperation by the Tax Office arises from two anomalies in the application of TPB in the tax context. Firstly, not all taxpayers have complete volitional control of their compliance behaviour. To achieve certain tax obligations the taxpayer may need to overcome various obstacles, such as complicated forms or tools that are difficult to understand. Furthermore taxpayers are often unable to self-assess and thus determine whether or not they have performed adequately or correctly. Therefore, they cannot make the necessary adjustments to their actions in order to achieve the required outcome. A lack of certainty and inadequate feedback systems are major considerations for the actual control of behaviour. The second anomaly is the reliance on a third party, for example the Tax Office, to perform the behaviour. Tax compliance requires cooperation between taxpayers and the tax administrators which is a similar situation to that of the participants in the prisoner's dilemma – an experiment in game theory in which two people might not cooperate even if it is in both their best interests to do so. Ajzen and Fishbein (2005, p. 95) evaluated the TPB when used in the prisoner's dilemma and discovered that perceptions of cooperation had a strong influence on participants' intention to cooperate with other players. In summary, the additional variable of perceptions of cooperation by the Tax Office was included in our compliance model to assess its effect on the taxpayer's intention to comply.



The second new variable, Taxpayer identity is consistent with the concept of self-identity as a factor in symbolic interactionism (Tice & Wallace, 2005, p. 92). The identity is formed and continues to evolve as a response to feedback. In the case of tax compliance, the feedback is provided by the Tax Office or its representatives interacting with the taxpayer. The quality of this interaction may contribute to the changing position the taxpayer may adopt in regards to the tax authority. While similar to the concept of a motivational posture (Braithwaite, 2003), taxpayer identity is not a projection of the taxpayer's position in regards to the authority. Instead it is the relative assessment taxpayers make of themselves as good taxpaying citizens. Research in fields unrelated to tax compliance has shown that the application of the TPB has been greatly enhanced by including self-identity as an independent variable (Hagger & Chatzisarantis, 2006; Sparks & Guthrie, 1998; Sparks & Shepherd, 1992; Terry, Hogg, & White, 1999; Tittle, Welch, & Grasmick, 2008). Self-identity is a strong predictor of behaviour, particularly when the decision making framework involves self-categorisation due to socialisation (Rise, et al., 2010). Rise et al. (2010) mount a strong argument for the inclusion of self-identity in the TPB as the additional variable accounts for 6-9% of variance in the model when other variables are controlled. Due to the moral nature of tax compliance decision making the incorporation of a concept of self to the decision making process has great predictive potential.

The complexity of the tax system itself is shown to have a great effect on the outcome of compliance behaviour. Which is why the third variable awareness has been included in the model. In most cases, the average person does not know whether they have been compliant (Ashby & Webley, 2008) and further to this, complexity reduces the likelihood of compliance due to uncertainty in behavioural outcomes (Alm, et al., 2010; Long & Swingen, 1991; McKerchar, 2002). Other researchers such as Lawsky (2009, p. 1023) and Alm, Jackson and McKee (1992) reveal how areas of the tax law which appear certain, may be overturned or re-interpreted in court as auditors interpretation of the law is inconsistent and indeterminate. The current version of the Tax Act (Income Tax Assessment Act, 1936 ) alone has 468 sections and over 8055 pages. The Master Tax Guide, which provides guidance on the application of the law, for the same year (2007), is 2333 pages. The 1936 Income Tax Assessment Act must be read in context with the 1997 act (Income Tax Assessment Act 1997). The sheer volume of the tax legislation makes apparent the difficulty the average taxpayer has in understanding and applying the law to his or her own circumstances. The lack of certainty around the application of the law not only creates ambiguity but is also misleading. The inclusion of the variable awareness is required to assess the taxpayer's understanding of the law and whether it has been correctly applied. Therefore, it will reveal whether the outcome of the behaviour matches the taxpayer's intention.

As the new model pertains specifically to any behaviour that requires compliance, as opposed to being one deliberately planned or reasoned by an individual, it is termed the Compliance Behaviour Model (CBM). Figure 1 depicts the CBM and shows the relationship between the original variables and the new variables used for the prediction of tax compliance behaviour.



**Figure 1 - The Compliance Behaviour Model applied to correctly reporting income and deductions**

Our hypotheses relating to the CBM are shown in Table 1.

**Table 1 - Research hypotheses**

No	hypothesis
1	The <i>Intention</i> of taxpayers to comply will predict <i>compliance behaviour</i>
2	<i>Attitude</i> towards correctly reporting and maintaining tax records will effect <i>intention to comply</i> with tax obligations
3	<i>Norms</i> in relation to correctly reporting and maintaining tax records will effect <i>intention to comply</i> with tax obligations
4	<i>Perceived control</i> of correctly reporting income tax will effect <i>intention to comply</i> with tax obligations
5	<i>Perception of the Tax Office's willingness to cooperate</i> will effect taxpayer's <i>intention to comply</i> with tax obligations
6	<i>Perception of the Tax Office's willingness to cooperate</i> will effect taxpayer's <i>compliance behaviour</i>
7	<i>Tax payer identity</i> will effect <i>intention to comply</i> with tax obligations
8	<i>Taxpayer identity</i> will effect <i>compliance behaviour</i>

### 1.3 The current research

The research presented in this paper used several approaches to identify and resolve methodological issues which have made previous studies unreliable and inconclusive. Ajzen and Fishbein (2010, pp. 54-55) are highly critical of existing research utilising their theory and suggest inconsistent results are due to failures in one of five areas:

behavioural incompatibility; scale incompatibility and category incompatibility as well as temporal instability and accuracy. Ajzen and Fishbein's (2010) recommended procedures were followed with particular attention to these issues.

The behaviour to be applied to the model must have a target, action context and time and is defined for the purpose of our study as: Reporting income and deductions without errors and omissions in the 2011 income tax return was. All attitude, normative and control factors were measured at the same level of specificity.

The research was conducted in two parts: (i) a pilot study to construct the measures for the variables in the model based on salient beliefs; and (ii) a main study to provide data to test the related hypotheses and evaluate the model. Both studies used online anonymous survey instruments to provide confidence to participants that their responses would be anonymous.

A significant challenge for research into compliance behaviour is developing an appropriate measure for tax compliance behaviour. It is impossible to measure and compare actual tax compliance behaviour against self-reported behaviour due to ethical and privacy constraints. Regardless, studies that have attempted this have shown unpredictable results due to taxpayers' inability to correctly assess the success of their attempts at compliance (Hessing, et al., 1988). Additionally, many researchers are sceptical of self-reported behaviour due to the likelihood for self-presentation, a person's need for social desirability as well as other common methods bias. The subject matter explored by our research is potentially sensitive for many taxpayers and therefore risk of reporting bias is real. A number of measures have been taken to reduce, moderate, or interpret the effect any bias has had on the results.

To overcome the difficulty of measuring actual compliance behaviour, hypothetical scenarios were used as proxy measures. Measuring behaviour at the time of the survey also eliminates the impact of temporal stability on the behaviour measure. Hypothetical scenarios provide participants with detailed real life situations where they are required to respond to how they might behave given a set of circumstances. These scenarios are known as vignettes and they contain brief but precise descriptions of what are considered to be the most important factors in decision making (Alexander & Becker, 1978). Vignettes are used in psychology and also as a valid method for collecting and communicating data in sociological qualitative research (Finch, 1987; Greenhalgh, Chowdhury, & Wood, 2006; King, Murray, Salomon, & Tandon, 2003). Scenarios of varying complexity were developed around situations where reporting income and deductions could be either manipulated or might cause confusion when completing the task. Only situations common to most businesses and that were also regarded as risk areas by the Tax Office (2011) were used.

The primary criticism of hypothetical scenarios relates to the discrepancy of information available to an individual when completing a questionnaire as compared to the actual behaviour in the 'heat of the moment' (Fishbein & Ajzen, 2010, p. 62). To minimise the chance of hypothetical bias, scenarios were created utilising real world decision making and problems. The scenarios included system obstacles and legal complexity that forced taxpayers to make decisions that test the boundaries of

hypothetical thinking. By placing an individual in a realistic setting and providing the safety of anonymous self-reporting it was anticipated that business owners would admit to selecting one of the likely options.

The methods used to evaluate the model and the related hypotheses will now be described in detail, results from the procedures will follow with a discussion of the conclusions and the implications for tax authorities.

## **2. METHOD**

### **2.1 Participants and sampling procedure**

A total of 6015 business owners or controlling minds<sup>6</sup> of small and medium enterprises were invited by postal mail to participate in the online survey. To construct the final sample a data extraction was conducted on the Tax Office client data store in July 2011. This file contained the postal mail contact details (name of contact, role, postal address) of 5000 business entities in the \$2 - \$250 million Total Business Income (TBI) range from all geographical locations located within Australia with only 1-4 registered directors. Only businesses with active ABNs and TFNs were selected. The extraction was administered using a random selection algorithm. The initial contact list was screened to remove duplicate entries that contained the same contact and business name. A further data cleanse was conducted to remove all businesses that were listed with tax agents as their primary contact. The remaining data contained 6015 contact names for 5000 small and medium enterprises.

### **2.2 Materials and procedure**

#### **2.2.1 Pilot study**

Members of the Small Business Advisory Group (SBAG)<sup>7</sup> were invited to participate in the pilot survey to identify the salient beliefs of the target population in relation to the behaviour of interest. In addition, the pilot study was used to test the scenarios as a means to measure compliance behaviour. Scenarios were used as a proxy for environmental conditions or complexity and therefore these variables were not specifically measured in this study.

To enhance the reliability of the salient belief measures gathered from the survey, additional data was gathered and compared from interviews with businesses (conducted previously) and a literature review. A final list of salient beliefs and norms compiled from the analysis was used to develop measures of the constructs in the CBM. The measures were incorporated into the main survey instrument. The final survey instrument was tested for usability and readability with five participants of the extracted target population.

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<sup>6</sup> The controlling mind is an individual who has a controlling interest in the business entity and who directs the finances of the business.

<sup>7</sup> A community consultation group created and administered by the Australian Taxation Office.

### 2.2.2 Main study

The online survey was conducted over a six week period between 26 August and 10 October 2011. The survey instrument contained three parts: hypothetical scenarios; measurement of the TPB variables; and control measures. Backward movement through screens was disabled on the online survey instrument to prevent participants from reviewing and modifying answers based on subsequent questions.

Several controls were included in the main study relating to previously determined items which influence compliance, such as age (Wenzel, 2002), level of education (Carroll, 1992) and gender (Cullis, Jones, & Lewis, 2006; Wenzel, 2005). Additional controls for business size, structure and the position of the participant in the organisation hierarchy were included. Finally three controls for the type and amount of previous contact the participants had with the Tax Office were included: no contact, phone contact (more than once in last 12 months) and audit (in the last 12 months).

## 3. MEASURES

The following variables were considered in the study to evaluate the compliance behaviour model: attitude, subjective norms, perceived behavioural control, taxpayer identity, perceived cooperation by the Tax Office, intention, behaviour and awareness.

**Attitude** was measured with 13 items relating to salient beliefs about income tax reporting. There are no existing measures of this variable in the tax context, and so they were created *de novo* from formative research, including interviews conducted with business owners selected randomly from the sample population as well as a detailed literature review. The items based on the salient beliefs were: Being free from worry about business tax position; having a clear conscience; Removing the fear of a tax audit; Accurately understanding my business finances; Contributing to the community welfare; Paying exactly the right amount of tax; Being in control of business finances; Having a financial advantage over my competitors; Utilising loopholes or grey areas of the law; My competitors will have a financial advantage over me; Paying as little tax as possible; Using the tax system to gain a financial advantage; Having a high degree of self-respect. Participants were asked to rate these as bad(1) - good(7) or unimportant(1) - important(7) on a seven point semantic differential scale. The final behavioural attitude measure was constructed using the expectancy value equation which in the summed product of the attitude measure multiplied by the outcome strength (Fishbein & Ajzen, 2010, p. 97). The constructed variable was compared with a direct measure of attitudes to validate the scale. The outcome scale of "bad: good" had a higher correlation with the direct attitude measure ( $r=.624$ ,  $p<0.01$ ) in comparison to that using the important: unimportant scale ( $r=.600$ ,  $p<0.01$ ) and thus was used in this study.

**Subjective norms** were constructed using measures for both injunctive and descriptive norms. Injunctive norms are defined as the perceived pressure from important others to perform an action or behaviour, whereas descriptive norms are perceptions that the people who want the behaviour performed are performing the behaviour themselves (Fishbein & Ajzen, 2010, p. 131). Both must be included the research to provide a comprehensive measure of the subjective norm. Normative referents used in the study

were: spouse; close friends; siblings; parents; tax agent or book keeper; accountant; and competitors.

A direct measure for the injunctive norms was constructed through the addition of two norm items. The measures for injunctive norms were calculated in a similar manner to those for attitudes. Normative belief and motivation to comply were multiplied to create normative injunctive pairs. Each normative pair was correlated with the direct measure for injunctive norms. A similar procedure was followed for the descriptive normative pairs. The two factors were then summed to provide a single measure of a second order norm construct. This combined measure produced a correlation of .326 ( $p < 0.01$ ) with the direct measure.

**Perceived behavioural control** was calculated by summing the scores from each of the four direct PCB items. This final direct measure was correlated against each of the six PCB control/belief pairs: No threat of detection or audit; Fear of being punished for something you feel you have no control over; Ambiguous law or rulings; Perception of unfairness of the law; Traceable transactions; Ongoing change of tax law and tax system. Two of these (ambiguous law or rulings and traceable transactions) were significantly correlated with the direct measure. The products of these two items were summed to give the total salient belief PBC measure, which had a correlation of  $r = .304$  ( $p < 0.01$ ) with the direct measure of PBC.

**Taxpayer identity** was measured in two parts. First, nine characteristics that would describe an ideal taxpayer were assessed on a seven-point Likert scale. These characteristics were: honesty; generosity; consideration; organisation; community mindedness; cleverness; meticulousness and hard-working and respondents were asked to score these according to agreement with the statements: strongly disagree(1) and strongly agree(7). A factor analysis was conducted using a principle-axis extraction with direct oblimin rotation. Three eigenvalues were obtained when using Kaiser's criterion of 1 which explained 76.7% of the variation. The first factor was associated with personal characteristics, such as generosity, consideration, and cleverness. The second factor was related to honesty and honour. The final factor was related to instrumentality, in other words being meticulous and well organised. Participants were asked to rate identification with being an "ideal" taxpayer. This item was multiplied against the ideal taxpayer measure to give an overall score of identification with the taxpayer identity. Three resulting variables were created: Taxpayer ID characteristics, Taxpayer ID honesty and Taxpayer ID instrumentality and all variables were used in the model testing.

**The perception of Tax Office cooperation** was measured using a 16 item scale. The only item scored with a positive associate was the Tax Office was respectful of me as a taxpayer ( $\bar{X} = 4.28$ ). All items were factor analysed using a principle axis extraction with oblimin rotation as the items were not independent. The results showed the items loaded on two primary factors. A reliability analysis of the scale was conducted, showing an alpha value of .940 for the first factor and .914 for the second. The perception of cooperation by the Tax Office belief measures were correlated against a single item direct measure of "in my interactions with the Tax Office in the 2011 financial year I believe they have willingly tried to cooperate with me" (disagree(1):

agree(7) - seven point Likert scale). The analysis produced a significant correlation ( $p < 0.01$ ) of  $r = .584$  and  $r = .773$ . The items from each of the factors were summed and then averaged to create two variables of perception of cooperation by the Tax Office. The first variable relates to customer service, perceptions of trust, acknowledgement and fairness and was called Tax Office - customer service. The second factor related to the ease of use and accessibility of tools and procedural justice, therefore this second factor was called Tax Office - access to services. Both of these variables were used in the model testing.

**Intention** was constructed as a direct measure only and incorporated the elements of willingness, expectation, intention and trying (Fishbein & Ajzen, 2010, p. 43). All items have inter-item correlations over 0.7, ( $p < 0.01$ ) and the combined scale revealed a high level of internal consistency  $\alpha = .934$ .

**Behaviour** was constructed as a dichotomous measure of correctness (right or wrong) of compliance choices. The measure was obtained through the use of scenarios. The participant was required to select the option that most closely represents how they would respond if presented with the situation in real life.

Scenario 1 incorporated a real world difficulty encountered by many businesses when keeping good records: collecting and recording receipts of fuel spent and distances travelled by multiple employees. The scenario also introduced a contingent obstacle for compliance: which was that the employees had not kept accurate records. Participants had to decide whether or not to claim kilometres travelled based on estimates, without any evidence to support the claims. In this example a total of 400km could be claimed without receipts. The scenario had additional parameters: not all staff had travelled 400km, but all travelled over 100km and less than 800km. Participants had to decide whether to over compensate and declare nothing, or to be non-compliant by declaring an offset without evidence.

The second part to the hypothetical situation outlined in Scenario 1 was bypassed for participants who had decided to claim nothing: their responses were automatically coded 2 (correct). The remaining participants were provided with Scenario 2 which required them to respond to a question on how they would declare the kilometres if they encountered a system limitation, that is the interface of the tool prevented the correct declaration. The system in the hypothetical scenario only allowed a maximum of 400 to be entered for each employee. Participants had to choose between two options: (i) accepting the limitation and declaring 400km per employee spreading all of the kilometres across all of the employees so that it would total the amount travelled, or (ii) claiming the maximum amount for each employee regardless of kilometres travelled.

The third scenario contained no external obstacles to compliance, complexity was minimised and there were no system restrictions to influence the compliance behaviour of the participant. Participants had to make a simple decision of whether or not they would choose to enter into an exchange of goods for services arrangement without declaring this to the Tax Office if cash-flow became a problem.

**Awareness** - Participants were scored for awareness (i.e. knowledge of the rules) on each scenario and how the knowledge was utilised in the hypothetical situation. Scenario 1 and 2 incorporated four (true/false) awareness items: It is legal to declare nothing in your tax return in regards to kilometres; If you are going to declare kilometres as a tax deduction you are limited to a maximum of 800Km per person, per week; It doesn't matter if the kilometres are shared between employees, as long as they add up to the total of actual kilometres travelled; It is ok to claim 400km kilometres for each staff member without receipts; It is ok to claim 400km for each staff member even if they didn't travel those kilometres. Scenario 3 had a singular (true/false) measure namely: legally it is OK to exchanges business services without declaring them for tax purpose

#### 4. RESULTS

After three weeks, 196 responses had been received. A second letter was sent to the same sample group (excluding the 196 responders) again asking for participation. A further 124 responses were received. 70% of the respondents were 45 years old or over, 63% were male, 64% had a minimum of an undergraduate degree and 68% were Australian born. Respondents were either sole owners or in partnership (78%) and distributed across the TBI range with 73.8% in the \$2-\$50 million segment.

Of the 320 cases in the data file 86 had missing data. As mandatory field coding was used in the survey construction, the cases with missing data were due to participants leaving the online survey and not returning to complete it. These cases were eliminated from the final analysis. No further instances of missing data were identified.

A 13 point Marlowe-Crowne scale was used to identify any social desirability bias present in the responses provided by participants. Responses were relatively normally distributed ( $M=8$ ,  $SD=2.58$ , skewness =  $-.393$  kurtosis =  $-.258$ ). Responses were highly clustered around the mean, with modes of 7 and 9. These results indicate that the effect of social desirability in the response set was minimal.

##### 4.1 Model testing

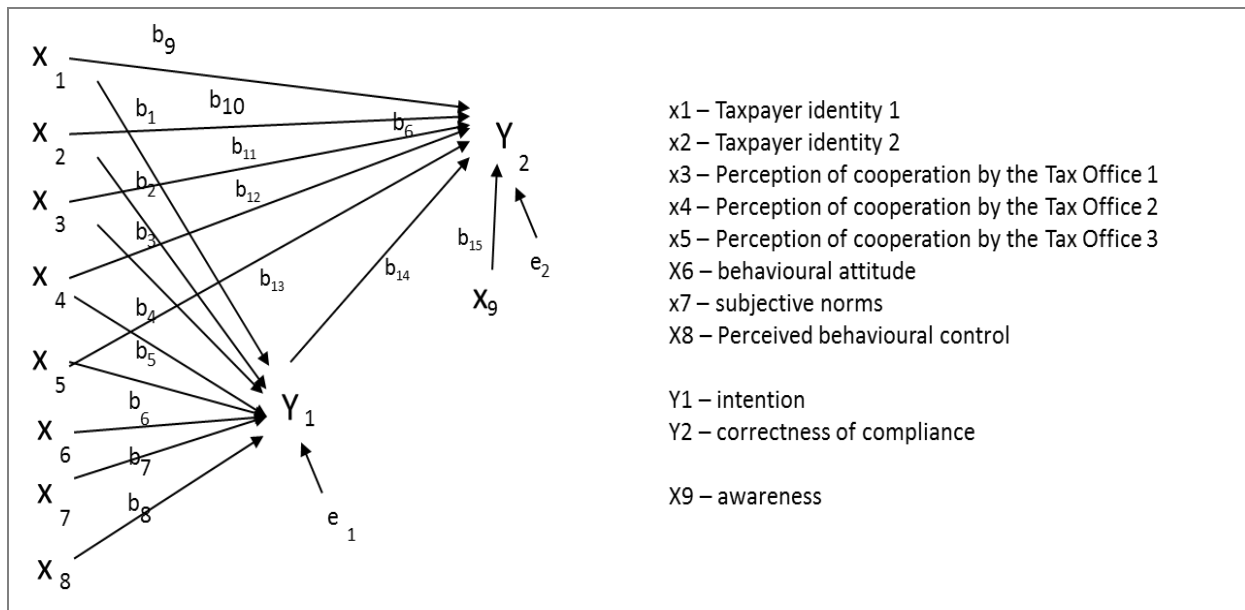
The complete Compliance Behaviour Model to be estimated is shown as a path diagram in Figure 2. The CBM specifies two endogenous variables intention ( $Y_1$ ) and behaviour ( $Y_2$ ) and nine exogenous variables: Taxpayer identity 1 ( $x_1$ ); Taxpayer identity 2 ( $x_2$ ); perception of cooperation by the Tax Office 1 ( $x_3$ ); perception of cooperation by the Tax Office 1 ( $x_4$ ); perception of cooperation by the Tax Office 1 ( $x_5$ ); behavioural attitude ( $x_6$ ); norms ( $x_7$ ); perceived behavioural control ( $x_8$ ); and awareness ( $x_9$ ). Theoretically the model assumes a full mediation of  $x_6$ ,  $x_7$ ,  $x_8$ , and  $Y_2$  by the variable  $Y_1$ . Statistical Package for the Social Sciences (SPSS) was used for all statistical analysis reported.

Two structural equations are required to estimate the model:

$$\text{Equation 1: } Y_1 = a_1 + b_1x_1 + b_2x_2 + b_3x_3 + b_4x_4 + b_5x_5 + b_6x_6 + b_7x_7 + b_8x_8 + e_1$$

$$\text{Equation 2: } Y_2 = a_2 + b_9x_1 + b_{10}x_2 + b_{11}x_3 + b_{12}x_4 + b_{13}x_5 + b_{14}Y_1 + b_{15}x_9 + e_2$$





**Figure 2 - The path estimation of the Compliance Behaviour Model**

The following section outlines the estimation of this model from left to right in two parts: the prediction of intention based on attitude, norms, PBC, Tax Office willingness and taxpayer identity; and the prediction of behaviour (correctness) based on intention and awareness.

#### 4.2 Part 1 of CB model – prediction of intention

This section will be used to estimate the first part of the model where  $Y_1$  is predicted intention:

$$Y_1 = a_1 + b_1x_1 + b_2x_2 + b_3x_3 + b_4x_4 + b_5x_5 + b_6x_6 + b_7x_7 + b_8x_8 + e_1$$

##### 4.2.1 Linear Regression – Intention

A simultaneous multiple regression was performed on the variables as identified in the proposed theoretical model. Table 2 displays the correlations between variables and Table 3 the unstandardized regression coefficients ( $B$ ) and intercept, the standardized regression coefficients ( $\beta$ ) and the goodness-of-fit  $R^2$ . The  $R$  for the regression was significantly different from zero,  $F(8, 224) = 21.512$ ,  $p < .001$ , with  $R^2$  at .434  $p < .001$ . Attitudes, Norms, and taxpayer identity were all significant.

**Table 2 - Correlations between the dependent variable intention and the predictor variables in the CBM**

	DV	1	2	3	4	5	6	7
Attitude - salient beliefs	.555							
Norm – salient beliefs	.315	.277						
PBC – salient beliefs	.005	.069	.048					
Tax Office 1 – customer service	.221	.187	.143	-.010				
Tax Office 2 – access to services	.152	.134	.200	-.023	.680			
Taxpayer ID 1 – characteristics	.327	.362	.205	.082	.121	.134		
Taxpayer ID 2 – honesty	.457	.304	.254	.056	.213	.213	.727	
Taxpayer ID 3 – instrumentality	.348	.308	.223	.042	.206	.190	.794	.833

**Table 3 - Standard multiple regression of attitude, norms, PBC, Taxpayer identity and Perceptions of willingness of Tax office on intention to comply**

	$\bar{X}$	SD	B	$\beta$	t	95% CI		sig
						Lower	upper	
Intention	6.52	.71						
Attitude - salient beliefs	308.72	65.67	.005	.446	7.983	.004	.006	.000
Norm – salient beliefs	121.07	60.82	.001	.123	2.284	.000	.003	.023
PBC – salient beliefs	140.83	44.74	-.001	-.046	-.901	-.002	.001	.368
Tax Office – 1 customer service	3.61	1.17	.062	.104	1.491	-.020	-.144	.137
Tax office - 2 access to services	3.97	1.16	-.039	-.064	-.921	-.122	.044	.358
Taxpayer ID 1 - characteristics	26.51	9.44	-.006	-.081	-.930	-.019	.007	.353
Taxpayer ID 2 - honesty	33.48	10.27	.032	.466	4.980	.019	.045	.000
Taxpayer ID 3 - instrumentality	30.59	10.75	-.010	-.149	-1.415	-.023	.004	.159
Constant			4.279		18.727	3.829	4.729	.000

$R^2 = .434$  ( $p < 0.01$ )

N=232

To determine the effect of the control variables on the CBM, a second sequential multiple regression was performed between *intention* to comply with tax reporting for the 2011 income tax return, the TPB variables (attitude, norms, perceived behavioural control) and the control variables. Items were loaded into the regression in the following order: controls; TPB variables; taxpayer identity; perceptions of ATO willingness; and past behaviour.

Table 4 displays the results of the unstandardized regression coefficients (B) and intercept,  $R^2$  and adjusted  $R^2$  and the change in  $R^2$ .

**Table 4 - Sequential regression on hypothesised predictors of compliance intention**

	Step 1	Step 2	Step 3	Step 4
Constant	5.701**	3.836**	3.181**	4.647**
Age	.029	.014	.031	.016
Gender	.072	-.024	.002	-.041
Education	.093	.104*	.087*	.081*
Australian born	.263*	.236*	.198*	.175*
Business turnover	-.001	.083	.064	.028
Location	.009	.002	.007	-.015
Number of directors	.003	-.008	-.004	-.015
Your position	-.004	-.049	-.054	-.045
Attitude - salient beliefs		.006**	.005**	.004**
Norm – salient beliefs		.002*	.001*	.001
PBC – salient beliefs		.000	.000	.001
Tax office 1 – customer service			.058	.051
Tax office 2 – access to services			-.020	.000
Taxpayer ID 1 - characteristics			-.046	-.011
Taxpayer ID 2 – honesty			.190**	.115*
Taxpayer ID 3 – instrumentality			-.042	-.041
Number of times in previous years return declared incorrectly				-.130**
Behaviour last year				-.274**
R	.205	.625	.673	.771
$R^2$	.042	.390	.453	.594
Adjusted $R^2$	.008	.360	.412	.560
$R^2$ Change	.042	.348**	.062**	.142**

\*p<.05

\*\*P<.001

The  $R^2$  change was significant after steps two (TPB variables), three (taxpayer identity and perceptions of Tax Office cooperation) and four (past behaviour). The variable of perceptions of Tax Office cooperation was not a significant contributor to intention. The final model with all independent variables in the model was significant at  $R^2 = .594$  ( $p < 0.01$ ). Indicating that approximately two thirds (60%) of taxpayer's intentions to comply is predicted by the variables in the model.

Several hypotheses relating to the antecedents of *intention* are addressed by these results.

**Hypothesis 2:** Taxpayers' attitude towards correct reporting will affect intention to comply with tax obligations. The null hypothesis can be **rejected** as the salient beliefs are significant at the 95% confidence interval  $t=7.88$  (.003, .005).

**Hypothesis 3:** Taxpayers' norms in relation to correct reporting will affect intention to comply with tax obligations. The null hypothesis can be **rejected** as the direct measure of the effect of norms is significant at the 95% confidence interval  $t=5.027$  (.120, .274).

**Hypothesis 4:** Taxpayers' perceived control of correct reporting will affect intention to comply with tax obligations. The null hypothesis must be **retained** as the direct measure of PBC is not significant at the 95% confidence interval  $t=1.092$  (-.001, .002).

**Hypothesis 5:** Taxpayer's perception of the Tax Office's willingness to cooperate will affect intention to comply with tax obligations. The null hypothesis must be **retained** as neither factor is significant at the 95% confidence interval  $t=-.200$  (-.103, .084) and  $t=1.245$  (-.035, .154).

**Hypothesis 7:** Taxpayers' awareness of the rules and how they apply will affect compliance behaviour. The null hypothesis can be **rejected** as one of the two factors are significant at the 95% confidence interval: factor 2 instrumental identification  $t=-2.643$  (-.037, -.005).

#### 4.3 Part 2 of CB model – prediction of behavior

This section describes the estimation of the second part of the proposed model equation where  $Y_2$  is the predicted probability of correct behaviour (compliance):

$$Y_2 = a_2 + b_9x_1 + b_{10}x_2 + b_{11}x_3 + b_{12}x_4 + b_{13}x_5 + b_{14}Y_1 + b_{15}X_9 + e_2$$

Environmental complexity is captured through the use of different scenario situations (Scenarios 1-3). Consequently, the measured intention variable will be regressed separately on the correctness measure in each scenario. The effect of knowledge or awareness will also be assessed separately to determine its role in the performance of behaviour.

Logistic regression was used for each of the analysis of the second part of the model as the dependent variables are dichotomous and assumptions of normality are violated. However, logistic regression is sensitive to issues of multicollinearity, ratio of cases to predictor variables, and also expected power may be influenced by size of frequencies (Tabachnick & Fidell, 2007). Logistic regression also assumes linearity of the predictor variables with the dependent variable (Tabachnick & Fidell, 2007). Therefore, each of these aspects was considered for each regression.

##### 4.3.1 Scenario 1

A simultaneous logistic regression was performed on the correctness variable for Scenario 1, loading only intention. According to the Wald criterion (Tabachnick & Fidell, 2007), intention is significant and predictive of correctness:  $\chi^2(1, N=233) = 11.21, p<0.05, R^2=.066$ . Consequently 69.5% of the model is classified correctly with intention.

A sequential logistic regression was performed on the correctness variable for Scenario 1, loading both the predictors of intention and awareness. The model was significant  $\chi^2$  (2, N=233) = 9.871,  $p < 0.05$ . The Perception of cooperation by the Tax Office variables were then entered and the model was significant  $\chi^2$  (4, N=233) = 10.236,  $p < 0.05$ . Finally, the Tax payer identity variables were entered and the model was not significant  $\chi^2$  (7, N=233) = 12.16,  $p = 0.095$ . The model goodness-of-fit Nagelkerke  $R^2 = 0.074$ . The proportion of cases correctly classified was 73.4%.

Table 5 shows the regression coefficients, Wald statistics, and odds ratios and their 95% confidence intervals for each of the predictors. According to the Wald criterion intention is significant and predictive of correctness: ( $\chi^2$  (1, N=233) = 5.801,  $p < 0.05$ ). Awareness is also significant ( $\chi^2$  (1, N=233) = 4.098,  $p < 0.05$ ). The Perceptions of cooperation by the Tax Office and Taxpayer identity variables were not significant.

**Table 5 - Logistic regression of correctness (scenario 1) of behaviour as a function of intention, awareness, perceptions of cooperation by the Tax Office and taxpayer identity**

Variables in the Equation	B	S.E.	Wald	df	Sig.	Odds ratios	95% C.I. for odds ratios	
							Lower	Upper
Intention - direct	.756	.314	5.801	1	.016	2.129	1.151	3.938
Awareness	-.774	.382	4.098	1	.043	.461	.218	.976
Tax Office 1 – customer service	.135	.184	.542	1	.462	1.145	.798	1.642
Tax Office 2 – access to services	-.070	.181	.150	1	.699	.932	.654	1.329
Taxpayer identity 1 - characteristics	.009	.027	.118	1	.731	1.009	.957	1.065
Taxpayer identity 2 – honesty	-.005	.028	.030	1	.863	.995	.943	1.051
Taxpayer identity 3 - instrumentality	-.023	.029	.639	1	.424	.977	.922	1.035
Constant	-5.422	1.961	7.642	1	.006	.004		

#### 4.3.2 Scenario 2

A sequential logistic regression was performed on the correctness variable for Scenario 2, loading the predictors of intention and awareness followed in steps with the predictors Perception of cooperation by the Tax Office and finally Taxpayer Identity. The initial model with the predictors of awareness and intention for Scenario 2 was tested and found to be significant  $\chi^2$  (2, N=233) = 13.23,  $p < 0.05$ . Nagelkerke  $R^2 = .08$ . Classification showed 74.2% of cases were correctly classified from the model. The final model, with all predictor variables included, was significant  $\chi^2$  (7, N=233) = 15.97,  $p < 0.05$  with 73.8% of cases classified correctly.

Table 6 shows the regression coefficients, Wald statistics, odds ratios and the 95% confidence intervals for odds ratios for each of the predictors. Both Intention  $\chi^2$  (1, N=233) = 4.782,  $p < 0.05$  and awareness  $\chi^2$  (1, N=233) 5.215,  $p < 0.05$  were significant. The model had a goodness-of-fit  $R^2 = .096$ .

**Table 6. Logistic regression of correctness (Scenario 2) of behaviour as a function of intention and awareness.**

Variables in the Equation	B	S.E.	Wald	df	Sig.	Odds ratios	95% C.I. for odds ratios	
							Lower	Upper
Intention - direct	.515	.236	4.782	1	.029	1.674	1.055	2.657
Awareness	-.902	.395	5.215	1	.022	.406	.187	.880
Tax Office 1 – customer service	.154	.179	.736	1	.391	1.166	.821	1.656
Tax Office 2 – access to services	-.150	.180	.692	1	.405	.861	.605	1.225
Taxpayer identity 1 - characteristics	-.019	.028	.481	1	.488	.981	.929	1.036
Taxpayer identity 2 - honesty	-.015	.028	.281	1	.596	.985	.932	1.041
Taxpayer identity 3 - instrumentality	.037	.030	1.559	1	.212	1.038	.979	1.101
Constant	-1.725	1.404	1.509	1	.219	.178		

#### 4.3.3 Scenario 3

A sequential logistic regression was performed on the correctness variable for Scenario 3, loading the two predictors of intention and awareness followed in steps with the predictors Perception of cooperation by the Tax Office and finally Taxpayer Identity. The initial model with the predictors of awareness and intention for Scenario 3 were tested and found to be significant  $\chi^2$  (2, N=233) = 29.036,  $p < 0.01$  with a goodness-of-fit Nagelkerke  $R^2 = .164$ . 74.2 % of cases were correctly classified from the model. The final model with all predictor variables included was significant  $\chi^2$  (7, N=233) = 40.63,  $p < 0.01$  with 75.1% of cases classified correctly.

Table 7 shows the regression coefficients, Wald statistics, odds ratios and the 95% confidence intervals for each of the predictors. According to the Wald criterion, both Intention  $\chi^2$  (1, N=233) = 4.127,  $p < 0.05$  and awareness  $\chi^2$  (1, N=233) 16.285,  $p < 0.01$  were significant. Additionally, the Perception of cooperation by the Tax Office variable 1 (customer service)  $\chi^2$  (1, N=233) = 5.057,  $p < 0.05$  was also significant. None of the taxpayer identity variables were significant.

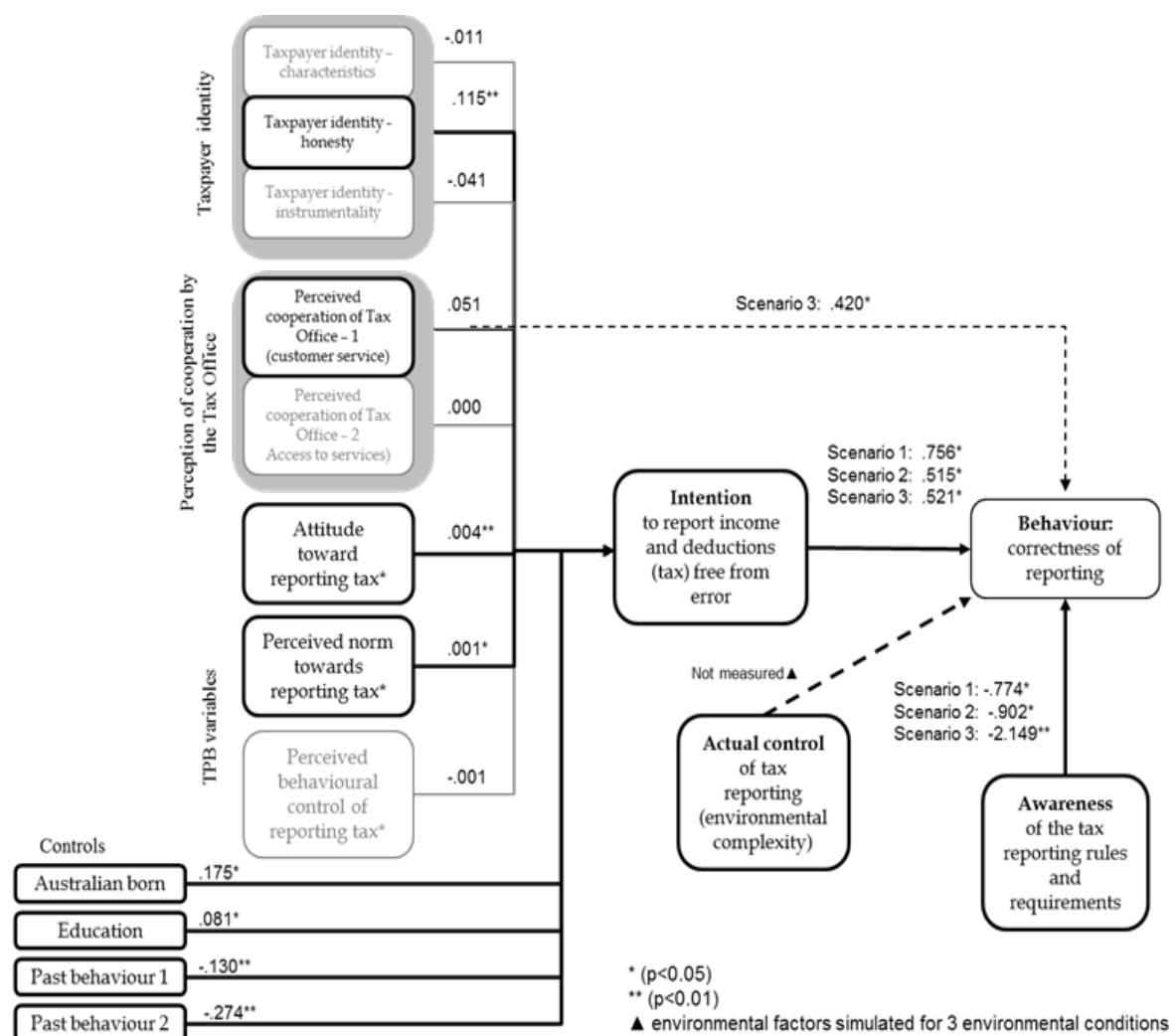
**Table 7 - Logistic regression of correctness (Scenario 3) of behaviour.**

Variables in the Equation	B	S.E.	Wald	df	Sig.	95% C.I. for odds ratios		
						Odds ratios	Lower	Upper
Intention - direct	.521	.257	4.127	1	.042	1.685	1.019	2.786
Awareness	-2.149	.533	16.285	1	.000	.117	.041	.331
Tax Office 1 – customer service	.420	.187	5.057	1	.025	1.522	1.055	2.195
Tax Office 2 – access to services	-.140	.182	.589	1	.443	.869	.608	1.243
Taxpayer identity 1 - characteristics	.048	.028	2.877	1	.090	1.049	.993	1.110
Taxpayer identity 2 - honesty	-.029	.029	.953	1	.329	.972	.917	1.029
Taxpayer identity 3 - instrumentality	.011	.030	.132	1	.716	1.011	.953	1.072
Constant	-3.966	1.572	6.365	1	.012	.019		

Intention and awareness were significant in all three scenarios. The null **hypothesis No 1** which posits that intention has no differential effect on compliance behaviour can be **rejected**.

Perception of the Tax Office's willingness to cooperate was significant in Scenario 3 where there were no obstacles to behaviour; therefore the null **hypothesis 6** can be **rejected**.

The variable Taxpayer identity was not significant in any of the three scenarios therefore the null **hypothesis 8** that Taxpayer identity will have no effect on the compliance behaviour must be **retained**.



**Figure 3 - The Compliance Behaviour Model showing the tested and significant paths**

#### 4.4 Discriminant analysis

Initially, discriminant analyses were conducted to differentiate the variables which could correctly predict correct or incorrect behaviour in the three scenarios. All predictor variables were loaded to distinguish correctness.

In Scenario 1 the results showed intention and business turnover had the highest loadings. The structure matrix showed intention (.714), and business turnover (.692), had loadings in excess of .400. Table 8 shows the results of the direct discriminant analysis for Scenario 1. Those surveyed who were most likely to choose the correct behaviour option in Scenario 1, had higher intention scores (mean=6.7 SD=.48) a lower awareness scores (mean=.18 SD=.38) and higher business turnover (mean=2.3 SD=.86). This scenario had the greatest complexity and therefore the results show business owners or decision makers of businesses over \$10 million (TBI) may be



more inclined to select the correct option even if they are less aware of the legality of their choices and also a higher intention to make the right decision.

**Table 8 - Discriminant analysis for scenario 1, Dependent variable *correctness***

Scenario 1	Mean	SD	Wilk's lambda	F	Df1	Df2	Sig
Intention direct			.978	5.076	1	231	.025
Business turnover			.979	4.912	1	231	.028
Awareness			.985	3.418	1	231	.066
<b>Model</b>			.934	<b>Chi square</b> 14.194	3		.002
No of functions = 1      eigenvalue .071      74.5% of original grouped cases correctly classified							

The discriminant analysis for Scenario 2 (Table 9) revealed that nine items provided significant discrimination. The second scenario had minor system obstacles, forcing participants to choose between over-compliance and non-compliance. Results show participants who chose the correct option (in this case over-compliance) had a higher intention ( $\bar{X}$ =6.6 SD=.66), higher scores on the attitude salient beliefs ( $\bar{X}$ =317.65 SD=64.47), higher scores on the normative beliefs ( $\bar{X}$ =162.35 SD=59.98), were from businesses with turnover over \$10M, and 2 or more directors, and were more aware (mean=.311 SD=.46).

**Table 9 - Discriminant analysis for scenario 2, Dependent variable *correctness* (behaviour)**

Scenario 2	Wilks' lambda	F	Df1	Df2	Sig
Intention direct	.966	8.130	1	231	.005
Attitude – salient beliefs	.950	12.190	1	231	.001
Norms – salient beliefs	.980	4.816	1	231	.029
Business turnover	.967	7.937	1	231	.005
No of directors	.972	6.685	1	231	.010
Your position (in the business)	.982	4.135	1	231	.043
Awareness	.977	5.540	1	231	.019
Past behaviour 1	.932	16.851	1	231	.000
Past behaviour 2	.977	5.374	1	231	.021
<b>Model</b>	.804	<b>Chi square</b> 48.239	20		.000
No of functions = 1      eigenvalue .244      78.1% of original grouped cases correctly classified					

The greatest predictors identified by the discriminant analysis for Scenario 3 (Table 10) were: norms; attitudes towards the behaviour; taxpayer identity; intention; and perception of the willing cooperation of the Tax Office. Several controls were also identified including: Number of directors, position in the business, and past behaviour.

**Table 10 - Discriminant analysis for Scenario 3**

	<b>Wilks' Lambda</b>	<b>F</b>	<b>df1</b>	<b>df2</b>	<b>Sig.</b>
Intention – direct	.950	12.119	1	231	.001
Attitudes – salient	.949	12.382	1	231	.001
Norms – salient	.949	12.386	1	231	.001
Tax office 1 – customer service	.954	11.108	1	231	.001
Tax office 2 – access to services	.981	4.555	1	231	.034
Tax identity 3 – instrumentality	.969	7.415	1	231	.007
Tax identity 2 - honesty	.972	6.757	1	231	.010
Tax identity 1 – characteristics	.965	8.467	1	231	.004
Number of directors	.982	4.167	1	231	.042
Position	.982	4.344	1	231	.038
Awareness	.913	22.110	1	231	.000
Past behaviour 1	.919	20.274	1	231	.000
<b>Model</b>	<b>.727</b>	<b>Chi square 70.464</b>	<b>20</b>	<b>.000</b>	<b>.000</b>

No of functions = 1 eigenvalue .376 76.8% of original grouped cases correctly classified

## 5. DISCUSSION

Ajzen and Fishbein claim by using the Theory of Planned Behaviour any behaviour can be predicted by intention (Ajzen & Fishbein, 1980, p. 4). They qualify this statement by excluding behaviours outside the control of individuals. Tax systems in countries such as Australia, rely on the willing participation of taxpayers for high levels of compliance. This presupposes that taxpayers who are motivated will also have control over their ability to comply. Significant strategy development is founded on the premise that encouraging taxpayers to comply will increase levels of voluntary compliance. However, our research demonstrates two clear discrepancies in these presumptions: i) taxpayers do not have sufficient control over their behaviour to ensure successful completion of all tax tasks; and ii) high levels of intention to comply does not equate to compliance.

The Compliance Behaviour Model (incorporating attitudes, norms, perceived behavioural control, taxpayer identity and perceptions of cooperation) does predict the correctness of a taxpayer's compliance behaviour. However, the mediating variable intention to comply is not always a strong predictor of behaviour. Actual control moderates the intention-behaviour relationship. As intention is crucial in any system reliant on self-assessment its absence results in non-compliance. However, even when strong intention is present compliance does not necessarily follow. Complexity and obstacles to performance prevent even the most willing from complying.

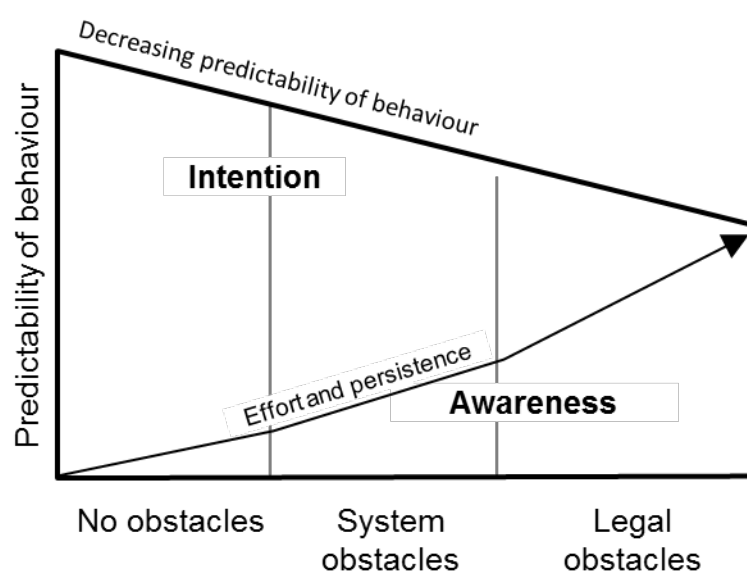
In the three scenarios provided to participants, the only one that held no potential obstacles to the performance of the behaviour was Scenario 3: intention as well as awareness or knowledge of the law was predictive of the compliance behaviour. However, for both Scenario 1, which contained minor legal complexity, and Scenario 2, which included system obstructions, the model was predictive but with low goodness-of-fit ( $R^2 < 0.1$ ). Some other factors were strongly predictive of behaviour when obstructions were absent, including perception of how cooperative the Tax Office had been in the previous 12 months.

