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Tax return simplification: risk key engagement, a return to risk?

Jason Kerr¹

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-filing 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.'² Evans and Kerr suggest the best reform in tax return

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² 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> 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.³ 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’.⁴ 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.⁵ 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.⁶ 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.⁷

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

³ Chris Evans and Jason Kerr, ‘Tax Reform and “Rough Justice”: Is it Time for Simplicity to Shine?’ (2012) 27 *Australian Tax Forum* 299, 323.

⁴ Cedric Sandford (ed), *Tax Compliance Costs Measurement and Policy* (1995) 4.

⁵ 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.

⁶ OECD, *Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series* (2010) 229-233.

⁷ 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.⁸ 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.⁹ The idea was also canvassed by the Australia's Future Tax System Review Panel (Henry Review),¹⁰ 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'.¹¹ 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.¹²

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.¹³ 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.¹⁴ 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:

⁸ Koenraad van der Heeden, 'The Pay-As-You-Earn Tax on Wages' in Victor Thuronyi (ed) *Tax Law Design and Drafting* (1998) 73.

⁹ 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.

¹⁰ Australia's Future Tax System Review Panel, *Review of Australia's Tax System Final Report* (2009).

¹¹ Australia's Future Tax System Review Panel, *Report to the Treasurer Part One Overview* recommendation 123, 104.

¹² Chris Evans and Jason Kerr, above n3, 321.

¹³ Australia's Future Tax System Review Panel, *Australia's Future Tax System: Part Two Detailed Analysis* (2010) 709.

¹⁴ 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-filing purposes, the full benefits of pre-filing may not be available to the 1.5 million or so taxpayers who lodge their returns in July.¹⁵

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-filing service.¹⁶ This compares to 2.37 million using e-tax in 2008-09 and 1.74 million (73%) who pre-filled.¹⁷

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.¹⁸ Nudge theory is often advocated by proponents of libertarian paternalism.¹⁹ 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.'²⁰ 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.²¹

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'.²² 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.²³

¹⁵ Australian Taxation Office, *Making it Easier to Comply 2007-08* (2008) 13.

¹⁶ Australian Taxation Office, *Annual Report 2010-11* (2011) 81.

¹⁷ Australian Taxation Office, *Annual Report 2009-10* (2010) 26.

¹⁸ Andrew Reason and Simon Dunstall, *Behavioural Economics and Complex Decision-Making: Implications for the Australian Tax and Transfer System* (2009).

¹⁹ Also known as soft paternalism and asymmetrical paternalism.

²⁰ Cass Sunstein and Richard Thaler, 'Libertarian Paternalism is Not an Oxymoron' (2003) 70 *The University of Chicago Law Review* 1159, 1162.

²¹ *Ibid* 1161.

²² Cabinet Office, *Behavioural Insights Team: Annual Update 2010-11* (2011) 3.

²³ *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.²⁴ 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.²⁵

Needless to say, Australia went down the electronic lodgment path, something that even Danish Revenue officials would describe as 'second best'.²⁶ 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.'²⁷ 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.'²⁸

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'.²⁹ 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.³⁰

²⁴ Philip Burgess, 'Contagious Trends in Australian Tax Administration' (1991) 21 *Victoria University of Wellington Law Review* 59, 66.

²⁵ *Ibid.*

²⁶ OECD, *Third Party Reporting Arrangements and Pre-filled Tax Returns: The Danish and Swedish Approaches* (2008) 9.

²⁷ Simon James and Ian Wallschutzky, 'An Australian Cumulative Withholding Tax System?' (1994) 11 *Australian Tax Forum* 311, 320.

²⁸ *Ibid.* 335.

²⁹ 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.

³⁰ 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),³¹ 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’,³² removing ‘many of the onerous, repetitive requirements that the current tax system places on salary and wage earners and employers’³³ and reducing ‘the extent to which the tax system intrudes on the lives of most individual taxpayers’.³⁴ 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 IR56³⁵ taxpayer only.³⁶

For those taxpayers who do not automatically receive a PTS, they may need to request one, as per Table 1.

³¹ Australian Taxation Office, *Australian Taxation Office Annual Report 2008-09* (2009) 29.