The results show that intention on its own is not enough to overcome non-compliance at all levels of complexity. Most participants have a high degree of intention (mean=6.5 on a seven point scale,  $SD=.706$ ) although as complexity increased, intention decreased as a predictor of correctness. This pattern was shown for those participants who had low intention scores but who were accidentally compliant. The lack of predictability or 'randomness of correct compliance' increased as the system became more complex. Awareness (i.e. knowledge of the rules and how they apply) had a greater influence on the outcome when both the process and the system were understood. However awareness is only one aspect of the actual control of a taxpayer's behaviour. Knowledge of the law serves to counteract the obstacle of legal complexity. Further research is required to understand how the other elements of actual control influence an individual's ability to achieve his or her behavioural outcome. Issues such as system certainty, orientation in the process and feedback on task completion must be investigated and quantified to fully comprehend their individual and combined effects on compliance behaviour. The usability of the system, understanding of the law and straight-forward processes will further contribute to taxpayer control of behaviour. A recently published article (Ajzen, 2011) corroborates this part of our findings, stating that lack of actual control does reduce the predictive validity of intentions.

The results reported here are consistent with those of McKerchar (2002) who demonstrated that increased complexity, increases compliance costs as well as non-compliant behaviour. However, the results of our research go much further and enhance our understanding of the effects of environmental factors on compliance behaviour. System obstructions cause many taxpayers to over-comply. When taxpayers do not understand the parameters of the task that they are performing, they elect to pay more than what is required, rather than risk being non-compliant. Overpayment disadvantages such taxpayers and is considered a form of non-compliance because they are not paying the correct amount of tax for their circumstances.

The effect of system complexity is also evident when measuring the independent variable perceived behavioural control. The direct measure of perceived behavioural control was significant but the salient beliefs used in the final model estimation were not significant. These results may arise from the difficulty some participants had in conceptualising the factors that reduce or contribute to their control of tax reporting. Thus, the salient beliefs identified through the pilot study with regards to PBC are not the ones that actually effect control.

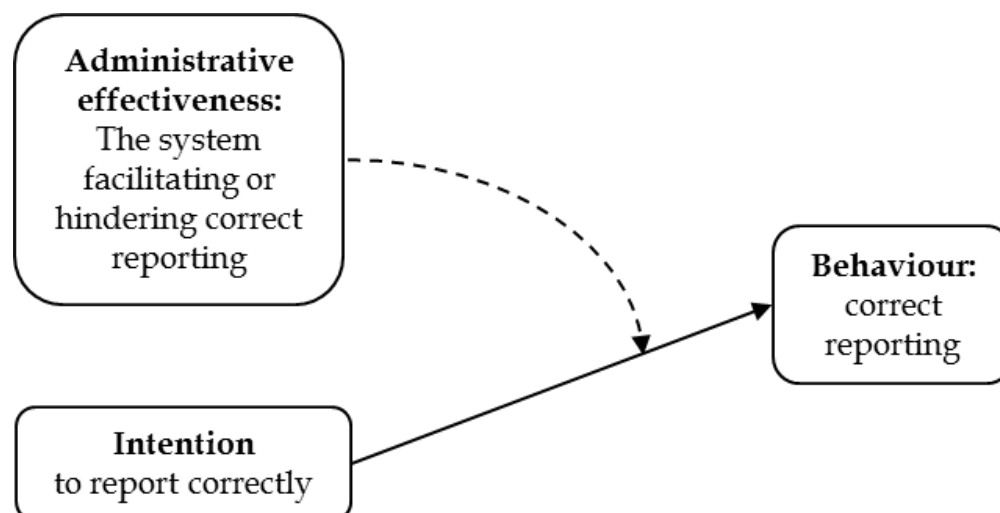
Figure 4 illustrates that the difficulty of predicting compliance increases when a taxpayer does not have complete volitional control of his or her behaviour. At the lower left of the diagram, where there are no obstacles to performance, intention and awareness are predictive of the correctness of the compliance behaviour. Additional factors such as taxpayer identity and perceptions of cooperation also contribute to the final behaviour. When there are system obstructions, the accuracy of predicting behaviour from intention is reduced, but predictive accuracy is aided by increased awareness of the law. The taxpayer must apply effort and persistence to overcome the environmental factors which limit the performance of the behaviour. Legal complexities and jargon create further difficulty and, where this is present, awareness is a better predictor of compliance than intention. This finding is related to the resources available for the taxpayer to overcome the obstacles to compliance. The predictive validity of intention and awareness is also significantly related to the amount of disturbance created by obstacles to performance.



**Figure 4 - Proportion of intention and awareness required to predict behaviour when behaviour is affected by environmental complexity**

## 6. IMPLICATIONS FOR TAX AUTHORITIES AND FUTURE RESEARCH

Implementing changes due to findings in this research and the consequent Compliance Behaviour Model will be challenging for government and tax administrators. Essentially there are two factors that can be manipulated to increase voluntary compliance: intention to comply and effectiveness of the tax administration. Intention to comply only influences actual compliance behaviour where there is a clear distinction between correct and incorrect compliance options. Furthermore, intention has a far less an impact on behaviour where the system<sup>8</sup> obstructs taxpayer's control of behaviour. This paper has focussed on only two aspects of control: environmental complexity and awareness of the tax rules. However successful taxpayer compliance is reliant on the individual's ability to perform the requisite behaviour. Taxpayer "ability" is determined by a number of factors: tax system support and guidance, error prevention, legal knowledge, usability and accessibility of tools, clear terminology, adequate resourcing and sufficient capacity. Obstacles to these factors affect ability to comply. Thus, actual control in this context is the administrative effectiveness of the tax system. Figure 5 depicts the relationship between compliance behaviour and the two primary predictors: intention and administrative effectiveness.

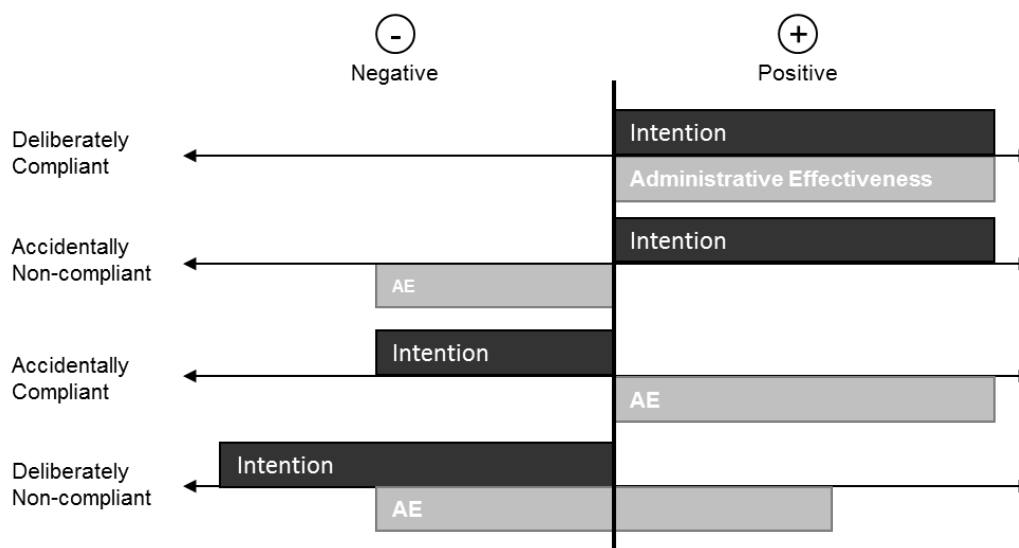


**Figure 5 - The two primary predictors of compliance behaviour, intention and administrative effectiveness**

One or both of the two primary factors (intention and administrative effectiveness) must be leveraged to improve voluntary compliance. Figure 6 depicts the four types of compliance behaviour (deliberately compliant, accidentally non-compliant, accidentally compliant and deliberately non-compliant) and the contribution that intention and/or administrative effectiveness provides to the performance of the behaviour. Deliberately compliant taxpayers have both the ability to overcome any obstacles as well as a strong positive intention to comply. This propensity should be recognised, facilitated and supported by the tax system. Taxpayers who are accidentally non-compliant may have a high intention, but not have the ability to

<sup>8</sup> The tax 'system' is defined here as any law, person, system, process, product or tool that a taxpayer must interact with to meet their obligations.

comply. This accidental non-compliance (and the negative outcomes) could be prevented by a responsive and supportive system. Taxpayers who are accidentally compliant are those who intend to evade but the system prevents mistakes either forcing compliance or increasing the difficulty in non-compliance. These taxpayers need to be exposed to interventions that affect both intention as well as ability to comply. Finally, taxpayers who are deliberately non-compliant are those who may well have the ability to comply but have an intention to evade. Interventions must be targeted at changing their intention and well as preventing non-compliance.



**Figure 6 - four types of compliance behaviours showing how differing levels of intention as well as administrative effectiveness contribute to the outcome of compliance behaviour**

Where obstacles to performance reduce the impact of intentions on behaviour, interventions targeted at increasing taxpayer's willing participation are likely to be inefficient and worthless. Under such circumstances, the intention of the taxpayers is less important than the role of the tax administration in improving compliance. Education and marketing campaigns are of limited value if the system is too difficult or the law is so complex that only the most highly qualified and motivated can understand and apply the interpretation to their circumstances. Therefore, where the situation has either a level of legal complexity, or has potential system obstacles, only those who have the means and resources to understand the rules and apply them are the ones who also have the ability to comply.

The administrative effectiveness necessitates both a perception of control as well as actual control to perform the desired behaviour. Where there is a perception of control but no actual control, individuals may persist with attempts to perform the behaviour yet are unlikely to be successful. Where an individual can control the behaviour but is unaware that they have the control, they may not even attempt to perform the behaviour. Therefore, a successful performance outcome requires the ability to perform the behaviour: both a perception as well as a level of actual control. Enabling and supporting these abilities will aid in achieving compliance.

The concern about increasing the taxpayers' actual control (or in this case administrative effectiveness) is that it may enhance or even encourage their ability to be non-compliant. Our results show that this is not the case. Facilitating actual control of the desired behaviour enhances correct performance but also minimises mistakes or unforced errors.

It may be argued that system complexity and obstructions to performance aid administrators in reducing tax evasion, but our research suggests otherwise. We have shown that the confusion created by complexity, not only reduces control of behaviour but also the ability of the Tax Office to predict and thus support those who are attempting to comply. In other words, complexity obscures the effective detection of those who intentionally evade. When obstructions are minimised, administrators have a clear view of the beliefs or intentions that guide and influence taxpayer decision making and, therefore, would be able to affect and change behaviour in a productive manner. This is superior to saturating the entire population with information in the (misplaced) belief that some important messages will filter through to those who need them the most, individual issues can be targeted and addressed in a systematic fashion. Additionally, risk assessment and audit can then also be utilised more effectively.

Further research needs to be conducted to understand what is considered manageable complexity for the majority of taxpayers. The hypothetical Scenario 1 incorporated minimal complexity; the problem required no direct calculations and required only a single decision about which actions to take given certain clearly defined legal parameters. An initial assumption was made that most people who manage their own business would be able to answer basic tax questions. However, 73% of participants failed to correctly interpret the legal guidelines around Scenario 1. Those who had higher scores of awareness were more likely to choose the correct compliance options. However, high levels of compliance were only correlated with high levels of awareness where there were no system obstacles.

It is to be expected that normative referents were influential in the model. Taxpayers rely heavily on book keepers, accountants and tax agents to make the correct decisions on their behalf. This reliance is predictive of compliance behaviour. Taxpayers delegate their responsibility for understanding and applying the law to those they consider better equipped to make such decisions. The increasing reliance on tax practitioners conditions taxpayers to have less awareness of legal choices, and so when faced with even simple problem solving, they are unable to comprehend and resolve basic tax issues.

The delegation of obligations to tax practitioners has a second implication for tax authorities. As system and legal complexity increases, taxpayers become less responsible and unable to interpret and apply the law to their own circumstances. Contrary to its intention, the Tax Agent Services Act 2009<sup>9</sup> with the provision of safe harbour for errant taxpayers, will most likely compound this effect. Safe Harbour

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<sup>9</sup> Information available on safe harbour provisions at  
<http://www.ato.gov.au/taxprofessionals/content.aspx?doc=/content/00230818.htm&pc=001/005/041/015/001&mnu=43387&mfp=001/005&st=&cy=1&alias=newregime>

introduces additional duty of care protection for taxpayers. If taxpayers are able to show they have employed a tax agent to act on their behalf and non-compliance is discovered, the responsibility for the non-compliance is diminished or even eliminated. This policy will encourage and reinforce taxpayer's reliance on tax practitioners. As a consequence awareness will decrease and may actually reduce levels of voluntary compliance.

Nonetheless, as complexity increases only those who are able to employ specialist tax advisers are able to be compliant. Business turnover is a predictor of compliance behaviour, and therefore it is those with higher income and access to resources who are more capable of compliance. The taxpayer is thus left in the predicament where in order to be compliant in a system of increasing complexity, he or she must pay tax specialists to interpret and manage tax affairs. However, reliance on others is related to low levels of awareness of the law, and also low correctness. To meet their obligations, taxpayers become vulnerable due to their inability to make good compliance decisions on their own.

The tax system becomes increasingly imbalanced with such complications. All taxpayers should have equal opportunities for compliance, but due to the increasing complexity only those who have the means and resources for compliance are able to comply. The issue is recursive, requiring intervention by the government and tax authorities to disable the downward spiral.

Sweeping reform of legislation and wide scale simplification of the tax system is unlikely. Several attempts at radical change have been considered or attempted including the Ralph Review, the introduction of the New Business Tax System (Simplified Tax System) Act 2001 (Tretola, 2007) and the 2010 Henry Review of Taxation – where to date (February 2012) only four recommendations out of the 138 have been implemented (Commonwealth of Australia, 2010). A serious attempt to reduce complexity and implement a root and branch reform would be heroic for most governments because it may prove political suicide. Therefore, changes in the administration of the existing tax system are the only realistic approaches to improved revenue collection and compliance. The tax authority has the responsibility to intervene and prevent increasing complexity for taxpayers to meet their obligations, through introducing simplicity into the design of tax administration. Removing the barriers for taxpayers who choose to be compliant will reward those who willingly participate in the system and correspondingly expose those who deliberately evade.

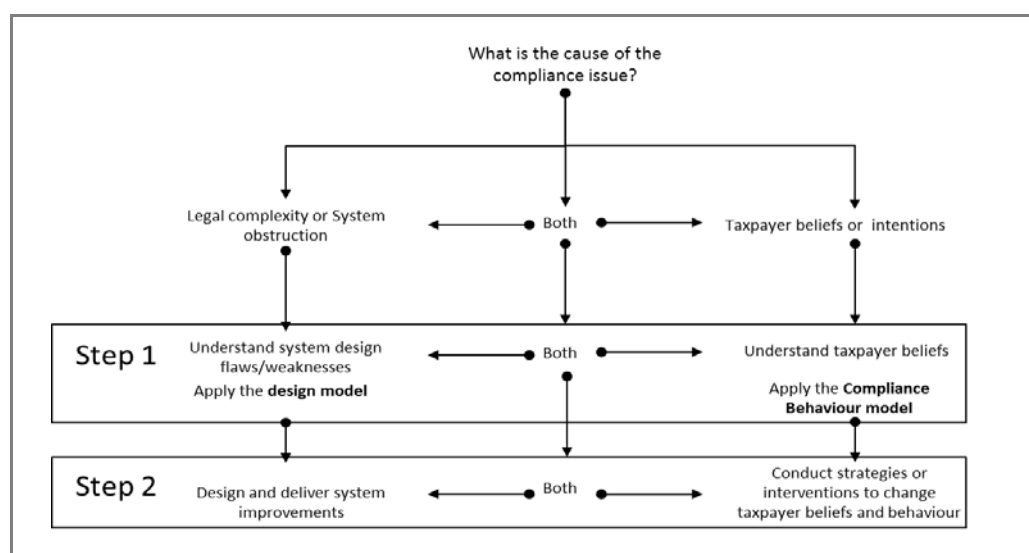
Our research shows that compliance behaviour increased if taxpayers believed that the Tax Office was being cooperative. Wahl et al. (2010) define trust as “a general opinion of individuals and social groups that the tax authorities are benevolent and work beneficially for the common good”. The way taxpayers develop trust is through perceptions of cooperation and reciprocity. Business taxpayers observed cooperation through either high levels of customer service (consideration, patience, support, openness, the assumption of innocence, respect, fair and flexible, consistency and reliability and acceptance of responsibility for mistakes) or sound access to necessary services (simple, reliable and accessible processes and tools, understanding the community's needs and what they have been told, using clear plain language, reducing the effort or resources required for compliance, or reliable good advice from the Tax



Office). Early interventions that address these areas can be used to influence beliefs about the support from the Tax Office, responsibility and trust in the system: this in turn will also affect willingness to comply.

## 7. APPLYING THE MODEL

The new Compliance Behaviour Model can be utilised to develop a methodology to apply compliance interventions and strategies for treating population level compliance issues. A greater understanding of the compliance issue can be obtained by first investigating the type and level of difficulties apparent in the performance of the compliance behaviour. Where components of the tax system are difficult to understand or legally complex, improved administrative design<sup>10</sup> can be utilised to facilitate taxpayer compliance. Where there are few environmental factors influencing the performance of behaviour, interventions that address the salient beliefs and intentions of the compliance behaviour as identified in the CBM can be targeted. Holistic compliance strategies may require both approaches. The logic behind this proposal is depicted in a decision tree model (Figure 7).



**Figure 7 - Decision tree for utilising the Compliance Behaviour Model**

Further research is required to fully elaborate, prototype, and test the CBM and eventually integrate it into the operation of an agency such as the Tax Office. Such research must also seek to further understand the factors that contribute to taxpayer control and how these can be incorporated into improved administrative design solutions.

<sup>10</sup> Design is defined here as relating to the deliberate planning analysis and implementation of solutions to problems which relate to any part of the tax system, i.e. policy, law or administration.

We recommend an uncomplicated approach to improving voluntary compliance: remedy obstructions to compliance; and influence taxpayer beliefs and intentions to comply. Obstructions may include: uncertain tax positions, confusing or ambiguous tools and systems, lack of feedback on completion of tax filing and lengthy and circuitous tax administrative processes. Taxpayers must also believe that their contributions are used wisely and that they are receiving worthwhile services for their payments. Interventions that focus on these elements will be more successful in building trust with the community and enabling larger segments of the population to be responsible for their own tax obligations.

A similar conclusion has been drawn by Holmes (2011) who has made the case for the IRS handling of Large Businesses<sup>11</sup> with increasing automation of systems to short circuit non-compliance – or what she has called “forced cooperation”. The approach to compliance is based on a trial of the Compliance Assurance Program (CAP), which is similar to Australia’s Forward Compliance Agreement approach with Large Business. This is a system that targets uncertainty, enabling taxpayers to sign-off on the business compliance without further costly audits. It is also a cooperative approach that builds trust between the taxpayer and the tax authority.

## 8. FURTHER RESEARCH

Whilst presenting the need for the development of a new paradigm for taxpayer compliance behaviour, our investigations identify a number of additional research objectives. Our examination of taxpayer self-identity confirms that a complex relationship exists between tax officers and taxpayers. This relationship, and the impact that it has on compliance behaviour, warrants further investigation. Private sector organisations have recognised the impact that employee attitudes have on organisation profitability and customer satisfaction (Homburg, Wieseke, & Hoyer, 2009; Yee, Yeung, & Cheng, 2008). Similarly, the attitudes of public service employees will impact levels of compliance.

This paper recommends the integration and operationalisation of the CBM to develop compliance interventions. Further research must be conducted as to how best to apply the techniques and carry out pilot studies to assess the effectiveness of interventions to change and enhance compliance behaviour.

Further research is also necessary to define and understand what is considered to be ‘too complex’ for a taxpayer. Evaluation of different levels of taxation and administrative system complexity can be used to develop interventions that can assist taxpayers in meeting their obligations.

Although some research has been conducted into the role of tax agents in compliance, further investigations are needed to evaluate the impact of increasing taxpayer reliance on accounting and taxation advice and any negative impacts that the delegation of responsibility has for tax compliance. We have established a connection between the strongest normative influences of tax behaviour, i.e. tax agents and an increasing

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<sup>11</sup> Businesses over \$250 TBI

inability for taxpayers to make correct compliance decisions. Understanding this relationship and how to empower taxpayers, whilst still providing support, will aid in increasing voluntary compliance.

## 9. CONCLUSION

There are no simple solutions to facilitating and removing obstructions to compliance. Design improvements come at a high cost and involve people, time and resources and are considered risky to large organisations, such as the Tax Office. The recommendations contained in this paper are made in a climate of reduced budgets and the need for greater efficiencies. Agencies such as the Tax Office are not immune to budget reductions and will be required to shed staff whilst increasing revenue collection. Therefore, the recommended design changes are timely but will need vision and courage to implement.

The Tax Office must remain cognisant of the cost to taxpayers when required to contribute voluntarily and comply with their obligations, as this price is often high and may not provide the outcome sought by the government. It is in the authority's best interests to heed the obligation that it has to maintain legitimacy in the system, through judicious procedures, fairness and mutual trust. The Tax Office must continue to ensure taxpayers are given a fair chance to comply, to equalise the legal complexity, remove obstacles to compliance and to make all able and willing Australians responsible for what is ultimately their tax system.

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## APPENDIX A

The first hypothetical scenario used in the pilot questionnaire.

**Table 11 - Hypothetical scenario used in the main study questionnaire**

Last year your business was audited and you now have a debt with the Tax Office of \$10000 due to interest made on shares that the business owned but had not been included by the accountant and the bookkeeper. This hurt both you and the business as you had to pay the debt just before Christmas. This meant you were unable to pay yourself a hard earned bonus you had made during the year.



It is nearly time to lodge your BAS for this quarter and you are calculating your expenses and tax payable. This year you may be eligible for a tax deduction on the fuel and mileage for your employees. However, the 10 staff this rule applies to have not kept the required records. You know they have travelled at least 100km each, but no more than 800km per employee, per week. You also know that you aren't required to keep records for anything less than 500km per week.

### Q3.3 Do you:

Declare nothing – it's too hard with no records and it is too much to worry about if you need to justify it.  
(2)

Declare 500km per employee – this is worth about \$305 each as a deduction. You feel that you can justify this if you need to. It's a realistic amount in your mind. (1)

Declare 700km per employee (roughly \$700 in deductions) Claim a little more than you could justify – but not enough that it should stand out and bring attention to you. (1)

Other – please describe (4) \_\_\_\_\_

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### Part B

Please state what you think are the LEGAL requirements in regards to the following:

It is legal to declare nothing in your tax return in regards to kilometres

True (1)

False (3)

If you are going to declare kilometres as a tax deduction you are limited to a maximum of 800Km per person, per week

True (3)

False (1)

It doesn't matter if the kilometres are shared between employees, as long as they add up to the total of actual kilometres travelled.

True (3)

False (1)

It is ok to claim 400km kilometres for each staff member without receipts

True (1)

False (3)

It is ok to claim 400km for each staff member even if they didn't travel those kilometres

True (3)

False (1)

# Intervening to reduce risk: identifying sanction thresholds among SME tax debtors

Elisabeth Poppelwell, Gail Kelly and Xin Wang<sup>1</sup>

## **Abstract**

Debt growth is outpacing the New Zealand Inland Revenue's capacity to manage it. This has triggered investment by the Government for Inland Revenue to look at new systems, approaches and tools to reduce debt, while maintaining integrity of the tax system. In New Zealand the small business sector makes a significant contribution to the economy, but it tends to be more susceptible to incurring debt. A large proportion of the total tax debt is owed by this sector with it making up about a third of tax debtors within New Zealand.

This research was designed to better understand intervention to reduce the risk of higher levels of debt for this business group. The research used a multi-method approach and included both debtor and non-debtor small and medium business participants to better understand what determines compliance behaviour. It explored the effectiveness of current sanctions and sought views on non-financial sanctions. It also attempted to identify tipping points and thresholds when penalties and interest become so large the SME debtor is unable to continue to make repayments.

The findings indicate that penalties and interest are influential. Improving awareness and knowledge of penalties would be effective in preventing or limiting tax debt in the early stages, but there are thresholds and tipping points based on business size and debt status. The results indicate that a better targeted 'wrap around approach' to early intervention would be more effective and suggest that, rather than changing the penalty rules, Inland Revenue can use the existing sanctions more effectively. The research identified the use of Inland Revenue's discretionary power to waive penalty charges is an effective lever and this, along with the threat of non-financial sanctions, will provide a more effective approach to managing SME tax debt.

## **1. INTRODUCTION**

This research was undertaken to reduce Inland Revenue's risk of investing in tax debt mitigation actions that are unlikely to work. The Inland Revenue department plays a central role in securing and delivering most of the financial resources required by Government to provide services and facilities that improve New Zealanders' quality of life. Delays in collection can affect the level and timeliness of resources available to the government, and in the worst case scenario at the macro-economic level those delays could add to the level of government borrowing and public debt interest (Inland Revenue, February 2011). A further impact of delays in collection is that those who withhold tax payments to improve their cash flow can secure an unfair competitive advantage and 'push' other businesses to follow suit.

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In broader terms, considerable research has been undertaken to understand compliance behaviour of taxpayers. A 2010 OECD report collating research on taxpayers' compliance behaviour confirms that although the success of deterrence strategies can be linked to fear of detection or severity of punishment, deterrence is more effective when strong positive social norms exist.

However, despite this high level understanding of drivers of compliance behaviour, tax debt in New Zealand continues to grow rapidly.<sup>2</sup> It appears that current sanctions are only partially effective as a compliance mechanism. The OECD report argues that revenue bodies should consider the use of non-monetary penalties to influence compliance behaviour.

Introducing different sanctions is a risky business. What will work best to reduce tax debt? And what other changes could be made to current policies and processes (or social messages) to support a new sanctions regime? These questions were the key reasons for conducting research on the usefulness of sanctions and identifying debt tipping points in influencing compliance behaviour.

## 2. THE PROBLEM OF DEBT

Debt<sup>3</sup> growth is outpacing Inland Revenue's capacity to manage it. In 2005-2006 total debt was \$3.5 billion and total tax revenue for the same period was \$46.8 billion. In 2010-11 the total debt increased by 57.1% to \$5.5 billion, whereas there was no change (\$46.8 billion) to the total tax revenue for the same period.<sup>4</sup>

This has triggered investment by the Government for Inland Revenue to look at new systems, approaches and tools to reduce debt, while maintaining integrity of the tax system. The (2009) Inland Revenue Annual Report notes that debt growth is influenced by historical factors such as the effects of rising revenue along with consistent increases in the customer base. In New Zealand and internationally, the recession has created challenges for tax administrations managing the growth of tax debt with increases in uncollectable debt and decreases in collectable debt.

Inland Revenue recognises that to reduce tax debt it needs to have better information on tax administrative sanctions such as late payment penalties and interest charges. It is important that these sanctions are administered appropriately and evaluated for their effectiveness. A review of recent debt research and consultation highlighted areas for further investigation to inform debt management policy and operations.

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<sup>2</sup> There are five components of tax compliance. These are registration, reporting, filing, payment and claiming. The research focuses on the payment component of compliance. This category is defined as the percentage of payments made on time. That is the ratio of number of late payments to a total number of payments per tax year. A payment is considered to be paid on time if it is paid in full within seven days are the due date.

<sup>3</sup> Overdue tax debt is the amount of tax that remains unpaid after the due date for payment. This includes any penalty and interest applied to the debt.

<sup>4</sup> Note: During this period, total tax revenue peaked at 51.9 billion in 2007-08 (11% up on 2005-06). *Briefing for the Incoming Minister of Revenue – 2011*. November 2011.

The taxpayer group of interest for this research was the small and medium enterprise (SME) sector.<sup>5</sup> The economic downturn has, in particular, put small businesses under pressure to prioritise payment obligations. In New Zealand this sector makes a significant contribution to the economy, but small businesses tend to be more susceptible to incurring tax debt when compared to other Inland Revenue customer groups. A large proportion of the total tax debt is owed by SMEs, with this sector making up about a third of tax debtors within New Zealand. This debt is primarily made up of financial penalties that result from late payment of income tax, GST<sup>6</sup> and PAYE.<sup>7</sup>

## 2.1 The role sanctions play in compliance behaviour

Earlier research on compliance behaviour (Allingham and Sandmo, 1972; Srinivansan, 1973) argues that for some tax customers, sanctions (as a deterrence tool) are effective motivators to compliance. These tax customers tend to be the ‘rational economic actors’, who are motivated to comply by a financial advantage and see sanctions as an ‘incentive’ to comply.

However, the OECD (2010) report comments that deterrence on its own (in the absence of personal and social norms) *“will have to be very strong in order to work (and thus running the risk of further preventing norms to be fostered). It is therefore essential to use deterrence and interventions as a way of creating or supporting social norms”* (p.35).

Norms can drive tax compliance, with deterrence playing a role when obligation and social pressure fails (Wenzel, 2004; OECD, 2010). A tax policy based on the use of sanctions to enforce compliance behaviour can be more effective where trust in authorities is low. High tax morale, perceived fairness of the tax system, good tax knowledge, trust in the tax authority and strong social norms, are all important drivers for compliance (Braithwaite, 2002; Wenzel, 2004; Kirchler et al., 2007).

Tax customers who have high tax morale (Feld and Frey, n.d.; Frey and Feld, 2002; Feld and Tyran, 2002; Torgler, 2002, 2007) are motivated to comply because it is the ‘right thing to do’. The behavioural approach acknowledges that taxpayers do not always behave like rational beings, motivated purely by self-interest and the desire to maximise economic outcomes. Instead, individuals act on their motivations to participate in the tax system (Torgler, 2007). People are influenced by the attitudes and behaviours of others within their social reference group. In other words, individuals look towards their family and friends to establish what is socially acceptable and what is not. The resultant collective behaviour is referred to as a social norm (Inland Revenue, September 2011).

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<sup>5</sup> SMEs are all entities with an active relationship for GST or PAYE that do not belong to large enterprises or non-profit organisations, and all non-individual entities without active registration for GST or PAYE not belonging to non-profit organisations and with an annual GST turnover less than \$100 million.

<sup>6</sup> GST stands for Goods and Services tax.

<sup>7</sup> PAYE stands for ‘pay as you earn’ and is the tax element on employee salaries and wages.

A review of research conducted by other tax jurisdictions has investigated the role of sanctions in relation to compliance behaviour. These are briefly reviewed below.

The Irish Revenue postal Survey of Small and Medium Sized Business Customers 2008: Results and Analysis (2009) identified a range of factors that influence compliance. These include revenue sanctions (concern at having to pay interest charges for late payment of tax), concern of being audited, and concern that the revenue department will obtain a court judgement and publish details of the judgement.

Most participants in the Canada Revenue Agency (CRA) Attitudes towards payment of debt and compliance (2009) research thought that the financial consequences of late payment can be serious. They also thought that experiencing interest or penalty charges has a deterrent impact on late payment in the future for some respondents, but not for others.

The Australian Taxation Office (ATO) Understanding the characteristics of micro business tax debtors (2008) study reported low levels of comfort regarding having a tax debt; significantly lower than comfort levels of debt with other creditors. Businesses with recent debt were significantly more likely to believe ATO is lenient on businesses regarding missed payments.

Participants in the UK HM Revenue and Customs (HMRC) late payment of tax: motivations and sanctions (2008) study acknowledged that sanctions are essential in the tax system. They felt that systems need to be in place to encourage taxpayers to pay on time and penalise those who deliberately do not pay when cash availability is not an issue. They said that the sanctions helped the system be fair to all taxpayers and were necessary to both deter avoidance and encourage payment by all.

## 2.2 The role fairness plays in compliance behaviour

The OECD (2010) report notes that fairness and trust are important drivers for compliance. For example, *“it is not only important what a revenue body does; it is also important how the revenue body does it”* (p.30).

Researchers (Ayres and Braithwaite 1992; Braithwaite, 2002; Braithwaite, Murphy and Reinhart, 2007; Braithwaite and Wenzel 2008; Murphy and Tyler 2008; Murphy, Tyler and Curtis, 2009; Tyler 1990, 2006) have found that if authorities treat people with trust, fairness, respect and neutrality, people will be more willing to cooperate with authorities, and also more likely to comply with authority decisions and rules such as sanctions (penalties) for late payment of taxes. Customers will see the tax authority's status as more legitimate and be more inclined to accept decisions even if the outcomes, such as tax owing, are unfavourable.

Sanctions are used to help the system be fair to all taxpayers - to encourage both payment and discourage avoidance. Sanctions become ineffective motivators when the balance between deterrence measures and perceived justice tips towards excessive use of sanctions to 'punish' customers. If it tips the other way, the public perceive a lack of fairness and trust, and lose confidence in the integrity of the tax system thereby

increasing the risk of non-compliance from tax payers who have previously complied. The balance is restored when tax debtors are perceived to receive their deserved 'penalty' by the tax authority, tax compliers and the tax debtor.

Lack of confidence in the system or perception that there is a lack of fairness or trust can occur when there is a disjoint between tax administration policy and operations. For example, participant perceptions, in the (2009) CRA study, was that written communication did not give an indication that the revenue body was willing to work with people unable to pay the full amount right away or offer payment options. Some instalment payers said it took too long to hear about their late payment and most said they preferred written communication to a phone call about their late payment.

### **2.3 Lack of understanding of tax sanctions**

Inadequate knowledge of tax law has been argued by small business taxpayers as a reason for their inability to meet their obligations (McKerchar, 1995; Coleman and Freeman, 1994, 1997; CRA, 2009). A meta-analysis conducted by the National Research Unit within Inland Revenue (2010) noted that the number of customers filing GST but not filing income tax was approximately 20,000 per annum and warranted further investigation.

Although the majority of participants in the (2009) CRA study assumed there would be some sort of adverse financial consequence, such as interest, awareness was low about late filing penalty and how charges are calculated, and participants felt that information on interest and penalty charges was hard to understand. In addition, while none of the participants from the study had filed late due to lack of awareness of the filing deadline, some suggested that young people and newcomers to Canada might be at risk of filing late. Some participants suggested that more advertising of the consequences of not filing on time, and promotion of payment options, could help taxpayers file on time.

Although some respondents did understand the role of charges as a penalty (and for some it was a deterrent) they thought that more knowledge about how charges were calculated could have a stronger deterrent impact. Participants also thought tax debt, caused by late filing of returns, was due to a lack of awareness of how penalties and interest were charged, and a lack of awareness of options for partial payments.

Some participants suggested more advertising about the specific consequences of not filing or paying by the due date. There was also confusion for those who are self-employed over the filing deadline date and the payment date being the same. Others reported that they pay when instructed by their accountant, which helped mitigate the impact of misunderstanding over deadlines.

While accruing debt is often part of small business, the authors of the (2008) ATO study identified steps and investigations that ATO could undertake to reduce the level of debt generally and of collectable debt in particular. These include further investigation between the link with a business life cycle (issues of capability and business growth) and tax debt; whether encouraging or compelling businesses to

update records more regularly will minimise business activity statement (BAS) related debt;<sup>8</sup> and the extent payment methods contribute to the likelihood of incurring debt.<sup>9</sup>

The literature and data reveals that tax debt is caused by a combination of economic and social factors, and that SMEs are more susceptible to incurring debt than other tax authority customers. Based on this understanding, Inland Revenue recognised that it needed to identify why sanctions are effective to a certain extent, and if there are sanction thresholds and debt tipping points. Better information will help tax authorities to intervene to reduce the growing number of SMEs with tax debt, minimise the time SMEs spend with tax debt, and reduce the level of long-term debt.

By identifying SMEs at risk of incurring tax debt and the drivers behind SMEs' debt it would enable tax authorities to more effectively use its interventions to assist its customers to comply with their tax obligations.

### **3. OBJECTIVES OF THE RESEARCH PROJECT**

The objectives of the project were to explore whether current financial sanctions can be used more effectively to change debt behaviour, and whether different sanctions work better for different SME taxpayer groups. Hence the research explored opinions and effectiveness of current late payment sanctions, and participant response to other types of sanctions. The research also wanted to determine if there is a tipping point where the penalties regime changes compliance behaviour, and identify penalty thresholds to help Inland Revenue better target its intervention processes.

The research focused specifically on tax debt incurred through late payment of income tax, GST and PAYE, and was principally concerned with late penalty payments and associated interest charges.

### **4. METHODOLOGY**

The research used a mixed-method approach to reach its target groups: SMEs with debt, SMEs with cleared debt, SMEs that have never been in debt, and tax agents (who have SME clients). This included in-depth face-to-face interviews, a phone survey, and a behavioural economics 'tax experiment'. The approach was taken as involvement by participants, in the decision-making process can increase the likelihood of support for changes to procedures and policy (Hall, 1992; O'Brien, 2001; Tashakkori and Teddlie, 2003; Ahmed and Braithwaite, 2005). Furthermore, using qualitative and quantitative methods also increases the reliability and validity of the results by reducing bias (Denzin and Lincoln, 2000; 2003).

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<sup>8</sup> The majority of respondents reported changing businesses practices as a result of incurring debt, with half of these changing their cash flow planning and management.

<sup>9</sup> The ATO findings showed a marked difference in tax payment methods; those with recent BAS debt were more likely to use BPAY (an electronic payment banking service) and less likely to use a cheque or money order.

Inland Revenue's National Research Unit commissioned an external provider (Colmar Brunton) to undertake the fieldwork. Tax debt is a sensitive issue and the unit decided that using an external researcher would encourage more respondents to participate due to any perceived lack of 'objectivity' and independence from Inland Revenue.

#### **4.1 Inland Revenue administrative data**

The analysis of Inland Revenue's administrative data (at April 2010) investigated tax debt owed by SME customers. It includes analysis by industry type, SME size and debt by tax type. It also includes the components of penalty and interest and the portion that can be collected under Inland Revenue administrative definition.<sup>10</sup>

#### **4.2 Interviews**

Analysis of Inland Revenue's administration data only tells part of the story – it tells us 'what is'. Interviews provide in-depth information about why people have certain attitudes and behaviour and it increases the likelihood that participants will discuss sensitive issues (like debt). It was anticipated that the qualitative component would provide deep insight into participant awareness and understanding of Inland Revenue penalties.

A total of 60 in-depth interviews were conducted as part of the qualitative phase. These were undertaken in two phases; 15 interviews were undertaken in Auckland and Wellington in April 2011 prior to the implementation of a quantitative survey. The remaining 45 were undertaken in the main metropolitan centres of Auckland, Hamilton, Wellington and Dunedin during the month of August 2011.<sup>11</sup>

#### **4.3 Survey**

Surveys are useful in describing the characteristics of a large population. No other method of observation can provide this general capability.

A quantitative survey of 500 Computer Assisted Telephone Interviews (CATI) (450 active SMEs and 50 tax agents) was conducted in June and July 2011. The final draft of the questionnaire was pre-tested among six SMEs and a tax agent. As a result of the cognitive pre-testing phase further changes were made to improve the flow of the questionnaire, the relevance of the questions to SMEs and tax agents, and the accuracy of the data collected.

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<sup>10</sup> Collectable debt is debt Inland Revenue expects to collect and where active collection is occurring or possible. This includes debt that is being progressively repaid under an instalment arrangement.

<sup>11</sup> Thirty interviews were with SMEs with a current tax debt (nine with cash flow difficulties and no payment arrangement, 14 caused by cash flow difficulties and with a payment arrangement, seven with tax debt caused by administrative error), 12 with cleared tax debt, 8 SMEs that have never had tax debt, and 10 tax agents.



#### 4.4 Tax Experiment

An online behavioural experiment was designed by Victoria University of Wellington (VUW)<sup>12</sup> The tax experiment was an environmental economics exercise and was the first time Inland Revenue has used this type of method to research taxpayer behaviour. It provided an environment where (unlike a survey) actual debt prioritisation behaviour can be observed. The experiment tested how individuals behaved in response to different levels of payment; that is, whether larger tax debts generated higher or lower levels of subsequent compliance than smaller tax debts.

Colmar Brunton distributed an electronic invitation to individuals on its own database to participate in this experiment. The database consisted of members of New Zealand's largest retail rewards programme. The target was 500 New Zealand taxpayers who were senior decision-makers in a business; in total 527 participated in the 'tax game'. Individuals were rewarded with 'points' from the retail reward scheme for participation. The advantage with using an independent research company to target their members is the ability to target the types of individuals that we wanted to take part in the experiment. Moreover, this approach guaranteed a specified number of responses. The data was compiled by VUW and anonymous results were analysed by the National Research Unit within Inland Revenue.

#### 4.5 Sample sources

The samples for the interviews and survey are from Inland Revenue's administrative data. They included SMEs with current tax debt, SMEs who have a history of debt but are not currently in debt, and SMEs who have never been in debt. A smaller sample of tax agents (who have SME clients) was also included. Variables also included entity types, business size (number of employees), and location.

Tables 1 and 2 show the breakdown by debt status of participants for the in-depth interviews and phone survey.

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<sup>12</sup>Dr Lisa Marriott is a senior lecturer at the School of Accounting and Commercial Law and Dr John Randal is a senior lecturer at the School of Economics and Finance at Victoria University of Wellington.

**Table 1: Profile of participants by debt status for the qualitative phase (in-depth face-to-face interviews) N=60**

Interview participants by debt status		Number of participants
Current tax debt	Tax debt caused by cash flow difficulties with <b>no</b> payment arrangement	9
	Tax debt caused by cash flow difficulties with payment arrangements	14
	Tax debt caused by administrative error (with or without payment arrangements)	7
Cleared tax debt	No current tax debt although have had tax debt in the past	12
Never had tax debt	No current tax debt and no previous tax debt	8
Tax agents with SME clients	Currently working as a tax agent for SMEs	10
<b>TOTAL</b>		<b>60</b>

**Table 2: Phone survey SME participants by debt status, age of debt and business size group (N=450)**

Debt status	Age of current debt	Sole trader	1 to 5 employees	6 or more employees
Never had debt	Not applicable	50	30	20
Has a debt history	Not applicable	73	47	31
Currently has debt	Less than 1 year	36	29	15
	1 to 3 years	34	16	20
	More than three years	19	10	20

Note: For this survey SMEs were not considered to have had a debt unless that debt was over \$100. Fifty tax agents who had SME clients also took part in the phone survey.

The research began shortly after the Canterbury earthquakes and this region was excluded from the sample because many SMEs were busy dealing with more urgent issues.

Pre-notification letters were sent to all contacts by Inland Revenue's National Research Unit approximately two weeks prior to the beginning of fieldwork. This letter informed businesses of the nature of the research, and gave them the opportunity to opt out of the research before their contact information was passed to the external research provider. Businesses were assured through the pre-notification letter and during the interview and survey introduction that only the research provider and researchers from the National Research Unit within Inland Revenue would have access to their individual responses.

Disproportionate sampling schemes were employed so the final active SME and tax agent samples contained large enough sub-groups for analysis purposes.

#### **4.6 Analysis of data**

The analysis of survey and interview data included a comparison of the three SME groups; SMEs in debt, SMEs with cleared debt and SMEs that have never incurred tax debt.

The analysis of the interviews consisted of: highlighting the key relevant findings from the quantitative survey report; analysing interview summary notes (in Excel) against each of the objectives; and analysing the verbatim quotes from a cross-section of 25 transcribed interviews.

The survey was analysed by Colmar Brunton using the Toolbox programme, by Info Tools as a visualisation tool for reporting of findings, and SPSS for in-depth statistical analysis. All sub-group differences described in the technical survey report are statistically significant at the 95% confidence level (unless otherwise specified). The sample of SMEs has a maximum margin of error of +/- 6.4% at the 95% confidence level. The sample of tax agents has a maximum margin of error of +/- 16% at the 95% confidence level.

Two SME populations were analysed in the administrative data; SMEs under Inland Revenue definition<sup>13</sup> and Active SMEs.<sup>14</sup> The descriptive analysis also included a breakdown of the debt by the following areas: tax type; location; entity type; business age; industrial areas; agent linkage; GST turnover; business size (number of employees) and customer initiated contact. The data was analysed by Inland Revenue researchers using the statistical software SAS.

The tax experiment was hosted by the external research provider. VUW collated the data and the data was analysed by the National Research Unit within Inland Revenue

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<sup>13</sup> The SME population, in this research, includes all non-individual customers that are not non-profit organisations and not registered in a Corporate Service Centre area, individual customers if they registered for tax types of 'GST' and/or 'PAYE', with annual GST turnover less than \$100 million. The SME customers in the analysis include all active entities that meet the above definition at 1st April 2010. For those owing debt to IR, the debt value and debt elements are measured at the same date

<sup>14</sup> Active SMEs, for this research, are the SMEs that filed GST returns and/or employer returns for the period of April 2009 to March 2010.

using the statistical software SAS. The data was analysed by participant region, industry areas, business size and GST turnover.

#### **4.7 Limitations**

Telephone surveys achieve a higher response rate among SMEs because interviewers can ask for a named contact, and can make appointments and carry out call backs. The vast majority of SMEs will use a telephone for business purposes, and there are a lower proportion of incomplete surveys because respondents are less likely to withdraw when speaking to a 'real person'. However, they can be cognitively demanding, especially when asking respondents how they would act in certain scenarios (e.g. tipping point questions or to visualise what information they would like to have in a statement).

In-depth interviews are very time-consuming and can be off-putting to busy SMEs. To help with recruitment, the external research provider offered SMEs an incentive for participating. In qualitative research, reciprocity is ethically important. Incentives can be useful for increasing participation rates, and may help reduce sampling bias among individuals who are typically less likely to take part in research projects.

Nobel Laureate Vernon Smith (1982) has established the importance of financial incentives in experimental economics research. While not all disciplines adopt this approach, tax experiments typically use reward payments to assist in aligning behaviours in the artificial experimental environment.<sup>15</sup> In this research we provided a reward to encourage participation in the experiment, rather than as a tool to align behaviours. This approach was adopted as the experiment did not follow the typical tax experiment design, i.e., the optimal strategy was not full tax evasion. There was no incentive for participants to try to maximise or minimise any one payment method; instead, payment preferences would determine how participants allocated their 'virtual' funds to meet obligations.

### **5. KEY FINDINGS**

This section synthesises the key findings from the four data collection methods used for this project. As previously stated, the project used a mixed method approach to reach its three groups of SMEs with different debt status,<sup>16</sup> whereby the qualitative interviews identified key themes and the quantitative survey measured these themes.<sup>17</sup> The results compare the responses from the three groups and these are presented under five broad themes: awareness of late payment penalties; reasons for late payments; thresholds and debt tipping points; the role of non-financial sanctions and incentives; and the role of Inland Revenue (the tax administration). When applicable, the views of the tax agent group are presented separately.

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<sup>15</sup> Experiments are typically conducted in an environment where there are no penalties for non-compliance, and minimal third-party impact from decisions made. This reduces the need to behave ethically, and potentially may weaken the validity of experimental research.

<sup>16</sup> SMEs with debt, SMEs with cleared debt (had a history of debt but are no longer in tax debt), SMEs that have never been in debt, and tax agents.

<sup>17</sup> Proportions stated relate to findings from the survey, unless otherwise specified.

## 5.1 Awareness of late payment penalties

In the majority<sup>18</sup> of cases, penalties influence payment, and discourage it in a minority of cases. For SMEs who have never been in debt, it is the mere existence of penalties that influences payment (rather than the specific details about the penalties). The majority of SMEs said the penalties are influential in making sure they pay their business tax by the due dates. This is because they want to avoid any additional or unnecessary cost to their business. Just one fifth of SMEs commented specifically on the size of the penalties or the interest rate; e.g. that the penalties can build up quickly, or that the penalties could impact on their business.

Data from the tax agents were useful in providing another perspective. The most common reason provided by tax agents for SMEs' making payments is that SMEs simply do not want to pay penalties. Nearly all tax agents said the penalties are at least quite influential (but less likely than SMEs to say the penalties are very influential) in making sure SMEs pay their tax by the due dates. Just over a quarter of tax agents stated the penalties are very influential because of the size of the penalties, the interest rate, or because the penalties can build up quickly. Tax agents' reasons for saying the penalties are not influential included a perception that the penalties are not severe enough, that SMEs don't have the money to pay, that paying other bills is more important, and that businesses aren't aware of the penalties.

Results indicate that most SMEs are aware there are financial penalties for late payment of business tax. Most SMEs reported that they are aware that interest accrues on any unpaid amount and that penalties and interest are calculated on the total unpaid amount, including any unpaid penalties. There appears to be a complex relationship between awareness of sanctions (penalties and interest) and compliance. For example, awareness and imposition of penalties and interest can increase compliance in the early stages of the tax debt being incurred. But increased awareness due to receiving additional information by Inland Revenue about the applied sanctions does not make a difference for long term debt. SMEs felt by this stage there is very little they can do and further information can have a detrimental effect with SMEs more likely to feel a sense of hopelessness. There are relatively few differences in knowledge of the penalty system by debt status (i.e., currently in debt, history of debt, or never had debt).

There is a lack of detailed knowledge and understanding of late payment penalties. Although most SMEs in the research were aware there are financial penalties for late payment of business tax and see them as influential, they lacked specific knowledge of how they were applied. For example, less than a third of SMEs said they are aware that on the day following the due date a penalty of 1% is applied, with only 15% being aware that after the seventh day following the due date a penalty of 4% is applied and 23% aware that a 1% penalty is applied per month on any unpaid amount. Just over one quarter (of SMEs) was aware that the interest rate is around 9%. Nearly one fifth believed the penalty for late payment is still 10%.

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<sup>18</sup> In the survey findings, 'most' refers to more than 80%, 'majority' refers to more than 50% and less than 80%, and 'minority' refers to less than 50%.

## 5.2 Reasons for late payments

The main causes of tax debt include administrative mistakes or cash flow problems. For SMEs that have never been in debt, the reasons tend to relate to an error on the part of the business, such as not being aware of or forgetting the date, or some other error.<sup>19</sup> SMEs with a debt history tended to attribute their most recent late payment to not being aware of or forgetting the due date, or external circumstances beyond their control. On the other hand, SMEs currently in debt tended to attribute their late payment to poor cash flow. These SMEs were also more likely than average to say they used the money for other expenses.

In terms of mitigating the impact of potential late payment, more than two thirds of SMEs who have been late with a payment had no contact with Inland Revenue prior to the due date. Further, more than two thirds of SMEs were aware they can contact Inland Revenue in advance to avoid some penalties, but SMEs currently in debt are less likely to be aware of this. Most tax agents believed SMEs miss the due dates for tax payment primarily due to a lack of cash flow.

Importantly, the majority of SMEs make changes to practices and processes as a result of making a late payment. The cause and simplicity of the tax debt has a direct correlation with changes to business practices – the more simple the cause of the debt, the more likelihood of change (and vice versa). Results show that two thirds of SMEs that have missed a recent payment said they have made a change to their practices or processes as a direct result of having missed a payment. The types of changes made were wide ranging, and tended to relate to the key reasons for late payment.

SMEs currently in debt (for whom short-term cash flow was the primary reason for late payment) are most likely to say they now set funds aside to ensure they make payments or that they keep a closer eye on their obligations and finances. SMEs with tax debt caused by long-term cash flow difficulties and more complex financial issues in their business are likely to be more restricted in the immediate, simple, straightforward changes they can make. They will need to make more substantial changes to avoid this situation in the future, (e.g., generating more revenue, improving debtors' management and better management of finances). The potential for change to the businesses practices and processes depends on a number of factors such as the economy, overall debt level of the business, the ability to generate income and whether they can realistically trade out of difficulties.

SMEs with a debt history (who tended to say they were not aware of or had forgotten the due date) were more likely than SMEs currently in debt to say they have set up a reminder to ensure they do not miss due dates in future. SMEs with tax debt caused by

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<sup>19</sup> In the 2004 Colmar Brunton research (commissioned by Inland Revenue), the two main reasons for paying late in the past among current compliers were administrative error by business and cash flow problems.

administrative errors said they made straightforward changes to business practices and processes to ensure it doesn't happen again, for example, reminders of due dates and improved administrative practices.

Findings from the tax experiment provided insight into how SMEs prioritise the payment of debt. As part of the experiment decision-makers were required to trade-off various competing payment priorities under different penalty regimes. Paying employee wages consistently received the highest average priority rating, regardless of the threat of implications. Payments to Inland Revenue rated second (with PAYE rating higher than GST). The behavioural differences observed between small and larger sized SMEs are quite notable, suggesting that different compliance strategies may be required for different sized businesses.<sup>20</sup>

Perception of fairness of the penalties was explored with participants. SMEs were evenly divided on this issue, with about half of the participants perceiving Inland Revenue financial penalties as fair when it comes to financial penalties for late payment. As would be expected however, perceived fairness varies by debt status. For example, SMEs with a debt history and SMEs that are currently in debt were more likely to perceive the financial penalties as being unfair for businesses.<sup>21</sup>

The most common reasons for perceiving penalties and interest as unfair included that they are high, or concern that they can compound and get out of control. Reasons for perceiving penalties and interest as fair included that they are a lever to obligate SMEs to pay on time, and that they are needed to encourage compliance. There is a strong sentiment that on-going penalties are unfairly harsh for those who are making an attempt to pay, and in this situation the penalties undermine the ability to comply. There is, however, support for the continued application of interest rates (more than the banks' loan rates) for unpaid amounts.

Analysis of the tax agent data showed that their views were also divided about whether the system is fair or unfair; half of tax agents believed the penalties are fair.<sup>22</sup> Reasons for saying the financial penalties are fair included that it is a business's obligation to pay on time, that the interest rate is fair, and that the penalties are an incentive for businesses to pay on time. Reasons for saying the financial penalties are unfair centre mainly on a view that the penalties or interest rate is too high, or that penalties can build up and become out of control. Overall all these views are similar to that of the SMEs themselves.

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<sup>20</sup> Previous research (CRA, 2009) found that participants perceive tax debt as different from other forms of debt and this may be a factor when SMEs cannot meet all their payment obligations. In the Colmar Brunton (2004) survey, non-complier businesses (who at least 'occasionally' experience cash flow difficulties) were asked to rank their payment priorities. They ranked staff first followed by supplier and IR third. Whereas complier respondents ranked IR first, followed by staff and supplier third.

<sup>21</sup> 55% of SMEs never in debt, 45% with cleared debt and 40% of SMEs with debt rated the current financial penalties for late payment as fair.

<sup>22</sup> 38% of tax agents believe they are unfair, and 11% believe they are both fair and unfair.

Results show that attitudes and behaviours vary across the SME customer groups. Importantly financial (and business) aptitude marks the difference between those SMEs that have never been in tax debt and SMEs that have experience of tax debt. This highlights the need for Inland Revenue's appropriate and effective management of tax debt to consider the difference between SMEs that have tax debt caused by administrative error (but ability to pay), tax debt caused by short-term cash flow, and on-going cash flow difficulties associated with reduced ability to pay.

Another important finding is that SMEs are not gambling that tax debts will be written off. Most SMEs with tax debt believed that their tax debts will not be written off other than through bankruptcy. They have a perception that Inland Revenue uses bankruptcy as a tool of last resort. They want to avoid this, believing that, given an improvement in the economy, they may be able to trade their way out of their financial difficulties. However, SMEs that are not in debt perceived bankruptcy and tax debt written off as an 'easy option' taken by SMEs in debt. They would prefer that Inland Revenue recovers some tax debt rather than none. To this extent, they support the waiver of penalties (but not interest) so that SMEs have the ability to make inroads into the tax amount owed.

### **5.3 Penalty thresholds and debt tipping points**

One of the main objectives of the research was to examine perceptions of penalty thresholds by SME business groups. The survey sought to determine the point at which penalties encourage SMEs to make their payments by the due dates (the penalty threshold). Analysis of the data demonstrates there are penalty thresholds and debt tipping points. In relation to penalty thresholds, half of SMEs surveyed said that penalties and interest of just 1% at eight days would encourage them to pay by the due dates; three quarters (75%) of SMEs say that penalties and interest of 3.3% would encourage them to pay by the due dates;<sup>23</sup> and most (86%) SMEs say penalties and interest of 5.2% (build-up at eight days under the existing system) would encourage them to pay by the due dates.

Exploration of the penalty threshold and SME annual turnover revealed that there is an inverse relationship between penalty threshold and annual turnover. A comparison of SMEs based on their annual turnover and the percentage of tax bill that would be paid at the threshold at which 75% of SMEs would be encouraged to pay at eight days is shown in Table 3 below.

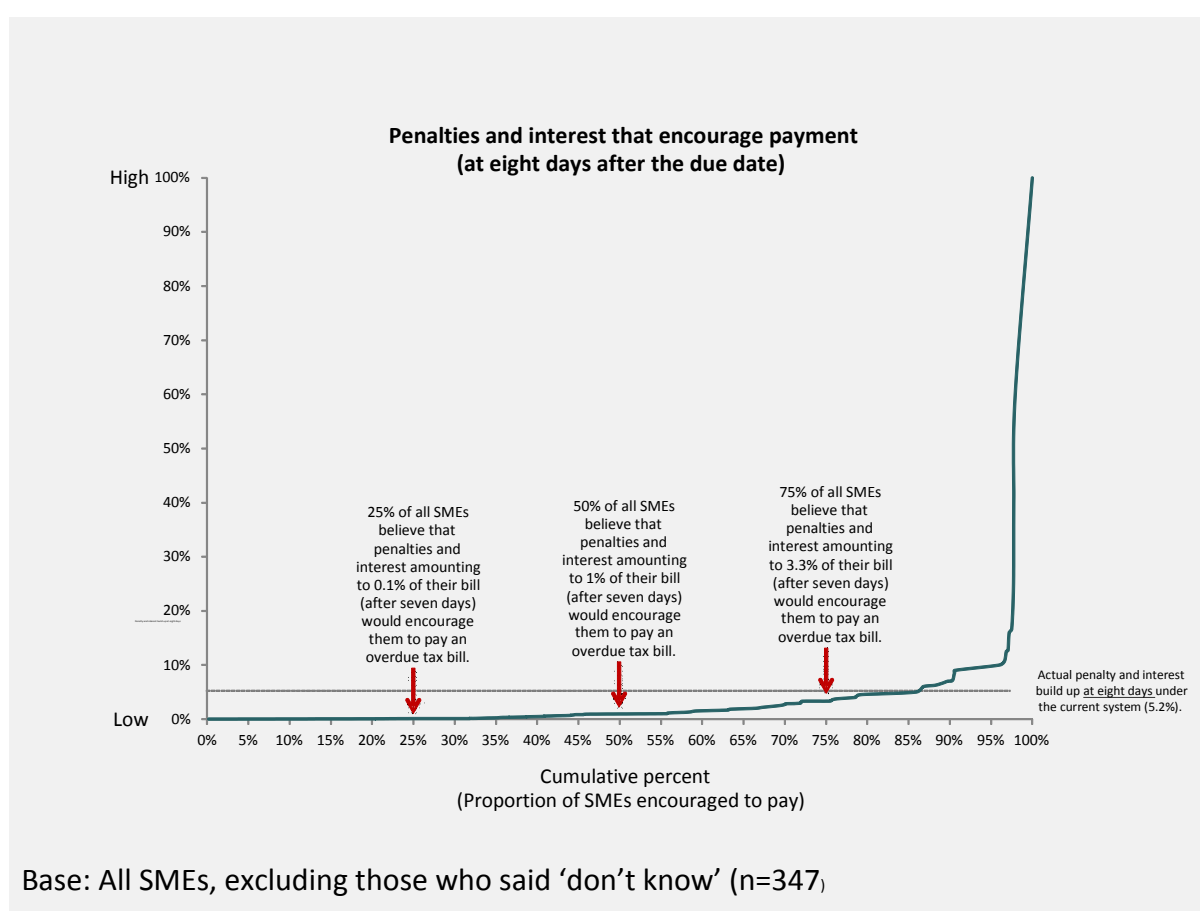
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<sup>23</sup> SMEs were asked to think about the value of their average GST bill and imagine that the bill remained unpaid for seven days past the due date. Once a realistic GST bill had been determined, SMEs were asked to think about the penalties and interest that would build up over seven days, and to tell us what penalty dollar value would be so low that the penalty would not encourage them to pay off the debt.



**Table 3: Percentage of tax bill by SME annual turnover**

% of SMEs tax bill	Annual turnover
6.5%	up to \$50 thousand
3.8%	\$50,001-\$100 thousand
2.0%	\$100,001-\$500 thousand

**Figure 1: Proportion of participants encouraged to pay at each penalty and interest value.<sup>24</sup>**

The figure above shows the proportion of all SMEs that would be encouraged to pay at each penalty and interest value. The horizontal line represents the penalty and interest build-up at eight days under the existing system (5.2% at eight days). At this point most SMEs say they would be encouraged to pay by the due dates. The results

<sup>24</sup> The diagram is from the Colmar Brunton (August 2011) quantitative technical report.

are consistent with responses about knowledge of how penalties and interest are applied, that for many SMEs the mere existence of a penalty encourages them to pay their tax by the due dates.

The research also sought to determine the amount at which debt becomes unmanageable for SMEs, and potentially threatens their ability to do business (the debt tipping point). The quantitative results suggest at around \$10,000 (total GST debt, including core debt, penalties and interest) people felt that they would not be able to pay off the amount. The results suggest that these median tipping points do not vary by debt status (i.e. SMEs with debt, SMEs with cleared debt, SMEs that have never been in debt).

In addition to the above dollar amounts, there are a number of other factors that influence the debt tipping points. For example, when penalties and interest have compounded to the extent that they are 50% or more of the original tax amount owing; the repayment amount that businesses can afford out of current revenue is so little that it is only addressing penalties and interest and not the original balance of tax owed; other business and personal debt (e.g. employee wage costs, suppliers, bank interest and other costs) contribute to SMEs inability to pay tax debt; there is a cumulative tax debt across several tax types; and the total amount owing is out of proportion with yearly income.

As can be seen in the tables 4, 5 and 6 below, across all SMEs the median tipping point is a total debt of \$10,000.<sup>25</sup> This tipping point remains relatively constant except for larger SMEs that have an annual turnover between \$500,001 and \$100 million, or six or more employees. The median tipping points for these SMEs are \$28,965 and \$40,000, respectively.<sup>26</sup>

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<sup>25</sup> The researchers felt it would not have been possible in a telephone survey to ask SMEs to differentiate (in a hypothetical future scenario) between core debt and debt owed due to the accumulation of penalties and interest charges. These tables are from the Colmar Brunton (August 2011) survey technical report.

<sup>26</sup> Inland Revenue's (2011) report 'The Habitual Non-complier Tier 2 Analysis' looks at a wider (tier 2) group of those who are habitually late. The data of debt comparisons between habitual non-complier customer group categories shows the debt mid-point amounts for 'self-employed' is \$12,411 and 'other business' is \$11,436.

**Table 4: Debt tipping point by annual turnover**

	All SMEs	Annual turnover			
		Up to \$50,000	\$50,001 to \$100,000	\$100,001 to \$500,000	\$500,001 to \$100 million
<i>Base (n=)</i>	251	41	57	88	62
10 <sup>th</sup> percentile	\$2,000	\$1,000	\$1,800	\$4,000	\$6,115
25 <sup>th</sup> percentile	\$5,000	\$2,000	\$5,000	\$5,948	\$10,000
<b>50<sup>th</sup> percentile (median)</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$12,000</b>	<b>\$28,965</b>
75 <sup>th</sup> percentile	\$30,000	\$20,000	\$20,000	\$38,680	\$180,000
90 <sup>th</sup> percentile	\$100,000	\$50,000	\$34,000	\$62,822	\$500,000

Base: All SMEs, excluding those that said 'no amount would be too high' or 'don't know'.

By annual turnover, findings indicate an interest scale could be an effective approach rather than a one size fits all. Smaller SMEs are more vulnerable to incurring debt and it appears they have a higher threshold to incurring debt.

**Table 5: Debt tipping point by number of employees**

	All SMEs	Number of employees		
		Sole trader	1 to 5 employees	6 or more employees
<i>Base (n=)</i>	251	71	124	56
10 <sup>th</sup> percentile	\$2,000	\$2,000	\$2,453	\$7,036
25 <sup>th</sup> percentile	\$5,000	\$3,628	\$5,000	\$15,406
<b>50<sup>th</sup> percentile (median)</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$40,000</b>
75 <sup>th</sup> percentile	\$30,000	\$20,000	\$20,000	\$180,114
90 <sup>th</sup> percentile	\$100,000	\$100,000	\$50,000	\$500,000

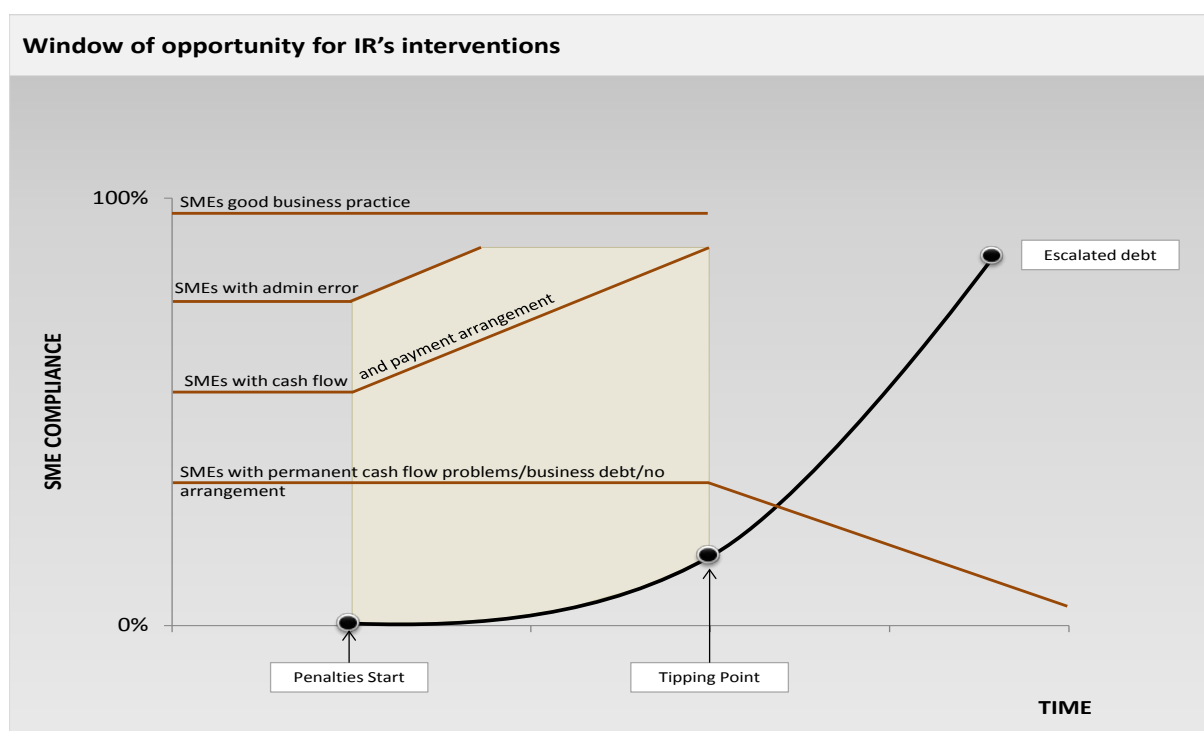
Base: All SMEs, excluding those that said 'no amount would be too high' or 'don't know'.

**Table 6: Debt tipping point by debt status**

	All SMEs	Debt status		
		Never had a debt	Has a history of debt	Currently has debt
Base (n=)	251	56	79	116
10 <sup>th</sup> percentile	\$2,000	\$1,000	\$3,000	\$2,000
25 <sup>th</sup> percentile	\$5,000	\$4,485	\$7,027	\$4,418
<b>50<sup>th</sup> percentile (median)</b>	<b>\$10,000</b>	<b>\$10,000</b>	<b>\$10,332</b>	<b>\$10,000</b>
75 <sup>th</sup> percentile	\$30,000	\$20,000	\$50,000	\$28,569
90 <sup>th</sup> percentile	\$100,000	\$50,000	\$150,000	\$78,176

Base: All SMEs, excluding those that said 'no amount would be too high' or 'don't know'.

When the thresholds and other additional factors are taken into account, there is a small window of opportunity where the tax administration can intervene for impact before the debt tipping point is reached – this is the best time to intervene to reduce the risk of debt. This is illustrated in figure 2 below.

**Figure 2: Window of opportunity before tipping point<sup>27</sup>**

<sup>27</sup> The diagram is from the Colmar Brunton (October 2011) qualitative technical report.

## **5.4 The role of non-financial sanctions and incentives**

A key objective of the research was to gauge the impact that non-financial sanctions and incentives might have on reducing the risk of debt. Research participants were asked their views on five hypothetical non-monetary sanctions and incentives and whether they thought they would be effective in encouraging SMEs to pay their outstanding tax. These included improved notification, credit reporting, an annual practising certificate, travel restrictions, and information on statements to show how penalties and interest build up.

Results indicate that non-monetary sanctions and incentives could be somewhat effective. Across all SMEs in the survey, travel restrictions, improved notification, and credit reporting received the highest effectiveness ratings. The majority of SMEs and tax agents believed that all five sanctions and incentives would be at least somewhat effective in encouraging on-time payment. However the perceived effectiveness of each non-monetary incentive and sanction differs considerably by sub-group. For example, SMEs that have never been in debt and tax agents tended to favour the more punitive options, such as travel restrictions and credit reporting, whereas SMEs with a debt history tended to rate improved notification as the most effective incentive, followed equally by travel restrictions and credit reporting.

When explored in-depth, interviewees thought that notification in itself would only partly effective. The full leverage comes from the dialogue and Inland Revenue's ability to waive penalties in return for a payment arrangement. Furthermore, notification and showing how penalties and interest build up over time are not effective for people who have long-term/large debt with insufficient revenue to enter into a payment arrangement. In this situation, the notification contributes to the tipping point leading to inaction.

In relation to travel restrictions and certificate of compliance, interviewees thought travel restrictions would be difficult to enforce, and a certificate of compliance is an ineffective incentive. Both SMEs and tax agents suggested that it would be difficult to have a clear criterion as to when and how travel restrictions apply (e.g. business or pleasure) and which directors of the business it would apply to. SMEs that are not in debt generally supported travel restrictions for SMEs in debt who 'just want to holiday', but they did not support travel restrictions for those who need to travel for their business. Results suggest travel restrictions would be ineffective for SMEs that have debt – they say they cannot afford to travel so it would not work as a punitive measure.

Credit reporting is perceived to be an effective tool and works as a sanction in much the same way as penalties. The threat of credit reporting would need to be used early (while the debt can still be managed) to warn SMEs of the consequences of not contacting and making arrangements with Inland Revenue for the repayment of outstanding tax. However, just like accumulated penalties and interest, credit reporting will contribute to the tipping point and will add to the business's inability to trade out of difficulty. Consequently, it is likely to be a short step from credit reporting

to bankruptcy for some SMEs. SMEs that are not in debt would welcome the protection offered by the credit reporting of businesses with substantial debt.

Generally, participants considered improved notification and information to show how penalties build up would be most effective when combined with the current financial penalties and interest. The tax experiment showed that smaller sized businesses are more sensitive to sanctions than larger SMEs, and that a combination of financial and non-financial sanctions would be effective for this group.

### **5.5 The role of the tax administration (Inland Revenue)**

Research findings indicate that the tax administration can play an instrumental role in preventing future tax debt. Overall, SMEs recognised that it is their responsibility to manage their business and comply with their tax obligations. However, SMEs thought that Inland Revenue taking a more proactive role in the management of tax debt would be effective; especially targeting those in early debt and those that have a history of debt.

Currently Inland Revenue notifies SMEs in debt that penalties and interest are applying, that they can enter into a payment arrangement and that they can phone the Department. However, this communication process is not maximising the leverage that Inland Revenue has for effective intervention to prevent, manage or limit tax debt. SMEs who were interviewed perceive that Inland Revenue currently prevents or limits tax debt almost solely through information and sanctions (with some payment arrangements). While on the one hand the debt is serious enough to impose penalties and interest, SMEs are also getting the message that it is not urgent or of sufficiently high priority for Inland Revenue to actively contact SMEs and instigate standard debt collection practices.

Those with a high level of financial management skill (and who meet their tax obligations) tend to perceive Inland Revenue's role as tax collection only. Responses in the qualitative research showed that some SMEs will contact the Department because they are generally proactive in dealing with business issues and ring to find out what they can do (they may also have the ability to pay). More contact may be generated if more SMEs are made aware earlier of payment arrangements and the possible waiver of penalties. At this point they are likely to have small or short-term debt and the cash flow reserves to enter into payment arrangements.

Those with a poor level of skill and/or extenuating circumstances (e.g. affected by a downturn in the economy) tended to suggest a greater role should be taken by the tax administration to prevent and/or manage tax debt. These SMEs are likely to need proactive management from Inland Revenue. They are likely to have large or long-term debt, have already incurred substantial penalties and interest, business financial difficulties and/or a 'mind-set' of not dealing with issues.

Overall survey results show that increased awareness of payment options and the waiver of penalties are likely to increase contact with Inland Revenue by SMEs at

risk. For example, more than two thirds of all SMEs surveyed said they were aware they can contact Inland Revenue in advance to avoid some penalties. SMEs currently in debt were less likely than average to be aware of this. More than two thirds of SMEs who have been late with a payment had no contact with Inland Revenue prior to the due date. Those who were not aware of the options said they would have contacted the Department had they known they could avoid some penalties.

There is a strong argument from SMEs and tax agents for Inland Revenue to manage tax debt through a more urgent, standardised business debt collection practice which would consist of early, personalised contact (by telephone from a dedicated debt collection team), dialogue, negotiation of the payment terms in return for avoiding negative consequences and then the consequences introduced if the business makes no attempt to pay (penalties, credit reporting and bankruptcy).

## 6. DISCUSSION

The issues regarding SME tax debt are complex and it would be naive to imagine that there can be a magic bullet that can fully address the growing level of tax debt. While the research has identified a number of opportunities for changes to policy and practices, any changes will require a sustained and consistent approach.

Most SMEs pay their tax on time, but some SMEs are at particular risk of incurring debt. This research included both debtor and non-debtor participants to better understand what determines compliance behaviour. It also identified tipping points and thresholds when penalties and interest become so large the SME debtor is unable to continue to make repayments. These indicate the importance of early intervention.

Key findings indicate that a ‘wrap around approach’ to early intervention would be more effective than one that is more ‘linear’. For example, notifying and educating SMEs who are late with their payments will not help those SMEs who do not have the capacity to make payments and a coordinated approach is likely to produce more effective outcomes. This approach would need to include early identification,<sup>28</sup> notification, and education, along with a long-term sustainable payment schedule that is closely monitored. The research identified the use of Inland Revenue’s discretionary power to waive penalty charges is an effective lever and this, along with the threat of non-financial sanctions, will provide a more effective approach to managing SME tax debt.

This section draws on findings from this research and other national and international studies to discuss mechanisms for reducing long-term tax debt. These include using financial and non-financial sanctions, penalty thresholds and debt tipping points, and conclude with the role Inland Revenue can play along with these tools.

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<sup>28</sup> In-depth profiling is currently being undertaken by Inland Revenue to help identify key groups that are vulnerable and require early intervention.

## **6.1 Intervening to reduce risks with current sanctions**

The majority of SMEs thought that penalties are influential in making sure they pay their business tax by the due dates. However, in-depth knowledge of the penalty rules does not necessarily equate to good compliance behaviour. Most SMEs were aware of financial penalties for the late payment of business tax, but the research highlighted a lack of detailed knowledge of how the sanctions were applied. For example, only a quarter of SMEs were aware of the current interest rate.

SMEs with debt or who have a history of debt were no more knowledgeable than SMEs that have never been in debt. Increased knowledge of the penalty rules would more likely benefit SMEs currently in debt or with a history of debt in the early stages of the tax debt being incurred, but less so for SMEs who have never been in debt. Knowing that penalties exist is enough for this group to ensure they comply.

These findings are similar to that identified in the CRA (2009) research 'Attitudes towards payment of debt and compliance'. In that research it was found that the majority of participants assumed there would be some sort of adverse financial consequence, such as interest, but awareness was low about how charges are calculated.

Inland Revenue's Finance and Planning's (January 2011) report 'Compliance & Penalties Post-Implementation Review: Customer Compliance Evaluation' concludes that the introduction of non-payment penalties appear to have had some success by encouraging customers into instalment arrangements. However, it noted that further analysis is required to establish whether customers have adhered to these payment arrangements. The report acknowledged that those who enter into instalment arrangements are those more vulnerable to being unable to make tax debt payments.

This current research looked at how penalties and interest encourage payment of tax. As highlighted in the findings, it is the fact that penalties merely exist (and not how they are applied) that is a deterrent for most SMEs, and in particular those that have never been in debt. The Irish Revenue (2009) 'Survey of Small and Medium Sized Business Customers' also found that knowing there were sanctions was one of the factors respondents gave that encouraged them to pay their taxes on time.

Overall, it is correct to assume that in the majority of cases penalties and interest encourages compliance and in a minority of cases they are less effective in encouraging compliance. The research showed that the current sanctions encourage payment of tax debt in the early stages but cease to become effective motivators the older the debt becomes.

The research suggests that the current penalties and interest offer very effective leverage to prevent debt and to manage debt within the first few weeks after a late payment (before the debt escalates). Beyond that window of opportunity, continued



application of penalties and interest without proactive (and effective) intervention from the tax administration becomes less effective. Proactive intervention, in combination with not imposing penalties when taxpayers comply with instalment arrangements, is likely to be effective.

There would appear to be no need to change the penalty or interest rates, but rather targeting the existing sanctions more effectively to different SME groups. Inland Revenue is undertaking segmentation analysis using its administrative data to help identify SMEs at risk of incurring tax debt.

## **6.2 The role of other types of sanctions and incentives to help Inland Revenue intervene to reduce risk**

Social or personal norms are important drivers of compliance. The OECD (2010) 'Understanding and Influencing Taxpayers' Compliance Behaviour' report confirms that although the success of deterrence strategies can be linked to fear of detection or severity of punishment, it is also linked to norms, and deterrence is more effective where strong positive social norms exist. It proposes that revenue bodies consider the use of non-monetary penalties as a 'social cost' response to non-compliance behaviour.

This was a focus for the current research where participants were asked about the potential effectiveness in encouraging SMEs to pay their tax by the due date of five non-monetary sanctions and incentives – improved notification, credit reporting, an annual practising certificate, travel restrictions and information on statements to show how penalties and interest build up. The improved notification, more information on the statements and an annual practicing certificate were an attempt to see if these hypothetical options could be used to influence normative behaviour.

A longer term approach to improve compliance levels would be to have performance measured more by impact on taxpayer behaviour than output measurement. The optimal system may need to strike a balance between punitive elements (penalties and interest charges for late payment) and assistance from Inland Revenue to help ensure payments are made by the due dates (such as improved notification and more information on statements).

The research suggests that the introduction of credit reporting is likely to work in similar ways to penalties and interest, in that it would give Inland Revenue effective leverage within the first few weeks of debt. However, credit reporting will also work in the same way that accumulated penalties and interest do – making it less likely for the debt to be repaid once the SME has accumulated penalties and interest and a bad credit rating. Overall, the research suggests that the threat of credit reporting should be introduced early, in combination with more proactive interventions from Inland Revenue.

Previous research by Inland Revenue (2003) 'Reducing the Tax Compliance Costs of Small Business – Final Qualitative Research Report' found that businesses would like the penalties and interest system to take account of good past history. The report also

noted that businesses wanted Inland Revenue to be flexible; they wanted more tolerant treatment in terms of penalties and interest for those who had good records. These issues came up again in the current research, in particular by SMEs who have never been in debt. Participants suggested that SMEs with a good track record should have some leniency (e.g. no penalty) if they have a one-off late payment (e.g. an administrative error). Interestingly, it appears that some SMEs are not aware of an amendment which was introduced in 2008 in which a range of policy changes were made to late filing and payment penalties and to voluntary disclosures. A grace period was introduced for consistently compliant customers who make a late payment or filing. It provides that Inland Revenue will notify a taxpayer the first time their payment is late, rather than imposing an immediate late payment penalty, and setting out a further date for payment. If payment is not made, penalties are then imposed. The evaluation (Inland Revenue, January 2011) investigating the impact of the 2008 initiatives reported that the granting of a grace period does not seem to affect the likelihood of customers paying their returns on time that is, they do not pay sooner or later than before their introduction.

SMEs (not in debt) and tax agents also suggest that if the tax administration wants to look at compliance incentives it would need to be a financial incentive to pay on time, rather than an annual practising certificate. The research also suggests that the most effective route to reducing risk is through Inland Revenue more effectively managing the existing interventions and adopting standard debt collection practices which consist of proactive, early and personalised intervention from staff who are skilled in negotiating and agreeing outcomes.

### **6.3 Identifying ‘at risk’ SMEs through sanction thresholds and debt tipping points**

One of the main objectives of this research was to identify if there were thresholds and tipping points in regard to the current sanctions – that is, are there recognisable points where sanctions cease to be incentives to paying tax and actually become a barrier? The research identified that the current sanctions would encourage most SMEs to pay by the due date. It also identified factors when these sanctions become unmanageable across all SMEs. These factors can be used as ‘red flags’ by Inland Revenue to help better target its interventions for at risk SMEs.

### **6.4 Triggers for debt**

The ‘triggers for debt’ identified in this research support previous findings and research from other tax jurisdictions. The two main reasons that emerged for late payment of tax are administrative errors and cash flow (short-term and long-term). These causes of tax debt are also found in other tax jurisdictions’ research (ATO, 2008; CRA, 2009; UK HMRC; 2008) and identified in Colmar Brunton’s (2004) research for Inland Revenue.

In regard to decision-making and triggers to debt, the UK HMRC (2008) research also found that many debtors described how the misalignment between tax due dates and business invoicing dates caused short-term problems. This was also raised in the interviews, with participants suggesting changes to income tax timeframes

(provisional and terminal) to smooth out payments, and aligning the due dates for each tax type.<sup>29</sup>

Paying tax owed was seen by participants as important. But the tax experiment showed that when it came to resource allocation decisions and prioritising outstanding debt, businesses ranked meeting employee wage costs above other bills. There is an assumption by those interviewed that small business is vital to the New Zealand economy, and that the Government needs small business earning revenue and employing people. Therefore, it will want to avoid bankrupting small businesses and causing additional burdens of unemployment and reliance on government benefits.

SMEs with long-term or high tax debt said they are not gambling on tax debts being written off. However, there was a hope that back penalties (and possibly some interest), as well as future penalties will be wiped, so that the original tax debt repayment is achievable. They often referred to as ‘burying their head in the sand’ when they felt they were unable to pay their tax debt or meet their instalment repayment obligations.

A group of motivational postures have been identified by Braithwaite (2002) as important in the context of taxation compliance - one of these is disengagement. This is where individuals and groups have moved past the point of challenging the tax authority. For these people the tax system and the tax office are ‘off the radar’. The objective is to be socially distant and blocked from view. Disengagement would be a ‘by-product’ of the tipping point with tax debt. The tax administration would need to be cognisant of early warning signs and act before the SME reaches their threshold, and therefore the point of no return (tax becomes uncollectable).<sup>30</sup>

## **6.5 The role of the tax administration (Inland Revenue)**

Most SMEs in the research recognise that it is their responsibility to meet their tax obligations on time and it is the tax administration’s responsibility to collect tax and impose consequences if tax is not paid by the due date. However, the findings indicate that a tax administration can achieve the appropriate balance of help versus consequences. Currently Inland Revenue provides information to businesses on its website with a section focusing on the needs of new businesses. In addition, The Department provides information to trade associations and other organisations dealing with businesses.

Many people interviewed emphasised the need for ‘debt prevention education’ for new businesses. Interviewees also identified the need for SMEs to be up-skilled in good business and money management skills to ensure that tax obligations are met in full and on time.

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<sup>29</sup> Participants also referred to seasonally-related revenue that can lead to short-term cash flow problems.

<sup>30</sup> Inland Revenue is using new technology and its campaign management teams to contact debtors in the days after the due date, to help get debt matters resolved earlier so that penalties and interest would be minimal.

Inland Revenue's role is primarily a tax collection agency and is not supposed to be an organisation whose aim is to coach business people to gain better business skills. Although some participants may see Inland Revenue not acting in line with government's policy to encourage economic growth, some participants understood that the Department is not in a position to make specific recommendations to an individual business.

The issue for Inland Revenue will be how it can clarify its role as government's principle revenue collector to its SME customers and at the same time provide a tax system that encourages communication and compliance.

## **6.6 Issues of fairness**

Issues of unfairness and inflexibility were identified for Inland Revenue as far back as 2005 in a literature review on SMEs. The review identified in the 2003 'Reducing the Tax Compliance Costs of Small business – Final Qualitative Research Report' that small businesses felt they needed to use tax agents because of the complexity of the tax system and fear of being penalised should they make mistakes in doing the tax themselves.

Sanctions can become ineffective motivators to tax compliance when they are perceived as unfair. The most common reasons in the current research for believing the financial penalties are unfair centre around the perception that penalties and rates are high, or a concern that the penalties and interest can compound and get out of control. In addition, delays in collection can affect levels and timeliness of resources available to the Government; and can provide an unfair competitive advantage for those who withhold tax payments to improve their cash flow.

As previously highlighted in the key findings, about half of the survey participants perceive the financial penalties as fair. SMEs never in debt view the current scheme as 'more fair' than the other SME groups. Reasons given as why sanctions are fair are similar to those in the UK HMRC (2008) research. Participants in the UK study recognised that a system of interest and penalties for non-payment of tax is necessary in order to ensure all taxpayers are treated fairly. They also perceived that percentage interest payments, in line with those of other financial institutions (such as banks), to be the fairest sanction for non-payment. Participants in the current research saw incurring interest on outstanding tax owed was fair. But they emphasised that SMEs that have entered into payment arrangements should not have on-going and compounding penalties. This is perceived as unfair because penalties and interest contribute to the tipping points and the erosion of the likelihood that the tax debt will be paid.

On one hand the issue of whether SME tax customers perceive the penalty rules as fair or not appears to be more of an issue for compliant behaviour than SMEs having in-depth knowledge of how penalties are applied. However, early communication with at risk SME groups (SMEs with early debt or a past history of debt) to raise awareness of how penalties are calculated, and a sustainable repayment schedule should help increase the perception of fairness in this group.

As discussed previously, Inland Revenue's Finance and Planning's (January 2011) report acknowledged that those who enter into instalment arrangements are those more vulnerable to being unable to make tax debt payments. The CRA (2009) research highlighted a lack of awareness that partial payments can be a viable option for final tax payments. Respondents in that research believed that CRA will not work with people to develop a payment schedule, but rather insist on receiving the full amount immediately. This belief resulted in participants saying that instead of filing on time and making partial payment at the deadline, they will delay filing and pay the entire amount late.

The current research extends this understanding and indicates that providing specific information about the penalties and payment options is likely to have some influence on SMEs with a debt history, or who are currently in the early stages of debt to contact the tax administration in advance. More than two thirds of SMEs that were not aware of payment options (and who have made a late payment in the last three years) say they would have contacted Inland Revenue had they known they could avoid some penalties.

Results suggest that providing information in the early stages, having a dialogue about payment options early in the process, and the possibility of avoiding penalties is likely to encourage more SMEs (especially those at risk of being late with their tax payments) to contact Inland Revenue before payment is due, thus preventing some debt from occurring. However, there is a debt tipping point beyond which penalties and interest are ineffective, if not obstructive for debt collection.

## **7. CONCLUSION**

There are two elements to mitigating risk; the first is when and how to intervene to reduce risk. The other element is the risk of making ineffective choices about what these interventions are because there is a lack of good information. This research addresses both elements.

This project explored factors underlying SME debt attitudes and behaviour, and identified evidence-based opportunities for changes to policy and practices. These will help Inland Revenue reduce the risk of making ineffective changes to current practices and to reduce the number of SMEs incurring high levels of debt, the length of time SMEs are in debt, and the number of SMEs in debt.

The research indicates that penalties and interest are influential. Improving awareness and knowledge of penalties would be effective in preventing or limiting tax debt in the early stages of tax debt, but there are thresholds and tipping points. These suggest that, rather than changing the penalty rules, Inland Revenue can use the existing sanctions more effectively. This would include better targeting of SMEs at risk, early dialogue, and ensuring that staff are skilled in negotiating and agreeing viable repayment agreements.

The introduction of credit reporting is likely to work in similar ways to penalties and interest, and could be used in combination with more proactive actions. In particular, the threat of non-financial sanctions can be raised as part of the early dialogue if SMEs do not adhere to payment arrangements.

Reasons for Inland Revenue's current interventions not making inroads into the tax debt problem are complex and arise from a combination of issues. This includes issues such as better trained front line implementation staff, staff approaches being consistent, that not all in-house systems are appropriate for the problem, and even how the penalties are applied. Another important factor this research highlighted is the lack of SME knowledge about regulation obligations. More than two thirds of SMEs were not aware of payment options and the possibility of avoiding penalties.

The research also identified how Inland Revenue can play an instrumental role in reducing future tax debt. While SMEs recognise that it is their responsibility to manage their business and comply with their tax obligations, Inland Revenue can use its ability to waive penalties to encourage SMEs to enter into payment arrangements earlier rather than later.<sup>31</sup>

Research (Battisti et al, 2011) investigating SMEs capability to manage regulation argues that capability to manage any type of regulation is closely related to the capability to manage the business in general.<sup>32</sup> The World Bank 2010 (Doing Business) report states that New Zealand is one of the easiest countries to start a new business but Inland Revenue tax data and Statistics New Zealand data show that SMEs are most vulnerable to fail in the first year. There could be a connection between the ease of set up, and the lack of knowledge of regulation obligations.

As raised at the beginning of the discussion, the complexities of the issues are such that it would require a collaborative, sustained and consistent ('wrap-a-round') approach by those in operations, policy and communications to make an impact on the debt problem and reduce the debt risk. Evidence properly assessed and applied is key to selecting and implementing effective programmes (Gluckman, 2011). No single intervention will in itself lead to a step change in outcomes; making a substantive difference over time will take an integrated and consistent approach involving new approaches and interventions.

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<sup>31</sup> Based on the findings from this research, Inland Revenue is trialling a TXT (SMS) messaging campaign with different messages for SMEs who have a history of debt, currently in debt and those that paid their tax obligations on time. Letters are also being developed to show how penalties and interest can 'pile up' if payment is not made on time. Inland Revenue is also using the research to better understand how and when to intervene. The research suggests that the most effective route to debt management and recovery is through adopting standard debt collection practices which consist of proactive, early and personalised intervention from staff that are skilled with negotiating and agreeing outcomes with SME customers. IR is also exploring further the feasibility of using non-financial sanctions as another tool to help mitigate the risk of SMEs incurring long-term and high levels of tax debt.

<sup>32</sup> The report also argues that while compliance is a measure of demonstrated action, the concept of capability expresses the broader potential to act. It allows for a more nuanced understanding of how SME owners manage regulation.

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# Developing risk management strategies in tax administration: the evolution of the Australian Taxation Office's compliance model

Robert B Whait\*

## ***Abstract***

The cooperative compliance model was introduced by the Australian Taxation Office (ATO) toward the end of the last century as a means of improving voluntary compliance with Australia's taxation system. In some circles, the model is regarded as a new and innovative approach to tax enforcement for administrations that had apparently hitherto relied upon deterrence strategies to enforce compliance. Since its introduction in Australia many other jurisdictions, including New Zealand and the United Kingdom, have also adopted the model.

The purpose of this study, from a historical perspective, is to reveal the reasons why the compliance model was adopted. It aims to uncover the nature of the transition from the previous deterrence approach to a cooperative approach and to determine the influences that shaped the emergence of the model as it was officially adopted. It also aims to discover the key precursors that created the environment that encouraged the paradigm shift from deterring non-compliance to encouraging compliance. The study employs a traditional historiographical methodology involving the assembly, organisation and analysis of written and oral historical data using content analysis and historical narrative analysis. An historical study of the compliance model offers insights into risk management approaches in tax administrations through its determination and consideration of the factors that led to the development and introduction of the compliance model within their historical context.

This article argues that administrative equity and administrative efficiency were two factors that influenced the development and adoption of the cooperative compliance model by the ATO. Here, administrative equity refers to the taking into account of the taxpayer's circumstances that led to non-compliance while administrative efficiency refers to the cost-effectiveness of the ATO in targeting non-compliers and carrying out audit and other activities aimed toward improving compliance. Based on this historical study, it is recommended that the ATO consider new techniques to assess risk in large businesses due to the ever-increasing amount of resources these businesses will require as they continue to grow and expand their operations. While the compliance model was adopted in part to improve administrative equity and administrative efficiency, these two goals may be in conflict and the compliance model may exacerbate any such conflict since both utilise the same types of information as their input. Where administrative efficiency dominates over administrative equity, the ATO may respond inappropriately. While automated risk based audit selection techniques may be efficient, such techniques tend to give priority to the risks to the revenue from the ATO's perspective over the risks to the revenue from the taxpayer's perspective, meaning that over-compliance is not addressed. Automated risk management techniques are less effective where taxpayers can change their behaviour to avoid audit, and as a consequence, automated risk assessment methods may be increasing the inequity of the tax system.

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## 1. INTRODUCTION

The cooperative compliance model (the compliance model) was first officially publicised by the Australian Taxation Office (ATO) in its large business and compliance publication in 2000 (Commonwealth of Australia 2000). The model combines responsive regulation and motivational posturing theories that advocate using persuasion to convince a taxpayer to comply. Further, the model advocates that compliance can be made easier through improved customer service and education in addition to the traditional deterrence strategies.

This article reports on research into the historical context, influences and key change factors that led to the introduction of the compliance model in the ATO. It attempts to determine the causes and preconditions, both external and internal to the ATO, which led the ATO to consider a new approach to compliance and the reasons behind the compliance model's adoption. In particular, the research aims to address the following central question:

What was the historical context, influences and pattern of development of cooperative compliance in Australian taxation policy?

The following supporting questions will aid in answering this central question.

What were the key change factors that prompted and shaped the emerging discourse?

What was the nature of the transition from the previous deterrence approach to the cooperative compliance model?

What influences shaped the emergence of the officially promulgated model?

These questions are important since the ATO was the first revenue authority to use such a model as the basis of its compliance approach. Furthermore, a historical perspective on the development of such an approach may inform future tax compliance approaches, including those based on risk management.

After this introduction the article will provide a brief literature review. The methodology adopted will then be outlined after which the history of the model and compliance approaches generally will be discussed with reference to the themes of administrative equity and administrative efficiency which were the main themes that emerged from the data collected in this study.<sup>1</sup> The implications of these themes for risk management will be then discussed. Lastly, a brief conclusion summarises the preceding discussion.

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<sup>1</sup> While many themes emerged out of data obtained in this study, the themes of administrative efficiency and administrative equity were particularly clear. These two themes have been chosen as the focus of this article in favour of other emerging themes due to this clarity. The other themes will be the focus of further research.

## 2. LITERATURE REVIEW

The literature contains only the briefest glimpses as to how the compliance model developed and why it was adopted by the ATO. A detailed history of the compliance model has not been addressed in the literature to date. This gap represents the basis for this research of which this article is a part.

The compliance model's origins are usually attributed either to John Braithwaite's (1985a) book, "To Punish or Persuade: Enforcement of Coal Mine Safety" or Ian Ayres and John Braithwaite's (1992) book, "Responsive Regulation: Transcending the Deregulation Debate." The former book discusses, from a policy perspective, when it is appropriate to use punishment or persuasion, or a combination of both, as regulatory tools in the context of the coal mining industry to improve safety. The latter book discusses whether governments and regulators should adopt a more *laissez-faire* approach to regulation over the centralised and tightly controlled forms of the past. As the sub-title of the latter book suggests, 'responsive regulation' is supposed to transcend this debate by suggesting that regulators adopt both forms of regulation, utilising one or other in the appropriate circumstances while being responsive to those same circumstances.

In 1996 the ATO established the Cash Economy Task Force in an effort to improve voluntary compliance in the cash economy and the Commissioner appointed Valerie Braithwaite to this Task Force after its first report was finalised in 1997. The second report of this Task Force, finalised in 1998, recommended that the compliance model be adopted by the ATO to improve voluntary compliance in the cash economy (Commonwealth of Australia 1998; Braithwaite, V & Braithwaite, J 2001; Braithwaite, J 2002a). The adopted model was significantly different from that described by Ayres and Braithwaite (1992). It retained Ayres and Braithwaite's responsive regulation theory but it had been combined with motivational posturing theory developed by Valerie Braithwaite. Motivational posturing is "social signals that individuals send to authority, to others, and to themselves to communicate the preferred social distance from that authority." (Braithwaite, V, Murphy & Reinhart 2007, p. 138). The 'BISEP' model was also developed to sit alongside the compliance pyramid to allow for the consideration of various business, industry, sociological, economic, and psychological (i.e. 'BISEP') factors that informed the pyramid's application and the ATO's response to non-compliance (Commonwealth of Australia 1998, p. 58).