³² New Zealand Inland Revenue, *Simplifying taxpayer requirements* (1997) iii.

³³ Ibid.

³⁴ Ibid 1.

³⁵ 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.

³⁶ 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 requests³⁷

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.³⁸

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.³⁹ Since then however, as evidenced by Table 2, there has been a sizable increase in the number of New Zealanders requesting a PTS.

³⁷ Ibid.

³⁸ Ibid.

³⁹ New Zealand Inland Revenue, n32, 9.

Table 2: New Zealand individuals – 2001-10 (,000)⁴⁰

	Mar 01	Mar 02	Mar 03	Mar 04	Mar 05	Mar 06	Mar 07	Mar 08	Mar 09	Mar 10
IR3 ⁴¹ 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.⁴² 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).⁴³ 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.⁴⁴

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).⁴⁵

⁴⁰ 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.

⁴¹ 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).

⁴² New Zealand Inland Revenue, Policy Advice Division, *Making Tax Easier: A Government Discussion Document* (2010) 6.

⁴³ 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> at 10 March 2012.

⁴⁴ 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.

⁴⁵ 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.⁴⁶

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.⁴⁷

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.⁴⁸ 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.'⁴⁹ Another goal is to increase taxpayer engagement with the system.⁵⁰

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.'⁵¹ Likewise, the lodgment of

⁴⁶ New Zealand Inland Revenue, n42.

⁴⁷ HM Revenue & Customs, *Modernising the Administration of the Personal Tax System: Tax Transparency for Individuals* (2011) 4.

⁴⁸ *Ibid* 11.

⁴⁹ *Ibid*.

⁵⁰ *Ibid* 20.

⁵¹ 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.⁵² 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.'⁵³ 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.⁵⁴ 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.⁵⁵

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 in taxpayers in Switzerland using data covering 1970 and 1995 and a survey of 26 cantonal tax authorities.⁵⁶ 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

⁵² 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).

⁵³ Lawrence Zelenak, 'Justice Holmes, Ralph Kramden, and the Civic Virtues of a Tax Return Filing Requirement' 61 (2007) *Tax Law Review* 53, 60.

⁵⁴ Werner Pommerehne and Hannelore Weck-Hannemann, 'Tax Rates, Tax Administration and Income Tax Evasion in Switzerland' (1996) 88 *Public Choice* 161.

⁵⁵ *Ibid* 167.

⁵⁶ 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'.⁵⁷ 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'.⁵⁸

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.⁵⁹

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

⁵⁷ 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.

⁵⁸ Bruno Frey, 'A Constitution for Knaves Crowds out Civic Virtues' (1997) 107 *The Economic Journal* 1043.

⁵⁹ 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.⁶⁰

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).⁶¹

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.⁶² 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).⁶³

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.⁶⁴

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

⁶⁰ 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.

⁶¹ 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.