After the Cash Economy Task Force made its recommendation to adopt the compliance model for the cash economy, the ATO considered whether it could be utilised to improve voluntary compliance of high wealth individuals and large corporations, but there were doubts as to whether the model was suitable for these taxpayer segments (Braithwaite, J 2002a, p. 177-180, 2002b, p. 267; Braithwaite, V 2002, p. 8). The ATO began looking into the affairs of these taxpayers in part due to accusations that the ATO was soft on them and treated others, such as salary and wage earners, more harshly. After its adoption in the high wealth individuals and large corporations segments, the model came to be applied across all taxpayers in the early 2000s (Australian Taxation Office n.d.).

With the introduction of the Goods and Services Tax (GST) as part of the New Tax System in the year 2000, the ATO acknowledged that it needed the cooperation of the taxpaying public to implement these large-scale reforms. Also in the late 1990s there were concerns that Australia's tax revenue stream was under threat from the cash economy and from aggressive tax planning (Braithwaite, V 2007, p. 4).

To redress the perceptions that the ATO was favouring some taxpayers over others, the ATO adopted the Taxpayers' Charter in July 1997 as a means of communicating to the taxpaying public its rights and obligations with respect to tax compliance and tax administration (Commonwealth of Australia 2004, p. 13). The compliance model was adopted to complement this Charter (Braithwaite, V 2002, p. 2; Commonwealth of Australia 1998, p. 58). At some stage, the ATO was persuaded to adopt an enforcement pyramid (Braithwaite, V & Braithwaite, J 2001, p. 216) but the story as to how, why or when that took place has not been written.

These brief accounts do not explain the specific reasons, causes, and influences as to why the ATO adopted the compliance model. This research therefore seeks to provide a platform for further research on voluntary tax compliance and risk management that may inform current and future compliance practices. A historical perspective can provide an evaluation of events so that decision making is improved in a later context (Parker 1997, 1999; Carson & Carson 1998). Since the reasons why taxpayers comply as much as they do is a puzzle that remains unsolved, this historical study may help to improve the understanding of tax compliance behaviour.

While there is some discussion of the preconditions from the preceding decades behind the development of the model, explanations of the origins of the model and the reasons for its adoption in the literature mainly refer to the flurry of activity in the mid to late 90s (Job, Stout & Smith 2007). This flurry of activity involved the adoption of the Taxpayer's Charter and the development of the model by the Cash Economy Task Force as discussed above. Despite these discussions, significant questions remain. What were the factors and causes that led to this flurry of activity in the mid to late 90s and what was the process of change? How did the Cash Economy Task Force develop the model and by which process? How did the model make the transition from being recommended for use for the cash economy to being the ATO's compliance approach for high wealth individuals and large corporations and ultimately all taxpayers?

The concentration on the flurry of activity in the late 90s suggests that the model and its associated compliance methods were unique developments for that time. Some describe the model as signalling a significant shift in tax administration since, "The traditional regulatory style of the ATO has been heavily weighted toward command and control with the automatic application of penalties for various forms of non-compliance." (Braithwaite, V 2002, p. 1; see also Job & Honaker 2002, p. 111-113; Leviner 2008, p. 360). Given that the model is being described in this way, the events surrounding its introduction are of historical significance. This research, of which this article is a part, hopes to provide that history.

### 3. METHODOLOGY

In broad terms, the methodology for this research encompassed traditional historiographic research. This constitutes the assembly, organisation and analysis of data from a variety of written and oral sources. Analysis involved searching for themes and patterns relevant to the above research questions. A combination of content analysis, oral history interviews and historical narrative analysis were used to provide an interpretational history that aims to describe and establish the relevant facts and interpret and evaluate relationships between those facts. This method involved an instrumentalist constructionist approach which focuses on the model that the ATO adopted and seeks to explain its existence by building an account of the past. This means that this historical study seeks to identify the causes that drove the model's development and its ultimate adoption by the ATO (Previts, Parker & Coffman 1990a, b; Parker 1997, 1999; Elliot 2005; Neumann 2006).

With respect to the development and adoption of the model, historical methodology can be used to determine how and why the model was adopted to inform decision making about tax compliance issues today and into the future. According to Parker (1999, p.18), historical methodology has this unique benefit because it contextualises the various historical data such as events, institutions, roles and culture. Contextualisation leads to improved understanding as to why decisions were made and why things were done (see also Fleischman, Mills & Tyson 1996; Bedeian 1998). Without proper context, understanding of the past can lead to inaccurate interpretations that may result in inappropriate decision-making (Bedeian 1998; Parker 1999).

Specific steps included locating the relevant evidence, evaluating the quality of that evidence, organising and synthesising the evidence, and developing historical arguments that address the research questions. All of the aforementioned tasks overlap iteratively (Tosh 1984, 2010; Fleischman, Mills & Tyson 1996; Gaffikin 1998; Neumann 2006). Rather than interview methodology being separate and distinct, this study utilised semi-structured interviews as part of the historical methodology. The semi-structured interviews employed a combination of open and closed questions that guided the interview as well as probing questions to draw out more information. The interview questions were derived from the central and supporting research questions stated above (Tosh 1984, 2010; Fontana & Frey 2000; Flick 2002; Elliot 2005; Glesne 2006; Shank 2006).

The completed interviews were transcribed from the audio recordings using a professional transcription service. They were then analysed using the steps described above. Themes (or codes) that emerged from the sources were compiled in a codebook along with a note detailing the source of the theme. This process facilitated triangulation since all the sources for a particular theme were gathered together in one place and the amount and variety of evidence for each theme could be easily determined. As more sources were analysed, some themes were combined into larger ones or were marked as being related to others.

Since this research seeks to explain the adoption of the model by identifying the causative factors in that adoption, an interpretational approach to writing the history

was adopted rather than a pure narrative approach (Tosh 1984, 2010; Previts, Parker & Coffman 1990a; Neumann 2006). Since the history was analysed thematically into codes as mentioned directly above, it is also presented herein thematically. Overall, the sources were utilised to construct the best interpretation for how and why the model was implemented from the available evidence (Tosh 1984, 2010; Gaffikin 1998; Neumann 2006).

Interview methodology raises the question as to how many interviews are sufficient. In addition to the written data obtained, this study is based on 12 interviews. The details of the types of sources used are provided below. With respect to qualitative research involving interview method, it is recognised that interview samples are purposive rather than probabilistic (Guest, Bunce and Johnson 2006, p. 61). Consequently, the number of interviews to be conducted is determined by theoretical saturation levels whereby saturation is the point where no new themes emerge (Morse, 1995; Guest, Bunce & Johnson 2006, p. 65). Guest, Bunce & Johnson (2006) found that saturation was often reached after 12 interviews and that many themes emerged after 6 interviews. Gay, Mills & Airasian (2009, p. 136) found that many qualitative studies had fewer than 20 participants. On the basis of these studies, worthwhile findings can be made after only 12 interviews. With respect to this study, the themes of administrative efficiency and administrative equity were clear themes that emerged very early in the interview process and were also present in the written data. As discussed later in this article, further research aims to conduct more interviews and gather more written evidence to uncover more themes.

#### 4. SOURCES

The most common historical source is the written word but oral evidence is becoming more commonly used (Tosh 1984, 2010; Fleischman, Mills & Tyson 1996; Previts, Parker & Coffman 1990a, b; Carnegie & Napier 1996; Parker 1997; Neumann 2006). The types of primary written and oral sources relevant to this research are outlined below. The relevant period was the late 1970s to 2000 when the model was first officially publicised.

##### *Primary written sources*

- Scholarly books
- Journal articles
- Working papers and other non-refereed or unpublished research papers
- Australian Taxation Office publications
- Speeches given by various Commissioners of Taxation and politicians
- Hansard
- Government taxation and finance reviews
- Senate inquiry and committee reports and associated discussion
- Submissions to senate committees by interested parties
- Miscellaneous government reports concerned with taxation
- Media articles
- Commentary from the professional accounting and taxation bodies.



*Primary oral sources*

The primary oral evidence was obtained through semi-structured, face-to-face interviews with personnel who were participants in, or observers of, the development of the model. Interviews were also conducted with those who were observers of, had knowledge of, or were involved in, the ATO's compliance strategies in recent decades. While the interviewees have been categorised among those three types as shown below, some participants have fulfilled roles in more than one category at different stages of their career. For this study, interviewees were categorised with reference to how that person predominantly contributed to the study. The personnel comprised:

- former ATO employees;
- former members of the Cash Economy Task Force; and
- taxation academics.

<b>Category of Interviewee</b>	<b>Number Interviewed</b>
ATO employee (former)	4
Academics	4
Cash Economy Task Force Members	4

The Cash Economy Task Force was made up of a mixture of people from the business community from various industries, the ATO and other government agencies, academics, and tax specialists.

*Secondary sources*

Secondary sources are those sources that are derived from primary sources. This study utilised, among others, texts and journal articles on the Australian corporate, social, financial, and taxation environment as well as newspaper, television and other miscellaneous media reports commenting on the aforesaid environments.

**5. DATA ANALYSIS - MAJOR HISTORICAL THEMES**

As mentioned previously, two major themes to have emerged from the data analysis that influenced compliance methods and the introduction of the compliance model are administrative equity and administrative efficiency. Tax systems are typically judged in accordance with whether they are equitable, efficient, and simple (Asprey & Parsons 1975; Lewis 1982; Woellner et al 2012). These criteria tend to be discussed in economic terms with respect to the legislation and the amount of tax expected to be raised from it. This article shows that these themes can also have administrative dimensions and it will now discuss how these dimensions influenced tax compliance methods and the adoption of the compliance model.

**5.1 Administrative Equity**

Equity can be expressed or defined in various ways. With respect to taxation, it is often defined in economic terms such as horizontal and vertical equity. Horizontal equity refers to taxpayers in the same financial position paying the same amount of tax

(Woellner et al 2012, p. 26). Vertical equity is more concerned with a taxpayer's capacity to pay and refers to people in different financial positions paying different amounts of tax in correspondence to that capacity (Lewis 1982, p. 10; Woellner et al 2012, p. 26). These two definitions are concerned with the normative view that all taxpayers should pay their fair share of tax. Whether this occurs is considered to be one of the main drivers of voluntary compliance (Wallschutzky 1985). When a taxpayer perceives that others are not paying their fair share, that taxpayer is likely to question why they should pay. Consequently, ensuring that the burden of tax does not fall on certain taxpayers and not others should be, and is often stated as, a key goal for a successful tax administration.

Despite equity being a goal of governments, tax administrations, policy makers and other interested parties; there have been periods of considerable inequity in Australia's taxation history. Perhaps the best recognised of these periods is the 1970s and early 1980s. The tax avoidance and evasion that was practised at that time has been well documented (Sutton n.d.; Boucher 2010) but how did this influence future compliance measures, particularly the development of the compliance model and what are the implications for risk management?

During the 1970s and early 1980s, paying tax was considered optional for the rich meaning that a substantial burden of tax was borne by the poor. There were two broad ways in which this reduction in tax by the wealthy was achieved. One was through tax avoidance schemes; the other was through the fraud associated with the 'bottom of the harbour' schemes, that is, through the typical means of tax avoidance and tax evasion (Bright 1978, p. 166; Wallschutzky 1985, p. 177). The tax avoidance activities of certain taxpayers angered many others.

The massive tax avoidance of recent times has represented a scandalous inequity in the burden of taxes, and a shifting of taxes away from those most able to pay (Australian Financial Review 13 June 1979 as cited in Wheelwright 1980, p. 82).

We are being absolutely ripped off by people who are avoiding tax hand over fist, and those people are not wage-and-salary earners (Hansard 5 June 1979, p. 2936 as cited in Wheelwright 1980, p. 84).

The sources cited directly above mainly date from the late 1970s showing that the tax avoidance and evasion was tolerated for much of the 1970s until the full extent of it became understood by the general public. Reasons for such inequity include systemic factors not related to tax administration such as the legislation itself, relatively high tax rates for individuals compared to corporate entities and the double taxation of dividends. The high inflation present in the economy during the 1970s also played a role (McKerchar & Coleman 2012, p. 384). These systemic factors created incentives for tax avoidance by those who had the opportunity. The High Court of Australia (High Court) interpreted the tax laws literally and decided in favour of the taxpayer in virtually all tax avoidance cases that came before it during the 1970s (Sutton n.d. p. 4; Boucher 2010; McKerchar & Coleman 2012). Sutton (n.d., p. 4) comments that the High Court's decisions had a major impact on the Commissioner's role so as to render

his judgements about whether tax avoidance had taken place no longer appropriate. Instead the Commissioner could only “check whether the letter of the law had been obeyed.” (Sutton n.d., p. 4). This gave an open invitation to certain taxpayers to keep pushing the boundaries of tax avoidance further and develop more daring schemes. The lack of success by the ATO in addressing tax avoidance through the courts due to the literal interpretation of the general anti-avoidance rule that existed at that time by the High Court is evident in the following comment:

*The Tax Office lost everything in the 70s. The other big case is Westrad. If you look at that it's a very blatant 'find the loophole' kind of scheme and that was really Barwick's [former Chief Justice of the High Court] approach (Academic).*

But the courts cannot be, and were not, held solely accountable for the widespread tax avoidance and evasion of the 1970s. There were administrative causes for the inequity during this period in addition to the typical form of inequity created by the law itself. Some have interpreted the ATO's actions as legitimising evasion and avoidance through it being seen as a representative of oppression (Bright 1980, p. 168). But there was worse to come. The Costigan Royal Commission was established to investigate the activities of the Federated Ship Painters and Dockers Union and the diligence of Mr Costigan exposed the ‘bottom of the harbour’ schemes. In the wake of this discovery, the ATO came in for stinging criticism. The performances of the ATO and the Commonwealth Crown Solicitor's office were described as ‘demoralised’ and ‘inept’ with both offices being held equally responsible (Costigan 1982 as cited in Sutton n.d., p. 4). Examples of such inept performances were the ATO's secrecy and lack of cooperation with other investigators and its apparent reluctance to initiate prosecutions or pursue test cases (Costigan 1982 as cited in Sutton, p. 4).

Instead, the ATO had turned its attention to ‘ordinary people’ compounding the burden. The poor were an easy target to collect revenue since their affairs were relatively simple and mistakes could be easily found (J Braithwaite 1985b). Thus it was easier for auditors to chase small taxpayers and rake in extra tax revenue through lots of small adjustments than it was to audit larger business whose affairs were more complex.

*There was a perception in the community that if you were rich you got away with it, if you were poor you got audited... they weren't necessarily clean, but we weren't talking mega dollars (former ATO employee).*

In the mid to late 1990s the issue of certain groups of taxpayers escaping tax arose once more. This group included taxpayers who were part of the cash economy as well as those who were involved in mass marketed schemes. When Peter Costello (the then Federal Treasurer) was quizzed in Parliament about what he was doing about the cash economy, he replied that the Commissioner had established a Cash Economy Task Force in November 1996. The Task Force was established to respond to community perceptions that the cash economy was growing and due to fears the integrity and equity of the taxation system were under threat (Australia, House of Representatives, *Questions Without Notice*, 1997, p. 4661).

On the same day that Peter Costello made the above announcement, the ATO issued a press release in response to the Task Force's first report (Australian Taxation Office 1997). In that report, the Task Force recognised that the ATO's actions in reducing the cash economy were not perceived by the community as having "sufficient impact" (Commonwealth of Australia 2003, p. 15) and that this view was "a major threat to maintaining public confidence in the tax system and the ATO's administration" (Commonwealth of Australia 2003, p. 15). However, the compliance model did not appear until the second report was finalised in 1998 (Commonwealth of Australia 1998, p. 58). The model was introduced to the Task Force by Valerie Braithwaite and was subsequently recommended to the ATO. Equity was one of the main concerns of some Task Force members.

*Industry associations... always come from the proposition that says that it is in the best interests of the industry as a whole, if everybody within that industry sector complies with the law, so there's a level playing field (Cash Economy Task Force member).*

What types of equity were the developers of the model interested in? While it appears that the traditional notions of horizontal and vertical equity were relevant, what most concerned members of the Task Force was the ATO taking into account the taxpayer's circumstances in determining how it responds to non-compliance, that is, administrative equity. This type of equity includes consideration as to how penalties for non-compliance were meted out and the severity of those penalties. Relevant circumstances that the Task Force thought ought to be taken into account included difficult personal issues, difficult business issues, and the taxpayer's knowledge of business methods such as appropriate record keeping, cash controls and accounting methods. The Task Force was of the view that longer-term compliance would be forthcoming if these various reasons for non-compliance were addressed rather than simply penalising the taxpayer immediately. The Task Force and the ATO wanted to move away from a one-size-fits-all approach to tax administration. This desire was consistent with the principles of responsive regulation and made a clear distinction between those who were paying less tax due to various mitigating circumstances versus those who made a deliberate decision to evade tax. The Task Force, and those within the ATO behind the development of the model, were of the view that those two groups of taxpayers ought to be treated very differently.

*So do you treat a person who, because he's not keeping records, actually hasn't given a very good reflection of his tax, the same way as you treat somebody who is criminal in the activities and is deliberately trying to absolutely knowingly break the law? Do you treat the two the same? I don't think you do... So fairness in that sense is also fairness against the person that has just made a mistake and basically wants to make good. So you make it easier for them to make good, and you bring them back into the fold and you support them (Cash Economy Task Force member).*

Since the taxpayer's circumstances were the primary consideration in determining the way the ATO treats taxpayers, a method was required to gather information so as to assess and evaluate those circumstances. The aforementioned 'BISEP' approach was

developed for this purpose and was included as part of the Cash Economy Task Force's compliance model in its second report.

Despite the establishment of the Cash Economy Task Force in 1996, perceptions of administrative inequity still dogged the ATO into the late 90s. These perceptions were influenced by the Nine Network's *Sunday* television program which alleged that organised crime had infiltrated the ATO and that the ATO "treats small taxpayers unfairly and inequitably while it goes soft on the 'big end of town'" (Senate Economics References Committee 2000, p. ix). In response to these allegations, on 24 June 1998 the Senate Economics References Committee began an inquiry into the operation of the ATO. The inquiry was concerned, in part, with the equitable treatment of taxpayers from an administrative viewpoint. In its submission to that enquiry, the ATO outlined the compliance techniques it had used since self-assessment, with the newly developed compliance model taking centre stage (Australian Taxation Office 1999). The compliance model enabled the ATO to move away from a one-size-fits-all approach and consider the taxpayer's circumstances in its administration of the tax system. The ATO recognised that administrative equity also influenced vertical and horizontal equity, thus the ATO acknowledged its role in producing a more equitable tax system more generally.

It [the compliance model] summed up the evolution away from a one-size-fits-all approach to a philosophy of working with taxpayers by taking account of their taxpaying history, considering their current circumstances, and then treating them accordingly (Australian Taxation Office 1999).

The ATO is using the principles reflected in the Compliance Model in its various strategies, which include addressing compliance in the cash economy and by large corporates. Application of these principles should ensure that the community is confident that each segment pays its fair share towards funding the services for all Australians (Australian Taxation Office 1999).

This discussion has shown that equity and the equitable treatment of taxpayers from an administrative viewpoint was one driver of compliance approaches in the wake of the 'bottom of the harbour' and tax avoidance schemes of the 70s and beyond. Administrative equity also influenced the development and adoption of the compliance model. It was neither the economic concepts of vertical nor horizontal equity that was the primary concern, but rather the taking into account of the taxpayer's particular circumstances that may have led to non-compliance. With administrative equity in mind, the article will discuss the implications of it for risk management, but first the theme of administrative efficiency will be discussed.

## 5.2 Administrative Efficiency

Efficiency is generally defined in terms of administrative and compliance costs from the taxpayer's perspective (Woellner et al 2012, p. 32). Efficiency also refers to the tax system being neutral, an ideal where the tax system itself should not influence a taxpayer's decision making (Woellner et al 2012, p. 32). An alternative view is to define efficiency from the ATO's perspective since it needs to prioritise the allocation of its resources and ensure it is not wasteful. Efficiency from the ATO's perspective

may be named administrative efficiency. Included within its ambit is the process of selecting taxpayers for audit and the how the audit is conducted. The ATO's approach to audit in the 70s and early 80s has been already discussed above with respect to administrative equity, but there were also administrative efficiency issues associated with audits. While it was easy to audit many smaller taxpayers and create lots of adjustments that in aggregation brought in much tax revenue, the process was inefficient.

*... there was certainly not a great deal of reflection on the costs of doing that. So an amendment was probably was costing \$70 in those days [early 80s], there was no limitations so we were doing adjustments for a two-dollar adjustment which might have been 60 cents worth of tax (former ATO employee).*

*I do remember a conversation with a senior member of [ATO] staff, who shall remain nameless, who pointed out, and I looked at the Auditor General's report and it endorsed it, that audit was an extremely expensive method of collecting tax... I forget the figures... audit was something like five times as much as education or the other methods that they used (Academic).*

Due in part to the administrative inefficiencies associated with how audits were conducted at that time, and the abovementioned inequities, the ATO began to reconsider its audit approach. A key cause of this change was the appointment of Trevor Boucher as Commissioner of Taxation in 1984. Interviews conducted for this research continually single him out as the one who brought in new ideas to the ATO and drove a new approach to tax administration. Commissioner Boucher's new approach was signalled in his first annual report where he stated that most taxpayers comply voluntarily (Commonwealth of Australia 1993, p. 19). At the same time, it was recognised that a lack of resources in the form of staff was a major issue for the tax office and this hampered its ability to conduct audits (Wallschutzky 1985, p. 172). New taxes such as Fringe Benefits Tax and Capital Gains Tax (as part of the income tax system) also needed resources to administer. Later, the ATO became responsible for the Child Support Agency which further stretched its resources.

*...there were insufficient resources to deal with it [corporate tax evasion and the cash economy] (former ATO employee).*

The introduction of self-assessment in 1986 was a major part of the new strategy towards greater efficiency in resource allocation. The self-assessment system was adopted in response to the ATO's realisation that it did not have the resources to continue processing returns under a full assessment system, especially as the number of returns that required processing increased over time. Under the aforementioned assumption that most taxpayers are compliant, resources could be diverted toward those taxpayers that were not compliant or needed help. Self-assessment was not only a major paradigm shift in tax administration in itself but also a major shift in compliance strategies since the ATO relied on the deterrence effect of full assessment to achieve compliance prior to self-assessment. Self-assessment required the taking of a different approach to achieve compliance. The risk to the revenue had taken a

different form with post assessment audit now becoming a more important strategy. However, voluntary compliance was not the main focus at this early stage.

Self-assessment, coupled with post assessment audit, necessitated a determination of who was compliant and who was not. When self-assessment was introduced, the ATO was ill equipped to identify non-compliant taxpayers since it did not have the resources in terms of technical know-how to select cases for audit (Australian Taxation Office 1987, p. 6 as cited in Wickerson 1995, p. 219). Computer technology and statistical techniques were not in widespread use at that time (Wallschutzky 1985, p. 172). Such case selection techniques had to be developed. In the early days of self-assessment, audits still served a primarily enforcement function rather than provide support for taxpayers. The overall strategy was to increase the administrative efficiency and effectiveness of audits to recoup tax from non-compliant taxpayers (Wickerson 1995, p. 219-220).

Various reviews led to the division of audit into three main business lines in 1988, namely, complex audit, business audit and primary audit (Wickerson 1995, p. 222; Commonwealth of Australia 1993, p. 24). In doing so, audit activities became systematised for the first time. In the same year, project based audits were introduced as a means of gathering information and learning about compliance and non-compliance behaviour in certain industries (Boucher 1993, p. 239; Wickerson 1995, p. 224). In the early 90s the ATO divided taxpayers into market segments on the basis of their size and type, for example, 'non-business individuals' and 'large and international business' (Boucher 1993). The ATO operations were then streamlined into those segments so that the ATO could develop "an appropriate service, enforcement, systems and collection mix for each of these markets." (Boucher 1993, p. 231). This contrasted with the previous way the ATO organised its operations which had been on a geographic basis with individual local offices in charge of all taxpayers in their area. This market segmentation automatically resulted in taxpayers being categorised and treated differently on the basis of that categorisation.

*In fact there's a guy... who came in as a consultant... he brought marketing principles, and market segmentation is of course what you do if you're a marketing man. And he looked around and said, "You're not segmenting your markets, what are your main markets... And then of course that gives extra stimulus role to the idea of, "How do you treat them differently?" (former ATO employee).*

Scoping audits were introduced in 1990 primarily for research purposes, not for the purpose of revenue recovery (Wickerson 1995, p. 224, 226). Their role was to obtain reliable and unbiased quantitative and qualitative data about the extent and nature of non-compliance among various taxpayers. Random sampling techniques were used within stratified groupings to select taxpayers for a scoping audit (Wickerson 1995, p. 226).

While these new audit techniques based on risk management principles were being developed, there were calls to provide more taxpayer assistance under the relatively new self-assessment regime. A more comprehensive and accessible ruling system was

advocated by the Joint Committee of Public Accounts report ‘*An Assessment of Tax*’ (see recommendations 20 and 28-43). By this time, education and service had been combined with audit as part of an overall risk management strategy (D’Ascenzo 1993, Australian Taxation Office 1999). The ATO realised that audits did not achieve compliance ‘lock-in’ (Australian Taxation Office 1999) and it became clear that if improvements in compliance were to be achieved, a method other than audit would have to be developed. Wickerson (1995, p. 226-231) describes how the role of audit shifted from one of enforcement and recovery to one that tries to improve future compliance primarily to achieve compliance ‘lock-in’. This was in part sparked by the aforementioned Joint Committee of Public Accounts report which recommended that auditors be briefed on the reasons why an audit had been selected and that these briefings should stress the need to improve future voluntary compliance (Commonwealth of Australia 1993, p. 251 and recommendation 92). The aforementioned focus on audits for enforcement and information gathering had given way to a new goal of finding a correct mix of service and enforcement with service including education programs. For example, a review of the Large Case Program (discussed in Boucher 1993, p. 237) revealed that differing interpretations of the law accounted for more than half of the tax raised by the Program. Boucher (1993) regarded the production of rulings as being more effective than litigation and legislative reform in reducing the gap between the ATO’s view of the law and the view held by large corporates. Another example, from the small to medium sized business segment, was that project based audits would not necessarily result in more auditing of a particular taxpayer, but instead better leverage could be obtained through education and persuasion. Thus the risk to the revenue was being managed via education, service, and persuasion.

*We have realised for some time ... that voluntary compliance is not achieved by enforcement alone. On the other hand, you cannot hope to achieve voluntary compliance without a strong enforcement arm. What is needed is an integrated approach to achieving voluntary compliance – that is, an approach that combines enforcement, service and education (D’Ascenzo 1993).*

As mentioned above, this ‘realisation’ had its origins in self-assessment since the ATO knew that it did not have the resources to process ever increasing numbers of returns. As mentioned above, the resources required for administration of new taxes such as FBT and CGT, as well as the later responsibility associated with the Child Support Agency, would also have necessitated a more efficient resource allocation.

*I think as a result of the realisation of that [that the ATO did not have the resources to process burgeoning numbers of returns] the notions of voluntary compliance, risk management, market segmentation, compliance model, they were all natural outcomes (former ATO employee).*

*The compliance model is a risk management [model], the risk management framework is a compliance model (former ATO employee).*

These new compliance strategies as described by Boucher (1993) and others above are similar to what is advocated by responsive regulation as described by Ayres and Braithwaite (1992). Indeed, Boucher’s description of ATO’s ‘Risk Management on a



Market Segmented Basis' was published in a volume on business regulation edited by Peter Grabosky and John Braithwaite, two pioneers of responsive regulation theory which underpins the compliance model. Boucher first presented this paper at the Australian Institute of Criminology in March 1992 (Wickerson 1994, p. 128 at footnote 11). This similarity raises the question as to how the ATO became exposed to responsive regulation techniques. It has been suggested by one interviewee (Academic) that knowledge of responsive regulation was dispersed by students and influenced thinking in the workplaces that they entered into, including the ATO. The ATO was also possibly influenced by the Organisation for Economic Cooperation and Development through its publication *'Administrative Responses and the Taxpayer'* (OECD 1988). However, it is also possible that the ATO began using techniques advocated by responsive regulation of its own volition and had come to see the usefulness of those techniques independently, through its own realisation that audit and service ought to be combined together.

*...the Taxpayer's Service Group was set up to complement the Taxpayer's Audit Group. They didn't really talk to each other, so it was really when the market segments came together that the notion of service and audit really began to gel together. And you really can't make a distinction between audit and service... They are not separate concepts... It's ridiculous to say that you can have an audit program that is conceptually separate from service. Even the auditors who are in "gotcha" mode would admit that often they ended up, as, part of their audit, actually helping the taxpayer anyway, because in the process of auditor saying, "Your records don't support this deduction." That's a learning thing, so it was really when all the market segments came together that, in my view, deterrence and the support notions began to coalesce a bit and the project based audit program certainly was in that mode (former ATO employee).*

While the exact causal influences that led to the ATO adopting responsive regulation techniques and the exact timing of the adoption of these techniques cannot be yet determined, it can be shown that the ATO had adopted these techniques some years prior to the adoption of the compliance model. The Taxpayer Service Group was formed between 1987 and 1989 (Australian Taxation Office 1999) and thus the focus on services can be traced to that period at least. After that, the relationship between audit and services become progressively stronger. Therefore, there was a trend beginning in 1987 to 1989 to unite service and audit. By the time the abovementioned article, 'Risk Management on a Market Segmented Basis' was published; Trevor Boucher had already left the ATO and was no longer the Commissioner of Taxation. The new Commissioner, Michael Carmody, continued in the same vein. The Joint Committee of Public Accounts published *'An Assessment of Tax'* in 1993 which made many recommendations aimed toward improving administrative efficiency (for example: recommendations 54, 55, 56, 57, 72, 78) meaning that administrative efficiency remained a focus in the ATO throughout the rest of the decade thereby giving stimulus for the ATO to refine and develop its risk management strategies. In 1996, the re-emergence of non-compliance in the cash economy as an issue saw the establishment of the Cash Economy Task Force. Valerie Braithwaite's appointment to the second Task Force in 1997 or 1998 led to the introduction of the compliance model to the Task Force and its subsequent adoption by the ATO and its eventual rollout across all taxpayer segments.

Since the ATO was using responsive regulation techniques prior to the adoption of the compliance model, what particular advantage did the model bring to the ATO? Not everybody within the ATO agreed that service and education was part of their job description, particularly some auditors. The compliance model was adopted in the late 90s to provide a means of communicating the compliance approach involving services, education and persuasion consistently across the whole of the ATO and even to external parties when required.

*...and it was very much a tool that was used by senior people to drive down into the organisation, because even in my latter period there was a number of, you might call old-fashioned auditors, who still said, "We're just here to audit people, we don't do any of that risk nonsense", you know, "How does this help us?" you know and this was a tool to get a sense of common spirit through the organisation (former ATO employee).*

*I thought it was very powerful and very effective as a symbol, and as a talisman for the new approach. I thought it was great. I'm not sure it's the most accurate representation of the actual influences or comparative influences on tax paying, tax compliance, but it plays a very effective, very clever talisman or clever icon, symbol, because everybody in the Tax Office, everybody in practice, more sophisticated taxpayers all know about it and they understand what it means and it endorsed the rhetoric (Academic).*

This section has shown that self-assessment was adopted so that the ATO could allocate its scarce resources toward those who were non-compliant; however this necessitated the development of methods that could detect the non-compliant. Risk management strategies were adopted whereby information would be gathered about taxpayers so that an assessment of likely non-compliance could be made. Initially, risk management had the narrow goal of detection of non-compliance and subsequent recovery of tax, but this broadened over later years to include strategies such as education, persuasion and customer service. The ATO adopted the compliance model in part to more easily and succinctly communicate these risk management strategies throughout the whole of the organisation to ensure consistency in their adoption and application.

The [compliance] model has its basis in risk management (D'Ascenzo 2011).

## **6. IMPLICATIONS OF ADMINISTRATIVE EQUITY AND ADMINISTRATIVE EFFICIENCY FOR RISK MANAGEMENT**

As discussed above, risk management techniques were developed to allow for the efficient allocation of the ATO's resources toward non-compliant taxpayers. The ATO's compliance model was adopted to facilitate the adoption of risk management process that combined audit, service and education across the whole of the ATO. Additionally, the ATO's compliance model was borne out of concern for administrative equity, that taxpayers should have their particular circumstances taken into account when the ATO determines its compliance strategy and associated penalties for that taxpayer. This section discusses the implications of administrative

equity and administrative efficiency for risk management in general. While there may be many implications of the history presented herein, the implications discussed in this section concern future ATO resourcing issues, administrative equity issues surrounding self-assessment, potential incompatibility between risk management and the responsive regulation, and taxpayer responses to risk management and compliance. Each of these areas will be discussed in turn.

## 6.1 Future ATO resourcing issues

Given that post self-assessment audit was introduced as a risk management and resource allocation process in the mid-late 80s and early 90s, examining where audits were undertaken at a particular time provides a picture as to where the ATO saw the risks at that time. Wickerson (1995, p. 224) tabulates the audits conducted over the period of 1988 to 1993. There was a sharp drop in the overall number of audits from 1988 to 1989 and then a slow rise to 1993. The trend shows a continual increase in the proportion of companies audited out of the total from 12.3% in 1988 to 30.5% in 1993 (Wickerson 1995, p. 224). Wickerson (1995, p. 229) also observes an increasing emphasis in the auditing of larger business from the period 1988 to 1993, and especially companies. After 1993, Boucher (1993, p. 237-238) explained that a key group of high-risk large corporates would be under continual observation with other less risky companies being subject to less scrutiny.

*Trevor Boucher's initial plans was that he decided that he would audit the top 100 companies, and that he would place an auditor in those top 100 companies (former ATO employee).*

The ATO created the role of a key account manager to act as a contact point between a large corporate entity and the ATO (Boucher 1993). Specifically, the manager's role was to ensure that the ATO's information about the business was up to date, to take note of major developments and to identify whether action was necessary. One person was charged with these tasks.

Various high wealth individual and large corporate audit programs have been undertaken by the ATO in recent decades. Resourcing issues similar to those that existed prior to the introduction of self-assessment are likely to resurface in the future as the ATO is unlikely to be able to keep up with the growth, complexity and detail of these companies and their increasing globalisation. The key account manager's role will ultimately become too large for one person to fulfil. Therefore the ATO will have to find newer and more resource efficient methods of auditing or observing large businesses.

Perhaps in recognition of the resourcing difficulties associated with auditing large business, the ATO has recently introduced the Reportable Tax Position framework as a pilot project following a similar framework introduced in the United States. This ATO framework currently targets the top 100 companies and 46 have already been selected for participation in the pilot (Branson 2012). This initiative requests that the selected large companies report to the ATO on every tax position that that is "as likely

to be as correct or incorrect or less likely to be correct than incorrect.” (Branson 2012, p. 298). With this initiative, it appears that the ATO wants large businesses to self-assess their own risks. This may increase compliance costs for large corporations in a similar fashion to that of self-assessment which is considered to have increased costs for taxpayers generally compared to full assessment.

*There was such a fundamental change [that is, self-assessment] that in fact I think initially the Tax Office thought all they were doing was shifting resources into audit, and building up their audit capacity...but in doing so they didn't appreciate, I don't think, they they'd actually shifted a massive burden from themselves to the general public (former ATO employee).*

*It [self-assessment] was partly outsourcing the work. If they are not doing the work, any job you don't do yourself looks easy (Academic).*

Imposing undue costs on compliant taxpayers is contrary to the compliance pyramid which advocates that the ATO makes it as easy as possible for taxpayers to comply. Companies may manage their own risk in response to this initiative by simply reporting all possible risks to the ATO since judgement about what is as likely to be as correct as incorrect will be difficult. If companies report all possible risks, the initiative may backfire on the ATO due to it being overwhelmed by reported tax positions stretching its limited resources even further.

## 6.2 Administrative equity issues surrounding self-assessment

Continuing with self-assessment issues, it has been argued that self-assessment is inherently inequitable since taxpayers have to deal with the uncertainty associated with complex tax legislation and are faced with penalties and general interest charge for non-compliance as well as the onus of proof in arguing that they have applied the law correctly (Dirkis & Bondfield 2008). The Joint Committee of Public Accounts in its 1993 report *An Assessment of Tax* acknowledged as much when it recommended the ATO provide more support for taxpayers in applying the law to their own circumstances. The report also acknowledged that the Commissioner effectively has the power to create law under a self-assessment system (Commonwealth of Australia 1993, p. xix, xx; see also Dirkis & Bondfield 2008; Woellner et al, p. 47-48). Little has changed since the Committee made its recommendations with the wealthy being in a better position to challenge the Commissioner's views in court meaning that despite a more binding rulings system, the Commissioner's 'power' to make law remains undiminished.

Self-assessment has led to the ATO focusing on the risks to the revenue (Wickerson 1995; Boucher 1993). Expressing the risk in this way implies that the ATO is concerned with the underpayment of tax. Self-assessment creates the environment where there are likely to be significant numbers of taxpayers who are too compliant. The ATO's risk management or compliance strategy does not contain a statement outlining a desire to reduce the burden of taxes on over-compliant taxpayers. Indeed, risk management strategies are focused on underpayment of tax rather than an

overpayment of tax. Since the burden of taxes is one factor that influences voluntary compliance, the ATO could make a greater effort to reduce over-compliance. For example, under responsive regulation, salary and wage earners who have claimed a higher level of deductions compared to others in their occupational group will be sent a letter advising them to be careful when claiming their deductions. This strategy has been regarded as successful since sending out a letter to these taxpayers usually results in more tax being paid in the next year.

Viewing it from the angle of salary and wage earners as a group, the compliance issue moves more to that of work-related expenses. They are running at a high level, despite substantiation requirements, but it is pleasing to observe that claims for such expenses in last year's returns are somewhat below what we had anticipated. This may be due to the 'steady on' messages we were sending in the middle of last calendar year (Boucher 1993, p. 242).

Our compliance approach has a strong emphasis on 'prevention is better than cure'. We alert the community to what we are focusing on at tax time and write to people we think are at risk of over-claiming (based on their last year's return) before they lodge in the current year. We provide personalised information to raise awareness and understanding of their rights and responsibilities. The average adjustment following one of these letters is a reduction of 15% in claims. We also send information to people who in the previous year claimed work-related expenses for the first time (Commonwealth of Australia 2008, p. 17).

The salary and wage taxpayer, or even a small business, receiving such a letter may actually be compliant, even though the taxpayer is regarded as a risk. There remains a danger, however, that a taxpayer who is assessed as a risk to the revenue is actually compliant but has their 'non-compliant' status reinforced through that taxpayer reducing their claims for deductions due to being scared of audit activity. In this way the risk assessment of a taxpayer as non-compliant becomes a self-fulfilling prophecy. Taxpayers who are not deterred by such letters since they are of the view that they are compliant and who do not reduce their deduction claims would be labelled as 'resistive' under the compliance model. Therefore, taxpayers who are legitimately on the high side of the deductions spectrum are backed into a corner with respect to their future compliance behaviour.

*...they can send a letter out saying, 'we've had a close look at your rental expenses this year, we're not going to do anything about it but can we just remind you what your obligations are and what the rules are' then they track that and next year those people always claim less. So they just send a letter, 20 bucks cost the letter, to all these people and next year their claims reduce by 1000, pretty good bang for your buck (Cash Economy Task Force member).*

When the same interviewee was asked about the possibility that the taxpayer receiving a letter was actually claiming the correct amount they responded:

*Quite possibly. They just [had] the s\*\*\* scared out of them (Cash Economy Task Force member).*

### 6.3 Potential incompatibilities between risk management and responsive regulation

The risk management strategies developed by the ATO from the late 1980s relied upon both qualitative information about the business, its environment and the factors impacting on that business's ability to pay tax as well as quantitative information such as the business's financial records and information in its tax return and the general economy (Boucher 1993; Wickerson 1995). Similar types of information are also part of the 'BISEP' model that was developed to support compliance pyramid by informing the ATO about the taxpayer's circumstances so that an appropriate regulatory action can be made which takes into account those circumstances.

There is, however, disagreement concerning how risk management strategies fit within a responsive regulation strategy and vice versa. As discussed above, the ATO adopted the compliance model as part of its risk management strategy and to communicate that strategy throughout the ATO. Indeed, as written above, some are of the view that the compliance model and risk management are merely different labels for the same strategy. But others are of the view that risk management is very different in nature to responsive regulation and the compliance model.

*So that's one of, you know, when I was trying to answer that very early question about, well, what were the other models [that were considered]. Well the risk based regulation is obviously one of them (Academic).*

*...there was also the risk analysis sort of movement in government which I see as a rather, one of those different things, from responsive regulation. I don't see there being a simple progression from the bottom of the pyramid to the top of the pyramid that corresponds with risk (Academic).*

For these people, since responsive regulation is a pluralist model that could encompass many potential compliance measures within it as determined by the context (Academic), the issue is not primarily whether risk management can be used with responsive regulation, but rather how these two approaches should be used in combination.

*...it [the compliance model] was never about risk... but somehow with risk management, instead of seeing the differences between the compliance model and risk management there was a desire to push them together in ways that they should never have been pushed together (Cash Economy Task Force member).*

While risk management can inform the compliance model, and the compliance model is itself a risk management strategy, the compliance model is not supposed to be a strategy where the lowest part of the pyramid represents the lowest risk and the highest part of the pyramid represents the highest risk. When the same type of information is used by the risk assessment and the 'BISEP' analysis, there is a danger

that the response of the ATO as determined by the 'BISEP' analysis becomes commensurate with the compliance strategy advocated by the risk assessment. This is because risk assessment is designed to identify taxpayers who are not compliant and naturally categorises taxpayers as either low risk or high risk or somewhere in between. Since the 'BISEP' approach is designed to also inform the response of the regulator to a taxpayer's circumstances as well as the risk management assessment, the response from the regulator effectively becomes aligned with the risk assessment. Such alignment means that there is a danger that the 'BISEP' analysis that is supposed to take into account the taxpayer's circumstances and administrative equity ends up becoming more focused on administrative efficiency instead. The diametrically opposed views expressed by some participants in this study concerning whether the compliance model is a risk management strategy or otherwise indicates there is potential for conflict where the same model is trying to achieve two different objectives. In some cases, risk management strategies can lead directly into deterrence strategies in response.

*...in a lot of work there is a simple minded assumption that [if] the red flag for fraud is there you would want an investigation and if there is culpability [then] a prosecution (Academic).*

If risk management results in an automatic fine, prosecution or a similar tough stance by the ATO, then the tax system is not being regulated in the way that responsive regulation intended and in the way that the ATO communicates to the taxpayer through its compliance program. This is because such compliance measures would not be taking into account the circumstances of the taxpayer, a key element that was desirable to members of the Cash Economy Task Force and the basis of the responsive regulation methods that underpin the model.

#### **6.4 Taxpayer responses to risk management and compliance**

As discussed above, the literal interpretations of the High Court were one reason for tax avoidance being allowed to flourish in the 70s and early 80s. As more and more cases were decided, the schemes became more daring.

*...it was a frustrating time because the Tax Office were, from a Tax Office perspective, were just losing cases and I thought that the cases were more egregious as time went on, but maybe that was just my perspective of being involved (former ATO employee).*

The ATO fought these schemes by trying to stay one step ahead of taxpayers by advocating for new legislation to deal with specific cases. One of the eventual legislative changes was the introduction of a new general anti-avoidance rule which exists to this day (McKerchar & Coleman 2012, p. 390). The tax avoidance cases and the subsequent rulings of the High Court showed that taxpayers who wanted to avoid tax were prepared to adapt to the new rules in the process. Taxpayers remain frustrated with the current general anti-avoidance rule since there appears to be considerable

uncertainty surrounding its application (See, for example, Cashmere 2004, 2006; Thompson 2007; Pagone 2010; Cooper 2011).

The ‘bottom of the harbour’ schemes also showed evidence of taxpayers engaging in certain behaviour to avoid tax, specifically with the hope of remaining off the ATO’s radar. While members of the Federated Ship Painters and Dockers Union were involved in these schemes, there were also labourers, debt collector agents and sales people who were involved (Sutton n.d., p. 9). In Sutton’s view (n.d., p. 9) these people were chosen on the sole basis that their lifestyle would make them difficult to trace. The cash economy is another example of certain taxpayers undertaking activity specifically to stay off the ATO’s radar. Indeed, the Cash Economy Task Force was established in part to bring these taxpayers within the ATO’s vision.

*They wanted to get more people into the system. The GST and the BAS and so on helped that and brought a lot of people in much, much more knowledge and information which they could develop the industry standards and so on, percentages and if you are outside that then we would have a look at you (Cash Economy Task Force member).*

It is perhaps useful to remember that despite the ATO’s efforts, as well those of the courts, taxpayers are able to adapt and modify their own behaviour. The courts and the ATO are not benign observers of taxpayer behaviour, but compliance actions of the ATO will itself have a reflexive influence on it. While it is the point of such compliance activities to change taxpayer behaviour to improve voluntary compliance, the ATO must be prepared that its actions may also make some taxpayers less compliant and take this into account in developing its risk management systems. Once certain taxpayers become aware of compliance activities that are being pointed in their direction, they will work toward changing their behaviour once more to avoid scrutiny. On the one hand, this change might be desirable from the ATO’s perspective, such as the case with the sending of letters to salary and wage earners who appear to be overclaiming deductions, assuming that is indeed the case. Such changes lead to the claiming of fewer deductions, as discussed above, leading to the taxpayer escaping the ATO’s vision. In other cases, however, a taxpayer who continually avoids the ATO’s radar may be engaging in persistent non-compliance of a kind that existing risk assessment strategies cannot detect. Risk assessment is therefore a double-edged sword since taxpayers in general need to be aware of the risks for it to be effective.

Computer surveillance may be used but unless taxpayers are aware of its use and its potential to catch them, it cannot effectively constrain evasion (Wallschutzky 1985, p. 172).

A similar conclusion could be made regarding any compliance measure. It could be concluded that risk assessment and an associated compliance measure may lead to increased compliance from some taxpayers; but it is also likely to lead to reduced compliance, or result in no change in compliance, from another more elusive group of taxpayers who are determined to stay off the ATO’s radar. In essence, these two groups of taxpayers represent two different market segments requiring different methods of risk management. With the more elusive group, the consideration of



unusual or seemingly irrelevant data using flexible, non-automated risk assessment methods combined with a willingness to follow a lead to its conclusion may yield fruitful results.

## 7. CONCLUSION

This article has argued how the two factors of administrative efficiency and administrative equity were influential in the development and adoption of the ATO's cooperative compliance model. Based on the evidence and analysis presented herein, this article suggests that in addition to equity and efficiency having an economic dimension, these concepts also have an administrative dimension. For those involved in developing the compliance model, equity not only means that all taxpayers shoulder the burden of tax fairly, but also that the administrator should use different means to achieve equity where appropriate. Administrative equity also influences voluntary compliance such that if a taxpayer is of the view that they unfairly shoulder the burden of taxes they are more likely to engage in non-compliant behaviour. Furthermore, if the ATO is perceived to be wasteful in how it administers the tax system, taxpayers will evaluate it like any other government agency and reduce their compliance activity accordingly (Bowler & Donovan 1995).

In order to achieve administrative efficiency, the ATO has adopted risk management techniques that have evolved over time. However these techniques potentially come at the expense of equity, in both a traditional economic and administrative sense. Limited resources will affect the ATO's ability to audit large businesses as these businesses continue to grow and expand globally; therefore administratively efficient and equitable risk management techniques that do not place undue burden on compliant taxpayers will need to be developed. While the compliance model is a risk management tool developed to help improve administrative efficiency, parts of it (such as 'BISEP') were developed to also improve administrative equity. Just as the traditional economic concepts of equity and efficiency are in conflict (Asprey & Parsons 1975) administrative efficiency may also conflict with the administrative equity. Any such conflict may be exacerbated by the use of similar information as inputs to the compliance model, and 'BISEP' in particular, that are used to achieve these two potentially conflicting goals.

Owing to this potential conflict, the ATO must endeavour to remain aware of community views on the appropriate mix of administrative equity and administrative efficiency lest they fall out of step with community expectations to the detriment of voluntary compliance. The history of the model as argued herein shows that administrative efficiency issues tend to predominate over administrative equity issues. Administrative equity issues tend to remain in the background, seemingly of lesser day-to-day importance. When administrative equity issues do arise, they have usually festered among taxpayers for some time thereby turning administratively equitable treatment by the ATO into a controversial issue resulting in calls for an inquiry. It is important therefore to always take into account administrative equity issues to prevent another crisis developing.

The focus of risk management and managing the risks to the revenue appears to not take into account any taxpayer over-compliance and it may also lead to risk assessments becoming a self-fulfilling prophecy. Some taxpayers will alter their behaviour to work around the risk assessment once they become aware of the rules in order to remain under the ATO's radar. New, more flexible, non-automated risk management and assessment techniques will be required to detect persistent any non-compliance that would otherwise remain hidden.

Historical studies inevitably suffer from similar limitations and these are acknowledged herein. All the sources may not be available or, on the other hand, an overwhelming amount of sources may lead to a necessary selection of facts via a judgement process. Selection of evidence or lack of evidence will mean that the resulting narrative and interpretation can never be complete thereby reducing the level of certainty for the specific causes for why the compliance model was adopted. Oral history has its own set of limitations in that interviewees' memories may have faded or they may be biased thus recalling events in a distorted fashion. Interviewees may also simply be mistaken about what took place given the passage of time. Nostalgia, grievance and contamination by other sources may also occur with memories being filtered by later experiences and hindsight reflection. These potential distortions and biases mean that while the voice of an oral source may be stronger than the 'voice' of a written source, it may not always be clearer (Tosh 1984, 2010). These various limitations mean that exact causes and timing of events may never be known.

Further research areas include conducting more interviews and collecting more written data to uncover more themes. Further research will focus in the research questions raised above that have not yet been addressed in this article. Administrative equity and administrative efficiency are not necessarily the only themes that explain the development and adoption of the compliance model. In many ways this study will always remain incomplete since over time more sources and evidence will come to light that might alter previously held views on the compliance model's history. For example, as more data becomes available, the timing of events may become clearer. Since responsive regulation is a pluralist model that allows the ATO to use many responses in achieving voluntary compliance in a certain context, further research also includes determining the most appropriate response to that context. While the 'BISEP' model provides a framework for consideration of the taxpayer's circumstances, how the 'BISEP' model results in an appropriate response by the ATO is not clear. Consequently, the need for tax compliance research is undiminished as we strive to further understand taxpayer behaviour.

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# Tax return simplification: risk key engagement, a return to risk?

Jason Kerr<sup>1</sup>

## **Abstract**

Australia's personal income tax system is at the point of no return. The momentum for administrative simplification is such that the majority of taxpayers may soon be alleviated of the onerous task of lodging tax returns. This is despite the fact the Henry Review recommended the tentative option of default pre-filled tax returns, rather than the bolder move to a reduced filing system (like the UK and New Zealand – where most taxpayers do not have to do anything at the end of the year). But what will the impact of such a move be on taxpayer engagement, given that for most people this is their only interaction with the tax system during the year? Will Australia be risking taxpayer engagement with the system for the sake of simplification?

This article looks at the concept of a default pre-filled tax return within the Australian context. It contrasts this with the system of reduced filing used in the UK and New Zealand, and draws similarities with New Zealand's personal tax summary. Where relevant, it explores the literature on taxpayer engagement amid the concern that taxpayers may potentially engage less with the tax system if they do not have to lodge tax returns.

The article concludes by suggesting best practice in future tax administration may be a hybrid system where elements of both reduced filing and pre-filling co-exist. Put simply, people with simple tax affairs will not have to lodge tax returns and those with more complex arrangements will file pre-filled returns. The debate as to whether we should have tax returns or not for people with simple tax affairs may therefore be a moot point. The real question for the future would be, and one worthy of further research, whether revenue authorities should continue to issue refunds to the majority of taxpayers.

## **1. INTRODUCTION**

There's a time for playing it safe and a time for risky business. Even though this may be a tagline from a 1983 Hollywood film, it is equally apt to modern tax administration. For while there has been much focus on simplifying personal income tax (PIT) returns over recent years, the Australian experience has been somewhat modest and incremental. Indeed, even within the climate of PIT reform, unshackled from the burden of having to play it safe, recent official proposals in PIT administration have not been as ambitious as what they could have been. As Cooper notes: '[w]hile the Review of Australia's Future Tax System proposed some measures which would reduce the compliance burden for individuals, it was insufficiently bold in its recommendations.'<sup>2</sup> Evans and Kerr suggest the best reform in tax return

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<sup>2</sup> Graeme Cooper, *Tax Forum: Statement of Reform Priorities* (2011) A Tax Plan for Our Future <[http://www.futuretax.gov.au/content/taxforum/statements/academics/University\\_of\\_Sydney\\_Cooper.pdf](http://www.futuretax.gov.au/content/taxforum/statements/academics/University_of_Sydney_Cooper.pdf)> at 16 March 2012.



simplification may not be one that is slow and tentative, but one that is made in quantum leaps using large packages.<sup>3</sup> But what is the relevance of what academics think when it comes to tax administration? As Sandford noted, ‘academic research and government concern are intimately interconnected’.<sup>4</sup> Possibly a healthy intimacy - academics can be risky with theory, but it is government who make the business decisions and administrators who in turn carry those decisions out.

Implementing tax measures in a complex and changing world means that the role of administrators can indeed be risky. There are many risks, including risks to revenue, reputation (confidence), compliance and engagement. Despite this, in an environment where ideas, innovations and information are shared on an increasing basis, modern tax administrations are becoming more adaptable to risk as they continue to move from being inward looking and procedure focused, to outward looking and taxpayer focused. In an age of technology, modern tax administrators can probably afford to be less cautious with those taxpayers who have simple tax affairs and tax withheld at source. Australia is fairly well placed in this regard as most taxpayers want to do the right thing.<sup>5</sup> Being less cautious means making it easy and simple for taxpayers to interact with the tax system. For most Australians, this interaction (involving high compliance costs) primarily involves the annual ritual of lodging a tax return.

Possibly the best way to make it easier and much simpler for taxpayers would be to reduce the need for most of them to lodge annual tax returns. Such ‘reduced filing’ systems already exist in a large number of jurisdictions around the world, in fact in more than two-thirds of countries recently surveyed by the OECD.<sup>6</sup> Reduced filing systems feature comprehensive withholding mechanisms and little or no deductibility for expenses and result in a situation where the majority of taxpayers are not required to annually reconcile their tax. In a reduced filing system some taxpayers are still obligated to file, namely those with income that has not been taxed at source but is still assessable (such as sole traders). In this sense ‘reduced filing’ could be seen as a more accurate term than ‘return free’ or ‘no return’, which can sometimes be found in the literature for similar proposals in the United States.<sup>7</sup>

While the benefits of a reduced filing system are self-evident, there are also those who still advocate tax returns for all taxpayers. For example Van der Heeden identifies four arguments in favour of universal return filing. Firstly, ‘the prospect of claiming tax relief (deductions or credits), however small they might be, gives taxpayers a satisfaction that can outweigh the burden of filing.’ The second argument is that taxpayers have a greater awareness of their tax burden. Thirdly is the notion that refunds are enticing to taxpayers, and finally, return filing generates the information

<sup>3</sup> Chris Evans and Jason Kerr, ‘Tax Reform and “Rough Justice”: Is it Time for Simplicity to Shine?’ (2012) 27 *Australian Tax Forum* 299, 323.

<sup>4</sup> Cedric Sandford (ed), *Tax Compliance Costs Measurement and Policy* (1995) 4.

<sup>5</sup> Australian Taxation Office, *Strategic Statement 2010-15* (2010) Australian Taxation Office <<http://www.ato.gov.au/corporate/content.aspx?doc=/content/00243384.htm>> at 15 March 2012.

<sup>6</sup> OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series* (2010) 229-233.

<sup>7</sup> See eg. Austan Goolsbee, *The ‘Simple Return’: Reducing America’s Tax Burden Through Return-free Filing* (2006); William Gale, ‘On the Possibility of a No-Return Tax System’ (1997) *L National Tax Journal* 475.

needed for means testing.<sup>8</sup> While it would seem that Van der Heeden's first and third points are one in the same, these arguments generally do form the basis for most opposition to a reduced filing system.

Calls for reduced filing in Australia have come from a range of quarters.<sup>9</sup> The idea was also canvassed by the Australia's Future Tax System Review Panel (Henry Review),<sup>10</sup> as 'abolishing returns', though the final report fell short of outlining any such bold recommendation, opting more for a status quo approach - 'pre-filled personal income tax returns should be provided to most personal taxpayers as a default method of settling their tax affairs each year'.<sup>11</sup> Despite this, reduced filing was again raised at the Australian Government's Tax Forum in 2011 with the simplification of tax returns seeming to dominate the first half of discussion in the 'Tax System Governance' session. As Evans and Kerr noted, those arguing in favour of the alternate pre-filing approach to tax return simplification probably held greater sway at the forum.<sup>12</sup>

This paper attempts to pick up the thread from the Tax Forum and explore the logical next steps for discussion. As such, the paper is divided into four main parts. Firstly there is a brief overview of the default pre-filled tax return to provide some context and description. New Zealand's personal income tax statement (PTS) is then outlined in part two, along with the impact that recent lodgment patterns are having on their reduced filing system. The literature on taxpayer engagement is then explored in the third section in order to provide insights as to potential impacts of simplifying the tax return process. All this relies on the mechanism of withholding tax, which is examined in the fourth and final part prior to a concluding note which highlights the remaining questions for further discussion and research.

## 2. DEFAULT PRE-FILLED TAX RETURN

The recommendation to implement a default tax return in Australia was the second of ten recommendations in the 'client experience' section (section G4) of the Henry Review.<sup>13</sup> Using 2007-08 data, the Henry Review estimated about 11 per cent of the more than 12 million taxpayers who lodge tax returns would benefit from a default pre-filled tax return.<sup>14</sup> Interestingly, and possibly not just coincidentally, approximately 11% of personal taxpayers lodge tax returns within the first month of the lodgment period (July 1 to July 31). As the Australian Taxation Office (ATO) notes:

<sup>8</sup> Koenraad van der Heeden, 'The Pay-As-You-Earn Tax on Wages' in Victor Thuronyi (ed) *Tax Law Design and Drafting* (1998) 73.

<sup>9</sup> See eg. Chris Evans, 'Diminishing Returns: The Case for Reduced Annual Filing for Personal Income Taxpayers in Australia' (2004) 33 *Australian Tax Review* 168; Chris Evans and Paul Drum, 'Ten Million Reasons for Personal Tax Reform in Australia' in Margaret McKerchar and Michael Walpole (eds) *Further Challenges in Tax Administration* (2006) 377.

<sup>10</sup> Australia's Future Tax System Review Panel, *Review of Australia's Tax System Final Report* (2009).

<sup>11</sup> Australia's Future Tax System Review Panel, *Report to the Treasurer Part One Overview* recommendation 123, 104.

<sup>12</sup> Chris Evans and Jason Kerr, above n3, 321.

<sup>13</sup> Australia's Future Tax System Review Panel, *Australia's Future Tax System: Part Two Detailed Analysis* (2010) 709.

<sup>14</sup> Australia's Future Tax System Review Panel, *Australia's Future Tax System: Part Two Detailed Analysis* (2010) 710.

[B]ecause it will be late July or mid-August before much of the information we receive from third parties is available for pre-filling purposes, the full benefits of pre-filling may not be available to the 1.5 million or so taxpayers who lodge their returns in July.<sup>15</sup>

It would be fair to say that generally these would be people with simple tax affairs. For these taxpayers it would be arguable whether a pre-filled return would be of any major benefit as their tax affairs may be so straight-forward that the time taken to enter their income details could be less than the time taken to pre-fill a return. In 2009-10, 2.5 million personal taxpayers lodged their income tax returns using e-tax (the ATO's free self pre-preparer application), of whom 72% chose to use the pre-filling service.<sup>16</sup> This compares to 2.37 million using e-tax in 2008-09 and 1.74 million (73%) who pre-filled.<sup>17</sup>

The rationale behind the recommendation for default pre-filled tax returns is founded in analysis of human behavioural research suggesting assisted decision-making and choice 'nudging' in order to help taxpayers make complex decisions and alleviate the burden of complexity.<sup>18</sup> Nudge theory is often advocated by proponents of libertarian paternalism.<sup>19</sup> This school of thought tends to argue for 'self conscious efforts by private and public institutions, to steer people's choices in directions that will improve the chooser's own welfare.'<sup>20</sup> Sunstein and Thaler suggest, because a default must be chosen, and because many individuals are likely to remain irrationally with the default option, it is better to set the default to the welfare-enhancing choice. While individuals remain free to deviate from the default option, they argue that those who advocate freedom of choice should not be troubled by this weak form of paternalism.<sup>21</sup>

Libertarian paternalism was behind the Cabinet Office in the United Kingdom (UK) establishing a 'Behavioural Insights Team' in 2010 to 'find intelligent ways to encourage, support and enable people to make better choices for themselves'.<sup>22</sup> In conjunction with Her Majesty's Revenue & Customs (HMRC), this team engaged in a series of trials using various 'nudges' to encourage tax compliance. For example, they sent letters to taxpayers in selected regions saying that most people in their local area had already paid their taxes. This increased repayment rates by 15 per cent.<sup>23</sup>

<sup>15</sup> Australian Taxation Office, *Making it Easier to Comply 2007-08* (2008) 13.

<sup>16</sup> Australian Taxation Office, *Annual Report 2010-11* (2011) 81.

<sup>17</sup> Australian Taxation Office, *Annual Report 2009-10* (2010) 26.

<sup>18</sup> Andrew Reason and Simon Dunstall, *Behavioural Economics and Complex Decision-Making: Implications for the Australian Tax and Transfer System* (2009).

<sup>19</sup> Also known as soft paternalism and asymmetrical paternalism.

<sup>20</sup> Cass Sunstein and Richard Thaler, 'Libertarian Paternalism is Not an Oxymoron' (2003) 70 *The University of Chicago Law Review* 1159, 1162.

<sup>21</sup> *Ibid* 1161.

<sup>22</sup> Cabinet Office, *Behavioural Insights Team: Annual Update 2010-11* (2011) 3.

<sup>23</sup> *Ibid*.

Possibly in the days before libertarian paternalism, back in 1991, Burgess identified that the ATO had a choice as to what its next step would be in PIT administration.<sup>24</sup> He noted:

The first is electronic lodgment. Under this system a taxpayer or his or her agent would enter all the return details on a personal computer and send them in to the Tax Office by modem. Processing at the Tax Office would be virtually automated. The Second, and to my mind much more attractive proposal, is to abolish the requirement for most people to file.<sup>25</sup>

Needless to say, Australia went down the electronic lodgment path, something that even Danish Revenue officials would describe as 'second best'.<sup>26</sup> In 1994 James and Wallschutzky observed that for Australia 'to avoid the use of tax returns for most taxpayers, the system would have to withhold tax extremely accurately'.<sup>27</sup> This was viewed as too difficult at the time – '[t]here seems to be too great an upheaval of the existing tax system for too little gain to recommend a cumulative system like the one presently operating in the UK'.<sup>28</sup>

Treasurer Peter Costello even floated the idea of a reduced filing system in the lead-up to the introduction of the Goods and Services Tax. At the Committee for the Economic Development of Australia in January 1998, he is reported as saying that if Australia 'had a strong pay-as-you-earn tax system with a strong interest-withholding tax system, we could kick most Australians out of the necessity to file income tax returns'.<sup>29</sup> Similarly, the potential of an ATO generated income statement was explored at about the same time, with Treasury originally planning to pilot these statements for the 2001-01 income year.

The statement would contain the income details that have been reported through the new withholding and other systems. Taxpayers could simply confirm the information by telephone to receive their refund, or add details of any other income and claims for rebates or deductions as appropriate. Conceptually a statement approach would apply to 3½ million taxpayers whose income is derived from wages and salaries, dividends and interest investments and who have the more straight-forward rebates and deductions.<sup>30</sup>

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<sup>24</sup> Philip Burgess, 'Contagious Trends in Australian Tax Administration' (1991) 21 *Victoria University of Wellington Law Review* 59, 66.

<sup>25</sup> Ibid.

<sup>26</sup> OECD, *Third Party Reporting Arrangements and Pre-filled Tax Returns: The Danish and Swedish Approaches* (2008) 9.

<sup>27</sup> Simon James and Ian Wallschutzky, 'An Australian Cumulative Withholding Tax System?' (1994) 11 *Australian Tax Forum* 311, 320.

<sup>28</sup> Ibid 335.

<sup>29</sup> Peter Martin, *Annual Tax Pack Ritual is Just Poor Form*, The Sydney Morning Herald (2006) <<http://www.smh.com.au/news/opinion/annual-tax-pack-ritual-is-just-poor-form/2006/03/14/1142098461267.html?page=2>> at 16 March 2012.

<sup>30</sup> Australian Treasury, *Reforms to Income Tax and Social Security* (1998) Australian Treasury <<http://www.treasury.gov.au/documents/167/HTML/docshell.asp?URL=chp4.asp#Simplifying%20tax%20returns>> at 16 March 2012.

It would seem these income statements would have been intended to provide the same function as default pre-filled tax returns. So even prior to the implementation of the pre-filing service in Australia (which went from a trial to full production in 2008),<sup>31</sup> it would seem the necessary mechanisms and technology were already in place to produce such statements. This would certainly seem to be in line with New Zealand who introduced a PTS as part of their reduced filing system in the late 1990s.

### 3. NEW ZEALAND'S PTS

The reduced filing system in New Zealand was officially proposed in 1997 with the Government discussion document – *Simplifying taxpayer requirements*. The Government suggested the measures would ‘significantly reduce the compliance burden on taxpayers’,<sup>32</sup> removing ‘many of the onerous, repetitive requirements that the current tax system places on salary and wage earners and employers’<sup>33</sup> and reducing ‘the extent to which the tax system intrudes on the lives of most individual taxpayers’.<sup>34</sup> Under this system, most taxpayers are relieved of the need to lodge tax returns, while some merely need to be issued with, or request, a PTS – which summarises a salary and wage earner’s income and tax deductions for the year. Inland Revenue automatically send a PTS to selected taxpayers based on their circumstances – criteria which has been extended in recent years to now include those who:

- received Working for Families Tax Credits from Inland Revenue
- received Working for Families Tax Credits from Work and Income and earned over:
  - \$36,827 for the 2010 tax year
  - \$35,914 for the 2009 tax year
  - \$35,000 for the 2007 and 2008 tax years
  - \$20,356 for the 2005 and 2006 tax years
  - \$20,000 for the 2004 and previous tax years
- have a student loan and have not had enough money deducted from their salary, wage or benefit income. Inland Revenue will also send them an end of year repayment calculation for their student loan.
- used the wrong tax code
- used a special tax code
- used a casual agricultural employee or an election day worker tax code and earned more than \$200 from that source
- received income as an IR56<sup>35</sup> taxpayer only.<sup>36</sup>

For those taxpayers who do not automatically receive a PTS, they may need to request one, as per Table 1.

<sup>31</sup> Australian Taxation Office, *Australian Taxation Office Annual Report 2008-09* (2009) 29.

<sup>32</sup> New Zealand Inland Revenue, *Simplifying taxpayer requirements* (1997) iii.

<sup>33</sup> Ibid.

<sup>34</sup> Ibid 1.

<sup>35</sup> An IR56 taxpayer can be a part-time private domestic worker, embassy staff member, New Zealand based representative of an overseas company or United States Antarctic program worker. They are required to pay their own PAYE tax to Inland Revenue.

<sup>36</sup> New Zealand Inland Revenue, *Individual Income Tax* (2010) New Zealand Inland Revenue <<http://www.ird.govt.nz/income-tax-individual/end-year/pts/>> at 18 March 2012.

**Table 1: PTS requests**<sup>37</sup>

You must request a PTS if you...	and you received more than \$200 of ...
received income from \$48,001 to \$70,000	interest taxed at less than 33%.
received income over \$70,000	interest or dividends taxed at less than 38%.
received income over \$48,000	taxable Māori authority distributions.
paid child support through Inland Revenue	interest, dividends or taxable Māori authority distributions.
have a student loan and earned over the repayment threshold of \$19,084 (for the 2010 and 2011 tax years)	interest, dividends or taxable Māori authority distributions.

Alternatively, taxpayers can request a PTS if they:

- are entitled to the tax credit for children and/or the income under \$9,880 tax credit
- were entitled to the independent earner tax credit, but did not receive it all during the year
- had more than one job during the year
- worked for only part of the year
- can claim expenses against their income.<sup>38</sup>

Originally it was intended that of the 1.2 million people who were filing tax returns (in 1997), 400,000 would need to be issued with a PTS and the remaining 800,000 would not need to do anything.<sup>39</sup> Since then however, as evidenced by Table 2, there has been a sizable increase in the number of New Zealanders requesting a PTS.

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

<sup>39</sup> New Zealand Inland Revenue, n32, 9.

**Table 2: New Zealand individuals – 2001-10 (,000)**<sup>40</sup>

	Mar 01	Mar 02	Mar 03	Mar 04	Mar 05	Mar 06	Mar 07	Mar 08	Mar 09	Mar 10
IR3 <sup>41</sup> s lodged	966.9	972.6	974.3	981.0	982.0	1,059.2	1,083.7	1,114.3	1,186.5	1,221.6
Individuals lodging IR3s	996.3	968.7	986.3	1,025.6	1,061.5	1,096.0	1,122.5	1,163.4	1,150.2	1,097.9
PTSs issued/requested	445.3	591.5	667.8	727.8	770.8	709.8	766.7	724.4	1,087.0	1,273.6
Individuals issued/requested PTSs	603.9	644.4	674.8	747.6	811.1	882.5	884.7	976.5	948.3	900.7
Registered individuals	4,189.1	4,378.5	4,552.2	4,707.9	4,855.0	5,018.4	5,199.4	5,372.8	5,536.7	5,683.4
Active individuals	3,554.4	3,646.2	3,743.0	3,873.2	3,978.6	4,100.0	4,180.2	4,292.5	4,361.1	4,402.2

The increase in the number of requests for PTSs can primarily be attributed to two reasons. Firstly, the increased use of the tax system to administer other policy measures, particularly the student loan, family benefits and KiwiSaver (retirement income) schemes.<sup>42</sup> Secondly, and more notably, there has been a proliferation of ‘shopping centre’ type intermediaries who are requesting this information in order to ascertain whether people are entitled to refunds. This ‘tax refund industry’ then charges a fee and lodges a return only when the taxpayer is entitled to a refund (and not when they have to pay tax).<sup>43</sup> In addition to the increased workload for Inland Revenue as people re-enter the annual filing system, this phenomenon has also impacted Government coffers. Latham notes:

The ability for some taxpayers to access refunds of over-deducted PAYE, but not pay their under-deducted PAYE, has resulted in a situation where large amounts of revenue are being paid out, without a reciprocal obligation on taxpayers to pay potential shortfalls.<sup>44</sup>

In response, the New Zealand Government has proposed that those who wish to re-enter the system and claim a refund will also be required to lodge a tax return for the previous four years and pay any tax owing (rather than pick and choose only refund years).<sup>45</sup>

<sup>40</sup> Compiled from statistics from: New Zealand Inland Revenue, *Tax Statistics* (2011) New Zealand Inland Revenue <<http://www.ird.govt.nz/aboutir/external-stats/>> at 17 March 2012.

<sup>41</sup> An ‘IR3’ return is the individual income return for taxpayers who generally earned income that was not taxed at source (similar to the Self-Assessment tax return in the UK).

<sup>42</sup> New Zealand Inland Revenue, Policy Advice Division, *Making Tax Easier: A Government Discussion Document* (2010) 6.

<sup>43</sup> Susan Edmunds, *Tax Expert Questions IRD Tactics* (2012) New Zealand Herald <[http://www.nzherald.co.nz/business/news/article.cfm?c\\_id=3&objectid=10786440](http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10786440)> at 10 March 2012.

<sup>44</sup> Craig Latham, *Regulatory Impact Statement: Simplifying Requirements for Individuals and Record-Keeping Requirements for Businesses* (2011) Inland Revenue New Zealand Policy Advice Division <<http://www.treasury.govt.nz/publications/informationreleases/ris/pdfs/ris-ird-sfr-sep11.pdf>> at 10 March 2012.

<sup>45</sup> Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill (2011) (NZ).

Another recent proposal of note has been the bid to make New Zealand's PAYE (pay-as-you earn) a final tax. The concept of PAYE as a final tax would apply only to taxpayers in stable employment for 11 months or more in the income year. Those who earned wages and salary income for 10 months or less in the year would still continue to be able to square-up their PAYE at year's end.<sup>46</sup>

The New Zealanders therefore seem to be tightening their withholding system even further, re-iterating their commitment to a system where most people will not lodge tax returns.

Interestingly, in the UK, HMRC are looking at the potential of using pre-filled tax returns (for taxpayers with complex affairs) and online individual client accounts. As David Gauke, Exchequer Secretary explains:

For most people, personal tax is deducted at source during the year and, in a minority of cases, an adjustment is made by HMRC at the end of the tax year when all relevant information is provided to it. It is a system that does not place much by way of demands of time on taxpayers, but it can also be remote and confusing.<sup>47</sup>

While PAYE will still remain the cornerstone of the PIT system in the UK (seeking to get tax right in-year with little taxpayer involvement), HMRC is seeking to enhance this system by utilising ideas from other tax systems that allow taxpayers to gain a greater awareness and understanding of tax.<sup>48</sup> The goal for a more transparent PIT is 'to improve the customer experience so that awareness and accountability will increase amongst individual taxpayers through the use of online and mobile technology.'<sup>49</sup> Another goal is to increase taxpayer engagement with the system.<sup>50</sup>

#### 4. TAXPAYER ENGAGEMENT

Taxpayer engagement involves taxpayers not only fulfilling their tax obligations (registering in the system, lodging on time, paying the right amount and keeping accurate records) but also arguably understanding the system and having knowledge of how much income tax they are paying. One of the drawbacks of simplifying tax returns, whether by a default pre-filled return or a reduced filing system, is that potentially taxpayer engagement may reduce.

Drum suggests the tax return is the mechanism that draws together all income and expenses and keeps individuals engaged with revenue authorities on an annual basis, 'this is a key factor – and one often overlooked by many of those calling for "simplification" – in having a robust income tax system.'<sup>51</sup> Likewise, the lodgment of

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<sup>46</sup> New Zealand Inland Revenue, n42.

<sup>47</sup> HM Revenue & Customs, *Modernising the Administration of the Personal Tax System: Tax Transparency for Individuals* (2011) 4.

<sup>48</sup> Ibid 11.

<sup>49</sup> Ibid.

<sup>50</sup> Ibid 20.

<sup>51</sup> Paul Drum, *Death of the Individual Tax Return? Or Going Bananas?* (2010) CPA Australia <<http://gfc.cpaaustralia.com.au/category/budget/> at 17 December 2010.



a tax return could also be seen as a civic duty that increases 'tax consciousness'. Tax consciousness is the awareness of taxpayers of their tax contribution, and, more generally, an interest in how it is being spent. The taxpayer's duty to lodge a return is one of the responsibilities of citizenship and arguably a requirement that leads to greater awareness of the cost of government and transparency of tax burdens.<sup>52</sup> Zelenak suggests that as paying tax is an important civic duty, it requires a ceremony 'and the filing of one's tax return is that ceremony.'<sup>53</sup> Despite this, Zelenak concedes that an individually based reduced filing system, such as PAYE in the UK can confer some sense of widespread taxpayer status, but not to the extent of a return-based one.

While the impact that filing tax returns has on taxpayer engagement has not been studied specifically, active participation more generally has been shown to have a positive effect on taxpayer engagement. Pommerehne and Weck-Hanneman conducted empirical analysis among the Swiss cantons on the influence of direct participation on tax compliance.<sup>54</sup> Switzerland was chosen as various cantons have differing degrees of public participation in the political, budgetary and regulatory process. The results showed that among other factors, the extent of direct participation had a positive and significant impact on tax compliance. Pommerehne and Weck-Hanneman noted that for cantons with a high degree of direct political control, the average amount of concealed income (per capita of taxpayer) was, all things being equal, about 30 per cent less than the mean of all cantons.<sup>55</sup>

Considering the act of tax return lodgment as akin to the wider scheme of active democratic participation may be drawing a long bow, however the similarity between voting and tax return filing is probably made even more pertinent in a country like Australia where both obligations remain compulsory. Therefore such literature is still worth pondering as it may provide indicators for further research, particularly when looking at taxpayers' motivations.

A reduced filing PIT system may have a positive effect on taxpayers' belief that the government respects them and their ability to do the right thing. Universal filing on the other hand may lend itself to the belief (whether right or wrong) that taxpayers may be prone to mistakes and therefore need to lodge returns so that the revenue authority can keep an eye on them. Feld and Frey tested taxpayer engagement and the relative level of respect towards taxpayers in Switzerland using data covering 1970 and 1995 and a survey of 26 cantonal tax authorities.<sup>56</sup> Similar to Pommerehne and Weck-Hanneman, Feld and Frey argued that Switzerland provided a relevant comparison between varying levels of tax authority treatment. They noted that 58 per cent of Swiss cantonal tax authorities believed that mistakes in reported incomes (in

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<sup>52</sup> Eric Toder 'Policy Analysis of "Return-Free" Tax System' *Return-Free Tax Systems and Taxpayer Compliance Costs: Hearing Before President's Advisory Panel on Federal Tax Reform* (statement: 17 May 2005).

<sup>53</sup> Lawrence Zelenak, 'Justice Holmes, Ralph Kramden, and the Civic Virtues of a Tax Return Filing Requirement' 61 (2007) *Tax Law Review* 53, 60.

<sup>54</sup> Werner Pommerehne and Hannelore Weck-Hannemann, 'Tax Rates, Tax Administration and Income Tax Evasion in Switzerland' (1996) 88 *Public Choice* 161.

<sup>55</sup> Ibid 167.

<sup>56</sup> Lars Feld and Bruno Frey, 'Deterrence and Tax Morale: How Tax Administrations and Taxpayers Interact' (2003) 3 *OECD Papers (Special Issue on Taxation)* (10).

tax returns) were in favour of taxpayers, 31 per cent of neutral favour and 12 per cent believed mistakes were generally to the disadvantage of taxpayers. They suggested this was reflected in the way taxpayers were treated and the relative respect given to taxpayers. Feld and Frey found that the more respectfully a tax authority treated taxpayers, the higher the level of voluntary compliance. In addition, they showed that tax evasion was lowest in the instances, where minor mistakes in the tax return were not treated as a misdemeanor, in contrast to intentional tax fraud being punished severely. While the results of this study are relevant, it should be noted that the survey of tax authorities took place at a time much later than the taxpayer data being studied. It does not seem the researchers accounted for any potential time discrepancies between the datasets.

The level to which taxpayers are engaged with the tax system may extend beyond the mere mechanics of return filing towards something more fundamental and intrinsic. Feld & Frey go beyond the standard arguments and suggest the relationship between taxpayers and administrators can be modelled as an implicit ‘psychological tax contract’.<sup>57</sup> They advocate that ‘genuinely’ rewarding taxpayers in an exchange relationship will increase tax compliance and should be considered as the dominant compliance strategy with administrators able to resort to punishment if such a measure fails. Frey observed that it is now generally accepted among behavioural economists that external intervention does not always crowd out intrinsic motivation; there are conditions under which it fosters ‘crowding-in’.<sup>58</sup>

Despite this, in reality, such notions possibly have very little relevance to the majority of personal taxpayers. This is because their tax compliance is ‘quasi- voluntary’ or ‘voluntary by default’ as virtually all their required income tax is withheld from their pay packets. Therefore the notion that active participation through the tax return increases tax engagement may be unfounded, as for the most part, taxpayers may give little thought to such matters. As Pope noted:

One of the weaknesses of the tax compliance field overall is that a high proportion of work is focused on individuals who are generally subject to withholding tax (PAYE/PAYG) on most, if not all, of their income, with much less on the self-employed, who have much greater discretionary power as to how much tax they decide to pay.<sup>59</sup>

## 5. WITHHOLDING

Tighter withholding at source is about ‘getting it right first time’ and thereby eliminating the need for a year-end ‘square-up’ to reconcile tax paid against income earned. Shaw, Slemrod and Whiting note that withholding from income tax is widespread among developed countries and is required for wages and salaries in all

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<sup>57</sup> Lars Feld and Bruno Frey, ‘Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation’ (2007) 29 *Law & Policy* 102.

<sup>58</sup> Bruno Frey, ‘A Constitution for Knaves Crowds out Civic Virtues’ (1997) 107 *The Economic Journal* 1043.

<sup>59</sup> Jeff Pope, ‘Benno Torgler, Tax Compliance and Tax Morale’ (2008) 15 *Agenda* 73.

but two of the OECD member countries, and 21 of the OECD countries for interest and dividends.<sup>60</sup>

Chu and Macnaughton summarised the main international arguments for more accurate at-source withholding for individuals. These included an increase in horizontal equity (between instalment payers and those subject to withholding), an increase in vertical equity (reducing involuntary over-withholding), greater immediate cash-flow for retirement saving and charitable donations, a reduction in compliance costs (through a move to pre-filled tax returns), and increased compliance (through an increase in the perception of fairness).<sup>61</sup>

Much tighter withholding may increase the willingness of taxpayers to comply with their obligations for a number of different reasons. Using data provided by the Internal Revenue Service of the United States (US) from the Tax Compliance Measurement Program, Chang and Schultz investigated whether individual taxpayers who owe additional tax when they file their returns are generally less compliant than those who are due refunds.<sup>62</sup> Their findings supported the proposition that those taxpayers who owe tax at the end of the year are less likely to comply than those in a refund-due withholding position. They noted however, that while they observed a strong result with respect to the withholding phenomenon, they were unable to determine the underlying cause.

Arguments against more accurate withholding are often part of the more generalised assumption that taxes should be as visible and as painful as possible, on the theory that the public will resist the growth of big government under such circumstances. For these commentators, the ideal income tax system would retain filing obligations (to ensure visibility) and repeal withholding (to maximise the pain of payment).<sup>63</sup>

Researchers and administrators have also recognised that a tighter withholding regime may impose new costs on various third parties (such as financial institutions). Holtzblatt noted that past attempts in the US to extend withholding requirements to non-wage income had been met with significant resistance from banks and other third party reporters, however recent technological advances may have alleviated some of those concerns.<sup>64</sup>

For many Australian personal taxpayers, the issue of withholding may not really be a question of accuracy. Rather, withholding would seem to be linked with excess tax

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<sup>60</sup> Jonathan Shaw and Joel Slemrod, *Administration & Compliance* (2008) *Institute of Fiscal Studies* <<http://www.ifs.org.uk/mirrlees/mrResearch/id/220>> at 18 March 2012.

<sup>61</sup> Ling Chu and Alan Macnaughton, 'Canadian Personal Tax Refunds: Voluntary or Involuntary?' (Paper presented at the Tax Policy Research Symposium: Perspectives from Law and Accounting, University of Waterloo, Toronto, 24 August 2006) 21-23.

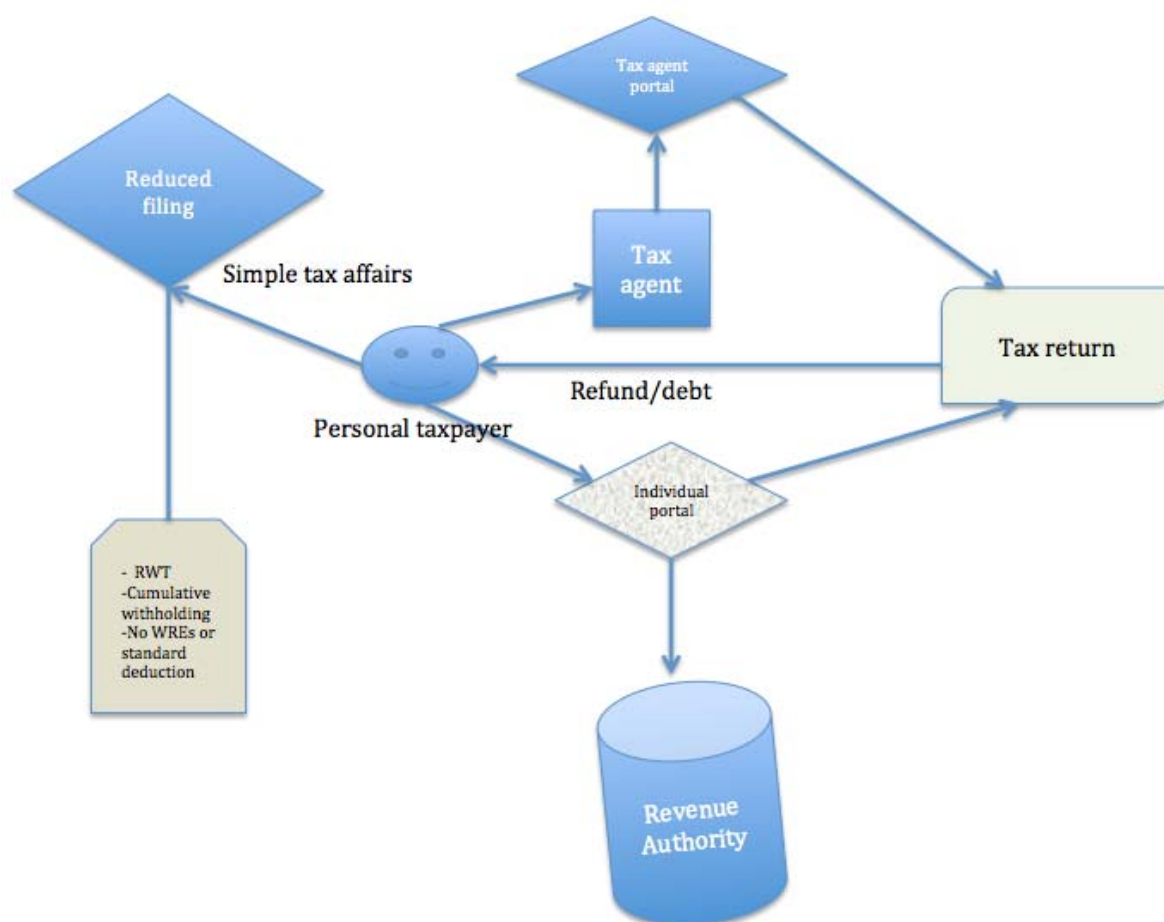
<sup>62</sup> Otto Chang and Joseph Schultz 'The income tax withholding phenomenon: evidence from TCMP data' (1990) 12 *Journal of the American Tax Association* 88.

<sup>63</sup> Lawrence Zelenak, above n53, 57.

<sup>64</sup> Janet Holtzblatt, 'Implications of return-free tax systems for the structure of the individual income tax' (Paper presented at the Conference on Alternative Methods of Taxing Individuals, Andrew Young School of Political Studies, Georgia State University, Atlanta, 8 June 2006) 23.

payments during the year, supported by robust withholding schedules and the ability to claim deductions. Indeed, though not necessarily economically rational, it is the annual expectation of refunded overpaid tax that may seem to be more critical. If the New Zealand experience has taught us anything, it is the realisation that the promise of a refund would seem to be one way of keeping people engaged in the system. Therefore a possible model for Australia, could a hybrid of both the reduced filing and pre-filing systems (as is being canvassed in the UK) where the majority of people do not lodge returns, and those with more complex tax affairs may have access to pre-filled information via an online account (similar to the ATO's current tax agent portal). Such a scenario is depicted in Figure 1.

**Figure 1: Possible future PIT lodgment system**



While there have been some laudable advancements in Australia towards such a system in Figure 1 (such as a portal for tax agents which includes clients' pre-filling data), there are still a number of issues to be addressed. Indeed, a range of factors have been identified as inhibiting the success of pre-filling in Australia. Highfield notes that the early availability of pre-filled return information has been a key part of the effectiveness of pre-filled returns in the Nordic region.<sup>65</sup> This can be contrasted with Australia however, where under legislation third party reporters are not required to supply the ATO with information until six weeks (for employment income) or four months (investment income) after the end of the income year. In most cases PAYG annual reports are required by no later than August 14 (Tax Assessment Act 16-153(2)) while the Annual Investment Income Report is required from investment bodies by October 31 following a financial year ending 30 June (sub-regulation 56(3) of the Income Tax Regulations). The ATO therefore relies on third party reporters to voluntarily provide the data required by the ATO earlier than the legislated requirements in order to enable the pre-filling activities to occur. The Australian National Audit Office suggested that given the Government's intention to simplify income tax returns by providing pre-filling services for around nine million individual taxpayers, the reliance on the goodwill of data providers to provide data earlier might not be sufficient to optimise the implementation and efficiency of the pre-filling initiative.<sup>66</sup> ATO statistics show that while approximately 75% of all total PAYG and welfare payment pre-filling data has been received by July 31, only about half of interest data and less than a quarter of dividend data has been received by the same time.<sup>67</sup>

Evans and Tran-Nam summarise pre-filling's 'teething problems' as relating to: timeliness, comprehensiveness, availability, and reliability and accuracy.<sup>68</sup> These problems may possibly be due to the fact that 'the pre-filling initiative is partial and still at a very early and experimental stage in Australia'.<sup>69</sup> Notably, while the initiative is seen as a welcome simplification measure, in its current form it is 'unlikely either to have a significant impact on the compliance or administrative costs burden or to represent a significant step in the direction of a return-free tax jurisdiction for many or even some personal taxpayers'.<sup>70</sup>

In order for the pre-filling service to be more successful and to ensure the effective implementation of a default pre-filled tax return, legislative amendments are an absolute necessity in order to remove current impediments.<sup>71</sup> These amendments are best outlined in table form. Table 3 displays some of these changes, and while not

<sup>65</sup> Richard Highfield, 'Pre-populated Income Tax Returns: The "Next Big Thing" in Reform of the Administration of Australia's Personal Income Tax System' in Margaret McKerchar and Michael Walpole (eds) *Further Global Challenges in Tax Administration* (2006) 331.

<sup>66</sup> ANAO, *The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration* (2008) 85.

<sup>67</sup> Australian Taxation Office, *Taxation Statistics 2008-09*  
[http://www.ato.gov.au/corporate/content.aspx?menuid=0&doc=/content/00268761.htm&page=8#P378\\_13499](http://www.ato.gov.au/corporate/content.aspx?menuid=0&doc=/content/00268761.htm&page=8#P378_13499) at 16 March 2012.

<sup>68</sup> Chris Evans and Binh Tran-Nam 'Australia' in Francois Vaillancourt (ed) *Prefilled Personal Income Tax Returns* (2011) 1, 13.

<sup>69</sup> Ibid 18.

<sup>70</sup> Ibid 19.

<sup>71</sup> Chris Evans and Jason Kerr, above n3, 322.

exhaustive, such amendments would certainly provide a more comprehensive pre-filled tax return for the bulk of Australian personal taxpayers.

**Table 3 – Simplification measures required to enable pre-filled default returns**

Change required	What is the irritant?	Amendment/new provision
Reduction/elimination of deductions.	There are currently a total of 15 separate deduction questions in the individual tax return (ITR) for a myriad of various expenses, the vast majority of which need to be self-assessed by the tax payer. This layer of complexity provides pre-filling with a major impediment to the 'tick and flick' concept. In most instances, deductions create refunds. This would be the case even, and arguably more-so, with a \$1000 standard deduction. Refunds tend to encourage taxpayers to lodge earlier in the tax season, which also proves problematic to a full pre-filling experience.	Remove ITAA 1997 sec 8-1(1)a. Only those deductions which are expressly authorised by the Act may be made in calculating a person's tax liability. If a taxpayer wishes to claim a particular deduction they must be able to point to a provision which allows it.
More accurate withholding at source regime.	Pay-as-you-go withholding provides a broad approximation of tax liability often leading to an 'over-withholding' encouraging the earlier lodgment of tax returns. With a future move to reconciliation, there is a greater need to accurately withhold throughout the year.  While Australia has withholding at source on interest and dividend payments, this does not extend to residents.	Possible introduction of individual 'tax codes' reflecting appropriate tax rate.  Implementation of resident withholding regime (RWT). This would increase the effectiveness of pre-filling but also reduce the need for tax returns altogether for those taxpayers whose income has been accurately taxed at source.
Comprehensive third party reporting.	Investment bodies have 4 months after the end of year until they have to report. This can cause delays in the availability of the information for pre-filling.	RWT could incorporate mandatory reporting requirements bringing forward the date at which investment data is made available.

Change required	What is the irritant?	Amendment/new provision
Remove zone/overseas forces offset.	Self assessment aspect - residency does not have to be continuous. Zones do not always correlate directly to postcodes.	Potentially this negative taxation could be moved to the <i>Social Security Act 1991</i> .
Remove parent, spouse's parent, invalid relative offsets.	Relies on taxpayer self assessment of taxpayer household circumstances.	Removal of ITAA 1936 s159J.
Remove spouse, child-housekeeper or housekeeper.	Relies on taxpayer self assessment of taxpayer household circumstances - plus taxpayer calculation of spouse's SNI (which can not be pre-filled).	Could be argued that spouse offset is no longer relevant (The Government announced from July 1 2011 - a phase-out for spouses aged less than 40). ITAA 1936 s159J; 159H maybe better suited to Social Security Act 1991.
Alter the process for gift deductibility.	Current system prohibitive for pre-filling ad hoc gifts.	ITAA 1997 Div 30 could be amended to allow a gross up of the basic rate of income tax. A gift aid declaration could be implemented (similar to the UK).
Alter process for assessment of Medicare levy.	Irritants relate to the 6 exemption categories and the need to assess the eligibility of dependents in addition to the prescribed person eg. ½ Medicare levy exemption. Taxpayers also need to self assess where there is partial relief. Problems may also be encountered with eligibility to the reduction.	Due to the fact the tax system is being used to collect the Medicare levy - the tax unit could effectively be used for this process. Changes to definitions in the <i>Medicare Levy Act 1986</i> would be required.
Alter process for assessment of Medicare levy surcharge.	The interaction of the tax system with the Medicare system requires the taxpayer to assess their dependent's cover. This can include students up to the age of 25 living away from home. Mere pre-filling of private health insurance details is not sufficient to completely pre-fill this label.	As per above, effective 'tick and flick' would require changes to a range of Medicare provisions.
Adjust process for reporting of net capital gains.	Complexities exist for pre-filling in relation to: 1. Grandfathering 2. Indexation/Discount 3. Cost base	Potential for de minimis amount.

Change required	What is the irritant?	Amendment/new provision
Alter Senior Australians Tax Offset reporting requirements.	Difficult to pre-fill totally as spouse income required.	Coherent principles drafting may utilise consistency of tax unit throughout the legislation, including ITAA 1936 s 160AAA(1). Whether a taxpayer has a spouse could still be a factor in calculation of entitlement, however spouse income does not necessarily have to be included in eligibility.
Alter the treatment of employee share acquisition schemes.	Despite the introduction of Div 83A 1997, issues still remain due to: 1. The transitional rules which still preserve some of the old rules in Div 13A 2. Ability in some circumstances to still defer discount. While upfront discount amounts can be supplied to taxpayers, automatic pre-filling is still not possible.	\$1000 de minimis eliminates some of the problems ie. no need to include in income. Little else can be done legislatively without removing the transitional treatment.
Private health insurance rebate.	As the person paying the policy, not the person named on the policy is eligible for the rebate, this question is difficult to automatically pre-fill (particularly for joint policies).	Moving from a policy driver of private health insurance 'choices' to a simpler private health insurance system could result in the 30% incentive only being available as a reduced health insurance premium (under the <i>Private Health Insurance Incentives Act 1998</i> ) or direct from Medicare.
Provide greater taxpayer certainty.	There is no specific legislative provision to enable the Commissioner to verify taxpayer compliance apart from the general provisions which give the Commissioner the responsibility of administering the tax laws.	Up-front compliance verification may highlight the need for specific legislation to 1. Collect third party information for pre-filling 2. Display this information and conduct real-time compliance assessments.