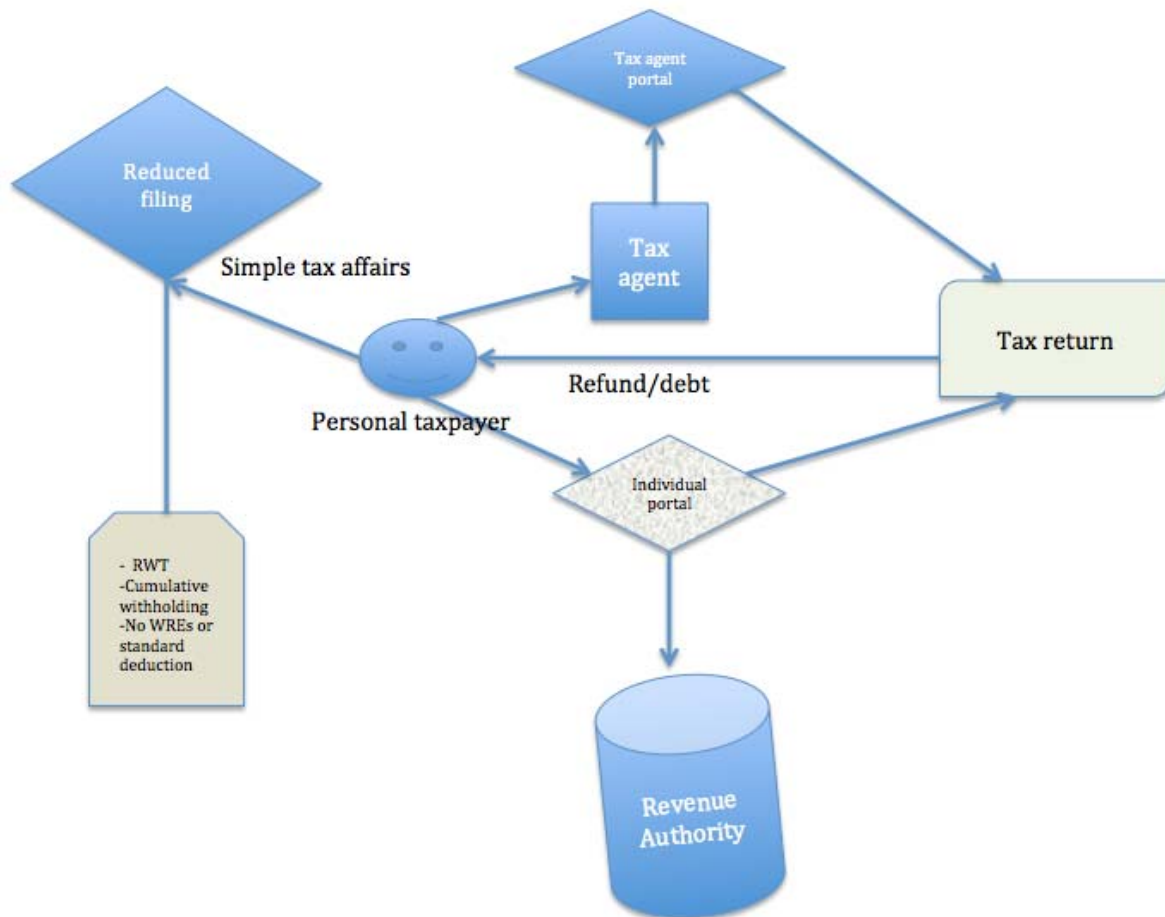
⁶² Otto Chang and Joseph Schultz 'The income tax withholding phenomenon: evidence from TCMP data' (1990) 12 *Journal of the American Tax Association* 88.

⁶³ Lawrence Zelenak, above n53, 57.

⁶⁴ 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-filing 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-filing 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.⁶⁵ 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-filing activities to occur. The Australian National Audit Office suggested that given the Government's intention to simplify income tax returns by providing pre-filing 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-filing initiative.⁶⁶ ATO statistics show that while approximately 75% of all total PAYG and welfare payment pre-filing 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.⁶⁷

Evans and Tran-Nam summarise pre-filing's 'teething problems' as relating to: timeliness, comprehensiveness, availability, and reliability and accuracy.⁶⁸ These problems may possibly be due to the fact that 'the pre-filing initiative is partial and still at a very early and experimental stage in Australia'.⁶⁹ 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'.⁷⁰

In order for the pre-filing 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.⁷¹ These amendments are best outlined in table form. Table 3 displays some of these changes, and while not

⁶⁵ 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.

⁶⁶ ANAO, *The Australian Taxation Office's Use of Data Matching and Analytics in Tax Administration* (2008) 85.

⁶⁷ 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 at 16 March 2012.

⁶⁸ Chris Evans and Binh Tran-Nam 'Australia' in Francois Vaillancourt (ed) *Pre-filled Personal Income Tax Returns* (2011) 1, 13.

⁶⁹ Ibid 18.

⁷⁰ Ibid 19.

⁷¹ 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.⁷² Indeed, the benchmark of a successful pre-filled tax return system, such as the experience in Denmark, is one where tax returns do not

⁷² 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.⁷³ 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.⁷⁴

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.⁷⁵

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.

⁷³ OECD, *Third Party Reporting Arrangements and Pre-filled Tax Returns: The Danish and Swedish Approaches* (2008) 9.

⁷⁴ Graeme Cooper, above n2.

⁷⁵ Chris Evans and Jason Kerr, above n3, 321.