The obvious end state of a pre-filled tax return is one where taxpayers do not have to do anything at the end of the year.<sup>72</sup> Indeed, the benchmark of a successful pre-filled tax return system, such as the experience in Denmark, is one where tax returns do not

<sup>72</sup> Jason Kerr, 'The Bridge to No Return: The Need for Simplification Versus the Refund Culture' in *International Tax Administration: Building Bridges* (CCH Australia Limited, 2010) 173, 182.



even exist.<sup>73</sup> In Denmark, taxpayers are not obligated to respond to a pre-filled return – a ‘no response’ is deemed to be acceptance of the return. The development of a default pre-filled tax return may therefore be self defeating in that its success will be its own obsolescence.

## 6. CONCLUSION

The impact of tax return simplification is yet to be fully explored. The answer is important. The prospect of disengaged taxpayers may worry some tax administrators. Likewise, the thought of continuing taxpayer engagement could be comforting to some, sleeping easy at night, resting safe in the knowledge that taxpayers remain fully connected with the system. Taxpayers may in fact wish to know every single scrap of detail about their tax situation. Or it could be that they do not really care that much at all. As Cooper suspects:

[M]ost people would prefer to be freed from the tax system altogether – having satisfied themselves that the system is fair or fair enough, to let it run its course and live in considered ignorance of it and not to pursue ‘timely information’ about its impact in their lives thereafter.<sup>74</sup>

The move to an effective default pre-filled tax return is therefore not merely a seamless natural progression. Tough decisions need to be made and it would seem the time for ‘playing it safe’ is drawing to a close. Change is required. Policy makers may therefore consider it worthwhile to weigh up the merit in making such changes for a short-term solution, or explore the capacity for longer-term gains. To reiterate, if the benchmark of a pre-filled tax return is that a taxpayer only needs to confirm their details are correct, then success of such an initiative is surely an end state where most taxpayers need no longer do anything.<sup>75</sup>

Thus the question is not so much whether we should have default pre-filled tax returns or a reduced filing system, as both would entail the death of the tax return for the majority of taxpayers. The big question for now is whether such a system should still incorporate annual refunds of overpaid tax. To answer this, taxpayer engagement could be a key factor. But then again, it may not be. Perhaps extensive research is required. Or alternatively, maybe just some common sense.

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<sup>73</sup> OECD, *Third Party Reporting Arrangements and Pre-filled Tax Returns: The Danish and Swedish Approaches* (2008) 9.

<sup>74</sup> Graeme Cooper, above n2.

<sup>75</sup> Chris Evans and Jason Kerr, above n3, 321.

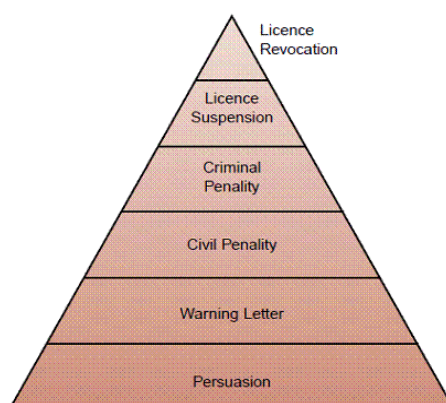
# New dimensions in regulatory compliance – building the bridge to better compliance

Stuart Hamilton<sup>1</sup>

## Abstract

This article examines the background of the risk differentiation framework now being used as an adjunct to Ayres-Braithwaite pyramid of compliance strategies by the Australian Taxation Office. The two aspects complement each other, one guiding ‘who’ the regulator should prioritise for review, the other guiding the appropriate choice of remedy if non compliance is found.

Since it was laid out so cogently in the seminal Ayres and Braithwaite book<sup>2</sup>, the compliance pyramid has become the foundation ‘compliance model’ for a significant number of regulatory agencies<sup>3</sup>, including several tax administrations.



Source: Ayres and Braithwaite (1992).

Figure 1  
The Ayres and Braithwaite Compliance Pyramid

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<sup>2</sup> Ayres, I & Braithwaite, J 1992, *Responsive regulation: Transcending the deregulation debate*. Oxford University Press, New York, p 35. It was earlier described by John Braithwaite (1985) in *To punish or persuade*, State University of New York, p 142.

<sup>3</sup> See for example the sample in Annex 1.

While other regulators have also shifted towards more client<sup>4</sup> centric approaches<sup>5</sup>, it would be my view<sup>6</sup> that those that have adopted, either explicitly or implicitly, the escalatory approach ('responsive regulation') of the compliance pyramid<sup>7</sup> as a central paradigm or shared value set, have made the greatest strides forward in engaging with the diversity of compliance behaviours and causal factors that their client base inevitably presents.

However not every client can be reviewed and prioritization decisions have to be made about 'who' to review and on 'what' basis. The article describes the background to the risk differentiation approach being used by the ATO that addresses some of the conceptual and practical difficulties<sup>8</sup> that have arisen in trying to bring the Compliance model approach to 'life'.

## 1. THE IMPORTANCE OF VOLUNTARY COMPLIANCE IN REGULATORY SYSTEMS

It is probably clear to most observers that regulatory systems function in the real world because most clients do the right thing most of the time. In the case of taxes this is also generally true, as James Alm noted in 1996 "Most people pay most of their taxes most of the time".<sup>9</sup>

Much has been written on the factors influencing tax compliance. A small sample of salient articles are outlined in the footnotes for the interested reader.<sup>10</sup> As a working

<sup>4</sup> While some may argue against identifying those being administered by a regulator as "clients", the use of such language, like the compliance model itself, is a subtle, but important part of engendering cultural change away from possible dualistic mentalities so easily slipped into by those undertaking regular enforcement activities ('you are what you repeatedly do' to paraphrase Aristotle). We should also note that clients in regulatory systems do have a choice – they can choose not to comply, and as most regulatory systems are premised on the basis of significant voluntary compliance, continuing 'client engagement' is a really critical frame of mind to maintain with staff.

<sup>5</sup> See for example Hamilton, S 2003, 'Putting the Client First: the Emerging Copernican Revolution of Tax Administration', *Tax Notes International*, Vol 29, Part 6, February 2003, pp 569-576.

<sup>6</sup> Other commentators offer a similar view, such as: Parliament of Australia 2008, *Joint Parliamentary Committee Report 410 Tax Administration*, Commonwealth of Australia, Canberra, p 114 at <http://www.aph.gov.au/house/committee/jcpaa/taxation06/report/fullreport.pdf>; Hasseldine J (draft) 2007 *Tax implementation: Commentary*, p 4, <http://www.ifs.org.uk/mirrleesreview/commentaries/hasseldine.pdf>; Leviner, S 2008, 'An Overview: A New Era of Tax Enforcement - From 'Big Stick' to Responsive Regulation' in *Regulation and Governance*, Vol 2, State University New York, Buffalo. Available at SSRN: <http://ssrn.com/abstract=1082247>.

<sup>7</sup> The compliance pyramid's evolution is tracked in Braithwaite, J & Braithwaite, V 'An evolving compliance model for tax enforcement' in Shover, N & Wright, J P (ed) 2000, *Crimes of Privilege: Readings in White-collar Crime*, OUP, New York, pp1-19 @ <http://vab.anu.edu.au/pubs/1/anevolvingcompliance.pdf>.

<sup>8</sup> See for example the consistency of treatment aspects noted by Waller, V 2007, 'The Challenge of Institutional Integrity in Responsive Regulation: Field Inspections by the Australian Taxation Office, 29 Law & Policy, 67 – 69, and the comments of Burton, M 2007 in 'Responsive Regulation and Uncertainty of Tax Law – Time to reconsider the Commissioner's Model of cooperative compliance?' 5 eJournal of Tax Research, 71 – 73, where the application of the law to a set of facts and circumstances is unclear. Kornhauser, M, 2007, in 'Normative and Cognitive aspects of Tax Compliance: Literature Review and Recommendations for the IRS regarding individual Taxpayers', Taxpayer Advocate Service – 2007 Annual Report to Congress' at 157 – 158 also notes that tax morale models only work as well as the regulators understanding of client attitudes and behaviours.

<sup>9</sup> Pozo, S. (ed) 1996, *Exploring the underground economy*, Upjohn Institute, Michigan. Several other researchers, such as Henk Elffer have made similar comments. See Van Vugt, M et al 2000 'But taxpayers do cooperate' in *Cooperation in modern society: promoting the welfare of communities, states and organisations*, Routledge, London.

<sup>10</sup> For examples of the rich vein of academic research in this area see:

generalization for the purposes of this article, I will work on the basis that most people comply because it is the accepted thing to do, a societal or peer norm, rather than through deliberate calculation, compulsion or fear.

Without such a broad level of voluntary compliance any regulatory system would be swamped with cases that called for intervention - which would quickly outstrip the resources and remedies available.<sup>11</sup> That's not to say it is all smooth sailing. Norms can clearly change over time - sometimes rapidly - and from a tax compliance viewpoint, breakouts of mass marketed arrangements have at times severely strained the Australian system.<sup>12</sup>

The compliance framework or model that a regulatory authority adopts is like a 'lens' it uses to view its clients and it appears to become part of a shared value set that inevitably permeates its strategies, systems, and style of interactions with clients.<sup>13</sup>

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Allingham, M G & Sandmo, A 1972, 'Income tax evasion: a theoretical analysis', *Journal of Public Economics* 1, pp 323–338. While this was the initial ground breaking paper on the economics of tax evasion and the effect of penalties, it predicted a far higher rate of non compliance than was in fact observed given actual audit rates and penalties. [http://darplse.ac.uk/papersdb/allingham-sandmo\\_\(jpube72\).pdf](http://darplse.ac.uk/papersdb/allingham-sandmo_(jpube72).pdf); Sandmo, A 2006, 'The theory of tax evasion: A retrospective view', *National Tax Journal* 58, pp 643 – 663 at <http://old.nhh.no/sam/stabssem/2004/sandmo.pdf>; Fischer, C M, Wartick, M & Mark M 1992, 'Detection Probability and Taxpayer Compliance: A Review of the Literature', *Journal of Accounting Literature* 11, pp 1–46, brings a richer conceptual compliance framework taking into account: demographic factors (e.g. age, gender and education); non-compliance opportunity (e.g. income level, income source and occupation); attitudes and perceptions (e.g. fairness of the tax system and peer influence) and tax system/structure (e.g. complexity of the tax system, probability of detection, penalties and tax rates); Chau, G and Leung, P 2009, 'A critical review of Fischer tax compliance model: A research synthesis', *Journal of Accounting and Taxation Vol.1* (2), July, pp.034–040 at <http://www.academicjournals.org/jat/PDF/Pdf2009/July/Chau%20and%20Leung.pdf>; Feld L, & Frey, B 2003, 'Deterrence and Tax Morale: How Tax Administrations and Taxpayers Interact', *European Review*, Vol 11 No3, pp 385–406 @ <http://www.oecd.org/dataoecd/9/51/2789923.pdf>; Feld, L, Torgler, B & Dong, B 2008, 'Coming Closer? Tax Morale, Deterrence and Social Learning after German Unification' *Discussion and Working Paper Series # 232*, QUT School of Economics and Finance at <http://external-apps.qut.edu.au/business/documents/discussionPapers/2008/232Torgler.pdf>; Wittberg, L 2005, *Right From The Start - Research and Strategies*, Swedish Tax Agency at [http://www.skatteverket.se/download/18.612143fd10702ea567b80002569/rapport200501\\_eng.pdf](http://www.skatteverket.se/download/18.612143fd10702ea567b80002569/rapport200501_eng.pdf); Gino, F, Ayal, S, & Ariely, D 2009, 'Contagion and Differentiation in Unethical Behavior - The Effect of One Bad Apple on the Barrel' *Journal of Psychological Science*, Volume 20—Number 3, pp 393 – 398 at <http://duke.edu/~dandan/Papers/contagion.pdf>.

<sup>11</sup> Though views of compliance, embodied in the legislation passed, are generally set by reference to what society regards as normal or broadly accepts as appropriate. Where this isn't the case, as with Prohibition in the US in the 1920s, non-compliance can be a norm.

<sup>12</sup> See for example the work of a former Australian Commissioner of Taxation: Boucher, T 2010, *Blatant, artificial and contrived: Tax schemes of the 70s and 80s*, ATO, Canberra at <http://www.ato.gov.au/content/downloads/cor00244226.pdf> and Xynas, L 2010 'Tax Planning, Avoidance and Evasion in Australia 1970–2010: The Regulatory Responses and Taxpayer Compliance' in *Revenue Law Journal*, Vol. 20, Issue 1 @ <http://epublications.bond.edu.au/rlj/vol20/iss1/2>. A robust debate regarding the role of 'literal' rather than 'substance' based interpretations by the Courts of anti-avoidance provisions (following in the 1936 Duke of Westminster case tradition) in fermenting a mutually assured process of escalating legislative complexity is perhaps overdue. This is particularly pertinent given some recent decisions that are perhaps somewhat reminiscent of the Barwick days. For a more expansive discussion of this aspect see: 'Experience and innovations in other countries' by Owens, J. and Hamilton, S. in the compilation by Aaron, H J & Slemrod, J 2004, *The crisis in tax administration*, Brookings Institute.

(“You are what you do” said Aristotle.) It becomes a key facet in shaping the compliance ‘culture’ of the organisation and can even influence its structure, since structure often follows strategy, as Alfred Chandler noted in 1962.<sup>14</sup>

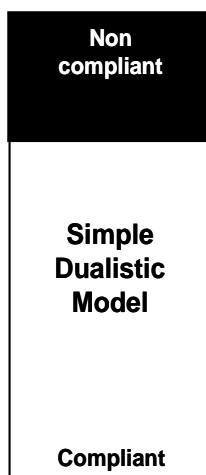
Such frameworks or models are more useful if they provide logical guidance or direction, allow for improvements on previous approaches, add insight by explaining apparent compliance relationships or better yet, make predictions as to outcomes.

Regulators use such frameworks because they provide a rationale or direction - as the French essayist Michel de Montaigne expressed it: “No wind favours he who has no destined port.”

## 2. BLACK AND WHITE

A regulator could, for example have a simple dualistic regulatory model that views a client’s behaviours as being either right or wrong. This is a black or white or ‘mousetrap’ view of compliance where, as they say in quality control circles: “you get what you ‘inspect’, not what you ‘expect’”, so the tendency of such a regulator is to try to inspect everything and everyone!

Clearly there are significant limits to the effectiveness of such an approach unless non-compliance is obvious, the causes simple, and the treatment straight forward.



**Figure 2**  
**A simple dualistic or binary compliance model**

For very simple regulatory systems (often those with ‘strict liability’ aspects) such a dualistic model may be enough for the regulator to work with. However it is a truism that ‘if the only tool you have in your bag is a hammer then the solution to every problem starts to look like a nail’.

<sup>13</sup> Raskolnikov, A 2009, ‘Revealing choices: using taxpayer choice to target tax enforcement’, *Columbia Law Review* Vol 109:689@ <http://www.columbialawreview.org/assets/pdfs/109/4/Raskolnikov.pdf>.

<sup>14</sup> Chandler, A 1962, *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*, MA: MIT, Cambridge.

Regulatory systems where the only answer is, for example, a prosecution, tend to view the solution set to a compliance issue as ‘prosecuting the right clients’ – even though a prosecution might not be the most effective treatment to engender long term compliant behaviour.<sup>15</sup>

It’s a rather limited tactical response for an increasingly complex regulatory world. Indeed a side effect of such a simple dualistic approach can be that an ‘enforcement culture’ permeates the organisation rather than a client service ethic that realises clients can get it ‘wrong’ for a wide variety of reasons that need to be addressed.

Means can start to become viewed as ends as employees strive to deliver what they perceive they are being ‘measured on’, such as ‘strike rates’ in audits and prosecutions rather than the desired outcome of improved long term voluntary compliance.

This can set the organisation up for claims of ‘unreasonableness’ or ‘over-zealousness’. The credibility of the organisation as a fair regulator can suffer and community and ministerial confidence in the regulator can decline as a result.

This is a real risk for a regulatory authority and one that can be easily overlooked, with dire consequences.<sup>16</sup> Alternatively, having only a few hardline regulatory responses can lead to them not being applied at all. Like nuclear weapons they become an arsenal that is effectively un-useable in most situations confronting a regulator.<sup>17</sup>

### 3. SHADES OF GREY

A straight forward enhancement to the simple dualistic compliance model is to introduce the view of a continuum, or spectrum, of compliance behaviours, ranging from deliberately non-compliant through to fully compliant – and ideally have a choice of several remedies that appropriately reflect an informed judgement of a client’s position within the compliance continuum.<sup>18</sup>

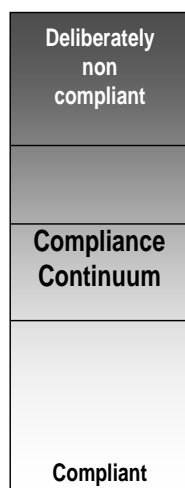
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<sup>15</sup> OECD FTA Information Note, 2010 ‘Understanding and Influencing Taxpayers’ Compliance Behaviour’, *Forum on Tax Administration: Small/Medium Enterprise Compliance Subgroup*, p 40 point 3 at <http://www.oecd.org/dataoecd/58/38/46274793.pdf>.

<sup>16</sup> See for example the Palmer Report into the detention of Cornelia Rau, July 2005 at <http://www.immi.gov.au/media/publications/pdf/palmer-report.pdf>.

<sup>17</sup> See for example Braithwaite V & Braithwaite J ‘An evolving compliance model for tax enforcement’ in Shover, N & Wright, J P (ed) 2000, *Crimes of Privilege: Readings in White-collar Crime*, OUP, New York, p1-19 at <http://vab.anu.edu.au/pubs/1/anevolvingcompliance.pdf>.

<sup>18</sup> See for example the Australian Customs ‘Compliance Continuum’ at [http://www.customs.gov.au/webdata/resources/files/FS\\_CustomsCompliance.pdf](http://www.customs.gov.au/webdata/resources/files/FS_CustomsCompliance.pdf).



**Figure 3**  
**A linear compliance continuum – introducing shades of grey**

This more nuanced view is one of the conclusions of the OECD Forum of Tax Administration (2010):

“Circumstances and drivers change and it is too simplistic to divide the taxpayer population into just compliers and non-compliers. Taxpayers can be found on a continuum from total compliance to total non-compliance. The individual’s position on this continuum is not fixed — it changes depending on both the individual and the situation or circumstances.”<sup>19</sup>

#### **4. BROADENING THE BASE – ADDING A HIERARCHY OF RESPONSES TO THE COMPLIANCE CONTINUUM**

Research on compliance approaches by Braithwaite and others<sup>20</sup> on regulatory systems suggests that a range of treatments should be available to engender long-term voluntary compliance.<sup>21</sup> An escalatory or responsive (‘if you do this then I’ll do that’) model was put forward to create an incentive for the client to move towards a more engaged and compliant behavioural set.

The pyramid shape of the Braithwaite model effectively adds another dimension to the simple linear compliance continuum, allowing for a somewhat richer and more

<sup>19</sup> OECD Forum of Tax Administration, 2010, *Small/Medium Enterprises Compliance Subgroup, Information Note. Understanding and Influencing Taxpayers’ Compliance Behaviour*, November 2010.

<sup>20</sup> See for example the useful state of play summary in *Law & Policy, Volume 29, Issue 1, January 2007*.

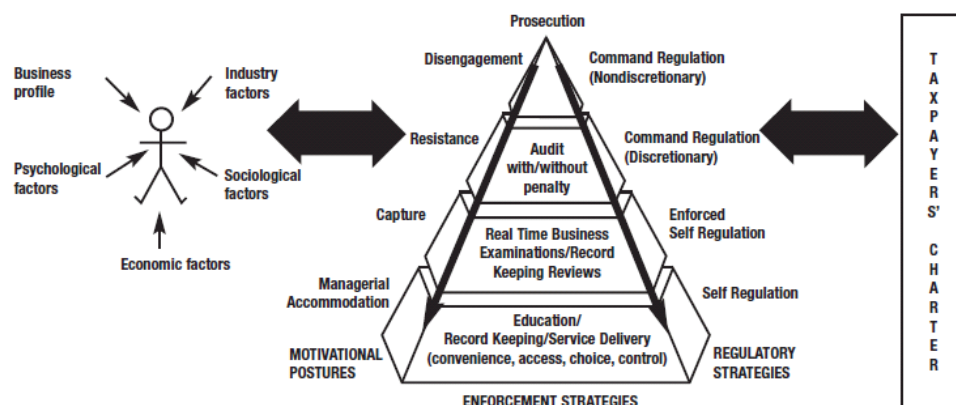
<sup>21</sup> See for example the range of escalatory sanctions contained in the UK “Regulatory Enforcement and Sanctions Act” 2008 @ <http://www.lbro.org.uk/docs/regulatory-enforcement-and-sanctions-act-2008.pdf>.

informed view and discussion of compliance behaviours and the appropriate regulatory responses.

The shape roughly indicates the number of clients that might be found at each 'level', the hierarchical and escalatory nature of the engagement, and the increasing focus on the minority who appear to deliberately seek to abuse the system and undermine its integrity.

The choice of remedy imposed (and the model is conceptually a 'choice of remedy' framework – what you do after you determine that non compliance has occurred) becomes increasingly severe the higher up the pyramid you go - with the view of creating an incentive for clients to move towards more compliant behaviours. "Create pressure down" is the terminology used by both the Australian and New Zealand tax authorities in this regard.

The regulatory compliance pyramid was developed further during work with the Australian Taxation Office's (ATO) Cash Economy Project in the mid-to-late 1990s where the client's perceived broad motivational posture was explicitly coupled with a suggested regulatory response:



**Figure 4**  
Integrating the Braithwaite compliance model into ATO operations<sup>22</sup>

In this version of the compliance model, a series of simplistic client 'archetypes'<sup>23</sup> were defined by their implied motivational posture:<sup>24</sup>

<sup>22</sup> See ATO Cash Economy Task Force 1998, *Improving Tax Compliance in the Cash Economy Second Report*, p 58 <http://www.ato.gov.au/content/downloads/SB39073.pdf>.

<sup>23</sup> In my view the use of client 'archetypes' in a compliance setting can be dangerous for a regulator undertaking case selection as it explicitly leads to labelling of the client rather than of the apparent behaviour. Given the rate of false positives in case selection systems such mislabelling would be of real concern – eg being labelled as a 'resistant client' before compliance contact sets up the wrong tone for the interaction. For example with a 90% compliant population a non compliance test with a 90% accuracy will still only lead to a 50% strike rate. (Why: 90% of the 10% non-compliers are correctly identified, but the 10% error rate will identify the same number of false positives in the 90% compliant part of the population giving an overall strike rate of just 50%. This inevitable outcome is often not considered when judging compliance effectiveness.) Archetype labeling might be seen as prejudging



- The disengaged clients who have decided not to comply,
- The resistant clients who don't want to comply,
- The captured clients who try to comply, but don't always succeed, and
- The accommodating clients who are willing to do the right thing.

To work the Braithwaite model requires compliance staff to make reliably informed and accurate judgments not merely about whether non-compliance has occurred but also in respect of the 'motivation' for that non-compliance – a challenging ask as it goes beyond observed behaviours to making inferences about a client's state of mind. There is a real risk that staff focus on the perceived client attitude rather than on the actual client behaviour.

It should also be noted that some commentators<sup>25</sup> have raised questions regarding the applicability of the compliance pyramid in situations where the determination of compliance itself is uncertain – where legitimate differences of views exist regarding what compliant behaviour is. This situation, not uncommon with large complex transactions, magnifies the danger of asking staff to reliably form views as to the apparent motivation for perceived non-compliance. 'Difficult' tax minimisers may be inappropriately viewed as 'aggressive' tax avoiders. This aspect is discussed further later in this article.

As noted earlier, the compliance pyramid posits an escalating choice of remedy matched to observed client behaviours and the perceived motivation. For example:

- For those perceived as doing the "right thing" – the majority of clients – compliance is made as simple as possible. Information reporting requirements are reduced and interactions are made as cheap and easy as is practical.<sup>26</sup>
- For those perceived as trying, but not succeeding, in doing the right thing, education and advice is provided to enable compliance. This can be general, or aimed at a specific client segment – an industry or occupation group or some other discernable client grouping.<sup>27</sup>
- Some clients may be selected for a review where the output is advice on how to comply in the future, rather than an adjustment that punishes the past. For example, 'record keeping reviews' where the output is often advice on how to better record transactions. These interventions are generally relatively quick,

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the client rather than indicating a level of concern (a view of risk) at that point in time that suggests follow up action to ascertain the relevant salient facts and circumstances. A more appropriate regulatory approach therefore is to describe the level of 'risk' or 'concern' associated with evidenced behaviours.

<sup>24</sup> Braithwaite, V 2003, 'Dancing with Tax Authorities: Motivational Postures and Non-compliant Actions' in Braithwaite, V (ed) *Taxing Democracy: understanding tax avoidance and evasion*, Ashgate, Aldershot. 5 postures suggested: Commitment, Capitulation, Resistance, Disengagement, Game-playing: at [http://demgov.anu.edu.au/papers/Braithwaite2003TD\(2\).pdf](http://demgov.anu.edu.au/papers/Braithwaite2003TD(2).pdf).

<sup>25</sup> Burton, M 2007, 'Responsive Regulation and the Uncertainty of Tax Law – Time to Reconsider the Commissioner's Model of Cooperative Compliance?' *eJournal of Tax Research*, Volume 5, VI, at [http://www.atax.unsw.edu.au/ejtr/content/issues/previous/paper4\\_v5n1.pdf](http://www.atax.unsw.edu.au/ejtr/content/issues/previous/paper4_v5n1.pdf).

<sup>26</sup> See for example the direction of the ATO 'Easier, Cheaper, More Personalised Change Program' at [http://www.ato.gov.au/content/downloads/Making\\_it\\_easier\\_to\\_comply\\_2005\\_06.pdf](http://www.ato.gov.au/content/downloads/Making_it_easier_to_comply_2005_06.pdf).

<sup>27</sup> See <http://ato.gov.au/corporate/content.asp?doc=/content/42628.htm> on marketing aspects to particular groupings.

lower cost mechanisms for enhancing voluntary compliance for the majority of clients who are trying to comply.

- A smaller number of clients will usually exist who, for a variety of reasons, appear to have carelessly, negligently or deliberately not complied. For these clients in the tax system the common response is an administrative one – an audit to determine the amount of non-compliance and the reasons for it and, if appropriate, apply penalties for the non-compliance. The audit may be targeted at a specific issue (eg work related expenditure claims) or be a comprehensive review of the client's tax affairs.
- For those few clients considered to be 'aggressively' non-compliant, the treatment may be to investigate, with a view to prosecution (civil for abuse or criminal for fraud). Due to the legal evidence-gathering nature of these cases they tend to be adversarial, resource intensive, time consuming and costly for all sides.

All of these variations in regulatory response maintain the essential aspect that the choice of remedy should be appropriate and take into account the facts and circumstances of the client's situation so as to treat the client in an appropriate and proportionate way:

- For example recidivist clients (those who repeatedly offend after treatment) would generally warrant a different treatment than a client detected making an error for the first time.
- Similarly those who knowingly promote non-compliance by others generally warrant different treatment to those who don't.
- Those in special positions of knowledge, trust and influence in the regulatory system (eg key intermediaries, agency staff, lawyers, judges, police and accountants) generally warrant different treatment to those who aren't in such positions.
- Those involved in avoidance arrangements aren't all the same. Clients with relatively low knowledge of the regulatory system who enter arrangements on the advice of their trusted advisor should not be treated the same as those who would be reasonably expected to have sound knowledge.

The correct translation of the perceived motivational postures from observed behaviours and into the subsequent choice of remedies is critical, as the effectiveness of the Braithwaite compliance model is posited on applying the right remedy to the right situation.<sup>28</sup>

It is naturally quite important that the compliance strategy or 'choice of remedy' always be appropriate and defensible – and that the mechanism to get to a decision on the remedy is evidence based and repeatable.

<sup>28</sup> Black, Dr J 2008, 'Chancer', 'Failure' or 'Trier'? Regulatory Conversations and the Construction of Identities' July 2008, *Crime Narratives in Context Seminar Papers* at <http://www.cardiff.ac.uk/chri/research/cnic/J%20Black%20CNIC%20Paper.doc>.

There is also a broadly accepted order – persuasion before punishment, education before enforcement. Fair warning and firm, but fair, treatment. A common-sense approach to compliance activities.

Both the Australian Tax Office and the New Zealand Inland Revenue documents suggest the use of a broad analysis approach to create an understanding of the client's motivational stance based on: Business and Industry factors, Social and Economic aspects, as well as Psychological influences - a 'BISEP' analysis.<sup>29</sup>

In practice both the capacity and capability to do this kind of analysis 'in depth' for large numbers of clients in a regulatory system is significantly constrained by real resource and competence limitations. A way of prioritising in whom and how much you invest is inevitably required.

The causal factors (a view of the motivational posture) involved in the non-compliance should clearly factor into the appropriateness of the choice of remedy with the Braithwaite approach. For example the causal factors<sup>30</sup> for non-compliance could be as a result of:

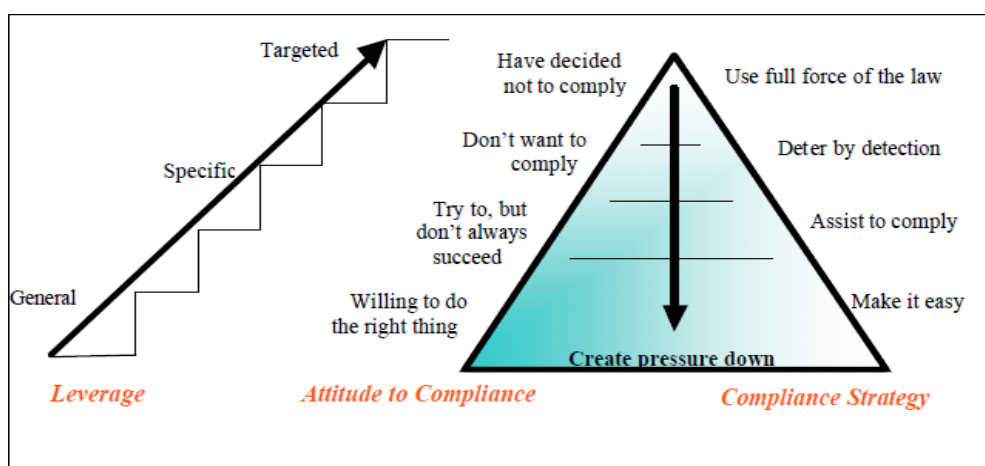
- deliberate intent,
- negligence,
- carelessness or recklessness,
- ignorance, (ie a lack of knowledge of the regulators view of compliance)
- honest mistake,
- not being in a position to comply,
- or a difference of views as to what compliance is. This can range from reasonably arguable positions (differences of view as to where the 'line' is) to positions that are more clearly aggressive or 'hard' avoidance.

In the Australian Tax System these aspects factor into penalty imposition considerations and towards the end of this article I'll bring these into a broader risk management approach. A New Zealand variation of the compliance pyramid approach highlights different leverage effects possible, in that:

- Some treatments will apply to many clients at once and be rather general in nature – such as education materials available to the public.
- Other treatments will be client group specific, advice aimed at a particular industry or occupation or segment.
- Finally, some treatments are targeted at clients considered to have been deliberately non compliant.

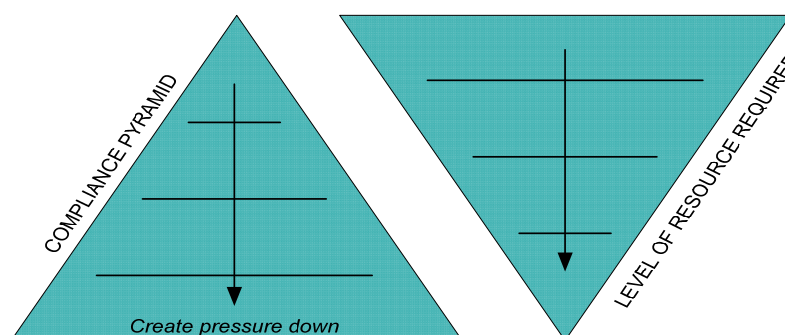
<sup>29</sup> Shover, N, Job, J & Carroll, A 2003 'The ATO Compliance Model in Action: A Case Study of Building and Construction' in Braithwaite, V (ed) *Taxing Democracy: understanding tax avoidance and evasion*, Ashgate, Aldershot at [http://demgov.anu.edu.au/papers/ShoverEtal2003TD\(8\).pdf](http://demgov.anu.edu.au/papers/ShoverEtal2003TD(8).pdf).

<sup>30</sup> OECD Regulatory Management and Reform Group 2000, *Reducing the risk of policy failure: challenges for regulatory compliance* @ <http://www.oecd.org/dataoecd/48/54/1910833.pdf>.



**Figure 5**  
**Compliance Pyramid - Types of Leverage<sup>31</sup>**

A further NZ variation in presentation also uses an inverted pyramid to show the relative resource intensity per client generally increases as we move up the compliance pyramid:



**Figure 6**  
**Relative resource intensity per client.**  
**New Zealand Inland Revenue, Internal Document**

The 'Law & Policy' special edition<sup>32</sup> in January 2007 brought together a compilation of papers exploring and commenting upon the implementation of 'responsive regulation' and was a useful summary of the overall state of play with the regulatory compliance pyramid at that time.

The approach has garnered wide acceptance by regulatory agencies in Australia, though in my discussions with their staff it is more rhetoric than reality. Dig deeper and there isn't much more than a triangle on a corporate document.

<sup>31</sup> Morris, T & Lonsdale, M 2005, 'Translating the compliance model into practical reality', New Zealand Inland Revenue, February 2005 @ <http://www.irs.gov/pub/irs-soi/04moori.pdf>.

<sup>32</sup> *Law and Policy* Vol 29 January 2007, John Wiley & Sons / University of Denver available at <http://onlinelibrary.wiley.com/doi/10.1111/lapo.2007.29.issue-1/issuetoc>.

## 5. EXPLICITLY BRINGING RISK INTO THE PICTURE

As noted earlier, before a regulator can determine whether a client is compliant or not decisions have to generally be made about ‘who’ to review. Aspects concerning likelihood of non-compliance, the potential consequences of that non-compliance and the degree of certainty of these need to be guided by risk based case selection (who the regulator reviews to determine whether or not they are, in the regulators view, compliant) and client engagement approaches in a practical sense, where it is both evidence based, repeatable and scalable across markets. Making it reality rather than mere organizational rhetoric.

At their most basic level, risks are simply things that can threaten our success in achieving our intent or vision. Risk events have both a likelihood of occurrence and a consequence of occurrence and it is critically important to understand the difference between these two aspects, ‘how likely’ and ‘how much’, in order to consciously manage and treat risk.

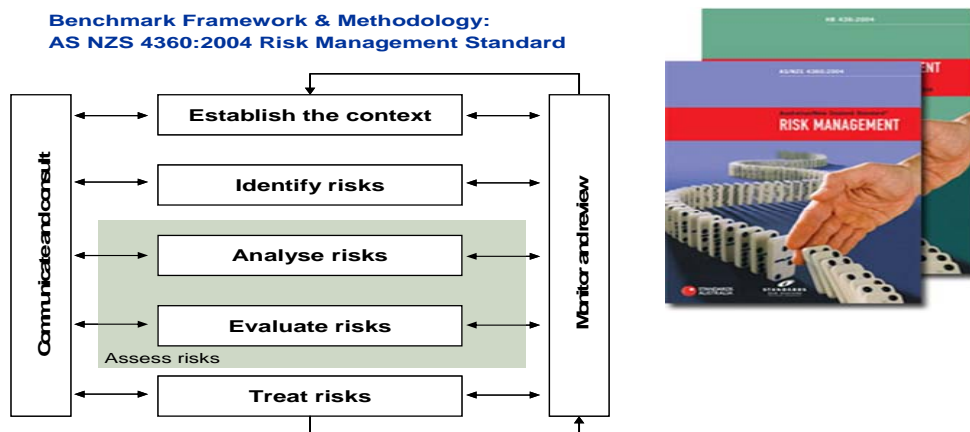
My experience is that it isn’t uncommon for people to talk about risk just in terms of likelihood and not calculate the relative and absolute consequence aspects. That tends to fuel ‘one size fits all’ approaches that may work well when all are of one size – but most aren’t (eg A hundred dollar consequence is ten thousand times smaller than a million dollar consequence and ten million times smaller than a billion dollars... if you just use likelihoods you effectively lose the significance of the dimension of consequence.)

A risk with a lower likelihood, but higher consequence is generally a very different thing to a risk with a higher likelihood, but lower consequence – even though the risk event and overall risk rating may be the same, you usually need to approach them very differently to be effective.<sup>33</sup>

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<sup>33</sup> The standard 4 ‘Ts’ of risk management (ie Tolerate, Treat, Transfer, or Terminate the risk) play out differently by the combination of likelihood and consequence. See for example HM Treasury 2004, *The Orange Book - Management of Risk - Principles and Concepts* at [http://www.hm-treasury.gov.uk/d/orange\\_book.pdf](http://www.hm-treasury.gov.uk/d/orange_book.pdf) (Eg ‘Tolerate’ is appropriate for Lower risk, Terminate the process for Higher risk etc.).

In its approach to risk management the ATO follows the standard for risk management – ISO31000<sup>34</sup> - derived from ASNZS 4360.



**Figure 7**  
**The AS NZS 4360 Risk Management Steps**

We should note that risk management frameworks bring with them relatively mature and robust approaches to the prioritisation of very different risks for treatment – a key facet in considering compliance interventions.

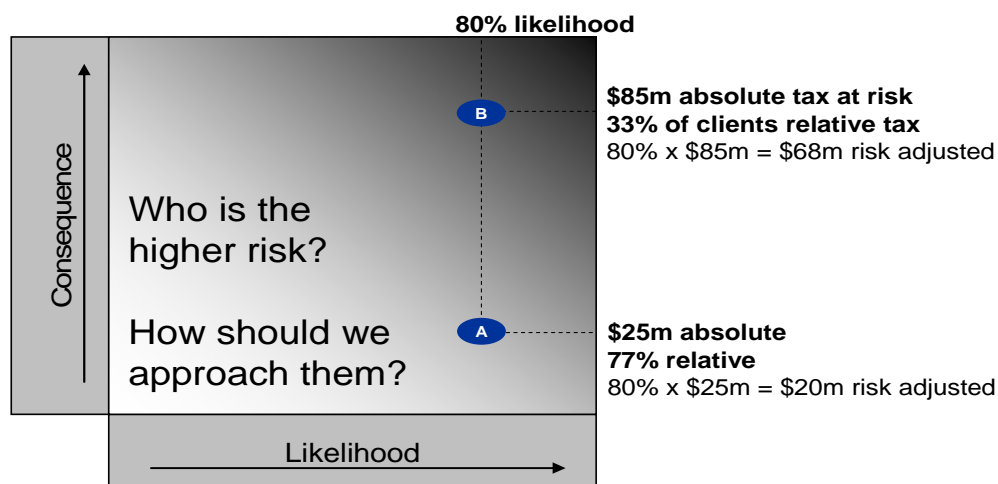
Like most organisations, the ATO has utilised a risk matrix as a conceptual aid for displaying and considering relative risk levels of various, and often very different, risks.

<b>Consequence</b>	Extreme	High	High	Severe	Severe	Severe
	Very High	High	High	High	Severe	Severe
	High	Significant	Significant	High	High	High
	Medium	Moderate	Moderate	Significant	Significant	Significant
	Low	Negligible	Negligible	Moderate	Moderate	Significant
<b>Example Risk Matrix</b>		Rare	Unlikely	Even Chance	Likely	Almost Certain
		<b>Likelihood</b>				

**Figure 8**  
**Example Risk Matrix**

<sup>34</sup> Available at <http://www.riskmanagement.com.au/>.

An issue was how compliance ‘view’ of risk might best fit with these broader risk management approaches. For example, if we had two clients with the same likelihood of potential non-compliance, but significantly different relative and absolute consequences of non-compliance, who should we prioritise for review and how should we map<sup>35</sup> them onto a risk matrix?



**Figure 9**  
**Differing absolute (\$) or relative (%) risk positions**<sup>36</sup>

- How should we best combine or take into account in our risk prioritisation, concepts such as relative non-compliance (eg client A evaded 77% of their tax – a view of severity of offence) and absolute non-compliance (eg client B evaded \$85 million of tax)?
- How should leverage aspects, such as the influence or impact over clusters of clients that a market leader or an advisor might have, come into the picture?
- Can we find features associated with ‘attitude’ towards compliance (however that might be effectively and consistently estimated beforehand) or are we in practice largely limited to identifying potential non-compliance before client contact is made?

A further, and very important, consideration for a tax administration is how should possible avoidance<sup>37</sup> (bending the rules or having a tax position the Commissioner regards as contentious) figure relative to possible evasion (breaking the rules)?

<sup>35</sup> The scaling of the likelihood and consequence dimensions of a risk matrix is an ‘informed judgment’ by the organisation. Eg Logarithmic scales (eg by factors of ten) may be used for plots of absolute consequence and likelihood. The choice between say linear or logarithmic scales depends on the nature of the risks being plotted, what the tolerance for risk is and how many risk levels it wants to identify. A risk matrix is essentially a prioritisation tool for sorting risks, and hence scales that best suit the organisations decision-making on risk should be used.

<sup>36</sup> See Hamilton, S 2006, *Optimising Compliance – the role of analytic techniques* available at <http://www.itdweb.org/documents/Optimising%20Compliance%20-%20Role%20of%20Analytic%20Techniques.pdf> for a deeper discussion.

As previously noted, we need to be able to effectively approach the compliance pyramid, with its responsive regulation concepts, in situations where *compliance itself is uncertain*, for example where the law's application to a set of facts and circumstances may be unclear and a reasonable contention exists.

This 'zone of uncertainty' in the operation of the law may range from facts and circumstances that appear to be legitimate tax minimisation, through to arrangements that appear to have little commercial purpose other than to obtain a tax benefit<sup>37</sup> not otherwise available.

It should be noted that, for large corporate clients involved in complex transactions this uncertainty of 'what is compliant' is associated with most of the risk of being viewed by the regulator as being *potentially non compliant*.<sup>39</sup>

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<sup>37</sup> See the discussion in Chapter 1 "Tax Avoidance" of Pagone, G. T. "Tax Avoidance in Australia", The Federation Press, 2010.

Stripped to its basics avoidance generally works towards seeking a tax advantage in altering:

- who incurs the tax (alienation),
- when they incur it (timing),
- where they incur it (profit shifting),
- what is taxed (characterisation) and/or
- how the tax is calculated (eg changing valuation methodologies).

Another view of this is:

- Person (who),
- Period (when),
- Place (where),
- Product (what),
- Process (how) as a mnemonic for these basic avoidance or tax minimization strategies.

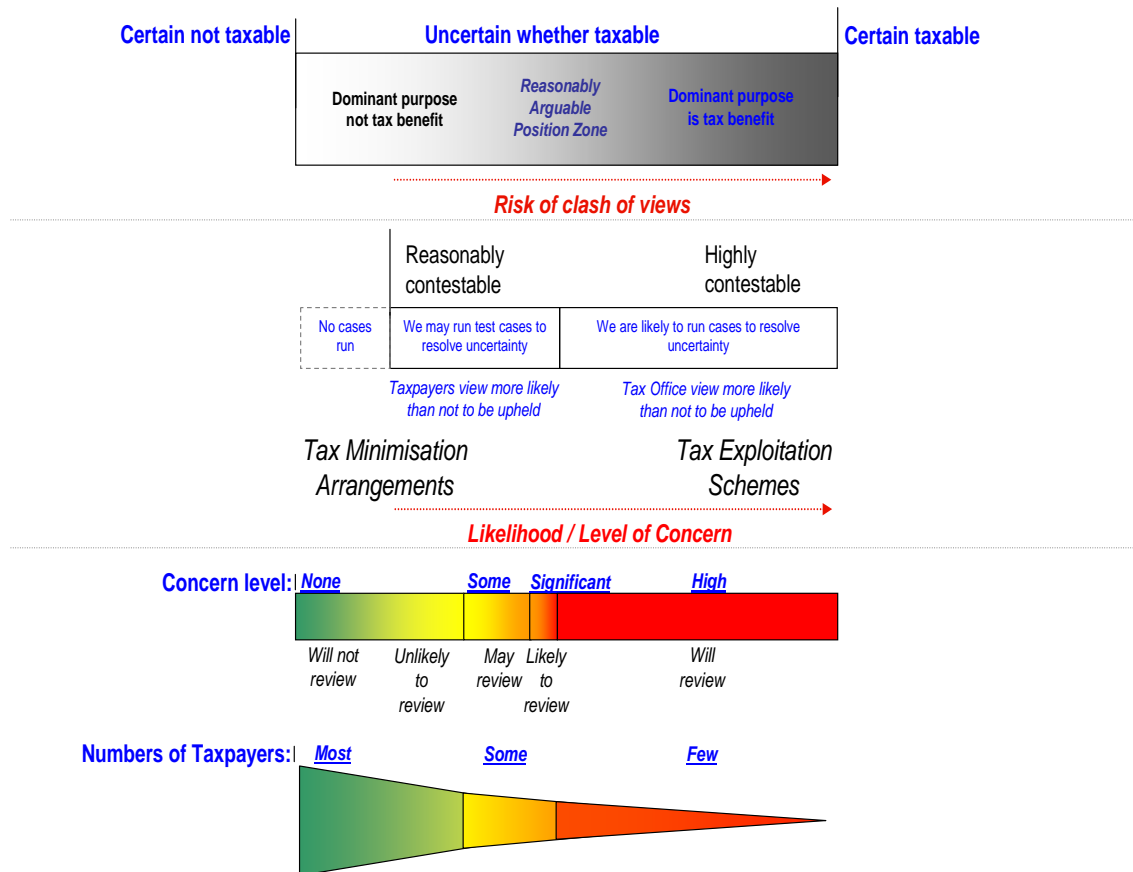
<sup>38</sup> See for example the discussion in Chapter 4 "Tax Benefit" of Pagone, G. T. "Tax Avoidance in Australia", The Federation Press, 2010.

<sup>39</sup> See for example the discussion by Freedman, J. Loomer, G. and Vella, J at Section 2 "The Continuing Importance of the 'Boundary of the Law'" in "Moving Beyond Avoidance? Tax Risk and the Relationship between Large Business and HMRC, Report of a preliminary survey", June 2007 at <http://denning.law.ox.ac.uk/tax/documents/Movingbeyondavoidance.pdf>.



## Certainty level re application of the law to facts and circumstances

Shades of Grey → **Informed Judgment** necessary



**Figure 10**

**Contentious tax positions - Tax Minimisation and Avoidance - The zone of uncertainty**

Potentially contentious arrangements - it is where advisors<sup>40</sup> really earn their money in the face of appropriate, but perhaps not always appreciated, professional scepticism<sup>41</sup> and judgment<sup>42</sup> by the regulators compliance staff.

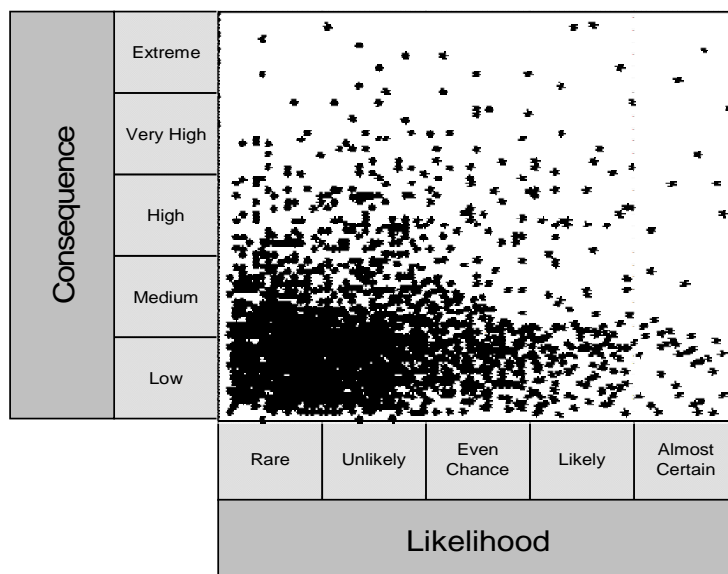
From a regulator's perspective we need to be able to factor this aspect of the likelihood and consequence of potential non-compliance, both absolute and relative, and our degree of confidence in these aspects, into our view of risk in a consistent, logical, repeatable and defensible manner.

<sup>40</sup> See for example the discussion in Chapter 10 'Advising on Tax Avoidance' of Pagone, G. T 2010, *Tax Avoidance in Australia*, The Federation Press, Sydney.

<sup>41</sup> As defined in Australian Auditing Standard ASA 200 requirement paragraph 15 and A18 – A22 <http://www.comlaw.gov.au/Details/F2009L04064>.

<sup>42</sup> As defined in Australian Auditing Standard ASA 200 requirement paragraph 16 and A23 – A27.

Represented as a scatter plot of compliance risk we are likely to have something like:



**Figure 11**

**Most clients have a lower consequence and lower likelihood of non-compliance – most clients are compliant most of the time**

There is a natural logic to this. In both cases the probability distribution of clients would generally follow a scale invariant<sup>43</sup> inverse power distribution<sup>44</sup>, such as Pareto, of a few large consequence or higher likelihood clients and many lower likelihood/consequence ones. It is the way nature and regulatory systems generally work.

The reason for this in living systems is both obvious and subtle: viable systems adapt to reduce the impact and/or the likelihood of severe events, making them relatively 'rarer' over time. If they didn't the system wouldn't 'survive' long term (eg prohibition in the USA). This result will hold true whether our view of risk is event based or whole of client. A whole of client risk view is essentially a summation of the client's risk events.

<sup>43</sup> Essentially the shape of the distribution looks similar at all scales: eg the shape of cumulative tax paid by a hundred clients, a thousand, or a million etc.

<sup>44</sup> Eg one over x to the nth power ( $1/x^n$ ) so small values of x are more probable than large values. In nature (many creeks few continent draining rivers) and in human systems (many towns few mega cities, many small taxpayers few billion paying taxpayers). See for example: Newman, M 2006 *Power laws, Pareto distributions and Zipf's law* at [http://aps.arxiv.org/PS\\_cache/cond-mat/pdf/0412/0412004v3.pdf](http://aps.arxiv.org/PS_cache/cond-mat/pdf/0412/0412004v3.pdf).

It is not a simple ‘add and average’ since probabilities are involved, but the mathematics of forming a whole of client view is not really that complicated.<sup>45</sup> On the other hand how you form a view on the probabilities themselves can be quite complex; using either ‘decision rules’ from subject matter experts or, if sufficient data exists, from predictive data mining approaches – eg logistic regression, neural networks, decision trees etc.<sup>46</sup>

Having formed a risk based view of where a client sits relative to other clients we can then consider who we may want to, or can focus on – those who appear to present a higher relative risk. One way of thinking about this is to imagine that we are essentially zooming in on ‘who’ we might have compliance ‘concerns’ about and therefore may want to review.

We do this by considering the potential consequences of possible non-compliance as well as our view of the likelihood of non-compliance. (Eg A larger client generally warrants a different level of interaction and investment to a smaller client.) Clearly, from a risk management perspective, we will have a more significant interest in, and need for assurance with, higher consequence clients or events than lower consequence ones.

Equally we will be more interested in reviewing those clients or events that have a higher likelihood of being non-compliant (having a contestable position – one that we have concerns with) than those with lower likelihoods.<sup>47</sup>

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<sup>45</sup> Overall likelihood for ‘n’ mutually exclusive ‘i’ risk events:  $L_n = \Sigma(L_i \times C_i) / \Sigma(C_i)$ . [Note this is not the average likelihood ‘ $\Sigma(L_i)/n$ ’ unless all risks have the same the consequence.] The overall consequence is:  $C_n = \Sigma(C_i)$  and the overall risk is:  $R_n = L_n \times C_n = \Sigma(L_i \times C_i)$ .

For example say we have a taxpayer with:

- a late lodgement likelihood of 50% and a consequence of lodging late of \$200,
- a likelihood of reporting incorrectly on the return of 10% with a consequence of \$1,000, and
- a likelihood of late payment of 20% with a consequence of \$500.

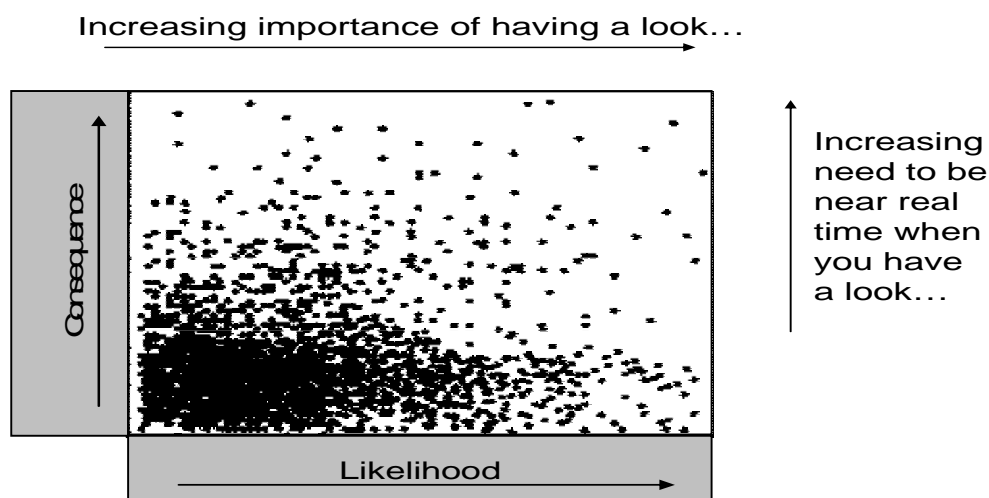
Then:

- Overall consequence = \$200 + \$1,000 + \$500 = **\$1,700**
- Overall likelihood =  $[(50\% \times \$200) + (10\% \times \$1,000) + (20\% \times \$500)] / \$1,700 = \mathbf{17.64\%}$ , and
- The overall taxpayer risk =  $(50\% \times \$200) + (10\% \times \$1,000) + (20\% \times \$500) = \mathbf{\$300} = 17.64\% \times \$1,700$ .

The technical challenge is designing risk filters using limited, often highly summarised, data to provide useful and robust views of likelihood and consequence that can then be scaled and brought together in this fashion. This view of a taxpayer’s risk then needs to be considered relative to other taxpayers to decide on an appropriate prioritisation.

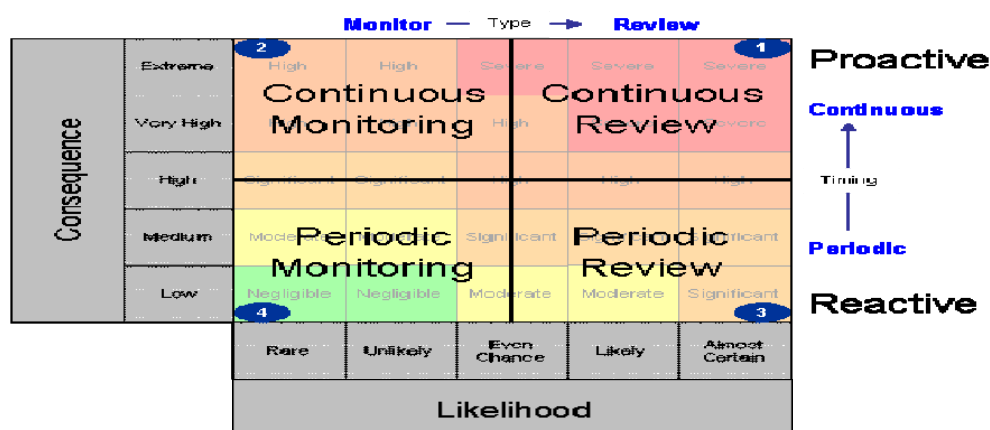
<sup>46</sup> Tools such as SAS JMP (<http://www.jmp.com/>) have made simple data mining, both descriptive and predictive, easier to access and use, though there is still considerable science and ‘art’ involved in both getting the data in a state to mine and in what tool to use to best mine it. Open source software, such as the r based “RATTLE” system (<http://rattle.togaware.com/>) is also available.

<sup>47</sup> This is effectively the same as the requirements in the Australian Auditing Standard ASA 200 where the ‘nature, timing and extent’ of audit testing is associated with professional judgments regarding the likelihood and consequences of a material misstatement.



**Figure 12**  
Timing and importance of detection efforts

If we then map a client engagement approach based on timing and frequency of the suggested detection effort - periodic to continuous (ie ~near real time) and the type and intensity of detection effort - passive monitoring to active review, the following risk differentiation framework emerges for the large market:<sup>48</sup>

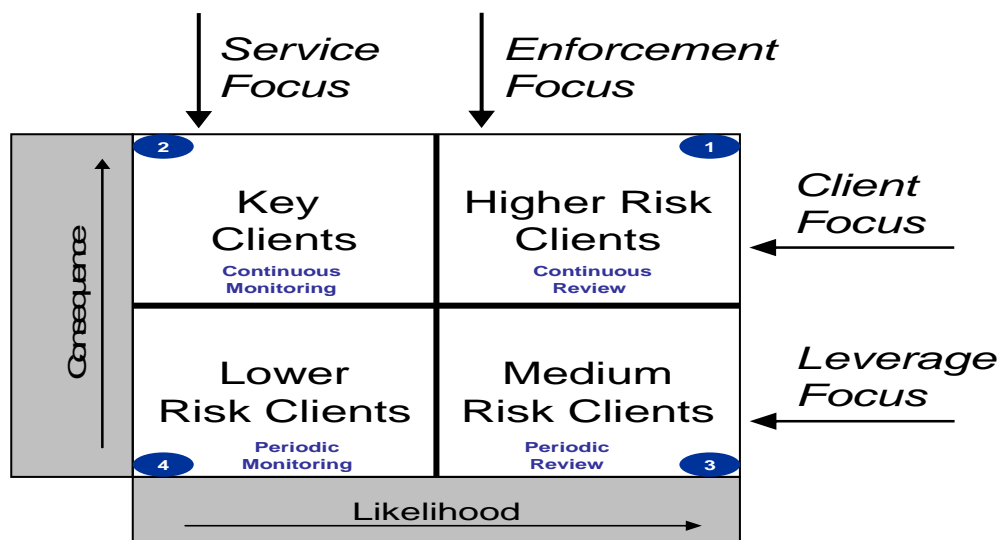


**Figure 13**  
Detection strategies/investment laid over a risk matrix

This framework is the basis of a risk differentiation framework now being used by the Australian Tax Office for its large corporate clients. Similar approaches are being used for advisors and intermediaries.

<sup>48</sup> For areas with much larger client numbers the engagement stances associated with the risk categorisations clearly need to be modified to match capability and cost effectiveness. The engagement stance should always be an appropriate and proportionate response to the risk posed.

Giving the quadrants broadly representative names<sup>49</sup> we derive the following:



**Figure 14**  
Service, enforcement, leverage and client focus

This isn't really a radical change to the way the Australian Tax Office has been dealing with its clients in the large market in the past – it is very much a logical framework within which to set and guide what they have been doing day to day.

By taking into account consequence, it makes it explicit that there is a set of clients in whom we may need to make an extra investment to keep them from moving 'up' the compliance model.

These are the 'Key clients', where the precautionary principle of risk management is of increased importance – where you don't want to wait for things to go wrong if they can be reasonably prevented and where it is important to be able to demonstrate to the broader community that the largest players are being appropriately monitored by a prudent regulator.

<sup>49</sup> Note that one of the areas of concern regarding the framework is the terminology used for quadrant 1 (higher risk). Some consider this a pejorative term that may cause unnecessary dispute. Perhaps 'higher concern' or 'higher interest' may be considered less inflammatory terms for this quadrant.

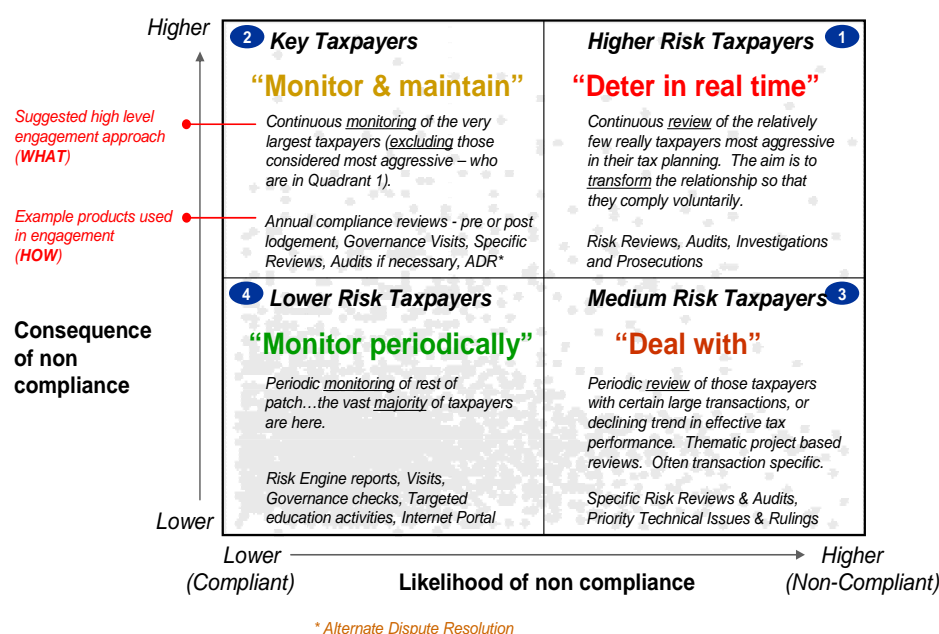
Another aspect is that the risk descriptions are relative – quadrant 1 clients are higher risk relative to key and lower risk clients. It is not high and low and not an absolute threshold set in stone, but a relative one.

We are not dealing with certainties but with risk, so categorising a client as 'higher risk' is not the same as saying that they actually have made an error – we don't know that until we have reviewed law as it applies to the facts and circumstances. Instead a higher risk client is perceived by us, based on the information and intelligence we have at that point in time, to have a higher relative likelihood of having a potentially contentious tax position than a key or a lower risk client – so more time and effort is expended in checking whether this is the case. The efficacy of the risk differentiation approach should not turn on the descriptive labels used and the most practical and appropriate set should be used.

In one sense this is a level of recursion of how the broader market segmentation approach effectively operates within the Australian Tax Office. For example, if we use turnover as a proxy for consequence<sup>50</sup> the following picture broadly emerges:

- Large business (Higher coverage rates)
- Quasi evasion behaviours (Higher coverage rates)
- Small & medium enterprise (Moderate coverage rates)
- Micro enterprises and individuals (Lower coverage rates)

It can be seen that such a framework effectively makes clearer many of the risk based approaches that people have implicitly been using within tax administrations for years. The approach makes the decision process on risk prioritisation more coherent, consistent, explicit and transparent. Drawing these threads together we can obtain an overarching strategic framework for differentiated approaches to compliance risk management for large corporate clients:



**Figure 15**  
The quadrant risk differentiation framework for large business compliance engagement

In broad conceptual terms, this risk differentiation framework<sup>51</sup> suggests a different high level engagement approach for clients in each quadrant:

<sup>50</sup>Turnover has proved to be a useful proxy. An analysis of adjustments made over several years showed that most adjustments of business returns were for less than 10% of turnover and it is rare for an adjustment to be greater than turnover (eg as with a large CGT event). Most adjustments were thus relatively small compared to turnover and both smaller and larger business adjustments were usually 'small' when compared to the largest adjustments. As would be expected, the relatively rarer large adjustments are associated with the largest businesses.

- For those clients with relatively higher consequences (often the largest clients or those with significant influence in the tax system) the logical strategy is that the regulator would invest more time and effort in trying to reduce the likelihood of non-compliance – of the client having a contentious tax arrangement.
- For those clients with lower consequences of non-compliance if deterrence efforts failed the regulator would look for more efficient leverage approaches to detect and deal with potential non-compliance.

Reflecting the underlying Pareto nature of risk, the risk differentiation framework suggests that relatively few clients would be treated as ‘higher risk’ – perhaps 2% or fewer.<sup>52</sup> This is how it has played out in practice as well. Correctly identifying these relatively few higher risk clients or transactions is clearly critical for overall compliance effectiveness.

The framework suggests a relatively intense focus on clients considered as ‘higher risk’ even though these may not produce the greatest immediate result since compliance activities with higher risk clients can be drawn out, litigious affairs often involving entrenched positions. The activities of higher risk clients tend to set the bar of acceptability in the market, particularly if their activities go unchallenged for a period of time.

For the long term success of the regulatory system, higher risk clients need to be effectively engaged with credible compliance approaches – and this needs to have a degree of visibility in the market.

If a regulator is slower than ‘market time’<sup>53</sup> to be ‘seen’ to deal with aggressive avoidance behaviours then ‘breakouts’ of such arrangements occur as more risk-neutral clients begin to take up the scheme.

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<sup>51</sup> While in strict risk terms the Key Client quadrant might also be seen as “medium risk” (eg 80% x \$200 = 20% x \$800), the two quadrants (2 and 3) can be clearly distinguished on the basis of the dominant part of the likelihood and consequence calculation. The Key Client quadrant has clients with a relatively lower likelihood and higher consequence, whereas the Medium Risk Client quadrant has clients with a relatively higher likelihood and lower consequence. They are likely to be behaviourally different and impact the system differently.

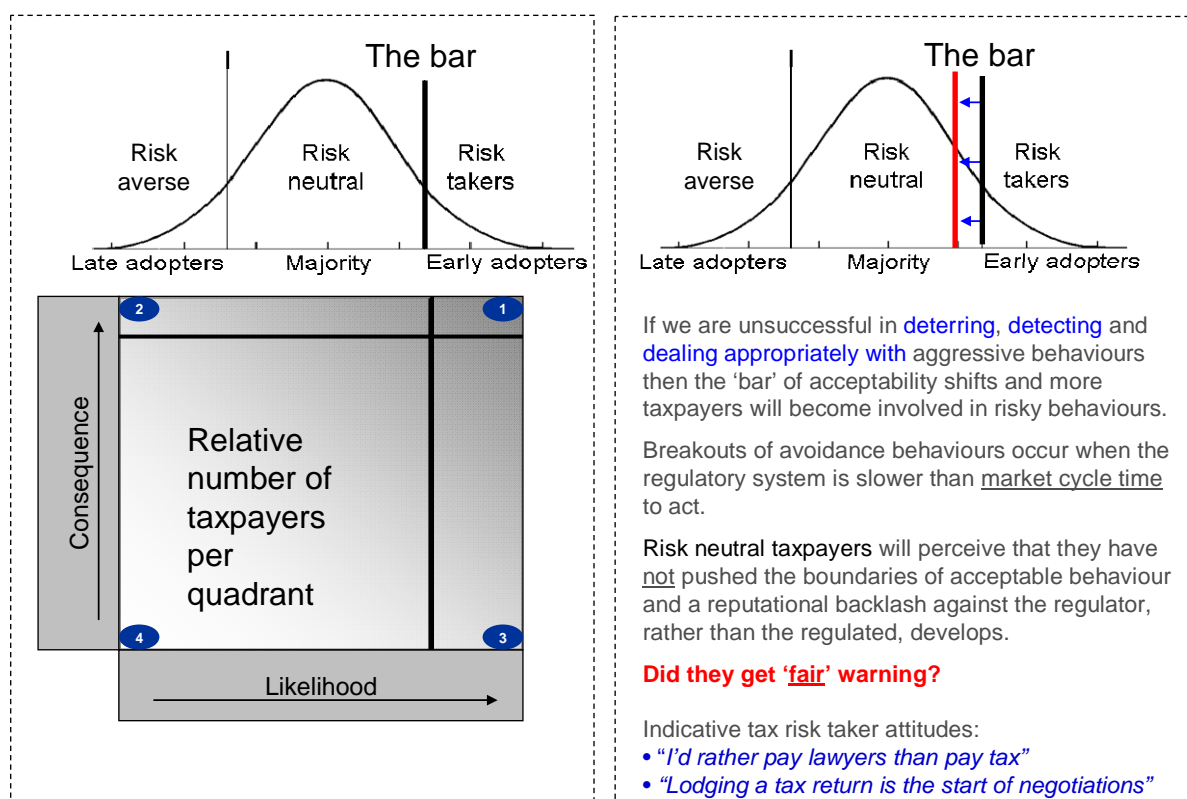
<sup>52</sup> For example a 90:10 Consequence and 80:20 Likelihood split gives 10% x 20% = 2% as ‘Higher Risk’, 10% x 80% = 8% as ‘Key clients’, 90% x 20% = 18% as ‘Medium risk’ and 90% x 80% = 72% as ‘Lower risk’. Note these are indicative figures only and in practice additional taxpayers have been categorised as medium risk for assurance (checking relatively large claims) and scoping purposes (checking an unusual or novel arrangement) than would be otherwise selected as medium risk on simple likelihood of non compliance grounds.

<sup>53</sup> In the highly concentrated and interconnected large business market arrangements tend to spread rapidly. One recent financial arrangement with significant alleged tax benefits spread between the major players within a year, highlighting the need to be ‘real time’ in detecting and dealing with such arrangements. In markets with much larger numbers of clients the take-up time is longer, typically in the order of several years.

The generally long lead times of legal processes don't help in this regard and it highlights the importance of explicit signalling of the regulator's views in a timely manner. Accusations of 'U-turns' by the regulator regarding process or interpretation can follow as it switches gear to focus on the break-out of non compliance. Perhaps<sup>54</sup> understandably, risk neutral clients may perceive that they did not receive 'fair' warning in such circumstances.

## 6. THAT 'DAM' WALL

One experienced tax auditor said to me that a number of large clients appear to 'sit just behind the dam wall'. We can usefully think of that dam wall as the bar or line where acceptable tax planning becomes unacceptable tax avoidance, where tax positions transit to become more 'highly contestable'. Clients, advisors and the regulator may have very different views on where that line is and it is important for the parties to consult to get a robust view into the market.



**Figure 16**  
**Risk positioning and behaviours (Concept adapted from: *Diffusion of Innovations* by E. M. Rogers, 1962, Free Press, New York)**

<sup>54</sup> Though a well-informed and advised large taxpayer with good tax governance should generally have a reasonable feel for when it is playing in the grey, and if wanting certainty, can always request a ruling.



Successfully addressing clients in ‘market time’ who breach the ‘dam wall’ is clearly a priority for any effective compliance strategy otherwise more risk-neutral clients<sup>55</sup> will become involved.

Such breaches can be opportunistic constructs of advisors, devised for a particular business situations faced by a large client. The advisors or others associated with the transaction then may use the template of the approach and promote<sup>56</sup> its use with other clients, facilitating a break-out of avoidance activity that exhibits the classic “S” innovation growth curve.<sup>57</sup>

The risk differentiation framework provides for the needed higher level of focus on clients that are, based on past experience and current market intelligence, perceived as being more likely to be involved in such contentious approaches.

A key caveat with all of this is that frameworks are broad guides rather than absolutes and they do not mandate, nor sanction, the use of an inappropriate approach, given an understanding of a client’s facts and circumstances. The framework should provide guidelines for engagement - rather than tramlines for action.

The framework does not suggest that a higher risk client has made an error or is non compliant. In the large market it is about coming to an informed professional judgement, using the limited amount of information available, of who is relatively more likely to have a significant contentious arrangement. Identifying and resolving those contentions, whether by agreement or by going to the Courts, is key to providing increased certainty of tax outcomes to the market.

In the framework, tax attitudes and behavioural indicators would be expected to differ between the left and right hand sides. However there is no sharp divide between the two sides, rather a spectrum of behaviours that change from left (lower likelihood) to right (higher likelihood).

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<sup>55</sup> “Saints, Swingers, and Sinners” is a simplistic, but useful, mnemonic of some broad groupings of a regulated population to be kept in mind. One can think of the 15% to 20% or so risk averse as being “Saints”- who won’t cheat or bend the rules even when highly unlikely to be caught or punished, “Sinners” as the 15% to 20% or so risk takers who are more likely to defy the system and gamble on not being detected or on coming out ahead even after penalties, and “Swingers” as the 70% to 60% or so more risk neutral, who will tend to *swing one way or the other* depending on what they perceive the majority as doing/getting away with – the ‘norm’. One can easily see how ‘tipping points’ come into this picture. In a somewhat similar vein Valerie Braithwaite in her book *Defiance in Taxation and Governance: Resisting and Dismissing Authority in a Democracy* (2009) identifies ‘resistant defiance’ involving about half the population and ‘dismissive defiance’ about 20%. A less emotive terminology, using a traffic light analogy, has ‘green’, ‘amber’ and ‘red’ taxpayers in terms of broad groupings by likelihood of concern.

<sup>56</sup> The introduction of Promoter Penalty Legislation has had an influence on the explicit marketing of such arrangements within Australia.

<sup>57</sup> See for example Boucher, T 2010, *Blatant, artificial and contrived: Tax schemes of the 70s and 80s*, ATO, Canberra at <http://www.ato.gov.au/content/downloads/cor00244226.pdf> on the regular cycle of breakouts of tax avoidance.

For example, broadly speaking, higher and medium risk clients might be expected to have some aspects of the following behaviours,<sup>58</sup> none of which is definitive:

- Relatively low effective tax rates over time (compared to peers, partners, or the past) that often appears to be at odds with the economic outcomes being achieved.
- A history of relatively aggressive tax positions that the regulator has concerns about.
- Relied on non disclosure or limited disclosure of significant, potentially controversial tax positions. (For example not seeking rulings or seeking rulings only on parts of a transaction without disclosing the more contentious aspects of the arrangement.)
- Used concealment or obfuscation as part of process, playing the audit lottery approach.
- Utilised complex tax driven structures that appear make little sense other than to obtain a tax benefit or inserted otherwise unnecessary steps into a transaction that would objectively appear to be for the dominant purpose of obtaining a tax benefit.
- Tax risk is not appropriately factored into corporate governance process, such as rewarding the attainment of effective tax rates significantly below that of competitors.
- Used 'game playing' in negotiations, trickle feeding information (and sometimes misinformation) rather than 'full and true' disclosure of the facts. This includes non bona-fide behaviours in negotiations - 'deny, delay, deflect, defeat' activity by a few.
- Sought out and used advisors, intermediaries or associates with history of aggressive tax planning for their tax arrangements. ('Where there is smoke, there may be fire'...)

Key and lower risk clients on the other hand might be expected to have more of the following behaviours:

- Relatively higher effective tax rates that accord with the economic outcomes achieved.
- Generally no significant history of adjustments, though that is not to say that they don't have disputes or differences of opinion on the tax outcomes intended by law. The key difference compared to higher risk clients is that they let the regulator know and do not seek to conceal relevant facts, so that the regulator can choose to disagree and negotiate or go to the umpire (the courts) for a decision.
- Upfront full and true disclosure of significant, potentially controversial tax positions via rulings process. They seek the regulator's opinion regarding controversial or contentious issues and keep them informed of decisions and actions.

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<sup>58</sup> See also the indicators of possible non compliance in paragraph A13 in Australian Auditing Standard ASA 250.

- Tax risk as an explicit considered part of a robust corporate governance process where independent advice is generally sought on potentially contentious matters.
- Business driven transactions, structures and approaches.
- Use of advisors, intermediaries or associates noted for advice and arrangements that doesn't push the boundaries of aggressiveness.

*Consequence Factors:*

Key and higher risk taxpayers might be expected to have one or more of the following consequence features:

- Significant potential revenue impact (this may be reflected by relatively high turnover as most adjustments are for less than 10% of turnover and that it is rare for an adjustment to be more than turnover)
- Control or influence over a relatively large amount of assets
- Occupy perceived positions of trust in the community or in the market
- Directly or indirectly influence significant numbers of other taxpayers
- Significant linkages and influence regarding advisors and intermediaries.

These taxpayers are material leverage points in the system – the regulator needs to invest in knowing what they are doing now – 'real time' compliance.

Broadly speaking, lower and medium risk taxpayers might be expected to have the following features:

- Relatively lower revenue impact per taxpayer
- Not in positions of significant trust in the community or market
- Relatively lower influence over other taxpayers or advisors and intermediaries.

These taxpayers are not, by themselves, material leverage points in the compliance market, though in total they may be.

The ATO risk differentiation framework is thus based on the very simple premise that the risk management stance should differ based on an informed perception of a taxpayer's relative:

- Likelihood of non compliance (that is having a tax outcome that the regulator doesn't agree with and may want to contest), and the
- Consequences (dollars, relativities, reputation, precedent) of that potential non compliance.

The design challenge then was how to meld these various views and concepts of quantitative and qualitative intelligence, risk, engagement and enforcement strategies into a coherent, consistent and considered framework for risk differentiation of the taxpayer base. Doing this effectively integrated the risk differentiation framework within the corporate approaches and directions, such as the Strategic Statement and Enterprise Risk Framework, and operationalised them.

One thing to keep in mind is the significant information asymmetries involved here:

- The taxpayer will generally have a deep, detailed knowledge of themselves, the transactions they have entered into, and probably a reasonable degree of awareness about those of their immediate competitors, but little about their claims relative to the distribution for the entire business population.
- The tax regulator, on the other hand, has a wide but very limited set of information about all taxpayers, primarily that which is on the tax returns and activity statements, but little specific information about the businesses transactions that go to make up the high level summary detail in those returns and statements.

The regulator's view of a client's risk, determined by the evidence and information they have about all clients at a point in time may well differ from a client's view of their risk. This is not unexpected given the significant information asymmetries that exist.

While in the majority of cases the regulators view of client risk and the client's view will in fact coincide, as most clients are viewed as lower risk or key, it is not surprising that views of relative risk for the much smaller number of 'higher risk' and "medium risk" clients may differ.

Understanding the reasons behind those different views requires openness and transparency and is critical to resolving possible contentions of view. Part of being fair and professional, open and accountable is being prepared to communicate to the client the regulator's view of the client's risk of non compliance to enable a more informed view of self assessment to take place.

Such communication is in fact an important part of the regulator explaining and educating the client about concerns about the perceived risk of non compliance, so that the client has the chance to explain or self correct matters in the future - should they wish or choose to. It is an opportunity to discuss behaviours and the regulator's view of them in an open and frank way.

That some clients dispute the regulator's view of the perceived risk of non compliance should not be a blocker to the implementation of risk categorisations and risk based differentiation frameworks. That will always be the case. It is always open to the client to show why the regulator's view of them is incorrect, thus updating the regulator's intelligence picture.

## 7. USING THE RISK DIFFERENTIATION APPROACH IN PRACTICE

In practice the ATO's Compliance Risk Differentiation Framework<sup>59</sup> serves several purposes:

- It provides an overarching framework for differentiating engagement stances with taxpayers according to an informed 'professional judgment'<sup>60</sup> of their likelihood and potential consequences of non-compliance.
- It enables a coherent, consistent and considered approach to form a view of a taxpayer's relative risk of non compliance, taking into account the multiple factors associated with likelihood and consequence, and the intensity of the response to that risk.
- It allows the communication of the approach, and view of a taxpayer's risk categorisation, to the taxpayer in an open and transparent manner so as to enable an informed discussion about their perceived risk of non-compliance.
- It facilitates resource and capability discussions and decisions regarding quite diverse compliance risks<sup>61</sup> (eg Transfer Pricing, Thin Capitalisation, Capital Gains Tax Reduction, Inappropriate use of losses etc) all within a consistent framework.

Using a range of risk filters and factors,<sup>62</sup> the ATO formally profiles large businesses twice a year (when enough comparative data from Tax Returns exists and the timing allows for substituted accounting period taxpayers, late lodgers, self amendments to be appropriately considered) against previous results and data from other businesses, both domestic and international.

This 'past and peers' quantitative analysis is then supplemented with qualitative intelligence from other sources (media, external databases, observations by field staff, other tax administrations etc) regarding potential problem areas, to place large market taxpayers into one of the four risk categories of each tax type (Income Tax, GST etc):<sup>63</sup>

- Higher risk, (relatively higher likelihood and consequence)
- Key Taxpayer, (relatively lower likelihood and higher consequence)
- Medium risk, (relatively higher likelihood and lower consequence) and
- Lower risk, (relatively lower likelihood and consequence).

<sup>59</sup> The Risk Differentiation Framework is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00246010.htm>.

<sup>60</sup> See the requirements of Australian Auditing Standard ASA 200 regarding "Professional Judgment" at paragraphs A23 to A27.

<sup>61</sup> These compliance concerns are largely identified in the annual compliance program and are incorporated into the quantitative risk filters. The Compliance Program is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00248103.htm&mnu=47063&mfp=001>.

<sup>62</sup> Roughly one hundred tests are applied in total, grouped around concerns that are largely identified in the Compliance Program such as Capital Gains Tax, Loss Utilisation, Profit Shifting (eg Transfer Pricing, Cross border Financial Arbitrage, and Thin Capitalisation), R&D and other Concessions, Capital/Revenue distinctions, Source & Residence aspects, Royalty Withholding Tax, Consolidation, etc. The broad description of these filters is now available on the ATO website.

<sup>63</sup> The Commissioner's speech on the risk differentiation framework is "Do you see what I see?" available at: <http://www.ato.gov.au/corporate/content.asp?doc=/content/00228656.htm>.

The risk categorisation in the large market is thus an informed professional judgement, using intelligence available at a point in time, rather than something produced at the push of a button. As the information set changes or is enhanced, the categorisation of a client's relative risk may change.

Importantly, the risk categorisation of a taxpayer does not in any way influence the outcome of a possible risk review of a client nor the choice of remedy – that of course depends on the facts and circumstances found regarding their compliance obligations. However it does influence the initial likelihood and initial intensity of a review.

The numbers of taxpayers placed in each category is informed by analysis of the Pareto-like distribution of taxpayers and their risk and the ability to resource responses to that risk:

- Relatively few taxpayers, about 2%, are considered higher risk,
- about 8% are considered key taxpayers and these account for the majority of income and other taxes paid,
- roughly 25% of large market taxpayers are categorised as medium risk (selected for a variety of risk themes such as compliance assurance of large claims, risk scoping of new arrangements, and some for potential enforcement), and
- the majority, about 65%, are considered relatively lower risk.

(These are indicative percentages only and may vary from year to year as risk themes change.)

## 8. ENGAGEMENT STANCE

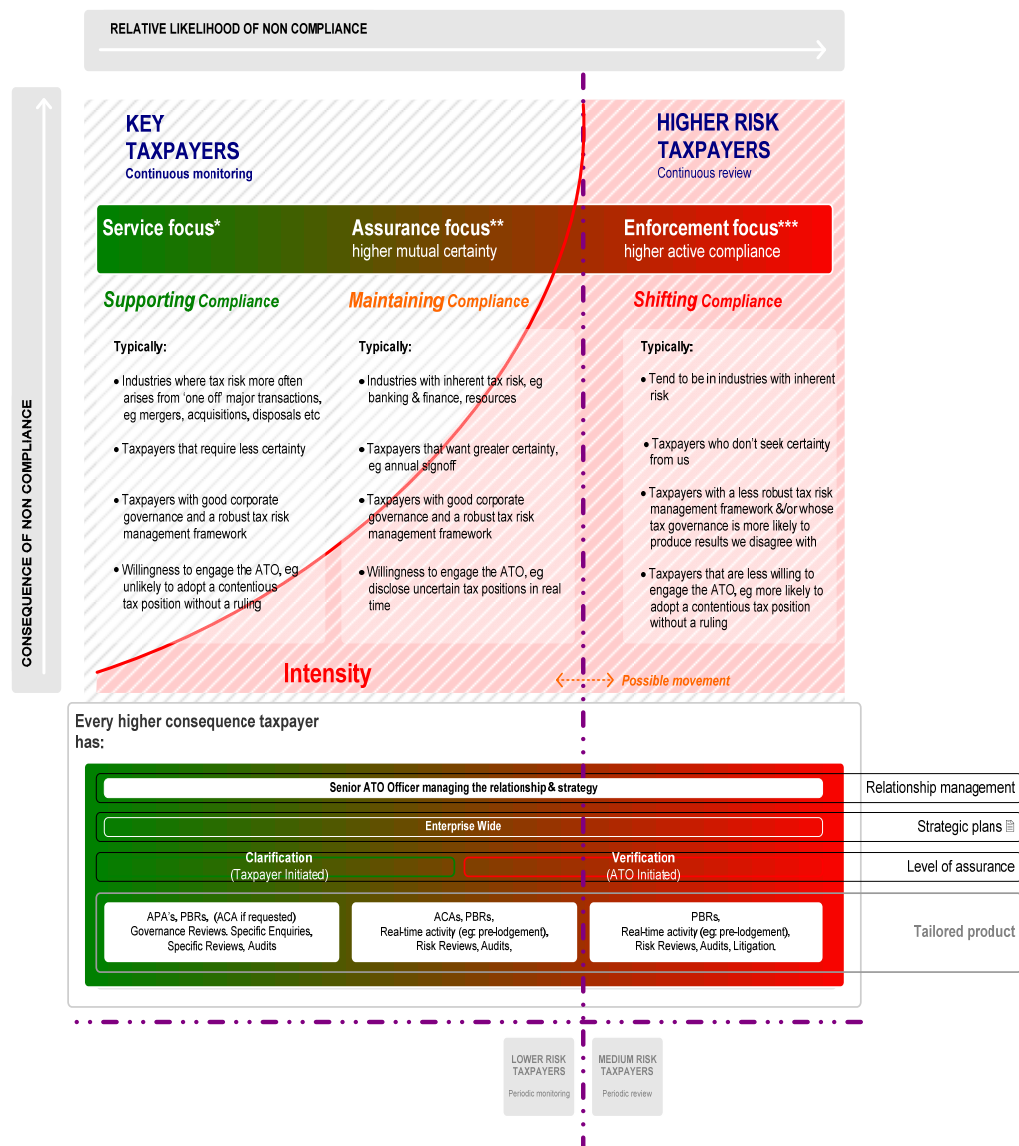
For higher risk taxpayers, the suggested engagement stance is a real time/continuous risk review. These taxpayers matter a lot and often set the tone for the market. Accordingly, the ATO assigns sufficient resources to enable it to identify, review and understand any material transactions that have the potential for tax planning so that it can quickly form a view as to their appropriate treatment, ideally before that tax return has been lodged.

For key taxpayers, the framework is suggestive of a continuous monitoring stance. Most of Australia's largest businesses fall into this category, they pay most of the taxes and they have significant influence on the tax system.

As major 'payers and players' the actions of key taxpayers matter a great deal to the overall health of the tax system. Hence the ATO has a particularly keen interest in appropriately verifying that the key taxpayer's risk management and governance frameworks adequately identify and mitigate tax compliance risks.

Most taxpayers categorised as key taxpayers will engage with the tax office to seek or understand the Commissioner's view on a potentially contentious matter, whereas our experience has been that higher risk taxpayers largely 'default to detection' by the Tax Office – hence the larger investment in detection effort by the Tax Office with these taxpayers.

Obviously perceptions of truth and transparency engender greater trust by a regulator while apparent non disclosure, obfuscation and concealment generate mistrust ie if we can't see in and understand something of apparent concern to us then we are more likely to come searching to get the data to provide that understanding – as any prudent regulator would do.

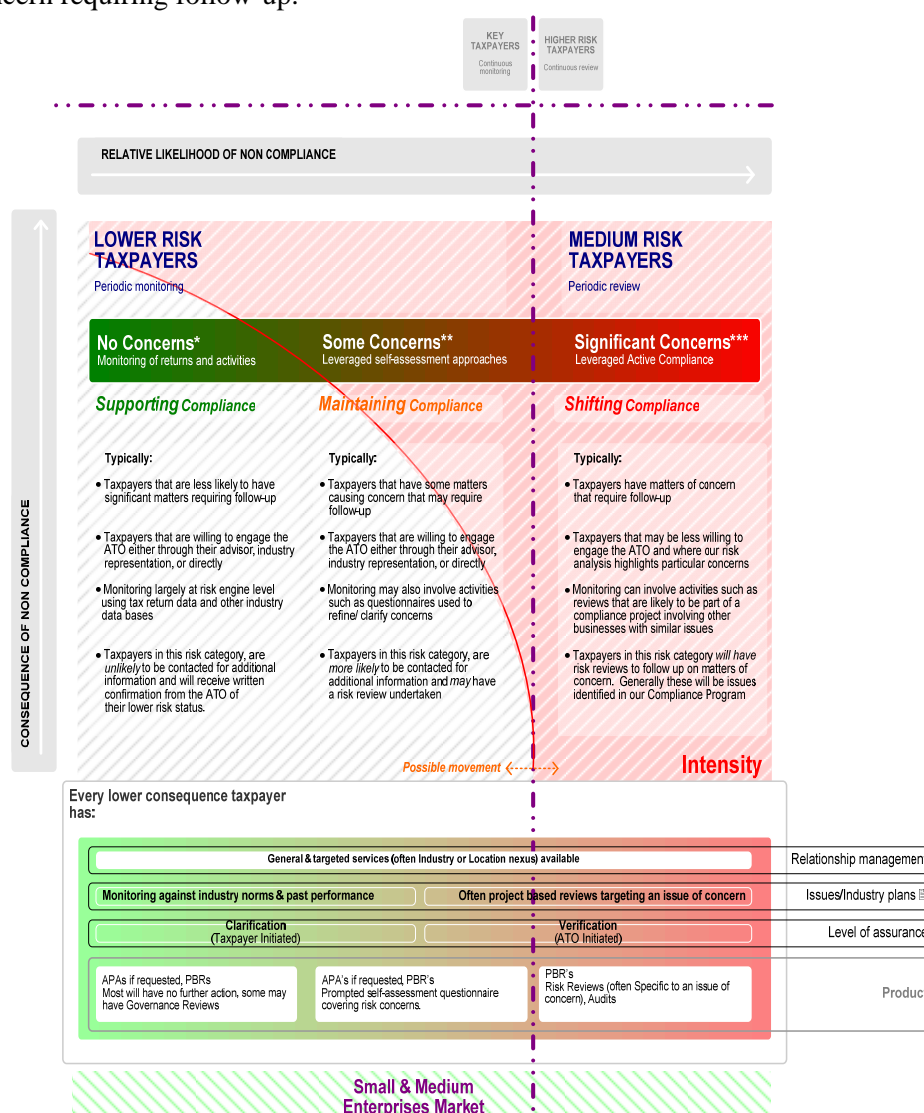


**Figure 17**  
**ATO Large Market engagement model for Higher consequence taxpayers**  
**(Higher risk and Key Large Market Taxpayers)**

For medium risk taxpayers, the framework suggests a more periodic review stance. From time to time the ATO may involve the business in specific risk reviews, where matters of concern relating to specific issues are followed up. These are generally issues identified in the annual Compliance Program. These reviews are likely to be part of a compliance project involving other businesses with similar issues.

This approach allows the ATO to more consistently address the issue across the market and reduce compliance costs for the business. These medium risk reviews may have an assurance -like focus (eg check compliance with Section 40.880), a scoping like focus (eg understand the nature of the 23AJ/25.90 arrangements) or an enforcement- like focus (eg gather information to determine whether to proceed to a transfer pricing audit).

The majority of large businesses have a lower risk categorisation. For lower risk taxpayers the framework suggests a periodic monitoring stance. This can involve activities such as the provision of targeted information about specific issues identified in the market, visits and normal internal risk analysis involving the monitoring tax activities and outcomes. If a business is in this risk category, they are unlikely to be contacted for additional information and are less likely to have significant matters of concern requiring follow-up.



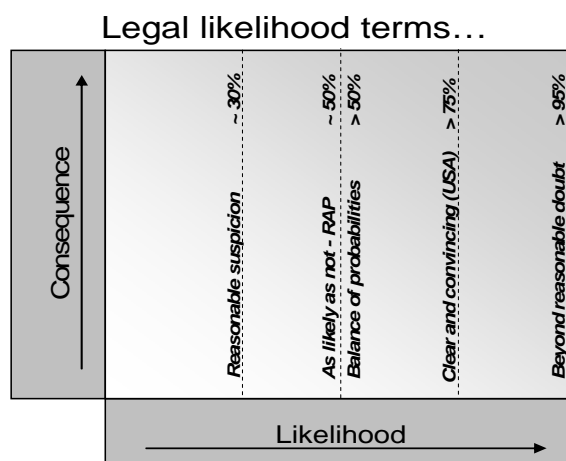
**Figure 18**  
**ATO Large Market engagement model for Lower consequence taxpayers (Medium risk and lower risk Large Market taxpayers)**



The underlying tone or nature of the approach thus changes from a service to assurance to more of an enforcement orientation as the perception of the relative likelihood of non compliance changes. The frequency and intensity of monitoring or review activity also changes from a periodic and leveraged one to a more real time and intense one as the consequences of potential non compliance changes.

These changes should generally be reflected in the compliance product set applied: Lighter touch Governance Workshops and Assurance Reviews for Key Taxpayers and more resource intensive Pre-lodgement Compliance Reviews for Higher Risk Taxpayers. Project based Assurance Reviews and Risk Reviews for medium risk taxpayers, high level monitoring, generally without field contact, for lower risk taxpayers. (Whether a Taxpayer Audit is subsequently undertaken depends on what is found in the review.)

It can also be seen that risk likelihood can be roughly, though usefully, linked to legal concepts such as the evidentiary requirements to support 'reasonable suspicion', 'reasonably arguable position' and 'balance of probabilities'. This view can be useful in scaling different compliance risks appropriately.



**Figure 19**  
**Legal likelihood**

Forming views of a client's likelihood of non compliance is inherent in a regulatory system and the administrator is required to both appropriately form and make reasonable evidence based decisions regarding these views. In many regulatory systems this isn't easy.

Detecting non compliance in a largely compliant population is often quite difficult as they often share most of the same attributes. For example low effective tax rates can have a variety of causes. As has been noted the signal to noise ratio, how discriminant features of the potential non compliance stand out, is often fairly low, generating significant numbers of false positives.

Moreover, if the regulator can prioritise clients by risk, as caseload increases the conversion or strike rate decreases, producing an explicit compliance/coverage trade-off.

There is also the ‘prosecutor’s fallacy’ to keep in mind when using a test, even a good one, to examine a largely compliant population – many false positives are likely to be generated.<sup>64</sup>

We also need to remember that regulators treat compliance within certain resource constraints<sup>65</sup> allocated by Government and by their Executive. Most regulators are not resourced to do every possible compliance case and it is inevitable that action on risk in practice will be more influenced by a bias towards higher likelihood than higher consequence in the prioritisation process. (You tend to focus on what is happening rather than what may happen.)

As the regulator’s ability to resource risk alters, the number of clients in each quadrant of the framework can be varied by changing their thresholds. The ‘bars’ are not static and moving the threshold bars for treatment does not change the relative prioritisation of a client’s risk, only the suggested engagement stance and resource intensity that might be initially assigned.

For example, if more staff were allocated to discretionary risk work the likelihood cut-off point could be lowered – increasing client numbers for quadrants one (higher risk) and three (medium risk) or the cut-off point for consequence could be lowered, increasing client numbers for quadrants one (higher risk) and two (key clients).

Equally, as the regulator experiences non discretionary resource constraints it can raise the threshold for likelihood or consequence, thus reducing the relative client numbers in those quadrants. The risk differentiation approach thus provides guidance for a considered and consistent response to resource changes and constraints in a dynamic risk environment.

Another way of saying this is: what is the appropriate risk treatment isoquant that can be resourced at a point in time?

For example, while the regulator should treat<sup>66</sup> a lower consequence client that it is ‘confident’ did not comply, where should it draw the line regarding a higher

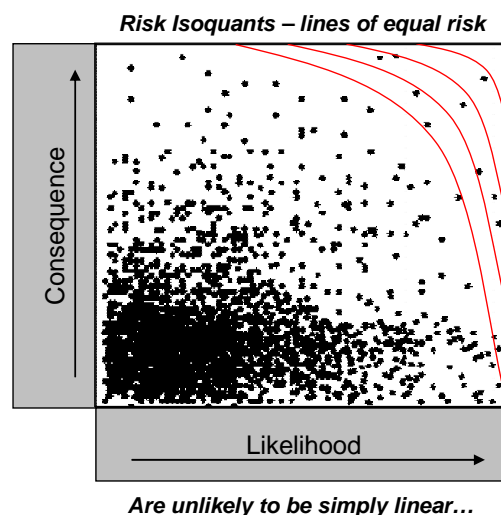
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<sup>64</sup> For example if our case selection sensitivity (ability to detect true positives) is 70% and the population is 90% compliant then our false positive rate will be  $30\% \times 90\% = 27\%$  while true positives will be  $70\% \times 10\% = 7\%$  giving a strike rate of 7% ( $27\% + 7\%$ ) = 21%.

<sup>65</sup> For example see the conceptual framework of Hamilton, S 2006, *Optimising Compliance – the role of analytic techniques*, p 5 at <http://www.itdweb.org/documents/Optimising%20Compliance%20-%20Role%20of%20Analytic%20Techniques.pdf>.

<sup>66</sup> Naturally this treatment should always be in a proportionate and appropriate manner based on the facts and circumstances found.

consequence client where there is merely a ‘reasonable suspicion’ of potential non compliance?



**Figure 20**  
**Risk isoquants – lines of equal risk**

## 9. COMMUNICATION

The approach is explained to taxpayers in the co-designed ‘Large Business and Tax Compliance’<sup>67</sup> booklet which sets out in relatively plain language how the ATO considers:

- the roles of the parties involved
- the approach to the market including the Taxpayers Charter setting out broad rights and obligations
- the end-to-end compliance program approach of deterring, detecting, and dealing with compliance risk
- the products that enable this such as our speeches, media releases, guides, advice, public and private rulings through to risk reviews, audits, investigations and regulatory system changes
- the expectations regarding corporate governance and its role in managing tax risks
- ways in which the parties can work together to provide certainty to the market
- differentiation and management of tax compliance risks (Chapter 7 of the booklet)
- the conduct of risk reviews, audits and disputes.

The Large Business and Tax Compliance booklet is supplemented on an annual basis with the Compliance Program<sup>68</sup> where it is set out, again in relatively plain language,

<sup>67</sup> The Large Business and Tax Compliance booklet is available at:  
<http://www.ato.gov.au/corporate/content.asp?doc=/content/33802.htm>.

<sup>68</sup> The Compliance Program is available at:  
<http://www.ato.gov.au/corporate/content.asp?doc=/content/00248103.htm&mnu=47063&mfp=001>

what compliance concerns exist for each market segment. For each of the compliance concerns identified, the ATO appoints a risk owner who is responsible for the overall end-to-end management of that risk, ensuring that appropriate strategies exist to deal with the compliance constraints encountered.

The ATO Strategic Statement<sup>69</sup> explains its vision, strategic themes, values and approaches, such as the Compliance Model<sup>70</sup> and the Enterprise Risk Management Framework<sup>71</sup> which form the corporate foundation of work on compliance risk differentiation. This integration is important.

An annual assessment of the efficiency and effectiveness of processes, opportunities and vulnerabilities, and the sustainability of the various systems is carried out. The outcomes from the ATO's compliance activities are reported in its Annual Report<sup>72</sup>, which also includes compliance effectiveness<sup>73</sup> indicators as well as revenue outcomes.

## 10. BRINGING THE COMPLIANCE IMPROVEMENT STRATEGIES TOGETHER – THE REGULATORY RISK BOW-TIE

The ultimate aim is to have taxpayers who are ready, willing and able<sup>74</sup> to participate in their tax and superannuation system:

<u>Aspect</u>	<u>Compliance Constraint</u>	<u>Compliance Strategy</u>
Ready	> Knowledge (I know how to comply)	> Educate and Exemplify
Willing	> Attitude (I want to comply)	> Engage, Encourage, Enforce
Able	> Capability (I can comply)	> Enable and Empower

These broad strategies and the risk differentiation framework can be brought together in a regulatory risk 'bow-tie'<sup>75</sup> that neatly maps the causes, consequences and controls

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The compliance concerns identified in the program are incorporated into the quantitative risk filters. (eg Thin Capitalisation, Transfer Pricing, Capital Gains Tax, Loss Utilisation, etc).

<sup>69</sup> The Strategic Statement is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00243384.htm>.

<sup>70</sup> The Compliance Model is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/5704.htm>.

<sup>71</sup> The Enterprise Risk Management Framework frequently asked questions is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00246438.htm>.

<sup>72</sup> The Annual Report is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00216293.htm>.

<sup>73</sup> The Compliance Effectiveness methodology is available at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/00149070.htm>.

<sup>74</sup> See Box 2 page 12 in "Reducing the Risk to Policy Failure: Challenges for Regulatory Compliance," OECD, 2000 at <http://www.oecd.org/dataoecd/48/54/1910833.pdf>.

<sup>75</sup> Originally conceived of in the late 1970s by the University of Queensland and then brought to the fore by Royal Dutch Shell after the Piper Alpha disaster. Now a widespread risk management approach, the 'bow-tie', a cause, consequence and control map, usefully shows the 'paths' by which a risk event can

and then ties together these end-to-end strategies to address the compliance constraints encountered.

Using the bow-tie approach it becomes immediately apparent that there is a series of proactive and reactive compliance enhancement strategies that can be utilised to assist in achieving and maintaining higher rates of compliance.

Laid out as a risk 'bow-tie' these compliance enhancement strategies fit into standard regulatory deter, detect and deal with approach:

<i>Deter</i>	(the things you do to prevent or lessen the likelihood of a problem);
<i>Detect</i>	(the things you do to detect when a problem may have occurred); and
<i>Deal with</i>	(the things you do to deal with /lessen the consequences of a problem.)



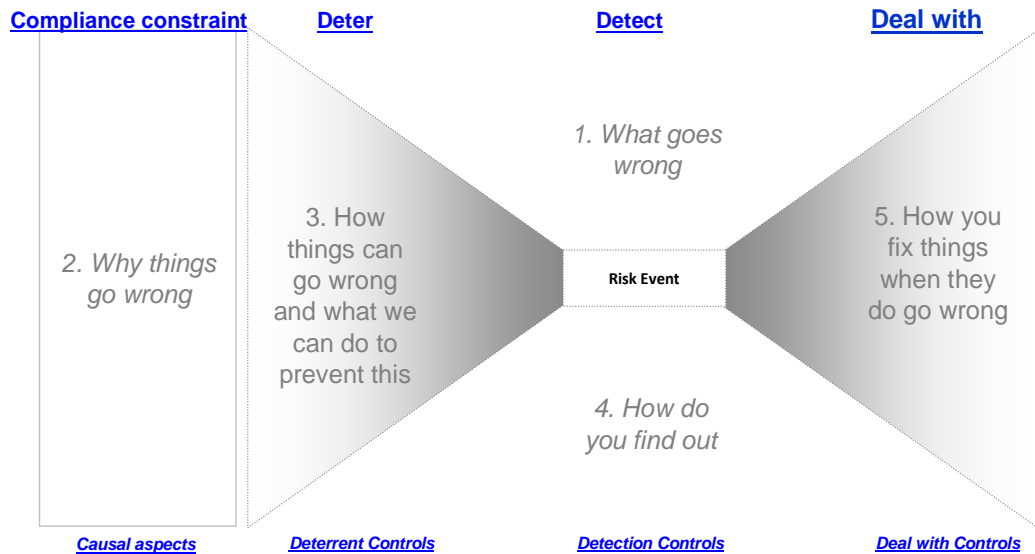
**Figure 21**  
**The Risk bow-tie approach**

Risk bow-ties are an intuitive way of graphically representing:

1. the risk event (what goes wrong – the 'knot' of the bowtie),
2. the causal factors associated with a risk (why things go wrong – on the left of the bowtie),
3. the different pathways that lead up to the risk event and the controls you have to prevent or deter the risk event (how things go wrong and what you do to prevent this),
4. the ways you detect the risk event occurring (intelligence), and finally,
5. the different ways you deal with the consequences of the risk event (your choice of remedy to fix things on the right hand side of the bowtie).

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occur, where preventative or deterrent controls are used, the event itself and detective controls and the consequence paths and restorative controls. [http://www.bowtiepro.com/bowtie\\_history.asp](http://www.bowtiepro.com/bowtie_history.asp).



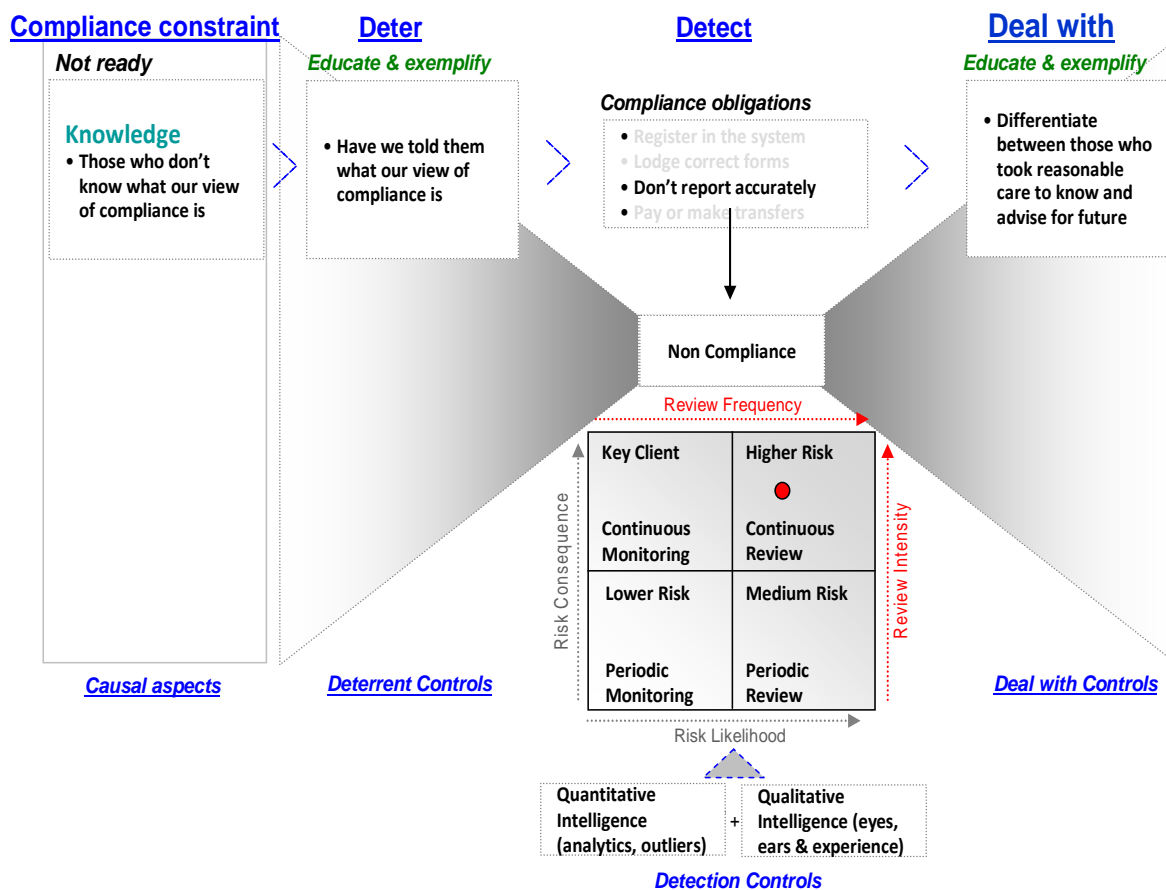
**Figure 22**  
**Risk bow-tie concepts**

Now if we begin to populate a regulatory risk bow-tie with the compliance constraints:

- (why things go wrong – knowing what compliance is, wanting to comply, and, being able to comply), and the
- compliance strategies (eg for the knowledge deficiency compliance constraint, what we do to address that deficiency by use of targeted or marketing campaign education programmes, and by ensuring that we have appropriate and influential exemplars of what ‘good’ compliance is, etc),

we start to flesh out a much more complete and nuanced ‘end to end’ deter, detect and deal with risk management narrative.

Linking the compliance constraints to the relevant deter > detect > deal-with risk management approach we have (read across left to right):



**Figure 23**  
**Risk bow-tie concepts**  
**Showing knowledge constraint and deter and deal with mitigation**

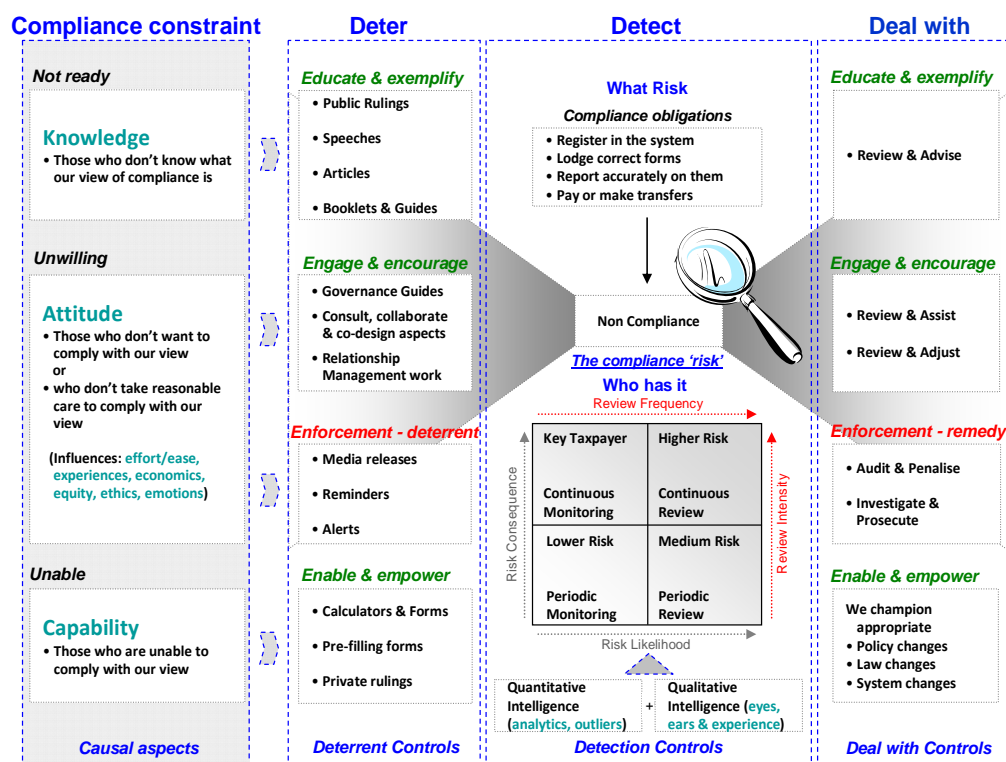
The risk being highlighted in Figure 23 is the one that in the tax system generates the most contention: the obligation to report accurately on the forms.

In this diagram the compliance constraint being illustrated is: “Clients not knowing what the regulator’s view of compliance is”. (The client may have their own view of what compliance is, but if this differs materially from the regulator’s view then it may be considered as contestable by the regulator and ultimately the Court could be asked to decide.)

This risk can be deterred by the regulator providing both general and/or targeted education processes such as guides, speeches, articles, mail-outs, marketing and other media. In prioritising the investment and delivery mode (message and media) of this,

the regulator should consider ‘who’ needs this knowledge and ‘how’ important are they in the system. To detect potential non compliance the regulator uses both qualitative and quantitative intelligence to form a view of who is more likely to have not reported accurately and what the potential consequences of this might be. This provides an initial risk based view of the potential non-compliance, allowing for a prioritisation of resources and responses.

To appropriately deal with instances of non compliance associated with the knowledge compliance constraint, it is important for the regulator to then distinguish between those that took reasonable care to know, and those that didn’t. The regulator then needs to choose an appropriate remedy for each client’s facts and circumstances: eg advise for the future, or correct without penalty, or if warranted impose an administrative penalise, or seek to prosecute. If we put in the other constraints and strategies, the following generic regulatory risk bow-tie emerges:



**Figure 24**  
**Generic Regulatory Compliance Risk Bow-Tie**  
**Author 2010**

This generic framework neatly ties together the compliance constraint with the appropriate deterrent strategies, the detection and engagement approach and the ‘deal with’ strategies (choice of remedy).

Importantly, it explicitly includes other options from a risk management perspective, such as changing the system itself, that were not part of the compliance model.



Both the risk differentiation framework and the compliance model are explicitly encapsulated in this more holistic risk management approach to regulatory compliance:

- Input from intelligence sources is used to form a view of where taxpayers sit in the risk differentiation framework – which guides engagement and detection efforts – so the risk categorisation of a taxpayer is a key output of the ‘discovery and detection’ effort.
- The compliance model is embedded as the choice of remedy taken in response to the reasons for non compliance and how these are escalated, where necessary over time, on the ‘deal with’ side.

The use of the differentiation framework and risk bow-tie processes maintains the ATO’s position at or near the leading edge of compliance risk management internationally<sup>76</sup>, most significantly through the peak tax administration body, the OECD Forum of Tax Administration<sup>77</sup> and it is changing the nature of the compliance dynamic with large taxpayers.<sup>78</sup>

That said the ATO is very conscious of the challenges associated with the use of risk frameworks. The five design reflections regarding risk frameworks discussed in Dr Julia Black’s 2004 paper “The Development of Risk Based Regulation in Financial Services: Canada, the UK and Australia”<sup>79</sup> have been considered. The five reflections by Dr Black were:

- the danger of focusing more on diagnosis than cure;
- the importance of organizational culture in implementing risk based regulation;
- risk based frameworks can create risks; (eg ‘process induced myopia’)
- the danger of inappropriate reliance on firms’ internal controls is reduced, but not removed in risk based approaches;
- in making it clear what issues are not regulatory priorities, risk based regulation can have a potentially contentious political message.

She goes on to note:

<sup>76</sup> See for example the discussion in Ernst & Young 2011-12 *Tax risk and controversy survey*, pp 30, 36 & 53 at

[http://www.ey.com/Publication/vwLUAssets/2011-2012\\_Tax\\_risk\\_and\\_controversy\\_survey/\\$FILE/2011-2012\\_Tax\\_risk\\_and\\_controversy\\_survey.pdf](http://www.ey.com/Publication/vwLUAssets/2011-2012_Tax_risk_and_controversy_survey/$FILE/2011-2012_Tax_risk_and_controversy_survey.pdf).

<sup>77</sup> The OECD FTA guidance and information publications are listed on the report available at:

<http://www.oecd.org/dataoecd/28/12/39965074.pdf>. & [http://www.oecd.org/findDocument/0,3354,en\\_2649\\_33749\\_1\\_119666\\_1\\_1\\_1,00.html](http://www.oecd.org/findDocument/0,3354,en_2649_33749_1_119666_1_1_1,00.html).

<sup>78</sup> ‘Risk differentiation hardly sounds exciting but it’s one of the hottest issues in tax space.’ KPMG Tax Partner David Drummond indicated it was ‘probably the biggest development in tax administration [risk management] in the past 30 years’ in Nassim Khadem, ‘Who’s who on the ATO hit list’, *BRW*, 31 August 2011.

[http://afr.com/p/sections/professions/who\\_who\\_on\\_the\\_ato\\_hit\\_list\\_R6JrLtISntHQI47y4kVimL](http://afr.com/p/sections/professions/who_who_on_the_ato_hit_list_R6JrLtISntHQI47y4kVimL).

<sup>79</sup> Back, Dr J 2004, *The Development of Risk Based Regulation in Financial Services* is well worth a read and is available at

<http://www.lse.ac.uk/collections/law/staff%20publications%20full%20text/black/risk%20based%20regulation%20in%20financial%20services.pdf>

“Any risk based framework is only as good as those who implement it, and risk based frameworks may not be implemented in such a way as to deliver on their promise of producing dynamic, risk sensitive regulation.

Whilst senior management in each regulatory agency are clearly committed to the principles of risk based regulation, in any organisation, bridging the gap between senior management and those at the front line is a core challenge, and regulators are no exception. Re-skilling is always hard to achieve. It is particularly hard in the case of risk based approaches because, as senior officials in each regulatory agency recognised, the frameworks are requiring officials to operate ‘outside their comfort zones’.

Ensuring that front line officials move from a compliance or comparatively passive supervisory mentality to the more reflective and dynamic approach that risk based regulation is meant to introduce will take time, and some organisations and some parts of an organisation will move faster than others.”

It is a difficult cultural change to progress and refine over time and there is a danger of an undue initial focus on the risk process activities and outputs rather than on the broader systemic, longer term outcomes. In particular those few categorised as higher risk are likely to strongly disagree with the regulators viewpoint and complain about the approach to the regulator, the media and ministers.

There is no getting around the fact that using any risk management approach to verify compliance requires the regulator to have a process to form a reasonably robust view of a client’s risk of non compliance and how that risk sits relative to other clients – their priority for action. This risk prioritisation process is quite fundamental to risk management and will exist for any regulatory risk assessment system. (For example the Australian Prudential Regulatory Authority’s “Probability and Impact Rating System” and “Supervisory Oversight and Response System”<sup>80</sup> shows a very similar coupling of risk and regulatory response.)

## 11. DEVELOPMENTS IN THE UK REGARDING REGULATORY APPROACHES

Looking further a field, an analysis of other countries regulatory best practices indicates that in some ways the UK has moved past Australia in modernising its approach to risk based regulatory guidance, enforcement and sanctioning.

For example, the UK Hampton Review “Reducing administrative burdens – effective inspection and enforcement”<sup>81</sup> which culminated in the UK Statutory Code of Practice for Regulators<sup>82</sup>, set the scene for a more holistic and whole of government approach

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<sup>80</sup> APRA’s PAIRS and SOARS documents are available at [http://www.apra.gov.au/PAIRS/upload/PAIRS\\_Final\\_May\\_2008\\_External\\_Version.pdf](http://www.apra.gov.au/PAIRS/upload/PAIRS_Final_May_2008_External_Version.pdf) & [http://www.apra.gov.au/PAIRS/upload/SOARS\\_Final\\_May\\_2008\\_External\\_Version.pdf](http://www.apra.gov.au/PAIRS/upload/SOARS_Final_May_2008_External_Version.pdf).

<sup>81</sup> Hampton, P 2005, *Reducing administrative burdens – effective inspection and enforcement (The Hampton Report)*, HM Treasury is available at: <http://www.berr.gov.uk/files/file22988.pdf>.

<sup>82</sup> The UK Statutory Code of Practice for Regulators is available at: <http://www.berr.gov.uk/files/file45019.pdf>.

to regulatory work that, crucially, included explicit consideration of the likelihood and consequence of non compliance:

“4.1 Regulators should ensure that the allocation of their regulatory efforts and resources is targeted where they would be most effective by assessing the risks to their regulatory outcomes. They should also ensure that risk assessment precedes and informs all aspects of their approaches to regulatory activity, including:

- data collection and other information requirements;
- inspection programmes;
- advice and support programmes; and
- enforcement and sanctions.

4.2 Risk assessment should be based on all available relevant and good-quality data. It should include explicit consideration of the combined effect of:

- the *potential impact* of non-compliance on regulatory outcomes; and
- the *likelihood* of non-compliance.

4.3 In evaluating the likelihood of non-compliance, regulators should give consideration to all relevant factors, including:

- past compliance records and potential future risks;
- the existence of good systems for managing risks, in particular within regulated entities or sites;
- evidence of recognised external accreditation; and
- management competence and willingness to comply.

4.4 Regulators should consult and involve regulated entities and other interested parties in designing their risk methodologies, and publish details of the methodologies.

4.5 Regulators should regularly review and, where appropriate, improve their risk methodologies. In doing so, they should take into account feedback and other information from regulated entities and other interested parties.” (Emphasis added)

The subsequent UK Macrory Review “Regulatory Justice – making sanctions effective”<sup>83</sup> led to the UK Regulatory Enforcement and Sanctions Act<sup>84</sup> that basically codifies the Ayres and Braithwaite compliance model<sup>85</sup> for UK regulators, thus modernising the regulatory choice of remedies available.

On the guidance side, the UK Anderson Review produced the “The Good Guidance Guide”<sup>86</sup> leading to a code of practice for guidance on regulation.

<sup>83</sup> The Macrory Review 2006, *Regulatory Justice – making sanctions effective* is available at: <http://www.bis.gov.uk/files/file44593.pdf>.

<sup>84</sup> The UK Regulatory Enforcement and Sanctions Act 2008 is available at: [http://www.legislation.gov.uk/ukpga/2008/13/pdfs/ukpga\\_20080013\\_en.pdf](http://www.legislation.gov.uk/ukpga/2008/13/pdfs/ukpga_20080013_en.pdf).

<sup>85</sup> The Ayres and Braithwaite compliance model was first articulated in their 1992 publication *Responsive Regulation: Transcending the deregulation debate* and an outline is available at: [http://en.wikipedia.org/wiki/File:Ayres\\_Braithwaite\\_Compliance\\_Pyramid.jpg](http://en.wikipedia.org/wiki/File:Ayres_Braithwaite_Compliance_Pyramid.jpg).

<sup>86</sup> The Anderson Review 2009, *Good Guidance Guide: taking the uncertainty out of regulation, UK*, is available at: <http://www.bis.gov.uk/files/file49881.pdf>.

These UK reports effectively took forward the earlier good work contained in the Australian Law Reform Commission's 2003 report "Principled Regulation: Federal Civil and Administrative Penalties in Australia".<sup>87</sup>

In my view there are real and significant opportunities for Australia to learn from the UK experience in setting up a consistent code of conduct for regulators as well as bringing non criminal regulatory compliance sanctions within a single coherent framework.

Rather than being faced with a large and bewildering array of differing regulatory sanctions and approaches, a consistent code like the UK Regulatory Enforcement and Sanctions Act could be created for use across regulatory agencies whose choice of remedy reflected the best practices of the Braithwaite compliance model.

This would both modernise the choice of remedies available to regulators and simplify the array of different administrative sanctions into a single coherent set. At present the use of responsive regulation in Australia appears somewhat 'grafted on' by the regulator rather than being explicitly built into the law.

Interestingly, and appropriately, to access the UK Regulatory Enforcement and Sanctions Act the regulator needs to show that they are following the UK Statutory Code of Practice for Regulators. Independent reviews, whose outcomes are published, are held to check that this is the case.

## 12. CONCLUSION

Sun Tzu, the Chinese military philosopher, has been attributed<sup>88</sup> as saying: "Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat."

Strategies are very much the game plans for how an organisation proposes to achieve its intent, taking into account the opportunities and threats that are in the environment, and the organisation's particular strengths and weaknesses.

Strategy in many ways is both the science and art of resource allocation between contending claims on scarce resources in order to achieve the best results at the least cost – the matching of ambition and capability.

For a regulator, a risk differentiation framework provides logic for the allocation of resources to specific client risk initiatives on a clearly differentiated basis.

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<sup>87</sup> The Australian Law Reform Commission Report 2003 *Principled Regulation: Federal Civil and Administrative Penalties in Australia* (ALRC 95) is available at: <http://www.austlii.edu.au/au/other/alrc/publications/reports/95/>.

<sup>88</sup> The saying is in fact not in his famous work of military strategy and tactics "The Art of War".

Those administering regulatory compliance systems need to have a clear strategy that sets out how they intend to encourage voluntary compliance - with a key risk to that intent being that clients don't voluntarily comply for a variety of reasons.

The Ayres and Braithwaite regulatory pyramid sets out a model for a choice of compliance remedy for administrators - and it is by differentiating our regulatory strategies by likelihood and consequences of non-compliance that we can more appropriately position ourselves to bring that model to life.

Bringing this more holistic view of compliance and risk mitigation together effectively adds another dimension to regulatory compliance approaches and enables a richer and more nuanced discussion to take place regarding compliance strategies and their targeting and timing.

The approach that has been outlined in this article provides a way of looking at the risk end to end, answering:

- the strategic question of *what* risks are important (credible threat agents intersecting with critical system vulnerabilities),
- the operational question of *who* may have or exhibit those risks, and
- the tactical question one of *how* to best deter, detect and deal with the instance:



**Figure 25 Bringing it together – End to end risk management**

It provides a way of looking at managing a risk from *discovery* of a ‘*matter of interest*’ through to ongoing activities to systemically deter, detect and deal with ‘*matters of concern*’ - an approach for appropriately considering and dealing with both emerging

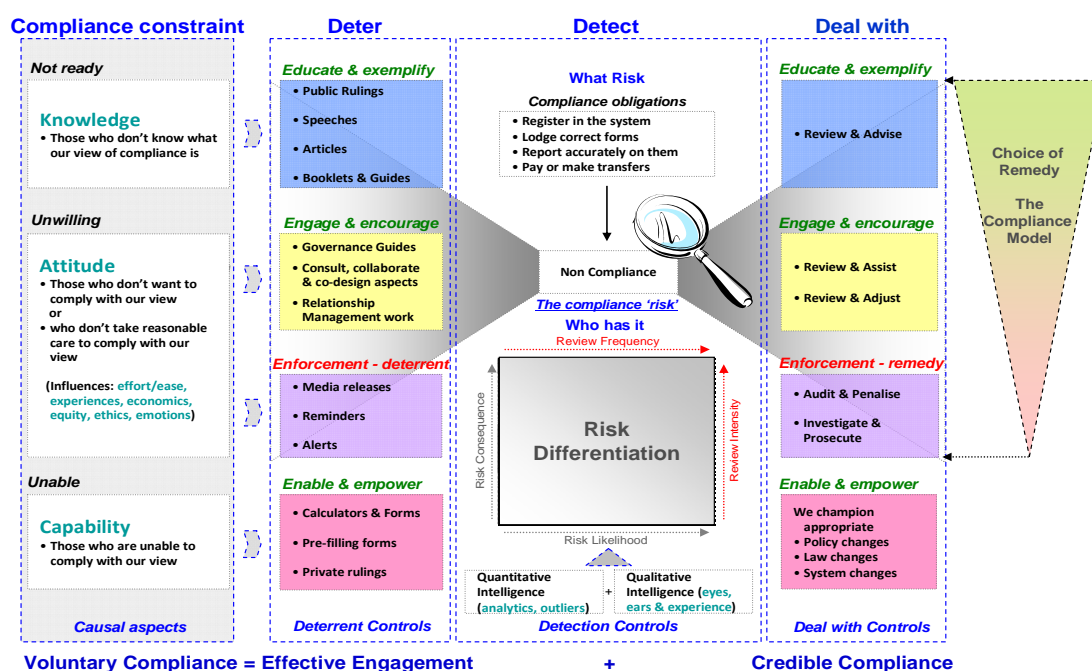
risks (such as a new tax effective financial arrangement) and those more endemic (such as transfer pricing) in the system.

In 2000 Professor Malcolm Sparrow in his book “The Regulatory Craft”<sup>89</sup> aptly noted the regulators ongoing dilemma:

“Regulators, under unprecedented pressure, face a range of demands, often contradictory in nature:

- be less intrusive - but be more effective;
- be kinder and gentler - but don’t let the bastards get away with anything;
- focus your efforts - but be consistent; process things quicker - and be more careful next time;
- deal with important issues - but do not stray outside your statutory authority;
- be more responsive to the regulated community - but do not get captured by industry.”

The implementation of risk bow-tie approaches, with a risk differentiation framework for engagement and detection, is part of an improved overall risk management strategy for regulators to deal with these apparently conflicting demands in a practical, logical and considered way. A way that links the strategic to the operational and tactical - and moves the ‘choice of remedy’ Braithwaite compliance model into ‘place’ in a more holistic end to end regulatory risk management framework.



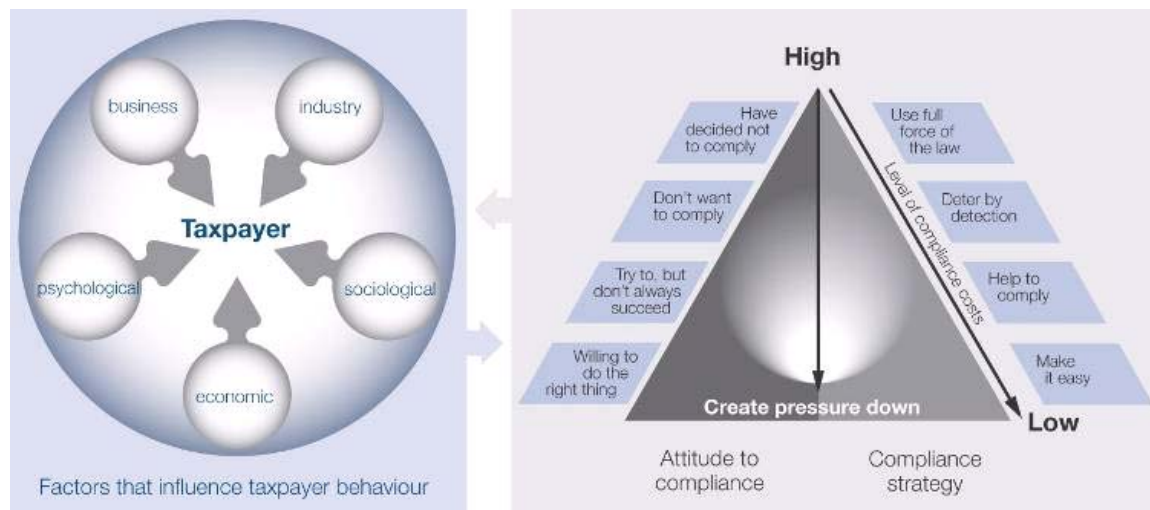
**Figure 26** The compliance model position as part of the ‘deal with’ choice of remedy in a generic regulatory risk bow-tie

<sup>89</sup> Sparrow, M, 2000, *The Regulatory Craft*, The Brookings Institution, Washington, DC.



**ANNEX 1: VARIATIONS ON THE COMPLIANCE PYRAMID THEME**

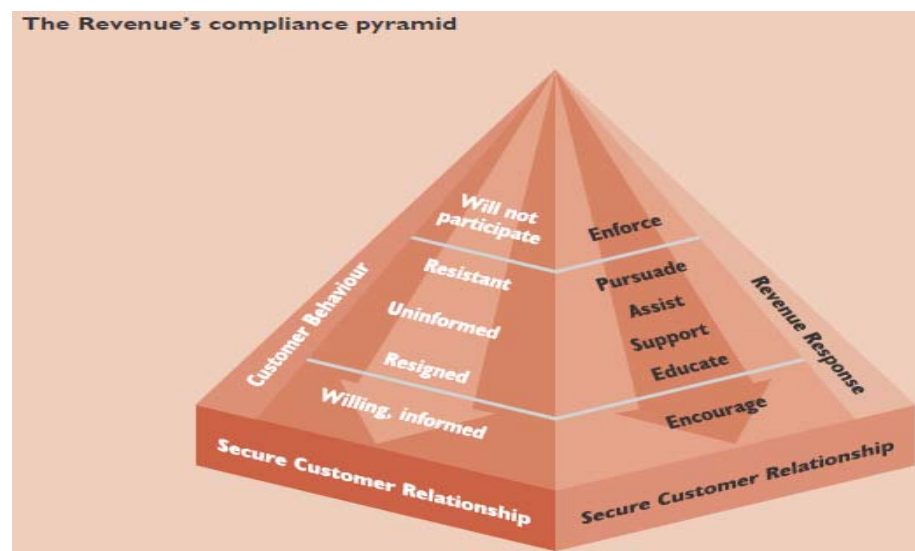
The concept of the compliance pyramid has been taken up by others and, though remaining broadly consistent to the Ayres and Braithwaite model, there are some subtle variations:



**Figure 27** A more recent representation of the compliance pyramid at the Australian Taxation Office

<http://atogovau/corporate/content.asp?doc=/content/5704.htm>

Australian Taxation Office, Australia



**Figure 28** The 2004 UK's Inland Revenue version

[http://www.hm-treasury.gov.uk/media/2/0/odonnell\\_ch2\\_497.pdf](http://www.hm-treasury.gov.uk/media/2/0/odonnell_ch2_497.pdf)

Chapter 2, page 31, in Financing Britain's Future, Review of the Revenue Departments by Gus O'Donnell, March 2004, HM Treasury, United Kingdom

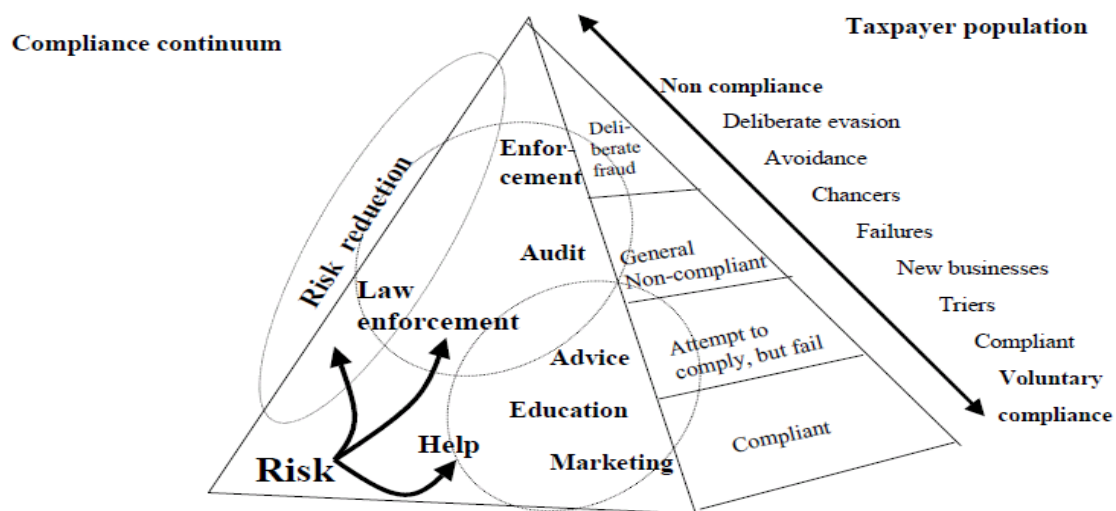


Figure 29

The 2006 European Union Fiscalis Risk Analysis Project

[http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/tax\\_cooperation/gen\\_overview/Risk\\_Management\\_Guide\\_for\\_tax\\_administrations\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/gen_overview/Risk_Management_Guide_for_tax_administrations_en.pdf)

Risk Management Guide for Tax Administrations, Fiscalis Risk Analysis Project Group, FINANCIAL CODE: FPG/11, Version 1.02, February 2006, Page 33

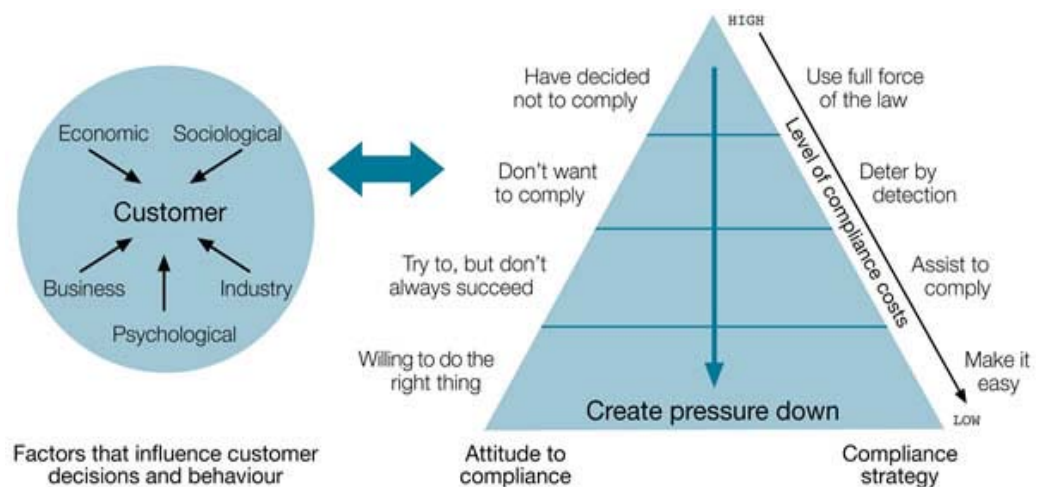


Figure 30

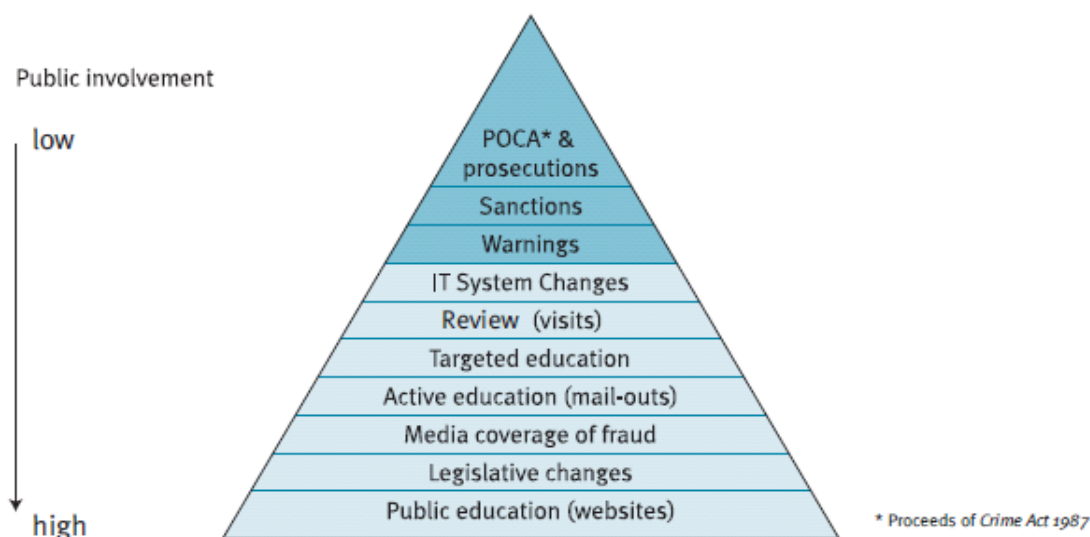
The New Zealand Inland Revenue Compliance Pyramid

<http://www.ird.govt.nz/aboutir/reports/annual-report/annual-report-2004/part3/annual-report-2004-part03-02.html>

New Zealand Inland Revenue, 2004



An example of a balanced and targeted child care payment compliance program.

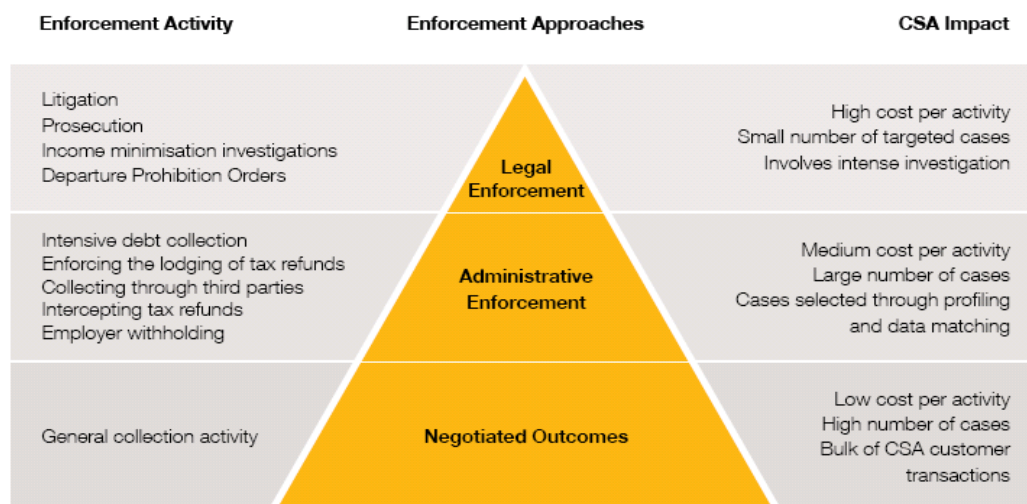


**Figure 31**

**The 2007 Australian Child Support Compliance Pyramid**

[http://www.facsia.gov.au/internet/facsinternet.nsf/vIA/cc\\_benefit\\_compliance/\\$File/CC\\_Comp\\_v4.pdf](http://www.facsia.gov.au/internet/facsinternet.nsf/vIA/cc_benefit_compliance/$File/CC_Comp_v4.pdf) Child Care Payment Compliance Framework, Department of Families, Community Services and Indigenous Affairs (FaCSIA), Australia, 2007

and

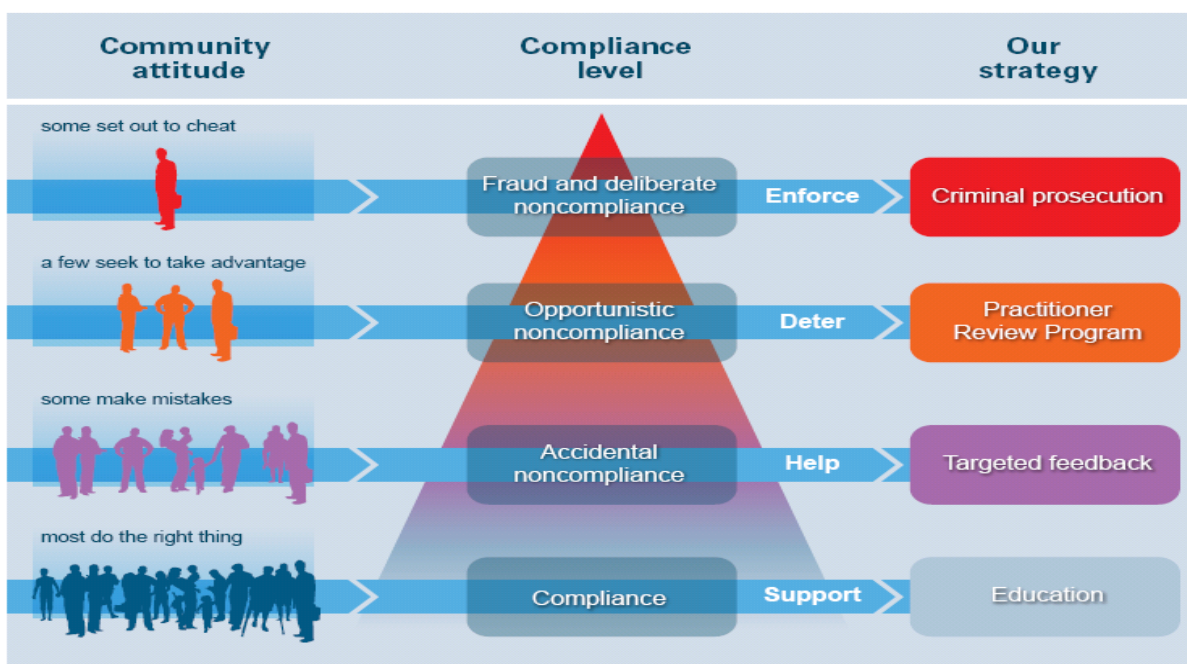


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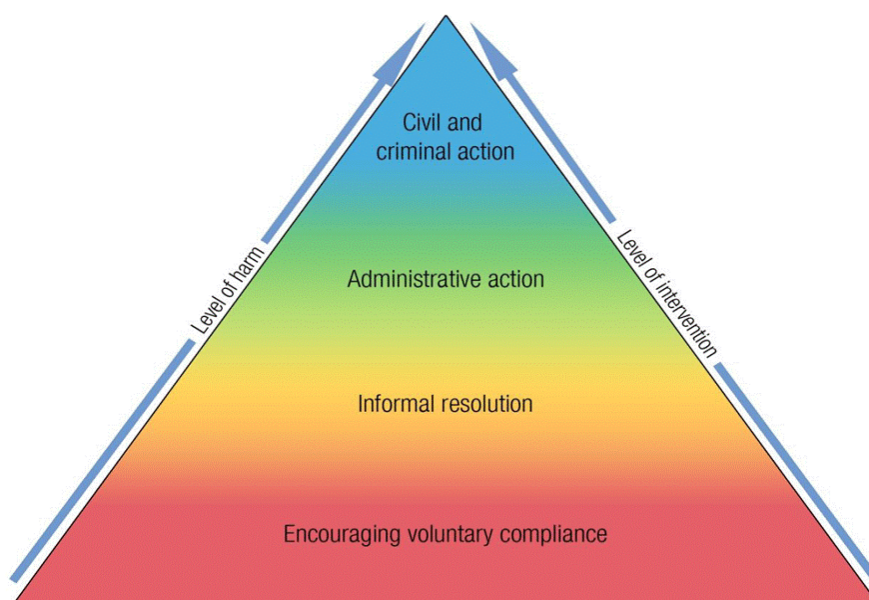
**Figure 32**

**Child Support Agency “Supporting parents to meet their child support responsibilities 2008-2010”** <http://www.csa.gov.au/publications/pdf/4073.pdf>

**Our compliance model****Figure 33**

Australian Medicare Compliance

[http://www.medicareaustralia.gov.au/resources/national\\_compliance/national\\_compliance\\_program\\_2007-08.pdf](http://www.medicareaustralia.gov.au/resources/national_compliance/national_compliance_program_2007-08.pdf) National Compliance Program, 2007–08, Medicare Australia

**Figure 34**

Australian Communications and Media Authority

[http://www.acma.gov.au/WEB/STANDARD/pc=PC\\_312247](http://www.acma.gov.au/WEB/STANDARD/pc=PC_312247)

ACMA compliance and enforcement policy, August 2010, Page 3